January 13, 2020

A Most Uncertain World, Take 2

- **The expected trade truce between China and the US removes a major tail risk for the global economy and significantly reduces the odds of a recession in the United States.**
- **Uncertainty will nevertheless remain elevated, as the trade deficit remains larger than when President Trump took office. Elevated event risk is here to stay as long as President Trump is in power.**
- **In this context, the evolution of household and business confidence will be critical to economic and financial prospects. There are signs of improvement in many countries on this front, but Canada is heading in the opposite direction, as consumer confidence fell very sharply in the final months of 2019.**

Developments in recent weeks serve as a stark reminder that the central economic and financial thesis of the last year remains unchanged: uncertainty is here to stay so long as President Trump remains in office. For much of the last year, markets have been waiting with bated breath for indications that there might be a truce in the costly trade war between China and the United States. As a reminder, we estimate that the trade war reduced the level of US economic activity by three-quarters of a percentage point relative to a situation in which uncertainty was at historical levels.

The hope, in some quarters, was that a deal between China and the US on the trade side, as seems likely to occur on January 15, would usher in a period of lower uncertainty, greater stability, and greater confidence. As a result, global trade activity might pick up, along with industrial activity and other business activity. This is a hopelessly optimistic take. A few days into the New Year, President Trump reminded us that event risk will remain a feature of his presidency. At this time, we view developments with respect to Iran as less important from a direct economic and financial perspective, but very important from an uncertainty perspective. President Trump is an erratic politician, prone to statements or actions that can destabilize sentiment and markets.

Moreover, as we have noted in the past, while trade-related uncertainty will be lower than the peaks observed in 19Q3, it will remain elevated so long as President Trump is in office. The US trade deficit remains significantly larger than when he took office. His mission to shrink the trade deficit is far from accomplished, and we expect continued drama on the trade front: perhaps more aggression towards Europe, the issue of auto tariffs remains in suspense, and we can't even be sure that deals that have been negotiated and ratified will be respected.

As a result, we take comfort in the détente between China and the US on the trade front, but this development has no tangible impact on our view, other than reducing a major tail risk. We continue to believe a modest expansion will continue in much of the global economy, though we have yet to be convinced that the green shoots observed in Europe are indicative of a fundamentally stronger economy.

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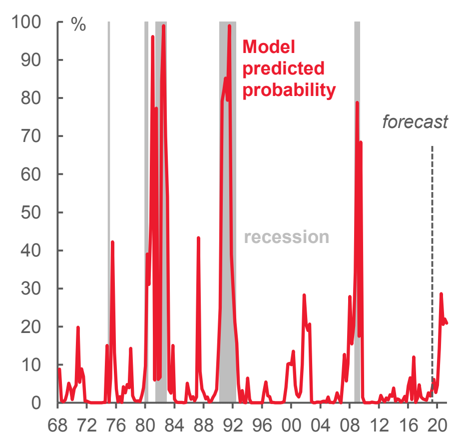
Chart 1

Probability of a Recession in Canada



Sources: Scotiabank Economics, Haver Analytics.

In the North American context, growth in Canada and the US is expected to fall relative to 2019, though we have marked down our Canadian forecast relative to our last publication owing to a very weak ending to 2019, which affects growth dynamics in 2020. While some of this weakness is attributed to the GM and CN Rail strikes and pipeline outages, the Canadian job market weakened considerably at year-end, and consumer confidence has fallen sharply from late Summer readings (to a three-year low, and in a manner that is inconsistent with the general state of the economy). This suggests there is considerable risk that growth may remain weak early in 2020. Perhaps most importantly, the decline in confidence is actually increasing the odds of a Canadian recession despite the steepening of the yield curve in recent months and the truce in the China-US trade war. We still believe a recession in Canada (and the US) is unlikely, but it is clear that Canadian households are much less confident in the outlook now than they were 3 or 4 months ago.

Table 1

Global Real GDP	2010–18	2018	2019e	2020f	2021f
	(annual % change)				
World (PPP)	3.8	3.8	2.9	3.1	3.4
Canada	2.2	2.0	1.6	1.5	2.0
United States	2.3	2.9	2.3	1.7	1.8
Mexico	3.0	2.1	0.0	1.0	1.8
United Kingdom	1.9	1.3	1.1	1.2	1.6
Eurozone	1.4	1.9	1.0	1.1	1.3
Germany	2.1	1.5	0.5	0.8	1.2
France	1.4	1.7	1.3	1.3	1.4
China	7.8	6.6	6.1	6.0	5.8
India	7.3	7.4	5.1	6.2	7.2
Japan	1.4	0.3	0.9	0.6	1.2
South Korea	3.4	2.7	1.8	2.1	2.5
Australia	2.7	2.7	1.8	2.1	2.5
Thailand	3.8	4.1	2.4	2.2	2.7
Brazil	1.4	1.3	1.1	2.1	2.1
Colombia	3.8	2.6	3.2	3.6	3.6
Peru	4.8	4.0	2.3	3.0	3.5
Chile	3.5	4.0	1.0	1.4	3.0

Sources: Scotiabank Economics, Statistics Canada, BEA, BLS, IMF, Bloomberg.

Given that downside risks remain elevated in the global economy, and are rising in Canada, we continue to believe some policy easing will be required in the US and Canada. In the US, we think 25 basis points will be required around mid-year, whereas we think there is a bit more urgency in Canada. We think the Bank of Canada will trim rates by 50 basis points owing to downward pressure on inflation coming from the weaker outlook, and to guard against the possibility of a more dramatic slowdown if consumer confidence continues to deteriorate.

Canada

- **With a truce in the China-US trade war expected on January 15, the key downside risk to the outlook is largely off the table. As a result, we expect growth of 1.5% in 2020, following an increase of 1.6% in 2019. Activity should be supported by continued strength in population growth and a buoyant (and undersupplied) housing market.**
- **The Canadian economy experienced a soft patch in 2019Q4, as it dealt with the impacts of the GM and CN strikes, and the effects of a pipeline shutdown. A number of indicators suggest the recent temporary weakness might persist, as employment and consumer confidence fell sharply in the final months of 2019.**
- **With growth expected to remain below potential, excess capacity should rise, putting downward pressure on inflation. With event and downside risks still high, we believe the Bank of Canada will need to cut interest rates in the first half of the year.**
- **While a recession is not likely in Canada, the large decline in consumer confidence recently observed increases the odds of a homegrown downturn. Confidence should stabilize around current levels, but a further degradation in sentiment could meaningfully affect the odds of recession.**

CONFIDENCE, CONFIDENCE, CONFIDENCE

The Canadian economy slowed sharply in the final quarter of last year reflecting in part a number of idiosyncratic and reversible shocks. These factors include strikes at GM and CN, and the Keystone pipeline outage. The weakness, however, seems broader-based than implied by these one-off events (chart 1). As a result, we now expect the Canadian economy to grow by 1.5% in 2020, slightly lower than the 1.6% expected for 2019. This weaker-than-earlier forecast growth will lead to an increase in excess capacity in the economy which—along with uncertainty remaining high and substantial event risk throughout the year—should prompt the Bank of Canada to cut interest rates by 50 basis points in the first half of the year.

At the moment, we remain reasonably confident that the weakness at end-2019 will be temporary. From a global perspective, trade-related risks are moderating (chart 2). US economic activity remains robust and there are early signs of a recovery in Europe. From a domestic perspective, the strongest population growth in 30 years (chart 3) continues to provide a powerful source of human stimulus to the economy, in the form of workers, consumers, and homeowners. Partly as a result, the rally in home sales activity continues to surprise on the upside, resulting in upward price pressures as homebuilders have been unable to keep pace with the increase in housing demand over the last few years (chart 4). Increases in oil prices and production, flowing from an easing of the curtailment in Alberta, will provide a boost to growth, as will an acceleration of the construction of the LNG Canada project in Kitimat. Firms, despite being less confident about the outlook, continue to indicate that labour shortages are the single most important challenge they face (chart 5).

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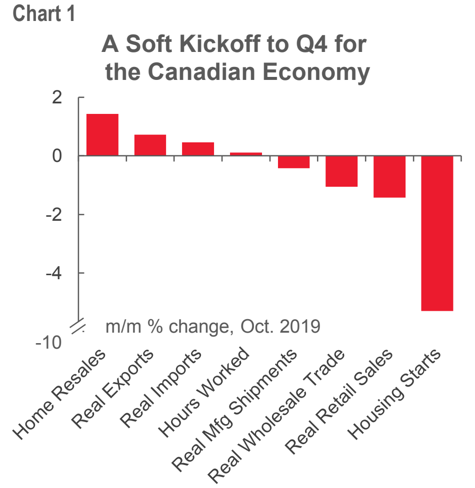
Canada	2018	2019e	2020f	2021f
Real GDP (annual % change)	2.0	1.6	1.5	2.0
CPI (y/y %, eop)	2.0	2.1	1.8	2.3
Central bank policy rate (%, eop)	1.75	1.75	1.25	1.25
Canadian dollar (CADUSD, eop)	0.73	0.77	0.80	0.80

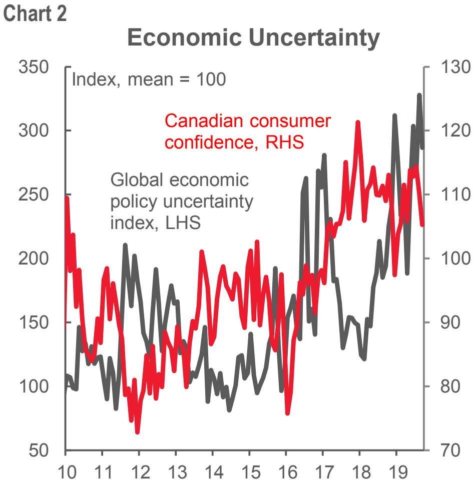
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Statistics Canada, CMHC, CREA.

Chart 2



Sources: Scotiabank Economics, PolicyUncertainty.com, Conference Board.

Offsetting some of these positives, household finances remain stretched, as debt service costs are at record highs. This no doubt accounts for some of the weakness in consumption growth over the last year, and will likely work to hold back consumption growth this year. Business investment was held back in 2019 by concerns about the China-US trade war and the associated risk of recession. While business investment should rebound in 2020 given the very evident labour shortages and attenuation of trade-related risks, the most recent data on imports of capital goods as well as readings of business confidence suggest firms will remain cautious in deploying capital early in the year.

Taken together, these factors suggest that growth should recover from end-2019 weakness through 2020, but remain below our estimate of potential growth (1.7%) for the year. As a result, the output gap, a key determinant of inflation, is expected to widen as excess capacity builds in the economy.

There are nevertheless clear risks to the downside. Looking through the temporary shocks hitting the fourth quarter, there are chances that the weakness observed at year-end may be longer-lasting than generally assumed. Job market dynamics shifted in the quarter, and wage growth moderated. Perhaps most importantly, measures of business and consumer confidence dropped quickly through the later months of the year, despite an evident cooling of global trade tensions and uncertainty. While economic conditions don't merit further declines in confidence, the speed at which confidence has fallen could indicate additional declines are forthcoming. If this were to happen, we would need to downgrade our outlook further. Equally importantly, consumer confidence is an important determinant of recession risk in our probability model. The drop in consumer confidence witnessed in December increased the odds of a recession in Canada to about 35%, despite a steepening of the yield curve. A further drop of the same magnitude, which we do not expect, would lift the probability of a recession significantly. Clearly, much hinges on the evolution of consumer confidence.

Table 1

Canada	2010–18	2018	2019e	2020f	2021f
	(annual % change, unless noted)				
Real GDP	2.2	2.0	1.6	1.5	2.0
Consumer spending	2.6	2.1	1.6	1.6	1.9
Residential investment	2.7	-1.5	-0.7	3.6	2.4
Business investment	2.4	1.8	0.2	3.7	3.5
Government	1.2	3.4	1.8	1.6	1.8
Exports	3.6	3.1	1.9	1.4	2.5
Imports	3.9	2.6	0.6	2.0	2.7
Nominal GDP	3.9	3.9	3.2	3.3	4.2
GDP Deflator	1.7	1.8	1.5	1.8	2.1
Consumer price index (CPI)	1.7	2.3	2.0	2.0	2.0
Avg. of new core CPIs	1.9	1.9	2.0	2.0	1.9
Pre-tax corporate profits	5.8	2.5	-0.2	0.9	2.0
Employment	1.2	1.3	2.1	0.9	1.0
Unemployment rate (%)	7.0	5.8	5.7	5.8	5.8
Current account balance (CAD bn)	-58.4	-55.5	-44.5	-47.3	-43.9
Merchandise trade balance (CAD bn)	-13.0	-22.1	-18.9	-26.9	-27.5
Federal budget balance (FY, CAD bn)	-19.4	-19.0	-14.0	-26.6	-28.1
percent of GDP	-1.0	-0.9	-0.6	-1.1	-1.1
Housing starts (000s)	200	213	210	206	202
Motor vehicle sales (000s)	1,809	1,983	1,922	1,915	1,915
Industrial production	2.7	3.1	-0.8	1.0	1.8
WTI oil (USD/bbl)	74	65	57	59	64
Nymex natural gas (USD/mmbtu)	3.39	3.07	2.53	2.39	2.63

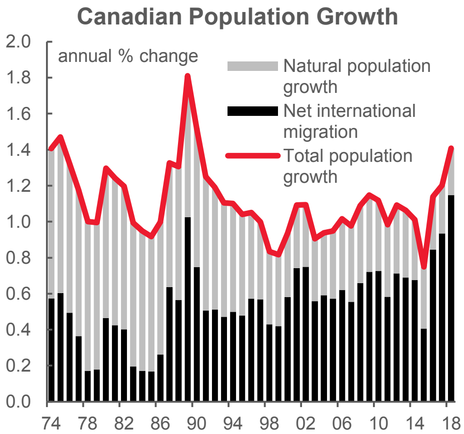
Sources: Scotiabank Economics, Statistics Canada, CMHC, Bloomberg.

Table 2

Quarterly Canadian Forecasts	2019	2020				2021			
	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic									
Real GDP (q/q ann. % change)	0.2	1.6	1.7	1.6	1.9	2.1	2.2	2.3	2.2
Real GDP (y/y % change)	1.5	1.7	1.2	1.3	1.7	1.8	1.9	2.1	2.2
Consumer prices (y/y % change)	2.1	2.3	2.0	2.0	1.8	1.7	1.8	2.0	2.3
Avg. of new core CPIs (y/y % change)	2.1	2.1	2.0	2.0	1.9	1.9	1.9	2.0	2.0
Financial									
Canadian Dollar (USDCAD)	1.30	1.28	1.27	1.26	1.25	1.25	1.25	1.25	1.25
Canadian Dollar (CADUSD)	0.77	0.78	0.79	0.79	0.80	0.80	0.80	0.80	0.80
Bank of Canada Overnight Rate (%)	1.75	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.25
3-month T-bill (%)	1.66	1.55	1.25	1.25	1.25	1.25	1.25	1.25	1.30
2-year Canada (%)	1.69	1.50	1.35	1.30	1.35	1.40	1.45	1.45	1.50
5-year Canada (%)	1.68	1.45	1.35	1.35	1.40	1.45	1.50	1.55	1.60
10-year Canada (%)	1.70	1.55	1.45	1.50	1.50	1.55	1.60	1.70	1.75
30-year Canada (%)	1.76	1.65	1.60	1.65	1.75	1.80	1.85	1.95	2.00

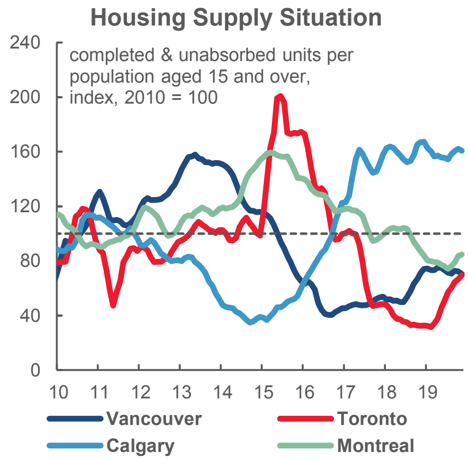
Sources: Scotiabank Economics, Statistics Canada, Bloomberg.

Chart 3



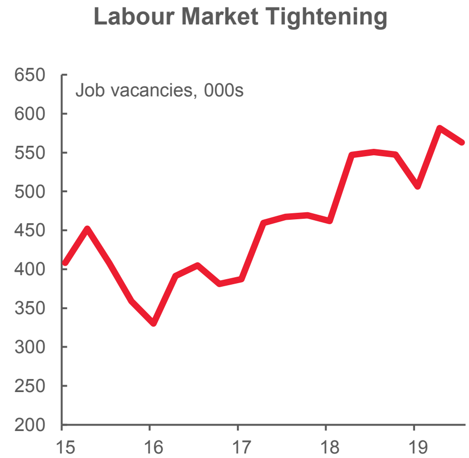
Sources: Scotiabank Economics, Statistics Canada.

Chart 4



Sources: Scotiabank Economics, CMHC, Statistics Canada.

Chart 5



Sources: Scotiabank Economics, Statistics Canada.

United States

SLOWING GROWTH CUSHIONED BY DOMESTIC DEMAND

- **Growth is expected to continue slowing from 2.3% in 2019 to 1.7% in 2020, before firming up slightly in 2021 as uncertainty begins to abate. Inflation isn't expected to reach the Fed's 2% target until early-2021.**
- **US-initiated trade wars have exacted a significant toll on manufacturing and have inhibited business investment, but domestic demand is expected to cushion downside risks, sustain activity in services and housing, and eventually underpin a modest recovery in capex and goods production.**

FISCAL STIMULUS WANES, RATE CUTS KICK IN

Overall, real GDP growth is expected to slow from 2.3% in 2019 to 1.7% in 2020, before accelerating slightly to 1.8% in 2021 as uncertainty begins to abate and 2019's policy rate cuts feed through into the real economy (table 1). Beyond the short-term volatility related to the October GM strike and the Boeing 737 Max production shutdown, US output growth is expected to trend below potential in 2020 and to close the small margin of positive excess demand accumulated over the past few years on the back of 2018's fiscal stimulus. Embedded in this outlook, the elevated trade-policy and geopolitical uncertainty in 2020 (chart 1) are shaving an average of 0.4 ppts from what headline real growth rate would otherwise be during 2020.

Core inflation, which has remained relatively weak, owing partly to idiosyncratic factors such as transportation costs and mobile phone charges, is forecast to rise only gradually to the Fed's 2.0% target by the beginning of 2021 (chart 2). It is expected to be lifted by the last vestiges of excess demand in 2020 and wage growth that is slightly outpacing productivity gains. As inflation is projected to remain below target until 2021, we anticipate that the Federal Reserve will cut the federal funds rate once more in Q1-2020, leaving the upper end of the range at 1.50% until end-2021.

CONSUMPTION GROWTH TO REMAIN SOLID

Private consumption is expected to be the main driver of growth, averaging around 2.3% during 2019–21, close to its annual mean since the financial crisis, supported by household balance sheets with early-cycle characteristics and robust labour markets (table 2). Average household combined principal and interest payments on accumulated debt account for the lowest share of personal disposable income (PDI) in forty years, while average household net worth is the highest multiple of PDI this century (chart 3). Wages continue to rise at rates near decade highs that are well above headline inflation, driven up by high quit rates in relatively tight labour markets (chart 4). Personal consumption accounts for around 69% of US GDP and the key financial and labour-market indicators that inform household spending decisions point to continued growth—despite the US economy being in the 11th year of a record-long expansion.

TRADE WARS AREN'T MAKING MANUFACTURING GREAT AGAIN

As was widely anticipated, White House trade policy is not producing much winning for the US balance of payments. As a share of GDP, the US's goods trade deficit over the

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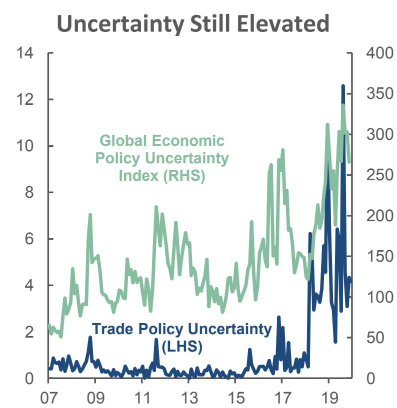
United States	2018	2019e	2020f	2021f
Real GDP (annual % change)	2.9	2.3	1.7	1.8
CPI (y/y %, eop)	2.2	2.0	2.2	2.4
Central bank policy rate (%, eop)	2.50	1.75	1.50	1.50
Canadian dollar (USDCAD, eop)	1.36	1.30	1.25	1.25

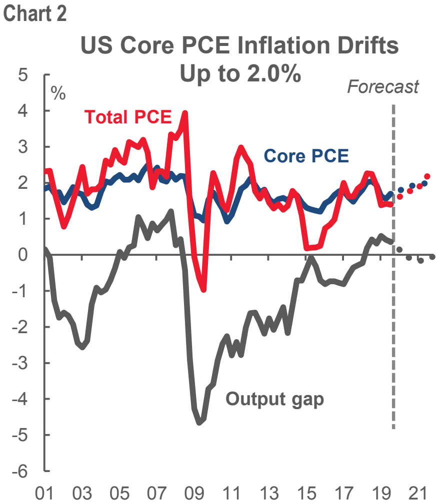
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, PolicyUncertainty.com

Chart 2

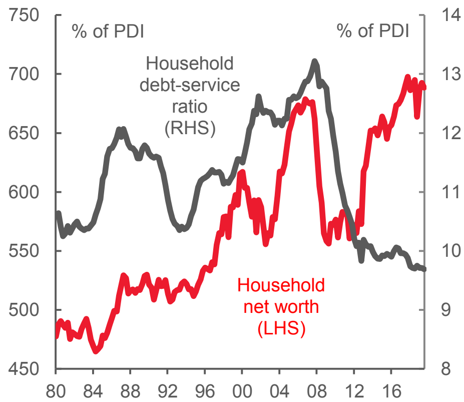


Sources: Haver, Scotiabank Economics.

last two years has narrowed only marginally below its 2010-onward average, driven mainly by a slight reduction in US import demand, where lower merchandise imports from China have been largely offset by increased imports from Mexico, Europe, and developing countries in Asia. In addition, the US surplus in services trade has declined since the start of the US-China trade war (chart 5). The lagged effects of years of a still-strong USD, the largest fiscal deficits since 2012, anaemic export order books, and ongoing uncertainty are forecast to widen the US trade deficit further.

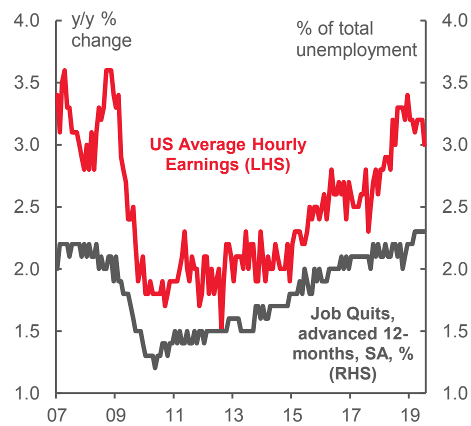
Despite the developing trend towards subdued growth in exports of services, US service industries continued to expand briskly over 2018–19. The data through Q2-2019, the latest date available, show that real value added at service industries in the private sector expanded by close to 3% Q/Q SAAR on average after Q1-2018. This pace of growth was sustained by the expansion of the information and professional service industries, which have ridden the technology boom and the growing demand for specialized expertise. Goods-producing industries, in contrast, grew by only 2.1% on average over the same period, hobbled by weak construction and manufacturing activity. Hence, the long-run trend that has seen goods production account for a progressively smaller share of total US output continues unchecked (chart 6).

Chart 3



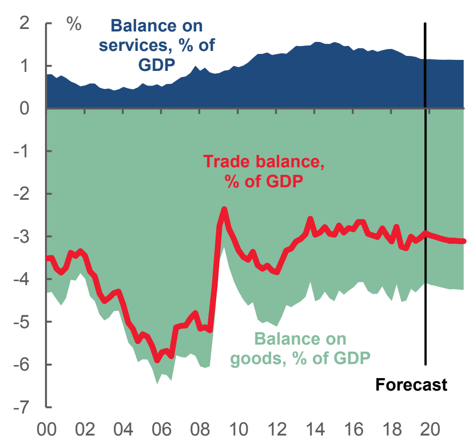
Sources: Scotiabank Economics, BEA, Federal Reserve Board.

Chart 4



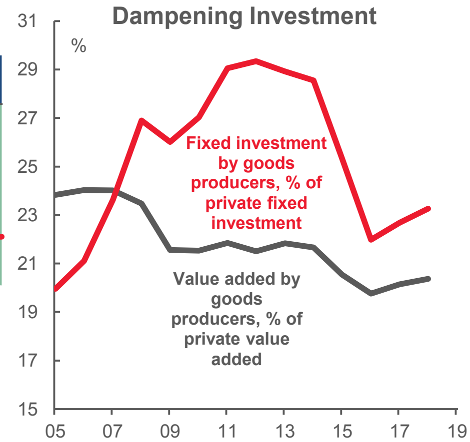
Sources: Scotiabank Economics, BLS, Bloomberg.

Chart 5



Sources: Scotiabank Economics, BEA.

Chart 6



Sources: Scotiabank Economics, BEA.

Table 1

Quarterly US Forecasts	2019	2020				2021			
	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic									
Real GDP (q/q ann. % change)	1.9	1.3	1.6	1.6	1.8	1.8	1.9	2.0	2.1
Real GDP (y/y % change)	2.3	1.8	1.7	1.6	1.6	1.7	1.8	1.9	2.0
Consumer prices (y/y % change)	2.0	2.2	2.3	2.3	2.2	2.3	2.3	2.4	2.4
Total PCE deflator (y/y % change)	1.5	1.6	1.8	1.8	1.7	1.9	2.0	2.2	2.3
Core PCE deflator (y/y % change)	1.7	1.8	1.9	1.9	1.9	2.0	2.0	2.0	2.0
Financial									
Euro (EURUSD)	1.12	1.12	1.14	1.15	1.16	1.17	1.18	1.19	1.20
U.K. Pound (GBPUSD)	1.33	1.33	1.34	1.36	1.36	1.38	1.39	1.41	1.42
Japanese Yen (USDJPY)	108	107	107	105	105	103	103	102	102
Fed Funds Rate (upper bound, %)	1.75	1.75	1.75	1.50	1.50	1.50	1.50	1.50	1.50
3-month T-bill (%)	1.51	1.55	1.55	1.30	1.30	1.30	1.30	1.30	1.30
2-year Treasury (%)	1.57	1.60	1.55	1.50	1.55	1.60	1.65	1.65	1.65
5-year Treasury (%)	1.69	1.65	1.60	1.60	1.65	1.70	1.75	1.80	1.80
10-year Treasury (%)	1.92	1.80	1.75	1.75	1.80	1.85	1.90	1.95	2.00
30-year Treasury (%)	2.39	2.25	2.15	2.20	2.25	2.30	2.35	2.40	2.45

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

In particular, survey data imply that the US manufacturing sector as a whole started to underperform the rest of the American economy around the same time that trade policy uncertainty and White House protectionism began to ramp up (chart 7). Rather than engineering a manufacturing revival, US trade wars are generating a contraction in US manufacturing, with the PMI for the sector hitting in December its lowest level in a decade.

Going forward, following short-term dislocations from recent labour strikes and the Boeing production shutdown, the rate of manufacturing expansion is expected to pick up in 2021 once the lingering effects of trade-policy uncertainty have begun to dissipate.

Table 2

United States	2010–18	2018	2019	2020f	2021f
	(annual % change, unless noted)				
Real GDP	2.3	2.9	2.3	1.7	1.8
Consumer spending	2.4	3.0	2.6	2.3	2.0
Residential investment	4.8	-1.5	-1.8	1.3	1.8
Business investment	5.2	6.4	2.3	1.0	2.5
Government	-0.3	1.7	2.3	1.8	1.6
Exports	4.1	3.0	0.0	1.3	2.2
Imports	4.9	4.4	1.7	2.6	2.9
Nominal GDP	4.0	5.4	4.1	3.4	3.8
GDP Deflator	1.7	2.4	1.8	1.7	2.0
Consumer price index (CPI)	1.8	2.4	1.8	2.3	2.4
Total PCE deflator	1.6	2.1	1.4	1.7	2.1
Core PCE deflator	1.6	1.9	1.6	1.9	2.0
Pre-tax corporate profits	4.6	3.4	-0.5	2.3	1.8
Employment	1.4	1.7	1.6	1.0	1.0
Unemployment rate (%)	6.5	3.9	3.7	3.8	3.8
Current account balance (USD bn)	-421	-491	-510	-525	-555
Merchandise trade balance (USD bn)	-754	-887	-881	-924	-976
Federal budget balance (USD bn)	-813	-779	-960	-1,008	-1,034
percent of GDP	-4.6	-3.8	-4.5	-4.6	-4.5
Housing starts (mn)	0.96	1.25	1.25	1.26	1.26
Motor vehicle sales (mn)	15.5	17.2	16.9	16.9	17.0
Industrial production	2.2	4.0	0.7	0.8	1.9
WTI oil (USD/bbl)	74	65	57	59	64
Nymex natural gas (USD/mmbtu)	3.39	3.07	2.53	2.39	2.63

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

CAPITAL-INTENSIVE INDUSTRIES TO DELAY INVESTMENT UNTIL 2021

While the US tax changes that came into effect in 2018 spurred an initial surge in investment, capex has disappointed so far in 2019, likely due to weaker investment spending by goods producers. Real machinery and equipment spending has been roughly flat since Q4-2018, while investment in structures has declined. The caution on the part of businesses comes despite the continued expansion of US corporate profits and a rebound in equity markets following uncertainty-induced declines at end-2018. Goods-producing industries are generally relatively more capital intensive and account for a disproportionate share of investment when set against their total contribution to US GDP, although the gap became less pronounced when mining and oil and gas firms cut capital expenditures after the 2014 oil price collapse (chart 6, again).

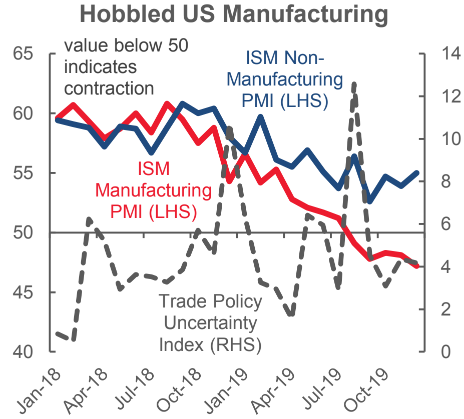
With a rebound in goods production likely to be delayed until uncertainty is lifted, business investment growth is set to remain subdued until 2021 (table 1, again). Mirroring the outlook for US manufacturers, subdued growth in business investment is expected to persist in 2020, averaging just 1.0% next year, before strengthening to 2.5% y/y in 2021. Capex growth is expected to receive a modest lift from a reduction in uncertainty following the November 2020 elections and lower costs of capital following the recently implemented and expected monetary stimulus.

RESIDENTIAL INVESTMENT TURNING A CORNER

In contrast with the gradual recovery expected for business investment, housing activity has already started to turn around. Residential investment expanded by 4.6% Q/Q SAAR in Q3-2019 following six straight quarters of declines, with housing starts reaching levels not seen since mid-2007 and housing prices showing persistent moderate gains. The housing market has been supported by gradually falling mortgage rates, which declined throughout 2019 on the back of the Federal Reserve's policy easing. In addition, strong employment gains in the second half of 2019 and personal disposable income growth above 4.0% have served to support housing demand (chart 8).

Chart 7

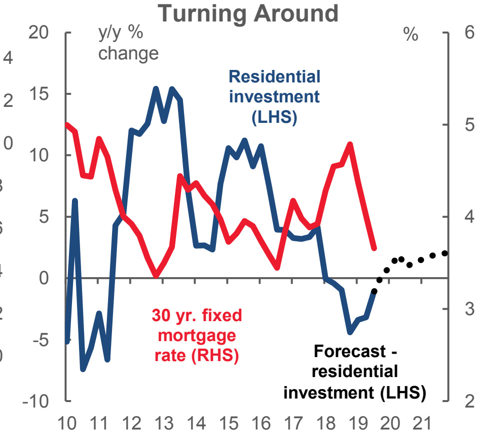
Rise of Trade Policy Uncertainty Hobbled US Manufacturing



Sources: Scotiabank Economics, ISM, PolicyUncertainty.com.

Chart 8

Residential Investment Turning Around



Sources: Scotiabank Economics. BEA. FMAC.

US & Canadian Monetary Policy & Capital Markets

- **The Bank of Canada is forecast to cut twice in 2020.**
- **The Federal Reserve may not be done cutting as the balance sheet expands.**
- **US and Canadian inflation risks are tilted lower.**

1. BANK OF CANADA—EASING IS COMPATIBLE WITH INFLATION GOALS

Two rate cuts are forecast in 2020 with our current placement anticipating them to occur in the first half of the year after which the overnight rate is expected to hold at 1.25%. Chart 1 shows our yield curve projections. The crux of the argument that follows is that to ease monetary policy would not be inconsistent with inflation presently being on target.

- A significant part of the reason that inflation landed on the 2% target in 2019 had to do with a series of idiosyncratic drivers that may prove to be transitory and that have nothing to do with economy-wide slack or the lack thereof;
- As slack nevertheless widens, this should marginally combine with the reversal of these more dominant temporary factors to put renewed downside pressure on inflation in 2020;
- From a risk management standpoint, the BoC should err on the side of easing when downside risks to inflation surface given its weak track record at forecasting inflation;
- The way the BoC has implemented policy measures suggests to economists, markets and businesses that 2% is an inflation ceiling as opposed to a symmetrical target implemented in what the BoC used to describe more commonly as a flexible inflation targeting framework. This tendency to act like it's a ceiling risks unmooring full-cycle inflation expectations—with some supporting evidence—and poses greater vulnerability to future shocks.

Secondary to the inflation argument for easing are four other matters that are addressed below. Amidst shaken consumer confidence due to financial stress and a weakened jobs trend, rate cuts could re-inject fresh confidence.

A. Inflation's Transitory and Idiosyncratic Drivers

The BoC has tended to argue that inflation around 2% is a signal that the economy is running at or very near full capacity. An alternative explanation is that inflation is being driven by a variety of idiosyncratic factors that may be transitory and that have nothing to do with slack or the lack thereof.

For starters, the connection between 'core' inflation and output gaps is tenuous at best. Chart 2 shows the BoC's two output gap measures and the average of the three 'core' measures of inflation. There is a broad connection over time but it is too strong a statement that if inflation is on target then it must be that spare capacity has been eroded. That's particularly since estimating potential growth is highly imprecise and hence so are slack estimates.

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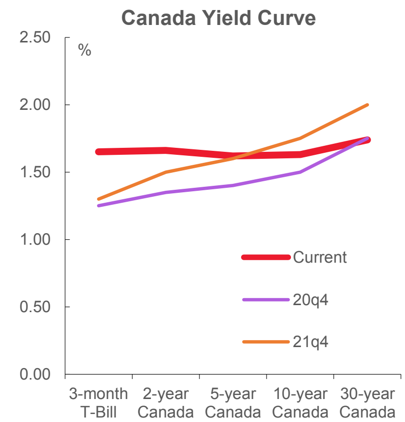
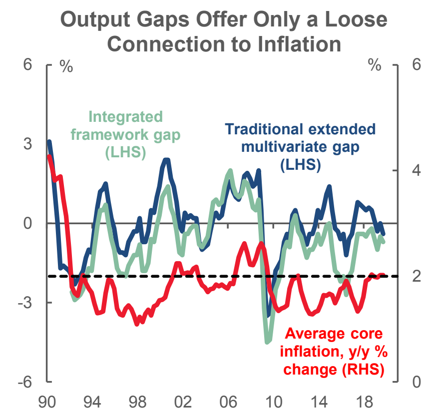
Chart 1



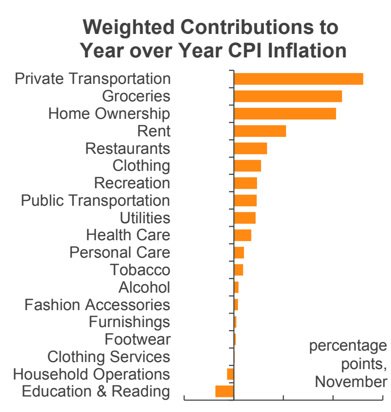
Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bank of Canada, Statistics Canada.

Chart 3



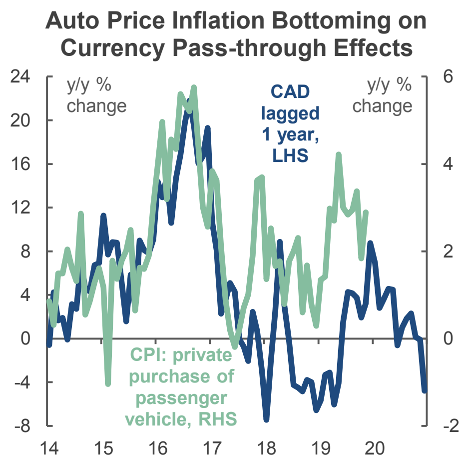
Sources: Scotiabank Economics, Statistics Canada.

Secondly, chart 3 shows the main drivers of annual CPI inflation as a segue into discussing potentially idiosyncratic drivers. Autos, gasoline, groceries, and home ownership costs including house prices and mortgage interest are the top drivers of inflation. Each of them potentially has little to nothing to do with broad slack conditions and much more to do with industry-specific drivers.

Take grocery prices for example. On a weighted contribution to overall CPI inflation basis, groceries rank as the second biggest driver. This annual report explains sources of food price pressures in terms of idiosyncratic factors like African swine fever's impact upon global pork supply, the impact of trade war frictions on supply chains, the impact on vegetable prices of E.Coli outbreaks and the impact of supply chain disruptions on beef prices. Whether such effects on grocery prices are transitory or not is uncertain, but they have little to do with broad economy-wide capacity pressures.

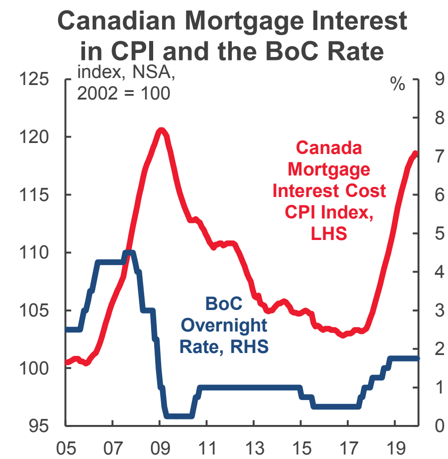
Or take the impact of past depreciation in the Canadian dollar on auto prices (chart 4) which has contributed to the biggest weighted contribution to overall CPI inflation. There is a one year lagged effect between changes in the dollar and auto prices when new models are introduced; as CAD appreciated this past year, there should be less auto price inflation in 2020.

Chart 4



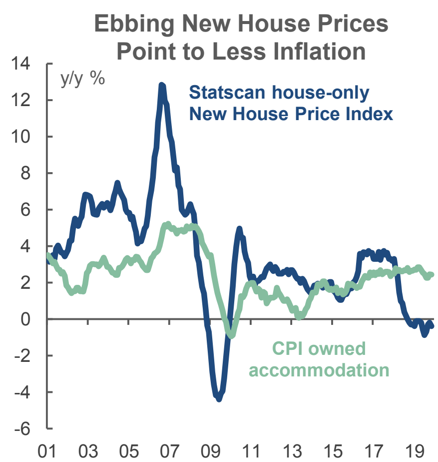
Sources: Scotiabank Economics, Statistics Canada, Bank of Canada.

Chart 5



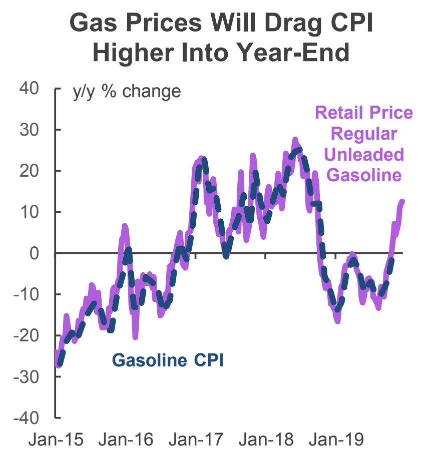
Sources: Scotiabank Economics, Bank of Canada, Statistics Canada.

Chart 6



Sources: Scotiabank Economics, Statistics Canada.

Chart 7



Sources: Scotiabank Economics, Statistics Canada, Natual Resources Canada.

Or take the impacts of past rate hikes by the BoC on mortgage interest costs (chart 5) and the likelihood that this factor drops out as a driver of rising home ownership costs in 2020.

Further, the replacement cost component of the owned accommodation portion of shelter costs in CPI is driven by the 'house only' part of StatsCan's new house price index. As the latter has seen an abrupt ebbing in the pace of increase over the past year, the historical lagged effects point to downside risks to the owned accommodation part of CPI into 2020 (chart 6). Note that house price contributions to Canadian CPI are derived from builder prices and not resale prices.

The same transitory idiosyncratic argument may be true for gas price inflation this year off of low prior base effects but pending further evaluation of risks to energy markets that are discussed later (chart 7).

The large weighted roles played by several idiosyncratic drivers of inflation are probably not adequately filtered out by the 'core' measures of inflation. For instance, the latest month-ago change in the trimmed mean CPI gauge included several of these arguably idiosyncratic components (chart 8). They likely combine to play a significant role in driving inflation to the BoC's target. If they weaken, which is quite plausible, then achieving the BoC's 2% inflation target may itself be a transitory accomplishment.

B. Canada Is Building Slack Again

What reinforces downside risk to inflation is the possibility that as transitory drivers diminish, widening slack in the economy could sap pricing power. Economic growth over the second half of 2019 averaged below the BoC's estimate of potential growth that is required to soak up production inputs and preserve stable inflation. Our forecast is for GDP growth to equal about 1.5% in 2020 with possible downside risk which would ride roughly in tandem to potential growth or below it such that, at a minimum, widened slack by the end of 2019 persists over 2020. Household finances are strained and manufacturers and wholesalers have the highest inventory bloat since the 2009 recession which portends slowing production growth and likely slowing hiring activity with it.

C. Restoring Credibility to a Symmetrical Inflation Target

In a risk management sense, the BoC should place greater emphasis upon downside risks—like the ones discussed thus far—than upside risks to inflation given it has perennially over-predicted inflation in the past.

Enter chart 9. A very well established pattern is that the BoC constantly forecasts a return to 2% inflation within its projection period but almost never achieves it. Each dotted line shows the inflation forecast contained within successive Monetary Policy Reports over the years. The solid line is the actual trend in inflation. Note that average 'core' inflation fell below the 2% inflation target during 90% of the months during Governor Poloz's term as Governor. **If one's forecast bias has been to persistently predict inflation to be too high, then adopting a more cautious policy stance has merit.**

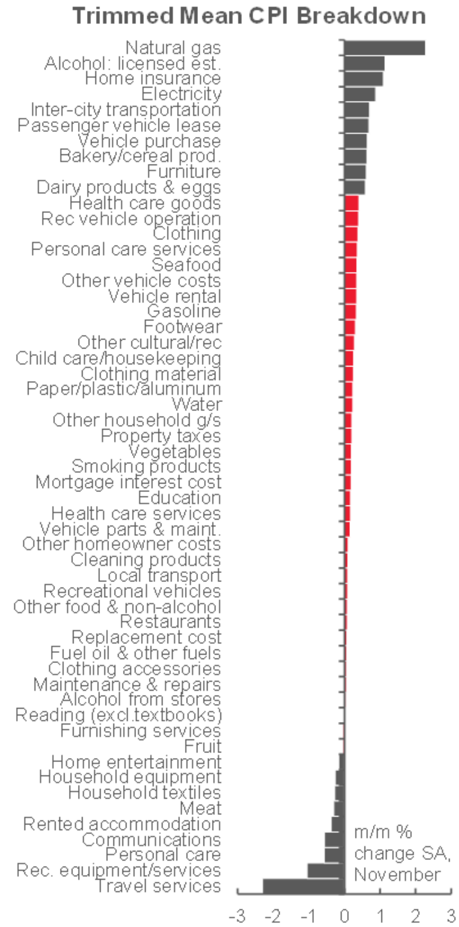
D. Inflation Expectations

A potentially dangerous unmooring of inflation expectations is occurring in Canada and it may be time for the BoC to return to emphasizing the flexible inflation targeting approach that it utilized toward the start of the decade. This may be a direct offshoot of the BoC's inability to sustainably achieve 2% inflation. Over Governor Poloz's term, average core inflation has run at about 1.7% y/y which is identical to the average over the slightly longer post-recession period since 2010. Just as inflation arrived at the 2% inflation target, the BoC has rung the all clear and declared the economy 'home', defined as a point at which supply and demand are balanced, slack has disappeared and stable prices are evident.

How do measures of inflation expectations behave in light of this approach? All measures of inflation expectations have their pros and cons, but they all suggest that the BoC's inflation target range is skewed to the lower 1–2% half of its 1–3% band. Bond market measures are below 2% (chart 10). Businesses don't believe 2% will be hit (chart 11). The consensus of private sector economists is the most optimistic, but a) it may suffer from the same inflation over-forecasting bias as the BoC, and b) the Bloomberg consensus only projects 1.9–2.0% inflation over 2020–21 and nothing higher.

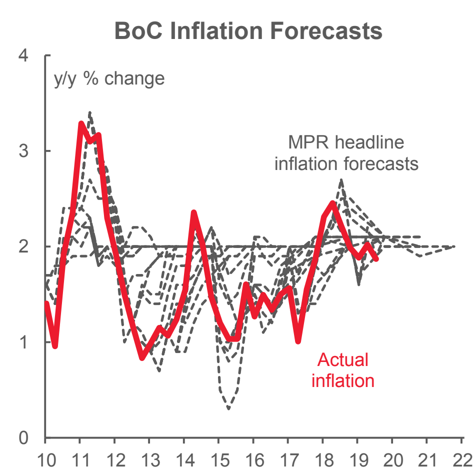
Now here lies the rub. When the Bank speaks of having returned to 'home' and signals that it is content with inflation at 2%, it implicitly signals to markets, households and businesses that 2% is a ceiling. By corollary, **it comes to be believed that average inflation over the cycle is being targeted at something materially**

Chart 8



Sources: Scotiabank Economics, Statistics Canada.
Red bars denote categories included in trimmed mean CPI.

Chart 9



Sources: Scotiabank Economics, Bank of Canada, Haver Analytics.

below 2%. This can mean that businesses, consumers and governments start to believe that wage- and price-setting exercises over the full cycle should be something below a 2% inflation and overall cost of living estimate. Measures of inflation expectations would appear to confirm this.

Does it matter? Probably. The lower inflation gets, the less of an unanticipated shock to the economy it takes to get deflation which is the worst overall scenario for the economy in that businesses and consumers put off spending plans in anticipation of lower prices in a self-fulfilling and damaging feedback loop.

Downside risks to inflation, a poor track record at forecasting it and potentially unmoored inflation expectations combine to counsel an easing bias.

E. Other Considerations

The crux of the easing argument is rooted in the inflation targeting framework, but other arguments are also briefly addressed.

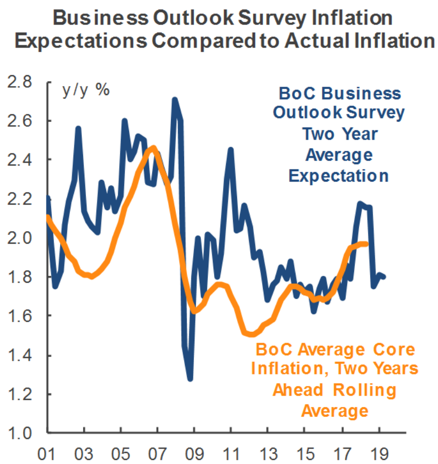
F. (i) A Softening Job Market

If job growth faces downside risk then that's a significant risk to the strained consumer sector and housing markets. In turn, this may merit easier financial conditions.

Chart 10

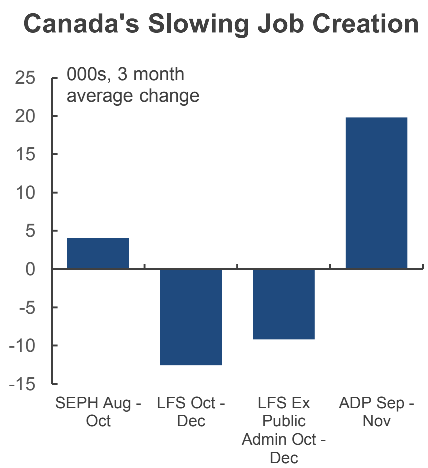
Sources: Scotiabank Economics, Bloomberg.

Chart 11



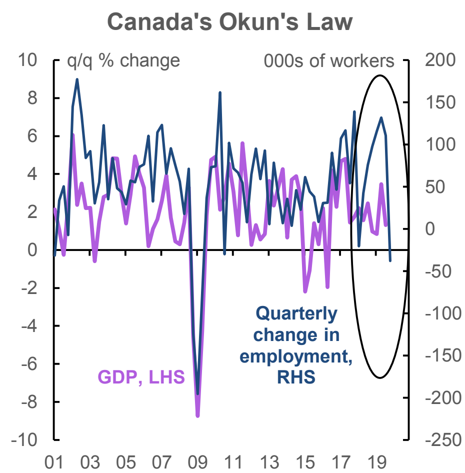
Sources: Scotiabank Economics, Bank of Canada.

Chart 12



Sources: Scotiabank Economics, Statistics Canada, ADP.

Chart 13

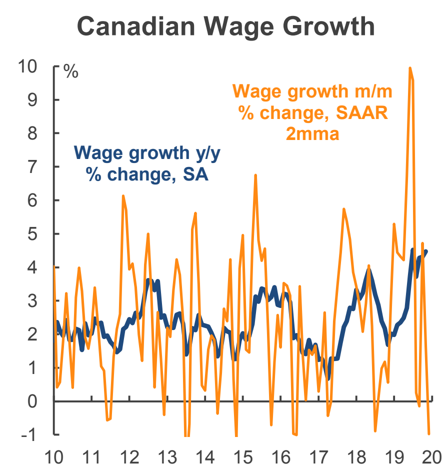


Sources: Scotiabank Economics, Statistics Canada.

There is no doubt that Canada's job market has been on a tear since mid-2016 when job growth began to accelerate. It has performed more strongly than the US job market over this time. More recent trends across the three main measures of job growth are nevertheless indicating somewhat greater caution on average (chart 12). It's feasible that job growth overshot what should have occurred in the context of soft trend growth in GDP over recent years and that the historical connections between the two measures will weaken job markets. This relationship is referred to as Okun's 'law' which posits that the historical connection between GDP growth and job growth is dragging job growth downward (chart 13).

A similar argument may hold in terms of wage growth. A weak pace of wage growth a year ago played a significant role in driving an overshoot of wage growth at present. Month-over-month gains were nevertheless quite strong over the middle of 2019 but may have since settled back down (chart 14). If monthly gains have slowed then when tacked onto this past year's strong gains, the pace of wage growth may abruptly slow in 2020. More disconcerting is that wage gains at the present rate are not backed by productivity gains casts doubt on the sustainability of wage pressures.

Chart 14



Sources: Scotiabank Economics, Statistics Canada.

F. (ii) What Fiscal Stimulus?

If there is a sense that fiscal stimulus can take over from monetary policy into 2020 then such beliefs should arguably be put to rest.

For one thing, incremental Federal fiscal stimulus has been focused upon a small increase in the Basic Personal Amount as a small tax cut. We estimate the incremental effect on economic growth to be small—at around a tenth of a percentage point into 2020 or less—and transitory (chart 15). Go here for more.

For another, this small amount of Federal stimulus is offset by near-universal fiscal consolidation across provincial governments and by an increase in Canada Pension Plan premiums that took effect at the beginning of 2020.

Third, Canada is projected to run deficits of 1.2% of GDP in FY20 and FY21 before they gradually diminish in subsequent years. Almost a third of this is not stimulatory, and is instead due to actuarial accounting for pension obligations. Recession risk would materially widen deficits given the Finance Department's estimate that each 1% shock to nominal GDP adds $5 billion to the deficit. Peak-to-trough NGDP growth involved a swing of eight percentage points in the early 1990s, over 10% in the early 2000s and about 15% in 2008–09. The federal government is not likely to materially pre-spend fiscal room much further as it could well expose the country to downside risk to its AAA credit rating—which the Finance Minister is explicitly mandated to protect—and risk pro-cyclical future belt-tightening that by practical necessity would focus upon the middle class.

Last, perhaps unlike some other parts of the world, Canada has room to act with monetary policy as a first line of defense relative to fiscal policy. In fact, many economists—likely including those at the BoC—believe that fiscal policy is likely to prove more powerful when the policy rate is toward the lower bound. Politically, it may also be unfeasible for the Federal Government to launch material fiscal stimulus without the BoC leading the way.

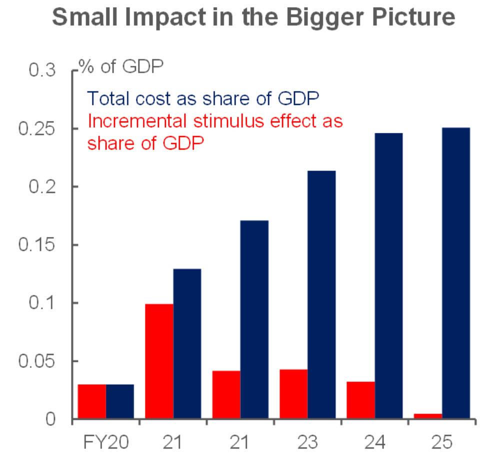
F. (iii) Household Debt and Stability Risks

Financial stability risks attached to easing are arguably exceeded by stability risks attached to having led households toward a low rate environment only to suddenly stop by not addressing downside risks to growth and inflation. The household saving rate sits at about 1%, and hence a fraction of what it is in the US while debt payments are at a cyclically elevated share of household incomes versus the historic lows in the US.

As a result of strained finances, Canada has been stuck in a soft trend growth environment for retail sales and broader consumption for about the past two years. Retailers have borne the brunt of this adjustment (chart 16).

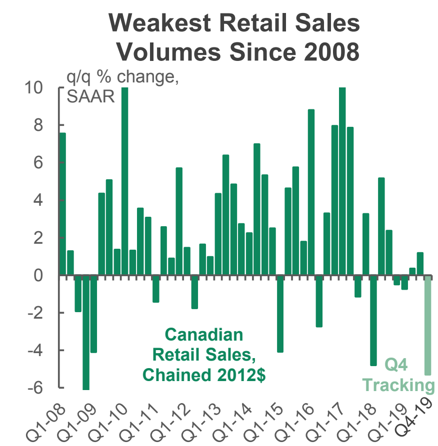
Furthermore, growth in existing home sales may have passed its peak. Sales were rising at a 1.5–3.5% monthly seasonally adjusted pace from April through to August. Over the three most recent months, sales growth has slowed to a crawl at 0.4% m/m on average even as year-ago growth rates remain elevated. Further, there was never an upswing in new home sales and absorptions as all of the arguably temporary upswing in housing was in the resale market. That in turn could have been driven by the maturation of the B20 dampening effect on home sales in 2018 that posed a soft jumping-off point for sales

Chart 15



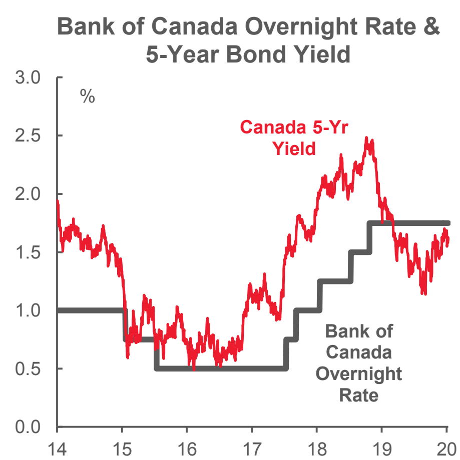
Sources: Scotiabank Economics, Finance Canada..

Chart 16



Sources: Scotiabank Economics, Statistics Canada.

Chart 17



Sources: Scotiabank Economics, Bank of Canada, Bloomberg.

and prices this year, and also by the bond market rally that drove fixed borrowing costs consistently lower before they increased after August. Both effects are arguably mature.

Last, chart 17 repeats an argument I've previously used. Easing back in 2015 flattened the entire term structure of rates and pushed through fixed and variable rate mortgages into housing markets. This past year, Canada imported a positive bond shock derived from market-driven actions as well as actions by the Federal Reserve and ECB. That motivated the earlier pick-up in home sales. The curve nevertheless remains inverted with a policy rate at 1.75% and the 5 year GoC yield under 1.6%. **Easing today may simply remove this inverted kink, ease businesses' working capital financing requirements and push back on an appreciating C$ over the past year.** The horse has arguably left the barn in terms of appetite for fixed rate mortgages that comprise over three-quarters of all mortgage debt in Canada and therefore it's unlikely that modest easing would spark a flood back into variable rate mortgages.

F. (iv) Iran and Oil

As uncertainty remains high, do higher oil prices stemming from US-Iran developments change the BoC picture? Not at this point. It's possible in future, but not in a way that is favourable to the outlook versus imposing an added downside risk to the overall Canadian economy and possibly reinforcing an easing bias. There are several supporting points.

1. The WTI moves so far are modest (+$8 off the early October levels, only back to April 2019 levels). Brent is a similar picture that matters to the east coast projects that sell into the northeastern US and with that price back up to April levels and US$10 higher than October. Western Canada Select—a proxy for Alberta's heavy crude—has barely budged by comparison.

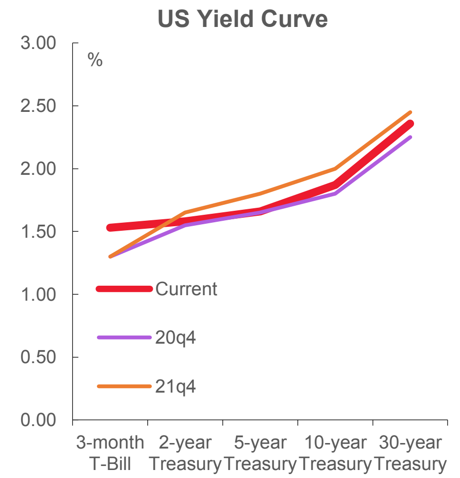
2. Any more material rise in oil prices would have to be sustained. It's not clear how next steps would impact oil prices over our full forecast horizon and hence whether any gains would be transitory or longer-lived. For instance, who knows where we go from here, but for reference purposes the Gulf War popped oil prices higher for less than six months.

3. It depends upon the nature of a potential oil shock. One that is driven by demand that supports oil prices in a sharply improving world economy could be constructive to the Canadian outlook in that the energy regions benefit but the improving world picture is a favourable offset to the regions that use more expensive oil (e.g. Ontario, Quebec).

   But an oil price shock led by tensions in the Middle East may be more of a supply shock with prices that could benefit Alberta and the east coast but offer a negative shock to central Canada absent a material pick-up in world growth. Shutting the Suez, for example, would hardly be favourable to the world economy, let alone Ontario and Quebec especially if accompanied by further appreciation in the partially petro-driven Canadian dollar. Heavily indebted Canadian consumers would no doubt just love higher home heating and gasoline costs and so it's the starting position on finances to when the shock is imposed that matters.

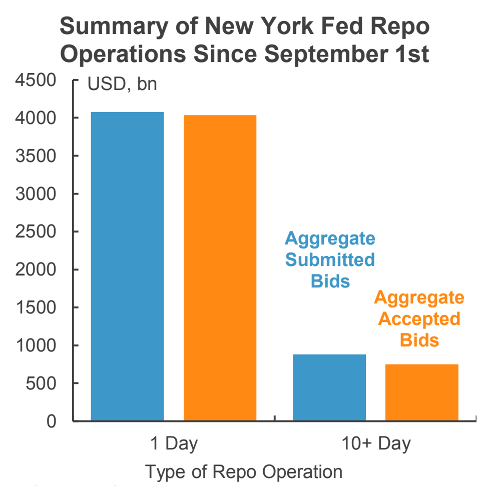
4. Further, Alberta's ability to get product out of the ground and to market is constrained and so any further gains in oil prices would be mostly a price effect with relatively little flow-through to cap-ex.

Chart 18



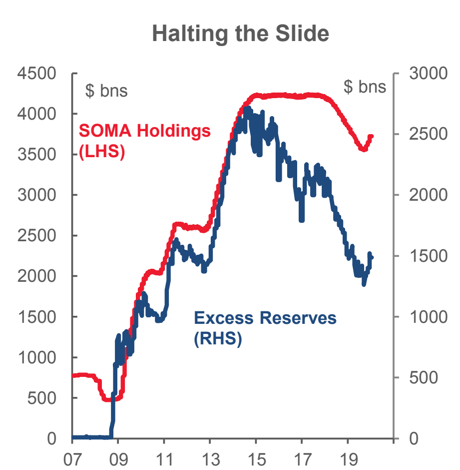
Sources: Scotiabank Economics, Bloomberg.

Chart 19



Sources: Scotiabank Economics, New York Federal Reserve.

Chart 20



Sources: Scotiabank Economics, Bloomberg.

2. FEDERAL RESERVE—EASY, BUT JUST DON'T CALL THEM THAT!

The Federal Reserve is likely on an extended pause with greater risk of further rate cuts than hikes later in the year. We've retained one rate cut in our forecast to signal our concerns about risks to the inflation outlook and growth prospects plus broader policy risks, but if the Fed were to resume easing then it is likely they would go beyond this forecast marker. Rate cuts are not expected to be withdrawn over our 2020–21 forecast horizon. To prevent the real policy rate from rising and imposing tightened conditions upon the US economy, inflation risks may require nominal rate cuts. Chart 18 shows our yield curve forecasts.

A. SO LONG, QUANTITATIVE TIGHTENING

As risks to the outlook and future potential rate cuts are evaluated, the more significant nearer-term development is the likelihood that within just a few months, the Federal Reserve will probably have fully unwound the shrinkage of its balance sheet that began in 2018. At present, the US$4.17 trillion in assets has already reversed about 60% of the decline in the size of the balance sheet that had been induced by ending reinvestment. By Spring, it's likely that the balance sheet will be pushing back toward US$4.5 trillion again. The Fed's prior plans to shrink the balance sheet are partially in tatters.

The balance sheet has been increased by the Fed in two primary ways that are expected to continue. One has been through the System Open Market Account (SOMA) portfolio that has climbed by over US$160 billion since October. This has been achieved through Treasury bill purchases as the Federal Reserve addressed liquidity risks overhanging markets. The New York Federal Reserve has pledged to continue these purchases "at least into the second quarter" of 2020. The second way has involved a large expansion of the overnight and term reverse repurchase agreements that were also designed to address funding pressures (chart 19).

To this point, we cannot refer to these balance sheet developments as restarting quantitative easing that involved the Fed engaging in non-sterilized purchases of Treasuries, agencies, mortgage backed securities and TIPS. All of the Fed's actions

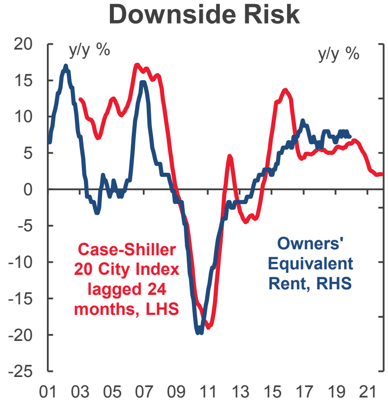
Chart 21

November Weighted Contributions to Headline CPI

Source: Scotiabank Economics, BLS.

Chart 22

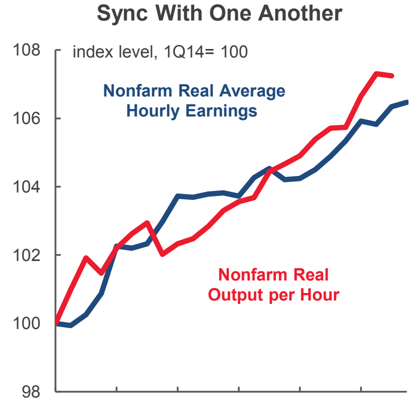
US Core CPI Could Face Downside Risk



Sources: Scotiabank Economics, BLS, Bloomberg.

Chart 23

US Real Wages & Productivity Are In Sync With One Another

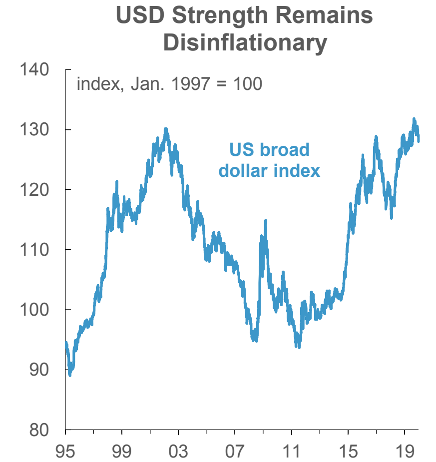


Sources: Scotiabank Economics, BLS.

of late have involved expanding holdings of shorter-term instruments in order to address funding risks, including by raising depleted excess reserves (chart 20).

Those funding risks were being driven by insufficient liquidity in the financial system that had arisen through multiple complex drivers as opposed to President Trump's accusation that the Fed simply mismanaged its balance sheet. In the context of those drivers, the Fed—in retrospect—had engaged in an overly rapid pace of balance sheet unwinding. Why? For one, the Liquidity Coverage Ratio had not been materially tested by fresh market developments and it arguably wound up tying up a higher proportion of assets held in liquid instruments than markets could handle during funding swings. For another, the US fiscal deficit has increased by about US$1.7 trillion since the 2016 election with about three-quarters of that rise occurring since the February 2018 spending bill and the January 2018 Tax Cuts and Jobs Act. So much for tax cuts paying for themselves! Pressure to fund quarterly corporate tax installments also grew relative to these other developments.

Chart 24



Sources: Scotiabank Economics, US Federal Reserve.

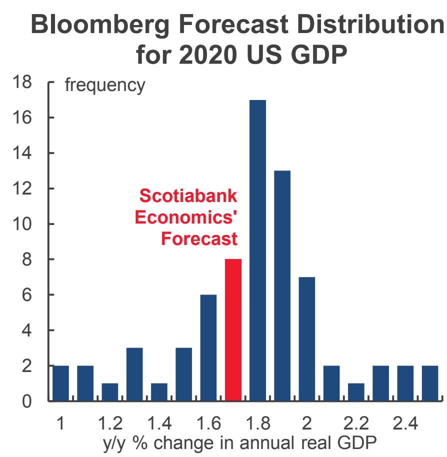
B. INFLATION DOWNSIDES

Part of our relatively dovish caution is rooted in the concern that renewed downside risk to inflation may surface. There are four reasons for this.

The US economy is operating under excess aggregate demand conditions with a positive output gap. Our growth forecast (1.7% 2020, 1.8% 2021) assumes that GDP expands at a slower pace than the FOMC's estimated potential rate of growth (1.9%). This should drive lower excess demand conditions and at least cap inflation risk to the extent to which today's flatter Phillips curve operates upon inflation risk.

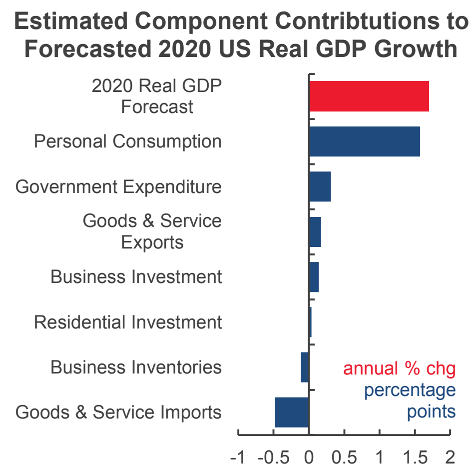
Second, housing is the dominant driver of inflation at the moment but this is likely to change. Chart 21 shows the weighted contributions to CPI inflation derived from various components and the dominant role played by shelter costs. 'Rent of shelter' is a category that includes rental payments of tenant-occupied housing but more importantly imputed rental of owner-occupied housing. This latter owners' equivalent rent component is climbing by 3.3% y/y and accounts for about one-quarter of the CPI basket. As chart 22 shows, cooling house price inflation should carry lagged downward influences upon owners' equivalent rent in CPI and with that a material source of downward pressure on overall inflation.

Chart 25



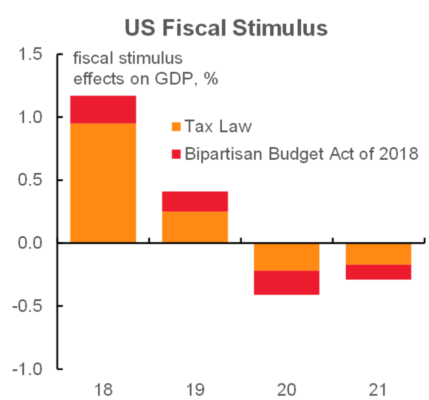
Note: Forecasts as of January 10th, 2020.
Sources: Scotiabank Economics, Bloomberg.

Chart 26



Sources: Scotiabank Economics, BEA.

Chart 27



Sources: Scotiabank Economics, Joint Committee on Taxation, Central Budget Office, "The Tax Cuts and Jobs Act: A Boost to Growth or Missed Opportunity?" - Jason Furman.

Chart 28

Source: Scotiabank Economics, U.S. Census Bureau.

Third, whereas wage growth has accelerated over time to the present 3.1% y/y rate, it has slightly cooled from the pace being set earlier last year. More important is that to translate into classic cost-push types of wage pressures, there would need to be more evidence that real wage growth (presently less than 1%) is exceeding soft productivity growth but this is not evident (chart 23).

Last is the impact of the USD (chart 24). We believe that the estimates of dollar pass-through into inflation that were provided in this speech remain valid. Each sustained 10% appreciation/depreciation in the broad US$ subtracts/adds about 0.5% to US inflation within six months and dissipates to about 0.25% within one year. Despite its slight depreciation since September, the broad dollar remains slightly firmer than at the start of 2019 and still over 10% stronger since early 2018. There isn't enough depreciation in place yet to drive an inflationary reversal of currency influences but this will require continued monitoring.

C. GROWTH RISKS

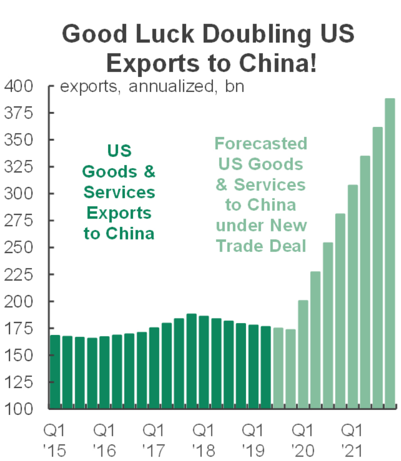
Scotiabank Economics forecasts US GDP growth to occur at a rate somewhat below Bloomberg consensus. We think the economy will expand by 1.6% this year and 1.8% next year. Chart 25 shows how we compare to consensus for 2020 growth. Chart 26 breaks down drivers.

One reason we are below consensus is that we anticipate significant import leakage of activity driven in part by lagging effects of broad dollar strength.

Another reason is that fiscal stimulus is turning toward fiscal drag. Chart 27 shows a respected fiscal economist's estimates of the impact of the US$300 billion spending bill in February 2018 and the prior month's tax cuts upon growth in GDP over 2018–21. Stimulus is dropping out of the equation this year. Tax Cuts 2.0 in this Congress—in arguably the most divided election year in recent memory—is highly unlikely to be delivered. Fiscal hawks within Congress that supported earlier stimulus are likely more agitated by the predictable failure of self-funding promises. In spite of his propensity to spend, partisan policy precludes any further fiscal stimulus in an election year (outside of a war act).

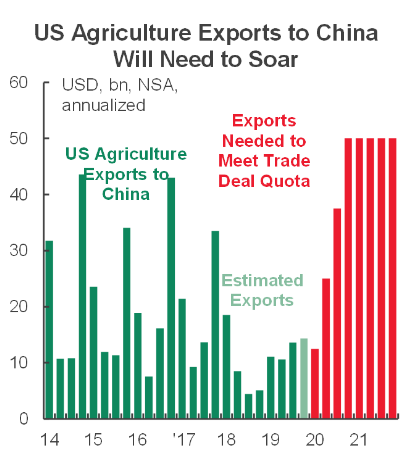
Chart 28 demonstrates that even if relative peace has been achieved for trade policy risks, the second round effects of trade wars are likely to be a weight on GDP growth. The disruption across supply chains has driven upward pressure upon inventories relative to sales with the ratio back toward cycle peaks and that bodes poorly for production and employment. A portion but not all of this is traceable to Boeing's 737Max challenges that we estimate will subtract a meaningful amount from GDP growth at least at the start of 2020.

Chart 29



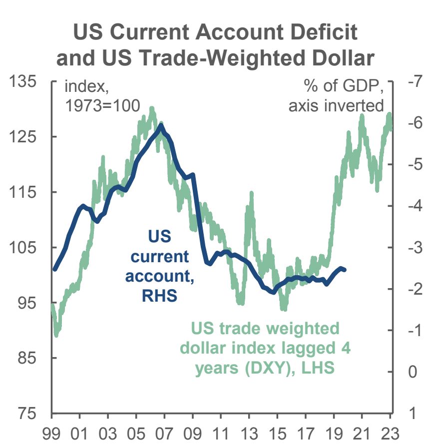
Sources: Scotiabank Economics, US Congressional Research Service.

Chart 30



Sources: Scotiabank Economics, US Census Bureau Trade Data.

Chart 31



Source: Scotiabank Economics, Federal Reserve, Bloomberg.

We conclude this article with charts 29–31 because no discussion on risks to markets and Fed policy can leave behind trade policy. Over 2019, we underestimated the magnitude of the risks to trade policy and their growth-dampening influences upon the world economy. It's still prudent to err on the side of prolonged trade tensions despite a current pause in the action. The US-China 'phase 1' trade agreement has set unachievable targets for China to purchase overall US goods and services. Ditto for just the agricultural products portion. It's unclear if China agreed to this to achieve partial tariff relief and had one over on Trump in the process, or if Trump has set up China to fail and take another end-run at protectionist measures when enforcement efforts may fail. The lagged influences of dollar strength on the current account deficit add to skepticism that the US trade deficit will durably dwindle as it has of late. If not, the politics of trade deficits could well resurface and probably after the election this November.

Table 1

Scotiabank Economics' Canada-US Yield Curve Forecast

	2019	2020				2021			
	(end of quarter, %)								
Canada	**Q4**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
BoC Overnight Target Rate	1.75	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.25
Prime Rate	3.95	3.70	3.45	3.45	3.45	3.45	3.45	3.45	3.45
3-month T-bill	1.66	1.55	1.25	1.25	1.25	1.25	1.25	1.25	1.30
2-year Canada	1.69	1.50	1.35	1.30	1.35	1.40	1.45	1.45	1.50
5-year Canada	1.68	1.45	1.35	1.35	1.40	1.45	1.50	1.55	1.60
10-year Canada	1.70	1.55	1.45	1.50	1.50	1.55	1.60	1.70	1.75
30-year Canada	1.76	1.65	1.60	1.65	1.75	1.80	1.85	1.95	2.00
United States	**Q4**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Fed Funds Target Rate	1.75	1.75	1.75	1.50	1.50	1.50	1.50	1.50	1.50
Prime Rate	4.75	4.75	4.75	4.50	4.50	4.50	4.50	4.50	4.50
3-month T-bill	1.51	1.55	1.55	1.30	1.30	1.30	1.30	1.30	1.30
2-year Treasury	1.57	1.60	1.55	1.50	1.55	1.60	1.65	1.65	1.65
5-year Treasury	1.69	1.65	1.60	1.60	1.65	1.70	1.75	1.80	1.80
10-year Treasury	1.92	1.80	1.75	1.75	1.80	1.85	1.90	1.95	2.00
30-year Treasury	2.39	2.25	2.15	2.20	2.25	2.30	2.35	2.40	2.45

Sources: Scotiabank Economics, Bloomberg.

Mexico

2020: A LACKLUSTER OUTLOOK

- **After a flat 2019, modest growth is expected in 2020 as the negative shocks of last year are absorbed. Stronger growth will require a significant increase in consumer and business confidence.**
- **Prospects for investment generally remain challenging as poor security in some regions paired with changes in the energy policy pose a headwind to what should be a more favorable investment climate now that USMCA seems set for ratification.**
- **The fiscal situation remains challenging to low growth and the government's support for Pemex. To meet fiscal objectives, more spending cuts may be required, as credit rating agencies will be focused on budgetary execution.**
- **Inflation has been declining, opening space for some reductions in monetary reference interest rate that could provide some limited relief, with one more 25 basis point cut expected shortly.**
- **In this environment, we forecast a modest increase of 1.0% GDP growth for 2020. Firms and households are expected to remain very cautious with their spending.**

A COMPLEX MIX FOR 2020

A new year and a new decade are starting, and usually this represents a fresh opportunity to set new goals and to evaluate if we are on the desired path. For the Mexican economy, 2020 will be a decisive year, and prospects remain challenging.

In 2019, a toxic combination of factors generated significant uncertainty, taking growth to a standstill, with many sectors contracting, investment falling and subdued private consumption.

Many of these factors holding back growth appear to be in the rear-view mirror, opening the possibility of a return to growth in 2020. Anxiety produced by commercial frictions between USA and China or by a possible chaotic Brexit have lessened after latest developments. The agreement reached around the USMCA eliminates a key factor contributing to elevated uncertainty, even though a final ratification by the US Senate is still pending. Within Mexico, the natural uneasiness following a change of government and the learning curve of the new officials should now be in the past and no longer be a drag on the economy. Inflation has descended to reach the official target, opening some room for Banco de Mexico to reduce interest rates. The Mexican Peso (MXN) has strengthened to levels below 19 MXN/USD, signaling a low risk perception from international financial investors. Retail sales kept growing at positive real rates and remittances kept rising.

Looking forward, the outlook seems less stressful but not free of concerns, as some factors will keep producing uncertainty, holding back the business

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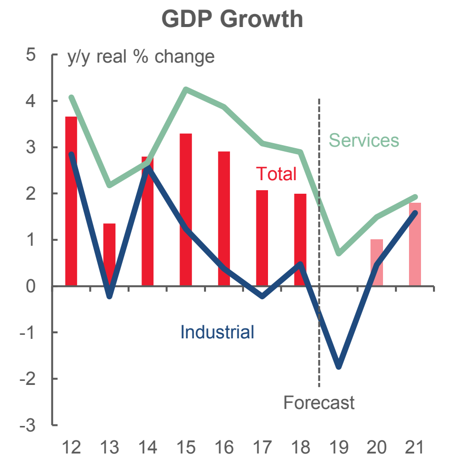
Mexico	2018	2019e	2020f	2021f
Real GDP (annual % change)	2.1	0.0	1.0	1.8
CPI (y/y %, eop)	4.8	2.8	3.8	3.7
Central bank policy rate (%, eop)	8.25	7.25	7.00	7.00
Mexican peso (USDMXN, eop)	19.65	18.85	20.52	21.21

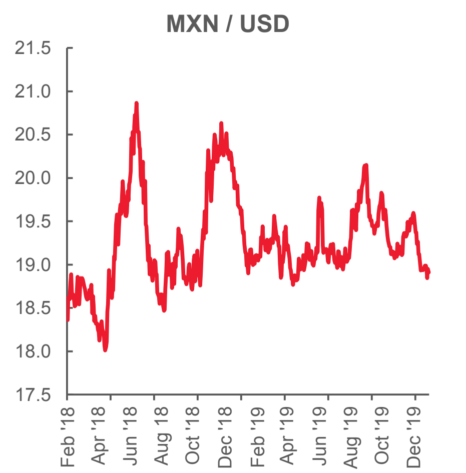
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, INEGI.

Chart 2



Sources: Scotiabank Economics.

environment. On the external front, the US political situation remains complicated, with a polarized population immersed in the impeachment process of President Trump and the 2020 Presidential election. We should not forget how threatening Mexico politically benefitted President Trump, and that could happen again.

On the domestic front, there are some remaining concerns that will weigh on the economy. If aggregate demand reignites, economic growth could accelerate, but it is yet to be seen if firms would reactivate investment projects and households start spending more. For private investment to improve, confidence levels need to rise, which will depend on issues such as strengthening the rule of law and increasing the perception of security. Especially important is to tip the balance between opportunities and risks in favor of the former. One of the perceived obstacles to this is the changes happening in the energy sector, where actions taken by the government are blocking or restricting private sector participation. It is also uncertain if the final USMCA agreement will be good enough to revive large investments.

On the macroeconomic side, fiscal discipline could be at stake, since the lack of economic growth is curbing tax revenues and could compromise fiscal targets. Pemex's performance will be key, as failing to reach the ambitious production plan laid down by the firm will produce poor financial results and will require more support from the federal government, thus weakening the fiscal stance. If things go off plan, a new reduction in credit ratings could occur, which would pressure the financial markets and the MXN.

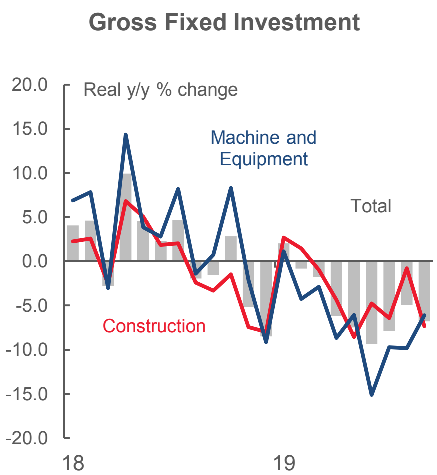
Inflation is expected to rise a bit from the low level reached in 2019, as some of the favorable shocks that helped to bring inflation down fade away, but it should remain within the range defined by Banco de Mexico. It is yet to be seen if the recent 20% increase in minimum wages will have some perceivable impact on inflation, since those firms that don't have profit margins wide enough to absorb a wage increase above productivity growth, could try to transfer it to prices or could translate it into lower employment or higher informality. An increase in year-to-year inflation is anticipated in the first half of the year.

Monetary policy is expected to be data dependent. One more 25 basis point cut of the monetary reference interest rate is expected in the first quarter, then remaining at 7.0% for the rest of the year. Further reductions will depend on inflation and exchange rate performance.

In this environment, a 1.0% growth in GDP is expected for 2020. Investment is expected to contract some more as firms remain skeptical and cautious while private consumption is forecast to grow a little bit faster, but at a weak pace.

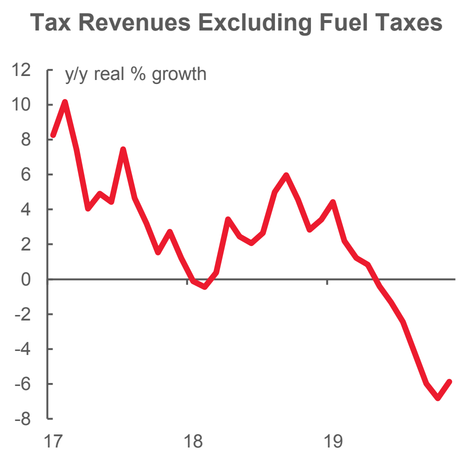
Finally, high uncertainty still lingers over the outlook, with some possibility to have a better than expected growth but a more relevant bias to the downside.

Chart 3



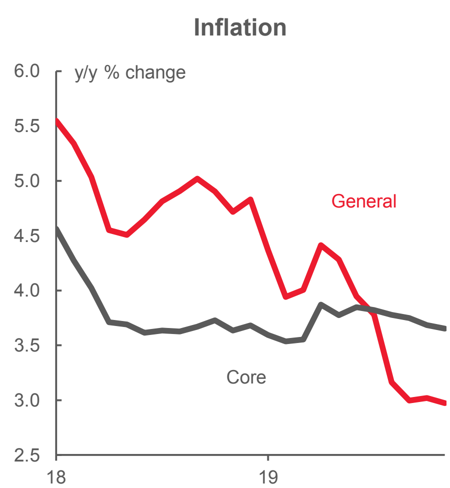
Sources: Scotiabank Economics, INEGI.

Chart 4



Sources: Scotiabank Economics, Ministry of Finance.

Chart 5



Sources: Scotiabank Economics, INEGI.

Brazil

- **As 2019 drew to a close, retail sales, manufacturing PMIs, and industrial confidence indicators showed signs of green shoots for 2020 growth. Still-subdued growth and tame inflation supports the Central Bank of Brazil's (BCB) very loose monetary policy settings, but on the flip side of that, historically low rates make the BRL vulnerable, as we saw in Q3 & Q4 2019. We think BRL pressure is what will force a BCB hike cycle.**
- **The Bolsonaro government delivered a somewhat stronger pension reform than we anticipated, which we see as a great starting point for fiscal consolidation efforts. Now the government needs to deliver on a material reform of both public spending and taxes.**
- **Brazil needs growth-boosting micro-reforms, as well as continuing to open the country's economy. Without progress on this front, alongside the expected increase in investment rates this would bring, Brazil's potential GDP would likely remain around 2%.**

SANTA DELIVERING HAPPIER 2020 ON THE DATA FRONT?

It has been a while since we've seen Brazilian growth forecasts revised upwards. That's precisely what we saw as 2019 drew to a close. In its December update, the BCB upgraded its 2019 GDP forecast from 0.9% to 1.2%, and 2020 from 1.8% to 2.2%. On the inflation front, the BCB expects 3.6% IPCA inflation for 2020. Those forecasts are broadly in line with the last survey among private economists that Bloomberg conducted: 2019 growth of 1.1%, 2020 growth of 2.3% and 2020 inflation of 3.7%. Our own forecasts have also been revised higher on growth, and lower on inflation: for 2019 we expect growth just above 1.1%, and for 2020 we foresee a 100bps acceleration in growth. On the inflation front we now see a 2019 close of 3.3%, rising to an average of 4.0%–4.2% in 2020. However, risks to our inflation forecasts remain tilted to the upside, with the Selic rate (and the whole yield curve) sitting at historic lows, making the BRL very vulnerable.

Among the drivers of the upward growth revision were stronger manufacturing PMIs for November (now printing in the 52–53 range), resilient services PMIs (around 51), material strengthening in retail sales data (+4.2% y/y in October), as well as better industrial confidence numbers (now in the 64 range, materially stronger than the prints below 40 we saw at the lowest point of the downturn in 2015). Note that the more rosy growth picture is still only suggesting a return to the country's modest potential growth rate of around 2%.

2020 KICKS OFF WITH FISCAL REFORM IN FOCUS

Brazil's tax system is so complex, that a local lawyer decided to print out the whole tax code, and came up with a document that weighs 8 tons in paper. The country's cumbersome tax code has many costs. According to the World Bank's "Doing Business" report, Brazil overall scores quite poorly in competitiveness, ranking 124th in the planet in terms of the quality of its business environment. One of the weak links is its tax system, where it ranks 184th, out of 190 economies. The country's byzantine tax & contribution system accounts for an average 65% of company profits, and takes an average 1,500 hours of company time to meet tax obligations. Fiscal

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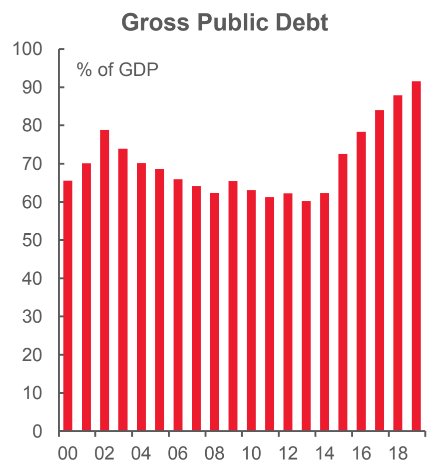
Brazil	2018	2019e	2020f	2021f
Real GDP (annual % change)	1.3	1.1	2.1	2.1
CPI (y/y %, eop)	3.8	3.3	4.2	4.1
Central bank policy rate (%, eop)	6.50	4.50	6.00	7.00
Brazilian real (USDBRL, eop)	3.88	4.09	4.18	4.30

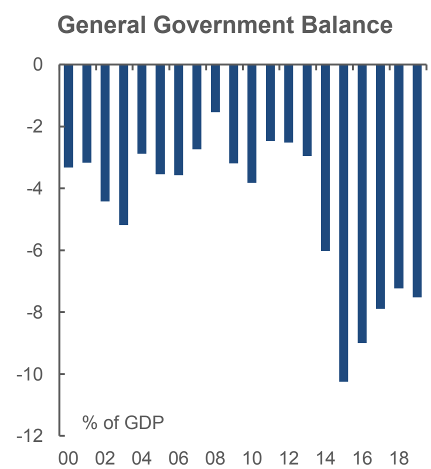
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, IMF.

Chart 2

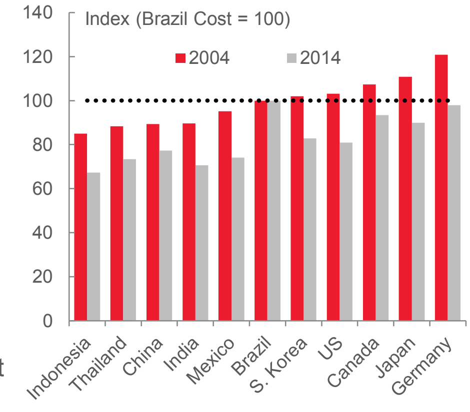


Sources: Scotiabank Economics, IMF.

consolidation could also be one of the factors contributing to improving the country's growth potential (more on this later). A study conducted by the IMF shows that like in much of LATAM, Brazilian public spending is very ineffective. One way of lifting growth could be to reduce the government's very large share of the economy (public spending represents over 38% of GDP—as opposed to much of the region where the government accounts for about a quarter of GDP), putting more resources in the hands of private players to allocate them.

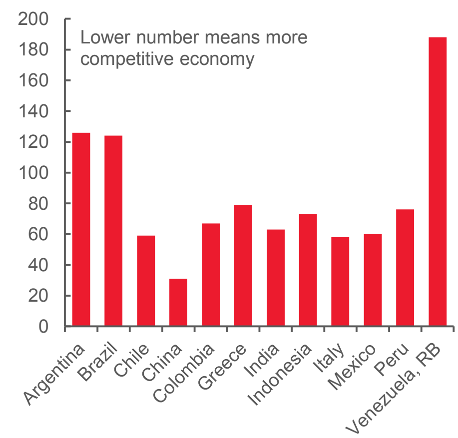
Fiscal sustainability is also an issue. Brazil is rated junk by all major rating agencies (Moody's Ba2, S&P BB-, and Fitch BB-), and to recover investment grade there is a lot of heavy lifting to be done on both the income and spending side of fiscal accounts. Inertially, gross debt could exceed 95% of GDP by the mid-2020s. The pension reform of 2019 was relevant, and is expected to stabilize pension spending, and save about 10 percentage points of spending over the next decade. However, according to IMF Article IV estimates, it only represents about one-third of the total adjustment that needs to be made in order to meet medium-term fiscal targets. Moreover with gross public debt at roughly 90% of GDP, debt having a short 4-year average life, and yields currently sitting below their steady state level—a rebound in the yield curve could eat up more fiscal space than that saved by the pension reform. Based on our estimates, current monetary policy settings are 200bps on the loose side at potential growth (which we expect in 2020), and the 10 year part of the curve should trade at least 550–650bps wide of the US 10-year.

Chart 3 **Manufacturing Costs**



Sources: Scotiabank Economics, Boston Consulting Group.

Chart 4 **Doing Business Rank**



Sources: Scotiabank Economics, World Bank.

WITHOUT HIGHER INVESTMENT, GROWTH SHOULD REMAIN CONSTRAINED

As we mentioned earlier, 2020 kicks off a little more upbeat on the growth front, but we highlight that Brazil has only printed one quarter above 2% y/y growth (Q4 2017) since 2014, and the old glamorous "BRICS" days seem long gone. Without a material increase in the country's investment rate, our estimates suggest the potential growth rate lies somewhere in the 1.5%–2.5% range, which is where the government's own estimates fall as well. Among the 6 largest economies in LATAM, since 2000 Brazil's average investment rate of 18.5% of GDP is only higher than Argentina's (17.3%), and is 3–5 percentage points lower than the averages seen in the PAC countries. How to boost growth?

Brazil is among the more closed major economies in the world. Heading into the 2014 slowdown (that is still lingering), the rise in the cost of manufacturing in Brazil increased more than in all but 3 of the 25 leading global manufacturers (only Austria, France and Switzerland increased more). Since the 2014 slump, which saw Brazil's manufacturing output dip about 15% off its top, the country has failed to get back above 2005 production levels. One potential root for this problem is that, in an economy as closed as Brazil's, there is not enough competition to keep costs in check relative to what happens elsewhere in the world. This cost-driven hangover could be part of the explanation for the slump—opening the economy should help check cost increases.

As measured by the World Bank's Doing Business survey, Brazil ranks as 124th out of 190 economies, in terms of the cost of doing business there. In order to make doing business easier, and boost investment, a very ambitious micro-reform agenda is necessary. According to the World Bank's index, Brazil only approaches being in the top-30% of the most competitive economies in: protecting minority investors (61st), enforcing contracts (58th), and resolving insolvency (77th). Outside of those three categories, Brazil tends to rank closer to the bottom 30%.

BRAZILIAN MARKETS—TOUGHER 2020?

Besides global factors, we see a number of domestic issues contributing to self-driven market moves as well as an increased level of vulnerability to external shocks. Key among them is historically low rate settings by the BCB (the current 4.5% SELIC rate is the lowest on record, and less than half of the 10% average since 2010). Our estimates suggest that Brazil's "neutral real rate" is around 3.5%, meaning that with IPCA at 3.3%, rate settings are decidedly on the loose side (about 200bps). Looking at its carry-risk ratio, BRL now ranks weaker than ARS, COP, MXN and CLP within the region, meaning that its liquidity (second only to MXN in LATAM) and relatively low cost of carry make the BRL vulnerable to risk-off shocks.

Colombia

DOMESTIC DEMAND STRENGTH TO CONTINUE, SOCIAL DISCONTENT IS CONTAINED SO FAR

- **In 2019, the Colombian economy outpaced its main Latam peers, due to idiosyncratic conditions that strengthened domestic demand. In 2020 GDP growth should remain strong as our forecast remains at 3.6% (same is expected for 2021), but external uncertainty and social discontent locally are downward risks.**
- **FX pass-through has been low as usual, and temporary supply shocks that affected headline inflation are about to vanish. In 2020 CPI inflation should converge to the central bank target (3%) and remain there in 2021 in the absence of additional shocks.**
- **In 2020 BanRep will likely adjust the MPR to a neutral level. We anticipate a rate hike of 25bps in 1H20, on the back of closing output gap, CPI inflation converging to the target (3%) and a widening current account deficit.**
- **Social protest leaders are not demanding a change in the status quo. Fiscal policy is in the spotlight since negotiations to end the protests implied some government concessions and extra expenditures.**

Colombian economic activity continues to outpace Latam peers, owing to a strong recovery in domestic demand, relatively stable inflation in the upper half of the target range and an extended period of low interest rates. Investment has benefited from the 2018 Financial Law and 4G infrastructure program, while private consumption accelerated partially a result of a demand shock on perishable goods due to Venezuelan migration. In 2020 Venezuelan migration and the 4G program will continue to boost domestic demand, and a moderation of imports should improve the external balance in the GPD.

November protests in Colombia demonstrated that the country is not insulated from regional political unrest, and have added some downside risks to domestic recovery that were not present in October. Although there is yet no hard data for 4Q19, preliminary calculations lead us to anticipate a rather mild impact from November protests, but we put downside risk on private investment decisions if manifestations remain. All in, our base case scenario continues to be slightly higher growth in 2020 than in 2019, although external uncertainty and local social and political tensions are downward risks. Both can exacerbate the already-high twin deficits. It is worth noting that fiscal policy is in the spotlight since it is already tight and social protest could lead to some deterioration. Finally, on monetary policy we still expect BanRep to remain on hold for the near future, while the temporary pick-up in headline inflation will likely vanish during 1H20.

ECONOMIC RECOVERY REMAINS STRONG ALTHOUGH RISKS ARE TILTED TO THE DOWNSIDE

Colombia's year-to-date GDP to 3Q19 showed that domestic demand growth continues to be strong. Domestic demand grew at 4.5% y/y up to September, well

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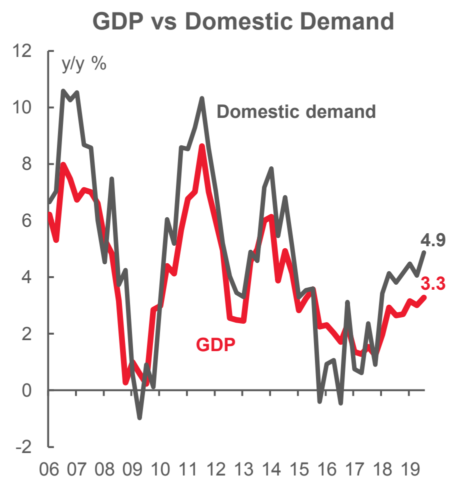
Colombia	2018	2019e	2020f	2021f
Real GDP (annual % change)	2.6	3.2	3.6	3.6
CPI (y/y %, eop)	3.2	3.8	3.3	3.1
Central bank policy rate (%, eop)	4.25	4.25	4.50	4.75
Colombian peso (USDCOP, eop)	3,254	3,287	3,250	3,180

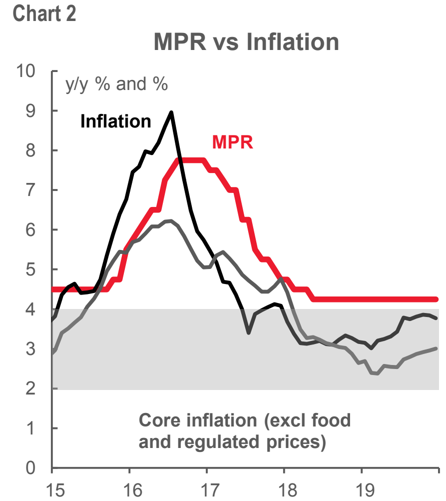
Source: Scotiabank Economics.

Chart 1



Sources: DANE, Scotiabank Economics.

Chart 2



Sources: Scotiabank Economics, Banrep, DANE.

above GDP growth (3.2% y/y). The trade deficit remained wide due to stagnant exports and strong imports of capital goods. Robust capital imports mirror the investment recovery and are one of the reasons why domestic demand outpaced GDP growth. Capital imports goods expanded by 8.3% y/y, and investment has recovered (+4.6% y/y YTD up to 3Q19). On the supply side, services sectors continue to lead growth in 2019, while construction, and specifically building construction, is the only sector of the economy with annual declines (-7.9% y/y YTD up to 3Q19). It is worth noting that the recovery in economic activity is not being reflected by labor dynamics—unemployment remains above 10%. Venezuelan migration may be a partial explanation for the high unemployment rate (supply shock), but is not the whole explanation. Higher automatization and a structural change of the economy to be more services-based and less labor intensive are also affecting labor demand.

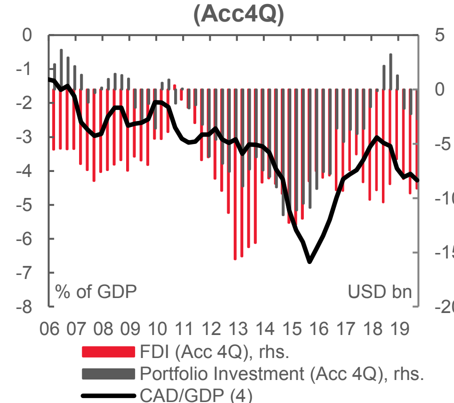
Financial services and commerce grew above 4%. October coincident indicators, such as retail sales, manufacturing, energy demand, and oil production, among others, point to a still-strong domestic demand in 4Q19. Having said that, November's nationwide protests may affect 4Q19 GDP. Preliminary calculations indicate that protests (especially November 21st and 22nd) could cost around 0.07pp of GDP in nominal terms which, although appearing minor, does tilt risks to the downside. Additionally, weaker global demand also puts a downward bias on our economic activity projections, especially for 2020–21.

Inflation continues to hover near BanRep's target range ceiling due to a temporary supply shock in food prices and a mild FX pass-through effect. In fact, headline inflation ended at 3.8% in 2019, while core inflation (excluding food and regulated prices) remains close to 3%, although with a slightly positive trend since March. A base effect in foodstuffs should start to vanish as soon as in January 2020. The only current upside risk for headline inflation in the near term is a higher FX pass-through due to an average depreciation of 11.6% in 2019. However, since we are projecting a mild appreciation this year, we think headline inflation will converge to the central bank target (3%) by 2H20. Beyond 2020 we do not anticipate shocks; therefore, with a closing output gap, inflation in 2021 should continue close to 3%. BanRep's staff and some board members have explicitly said that they prefer to keep policy rate at the current slightly expansionary level (4.25%) for longer. Higher temporary headline inflation has not affected inflation expectations, so far, while economic activity recovery, although stronger than BanRep's expectations, is still below potential output growth. Central bank staff said that, according to their models, normalization of the policy rate (for them neutral real rate is 1.4%) should start beyond 1H20 once it is clear that the output gap is close to zero. Having said that, without a perspective of additional monetary stimulus in developed countries' central banks, depreciation risks and a wider current account deficit would be the trigger to a rate hike. Additionally, an increase in domestic demand also could make BanRep to turn a bit more hawkish. Our base case scenario involves strong domestic demand in 1H20, which we think will trigger one hike to 4.5% as soon as April 2020, although we are aware that domestic demand can surprise us to the downside if political and social uncertainty escalate and investment projects are postponed.

Another important topic that recently has been relevant for markets is the possibility that BanRep intervenes in the FX market if USDCOP continues to weaken. Banrep's Board members have said that, although mechanisms are already set up, any kind of FX intervention is currently not under discussion within the Board. Additionally, it is worth remembering that despite 90% COP depreciation in 2015–2016 BanRep did not intervene in the FX market, arguing that Colombia has a flexible exchange rate. Thus, although the exchange rate touched historical highs back in November 2019 we do not see the possibility of BanRep's intervention in the short run.

Chart 3

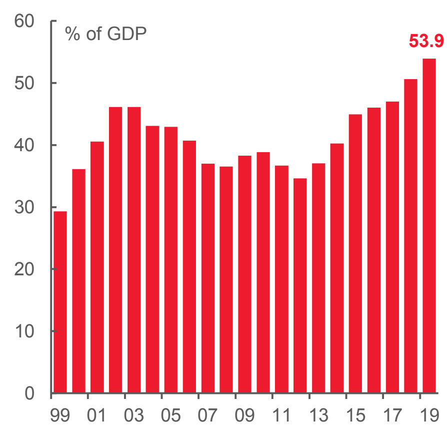
Current Account Deficit (% of GDP) Net FDI and Portfolio Investment (Acc4Q)



Sources: Scotiabank Economics, Banco de la Republica.

Chart 4

Gross Debt



Sources: Scotiabank Economics, Ministerio de Hacienda y Credito Publico.

The 2019 USDCOP weakness was mainly explained by three factors: i) High external imbalance creates a structural and natural demand for dollars that produces depreciation. In fact, the current account deficit reached approximately USD14bn that although well-financed naturally pushed the exchange rate up; ii) External uncertainty due to political and social conflicts around the world triggered risk aversion in big trust funds that liquidated some EM assets and strengthened the dollar against the majority of currencies; and iii) In Latam there was an amplified effect from the global risk aversion due to the regional social unrest that characterized some of the big economies in the region. We think that Trump's campaign ahead of the 2020 US elections may ease the external uncertainty and the USD could weaken. Additionally, in our base case scenario, regional political and social unrest already peaked, and therefore currencies should stabilize a bit in the region. Therefore we expect a mild appreciation of the USDCOP this year although it will be similar to last year's average. For 2020 we think USDCOP will end the year at 3,250 and, on average, the Colombian exchange rate will hover around 3,280.

SOCIAL UNREST IS CONTROLLED, AND DEMANDS ARE FAR FROM CHANGING THE STATUS QUO

Despite protests having lasted longer than initially anticipated, economic and confidence losses have been contained. In fact, preliminary calculations are such that during the most violent and difficult days of the protests (November 21–22) economic losses were between 0.07 and 0.09pp of GDP in nominal terms, and after protests became peaceful, commerce and industry went back to normal. So far, protests have lost steam in number of people (from around 300,000 people on the 21st to less than 1,000 people in recent protests), and protest leaders' petitions have been related to the tax reform that was already passed in congress and reforms of pensions and labor that are not yet under discussion in congress. Therefore, none of the disagreements are trying to change the status quo of a pro-market economic model or change any institutions such as congress, the presidency, central bank independence, free-floating exchange rate framework or fiscal rule. Therefore we have not changed our forecasts due to recent social unrest since we see it as controlled with little significant effect on economic activity.

Having said that, this mild social unrest skewed economic activity risks to the downside for two reasons: i) Duque's governability was shown to be weak and tax reform turned out to be much more costly to the fiscal side. Thus government has to adjust other expenditures to comply with the fiscal rule; and ii) protests can increase uncertainty and make some agents postpone investment projects.

Finally, fiscal and external imbalances continue to be the main concern for longer-term Colombian economic stability. Current account deficit continued to widen in 3Q19 and came in at 4.9% of GDP, although 100% financed by FDI. After negotiations with protesters, the tax reform passed in congress in December 2019 reduced government revenues by 0.3pp of GDP, mainly on the back of VAT rebates to the most vulnerable 20% of the population, which puts more pressure on already tight fiscal accounts after cutting corporate tax from 37% to 32% and with tax evasion estimated to cost 0.5pp of GDP.

Peru

2020: NO REAL ACCELERATION IN GROWTH, BUT GOOD MACRO BALANCES AND LOWER POLITICAL TENSION

- **There has been a sharp decrease in political tension that will likely continue in 2020, despite a new Congress, more corruption news, and the uncertainty of the 2021 elections.**
- **The government is focused more on policy, but not actively enough.**
- **Headline GDP growth will be higher in 2020 (3.0% versus 2.3% in 2019), but the difference is not really material.**
- **Private investment appears to be reviving, but we need more continuity to be convinced.**
- **The PEN is consistently stronger than expected. We're revising our 2020 year-end forecast from 3.42 to 3.35.**
- **The government softens its fiscal rules, even as fiscal accounts surpass expectations.**

Politics has finally taken a back seat to policy, since President Vizcarra legally maneuvered a closing of Congress in September and called for new Congressional elections to take place on January 26th. Political news hasn't disappeared, and corruption and controversies that have led to three cabinet members being replaced have continued to headline newspapers, but political tension has eased, and there is more confidence now that there is a clear electoral path forward. Business sentiment has improved, and the remaining malaise is now more linked to weak economic growth than to politics.

Now that it need not contend with Congress, the government is more focused on the economy and social policy, and has issued a number of decrees with economic and social overtones. Although many of the measures are simply housekeeping (renewing tax exemptions, for example), a number are of greater importance, and point to the direction the government wishes to take. Among these are measures to accelerate 52 high-priority infrastructure projects by dealing with the legal/regulatory obstacles. The government is indeed showing that it is motivated to increase public sector investment, even though it hasn't really been successful in doing so.

As we enter 2020, we are maintaining nearly all of our forecasts for the year. The one exception is the Peruvian sol (PEN), which ended 2019 at 3.31, versus our forecast of 3.35. Given this lower start, together with the ongoing strength of the PEN, and the relatively unexpected improvement in terms of trade, we are revising our 2020 year-end forecast from 3.42 to 3.35. Global uncertainty, a reversal in metal prices, or local political uncertainty (the elections period will begin in earnest at the end of 2020), are risks. However, one of the significant messages given in 2019 was that the PEN has proved exceedingly resilient to local and global uncertainty.

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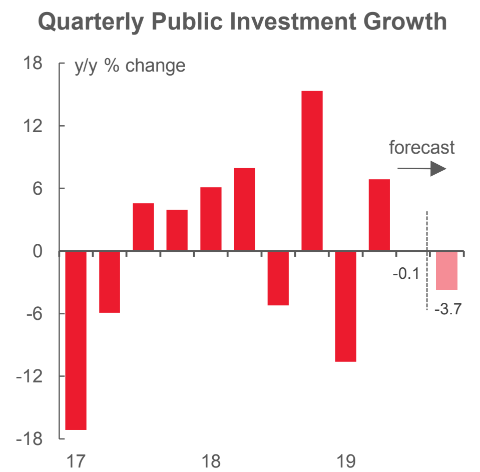
Peru	2018	2019e	2020f	2021f
Real GDP (annual % change)	4.0	2.3	3.0	3.5
CPI (y/y %, eop)	2.2	1.9	2.0	2.3
Central bank policy rate (%, eop)	2.75	2.25	2.25	2.50
Peruvian sol (USDPEN, eop)	3.37	3.31	3.35	3.35

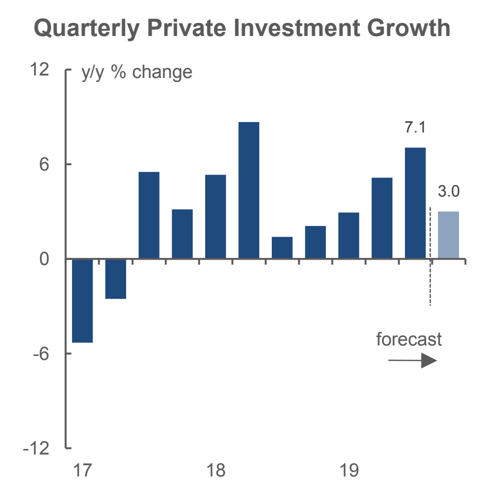
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, BCR.

Chart 2

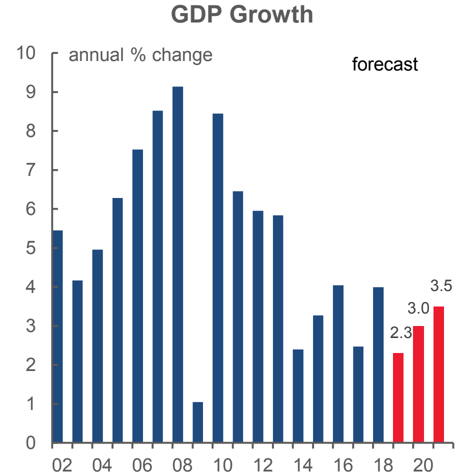


Sources: Scotiabank Economics, BCR.

Another figure we shall be taking a closer look at, once the final 2019 full-year number is released in mid-January, is the 2020 fiscal deficit. However, the change is likely to be mild and not really material. The 2019 fiscal deficit to November was 1.6% of GDP, and is likely to come in at or below our 2% forecast for the full year. This not only reflects weak public spending growth, which is trending at only 1%, but also robust tax revenue, which is rising at a healthy +8% clip, apparently reflecting a better job by the government at collecting sales taxes.

Meanwhile, in December, the government changed the fiscal deficit ceilings for 2021 to 2024. The debt ceiling for 2020 remains at 1.8%. The new ceilings are: 1.8% of GDP for 2021, 1.6% for 2022, 1.3% for 2023, and 1.0% from 2024 onwards (previous: 1.0% from 2021 onwards). These revised ceilings are feasible and more realistic. The new 2021 ceiling coincides with our forecast. For 2020, our forecast is 2.0%, which actually looks a little high given the fact that the deficit is trending under 2% as we close 2019. Note that these ceilings are legally binding (non-compliance is not punished, however), although they will need to be ratified by Congress once a new Parliament is in place.

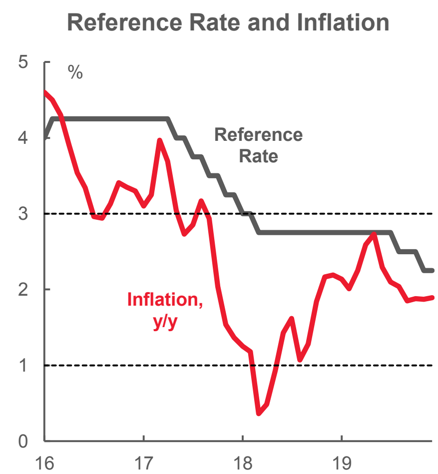
Chart 3



Sources: Scotiabank Economics, BCR.

We are maintaining our GDP growth forecast for 2020 at 3.0%, even though 4Q2019 is appearing mildly weaker than expected. GDP growth for October was a disappointing 2.1%, and growth is trending at 2.2% for the year, just below our 2.3% full-year forecast. Most sectors are performing as expected, but the exceptions—manufacturing and construction (1.2%)—are key to domestic demand. The basic story for 2020 hasn't changed much. It is likely to feel very much like 2019 in terms of domestic demand. Some of the improvement will come from resource sectors (although less so than we initially thought, as the current fishing season is turning out to be dismal), some will come from public sector investment, specifically from regional and local governments which, if precedent holds true, will begin spending more in their second year in office. Finally, some improvement may come from private investment. This is new. Private investment performed mildly better than expected in the second half of 2019. If there is any hopeful sign in terms of growth, this is it. Our forecast of 1.1% private investment growth for 2020 now seems to have more upside to it than we initially thought. Consumption growth will remain stable. Exports may also add a couple of decimal points to growth, as agroindustry continues booming, and mining output stops falling. We are forecasting 3.5% growth for 2021, but admit that uncertainty is so high in this election year (who will win?) that the number is more referential than anything else. The assumption is that the new government will be not only sufficiently market-friendly, but also at least adequate in terms of governance.

Chart 4



Sources: Scotiabank Economics, BCR, INEI, EE.

Inflation for full-year 2019 came in at 1.9%, in line with our 2.0% forecast. We see no looming inflationary pressures in 2020, and, therefore, expect a repeat of close to 2% inflation for the year.

The Central Bank kept its rate at 2.25% in December, as expected. The forward-looking statement given by the CB was very neutral. With inflation hovering around the Central Bank's sweet spot (not too high, not too low), the CB is likely to focus more on growth in determining its reference rate policy in 2020. In 2019 two arguments swayed the CB decision to lower rates: 1. GDP growth significantly below the CB's expectations, and 2. lack of fiscal stimulus, and, therefore, a perceived need for the CB to compensate. Although both factors will likely persist in 2020, they will do so to a much lesser degree, which makes it difficult to determine whether the CB will continue lowering rates. Given this grey area, and the fact that the CB officials do not really seem comfortable reducing rates, we maintain our expectation that it will not reduce rates further in 2020, but consider it a close call.

Chile

SOCIAL UNREST WILL DELAY BUT NOT PREVENT ECONOMIC RECOVERY

- **The social protests of October have increased political uncertainty, affecting business conditions. Accordingly, we have updated our GDP growth projections to 1.0% and 1.4% for 2019 and 2020, respectively. In the political arena, lawmakers have agreed to an April 2020 referendum on changing the Constitution.**
- **We have modestly adjusted downward our forecast for investment growth to 3.8% and 4% for 2019 and 2020, respectively, since a significant amount of public and private investment is at advanced stages of construction. Additionally, higher political and economic uncertainty will probably deepen the deceleration in household consumption, postponing the recovery in domestic demand.**
- **Financial markets saw increased volatility in October and November, along with a significant depreciation of the peso following the first weeks of the outbreak, but volatility eased toward year-end after a successful FX intervention and liquidity provision by the Central Bank. We do not discard the possibility of new outbreaks of volatility during the year.**

MACRO UPDATE

GDP for 3Q19 confirmed the Chilean economy was going through a process of sustained recovery, although not across all sectors. Weak consumption of durable goods contrasted with the solid growth in consumption of services and investment in construction. All in all, as of September, we projected a GDP expansion of 2.7% for 2019. However, the social outbreak of October prompted significant changes in the economic outlook, and we now forecast a GDP growth of 1.0% for this year. This social unrest started when Metro de Santiago, the capital's subway operator, raised the price of its tickets, just weeks after the government announced a 10% hike in electricity bills. This triggered massive protests in several cities around Chile, with waves of violence that had a significant short-term impact as many industries were paralyzed and looting took a toll on infrastructure (chart 1). In the medium-term, the loss in confidence measures will certainly impact investment and consumption decisions (chart 2).

As of September, projected investment projects were increasing and the outlook for this sector was optimistic, especially in the mining industry. But then, the social protests arose and many investment projects suffered changes. It is notable that, according to the investment land tax register published by the *Corporación de Bienes de Capital*, most of the projects in the pipeline for the period 2019–2023 are already under construction, which makes it hard for them to be cancelled. Nevertheless, we do expect a delay in projects that are in preliminary stages (conceptual, basic and detailed engineering), especially in non-tradable sectors. But we still forecast stable growth through 2019 and 2020, although we acknowledge there has been a downward correction in this component.

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Chile	2018	2019e	2020f	2021f
Real GDP (annual % change)	4.0	1.0	1.4	3.0
CPI (y/y %, eop)	2.6	3.0	2.9	3.0
Central bank policy rate (%, eop)	2.75	1.75	1.00	2.00
Chilean peso (USDCLP, eop)	694	753	700	680

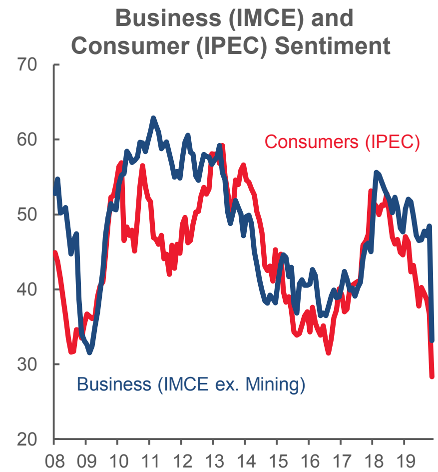
Source: Scotiabank Economics.

Chart 1

Sources: Scotiabank Economics, Central Bank of Chile.

Throughout most of 2019, household consumption was experiencing a deceleration related to higher precautionary savings. This was the result of rising external risks associated with the trade war. In contrast, disposable income was growing at a stable pace as of September. But then the events of October took place, which increased uncertainty levels domestically, and we anticipate a deepening of this precautionary savings behavior, postponing the recovery in confidence and domestic demand. In addition, we have seen a multilateral depreciation of the real exchange rate, which has also contributed to the increased cost of consumption. To compensate for this decline in private consumption, the Government has announced a massive fiscal package, proposing measures that entail a major increase in fiscal spending in 2020, which should be the main driver of growth next year. This increase in government spending is similar to the one implemented after the subprime crisis of 2008.

Chart 2



Sources: Scotiabank Economics, Adimark GFK.

The labor market is already showing signs of deterioration, as reflected in various sources of information. Even though the unemployment rate remained at 7% in October, the impact of October events will be seen in the coming months. On the one hand, the labor market shows weakness in private jobs, especially in manufacturing and commerce, as these sectors have seen reductions in wage-earners jobs. On the other hand, there are still many investment projects under construction, which will require labor force and thus will likely offset the damage in the labor market caused by the social protests of October. We project the unemployment rate will reach 8.5% in 2020.

Inflation normalization is progressing but at a slow pace. The path of inflation in the monetary policy horizon will be determined by two key factors: lower inflationary pressures deriving from widened capacity gaps, and; cost-push pressures above those previously considered, in particular because of the idiosyncratic nature of the recent peso depreciation. The uncertainty that surrounds the future evolution of the macroeconomic scenario is higher than normal, but we forecast an annual inflation slightly above 3% during the first half of 2020, followed by a deceleration toward 2.9% by December next year. Thus, we anticipate the widened capacity gap effect to dominate in the coming months.

Given this scenario, we expect the Central Bank to cut the Monetary Policy Rate to 1.0% by the first half of 2020. The widening of output gaps, in a context of controlled inflation, requires a larger monetary stimulus that could only be reached with a lower MPR. In addition, the FX intervention has been successful, which increases the scope of the Central Bank to expand its monetary stimulus.

In the FX market, we experienced a sharp depreciation of the peso in November—reaching historical levels—and high volatility, leading the Central Bank to intervene. This intervention, followed by a mitigation of violence and political uncertainty, has led the peso to appreciate more than CLP80 (~10%) since late-November. We still expect high volatility in the FX market, especially as the referendum for a new constitution approaches (it will be held in April 2020).

All in all, the Chilean economy suffered a significant shock in October, prompting a change in activity and financial indicators. We have updated our estimates in the short run, but we acknowledge the level of uncertainty has risen sharply, and we still await more economic releases to better assess the impact of this social outbreak.

United Kingdom

PLUS ÇA CHANGE…

- **Although the December general election delivered a decisive parliamentary majority for the Johnson Government, Brexit-related uncertainty is likely to remain elevated and a significant drag on growth over our forecast horizon to end-2021.**
- **We continue to expect the Bank of England to keep its benchmark Bank Rate on hold through end-2021 unless the Johnson Government makes good on its threat to crash out of the post-Brexit transition period without an agreement in place to ensure continued free trade with the European Union.**

WE'LL ALWAYS HAVE BREXIT

The United Kingdom (UK) and Northern Ireland's December 12 general election gave the ruling Conservative Party a clear mandate to "get Brexit done", but the UK's future economic relationship with the European Union is likely to remain under development for years to come. There is now little doubt that the UK will leave the EU on January 31, 2020: the Johnson Government's EU *Withdrawal Agreement Bill* (*WAB*) is expected to be passed into law before end-January, pushed through by the Conservatives' strong parliamentary majority.

Brexit will take the UK into a transition period during which the UK and EU will maintain their current mutual rules while they negotiate their future economic relationship. Prime Minister Johnson has vowed to conclude the transition by end-2020 and the *WAB* current prohibits any extension beyond this point. During the transition, the UK remains in the EU customs union and continues to pay into the EU budget, but loses membership in EU institutions and ceases to have Euro MPs in Brussels. A substantial portion of the Conservative caucus would threaten revolt at a longer spell of taxation without representation.

Since it is entirely unrealistic to expect a comprehensive UK-EU post-Brexit agreement to be hammered out by end-2020, the Johnson Government will either move to amend the *WAB* in the autumn of 2020 to permit an extension of the transition period for multi-year negotiations—or it will settle for a modest deal that substantially increases frictions in UK-EU commerce, likely reintroduces some tariffs, and is an ongoing dampener on UK growth. The remaining 27 EU member states and European Parliament aren't likely to agree on a common negotiating position until March. A high-level UK-EU meeting is subsequently planned for June to check on progress.

Boris Johnson's pledge to push for a "super Canada-plus" deal—an enhanced facsimile of the Comprehensive Economic and Trade Agreement (CETA)—by end-2020 isn't credible. CETA, which came into effect in 2017, took seven years to negotiate and has so far been ratified by only half of the 28 EU member states, and will only be fully implemented seven years from its

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United Kingdom	2018	2019e	2020f	2021f
Real GDP (annual % change)	1.3	1.1	1.2	1.6
CPI (y/y %, eop)	2.1	1.8	2.0	2.1
Central bank policy rate (%, eop)	0.75	0.75	0.75	0.75
UK pound (GBPUSD, eop)	1.28	1.33	1.36	1.42

Source: Scotiabank Economics.

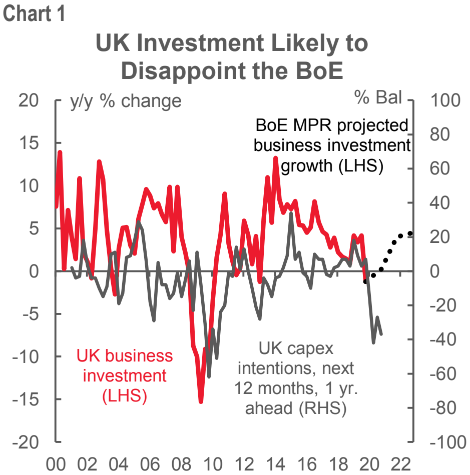
Table 1

BoE November MPR Forecasts

	2019	2020	2021	2022
Real GDP (% y/y)	1.3	1.3	1.8	2.0
CPI Inflation (% y/y)	1.5	1.5	2.0	2.3
LFS unemployment rate (%, eop)	4.0	4.0	3.8	3.5
Output gap (% potential GDP)*	-0.25	-0.25	0.50	1.00
Bank Rate (%, eop)**	0.70	0.50	0.50	0.50

Sources: Scotiabank Economics, BoE Monetary Policy Report.
* +'ve = excess demand, -'ve = excess supply.
** The path for Bank Rate implied by forward market interest rates. The curves are based on overnight index swap rates.

Chart 1



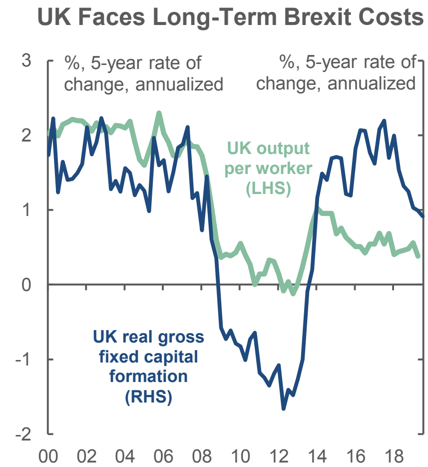
Sources: Scotiabank Economics, ONS, BoE Monetary Policy Report, CBI.

inception, i.e., 2024. CETA eliminates tariffs on 98% of goods traded between Canada and the EU, but maintains a range of regulatory barriers and doesn't provide full access for Canadian financial and other services to the European market.

PM Johnson has argued that a wide-ranging UK-EU deal will be easier to agree than CETA was because standards are currently aligned between the UK and the European common market—but this contradicts the core of the Brexit project. Regaining regulatory sovereignty has always been a major priority for Brexiteers and a divergence in standards from the EU will be nearly unavoidable as the UK pursues free-trade agreements with other countries.

As a result, the UK's Brexit *Sturm und Drang* is set to go on for years, with ongoing uncertainty curbing business activity, consumer confidence, and growth. Any UK attempt to simultaneously open free-trade talks with the US will just delay further an eventual UK-EU arrangement.

Chart 2



Sources: Scotiabank Economics, ONS.

THE POST-ELECTION REBOUND WILL—STILL—HAVE TO WAIT

With Brexit-related uncertainty set to remain elevated and the possibility of new EU-UK trade frictions, consumers and businesses are going to remain tentative through 2021. Growth in 2019 appears to have fallen to its lowest rate outside of a recession since WWII and isn't showing incipient signs of a post-election bounce. Labour markets appear to have come off their mid-2019 boil. As a result, consumer confidence has dropped, retail activity has stagnated, and savings behaviour has turned precautionary. Our pre-election macroeconomic forecasts (table) remain largely unchanged and less optimistic than the Bank of England's (BoE) outlook (table 1).

Major surveys imply that a rebound doesn't lie just over the horizon. December's composite purchasing managers' index (PMI) fell into contractionary territory at 49.3, with manufacturing down markedly at 45.6 and services at 50. The British Chamber of Commerce's (BCC) fourth-quarter survey of 6,500 firms saw a clear downturn in the service sector, while factories' export and domestic orders were negative for two consecutive quarters for the first time in a decade; similarly, manufacturers' investment intentions fell to an eight-year low and capex growth looks set to significantly undershoot the Bank of England's forecast (chart 1). In the context of a decade of poor productivity gains (chart 2), weak investment growth implies that the costs of the UK's Brexit saga will stretch well into the coming decade and be compounded by an ageing population.

CONSERVATIVES WILL SPEND, SPEND, SPEND AND THE BoE WILL REMAIN ON HOLD

The Conservative Party's election platform promised extra fiscal stimulus of 0.2% of GDP by end-2022. Moreover, the Johnson Government has also indicated that it will loosen existing fiscal rules to allow nearly 1% of GDP in additional investment spending in its first post-EU budget due on March 11. Fiscal policy could be even more stimulative and would be focused in five areas: (i) at least GBP 20 bn of additional capital spending; (ii) a change in investment decision rules to de-emphasize gross value added and consider expected improvements in well-being and reductions in regional disparities in an effort to direct more spending to the North and Midlands; (iii) improved public services through additional funding for new hospitals, schools, and vocational training; training additional police officers; and better social care; (iv) meeting the government's 2050 net-zero carbon emissions commitment, including through support for more efficient homes and public buildings, carbon capture, emissions reduction, and alternative energy; and (v) individual and business tax cuts. Together, this would take public spending from 39.3% of GDP in FY2019 to more than 42% by FY2023.

In its first post-election rate-setting decision on December 19, the BoE's Monetary Policy Committee (MPC) confirmed that economic developments remained consistent with its November MPR forecasts and that it didn't see pressures ahead to move rates in either direction. Both the BoE and we expect headline inflation to get back to 2% only at end-2020. Even if 2020 comes in weaker than forecast, the MPC would keep its powder dry for the divergent possibilities of a larger-than-expected fiscal stimulus and/or a hard Brexit at year-end. If the economy over-performs, the MPC would likely be inclined to let it run a bit hot to ensure the rebound is locked in after all of the disruptions of the last three years of Brexit. The change in Governor at mid-March should have little bearing on this outlook.

Eurozone

SETTLING IN

- **The Eurozone economy appears to have stabilized, with reduced trade tensions and export demand from China likely to provide an ongoing floor under European growth. A further pick-up in activity will need to be led by increased credit demand and business investment.**
- **The ECB is expected to maintain its recent package of exceptional monetary measures over the entire forecast horizon. It's not clear that further monetary easing is politically feasible or would be effective.**

GROWTH HAS BOTTOMED, BUT NOT CLEAR IT WILL PICK UP

Eurozone growth continues to underperform, dampened by the gradual slowdown in China, the ongoing Brexit saga, White House protectionism, and the threat of more tariffs to come. Nevertheless, the worst appears to be passing and the currency-area's economy appears to be stabilizing, but with a still-weak hand-off into 2020 owing to drags from inventory drawdowns and trade. We forecast annual real GDP growth to pick up only slightly over the next two years and remain just north of 1%—below potential and too slow to bring unemployment down further and return inflation to the ECB's target by end-2021. Our forecasts are changed only marginally from a quarter ago, and remain consistent with the ECB's own projections (table 1).

Manufacturing has been particularly hard hit by decelerating growth in China and the trade wars (chart 1), but we believe that it has found its bottom and will not slide further and pull down services with it. European exports, particularly from Germany, tend broadly to track a range of major Chinese aggregate demand components, such as public spending (chart 2). With the centenary of the Chinese Communist Party coming in 2021, we expect efforts to sustain Chinese demand will put a floor under their imports of European manufactured goods.

On the domestic front, greater private-sector credit demand will be critical to driving a virtuous circle in which exceptional monetary stimulus leads to increased lending and investment, jobs growth, higher incomes, greater demand for goods and services, and an acceleration in inflation that would permit the ECB to move out of negative-rate territory. A reduction in uncertainty, fiscal stimulus, and foreign demand will be needed to translate banks' survey expectations of stronger business-loan demand into a meaningful pick-up in credit extension and investment. Exceptionally accommodative monetary policy has so far been necessary, but not sufficient, to stimulate borrowing (chart 3).

Europe's consumers could also help lead the recovery in Europe. Retail spending growth remains remarkably resilient across the Eurozone's four largest economies, with sustained gains over the last few months. December's Eurozone consumer confidence readings provide some measure of hope for continued retail strength, with intentions to make major purchases at a one-year high, while savings expectations have come down to a one-year low. It will, however, take several months of similar readings for business to commit to more investment.

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Eurozone	2018	2019e	2020f	2021f
Real GDP (annual % change)	1.9	1.0	1.1	1.3
CPI (y/y %, eop)	1.5	1.2	1.3	1.5
Central bank MRO rate (%, eop)	0.00	0.00	0.00	0.00
Central bank deposit rate (%, eop)	-0.40	-0.50	-0.50	-0.50
Euro (EURUSD, eop)	1.15	1.12	1.16	1.20

Source: Scotiabank Economics.

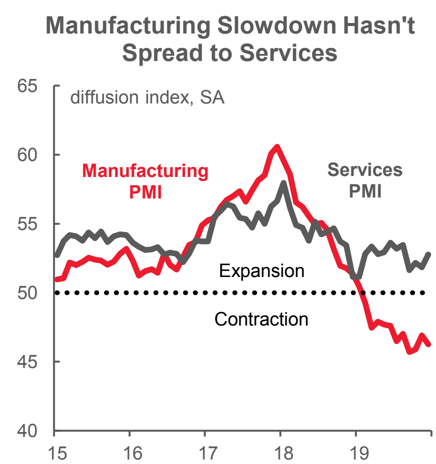
Table 1

ECB December 2019 Macro Projections

	2019	2020	2021	2022
Real GDP, % y/y	1.2	1.1	1.4	1.4
HICP Inflation, % y/y	1.2	1.1	1.4	1.6
Unemployment rate, %, eop	7.6	7.4	7.2	7.1

Sources: Scotiabank Economics, ECB.

Chart 1

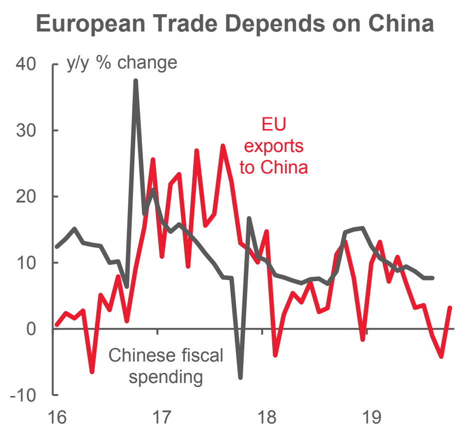


Sources: Scotiabank Economics, IHS Markit.

ECB: WAITING FOR A MIRACLE AT HOME AND FROM ABROAD

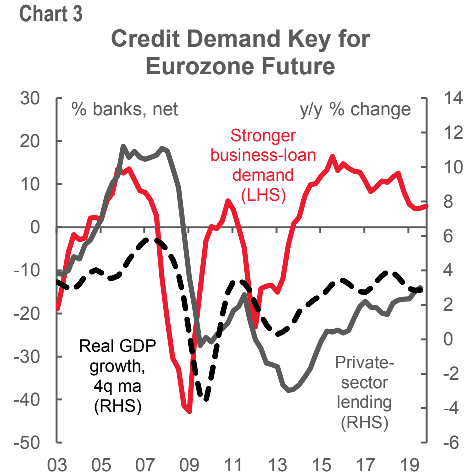
Following the package of exceptional monetary policy easing agreed in September during Mario Draghi's second last meeting as ECB President, the Eurozone continues to have the lowest real policy rates of any major economy (chart 4). Inflation remains well shy of the ECB's just-below 2% target and is not projected—by us, by consensus, or by markets—to get back to the target during our forecast period (chart 5); as a result, we expect the ECB to remain on hold at least through end-2021 as it's not clear a push for further easing is possible. A move by Pres. Lagarde to lower rates again would exacerbate the already stark divisions between the Governing Council's hawks and doves and impose greater costs on the European banking system, without a firm expectation that it would translate into higher credit growth.

Chart 2



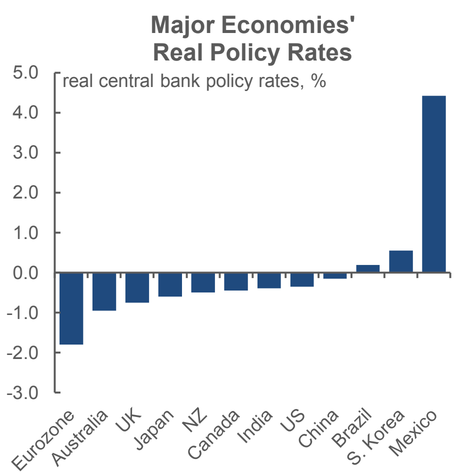
Sources: Scotiabank Economics, Bloomberg, Statistical Office of the European Communities

Chart 3



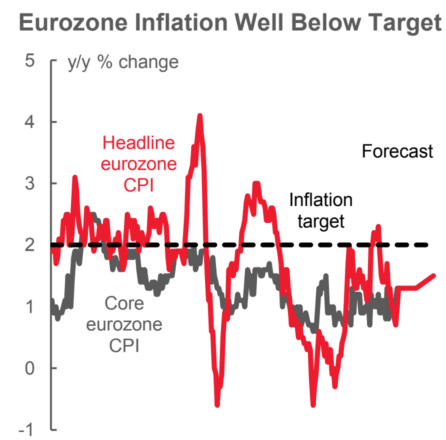
Sources: Scotiabank Economics, ECB, Bloomberg.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

Chart 5



Sources: Scotiabank Economics, Bloomberg.

Instead, we expect the ECB to focus on amplifying Pres. Lagarde's calls for Eurozone members with unused fiscal space to put it to work to stimulate growth. Yet, even if this lobbying is met with extra spending, it will not be enough to have a meaningful impact on Eurozone activity. Under European and national fiscal rules, governments don't have sufficient remaining room to provide meaningful stimulus. The ECB Governing Council will have to hope that a combination of ex-Pres. Draghi's last shot of "whatever it takes, for as long as it takes", combined with easing by nearly all of the world's major central banks, whatever fiscal stimulus it can cajole member states into deploying, and a mild reduction in global trade uncertainty will, together, provide European business with the conditions it needs to borrow and invest at greater scale. With all of these contingencies, we expect the ECB's restarted, open-ended programme of quantitative easing to extend beyond end-2021.

The ECB's coming strategic review will also dominate headlines over the course of 2020, but we expect few meaningful changes to result from it beyond a possible move away from characterizing the inflation target as sitting just below 2% and toward full institutionalisation of symmetry in the objective—a move that ex-Pres. Draghi left only partially complete.

ZOMBIE BREXIT REPLACES HARD BREXIT THREAT

As we explain in the United Kingdom section of this report, we do not foresee a substantial reduction in Brexit-related uncertainty over the next two years. It is incredible to believe PM Johnson's claims that a comprehensive free-trade deal can be negotiated by end-2020. This could imply that London and Brussels will agree on only a minimalist deal to meet the deadline—a deal that would insert substantial trade frictions across the English Channel. Instead, we expect the Johnson Government's self-imposed end-2020 deadline to be extended, with UK-EU trade negotiations continuing for years to come.

China

- **China's annual economic growth is set to drop below 6% by 2021 on the back of global uncertainties, continued trade headwinds, and the economy's ongoing structural transition.**
- **Counter-cyclical fiscal policy is expected to provide support to the economy in the near-term, while economic reforms should improve longer-term growth prospects.**
- **The "phase one" trade deal between the US and China is a welcome development, yet the bilateral relationship will remain tenuous as negotiations move on to more challenging issues.**
- **Intensified inflationary pressures are expected to be transitory, allowing for further monetary policy easing.**

ECONOMIC GROWTH OUTLOOK

The Chinese economy's gradual growth slowdown is set to continue over the coming quarters, despite a recent stabilization in confidence indicators (chart 1) that reflects anticipated improvement in the bilateral trade relationship between China and the US (trade policy discussion to follow). The Chinese leadership is expected to set the 2020 real GDP growth target at around 6% y/y, marking a shift down from the 2019 goal of 6–6½%; the target will be unveiled at the National People's Congress in March 2020.

Regardless of the 2020 growth goal, it is clear that the Chinese economy's momentum is decelerating, as indicated by various high-frequency indicators such as retail sales, industrial profits, and industrial production (chart 2). While the muted trade performance (chart 3) is also contributing to such dynamics, the Chinese economy's continued structural change from an industrial and investment-focused economy to a services and consumer-driven one is leading to a slower—yet more sustainable—growth trajectory. We forecast that China's real GDP growth will decelerate from an estimated 6.1% y/y in 2019 to 5.8% by 2021.

The Chinese government will likely continue its efforts to support the economy through proactive fiscal policies that will complement more accommodative monetary conditions set by the Chinese central bank. We foresee further tax and fee cuts that will underpin the Chinese consumer; support measures for private sector enterprises; as well as additional infrastructure outlays by local governments that focus on urban transportation, utilities facilities, and rural development. In addition to targeted fiscal stimulus efforts, the Chinese leadership remains committed to advancing the country's economic development over the medium and long term. At the annual Central Economic Work Conference, held in December 2019, Chinese policymakers highlighted the need for promoting innovation, accelerating structural reforms and economic liberalization, reducing financial risks, as well as improving citizens' quality of life by policies that focus on the environment, employment, pension, healthcare and housing. We assess that such undertakings will play an important role in boosting China's longer-term growth potential and helping the economy avoid the middle-income trap.

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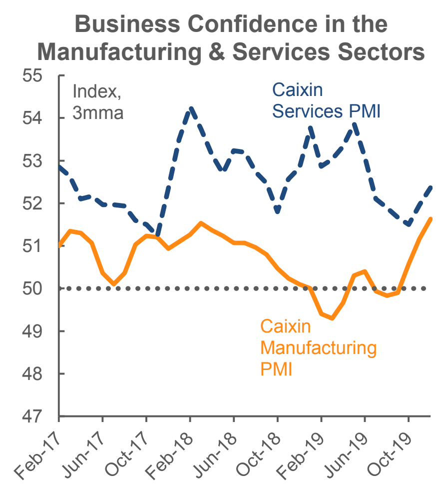
China	2018	2019e	2020f	2021f
Real GDP (annual % change)	6.6	6.1	6.0	5.8
CPI (y/y %, eop)	1.8	4.5	2.1	2.5
Central bank policy rate (%, eop)	4.35	4.15	4.00	4.00
Chinese yuan (USDCNY, eop)	6.88	6.96	6.70	6.50

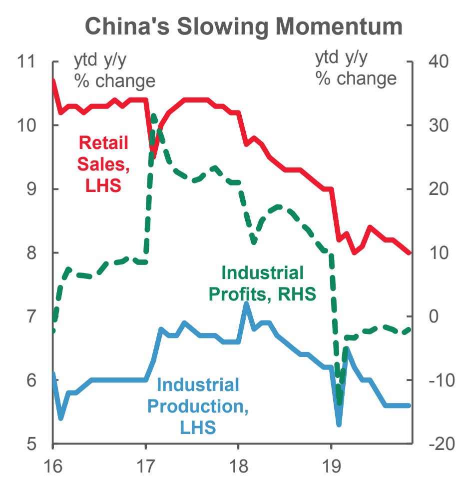
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

TRADE POLICY OUTLOOK

The US and China are in the process of finalizing a "phase one" trade deal. We assess that the deal is a welcome development for China's and the global economic outlook as it should boost confidence and provide some support to trade, yet we highlight that the bilateral US-China relationship will continue to be subject to substantial challenges for the foreseeable future. As a part of the deal, the US agreed not to impose additional tariffs in mid-December 2019 and promised to reduce the 15% tariff introduced in September 2019 to 7.5% on around USD 120 bn worth of imports from China. Nevertheless, 25% tariffs on around USD 250 bn of Chinese goods remain in place, highlighting that the tariff rollback is only modest. China, meanwhile, has agreed to raise its purchases of US goods substantially, including agricultural commodities. Moreover, China has also promised to address some of the US concerns regarding intellectual property rights, technology transfers, financial services sector access, exchange rate, trade expansion, as well as dispute resolution. However, details of such reforms are limited at the time of writing.

Looking beyond the "phase one" deal, it is clear that bilateral tensions will linger for an extended period of time. Negotiations of any subsequent deal will be even more challenging given the difficult issues that need to be solved, such as further enhancements to the "phase one" policies, industrial subsidies, security, technology and China's technological aspirations. Above all, the fact that the world view and economic systems of the two countries are very different will continue to create tensions along the negotiation process. Therefore, we expect "phase two" talks to drag on beyond the US presidential election in November 2020, with the majority of tariffs remaining in place. Moreover, the risk of renewed escalation remains high.

INFLATION AND MONETARY POLICY OUTLOOK

Inflationary pressures have intensified in China on the back of higher food—particularly pork—prices. Headline inflation has reached 4½% y/y, exceeding the government's target of around 3% y/y (chart 4). We assess that the price pressures are transient, with headline inflation expected to decelerate back below the 3% mark before the end of 2020. Moreover, inflation further up the distribution chain remains non-existent, with annual producer price gains currently residing in negative territory.

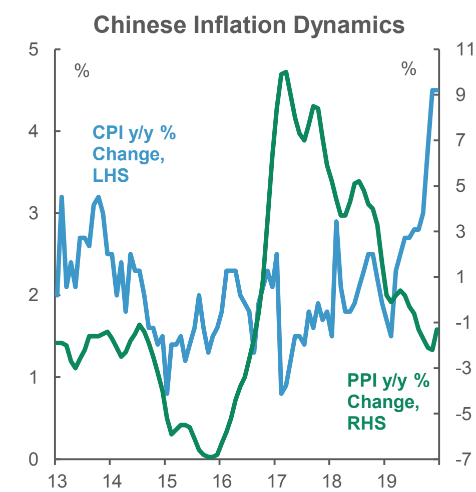
As the uptick in headline inflation does not reflect demand-driven price pressures, the People's Bank of China (PBoC) will likely see through it and maintain accommodative monetary conditions in the economy. Chinese policymakers are trying to find a balance between supporting economic growth via new lending and addressing systemic financial risks stemming from weak and overleveraged borrowers. Accordingly, the PBoC's efforts to improve financial transparency and oversight are set to continue.

The PBoC has rolled out additional monetary stimulus by guiding interest rates gradually lower. The new benchmark lending rate, the 1-year Loan Prime Rate (LPR) has been lowered by 10 basis points to 4.15% since the interest rate reform in August 2019. We expect further cautious reductions in the months ahead. Moreover, monetary policy transmission will get a boost from the fact that since January 1, 2020 Chinese financial institutions have been required to link new loans to the LPR. The PBoC has also been easing monetary conditions by providing liquidity to the financial system and by implementing significant cuts to banks' reserve requirement ratios. In January 2020, the reserve requirement ratio for large banks was lowered by 50 bps to 12.5%, which follows 150 bps of cuts over the course of 2019 (chart 5).

Chart 3

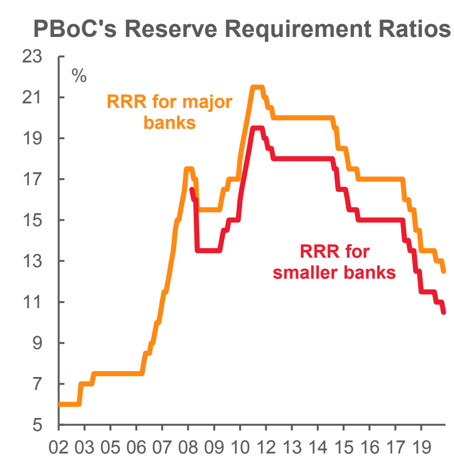
Sources: Scotiabank Economics, Bloomberg, Customs General Administration PRC.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

Chart 5



Sources: Scotiabank Economics, the People's Bank of China, Bloomberg.

Japan

- **Simultaneous domestic and external headwinds weigh on Japan's economic growth momentum.**
- **Loose monetary and fiscal policies will provide support to the economy.**

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ECONOMIC GROWTH OUTLOOK

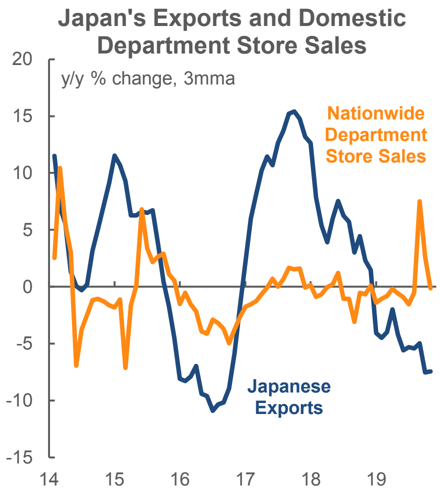
The Japanese economy is weighed down by both domestic and external challenges. The near-term outlook for domestic demand remains fragile, reflecting the increase in the consumption tax rate from 8% to 10% in October 2019. The hike triggered a dip in consumer spending in the final months of 2019 following a pre-tax-hike spike (chart 1). Due to dropping domestic demand, real GDP is set to contract in the final quarter of 2019; the speed of consumer spending recovery will determine how the Japanese economy kicks off 2020. To offset the domestic demand-related weakness, the Japanese government has unveiled a fresh round of fiscal stimulus, totalling JPY13.2 trillion (USD 121 billion, equivalent to 2.4% of GDP). The package—approved by the Cabinet in early December—includes an extra budget for the current fiscal year (April–March) as well as additional spending planned for FY2020. The public outlays will help maintain growth momentum beyond the 2020 Summer Olympics in Tokyo, support businesses that are feeling headwinds related to trade and the consumption tax hike, and focus particularly on infrastructure related to natural disaster preparedness.

Japan's external sector continues to be negatively impacted by weak global demand, the electronics sector downturn, as well as adverse weather that has caused output disruptions. Indeed, the nation's exports have been below year-earlier levels since end-2018 (chart 1). While conditions will remain challenging in 2020, we expect a gradual recovery to unfold over the coming quarters, with sentiment boosted by both the newly-approved trade deal with the US and domestic stimulus efforts. We expect Japan's real GDP to grow by 0.9% y/y in 2020–21, in line with the estimated expansion in 2019.

Japan	2018	2019e	2020f	2021f
Real GDP (annual % change)	0.3	0.9	0.6	1.2
CPI (y/y %, eop)	0.3	0.9	0.6	0.8
Central bank policy rate (%, eop)	-0.10	-0.10	-0.10	-0.10
Japanese yen (USDJPY, eop)	110	108	105	102

Source: Scotiabank Economics.

Chart 1

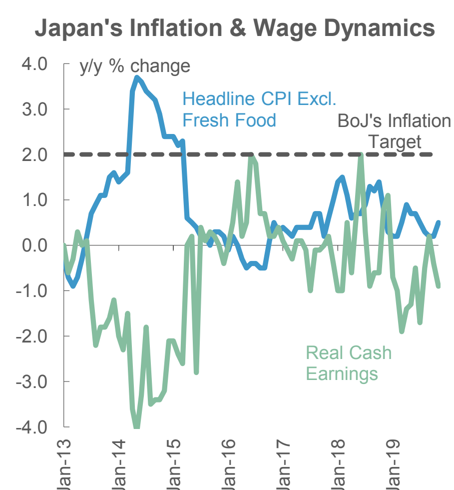


Sources: Scotiabank Economics, Bloomberg.

INFLATION AND MONETARY POLICY OUTLOOK

The Bank of Japan (BoJ) will likely maintain highly accommodative monetary conditions through 2021, continuing the policy outline of "Quantitative and Qualitative Monetary Easing with Yield Curve Control". The central bank's forward guidance suggests that short- and long-term interest rates are expected to remain "at their present or lower levels" as monetary authorities continue their efforts to bring annual inflation toward the central bank's 2% target. Nevertheless, we note that the BoJ has fairly limited policy room left to step up its monetary stimulus efforts if needed. Low inflation will continue to trouble the BoJ over the foreseeable future as both domestic and global uncertainties weigh on economic growth prospects and demand-driven inflationary pressures. The CPI excl. fresh food—the BoJ's preferred inflation measure—currently hovers at 0.5% y/y, significantly below the 2% target (chart 2). While the inflation metric is set to pick up slightly in the near term as the implementation of the consumption tax rate hike in October 2019 feeds through to prices, we forecast that inflation will remain well below the 2% mark through 2021.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

India

- **The economy is suffering from a combination of weak domestic demand and external sector challenges with only a gradual recovery in sight.**
- **Policymakers implement stimulus measures and reform initiatives to underpin the economy's recovery.**
- **Soaring food prices complicate the Reserve Bank of India's monetary policy stimulus efforts.**

ECONOMIC GROWTH OUTLOOK

India's current economic growth performance is soft, highlighting the need for continued fiscal and monetary stimulus efforts by the country's policymakers. Real GDP grew by only 4.5% y/y in the third quarter of 2019—the slowest pace since early-2013—reflecting muted consumer spending and fixed investment growth (chart 1). We estimate that real GDP gains averaged only 5.1% y/y in 2019. Nevertheless, we assess that India is on the verge of a gradual recovery—with annual output gains likely to reach 6.2% and 7.2% in 2020 and 2021, respectively—implying that the economy will remain below its estimated potential growth of 7–7½% for several quarters yet.

Household spending growth will play a key role in India's economic outlook, yet its momentum—both rural and urban—remains muted. Weak demand dynamics combined with the Indian financial sector's troubles are reflected in a continued downward trend in credit growth (chart 2). Business confidence indicators are showing tentative signs of stabilization, boosted by authorities' monetary and fiscal stimulus efforts as well as the 2019 corporate tax reform that reduced India's corporate tax rates from 30% to 22%. We expect gradually improving sentiment to lead to a measured recovery in fixed investment growth and industrial activity in the near term. For the time being though, India's industry remains in the doldrums with vehicle production and output in eight core industries (electricity, steel, refinery products, crude oil, coal, cement, natural gas and fertilizers) contracting (chart 3). India's domestic demand weakness is accompanied by external sector challenges that reflect softer global demand conditions.

Monetary and fiscal support will help with India's nascent recovery. We expect fiscal policy to remain growth supportive in the foreseeable future; the Union Budget for FY2020–21 (April–March) will be unveiled in early February and will likely include measures that address faltering household spending. Nevertheless, we note that the nation's room for significant fiscal stimulus is limited on the back of already weak public finances and downward pressure on tax revenue. In fact, we assess that it is highly unlikely that India will be able to meet the fiscal year 2019–20 (April–March) central government budget deficit target of 3.3% of GDP. Moreover, we note that the fiscal shortfall remains significantly bigger at the general government level, around 7½% of GDP in FY2019–20.

In recent months, the Indian government has made several policy announcements and implemented structural changes to help the economy perform better, including the aforementioned corporate tax reform, public sector bank

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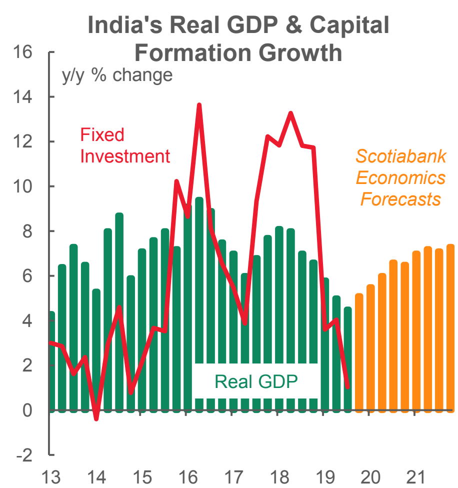
India	2018	2019e	2020f	2021f
Real GDP (annual % change)	7.4	5.1	6.2	7.2
CPI (y/y %, eop)	2.1	6.1	4.3	4.9
Central bank policy rate (%, eop)	6.50	5.15	4.90	5.50
Indian rupee (USDINR, eop)	69.8	71.4	70.0	69.0

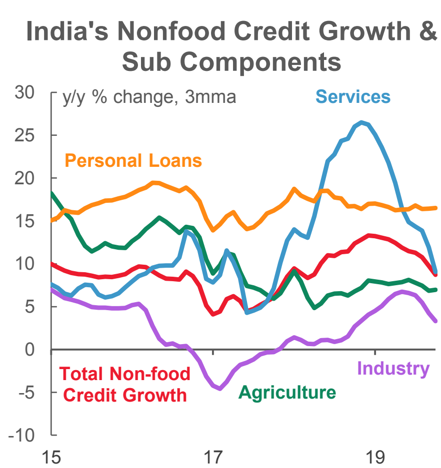
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Reserve Bank of India.

recapitalization and consolidation, FDI liberalization, support for several industries—such as automotive, real estate, and manufacturing industries—and a rollback of a tax surcharge on foreign portfolio investment. Nevertheless, more structural reforms are needed, particularly regarding the complex labour laws that keep the size of Indian manufacturing firms relatively small and prevent them from fully benefiting from the economies of scale. Indeed, expansion of the manufacturing industry and creation of jobs are critical for the economy's outlook; according to the World Bank, around eight million new jobs need to be created annually in India just to absorb new entrants to the labour force. Nevertheless, we expect only modest progress on the reform front. Even though Prime Minister Narendra Modi's Bharatiya Janata Party-led government holds a majority in the lower house (Lok Sabha), its minority position in the upper house (Rajya Sabha) slows policy execution and reform implementation.

INFLATION AND MONETARY POLICY OUTLOOK

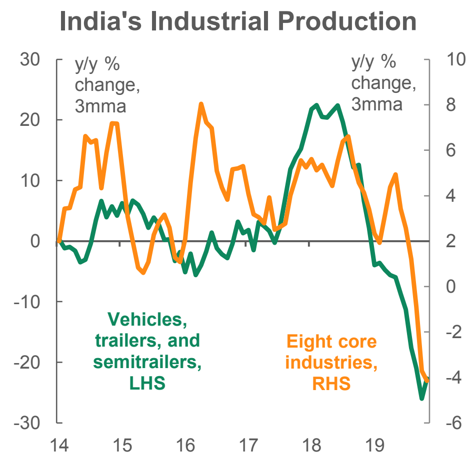
The Reserve Bank of India (RBI) is supporting the economy with monetary stimulus. Between February and October 2019, the benchmark repo rate was reduced in five consecutive monetary policy meetings by a total of 135 basis points (chart 4). Against expectations, the RBI left the key interest rate unchanged at 5.15% following the December 5, 2019 meeting, yet the central bank maintained its "accommodative" policy stance. Monetary authorities assessed that there is monetary policy space left for further interest rate reductions. Indeed, given India's weak economic growth momentum and transient inflationary pressures, we assess that the RBI's monetary easing cycle is not over yet; we forecast one more 25 bps benchmark interest rate cut before mid-2020.

The RBI's policymakers have emphasized that the central bank's main objective is inflation-targeting; accordingly, they want to have greater clarity on inflationary developments before stimulating the economy further. The policymakers have also highlighted that the prior cuts would continue to be transmitted into lower lending rates. The Indian economy continues to struggle with weak monetary policy transmission, partly reflecting the challenges of the country's financial sector. Following the December policy meeting, the RBI assessed that the 135 bps of easing in 2019 had reduced the weighted average lending rates on new rupee loans by only 44 bps, though they expected the transmission to improve in the near term.

India's inflation dynamics have become more complex recently with headline inflation accelerating sharply. Inflation will likely hover near the upper limit of the RBI's annual target of 4% ±2% over the coming months. The pick-up is largely due to a surge in food prices (chart 5) that reflects an erratic monsoon rainfall. Meanwhile, core inflation remains contained at around 3½% y/y on the back of weak demand-driven price pressures.

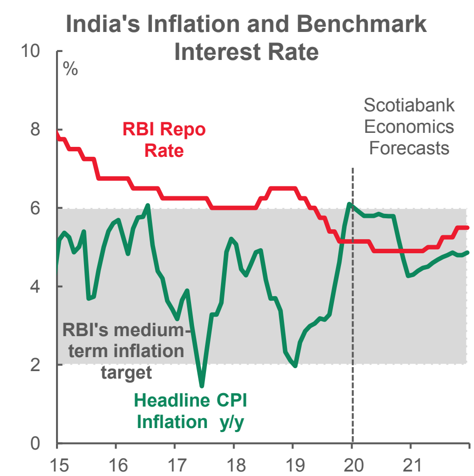
We expect the current headline price pressures to be transitory. Nevertheless, various simultaneous factors will influence India's inflation outlook: 1) the government's fiscal trajectory; 2) prices of vegetables and other food items; 3) rising inflation expectations by households; 4) volatile domestic financial markets; 5) weakness in domestic demand and its impact on core inflation; and 6) international oil prices. While we closely monitor the aforementioned developments, we forecast India's inflation rate to return toward the 4% y/y mark in 2021.

Chart 3



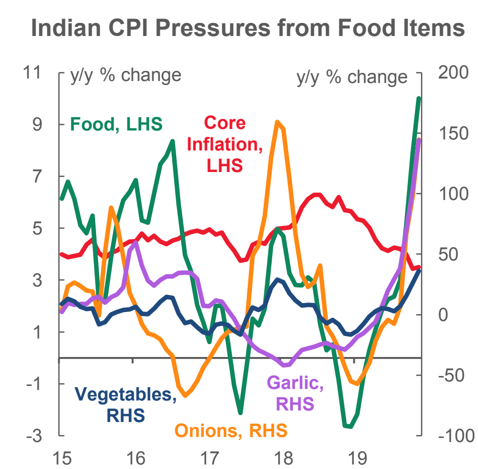
Sources: Scotiabank Economics, Reserve Bank of India, India Ministry of Commerce and Industry.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

Chart 5



Sources: Scotiabank Economics, Central Statistics Office of India, Bloomberg.

South Korea

- **South Korea's export-oriented economy continues to face headwinds, yet a modest recovery is in sight with the help of stimulative policies.**
- **Muted demand-driven price pressures keep inflation low, allowing for accommodative monetary conditions.**

ECONOMIC GROWTH OUTLOOK

The South Korean economy continues to be weighed down by the external sector's challenges. The nation's exports have been below year-earlier levels since the end of 2018 (chart 1) on the back of weaker global demand and the supply chain ripple effects from the US-China trade conflict. Moreover, the global electronics sector downturn continues, reflecting softer Chinese demand and oversupply conditions in the semiconductor sector, which is adjusting to a longer replacement cycle of smartphones.

External sector challenges have spilled over to domestic demand, as reflected by slower momentum in household spending and fixed investment. However, both consumer and business confidence indicators have bottomed out, pointing to a gradual recovery in the months ahead. South Korea's state budget for 2020, passed by the National Assembly in December, remains expansionary. Indeed, public outlays are set to rise by 9.1% y/y in 2020, with focus on such areas as R&D, industrial and export sector support as well as health, welfare, and employment. The government aims to frontload the spending in early 2020—with 70% of the budget to be spent in the first half of the year—in order to maximize the stimulative impact on the economy. The growth-supportive fiscal policies will complement the Bank of Korea's (BoK) monetary easing efforts, helping with the country's economic recovery.

We estimate that South Korea's real GDP grew by slightly less than 2% in 2019. A modest recovery is in sight over the coming quarters with output gains expected to average 2⅓% y/y in 2020–21.

INFLATION AND MONETARY POLICY OUTLOOK

South Korea's monetary conditions will remain accommodative for an extended period of time. The BoK lowered the benchmark interest rate by 50 basis points to 1.25% between July and October, 2019 (chart 2). The central bank will likely leave the policy rate unchanged over the near term, as it assesses the impact of the recent rate cuts and monitors how global trade uncertainties evolve. Nevertheless, BoK Governor Lee Ju-yeol has emphasized that the central bank has room for further policy action if needed. Indeed, developments on the US-China trade front will play a key role in future monetary policy decisions as the South Korean economy continues to feel the adverse impact of trade-related challenges.

Against the backdrop of economic weakness, South Korea's inflationary pressures remain low, with headline inflation closing 2019 at less than 1% y/y. Core inflation is equally muted (chart 2). We do not expect annual headline inflation to reach the BoK's 2% y/y target before 2021, allowing the BoK to maintain a loose monetary policy stance.

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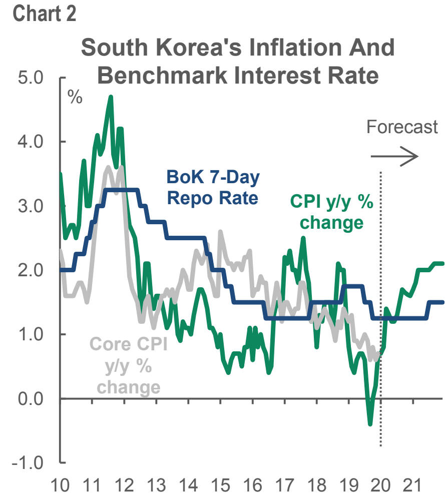
South Korea	2018	2019e	2020f	2021f
Real GDP (annual % change)	2.7	1.8	2.1	2.5
CPI (y/y %, eop)	1.3	0.7	1.6	2.1
Central bank policy rate (%, eop)	1.75	1.25	1.25	1.50
South Korean won (USDKRW, eop)	1,116	1,156	1,120	1,080

Source: Scotiabank Economics.

Chart 1

Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Australia

- **Australia's economic growth is expected to pick up in 2020, yet momentum is set to remain below the economy's potential.**
- **Labour and housing market dynamics will likely pull the Australian consumer in opposite directions.**
- **Below-target inflation allows for accommodative monetary policy; fiscal stimulus space exists if needed.**

ECONOMIC GROWTH OUTLOOK

The Australian economy has shifted to a lower economic growth trajectory on the back of global growth concerns and soft domestic demand momentum. We estimate that Australia's real GDP expanded by only 1.8% y/y in 2019, well below the nation's estimated potential growth of 2¾%. Nevertheless, accommodative monetary policy, tax cuts, public infrastructure outlays, and a recovering housing market should help the economy to regain momentum—albeit only gradually—over the coming quarters, with output gains likely to average 2.3% y/y in 2020–21.

Despite weak global demand dynamics, Australia's external sector is contributing to growth thanks to a weaker Australian dollar, improved terms of trade, and solid commodities demand in China (chart 1). Meanwhile, Australia is less integrated into the Asia-Pacific manufacturing supply chains than many of its regional peers, which insulates the country from some of the ripple effects stemming from the US-China trade conflict.

On the domestic demand side, the outlook for the Australian consumer—which accounts for close to 60% of the nation's GDP—is impacted by two key factors: the labour market and the residential real estate market, which are giving mixed signals about future spending prospects with the former moderating and the latter strengthening. Meanwhile, the impact of wildfires on consumer confidence and the economy at large has yet to transpire.

Some signs of softening in Australia's labour market have started to emerge, yet employment conditions still remain solid by historical standards. Over the past six months to November, an average of 17,000 new jobs has been added to the economy every month, down from the 25,500 average recorded in the preceding 6-month period. Furthermore, the share of full-time jobs in new positions has decreased, while the unemployment rate has crept up slightly yet this partially reflects higher labour force participation (chart 2). We expect some further softening in the labour market over the coming quarters, which will keep a lid on wage growth and consumer spending growth.

Meanwhile, consumer confidence will be supported by the continued rebound in Australia's residential property market (chart 3), which reflects lower interest rates, relaxation of home loan lending restrictions, and recent income tax cuts. House prices in large cities have recorded monthly price gains since July 2019, though large regional differences remain in place. We remain cautious on the sustainability of the price recovery against the backdrop of high household debt

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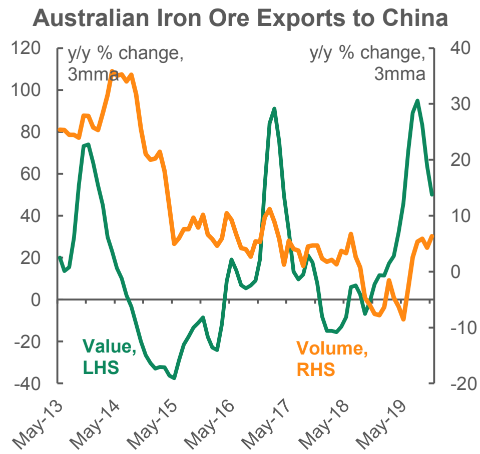
Australia	2018	2019e	2020f	2021f
Real GDP (annual % change)	2.7	1.8	2.1	2.5
CPI (y/y %, eop)	1.8	1.6	1.9	2.1
Central bank policy rate (%, eop)	1.50	0.75	0.50	0.50
Australian dollar (AUDUSD, eop)	0.70	0.68	0.72	0.74

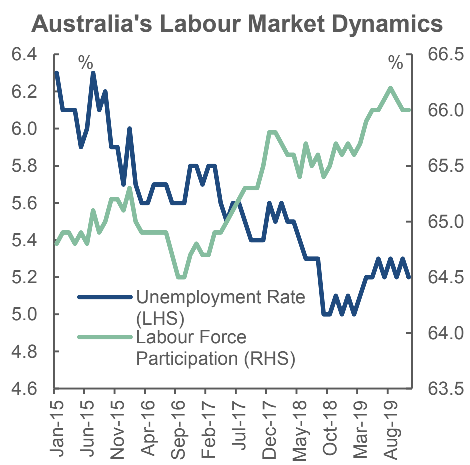
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Australian Bureau of Statistics.

Chart 2



Sources: Scotiabank Economics, Australian Bureau of Statistics.

levels, muted income growth, weaker employment gains, and associated affordability challenges. At the same time, however, limited future supply will provide some support to the market as a meaningful recovery in housing starts has not yet transpired (chart 4).

Australia's fiscal policy remains prudent. The centre-right Liberal-National Coalition government led by Prime Minister Scott Morrison maintains its commitment to bringing the budget to a surplus position in the current fiscal year (July–June). We note that the nation has sufficient fiscal room to provide further support to the economy if needed to complement the Reserve Bank of Australia's (RBA) monetary stimulus efforts. While private sector business investment plans remain soft on the back of persistent uncertainty about the economy's outlook, public sector outlays—particularly focusing on transport infrastructure—will support construction activity over the coming quarters.

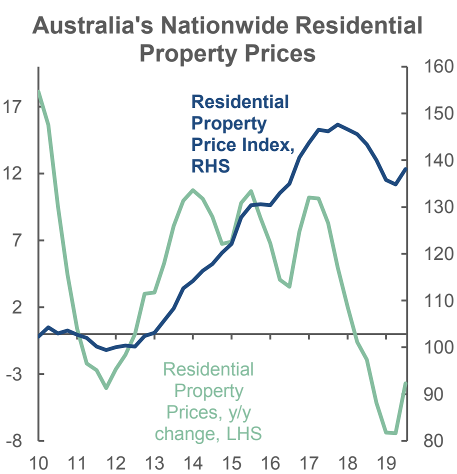
INFLATION AND MONETARY POLICY OUTLOOK

Australia's headline inflation remains below the RBA's 2–3% annual inflation target, with prices rising by 1.7% y/y in the third quarter of 2019 (chart 5). Demand-driven price pressures will likely remain largely absent in the foreseeable future; we expect headline inflation to accelerate only gradually, reaching the lower end of the RBA's target range in early 2021.

Enabled by low inflationary pressures, the RBA remains committed to supporting the economy through accommodative monetary policy. The central bank has lowered the benchmark cash rate by 75 basis points since June 2019 (chart 5). Following the most recent monetary policy meeting in early December, the RBA left the key rate unchanged at 0.75% in order to assess the impact of recent rate cuts. Nevertheless, RBA Governor Philip Lowe has highlighted that the RBA is prepared to ease monetary policy further if needed to reach full employment in the economy and to bring inflation toward the target. Governor Lowe has also indicated that the central bank would consider quantitative easing—i.e. purchasing of government bonds in the secondary market—in a situation where the cash rate had reached 0.25%. However, he has emphasized that conditions for implementing such policy measures have not been reached, and the near-term outlook does not indicate a need for such action either.

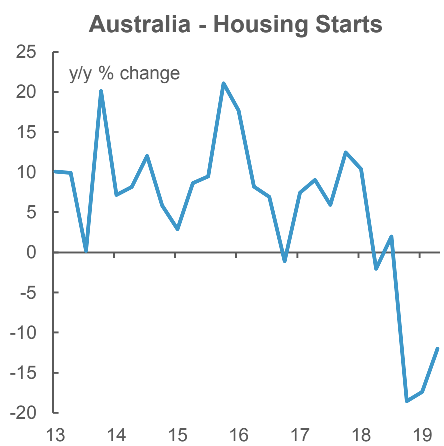
International developments—particularly the US-China trade talks—will play a role in Australia's monetary policy outlook, as they will influence consumer and business confidence and spending decisions. Additionally, the wildfires as well as domestic labour market conditions will factor into the RBA's policy conduct. While global downside risks have lately diminished somewhat, we maintain our expectation that Australia's labour market will fail to strengthen in the near term. Accordingly, we assess that the RBA will cut the benchmark interest rate one more time in this easing cycle, taking the cash rate to 0.50% in the first half of 2020.

Chart 3



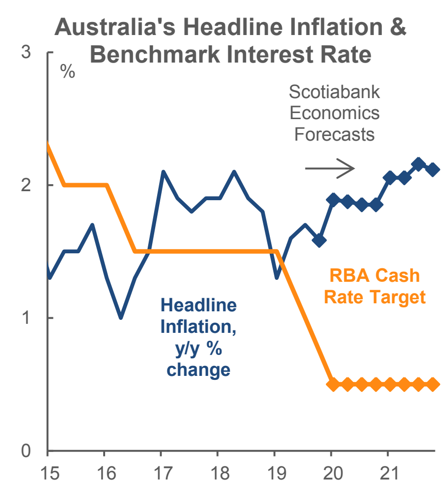
Sources: Scotiabank Economics, Australian Bureau of Statistics, Bloomberg.

Chart 4



Sources: Scotiabank Economics, Australian Bureau of Statistics, Bloomberg.

Chart 5



Sources: Scotiabank Economics, Bloomberg.

Commodities

- **Macro sentiment is expected to continue dominating commodity price formation in 2020 before risks ease in 2021 and commodities are able to resume price paths driven by commodity-specific fundamentals.**
- **A mild easing of US-China trade tensions on the back of the soon-to-be-signed Phase I deal as well as continually worsening US-Iran relations have boosted the prospects for oil and copper prices while modestly dimming the outlook for gold in 2020.**

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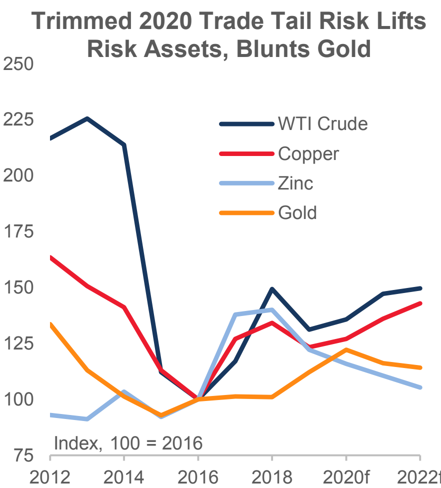
2020 BRINGS FAMILIAR RISKS FOR COMMODITY MARKET, THOUGH THE WORST MAY HAVE BEEN AVOIDED

The defining feature of commodity price formation through 2019 was market sentiment toward Washington and Beijing's capricious trade relationship—pushing around contracts far more than any commodity-specific fundamental news. This despite the fact that last year witnessed historic supply-side risk events, including massive protests in copper juggernaut Chile, a tragic tailings dam collapse in Brazil that idled much of the country's iron ore mines, ever-ramping Iranian regional aggression culminating in the largest-ever disruption to Saudi oil supplies, and most recently the largest shock to US-Iran relations since the 1979 hostage crisis in the targeted killing of Iran's most powerful military leader. Still, it was the on-again-off-again headlines related to this-or-that US-China trade development that packed the biggest price punch, bringing commodities higher and lower together as a pack with few exceptions.

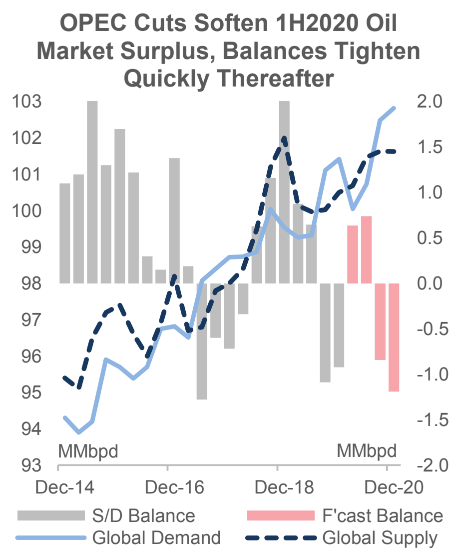
We expect another year of trade policy dominance in 2020 before risks gradually abate following the US presidential election, regardless of who lays claim to the Oval Office. Our view remains more or less unchanged from our last quarterly forecast release, though the avoidance of additional tariffs scheduled to take effect on December 15th and the announcement of a potential Phase I trade deal to be signed on January 15th (according to the President's Twitter account, so we're taking it with healthy wallop of salt) signals the first real progress on the trade file since the trade war began in earnest in mid-2018. While we remain skeptically optimistic that trade negotiations will advance further over the coming months we are not yet committing to an outright reduction in trade risks, rather trimming our assumed probability of a worst-case trade outcome—namely the further descent into trade animosity between the world's two largest economies and ramp ups of even less predictable non-tariff barriers. Our commodity price outlook remains mostly unchanged from last quarter (chart 1), save for very modest upgrades to copper and a minor trimming to gold's price path, the two most risk-sensitive commodities, as well as an upgrade to the crude price outlook to account for increased supply risk following the US killing of Iran's most influential general.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



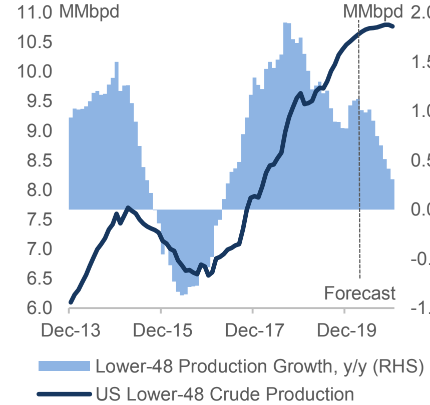
Sources: Scotiabank Economics, Scotiabank GBM, IEA, EIA, JODI, OPEC.

ENERGY: OIL MARKET SPEED BUMP AHEAD, STRENGTH THEREAFTER

Oil prices rallied through December on the back of positive US-China trade developments despite widely anticipated surplus conditions in the first half of 2020 (chart 2). Crude prices are expected to ease slightly as this sentiment normalizes, forward curves flip into mild contango, and global inventories begin to rise, signalling the onset of surplus supply conditions that are anticipated to persist until the second half of the year. But this surplus reflects a different kind of supply than that which has cast a bearish cloud over crude contracts since late-2014—not a US shale surge or OPEC battle for market share, but a coincidence of timing that has three long-lead-time, offshore jurisdictions ramping new project output together in Brazil's pre-salt, a Norwegian mega-project in the North Sea, and the first-ever barrels produced in tiny Guyana, which is now expected to shift from no production to the highest per-capita production on the planet.

Chart 3

US Crude Production Growth Slipping Fast



Sources: Scotiabank Economics, EIA.

Conditions begin to tighten quickly in the second half of 2020 into 2021 after the oil market progresses past these one-time boosts to global supply. US shale supply growth is expected to exit 2020 at less than 1 MMbpd y/y down from more than 2 MMbpd in 2018 as drilling activity continues to stagnate and productivity plateaus—US production growth is expected to stabilize in the early-2020s at around 300–500 kbpd annually (chart 3), which will leave room for OPEC+ to finally begin returning withheld barrels to the market and still have enough additional demand buffer for other non-OPEC countries outside the US (Canada as curtailment is lifted, Brazilian offshore, etc.) to organically grow output as well. Demand growth is expected to begin accelerating again in 2021 as trade uncertainly rolls off and the global economy makes up for lost time amidst delayed investment decisions in 2019–2020—demand growth of only roughly 1 MMbpd last year was well below the market's trend growth rate.

Crude prices received an additional, classic geopolitical risk boost following news that US air strikes on Baghdad airport killed Iran's Major General Qassim Suleimani, head of the elite Quds force within the Islamic Revolutionary Guards Corps and effectively the second most powerful individual in the Iranian government behind only the Supreme Leader. How Iran decides to retaliate for the assassination of one of their upper most leaders remains to be seen, but all else equal this event considerably increases the risk of further escalation between Washington and Iran and potential spillovers to oil supply assets in the region. Factoring for this increased downside supply risk, WTI oil prices are now forecast to average $59/bbl in 2020 with prices weakening in 1H2020 alongside the supply glut and rising thereafter as conditions tighten to average $64/bbl in 2021.

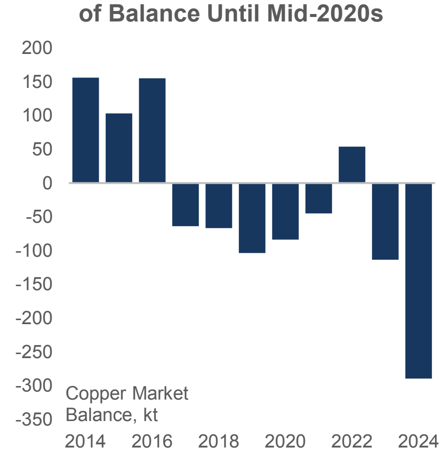
The differential borne by barrels of Canadian heavy crude (WCS) is forecast to rise to $19/bbl under WTI in 2020 and $24/bbl in 2021 as the Alberta government continues to ease its curtailment policy, pipeline capacity remains insufficient even after the assumed end-2020 start-up of Line 3, and necessary oil-by-rail economics persist as a requirement to balance the Western Canadian oil market.

INDUSTRIAL METALS: STEADY SENTIMENT TO HOLD PRICES UNTIL FUNDAMENTALS REASSERT THEMSELVES IN 2021

The trade policy narrative tugging around commodity prices last year was most evident in the base metals complex and we expect another year of relatively tight metals performance in 2020, while steel complex inputs like iron ore and coking coal are expected to better track Chinese domestic policy. Global PMI readings appear to have bottomed out in the latter months of 2019 and look to be rebounding—even as trade uncertainty remains elevated heading into the 2020 US presidential election industrial activity is expected to present stronger than last year's anemic showing.

Chart 4

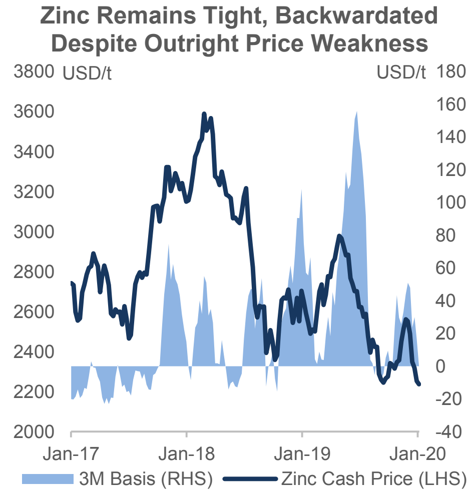
Copper Market Trading Either Side of Balance Until Mid-2020s



Sources: Scotiabank Economics, Wood Mackenzie.

Part of the reason that sentiment has been able to direct copper prices to this extent is that copper's physical balances aren't particularly extreme (chart 4) Demand growth was relatively steady but weak last year and we expect more of the same over the coming quarters, balanced between weak manufacturing demand in China on the back of, among other things, the drawdown of air condition inventory following the implementation of new efficiency standards, and the likely upswing of grid investment related to stronger stimulus efforts from Beijing. Despite relatively even physical balances, exchange-listed copper inventories are down 60% from early-2018 and 37% since late-3Q19. Speculative positioning in Comex and LME futures contracts remains well below early-2018 levels before the US-China trade dispute really gained steam but has steadily improved over the past few months as hope for some kind of agreement between Washington and Beijing approaches validation in the signing of a Phase I deal scheduled for mid-2020. Commensurate with the tail-risk trimming mentioned above, we have mildly upgraded our copper price forecast for 2020 to $2.80/lb (from $2.75/lb last quarter) and 2021 at $3.00/lb.

Chart 5



Sources: Scotiabank Economics, LME.

Zinc offered a telling illustration of how powerful trade war sentiment effects have been on metals prices, with contracts falling by one-third since mid-2018 at the same time that all evidence continued to suggest extremely tight physical markets (chart 5). Despite the surge in mine supply brought on by decade-high prices last year, the surplus of concentrates have thus-far failed to materialize in refined metal balances due to tightness and bottlenecks in the smelting sector; environmental regulations in China are further straining the domestic smelting sector that would otherwise be ramping up utilization at their plants to capture the favourable difference between loose concentrate markets and tight metal markets. This tightness in metal markets is vividly evident in the exaggerated backwardation zinc contracts have experienced over the past few years; even if that backwardation is easing, it looks like we're still at least a few months out before the market reaches any meaningful near-term balance. Zinc metal inventories remain perilously low and will take time to re-accumulate after the market enters a surplus period. While we continue to expect that this concentrate surplus will work its way through into the finished metal market this year, smelting sector tightness is expected to keep prices more or less around current levels ($1.08/lb in 2020, $1.05/lb in 2021) until metal surpluses can replenish anemic inventory levels.

PRECIOUS METALS: GOLD FORECAST TRIMMED IN LINE WITH REDUCED TAIL RISK, DEATH OF IRANIAN GENERAL PROVIDES TEMPORARY BOOST

Bullion prices received a fresh risk bid following the targeted killing of Iran's Major General Qassim Suleimani (fuller analysis above in Energy section), nearing a 7-year high of $1,600/oz (chart 6). While we expect these recent heights to be fleeting as the prospect of outright military confrontation between Washington and Tehran diminishes over the coming weeks, we continue to believe that 2020 will be a good year for gold pricing given lingering US-Iran concerns, a particularly contentious US presidential election, currently-frothy equity prices with mounting downside risks, and still-hesitant central banks waiting for more political certainty before resuming their prior tightening path.

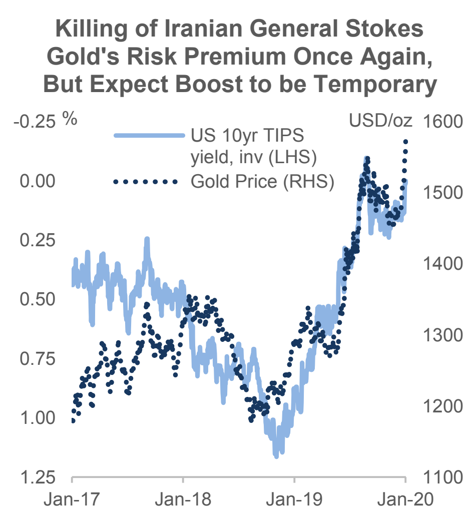
Gold prices are forecast to average a near-term annual peak of $1525/oz in 2020 before declining to $1450/oz in 2021 and further in the early 2020s on the back of falling political uncertainty and an eventual resumption of global monetary policy tightening.

Table 1

Commodities	2010–2018			Annual Average		
	Low	Avg.	High	2019	2020f	2021f
WTI Oil (USD/bbl)	26	74	114	57	59	64
Brent Oil (USD/bbl)	28	82	127	64	63	67
WCS - WTI Discount* (USD/bbl)	-50	-18	-7	-14	-20	-24
Nymex Natural Gas (USD/mmbtu)	1.64	3.39	6.15	2.53	2.39	2.63
Copper (USD/lb)	1.96	3.10	4.60	2.72	2.80	3.00
Zinc (USD/lb)	0.66	1.02	1.64	1.16	1.10	1.05
Nickel (USD/lb)	3.50	7.00	13.17	6.32	6.50	7.00
Aluminium (USD/lb)	0.65	0.89	1.26	0.81	0.90	0.90
Iron Ore (USD/tonne)	39	101	194	94	78	70
Metallurgical Coal (USD/tonne)	81	179	330	184	145	150
Gold, London PM Fix (USD/oz)	1,049	1,342	1,895	1,393	1,525	1,450
Silver, London PM Fix (USD/oz)	13.58	21.64	48.70	16.21	18.75	17.75

* 2008–18 average.
Sources: Scotiabank Economics, Bloomberg.

Chart 6



Sources: Scotiabank Economics, Bloomberg.

Foreign Exchange

- **USD expected to soften if global risks dissipate.**

The cloud of risk that hung over markets through 2019 is showing some signs of dispersing as 2020 gets underway; a trade truce between the US and China has broken out but the fog of Brexit remains visible. At the very least, central bankers appear less concerned about downside risks facing the global economy and less inclined to provide any more accommodation in support of growth as a result. The **US dollar (USD)** has benefitted significantly from safe-haven demand over the past year amid trade uncertainty in particular. Analysis by Scotiabank Economics estimated that the USD was trading some 11% above its fundamental value in Q4 last year due to uncertainty driving demand for USD-denominated safe-haven assets. We expect reduced demand for safety to undercut the USD in the coming year, assuming that newly evolving tensions in the Middle East do not develop into a more serious conflagration.

In trade-weighted terms, the USD remains relatively firm, holding near the highest level since 2017. However, it has failed to advance at all over the past year and we remain of the opinion that it is more likely to fall than rise in the medium term. Progress on trade will lift global growth prospects and reduce the appeal of holding USDs. The Fed's mid-cycle policy correction has reduced the USD's yield advantage and perhaps leaves the USD vulnerable to more international scrutiny of the US's structural imbalances. Meanwhile, US growth has slowed from the 3% clip seen at the start of 2019 and we expect the US economy's relative growth advantage to weaken further in 2020. The late 2019 peak in the USD against its major currency peers represents a high-water mark of some significance, we feel.

Over the next few months, investors will also have to start to figure out how the 2020 US presidential election cycle might shape currency trends. President Trump's pro-growth stance is USD-positive on the face of it but trade and competitiveness concerns suggest there are limits to how much the USD could benefit from that. Meanwhile, some Democratic contenders have policy platforms that target the USD directly (Elizabeth Warren) or might imply more downside risk for the USD (Bernie Sanders) in the longer run. Overall volatility in the FX space was extremely subdued through much of 2019; we expect more volatility in the year ahead.

For Canada and Mexico, progress on USMCA is welcome but largely factored into both the **Canadian dollar (CAD)** and Mexican peso (MXN); broader relief from US/China trade tensions should be CAD-positive on balance as the year progresses. In Canada, growth is showing signs of stalling sharply in Q4, with the data in hand through the end of the year suggesting that the economy is tracking well below the Bank of Canada (BoC) estimate for the quarter (1.3%). Given that BoC Governor Poloz expressed confidence in the outlook in early December, markets are not rushing to factor in interest rate cuts and are barely pricing in 50% chance of a rate cut in late 2020 at this stage. "Sticky" domestic yields are keeping short-term US/Canada interest rate differentials at very CAD-supportive levels for the moment, at least.

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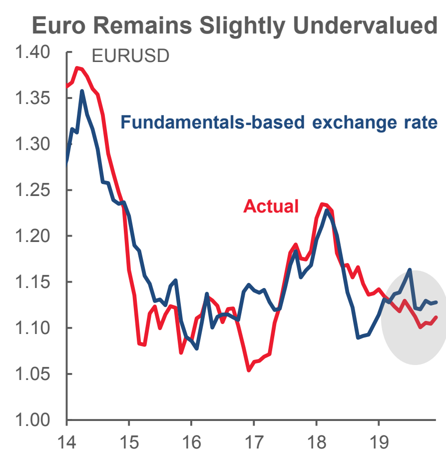
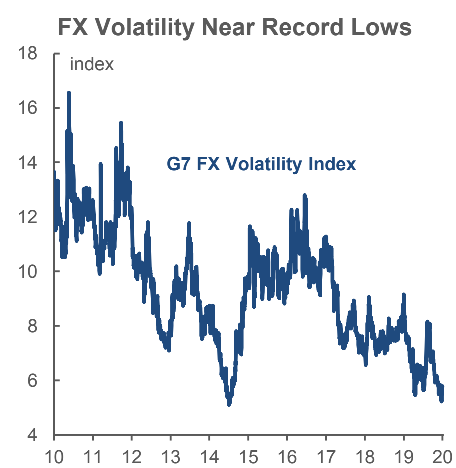
Chart 1



Sources: Scotiabank Economics, Bloomberg, Scotiabank FICC Strategy.

Chart 2



Sources: Scotiabank Economics, Bloomberg, Scotiabank FICC Strategy.

Over the coming year, we expect more balanced global growth to emerge. Even with some modest, additional policy accommodation from the BoC, we think the CAD can strengthen somewhat against the USD as growth differentials between the two economies are likely to narrow considerably—and the CAD realigns itself with its fundamental drivers following uncertainty-driven flows into USDs. We forecast very similar levels of growth for the US (1.6%) and Canada (1.5%) in 2020 and anticipate a slight growth advantage for Canada in 2021. Speculative sentiment on the CAD has remained constructive since mid-2019, as reflected in CFTC positioning data, and we echo their bullishness—but recognize that there may be a need for patience. We are maintaining a 1.25 forecast for the end of 2020. The Australian and New Zealand dollars (AUD and NZD respectively) may out-perform the CAD slightly in 2020 if global trade tensions ease and growth trends remain constructive.

In Europe, the UK general election has provided some much-needed political clarity for the pound (GBP) by producing a substantial Conservative majority for Prime Minister Johnson. The GBP rose strongly in advance of the election and extended gains on news of Johnson's large win in anticipation of progress on Brexit. But while the Brexit path is now clearer—the UK will exit the EU on January 31st, per pending legislation—the government's insistence that it will not tolerate an extension to the transition period (following the UK's formal departure) beyond December 2020 leaves little time to secure a workable trade deal with Brussels. The threat of a no-trade-deal departure remains real. We think the post-election position adjustment could see corrective GBP losses extend to 1.27/1.28 but we still expect the GBP to firm to 1.36 through the end of 2020.

Progress on Brexit should prove somewhat supportive for the euro (EUR) also but investors may struggle to warm to the single currency while European Central Bank policy remains accommodative and growth trends are soft. The good news for the EUR is that the weakening in the Eurozone manufacturing sector appears to have stabilized and policy makers seem to feel that the worst is over. However, we see no change in European Central Bank (ECB) monetary policy through 2020 at least and a strategic review launched by the ECB's new president, Christine Lagarde, is unlikely to alter that prospect. We think the EUR's main assets are its low valuation (we estimate fair value currently is closer to 1.13) and the potential for investors to diversify away from an over-valued—and perhaps "over-owned"—USD.

The **Japanese yen (JPY)** has resisted the broader rise of the USD over the past year (while the Swiss franc—CHF—remained virtually flat versus the USD), reflecting sporadic demand for safe-havens amid vacillating trade, geopolitical and market risks. Japan's large and persistent current account surpluses (in excess of 3% of GDP) leave the currency less prone to capital flight and support its "refuge" status. We anticipate modest gains for the JPY versus a weaker USD in the coming year and anticipate some JPY under-performance on the crosses as trade tensions abate.

China's phase-one trade deal with the US as well as the accommodative policy stance of G-10 central banks will sustain a risk-friendly mood for Asian currencies in the first quarter of 2020. The Chinese yuan (CNY & CNH) will likely edge towards 6.80 as trade tensions ease. Export-driven currencies such as the South Korean won (KRW) and Taiwanese dollar (TWD) should also benefit. The Thai baht (THB) will advance as well but to a lesser extent and at a slower pace relatively, given that its 2019 outperformance hurt Thailand's tourism and export competitiveness.

A pro-risk mood will continue to drive international investors towards higher-yielding regional assets denominated in the Indian rupee (INR), Indonesian rupiah (IDR), Malaysian ringgit (MYR) and Philippine peso (PHP). More deregulation in Indonesia may attract additional foreign investment inflows and if Malaysia retains a Market Accessibility Level of 2 that is required for the FTSE World Government Bond Index (WGBI) eligibility, the MYR will benefit.

Despite continued civil unrest, the Hong Kong dollar (HKD) will likely remain firm amid portfolio inflows and recovering IPO markets. Meanwhile, the Monetary Authority of Singapore (MAS) is expected to stand pat on its S$NEER policy in April, but the Singapore dollar (SGD) will likely rise further along with a strengthening EUR.

Latam currencies fared well in the final month of 2019 amid an easing of social unrest across the region—principally in Chile and Colombia, which pushed the Chilean and Colombian pesos (CLP and COP, respectively) to all-time lows against the greenback—while garnering support from an improved risk backdrop owing to the China-US phase one deal announcement and lessening Brexit uncertainty. Central bank intervention in currency markets in Brazil and Chile also helped to stave off downward pressure on the Latam currencies. Regional growth is forecast to accelerate though 2020, though remain relatively subdued by historical standards as the uncertain speed of the global economic recovery keeps investment and trade flows at bay—thus limiting upward momentum in commodity prices—while social unrest delays the economic adjustment domestically in Chile.

Despite an expected easing of monetary conditions in Mexico, Banxico's policy rate will remain among the highest of all major central banks and while real rates will provide support for the MXN, domestic financial conditions will remain relatively restrictive; Mexican real GDP growth is expected to only reach 1% in 2020. Elsewhere in the region, the Peruvian and Brazilian central banks will likely remain on the sidelines this year while their Chilean counterpart is expected to cut its policy rate once more in early-2020 before it hits the brakes on easing. In Colombia, BanRep is expected to bring policy back to a neutral stance with one hike in 1H2020. With the Fed in 'pause' mode, the expected stability in rate differentials will result in greater emphasis being placed on global and domestic political risks as drivers of exchange rate fluctuations.

We anticipate that regional FX will remain relatively stable through 2020 with the MXN set to underperform among its Latam peers—and make another move above 20 pesos per dollar—as it drifts modestly downward amid further easing by Banxico and mediocre gains in output. On the opposite end of the spectrum, we expect the CLP to strengthen near the 700 pesos per USD level thanks to central bank intervention and fading political risks.

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APPENDIX 1

International	2010–18	2018	2019e	2020f	2021f	2010–18	2018	2019e	2020f	2021f
	Real GDP (annual % change)					**Consumer Prices** (y/y % change, year-end)				
World (based on purchasing power parity)	3.8	3.8	2.9	3.1	3.4					
Canada	2.2	2.0	1.6	1.5	2.0	1.7	2.0	2.1	1.8	2.3
United States	2.3	2.9	2.3	1.7	1.8	1.7	2.2	2.0	2.2	2.4
Mexico	3.0	2.1	0.0	1.0	1.8	4.1	4.8	2.8	3.8	3.7
United Kingdom	1.9	1.3	1.1	1.2	1.6	2.2	2.1	1.8	2.0	2.1
Eurozone	1.4	1.9	1.0	1.1	1.3	1.3	1.5	1.2	1.3	1.5
Germany	2.1	1.5	0.5	0.8	1.2	1.3	1.6	1.3	1.4	1.6
France	1.4	1.7	1.3	1.3	1.4	1.1	1.6	1.3	1.4	1.5
China	7.8	6.6	6.1	6.0	5.8	2.5	1.8	4.5	2.1	2.5
India	7.3	7.4	5.1	6.2	7.2	7.3	2.1	6.1	4.3	4.9
Japan	1.4	0.3	0.9	0.6	1.2	0.6	0.3	0.9	0.6	0.8
South Korea	3.4	2.7	1.8	2.1	2.5	1.8	1.3	0.7	1.6	2.1
Australia	2.7	2.7	1.8	2.1	2.5	2.1	1.8	1.6	1.9	2.1
Thailand	3.8	4.1	2.4	2.2	2.7	1.5	0.4	0.9	1.3	1.6
Brazil	1.4	1.3	1.1	2.1	2.1	6.0	3.8	3.3	4.2	4.1
Colombia	3.8	2.6	3.2	3.6	3.6	3.9	3.2	3.8	3.3	3.1
Peru	4.8	4.0	2.3	3.0	3.5	3.0	2.2	1.9	2.0	2.3
Chile	3.5	4.0	1.0	1.4	3.0	3.1	2.6	3.0	2.9	3.0
Commodities										
	(annual average)									
WTI Oil (USD/bbl)	74	65	57	59	64					
Brent Oil (USD/bbl)	82	72	64	63	67					
WCS - WTI Discount (USD/bbl)	-18	-26	-14	-20	-24					
Nymex Natural Gas (USD/mmbtu)	3.39	3.07	2.53	2.39	2.63					
Copper (USD/lb)	3.10	2.96	2.72	2.80	3.00					
Zinc (USD/lb)	1.02	1.33	1.16	1.10	1.05					
Nickel (USD/lb)	7.00	5.95	6.32	6.50	7.00					
Aluminium (USD/lb)	0.89	0.96	0.81	0.90	0.90					
Iron Ore (USD/tonne)	101	70	94	78	70					
Metallurgical Coal (USD/tonne)	179	207	184	145	150					
Gold, London PM Fix (USD/oz)	1,342	1,268	1,393	1,525	1,450					
Silver, London PM Fix (USD/oz)	21.64	15.71	16.21	18.75	17.75					

Sources: Scotiabank Economics, Statistics Canada, BEA, BLS, IMF, Bloomberg.

APPENDIX 2

North America	2010–18	2018	2019e	2020f	2021f	2010–18	2018	2019e	2020f	2021f
	Canada (annual % change, unless noted)					United States (annual % change, unless noted)				
Real GDP	2.2	2.0	1.6	1.5	2.0	2.3	2.9	2.3	1.7	1.8
Consumer spending	2.6	2.1	1.6	1.6	1.9	2.4	3.0	2.6	2.3	2.0
Residential investment	2.7	-1.5	-0.7	3.6	2.4	4.8	-1.5	-1.8	1.3	1.8
Business investment*	2.4	1.8	0.2	3.7	3.5	5.2	6.4	2.3	1.0	2.5
Government	1.2	3.4	1.8	1.6	1.8	-0.3	1.7	2.3	1.8	1.6
Exports	3.6	3.1	1.9	1.4	2.5	4.1	3.0	0.0	1.3	2.2
Imports	3.9	2.6	0.6	2.0	2.7	4.9	4.4	1.7	2.6	2.9
Nominal GDP	3.9	3.9	3.2	3.3	4.2	4.0	5.4	4.1	3.4	3.8
GDP deflator	1.7	1.8	1.5	1.8	2.1	1.7	2.4	1.8	1.7	2.0
Consumer price index (CPI)	1.7	2.3	2.0	2.0	2.0	1.8	2.4	1.8	2.3	2.4
Core inflation rate**	1.9	1.9	2.0	2.0	1.9	1.6	1.9	1.6	1.9	2.0
Pre-tax corporate profits	5.8	2.5	-0.2	0.9	2.0	4.6	3.4	-0.5	2.3	1.8
Employment	1.2	1.3	2.1	0.9	1.0	1.4	1.7	1.6	1.0	1.0
Unemployment rate (%)	7.0	5.8	5.7	5.8	5.8	6.5	3.9	3.7	3.8	3.8
Current account balance (CAD, USD bn)	-58.4	-55.5	-44.5	-47.3	-43.9	-421	-491	-510	-525	-555
Merchandise trade balance (CAD, USD bn)	-13.0	-22.1	-18.9	-26.9	-27.5	-754	-887	-881	-924	-976
Federal budget balance (FY, CAD, USD bn)	-19.4	-19.0	-14.0	-26.6	-28.1	-813	-779	-960	-1,008	-1,034
percent of GDP	-1.0	-0.9	-0.6	-1.1	-1.1	-4.6	-3.8	-4.5	-4.6	-4.5
Housing starts (000s, mn)	200	213	210	206	202	0.96	1.25	1.25	1.26	1.26
Motor vehicle sales (000s, mn)	1,809	1,983	1,922	1,915	1,915	15.5	17.2	16.9	16.9	17.0
Industrial production	2.7	3.1	-0.8	1.0	1.8	2.2	4.0	0.7	0.8	1.9
	Mexico (annual % change)									
Real GDP	3.0	2.1	0.0	1.0	1.8					
Consumer price index (year-end)	4.1	4.8	2.8	3.8	3.7					
Current account balance (USD bn)	-21.0	-22.2	-0.2	-14.4	-16.7					
Merchandise trade balance (USD bn)	-6.8	-13.6	2.3	-21.1	-29.9					

Sources: Scotiabank Economics, Statistics Canada, CMHC, BEA, BLS, Bloomberg. *For Canada it includes capital expenditures by businesses and non-profit institutions.
** US: core PCE deflator; Canada: average of 3 core measures published by the BoC.

Quarterly Forecasts	2019	2020				2021			
Canada	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Real GDP (q/q ann. % change)	0.2	1.6	1.7	1.6	1.9	2.1	2.2	2.3	2.2
Real GDP (y/y % change)	1.5	1.7	1.2	1.3	1.7	1.8	1.9	2.1	2.2
Consumer prices (y/y % change)	2.1	2.3	2.0	2.0	1.8	1.7	1.8	2.0	2.3
Avg. of new core CPIs (y/y % change)	2.1	2.1	2.0	2.0	1.9	1.9	1.9	2.0	2.0
United States									
Real GDP (q/q ann. % change)	1.9	1.3	1.6	1.6	1.8	1.8	1.9	2.0	2.1
Real GDP (y/y % change)	2.3	1.8	1.7	1.6	1.6	1.7	1.8	1.9	2.0
Consumer prices (y/y % change)	2.0	2.2	2.3	2.3	2.2	2.3	2.3	2.4	2.4
Total PCE deflator (y/y % change)	1.5	1.6	1.8	1.8	1.7	1.9	2.0	2.2	2.3
Core PCE deflator (y/y % change)	1.7	1.8	1.9	1.9	1.9	2.0	2.0	2.0	2.0

Sources: Scotiabank Economics, Statistics Canada, BEA, BLS, Bloomberg.

APPENDIX 3

	2019	2020				2021			
Central Bank Rates	**Q4**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Americas				(%, end of period)					
Bank of Canada	1.75	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.25
US Federal Reserve (upper bound)	1.75	1.75	1.75	1.50	1.50	1.50	1.50	1.50	1.50
Bank of Mexico	7.25	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00
Central Bank of Brazil	4.50	4.50	5.00	5.50	6.00	6.50	6.75	7.00	7.00
Bank of the Republic of Colombia	4.25	4.25	4.50	4.50	4.50	4.75	4.75	4.75	4.75
Central Reserve Bank of Peru	2.25	2.25	2.25	2.25	2.25	2.25	2.25	2.50	2.50
Central Bank of Chile	1.75	1.75	1.50	1.00	1.00	1.00	1.25	1.75	2.00
Europe									
European Central Bank MRO Rate	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
European Central Bank Deposit Rate	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
Bank of England	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Asia/Oceania									
Reserve Bank of Australia	0.75	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Bank of Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
People's Bank of China	4.15	4.05	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Reserve Bank of India	5.15	5.15	4.90	4.90	4.90	4.90	5.00	5.25	5.50
Bank of Korea	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.50	1.50
Bank of Thailand	1.25	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.25
Currencies and Interest Rates									
Americas				(%, end of period)					
Canadian dollar (USDCAD)	1.30	1.28	1.27	1.26	1.25	1.25	1.25	1.25	1.25
Canadian dollar (CADUSD)	0.77	0.78	0.79	0.79	0.80	0.80	0.80	0.80	0.80
Mexican peso (USDMXN)	18.85	19.51	20.15	20.25	20.52	20.74	20.80	20.92	21.21
Brazilian real (USDBRL)	4.09	4.26	4.32	4.26	4.18	4.21	4.24	4.27	4.30
Colombian peso (USDCOP)	3,287	3,295	3,237	3,258	3,250	3,233	3,215	3,198	3,180
Peruvian sol (USDPEN)	3.31	3.35	3.33	3.35	3.35	3.34	3.38	3.34	3.35
Chilean peso (USDCLP)	753	770	750	720	700	700	690	685	680
Europe									
Euro (EURUSD)	1.12	1.12	1.14	1.15	1.16	1.17	1.18	1.19	1.20
UK pound (GBPUSD)	1.33	1.33	1.34	1.36	1.36	1.38	1.39	1.41	1.42
Asia/Oceania									
Japanese yen (USDJPY)	108	107	107	105	105	103	103	102	102
Australian dollar (AUDUSD)	0.68	0.69	0.70	0.71	0.72	0.72	0.73	0.73	0.74
Chinese yuan (USDCNY)	6.96	6.80	6.80	6.70	6.70	6.60	6.60	6.50	6.50
Indian rupee (USDINR)	71.4	70.5	70.5	70.0	70.0	69.5	69.5	69.0	69.0
South Korean won (USDKRW)	1,156	1,140	1,140	1,120	1,120	1,100	1,100	1,080	1,080
Thai baht (USDTHB)	30.0	30.0	30.0	29.9	29.9	29.8	29.8	29.7	29.7
Canada (Yields, %)									
3-month T-bill	1.66	1.55	1.25	1.25	1.25	1.25	1.25	1.25	1.30
2-year Canada	1.69	1.50	1.35	1.30	1.35	1.40	1.45	1.45	1.50
5-year Canada	1.68	1.45	1.35	1.35	1.40	1.45	1.50	1.55	1.60
10-year Canada	1.70	1.55	1.45	1.50	1.50	1.55	1.60	1.70	1.75
30-year Canada	1.76	1.65	1.60	1.65	1.75	1.80	1.85	1.95	2.00
United States (Yields, %)									
3-month T-bill	1.51	1.55	1.55	1.30	1.30	1.30	1.30	1.30	1.30
2-year Treasury	1.57	1.60	1.55	1.50	1.55	1.60	1.65	1.65	1.65
5-year Treasury	1.69	1.65	1.60	1.60	1.65	1.70	1.75	1.80	1.80
10-year Treasury	1.92	1.80	1.75	1.75	1.80	1.85	1.90	1.95	2.00
30-year Treasury	2.39	2.25	2.15	2.20	2.25	2.30	2.35	2.40	2.45

Sources: Scotiabank Economics, Bloomberg.

APPENDIX 4

The Provinces	(annual % change except where noted)										
Real GDP	**CA**	**NL**	**PE**	**NS**	**NB**	**QC**	**ON**	**MB**	**SK**	**AB**	**BC**
2010–18	2.2	0.5	2.0	0.9	0.6	1.7	2.2	2.2	2.5	2.8	2.8
2018	2.0	-2.7	2.6	1.2	0.1	2.5	2.3	1.3	1.6	2.3	2.4
2019e	1.6	2.0	2.1	1.3	0.6	2.4	1.7	1.4	1.3	0.5	2.2
2020f	1.5	0.6	1.9	1.3	0.8	1.6	1.7	1.5	1.5	2.4	2.8
2021f	2.0	0.8	1.8	1.1	0.7	1.6	1.6	1.5	1.7	2.7	2.4
Nominal GDP											
2010–18	3.9	3.2	3.9	2.7	2.8	3.7	4.1	4.0	3.3	3.8	4.5
2018	3.9	0.5	4.6	3.2	1.9	4.2	3.5	3.1	3.8	4.5	4.4
2019e	3.2	3.5	4.1	3.0	2.2	3.7	3.3	3.4	3.4	1.9	4.4
2020f	3.3	2.9	3.9	3.2	2.4	3.3	3.4	3.3	3.8	4.5	5.4
2021f	4.2	3.7	3.8	2.8	2.1	3.6	3.9	3.3	4.5	5.7	5.1
Employment											
2010–18	1.2	0.5	1.2	0.2	-0.2	1.1	1.3	0.8	0.9	1.5	1.4
2018	1.3	0.5	3.0	1.5	0.3	0.9	1.6	0.6	0.4	1.9	1.1
2019e	2.1	1.1	1.8	2.2	0.6	1.6	2.6	1.2	1.7	0.8	3.0
2020f	0.9	0.0	0.8	0.3	0.2	0.8	1.2	0.6	0.7	1.0	1.5
2021f	1.0	-0.1	0.6	0.1	0.2	0.8	1.0	0.6	0.6	1.2	1.3
Unemployment Rate (%)											
2010–18	7.0	13.3	10.8	8.8	9.3	7.4	7.3	5.5	5.2	6.1	6.4
2018	5.8	13.8	9.4	7.6	8.0	5.5	5.6	6.0	6.1	6.6	4.7
2019e	5.7	12.1	8.9	6.8	8.1	5.2	5.6	5.4	5.4	6.8	4.6
2020f	5.8	12.1	9.0	6.8	8.1	5.4	5.8	5.5	5.5	6.9	4.8
2021f	5.8	12.0	9.1	6.9	8.0	5.5	5.8	5.6	5.4	6.8	4.9
Housing Starts (units, 000s)											
2010–18	201	2.4	0.8	4.1	2.7	44	70	6.5	6.4	31	33
2018	213	1.1	1.1	4.8	2.3	47	79	7.4	3.6	26	41
2019e	210	0.9	1.1	4.6	2.8	49	71	6.8	2.5	27	44
2020f	206	1.3	1.1	4.2	2.4	46	76	6.0	3.3	30	37
2021f	202	1.1	1.0	4.2	2.4	44	78	6.0	3.7	31	32
Motor Vehicle Sales (units, 000s)											
2010–18	1,847	33	7	52	42	439	725	56	54	241	197
2018	1,983	28	8	51	38	449	853	67	47	226	217
2019e	1,922	31	9	51	39	448	810	60	49	223	215
2020f	1,915	26	7	50	38	435	805	58	50	227	219
2021f	1,915	26	7	47	36	435	805	58	51	231	219
Budget Balances, Fiscal Year Ending March 31 (CAD mn)											
2019	-14,000	-911	75	226	67	4,915	-3,672	-695	-303	-8,023	314
2020f*	-26,600	-552	57	120	73	4,803	-7,435	-163	-268	-6,711	1,535
2021f	-28,100	-944	1	37	88	1,400	-9,023	-350	37	-8,704	148

* NL budget balance in 2020 is net of one-time revenue boost via Atlantic Accord. Sources: Scotiabank Economics, Statistics Canada, CMHC, Budget documents; Quebec budget balance figures are after Generations Fund transfers.