Canada

EXPECTING THE BEST, PREPARING FOR THE WORST

- **Our stable Canadian outlook rests on a central view that an escalation of US protectionism into a global trade war remains unlikely, notwithstanding recent rhetoric. We continue to expect NAFTA talks to resume and reach a benign conclusion in 2019.**
- **A US move to impose auto tariffs would be the tipping point toward a global trade war featuring a cascading set of retaliations that would push the US and most of its major trading partners, including Canada, into recession by 2020.**

MIXED MESSAGES

Despite the recent cooling in the data and fattening tail risks related to US protectionism, our central view on the Canadian economy remains little changed from the previous quarter. The *Scotiabank Global Macroeconomic Model* (SGMM) continues to forecast real growth around 2% this year and next (table 1), supported by consistent domestic and US demand. The sources of Canadian growth may finally be evolving toward a more sustainable mix with a lighter emphasis on household consumption and residential real estate, and a greater contribution from business investment and trade that could help boost productivity. Aggregate growth in 2018 could still surprise to the upside at 2.3% rather than our current 2.0% forecast if the negative effects of existing trade tensions are lifted more quickly than currently projected (table 2) and competitiveness concerns are addressed.

Rising oil prices, following US withdrawal from the Iran accord, have lifted sentiment on both the energy industry and Canada more generally. The Alberta oil patch received additional assurances from the federal government's announcement that it intends to purchase the Trans Mountain pipeline. Nevertheless, as the ***Commodities*** section of *Global Outlook* details, we have widened our forecast WCS discount for 2018–19 as capacity out of Western Canada is expected to remain exceedingly tight despite the breathing room now provided through mid-August by the recent power outage at Alberta's Syncrude facility.

Other recent economic developments have, however, been undeniably downbeat. Economic activity in Q2-2018 has tended to disappoint, with jobs numbers, building permits, sales of manufactured goods, retail sales, and inflation all coming in somewhat lower than consensus and, in general, our own forecasts. Q2-2018 GDP growth is tracking around 2.2% SAAR, below the 2.5% forecast in the Bank of Canada's April ***Monetary Policy Report*** (MPR). Moreover, the Syncrude disruption is expected to subtract up to 0.2 ppts from Q/Q SAAR real GDP growth in Q3-2018, before a corresponding rebound in the last quarter of 2018 to leave our projection for Canada's annual real GDP growth rate for 2018 at 2.0%. But these data need to be set against the backdrop of a real economy that continues to expand at near-full capacity, tight labour markets, rising wages, strengthening investment growth, and inflation set to remain above 2%.

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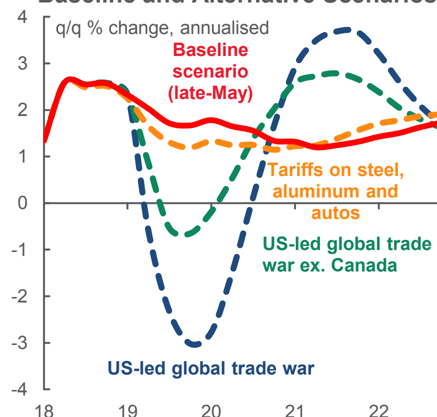
Canada	2017	2018f	2019f
Real GDP (annual % change)	3.0	2.0	2.1
CPI (y/y %, eop)	1.8	2.7	2.1
Central bank policy rate (%, eop)	1.00	1.75	2.50
Canadian dollar (CADUSD, eop)	0.80	0.78	0.80

Source: Scotiabank Economics.

Chart 1



Source: Scotiabank Economics.

Although US tariffs dominate discussions on Canada's economic prospects, our baseline forecasts continue to reflect our expectation that a further substantial escalation in trade tensions will be avoided. The economic and political logic underpinning NAFTA remains compelling for all three countries. Parties from all sides, including possible members of a future Mexican government, indicate that they expect talks to resume soon, with a view to sustained progress toward a deal.

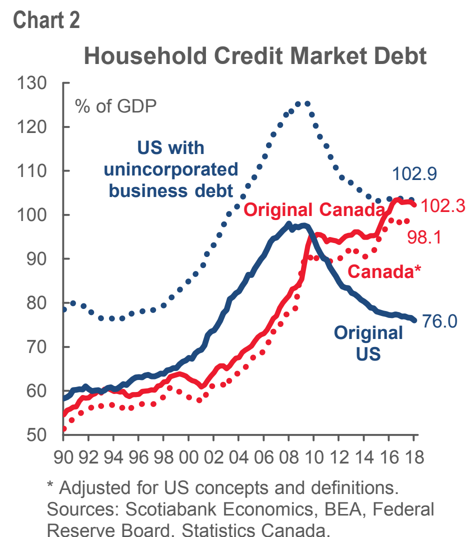
The introduction of new US tariffs on autos and parts is likely to be stayed. Auto tariffs would invite such wide-ranging retaliatory duties that the US and its major trading partners, including Canada, would be pushed into recessions by 2020, just as the current US president is expected to seek re-election. While our baseline reflects the high probability we assign to a trade war being avoided, our recent paper ***NAFTA: Steeling Ourselves for the Macro Costs of Tariffs*** models the macroeconomic implications of several scenarios where the US withdraws from NAFTA and/or moves ahead with more tariffs (chart 1). Short of an all-out, auto-tariff-induced trade war, Canada's growth prospects are encouraging.

While the Bank of Canada is right to lose a little sleep over trade, our baseline is consistent with further policy normalization. We continue to expect two more 25 bps increases during 2018 in the Bank of Canada's target overnight rate, with the first of these coming this month, and three additional 25 bps increases during 2019 to take the policy rate to 2.50% by end-2019, as detailed in the ***US & Canadian Monetary Policy & Capital Markets*** report.

CANADIAN CONSUMERS CURB THEIR ENTHUSIASM

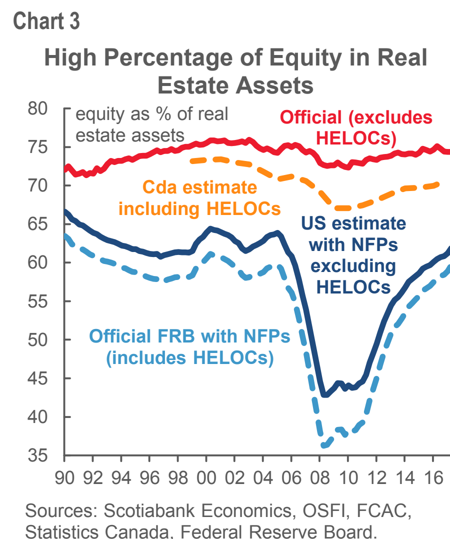
Canadian consumers continue to moderate their activity after 2017 recorded the strongest growth in household expenditures since 2010. Tight labour markets, low unemployment at 5.8% (table 3), strong wage growth, and further mandated minimum-wage increases should continue to provide support for consumer spending. However, a weaker-than-expected start to 2018 amidst slowing credit growth has nudged us to mark down our forecast for 2018 consumption growth from 2.6% in our last quarterly outlook to 2.1% (table 3). Total retail sales were down by 1.2% m/m in April, brought

Chart 2



* Adjusted for US concepts and definitions.
Sources: Scotiabank Economics, BEA, Federal Reserve Board, Statistics Canada.

Chart 3



Sources: Scotiabank Economics, OSFI, FCAC, Statistics Canada, Federal Reserve Board.

Table 1

Quarterly Canadian Forecasts	2017	2018				2019			
	Q4	Q1	Q2e	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic									
Real GDP (q/q ann. % change)	1.7	1.3	2.2	2.2	2.5	2.1	2.0	1.9	1.8
Real GDP (y/y % change)	3.0	2.3	1.7	1.9	2.1	2.2	2.2	2.1	2.0
Consumer prices (y/y % change)	1.8	2.1	2.2	2.6	2.7	2.5	2.4	2.2	2.1
Avg. of new core CPIs (y/y % change)	1.7	1.9	1.9	2.0	2.1	2.2	2.2	2.2	2.2
Financial									
Canadian Dollar (USDCAD)	1.26	1.29	1.31	1.28	1.28	1.25	1.22	1.22	1.25
Canadian Dollar (CADUSD)	0.80	0.78	0.76	0.78	0.78	0.80	0.82	0.82	0.80
Bank of Canada Overnight Rate (%)	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.25	2.50
3-month T-bill (%)	1.06	1.15	1.26	1.55	1.80	2.05	2.30	2.30	2.50
2-year Canada (%)	1.69	1.78	1.91	2.05	2.30	2.40	2.50	2.55	2.60
5-year Canada (%)	1.87	1.97	2.07	2.25	2.45	2.55	2.60	2.65	2.70
10-year Canada (%)	2.05	2.09	2.17	2.40	2.55	2.60	2.65	2.70	2.75
30-year Canada (%)	2.27	2.23	2.20	2.50	2.70	2.80	2.85	2.90	2.95

Sources: Scotiabank Economics, Statistics Canada, Bloomberg.

lower mainly by a decrease in auto sales, although retail activity still dropped by 0.1% m/m exclusive of autos. Poor weather conditions appeared to play some role in the decline, but a more substantial rebalancing of household economics also appears to be at work as rising interest rates, tighter lending standards, and NAFTA anxieties may be prompting more considered spending and saving decisions.

Credit data imply that Canadians are responding to encouragements by policy makers to improve the soundness of their accounts. Growth rates in household, consumer, mortgage, and auto credit have all declined in recent quarters as, amongst other things, interest rates have risen, credit rules have tightened, lending standards have been raised, and growth has slowed. In Q1-2018, for instance, new mortgage flows hit their lowest level since Q2-2014.

Table 2

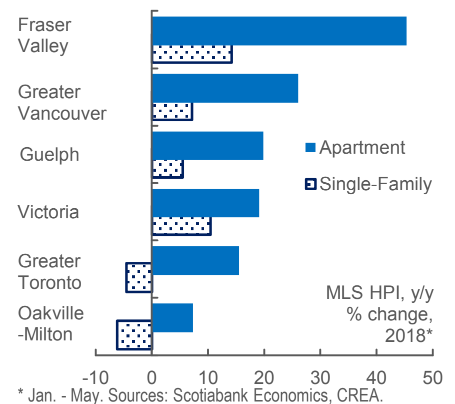
Real GDP growth: impact of policy developments

	2018f	2019f
Model-based projections based on fundamentals	**2.3**	**2.3**
Less: adjustments for policy developments	**-0.3**	**-0.2**
B-20 mortgage rules	-0.1	0.0
Steel & aluminum tariff	0.0	-0.1
NAFTA uncertainty	-0.1	0.0
Global protectionism	-0.1	-0.1
Current baseline	**2.0**	**2.1**

Source: Scotiabank Economics.

Household balance sheets still compare favourably with those of our US neighbours. The headline ratio of household credit-market debt to personal disposable income has continued edging down from a record high of 170.5% in Q3-2017 to 168.0% in Q1-2018. Reconfigured on terms comparable with the parallel US headline figure, at 162.2% the Canadian ratio remains below the US peak of 168.4% in 2007. Canada's economy-wide household credit to GDP ratio remains lower than the comparable figure in the US even after a decade of American financial repair (chart 2). The ratio of household liabilities to assets has always been more modest in Canada than in the US, and Canadians' equity in the real-estate component of those assets remains consistently stronger than in the US (chart 3). Looking forward, Canadians' vulnerability to further interest rate increases is somewhat contained by the fact that less than half of Canadian households have any exposure to mortgage and/or HELOC borrowing.

Chart 4



* Jan. - May. Sources: Scotiabank Economics, CREA.

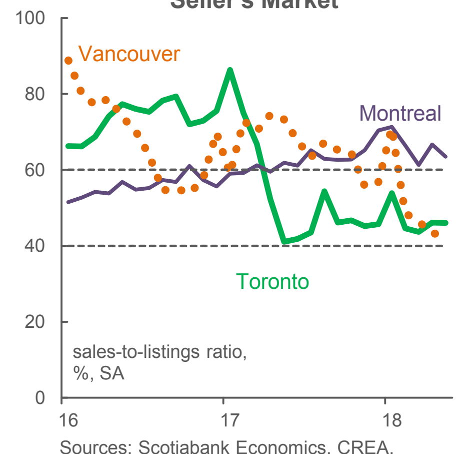
HOUSING ACTIVITY RESPONDS TO POLICY CHANGES

Monetary-policy tightening and the B-20 mortgage stress test rules that took effect January 1, 2018 continued to dampen home-buying activity in Q2, with country-wide corrections in unit sales volumes. The drop in transactions has been concentrated in the greater Toronto and Vancouver areas. The two cities are relatively sensitive to the new regulations owing to their already-elevated home prices and their relatively high shares of uninsured mortgages. Both metropolitan areas witnessed year-on-year residential unit sales declines of more than 20% in both April and May, which fed into a 16.2% y/y decrease in nation-wide unit sales in May.

The Canada-wide average sale price was down 6.4% y/y in May, weighed down by a 6.8% y/y decrease in Toronto. Prices, however, have remained firm once one adjusts for the shift in the composition of sales from single-detached homes to more affordable unit types, such as apartments and townhomes. The Composite MLS Home Price Index (HPI) implies that unit-type adjusted prices are still up 1.0% y/y in May. Over the last year, price increases for apartment properties have outpaced those for single-detached homes in and around Canada's higher-priced metropolitan areas (chart 4).

We look for the pace of home sales to recover in the second half of this year and continue on an upward trajectory in 2019. The rebound is expected to be led by developments in and around the Greater Toronto and Greater Vancouver areas, which

Chart 5



Sources: Scotiabank Economics, CREA.

continue to witness healthy economic expansions, and to a lesser extent Montreal, where the local market remains tipped in favour of sellers (chart 5). Markets in the rest of the country are largely balanced, with the exception of major cities in the Western net oil-producing provinces, which are still absorbing inventory accumulated since the last oil-price correction in mid-2014.

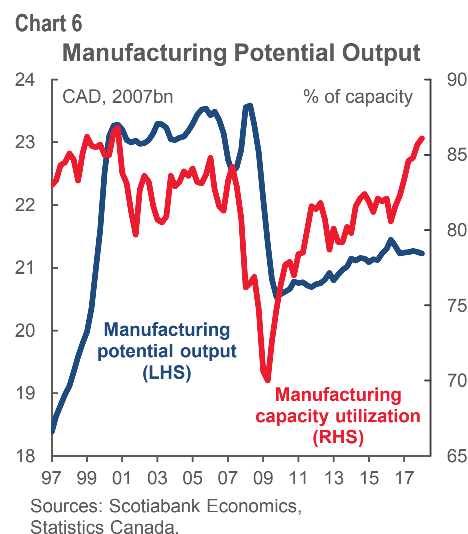
Housing starts are projected to come down gradually from 220,000 units in 2017 to 213,000 in 2018 and 200,000 units in 2019. Housing construction is expected to slow modestly in Southern BC and the Greater Golden Horseshoe this year before cooling more substantially in 2019, when the slowdown is likely to be focused on Quebec as it comes off a cycle peak. In Alberta, net interprovincial migration is expected to turn modestly positive, adding to elevated international immigration, helping to absorb existing excess housing inventory. Over the next year and a half, even as job creation eases and rising interest rates reduce affordability, increased immigration and still-high home prices should put a floor under building activity.

INDUSTRY HITS INVESTMENT-INDUCING CAPACITY CONSTRAINTS

Canadian manufacturing sales have been supported in recent years by a combination of robust domestic consumption growth and increased demand from the United States that has received an additional boost from federal tax cuts and increased public spending. Real manufacturing shipments, excluding petroleum products, were 2.7% higher in the first four months of 2018 compared with the same period in 2017. At the same time, in Q1-2018 manufacturing utilization rates hit their highest levels since mid-2000 at 86.1% of total capacity (chart 6).

Manufacturing production processes have become stretched as investment growth has, until recently, been relatively weak. Since the 2008 global financial crisis, firms have seemed reluctant to boost capital expenditure (capex) when the strength of the recovery has intermittently been in doubt. More recently, investment in plant and equipment has been tempered by the commodity-price downturn in 2014–15. Uncertainty about trading arrangements with the US since end-2016 has likely further inhibited investment decisions.

Chart 6



Sources: Scotiabank Economics, Statistics Canada.

Export-sensitive sub-sectors have seen some of the steepest increases in operating rates in response to strengthening and synchronizing global demand, particularly from the US (chart 7). In machinery manufacturing, where over three-quarters of total production is destined for the US, capacity utilisation has risen from 70% in the second quarter of 2016 to 90.2%. Similarly, the computer and electronics industry, which sends around 75% of its output south of the border, is currently operating at just under 90% of total capacity.

Some firms appear to have attempted to substitute labour for new physical capacity in order to increase production and fill burgeoning order books—and have nearly exhausted available labour pools in the process. Manufacturing employment increased by 2% last year, its fastest annual increase since 2000, and the unemployment rate in Canadian manufacturing now sits near its all-time low at 3.4%. However, labour productivity growth was negative in the first quarter of 2018 (chart 8) as the substitution of labour for capital encountered deeply diminishing returns. As Canadian manufacturing hits the limits of labour-capital substitution, capex becomes the

Table 3

Canada	2000–16	2016	2017	2018f	2019f
	(annual % change, unless noted)				
Real GDP	2.1	1.4	3.0	2.0	2.1
Consumer spending	2.9	2.3	3.4	2.1	2.0
Residential investment	3.7	3.4	2.8	0.1	0.4
Business investment	2.2	-8.8	2.7	6.8	2.6
Government	2.2	2.7	2.6	2.6	1.5
Exports	1.3	1.0	1.1	2.5	3.7
Imports	2.9	-1.0	3.6	4.5	2.6
Nominal GDP	4.2	2.0	5.4	4.3	4.7
GDP Deflator	2.1	0.6	2.3	2.3	2.5
Consumer price index (CPI)	1.9	1.4	1.6	2.4	2.3
CPI ex. food & energy	1.6	1.9	1.6	1.8	2.0
Pre-tax corporate profits	3.6	-1.9	19.9	4.8	4.3
Employment	1.3	0.7	1.9	1.2	1.0
Unemployment rate (%)	7.1	7.0	6.3	5.8	5.7
Current account balance (CAD bn)	-17.1	-65.4	-63.3	-71.0	-60.2
Merchandise trade balance (CAD bn)	25.1	-25.9	-24.0	-30.1	-22.5
Federal budget balance* (FY, CAD bn)	-2.8	-1.0	-17.8	-20.0	-18.0
percent of GDP	-0.2	0.0	-0.9	-0.9	-0.8
Housing starts (000s)	199	198	220	213	200
Motor vehicle sales (000s)	1,657	1,949	2,041	2,000	1,950
Industrial production	0.6	0.1	5.2	2.4	1.0
WTI oil (USD/bbl)	63	43	51	68	71
Nymex natural gas (USD/mmbtu)	4.94	2.55	3.02	2.93	2.90

Sources: Scotiabank Economics, Statistics Canada, CMHC, Bloomberg. * Canada ex risk adjustment of $1.5bn & $3.0bn for FY18 & FY19.

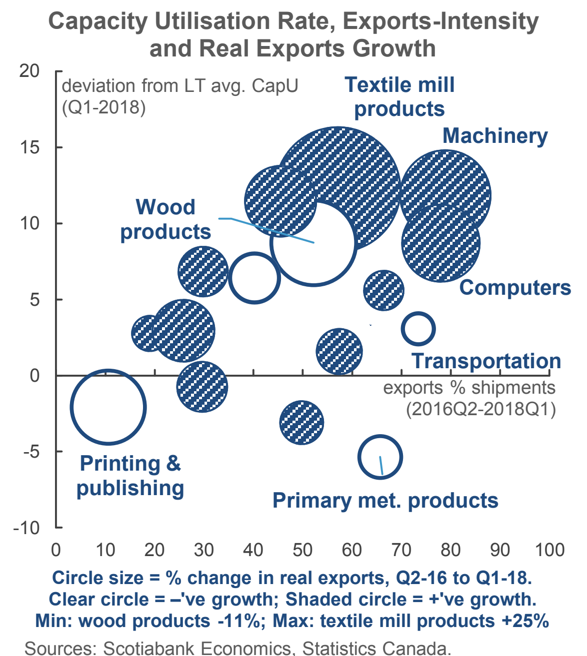
alternative route to expand output—which likely explains the expansions of 8.7% y/y in Q4-2017 and 8.2% y/y in Q1-2018 in spending on non-residential structures, machinery and equipment, and intellectual property.

Notwithstanding this recent boost, non-residential capital spending still sits 14% below its late-2014 high owing to reduced activity in the energy sector. In contrast, business investment outside the energy sector is returning to prior peaks.

Despite the uncertainty induced by growing US protectionism and NAFTA's still-pending status, the combination of strong US demand, tight domestic labour markets, and abundant financial capital make conditions ripe for further growth in business investment. We project an annual increase of 6.8% in 2018 (table 3), the strongest growth in business investment since 2011. We expect investment expenditure to continue growing into 2019, albeit at a softer pace of around 2.6%. Trade-policy worries will likely mean that spending on machinery, equipment, and intellectual property will dominate investment decisions, while commitments to non-residential structures could require greater clarity on the near-term outlook before being approved.

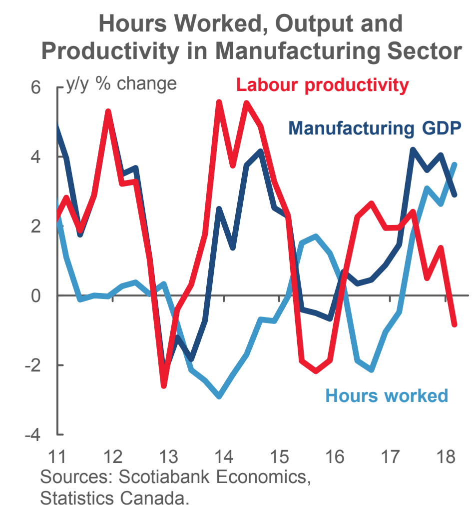
Efforts to enhance Canada's competitiveness would be timely to convert capacity constraints into firm investment decisions. Attention has been focused on how US tax changes have more or less eliminated the former gap between US and Canadian statutory and effective corporate tax rates, but the link between tax rates and business investment has always been imperfect. More targeted measures focused on stimulating investment through tax deductions on accelerated depreciation schedules, enhanced tax credits, smoother immigration processes for skilled talent, simpler permitting and regulatory compliance, and better public infrastructure could all stimulate private capex and boost Canadian productivity. Moreover, they would provide a smart reply to US tariffs that, unlike retaliatory tariffs, wouldn't hurt Canadian industry and consumers.

Chart 7



Sources: Scotiabank Economics, Statistics Canada.

Chart 8



Sources: Scotiabank Economics, Statistics Canada.

FISCAL POLICY STILL PRO-CYCLICAL

For the third consecutive year, current and capital spending in 2018 across all levels of government is expected to contribute 0.6 ppts to national real GDP growth (over one-quarter of economy-wide growth). This projection reflects the federal government's assumption of a larger role in many policy areas where it has used its spending power to leverage provincial and municipal outlays that might otherwise not have occurred: additional expenditure in social housing, mental health, and water treatment particularly stand out. Federal transfers ramped up late in fiscal 2017–18 to support these programs. In some sectors, such as infrastructure, the roll-out of spending is now planned to be slower than initially announced, but the spring *Budget* outlined federal initiatives in R&D and other areas to fill this gap.

In 2019, growth in government spending is expected to moderate, trimming the public sector's contribution to real GDP growth to a still-solid 0.3 ppts. Provincial and local governments are expected to limit further increases in taxes and other levies in order to make life more affordable for moderate-income households. This will steepen the challenge of sustaining balanced operating budgets and encourage careful expenditure management. In this context, several Provinces are also pursuing initiatives to minimize the impact on household finances and business competitiveness of Ottawa's pending carbon-pricing framework. Specific measures are focused on both the application of carbon pricing and in the use of the resulting revenues.

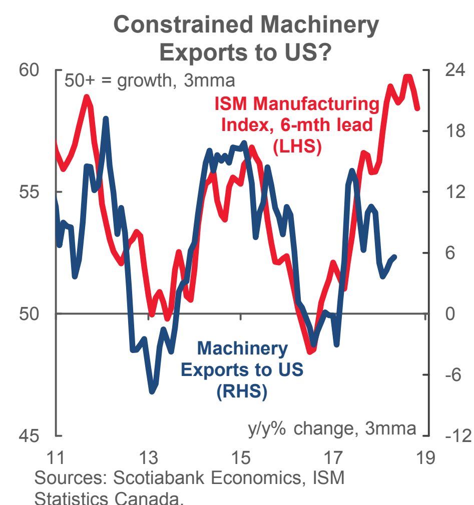
Federal deficits for fiscal 2018–19 and 2019–20 are expected to exceed Ottawa's spring *Budget* estimates (table 1). The Provinces' fiscal 2018–19 plans indicate an aggregate shortfall this year that is set to widen once again beyond CAD 15 bn,

assuming significant red ink from Ontario's new administration. Consequently, though borrowing by a number of Provinces is now largely constrained to fund capital investment, their combined net debt is expected to rise toward 34% of their aggregate GDP, above the prior peak in the mid-1990s.

TRADE: STARKLY DIFFERENT POSSIBILITIES

Rising industrial production in the US has lifted demand for Canadian-made machinery, with exports of these products to the US up by 4.6% in the first four months of 2018 compared with the same period in 2017, though this represents a bit of a slowdown from the 8% y/y expansion recorded over the entirety of last year. Although manufacturing sentiment (i.e., the broad purchasing managers' index, PMI) in the US is currently sitting at its highest level since 2004, stretched capacity in Canada's machinery fabrication sector may be limiting shipments south of the border (chart 9). As new production capacity in the industry comes online, machinery exports should bounce back from what is expected to be a temporary, though marked, slowdown.

Chart 9



Sources: Scotiabank Economics, ISM Statistics Canada.

Exports of steel and aluminum products to the US soared as American companies hoarded product ahead of the imposition of so-called Section 232 'national security' tariffs, from which Canada was exempt until May 31st (chart 10). This specious national-security justification for the tariffs is being invoked purely to allow the US president to impose tariffs under one of the office's narrow powers that do not require Congressional approval. While the 10% tariff imposed on Canadian aluminum imported into the US is lower than the 25% duty now applied to steel products, the US remains relatively more dependent on foreign aluminum for its domestic consumption than it does for steel: around 60% of aluminum consumed in the US comes from abroad compared with about a fifth of steel, but steel products are more specialized. This implies that the US tariffs are likely to have a limited impact on Canadian steel and aluminum exports to the US, but should undermine US competitiveness through higher costs for US industry and consumers.

Chart 10

Sources: Scotiabank Economics, Statistics Canada.

We expect the tariffs on steel and aluminum to be short-lived—similar US tariffs imposed in 2002 lasted 20 months and cost the US far more jobs than they protected. An exemption would likely be re-authorized for Canada when a consensus is reached on revising NAFTA, which in our baseline remains programmed for early-2019. In the meantime, the US tariffs and the Canadian retaliation are forecast to shave about 0.1 ppts from Canadian GDP growth during 2019. Given the US stockpiling of Canadian steel and aluminum earlier this year, demand for these products is expected to soften throughout the remainder of 2018. There is likely to be a less pronounced slump in aluminum than steel, despite more than 21,000 requests for tariff exemptions by affected US companies.

Table 4

Impact of US Protectionism on Canadian Economy: Deviation from Baseline Forecast

	2018	2019	2020	2021	2022
Tariffs on Autos, Steel and Aluminium Scenario					
GDP growth, ppts difference	0.0	-0.2	-0.4	-0.1	0.2
Monetary policy rate, ppts difference	0.00	-0.06	-0.20	-0.21	-0.11
Core CPI inflation, ppts difference	0.0	0.0	-0.1	-0.1	0.0
CADUSD, annual average % difference	0.0	-0.8	-1.6	-1.6	0.0
Global Trade War (20% tariffs on trade with US)					
GDP growth, ppts difference	0.0	-1.3	-3.5	1.0	1.6
Monetary policy rate, ppts difference	0.00	-0.30	-1.21	-0.98	-0.23
Core CPI inflation, ppts difference	0.0	0.3	-0.5	-0.5	0.0
CADUSD, annual average % difference	0.0	-2.4	-10.7	-12.1	-2.4

Source: Scotiabank Economics "Steeling Ourselves for the Macro Costs of Tariffs" (June 14, 2018).

Canada's trade skirmish with the US is set to escalate in ways that could quickly turn it into a full-on trade war that could tip both countries into recession (table 4). Canada is imposing from July 1 retaliatory tariffs on US steel and aluminum products, as well as a range of consumer goods produced in politically-sensitive US Congressional districts with a view to inflicting economic pressure ahead of the November US midterm elections. The US Administration has threatened to ratchet up the conflict by imposing a further 25% tariff on motor vehicles and parts imports from the rest of the world. As Canada's second-largest export sector (after energy products), and the export sector that depends most heavily on NAFTA's tariff preferences (96% of exports to the US pass under NAFTA), auto tariffs would hit the Ontario economy particularly hard and dampen Canadian growth in 2019 and 2020 (see chart 1 again).

Auto tariffs would be a disaster for the industry on both sides of the Canada-US border. The tariffs' extra costs and the ensuing impact on vehicle affordability would pull auto sales down from around record highs in both countries. North American auto supply chains would be impaired, and the Canadian growth rate would be cut by 0.4 ppts in 2020, as shown in table 4 (see table 3 in the ***US section*** of *Global Outlook* for more details on the impact on the American economy), and the level of Canadian GDP would be down 0.6 ppts. Sustained imposition of the mooted auto tariffs could force entire parts of the industry to be moved offshore given the intense integration of vehicle and parts production across Canada, the US, and Mexico.

Global tariffs on US auto imports would invite such a wide-ranging trade war that our baseline remains that these duties will not be imposed. American industry has made it clear that they don't want this 'protection'. US workers are already seeing the first layoffs linked to the Section 232 steel and aluminum tariffs. And our modelling implies that US politicians from key Congressional districts would be expected to see even larger job losses just as they and the current president come up for re-election in 2020.

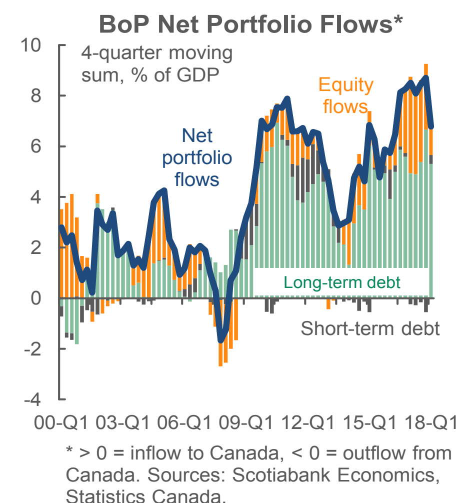
In what we *still* view as an unlikely event that the US imposes auto tariffs and the rest of the world responds, a trade war would quickly unfold that would push Canada into recession in the second half of 2019 and into 2020 (again, table 4 and chart 1). Growth would drop into mildly negative territory in the second half of 2019, and -1.8% in 2020, a recession about half as deep as the post-2008 downturn. Unemployment, however, would be expected to head back up to 9%, similar to levels a decade ago, owing to the sectoral impact of the trade conflict. The US and Mexico would also be pushed into a recession by 2020, but the impact on the US would be the mildest amongst the three 'amigos'.

INTERNATIONAL CAPITAL FLOWS: BETTER THAN THE HEADLINES

In the year-to-April, net inward flows into Canada have slowed from the record-setting pace recorded in 2017 (chart 12), dragged down by a decline in net flows into Canadian federal government debt (chart 13). With a shrinking deficit, the federal government has not had to tap bond markets for financing to the same extent that it did last year. Additionally, the spread of US Treasuries over Canadian government paper has widened since late-September. Expectations that the Federal Reserve is set to hike a total of four times in 2018—one more hike than forecast for the Bank of Canada—has decreased the relative attractiveness of Canadian government bonds.

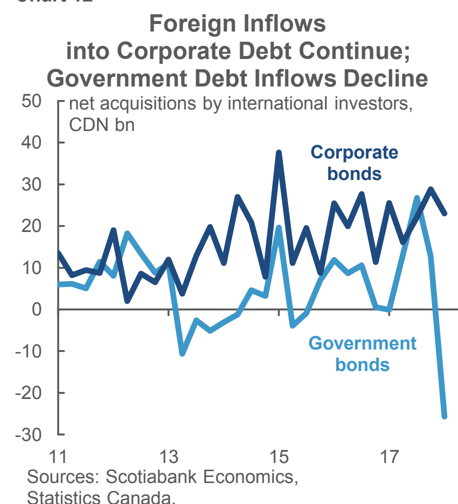
In Q1-2018, net direct investment flows into Canada from non-residents reached their highest level since the third quarter of 2015. International investors made large outlays in the Canadian manufacturing sector, where net non-resident inflows exceeded CAD 10 bn for the first time in the post-crisis period. The balance of net direct investment flows by *both* residents and non-residents into and out of Canada turned positive in Q1-2018 for the first time in 10 consecutive quarters.

Chart 11



* > 0 = inflow to Canada, < 0 = outflow from Canada. Sources: Scotiabank Economics, Statistics Canada.

Chart 12



Sources: Scotiabank Economics, Statistics Canada.

SUMMING UP: MOOSE OR MOUSE, CANADA SLEEPS BESIDE AN ELEPHANT

The entire direction of our Q3 Canadian outlook hinges sensitively on the low probability we assign to a further escalation in trade tensions between the US and its major trading partners. Two main possibilities lie ahead:

- Our baseline forecast for the Canadian economy, in which NAFTA is renovated or retained uncompromised, is unflashy and straightforward: Canadian growth moves somewhat above potential, increasing wage and price pressures support further monetary policy normalization, consumer spending moderates, households gradually deleverage their balance sheets, and investment-led improvements in the composition of growth gently sustain Canadian output in the face of US tax cuts; or

- If the US elephant moves to further restrict imports, particularly through tariffs on autos and parts, and touches off a global trade war, the likely outcome is starkly worse: recession across North America by 2020.

US action on auto tariffs will be the key fork in the road that leads us toward one of these binary outcomes.

The Provinces

- **British Columbia and Alberta retain growth leadership through 2019, but expansion is forecast to continue across all provinces despite US trade actions contributing to elevated uncertainty.**

- **After the combined provincial deficit widens in fiscal 2018–19 (FY19), propelled by Ontario's return to red ink, aggregate deficit reduction is expected to restart (chart 1).**

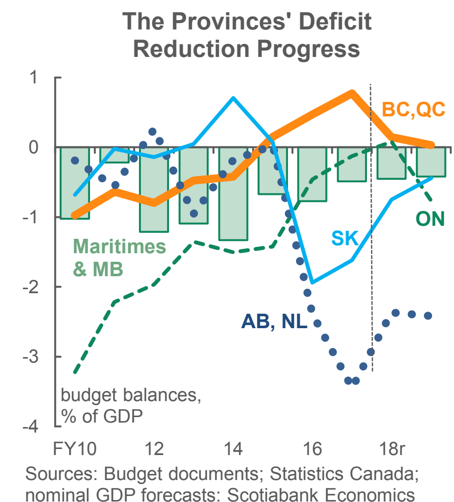
RESILIENT BUT SLOWING GROWTH

Data to date in 2018 confirm continuing momentum across most Provinces, with manufacturing orders still climbing, infrastructure spending proceeding and a long-awaited business investment recovery gaining traction. At least half of the provincial economies this year and next will likely operate above their longer-term growth rates, maintaining upward pressure on wages and prices. In most regions this year business investment is forecast to be a key source of growth, with government spending a continued support. In 2018, rising imports to meet consumer and capital demand are forecast to erode net exports; next year easing import growth should boost net exports. In the seven net oil-consuming provinces, late-cycle consumers are expected to become more circumspect through 2019.

Machinery & equipment (M&E) purchases are forecast to drive business investment this year in most provinces, starting to reverse the decline in M&E stocks since 2011 outside of the major oil-producing provinces (chart 2). Through April, seven provinces reported y/y increases in machinery imports, building on the growth in Q4 –2017. Capacity constraints, spurring investment to meet stepped-up demand, are especially tight in most regions in manufacturing, notably in forest products, rubber & plastics, machinery and petroleum refining.

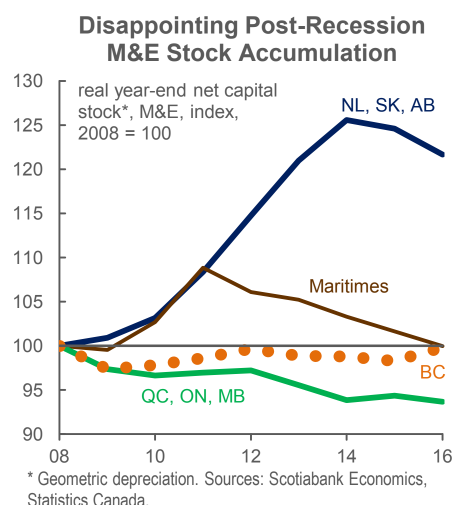
For Canadian machinery and related industries, adding to domestic orders is robust US industrial production alongside enhanced US tax incentives for M&E. Through April, double-digit y/y growth in machinery sales is estimated for Ontario, Alberta, Saskatchewan and PEI. As machinery and related output gains moderate in 2019, advances are anticipated in other industries, including bus production, and aerospace.

Chart 1



Sources: Budget documents; Statistics Canada; nominal GDP forecasts: Scotiabank Economics

Chart 2



* Geometric depreciation. Sources: Scotiabank Economics, Statistics Canada.

Food manufacturers are expected to address current record-high capacity rates with new capital, including major new plants in Manitoba and Alberta.

Non-residential construction is expected to provide a significant but smaller push to growth in 2018–19. In seven provinces, industrial & commercial building activity has climbed for two consecutive quarters, with business services and tech activity aiding space absorption. Major projects range from large hydro installations to pipelines to port infrastructure. In Alberta, investment in conventional oil & gas remains buoyant after the 2017 rebound exceeding 50%, but oil sands investment is expected to be subdued this year and a sizeable pick-up in non-residential, non-energy construction awaits 2019. After delays, Phase 1 of the federal infrastructure plan is leveraging transit, social and green capital investments across large and small centres.

Though eroded by higher imports, petroleum and non-energy exports are expected to shift higher in 2018. Oil production is expected to ramp up at Hebron, Newfoundland and Labrador's fourth offshore field, and in Alberta, an increase north of 5% is anticipated. At Alberta's major Syncrude oil sands facility, output as of late June is expected to be disrupted for at least five to six weeks. With a subsequent rebound anticipated, Alberta's real GDP growth is edged slightly lower to 2.4%. Potential volatility in the light-heavy oil price differential due to pipeline capacity constraints is a risk through 2019, though the recent approval for the Line 3 pipeline refurbishment is encouraging. Firmer prices and new capacity should boost metal mining shipments in Newfoundland and Labrador, Nova Scotia, Quebec and BC. For aluminum producers in Quebec and BC, and steel and softwood lumber output in multiple provinces, US tariffs near term are expected to have little volume impact, largely translating into higher prices south of the border. In Ontario, motor vehicles assembled are expected to fall 6¼% in 2018 and slip lower in 2019, with downside risk if the US proceeds with tariffs on Canadian autos.

Strength in services exports is highly visible in tourism and the tech sector. After record numbers of international visitors for many regions during the sesquicentennial celebrations in 2017, further y/y increases are reported in seven provinces as of April 2018. Real GDP in information & communications technology (ICT) advanced 14.7% nationally over 2011–17, outstripping the 8.5% rise for other industries. This sector includes industries with a significant export component, from engineering services to specialized manufacturing. For 2011–17, the sector expanded by more than 16% in five provinces, with Central Canada and BC gaining 10% or more since 2014 (chart 3).

Consumers in early 2018 were less buoyant than a year earlier, with y/y gains in cumulative retail sales through April weakening in every province (chart 4). In high-flying BC, the cumulative y/y rise in full-time employment through May cooled to 1.1% and the 4.7% retail sales gain through April was solid but only about half the 9.3% jump a year ago. From this soft start, consumer outlays in most provinces are likely to strengthen during H2–2018. Next year, however, easing housing activity and real consumption should become increasingly evident across the seven net oil-consuming provinces given our expectation for slower job creation and higher interest rates to exacerbate prior regulatory tightening. By contrast, household spending in the three oil-producing provinces is expected to firm after the setback from lower oil prices.

The pickup in average weekly wages through April (chart 5) points to annual increases of 2% or higher in a majority of provinces. Minimum wage hikes are contributing to these gains, especially in Ontario, Alberta and BC where increases are

Chart 3

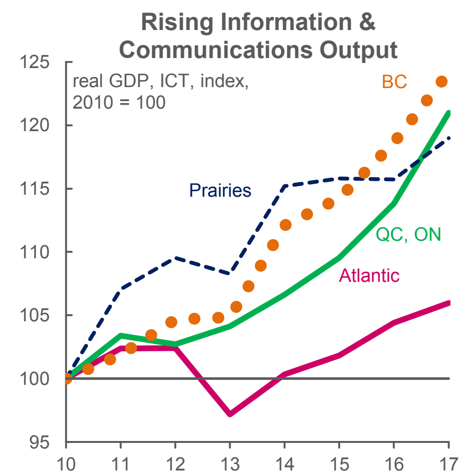
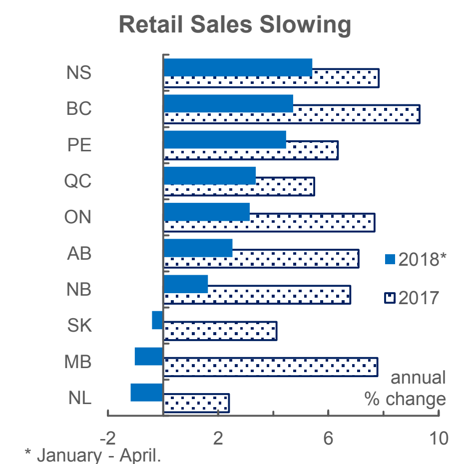
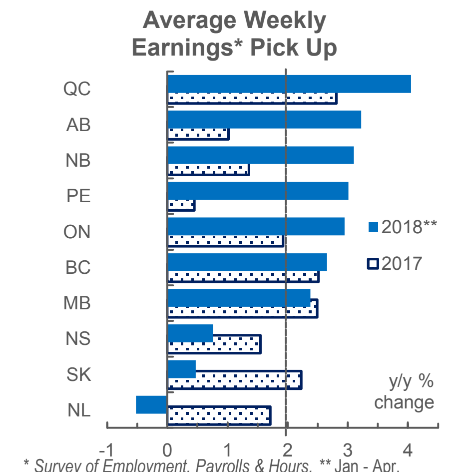


Chart 4



* January - April.

Chart 5



* *Survey of Employment, Payrolls & Hours.* ** Jan - Apr.

Sources for charts: Scotiabank Economics, Statistics Canada.

over 10%. In 2019, the forecast rise in weekly wages should moderate only slightly given continuing skills shortages. Rising headline CPI inflation is expected to absorb much of the regional wage increases, with only Central Canada likely to witness significant purchasing power gains in both 2018 and 2019.

Housing starts, revised higher for 2018 and 2019, reflect Quebec and PEI maintaining their elevated 2017 pace this year and increased attention to affordable units. For centres in Southern BC and Ontario's Greater Golden Horseshoe, affordability is expected to remain an issue through the forecast period given the cumulative supply shortage at more modest price points. Limited ownership options are compounded by constrained rental availability, though this year's rise in multi-unit starts in both regions should start to alleviate the upward pressure on rents. In Alberta's and Saskatchewan's major cities, new building is forecast to remain relatively muted as the existing inventory overhang is reduced. Over the next two years, Halifax is expected to absorb substantial new condominium and commercial space and Winnipeg housing starts are forecast to cool from a 30-year peak in 2017.

Table 1

The Provinces	(annual % change except where noted)										
Real GDP	**CA**	**NL**	**PE**	**NS**	**NB**	**QC**	**ON**	**MB**	**SK**	**AB**	**BC**
2000–16	2.1	2.5	1.7	1.3	1.2	1.7	2.0	2.3	2.0	2.7	2.8
2016	1.4	1.9	2.3	0.8	1.2	1.4	2.6	2.2	-0.5	-3.7	3.5
2017*	3.0	2.1	3.2	1.2	1.9	3.1	2.8	2.9	2.9	4.9	3.9
2018f	2.0	0.5	1.9	1.2	1.0	2.1	2.0	1.9	1.6	2.4	2.5
2019f	2.1	1.2	1.6	1.0	0.9	1.9	2.0	1.9	2.0	2.5	2.5
Nominal GDP											
2000–16	4.2	5.6	4.2	3.4	3.3	3.6	3.8	4.4	5.3	5.9	4.5
2016	2.0	2.6	4.0	2.8	3.6	2.7	4.3	2.3	-4.0	-4.9	4.8
2017e	5.4	5.6	4.7	3.1	3.2	4.5	4.8	4.3	5.4	7.9	5.9
2018f	4.3	4.1	3.8	3.2	2.8	3.9	4.1	3.9	4.1	5.4	5.0
2019f	4.7	4.0	3.9	3.1	2.9	4.3	4.4	4.2	4.7	5.7	5.1
Employment											
2000–16	1.3	0.8	1.0	0.6	0.4	1.3	1.3	0.9	1.1	2.3	1.4
2016	0.7	-1.5	-2.3	-0.4	-0.1	0.9	1.1	-0.4	-0.9	-1.6	3.2
2017	1.9	-3.7	3.1	0.6	0.4	2.2	1.8	1.7	-0.2	1.0	3.7
2018f	1.2	-0.8	1.9	0.6	0.4	1.4	1.4	0.7	0.0	1.6	1.3
2019f	1.0	-0.5	0.9	0.3	0.2	0.9	1.0	0.7	0.5	1.1	1.2
Unemployment Rate (%)											
2000–16	7.1	14.3	11.2	8.8	9.6	8.0	7.1	5.1	5.0	5.1	6.6
2016	7.0	13.4	10.7	8.3	9.5	7.1	6.5	6.1	6.3	8.1	6.0
2017	6.3	14.8	9.8	8.4	8.1	6.1	6.0	5.4	6.3	7.8	5.1
2018f	5.8	14.7	9.9	8.0	8.0	5.5	5.5	5.6	5.9	6.8	4.8
2019f	5.7	14.6	10.1	7.9	8.0	5.4	5.4	5.5	5.8	6.7	4.8
Housing Starts (units, 000s)											
2000–16	199	2.6	0.8	4.3	3.5	44	72	5.1	5.2	34	28
2016	198	1.6	0.5	3.7	1.8	39	75	5.3	4.8	25	42
2017	220	1.4	1.0	4.0	2.3	46	80	7.6	5.0	29	44
2018f	213	1.4	1.0	3.9	1.9	46	77	6.2	4.2	29	42
2019f	200	1.3	0.9	3.8	2.1	41	71	6.3	4.5	30	39
Motor Vehicle Sales (units, 000s)											
2000–16	1,657	29	6	48	38	413	635	47	45	216	180
2016	1,949	33	9	54	44	458	807	55	51	220	218
2017	2,041	33	9	59	42	453	847	62	56	245	235
2018f	2,000	32	8	58	40	445	821	61	56	248	231
2019f	1,950	30	8	56	39	434	791	60	56	250	226
Budget Balances, Fiscal Year Ending March 31 (CAD mn)											
2000–16**	-2,803	-93	-38	-30	-153	-768	-5,115	-142	307	1,064	319
2016	-987	-2,206	-13	-13	-261	2,191	-3,515	-839	-1,520	-6,442	811
2017	-17,770	-1,148	-1	150	-119	2,361	-991	-764	-1,218	-10,784	2,737
2018f***	-20,000	-812	1	134	-115	850	642	-726	-595	-8,023	151
2019f***	-18,000	-683	1	29	-189	0	-6,704	-521	-365	-8,802	219

Sources: Scotiabank Economics, Statistics Canada, CMHC, Budget documents. * Real GDP by industry, basic prices. ** MB:FY04–FY16; AB:FY05–FY16. *** Federal & Provinces' FY18 & FY19: Budget documents. Federal FY19: ex risk adjustment of $3.0bn.

THE PROVINCES' FISCAL PATHS DIVERGE

The Provinces' revenue and expenditure outlooks are presently clouded as Ontario's new government assesses accounting adjustments and the impact of its platform commitments, New Brunswick and Quebec face Fall elections, and the federal government, Alberta, PEI and Newfoundland and Labrador visit the polls in calendar 2019. Several trends should persist, such as BC's careful balancing of multiple, multi-year program and infrastructure priorities and the current fiscal repair focus of the three major oil-producing Provinces and Manitoba. Over the next two years, the economic backdrop is expected to be less conducive to fiscal repair with slower output growth, public-sector compensation catch-up pressure, and higher interest rates. Several Provinces are grappling with appropriate support for communities affected by US trade actions; the varied proposals from the Provinces related to the Pan-Canadian carbon price are expected to shift to centre stage this Fall; and ambitious program policy suggestions such as national pharmacare await resolution. With large surpluses expected to be harder to achieve, trimming net debt burdens will probably require attention to other liabilities. Alberta, for example, is reducing its FY19 *Capital Plan* by 28½%, scaling back public-sector construction activity as the province's private-sector activity recovers.

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