# Solid Growth, Risks Rising

- **The global economy remains on solid footing. Global growth will slow modestly in 2019 as should be expected at this stage of the cycle, but activity levels will remain high.**

- **The risk of a self-inflicted wound in the US is rising. The dominant downside risk to the global outlook remains the Trump Administration's attempt to rebalance trade with China through tariff policy.**

The global economy remains strong, but we have passed the cyclical peak in global growth. As has been the case for many months now, the greatest risk to the expansion remains the escalation of trade tensions between China and the United States. This is a dark cloud on the horizon, as both countries appear unwilling to cede ground in what appears to be increasingly acrimonious positions. We continue to believe cooler heads will prevail and that we avoid an all-out trade war between the world's two largest economies, but our confidence in that view is fading. President Trump appears to be emboldened by the United States Mexico Canada Agreement, and may well push forward with tougher trade actions against China.

The consequences of escalating trade actions are undeniable: higher prices in China and the US, less purchasing power for consumers in these countries, higher input costs, heightened financial market volatility, and possibly higher interest rates. These effects would likely spill over from these countries to others given that China and the US account for close to 34% of global GDP when measured on a PPP basis.

Actions to redress trade imbalances by focusing on tariff measures will prove futile as trade deficits ultimately reflect imbalances between savings and investment in a country. The very large increase in the US federal deficit will lead to a widening of the US trade deficit despite attempts to use trade policies to prevent that from happening. One of two things must happen to reduce the US trade deficit: an increase in private saving—which would require a reduction in consumption or investment due to higher interest rates and/or a weaker currency—or a reduction in the fiscal deficit. As neither appear desirable from a political perspective, there is a real risk the Trump Administration remains on the path of tariff increases, which would ironically reduce US consumption and investment, while also potentially reducing private savings, and therefore possibly increase the trade deficit. It is clear the Trump Administration does not agree with that analysis. As a consequence, trade tensions, whether they be with China or another country, will remain so long as Mr. Trump remains President and the US avoids tackling the underlying cause of its trade deficit with the rest of the world by instead focusing on ineffective and harmful policies.

The trade tensions are clouding prospects in what is otherwise a robust global economy. Growth is expected to accelerate in fewer countries in 2019 and 2020 relative to 2018, but nearly all OECD and the main emerging market countries are expected to grow in both years, despite the financial and economic challenges in a few emerging markets. Labour markets are generally tight in advanced economies, with unemployment rates at cycle lows in many countries, though

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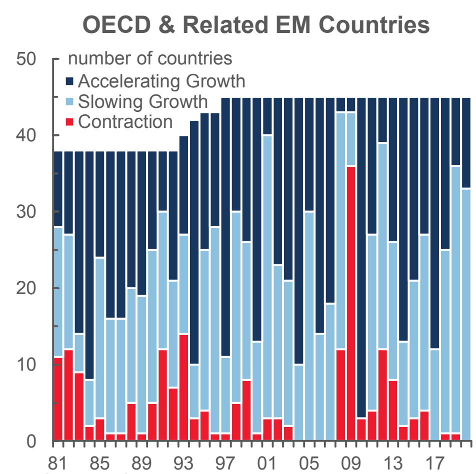
Chart 1



Sources: Scotiabank Economics, IMF.

wage gains remain weak. Inflation remains generally well contained because of these modest wage gains, but inflation is on the rise in Canada and the United States, prompting those countries to undertake what is expected to be the most aggressive monetary policy tightening among advanced economies. All these developments reflect what remains a fundamentally strong global economy.

From a Canadian perspective, two major developments will be shaping the outlook over the next couple of years, with both adding to earlier growth forecasts. The USMCA eliminates NAFTA-related uncertainty, which had been a drag on Canadian growth for close to two years. A reversal of this uncertainty could add about 0.1 percentage points to growth in 2019, pushing growth to 2.2%. This makes the USMCA an unambiguously positive near-term development for Canada but the deal is far from perfect. It buys trade peace with the US at the cost of North American competitiveness. It will mean less free trade in the auto sector, likely making the North American auto industry less competitive relative to its global competition, and which would increase costs for buyers of vehicles made in North America once these provisions come into effect.

**Table 1**

| Global Real GDP | 2000–17 | 2017 | 2018f | 2019f | 2020f |
|---|---|---|---|---|---|
| | (annual % change) | | | | |
| **World (PPP)** | 3.9 | 3.8 | 3.8 | 3.7 | 3.5 |
| Canada | 2.2 | 3.0 | 2.1 | 2.2 | 1.8 |
| United States | 2.0 | 2.2 | 2.9 | 2.4 | 1.7 |
| Mexico | 2.2 | 2.0 | 1.8 | 2.1 | 2.4 |
| United Kingdom | 1.9 | 1.7 | 1.4 | 1.5 | 1.5 |
| Eurozone | 1.3 | 2.4 | 2.0 | 1.9 | 1.7 |
| Germany | 1.4 | 2.2 | 1.9 | 1.9 | 1.6 |
| France | 1.4 | 2.2 | 1.6 | 1.6 | 1.6 |
| China | 9.3 | 6.9 | 6.6 | 6.2 | 6.0 |
| India | 7.0 | 6.3 | 7.6 | 7.5 | 7.5 |
| Japan | 1.0 | 1.7 | 1.2 | 1.0 | 0.9 |
| South Korea | 4.1 | 3.1 | 2.9 | 2.8 | 2.6 |
| Australia | 2.9 | 2.2 | 3.1 | 2.7 | 2.5 |
| Thailand | 4.0 | 3.9 | 4.3 | 3.8 | 3.5 |
| Brazil | 2.5 | 1.0 | 1.3 | 1.8 | 2.1 |
| Colombia | 3.9 | 1.8 | 2.5 | 3.5 | 3.6 |
| Peru | 5.0 | 2.5 | 3.7 | 4.0 | 4.1 |
| Chile | 3.9 | 1.5 | 3.9 | 3.2 | 3.2 |

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

The second development is the decision to move forward with an LNG terminal in northern British Columbia. We expect the CAD 40 billion project will ramp up slowly in 2019 with construction accelerating in 2020. Once completed sometime in the mid-2020s, the project could add about CAD 10 billion to Canadian exports. In the meantime, the construction will add significantly to BC and Canadian output growth. We currently estimate it will add about 0.4 percentage points of growth in BC in 2019 and almost 2 full percentage points to BC growth in 2020, and in so doing add about 0.2 percentage points to Canadian growth in 2020, pushing growth to 1.8%. The project comes at a time of significant capacity constraints in the BC construction industry and the draw on labour—where there are already significant labour shortages in the construction sector—is likely to lead to exacerbate these shortages and bid up the price of labour, adding to inflationary pressures.

If trade tensions can be kept at bay, it is likely that the global expansion will remain robust over the next couple of years. Traditional late cycle indicators in the US (and Canada) do not point to an imminent slowdown. The Federal Reserve is raising rates gradually, and at a pace that is unlikely to trip the US economy into recession. If our forecast is accurate and the Fed raises rates by 100 basis points through end-2019, monetary policy in the US would remain stimulative for much of next year since the fed funds target rate would remain around the Fed's estimate of the neutral rate. We are not yet at a point of natural exhaustion of the cycle. At this point, only self-inflicted wounds could cause a dramatic slowdown.

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# Canada

- **A marked improvement in the outlook is underway, as NAFTA-related uncertainty falls and the massive Kitimat LNG plant is set to raise growth as of next year. The still-strong global and US economies are helping the Canadian economy rotate away from consumption and housing to investment and exports.**
- **Capacity constraints are serious, prompting Canadian firms to invest in spite of what many characterize to be a challenging business climate. Labour shortages are acute, even though wages aren't fully reflecting this.**
- **With capacity constraints limiting firms' abilities to expand and growth expected to be above potential this year and next, inflationary pressures are on the rise. We expect the Bank of Canada will raise interest rates by 150 basis points by 2020Q1, to the mid-point of what it considers to be the range for neutral interest rates.**
- **While risks associated with the elimination of NAFTA and tariffs on Canadian-made autos now gone, risks of a trade war between China and the US are rising. This poses a material threat to the Canadian outlook, though we expect an orderly resolution of the current dispute.**

## TOO MUCH OF A GOOD THING?

**The Canadian outlook has improved markedly in recent weeks.** The long-awaited rotation of demand away from housing and consumption towards investment and exports is underway, as regulatory changes and higher interest rates are slowing the former and capacity constraints and very strong growth in the United States are spurring the latter. Adding to this favourable dynamic is a marked reduction in uncertainty owing to the United States Mexico Canada Agreement (USMCA), and a significant boost to growth in 2020 associated with the construction of the CAD 40 billion Kitimat LNG terminal. Taken together, these developments suggest growth in Canada will accelerate from 2.1% in 2018 to 2.2% in 2019 before slowing modestly to 1.8% in 2020. For 2018 and 2019, these forecasts are below model-generated outcomes, as we continue to mark forecasts down to account for the impact of regulatory changes on the housing market and trade uncertainty (table 1). In 2020, growth is boosted above that predicted

**Table 1**

**Real GDP growth: impact of policy developments**

| | 2018f | 2019f | 2020f |
|---|---|---|---|
| **Model-based projections based on fundamentals** | **2.4** | **2.3** | **1.6** |
| **Adjustments for policy developments and other factors** | **-0.3** | **-0.1** | **0.2** |
| B-20 mortgage rules | -0.1 | 0.0 | 0.0 |
| Steel & aluminum tariffs | 0.0 | -0.1 | 0.0 |
| NAFTA uncertainty | -0.1 | 0.1 | 0.0 |
| Global protectionism | -0.1 | -0.1 | 0.0 |
| Kitimat LNG Project | 0.0 | 0.0 | 0.2 |
| **Current baseline** | **2.1** | **2.2** | **1.8** |

Source: Scotiabank Economics.

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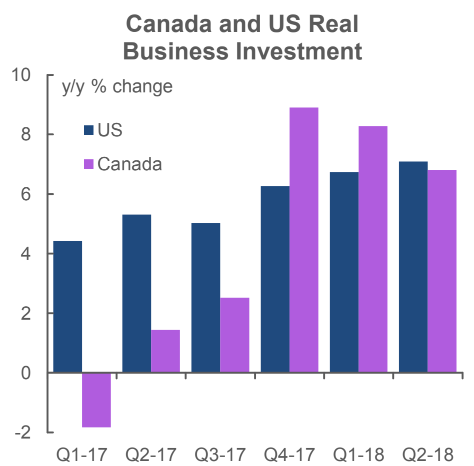
| Canada | 2017 | 2018f | 2019f | 2020f |
|---|---|---|---|---|
| Real GDP (annual % change) | 3.0 | 2.1 | 2.2 | 1.8 |
| CPI (y/y %, eop) | 1.8 | 2.9 | 2.1 | 2.0 |
| Central bank policy rate (%, eop) | 1.00 | 1.75 | 2.75 | 3.00 |
| Canadian dollar (CADUSD, eop) | 0.80 | 0.78 | 0.82 | 0.82 |

Source: Scotiabank Economics.

**Chart 1**




Sources: Scotiabank Economics, Statistics Canada, BEA.

by the model owing to the LNG project. These outcomes should push Canada into modest excess demand through 2019, driving core inflation to 2.2, and requiring 150 basis points of tightening by the Bank of Canada through mid-2020.

**The Canadian outlook has been clouded by NAFTA-related uncertainty for much of the last 2 years**. Will Trump rip up the Agreement? Will we lose our privileged access to the United States and Mexico? These and related uncertainties are thought to have acted as a drag on growth in Canada, principally through their impact on business decisions. While the behaviour of the economy—and business investment in particular—so far this year suggest the drag may not have been as large as feared, NAFTA discussions have unquestionably weighed on the outlook. So much so that this has been a recurring feature of Governor Poloz's communications. He was adamant in arguing that trade uncertainty was having a depressing impact on investment and exports in Canada, even when survey data contained in the Bank of Canada's Business Outlook suggested there wasn't much of an impact. We had explicitly clawed back our model-based forecast on account of this very uncertainty.

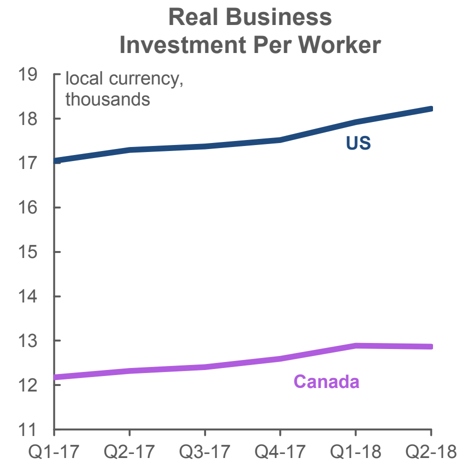
**With agreement reached on USMCA now and the associated doubts largely eliminated, some of the drag resulting from the uncertainty should be reversed.** This is not to say the new Agreement will lead to a boom in growth. On the contrary. The auto provisions of the deal will reduce the competitiveness of the North American auto industry over time, leading to higher prices and a possible loss of global market share. As it relates to autos, the USMCA is a move away from free trade. In the shorter run, the impact of USMCA should be unambiguously positive, as it eliminates a key risk facing the Canadian economy.

**At this time, we anticipate only a modest increase in growth from the reduction in uncertainty**. The evidence to date suggests that the corporate sector has looked through much of the challenges facing Canada so far this year. Over the last year, non-residential investment has kept pace with that in the United States (chart 1); though Canadian business investment per worker remains well below the level seen in the United States (chart 2) . Moreover, foreign direct investment into Canada as a proportion of GDP has been rising since early 2017 while it has been falling precipitously in the United States (chart 3).

**These two developments suggest that the litany of factors thought to be depressing business investment in Canada (NAFTA negotiations, the cut in US corporate tax rates, increases in minimum wages, lack of pipeline capacity, etc.) have taken a back seat to what are clear capacity constraints in the Canadian economy.** Utilization rates suggest that firms are operating at full capacity in a number of sectors (chart 4). Nearly 60% of firms surveyed by the BoC report some or significant challenges in meeting increases in demand. Labour shortages are increasingly prevalent. The job vacancy rate is at its highest level in recorded history (which only starts in 2011), and it has nearly doubled since early 2016. One third of firms surveyed by the BoC indicate that labour shortages will restrict their ability to meet demand, the highest level in 10 years. Given these capacity constraints, firms have ramped up investment despite factors that suggest some caution may be warranted. We expect this to continue, and to accelerate modestly given the reduction in trade-related uncertainty.

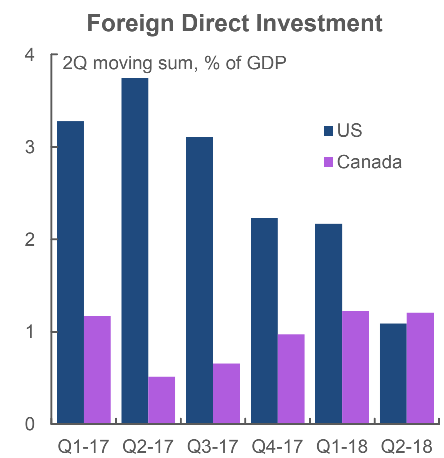
**Up to this point, a key factor holding back inflationary pressures has been reasonably muted wage pressures despite the tightest labour market in generations.** The reasons for this remain unclear, and could, as Governor Poloz believes, reflect greater slack in the labour market than captured by labour market statistics. Acute wage pressures are currently more evident in the market for hourly workers, where wages rose about 4% y/y in July, the most recent data point. As we head into the holiday period and seasonal demand for retail

Chart 2



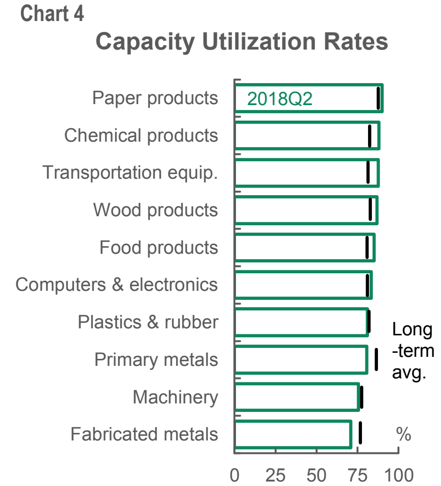

Sources: Scotiabank Economics, Statistics Canada, BEA, BLS.

Chart 3




Sources: Scotiabank Economics, Statistics Canada, Federal Reserve Board, BEA.

Chart 4




Sources: Scotiabank Economics, Statistics Canada.

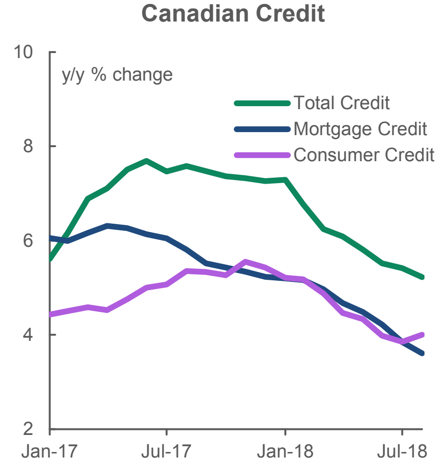
workers picks up, the confluence of a high job vacancy rate and high demand for workers may lead to an unusually large seasonal increase in wages. If so, this could be confirmation that wage pressures are finally beginning to reflect the labour situation, and this could add to inflationary pressures in a meaningful way.

**There is no compelling evidence, yet, of an outsized impact on the economy from the increase in the BoC's policy rate.** The available data suggest the economy appears to be handling the BoC's interest rate increases with relative ease. The debt service ratio has increased modestly from its lows, while the debt-to-income has come off its peak. Though we still do not have data to make a conclusive judgement on this, the sharp downshift in mortgage growth (chart 5) appears to be the result of the change in mortgage eligibility rules that took effect at the start of the year and less the result of interest rate hikes (chart 6). Mortgages in arrears as a proportion of total mortgages continue to fall and now stand at their lowest level since 1990, and credit card delinquency rates are below those for comparable periods over the last 2 years.

**As economic growth accelerated and interest rates remained low, housing markets across Canada enjoyed a modest recovery this summer.** MLS unit sales increased for the fifth consecutive month in August, with y/y declines moderating significantly versus earlier in 2018. While recent home price gains were concentrated in lower-cost dwellings such as apartments and townhomes, decreases among more expensive unit types are easing. Rebounding or stabilizing sales activity in most major markets (chart 6) suggests buyers and sellers are adjusting to higher borrowing costs and stricter mortgage qualification tests implemented January 1st, 2018.

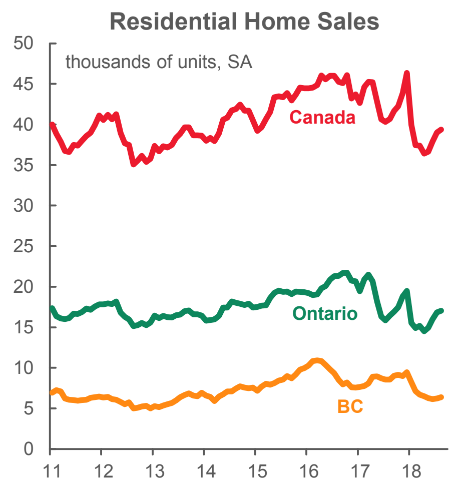
Housing affordability is the primary concern in Ontario and BC. We expect still-high home prices and still-low interest rates to incite 78,000 housing starts in Ontario this year and 72,000 units in both 2019 and 2020. Assisted by the same factors, residential construction in BC will also remain historically elevated, with starts projected to average about 40,000 units during 2018–20. Yet, new building should only slowly erode the significant supply shortfalls accumulated in both regions, and we look for strong home price growth to resume next year. Centres in Southern BC, Ontario's Greater Golden Horseshoe and across the net oil-producing provinces will continue to grapple with

Chart 5



Sources: Scotiabank Economics, Statistics Canada.

Chart 6



Sources: Scotiabank Economics, CREA.

**Table 2**

| Quarterly Canadian Forecasts | 2018 | | 2019 | | | | 2020 | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Q3e | Q4f | Q1f | Q2f | Q3f | Q4f | Q1f | Q2f | Q3f | Q4f |
| **Economic** | | | | | | | | | | |
| Real GDP (q/q ann. % change) | 2.1 | 2.4 | 2.1 | 2.1 | 1.9 | 1.7 | 2.1 | 2.0 | 1.5 | 1.5 |
| Real GDP (y/y % change) | 2.0 | 2.2 | 2.4 | 2.2 | 2.1 | 1.9 | 1.9 | 1.9 | 1.8 | 1.8 |
| Consumer prices (y/y % change) | 2.9 | 2.9 | 2.8 | 2.6 | 2.3 | 2.1 | 2.1 | 2.0 | 2.0 | 2.0 |
| Avg. of new core CPIs (y/y % change) | 2.1 | 2.2 | 2.1 | 2.2 | 2.2 | 2.2 | 2.2 | 2.2 | 2.2 | 2.2 |
| **Financial** | | | | | | | | | | |
| Canadian Dollar (USDCAD) | 1.29 | 1.28 | 1.25 | 1.25 | 1.22 | 1.22 | 1.22 | 1.22 | 1.22 | 1.22 |
| Canadian Dollar (CADUSD) | 0.77 | 0.78 | 0.80 | 0.80 | 0.82 | 0.82 | 0.82 | 0.82 | 0.82 | 0.82 |
| Bank of Canada Overnight Rate (%) | 1.50 | 1.75 | 2.00 | 2.25 | 2.50 | 2.75 | 3.00 | 3.00 | 3.00 | 3.00 |
| 3-month T-bill (%) | 1.58 | 1.80 | 2.05 | 2.30 | 2.55 | 2.80 | 3.00 | 3.00 | 3.00 | 3.00 |
| 2-year Canada (%) | 2.21 | 2.50 | 2.40 | 2.55 | 2.70 | 2.85 | 3.05 | 3.05 | 3.05 | 3.05 |
| 5-year Canada (%) | 2.34 | 2.55 | 2.50 | 2.60 | 2.75 | 2.90 | 3.10 | 3.10 | 3.10 | 3.10 |
| 10-year Canada (%) | 2.43 | 2.60 | 2.60 | 2.70 | 2.85 | 3.00 | 3.15 | 3.15 | 3.15 | 3.15 |
| 30-year Canada (%) | 2.42 | 2.65 | 2.65 | 2.75 | 2.90 | 3.10 | 3.30 | 3.35 | 3.35 | 3.35 |

Sources: Scotiabank Economics, Statistics Canada, Bloomberg.

fundamental demand-supply imbalances. In other regions, the forecast trajectory of housing construction and price gains mirror employment growth and underlying demographic trends.

**Robust demand from the US and a spike in energy products shipments are leading to a rapid rebound in export growth so far this year.** Exports to the US were also supported by a frontloading of steel and aluminum products—which grew by an annualised rate of over 40% q/q in nominal terms—ahead of tariffs imposed on June 1st on imports of these goods from Canada. Outbound trade likely softened in the third quarter as temporary tariff-related effects faded, though remains strong owing to vigorous growth in the US and the solid, though softening, global economic expansion. We anticipate that the US economy will continue to support strong growth in Canadian goods and services exports which we forecast at 3.1% in 2018 and 3.6% in 2019 before slowing to 2.2% in 2020 as US economic growth reverts closer to its long-run potential.

**Table 3**

| Canada | 2000–17 | 2017 | 2018f | 2019f | 2020f |
|---|---|---|---|---|---|
| | (annual % change, unless noted) | | | | |
| **Real GDP** | 2.2 | 3.0 | 2.1 | 2.2 | 1.8 |
| Consumer spending | 2.9 | 3.4 | 2.2 | 2.1 | 1.7 |
| Residential investment | 3.7 | 2.8 | -0.2 | 0.6 | 0.9 |
| Business investment | 2.2 | 2.7 | 6.4 | 2.7 | 6.2 |
| Government | 2.2 | 2.6 | 2.6 | 1.4 | 1.6 |
| Exports | 1.3 | 1.1 | 3.1 | 3.6 | 2.2 |
| Imports | 2.9 | 3.6 | 4.4 | 2.5 | 3.1 |
| Nominal GDP | 4.3 | 5.4 | 4.3 | 4.6 | 4.1 |
| GDP Deflator | 2.1 | 2.3 | 2.2 | 2.4 | 2.2 |
| Consumer price index (CPI) | 1.9 | 1.6 | 2.6 | 2.4 | 2.0 |
| CPI ex. food & energy | 1.6 | 1.6 | 1.9 | 2.2 | 2.3 |
| Pre-tax corporate profits | 4.4 | 19.9 | 4.4 | 4.7 | 2.1 |
| Employment | 1.4 | 1.9 | 1.2 | 1.0 | 0.8 |
| Unemployment rate (%) | 7.1 | 6.3 | 5.9 | 5.8 | 5.8 |
| Current account balance (CAD bn) | -19.7 | -63.3 | -62.6 | -51.5 | -54.2 |
| Merchandise trade balance (CAD bn) | 22.3 | -24.0 | -22.6 | -12.9 | -19.1 |
| Federal budget balance* (FY, CAD bn) | -3.6 | -17.8 | -20.0 | -18.0 | -17.0 |
| percent of GDP | -0.2 | -0.9 | -0.9 | -0.8 | -0.7 |
| Housing starts (000s) | 200 | 220 | 213 | 202 | 201 |
| Motor vehicle sales (000s) | 1,679 | 2,041 | 2,000 | 1,950 | 1,900 |
| Industrial production | 0.8 | 5.3 | 3.3 | 2.3 | 2.0 |
| WTI oil (USD/bbl) | 62 | 51 | 68 | 72 | 72 |
| Nymex natural gas (USD/mmbtu) | 4.83 | 3.02 | 2.93 | 2.93 | 2.93 |

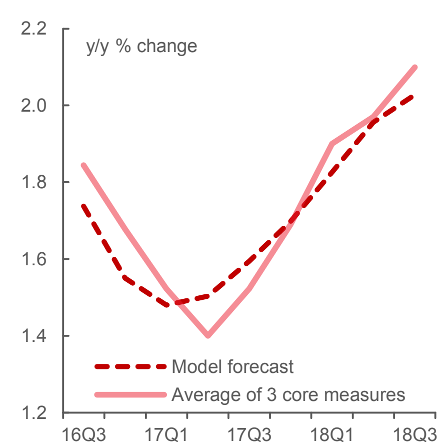
Sources: Scotiabank Economics, Statistics Canada, CMHC, Bloomberg. * Canada ex risk adjustment of $1.5bn & $3.0bn for FY18 & FY19.

**Over time, export growth will benefit from the massive LNG plant to be built in British Columbia, likely generating total additional exports of around 10 billion dollars annually.** While impacts on exports are unlikely be felt until the mid-2020s, construction of the CAD40 billion project will have substantial economic impacts as it is being built. We currently estimate the project will add 0.2 percentage points to Canadian growth, and almost 2 full percentage points to BC growth in 2020 when we think construction will be in full swing. This boost in growth coincides with national growth falling below potential given the BoC's efforts to restrain growth. The project is likely to create some challenges given the nearly 60,000 job vacancies in BC, 5,400 of which are in the construction sector. This additional demand for labour created by the project will create additional pressure on wages, and should add to inflationary pressures.

**Capacity constraints are already creating inflationary pressures as inflation continues to evolve largely as suggested by our model (chart 7).** With excess demand expected to rise further through 2020, inflationary pressures will remain front and centre. The average of the three core measures of inflation is now above the BoC's 2% target, and is likely to move even further away from the BoC's target in quarters ahead, prompting another 150 basis points in policy tightening by 2020Q1.

**Despite generally positive developments in recent months, important risks remain.** With NAFTA out of the way, the Trump Administration is likely to escalate trade tensions with China. While we continue to believe cooler heads will prevail in light of the economic damage caused by an escalation of trade actions, it is quite possible that the Trump administration continues on a path of trade aggression. Were this to occur, growth in the US and China would slow, possibly substantially, with consequential impacts on the Canadian economy. We are also carefully monitoring developments in the Canadian housing market. As noted above, our view is that much of the weakness has been localized and largely reflects regulatory changes, but it is possible there are deeper causes to the weakness that could act as a more important drag than we currently estimate. There are, however, important upside risks. The US economy remains very strong and it is possible that this provides more support to our economy than expected. At the same time, we have included only a modest reversal of the NAFTA-related drag observed so far. There is a good chance that the reduction in uncertainty coming with the USMCA leads to a more sizeable acceleration in corporate spending than we are building into our forecast.

Chart 7 Canadian Core Inflation




Source: Scotiabank Economics.

## The Provinces

- **Alberta and BC are forecast to top provincial economic growth in 2018, with BC reclaiming the outright lead thereafter due to new major project activity; all provinces are expected to continue expanding through 2020.**
- **Pressure to restrain public spending is intensifying as revenue growth slows, with the federal government offering some near-term assistance.**

### NEW PROJECTS, TRADE PACT BUOY PROVINCIAL PROSPECTS

**Expectations of moderating consumer spending across the provinces still underlie our forecast.** Slower job creation is the proximate cause in net oil-consuming regions. Waning Fort McMurray rebuild-related outlays are negating Alberta's year-to-date hiring pick-up. Newfoundland and Labrador's falling population should offset modest projected job gains, and weak wage growth plus rising inflation are weighing on Saskatchewan consumer spending. As job creation eases further, Canada Child Benefit stimulus continues to dissipate, interest rates rise and housing activity slows through 2020, we foresee a gentle cooling of real consumer expenditure growth in most regions.

**Labour shortages, arising across Central and Western Canada after above-trend job creation last year, present new challenges.** Though tight labour markets have the potential to push wages higher, they also limit businesses' ability to hire and expand. In June, job vacancy rates reached record highs in Quebec, Ontario and BC and a post-2014 high in Alberta (chart 1), with elevated numbers of unfilled positions reported in a range of industries.

**Skills shortages come as interprovincial migration is shifting.** A cooling economy and housing affordability pressures appear to be weakening BC's attraction, with Ontario benefiting to date. Alberta's improving employment prospects and competitive wages are increasing its draw following the 2015–16 recession (chart 2). Quebec's net population outflow to other regions—in progress since Q2-2003—receded amid a robust 2017 expansion but is rising again.

**These changes highlight the importance of immigration in Central Canada and BC.** The integration of skilled immigrants is crucial to maintaining BC's attraction and addressing labour market shortages. Ontario's labour productivity lags that in BC, Saskatchewan, and Alberta, and this year's rise in economic immigrants—newcomers admitted for their ability to contribute to the economy—bodes well for its longer-term productive capacity. Newcomers to Quebec have historically not fared as well in the labour market as in other regions, but the province needs immigration to sustain population growth given its older populace.

**Immigration is expected to assist population growth in other provinces.** Increases to Ottawa's 2018 and 2019 immigration targets provide a basis for newcomer attraction, especially in the Prairies, where immigrants have historically best integrated into the labour market. The *Atlantic Immigration Pilot* will support retention in Atlantic Canada, helping to mitigate the effects of aging populations.

**We still expect accelerating machinery & equipment (M&E) outlays in most provinces this year as firms bump up against capacity constraints.** Ontario's

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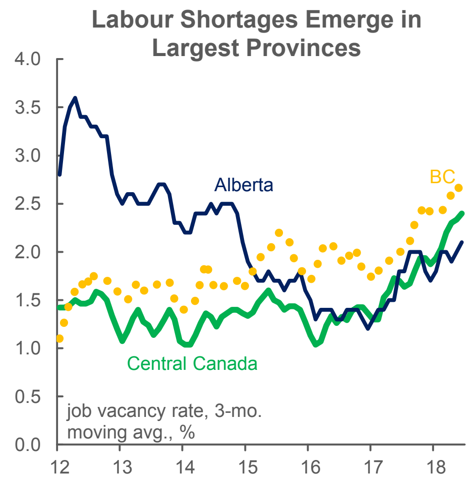
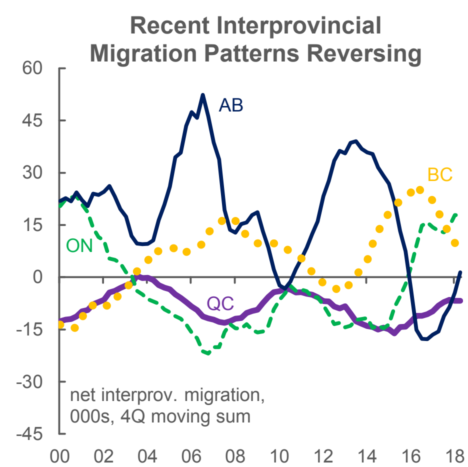
Chart 1



Sources: Scotiabank Economics, Statistics Canada.

Chart 2



Sources: Scotiabank Economics, Statistics Canada.

torrid 22.7% (q/q ann.) Q1-2018 real M&E investment jump drove national-level gains, while Quebec M&E spending accelerated in Q2 after a first-quarter pause.

**As firms address capacity limitations this year, we expect rising non-residential construction investment already underway** (chart 3) **to supplant M&E as a key driver of growth in many provinces.** Alberta's steady forecast gains in capital outlays on non-residential buildings reflect construction of petrochemicals and conventional oil & gas facilities. Volatility in the light-heavy oil price differential due to insufficient pipeline capacity continues to pose significant downside risk for investment in both Alberta and Saskatchewan. Industrial and commercial activity—concentrated in Toronto but also present in other major cities—should propel Ontario's continued expansion. The industrial and commercial sector is also expected to support Quebec's economic growth, with mining investment and a port expansion providing an additional lift.

**BC's economic outlook is dominated by the CAD 40 bn LNG Canada project, which received a final investment decision on October 2nd.** The venture will see construction of a natural gas pipeline from northeast BC to a new export terminal in Kitimat, with work likely proceeding until 2025. Our forecast assumes capital outlays of nearly CAD 14 bn during 2019–20, which add about two percentage points to real GDP over the two years and propel BC well ahead of the other provinces. Hydroelectricity projects provide a further assist for non-residential building investment.

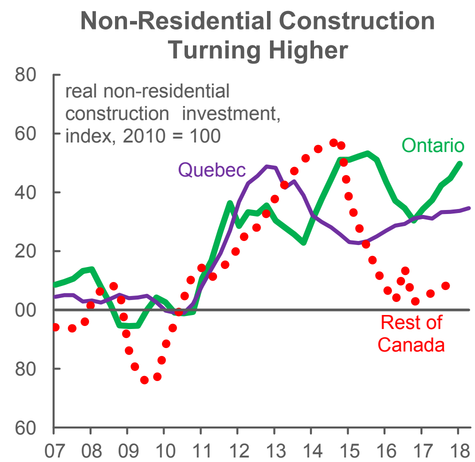
**For most provinces, the US-Mexico-Canada Agreement (USMCA) free-trade pact forestalls downside associated with NAFTA termination.** Ontario, where motor vehicles and parts to the US made up 30% of 2013–17 nominal export receipts, likely averts 25% US tariffs on foreign-made automobiles. Some farmers are aggrieved over greater US access to Canadian dairy markets, but the deal helps Quebec skirt major downside risk. New Brunswick remains subject to softwood lumber duties with Quebec and BC, but will breathe a sigh of relief given its 88% share of non-energy exports bound for the US market over 2013–17 (chart 4). For the net oil-producing regions—less sensitive to US trade disruptions—the pact scrapped a number of archaic regulations that largely did not constrain producers under NAFTA. Potential drawbacks come via terms requiring advance notice of free-trade negotiations with 'non-market' countries, which may hinder several provinces' efforts to expand Asian market access.

**The near-term outlook for agricultural output and exports is mixed.** Farmers anticipate principal field crop production declines this year across the prairies—largely due to dry growing conditions—as well as in Ontario. Other trends include a more competitive global market for wheat—a staple crop in many provinces—and greater protein demand in the Indo-Pacific region. The latter could benefit meat and pulse producers, but Indian import tariffs on Canadian pulses present challenges.

**Services exports will remain anchored by tourism and the tech sector.** Eight provinces reported y/y ytd gains in July and tourism facility expansions are underway in many jurisdictions. Investments in video game design should support tech sector gains in Quebec. A self-driving vehicle company and an e-commerce firm are expanding their footprints in Toronto. Vancouver and Victoria are home to many high-tech satellites of large international corporations and fast-growing local firms.

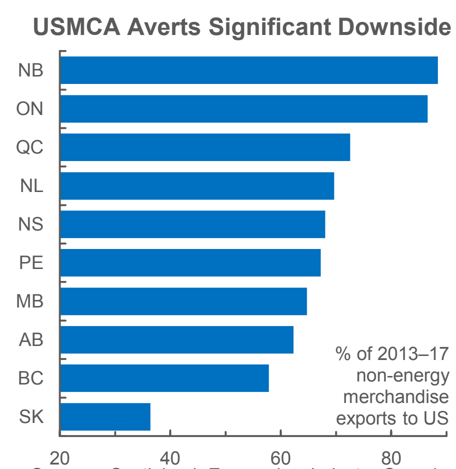
**In 2020, a slowing US economic expansion should induce easing export gains in Central Canada.** Our forecast of moderating economic growth in Quebec and Ontario mirrors cooling US import demand. By contrast, rising oil production should continue to power robust export gains and trade surpluses in the net oil-producing regions.

Chart 3



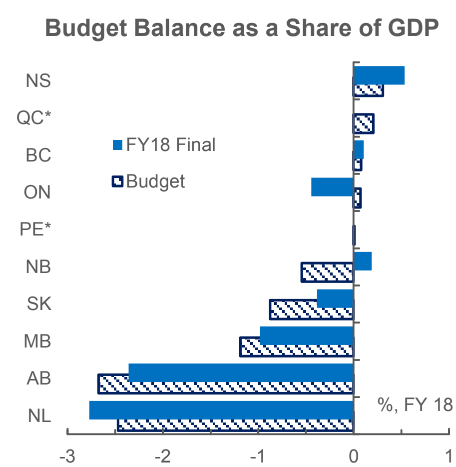
Sources: Scotiabank Economics, Statistics Canada.

Chart 4



Sources: Scotiabank Economics, Industry Canada.

Chart 5



* FY18 results not yet available. Sources: Scotiabank Economics, Budget Documents.

## PROVINCES' FISCAL PATHS BUILD ON SLOWER GROWTH

**Slowing revenue growth is a key fiscal concern going forward.** As last year's economic expansion wanes, many Provinces will need to rely more heavily on expenditure restraint to reduce deficits and address policy priorities. Six Provinces have thus far reported better-than-expected FY18 fiscal positions (chart 5, p.2), but health care systems will be increasingly strained by aging populations and rising interest rates will push debt servicing costs higher as we enter 2020. With a strong fiscal position, the new administration elected in Quebec has promised to target competitiveness and pocketbook relief once it takes office. In Ontario, however, personal and business tax cuts proposed during this year's campaign may be postponed following reports of a much larger-than-expected deficit from the Province's *Independent Financial Commission of Inquiry*.

**Federal policy should offer some support for near-term provincial fiscal repair and economic growth.** Ottawa has allotted funding of CAD 33 bn over the next 10 years as part of the second phase of its infrastructure plan. Targeted tax changes aiming to boost competitiveness after January's US federal corporate income tax rate cut are expected in the fall fiscal update.

**Table 1**

| The Provinces | (annual % change except where noted) | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Real GDP** | **CA** | **NL** | **PE** | **NS** | **NB** | **QC** | **ON** | **MB** | **SK** | **AB** | **BC** |
| **2000–17** | 2.2 | 2.4 | 1.8 | 1.3 | 1.3 | 1.8 | 2.1 | 2.4 | 2.0 | 2.8 | 2.8 |
| **2017*** | 3.0 | 2.1 | 3.2 | 1.2 | 1.9 | 3.1 | 2.8 | 2.9 | 2.9 | 4.9 | 3.9 |
| **2018f** | 2.1 | 0.5 | 2.0 | 1.2 | 1.1 | 2.1 | 2.1 | 1.9 | 1.5 | 2.4 | 2.4 |
| **2019f** | 2.2 | 1.2 | 1.6 | 1.0 | 0.9 | 2.0 | 2.1 | 1.9 | 1.8 | 2.5 | 2.7 |
| **2020f** | 1.8 | 0.8 | 1.1 | 0.9 | 0.9 | 1.5 | 1.6 | 1.5 | 1.8 | 2.0 | 3.6 |
| **Nominal GDP** | | | | | | | | | | | |
| **2000–17** | 4.3 | 5.6 | 4.2 | 3.3 | 3.3 | 3.7 | 3.9 | 4.4 | 5.3 | 6.0 | 4.6 |
| **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 | 3.9 | 3.2 | 2.9 | 3.8 | 4.1 | 3.9 | 4.1 | 5.5 | 5.0 |
| **2019f** | 4.6 | 4.1 | 3.9 | 3.1 | 3.0 | 4.3 | 4.6 | 4.3 | 4.1 | 5.5 | 5.3 |
| **2020f** | 3.7 | 3.9 | 2.9 | 2.8 | 2.4 | 3.4 | 3.7 | 3.5 | 4.4 | 4.8 | 5.8 |
| **Employment** | | | | | | | | | | | |
| **2000–17** | 1.4 | 0.6 | 1.1 | 0.6 | 0.4 | 1.3 | 1.3 | 1.0 | 1.1 | 2.2 | 1.5 |
| **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 | 0.3 | 2.5 | 1.1 | 0.4 | 1.1 | 1.5 | 0.5 | 0.0 | 1.8 | 0.8 |
| **2019f** | 1.0 | 0.1 | 0.9 | 0.3 | 0.2 | 0.9 | 1.1 | 0.7 | 0.5 | 1.2 | 1.1 |
| **2020f** | 0.8 | -0.1 | 0.5 | 0.2 | 0.2 | 0.7 | 0.9 | 0.6 | 0.7 | 1.2 | 1.1 |
| **Unemployment Rate (%)** | | | | | | | | | | | |
| **2000–17** | 7.1 | 14.3 | 11.1 | 8.8 | 9.5 | 7.9 | 7.0 | 5.1 | 5.0 | 5.2 | 6.5 |
| **2017** | 6.3 | 14.8 | 9.8 | 8.4 | 8.1 | 6.1 | 6.0 | 5.4 | 6.3 | 7.8 | 5.1 |
| **2018f** | 5.9 | 14.5 | 9.9 | 7.9 | 8.0 | 5.5 | 5.6 | 5.8 | 6.2 | 6.6 | 4.8 |
| **2019f** | 5.8 | 14.1 | 10.0 | 7.8 | 8.0 | 5.4 | 5.5 | 5.6 | 6.1 | 6.5 | 4.9 |
| **2020f** | 5.8 | 14.0 | 10.0 | 7.7 | 7.9 | 5.4 | 5.5 | 5.5 | 6.0 | 6.4 | 4.9 |
| **Housing Starts (units, 000s)** | | | | | | | | | | | |
| **2000–17** | 199 | 2.6 | 0.8 | 4.3 | 3.5 | 44 | 72 | 5.1 | 5.2 | 34 | 28 |
| **2017** | 220 | 1.4 | 1.0 | 4.0 | 2.3 | 46 | 80 | 7.6 | 5.0 | 29 | 44 |
| **2018f** | 213 | 1.5 | 0.9 | 4.7 | 2.1 | 46 | 77 | 6.9 | 3.7 | 29 | 41 |
| **2019f** | 202 | 1.4 | 0.8 | 3.9 | 2.0 | 42 | 72 | 6.1 | 4.6 | 30 | 39 |
| **2020f** | 201 | 1.4 | 0.8 | 3.8 | 1.9 | 41 | 72 | 6.1 | 5.0 | 31 | 38 |
| **Motor Vehicle Sales (units, 000s)** | | | | | | | | | | | |
| **2000–17** | 1,657 | 29 | 6 | 48 | 38 | 413 | 635 | 47 | 45 | 216 | 180 |
| **2017** | 2,041 | 33 | 9 | 59 | 42 | 453 | 847 | 62 | 56 | 245 | 235 |
| **2018f** | 2,000 | 29 | 9 | 53 | 39 | 450 | 855 | 68 | 48 | 230 | 219 |
| **2019f** | 1,950 | 31 | 8 | 50 | 37 | 435 | 825 | 60 | 50 | 225 | 229 |
| **2020f** | 1,905 | 30 | 8 | 48 | 35 | 420 | 810 | 55 | 49 | 215 | 235 |
| **Budget Balances, Fiscal Year Ending March 31 (CAD mn)** | | | | | | | | | | | |
| **2000–17**** | -3,635 | -93 | -38 | -30 | -153 | -768 | -5,115 | -142 | 307 | 1,064 | 454 |
| **2017** | -17,770 | -1,148 | -1 | 151 | -117 | 2,361 | -991 | -764 | -1,218 | -10,784 | 2,737 |
| **2018f***** | -20,000 | -911 † | 1 | 230 † | 67 † | 850 | -3,700 † | -695 † | -303 † | -8,023 † | 301 † |
| **2019f***** | -18,000 | -683 | 1 | 29 | -187 | 0 | -15,000 | -521 | -306 | -7,757 | 669 |
| **2020f** | -17,000 | -507 | 3 | 39 | -124 | 0 | n/a | -388 | 6 | -7,912 | 810 |

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

# United States

## GROWTH HAS PEAKED

- **Fiscal stimulus and efforts to pull trade forward to avoid new duties are papering over the incipient damage from tariffs and inconsistent policy-making. Real GDP growth in 2018 remains on track toward 2.9% for the year, the fastest annual expansion since 2015 and well above our 2.0% estimate of underlying potential. As 2018's government-induced spike fades, growth is expected to taper rapidly toward potential by 2020.**
- **On pure momentum, the US's post-2008 expansion is on-track to become the longest in the country's post-war history by mid-2019. The main threat to the US outlook remains the possibility of increased protectionism.**

## COOLING BEGINS, BUT STILL ON-TRACK FOR RECORD-LONG EXPANSION

**The US continues to lead major developed market growth, tracking 2.9% in 2018, as a result of the late-cycle fiscal boost it has received from federal tax changes and additional public spending during 2018.** While this additional expansionary impulse is expected to wane going into 2019—with US growth projected to decelerate to 2.4% in 2019 and 1.7% in 2020—the US economy is not forecast to head into recessionary territory in our forecast horizon given that the sources of growth are widely spread across the major components of the US economy (chart 1).

**Our baseline forecasts incorporate a move to boost the 10% duty imposed on September 24 on 'phase II' of USD 200 bn of annual US imports from China to 25% on January 1, 2019 (chart 2**). In our forecasts, 25% US tariffs on USD 250 bn of Chinese imports shave at least 0.1 ppts from headline growth in 2019.

**Under our baseline forecasts, we do not expect Washington to impose further duties on the remaining USD 267 bn of 'phase III' imports it takes in annually from China.** About a third of this last tranche of tariffs would hit a range of popular consumer goods just as the White House would be preparing for the 2020 elections.

**On the US economy's current policy mix and growth trajectory, we forecast that the Fed will raise the upper bound of its target fed funds rate from its current 2.25% to a peak of 3.25% by Q3-2019**. See the ***Monetary Policy and Capital Markets*** section for our view on North American policy rates and yields.

## GROWTH PROSPECTS CONTINGENT ON TRADE POLICY

**Growth continues to advance robustly above underlying potential and remains broadly-based, with the trade deficit providing the only substantial dampener on the GDP expansion.** After US growth clocked in at 2.2% in Q1 and 4.2% in Q2 q/q annualised—the fastest expansion in four years—we expect it to average around 2.8% q/q in the second half of 2018 (table 1). Post-hurricane reconstruction should provide a small addition to growth in Q4 and Q1-2019, but does not otherwise affect our outlook. The conclusion of the successor to NAFTA—the US-Mexico-Canada Agreement (USMCA)—has little material impact on our growth outlook as it had been anticipated in our prior baseline.

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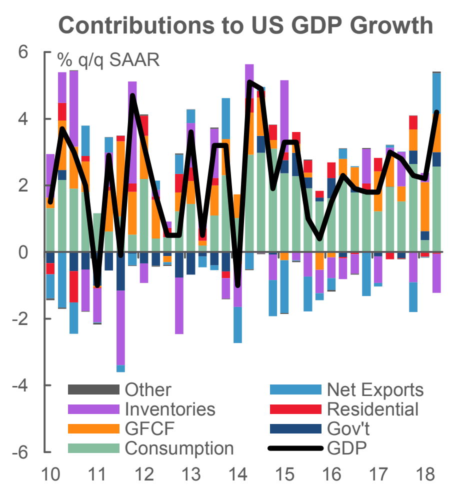
| United States | 2017 | 2018f | 2019f | 2020f |
|---|---|---|---|---|
| Real GDP (annual % change) | 2.2 | 2.9 | 2.4 | 1.7 |
| CPI (y/y %, eop) | 2.1 | 2.4 | 2.2 | 2.1 |
| Central bank policy rate (%, eop) | 1.50 | 2.50 | 3.25 | 3.25 |
| Canadian dollar (USDCAD, eop) | 1.26 | 1.28 | 1.22 | 1.22 |

Source: Scotiabank Economics.

Chart 1

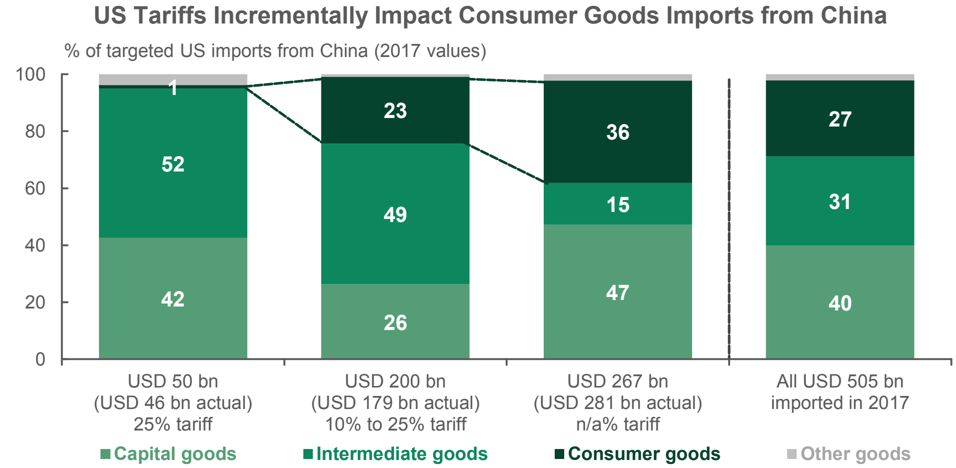



Sources: Scotiabank Economics, BEA.

**Fed Chair Jerome Powell noted on October 2 that "there's no reason to think this cycle can't continue for quite some time, effectively indefinitely."** But this doesn't mean growth won't slow heading into 2019 as the effects of this year's fiscal stimulus begin to dissipate. Real GDP growth is expected to decelerate to 1.8% q/q annualised by Q4 of 2019 and to a below-potential 1.5% by Q4-2020 (table 1 again).

**The US growth outlook remains contingent on the future imposition of tariffs on China and other trade partners.** A decision to follow through on Phase III of 25% tariffs on Chinese imports would knock at least another 0.1 ppts from our forecast for growth in 2019.

Chart 2




Sources: Scotiabank Economics, US ITC, International Trade Centre, USTR.

## TIGHT LABOUR MARKETS, BUT RELATIVELY MODERATE WAGE GAINS

**US labour markets continue to advance with the lowest unemployment rate since 1970 and hiring averaging around 200k positions each month.** With the ratio of job-seekers to vacancies near all-time lows, quit rates at 17-year highs, and still-strong hiring intentions outside of industries directly hit by tariffs, the Fed's wage growth tracker should remain at or above 3% y/y in the coming quarters.

**Consumption was variable in the first half of 2018, with a poor 0.5% q/q expansion in Q1 succeeded by a breakout 3.8% q/q annualised growth rate in Q2 (table 2).** With inflation nearly on par with nominal wage increases, consumption growth is expected to remain solid, but come down below 2.0% q/q annualised through 2019 as federal fiscal stimulus wanes, households continue modest efforts to raise their savings, and higher interest rates dampen purchases of big-ticket items that usually require financing. Auto sales, typically sensitive to interest rates and oil prices, continue to show signs of having peaked at last year's record level of 17.0 mn units and are not expected to go any higher in 2018–19 owing to higher borrowing costs (table 2 again).

Table 1

| Quarterly US Forecasts | 2018 | | 2019 | | | | 2020 | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Q3e | Q4f | Q1f | Q2f | Q3f | Q4f | Q1f | Q2f | Q3f | Q4f |
| **Economic** | | | | | | | | | | |
| Real GDP (q/q ann. % change) | 3.2 | 2.5 | 2.1 | 2.0 | 1.9 | 1.8 | 1.7 | 1.7 | 1.6 | 1.5 |
| Real GDP (y/y % change) | 3.0 | 3.0 | 3.0 | 2.4 | 2.1 | 1.9 | 1.9 | 1.8 | 1.7 | 1.6 |
| Consumer prices (y/y % change) | 2.6 | 2.4 | 2.2 | 2.2 | 2.2 | 2.2 | 2.1 | 2.1 | 2.0 | 2.1 |
| CPI ex. food & energy (y/y % change) | 2.2 | 2.3 | 2.1 | 2.2 | 2.2 | 2.2 | 2.2 | 2.2 | 2.2 | 2.2 |
| Core PCE deflator (y/y % change) | 2.1 | 2.1 | 2.2 | 2.2 | 2.2 | 2.1 | 2.1 | 2.0 | 2.0 | 2.0 |
| **Financial** | | | | | | | | | | |
| Euro (EURUSD) | 1.16 | 1.20 | 1.22 | 1.24 | 1.26 | 1.30 | 1.30 | 1.30 | 1.32 | 1.32 |
| U.K. Pound (GBPUSD) | 1.30 | 1.32 | 1.32 | 1.35 | 1.37 | 1.40 | 1.42 | 1.42 | 1.45 | 1.45 |
| Japanese Yen (USDJPY) | 110 | 110 | 110 | 110 | 108 | 108 | 107 | 107 | 105 | 105 |
| Fed Funds Rate (upper bound, %) | 2.25 | 2.50 | 2.75 | 3.00 | 3.25 | 3.25 | 3.25 | 3.25 | 3.25 | 3.25 |
| 3-month T-bill (%) | 2.20 | 2.45 | 2.70 | 2.95 | 3.20 | 3.20 | 3.20 | 3.20 | 3.20 | 3.20 |
| 2-year Treasury (%) | 2.82 | 3.00 | 3.00 | 3.10 | 3.30 | 3.30 | 3.30 | 3.30 | 3.30 | 3.30 |
| 5-year Treasury (%) | 2.95 | 3.15 | 3.05 | 3.15 | 3.35 | 3.35 | 3.40 | 3.40 | 3.45 | 3.45 |
| 10-year Treasury (%) | 3.06 | 3.25 | 3.15 | 3.20 | 3.40 | 3.40 | 3.50 | 3.50 | 3.55 | 3.55 |
| 30-year Treasury (%) | 3.21 | 3.40 | 3.30 | 3.30 | 3.50 | 3.50 | 3.60 | 3.60 | 3.65 | 3.65 |

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

## RISING HOME PRICES, BUT FALLING SALES

**Home prices continue to climb across the US.** The national Case-Schiller Home Price Index rose (nsa y/y) for the 78th consecutive month in July, though it remained more than 11% below the peak achieved in 2006 on an inflation-adjusted basis (chart 3). The National Association of Realtors' (NAR) housing affordability index has sat at or near its lowest level since 2008 throughout 2018 in all four major US areas surveyed; however, affordability is better than it was during much of the period prior to the 2008 global financial crisis (chart 4)

**Falling home sales—reflected in a national-level 1.9% y/y ytd decline in purchases of existing homes through August plus decreases in every region but the South—are a consequence of rising prices and relatively limited supply.** Weakness is concentrated amongst lower-end houses, while homes valued below USD 250k are driving the bulk of the sales declines amongst existing properties. This is occurring even as the late-cycle economic expansion is generating the aforementioned wage gains for lower-income earners (chart 5). Reductions to the ceiling for interest deductions on new mortgages and the cap on state and local income tax exemptions introduced in January may also be leading to some weakness in home sales.

**Rising bond yields are also contributing to weak affordability and home sales activity.** The average 30-year fixed mortgage rate has recently hovered around a seven-year high. Higher rates continue to discourage existing owners from undertaking refinancing and move-up purchases, leaving a dearth of available inventory on the lower-end of the market.

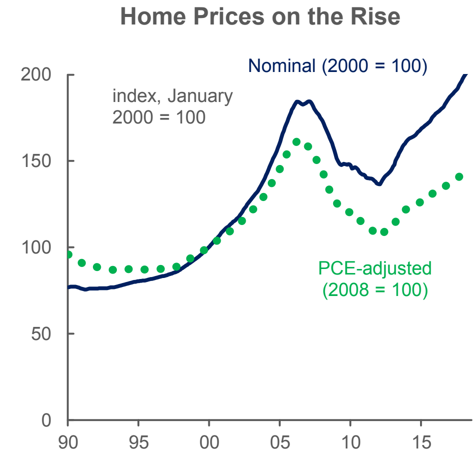
**We expect an exacerbation of the existing housing supply shortfall to push prices higher, further weakening affordability and home sales.** Housing starts averaged 1.27 mn units (SAAR) as of August this year—a pace that, if maintained, would represent a post-recession high—but this is well short of the 1.5–1.6 mn units associated with the existing level of underlying demand. We expect starts to moderate to 1.25–1.26 mn units over 2019–20, with job creation and household incomes forecast to ease across the country, and three Fed rate hikes over 2018–19 likely to weigh on building activity.

**Rising material costs may also discourage residential construction.** Builder confidence, as measured by the National Association of Home Builders (NAHB) index, has firmed up. Yet, rising construction costs, often cited lately as a challenge for builders, should be exacerbated by recently announced US tariffs on Chinese imports. We expect lumber prices to remain at historically elevated levels in the USD 350–400 range throughout the forecast period, though the early-2018 spike in lumber costs appears to have faded and will likely be increasingly absorbed by an appreciating US dollar.

## MANUFACTURING CONTINUES TO POST GAINS

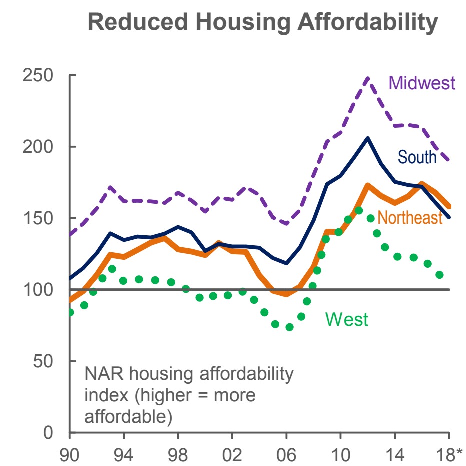
**The US manufacturing sector is forecast to post its steepest annual increase since 2011 this year, which will be followed by a robust, though softer expansion in 2019.** Amidst post-recession highs in consumer and business optimism stemming from the aforementioned solid employment growth and recently-legislated

Chart 3



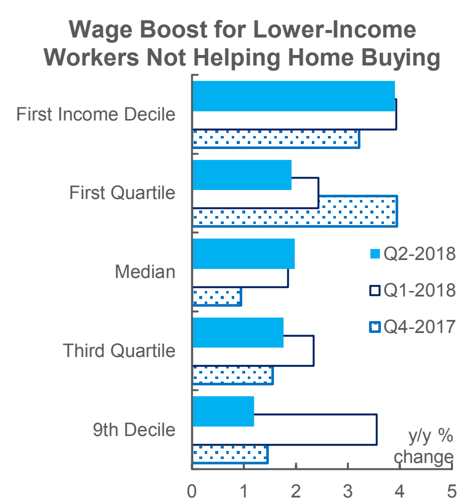

Sources: Scotiabank Economics, Robert Shiller, Haver Analytics.

Chart 4




* Jan.–July. Sources: Scotiabank Economics, NAR, Haver Analytics.

Chart 5




Sources: Scotiabank Economics, BLS, Haver Analytics.

corporate tax cuts, domestic demand for US manufactures has supported robust gains in the industry. However, the intensifying US-initiated trade spat with China is likely to dampen sectoral sales and may pose bigger risks to manufacturing output from spillovers into household and enterprise confidence. Furthermore, despite resilient industry sentiment domestically, the rise of US protectionism has halted recent lifts to business optimism in some of the US's largest trading partners such as the European Union.

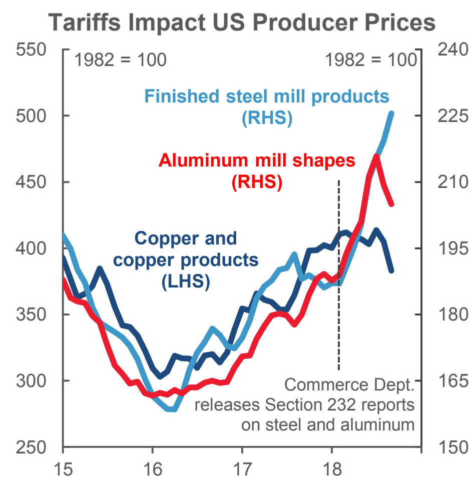
**Despite a strong expansion in manufacturing output, operating rates in the manufacturing sector have climbed only slowly since late-2016 and remain around their post-recession averages (chart 6).** Private fixed investment in machinery and equipment has increased by 13% in real terms since Q3-2016 after two years of practically flat outlays, and employment in the manufacturing industry is growing at its fastest rate since the mid-90s. This increase in productive capacity in the sector has managed to keep operating pressures at bay, although certain sub-industries have seen a pointed turn-around in operating rates that may be limiting their sales. Owing to the rise in business investment, a surge in demand for machinery has pushed the capacity utilisation rate in the sector from as low as 66% in mid-2016 to 77.8% in August.

Chart 6


Sources: Scotiabank Economics, FRB.
Dotted lines represent 2011-present average.

**Unfilled orders, excluding transportation manufacturing, have posted five consecutive months of 5% or higher year-on-year growth, a first such run since 2012.** As manufacturers attempt to keep up with rising demand, inventory levels are slowly lagging shipments with the inventory-to-sales ratio ticking down from 1.44 in February 2016 to 1.34 in August 2018. Adjusted for inflation, manufacturing inventories of finished goods have remained relatively flat for the last two or so years, after rising without pause between 2010 and 2016. This implies that the late-stage economic expansion currently underway has exceeded manufacturers' expectations and led to a lagged response toward increasing their productive capacity.

Chart 7



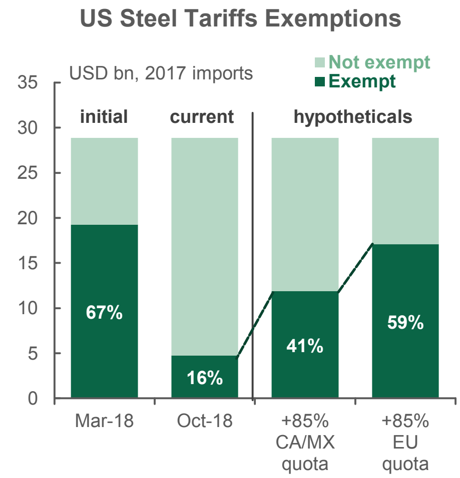

Sources: Scotiabank Economics, BLS.

**US import tariffs on both Chinese industrial goods, and various steel and aluminum products, combined with rising demand for materials worldwide, have led to a strong increase in producer prices which may begin to take a toll on corporate profits (chart 7).** Prices paid for durable manufacturing inputs have climbed by close to 10% y/y in recent months, nearing the pace observed in 2011. Since December 2017, prices of steel mill products and aluminum mill shapes have increased by 19.5% and 9.2% respectively—close to the corresponding tariff rates of 25% and 10%. In comparison, copper and brass mill shapes have seen a decrease in prices of 5.6% during the same period. Some US automakers have also noted an erosion in profits stemming from the so-called 'national security' metals tariffs. Ford, the second largest automaker in the US, has claimed that the tariffs have cost the company around USD 1 bn in profits. For instance, while prices for electronic equipment in autos have climbed by 0.6% since December, those of motor vehicle bodies and trailers have increased by 3.4% during the same period.

**US manufacturers may breathe a sigh of relief over the conclusion of the NAFTA renegotiations, which could be followed by an exemption from the Sec. 232 metals tariffs on steel and aluminum imports from Canada and Mexico.** North America accounts for 26% and 42% of all US imports of tariffed steel and aluminum products, respectively. Roughly 67% of total steel and 55% of total aluminum imports were exempt from the initial March imposition of the Sec. 232 tariffs (charts 8 and 9, left-hand sides). By October, these exempt shares had shrunk to 16% and 4% respectively, mainly due to the removal of exemptions for Canada, Mexico, and the European Union. Certain countries then came to agreements with the US to limit their metals shipments to defined quotas. Australia is the only country whose exports are fully exempt from Sec. 232 duties on both steel and aluminum. Over the summer, Argentina, Brazil, and Korea agreed to steel quotas that, across the three countries, averaged 85% of their 2017 exports to the US; these agreements ensure that their current exports continue to enter the US free of tariffs. In the case of aluminum, 70% of imports from Argentina are also exempt. If Canadian and Mexican steel and aluminum products were also to win exemptions, possibly in exchange for an agreement on quotas of, say, 85% of 2017 flows, the share of US imports exempted from the Sec. 232 tariffs would rise to 41% of total annual imports of steel, and 39% of total annual aluminum imports. If the EU also successfully negotiated an 85% exemption, the exempt share would rise to 59% for steel and 45% for aluminum (charts 8 and 9, right-hand sides).

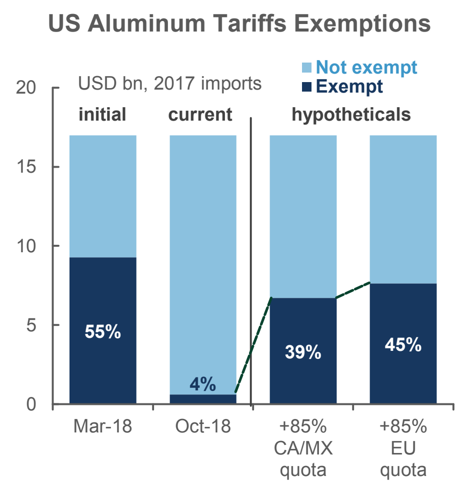
**The newly-negotiated USMCA could lead to an increase in auto parts output in the US owing to the high-wage share requirement for motor vehicles exports.** Canada, Mexico, and the US agreed to increase the regional content share requirement in autos from 62.5% to 75%—under a four-year phase-in period beginning in 2020—and incorporated a clause in the new deal that mandates that 40% of the value of a vehicle traded within the region must originate from factories where the average wage is USD 16/hr. Since employees in the Mexican motor vehicle manufacturing sector earn, on average, around USD 3/hr, certain auto producers in Mexico will require a greater share of US, or Canadian, auto parts. However, tighter rules of origin requirements will likely result in higher auto prices due to increased input costs, which could ultimately dent North American competitiveness and see some production moved overseas.

Chart 8




Sources: Scotiabank Economics, US ITC.

Chart 9




Sources: Scotiabank Economics, US ITC.

## INVESTMENT PEAK AT THE HEART OF ECONOMY-WIDE GROWTH PEAK

**Business investment accelerated in the first half of 2018—capital expenditures came up by 6.7% y/y in Q1 and 7.1% y/y in Q2. We forecast investment to continue at a slower, but still robust, pace in the back half of 2018 as relatively tight labour markets force firms to spend on plant and equipment—rather than chase scarce workers—in order to meet order demand.** Mirroring the greater economy's broadly-based growth profile, capital-spending growth was driven by a wider range of activities in the first half of 2018 than in the previous year. The tax incentives provided by Washington at the beginning of the year through full expensing on equipment purchases under the US Tax Cuts and Jobs Act and cuts in corporate income tax rates may also have provided a small boost to some specific forms of investment. Intellectual property investment in H1-2018 surged and contributed as much to investment growth as capital expenditure in the energy sector (see the ***Commodities*** section). For 2018 as a whole, business investment is forecast to register 6.9% growth, its fastest expansion in several years.

**Weaker business investment underlies our forecast of moderating growth heading into 2019 and 2020.** Annual capital spending growth is forecast to decline to 3.1% and 2.3%, respectively (table 2 again).

## US POLICY DRIVING RECORD TRADE DEFICITS

**The Trump Administration's policy stance, with its mix of expansionary tax cuts and increased spending, combined with a strong US dollar, underpins increasing imports and consistently wider US trade deficits with the rest of the world.** In the second quarter of 2018, US merchandise export volumes rose by 13.5% q/q annualised, which represented their fastest pace of growth since late-2013. The surge in exports appears to have been boosted by a frontloading of orders from the US ahead of reciprocal tariffs on these goods. Exports of agricultural products and beverages rose by an annualised rate of 110% q/q in real terms. On the other hand, US goods' imports fell by 0.4% q/q.

**The US administration's trade conflict with China is set to continue for the foreseeable future as the US has yet to articulate clear demands to which China could respond.** Meanwhile, the US trade deficit with China hit a record USD 34 bn in September as the domestic fiscal stimulus continues to fuel imports. The US began charging an additional 10% duty on USD 200 bn in imports from China in late-September, which is set to rise automatically to 25% on January 1, 2019. US importers may, for now, not feel the pain of the new wave of tariffs on China owing to a depreciation of around 7% in the Chinese yuan year-to-date, which is helping to offset a large share of the tariffs. However, a number of firms may bring forward imports from China before year-end in order to avoid the forthcoming hike in tariffs. As the US administration's tariffs expand to a larger share of imports from China, the impact on consumer prices is set to become more direct. Around 1% of the initial USD 50 bn phase of tariffs comprised consumer goods, compared to 23% in the second phase which notably left out a number of prominent consumer electronics such as smart watches. Consumer goods represent 36% of the remaining third phase of USD 267 bn in US imports from China, which the President has threatened to slap with tariffs if China retaliates to the US's existing duties.

**Table 2**

| United States | 2000–17 | 2017 | 2018f | 2019f | 2020f |
|---|---|---|---|---|---|
| | (annual % change, unless noted) | | | | |
| **Real GDP** | 2.0 | 2.2 | 2.9 | 2.4 | 1.7 |
| Consumer spending | 2.4 | 2.5 | 2.6 | 2.4 | 1.8 |
| Residential investment | -0.3 | 3.3 | 0.5 | 1.3 | 1.9 |
| Business investment | 3.0 | 5.3 | 6.9 | 3.1 | 2.3 |
| Government | 1.0 | -0.1 | 1.8 | 2.3 | 1.6 |
| Exports | 3.7 | 3.0 | 4.6 | 2.3 | 2.0 |
| Imports | 3.7 | 4.6 | 4.0 | 3.0 | 2.7 |
| Nominal GDP | 4.0 | 4.2 | 5.4 | 5.0 | 4.1 |
| GDP Deflator | 1.9 | 1.9 | 2.5 | 2.6 | 2.3 |
| Consumer price index (CPI) | 2.2 | 2.1 | 2.5 | 2.2 | 2.1 |
| CPI ex. food & energy | 2.0 | 1.8 | 2.2 | 2.2 | 2.2 |
| Core PCE deflator | 1.7 | 1.6 | 2.0 | 2.2 | 2.0 |
| Pre-tax corporate profits | 5.3 | 3.2 | 6.6 | 2.8 | 1.9 |
| Employment | 0.7 | 1.6 | 1.6 | 1.2 | 1.0 |
| Unemployment rate (%) | 6.1 | 4.4 | 3.9 | 3.8 | 3.8 |
| Current account balance (USD bn) | -501 | -449 | -445 | -487 | -540 |
| Merchandise trade balance (USD bn) | -680 | -807 | -848 | -904 | -974 |
| Federal budget balance (USD bn) | -540 | -665 | -805 | -1,000 | -1,045 |
| percent of GDP | -3.7 | -3.4 | -3.9 | -4.6 | -4.7 |
| Housing starts (mn) | 1.26 | 1.20 | 1.27 | 1.26 | 1.26 |
| Motor vehicle sales (mn) | 15.6 | 17.0 | 17.0 | 16.8 | 16.7 |
| Industrial production | 0.7 | 1.6 | 3.5 | 2.5 | 2.1 |
| WTI oil (USD/bbl) | 62 | 51 | 68 | 72 | 72 |
| Nymex natural gas (USD/mmbtu) | 4.83 | 3.02 | 2.93 | 2.93 | 2.93 |

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

**In response to the Administration's tariffs, China has imposed its own duties ranging from five to 10 percent on imports from the US on USD 60 bn worth of goods, on top of an initial USD 50 bn worth of trade which faces 25% duties.** China is nevertheless running out of room on tit-for-tat import tariffs measures as the country imported only about USD 150 bn from the US last year. The Chinese authorities may deploy alternative retaliatory non-tariff actions such as efforts to complicate the operations of US multinational enterprises operating in China or by increasing border-processing times for US goods.

**Canadian and Mexican motor vehicles and parts exports to the US were granted an exemption up to a specified level of shipments from would-be tariffs under 'national security' concerns.** Under USMCA, up to 2.6 mn passenger vehicles and all light trucks from each of Canada and Mexico would be immune from the Section 232 tariffs, if imposed, while up to USD 32.4 bn in Canadian parts and 108 bn in Mexican parts would also be free from these duties. Both the vehicles and parts thresholds are far from current North American export levels to the US and are unlikely to be breached any time soon (char t10). Passenger vehicle imports from Mexico may touch this ceiling sometime in the latter years of the next decade if they continue on their current growth trajectory. However, by then, a future US administration may be willing to negotiate an increase in this threshold.

## CAPITAL REPATRIATIONS LARGE, BUT UNDERPERFORM EXPECTATIONS

**US firms repatriated a total of USD 464 bn in the first two quarters of the year in response to the US tax overhaul that gives them the opportunity to claim, and bring home, foreign profits accumulated abroad in exchange for a one-time tax payment.** For comparison, the two-quarter total is slightly more than the sum of repatriated profits in the previous four years combined. US corporate income tax reform lowered the tax rate paid on these assets from 35%—the previous corporate income tax rate—to 15.5% on cash and 8% on non-cash or illiquid assets, as the US administration attempts to incentivise domestic investment. Still, the less than half a billion USD in funds—which showed a quarter-on-quarter decrease from USD 295 bn in Q1 to USD 170 bn in Q2 (chart 11)—and any future foreign profits declared are unlikely to satisfy President's Trump's expectations of repatriations "over USD 4 trillion but close to USD 5 trillion". Furthermore, it remains unclear just how large a share of repatriated profits will be invested in firms' US operations or put toward share buybacks. An analysis by the Federal Reserve found evidence that repatriated profits in Q1-2018 resulted in a sharp increase in buybacks amongst the fifteen firms with the most cash abroad compared with the remainder of those listed in the S&P 500; the Fed could not, however, identify a clear increase in capital expenditures.

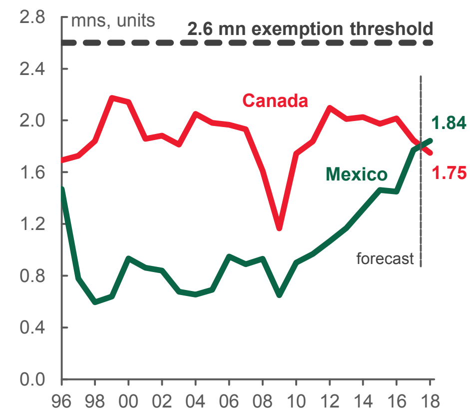
## FOREIGN APPETITE FOR US DEBT STABLE

**China's holdings of US Treasury (UST) securities have edged down slightly in recent months to USD 1.171 tn from a 2018-high of USD 1.188 tn in March.** In light of the tariffs imposed by the Trump Administration on imports from China, there has been speculation over an unwinding of Chinese holdings of USTs in response to US protectionism. China remains the largest holder of US treasuries (USTs) followed by **Japan** at USD 1.035 tn. While the recent decline in Chinese holdings is not significant, China's share of foreign-held USTs has, however, decreased from as high as 28% in mid-2011 to 19% in July 2018. Still, the US's public debt has risen from USD 19.9 tn at the beginning of President Trump's term in January 2017 to USD 21.5 tn in August. The additional USD 1.4 tn in marketable Treasury securities issued during this presidency far exceeds the concurrent USD 0.3 tn increase in foreign holdings of USTs; international investors' appetite for US debt may be waning slightly.

## OUTLOOK REMAINS HIGHLY POLICY DEPENDENT

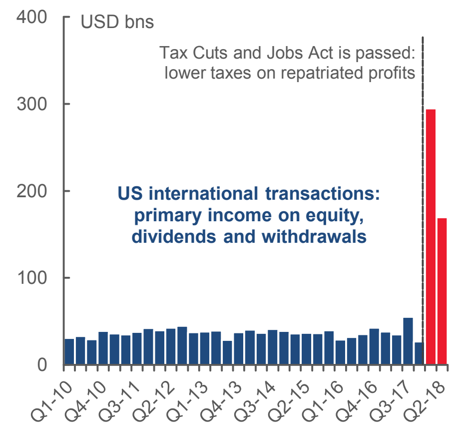
**As we have signalled for the last few quarters, the main threat to what would otherwise be a propitious mix of solid US growth and moderate inflation remains a set of fiscal and trade policy choices by the White House that are pushing the US economy toward excess demand, unpredictable protectionism, and increasing price pressures.** Fed Chair Powell recently characterised the current US situation as "a remarkably positive set of economic circumstances" that may be "too good to be true". Long expansions—and this one is set to become the longest on record—are typically undone by overly stimulative policy decisions that prompt precipitous tightening by monetary authorities. The US outlook continues to hinge on whether the White House validates Chair Powell's skepticism, or takes a more prudent course on its efforts to remake US trade relations and ensure positive economic conditions into the next electoral cycle.

**Chart 10** US Imports of Passenger Vehicles from North America




Sources: Scotiabank Economics, US ITC.

**Chart 11** US Firms Repatriate Under USD 500bn in First Half of 2018




Sources: Scotiabank Economics, BEA.

# US & Canadian Monetary Policy & Capital Markets

- **The Bank of Canada's overnight rate is forecast to double by early 2020;**
- **The Federal Reserve's policy rate is forecast to rise 100bps by 2019Q3;**
- **Yield curves to flatten further as cycle maturity limits term premia.**

## BANK OF CANADA—FROM GLACIAL TO GRADUAL

The Bank of Canada is forecast to raise its policy rate by 150bps by the first quarter of 2020 and to then shift to the sidelines. This should further narrow the Canada-US policy rate differential to -25bps in support of the C$. The Canadian yield curve is expected to shift upward and flatten particularly across the shorter yield spreads (chart 1). This is a continuation of our forecast stance dating back to the summer of 2017 when we intensified warnings of pending inflationary pressures that would motivate 100bps of rate hikes to date—and counting. We have now tweaked this successful thematic view to reflect greater conviction in the story, lessened NAFTA risks and a more positive outlook for business investment including progress on pipelines and LNG into 2020–21.

The core belief that is backing this forecast is that monetary policy is overly lax in Canada and that it continues to inappropriately cling to crisis levels of stimulus. The Bank of Canada has largely raised its policy rate at a pace that has been commensurate with increased inflation. This has left the inflation-adjusted (real) policy rate little changed, in negative territory howsoever defined (chart 2 for one example) and comparable to the most liberal monetary policy conditions abroad (chart 3). Alternative measures of the real policy rate—using average core CPI (2.1%), the 5yr inflation breakeven (1.8%), the Bloomberg inflation consensus for 2019 (2.1%), or the BoC's Business Outlook Survey's inflation expectations — all show that it presently lies between about -25bps and -50bps or possibly lower. As a consequence, the currency remains artificially weak, provincial and mortgage credit spreads are tight as are investment-grade and high-yield corporate spreads. Financial conditions are arguably overly stimulative.

Keeping company with other negative real rate economies is a curiosity when Canada's core inflation rate is double—or more—the rate in the Eurozone and Japan. Canada's core inflation rate is on par with the UK and both countries' central banks are durably achieving their 2% inflation targets. A major difference is that the UK continues to grapple with high Brexit uncertainty. Canada also faced high uncertainty over NAFTA negotiations, but has now reached agreement on a USMCA deal pending passage in all three countries' legislative assemblies which we think is likely but not until well into 2019. This development merits reducing negative risk judgement applied to our growth forecasts. Canada is therefore now alone among major economies in terms of possessing a negative real policy rate and easy financial conditions absent very low inflation, high risk to its principal trade regime and/or close proximity to a market with deeper negative real rates.

Policy needs to return to more normal conditions that are suited to an economy that is beginning to slip into excess aggregate demand amid high capacity constraints and rising labour shortages. It risks overheating with overly accommodative

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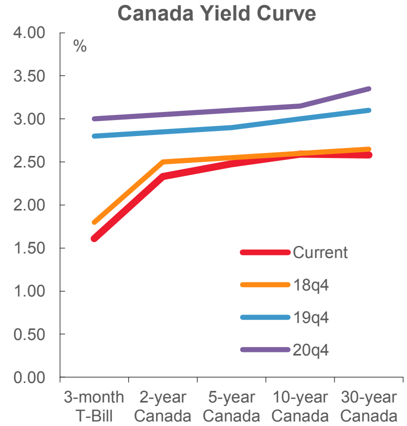
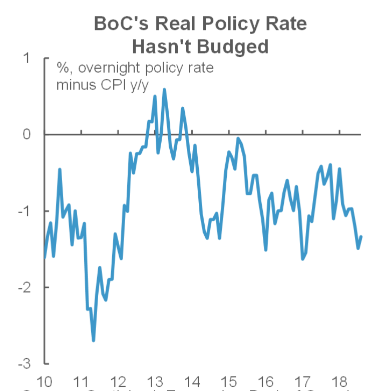
Chart 1



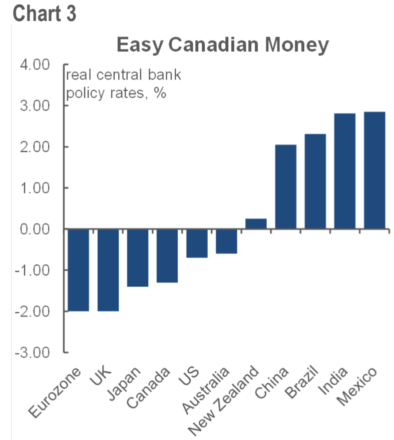

Sources: Scotiabank Economics, Bloomberg.

Chart 2




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

Chart 3



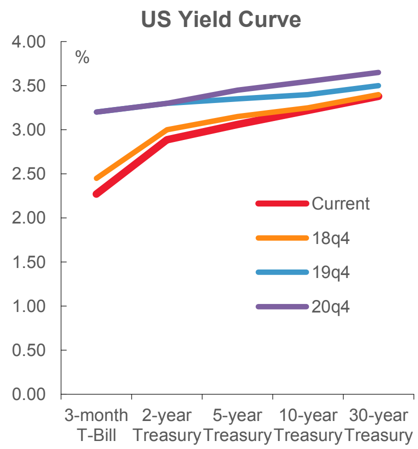

Sources: Scotiabank Economics, Bloomberg.

monetary policy and possibly expanded fiscal stimulus into an election year. The BoC should transition toward actually raising its policy rate at a gradual pace. It has not done so this year, other than applying two rate hikes at a glacial speed. A hike per quarter is how the Federal Reserve has defined 'gradual' in practice and we think the BoC should adopt this path. Indeed, there is now a case for a more expedited pace of rate hikes in order to achieve a zero or slightly positive real rate more quickly in what could amount to at least a temporary abandonment of the 'gradual' mantra. As business investment and trade face fewer trade policy risks and more pressure to invest as capacity constraints become binding, interest sensitive sectors like housing need to sustainably cool in order to keep broad economy-wide capacity pressures in check.

## FEDERAL RESERVE—LITTLE IN ITS WAY

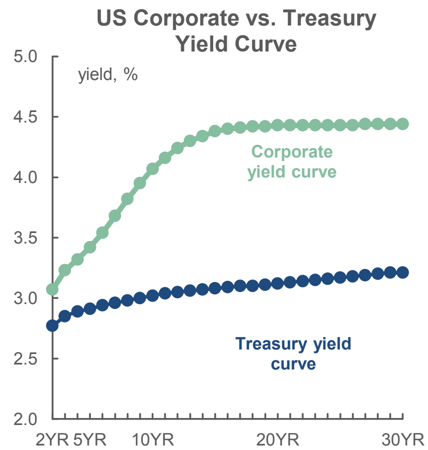
The Federal Reserve is forecast to raise the Fed funds target range by one more percentage point by the third quarter of next year. At that point, the policy rate is forecast to crest at a slight overshoot of the estimated neutral rate. Similar to the FOMC consensus, we anticipate the inflation-adjusted policy rate to rise at a somewhat quicker pace than the real neutral policy rate in a cyclical overshoot aimed at incrementally tightening monetary policy conditions. Markets are underpricing both the FOMC's 'dot plot' and Scotia's house rate forecasts (chart 4).

Chart 4




Sources: Scotiabank Economics, Bloomberg.

Chart 5

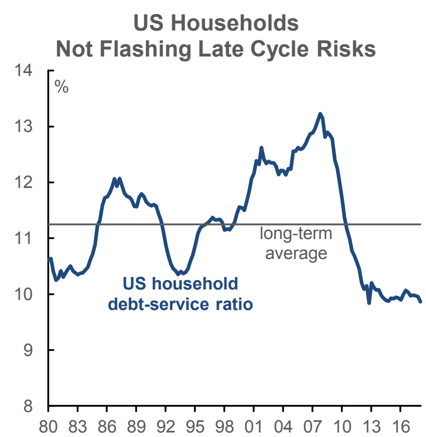



Sources: Scotiabank Economics, US Treasury.

Chart 6


Sources: Scotiabank Economics, US Treasury.

Chart 7




Sources: Scotiabank Economics, Bloomberg, Federal Reserve.

The profile of rate hikes is informed by three main arguments. One is that the Fed's signalled reaction function has defined 'gradual' hikes to mean a steady pace of one hike per calendar quarter in a straight line unless something big and possibly transitory—like 3 hurricanes in 2017—interrupts such plans. The Fed seems to want to gradually get toward a modest cyclical overshoot of its roughly 3% nominal neutral policy rate with pretty steady, unwavering determination. Fed Chair Powell's recent communications have leaned in favour of setting a high bar to being interrupted on such a path.

Second is that from a fundamentals standpoint, the case for continued Fed policy tightening is compelling. The US economy's output gap has shut and moved into material excess aggregate demand with more to come. Core PCE inflation is in-line with the Fed's 2% inflation target. Fiscal stimulus is a contributing factor to overshooting growth that I've long felt would necessitate sterilization efforts through a stronger US dollar and rising bond yields alongside Fed rate hikes. This view goes back to my initial assessment of Trumponomics back in a piece written in November 2016; the chickens may well be coming home to roost on the full cycle effects of Trumponomics that over-stimulated an economy that didn't need stimulus and that is left with high debt issuance and the worst performing US Treasury bond market of any prior President to a comparable stage of the Presidency.

Third, however, is that we are not in the camp that warns of limits to rate hikes derived from late-cycle risks and the slope of the yield curve. We don't expect the US Treasury curve to invert and its slope is a distorted signal for the economy versus in the past. Longer-run Treasury yields are expected to rise, albeit not at the sustained pace of late (see next section). Issuance and term premia effects of Fed balance sheet unwind could be drivers. In any event, the reward to taking term lending risk exists in the corporate market much more so than in the more policy-distorted sovereign market (chart 5). The corporate yield curve remains a fair distance away from inverting or becoming very flat as it has tended to do in the lead-up to past recessions (chart 6).

Drivers of such past recessions have typically involved greater evidence of balance sheet disrepair across households and businesses than we observe (chart 7).

## BONDS—HOW REGS BLEW A HOLE IN A NICE THEORY

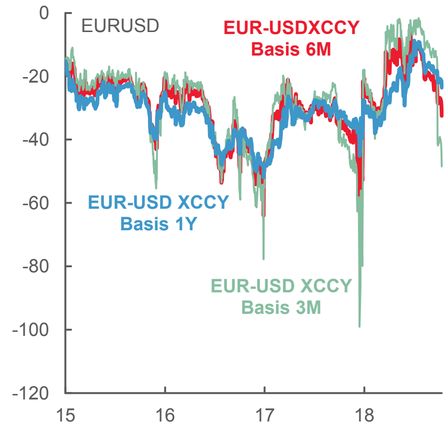
We're disinclined to extrapolate the recent rise in bond yields. The drivers of the large jump in yields may be relatively temporary through year-end before then reversing into the new calendar year. The more sustainable drivers of rising bond yields are likely to evolve more gradually over time.

In addition to uncertainty facing risk tolerance, the foundation to the explanation of this reservation that follows is a model called covered interest parity. Theory posits that the difference between identically defined rates in two markets should equate to the spread between the forward and spot exchange rates between those same markets. If it doesn't, then that means one of two things. Either market participants will spring into action to seek out arbitrage opportunities in order to bring the relationship back into line. Alternatively, when the relationship persistently fails to hold, then a residual term is given a name: the cross currency basis. In theory, the cross currency basis should not exist. Theory, however, assumes away sundry market imperfections and liquidity shortfalls that may restrain full deployment of balance sheets that would be necessary to pursue arbitrage profit opportunities. Those balance sheets have historically been the large, well-capitalized and relatively sophisticated traditional financial institutions.

Unfortunately, ever since at least 2007, the strictly defined covered interest parity model has not worked terribly well and deviations from it may be worsening. There has been a fairly persistent and highly seasonal residual term (aka the basis). Indeed, a major driver of the recent rise in bond yields that we think will persist into year-end is the strong rise in year-end demand for US dollars and its effect on foreign currency hedging costs for investors looking to buy more attractive Treasury yields relative to European and Japanese government bonds. At the heart of the issue is the blow-out in the so-called cross currency basis when swapping out of Euros and yen into the USD (charts 8, 9). After taking account of the rising cost of hedging FX risk, the yield pick-up on Treasuries vapourizes or at least turns less advantageous than keeping money in local currency EGBs and JGBs. That, in turn, has potentially destroyed foreign demand for Treasuries which had served to restrain the upward pressure upon their yields against the backdrop of strong US fundamentals and heavy US debt issuance. In short, arbitrage isn't occurring to take advantage of the much higher yield spread offered by Treasuries because the currency market is getting in the way. By extension, this has spilled over into rising Canadian bond yields, though less significantly. Obviously this is not a factor for investors not hedging currency risk, but many major types of nonfinancial and financial accounts do hedge.

Chart 8

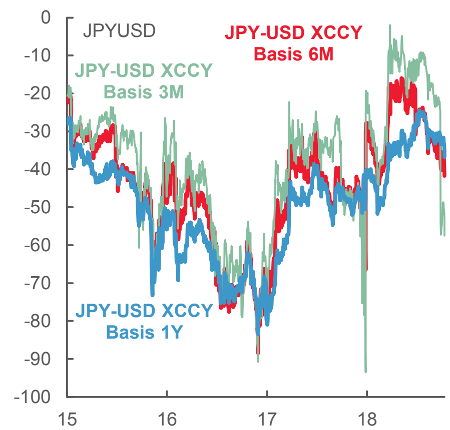
The EUR-USD Cross Currency Basis




Sources: Scotiabank Economics, Bloomberg.

Chart 9

The JPY-USD Cross Currency Basis




Sources: Scotiabank Economics, Bloomberg.

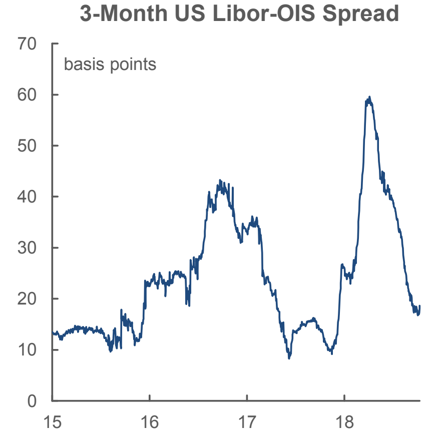
An entirely plausible explanation for the persistence of the cross currency basis relies upon two arguments. One is that there is heavy year-end seasonality to funding pressures as demand for USD soars from both nonfinancial firms and banks. Two is that an unintended consequence to a plethora of regulatory changes over the post-GFC era has been to restrain the effective deployment of balance sheets in order to drive arbitrage activities during such episodes. Whether Basel, or Dodd-Frank or the Volcker Rule, there is a serious risk that the good intentions of making the system 'safer' have perhaps achieved somewhat the opposite effect by allowing market dislocation effects to persist and pose risks to the economy and financial system. This can be particularly true during vulnerable stress points in global markets (e.g. trade wars, Italy's risks to the Eurozone, a potential US 'fiscal cliff', etc.).

Why I think these effects will subside leans heavily upon observing their seasonality. Going back to chart 8, note that the 3-month tenor has seen the biggest blow out in the cross currency basis relative to the six-month and one-year tenors. That supports a year-end funding challenge that is usually transitory. If FX hedging costs return to normal into the new year, then relative demand for US (and Canadian et al) rates product might improve and thereby put renewed downward pressure upon bond yields. This view would suggest that central banks should look through year-end market distortions but closely monitor them. To repeat, such possible effects are compounded upon uncertainty regarding risk tolerance into year-end.

What is nevertheless encouraging is that a measure of funding strains in short-term lending markets is not showing classic crisis widening (chart 10). Indeed, the three-month LIBOR-OIS spread is quite well behaved and has been falling since the US lifted the debt ceiling and passed a spending and appropriations bill in February. That indicates the absence of systemic risk considerations and leans further toward the possibility that reduced demand for Treasuries and the associated rise of FX hedging costs is a transitory year-end event.

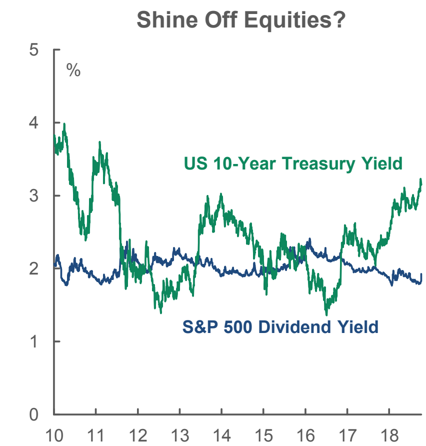
Nevertheless, pressures upon the US and global bond markets are likely to contribute toward a rocky road for equity markets into year-end. For income-oriented investors, the rise in Treasury yields has become tempting over the dividend yield on the S&P500 (chart 11). In fact, the unadjusted spread between the two measures sits at its widest since 2011; adjustments for risk, taxes and other factors are then necessary but the relative comparison has clearly changed. The rise in bond yields depresses the present value of expected future dividend streams and drives a reassessment of equity valuations. To the extent to which bond and currency market funding pressures may be proven to be temporary through year-end, so may emerge opportunities for equity investors on dips. Of course, how this plays out will also be informed by relative valuations across equity markets. Right now, the US markets remain among the world's most expensive even with recent declines. Equities will remain vulnerable to H2 earnings, currency and bond market developments, uncertainty into the US mid-terms, US-China tensions and Italy-Eurozone tensions.

Chart 10




Sources: Scotiabank Economics, Bloomberg.

Chart 11




Sources: Scotiabank Economics, Bloomberg.

**Table 1**

**Scotiabank Economics' Canada-US Yield Curve Forecast**

| | 2018 | | 2019 | | | | 2020 | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | (end of quarter, %) | | | | | | |
| **Canada** | **Q3** | **Q4f** | **Q1f** | **Q2f** | **Q3f** | **Q4f** | **Q1f** | **Q2f** | **Q3f** | **Q4f** |
| BoC Overnight Target Rate | 1.50 | 1.75 | 2.00 | 2.25 | 2.50 | 2.75 | 3.00 | 3.00 | 3.00 | 3.00 |
| Prime Rate | 3.70 | 3.95 | 4.20 | 4.45 | 4.70 | 4.95 | 5.20 | 5.20 | 5.20 | 5.20 |
| 3-month T-bill | 1.58 | 1.80 | 2.05 | 2.30 | 2.55 | 2.80 | 3.00 | 3.00 | 3.00 | 3.00 |
| 2-year Canada | 2.21 | 2.50 | 2.40 | 2.55 | 2.70 | 2.85 | 3.05 | 3.05 | 3.05 | 3.05 |
| 5-year Canada | 2.34 | 2.55 | 2.50 | 2.60 | 2.75 | 2.90 | 3.10 | 3.10 | 3.10 | 3.10 |
| 10-year Canada | 2.43 | 2.60 | 2.60 | 2.70 | 2.85 | 3.00 | 3.15 | 3.15 | 3.15 | 3.15 |
| 30-year Canada | 2.42 | 2.65 | 2.65 | 2.75 | 2.90 | 3.10 | 3.30 | 3.35 | 3.35 | 3.35 |
| **United States** | **Q3f** | **Q4f** | **Q1f** | **Q2f** | **Q3f** | **Q4f** | **Q1f** | **Q2f** | **Q3f** | **Q4f** |
| Fed Funds Target Rate | 2.25 | 2.50 | 2.75 | 3.00 | 3.25 | 3.25 | 3.25 | 3.25 | 3.25 | 3.25 |
| Prime Rate | 5.25 | 5.50 | 5.75 | 6.00 | 6.25 | 6.25 | 6.25 | 6.25 | 6.25 | 6.25 |
| 3-month T-bill | 2.20 | 2.45 | 2.70 | 2.95 | 3.20 | 3.20 | 3.20 | 3.20 | 3.20 | 3.20 |
| 2-year Treasury | 2.82 | 3.00 | 3.00 | 3.10 | 3.30 | 3.30 | 3.30 | 3.30 | 3.30 | 3.30 |
| 5-year Treasury | 2.95 | 3.15 | 3.05 | 3.15 | 3.35 | 3.35 | 3.40 | 3.40 | 3.45 | 3.45 |
| 10-year Treasury | 3.06 | 3.25 | 3.15 | 3.20 | 3.40 | 3.40 | 3.50 | 3.50 | 3.55 | 3.55 |
| 30-year Treasury | 3.21 | 3.40 | 3.30 | 3.30 | 3.50 | 3.50 | 3.60 | 3.60 | 3.65 | 3.65 |

Sources: Scotiabank Economics, Bloomberg.

# Mexico

## CHANGING COURSE

- **Mexico's elections result granted a lot of political power to AMLO and his movement, and people's expectations for the new government are sky-high. Changing course is the prevailing message of the winning group, and the macroeconomic picture will be heavily dependent on public policy definitions that will take place over the remainder of the year.**

The message from the ballot boxes is crystal-clear: Mexico wants a change. After a very unfriendly electoral process where rhetoric was plagued with populist promises from every candidate, Andrés Manuel López Obrador (AMLO) emerged as the undisputed winner, receiving the strongest support from the electorate since the old days when the PRI reigned the supreme and only political party, some 40 years ago. His political movement, MORENA (Movement for National Regeneration), was granted the absolute majority in Congress, which will give them total control of the federal budget; and the majority in 18 out of 32 local congresses, which puts them very close to having the qualified majority to change the Constitution. Mexico's people believed the promises made by AMLO and his movement, and granted them a strong political power to change the course of the country. The promise was simple and appealing: by eliminating corruption, the economy will thrive, employment will flourish and there will be money to spend on many social programs that will close the gap between the wealthy and the poor. Expectations are through the roof for the new government that now faces the gargantuan challenge of delivering on their promises in the real world, where reality is never as simple as that of the political campaigns.

We are now in a long transition period where the current government is gradually fading out while the future new government is in the spotlight. Good to know, the transition is being as soft as it could have been. In this period prior to Inauguration day on December 1st, the future government is working very hard to accommodate the campaign promises into the realm of what is possible. And they are really struggling. Many messages from the new government are the right ones: macroeconomic stability will be preserved, fiscal discipline will be a priority, public spending will be limited to prevent public debt from growing and Banco de Mexico's autonomy will be respected. But there are many other messages that are controversial to say the least and could produce a lot of trouble in our economy. Which ones should be listened to and incorporated in our projections?

Many of the expressed ideas and comments could suggest the new government will embrace a different paradigm for public policy, returning to an interventionist State that heavily participates in and influences economic matters, significantly changing course for the country. On frequent statements, the now President Elect blames the neo-liberalism for many of the country's shortcomings. It remains to be seen how difficult changing course will be, from a mere realignment of public spending but within fiscal responsibility or all the way to a more populist government.

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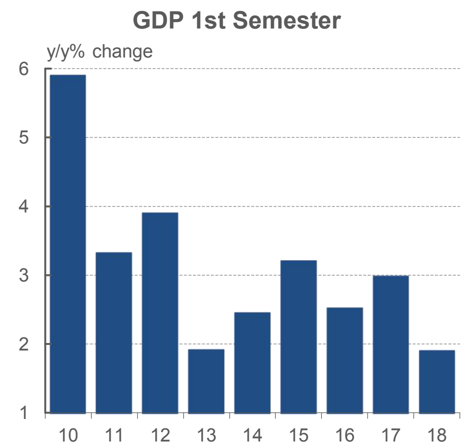
| Mexico | 2017 | 2018f | 2019f | 2020f |
|---|---|---|---|---|
| Real GDP (annual % change) | 2.0 | 1.8 | 2.1 | 2.4 |
| CPI (y/y %, eop) | 6.8 | 5.1 | 4.1 | 3.8 |
| Central bank policy rate (%, eop) | 7.25 | 8.00 | 8.00 | 7.50 |
| Mexican peso (USDMXN, eop) | 19.66 | 20.07 | 20.40 | 20.69 |

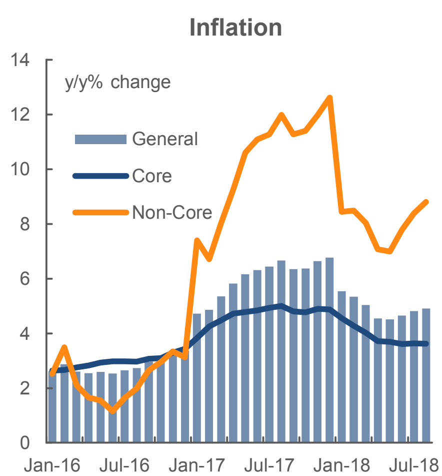
Source: Scotiabank Economics.

Chart 1




Sources: Scotiabank Economics, INEGI.

Chart 2




Sources: Scotiabank Economics, INEGI.

A few days ago, there were some unfortunate comments from the President Elect about Mexico being bankrupt, and warning that if something goes wrong with inflation and the macroeconomic stability, it will not be the fault of the President, but it will be on external circumstances or on Banco de Mexico's financial policy. Financial markets did not take that comment seriously because we all know Mexico's macroeconomic and financial conditions are pretty sound. Those comments could be the sign that reality is slowly sinking in, that the new government is realizing that available resources are scarce and the economic landscape is difficult to change. So, the federal Government budget to be presented to Congress no later than December 15th will provide the clues to really see what the new government will do and what promises will have priority. Until that happens, there is still some uncertainty affecting the public's expectations, even though we think that fiscal discipline and total respect for the macroeconomic stability will prevail.

Some positive developments have dissipated part of the prevailing uncertainty. The recently reached US-Mexico-Canada Agreement (USMCA) will keep the free trade in North America, even though it could have some negative impacts on regional competitiveness on certain industries, such as the automotive. Many new chapters could be positive for trade and growth in the three countries, but it is not clear as yet that economic prospects will improve dramatically from this event, mainly because we already had a functioning free trade agreement. Worth noting, mid-term elections in the US could affect the agreement. Another positive event to reduce some uncertainty was the appointing of Jonathan Heath to occupy a seat on the Banco de Mexico board as deputy-governor next December. Mr. Heath is a well-known economist with the necessary experience and, most of all, a clear independence reputation that will add to Banco de Mexico autonomy.

Turning to recent dynamics of the Mexican economy, we see a lackluster picture in the economic activity with GDP growing 1.9% real y/y in the first half of 2018 (the lowest since 2010 for such a period), although some marked contrasts are observed. On the positive side, services sector remains growing at healthy rates (+4.4% real y/y in July) with outstanding performance of retail trade (+7.1% real y/y), transportation (+5.6% real y/y) and financial services (+5.1% real y/y). Unemployment rate has been below 3.5% since last November and repetitive anecdotal information from our business clients refers to problems filling their vacancies, which suggests a very strong labor market. Our exports and imports are booming due to higher oil prices and to strong economic activity in our main trading partners. Financial activity keeps growing, with banking credit to the private sector expanding 6.0% real y/y in August. On the negative side, industrial output remains weak (+1.3% real y/y in July) with a persistent contraction in oil extraction that keeps mining activity on negative territory (-7.0% real y/y). Private consumption on the domestic market is decelerating and growing at weak rates (+1.6% real y/y in June) and fixed investment also weakening (+1.4% real y/y in June). Within banking credit, that devoted to consumption is decelerating, growing only 1.2% real y/y in August.

One of the most relevant concerns is inflation. After reaching 6.77% in 2017 (a level not seen since 2001), inflation was expected to rapidly descend as the temporary shocks of the previous year disappeared, but there have been some ugly surprises and inflation stopped descending in May (at 4.51% y/y) and rebounded to 5.02% y/y in September, pressured mainly by energy prices and some other shocks. With some heavy seasonal impacts in the months to come, and due to the recent methodology change in the National Consumer Price Index, we are expecting inflation to keep rising to a level slightly above 5% by the end of the year, and then descend to 4.1% by the end of 2019. One possible concern is the tight labor market, where there are frequent wage negotiations above 5%, which could produce some inflationary pressures in months to come.

Banco de Mexico has been decisively acting on the monetary policy, increasing several times the overnight rate to reach the current level of 7.75%, which represents a clear ex-ante real interest rate in restrictive territory, necessary to keep inflationary expectations well anchored. We were expecting the monetary reference rate to reach 8.5% by 1Q-2019; but now that the NAFTA uncertainty has dissipated, Banco de Mexico could have more time to remain on the sidelines. We are now expecting one more hike at the end of this year, to reach 8.0%; and then to remain on hold through all 2019.

The exchange rate is expected to remain sensitive to an increasingly complicated global financial environment, and then we still believe it will present volatility and end 2018 close to 20.07 pesos per US dollar and close to 20.40 pesos per US dollar by the end of 2019.

Economic activity will be somehow constrained by uncertainty. On the investment side, apart from the natural effect that heightened caution would have on businesses, a significant delay on public infrastructure spending is highly likely. Every time there is a change in administration, the learning curve of the new officials naturally produces a delay of public spending that affects total investment dynamics. On this occasion, the delay could be more accentuated, since a larger number of changes in the ranks of public servants is anticipated. On the one hand, there is a new group coming to power and many substitutions are expected; but on the other hand, the intended limit to public servants wages will most likely push the more talented to leave, while producing some negative selection that will imply a steeper learning curve for the new comers. In this environment, total investment is expected to contract throughout 2019, and private consumption is expected to decelerate as caution prevails among consumers. It could be argued that the intended new social programs will provide income to certain individuals, thus boosting consumption; but it is not clear yet if this incentive would not be at the expense of the middle class.

Mexico is passing through moments of important definitions. The new government is talking about the 4th transformation of Mexico while blaming the neo-liberalism as the root cause of many of the Nation's problems. High expectations from the people rose from campaign promises, and the new government should be very careful in the right mix of public policy to deliver while keeping in touch with reality, which along with market's discipline, will be the most relevant counter weight to prevent some unfortunate turn in the course of the country. The macroeconomic picture of the next couple of years will heavily depend on the public policy in the process of being defined.

# Brazil

## FISCAL ISSUES SHOULD TAKE CENTER STAGE AFTER THE ELECTION

- **Brazil's fiscal challenges are serious, and its politics does not seem conducive to a new reformist government with a legislative mandate taking over.**
- **External risks seem contained, outside of the pressure that tighter global financial conditions could exert on domestic financial markets, and through these to household, corporate and government balance sheets.**
- **The BCB should kick-off an aggressive monetary tightening cycle. How aggressive will depend on its ability to "get ahead of mounting inflationary pressures".**
- **We expect the gradual deterioration of macro-financial variables to continue, but the bottom line is Brazil looks like a train headed down the wrong track, but without any clear potential catalyst to trigger a derailing.**
- **Our base case and BRL forecasts envision the kick-off of the rate hike cycle, combined with the high yields already in place in the long end of the yield curve, triggering a hunt for yield behavior and boosting the BRL. We see the BRL's rebound as relatively short-lived, with the rally cut short by anticipated lack of progress on reforms.**

## BRAZIL'S BALANCE OF RISKS DOES NOT LOOK PRETTY

Brazil faces important challenges regarding its fiscal situation, and we believe there is room for additional deterioration due to an expected fairly steep BCB tightening cycle, which should push interest rates materially higher, in a country where the average maturity of public debt is relatively short—thus meaning quick resets to higher rates. In addition, the new governments that seem the most likely to emerge victorious from Presidential elections held this month (first round was on October 7th, and Haddad and Bolsonaro face a run-off on the 28th) seem unlikely to either be "reformist", or have a strong-enough legislative mandate to successfully pass much-needed fiscal and social security changes.

To some degree, Brazil reminds us of the film "The Good, the Bad and the Ugly":

The good:

- Relatively low dependence on foreign funding.
- FX reserve liquidity still very strong.
- Despite the ongoing, and in our view likely to continue, deterioration of the fiscal situation, we fail to see a potential near-term catalyst for more serious trouble. We don't see Brazil being caught up in the same degree of negative sentiment as Turkey or Argentina.

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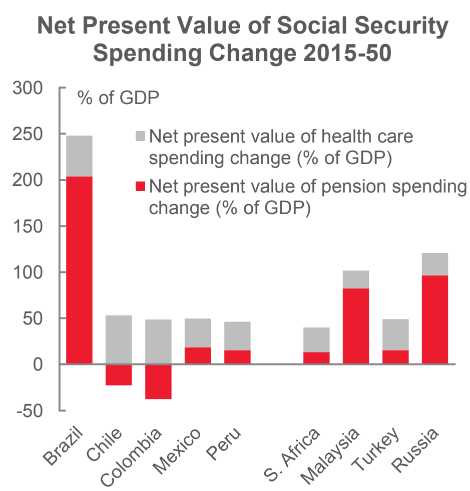
| Brazil | 2017 | 2018f | 2019f | 2020f |
|---|---|---|---|---|
| Real GDP (annual % change) | 1.0 | 1.3 | 1.8 | 2.1 |
| CPI (y/y %, eop) | 3.0 | 4.7 | 5.1 | 4.6 |
| Central bank policy rate (%, eop) | 7.00 | 7.25 | 9.75 | 10.00 |
| Brazilian real (USDBRL, eop) | 3.31 | 3.75 | 4.60 | 3.89 |

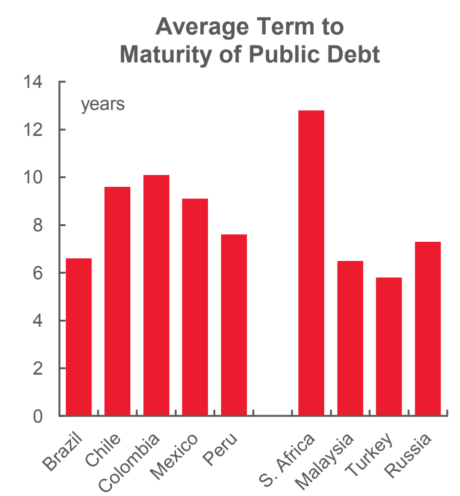
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, IMF.

Chart 2



Sources: Scotiabank Economics, IMF.

- Near term, we could even see a bounce in the BRL, as the steepening of the yield curve, and the BCB's expected hike cycle (if validated), can likely spark carry trade behavior, especially as global markets find their footing.

The bad and the ugly:

- The fiscal deficit is wide, and will require strong political will and power to solve.
- High debt burden, combined with structural high interest rates and a relatively short maturity is a bad cocktail.
- Is BCB already behind the curve? Suggesting higher terminal rate?
- Private sector also leveraged—potential spillover to public debt.
- Difficulty seeing reform scenario.

## BRAZIL'S FISCAL SITUATION LOOKS INCREASINGLY SHAKY

Over the past couple of years, we have seen repeated disappointment over the Brazilian government's failure to reform the country's pension system, pummeling the prices of Brazilian assets, as well as the country's credit ratings which fell from BBB in 2011, to BB- currently (S&Ps). Focus on the failure of addressing the country's large unfunded pension liabilities is justified, but is only part of the country's problems. As the chart on page one shows, unfunded pension and healthcare spending liabilities in Brazil dwarf those of the LATAM investment grade universe, as well as those of other large EMs outside the region. Partly due to the cost of these liabilities (annual pension spending by the Brazilian government currently amounts to 9.1% of GDP, expected to climb to 16.8% of GDP by 2050), Brazil's fiscal situation looks increasingly weak. Gross public debt of the general government is rapidly approaching 90% of GDP, and this year's fiscal deficit is expected to be close to 8% of GDP. In addition, with the BCB expected to enter an aggressive monetary policy tightening cycle, and with the government's public debt having a relatively short average maturity (about 6 years), financing costs should add to the financing pressures the government already faces.

It's also worth noting that Brazil has a relatively shallow pool of domestic pension savings, which serve as a "buyer of last resort", and thus also appear to lead to more stable foreign investment. The lack of large stable domestic savings, combined with a weak fiscal situation could explain the low foreign ownership of Brazilian debt. Moreover, the composition of Brazil's public debt is not ideal, with a relatively small share being "fixed rate", and large near-term roll-overs (at a time of rising local and global rates), which presents a potential source of weakness in volatile markets:

**Lack of a buyer of last resort, and sub-optimal debt composition are risks**

| Country | Pension assets (US$mn) | Gross public debt | Pension Assets / Gross Public Debt |
|---|---|---|---|
| Greece | 1,254 | $365,067 | 0% |
| India | 23,472 | $1,832,930 | 1% |
| Indonesia | 17,034 | $293,586 | 6% |
| Brazil | 231,592 | $1,725,763 | 13% |
| Poland | 36,930 | $269,697 | 14% |
| Turkey | 35,216 | $241,949 | 15% |
| Mexico | 145,819 | $622,668 | 23% |
| Russia | 87,038 | $266,345 | 33% |
| Colombia | 64,578 | $152,787 | 42% |
| Peru | 41,177 | $54,897 | 75% |
| S. Africa | 146,148 | $183,986 | 79% |
| Chile | 174,479 | $65,363 | 267% |

Sources: Scotiabank, OECD, IMF.

| Federal Government debt composition | % of total |
|---|---|
| Fixed rate | 32 |
| Inflation linked | 29 |
| Floating rate | 29 |
| FX linked | 3 |
| % maturing in the next 12 months | 19 |

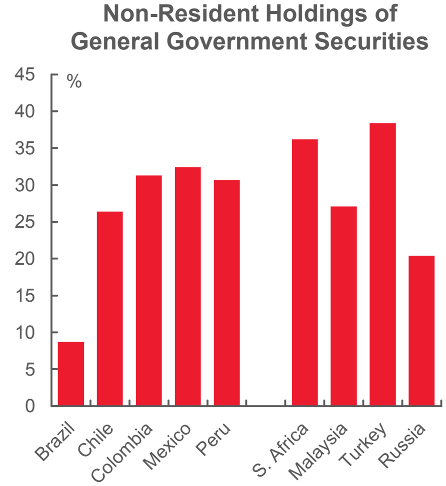
Sources: Scotiabank, Brazilian FinMin.

## THE EXTERNAL SIDE OF THE EQUATION LOOKS BETTER:

However, not all aspects of Brazil's balance sheet are weak. The stronger points on Brazil's financial situation are robust FX reserve liquidity (1.55X optimum reserves, compared with 0.64 for S. Africa, 0.86 for China, 0.82 for Chile, 1.26 for Colombia, 1.07 for Mexico, and 2.74 for Peru), and a relatively small share of non-resident holdings of total government debt (see chart on this page). This suggests that Brazil's risks are more linked to domestic risks (i.e. failure to address pensions and fiscal imbalances, as well as the risk the BCB fails to get ahead of inflation, driving up interest rates), or externally linked due to rising global rates pushing up domestic interest rates—and thus debt service costs.

At the present time, we don't see a potential catalyst for a full blown crisis / hard landing. Rather, we see a continued run down the wrong path, which will lead to a continued gradual deterioration in macro-financial variables.

Chart 3



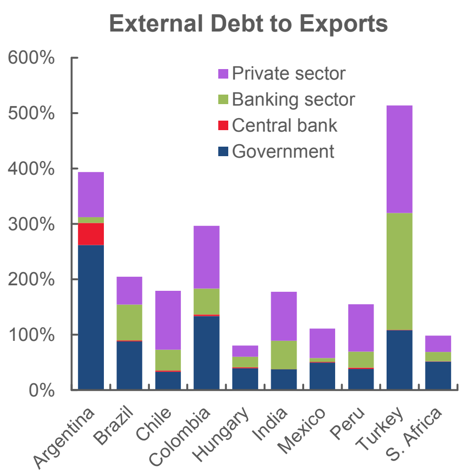

Sources: Scotiabank Economics, IMF.

## WILL THE BCB STAY AHEAD OF INFLATION? THAT WILL BE THE KEY FOR THE TERMINAL RATE

Consensus and rates markets both expect the BCB to wait until after the elections before kicking off its rate hike cycle, during which it is expected to deliver close to 400bps of hikes over the next 12-months (388bps according to the DI-rate curve). Even though 400bps of hikes qualify as a steep cycle in most countries, it's worth bearing in mind that Brazil's "real neutral rates" are somewhere around 4.0–4.5% and, with consensus inflation sitting at 4.20% by the end of 2019, those 400bps of hikes take real rates into "moderately tight" territory, but only if inflation stays under control. If inflation moves to the top half of the range, we see risks that the tightening cycle could be steeper than expected by markets at the moment. Although we don't see this scenario of an even deeper cycle as a "base case" at this stage, we see three potential catalysts that could trigger this:

- The first risk is that CPI inflation is trending higher (IPCA has risen about 130bps this year), manufacturing PPI stands at 15.1%—up over 1,000bps since January, and deteriorating!!, FGV IGPM inflation is now north of 10% (a composite of retail and wholesale prices, as well as construction costs), which points towards inflation already deteriorating.

Chart 4




Sources: Scotiabank Economics, World Bank, UNCTAD.

- A second risk is that fiscal settings are ultra-loose (the fiscal deficit is expected to be around 8% in 2018), meaning the BCB may have to compensate with tighter monetary policy settings.

- A third risk is the BRL. Brazil has a relatively high FX-inflation pass-through, of 20–30%. If the new government fails to deliver reforms, market disappointment should drive a weaker BRL.

Hence, those 400bps of hikes that DI rates are pricing are only a lot if the BCB does indeed manage to get ahead of inflation expectations, and the fiscal ship is successfully tightened. For the time being, we'd argue that risks to our base case are towards tightening needing to be deeper than what we and consensus expect.

## POLITICS DOESN'T SEEM CONDUCIVE TO REFORM

Although these still seems like a tough elections to call, the strong showing by "right leaning populist" Jair Bolsonaro in the first round (46%) suggests he has a strong kick-off point for the 2 weeks of second round campaign we now face. Lula heir-apparent Fernando Haddad (30%), may benefit from a consolidation of the more left leaning vote behind him. We expect both to tack to the center, in order to target the moderate vote. Bolsonaro has been somewhat unclear in terms of his economic agenda, but has spoken about potentially pursuing a more gradual pension reform than the current version being proposed. However, given the split of Congress / the Senate, which saw an emergence of non-traditional parties, and a robust showing by the left, we struggle to find a scenario where he could find a reformist mandate, even with post-election coalition building (the PSDB-PMDB failed to approve it back when they were a fairly harmonious coalition that had the PT on its knees). On the other hand, if Haddad were to emerge victorious, the PT has long opposed social spending cuts, as well as pension reform. In our view, it's hard to envision meaningful reforms being passed, without a severe financial pressure scenario pushing politicians to take bold steps.

**WITH ALL THESE RISKS, WE REVISED OUR BRL AND SELIC RATE FORECASTS:**

If inflation succumbs to PPI / fiscal pressures, and starts moving higher, while the BCB fails to get ahead of the curve, we could see the BCB's hike pipeline be even more aggressive. Although the election is extremely tough to call at this stage, we fail to see a likely scenario where a reformist with a mandate to execute change takes over. However, we think the kick-off of the BCB tightening cycle will trigger a BRL rebound, mostly chasing higher yields. We see that rally lasting a couple of months only, as reform disappointment, and fiscal concerns are likely to derail sentiment.

# Colombia

## COLOMBIA'S NEW GOVERNMENT SEEMS TO BE PREPARING FOR A TAX SYSTEM OVERHAUL

- **BanRep remains on hold, but we expect it to start hiking late-2018/ early-2019, as prices in some non-tradable elements in the core-CPI basket are trending higher, at the same time as foreign holdings of TES are dropping and the spread of BanRep's rate over the Fed is rapidly eroding.**
- **The big surprise from the central bank came from the announcement of a new FX reserve accumulation program through the options mechanism. The objective of the program is to boost reserves ahead of a potential reduction in the country's available resources through the IMF's FCL. No target size was announced, and we expect dollar accumulation to take place at times when COP is strengthening.**
- **On the fiscal front, the government has suggested it has plans to push for a fiscal reform, both to strengthen the country's financial position, but also to support an increase in potential growth. At this stage, it appears the government would like to reduce exemptions on VAT, and redistribute some income tax burden away from corporations.**

## GROWTH GAINING MOMENTUM, CONVERGING TO POTENTIAL

After growth bottomed in 3Q2016 (at 0.6% y/y), we've seen it gradually accelerating to just under 3.0% y/y last quarter. We have for some time argued that Colombia's potential growth rate is somewhere between 3.0% and 3.5%. At the moment, although growth remains slightly sub-potential (2.8%), recent data seems to suggest that during Q3, we are likely to see growth print slightly above 3%, now that industrial production, which had been lagging, is picking up steam (coming in above 3% this summer). Our base case is that towards the end of 2018, growth will sit in the 3.0%–3.5% range, before settling down around 3.5% for the coming couple of years.

The Duque government has a fairly ambitious agenda to accelerate investment which includes, among other measures, reducing the tax burden on corporates (which currently pay around 80% of total income tax receipts), towards a stronger contribution by VAT (eliminating exemptions), and personal income tax. If the reform succeeds, we'd expect an upswing in investment, which has been slowing the past couple of years (from around 24% of GDP back in 2014, to around 22% last year). However, we don't expect higher investment to materialize until late in our forecast horizon, even if the tax reform gets implemented in the short term.

## BANREP SHIFTS TACK—BUT ON FX, NOT RATES

As expected, BanRep left its policy rate unchanged on September 28th, as headline inflation remained near the central bank's target range, at 3.1%. However, the bank did acknowledge that the components of the CPI basket that are showing upward momentum are non-tradable goods, which would argue in

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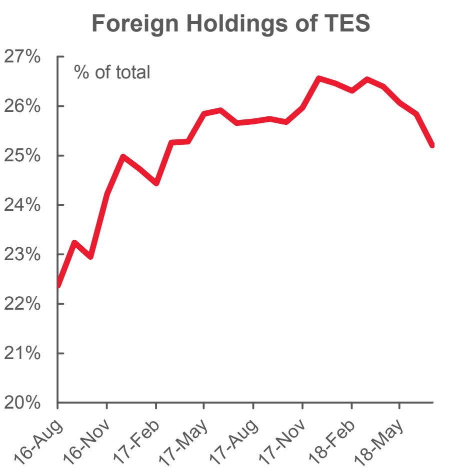
| Colombia | 2017 | 2018f | 2019f | 2020f |
|---|---|---|---|---|
| Real GDP (annual % change) | 1.8 | 2.5 | 3.5 | 3.6 |
| CPI (y/y %, eop) | 4.1 | 3.4 | 3.6 | 3.6 |
| Central bank policy rate (%, eop) | 4.75 | 4.50 | 5.50 | 5.50 |
| Colombian peso (USDCOP, eop) | 2,986 | 3,080 | 3,055 | 3,065 |

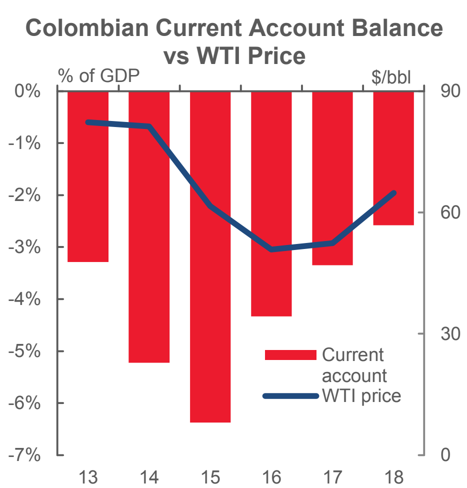
Source: Scotiabank Economics.

Chart 1




Sources: Scotiabank Economics, Colombian Ministry of Finance.

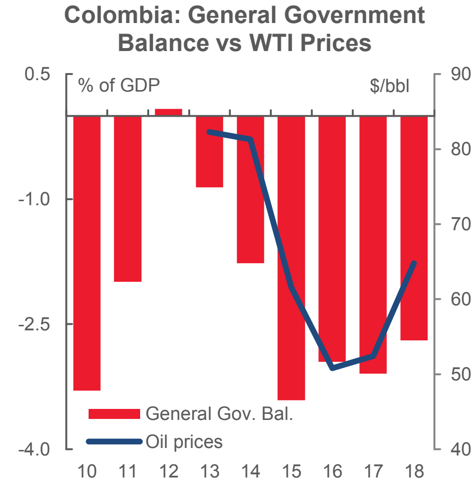
Chart 2




Sources: Scotiabank Economics, Bloomberg.

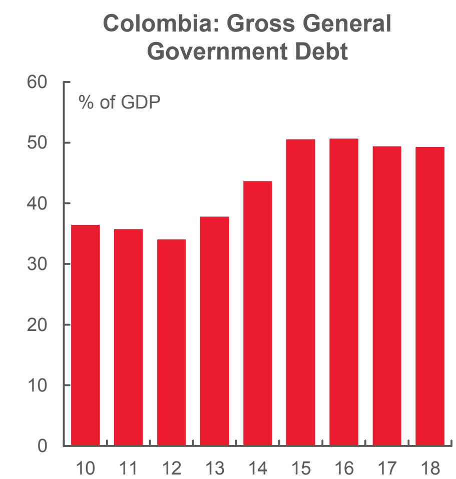
favor of mounting pressures (a large share of the disinflationary forces came from non-core items such as foodstuff, and FX-linked prices). BanRep is also comfortable with inflation expectations sitting at 3.2% for 2018, and 3.3% for 2019, although it's worth remembering these embed expectations for 90bps of hikes over the next 12 months, and 150bps over the next 2 years. The reasons behind the expected hike cycle by BanRep are likely more external than domestic. Colombian inflation is behaving well, but for a country with a current account that can be vulnerable (and its deficit is still relatively wide, despite its improvement alongside oil prices), and which already has foreign holdings of domestic debt dropping, keeping an eye on the spread between its policy rate and the Fed's seems wise. Note that the government has now formally acknowledged a drop in the country's "potential growth rate" from 4.8% back in 2012, to 3.5% in its 2018 estimate. This suggests that although the economy is still operating slightly below potential, it's now very close to it.

Chart 3




Sources: Scotiabank Economics, IMF, Bloomberg.

Chart 4




Sources: Scotiabank Economics, IMF.

The big surprise in BanRep's statement came on the FX front. BanRep stated that with a potential reduction of the resources the country has available from the IMF's FCL (Flexible Credit Line, which offers the country access to about US$11.4bn) in 2020, the board decided to boost the stock of its FX reserves. The board and said it will not target any specific level, but kicked off with an initial auction worth US$400mn. Our sense is the reason no target was announced was that the central bank is comfortable with USD/COP at current levels, and does not want to trigger too much peso weakness, as this could result in pressure on the inflation front. Hence, we expect the central bank to accumulate reserves when the peso is strengthening. At the moment, Colombia's stock of FX reserves are 1.26X their "optimum level", according to the IMF's ARA metric—which is sound, but not spectacular.

Our Colombian rate forecast has the hike cycle kicking off a couple of months before consensus, but we have a shallower tightening cycle altogether. This is because we are expecting that BanRep will stay ahead of inflation, and be mindful of the Fed. If the cycle is delayed, we would expect a higher terminal rate—closer in line with what the local interest rate swap curve is pricing.

In terms of currency moves, USD/COP has been quite stable for the past 2.5 years, mostly moving sideways in a 2,800–3,150 range since early 2016. We expect that pattern to hold, although we have some moderate near-term weakening of the peso, which we mostly see resulting from the yield disadvantage that COP offers relative to other LATAM currencies, such as BRL and MXN. As the tightening cycle in Colombia gains traction, we see USD/COP stabilizing around its fair value of 3,000, resuming a mild depreciation pattern into 2020.

## FISCAL REFORM 1.0 FAILED, WHAT TO EXPECT FROM ATTEMPT 2.0?

The results from the last attempt at fiscal reform were underwhelming, failing to reduce dependence on oil-related revenues and help get fiscal dynamics back on an improving trend. Accordingly, Moody's sounded some warnings on Colombia's fiscal situation towards the end of September, although we don't think a downgrade is a near-term risk—and we also don't think it would be justified by the country's current fundamental metrics. There have recently been signals from the government that suggest a more ambitious fiscal reform could be pursued, as Duque has been talking about the need for a more competitive and "just" tax system, while at the same time FinMin officials seem to be on a tax education campaign.

Even though we have seen an improvement on the deficit front, as in the current account, the vast majority of it was due to the rebound in oil prices. Overall, the country remains too dependent on oil price dynamics. The recent meetings held by FinMin Carrasquilla and his team to discuss the country's tax structure suggest that plans for a deeper overhaul are in place. The overhaul of the tax system and the consolidation of public finances are also at the heart of the government's push to bring potential growth back to their previous highs, while their presentations suggest that a combination of security, poor infrastructure, and "crowding out" is hurting the country's growth prospects. There has been discussion by the new government about the cost that the gap-filled structure of the country's VAT has on overall collection, and also on the negative effects the tax structure could be having on investment. Our take is that two priorities on the tax reform will be: 1) reducing exemptions in VAT, and 2) re-distributing the burden of income tax away from corporations:

- Here, the government addressed the problems that the current VAT structure has, both in terms of relatively low collection, but also on the positive spillovers it could have on the collection of other taxes—if addressed. The government also stressed that the current basket of exempted and 0-rate goods is overwhelmingly benefiting higher-income households (at about a 3:1 ratio).

- The government also appears to be in a lobby offensive, seeking to rebalance the burden of income tax receipts away from corporations (which in Colombia account for 80.9% of income tax receipts vs countries such as Mexico where it is 52.2%, Brazil 64.2%, and the OECD average 32.6%), towards more personal income tax collection—which currently represents a very low share.

If this stab at tax reform is successful, we would expect several positive results: 1) a more attractive tax environment for corporate investment, 2) a stronger fiscal stance which is less reliant on oil, and 3) a less distortive overall tax structure in the country. At this stage, it's hard to handicap the odds for the government's success in this campaign.

# Peru

## THE DIFFICULT PATH OF GETTING BACK TO BUSINESS AS USUAL

- **Mild increase in our 2018 GDP growth forecast from 3.5% to 3.7%.**
- **Raising our year-end FX forecast for the PEN from 3.22 to 3.26.**
- **Volatility in monthly GDP growth figures distorts true picture.**
- **Political tension has revived, but metal price trends are more important.**
- **Inflation is contained and macro balances remain robust.**

Lately, Peru's FX rate seems more stable than GDP growth. Year-over-year GDP growth has slowed rather dramatically to a 2.0%–2.5% range in the June–August period, after tallying 7.8% in April and 6.5% in May. The reasons behind the sharp slowdown are somewhat of a mixed bag. Second quarter figures were an overstatement as they compared with a low base due to last year's El Niño. In addition, since June, resource sectors—especially mining and fishing—have declined for reasons mostly short-term in nature (temporarily low ore grades, and an off-fishing season). As a result, neither second quarter nor more recent growth figures adequately reflect the actual underlying growth trend. Perhaps the best indicator would be non-resource GDP growth, which is more linked to domestic demand, and which rose 3.3% in June and 3.9% in July. There has been, however, one worrisome change recently, namely, a sharp decrease in government investment in July–August. This may continue. Furthermore, political tension between Congress and the Executive has revived, which raises the question of how much it may affect growth. Although demand growth is fairly robust, and the business community has largely given signs of going back to a business-as-usual mode, there is also a sense that politics is getting in the way of public sector investment, and weighing down on the private sector to some extent.

It's not easy to fit the unpredictability of politics into our growth equation. We've long said that our 2018 GDP forecast of 3.5% had upside to it, but that upside has narrowed, given the low growth of recent months. We are raising our forecast only mildly, to 3.7%, to account for the upside, but this is still below consensus and government forecasts which are in the vicinity of 4.0%. We are maintaining our 2019 GDP growth forecast of 4.0%. We would have lowered our forecast due to political risk, and key metal prices underperforming expectations, if not for the recent announcement by Anglo American that it will go ahead with its USD 5bn Quellaveco copper mine investment. This compensates for the greater uncertainty that we see for 2019.

The brighter side is that, if you ignore politics and metal markets (if only that were possible) nearly all economic indicators are actually quite positive. Both fiscal and external accounts have been surpassing expectations, inflation has stayed well within the bounds of the Central Bank target range, and the PEN has continued to be the most stable currency in the region. The fiscal deficit has come down from

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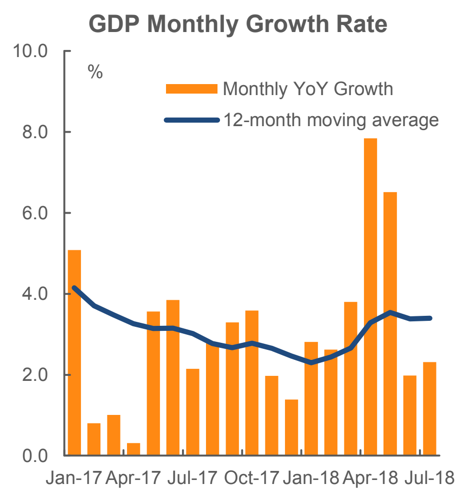
| Peru | 2017 | 2018f | 2019f | 2020f |
|---|---|---|---|---|
| Real GDP (annual % change) | 2.5 | 3.7 | 4.0 | 4.1 |
| CPI (y/y %, eop) | 1.4 | 2.0 | 2.5 | 2.5 |
| Central bank policy rate (%, eop) | 3.25 | 2.75 | 3.25 | 4.00 |
| Peruvian sol (USDPEN, eop) | 3.24 | 3.26 | 3.22 | 3.20 |

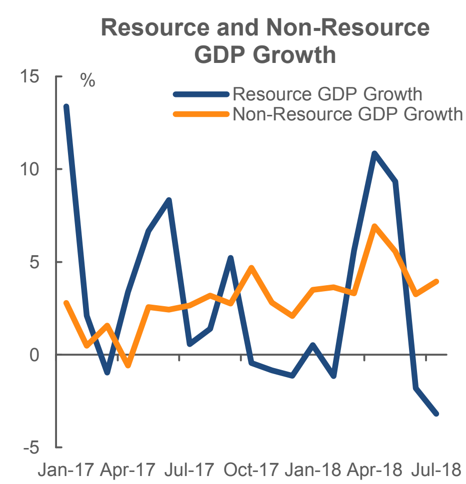
Source: Scotiabank Economics.

Chart 1




Sources: Scotiabank Economics, INEI.

Chart 2

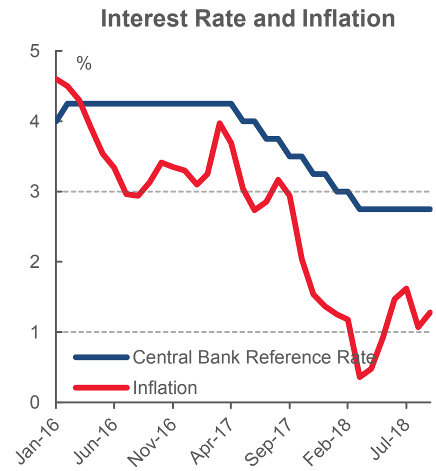



Sources: Scotiabank Economics, Central Bank of Peru.

3.2% of GDP at the turn of the year, to 2.1% in July. Importantly, the improvement is more from greater revenue—from both mining and domestic demand sales tax—than from low fiscal spending, which has also occurred. It will be a task for the government to spend enough to bring the deficit up to 3.0% by year-end. We hold to our 2018 2.8% full-year deficit forecast, but the risk is to the downside.

We also see no need to change our inflation forecast of 2.0% for the year. Yearly inflation to September came in at 1.2%, but should rise moderately henceforth. Monthly inflation will stay low in future months, but will temporarily compare with negative inflation in 2017. With inflation contained within its target range and GDP growth moderate, we continue to expect the Central Bank to not raise its reference rate, currently at 2.75%, until 2Q2019. The hardest price to forecast is the PEN/USD, since it has been driven by the USD, somewhat volatile in itself, and by speculation on how the trade war might affect metal markets, rather than by Peru's external accounts fundamentals per se. Even though we expect the market to correct from current levels of S/ 3.30–S/ 3.31, our forecast of 3.22 seems increasingly difficult to achieve. We are, therefore, raising our year-end forecast to 3.26.

**Chart 3**




Sources: Scotiabank Economics, Central Bank of Peru, INEI.

# Chile

## EXPERIENCING SOME HEADWINDS: GROWTH WILL DISAPPOINT CONSENSUS THE SECOND HALF OF 2018

- **Deterioration of some foreign conditions continued in the last months, with copper price falling below 280 US¢/lb. The US-China trade conflict has intensified which, together with the cyclical stage of the US economy and its differences with other developed economies has led to a global appreciation of the dollar and a fall in commodity prices.**
- **A surprising GDP growth of 5.3% yoy during the second quarter fed some exuberance for long-term growth. Domestic demand grew above expectations, reflecting a greater expansion of private consumption (mostly durable goods), an increase in inventory accumulation, and more dynamic investment in machinery and equipment.**
- **We foresee a deceleration to 3% yoy during Q3, consistent with a GDP growth for 2018 of 3.9%, below both consensus (4%) and the Central Bank baseline scenario (4.25%). The main drivers for good but not exuberant GDP growth during the second part of the year will come from deceleration of private consumption (particularly durable goods) and slow recovery in investment. Inflation expectations for the current year have increased due to volatile components, but are still well anchored at 3%. Central Bank will likely announce an increase of 25 bp to the MPR at the December meeting.**
- **Though domestic political conditions are stable, weakness in parliamentary support loomed again due to the tax reform. Government difficulties in accomplishing the main structural reforms might increase during the next months.**

## MACRO UPDATE: WEAKER GROWTH DURING THE SECOND SEMESTER

Headwinds have continued or deepened in the last three months. Terms of trade worsened, and some domestic conditions seemed to lose some steam (like Government expectation of wide support for critical reforms). However, as said in July, there is a prevalent set of conditions that can help in avoiding extremely negative effects: (1) Government's commitment to fostering domestic investment; (2) fiscal consolidation; (3) sustainable external accounts and economic-institutional stability.

Not surprisingly, the GDP growth in Q2 continued accelerating, but data already available for Q3 are showing deceleration. The labor market is posting a weaker-than-expected recovery, which will affect the dynamism of consumption during the second part of the year. Consensus and economic authorities will be disappointed during the second part of the year, which might cause a slight reversal in consumer and business confidence.

On the inflationary front, the exchange rate upsurge and higher oil price inched up inflation expectations for the current and next year, but the market remains very

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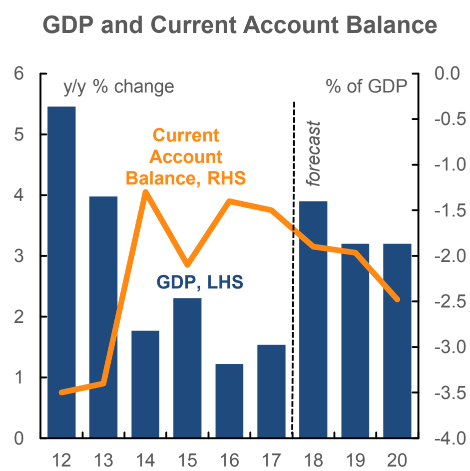
| Chile | 2017 | 2018f | 2019f | 2020f |
|---|---|---|---|---|
| Real GDP (annual % change) | 1.5 | 3.9 | 3.2 | 3.2 |
| CPI (y/y %, eop) | 2.3 | 3.2 | 3.0 | 3.0 |
| Central bank policy rate (%, eop) | 2.50 | 2.75 | 3.75 | 4.00 |
| Chilean peso (USDCLP, eop) | 615 | 650 | 650 | 640 |

Source: Scotiabank Economics.

Chart 1



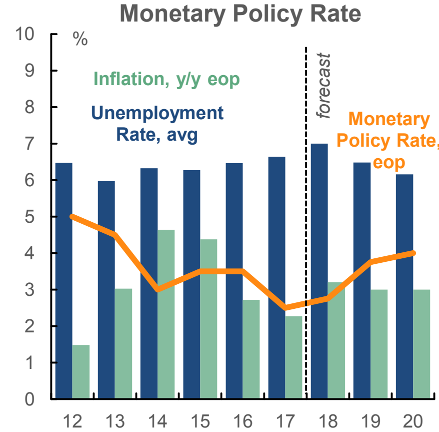

Sources: Scotiabank Economics, Banco Central de Chile.

conscious that causes are related to highly volatile items, while core inflation is evolving as expected. The Central Bank estimates that the current monetary stimulus is less necessary and will begin reducing it in the coming months with the next move likely at the December meeting. Finally, a very prudent and coordinated fiscal policy is expected to help avoid pressures due to rapid increases in the MPR. The 2019 budget report expects a 3.2% expansion in public expenditure (3.6% for current spending and 1.2% for public investment), the lowest since 2011 and below the GDP growth forecasted by the authorities for 2019. To be discussed in coming weeks, the reaction of the private sector was mostly positive.

Long term rates have retaken a smooth uptrend recently. There are many factors behind this: likely boosted in part by higher inflation expectations, by the Central Bank's less dovish speech, and by higher external interest rates. Though an uptrend seems the most likely scenario in coming months, a dramatic upsurge is not expected, though volatility will likely persist. One critical factor will be the exchange rate, whose wide trading range was remarkable in last two months. Our baseline scenario is a USDCLP around 650 by the end of 2018 and 2019.

Chart 2

Inflation, Unemployment and Monetary Policy Rate



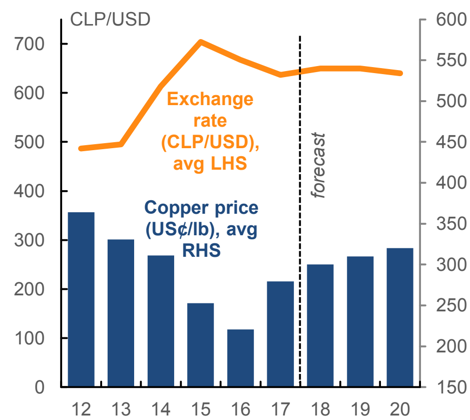

Sources: Scotiabank Economics, INE, Banco Central de Chile.

## POLITICAL PANORAMA: STILL FEW CHANGES

Politically, everything points to more difficulty to get the minimal support required to accomplish critical improvements and modernization, like that related to the tax framework, the pension system or labor regulations. On the other side, the opposition has intended to achieve some cohesion as a response to specific matters but has not been able to go much further, suggesting they still are not well organized and some wounds have not healed yet. If the Government were able to tap that, some critical reforms could go faster and better. There were some less-negative-than-expected reviews regarding the 2019 budget. The Government maintained its decision to accomplish as much as possible through non-legislative methods, but it is not quite clear how far this can go. As said, in politics time is limited and when some foreign conditions are becoming riskier, time is a critical variable.

Chart 3

Exchange Rate and Copper Price




Sources: Scotiabank Economics, Reuters Eikon

## MAIN RISKS

Despite variables having changed intensity, the structure of risks for the Chilean economy has not changed. Copper price, which affects not just the fiscal budget or the exchange rate, but is a keystone for private expectation, seems to have reached the bottom but it is still below the level reached in mid-2018. Expectations for the copper price are critical in the current stage of the cycle, because of its influential effect on investment decisions. Regional risk remains high, especially that from South America's large 'Atlantic' countries—Brazil and Argentina—which is not devastating but not positive either for the outlook. Another positive factor is the declining but still significant popularity of the President. These elements should be kept the sight in coming months to analyze risks.

# China

- **The US-China trade conflict has evolved from risk to reality.**
- **Weaker export sector activity will likely have a limited impact on headline growth; we see deteriorating sentiment and resulting weaker domestic demand as a bigger downside risk to the economy.**
- **The government is expected to take decisive policy action to offset the growth impact; accordingly, we expect China to sail through the trade turmoil reasonably smoothly.**
- **China will continue to reform the economy and address financial imbalances at a measured pace.**

## ECONOMIC GROWTH OUTLOOK SHAPED BY THE TRADE CONFLICT

The trade dispute between the US and China is one of the key factors shaping China's economic outlook through 2020. The conflict escalated in September following the Trump administration's announcement that the US would impose tariffs on USD 200 bn worth of imports from China. The tariff rate is initially 10% and is scheduled to rise to 25% on January 1, 2019. Prior to this announcement, 25% tariffs had already been applied on USD 50 bn of Chinese imports, an action that was subsequently matched by China. As a response to the escalation by the US, China imposed a second set of counter-tariffs on USD 60 bn of shipments from the US, with duty rates ranging between 5% and 10%.

The trade conflict will likely remain in place for an extended period of time, with a low likelihood of a near-term resolution given that bilateral talks have been halted for the time being; moreover, the US has not articulated a clear objective that China would need to accomplish to resolve the situation. We expect the US to move ahead with its plan of raising the tariff rate in January from 10% to 25% on the latest batch of targeted imports. Nevertheless, we consider it unlikely that the US would act on its threat regarding covering virtually all the remaining imports from China with additional tariffs. Such a move would be highly burdensome on US consumers and industry with most of the adverse impacts likely becoming evident in the run-up to the 2020 presidential election.

The escalated trade conflict will place the Chinese economy under downward pressure over the coming quarters. While we have long anticipated a gradual slowing in China's output growth, we highlight that the drivers behind such deceleration have recently changed. Instead of an organic loss of momentum due to the economy's structural changes and authorities' deleveraging efforts, the growth slowdown is now increasingly driven by trade conflict-related issues as deleveraging efforts are set to become less stringent. We expect most of the headwinds to be felt in 2019, with China's real GDP growth likely to decelerate from 6.7% y/y in 2Q2018 to 6.0% by 4Q2019 (chart 1); we had earlier expected output growth to stabilize at 6.3% y/y in the second half of 2019. Our full-year growth forecast for 2018 remains unchanged at 6.6%, but we have revised the 2019 forecast slightly downward, from 6.3% to 6.2%. In 2020, China's expansion will likely stabilize at around 6% y/y.

**CONTACTS**

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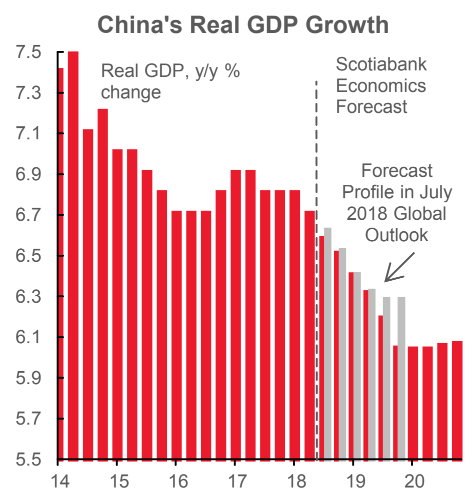
| China | 2017 | 2018f | 2019f | 2020f |
|---|---|---|---|---|
| Real GDP (annual % change) | 6.9 | 6.6 | 6.2 | 6.0 |
| CPI (y/y %, eop) | 1.8 | 2.4 | 2.5 | 2.3 |
| Central bank policy rate (%, eop) | 4.35 | 4.35 | 4.35 | 4.35 |
| Chinese yuan (USDCNY, eop) | 6.51 | 6.90 | 6.70 | 6.50 |

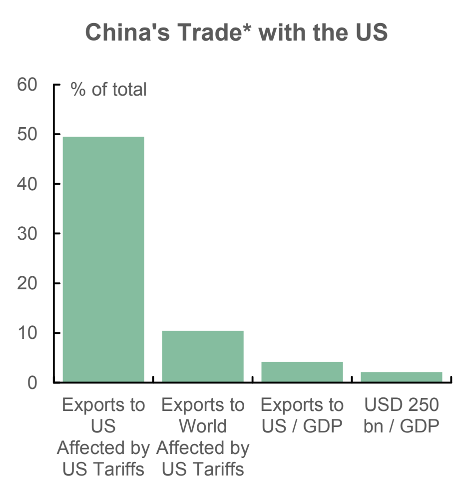
Source: Scotiabank Economics.

Chart 1




Sources: Scotiabank Economics, Bloomberg.

Chart 2




*2017 data. Sources: Scotiabank Economics, IMF.

## THE TRADE CONFLICT'S IMPACT ON THE ECONOMY

The US is China's main export destination, purchasing around 20% of all Chinese shipments abroad. Following the escalation of the conflict, around half of Chinese shipments to the US will face tariffs; the targeted USD 250 bn worth of Chinese exports to the US represent 10% of China's global shipments (chart 2). Against this backdrop, Chinese exporters may face lower demand for their products in the US if tariffs result in higher prices or if the US is able to find substitutes for Chinese goods. However, given that USD 250 bn worth of Chinese exports are equivalent to only 2% of China's GDP, we assess that even a significant drop in the US demand for Chinese goods could be compensated by more proactive fiscal and monetary policies. We also highlight that the US dollar has appreciated by around 9% vis-à-vis the Chinese yuan over the past two quarters (chart 3), which should help offset some of the upward price pressure on Chinese goods in the US.

The Chinese economy has gone through a marked change in recent years, with the significance of the external sector as a source of growth diminishing and domestic demand, particularly consumer spending, becoming more important. In fact, net exports were a drag on growth in the first half of 2018 (with -9% contribution) while consumption and fixed investment accounted for 78% and 31% of growth, respectively. With the aforementioned factors in mind, we assess that the trade conflict's direct impact from net trade on China's real GDP growth will be relatively small, particularly given that both China's exports and imports will be impacted by the tariffs.

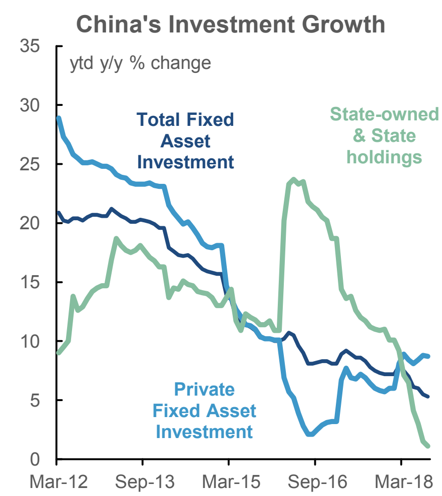
We assess that the trade conflict's biggest impact on the Chinese economy will come via business sentiment given that deteriorating confidence is likely to delay business investment decisions and alter hiring intentions, leading to broader downward pressure on domestic demand. In addition, if the conflict continues for an extended period of time, there is a risk that China's investment prospects deteriorate more dramatically as manufacturers may start shifting production facilities elsewhere, such as into neighbouring Vietnam. Recent high frequency indicators show some signs of softness in manufacturing sector sentiment. Meanwhile, aggregate fixed capital investment growth has been on a slowing trend for a prolonged period of time (chart 4). Nevertheless, robust private sector investment momentum has been a key factor preventing a more pronounced slowdown in investment growth. We will continue to monitor these developments closely over the coming months; we believe that public sector entities would pick up most of the slack should private sector investment growth come to a halt due to weaker business confidence.

In terms of the expected impact on Chinese consumer spending, we point out that—due to the government's control over media—consumers' discontent does not spread as easily in China as it does in the US. Therefore, the impact on Chinese consumer confidence and household spending will likely be relatively limited. In addition, the Chinese government's retaliatory tariffs have been planned in such a way that they minimize the impact on the consumer. Only if we saw significant job losses in the affected manufacturing sector, would consumer spending prospects soften more notably. While we continue to monitor such trends very closely, we consider that the outlook for the Chinese consumer remains solid for the time being; the median real disposable income per capita increased by 8.4% y/y in the first half of 2018, accelerating from the 2017 pace of 7.3% y/y.

Chart 3

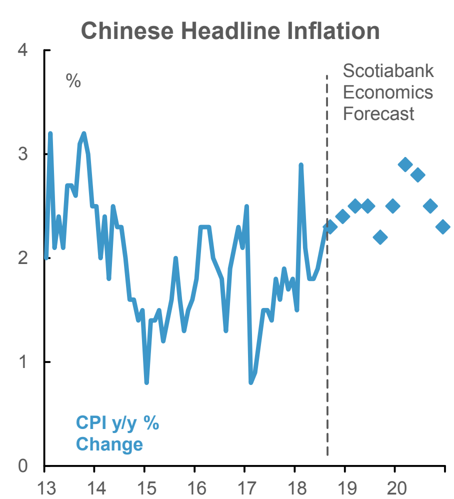

Sources: Scotiabank Economics, Bloomberg.

Chart 4




Sources: Scotiabank Economics, Bloomberg.

Chart 5

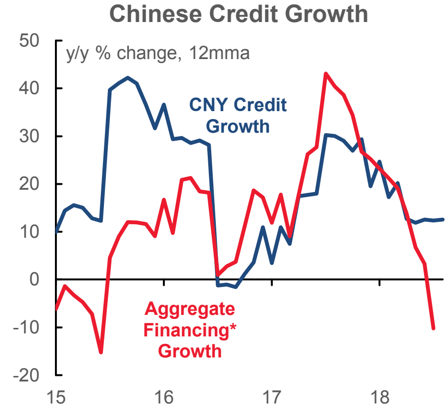



Sources: Scotiabank Economics, Bloomberg.

## FISCAL AND MONETARY POLICY OUTLOOK

In the current uncertain environment, the Chinese government has two somewhat contrasting objectives that are dominating its policymaking: 1) supporting economic growth as trade tensions weigh on the outlook, and 2) containing financial risks and imbalances in the economy by deleveraging, which is a prerequisite for further economic liberalization.

Chart 6



*PBoC changed the statistical basis for this series in August 2018; the chart depicts the old series with longer history. Sources: Scotiabank Economics, Bloomberg, PBoC.

The first objective will likely become increasingly dominant over the coming quarters. China has announced that it will take a more flexible approach to fiscal policy in order to offset the adverse economic impact. We expect the government to intervene in the economy to keep economic growth at 6% or above through the rest of the decade; Chinese policymakers will likely use various tools to stimulate the economy, such as personal and corporate tax cuts to boost domestic consumption, export tax rebates and other targeted aid for exporting and manufacturing companies, incentives for higher private investment, particularly in sectors that are in line with China's technology-focused industrial strategy, as well as infrastructure spending on high-speed rail for instance. The fiscal measures will likely mainly focus on enhancing China's economic transformation from focus on heavy industry and low-value-added manufacturing toward the services sector and high technology industries.

In addition to fiscal stimulus, monetary policy will remain accommodative to support the economy, allowed by contained inflationary pressures through 2020. We expect headline inflation to average 2½% y/y over the next two years (chart 5). The People's Bank of China (PBoC) will use various tools—such as open market operations, reserve requirements, as well as standing and medium-term lending facilities—to provide the financial system with ample liquidity ensuring that sectors with favourable growth prospects will continue to have access to funding. While we do not expect the benchmark deposit and lending rates to be changed over the coming quarters, we anticipate further reductions in banks' reserve requirement ratios. The PBoC is not expected to use currency devaluation as a tool to boost the country's exports; in fact, further currency weakness would be undesirable; should it become the market expectation, capital flows out of China would intensify. Less investor demand for Chinese assets would add to the refinancing challenges faced by China's indebted companies.

As for the Chinese administration's second objective regarding reducing financial risks, China's deleveraging process is advancing with credit growth slowing to more sustainable levels in recent quarters (CNY lending grew by 12.6% y/y 12mma in August vs. the 30.1% pace recorded a year earlier). Aggregate financing growth has decelerated more markedly (12mma growth has dipped into negative territory), given the administration's efforts to contain the shadow banking industry (chart 6). In addition to the administration's focus on growth in higher quality credit, the regulatory framework for the shadow-banking industry has been strengthened notably. We expect the deleveraging process to slow down somewhat over the coming months as Chinese policymakers will be forced to prioritize economic stability in the face of increasing downside risks to growth. Nevertheless, official communications indicate that the administration is firmly committed to preventing a further build-up of financial imbalances stemming from excessive credit growth.

We expect the trade issues to linger for a while, past the US midterm elections in November and well into 2019. Meanwhile, we continue to monitor the potential for further escalation, though we note that policymakers on both sides will have a strong incentive for solving the trade dispute through dialogue once the adverse impact on the economy has become more evident. Simultaneously, China will continue to implement its structural reform agenda, gradually opening up the economy. While further liberalization of the Chinese economy is one of the US's demands, we do not expect China to execute rushed reforms. Indeed, this year marks the 40th anniversary of China's "reform and opening-up", highlighting China's preference for maintaining a measured approach to structural changes.

# Japan

- **Output growth in line with potential with inflation staying below target.**

## ECONOMIC GROWTH OUTLOOK

The Japanese economy is propelling ahead reasonably well—by recent Japanese standards—with real GDP rising by 1.2% y/y in the first half of 2018. Business investment is buttressed by corporations' healthy balance sheets and stimulative fiscal and monetary policies, while a tightening labour market is expected to lift wages and support household spending. Robust global demand is reflected in Japan's export sector activity. However, with China and the US being Japan's two main export markets, the US-China trade conflict along with the US's protectionist biases—evidenced by the steel and aluminium tariffs—pose a downward risk to Japan's growth outlook. The scheduled consumption tax rate hike (from 8% to 10%) in October 2019 is set to cause growth volatility next year (chart 1). We expect Japan's real GDP to expand by 1.2% this year, followed by an average gain of 1% y/y in 2019–2020, which is virtually in line with the economy's potential.

Shinzo Abe won the ruling Liberal Democratic Party's (LDP) leadership election in September. The party leader will effectively be Japan's next prime minister, given that the LDP and its junior coalition partner Komeito control both the lower and the upper house of parliament. A renewed mandate will be a welcomed opportunity for Mr. Abe to focus on the third "arrow" of his economic revival plan. The monetary and fiscal "arrows" have been used extensively and have helped bring an end to deflation, yet the third one—structural reforms—has not progressed as fast as was envisioned when Abe first came to power in 2012. Successfully implemented reforms represent an upside risk to Japan's longer-term growth outlook.

## INFLATION AND MONETARY POLICY OUTLOOK

Japan's inflationary pressures are set to stay below the Bank of Japan's (BoJ) 2% target through 2020. Headline inflation has recently rebounded to 1⅓% y/y, driven by higher food costs. The CPI excl. fresh food—the BoJ's preferred measure—remains more muted at 0.9% y/y. We expect the recent modest pick-up to be short-lived with headline inflation closing 2018 at 1% y/y. Inflation will spike temporarily in the final months of 2019 reflecting the hike in the consumption tax rate, yet price gains will likely ease back toward 1% y/y over the course of 2020 (chart 2).

Highly-accommodative monetary policy will likely be maintained through 2020. Last July, the BoJ implemented some technical tweaks to its monetary operations in order to increase policy flexibility; the BoJ will allow for more volatility in yields depending on developments in economic activity and prices. We expect the monetary policy stance to remain unchanged over the coming quarters with the short-term policy rate kept at -0.1%. The BoJ will continue to adjust the amount of bond purchases depending on market developments, aiming to keep the 10-year bond yield close to 0%. The forthcoming consumption tax rate hike may cause a drop in real GDP or a growth slowdown; potential recessionary conditions do not create an environment where the BoJ would be tightening monetary policy. Against this backdrop, we do not foresee any adjustments to the policy rate before end-2020, yet the BoJ may allow long-term yields to rise marginally in 2020 assuming that the economy sails through the tax rate hike reasonably unharmed.

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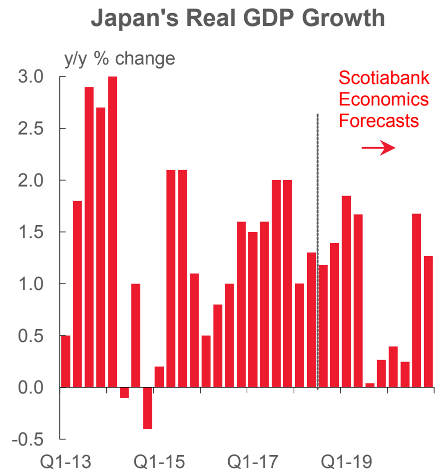
| Japan | 2017 | 2018f | 2019f | 2020f |
|---|---|---|---|---|
| Real GDP (annual % change) | 1.7 | 1.2 | 1.0 | 0.9 |
| CPI (y/y %, eop) | 1.0 | 1.0 | 2.3 | 1.1 |
| Central bank policy rate (%, eop) | -0.10 | -0.10 | -0.10 | -0.10 |
| Japanese yen (USDJPY, eop) | 113 | 110 | 108 | 105 |

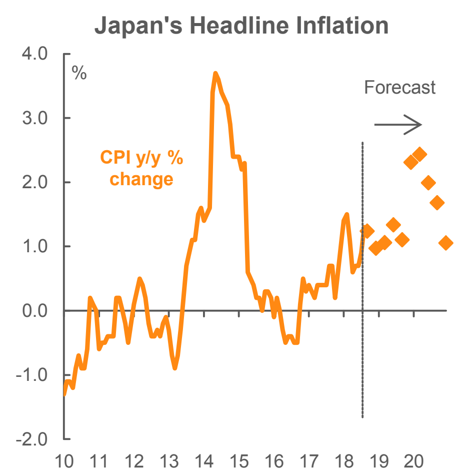
Source: Scotiabank Economics.

**Chart 1**




Sources: Scotiabank Economics, Bloomberg.

**Chart 2**




Sources: Scotiabank Economics, Bloomberg.

# India

- **India continues to be a growth outperformer among major economies.**
- **Inflation risks remain elevated, warranting monetary tightening.**
- **The rupee reflects emerging market concerns and India's current account and fiscal deficits.**

## ECONOMIC GROWTH OUTLOOK

The Indian economy is performing strongly. Real GDP growth averaged 7.9% y/y in the January–June period, following a 6.3% gain in 2017. We expect the economy to expand by 7.6% in 2018 as a whole (chart 1). Private consumption, investment activity, and momentum in the manufacturing and services sectors continue to be robust. In addition, the nation's fiscal policy stance remains growth-supportive. The fact that the Indian economy is less export-oriented than its regional peers is providing some protection against any adverse impact on real GDP growth stemming from the US–China trade conflict and the US's trade policy more broadly.

We assess that India's medium-to-longer-term growth outlook is reasonably encouraging as well. In our view, recent reforms—such as tax reform, bankruptcy code, bank recapitalization and non-performing asset resolution, liberalization of foreign direct investment, and various efforts to formalize the economy—will help revive credit growth, simplify India's complicated business environment, and encourage private sector investment, thereby supporting the economy's momentum. Accordingly, India is set to remain a growth outperformer among the world's major economies in the foreseeable future. We forecast India's real GDP to advance by 7½% y/y on average through the rest of the decade.

## INFLATION AND MONETARY POLICY OUTLOOK

India's inflation outlook continues to warrant close monitoring despite the fact that price pressures at the headline level have weakened in recent months. Consumer price inflation has eased—mainly due to base effects—to 3¾% y/y from over 5% at the beginning of 2018. We expect the headline rate to close 2018 at 4.0% y/y and to pick up moderately over the course of 2019 (chart 2). Nevertheless, we believe that the Reserve Bank of India's (RBI) monetary tightening will help keep inflation within the central bank's target of 4% ±2% through 2020.

Despite favourable developments in recent months, India's inflation outlook is not without its challenges, highlighted by the fact that core inflation remains elevated at close to 6% y/y. We continue to observe carefully the development of the following upside risks to inflation: 1) ongoing financial market volatility and the associated depreciation of the Indian rupee; 2) households' rising inflation expectations; 3) elevated crude oil prices; 4) higher input price pressures in the manufacturing sector; 5) below-average rainfall during the monsoon season (June–September) and its potential impact on food prices; 6) the central government's decision to implement minimum support prices for certain crops; 7) potential fiscal slippage ahead of the 2019 general election; and 8) higher housing rent allowances given to government employees.

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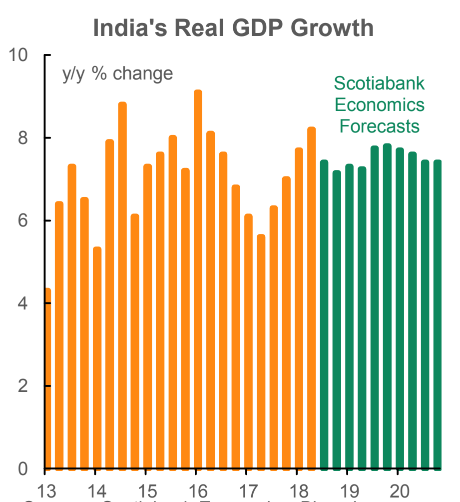
| India | 2017 | 2018f | 2019f | 2020f |
|---|---|---|---|---|
| Real GDP (annual % change) | 6.3 | 7.6 | 7.5 | 7.5 |
| CPI (y/y %, eop) | 5.2 | 4.0 | 5.2 | 4.8 |
| Central bank policy rate (%, eop) | 6.00 | 6.75 | 7.25 | 7.25 |
| Indian rupee (USDINR, eop) | 63.9 | 72.5 | 71.0 | 69.0 |

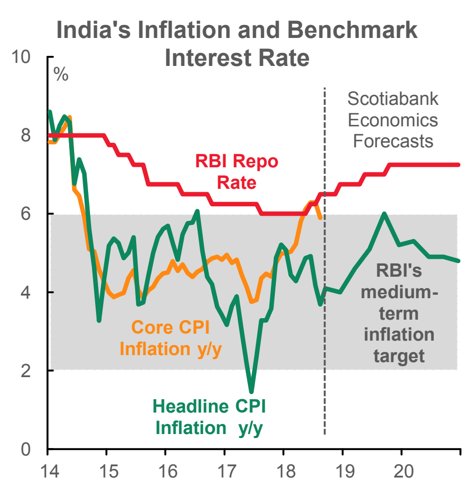
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

The RBI continues to give high priority to preserving policy credibility vis-à-vis the central bank's inflation targeting mandate. The RBI raised the benchmark repo rate by 25 basis points in June and August to the current level of 6.50%. Nevertheless, following the most recent policy meeting on October 5, the RBI opted to take a break from monetary tightening. Instead, it prioritised financial sector stability in the midst of elevated shadow banking sector stress and focused on maintaining adequate levels of liquidity in the system. Nevertheless, the central bank changed its policy stance from "neutral" to "calibrated tightening", indicating that further hikes are in store. We assess that the RBI will likely raise the policy rate by 25 basis points following the next monetary policy meeting on December 5.

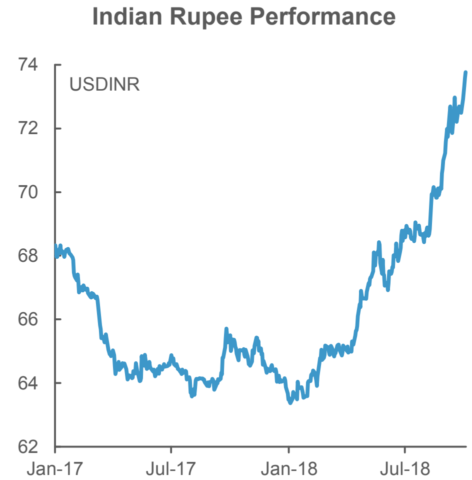
## ECONOMIC FUNDAMENTALS AND THE INDIAN RUPEE

The Indian rupee (INR) is facing significant depreciation pressure against the US dollar. The INR is the worst-performing Asian currency since the beginning of the year, having recorded double-digit losses vis-à-vis the USD (chart 3). Turmoil related to Turkey and Argentina combined with the US-China trade conflict has led to weaker sentiment toward emerging markets, leading to spillovers into India on the back of the country's fiscal and current account deficits (chart 4). In addition to the twin-deficit position, political uncertainty in India will remain high over the coming months due to four state elections that will be held by the end of January 2019, followed by general elections in April–May 2019; accordingly, we remain bearish on the INR over the medium-term.

While India's current account deficit is not notably large—likely to average around 2½% of GDP during the current fiscal year (April 2018–March 2019)—foreign direct investment inflows do not fully cover the deficit financing needs; therefore, India relies on more volatile portfolio inflows and external debt to finance the current account shortfall, leading to higher currency volatility. On the fiscal front, the Indian government remains committed to gradual fiscal consolidation. The Union Budget for Fiscal Year 2018–19 projects the central government deficit to narrow to 3.3% of GDP from 3½% a year earlier. Nevertheless, we note that the risk of fiscal slippage ahead of the 2019 general elections remains elevated. We further point out that India's public deficit remains substantially larger at the general government level, likely to average 6½% of GDP over the next couple of years. We assess that the Indian economy's main fundamental weaknesses and risks continue to lie on the fiscal front as the government's ability to respond to potential adverse shocks is somewhat limited.

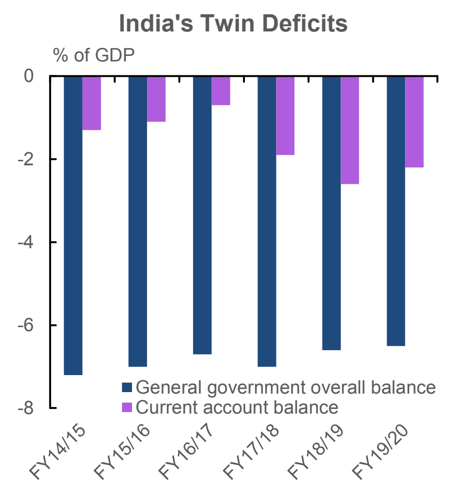
The RBI has intervened in the foreign exchange market in order to support the INR, leading to a decline in the central bank's reserves. Nevertheless, India's foreign reserves relative to short-term liabilities are reasonably solid. We assess that the central bank should have adequate tools to continue defending the currency if needed. In addition to market intervention, India has unveiled various other measures to support the INR, including steps to facilitate bond issuance by local companies in order to boost capital inflows, as well as higher tariffs to reduce imports.

Chart 3




Sources: Scotiabank Economics, Bloomberg.

Chart 4




Sources: Scotiabank Economics, IMF.

# South Korea

- **Real GDP growth is likely to remain in line with potential through 2020.**
- **Inflation is expected to reach the central bank's target in near-term.**

## ECONOMIC GROWTH OUTLOOK

South Korea's economic growth remains reasonably solid. We expect real GDP to advance by 2.9% in 2018, followed by an average gain of 2.7% y/y in 2019–2020 (chart 1). Momentum is driven by robust export sector activity; recent softness in consumer spending and fixed investment will likely prove temporary on the back of the government's growth-enhancing policies, such as minimum wage hikes, job creation measures, and innovation-related programs. High household debt levels and softer sentiment due to ongoing trade-related uncertainties will likely prevent the pace of growth from surpassing the economy's potential of around 2¾% y/y.

We identify two key risks for South Korea's economic growth: trade protectionism and domestic labour market developments. Given that the South Korean economy is export-oriented and tightly integrated into the Asian and global supply chains, it will likely feel the adverse impact from the escalating US-China trade conflict. China is South Korea's main export market, purchasing 30% of its shipments abroad; moreover, more than half of South Korean global exports are intermediate goods that, once assembled into final goods, could face US import duties. In addition, we are paying close attention to recent sluggishness in the domestic labour market. Reflecting the around 16% increase in the minimum wage earlier this year, the nation's unemployment rate has climbed from 3.6% to 4.0% as small companies have experienced difficulties in retaining prior employment levels. An additional minimum wage increase—of around 11%—is scheduled for 2019, pointing to further hardship ahead for small firms unless demand picks up enough to compensate for higher labour costs. To alleviate the pain, the South Korean government recently unveiled a proposal for an expansionary budget for 2019, which follows a jobs-focused supplementary budget approved for the current year.

## INFLATION AND MONETARY POLICY OUTLOOK

South Korea's inflation is strengthening, approaching the Bank of Korea's (BoK) 2% y/y target on the back of year-ago base effects, higher food prices, and imported price gains due to recent currency depreciation vis-à-vis the US dollar. We expect headline inflation to hover near the 2% mark in the final months of 2018. In 2019–2020, inflation will likely remain manageable—averaging 2½ y/y—as the BoK continues to tighten monetary policy cautiously.

With a pick-up in inflation, the BoK's policy rate in real terms has dipped into negative territory. This will likely prompt the central bank to redirect its current policy focus on financial stability in the face of persisting trade-related uncertainties, elevated risk aversion, and potential capital outflows. Moreover, reasonably solid economic momentum, continued high credit growth by South Korean households, and a widening interest rate differential between the US and South Korea will likely add to the pressure on the BoK to reduce monetary accommodation. Accordingly, the likelihood of the BoK raising the Base Rate by 25 basis points to 1.75% by the end of this year remains high.

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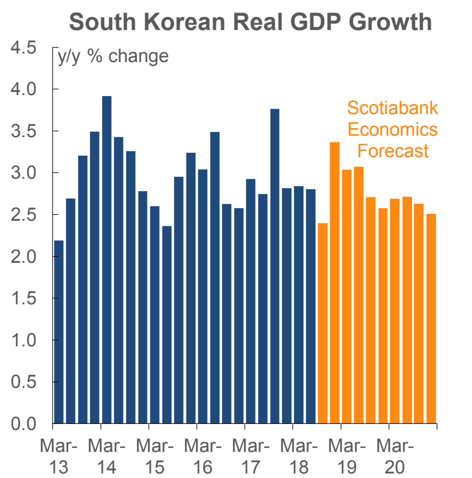
| South Korea | 2017 | 2018f | 2019f | 2020f |
|---|---|---|---|---|
| Real GDP (annual % change) | 3.1 | 2.9 | 2.8 | 2.6 |
| CPI (y/y %, eop) | 1.5 | 2.2 | 2.5 | 2.2 |
| Central bank policy rate (%, eop) | 1.50 | 1.75 | 2.25 | 2.50 |
| South Korean won (USDKRW, eop) | 1,067 | 1,100 | 1,085 | 1,070 |

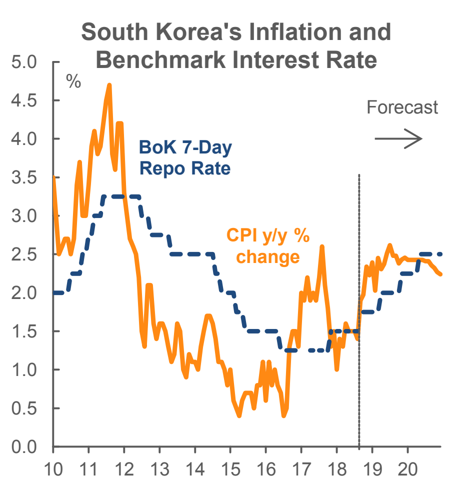
Source: Scotiabank Economics.

Chart 1




Sources: Scotiabank Economics, Bloomberg.

Chart 2




Sources: Scotiabank Economics, Bloomberg.

# Australia

- **Australia's economic growth to decelerate moderately in 2019–20.**
- **Manageable inflation outlook allows measured monetary normalization.**

## ECONOMIC GROWTH OUTLOOK

Australia's economic momentum so far this year has turned out to be stronger than we had anticipated, with real GDP averaging a solid 3.3% y/y in the first half of 2018 (chart 1). Therefore, we now expect the Australian economy to expand by 3.1% in 2018 (vs. 2.8% in the Q3 *Global Outlook* report). Activity is broadly based as domestic demand—notably non-mining investment, infrastructure investment, and private spending—as well as net exports are contributing to growth. Nevertheless, we assess that the economy will return toward potential growth rates of 2⅔% y/y in 2019–2020 on the back of slightly softer export sector performance. Moreover, the Australian consumer may not be able to underpin the economy's current momentum: while a strengthening labour market is supporting confidence, still-weak wage gains and high household debt levels will likely limit spending growth over the coming quarters.

We continue to monitor closely any potential adverse impact on the Australian economy stemming from the US-China trade conflict. We believe that the biggest downside risk caused by the trade dispute relates to weaker business sentiment globally. A deteriorating outlook for the global economy would likely be reflected in commodity prices, adversely affecting Australia's terms of trade. Additionally, non-mining business investment is currently an important growth driver in Australia; investment prospects would likely weaken along with softer business confidence. Nevertheless, we note that China does not purchase significant amounts of intermediate goods from Australia that, once assembled into final goods, could face US import tariffs. Therefore, we assess that Australia is less exposed to the conflict than several Asian economies, such as South Korea, Japan, and Taiwan. Australian exports to China support Chinese domestic demand, particularly construction and infrastructure development. In this light, we continue to monitor closely any further details on China's fiscal stimulus plans.

## INFLATION AND MONETARY POLICY OUTLOOK

The Reserve Bank of Australia (RBA) will likely maintain the current accommodative monetary policy stance over the coming months. On the back of a still-soft wage and price inflation outlook, we expect that the RBA's monetary tightening phase will wait until the second quarter of 2019 (chart 2), followed by cautious interest rate increases. The benchmark interest rate has remained at 1.50% since August 2016. The RBA's policymakers have highlighted that "the next move in the cash rate would more likely be an increase than a decrease". Meanwhile, they have also pointed out that there is "no strong case for a near-term adjustment in monetary policy". Australian wages and prices at the headline level are rising in tandem, by 2.1% y/y in the second quarter, leaving earnings flat in real terms. Wage inflation is expected to pick up modestly, yet demand-driven inflationary pressures are set to remain manageable in the foreseeable future. We expect headline inflation to close 2018 at 2.0% y/y and average 2½% y/y in 2019–2020, thereby remaining within the RBA's inflation target of 2–3% y/y.

**CONTACTS**

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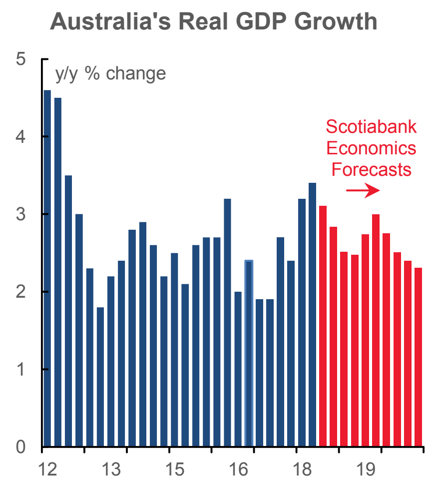
| Australia | 2017 | 2018f | 2019f | 2020f |
|---|---|---|---|---|
| Real GDP (annual % change) | 2.2 | 3.1 | 2.7 | 2.5 |
| CPI (y/y %, eop) | 1.9 | 2.0 | 2.5 | 2.6 |
| Central bank policy rate (%, eop) | 1.50 | 1.50 | 2.00 | 2.50 |
| Australian dollar (AUDUSD, eop) | 0.78 | 0.73 | 0.78 | 0.78 |

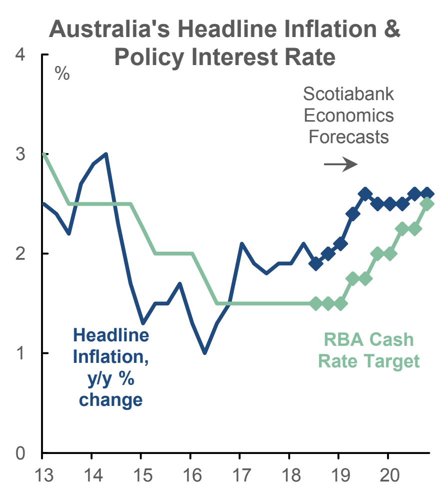
Source: Scotiabank Economics.

Chart 1




Sources: Scotiabank Economics, Bloomberg.

Chart 2




Sources: Scotiabank Economics, Bloomberg.

# Commodities

## US-CHINA TRADE HEAT SETTLES TO FRUSTRATING SIMMER, DIMMING METALS PRICE PROSPECTS

- **While NAFTA worries look to be in the rear-view mirror, US-China trade concerns remain front-and-centre for commodity markets with no obvious end in sight; we now believe that the US-China trade dispute will remain a slow-burn drag on industrial commodity sentiment through to the 2020 US presidential election.**
- **Chinese counter-stimulus will help offset trade-related headwinds, but we expect Beijing's policy package to be primarily targeted at domestic services industries and thus less metals-supportive than in the past.**
- **Our less constructive view on the tumultuous cross-Pacific trade environment leads to slower demand growth and thus lower forecasted prices for metals like copper, nickel, zinc, and aluminium through the end of 2020 (chart 1).**
- **Oil price prospects have been bolstered by tightening supply conditions and uncertainty regarding Saudi Arabia's capacity to fill in for production losses in Iran and Venezuela.**
- **Unfortunately for Canadian oil producers, pipeline constraints and sluggish oil-by-rail pickup have prompted discounts to blow out once again and differentials are expected to remain volatile until Line 3 enters service in early 2020.**

## FROM TRADE WAR FOOTING TO UNCOMFORTABLE UNPLEASANTNESS

**The Great US-China Trade War—or as we're choosing the think of it, the protracted US-China unpleasantness—looks like it's going to be a long-lived annoyance to the global economy and commodities producers need to get used to a few more years of slower-than-anticipated demand and tepid market sentiment**. In mid-September, the White House announced that the US would impose a 10% tariff on $200B of imports from China (chart 2), with the rate steepening to 25% at the start of the New Year. This latest salvo comes on top of the 25% tariff on $50B of Chinese shipments announced in mid-June as well as product-specific tariffs on steel, aluminium, washing machines, and solar panels rolled out earlier in the year. We expect US tariffs on $250B in Chinese goods to remain in place at a rate of 25% through to the 2020 US presidential election, presenting broad but relatively mild headwinds to the Chinese economy. Standing up to China on trade enjoys uncommon bipartisan support in Washington and even a decisive Democratic victory in Congressional mid-term elections is unlikely to materially change the current policy course. However, we believe that the White House will ultimately decline to impose further so-called Phase III tariffs on the remaining $267B in imports from China, primarily because this final list of goods is far more consumer-oriented (e.g. iPhones) and thus likely to prompt negative political sticker-shock.

CONTACTS

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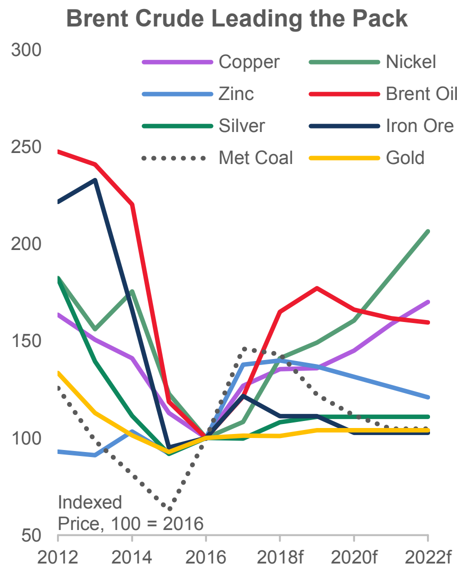
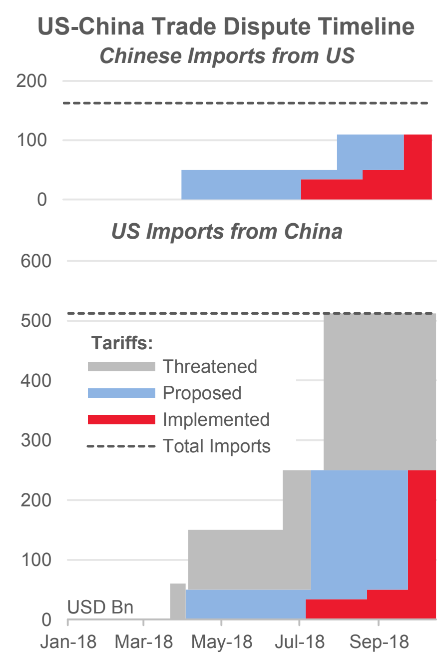
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, PIIE.

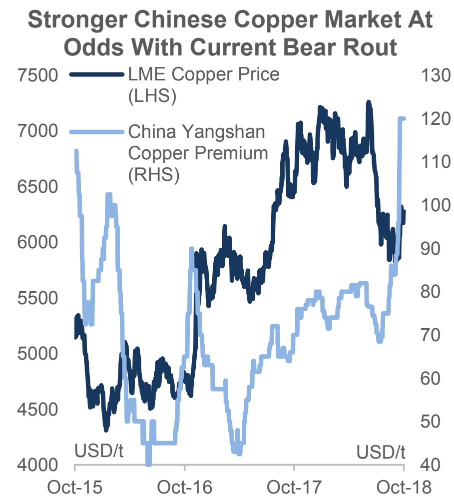
Beijing has retaliated with counter-tariffs to the extent that it can given that China imports less than $250B from the US, though non-tariff measures remain a future option should relations sour further. **More important for raw commodities demand are the steps that Chinese policymakers take to offset the drag of US tariffs on the Chinese economy.** Chinese Premier Li addressed some of the speculation around potential stimulus responses, stating that Beijing is not looking to engage in currency devaluation nor would it embark on the same kind of economic stimulus that helped China's economy avoid the worst of the 2008 financial crisis. Instead, Li stressed that Beijing would take "pre-emptive measures" and would use other macroeconomic policies to help industries hit by the mounting tariffs, with the vague pronouncement leaving considerable room for interpretation. We believe that while the Chinese government is likely to fast-track infrastructure projects that have been slow to break ground, Beijing is unlikely to kick off billions of dollars in new infrastructure projects as seen in previous stimulus efforts. This time around, we expect that the primary target of monetary and fiscal measures will be services-oriented sectors that China believes have significant growth potential, meaning that this policy package is likely to be less metals-supportive than previous efforts. Accordingly, we have softened our demand and price outlook across the base metals complex, reflecting the impacts of trade-related drag and unsupportive sentiment.

While a good deal of next year's commodity demand fundamentals will be determined by the type and intensity of policy assistance coming out of Beijing, it is notable that current spot prices are richer within China than global benchmarks would suggest. Despite LME copper prices falling from near-$3.30/lb to recent lows below $2.70/lb, physical premiums in China rose to three-year highs—global speculators were bidding down copper on bets that Chinese demand would falter in the face of US tariffs, while at the same time Chinese buyers on the ground were bidding up local premiums as they took advantage of the narrative-driven discount (chart 3). While we believe that Chinese demand will gradually slow through next year, LME prices are at least currently reflecting an overreaction to the US-China trade dispute.

## ENERGY: TIGHTENING CRUDE BALANCES AND LARGE IRANIAN EXPORT LOSSES PUT SAUDI ARABIAN SPARE CAPACITY IN THE SPOTLIGHT

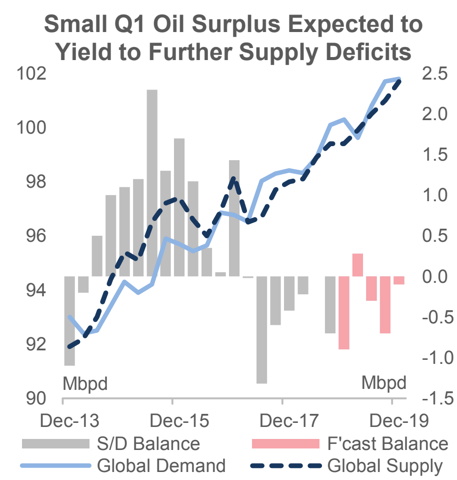
**The oil market is getting tight** and Brent crude breached $85/bbl in early October for the first time since 2014. Demand growth has been robust at 1.5 MMbpd y/y through the first half of 2018 and is expected to grow by a strong 1.6 MMbpd next year. The US shale patch satiated nearly all this new demand—pumping 1.8 MMbpd more through the first half of 2018—but looks set to slow to nearer 1 MMbpd in 2019 as drilling drifts into less prolific acreage and infrastructure constraints limit profitability. Within OPEC, Venezuelan production continues to collapse (-650 kbpd y/y) and Iranian exports are rapidly falling off (-1 MMbpd by year-end) in the face of renewed US sanctions. All this leaves considerable weight on the shoulders of Saudi Arabia, which holds virtually all of the OPEC's spare capacity. We expect Saudi Arabia to largely rise to the challenge, contributing enough supply to maintain market stability but not as many barrels are needed to close the supply gap completely. Global oil balances are expected to remain in a mild deficit of 200 kbpd in 2019 (chart 4), slightly less than the 500–600 kbpd deficits averaged over 2017–18 but with less of an inventory cushion (chart 5). Prices are expected to remain well-supported through 2020, though a forecast surplus in 1Q19 and an anticipated rebalancing of over-extended bullish positioning are expected to keep us from sustainably breaking above $90/bbl. Brent oil prices are forecast to

Chart 3



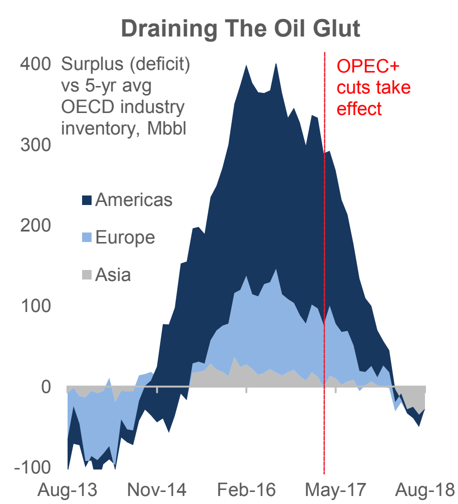

Sources: Scotiabank Economics, Bloomberg, LME.

Chart 4




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

Chart 5




Sources: Scotiabank Economics, IEA, OMI.

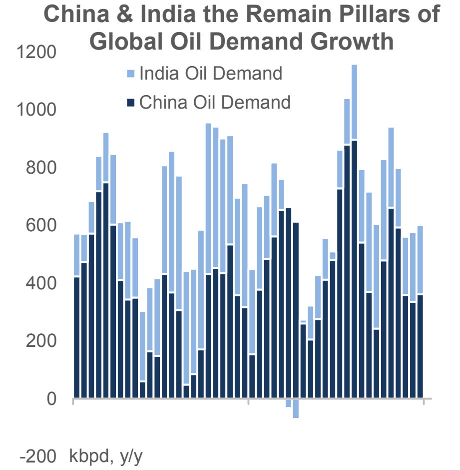
average $80/bbl in 2019 before gradually falling back to $75/bbl in 2020. WTI differentials are expected to remain wide given chronic infrastructure bottlenecks, averaging $72/bbl in 2019 and $69/bbl in 2020. On top of WTI's challenges, Canadian heavy crude is forecast to trade at a wider discount through 2020, with WCS contracts expected to average $24/bbl under WTI in 2019 as oil-by-rail services ramp up before narrowing to $21/bbl in 2020 as Line 3 enters service.

**Despite trade uncertainty the global economic backdrop remains robust and supportive of continued gains in oil demand**. Going into 2019, we expect global demand to advance by 1.6 MMbpd before slowing slightly in 2020 on the back of high prices. Emerging Asia remains the engine of global oil demand growth (chart 6), expected to advance 850 kbpd in 2019 with China accounting for just more than half that sum. While metals are going to miss out on Beijing's stimulus, services-targeted spending is likely to further support already strong Chinese demand growth. Indian demand is also picking up, averaging nearly 300 kbpd year-to-date following growth of only 100 kbpd in 2017 due to headwinds related to the late-2016 demonetization policy. High prices are expected to weigh on demand growth through the latter part of 2019 into 2020, and slower demand stemming from higher-than-anticipated oil prices could contribute to a smaller supply deficit in the latter half of 2019.

**Growth in the US shale patch will continue to march ahead in 2019, though at a noticeably slower pace than producers enjoyed in 2018**. From a breakneck pace of more then 1.7 MMbpd in 2018 (chart 7), shale's contribution to global balances looks to slow to nearer 1.0–1.2 MMbpd in 2019. Infrastructure bottlenecks present the first drag on shale growth as 2018's production gains overwhelmed the capacity of midstream assets—particularly around West Texas' Permian Basin and en route to export facilities on the US Gulf Coast—and enflamed discounts, which rose to nearly $20/bbl under WTI for many Permian producers and to more than $10/bbl under global Brent for WTI at Cushing, the primary US crude benchmark. These differentials are preventing US producers from receiving the full investment impulse that $85/bbl Brent would normally provide, though infrastructure buildouts are expected to mitigate this challenge through the end of 2019 and into 2020. The other, more structural challenge facing shale producers is the gradual shift into less prolific acreage. Many firms "high-graded" their drilling, focusing on the sweet spots in each play as a means of staying afloat amidst the post-2014 downturn in oil prices. These producers are now venturing further afield, which means that average well productivity is likely to decline slightly and leave much of the work of increasing production levels to higher drilling rates.

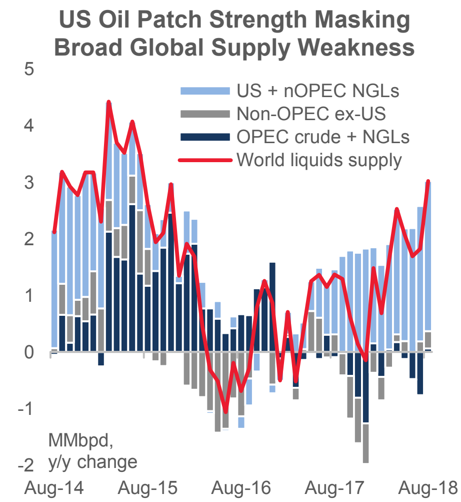
**A slower US shale patch shifts the marginal spotlight to OPEC where losses in Venezuela and Iran will put a lot of pressure on producers like Saudi Arabia to make up the difference**. Venezuelan production is down 642 kbpd y/y as years of mismanagement and underinvestment take their toll (chart 8). In Iran, US nuclear sanctions are having a much larger impact than initially forecast and an anticipated loss of 300–400 kbpd is now expected to exceed 1 MMbpd by the end of the year. Former purchasers of Iranian crude are taking no chances when it comes to US sanctions for fear of being locked out of the US financial system. This ground-level corporate aversion to Iranian oil is dramatically increasing the effectiveness of the US sanctions regime, negating the broad global government-level opposition which we originally believed would blunt their impact. The task of making up most of this shortfall will fall to Saudi Arabia, which isn't likely to receive much production assistance from the rest of OPEC, where six of fifteen members are experiencing chronic production declines.

Chart 6



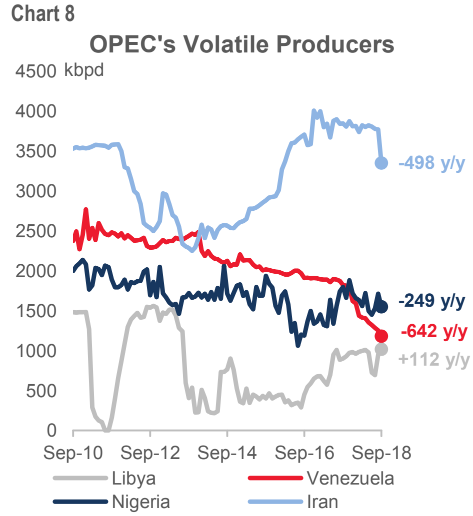
Sources: Scotiabank Economics, MPNG, NBS, OMI.

Chart 7



Sources: Scotiabank Economics, OMI.

Chart 8



Sources: Scotiabank Economics, OMI.

**Saudi Arabia typically holds back 1.5–2.0 MMbpd or more of its supply as a emergency cushion for potential shortfalls elsewhere in the world.** To keep up with demands on its production next year, we expect that Saudi Arabia will need to push its fields to more than 11 MMbpd for the first time in the country's history—a feat that many in the market are betting Riyadh can't pull off. We expect they'll succeed and maintain a reasonably well-supplied market in 2019, but it'll be a delicate balance and the oil industry isn't typically a delicate one. Two key areas to watch are Libya and Nigeria, where production statistics have been calm relative to recent militancy-fueled export volatility. A pipeline attack in Nigeria or a port seizure in Libya would quickly take 200–400 kbpd off the market and provide the propellant for a march into the $90s. Conversely, prior forecasts for slowing US shale growth have been consistently confounded and global crude prices comfortably in the $80s could derail recently strong demand growth, allowing us to drift back into the low $70s.

**Closer to home, the discount borne by Canadian heavy oil blew out to crisis levels once again in September, reaching an all-time high of more than $40/bbl under WTI as the ramp-up of necessary oil-by-rail capacity clearly fell below demand for non-pipeline egress out of Western Canada.** And while pipeline bottlenecks are most visible in Western Canadian Select heavy oil discounts, Canadian light crude benchmarks like Mixed Sweet and Synthetic Crude are also seeing differentials to US crudes rise, reflecting increasingly tight takeaway capacity across all crude grades. Canadian oil-by-rail shipments—which reached an all-time high of 204 kbpd in June—have further to climb and current commitments from major carriers like CP and CN Rail put nearer 300 kbpd of Canadian crude on the rails by year-end. Current challenges sourcing sufficient volumes of rail crews, locomotives, and tank cars to satiate the rapidly rising demand for non-pipeline egress out of Western Canada are expected to abate, facilitating a gradual easing of WCS discounts back toward the $18–22/bbl level required by oil-by-rail costs (chart 9). Given the multitude of challenges currently faced by Canadian energy infrastructure projects, many in the industry increasingly see oil-by-rail less as a temporary Band-Aid and more as a permanent, flexible component of the supply chain to a Canadian energy sector seemingly unable to push a major pipeline project to the finish line.

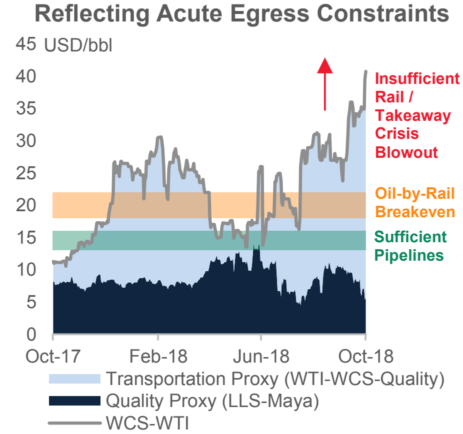
**The early-October confirmation of a positive final investment decision from the consortium behind the LNG Canada export facility on the BC coast is a major boost for Canada energy investment sentiment** following years of project delays hampering the prospects of other large energy projects. This success follows the high-profile abandonment of the similarly massive Pacific NorthWest LNG facility last year as well as the cancellation of much-needed pipelines like Northern Gateway and Energy East. The project is expected to enter service in 2024 and cost C$30–40B—depending on if and when the third and fourth of the initially proposed LNG trains are approved. But beyond the immediate impact to the BC economy, the most important factor in our view is the project's size—tens of billions of dollars with a multi-decade operating horizon, in many ways the first such investment since before oil prices collapsed in 2014. The post-2014 trend toward shorter-cycle investments like US shale helped firms manage uncertainty through the oil rout, but higher prices are helping those same firms extend their sights over a longer investment horizon. The LNG Canada facility will connect low-cost Montney Formation gas in north-eastern BC and north-western Alberta to rapidly growing demand and higher prices in Asian markets.

**Table 1**

| Commodities | 2000–2017 | | | Annual Average | | | |
|---|---|---|---|---|---|---|---|
| | Low | Avg. | High | 2017 | 2018f | 2019f | 2020f |
| WTI Oil (USD/bbl) | 17 | 62 | 145 | 51 | 68 | 72 | 69 |
| Brent Oil (USD/bbl) | 18 | 65 | 146 | 55 | 74 | 80 | 75 |
| WCS - WTI Discount* (USD/bbl) | -43 | -16 | -6 | -13 | -27 | -24 | -21 |
| Nymex Natural Gas (USD/mmbtu) | 1.64 | 4.83 | 15.38 | 3.02 | 2.93 | 2.93 | 3.00 |
| Copper (USD/lb) | 0.60 | 2.38 | 4.60 | 2.80 | 2.99 | 3.00 | 3.20 |
| Zinc (USD/lb) | 0.33 | 0.84 | 2.10 | 1.31 | 1.33 | 1.30 | 1.25 |
| Nickel (USD/lb) | 2.00 | 7.12 | 24.58 | 4.72 | 6.15 | 6.50 | 7.00 |
| Aluminium (USD/lb) | 0.56 | 0.87 | 1.49 | 0.89 | 0.95 | 1.00 | 1.00 |
| Iron Ore (USD/tonne) | 17 | 67 | 187 | 72 | 65 | 65 | 60 |
| Metallurgical Coal (USD/tonne) | 39 | 131 | 330 | 187 | 205 | 175 | 160 |
| Gold, London PM Fix (USD/oz) | 256 | 890 | 1,895 | 1,257 | 1,262 | 1,300 | 1,300 |
| Silver, London PM Fix (USD/oz) | 4.07 | 14.80 | 48.70 | 17.05 | 15.70 | 17.00 | 17.00 |

* 2008–16 average.
Sources: Scotiabank Economics, Bloomberg.

Chart 9
**Western Canadian Heavy Oil Discount Blows Out Again to Levels Reflecting Acute Egress Constraints**



Sources: Scotiabank Economics, Bloomberg.

## METALS: A REVERSAL OF FORTUNES AS BASE METALS WANE, BULKS OUTPERFORM

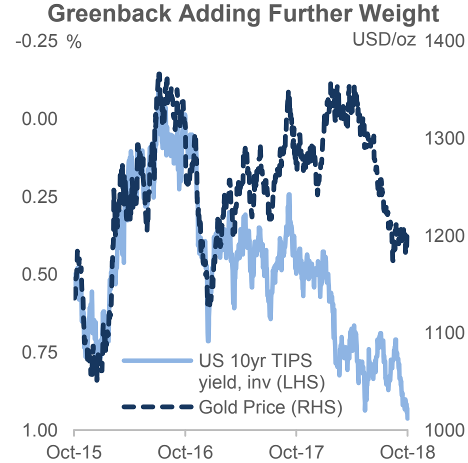
**The metals complex has experienced a stark reversal from where we stood last quarter, with base metals in retreat, precious metal prices easing, and previously-battered bulks outperforming**. Much of this shift can be explained by policy choices made in Beijing and Washington: the US-China trade dispute has dented the outlook for base metals demand, a stronger US dollar removed a key support and allowed higher interest rates to depress gold prices, and Chinese capacity rationalization policies have bolstered demand for high-quality steel ingredients.

**The base metals complex has gotten caught up in the macro headwinds of the US-China trade dispute and most metals have temporarily ceased trading on commodity-specific fundamentals**, with the LME index down 15% from where the complex stood before tariffs were announced in early-June. This rout occurred despite signals of tighter markets as inventories continue to draw— copper inventories are down 50% in the past six months, nickel inventories have fallen to five-year lows, and aluminium, zinc, and lead stocks have fallen to their lowest level in a decade. Copper demonstrated an indicative fundamental ambivalence to major supply news—the resolution of high-profile labour negotiations at a number large Latin American mines—by barely moving to what would typically be worth a few percentage points on the contract, but later that week reacted noticeably to a cooling of US-China trade rhetoric. Copper prices have stabilized around $2.80/lb, down 15% from before the US-China trade dispute heated up in early-June but up slightly from the depths to which speculators pushed the red metal in September. As stated earlier in the report, physical copper premia in China are at three-year highs despite the fallback in global LME prices as Chinese purchasers capitalize on lower prices, despite the fact that those prices are lower precisely because speculators were concerned about Chinese demand. This indicates that, at the very least, metals bearishness is running ahead of any realized demand loss. Unfortunately for base metals, negative macro sentiment can be a powerful drag on pricing and the expectation that US-China trade uncertainty will persist through 2020 is a large factor behind our near-term downgrade to the base metals price forecast. We now expect copper prices to average $3/lb in 2019 (down from $3.25/lb in our last outlook) and $3.25/lb in 2020 (from $3.40/lb).

**Bulk prices, meanwhile, have experienced a mild renaissance** following Chinese capacity rationalisation policies aimed at the bloated domestic steel industry. Beijing's policy actions have cut out a large piece of the domestic Chinese supply curve, inflated margins for remaining smelters, and pushed steel smelter capacity utilization higher across the board. Given the high value of steel products at present, Chinese smelters are running all-out and are prioritizing higher quality iron ore, which increases steel yield for a given volume of ore feedstock; premia for 65% fe ore vs 62% fe ore have risen to more than 50% while discounts for lower quality 58% fe ore sit around 25%. Premium hard coking coal shipments have also benefitted from Chinese buying and prices remain elevated at around $200/t. While steel throughput is currently supporting heady bulks prices, it is likely that environmental winter run cuts in China—set to begin in late-October—will be steeper than the market experienced last year, which will weigh on Chinese import demand for both iron ore and coking coal. Completing the bulks-base metal rotation, we expect that base metal prices will rebound through year-end as trade fears subside, Beijing provides further visibility on its policy response to US protectionism, and metal balances continue to tighten on insufficient mine supply.

**Gold prices have fallen to trade around $1,200/oz on the back of rising real yields, a stronger greenback, and an accumulation of bearish precious metals sentiment.** Gold prices finally gave way to the weight of stronger real yields (chart 10) in the US following the third interest rate hike out of the US Federal Reserve this year. Rising interest rates will continue to present the harshest headwinds for bullion through 2020, with US interest rates expected to rise by one more full percentage point by 3Q19. The US dollar provided an additional headwind, strengthening through the year when it was broadly expected to fall back and provide support to bullion. We believe that stronger US growth and tighter monetary policy are now mostly priced into current dollar strength, and speculative dollar positioning is relatively stretched to the upside. Going forward, USD risk appears broadly biased to the downside in both the short-term as sentiment normalizes and the long-term on widening US fiscal and current account deficits. We believe that a rapid covering of large speculative short positions will magnify any bounce from the dollar's reversal, bringing us back toward our $1,300 forecast for next year.

**Chart 10 Yields Drag on Gold, Stronger Greenback Adding Further Weight**




Sources: Scotiabank Economics, Bloomberg.

## Foreign Exchange

With three quarters of the calendar year in the books now, the US dollar (USD) is maintaining a moderate gain (up around 3% since January 1) against the major currencies whilst accumulating some outsized gains against currencies in the developing market space. So far this year, the USD has swung between modest losses in aggregate against the majors (falling around 4% in terms of the DXY index through Q1) and a net gain of around 5% from the start of the year through August. USD-bearish consensus trades at the start of the year delivered positive results for currency investors but subsequent developments have proven more difficult to trade around. Managed currency investment fund returns so far in 2018 are negative (down around 4% YTD) after down years in both 2016 and 2017. The trend of choppy and somewhat indecisive trading has reduced market conviction around the direction of the USD in the near term at least, raising the risk of more choppy range trading running through Q4.

We confess to siding with the USD-bearish view of the currency outlook in January and we still rather think that medium- and longer-run odds are stacking up negatively for the USD. Even in the short run, we believe that relatively strong growth and tighter Fed policy are largely factored in to the exchange rate. Market positioning is also biased strongly towards long USDs by a number of metrics. This does not mean the USD will weaken, but it does mean that it will be hard for the USD to advance without additional supportive news or developments. From this perspective, downside risks may start to tilt against the USD after the mid-term elections in the US which could alter the political dynamics and priorities in Washington.

From a longer-run perspective, we think that the accumulation of fiscal (especially) and current account deficits—traditionally, the Achilles' heel of the USD—will weigh on the USD's valuation in the coming years as investors will require either higher yields or a lower exchange rate (or a combination of both) in order to purchase US Treasury securities. Meanwhile, we continue to believe that 2017 was the high point in the USD's secular bull cycle which started in 2008/2009, given the propensity for the USD to move in (roughly) eight-year, alternating cycles of strength and weakness since the 1970s.

The Canadian dollar (CAD) is currently trading close to where we expect it to end the year against the USD (we currently forecast a year-end rate of CAD1.28, or 78 cents US). The CAD has been supported by firm domestic growth trends and prospects for further modest Bank of Canada (BoC) tightening at the late October policy meeting amid somewhat sticky inflation.

A new trade agreement with the US and Mexico added some upward momentum in the CAD, given that the tone of trade negotiations prior to the deal had suggested little common ground on key issues. The deal removes a large uncertainty hanging over the CAD but the new agreement looks an awful lot like the old one and we see limited economic impact from USMCA replacing NAFTA—beyond a minor relief rally, we do not expect the agreement to drive significant additional gains for the CAD. The best we can say for the CAD is that the worst case trade outcome has been avoided. Steel and aluminum tariffs remain in place

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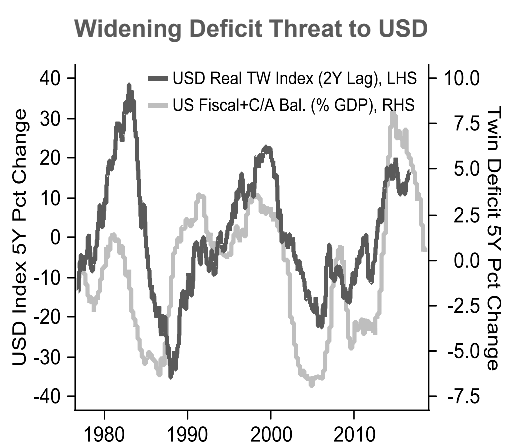
Chart 1




Sources: Macrobond, Scotiabank FICC Strategy.

at writing and the CAD may garner some modest, additional gains if these are lifted but we rather view that CAD rebound as looking somewhat stretched at this point.

Commodity prices remain firm but Canada-relevant commodities have eased somewhat in recent months. Lumber prices surged in the first half of the year but have now slumped 50% from the May peak while Canadian heavy crude continues to trade at a significant discount to the WTI benchmark. This situation leaves the CAD struggling to benefit from higher energy prices generally and undermines somewhat the support the CAD can derive from the improvement in terms of trade since the low point of the commodity cycle.

Against a backdrop of a generally softer USD and still firm—if somewhat slower—global growth trends into 2019, we think the CAD, alongside the Australian and New Zealand dollars (AUD and NZD), can appreciate modestly into 2019. Near-term risks for both the AUD and NZD revolve around trade; whereas the CAD is now significantly less susceptible to trade uncertainty, we think fragile US-China relations leave both the AUD and NZD prone to softness until prospects improve.

Pacific Alliance currencies have been buffeted by a difficult international trade environment, a generally stronger USD and tighter US monetary conditions which have contributed to heightened volatility in the more structurally vulnerable currencies in the region. The Argentine peso has declined by 50% over the year so far while the Brazilian real has fallen 16% against the USD. Against that backdrop, the Mexican peso performance (MXN, up nearly 5% on the year) looks positive. We expect modest losses for the MXN into year-end as markets focus on the presidential transition and the potential for economic activity to slow somewhat as the new government sorts out its fiscal priorities. The Colombian peso (COP) is currently outperforming relative to year-end expectations (and is more or less flat on the year) thanks to firm oil and domestic growth trends. The Chilean peso (CLP) weakened through mid-year, in line with the drop in copper prices. We look for the CLP to steady and improve somewhat in Q4, providing the international backdrop remains calm. The Peruvian sol (PEN) weakened modestly from mid-year despite supportive domestic fundamentals. USDPEN gains through the sensitive 3.30 level suggest risks may be tilting towards more PEN weakness.

In Europe, the euro (EUR) remains relatively stable despite widely negative interest rate differentials versus the USD. The European Central Bank (ECB) will wrap up its asset purchase programme at year-end amid rising confidence that the underlying strength in the economy will deliver higher inflation over time. We do not expect any shift in the ECB's key policy rate until H2 of next year, however. Eurozone-US short-term rate spreads reached a record of -336bps (for 2-year cash bond spreads) in early October—a significant yield premium for the USD which, ordinarily, we would expect to have led to a significantly weaker EUR and stronger USD. The fact that the single currency is resilient in the face of wide, negative spreads reflects renewed portfolio and foreign direct investment net inflows into the Eurozone this year, we think. It might also reflect the market's underlying concerns about the structural challenges facing the USD. We see potential for modest gains in the EUR initially next year and more significant appreciation in the second half of the year on the assumption that the ECB will start to reverse out of negative policy rates at that point.

The British government's attempts to formulate a plan that will allow it to smoothly decouple from the European Union (EU) by March 2019 remain a risk for the pound (GBP), meanwhile. Thus far, negotiations have not made progress towards an agreement that will be acceptable for the EU or workable for the varying political interests in the UK. The risk of a "cliff edge Brexit"—one that would see the UK out of the EU but with no arrangements made for trade and border issues—remains uncomfortably high from our point of view. Our base case view is that an agreement will be reached but that still implies relatively subdued growth and an exchange rate that will rise modestly against the USD but fall against the EUR next year. Time is running very short, however, and uncertainty alone risks driving the GBP sharply lower into 2019 absent a clearer Brexit path.

We anticipate slower growth in Japan next year, alongside subdued inflation. We expect the Bank of Japan (BoJ) to retain a substantial degree of policy accommodation, even if settings are tweaked and asset purchases reduced. The yen (JPY) will remain relatively soft as a consequence. The Chinese yuan (CNY & CNH) will remain vulnerable to depreciation amid an escalation in the US-China trade war but we expect the authorities will curb one-way speculation on the yuan if necessary, with the 7.00 level remaining China's bottom line for the yuan this year. The South Korean won (KRW), Taiwanese dollar (TWD) and Thai baht (THB) are more susceptible to external demand shocks than other regional currencies but we remain bearish on the Indian rupee (INR), Indonesian rupiah (IDR) and Philippine peso (PHP) as all the three economies are facing twin deficit problems. Firm crude oil prices will weigh on the struggling INR while bolstering the Malaysian ringgit (MYR) somewhat. Bank Indonesia (BI) will retain its hawkish stance as the Indonesian government and central bank are prioritizing economic stability over economic growth. Monetary Authority of Singapore (MAS) is likely to maintain its existing S$NEER policy band for now as the US-China trade dispute could shape up as a notable drag on global growth next year.

## APPENDIX 1

| International | 2000–17 | 2017 | 2018f | 2019f | 2020f | 2000–17 | 2017 | 2018f | 2019f | 2020f |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | **Real GDP** (annual % change) | | | | | **Consumer Prices** (y/y % change, year-end) | | |
| World (based on purchasing power parity) | 3.9 | 3.8 | 3.8 | 3.7 | 3.5 | | | | | |
| Canada | 2.2 | 3.0 | 2.1 | 2.2 | 1.8 | 1.9 | 1.8 | 2.9 | 2.1 | 2.0 |
| United States | 2.0 | 2.2 | 2.9 | 2.4 | 1.7 | 2.2 | 2.1 | 2.4 | 2.2 | 2.1 |
| Mexico | 2.2 | 2.0 | 1.8 | 2.1 | 2.4 | 4.4 | 6.8 | 5.1 | 4.1 | 3.8 |
| United Kingdom | 1.9 | 1.7 | 1.4 | 1.5 | 1.5 | 2.0 | 2.7 | 2.3 | 2.1 | 2.0 |
| Eurozone | 1.3 | 2.4 | 2.0 | 1.9 | 1.7 | 1.8 | 1.4 | 1.9 | 1.7 | 1.9 |
| Germany | 1.4 | 2.2 | 1.9 | 1.9 | 1.6 | 1.5 | 1.7 | 1.8 | 1.9 | 2.2 |
| France | 1.4 | 2.2 | 1.6 | 1.6 | 1.6 | 1.4 | 1.2 | 1.6 | 2.2 | 1.5 |
| China | 9.3 | 6.9 | 6.6 | 6.2 | 6.0 | 2.3 | 1.8 | 2.4 | 2.5 | 2.3 |
| India | 7.0 | 6.3 | 7.6 | 7.5 | 7.5 | 6.8 | 5.2 | 4.0 | 5.2 | 4.8 |
| Japan | 1.0 | 1.7 | 1.2 | 1.0 | 0.9 | 0.1 | 1.0 | 1.0 | 2.3 | 1.1 |
| South Korea | 4.1 | 3.1 | 2.9 | 2.8 | 2.6 | 2.6 | 1.5 | 2.2 | 2.5 | 2.2 |
| Australia | 2.9 | 2.2 | 3.1 | 2.7 | 2.5 | 2.7 | 1.9 | 2.0 | 2.5 | 2.6 |
| Thailand | 4.0 | 3.9 | 4.3 | 3.8 | 3.5 | 1.9 | 0.8 | 1.2 | 2.0 | 2.2 |
| Brazil | 2.5 | 1.0 | 1.3 | 1.8 | 2.1 | 6.5 | 3.0 | 4.7 | 5.1 | 4.6 |
| Colombia | 3.9 | 1.8 | 2.5 | 3.5 | 3.6 | 5.1 | 4.1 | 3.4 | 3.6 | 3.6 |
| Peru | 5.0 | 2.5 | 3.7 | 4.0 | 4.1 | 2.7 | 1.4 | 2.0 | 2.5 | 2.5 |
| Chile | 3.9 | 1.5 | 3.9 | 3.2 | 3.2 | 3.3 | 2.3 | 3.2 | 3.0 | 3.0 |
| **Commodities** | | | | | | | | | | |
| | | | (annual average) | | | | | | | |
| WTI Oil (USD/bbl) | 62 | 51 | 68 | 72 | 69 | | | | | |
| Brent Oil (USD/bbl) | 65 | 55 | 74 | 80 | 75 | | | | | |
| WCS - WTI Discount* (USD/bbl) | -16 | -13 | -27 | -24 | -21 | | | | | |
| Nymex Natural Gas (USD/mmbtu) | 4.83 | 3.02 | 2.93 | 2.93 | 3.00 | | | | | |
| Copper (USD/lb) | 2.38 | 2.80 | 2.99 | 3.00 | 3.20 | | | | | |
| Zinc (USD/lb) | 0.84 | 1.31 | 1.33 | 1.30 | 1.25 | | | | | |
| Nickel (USD/lb) | 7.12 | 4.72 | 6.15 | 6.50 | 7.00 | | | | | |
| Aluminium (USD/lb) | 0.87 | 0.89 | 0.95 | 1.00 | 1.00 | | | | | |
| Iron Ore (USD/tonne) | 67 | 72 | 65 | 65 | 60 | | | | | |
| Metallurgical Coal (USD/tonne) | 131 | 187 | 205 | 175 | 160 | | | | | |
| Gold, London PM Fix (USD/oz) | 890 | 1,257 | 1,262 | 1,300 | 1,300 | | | | | |
| Silver, London PM Fix (USD/oz) | 14.80 | 17.05 | 15.70 | 17.00 | 17.00 | | | | | |

* 2008-16 average.
Sources: Scotiabank Economics, Statistics Canada, BEA, BLS, IMF, Bloomberg.

## APPENDIX 2

| North America | 2000–17 | 2017 | 2018f | 2019f | 2020f | 2000–17 | 2017 | 2018f | 2019f | 2020f |
|---|---|---|---|---|---|---|---|---|---|---|
| | Canada (annual % change, unless noted) | | | | | United States (annual % change, unless noted) | | | | |
| Real GDP | 2.2 | 3.0 | 2.1 | 2.2 | 1.8 | 2.0 | 2.2 | 2.9 | 2.4 | 1.7 |
| Consumer spending | 2.9 | 3.4 | 2.2 | 2.1 | 1.7 | 2.4 | 2.5 | 2.6 | 2.4 | 1.8 |
| Residential investment | 3.7 | 2.8 | -0.2 | 0.6 | 0.9 | -0.3 | 3.3 | 0.5 | 1.3 | 1.9 |
| Business investment | 2.2 | 2.7 | 6.4 | 2.7 | 6.2 | 3.0 | 5.3 | 6.9 | 3.1 | 2.3 |
| Government | 2.2 | 2.6 | 2.6 | 1.4 | 1.6 | 1.0 | -0.1 | 1.8 | 2.3 | 1.6 |
| Exports | 1.3 | 1.1 | 3.1 | 3.6 | 2.2 | 3.7 | 3.0 | 4.6 | 2.3 | 2.0 |
| Imports | 2.9 | 3.6 | 4.4 | 2.5 | 3.1 | 3.7 | 4.6 | 4.0 | 3.0 | 2.7 |
| Nominal GDP | 4.3 | 5.4 | 4.3 | 4.6 | 4.1 | 4.0 | 4.2 | 5.4 | 5.0 | 4.1 |
| GDP deflator | 2.1 | 2.3 | 2.2 | 2.4 | 2.2 | 1.9 | 1.9 | 2.5 | 2.6 | 2.3 |
| Consumer price index (CPI) | 1.9 | 1.6 | 2.6 | 2.4 | 2.0 | 2.2 | 2.1 | 2.5 | 2.2 | 2.1 |
| CPI ex. food & energy | 1.6 | 1.6 | 1.9 | 2.2 | 2.3 | 2.0 | 1.8 | 2.2 | 2.2 | 2.2 |
| Pre-tax corporate profits | 4.4 | 19.9 | 4.4 | 4.7 | 2.1 | 5.3 | 3.2 | 6.6 | 2.8 | 1.9 |
| Employment | 1.4 | 1.9 | 1.2 | 1.0 | 0.8 | 0.7 | 1.6 | 1.6 | 1.2 | 1.0 |
| Unemployment rate (%) | 7.1 | 6.3 | 5.9 | 5.8 | 5.8 | 6.1 | 4.4 | 3.9 | 3.8 | 3.8 |
| Current account balance (CAD, USD bn) | -19.7 | -63.3 | -62.6 | -51.5 | -54.2 | -501 | -449 | -445 | -487 | -540 |
| Merchandise trade balance (CAD, USD bn) | 22.3 | -24.0 | -22.6 | -12.9 | -19.1 | -680 | -807 | -848 | -904 | -974 |
| Federal budget balance* (FY, CAD, USD bn) | -3.6 | -17.8 | -20.0 | -18.0 | -17.0 | -540 | -665 | -805 | -1,000 | -1,045 |
| percent of GDP | -0.2 | -0.9 | -0.9 | -0.8 | -0.7 | -3.7 | -3.4 | -3.9 | -4.6 | -4.7 |
| Housing starts (000s, mn) | 200 | 220 | 213 | 202 | 201 | 1.26 | 1.20 | 1.27 | 1.26 | 1.26 |
| Motor vehicle sales (000s, mn) | 1,679 | 2,041 | 2,000 | 1,950 | 1,900 | 15.6 | 17.0 | 17.0 | 16.8 | 16.7 |
| Industrial production | 0.8 | 5.3 | 3.3 | 2.3 | 2.0 | 0.7 | 1.6 | 3.5 | 2.5 | 2.1 |
| | Mexico (annual % change) | | | | | | | | | |
| Real GDP | 2.2 | 2.0 | 1.8 | 2.1 | 2.4 | | | | | |
| Consumer price index (year-end) | 4.4 | 6.8 | 5.1 | 4.1 | 3.8 | | | | | |
| Current account balance (USD bn) | -14.9 | -19.5 | -27.4 | -24.5 | -20.2 | | | | | |
| Merchandise trade balance (USD bn) | -7.2 | -11.0 | -17.1 | -16.5 | -18.9 | | | | | |

Sources: Scotiabank Economics, Statistics Canada, CMHC, BEA, BLS, Bloomberg. * Canada federal deficit ex risk adjustment of $3.0bn for FY19.

| Quarterly Forecasts | 2017 | 2018 | | | | 2019 | | | | 2020 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Canada | Q4 | Q1 | Q2 | Q3f | Q4f | Q1f | Q2f | Q3f | Q4f | Q1f | Q2f | Q3f | Q4f |
| Real GDP (q/q ann. % change) | 1.7 | 1.4 | 2.9 | 2.1 | 2.4 | 2.1 | 2.1 | 1.9 | 1.7 | 2.1 | 2.0 | 1.5 | 1.5 |
| Real GDP (y/y % change) | 3.0 | 2.3 | 1.9 | 2.0 | 2.2 | 2.4 | 2.2 | 2.1 | 1.9 | 1.9 | 1.9 | 1.8 | 1.8 |
| Consumer prices (y/y % change) | 1.8 | 2.1 | 2.3 | 2.9 | 2.9 | 2.8 | 2.6 | 2.3 | 2.1 | 2.1 | 2.0 | 2.0 | 2.0 |
| Avg. of new core CPIs (y/y % change) | 1.7 | 1.9 | 2.0 | 2.1 | 2.2 | 2.1 | 2.2 | 2.2 | 2.2 | 2.2 | 2.2 | 2.2 | 2.2 |
| **United States** | | | | | | | | | | | | | |
| Real GDP (q/q ann. % change) | 2.3 | 2.2 | 4.2 | 3.2 | 2.5 | 2.1 | 2.0 | 1.9 | 1.8 | 1.7 | 1.7 | 1.6 | 1.5 |
| Real GDP (y/y % change) | 2.5 | 2.6 | 2.9 | 3.0 | 3.0 | 3.0 | 2.4 | 2.1 | 1.9 | 1.9 | 1.8 | 1.7 | 1.6 |
| Consumer prices (y/y % change) | 2.1 | 2.3 | 2.6 | 2.6 | 2.4 | 2.2 | 2.2 | 2.2 | 2.2 | 2.1 | 2.1 | 2.0 | 2.1 |
| CPI ex. food & energy (y/y % change) | 1.7 | 1.9 | 2.2 | 2.2 | 2.3 | 2.1 | 2.2 | 2.2 | 2.2 | 2.2 | 2.2 | 2.2 | 2.2 |
| Core PCE deflator (y/y % change) | 1.6 | 1.7 | 1.9 | 2.1 | 2.1 | 2.2 | 2.2 | 2.2 | 2.1 | 2.1 | 2.0 | 2.0 | 2.0 |

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

## APPENDIX 3

| | 2018 | | 2019 | | | | 2020 | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Central Bank Rates** | Q3 | Q4f | Q1f | Q2f | Q3f | Q4f | Q1f | Q2f | Q3f | Q4f |
| **Americas** | | | (%, end of period) | | | | | | | |
| Bank of Canada | 1.50 | 1.75 | 2.00 | 2.25 | 2.50 | 2.75 | 3.00 | 3.00 | 3.00 | 3.00 |
| US Federal Reserve (upper bound) | 2.25 | 2.50 | 2.75 | 3.00 | 3.25 | 3.25 | 3.25 | 3.25 | 3.25 | 3.25 |
| Bank of Mexico | 7.75 | 8.00 | 8.00 | 8.00 | 8.00 | 8.00 | 8.00 | 7.50 | 7.50 | 7.50 |
| Central Bank of Brazil | 6.50 | 7.25 | 8.25 | 8.75 | 9.25 | 9.75 | 10.00 | 10.00 | 10.00 | 10.00 |
| Bank of the Republic of Colombia | 4.25 | 4.50 | 4.75 | 5.00 | 5.25 | 5.50 | 5.50 | 5.50 | 5.50 | 5.50 |
| Central Reserve Bank of Peru | 2.75 | 2.75 | 3.00 | 3.00 | 3.25 | 3.25 | 3.50 | 3.75 | 4.00 | 4.00 |
| Central Bank of Chile | 2.50 | 2.75 | 3.00 | 3.25 | 3.50 | 3.75 | 3.75 | 4.00 | 4.00 | 4.00 |
| **Europe** | | | | | | | | | | |
| European Central Bank | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.25 | 0.25 | 0.50 | 0.50 |
| Bank of England | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 |
| **Asia/Oceania** | | | | | | | | | | |
| Reserve Bank of Australia | 1.50 | 1.50 | 1.50 | 1.75 | 1.75 | 2.00 | 2.00 | 2.25 | 2.25 | 2.50 |
| Bank of Japan | -0.10 | -0.10 | -0.10 | -0.10 | -0.10 | -0.10 | -0.10 | -0.10 | -0.10 | -0.10 |
| People's Bank of China | 4.35 | 4.35 | 4.35 | 4.35 | 4.35 | 4.35 | 4.35 | 4.35 | 4.35 | 4.35 |
| Reserve Bank of India | 6.50 | 6.75 | 6.75 | 7.00 | 7.00 | 7.25 | 7.25 | 7.25 | 7.25 | 7.25 |
| Bank of Korea | 1.50 | 1.75 | 1.75 | 2.00 | 2.00 | 2.25 | 2.25 | 2.50 | 2.50 | 2.50 |
| Bank of Thailand | 1.50 | 1.75 | 1.75 | 2.00 | 2.00 | 2.25 | 2.25 | 2.25 | 2.25 | 2.25 |
| **Currencies and Interest Rates** | | | | | | | | | | |
| **Americas** | | | (end of period) | | | | | | | |
| Canadian dollar (USDCAD) | 1.29 | 1.28 | 1.25 | 1.25 | 1.22 | 1.22 | 1.22 | 1.22 | 1.22 | 1.22 |
| Canadian dollar (CADUSD) | 0.77 | 0.78 | 0.80 | 0.80 | 0.82 | 0.82 | 0.82 | 0.82 | 0.82 | 0.82 |
| Mexican peso (USDMXN) | 18.72 | 20.07 | 20.32 | 20.15 | 20.21 | 20.40 | 20.50 | 20.33 | 20.39 | 20.69 |
| Brazilian real (USDBRL) | 4.05 | 3.75 | 4.15 | 4.34 | 4.67 | 4.60 | 4.21 | 4.12 | 4.06 | 3.89 |
| Colombian peso (USDCOP) | 2,966 | 3,080 | 3,120 | 3,100 | 3,085 | 3,055 | 3,050 | 3,055 | 3,060 | 3,065 |
| Peruvian sol (USDPEN) | 3.30 | 3.26 | 3.27 | 3.23 | 3.24 | 3.22 | 3.20 | 3.20 | 3.20 | 3.20 |
| Chilean peso (USDCLP) | 657 | 650 | 650 | 650 | 650 | 650 | 650 | 640 | 640 | 640 |
| **Europe** | | | | | | | | | | |
| Euro (EURUSD) | 1.16 | 1.20 | 1.22 | 1.24 | 1.26 | 1.30 | 1.30 | 1.30 | 1.32 | 1.32 |
| UK pound (GBPUSD) | 1.30 | 1.32 | 1.32 | 1.35 | 1.37 | 1.40 | 1.42 | 1.42 | 1.45 | 1.45 |
| **Asia/Oceania** | | | | | | | | | | |
| Japanese yen (USDJPY) | 110 | 110 | 110 | 110 | 108 | 108 | 107 | 107 | 105 | 105 |
| Australian dollar (AUDUSD) | 0.73 | 0.73 | 0.75 | 0.77 | 0.77 | 0.78 | 0.78 | 0.78 | 0.78 | 0.78 |
| Chinese yuan (USDCNY) | 6.87 | 6.90 | 6.80 | 6.60 | 6.70 | 6.70 | 6.60 | 6.60 | 6.50 | 6.50 |
| Indian rupee (USDINR) | 72.5 | 72.5 | 72.0 | 70.0 | 71.0 | 71.0 | 70.0 | 70.0 | 69.0 | 69.0 |
| South Korean won (USDKRW) | 1,109 | 1,100 | 1,090 | 1,080 | 1,085 | 1,085 | 1,080 | 1,080 | 1,070 | 1,070 |
| Thai baht (USDTHB) | 32.3 | 32.2 | 32.0 | 31.6 | 31.8 | 31.8 | 31.6 | 31.6 | 31.4 | 31.4 |
| **Canada (Yields, %)** | | | | | | | | | | |
| 3-month T-bill | 1.58 | 1.80 | 2.05 | 2.30 | 2.55 | 2.80 | 3.00 | 3.00 | 3.00 | 3.00 |
| 2-year Canada | 2.21 | 2.50 | 2.40 | 2.55 | 2.70 | 2.85 | 3.05 | 3.05 | 3.05 | 3.05 |
| 5-year Canada | 2.34 | 2.55 | 2.50 | 2.60 | 2.75 | 2.90 | 3.10 | 3.10 | 3.10 | 3.10 |
| 10-year Canada | 2.43 | 2.60 | 2.60 | 2.70 | 2.85 | 3.00 | 3.15 | 3.15 | 3.15 | 3.15 |
| 30-year Canada | 2.42 | 2.65 | 2.65 | 2.75 | 2.90 | 3.10 | 3.30 | 3.35 | 3.35 | 3.35 |
| **United States (Yields, %)** | | | | | | | | | | |
| 3-month T-bill | 2.20 | 2.45 | 2.70 | 2.95 | 3.20 | 3.20 | 3.20 | 3.20 | 3.20 | 3.20 |
| 2-year Treasury | 2.82 | 3.00 | 3.00 | 3.10 | 3.30 | 3.30 | 3.30 | 3.30 | 3.30 | 3.30 |
| 5-year Treasury | 2.95 | 3.15 | 3.05 | 3.15 | 3.35 | 3.35 | 3.40 | 3.40 | 3.45 | 3.45 |
| 10-year Treasury | 3.06 | 3.25 | 3.15 | 3.20 | 3.40 | 3.40 | 3.50 | 3.50 | 3.55 | 3.55 |
| 30-year Treasury | 3.21 | 3.40 | 3.30 | 3.30 | 3.50 | 3.50 | 3.60 | 3.60 | 3.65 | 3.65 |

Sources: Scotiabank Economics, Bloomberg.

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**Foreign Exchange Strategy**

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