In the Hands of Politicians…

- **Global growth is slowing as the economy works through a soft patch. Early signs suggest the worst of the slowdown might be behind us.**
- **The expansion is in a delicate situation. Investors are nervous and maintaining confidence is key to continued growth. The global economy is particularly vulnerable to policy missteps, notably President Trump's continued threats to disrupt US trade flows.**

Global growth is slowing but risks of a prolonged deceleration appear to be overblown. A portion of the slowdown is the result of deliberate policy action, and thus engineered. In Canada, the United States and the United Kingdom, central bankers have been raising interest rates over the last few years to contain potential inflationary pressures. Those moves were designed to lower growth, albeit only modestly given the gradual pace of interest rate increases and the limited transmission of those interest rate increases up the yield curve.

Another portion of the slowdown results from policy missteps, and could have been avoided. The China-US trade war has unquestionably muddied the global outlook by raising uncertainty and causing a deceleration of growth in China and the US, with spillovers to other parts of world, perhaps most notably in Germany. Though the trade tensions between the US and China seem to be on the mend, as we have long expected, some of the damage caused will be long-lasting as can be seen in global trade flows (chart 1). In Europe and the UK, mismanagement of the Brexit process, which was going to be damaging to the UK even if properly managed, is depressing growth in the UK and increasing uncertainty on both sides of the Channel. Add to this the extended political turmoil in France related to the Gilets Jaunes' demands, and the situation in Europe is far more concerning than it was a few months ago. In China, the trade conflict with the US has been costly, but it has been an overlay on what had already been a slowing economy as Chinese policymakers continue to engineer a structural transition away from a reliance on foreign demand to domestic sources of growth. This degradation in the global outlook late last year led to significant swings in global equity markets, which only amplified concerns about global growth and, in conjunction with a more recent and temporary inversion of the yield curve in the US, has led many analysts to worry about a potential recession.

Much of this concern appears to be overblown, though there are reasons for caution. The Federal Reserve has clearly indicated that it will tighten policy much less than it earlier deemed necessary. We appear to be rapidly approaching a resolution of the China-US trade conflict. Partly as a result of that, and the Fed's softer approach to monetary policy, global equity markets have rebounded sharply since the lows seen last fall (chart 2). In China, recent policy measures put in place to boost growth in light of the deceleration of activity seem to be having a rapid impact on that economy, explaining in part why Chinese equities have roared back. In Europe, the ECB has effectively indicated that it stands ready to act if needed, though fiscal policy is becoming more stimulative in some countries, and indicators of service sector activity are improving. In Canada, oil prices have

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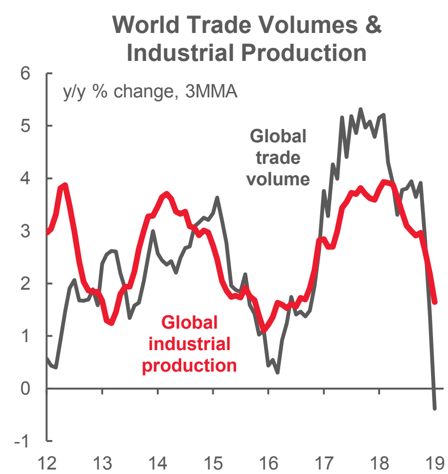
Chart 1



Sources: Scotiabank Economics, Netherlands Bureau for Economic Policy Analysis.

shot up to the highest levels seen in over a year, and to levels last seen in 2014 before that. Taken together, these positive developments suggest that the amount of gloom on the part of many analysts is excessive. It bears noting, for instance, that the consensus forecast for the US in 2019 is just slightly below 2.5%. Unless economists have it massively wrong, the risk of a recession appears dramatically overstated in the financial variables that suggest that risk exists.

While we continue to think the soft patch we are going through will be temporary for the reasons listed above, the global economy remains in a delicate position. For central bankers in Canada and the US, future policy actions will require convincing proof that the soft patch is temporary. That will take more time and data.

While the slowdown is being worked through, the global economy remains at risk of policy mistakes. Nowhere is this more the case than in the US, where President Trump is a one-man wrecking ball. His threat to shut the border with Mexico could severely affect the US economy. He appears to have backed off that for the time being given the damage this would cause, but the President has a remarkable tendency to change positions. He is unbound by commitments, as demonstrated by his threat to impose tariffs on Mexican-made autos and parts despite an agreement made by his administration explicitly excluding Mexico (and Canada) from future auto tariffs. With the US trade deficit in goods on track to reach $1 trillion by the end of President Trump's current mandate (due in large part to his actions), it is likely that his trade rhetoric will get more vocal and actions or threats of actions will become more damaging. At this point in the cycle, where confidence is key to sustaining the expansion, Trump's misguided efforts to make America great risk achieving the opposite.

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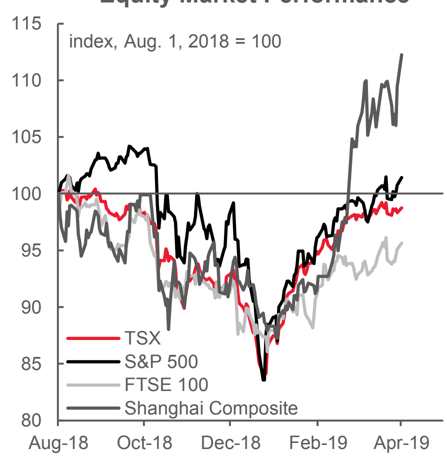
Table 1

Global Real GDP	2000–17	2017	2018	2019f	2020f
	(annual % change)				
World (PPP)	3.9	3.8	3.7	3.2	3.3
Canada	2.1	3.0	1.8	1.6	2.1
United States	2.0	2.2	2.9	2.4	1.9
Mexico	2.2	2.1	2.0	1.4	1.3
United Kingdom	1.9	1.8	1.4	1.1	1.2
Eurozone	1.4	2.4	1.8	1.1	1.5
Germany	1.4	2.2	1.4	0.9	1.4
France	1.4	2.2	1.5	1.3	1.4
China	9.3	6.8	6.6	6.2	6.0
India	7.1	6.7	7.3	7.0	7.3
Japan	0.9	1.9	0.8	0.8	0.7
South Korea	4.1	3.1	2.7	2.5	2.5
Australia	2.9	2.4	2.8	2.5	2.5
Thailand	4.1	4.0	4.1	3.8	3.5
Brazil	2.5	1.1	1.1	1.9	2.2
Colombia	3.9	1.8	2.6	3.4	3.8
Peru	5.0	2.5	4.0	4.0	4.0
Chile	3.9	1.5	4.0	3.2	3.2

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

Chart 2 **Equity Market Performance**



Sources: Scotiabank Economics, Bloomberg.

Canada

WORKING THROUGH THE SOFT PATCH

- **Above-potential growth to resume in Q2 as the factors contributing to the soft patch in 18Q4 and 19Q1 are reversing.**
- **The sharp improvement in equity markets, a very significant increase in oil prices, continued strength in employment, and rising unfilled orders point to growth momentum as early as 19Q2.**
- **We don't read too much into the yield curve. The risk of a recession remains very low.**

Perhaps the best way to characterize the divergence of views about the Canadian economy is to ask if the glass half full or half empty. Canada is clearly experiencing a soft patch. Growth in the final quarter of 2018 was unquestionably weak. Data so far in the first quarter suggest stronger, though still well-below-potential growth. How long will the soft patch last? Those that think the softness will continue point to signs of slowing growth in the US and Europe, declines in global trade volumes, an inversion of the yield curve, and declines in business and consumer confidence. While these factors are acting to hold back growth to some extent, fundamentals remain generally solid and our models continue to suggest that the probability of a recession in Canada is very low (chart 1). Moreover, a number of factors suggest activity will rebound as early as the second quarter and remain well above our estimate of potential growth (1.7%) through the remainder of the year and into 2020.

The root cause of our optimism lies in the reversal of the factors that led to a reduction in the growth forecast for Canada last fall. At that time, equity markets were correcting sharply on account of worries that the China-US trade war would amplify and that the Federal Reserve was on auto-pilot and would raise rates despite market-based fears that the economy might trip into recession. These concerns led to a global correction in equity markets (chart 2). Canada was not immune to this chill in equity markets. The associated reduction in financial wealth was compounded by weakness in the housing market, which led to declines in housing wealth. The decline in wealth acted as a brake on consumption, but also effectively increased the cost of equity capital for firms looking to invest, while increasing uncertainty about the outlook as a number of observers noted the decline in equity markets was a sure sign of recession to come.

Compounding these factors were acute egress challenges for western Canadian oil, as pipeline capacity remained woefully lacking, in an environment of weakening global oil prices. The net result was a precipitous fall in the price of Western Canadian Select (WCS) in absolute terms and also in relation to international oil benchmarks (chart 3). This too was a wealth shock for the Canadian economy. The Alberta government's response to limit oil production in the province as of January 1 led to a decline in the number of barrels produced in Alberta, even as the industry had started to curtail production of their own accord in the final months of 2018. This too, contributed to the gloominess felt by analysts.

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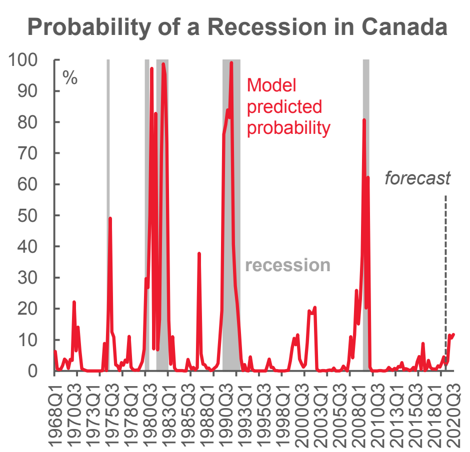
Canada	2017	2018	2019f	2020f
Real GDP (annual % change)	3.0	1.8	1.6	2.1
CPI (y/y %, eop)	1.8	2.0	1.5	2.0
Central bank policy rate (%, eop)	1.00	1.75	2.00	2.25
Canadian dollar (CADUSD, eop)	0.80	0.73	0.78	0.81

Source: Scotiabank Economics.

Chart 1



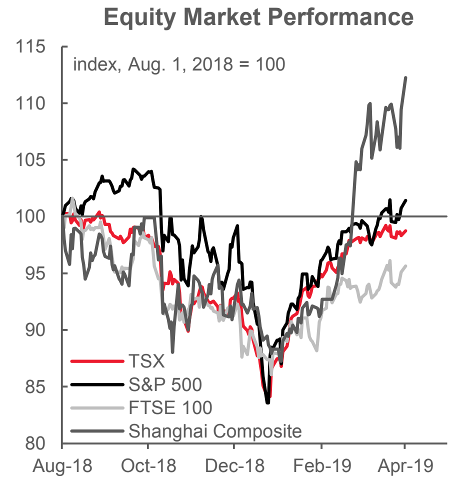
Sources: Scotiabank Economics, Haver Analytics.

The decline in equity and housing wealth along with the decline in oil prices and production led us to shave half a percentage point from our Canadian growth forecast in 2019.

What a difference a few months make

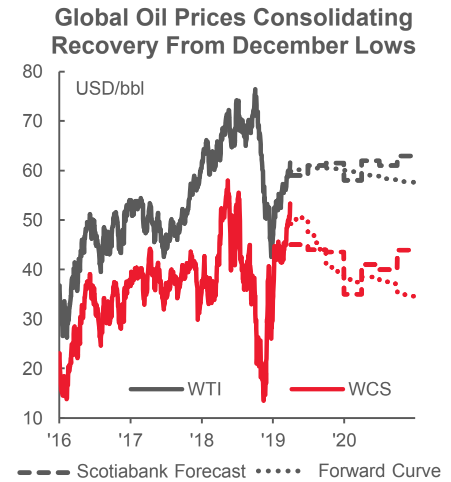
Since that major downgrade to Canadian growth, equity markets have roared back and are hovering near all-time highs, and WCS is $40 higher than the lows hit last November. Both developments are powerful drivers of activity and highlight the temporary nature of the soft patch Canada is experiencing, even though the oil curtailment will have a lasting impact on the number of barrels produced in Alberta. Our current forecast for WCS sees it averaging $44/bbl in 2019 (it is currently around $54/bbl), well above the average for 2018 and the highest level since 2014. According to our model, every 10 percent move in the price of oil adds about 0.1 percentage points to the level of Canadian GDP (chart 4), so the increase relative to last year will have a meaningful impact on growth as we progress through the year. Moreover, if our forecast is overly pessimistic, there is scope for an even greater oil-related bump this year and next in spite of the chronic lack of pipelines.

Chart 2



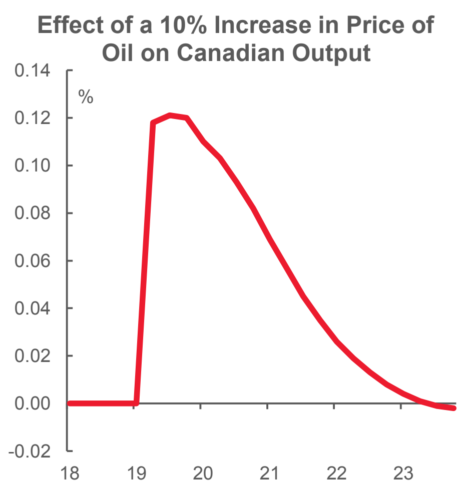
Sources: Scotiabank Economics, Bloomberg.

Chart 3



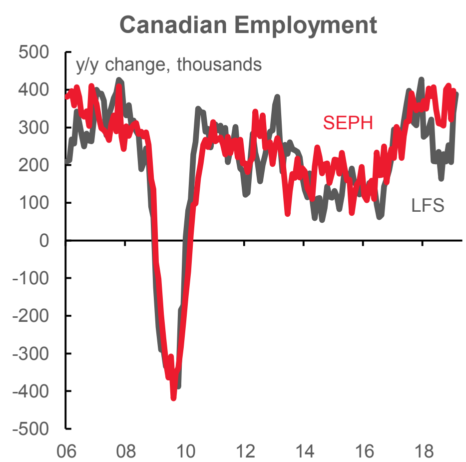
Sources: Scotiabank Economics, Bloomberg.

Chart 4



Source: Scotiabank Economics.

Chart 5



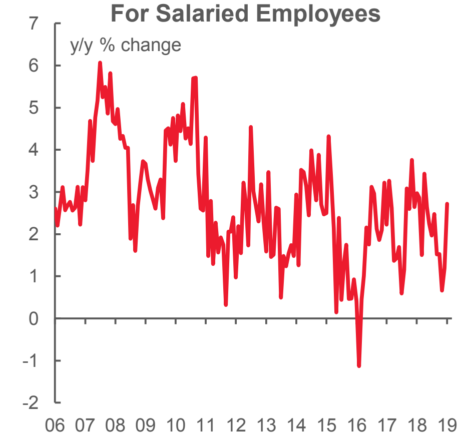
Sources: Scotiabank Economics, Statistics Canada.

Looking beyond financial markets, there are quite a few signs of resilience in hard economic data. The Canadian labour market is on fire, with nearly 50k full-time jobs created in February alone, and nearly 400k jobs created in the last 12 months (chart 5). The availability of labour remains a top concern of businesses, with nearly 40% of firms surveyed by the Bank of Canada reporting labour shortages that are impacting their ability to meet demand. Labour shortages appear to be finally translating into wage pressures, as wage growth has accelerated to its most rapid pace in a year (chart 6).

Taken together, the very strong jobs growth and increasingly rising wages suggest labour income growth is solid and should be supportive of consumption going forward. An early indication of this could be the pick-up in auto sales observed so far this year (chart 7). We expect to see consumption pick up later in 2019 and into 2020. The effect of tightened housing rules and the hangover from past rounds of fiscal stimulus delivered via the Canada Child Benefit should be maturing so that solid wage and income gains, and very strong recent job growth, should begin to drive our projection of an improving consumption outlook into 2020. Consumption spending should also find support from a recent turnaround in household credit growth, which appears to have found its bottom in mid-2018. Residential mortgage borrowing has led a trend pick-up in overall month-on-month credit expansion through February 2019. Household balance sheets remain solid, with high asset-liability ratios, strong equity positions in real-estate holdings, and stable consumer bankruptcies. Moreover, it continues to be the case that less than half of Canadian households have mortgages, which dampens the impact of possible further rate increases by the Bank of Canada. HELOC balances have significantly increased in recent months, outpacing growth in other forms of household credit, but the share of HELOC balances used to finance debt consolidation and repayments has fallen since 2016.

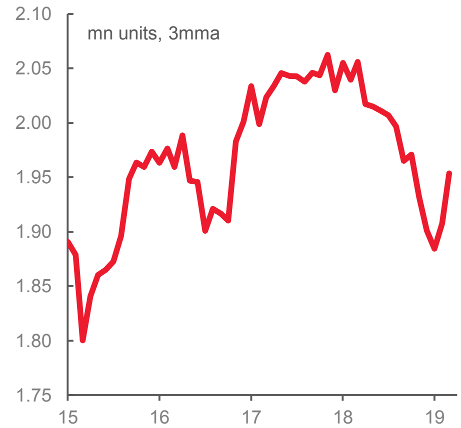
The strength of employment demand likely reflects in part still robust sales combined with serious capacity constraints (chart 8). According to the Bank of Canada once again, nearly 60% of firms they survey report they would have some or significant difficulty in meeting increases in demand. These capacity pressures should trigger greater capital spending by firms, but that has yet to happen as business investment fell in each of the last three quarters of 2018. The proximate cause of this decline in investment appears to be the ongoing egress challenges in the oil patch, along with concerns about the sustainability of the expansion given myriad developments over the last year. To date, firms have been able to tap labour markets to increase production, but with acute labour shortages and wages on the rise, firms are re-thinking the capital to labour mix. As a result, Statistics Canada reports that firms surveyed from September 2018 to January 2019—the period of peak uncertainty—are now planning to increase capital outlays at the most rapid pace since 2014 (chart 9). We are still maintaining a reasonable cautious view on business investment in Canada in 2019 (with growth of 0.5%), but expect that to accelerate significantly in 2020 as natural resource projects pick up.

Chart 6
Canada: Average Hourly Earnings For Salaried Employees



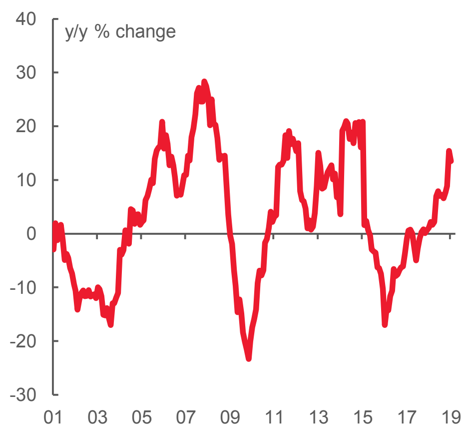
Sources: Scotiabank Economics, Statistics Canada.

Chart 7
Canadian Vehicle Sales



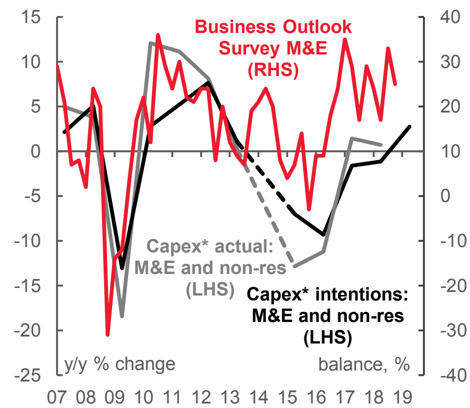
Sources: Company reports, Global Automakers of Canada.

Chart 8
Canadian Unfilled Orders



Sources: Scotiabank Economics, Statistics Canada.

Chart 9
Canada Capital Expenditures Intentions vs Actuals



Sources: Scotiabank Economics, Statistics Canada. *2007-13: Private and public investment in Canada survey; 2015-pres: Capital and repair expenditures survey. 2014 is interpolated data.

Table 1

Quarterly Canadian Forecasts	2018		2019				2020			
	Q3	Q4	Q1e	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic										
Real GDP (q/q ann. % change)	2.0	0.4	1.1	2.2	2.4	2.4	2.4	1.9	1.5	1.2
Real GDP (y/y % change)	1.9	1.6	1.5	1.5	1.5	2.0	2.3	2.3	2.0	1.7
Consumer prices (y/y % change)	2.7	2.0	1.4	1.4	1.4	1.5	1.8	2.0	2.1	2.0
Avg. of new core CPIs (y/y % change)	2.0	1.9	1.8	1.8	1.8	1.9	1.9	1.9	2.0	2.0
Financial										
Canadian Dollar (USDCAD)	1.29	1.36	1.33	1.32	1.30	1.28	1.25	1.25	1.23	1.23
Canadian Dollar (CADUSD)	0.77	0.73	0.75	0.76	0.77	0.78	0.80	0.80	0.81	0.81
Bank of Canada Overnight Rate (%)	1.50	1.75	1.75	1.75	1.75	2.00	2.00	2.25	2.25	2.25
3-month T-bill (%)	1.58	1.65	1.67	1.75	1.80	2.00	2.05	2.25	2.25	2.25
2-year Canada (%)	2.21	1.86	1.55	1.70	1.80	2.05	2.10	2.30	2.30	2.30
5-year Canada (%)	2.34	1.89	1.52	1.75	1.90	2.10	2.20	2.35	2.35	2.35
10-year Canada (%)	2.43	1.97	1.62	1.80	2.00	2.20	2.35	2.45	2.45	2.45
30-year Canada (%)	2.42	2.18	1.89	2.10	2.20	2.40	2.50	2.75	2.75	2.75

Sources: Scotiabank Economics, Statistics Canada, Bloomberg.

Work on LNG Canada's Kitimat project is expected to add meaningfully to growth as the year progresses, with a peak effect on growth in 2020, at which point we think construction related activity will add about 0.2 percentage points to national growth. Moreover, other firms are now considering adding to their current LNG plans, suggesting some degree of upside risk to activity throughout the forecast horizon.

While we believe signs point to a rebound as early as Q2, there are of course risks that this doesn't happen. Global growth is unquestionably slowing, and risks to the outlook are tilted to the downside. Despite survey evidence suggesting otherwise, firms could hold off on capital spending as they did for much of last year. Our outlook builds in a very modest increase of 0.5% in business investment in 2019 so we aren't counting on that as a driver of growth, but concerns about the outlook and the turbulent political climate in Canada could lead firms to scale back investment further despite their stated intentions. Canadian export performance remains disappointing, and global trade flows suggest little reason for optimism that this will turn around, even though Alberta's oil output will rise through the year. On the household side, even though job growth has been very strong, and there are signs that wage growth is picking up again, debt and debt service remain high, and the housing market remains flat. Given the late stage of the cycle, it may be that households choose to spend income gains on debt reduction rather than consumer goods.

Table 2

Canada	2000–17	2017	2018	2019f	2020f
	(annual % change, unless noted)				
Real GDP	2.1	3.0	1.8	1.6	2.1
Consumer spending	2.9	3.5	2.1	1.5	1.9
Residential investment	3.6	2.4	-2.3	-2.9	2.1
Business investment	2.2	2.2	2.0	0.5	6.8
Government	2.2	2.7	2.7	1.2	1.7
Exports	1.3	1.1	3.3	2.4	2.3
Imports	3.0	4.2	2.9	0.3	3.1
Nominal GDP	4.3	5.6	3.6	2.6	4.6
GDP Deflator	2.1	2.6	1.7	0.9	2.4
Consumer price index (CPI)	1.9	1.6	2.3	1.4	2.0
CPI ex. food & energy	1.6	1.6	1.9	1.8	2.0
Pre-tax corporate profits	0.0	20.1	0.5	-4.7	2.1
Employment	1.4	1.9	1.3	1.6	0.7
Unemployment rate (%)	7.1	6.3	5.8	5.8	5.9
Current account balance (CAD bn)	-18.7	-59.4	-58.7	-60.9	-62.8
Merchandise trade balance (CAD bn)	22.9	-23.9	-21.5	-30.1	-35.5
Federal budget balance* (FY, CAD bn)	-3.6	-17.8	-19.0	-18.1	-19.6
percent of GDP	-0.2	-0.9	-0.9	-0.8	-0.8
Housing starts (000s)	200	220	213	202	200
Motor vehicle sales (000s)	1,678	2,034	1,984	1,930	1,900
Industrial production	0.0	4.9	2.6	0.6	2.2
WTI oil (USD/bbl)	62	51	65	59	61
Nymex natural gas (USD/mmbtu)	4.83	3.02	3.07	2.90	2.90

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

The Provinces

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SUMMARY

- **As a result of weaker-than-previously anticipated growth in Q4-2018 and Q1-2019, we have edged down our forecast expansions for a number of provinces this year, and modestly raised projected advances for 2020.**
- **Nevertheless, most provincial economies are still on firm footing, and we continue to look for BC to lead provincial economic growth through 2020. Labour shortages and protectionist sentiment remain key risks.**
- **Several Provinces have progressed on fiscal consolidation plans, and newly released and upcoming financial blueprints underline a range of policy priorities.**

LOOK PAST LATE-2018 SOFT PATCH, FUNDAMENTALS REMAIN SOLID

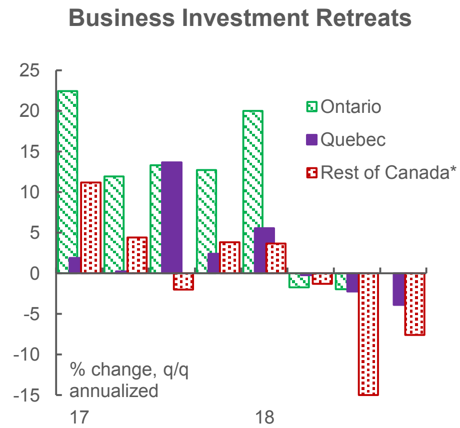
The slowdown in economic growth witnessed across Canada was felt in several regions. Real non-residential business investment, which was a key factor behind national-level weakness, fell 3.9% (q/q ann.) in Quebec in Q4-2018. The dip continued the retreat in that province after gains in 2017 and early last year that were largely attributable to capacity pressures; capital outlays thus far have followed a similar pattern in Ontario (chart 1). Alberta drilling activity, likely influenced by softer oil prices, slowed substantially in November and then fell by more than 20% y/y in December to reach the second-lowest ever recorded level for the latter month.

While a slower expansion in late 2018 provides a weak hand-off for 2019, we foresee a return to healthy growth in H2. To complement federal accelerated depreciation measures, BC, Ontario, and Nova Scotia have allocated funds for further capital expenditure write-offs, and Quebec added generous provincial-level incentives in December. Work will likely begin in earnest on the Kitimat LNG export terminal this year; this should boost capital outlays by nearly $14 bn in BC over 2019–20, and lift the province to the top of the growth table in both years. Firm full-time job creation in most regions thus far in 2019 should also support consumer outlays as monetary stimulus is withdrawn (chart 2).

Heavy oil production limits, implemented to alleviate the light-heavy oil price discount, continue to underlie our Alberta forecast. The cuts are expected to dampen key oil and gas sector output this year. Construction delays for the Line 3 pipeline will also likely weigh on price differentials throughout the forecast period and prolong the province's investment recovery. Outside the oil patch, there is more cause for optimism; work is expected to progress this year on petrochemicals facilities and a potato processing plant.

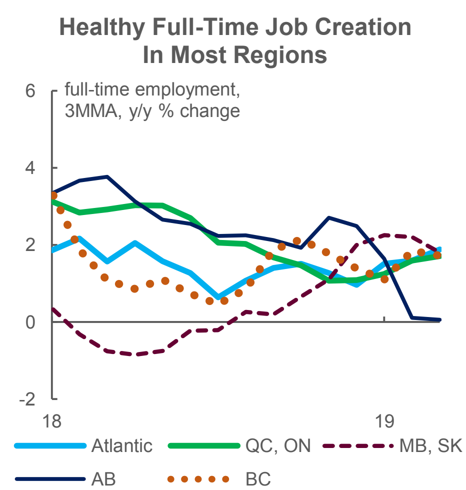
Stable, albeit more moderate export gains are also key to our forecast of a return to healthy economic growth. We expect resolution of ongoing Sino-US trade tensions to result in US demand for imports from most provinces that largely mirrors a more moderate, but still healthy expansion south of the border. We also anticipate exemptions to US import tariffs on steel and aluminum

Chart 1



* Q4-2018 figure is for Canada less Quebec. Sources: Scotiabank Economics, Statistics Canada, Ontario Finance, Insitut de la Statistique du Québec.

Chart 2



Sources: Scotiabank Economics, Statistics Canada.

products. The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) will provide new market access in the Pacific Rim. Exports to China are also forecast to assist economic growth in multiple jurisdictions, from BC where trade linkages to the country are strong (chart 3), to Newfoundland and Labrador as oil production rises, to Manitoba as soybean sales stabilize.

Labour shortages remain in place across multiple jurisdictions and continue to present barriers for firms that intend to hire and expand. Job vacancy rates averaged more than 3% in half of the provinces in 2018. Increases to Ottawa's newcomer admission targets through 2021 are constructive given the present tightness and expectations of population aging, especially in regions with a low immigrant population share (chart 4). In light of persistent labour shortages and a more moderate growth environment, we remain skeptical of the merits of Quebec's planned immigration cut. However, new programs that aim to lift immigrant integration are auspicious, and may help to improve newcomer labour market outcomes alongside further success with respect to attraction of net non-permanent residents.

We foresee relatively stable home sales and price growth in Ontario and BC after 2018's stress-test-led soft patch. Sales-to-new listings ratios still point to more muted home price rises in the Greater Golden Horseshoe over the next year than at the early 2017 market peak, though there is evidence that tightness and affordability pains have spread elsewhere in Ontario. BC sales continue to adjust to taxes enacted last year plus measures that target the high end market as of January 1, 2019. Elevated immigration and steady job creation should keep prices and rents elevated relative to incomes in both regions, even as still-high builder margins combined with government policy to incite near-record construction.

Cities in Canada's net oil-producing regions continue to grapple with an overhang of units accrued since the commodity price correction. Substantial building and home value increases are not expected until that glut is absorbed.

Elsewhere, housing construction and price gains are set to move with job creation and underlying demographics. Ownership and rental market tightness in Montreal and Ottawa reflect strong economic conditions rather than fundamental supply-demand imbalances, and should abate as growth cools in Central Canada.

BUDGET SEASON 2019 HIGHLIGHTS DISPARATE FISCAL PATHS

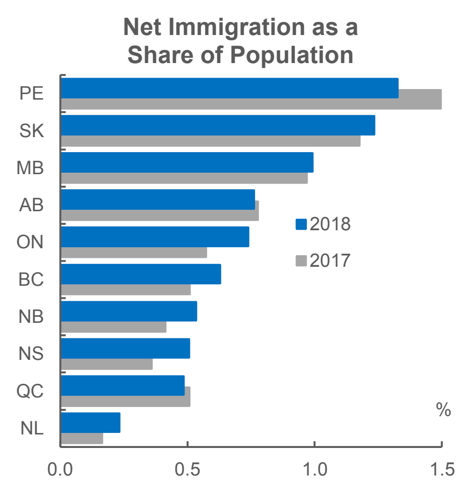
A number of Provinces will deploy surpluses to fortify policy plans already underway. As efforts to lift the supply of affordable housing progress, BC will direct stronger-than-anticipated revenue gains to enhanced child care benefits that build on fee reductions and investments in child care spaces announced in 2018. Nova Scotia, buoyed by a sizeable consolidation adjustment, will raise FY20 spending beyond prior plans, with a focus on health care and education. Quebec will allot an FY19 windfall to lower childcare costs and school tax rates paid by homeowners. It will maintain the accelerated borrowing retirement schedule unveiled in December to ramp up debt reduction completed since FY15 (chart 5).

Other jurisdictions will likely wait to loosen the purse strings. New Brunswick aims to balance the books and curtail net debt in FY20 via funding reductions across several government departments, but will review the competitiveness of its tax system. Amid uncertain energy sector conditions, Saskatchewan will contain spending and limit new measures to boutique personal income tax credits on its path to balance by FY20.

Chart 3

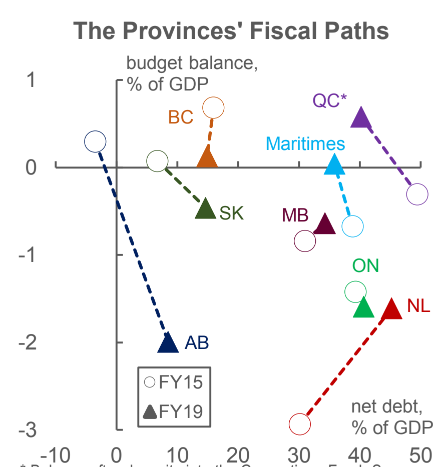
Sources: Scotiabank Economics, Industry Canada.

Chart 4



Sources: Scotiabank Economics, IRCC.

Chart 5



* Balance after deposits into the Generations Fund. Sources: Scotiabank Economics, Budget Documents.

Blueprints in Alberta and Newfoundland and Labrador should stay anchored to expenditure restraint. The latter's FY23 surplus target currently rests on a 1.4% average annual total spending contraction beyond FY19. Alberta's recent financial update—released in the shadow of an election—revised FY20–21 spending plans $8 bn higher than expected last year, in respect of outlays on crude-by-rail transportation to provide additional takeaway capacity until pipelines are built. A return to black ink relies on flat total spending during FY23–24. Regardless of the incoming government, Alberta's medium fiscal planning will require a balance between expenditure management and attention to the viability of large energy projects.

Campaign priorities look to be key for near-term fiscal policy elsewhere. Ontario's budget is the first for the new administration, and includes steps to reduce the Province's sizeable debt and deficit, as well as pocketbook relief and support for businesses. Manitoba recently reduced its Provincial Sales Tax to 7% from 8%, which fulfills a touchstone pledge from the 2016 election. With balanced books and an election only weeks away, PEI has outlined new pocketbook and small business tax relief and stepped-up infrastructure spending.

Table 1

The Provinces (annual % change except where noted)

Real GDP	CA	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
2000–17	2.1	2.4	1.8	1.3	1.2	1.8	2.0	2.3	2.0	2.8	2.7
2017	3.0	0.9	3.5	1.5	1.8	2.8	2.8	3.2	2.2	4.4	3.8
2018e	1.8	-0.6	2.0	1.2	1.1	2.1	1.8	1.8	1.4	2.1	2.2
2019f	1.6	1.3	1.5	1.0	0.8	1.7	1.7	1.6	1.6	1.2	2.4
2020f	2.1	0.9	1.1	0.9	0.9	1.7	1.7	1.5	1.7	2.5	3.5
Nominal GDP											
2000–17	4.3	5.6	4.2	3.3	3.4	3.7	3.9	4.4	5.4	5.9	4.7
2017	5.6	4.3	4.8	2.9	4.3	5.0	4.1	5.4	4.8	10.0	6.9
2018e	3.6	2.7	3.8	3.0	2.8	4.1	2.8	3.6	3.6	4.5	4.4
2019f	2.6	3.2	3.4	2.7	2.4	2.2	2.3	3.4	3.5	1.8	4.3
2020f	4.6	4.3	3.1	2.9	2.6	3.8	4.0	3.4	4.4	5.3	6.5
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
2018	1.3	0.5	3.0	1.5	0.3	0.9	1.6	0.6	0.4	1.9	1.1
2019f	1.6	1.2	0.9	1.3	0.3	1.2	1.8	1.3	1.2	1.1	2.1
2020f	0.7	0.0	0.7	0.2	0.2	0.6	0.7	0.6	0.6	1.0	1.0
Unemployment Rate (%)											
2000–17	7.1	14.3	11.1	8.8	9.5	7.9	7.0	5.1	5.0	5.3	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
2018	5.8	13.8	9.4	7.6	8.0	5.5	5.6	6.0	6.1	6.6	4.7
2019f	5.7	12.8	9.3	7.0	8.0	5.3	5.7	5.9	5.9	6.5	4.5
2020f	5.9	12.7	9.5	7.1	8.0	5.5	5.8	5.9	5.9	6.7	4.7
Housing Starts (units, 000s)											
2000–17	200	2.5	0.8	4.3	3.4	44	72	5.2	5.2	34	29
2017	220	1.4	0.9	4.0	2.3	46	79	7.5	4.9	29	44
2018	213	1.1	1.1	4.8	2.3	47	79	7.4	3.6	26	41
2019f	202	1.3	0.8	3.9	1.8	43	73	6.1	4.2	28	39
2020f	200	1.4	0.8	3.8	2.0	41	72	6.1	5.0	31	37
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
2018	1,984	28	8	51	38	449	853	67	47	226	217
2019f	1,930	30	8	48	35	430	826	60	48	220	225
2020f	1,900	30	8	47	34	420	810	55	48	215	233
Budget Balances, Fiscal Year Ending March 31 (CAD mn)											
2017	-19,000	-1,148	-1	151	-117	2,361	-991	-764	-1,218	-10,784	2,737
2018	-19,000	-911	75	230	67	2,622	-3,700	-695	-303	-8,023	301
2019e	-14,900	-547	14	28	5	2,500	-13,549	-470	-348	-6,930	374

Sources: Scotiabank Economics, Statistics Canada, CMHC, Budget documents; Quebec budget balance figures are after Generations Fund transfers.

United States

GROWTH COMING DOWN TO EARTH

- **As expected, the temporary boost from the Tax Cuts and Jobs Act (TCJA) and increased federal government spending has started to wane, with US economic growth slowing below potential in 2020.**
- **While the federal government shutdown and especially cold winter months are expected to crimp growth in Q1-2019, healthy economic fundamentals leave the economy on track for a strong 2019 as a whole.**
- **Our baseline forecast for a gradual US growth slowdown assumes a benign resolution to a multitude of trade and other risks, which have made for an unsettled atmosphere in financial markets and overseas economies.**
- **We assume no additional meaningful fiscal stimulus from the Trump administration.**

SLOWING BUT SOLID GROWTH DESPITE SIGNIFICANT RISKS

US economic conditions continue to evolve roughly as we have expected. The tailwinds of the US fiscal stimulus are waning, as the hoped-for boost to business investment has proved to be short-lived, consumption shows signs of slowing and trade remains a drag on growth, despite the trade ambitions of the US administration. Our forecast continues to incorporate a gradual and orderly slowdown of GDP growth from 2.9% in 2018 to 2.4% in 2019 and 1.9% in 2020, consistent with expected growth dynamics following a fiscal boost (chart 1). Relative to our previous forecast (see March 7 ***Forecast Tables***), growth in 2020 is revised up on account of lower short- and long-term borrowing rates, partly as a result of reduced expectation of monetary tightening over the next few years.

Despite the concern among analysts and market participants, we do not expect a recession in our baseline. Nevertheless, while the US economic fundamentals remain broadly healthy, the economy faces a long list of significant risks with a number of important issues waiting to be resolved that cloud the outlook, mainly centered on trade policy (e.g. China-US trade negotiations), and geopolitical risks, with Brexit being the most prominent one.

POLICY UNCERTAINTY UNSETTLES GLOBAL MARKETS

The fact that so many consequential issues are up in the air has made for an unsettled atmosphere in the business community and in financial markets, both in the US and globally in the last few quarters.

Partly as a result of erratic trade policy, economic activity outside of the US is slowing – industrial production in advanced economies other than the US declined in December in y/y terms and trade volumes disappointed (chart 2). Weakness in overseas economies, in addition to the impact of the US-China trade dispute, is expected to have constrained US export growth in Q4-2018, although more recently there are tentative signs of trade volumes improving.

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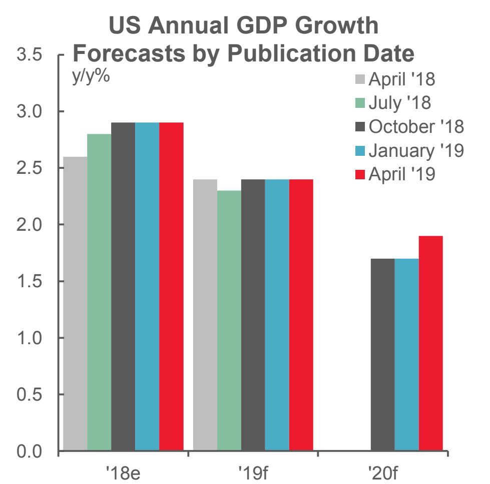
United States	2017	2018	2019f	2020f
Real GDP (annual % change)	2.2	2.9	2.4	1.9
CPI (y/y %, eop)	2.1	2.2	1.9	2.2
Central bank policy rate (%, eop)	1.50	2.50	2.50	2.75
Canadian dollar (USDCAD, eop)	1.26	1.36	1.28	1.23

Source: Scotiabank Economics.

Chart 1



Source: Scotiabank Economics.

As another reflection of uncertainty, equity markets have suffered periodic sell-offs, with the S&P 500 currently still about 2% below the peak reached at the end of September 2018, although it has recovered smartly since reaching a trough at the end of 2018. Cushioning the blow from lower equity prices, partly driven by the flight to safety and partly due to a lower expected path for the Federal Funds rate, the Treasury bond yields have declined in tandem: 10-year rates have fallen from a recent peak of just above 3.20% in early October to as low as 2.38% at the end of March, bringing down borrowing rates for private borrowers (chart 3).

SHORT-TERM FACTORS CONSTRAIN GROWTH

In addition to financial market volatility, moderating foreign demand, and the significant risks weighing on the outlook, the US economy entered 2019 with growth in the short term likely constrained by a slew of temporary factors. This included an unusually cold winter and the effects of the December-January federal government shutdown that ended up being the longest in history (the Congressional Budget Office estimates that the shutdown subtracted 0.4ppts from Q/Q SAAR real GDP growth in Q1-2019).

These temporary factors resulted in a string of weak data in January and February in the US, including distinct signs of a loss of momentum in household spending, with auto sales down by 4.8% m/m in January and retail spending down 0.2% m/m in February (chart 4), housing construction (housing starts fell to 1.16 million units in February) and hiring (total nonfarm payrolls +33K in February).

This weakness is expected to be transitory, and indicators in March point to improving conditions, including a rebound in car sales (+5.3% m/m), a sharp rise in existing home sales (+11.8% m/m) and a rebound in nonfarm payrolls (+196K).

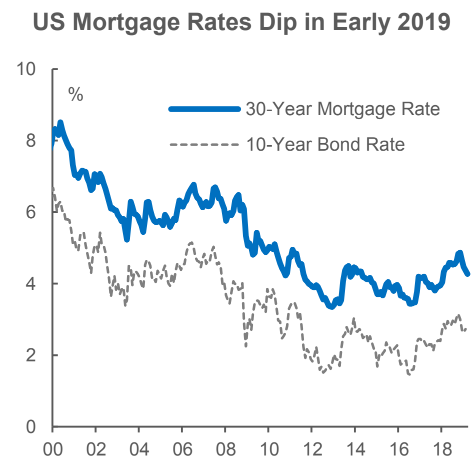
GDP OUTLOOK

As a result of temporary factors we expect GDP growth in Q1-2019 to reach just 1.7%. With the US federal government re-opening at the end of January, the resumption of activity is expected to boost growth in Q2-2019 to 2.5%. After Q2-2019

Chart 2

Sources: Scotiabank Economics, CPB World Trade Monitor.

Chart 3



Sources: Scotiabank Economics, Freddie Mac.

Table 1

Quarterly US Forecasts	2018		2019				2020			
	Q3	Q4	Q1e	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic										
Real GDP (q/q ann. % change)	3.4	2.2	1.7	2.5	2.1	2.1	1.7	1.7	1.7	1.7
Real GDP (y/y % change)	3.0	3.0	2.8	2.4	2.1	2.1	2.1	1.9	1.8	1.7
Consumer prices (y/y % change)	2.6	2.2	1.7	1.6	1.7	1.9	2.1	2.2	2.2	2.2
CPI ex. food & energy (y/y % change)	2.2	2.2	2.1	2.1	2.2	2.1	2.1	2.1	2.1	2.1
Core PCE deflator (y/y % change)	2.0	1.9	1.8	1.8	1.9	1.9	2.0	2.0	2.0	2.0
Financial										
Euro (EURUSD)	1.16	1.15	1.12	1.17	1.19	1.20	1.22	1.22	1.24	1.24
U.K. Pound (GBPUSD)	1.30	1.28	1.30	1.35	1.37	1.40	1.42	1.42	1.45	1.45
Japanese Yen (USDJPY)	114	110	111	110	108	108	107	107	105	105
Fed Funds Rate (upper bound, %)	2.25	2.50	2.50	2.50	2.50	2.50	2.75	2.75	2.75	2.75
3-month T-bill (%)	2.20	2.36	2.39	2.40	2.40	2.40	2.65	2.65	2.65	2.65
2-year Treasury (%)	2.82	2.49	2.26	2.45	2.50	2.60	2.80	2.80	2.80	2.80
5-year Treasury (%)	2.95	2.51	2.23	2.50	2.60	2.70	2.85	2.85	2.85	2.85
10-year Treasury (%)	3.06	2.68	2.41	2.65	2.75	2.85	2.95	2.95	2.95	2.95
30-year Treasury (%)	3.21	3.01	2.82	3.00	3.10	3.20	3.25	3.25	3.25	3.25

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

GDP growth gradually starts to slow and falls below that of potential output in 2020, as the temporary fiscal stimulus-driven boost to growth in business investment and consumption passes, 2017–18 interest rate increases slow growth in interest-sensitive sectors, and weaker foreign demand constrains exports.

Consumption and business investment explain most of the deceleration in growth over the next few years with their combined contribution to growth expected to decline from 2.2ppts in 2019 to 1.8ppts in 2020. Net exports are expected to continue to act as a drag on growth throughout the forecast.

HOUSEHOLDS AND BUSINESSES BACK TO SUSTAINABLE GROWTH

Consumer spending has recently begun to flag, after being a dominant source of US economic strength over 2018. Nevertheless, we continue to expect this pause by US consumers to be temporary. Consumption growth is expected to repeat 2018's 2.6% in 2019, before moderating to 2.1% in 2020.

US households are well-positioned to sustain this pace of consumption. Employment growth is near post-2008 highs, notwithstanding February's stumble; labour-market participation rates have increased from their 2015 post-crisis low; and unemployment at 3.8% remains near 40-year record lows. US households have 'dry powder' to support consumption growth and residential investment: the average ratio of household debt-service to disposable income is at 9.9%, its lowest level in 40 years of data (chart 5), and the average household saving rate is at 7.5%, well above the 4.6% pre-crisis average during 2000–07. A stabilizing housing market should provide new impetus to growth in consumer durables purchases. After four consecutive quarters of declines in 2018, residential investment is set to stabilize in Q1-2019, before resuming tepid Q/Q growth over 2019–20, helped by improved affordability and a recent decline in mortgage rates.

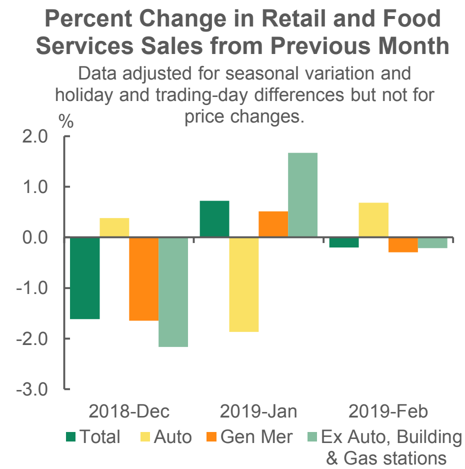
Growth in US business investment is expected to moderate during 2019–20 as the boost provided by the tax stimulus fades. Industrial capacity pressures, while being relatively acute now (chart 6), look set to diminish owing to strong capital outlays last year and slower domestic and global growth. The impact on business investment from the Tax Cuts and Jobs Act (TCJA)—which came into force in January 2018 and allows for a full tax write-off of expenses on equipment—likely ran its course in 2018, when it pushed investment growth to 7.0%. The hoped-for repatriation of overseas profits has fallen short of the US President's expectation of up to USD 4 tn and is unlikely to support investment growth going forward, with an important share of the USD 665 bn repatriated in 2018 having been spent on share buybacks (chart 7).

INTERNATIONAL TRADE: STUBBORN DEFICITS

Despite the likely resolution of its trade conflict with China, US exports are set to decelerate through the near future as global growth downshifts, particularly in China and the European Union. Furthermore, given the persistent strength of the USD against most major currencies, the US' trade deficit should continue to expand throughout the forecast horizon, mirroring the expansion of the US fiscal deficit and subtracting from GDP growth, as it has in 21 of the last 29 years since 1990.

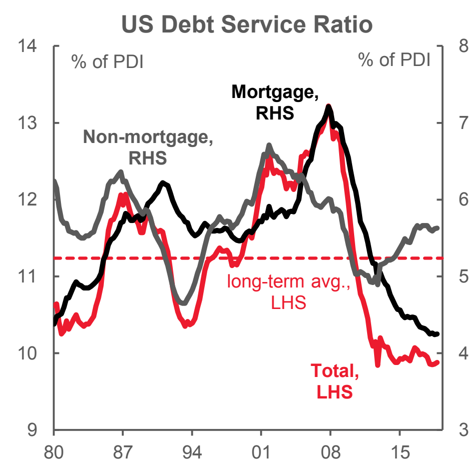
We anticipate that the US and China will come to an agreement that would see the removal of recent two-way protectionist trade measures. Relative to the situation prior to 2018, an eventual agreement is likely to provide a small increase in energy and

Chart 4



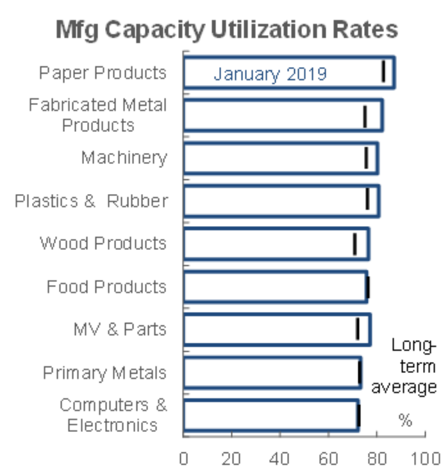
Sources: Scotiabank Economics, Census Bureau.

Chart 5



Sources: Scotiabank Economics, US Federal Reserve.

Chart 6



Sources: Scotiabank Economics, BEA.

agricultural exports to China. The costs of the trade war have likely outweighed the potential benefits: nominal merchandise exports to China fell sharply in 2018 (-6.2%), in particular as a result of a fall in exports of soybeans. In contrast, imports rose 6.8% in 2018 (chart 8).

INFLATION PUSHES UP TO 2.0%, GIVING THE FED CONFIDENCE TO HIKE

Over the course of 2018, on the back of the fiscal stimulus, significant excess demand has built up in the economy, with the output gap expected to peak at 0.6% in the second half of 2019 before starting to decline rapidly and finally closing in 2021. This excess demand continues to provide support to core PCE inflation throughout the forecasting horizon (chart 9), bringing it closer to the target and countering disinflationary pressure coming from the weak growth in unit labour costs, the recent decline in oil prices and the relatively strong US dollar. As core PCE inflation rises from 1.8% to 2.0% in Q1-2020 and the economy continues to operate with sizable excess demand, the Federal Reserve should feel confident to raise its Federal Funds rate by 25bps in Q1-2020 to 2.75%, our estimate of the neutral rate in the US (see *Monetary Policy and Capital Markets* section for more details).

Table 2

United States	2000–17	2017	2018	2019f	2020f
	(annual % change, unless noted)				
Real GDP	2.0	2.2	2.9	2.4	1.9
Consumer spending	2.4	2.5	2.6	2.4	2.1
Residential investment	-0.3	3.3	-0.3	-1.2	1.2
Business investment	3.0	5.3	6.9	3.6	2.4
Government	1.0	-0.1	1.5	1.8	1.7
Exports	3.7	3.0	4.0	1.9	2.0
Imports	3.7	4.6	4.5	3.2	2.8
Nominal GDP	4.0	4.2	5.2	4.3	3.9
GDP Deflator	1.9	1.9	2.3	1.9	1.9
Consumer price index (CPI)	2.2	2.1	2.4	1.7	2.2
CPI ex. food & energy	2.0	1.8	2.1	2.1	2.1
Core PCE deflator	1.7	1.6	1.9	1.9	2.0
Pre-tax corporate profits	5.3	3.2	7.8	3.4	1.9
Employment	0.7	1.6	1.7	1.4	1.0
Unemployment rate (%)	6.1	4.4	3.9	3.9	4.0
Current account balance (USD bn)	-501	-449	-488	-542	-603
Merchandise trade balance (USD bn)	-680	-807	-891	-949	-1026
Federal budget balance (USD bn)	-540	-665	-779	-1,091	-1,101
percent of GDP	-3.7	-3.4	-3.8	-5.1	-5.0
Housing starts (mn)	1.26	1.20	1.25	1.25	1.26
Motor vehicle sales (mn)	15.6	17.1	17.2	16.8	16.7
Industrial production	0.7	2.3	4.0	2.8	1.8
WTI oil (USD/bbl)	62	51	65	59	61
Nymex natural gas (USD/mmbtu)	4.83	3.02	3.07	2.90	2.80

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

Chart 7

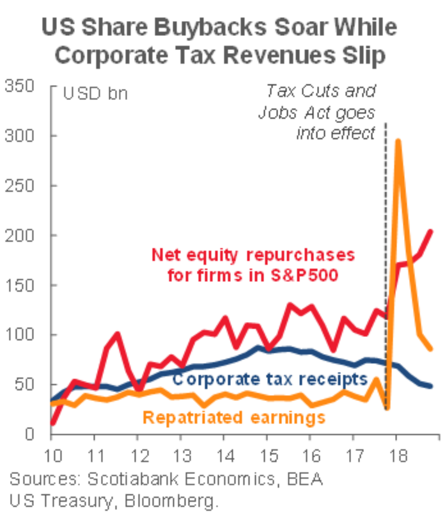
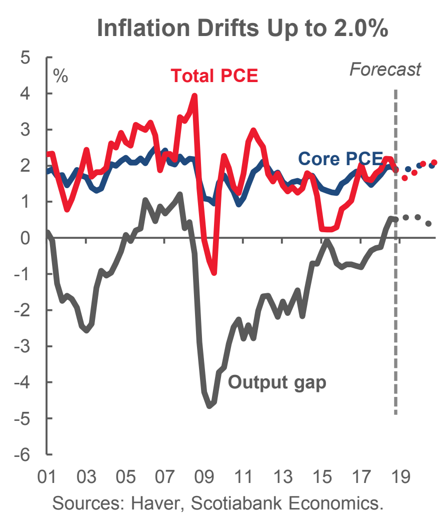


Chart 8

Chart 9



US & Canadian Monetary Policy & Capital Markets

- **There is a fairly high bar for easing that requires a lot to go wrong;**
- **The Fed is forecast to hike once more by early next year;**
- **The BoC is forecast to hike late in 2019, then again in 2020;**
- **The Fed's risk padding matters way more than the fundamentals;**
- **The drivers of yield curves have been reassessed;**
- **Still-high binary risks to the rates outlook are expected to improve;**
- **Curve inversion expected to give way to mild steepening;**
- **But we've still lowered longer yield forecasts.**

While we've long been forecasting flatter sovereign debt curves that have arisen this year, a major catalyst so far in 2019 has unexpectedly been falling longer term bond yields with some portions of the Treasury and Canada curves unexpectedly inverting (ie: higher short-term than longer-term yields). Why has this been happening? Does it matter as a signal regarding the outlook? And where to from here?

Because of the significance of bond market movements and the Fed's changed approach to balance sheet management, they will be addressed first before returning to the 2019–20 outlook for the policy rates set by the Federal Reserve (one more hike in 2020Q1) and the Bank of Canada (one hike in 2019Q4 and another in 2020Q2). This structure and flow to the arguments that follow also reflects what we think will be quite some distance before resuming any policy hikes and the uncertainty that brackets conventional rate forecasts at this juncture. The more pressing matters are expectations for reversing curve inversion and a modest projected rise in longer term bond yields. What follows informs our yield curve forecasts shown in charts 1 and 2 and the table on page 24.

The broad over-arching theme is that the Fed's abrupt policy change that started in January and culminated in its March FOMC meeting—and the impact upon Canadian markets—is more driven by a **much greater emphasis upon padding risk management exercises than a fundamentally soured view on the economy.** It is plausible that the Fed over-reacted to a temporary soft patch, temporary market instability in late 2018, and nearly worst-case scenarios for how geopolitical risks may unfold. It was also motivated by frank admission that there is enormous uncertainty over where neutral rates sit and what the optimal level of the Fed's balance sheet and bank reserves may be. Markets may have misinterpreted this 'patient' risk management posture as indicative of a bias toward cutting short-term policy rates as a next step. To cut rates requires a much more negative shock to markets and the economy than we anticipate. Cutting rates at this point would seem to be an absurdly unwise frittering away of precious bullets that may be needed to counter potential future problems.

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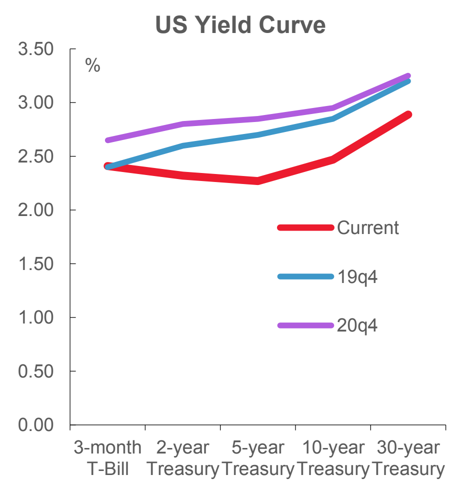
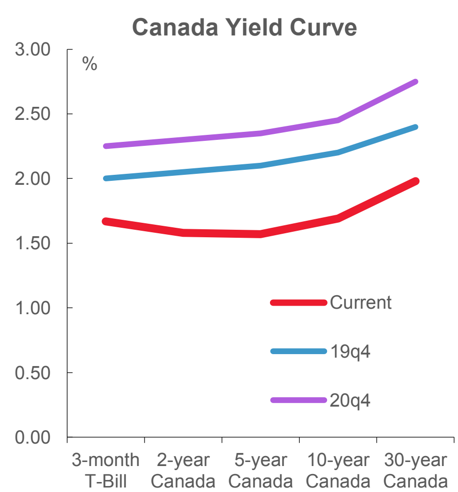
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

If one accepts this view, then by corollary the Fed's QE-era tools have already substantially eased financial conditions and some of this easing may ultimately have to be taken back rather than compounded easing. The present rates complex may be ill-positioned for this development over time. This is conditioned by our house views on how the economy evolves from here and our cautiously optimistic stance toward geopolitical risks such as Brexit, trade tensions and US fiscal policy applied to the recently invoked debt ceiling. Unstable politics threatens the world economy, but our base case remains generally constructive.

DRIVERS OF YIELD CURVES AND THEIR OUTLOOK

Why is the US Treasury curve inverting? While there remains a solid safe haven argument given ongoing US-China trade talks and ongoing Brexit uncertainty that could still go in either direction of risks as we publish, the curve is a doubtful recession signal and this will be returned to in a moment. Instead, **the curve needs to be interpreted with great care given several distortions and influencing factors beyond just expectations for the economy's performance.** Some of those factors are highlighted below. In general, however, a lower neutral rate environment than in past cycles is going to make yield curve inversions more likely without necessarily portending bad times ahead.

1. Federal Reserve Demand for Treasuries

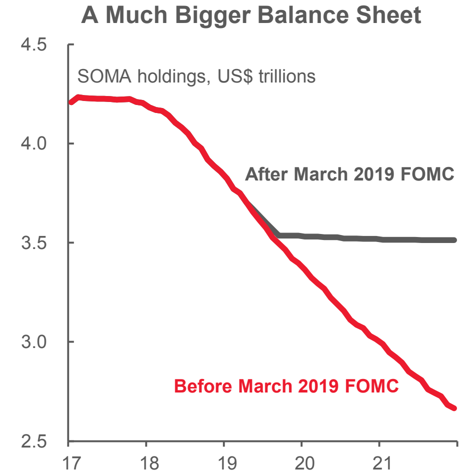
The Federal Reserve is now setting a course to be a much bigger source of demand for Treasuries than previously guided and only a part of this policy shift began to be anticipated starting in January with the rest occurring in the aftermath of the March FOMC meeting.

The March FOMC meeting was a seminal shift in balance sheet policy that requires some numbers to be crunched in order to showcase the magnitude of the shift. Before doing so, here are highlights of what they did:

- the maximum amount of Treasuries that are allowed to mature and fall off the balance sheet was tapered to US$15 billion per month from twice that amount previously and starting in May;
- the Treasury reinvestment caps—or more appropriately redemption caps—would then be eliminated in favour of full reinvestment after the end of September;
- up to US$20 billion of MBS principal will be rolled over into Treasuries per month on a weighted average maturity basis starting in October;
- any MBS amounts over US$20 billion per month will get reinvested into MBS but the amounts are expected to remain under this ceiling over much of the forecast period.

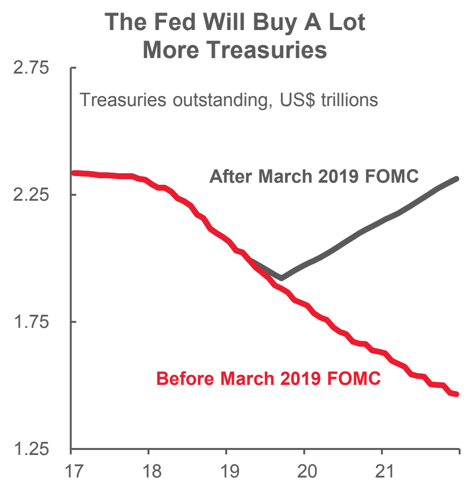
Charts 3 and 4 vividly illustrate the impact of this shift. Under the plan before the March FOMC, the System Open Market Account (SOMA) portfolio would have continued to decline from US$3.73 trillion now toward US$2.7 trillion in Treasuries, agencies, MBS, TIPS and FRNs at the end of 2021 through the combined effects of Treasury and MBS roll-offs and maturing other securities. The Treasuries-only component would have plunged from US$2 trillion now to about US$1.5 trillion by the end of 2021 just as issuance would be rising. Under the changes introduced in March,

Chart 3



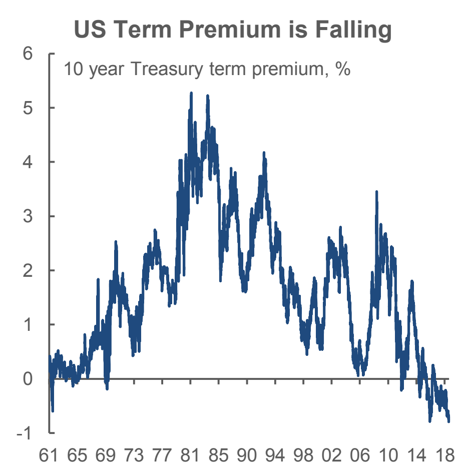
Sources: Scotiabank Economics, FRB New York.

Chart 4



Sources: Scotiabank Economics, FRB New York.

Chart 5



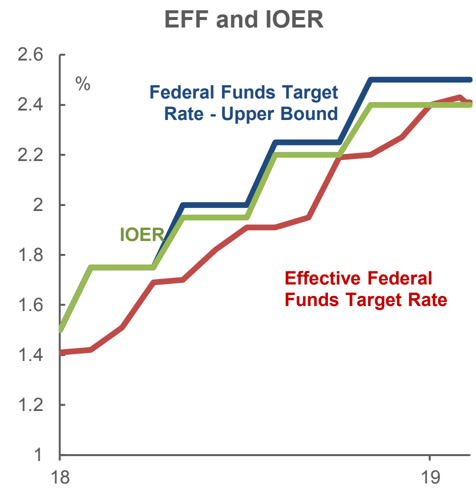
Sources: Scotiabank Economics, New York Federal Reserve.

the SOMA that holds these assets will instead flat line at about US$3.5 trillion from October 2019 onward and the composition will shift more toward *rising* holdings of Treasuries as the other components decline over time.

Overall, by the end of 2021, the SOMA portfolio will be over US$850 billion bigger than previously guided and this will be entirely due to rising holdings of Treasuries compared to plans before March. **Basically, the Fed added US$850 billion in extra demand for Treasuries through to the end of 2021** while assuming stable policy thereafter adds even more to longer run Fed demand for Treasuries.

The effects are vividly portrayed by the Treasury term premium. Against the long-held notion that the Fed's shrinking portfolio of Treasury securities could turn the negative term premium positive, it has continued to decline with the decline intensifying recently in the wake of the Fed's policy shifts (chart 5). The unwinding of the Treasury term premium that was expected as the Fed shrank its QE-era holdings of Treasuries is now on indefinite postponement which leads us to revise lower our bond yield projections. This has been a major reason for why the Treasury curve has flattened with portions at times modestly inverting. **In short, the flattened and at times inverted yield curve is significantly the Fed's own doing.**

Chart 6



Sources: Scotiabank Economics, Bloomberg.

The effects of Fed policy shifts on bond markets may not be over yet. There remain important matters to decide upon and implement. One possibility is whether the FOMC opts to **'twist' the Treasury curve**. This would entail reinvesting some portion of maturing Treasury proceeds into Treasury bills and thereby shortening the duration of the Fed's Treasury holdings within the SOMA account. If this were to happen, it may assist in steepening the Treasury yield curve. FOMC officials like Boston Fed President Rosengren and Philly Fed President Harker have recently indicated support for such action.

Further, while the decision to pad reserves may lessen this argument, it's also still possible that the Fed discusses rolling-out a **standing repo facility** designed to offer funds toward the purpose of controlling short-term market rates around the interest on excess reserves rate and its spread to fed funds given past pressures (chart 6). This would build upon efforts to contain potential upward pressure upon money market rates as excess reserves decline. Recall that the minutes to the December FOMC meeting indicated **there was a discussion about how to keep the effective fed funds rate within the FOMC's target range as reserves are drained** from the system beyond utilizing IOER cuts relative to the upper limit including adding new counterparties to the Open Market Desk's operations. On managing potential upward pressure upon money market rates as excess reserves decline, 'several' participants flagged using IOER technical adjustments, 'some' advocated slowing the pace of decline in reserves using standard open market operations, or ending portfolio redemptions at relatively high reserves.

Within that same set of minutes, **'several' FOMC participants were concerned that slowing redemptions "could be misinterpreted as a signal about the stance of monetary policy."** This is precisely what may have happened as markets moved toward pricing rate cuts and curve inversions and the fact that FOMC participants were concerned about this possibility may indicate they think markets have now gotten ahead of themselves.

2. Federal Reserve Policy Rate Guidance

The March FOMC meeting also eliminated two hikes from the Fed's so-called 'dot plot' for 2019 and retained one hike in its projection for 2020 while leaving the long-run neutral rate estimate unchanged at 2.75% after lowering this estimate in December. While markets are underpricing Fed funds and a rate cut is unlikely, the Fed's shift in guidance further tamped down the curve particularly across nearer term yields. A 'patient', 'watching,' 'waiting' and 'flexible' bias was communicated in the face of geopolitical risks that markets immediately interpreted to be a signal toward a rate cut bias that we feel is premature.

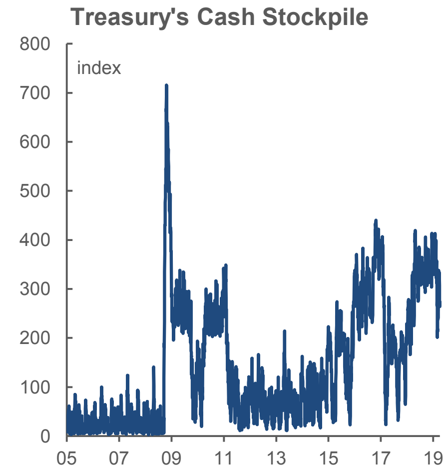
3. The Federal Reserve's "Reflection Problem"

Fed communications have been anything but impressive since last Fall. Recall that just a few months ago, Chair Powell was stating that the Fed was "a long way" from a neutral policy rate and the Fed's balance sheet policy was on "auto-pilot" with no tinkering expected. Now it says no hikes this year, maybe one next year and the balance sheet unwinding will be halted with demand for Treasuries to resume rising. All that in the space of just a few months! The Fed would have known all along last year even as it hiked in December before abruptly shifting course that risks such as Brexit, US-China trade talks and the debt ceiling loomed into 2019. Or at least it should have.

Markets are debating whether this sudden shift on both policy levers indicates a) whether the Fed knows something dark and foreboding about the outlook that no one else does, b) whether the Fed has simply decided to adopt a full-on risk management approach in the face of uncertainties by padding policy rates and the balance sheet until it has more clarity, or c) whether the Fed fouled up including the possibility of becoming more deeply politicized (e.g. Trump's incessantly self-serving Fed bashing, Moore's and Cain's potential nominations, etc.). Shades of each are plausible.

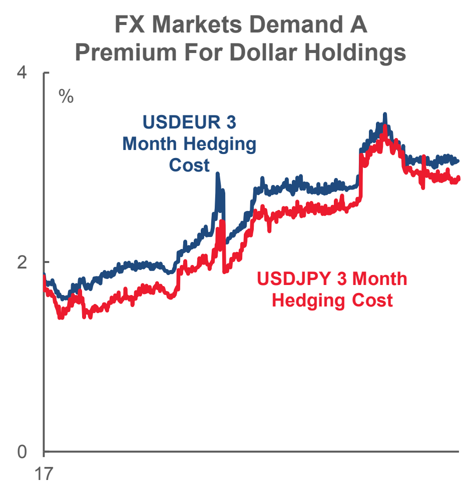
This is about more than just petty scorekeeping. **The Fed's own erratic actions may have shaken confidence in favour of attracting a high premium in Treasury prices.** Its policy shifts have been one part a reaction to stock market developments late last year while also leading market turbulence. The famous illustration of this bi-directional interdependence of market and Fed actions was **famously explained by the late US economist Paul Samuelson** when he likened the circularity of market outcomes and central bank actions as akin to a monkey seeing its reflection in the mirror for the first time, reacting as if it is unware it is its own reflection! A recent note here explored this "reflection problem" further in the era of forward guidance.

Chart 7



Sources: Scotiabank Economics, Bloomberg.

Chart 8



Sources: Scotiabank Economics, Bloomberg.

4. Scarcity

The US public debt ceiling became binding at about US$22.03 trillion at the start of the month. While eventually the Treasury market may get concerned about debt ceiling politics if it raises risks to honouring US debt obligations and debt ratings, that risk is likely pushed at least well into summer given Treasury's flexibility to manage within the debt ceiling for a time including drawing down its excess cash holdings at the Fed which it has already started doing (chart 7).

In the interim period, **while US debt is hardly scarce per se, the flat-lined stock of public debt may be adding a premium to Treasury prices.** On its own, this supply argument is an insufficient explanation. Through reducing its excess cash holdings at the Federal Reserve and through employment of extraordinary measures, the US Treasury can manage the US government's obligations until late Summer at most before markets get concerned about default risk. Default risk could perversely spawn greater safe haven demand for Treasuries which is what has happened previously to reward the country with the dysfunctional government. Achieving a funding agreement and raising the debt ceiling would bring forth the opposite effect through renewed supply and would, all else equal, drive yields higher. **The risks are two-tailed going forward, but probably more heavily skewed toward the settlement scenario in favour of a steeper curve on renewed supply pressures.**

5. Carry

The ECB's fresh round of Targeted Longer-Term Refinancing Operations (TLTROs III) that was announced on March 7th, will be started in September 2019 and end in March 2021 with two year maturities may be influencing carry arguments. An anticipatory effect upon liquidity combined with pushed out guidance for an ECB rate hike "at least through the end of 2019" has been followed by rallying bunds with the 10 year German yield falling to around zero and at times slightly negative perhaps also driven by Brexit and risks to Eurozone cohesion. The knock-on effects probably flattened the US Treasury curve by making Treasury yields relatively more attractive to bunds. Ergo, **as the ECB's actions lowered EGB yields, the ripple effect extended across the rather large pond.** With ECB action priced in, this effect on Treasury yields may be maturing pending further Brexit and other developments.

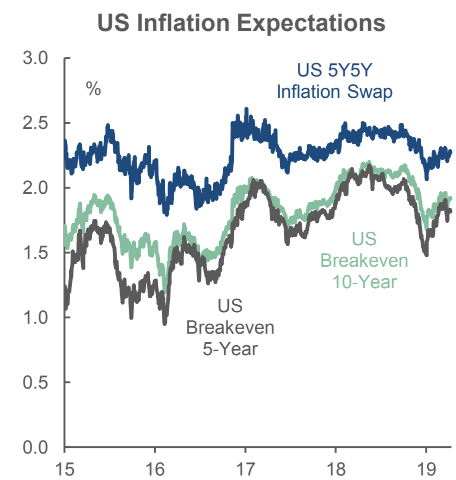
6. FX Hedging costs

What reinforces the prior point is that FX hedging costs have diminished somewhat this year and partly as a repeat of the common rise in Q4 and then decline each Q1 perhaps as year-end dollar demand subsides within a different regulatory environment that constrains arbitrage activity against seasonal demands. As FX hedging costs have reduced, demand for Treasuries out of yen and euro became relatively more attractive for those investors that do hedge currency risks. See chart 8. If the seasonality to past movements is at a point of settling down, then this effect may be maturing.

7. Inflation expectations

The decline in longer-term bond yields has not been driven by declining market-based measures of inflation expectations. It remains the case that the undershooting of such expectations in December through early January has significantly reversed higher in terms of the Fed's more preferred measure—the 5y5y inflation swap gauge (chart 9). **In itself, this weighs against the theory that the curve is signalling deepened recession and disinflation/deflation worries.**

Chart 9



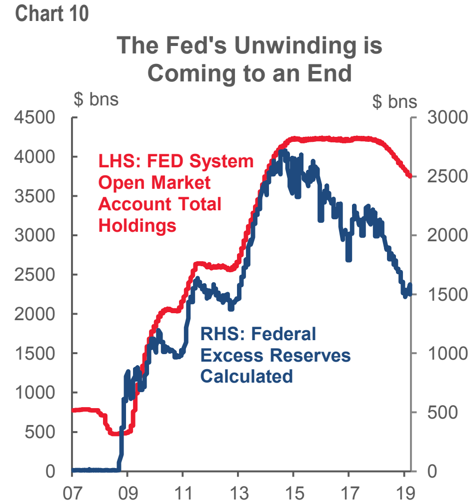
Source: Scotiabank Economics, Bloomberg.

WHY THE FED GOT SPOOKED INTO ACTION

While the Fed may have over-reacted to developments late last year into this year, there nevertheless remains a partial case for its abrupt changes to balance sheet policy. **It is important to understand that this case is heavily rooted in uncertainty over how large its balance sheet should be in a more normalized state and concern over the market effects as opposed to, say, a policy shift that is purely driven by concerns over the state of the economy going forward.**

At the heart of the matter is the junction between the Fed's uncertainty over the optimal level of reserves in the banking system and changed regulations governing liquidity and capital management in the banking sector. As the Fed shrinks its portfolio of holdings within the SOMA portfolio, the concomitant accounting entry is a decline in excess bank reserves held at the Fed. This carries market effects I'll return to after addressing the issue of optimal reserves.

Chart 10



Sources: Scotiabank Economics,, Bloomberg.

Chair Powell has guided that the optimal level of reserves in the system is uncertain but that US$1 trillion plus a buffer is a "reasonable starting point." It is important to acknowledge that there is so much guesswork involved when estimating optimal reserves that padding guesstimates and not risking going too low is the order of the day; the Fed significantly relies upon surveys of US primary dealers including our answers for estimates of the optimal size of reserves. Chart 10 depicts the drawdown of reserves that banks hold at the Fed and the shrinking size of the Fed's System Open Market Account (SOMA) through which they directed purchases of Treasuries, agencies and mortgage bonds during QE1–3. A continuation of the recent pace of unwinding before the policy changes in March could have risked bringing reserves down toward the US$1 trillion level and hence back to 2010 levels into early 2020. **This removal of liquidity could be too rapid from the standpoint of the proper functioning of markets.** Stopping the unwinding of the balance sheet by this September is consistent with achieving Powell's guidance toward padding US$1 trillion or more in reserves.

This action should not be taken as a negative signal toward the outlook so much as it is an indication that the Fed is highly uncertain about the optimal level of reserves and wishes to err on the side of overestimating them from a risk management standpoint. Shrinking the balance sheet by reinvesting less out of coupon and maturing flows from Treasuries and MBS drains reserves from the banking system. Draining reserves runs against the need for banks to hold high-quality liquid assets including through but not limited to the impact of the Liquidity Coverage Ratio (LCR). **Draining reserves too far and too fast risks negative effects upon markets by motivating banks to substitute holdings away from other less liquid**

assets in order to maintain required liquid holdings, or to sell other assets to buy Treasuries that are also favoured by the LCR. Hence the cross-asset class implications that highlight the interconnectedness of regulatory change with unwinding unconventional stimulus and how the effects can distort market appetite toward safe havens. **This mechanism can be destabilizing to markets and spark greater disturbances in short-term rates markets** even if the effects of unwinding the balance sheet are not showing up in a reversal of the Treasury term premium. For a good discussion of how the Fed views related topics see the recent speech by Vice Chair Quarles here.

All of this is not to say that markets have not had legitimate other worries (Brexit, trade, debt ceiling, etc.). Rather, had markets not misinterpreted Fed signals stemming from changes to balance sheet management, then Fed rate cuts might not have been priced and the Treasury curve might not be flirting with inversions.

EVALUATING YIELD CURVES AS HARBINGERS OF RECESSION

The discussion so far suggests that several idiosyncratic factors and policy adjustments have dominated the drivers of the yield curve of late. If so, that may lessen concern that the bond market is telling us something bad about the economic outlook. Again, recall Samuelson's 'reflection problem' in this regard as it remains entirely plausible that central banks *caused* a good portion of bond market developments.

Nevertheless, to cover the bases, **we have to consider the track record of bond markets in forecasting economic downturns** as a next step to inform our broader macro views.

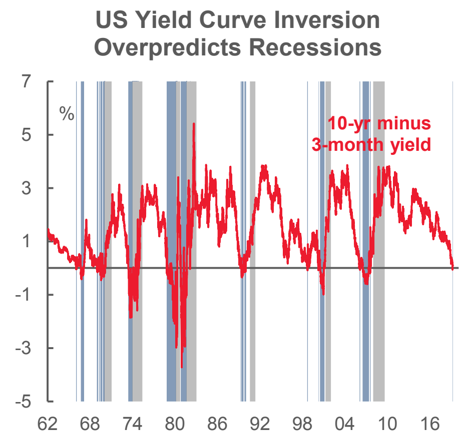
United States

Charts 11 and 12 demonstrate the evidence. The literature generally tends to indicate that the probability of recession is best indicated by the spread between the 90 day bill yield and the 10 year Treasury yield (chart 11). Greater history is available from Robert Shiller back to a few years before my son thinks I was born! This is shown in chart 12.

The first referenced chart 11 lines up the 10s90s slope with two definitions of recession. One definition of recession is the NBER method and the other is the technical definition of back-to-back declines in quarterly GDP. We see that the Treasury curve usually inverts ahead of US recessions but can sometimes shed false signals. For example, it inverted back in 1966 but no recession ensued by either definition. The curve inverted very slightly in September 1998 but recession didn't unfold by the NBER measure until early 2001. The curve came close to inverting a few years before that and, again, no recession.

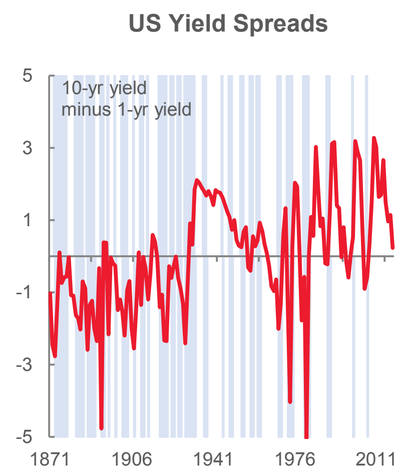
History buffs may wish to go back even further. Shiller's proxy for shorter term yields is impure for our purposes as it also includes a credit spread, but it's the best very long term data set to my knowledge and it helps to inform perspectives on the length of inversion versus length of economic downturns. By this measure, **the curve has been inverted for 75 out of 148 years since the start of the historical data set in 1871. Since 1950, the curve has been inverted 21 out of 68 years or about one-third of the time.** So clearly the frequency of recessions before the post-WWI period distorts things, but either way, the slope spends much more time inverted than the US economy spends in recession. Since 1871 when the chart starts, the US has been in recession for over 39 years cumulatively; since 1950, just under 8 years cumulatively.

Chart 11



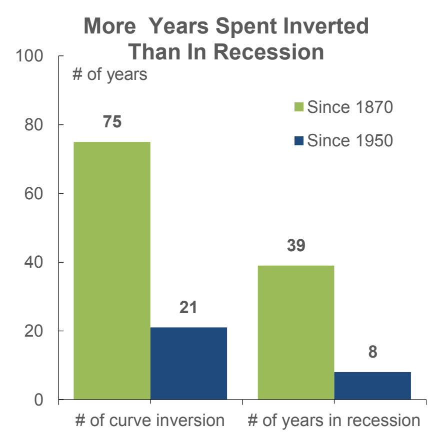
Sources: Scotiabank Economics, Bloomberg. Grey bars indicate NBER recession. Blue bars indicate periods of yield curve inversion

Chart 12



Sources: Scotiabank Economics, Federal Reserve Board, NBER.

Chart 13



Sources: Scotiabank Economics, Robert Shiller.

The curve has been inverted almost twice as long as the US has been in recession since 1871 and over 2½ times since 1950 (see chart 13). Granted, obviously it was a different bond market in oh so many ways that far back and that complicates comparisons over time; today's bond market is also exceptionally different from the past given overt central bank manipulation and that alone goes some distance toward invalidating comparisons between then and now.

Canada

How useful is Canada's yield curve as a predictor of recessions? Not very is the bottom line. The curves are worse predictors of the Canadian business cycle than the US curves. Charts 14–17 show different measures of the yield curve's slope and different measures of recession. One measure of recession is the technical definition of back-to-back quarterly declines in GDP and the other measure is the CD Howe's Canadian version of a more comprehensive definition along the lines of the NBER's approach to dating cycles in the US. The first two charts show shorter history using the 90s10s and 2s10s slopes comparable to charts frequently used in the US. The second set of two charts show longer history with longer time series using the spread between the 10 year and over yield minus the 1–3 year average yield as well as the spread between the 90s and 10+ yields. The conclusions are as follows.

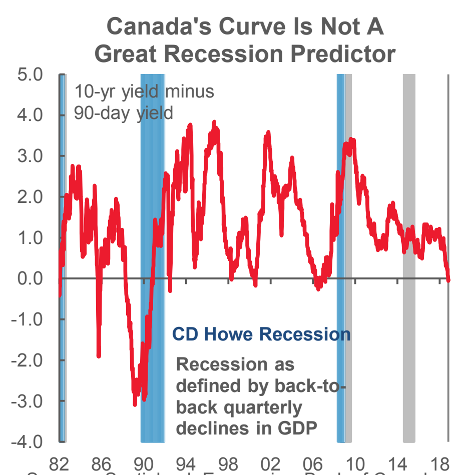
90s10s: There have been at least two and possibly three false positives when the spread between 90s and 10s inverted but no recession ensued. 1986 and 2000 were examples, and so was possibly late 2006 through early 2007 when the curve inverted quite a while ahead of Canada's brief recession. An accurate signal was sent when the curve inverted and the early 1990s recession ensued. 2015 was a false negative when the curve didn't invert and one definition of recession was hit but not the other.

2s10s: There were again three false positives when this curve inverted but no recession ensued (1986, Sept 1998, 2000). Accurate signals were sent into the early 1990s recession and the Global Financial Crisis although that time was so far in advance that its usefulness was less clear. A false negative was registered when the curve didn't invert and one definition of recession was hit in 2015.

Longer term histories are provided in the charts using alternative measures of the yield curve's slope such as the 10 year and over yield minus the yield on 1–3 year bonds and the spread between the 10 year and over Canada bond yield minus the 90 day bill yield. There were several other false signals in the 1960s when the curve either inverted or came very close to doing so. One measure inverted ahead of the 1974 recession and the other did not.

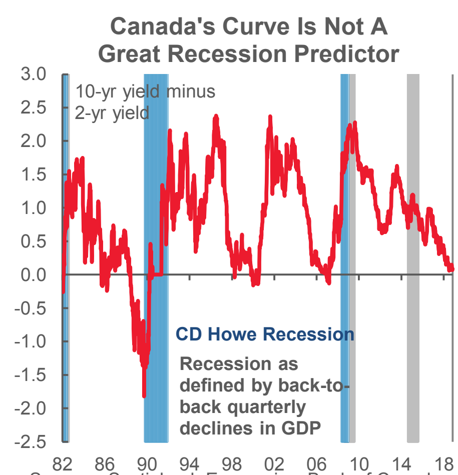
In addition to considering sovereign yield curves, **charts 18–21 evaluate corporate bond curves** using daily data on yields by maturity and risk rating in the US and

Chart 14



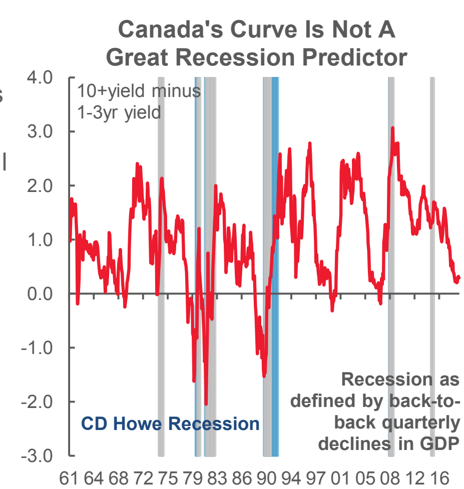
Sources: Scotiabank Economics, Bank of Canada, CD Howe.

Chart 15



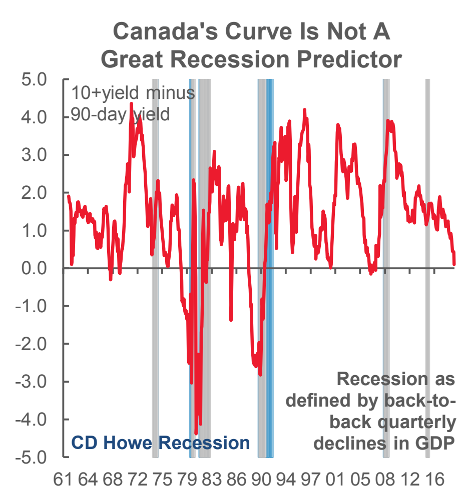
Sources: Scotiabank Economics, Bank of Canada, CD Howe.

Chart 16



Sources: Scotiabank Economics, BoC, CD Howe.

Chart 17



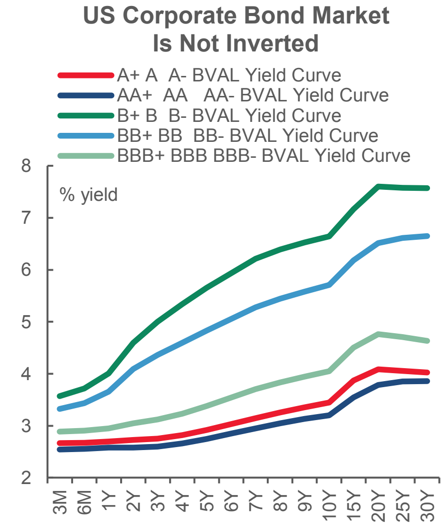
Sources: Scotiabank Economics, BoC, CD Howe.

Canadian markets. Chart 18 shows that the US corporate bond yield curve is flat to slightly upward sloping for the highest rated credits that are relatively closer to being government substitutes. There remains significant spread pick-up across maturities for other ratings. No risk rating curve is inverted. **This matters since lenders need positive spread pick-up to facilitate attractive lending conditions for longer term purposes and in turn that matters to the economy.** Chart 19 displays the 90s10s maturity spreads by risk rating in the US and how this corporate corollary to the best sovereign predictor of recessions remains positively sloped.

Charts 20 and 21 present the evidence for Canada. A distinction is that **the Canadian rating spread is more positive across all maturities and risk ratings including shorter dated maturities than is the case in the US.**

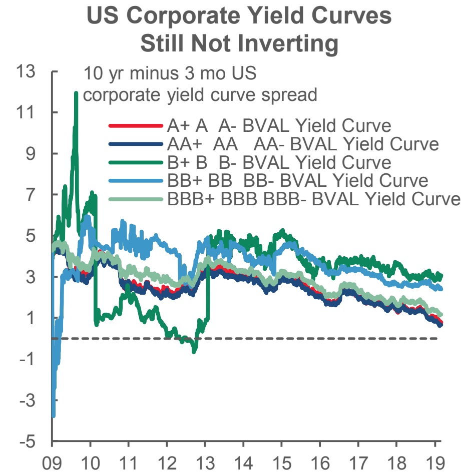
Other work done by Scotia's Nikita Perevalov (here) has indicated that the Canadian yield curve can be improved as a recession indicator by adding to a model the US yield curve slope and a confidence measure. This still yields a low probability of recession and even at that may be overstated for the reasons given here regarding the policy distortions to both countries' curves.

Chart 18



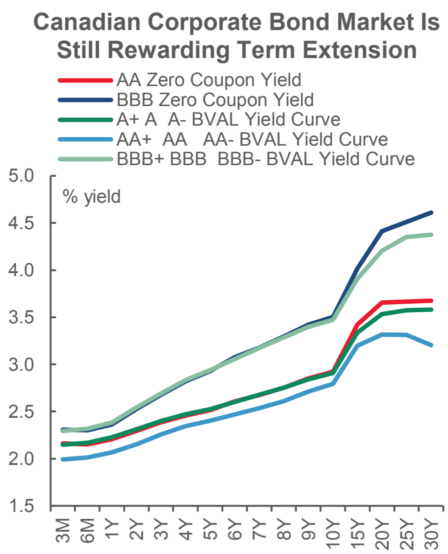
Sources: Scotiabank Economics, Bloomberg.

Chart 19



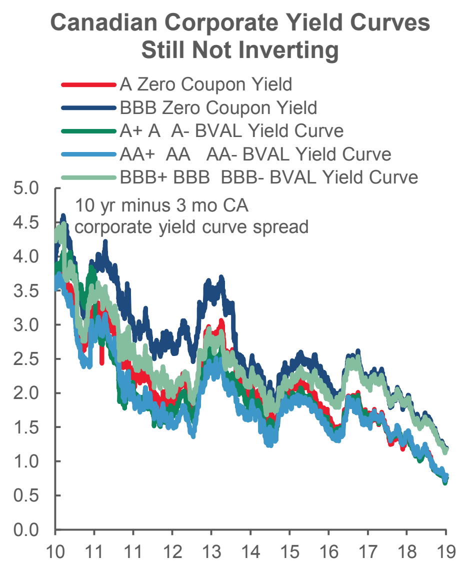
Sources: Scotiabank Economics, Bloomberg.

Chart 20



Sources: Scotiabank Economics, Bloomberg.

Chart 21



Sources: Scotiabank Economics, Bloomberg.

FEDERAL RESERVE—NOT NECESSARILY DONE

While present risks likely dampen most forecasters' conviction, we continue to prefer to argue that the Federal Reserve remains just shy of its neutral policy rate (2.75%) and could well return to fine-tuning the end of its hike cycle. In fact, we forecast one more hike and bracket this highest probability outcome by equal weights attached to two or none but lean particularly hard against a cutting scenario with the information presently available. The possibility of overshooting the neutral policy rate is driven by having eased financial conditions as explained thus far and by the expectation that the US economy will emerge from a not terribly 'soft' soft patch.

For now, the consensus of economists has abruptly revised its near-term forecasts for growth by tamping down Q1 expectations perhaps too far and punting a rebound into Q2 (chart 22). Such downward revisions were likely due to unanticipated idiosyncratic shocks like the government shutdown and periods of harsher-than-usual weather, but also due to pulled-forward demand due to stimulus that was applied earlier last year. This pulled forward effect should soon be maturing. Consensus did likewise with US core PCE inflation forecasts (chart 23). **Our house view calls for a rebound in growth** including the consumer sector over the duration of this year into next and **at a rate equal to or at times exceeding the economy's noninflationary potential growth rate.** The result would be to push the US economy further into excess aggregate demand when it is already running at the largest excess demand conditions since the early 2000s.

The Fed's desire to witness higher inflation readings to inform a renewed tightening bias may yet be fulfilled. Even with a flatter than historical Phillips curve, the lagging effects of the relatively recent move into excess demand conditions (chart 24) could combine with recent evidence of a topping USD and its disinflationary effects (chart 25) as well as firm wage growth to drive a gentle rise in core inflation.

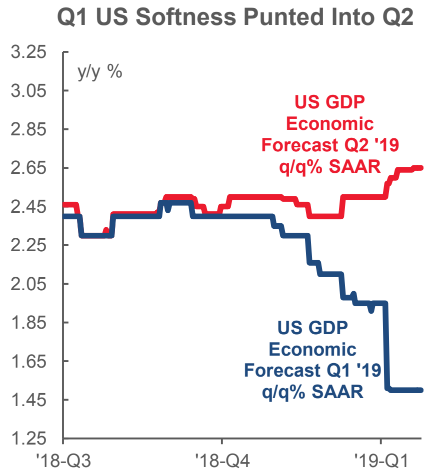
To return to tightening policy, however, requires continued improvement in market tone that analysts' expectations for resumed earnings growth after a soft Q1 may assist (chart 26). It also requires further traction toward settling major geopolitical risks such as Brexit, US-China trade negotiations, US-European trade negotiations, and US fiscal policy developments around the debt ceiling on top of a more stable US administration than witnessed to date. As a Presidential election year beckons, we assume that a focus on getting re-elected will translate to calmer policy amidst the rhetoric. **Instead of bashing the Fed and putting forth questionable candidates for the BoG, the best thing the Trump administration could do for the economy is get its fiscal policy and trade houses in order.**

A common assertion is that the Fed has never really paused a hike cycle with patient language only to resume hiking later on. This is not quite true. The so-called 'taper tantrum' in 2013 was one such example when the Fed announced that it would be tapering bond purchases under the QE3 program only to witness upheaval in the bond market. To the surprise of markets, the Fed postponed the decision to taper purchases in September of that year (an off-consensus call that Scotia Economics correctly made) during another destabilizing government shutdown. The Fed ultimately did return from hitting pause on its plans by reducing purchases at the December meeting. **Within well inside of a year, a hawkish stance that was pummelled back by dovish developments returned to hawkish action and may well offer a parallel to today.** In any event, even if such a recent parallel to a tighten-pause-tighten period did not exist, it's insufficient to argue against resumed hiking going forward just because of the past. **It may well be just another of a litany of things to happen this cycle without precedence and I've lost count of how many of those we're up to now!**

BANK OF CANADA—INTERRUPTED, NOT ABANDONED HIKES

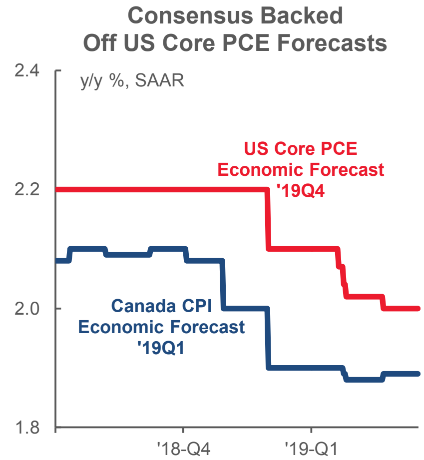
We continue to forecast one rate hike toward year-end and perhaps one more in 2020. This would still leave the policy rate toward or below the Bank of Canada's estimated range for the neutral policy rate. See Nikita Perevalov's piece here that lays out our house estimate of 'neutral' as we await the BoC's own update to its estimated range.

Chart 22



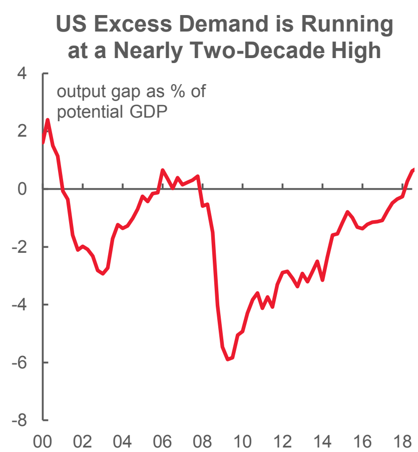
Sources: Scotiabank Economics, Bloomberg.

Chart 23



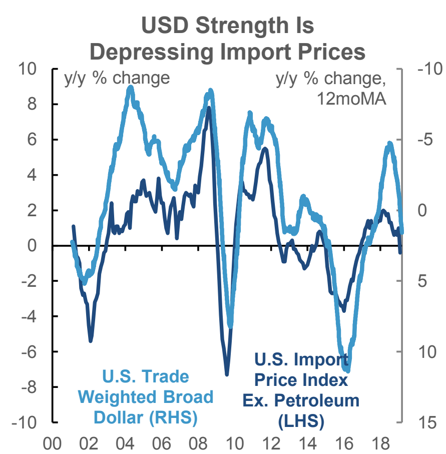
Sources: Scotiabank Economics, Bloomberg.

Chart 24



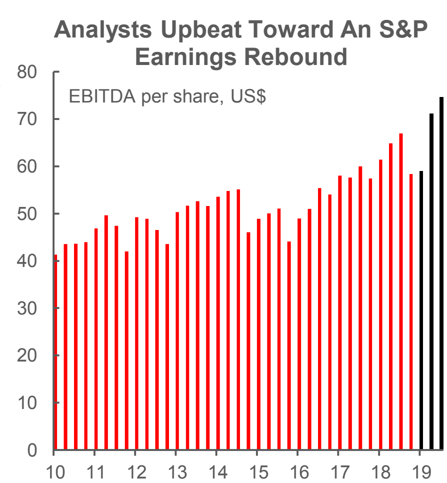
Sources: Scotiabank Economics, Congressional Budget Office.

Chart 25



Source: Scotiabank Economics, Bureau of Labour Statistics,Federal Reserve.

Chart 26



Sources: Scotiabank Economics, Bloomberg.

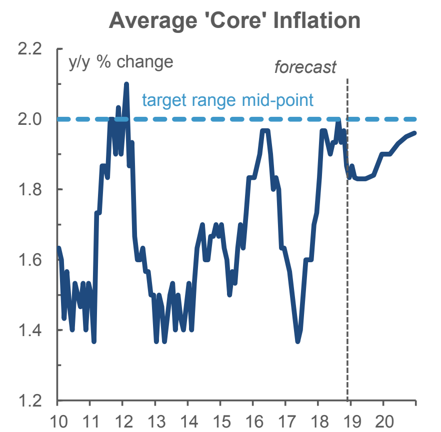
Many of the arguments presented thus far also inform our Bank of Canada views and therefore merit only a brief mention before returning to the role played by a fundamentals framework. For one thing, the Canadian sovereign debt curve is less useful than even the distorted US curve at predicting recessions. The corporate yield curve is more positively upward sloping than in the US. Canada has imported the bond market easing that the Fed has driven in addition to the effects of a more neutral sounding Bank of Canada than was the case at the start of the year. The BoC is as mindful toward geopolitical risks such as trade tensions, Brexit, US debt ceiling risks and potential trade conflict in the global auto sector as any other central bank and this is counselling near-term caution that can only be informed by the passage of unpredictable events that could turn out either favourably or not.

If there is a domestic case for easing, then markets likely view it as coming through moderate slippage in core inflation (chart 27) in the context of larger than previously estimated economic slack (chart 28). The greater slack derives from lowered GDP revisions over recent years and idiosyncratic factors that have weighed upon domestic growth of late.

This did indeed motivate the BoC to cut in 2015, but, dare we say it, this time may be truly different. **Conditions are unlike 2015 when there was a deeper and longer-lived correction in oil and other commodity prices.** The plunge in domestic oil prices due to transportation bottlenecks, inadequate pipeline capacity, lags in bringing rail transportation options to market and disruptions from last Fall's problems at US refineries has since reversed in favour of a very tight discount to WTI. This has lifted Canada's terms of trade—the ratio of export to import prices—by contrast to the more sustained plunge in the terms of trade from 2014-onward (chart 29). The implication is avoidance of the sustained drag effect on domestic incomes that would otherwise result from sustainably lower commodity prices.

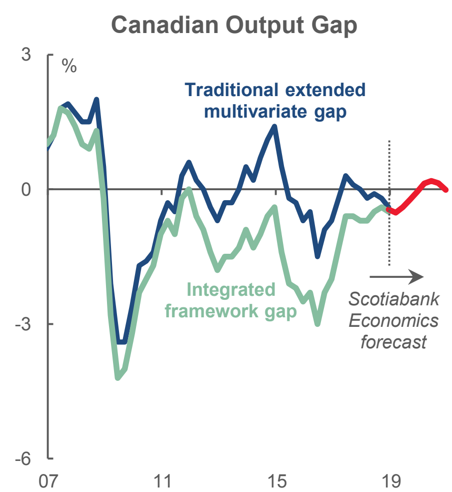
Going forward, charts 27 and 28 also depict our forecasts for a return to closing off spare capacity in the economy and a return to 2% core inflation as the operational guide to the BoC's 2% headline target toward the end of this year or early next. **Around that time frame, we anticipate that having closed capacity and "returned home" as Governor Poloz puts it will require converging the policy rate toward neutral.**

Chart 27



Sources: Scotiabank Economics, Statistics Canada.

Chart 28

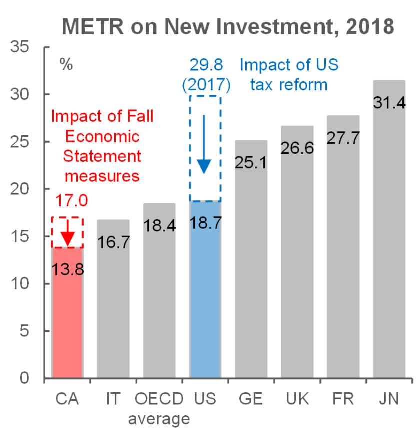


Sources: Scotiabank Economics, Bank of Canada.

Chart 29

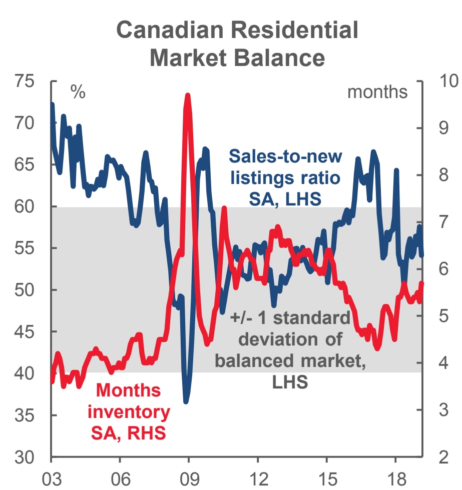
Sources: Scotiabank Economics, Statistics Canada.

Chart 30



Source: Department of Finance Canada, Fall Economic Statement.

Chart 31



Sources: Scotiabank Economics, CREA.

Buttressing the argument in favour of renewed hikes once slack is absorbed from a transitory soft patch are the facts that the BoC faces a weak dollar by contrast to the Fed and a policy rate 75bps lower than the Fed's and hence more stimulative relative to neutral rate estimates. Strong job growth should assist the household sector outlook while strong tax incentives could lift business investment (chart 30). Materially higher immigration helps housing with overall balanced conditions in the nationwide resale market (chart 31). Having signed several trade agreements in recent years is also positive for growth subject to CUSMA implementation risk.

Table 1
Scotiabank Economics' Canada-US Yield Curve Forecast

	2018	2019				2020			
	(end of quarter, %)								
Canada	**Q4**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
BoC Overnight Target Rate	1.75	1.75	1.75	1.75	2.00	2.00	2.25	2.25	2.25
Prime Rate	3.95	3.95	3.95	3.95	4.20	4.20	4.45	4.45	4.45
3-month T-bill	1.65	1.67	1.75	1.80	2.00	2.05	2.25	2.25	2.25
2-year Canada	1.86	1.55	1.70	1.80	2.05	2.10	2.30	2.30	2.30
5-year Canada	1.89	1.52	1.75	1.90	2.10	2.20	2.35	2.35	2.35
10-year Canada	1.97	1.62	1.80	2.00	2.20	2.35	2.45	2.45	2.45
30-year Canada	2.18	1.89	2.10	2.20	2.40	2.50	2.75	2.75	2.75
United States	**Q4**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Fed Funds Target Rate	2.50	2.50	2.50	2.50	2.50	2.75	2.75	2.75	2.75
Prime Rate	5.50	5.50	5.50	5.50	5.50	5.75	5.75	5.75	5.75
3-month T-bill	2.36	2.39	2.40	2.40	2.40	2.65	2.65	2.65	2.65
2-year Treasury	2.49	2.26	2.45	2.50	2.60	2.80	2.80	2.80	2.80
5-year Treasury	2.51	2.23	2.50	2.60	2.70	2.85	2.85	2.85	2.85
10-year Treasury	2.68	2.41	2.65	2.75	2.85	2.95	2.95	2.95	2.95
30-year Treasury	3.01	2.82	3.00	3.10	3.20	3.25	3.25	3.25	3.25

Sources: Scotiabank Economics, Bloomberg.

Mexico

LOSING ENERGY

- **Heightened uncertainty is leading to a slowdown in economic activity as investment stalls and public spending plans are delayed. Job creation is expected to cool down, leading to weaker private spending.**
- **Energy reforms have practically halted given significant changes in Pemex and the government. Market participants, analysts, rating agencies and investors have expressed concerns about the lack of a clear and convincing business plan in Pemex, thus putting pressure on the oil firms and sovereign ratings.**
- **Prospects for the Mexican economy are lackluster, with lower growth rates and plenty of risks on the horizon. Banco de Mexico is expected to remain firm on their monetary stance until core inflation presents a clear downward trend, perhaps in 2020Q1.**

The Mexican economy is losing energy. Real GDP grew only 1.7% y/y in 18Q4, presenting a marked contrast within its main components, as industrial production fell 0.9% while the services sector grew 2.7%. A large part of the industrial weakness is explained by the persistent decline in oil extraction (-8.2% real y/y in Q4) due to oilfield depletion and Pemex's structural problems. Adding to the weakness in Q4 was a decline in construction (-2.2% real y/y), which could reflect broader uncertainty.

Higher frequency indicators point to an extension of the slowdown. Job creation, as measured by the number of insured persons in the Mexican Social Security Institute (IMSS), is clearly decelerating (see chart 1). After a growth of 4.5% y/y and more than 850 thousand jobs created in the previous 12 months in April–May of last year, data for February show a marked deceleration to y/y growth of 3.1% and an increase of only 604 thousand jobs recorded. There is also a very clear downward trend in consumption and capital goods imports, that fell 5.3% and 5.5% y/y last February (chart 2).

The key narrative is that there are many factors producing high uncertainty that is curbing down investment, thus affecting job creation and then producing a more cautious consumer and a weaker economic activity.

Developments in the energy sector are a key factor affecting investment perspectives. The cancellation of oil and energy bidding processes as well as the delays in Pemex "farm-outs" have effectively halted the Energy Reform, which was expected to provide a large amount of investments for the country. There is also a widely controversial change in Pemex business plan, which now is preparing to build a new refinery in Dos Bocas, Tabasco, which markets, analysts and rating agencies reckon as a bad bet for a firm with a lot of operational problems and under financial stress. A financial support plan for Pemex is yet to be announced by the Government, which is considering using its "rainy day" fund

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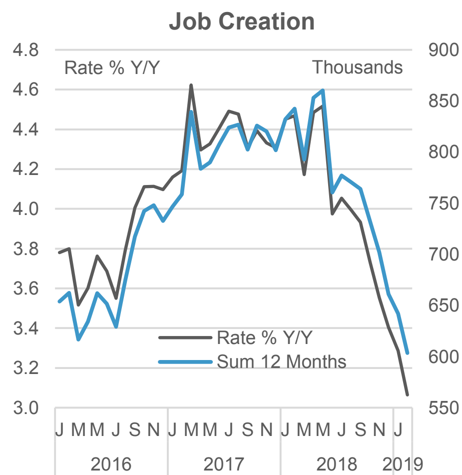
Mexico	2017	2018	2019f	2020f
Real GDP (annual % change)	2.1	2.0	1.4	1.3
CPI (y/y %, eop)	6.8	4.8	4.0	3.8
Central bank policy rate (%, eop)	7.25	8.25	8.25	7.50
Mexican peso (USDMXN, eop)	19.66	19.65	21.26	21.71

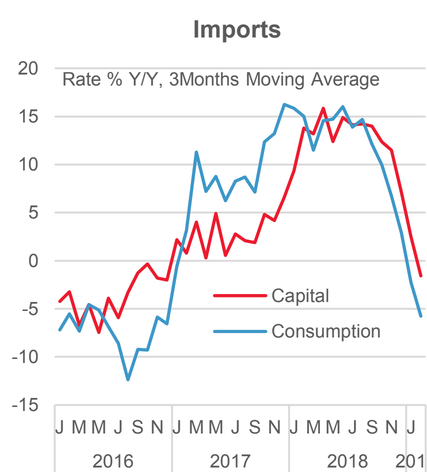
Source: Scotiabank Economics.

Chart 1



Source: Mexican Social Security Institute.

Chart 2

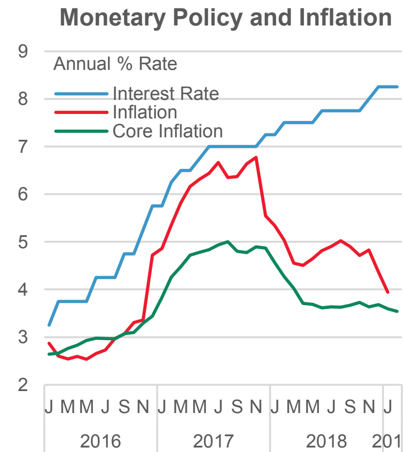


Source: Institute of Geography and Statistics.

(public revenue stabilization fund) as well as changing the tax regime of Pemex to alleviate the most urgent financial needs of the oil company. Pemex's finances are closely tied to the Government's, and if Pemex and the Federal Government are not able to provide a convincing business plan to restore the oil company's profitability, then both Pemex and sovereign debt ratings will be on a negative direction.

For the time being, one of the factors perceived as a clear positive is fiscal discipline. Hacienda set a target of a 1.0% of GDP primary surplus for 2019, and so far they are delivering on this commitment, with a primary balance above target in the first two months of the year (MXN 57.7 billion vs. 12.4 billion). There is, however, a risk of execution, as rating agencies have named it. As the economy weakens, tax revenues will be lower, as is already perceived in recent data, with tax collection and specially value added tax revenues below target (577.8 billion vs. 590.9 billion in the first case and 165.7 billion vs. 180.5 billion in the second). These numbers also suggest that economic activity is slowing down.

Chart 3



Sources: Banxico, Institute of Geography and Statistics.

There were some particular and unusual events in the first quarter that will have a negative but transitory impact on economic activity: an unfortunate disruption in fuel distribution in many states including large metropolitan areas, associated with fuel-theft combat, produced delays and many wasted hours for citizens in January. The blockade that some members of the Teacher's Union organized to railroads in Michoacán also caused economic disruptions. Finally, labor strikes in Matamoros, Tamaulipas, affecting several "maquiladoras", also had a toll on economic activity.

It is usual that in the first year of a new Government there is a delay in public spending, since the new officials have to pass the learning curve process of their new job. This year, however, a longer and deeper delay is expected, because a deep restructuring of the Federal Government is underway. The cap on wages of civil servants is leading to an exodus of human capital within the Government, with many vacancies in key positions and many newcomers without the required experience or skills.

Looking forward, the economy is expected to show a lackluster performance, with a 1.4% real growth in this year and 1.3% in 2020. Total investment is forecast to fall 3.1% in 2019 and 1.1% in 2020, while private consumption should expand by 1.6% in both years. Exports will remain as one of the engines for the economy, growing 4.8% and 3.8% in the non-oil sector for this year and the next in US dollar terms, provided that the US Government does not do something as extreme as putting tariffs on automobiles or shutting the border.

After the Federal Reserve made a significant change in its future guidance for their monetary policy, it is now expected that Banco de Mexico will keep its reference interest rate on hold for the reminder of the year and will start a reduction cycle at the beginning of 2020. This of course depends on the behavior of inflation, which we expect will decline gradually owing to the slowdown in growth. Financial markets in Mexico were already discounting a significant change in Banco de Mexico's tone and up to three cuts in the reference interest rate during this year. However, Banco de Mexico presented a firm tone and kept the upward bias in the balance of risks for inflation in their last monetary policy decision, meaning they are more inclined to wait and see. Worth noting is that, as public finances are expected to remain under pressure as the economy weakens, monetary policy becomes the most important anchor for the economy. Banxico knows this.

Regarding to the exchange rate, we anticipate high volatility throughout the year, as has happened in previous years, reacting to the fluctuations in expectations and in the global risk perception among international investors. In an adverse financial environment for emerging markets, a moderate depreciation of the national currency, reaching levels above 21 pesos per dollar by year-end, is expected.

More factors could produce an adverse economic scenario than a positive one, impelling a downward bias for economic activity in the outlook. Among those negative factors are: the possibility of greater financial problems in Pemex that could spread into the public finances that end up producing a sovereign rating downgrade; a potential erosion in the fiscal position if public revenues do not grow at the expected rate, a worsening in Mexico's rule of law; a more drastic contraction in foreign direct investment and total investment of the economy; new inflationary shocks that keep inflation from resuming its downward trend leading to a more restrictive monetary policy from Banco de México. On the external side, there is the possibility of global financial tensions due to events such as: an escalation of global trade frictions, a more abrupt slowdown in the global economy, a hard Brexit with negative global spillovers; a stronger deterioration among emerging markets and the possible surge of new geopolitical tensions.

Among the domestic factors that can produce a more favorable outlook for Mexico are: a convincing business plan for Pemex and the energy sector leading to greater productivity and profitability; a resumption of the oil and electricity auctions, a reallocation of social spending, actions to strengthen the rule of law; an injection of confidence into business sentiment to trigger investment; a growth in public revenues above what is expected as more taxpayers are included in the regulated sector; unexpected positive shocks that help reduce the inflation dynamics; and a shift of the sovereign rating to a positive outlook. External factors that could lead to a better scenario include: the dilution of global trade tensions, a successful agreement between the US and China; a considerable reduction in global risk perception, especially in emerging markets; and a pickup in the pace of economic activity in China and Europe.

Colombia

THE TALE OF TWO DEFICITS, IS IT SUSTAINABLE?

- **Colombian economic activity is gradually accelerating. Inflation and inflation expectations are under control, while the policy rate is slightly expansionary. A very gradual removal of monetary stimulus continues to be expected.**
- **External and fiscal imbalances in Colombia are growing at an uncomfortable pace. The recent relaxation of the fiscal rule and deterioration in the current account deficit for 2018 and 2019 might trigger a downgrade by ratings agencies, but investment grade should be maintained.**

The recovery of domestic demand recovery accelerated last year. While 2018 GDP grew 2.6% (from 1.4% in 2017) domestic demand rose 3.8% (from 1.2% in 2017). Recent indicators such as manufacturing activity, retail sales, energy demand, capital goods imports, point to further acceleration in domestic demand recovery. As the fiscal deficit has been larger than planned, the strength of domestic demand and fiscal deficit are leading to a larger deficit of the current account, raising some concerns. On the other hand, inflation pressures remain low despite the acceleration in growth as the economy is still running below potential.

The central government deficit was 3.1% of GDP last year after the independent fiscal committee allowed the government to borrow 0.4pp of GDP more than initially agreed in 2017, due to higher spare capacity in the economy. In fact, the most recent fiscal committee calculations says that economy will only run at potential by 2024 with the negative output gap widening to 3.7% in 2018. Additionally, the most recent fiscal committee decisions invoked an escape clause and increased the deficit target for 2019 by 0.3% to 2.7% and by 0.1% to 2.3% of GDP in 2020 to give the government a bit more room maneuver given the temporary spike in Venezuelan immigration and associated social expenditures. The size of the increase is reasonably small and hasn't, been much of an issue for markets. Rather, market concerns are focused on the ease with which it was raised suggests a much more flexible fiscal rule that thought.

The currency account deficit remains a concern. It stood at 3.4% of GDP in 2017 (in 2015 was 6.3% of GDP), it widened to 3.8% in 2018. Financing the deficit has thus far not been a challenge, as FDI has covered 105% of current account deficit (in 2018 was 87%). One interesting fact is that since domestic production of durable goods is low, economic expansions (especially investment) has been required a deterioration in current account deficit via higher capital and raw materials imports. The recent acceleration in domestic demand has followed this pattern, as imports of capital and raw materials have grown by close to 12% y/y. Normally imports of capital goods come with their own financing as a FDI but the large current account deficit means the recovery in domestic demand remains very reliant on external finance.

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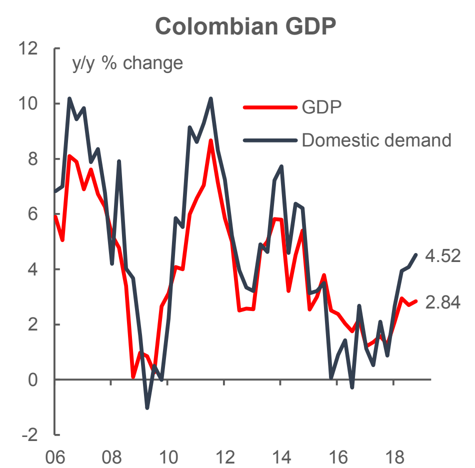
Colombia	2017	2018	2019f	2020f
Real GDP (annual % change)	1.8	2.6	3.4	3.8
CPI (y/y %, eop)	4.1	3.2	3.2	3.1
Central bank policy rate (%, eop)	4.75	4.25	4.50	4.75
Colombian peso (USDCOP, eop)	2,986	3,254	3,120	3,167

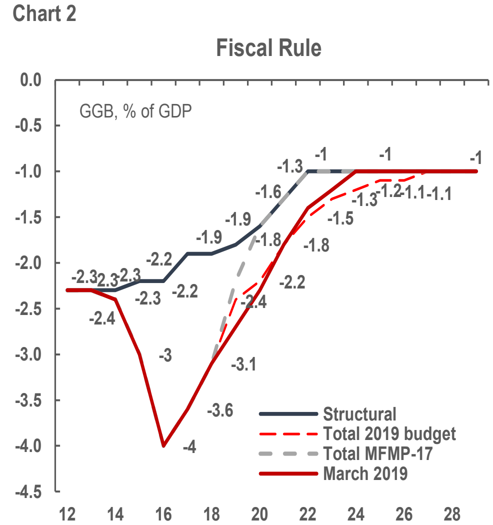
Source: Scotiabank Economics.

Chart 1



Sources: DANE, Scotiabank Economics.

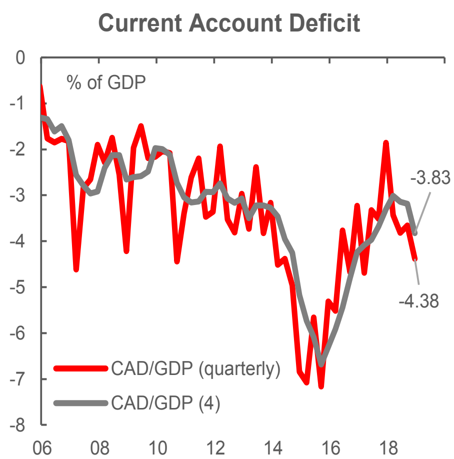
Chart 2



Sources: Comité de regla fiscal, Scotiabank Economics.

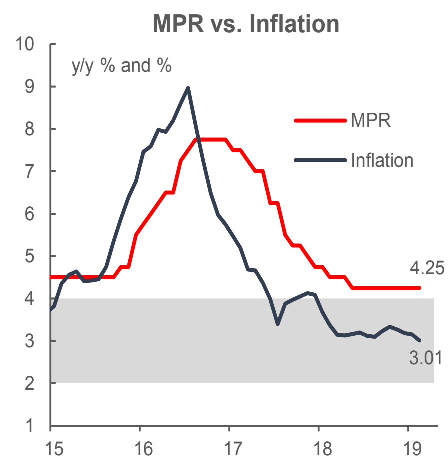
The elevated current account should not have an impact on the conduct of monetary policy, even though some analysts believe it will. BanRep has made it very clear that it considers the monetary policy rate an inappropriate tool to manage the country's external position. As a consequence, we do not believe BanRep will tighten policy to achieve this. With inflation will in the middle of the target range, inflation expectations well contained, and the Fed and ECB having adopted more dovish positions, there is no rush for BanRep to tighten policy in the face of strengthening growth. We anticipate that BanRep will keep the policy rate at 4.25% as long as inflation and inflation expectations remain close to target and the economy continue its gradual recovery. Therefore we think BanRep will only hike its policy rate once this year to 4.5% in September, once the growth outcomes in the first half of the year is released.

Chart 3



Sources: Banco de la República, Scotiabank Economics.

Chart 4



Sources: Banco de la República, DANE, Scotiabank Economics.

Peru

WITH 1Q2019 WEAKER THAN EXPECTED, WE SWITCH FROM UPSIDE TO DOWNSIDE RISK ON GDP GROWTH

- **A decline in government investment and resource sectors is impinging on growth.**
- **Consumption remains strong, but private investment is mild and patchy.**
- **Low inflation has the Central Bank signaling "less and later" on increasing its policy rate.**
- **The CB returned to the FX spot market after 14 months, to rein in the PEN appreciation.**
- **Macropolitics have improved, social conflict and corruption still a concern.**

We've lowered our 1Q19 GDP growth forecast from 3.7% to 3.2% y/y. GDP growth was a dismal 1.6% y/y, in January. February will be only slightly better. Most of quarterly growth will come in March, although this will largely be due to more working days as Easter will switch to April this year.

Two factors are behind GDP's underperformance in 1Q, namely, negative growth in resource sectors, and a sharp drop in public sector investment. Both were foreseen, but the magnitude has been greater than expected. The decline in fishing output (we expect -18% growth in 1Q) is temporary, and has to do with the impact of a weak Niño and shifts in fishing seasons. Mining GDP should end up in line with our forecast of 2.3% for the full year, as long as production at the Las Bambas copper mine is not too greatly affected by the social conflict that has been ongoing since February.

The main disappointment in 1Q, however, is public investment, down 6% in January and 29% in February. This reflects high rotation in regional and local governments since January 1, following last year's elections. Note that preliminary information suggests a rather sharp increase in March, however, so there is still hope. In general, public investment continues to be the swing factor for GDP growth in 2019. If it continues to be as weak as it has been in January–February, then reaching 4.0% aggregate GDP growth for the year will be more challenging. It is, however, a bit early to draw conclusions, as government investment is generally more volatile in the first quarter of each year.

Meanwhile, the private sector continues to fuel the economy. Consumption is robust enough for us to raise our 2019 forecast from 3.3% to 3.6%. Private investment, however, is showing initial signs of flagging a bit, judging from the deceleration of business loans growth, from 7.6% y/y, at the end of 2018, to 5.3% in February. Mining investment is the exception, having risen 48% y/y, in January. This should continue, despite social conflict. We have raised our forecasts for 2019 mining investment growth to 23%, from 14%. This represents an increase in

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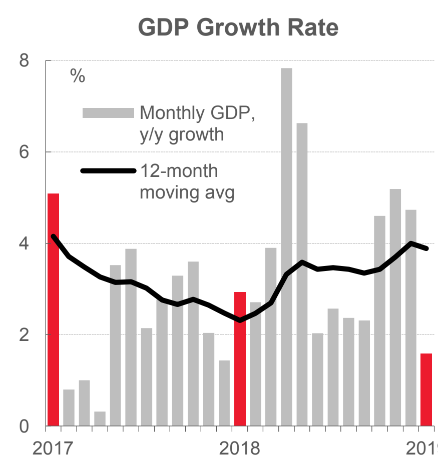
Peru	2017	2018	2019f	2020f
Real GDP (annual % change)	2.5	4.0	4.0	4.0
CPI (y/y %, eop)	1.4	2.2	2.4	2.5
Central bank policy rate (%, eop)	3.25	2.75	2.75	2.75
Peruvian sol (USDPEN, eop)	3.24	3.37	3.30	3.25

Source: Scotiabank Economics.

Chart 1



Sources: INEI; Forecasts: Scotiabank Peru Research.

total mining investment from US$4.95b in 2018, to US$6b in 2019, the highest figure in four years.

In sum, there is a divergence between resource sectors and non-resource sectors. At the same time, domestic demand leads growth, but its strength may have waned a little, due to low public investment. First quarter aggregate GDP growth overstates the magnitude of the slowdown, however, and is not indicative of a broad decline.

Inflation, at 2.2% to March, continues well within the Central Bank comfort zone. On balance, the CB perceives that upside inflation risks (low external demand and global market volatility) are compensated by downside risks (lower domestic demand), such that overall risk is neutral. With inflation near where it should be, an economy that is growing but not overheating, a well-behaved FX market, and metal prices that are neither hot nor cold, the CB has been more vocal about its intention to keep the reference rate stable, at 2.75%, for longer. The caveat to this view: the real rate is 0.35%, which means monetary policy is substantially expansionary for an economy growing at 4.0%. However, with the CB nested in its comfort zone, in an economy with very stable indicators, this low real rate is not factoring in on Central Bank decisions for the time being. At least, judging from the signals it is giving. As a result, we are changing our view of one reference rate hike in 2019, to none.

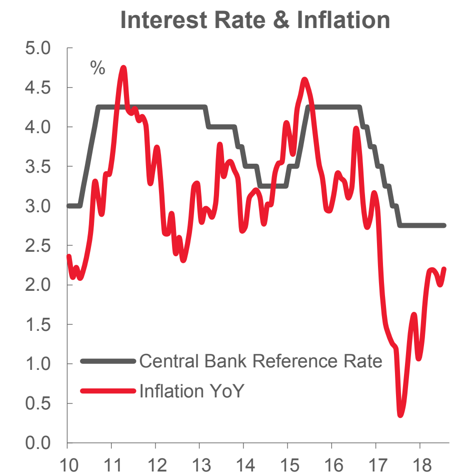
The Central Bank has changed its behavior in one area, however. After nearly 14 months of not intervening in the FX spot market, the Central Bank began to do so, in earnest, in March. This is likely linked to a US$3b inflow of offshore capital into sovereign bonds in 1Q. The CB tends to be more active in the FX market when it views large movements in short-term capital flows. Total offshore participation in sovereign bonds outstanding has risen to 51% in March, from 46% in December.

Peru's fiscal deficit fell to 2.1% in the twelve months to February, after ending 2018 at 2.5%. This is in line with our expectations of a 2.0% deficit for full-year 2019.

Politics continue to be messy, but are in general less of a threat than in 2018. Governability has improved, with a new cabinet, a stronger presidency and weaker opposition in Congress. The new cabinet that was appointed in March is likely to prove centrist and market friendly. Cabinet head Salvador del Solar is known to be reasonable, a good communicator, and non-corrupt, but has relatively little political experience, which is a risk. One of the first critical situations that Del Solar is facing is the social conflict surrounding MMG's Las Bambas copper mine. The access road to the mine has been blocked by a local community since early February, prompting Las Bambas to state that "force majeure will be declared under sales contract". Las Bambas represents 16% of the country's total copper output, or about 1% of total GDP, which will only impact our aggregate GDP forecast if output is affected for a prolonged time.

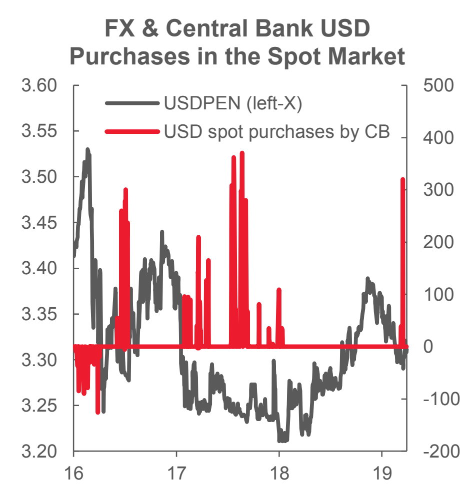
Finance Minister Carlos Oliva has been ratified, so we expect no major surprises in economic policy. Changes within the cabinet are likely to affect certain sectorial policies, but will not necessarily mean profound changes in overall policy guidelines or management. Del Solar will need to prove himself in establishing good relationships with regional governments, in accelerating government investment, and in managing the thorny, and ongoing, corruption issues in the country.

Chart 2



Sources: BCR, Scotiabank Peru Research.

Chart 3



Sources: BCR, Scotiabank Peru Research.

Chile

GROWTH TRACTION STILL ELUSIVE

- **We continue to anticipate an expansion of around 3.2% for the current year and next, with domestic demand led by investment and the velocity of the latter being highly conditioned, as usual, on the approval of political reforms and positive terms of trade. Growth is expected to accelerate as the year progresses.**
- **The unemployment rate is expected to decline only gradually, containing wage pressures and helping to keep a lid on inflation, which should reach 2.8% in 2019. As a result, the central bank should raise rates very gradually, with just one 25bp hike in Q4 and two more in H1 2020.**
- **Political developments are critical to the outlook, as reforms proposed by the Government are critical to improving the business environment.**

MACRO UPDATE

The Chilean economy grew 4% in 2018, in line with expectations, though growth slowed markedly as the year progressed. The difference between the very dynamic H1 (5%) and the rather sluggish H2 (3.1%) was notable and was evident in most of the sectors. Despite the fact that the last quarter of 2018 showed some acceleration compared with the previous one, the start of the current year has been weak. On the other hand, domestic demand grew 4.7% last year, led by investment (dominated by machinery), but consumption also increased 4% and government consumption slowed to 2.2%, its lowest pace in a decade. Most of the headwinds that pressed on expectations in H2, including the decrease in copper prices and the slow process of reforms pursued by the Government, may still be holding back growth. We maintain our forecast of growth around 3.2% for the current year and the next, with domestic demand led by investment and with the velocity of the latter highly conditioned, as usual, by the approval of political reforms and positive terms of trade. While some uptrend is undeniable and has been recently backed by reliable reports focused on planned investment, we expect the first half of the year to be slower in terms of growth than H2.

Consumption could be a laggard of the recovery because the labor market is not expected to rebound strongly in 2019. First, though arguably due to statistical anomalies, employment growth has remained low due to both cyclical and specific reasons. In 2018 the average unemployment rate reached to 6.9% and data for the first two months of 2019 did not show material improvements. Accordingly, the unemployment rate will remain elevated, and will lead to muted increases in wages and salaries. That will keep costs and inflation contained. As a reference, the 12 month inflation and core inflation (which excludes food and energy) are closer to 2% than to 3% (the central bank's inflation target for the next two years). Nevertheless, our inflation expectation is 2.8% for current year, while other market forecasts are higher. The main reasons for that divergence is weak service sector inflation, the effect of some regulated prices and a planned increase to the minimum wage in coming months, in addition to some upward effect from the exchange rate that is still in the pipeline.

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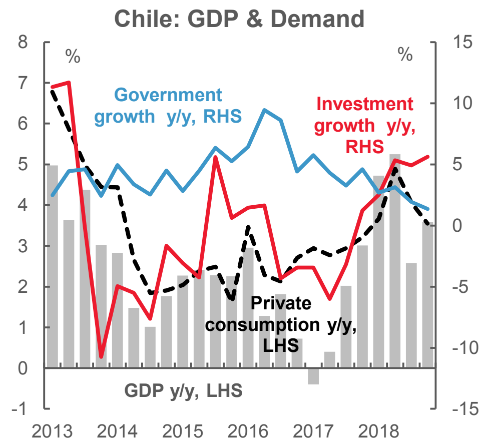
Chile	2017	2018	2019f	2020f
Real GDP (annual % change)	1.5	4.0	3.2	3.2
CPI (y/y %, eop)	2.3	2.6	2.8	3.0
Central bank policy rate (%, eop)	2.50	2.75	3.25	3.75
Chilean peso (USDCLP, eop)	615	694	650	640

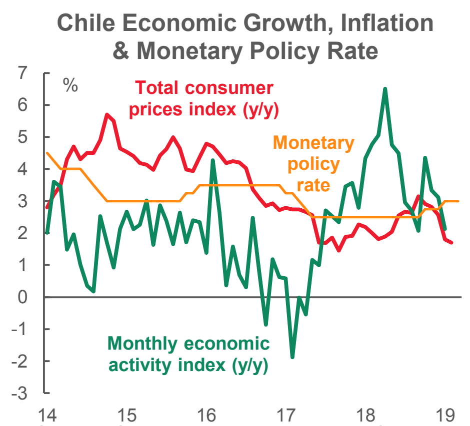
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Central Bank of Chile (BCCh).

Chart 2



Sources: Scotiabank Economics, Banco Central de Chile (BCCh), Instituto Nacional de Estadísticas (INE).

Accordingly, the monetary policy outlook is becoming less hawkish: the market that was calling for three MPR hikes last December (25bp each) to reach 3.5% or even 3.75% at the end of the current year is now mostly expecting one hike. That is our base case too, and we expect that to happen in Q4. Lower inflation, higher excess capacity and a more challenging external scenario are behind this new less hawkish normalization path, though we also expect a couple of hikes in the first half of next year. In the same line, the Central Bank adjusted downward growth and inflation projections for this year in its recently published Monetary Policy report. For the next report (due in June) it is expected that the Central Bank will revise the estimated neutral MPR, and most of the market is forecasting they will cut that estimate to a range between 3.75% and 4.25%.

POLITICAL PANORAMA: LAST YEAR WITHOUT ELECTIONS LIMITS TIME TO REACH AGREEMENTS

The political panorama has become critical in the sense that the final result of reforms proposed by the Government, whose coalition does not have majority in any Congress chamber, seems to be a determining factor to improving the business environment. First in the list of priority is the tax system reform, which will try to re-establish a link between corporate and personal income, which should stimulate and make easier the private investment process. The opposition is demanding some compensation (removing other tax exemptions, for example). More important than the volume of money involved in the change might be the style of the final solution and how fast it is reached in order to get a sharper picture for investors. We think the final result will unlikely be optimal, but some agreement with moderate opposition members could be reached to solve the impasse and to loosen some tax system knots. That could happen within 3 to 6 months. A simpler path is likely the pension system reform, which is expected to increase the contribution rate in order to improve future pensions, but the process would be gradual. On the other hand, the hardest work to be done is related to the labor reform, but in that case the Government has been intending to reach partial agreements. A more complete and powerful change is unlikely. There are no elections planned this year, so the Administration has an opportunity to focus on passing these key reforms without the burden of an electoral campaign.

MAIN RISKS: MORE OF THE SAME

The main risks haven't changed in some time. Foreign conditions are challenging and most of them are linked to the behavior of terms of trade. Copper prices have been rising moderately in the last three months, but risk of a correction due to a renewed weakness in China, for example, is the most important source of concern. Domestically, the main risk is political: the ability to reach agreements to approve critical reforms to enhance growth potential.

United Kingdom

- **Growth should remain sluggish this year and next given Brexit-related uncertainty and reduced global growth prospects. Alongside depressed economic growth and below-target inflation, we expect the BoE to remain on hold until Q3-2020.**

The UK economic outlook remains unambiguously binary. On one side is our baseline forecast: an orderly exit from the European Union—with bouts of political uncertainty on the way to its formalisation—where growth remains relatively sluggish in the near-term as the British economy adjusts to a post-Brexit world. In the opposite direction is a 'hard-Brexit' where an undevised break-up of political and economic ties with continental Europe pushes the UK into a recession in the latter part of 2019.

After cutting it close to a no-deal divorce on April 12, the EU has granted the UK a delay on its exit from the bloc until as late as October 31—with a compliance-check scheduled at the end of June—after PM May's agreement with the EU, and various alternative proposals to the EU-split, were rejected on multiple occasions by Parliament. Given the steep economic costs of a 'hard-Brexit', we continue to expect that sense will prevail in the UK and lawmakers will settle on a negotiated process for separation. Political uncertainty should remain elevated, however, given the possibility that the UK will negotiate with the EU under new leadership; PM May's time at the helm of the British government may be nearing an end due to a resounding failure to garner enough support for her deal with the EU.

While economic sentiment continues to worsen among households, rapidly rising wages and falling inflation have led to a sustained expansion in retail spending since summer 2018 (chart 1). Non-fuel retail sales volumes have risen by an average of 3.6% y/y since May 2018 in tandem with a 3.2% y/y average increase in wages during the same period on the back of the lowest unemployment rate in over forty years. Nevertheless, we anticipate that economic uncertainty, as well as slowing job creation, will begin to feed into reduced consumer spending growth in 2019 as households bolster their savings.

We forecast that GDP growth in the UK will reach a cycle bottom of 1.1% in 2019 before ticking up slightly in 2020 to 1.2%. Following last year's economic expansion of 1.4%, slower growth will follow in 2019 as business investment—which contracted through each quarter of 2018—is projected to decline for a second consecutive year, bogged down by Brexit-related uncertainty and reduced global growth prospects. A jump in government spending, principally on health, should, however, provide a boost to growth in the near term against declines in capital expenditures and household consumption.

Under our current baseline which considers an orderly exit from the European Union accompanied by sluggish growth through the forecast horizon, we expect the Bank of England to increase its policy rate only once in the second quarter of 2020 to 1.00%, up from 0.75% currently. We anticipate that inflation in the UK will not return to the BoE's 2% target prior to 2020 as falling energy prices and the fading impact on domestic prices from past GBP depreciation, as well as the fact that British economic output remains a tad below potential, are set to offset the upward pressure of rising wages on consumer prices.

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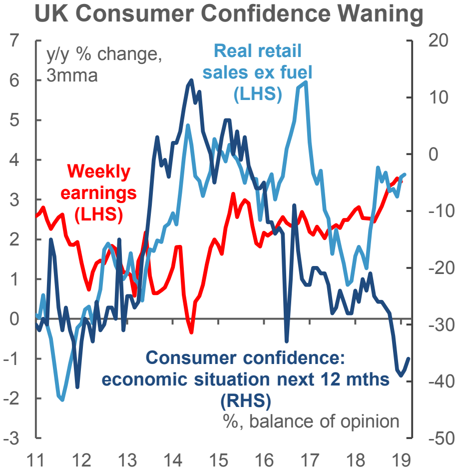
United Kingdom	2017	2018	2019f	2020f
Real GDP (annual % change)	1.8	1.4	1.1	1.2
CPI (y/y %, eop)	3.0	2.1	1.9	2.0
Central bank policy rate (%, eop)	0.50	0.75	0.75	1.00
UK pound (GBPUSD, eop)	1.35	1.28	1.40	1.45

Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Gfk, ONS.

Eurozone

- **We forecast that Eurozone real GDP growth will slow in 2019 owing to global trade and geopolitical uncertainty as well as certain transitory factors impacting the European industrial sector.**
- **The ECB is expected to maintain its accommodative monetary policy with no policy rate increases projected through our forecast horizon amid sluggish growth and subdued inflation.**

Growth prospects for the Eurozone have worsened of late as country- and sector-specific issues disrupted the bloc's economic expansion in the second half of 2018, while the risk of US auto tariffs and a 'hard' Brexit loom negatively over business sentiment in the region. The weaker Chinese outlook will continue to dampen growth in the euro bloc, though we consider that Chinese policy measures will have good traction on that economy through 2019. We forecast real GDP growth in the Euro Area to slow to 1.1% in 2019, after 2018's pace of 1.8%, before picking up to 1.5% in 2020.

Despite adverse external factors weighing on the outlook for the European manufacturing sector, domestic demand in the Eurozone remains resilient on the back of steady job gains and accelerating wage growth, with the unemployment rate currently sitting at a post-financial-crisis low. Activity readings for the service sector—which accounts for about three-quarters of economic output in the bloc—have ticked up recently in opposition to manufacturing production (chart 1). In spite of declining economic sentiment, business investment should stay solid in 2019 as industrial operating rates remain significantly above their recent long-term average in the euro bloc (chart 2).

Fiscal loosening is set to boost growth in 2019 in the face of softening economic activity (chart 3). A 100-euro/month increase in employment bonuses for minimum -wage workers in France kicked in on January 1 among other measures deployed to counter civil unrest, while the Italian government aims to cut taxes and expand welfare outlays in their upcoming budget. The German federal government has also revised upwards its planned investment outlays for 2019, and has signaled that it would table a bill introducing tax incentives for R&D, though it remains strongly opposed to fiscal deficits.

Germany, the euro-bloc's largest economy, has experienced a sharp deterioration in exports, due in part to one-time production issues in the auto sector but also owing to economic woes in some of its principal trading partners. New vehicle emission standards in the EU which came into force in September 2018 caught German automakers flatfooted, forcing them to suspend assembly of non-compliant vehicles ahead of the new regulations (chart 4). Though we expect German auto production—which also disrupted upstream manufacturing sectors—to normalise in the coming months, reduced demand for vehicles amid slower growth in the continent should keep assembly levels subdued. France and Italy will similarly face losses from a global economic slowdown, but domestic issues—such as the 'gilets jaunes' protests in France and the lingering impact on business and consumer confidence of the months-long EU-Italian battle over fiscal restraint—will likely compound external headwinds.

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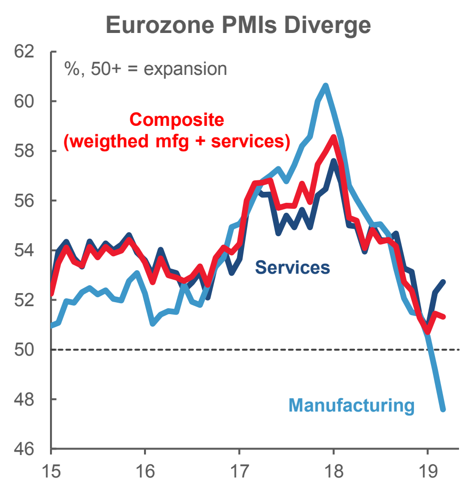
Eurozone	2017	2018	2019f	2020f
Real GDP (annual % change)	2.4	1.8	1.1	1.5
CPI (y/y %, eop)	1.3	1.5	1.2	1.6
Central bank policy rate (%, eop)	0.00	0.00	0.00	0.00
Euro (EURUSD, eop)	1.20	1.15	1.20	1.24

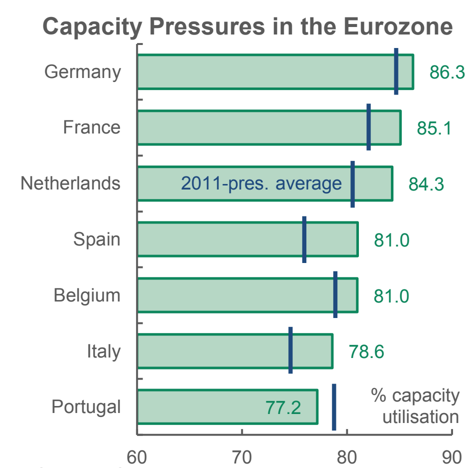
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, IHS Markit.

Chart 2

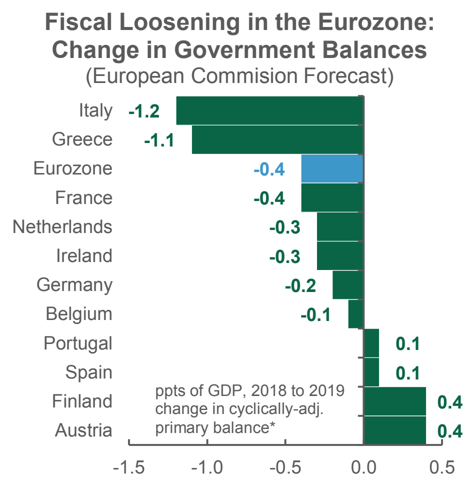


Sources: Scotiabank Economics, national statistics agencies.

We forecast that Eurozone HICP inflation will decelerate from 1.8% in 2018 to 1.2% in 2019, well beneath the ECB's target of 'below, but close to 2%'. After averaging 2.1% y/y from May to October last year, inflation in the euro area has markedly decelerated since November 2018 following a drop in energy prices (chart 5). While international oil prices have picked up since late-December, we anticipate that these gains will have only a short-lived impact on consumer prices: our latest forecast calls for Brent oil to average $67/bbl in 2019, down from $72/bbl in 2018. Prices excluding food and energy rose by only 0.8% y/y in March and are not expected to materially move the needle on headline inflation this year. Nevertheless, 'supercore' inflation has been on a steady upward trajectory since 2015 and may accelerate further on the back of rising employee compensation (chart 6).

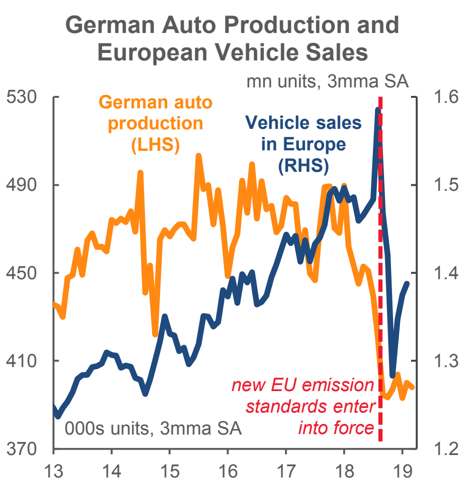
In light of weaker growth and subdued inflation, we believe that monetary policy will remain considerably accommodative in our forecast horizon, with the ECB's main refinancing and deposit facility policy rates set to remain unchanged at 0.00% and -0.40%, respectively, through 2019 and 2020. The ECB will also launch a third round of long-term loans to banks to maintain favourable credit conditions in the Eurozone beginning in September 2019, and will continue to reinvest funds from maturing securities acquired under its asset purchase programs which ran from March 2015 until December 2018.

Chart 3



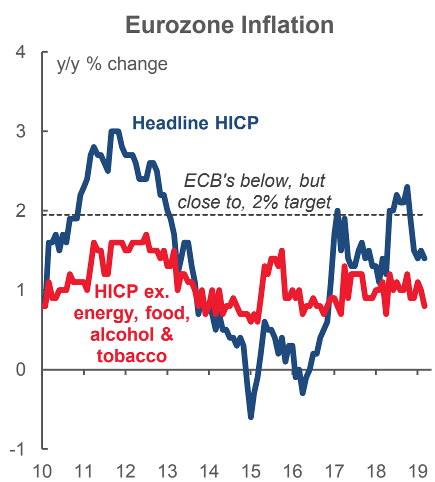
Sources: Scotiabank Economics, European Comm.
*fiscal balance that would apply under current policies if economy were at potential output, i.e. absent cyclical expenditure and revenue patterns.

Chart 4



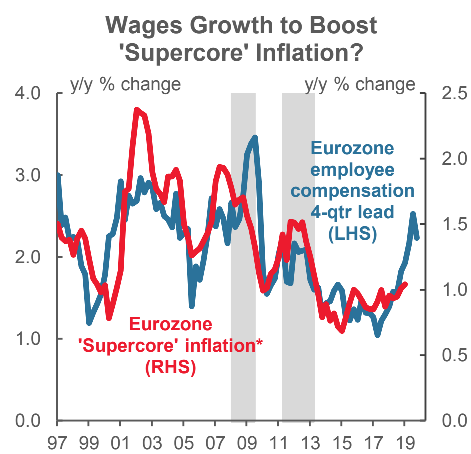
Sources: Scotiabank Economics, VdA.

Chart 5



Sources: Scotiabank Economics, Eurostat.

Chart 6



Sources: Scotiabank Economics, Eurostat, ECB, Haver Analytics.
*consumer prices excluding energy, food, alcohol, tobacco, air transportation, and packaged holidays (~2/3rds of headline basket).

China

- **Gradual real GDP growth deceleration will continue while stimulative fiscal and monetary policies are set to provide some counterbalance.**
- **The Chinese government remains committed to economic liberalization amidst ongoing trade negotiations with the US.**
- **China and the US are expected to reach a reasonably satisfactory agreement within the next couple of months, helping alleviate global growth concerns.**

ECONOMIC GROWTH OUTLOOK

The Chinese economy's long-term structural evolution toward a lower growth trajectory continues as activity becomes increasingly driven by the consumer and the services sector instead of fixed investment and the industrial sector (chart 1). Simultaneously, we identify two medium-term dynamics that are amplifying the economy's long-term trend. First, the government's deleveraging drive—a dominant policy priority in 2018—reduced access to credit as policymakers attempted to deflate the economy's financial imbalances stemming from the fast buildup of debt since the global financial crisis. We assess that the curtailing of funding over the course of last year is a key factor behind the current softer real GDP growth momentum. Nevertheless, policymakers' focus on deleveraging seems to be easing, which should help limit the downward pressure on the economy over the coming quarters. Second, the ongoing US-China trade dispute is reflected in external sector activity and China's export-oriented industries, with shipments to the US contracting from year-ago levels (chart 2). The dispute has triggered a weakening in sentiment, particularly in the manufacturing sector, yet early signs are emerging that business confidence is stabilizing on the back of recent progress in the trade talks.

High-frequency indicators reveal the economy's decelerating momentum. Activity in the industrial sector is weakening and its enterprises' profits are declining (chart 3). Softer retail sales and contracting auto sales demonstrate that households are less willing to spend in the current environment of elevated uncertainties and rising unemployment. Now, Chinese policymakers are taking decisive steps to counterbalance the downward pressure on the economy. The People's Bank of China (PBoC) has unveiled monetary stimulus measures while the government has adopted a more accommodative fiscal policy stance (see commentary below). We anticipate further policy support in the near future. While we recognize the fact that the Chinese administration has less policy space left to boost the economy compared with the post-2008 stimulus, we assess that the toolkit is big enough to help stabilize the Chinese economy within the next few quarters. We expect China's real GDP growth to average 6.2% y/y in 2019 following a 6.6% advance in 2018. In 2020, the economy will likely expand by 6.0% y/y.

POLICY OUTLOOK

China's 13th National People's Congress wrapped up its annual parliamentary session in mid-March and identified key macroeconomic goals for 2019 and

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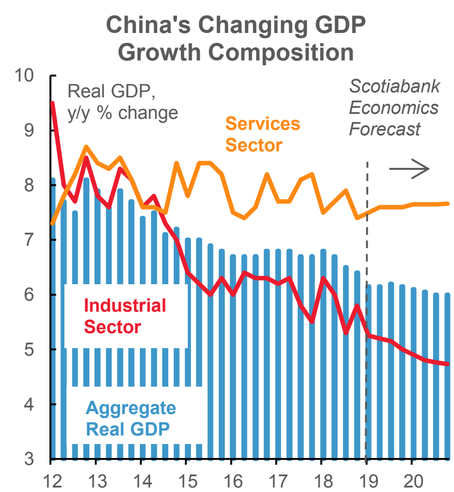
China	2017	2018	2019f	2020f
Real GDP (annual % change)	6.8	6.6	6.2	6.0
CPI (y/y %, eop)	1.8	1.8	2.2	2.3
Central bank policy rate (%, eop)	4.35	4.35	4.35	4.35
Chinese yuan (USDCNY, eop)	6.51	6.88	6.70	6.50

Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2

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

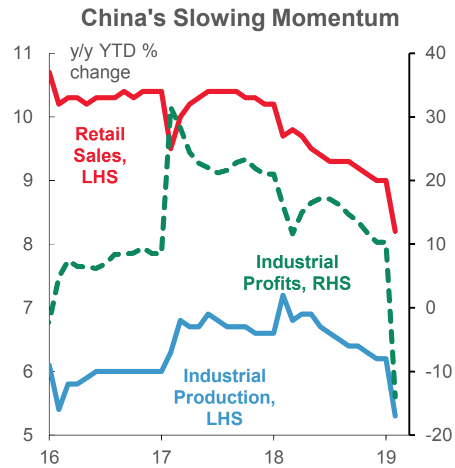
required policies to meet such targets. Recognizing elevated uncertainties surrounding the economic outlook and the downward pressure on the economy, the government lowered the real GDP growth target to 6.0–6.5% for this year from "around 6.5%" in 2018 (table 1). In March, the administration announced large-scale tax cuts and various fee reductions, amounting to almost CNY 2 trillion (equivalent to 2% of GDP). Further CNY 300 billion worth of support measures were unveiled in early April. For example, the value-added tax rate for manufacturers has been cut notably (effective on April 1), from 16% to 13%, while the tax rate for construction and transportation sectors was lowered from 10% to 9%. Spending by both corporations and consumers will be further supported by lower social security contributions, reduced electricity and internet costs and smaller fees associated with government-run licensing processes, such as real estate registration and passport issuance. In addition, a nearly 60% y/y increase (to CNY2.15 trillion) in the issuance of special-purpose local government bonds—which are not included in government debt figures— has been announced, with such outlays aimed at rural development, infrastructure, programmes to boost high-quality manufacturing, and fighting pollution. Indeed, the nascent pickup in infrastructure investment seen at the end of 2018 (chart 4) will likely gain momentum over the coming months.

In terms of economic reforms, Chinese policymakers have indicated that the economy will be liberalized further over the course of 2019. One of the cornerstones of China's recent reform drive is the newly-passed foreign investment law that will address market access issues, protect intellectual property rights, forbid forced technology transfers, and ensure equal treatment for foreign and domestic firms. The law— which will come into force on January 1, 2020—addresses several of the US administration's complaints, yet further amendments are still required to reduce its ambiguity. Another vital aspect in the Chinese economy's opening-up relates to financial sector reforms. China is planning to allow foreign financial firms to have a larger presence in China; greater openness would likely bring notable benefits to the economy, including improved risk management, transparency, competitiveness, and more effective allocation of capital. Indeed, we note that the strengthening of the financial system is a prerequisite for further economic and capital account liberalization.

Trade discussions between the US and China continue. According to both parties, the negotiations have been progressing well and have reached final stages that focus on more practical issues, such as implementation and enforcement. The talks over the past 4½ months have covered issues beyond trade, such as intellectual property protection, technology and cyber security, market access, and exchange rate management. We assess that both countries have strong economic incentives to reach an agreement soon; accordingly, we believe that an accord that satisfies both parties will likely be reached within the next two months. While this would be a welcome development for the global economy, we highlight that concrete actions need to be taken before the real economy would benefit from the easing of the trade conflict.

Regardless of any trade agreement between the US and China, the countries' differing fundamental views regarding the economy and the society at large will remain in place for years to come. Technological rivalry, in particular, will likely continue to create tensions between the two countries. From economic development point of view, it is important for China to transform itself toward an economy that is driven by productivity and technological advances in order to escape the middle-

Chart 3



Sources: Scotiabank Economics, Bloomberg.

Chart 4

Sources: Scotiabank Economics, Bloomberg.

Table 1

China's Key Economic Targets

	2019 Target	2018 Actual	2018 Target
Real GDP Growth, y/y % change	6.0-6.5%	6.6%	~6.5%
CPI Inflation, y/y % change	~3%	2.1%	~3%
Fiscal Deficit, % of GDP	2.8%	2.6%	2.6%
Urban Jobless Rate	~4.5%	3.8%	<4.5%

Sources: Scotiabank Economics, Bloomberg, CPC.

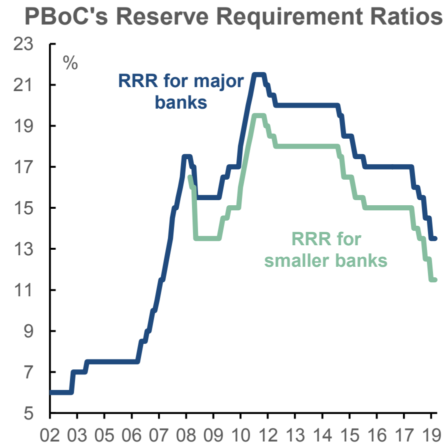
income trap. Therefore, China will likely maintain its focus on its current industrial strategy that aims to make the country a global technological powerhouse, though it will likely do so with less fanfare.

INFLATION AND MONETARY POLICY OUTLOOK

Chinese inflationary pressures will remain contained in the foreseeable future. Headline inflation will likely hover around 2% over the coming quarters, below the government's target of around 3% y/y. Price pressures further up the distribution chain are even lower with annual producer price gains near deflationary territory. Muted inflation allows monetary policy to become more accommodative. Indeed, Chinese monetary authorities have responded swiftly to the downward pressure on the economy. The PBoC will continue to provide the financial system with needed liquidity through open market operations, reserve requirements, and standing and medium-term lending facilities. The central bank will likely lower banks' reserve requirement ratios (RRR) further over the course of 2019, with the next reduction likely to take place in the current quarter. The most recent cut of 100 basis points was implemented in January, taking the ratio to 13.5% for major banks and 11.5% for smaller banks (chart 5). Meanwhile, we do not expect the PBoC to lower the 7-day reverse repo rate—which has stayed at 2.55% since March 2018—or the benchmark one-year deposit and lending rates—unchanged at 1.50% and 4.35%, respectively, since October 2015—over the coming quarters, as lower rates could add to financial instability risks.

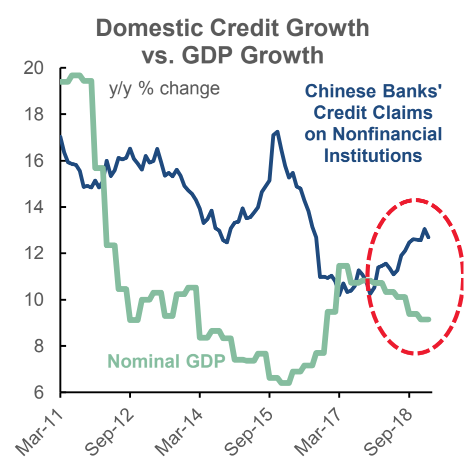
The government's deleveraging efforts have diminished somewhat, triggering a pickup in credit growth (chart 6). Nevertheless, the shadow banking sector will not play a key role in the current stimulus drive; instead, traditional bank lending will dominate. In March, the Chinese administration announced that its 2019 growth target for total social financing—which also captures shadow banking activity—is in line with China's nominal GDP growth. Hence, our estimates point to aggregate financing expanding by around 8½% y/y this year, which is notably slower than the average growth of 13¼% y/y over the past three years. Meanwhile, small/micro and private companies are set to benefit from improved access to funding following the government's another announcement that state-owned banks would increase lending to such entities by 30%. In the past, small firms have faced difficulties in obtaining credit as banks have prioritized other state-owned entities in credit allocation. Overall, we assess that monetary conditions in China will stay growth-supportive in the foreseeable future, yet the country's monetary authorities are more aware of the risks related to flooding the financial system with excessive liquidity, as was the case after the global financial crisis.

Chart 5



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

Chart 6



Sources: Scotiabank Economics, National Bureau of Statistics of China, The People's Bank of China.

Japan

- **Global growth uncertainties pose challenges for policymakers in Japan.**

ECONOMIC GROWTH OUTLOOK

Japan's near-term economic growth prospects are reasonably firm as consumers and businesses will likely bring forward their spending in anticipation of the consumption tax rate increase from 8% to 10%, which is scheduled for October 2019. The implementation of the higher tax is expected to cause a temporary dip in output (in q/q terms) in the fourth quarter of 2019; nevertheless, the adverse impact is set to be smaller than in 2014—when the tax rate was raised from 5% to 8%—due to planned offsetting measures, such as rebates and support for low-income households. Japan's 2019–20 real GDP gains are expected be in line with the country's potential growth of ¾% y/y, equal to the advance in 2018.

The Japanese economy grew by 0.5% q/q (non-annualized) in the final quarter of 2018 following a 0.6% q/q contraction in the third quarter (which reflected natural disasters). Net exports have recently been a drag on growth as shipments are adversely impacted by weaker global and Chinese demand. Softer export sector activity will continue to be reflected in weaker industrial production and manufacturing sector sentiment (chart 1). Consumer and public spending as well as investment have recently recorded decent growth, a trend that should continue over the medium term on the back of expansionary fiscal and monetary policies, sound corporate balance sheets, and tight labour market conditions.

INFLATION AND MONETARY POLICY OUTLOOK

The Bank of Japan (BoJ) will likely maintain its ultra-accommodative monetary policy stance through 2020, under the framework of "Quantitative and Qualitative Monetary Easing with Yield Curve Control". We expect the BoJ to keep the short-term policy rate and the 10-year bond yield target unchanged at -0.1% and around 0%, respectively, over the coming quarters. Against the background of rising global uncertainties and late-cycle dynamics, we note that the BoJ's monetary policy room is fairly limited. Should the economy need further stimulus in the foreseeable future, the main responsibility may fall onto fiscal policy—despite already weak government finances.

Inflation remains low and the BoJ's 2% annual inflation target seems unattainable: following years of deflation, Japan's cumulative inflation over the past two decades is only 2% (chart 2). In addition to domestic reasons, such as lackluster wage growth, reaching the inflation target can potentially be further challenged by weaker global growth prospects that might trigger a more pronounced domestic slowdown and renewed deflation, as well as by elevated global uncertainties that might translate to safe-haven flows and appreciation of the Japanese yen. Prices at the headline level are currently rising by only 0.2% annually while the CPI excl. fresh food—the BoJ's preferred inflation measure—also remains soft at 0.7% y/y. We estimate that in the near-term, headline inflation will stay below 1% y/y until the consumption tax rate hike will prompt a temporary pickup in the final months of 2019. After the tax hike impact wanes in late-2020, inflation is set to return below the 1% mark.

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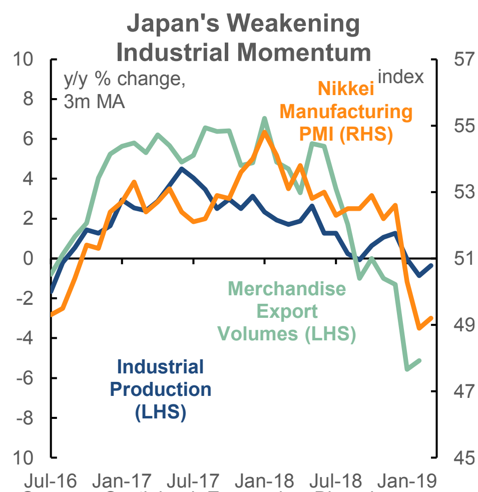
Japan	2017	2018	2019f	2020f
Real GDP (annual % change)	1.9	0.8	0.8	0.7
CPI (y/y %, eop)	1.0	0.3	2.3	1.0
Central bank policy rate (%, eop)	-0.10	-0.10	-0.10	-0.10
Japanese yen (USDJPY, eop)	113	110	108	105

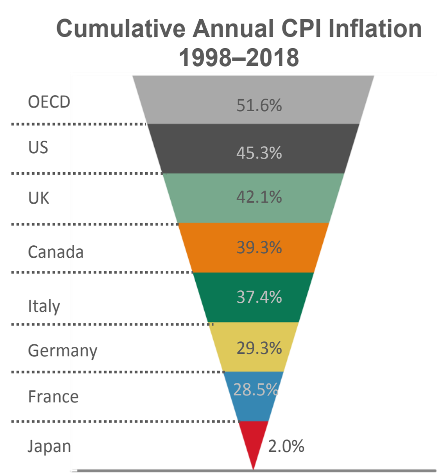
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, OECD.

India

- **India continues to be a growth outperformer among major economies globally through 2020, fuelled by sound domestic demand.**
- **Fiscal and monetary policies underpin the economy's momentum.**
- **Rising inflation limits the central bank's ability to loosen monetary policy aggressively.**
- **Political uncertainty remains elevated ahead of the general elections in April and May.**

ECONOMIC GROWTH OUTLOOK

India's economic growth will likely average 7.1% y/y over the next two years (chart 1). We have downgraded the forecast slightly (from the prior figure of 7.4% y/y in 2019–20), reflecting weaker sentiment and softer demand conditions globally. With real GDP gains in line with the country's estimated 7–7½% potential growth rate, India will continue to be the growth leader among major economies globally. We assess that India could reach even higher potential growth over the coming years on the back of the country's favourable demographics and continued streamlining of the Goods and Services Tax structure. Implementation of labour and land reforms would bolster India's longer-term growth outlook further.

Domestic demand will be the key driver of the Indian economy in the foreseeable future. The country is less export-oriented than its regional peers, which provides the economy with some protection against global headwinds. Fixed capital investment continued to outperform the economy's growth rate of 7.3% y/y in 2018, expanding by 11.1% y/y. Ongoing public infrastructure outlays as well as robust business confidence and bank credit growth (charts 2 and 3) point to continuing activity; the Reserve Bank of India's (RBI) looser monetary policy should further underpin business investment prospects. Nevertheless, momentum in eight core industries—electricity, steel, refinery products, crude oil, coal, cement, natural gas and fertilizers—has slowed in recent months (chart 3), which warrants close monitoring as weaker industrial activity and higher spare capacity could have an adverse impact on investment. Consumer spending will continue to be supported by rising incomes and the government's fiscal measures, such as tax rebates and support to small-scale farmers. Indeed, India's February 1st Interim Union Budget for fiscal year 2019–20 (April–March) is expansionary, arguably reflecting the imminent general election. The government expects the fiscal deficit in the FY2019–20 to be 3.4% of GDP, vis-à-vis the original target of 3.1% of GDP. We assess that the shortfall will likely turn out to be higher.

INFLATION AND MONETARY POLICY OUTLOOK

The RBI is taking steps to stimulate the economy. Following the Monetary Policy Committee's (MPC) bimonthly meeting on April 2–4, the benchmark repo rate was cut by 25 basis points to 6.0%, marking a second consecutive interest rate reduction. We believe that the MPC's sense of urgency to cut rates reflects its expectation of gradually rising inflation and the general election. Communications

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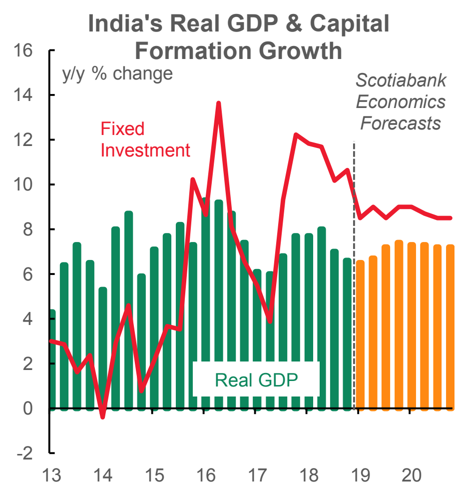
India	2017	2018	2019f	2020f
Real GDP (annual % change)	6.7	7.3	7.0	7.3
CPI (y/y %, eop)	5.2	2.1	5.1	5.0
Central bank policy rate (%, eop)	6.00	6.50	6.00	6.00
Indian rupee (USDINR, eop)	63.9	69.8	68.0	66.0

Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2

Sources: Scotiabank Economics, Bloomberg.

from the RBI reveal divisions within the six-member MPC regarding India's inflation outlook and risks. Accordingly, we do not foresee further interest rate cuts over the coming quarters, unless inflation significantly surprises on the downside.

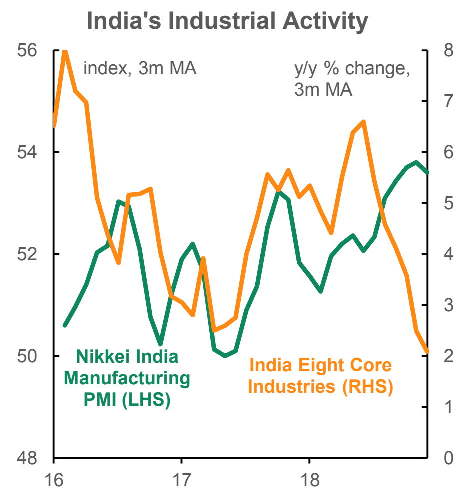
India's inflation signals are mixed. Core inflation has been decelerating gradually in recent months but remains elevated at 5⅓% y/y, vis-a-vis slightly over 6% in October (chart 4). Nevertheless, we note that the recent disinflation has not been broad-based across all index components. Meanwhile, headline inflation has been soft in recent months on the back of lower food and energy prices, yet the trend is now reversing. After reaching the low point of 2% y/y in January, inflation has rebounded to the current level of 2⅔%. The year-ago base effect will likely continue to inch the headline inflation rate higher over the coming months. We expect price gains to reach 5% y/y by the end of 2019; nevertheless, headline inflation is estimated to remain within the RBI's 4% ±2% target through 2020. We continue to observe carefully the development of the following risks to inflation: 1) financial market volatility and potential depreciation pressure on the Indian rupee; 2) volatile food prices; 3) international crude oil price developments; 4) ongoing global trade tensions that may cause a growth slowdown and softer commodity prices; 5) the approaching southwest monsoon (June–September) that will have an impact on food prices and rural incomes; and 6) fiscal measures announced in the Interim Union Budget that may trigger inflationary implications.

POLITICAL OUTLOOK

Political uncertainty will remain elevated in the near term. Elections for the Lok Sabha—the lower house of Parliament—are scheduled to take place in seven stages between April 11 and May 19. With India's 900 million eligible voters, the ballot is the largest in the world. Votes will be counted on May 23. An election outcome leading to a political standstill would have a significant adverse impact on India's structural reform prospects and long-term growth potential.

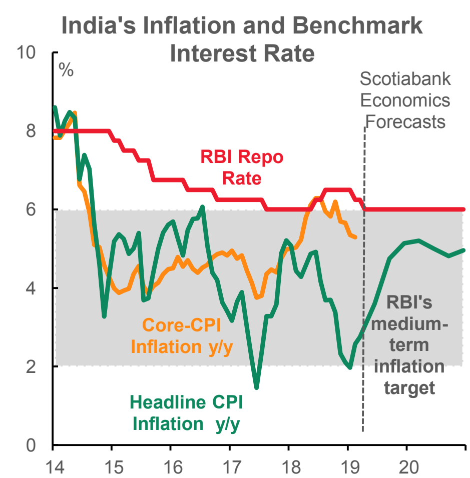
The ruling National Democratic Alliance—led by Prime Minister Modi's Bharatiya Janata Party (BJP)—would need a minimum of 272 of the 543 elected seats to be able to form a government; it currently holds 341 seats. We assess that the coalition has reasonably good chances of remaining in power despite the fact that the BJP has lost popularity recently while the approval ratings of the main opposition party, the Indian National Congress, have recuperated. Indeed, the BJP may not be able to replicate the 2014 election success when it secured a single-party majority. Nevertheless, populist fiscal measures announced in the Interim Union Budget on February 1 and looser monetary policy—which followed the appointment of pro-Modi RBI Governor Shaktikanta Das at the end of 2018—will likely help with the BJP's election ambitions.

Chart 3



Sources: Scotiabank Economics, Bloomberg.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

South Korea

- **Global trade-related uncertainties cloud South Korea's economic growth prospects.**
- **Fiscal and monetary policies are set to remain growth-supportive.**

ECONOMIC GROWTH OUTLOOK

South Korea's economic performance is expected to stay virtually in line with the country's potential growth through 2020, with real GDP expanding by 2½% y/y. The external sector will remain an important growth driver over the coming years, yet the outlook is shadowed by trade-related global uncertainties. A slowdown in Chinese demand is causing South Korean exports to China—the nation's largest export market—to decline. While shipments to the US—the second largest export destination—have been growing at a double-digit annual pace in recent months, the pending decision by the US on whether to impose tariffs on automobile imports poses a notable downside risk to South Korea's outlook, particularly as 30% of the nation's exports to the US consist of vehicles and their parts.

The domestic side of the economy will be supported by consumer and public spending. The government's stimulative fiscal policies—the already-expansionary budget for 2019 will likely be followed by a supplementary spending package—focus on "income-driven" growth. Indeed, job creation measures, higher minimum wages, and outlays related to the social safety net will support the consumer. We assess that active fiscal policy will play a key role in keeping the economy on a decent growth track in 2019–20 as global headwinds impact the externally-oriented economy. While the outlook for fixed investment remains uncertain on the back of softening global growth momentum and the associated dip in confidence (chart 1), the Bank of Korea's (BoK) ongoing accommodative monetary policy stance will provide needed support for private sector investment.

INFLATION AND MONETARY POLICY OUTLOOK

South Korea's inflation is expected to remain contained in the foreseeable future. Price pressures at the headline level have surprised on the downside; inflation is currently hovering below ½% y/y after being in line with the BoK's 2% inflation target as recently as in November (chart 2). Weaker price pressures reflect lower energy costs and stagnant government-administered prices (related to public transportation and communications, for instance). We expect headline inflation to rebound somewhat in the second half of 2019, closing the year at a still-low level of 1.3% y/y.

With demand-driven inflationary pressures likely to remain largely absent over the next two years, the BoK will be able to maintain an accommodative monetary policy stance through 2020. The central bank raised the benchmark interest rate by 25 basis points to 1.75% in November 2018; we do not expect any changes to the policy rate in the foreseeable future. The BoK will continue to monitor any risks related to financial stability and imbalances stemming from persistently rising household debt, while remaining vigilant regarding the elevated downside risks to the economy.

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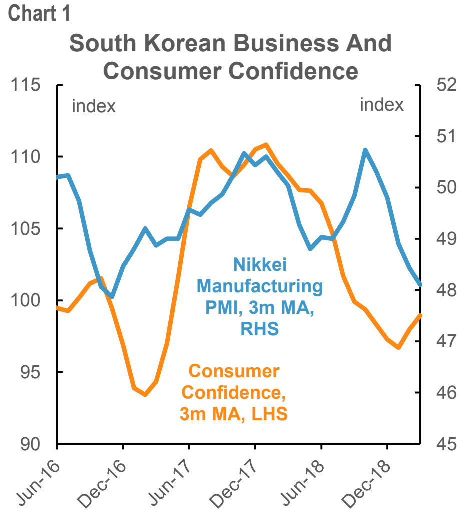
South Korea	2017	2018	2019f	2020f
Real GDP (annual % change)	3.1	2.7	2.5	2.5
CPI (y/y %, eop)	1.4	1.3	1.3	1.6
Central bank policy rate (%, eop)	1.50	1.75	1.75	1.75
South Korean won (USDKRW, eop)	1,067	1,116	1,120	1,080

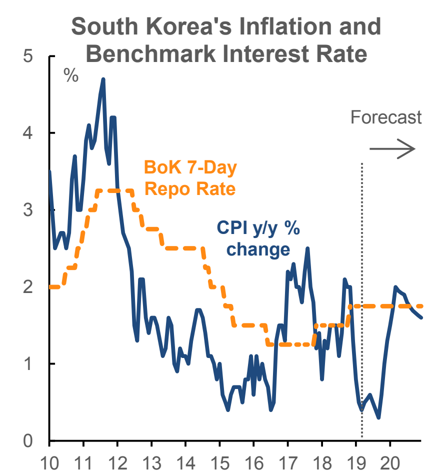
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Australia

- **The Australian economy continues to extend its non-recession record with at-potential output growth.**
- **A cooling residential real estate market and strong labour market send conflicting signals regarding consumer spending prospects.**
- **Monetary policy to remain accommodative on the back of contained inflation and elevated global growth uncertainties.**

ECONOMIC GROWTH OUTLOOK

Australia's economic growth is showing signs of moderation. Real GDP expanded by 2.3% y/y in the final quarter of 2018 following an average gain of 3.0% y/y in the first nine months of the year. We expect the nation's output growth to average 2½% y/y in 2019–20, roughly in line with the economy's potential. Accordingly, the Australian economy is expected to prolong its already respectable track record of having gone 27 years without a recession.

Australia's economic activity will continue to be driven by consumer spending, yet high household debt and cooling in the residential real estate market will weigh on the consumer. Nevertheless, a robust labour market and gradually rising wages should provide reasonable counterbalance. An easing in global uncertainties would be constructive for Australia's investment outlook, while solid government finances will allow for continued public spending in infrastructure.

The external sector will continue to feel the impact of slowing demand in China, which is Australia's main export destination. In the near term, however, Australian commodity exporters will benefit from two developments: 1) the Chinese government is in the process of rolling out fiscal stimulus, including higher infrastructure spending, and 2) iron ore prices have picked up following the dam disaster in Brazil; iron ore accounts for a fifth of Australia's total global exports and almost half of its exports to China (chart 1). We expect Australia's external sector to provide a moderate positive contribution to real GDP growth over the coming quarters, supported by improved terms of trade (chart 2) and higher resource export volumes.

HOUSING AND LABOUR MARKET DEVELOPMENTS

Australia's residential property market continues to cool. According to the Australian Bureau of Statistics, after rising by over 50% between early 2012 and end-2017, prices at the national level have dropped by 5.1% by the end of 2018 (chart 3). Private sector estimates point to continued price declines in the first quarter of 2019. Developments vary across the country, with Sydney and Melbourne leading the declines; housing prices have fallen in the two cities by 9.1% and 6.4% respectively, from their 2017 peaks. Meanwhile, in some other parts of the country, such as in Adelaide, house prices have been more stable. In our assessment, the correction is largely a result of tighter regulatory lending standards and increased housing supply, which is a delayed response to the prior price boom. Given Australia's low interest rates, a strong labour market, robust

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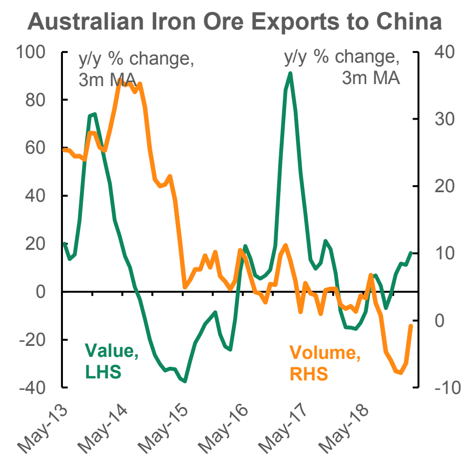
Australia	2017	2018	2019f	2020f
Real GDP (annual % change)	2.4	2.8	2.5	2.5
CPI (y/y %, eop)	1.9	1.8	2.0	2.2
Central bank policy rate (%, eop)	1.50	1.50	1.50	1.50
Australian dollar (AUDUSD, eop)	0.78	0.70	0.75	0.78

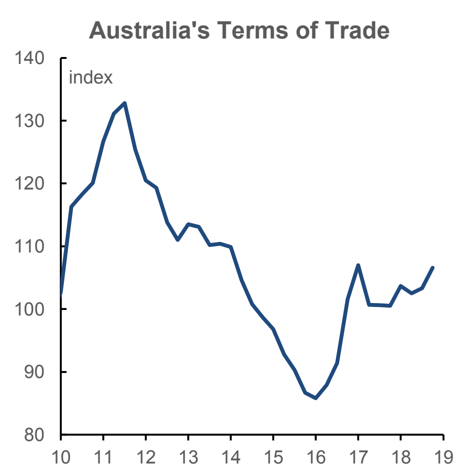
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Australian Bureau of Statistics.

Chart 2



Sources: Scotiabank Economics, Australian Bureau of Statistics.

loan quality, and continued strong net immigration, we assess that the housing market developments are not a cause for major concern at this point. While we expect the market to stabilize over the course of 2019, we continue to monitor the situation closely, particularly the price adjustment's impact on consumer confidence and any potential adverse developments in the labour market that could impact households' debt-servicing abilities.

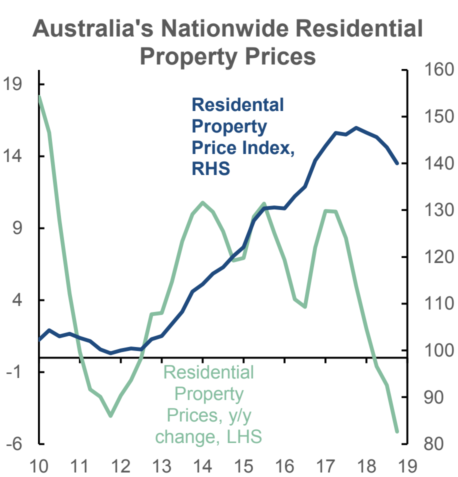
Australia's labour market conditions remain sound (chart 4); in the past 12 months to February, monthly job creation has averaged 24,000 positions, a high number by historical standards. More importantly, three-quarters of them have been in the full-time category. Surveys of hiring intentions indicate further employment gains. At 4.9% in February, unemployment is in line with the Reserve Bank of Australia's (RBA) "around 5%" estimate for the economy's NAIRU (non-accelerating inflation rate of unemployment), suggesting that labour market slack has virtually disappeared. This should boost incomes over the coming quarters.

INFLATION AND MONETARY POLICY OUTLOOK

Inflationary pressures will likely remain contained in the foreseeable future. At the headline level, prices rose by 1.8% y/y at the end of 2018. Meanwhile, consumers' inflation expectations are elevated at over 4% y/y, exceeding the RBA's 2–3% inflation target. Nevertheless, we assess that somewhat softer household spending prospects will likely keep demand-driven inflation in check. While we forecast a slight pickup in wage and price gains (chart 5), headline inflation is expected to remain in the RBA's target range through 2020.

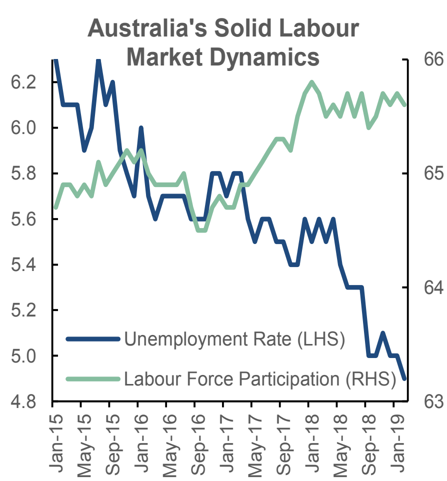
On the back of contained inflation and a challenging global growth outlook, the RBA will likely keep monetary policy on hold over the coming quarters. The central bank now assesses that the scenario in which it would need to ease monetary policy is equally likely as a scenario where policy would need to be tightened. Earlier, the RBA had assessed that an interest rate hike was the most likely next policy action. Given the RBA's changing tone, a challenging global growth outlook, and contained inflation domestically, we now anticipate the central bank to keep the benchmark interest rate on hold through 2020.

Chart 3



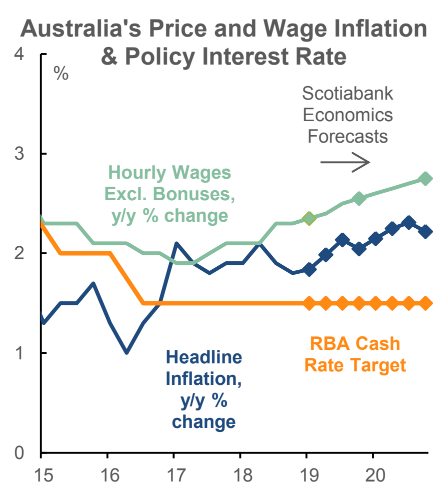
Sources: Scotiabank Economics, Australian Bureau of Statistics, Bloomberg.

Chart 4



Sources: Scotiabank Economics, Australian Bureau of Statistics.

Chart 5



Sources: Scotiabank Economics, Bloomberg.

Commodities

- **Healthy global economic growth provides a solid demand backdrop for commodities through 2020, allowing fundamentals to reassert commodity-specific price paths over the coming years (chart 1).**
- **After reversing the late-2018 bear route in risk assets through the first quarter of 2019, most major commodity prices—oil, copper, gold—are expected to trade around current levels through the remainder of the year.**
- **Policy and event-driven developments have modestly shifted the outlook for Western Canadian Select (WCS) crude due to challenges surrounding the Alberta government's production curtailment plan and iron ore following a crackdown on tailings dams in Brazil.**

FUNDAMENTALS TO RETURN AS COMMODITIES DRIVER AS NEGATIVE MACRO SENTIMENT NORMALIZES

Industrial commodity prices rallied through the first quarter of 2019 as markets reversed the bearish speculative sentiment that drove a sell-off of equity and commodity prices in the closing months of 2018. Oil and copper contracts are up 37% and 11%, respectively, from late-December lows while the S&P500—which also collapsed through December as sentiment toward risk assets soured—is up 22%. This rally occurred despite relatively weak industrial data (e.g. three months of contracting Chinese manufacturing activity) and falling trade flows on the back of the US-China trade war (global trade volume fell 1.7% y/y in December, chart 2), which primes commodities—particularly metals like copper—for further gains through 2019 as those trends normalize. The global economy's ongoing rebound is progressing largely along our prior forecast path and thus our major commodity price forecasts are largely unchanged on the quarter beyond policy-driven revisions to the WCS and iron ore outlooks. WTI oil prices are expected to average $59/bbl in 2019 (+$1/bbl versus our last quarterly outlook) and $61/bbl in 2020 (-$1/bbl), copper is forecast to average $3.00/3.20 per pound in 2019/2020 (unchanged), and we continue to anticipate that gold will remain range bound around $1,300 per ounce (unchanged).

Global growth is uneven, but largely tilting in the right direction. Industrial activity indicators are split between major markets, with the US showing continued strength while European activity looks soft and Chinese surveys finally showing a rebound from three consecutive months of contraction. Despite this mixed picture, we maintain our view that global growth remains on a solid footing and that the current slowdown is a natural deceleration off an artificially high stimulus-fuelled base; large fiscal outlays from US and Chinese authorities in late-2016 provided the impulse that lifted all boats through the synchronized global acceleration of 2017–1H2018. Uncertainty related to the US-China trade war, US monetary policy, and the end-2018 fallback in global equity markets, all contributed lacklustre industrial performance in the first quarter of 2019 but we believe that activity will bounce back over the coming months and provide a steady demand backdrop for commodity markets going forward.

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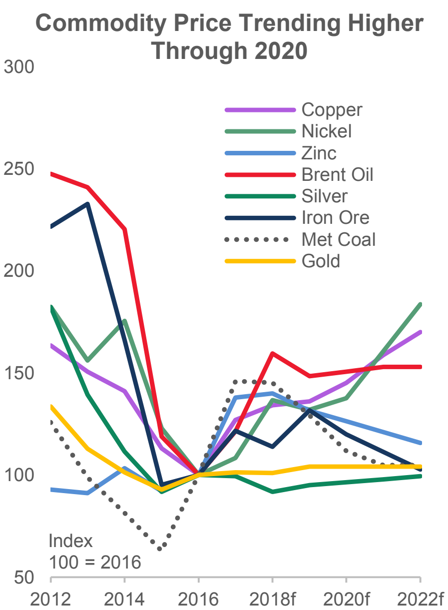
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2

Sources: Scotiabank Economics, CPB.

OIL PRICES UP SHARPLY AS OPEC CUTS OUTPUT, US SHALE'S PACE MODERATES

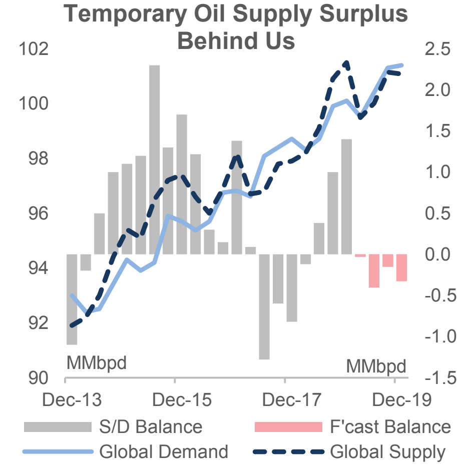
Global crude oil prices have rebounded and WTI contracts are up by more than a third from 2018's close. Demand growth remains healthy while supply is tightening on the back of a notable reduction in OPEC production—both voluntary and involuntary—as well as slowing momentum in the US shale patch. We expect oil markets to remain in mild deficit through 2019 (chart 3), which is forecast to maintain WTI prices around $59/bbl in 2019 and $61/bbl in 2020, with Brent trading at a $7–8/bbl premium to WTI through the forecast horizon on continued bottlenecks en route to the US Gulf Coast.

Global oil demand growth remains healthy and is expected to come in at around 1.4 MMbpd y/y in 2019—nothing to write home about but steady enough to keep the market more-or-less in balance through 2020. Emerging Asia continues to drive this growth, with China and India expected to contribute just more than half that total. More than the overall demand for crude by the world's refineries, the coming years will bring far larger changes to the *relative* demand for finished products as new fuel emissions standards from International Marine Organization (IMO2020) come into effect. The IMO2020 regulatory shift reduces the allowable sulphur concentration in the heavy fuel oil consumed by the roughly 80,000-strong global shipping fleet, which will reduce the demand for high-sulphur fuel oil (HSFO) and boost the demand for middle distillates—products like diesel or marine gas oil (MGO) that are either consumed directly or blended with traditional fuels to reduce the sulphur content of bunker fuels. This paradoxically increases the demand for heavy crudes like WCS, which can be blended with lighter crudes like those coming out of the US shale patch to increase middle distillate yields at refineries along the US gulf coast. Coupled with the declining supply of heavy crudes from Venezuela and Mexico, this tight market for heavy crudes has been a boon for the price of WCS, Canada's primary export benchmark.

Global oil supply growth is slowing from the remarkably strong gains witnessed in late-2018 as OPEC+ cuts production and the pace of growth in the US shale patch moderates. OPEC+ production fell in the opening months of 2019 between organized cuts taken to defend prices and steep involuntary losses in Venezuelan supply (chart 4). Venezuelan production difficulties ramped up considerably in March after weeks of intermittent days-long blackouts roil the country's oil production and export systems in addition to the vast majority of Venezuela's citizens. Problems with the electrical grid will continue to plague the production, blending, and export of Venezuelan crude, and the government lacks the capital and expertise to make any meaningful repairs to the system. In the US shale patch, supply growth continues to lead the world (chart 5) but the pace of gains is slowing as producers continue to move away from sweet-spots and the number rigs in the field flat lines.

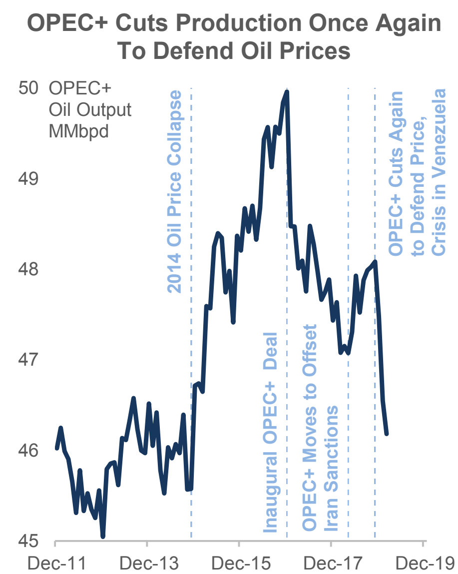
Closer to home, Western Canadian oil prices continue to trade at abnormally low discounts to US-based WTI of less than $10/bbl, relative to the last autumn's blowout above $50/bbl and oil-by-rail breakeven levels of around $15/bbl. While higher prices for Canadian crude would in normal times be cause for celebration, we unfortunately believe that today's differentials are artificially narrow and a concrete sign that too much crude production remains curtailed relative to the pace at which inventories can effectively be drawn down. Too few barrels are chasing available takeaway capacity, which has bid local barrels up (meaning a narrower discount to WTI) and priced much of the industries' newly acquired oil-by-rail capacity

Chart 3



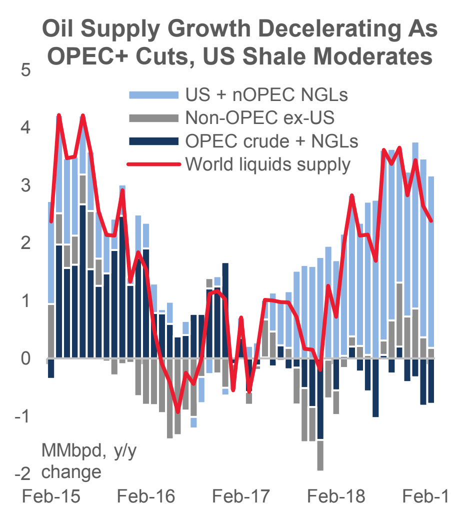
Sources: Scotiabank Economics, Scotiabank GBM, IEA, EIA, JODI, OPEC.

Chart 4



Source: Scotiabank Economics, OPEC, OMI.

Chart 5



Source: Scotiabank Economics, OMI.

out of the market. Oil-by-rail shipments slipped roughly 30 kbpd in January from all time highs in December and higher-frequency CN and CP Rail data indicate that volumes fell steeply through February before eventually stabilizing (chart 6).

Unfortunately we are going to need as many rail cars in service as we can get through the end of 2020, particularly now that the start-up of Line 3 has been delayed until the latter half of next year. While current light/heavy differentials around the US Gulf Coast implies that oil-by-rail could technically break even at less than $15/bbl under WTI, sub-$10/bbl discounts appear safely out of the money and differentials likely need to rise above simple breakeven levels and into the $15–20/bbl range to provide enough of an incentive to purchase additional rail cars (chart 7). Given the pace of expected oil sands production growth, we see the call on oil-by-rail services reaching 500–600 kbpd by late-2020 prior to the start-up of Line 3, well above the 355 kbpd record reached in December (see our full report on the Line 3 delay). In response to the narrower-than-anticipated differentials, Alberta's provincial government has announced an increase in allowable production under the curtailment every month since the program began—75 kbpd in Feb–March, and 25 kbpd in each of April, May, and June for a total easing for 150 kbpd through the first half of 2019 versus an initial cut of 325 kbpd. We anticipate that rising production capacity and easing output curtailment will facilitate the WCS discount's return to the $15–20/bbl oil-by-rail sweet spot, but our 2019 forecast has been revised to reflect the abnormal tightening in the first half of the year. **We now expect WCS discounts to average $15/bbl in 2019 and $21/bbl in 2020.**

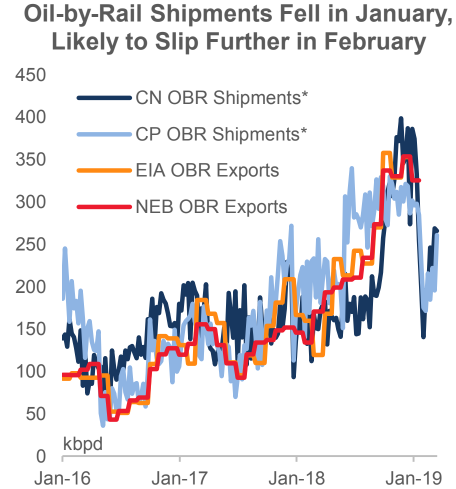
METALS: CHINA BEARISHNESS MOSTLY UNWOUND, FUNDAMENTALS IN THE DRIVER'S SEAT GOING FORWARD

Industrial metals have mostly unwound the negative sentiment that was weighing on pricing through the latter half of 2018 and individual metals are expected to resume a more fundamental-based price path over the coming years. The base metals complex slipped from last summer through the end of 2018, in large part due to negative macro sentiment enflamed by the first major volley of broad-based tariffs from the US in its trade dispute with China. The unwinding of this sentiment will allow metals prices to track metal-specific supply and demand considerations and facilitate a divergence between metals with plenty of long-term support (i.e. copper) and metals where the most acute tightness is behind us for now (i.e. zinc). Most metals forecasts remain unchanged on the quarter given our continued expectation for a steady global economic activity, while the outlook for iron ore has been revised to reflect the anticipated loss of Brazilian production following a crackdown on tailings dams in the country.

Given its outsized role in global commodity trade, particularly its more than 50% share of demand for most industrial metals, all eyes have been on China where the question of Beijing's stimulus efforts have been top of mind. Chinese manufacturing activity appeared to be contracting from December through February, but the latest PMI readings show that activity roared back to growth in March (chart 8). Some of this bounce-back can be attributed to seasonal factors coming out of Lunar New Year celebrations in February, but the jump in PMI readings is about double the typical seasonal retracement.

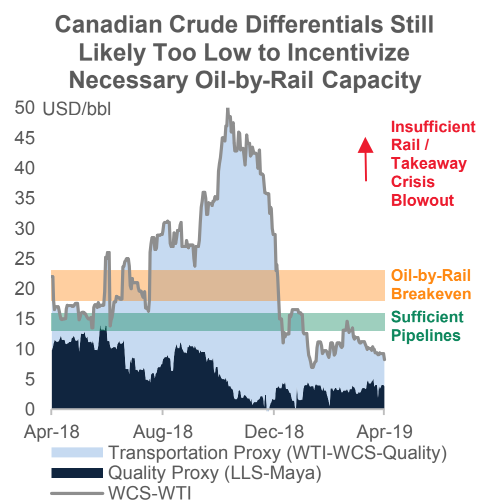
Beijing's modest stimulus efforts have begun to bear fruit, but policy-makers continue to stress that this isn't 2008 or 2016–both moments where China leaned

Chart 6



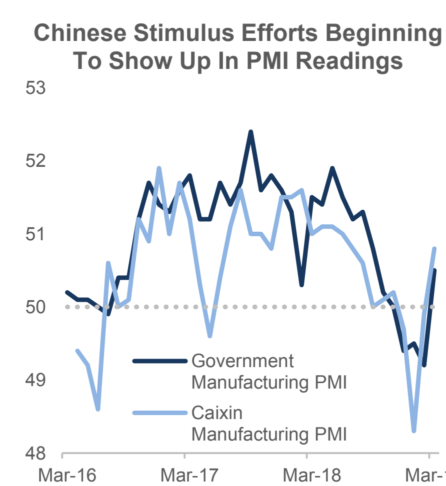
*CN/CP Rail shipments are less 300 kbpd to adjust for estimted structural/intrabasin volume.
Sources: Scotiabank Economics, NEB, EIA, CP, CN.

Chart 7



Source: Scotiabank Economics, Bloomberg.

Chart 8

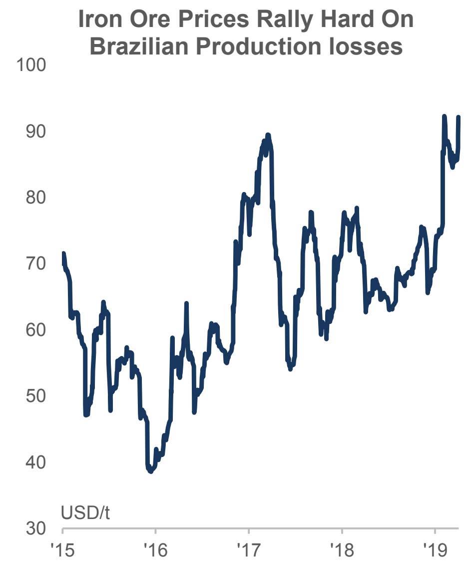


Sources: Scotiabank Economics, Bloomberg.

heavily on credit injections to stimulate the domestic, and in turn global, economy—and that China isn't falling back on its old habit of juicing traditional construction-heavy sectors. Nonetheless, the tension between Beijing's previously touted deleveraging goal and the political necessity of stable economic growth is evident in the course this particular bout of stimulus has taken; at the end of 2018 a Chinese government working group estimated that stimulus would amount to roughly 1.2T RMB, a number that was later revised upward to nearer 2T RMB. This lends at least some credit to the notion that the Beijing put— the idea that China will backstop any weakness in global industrial demand through stimulus injections—remains alive and well. Chinese policymakers are likely holding back on further stimulus until they receive additional macroeconomic data through the second quarter, to see how far the first stimulus kick lifted the economy.

Beyond the demand-driven considerations unwinding in base metals markets, Iron ore has shifted from a staid market defined by surplus supply and falling prices to a rollercoaster of production uncertainty following Brazil's fatal Brumadinho tailings dam collapse in January. Contracts for 62% iron content ore delivered to Northern China remain elevated at more than $90 per tonne up from less than $70/t at the end of 2018 and far above our prior forecast of $65/t for 2019–20 (chart 9). Work stoppages ordered by Brazilian regulators and courts are expected to reduce Vale's iron ore output by 75 Mt relative to prior guidance of 400 Mt and a total seaborne iron ore trade of roughly 1,600 Mt. While we expect to see supply offsets from higher production at other Brazilian mines—Vale's technical capacity is nearer 450 Mt, leaving ~50 Mt of theoretical slack—**the disruption and adjustment costs have prompted us to lift our iron ore price forecast to $77/t in 2019 and $70/t in 2020**.

Chart 9



Source: Scotiabank Economics, Bloomberg.

Table 1

Commodities	2000–2017 Low	2000–2017 Avg.	2000–2017 High	Annual Average 2017	2018	2019f	2020f
WTI Oil (USD/bbl)	17	62	145	51	65	59	61
Brent Oil (USD/bbl)	18	65	146	55	72	67	68
WCS - WTI Discount* (USD/bbl)	-43	-16	-6	-13	-26	-15	-21
Nymex Natural Gas (USD/mmbtu)	1.64	4.83	15.38	3.02	3.07	2.90	2.80
Copper (USD/lb)	0.60	2.38	4.60	2.80	2.96	3.00	3.20
Zinc (USD/lb)	0.33	0.84	2.10	1.31	1.33	1.25	1.20
Nickel (USD/lb)	2.00	7.12	24.58	4.72	5.95	5.75	6.00
Aluminium (USD/lb)	0.56	0.87	1.49	0.89	0.96	0.90	0.90
Iron Ore (USD/tonne)	17	67	187	72	70	77	70
Metallurgical Coal (USD/tonne)	39	131	330	187	206	185	160
Gold, London PM Fix (USD/oz)	256	890	1,895	1,257	1,268	1,300	1,300
Silver, London PM Fix (USD/oz)	4.07	14.80	48.70	17.05	15.71	16.00	17.00

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

Foreign Exchange

- **The USD is resilient but stronger fundamental headwinds are still likely to emerge this year.**
- **We have downgraded our EUR forecast after the ECB delayed its policy normalization process.**

The US dollar (USD) remains quite well-supported but has shown little directional momentum over the past three months and has clearly struggled to develop gains to extend beyond the limits of the range that has prevailed over the past two quarters versus its major currency peers. Currency market volatility has fallen to fresh multi-year lows. This reflects range-bound markets and a distinct lack of conviction amongst market participants about whether the major currencies will move decisively in any direction in the near future.

We continue to believe that the longer run trend in the USD is liable to tilt lower in the coming quarters, reflecting the USD's elevated valuation against major currencies. Political risks facing the USD appear to have diminished somewhat, following the conclusion of the Office of Special Counsel's investigation but the burden of significant US fiscal and current account deficits and slowing growth momentum (towards potential, nearer 2% or so GDP growth) into 2020 remain significant drags on the USD's outlook in our opinion.

Moreover, the Fed has indicated that policy is likely to now remain on hold through the balance of 2019 and that only one more hike will follow in 2020. Markets rather feel that, after an extended pause, the prospect of even one rate hike in 2020—an election year—is very remote. Investors have fully priced in the risk of a Fed rate cut in the next 12 months, flattening the US yield curve and creating more headwinds for the USD.

We expect the Canadian dollar (CAD) to strengthen moderately versus the USD. Domestic growth slowed through late 2018 but is showing signs of picking up again so far in Q1. The Bank of Canada (BoC) has indicated that it still expects interest rates to rise in the coming months but is in no hurry to tighten. The shift in messaging at the Fed has prompted markets to price in the strong chance of a BoC rate cut in the next 12 months but, with Canadian policy settings still well below neutral, short-term rates in Canada have less room to fall. As a result, US-Canada yield differentials at the shorter end of the curve appear to have peaked and should narrow, providing some underpinning for the CAD.

Additionally, tight global supplies have bolstered crude oil prices. The BoC's commodity index has gained a little more than 16% since the start of the year. This is due mainly to higher energy prices although non-energy prices have also risen (by a little over 5.5% over the same period). Rising commodity prices have boosted Canada's terms of trade and this improvement should provide some additional support for the CAD.

Broader market sentiment on the CAD appears less constructive, however, and some foreign investors continue to focus on issues such as the domestic housing

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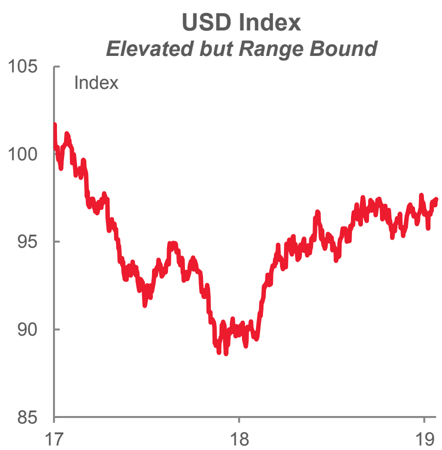
Chart 1



Sources: Scotiabank FICC Strategy, Bloomberg.

sector and high levels of household debt as grounds for bearishness on the CAD outlook. We acknowledge that these are *potential* threats to the CAD but these factors are not central to our base case outlook.

Rather, we think fundamental trends support our contention that the USD is likely to fall in the medium term. We employed Scotiabank's forecasts for inflation-adjusted US/Canada, long-term yields spreads, relative US/Canada current account and budget balances as well as OECD estimates for productivity growth through 2020 in a regression model with USDCAD. We found that these variables imply that USDCAD could fall to 1.16 over the next two years. Quantitative modeling based around our forecasts for nominal, short-term spreads and crude oil prices also suggest the USD is liable to weaken. We retain a formal forecast of USDCAD declining to 1.23 by the end of 2020, however.

We remain broadly positive on prospects for the euro (EUR), pound (GBP) and yen (JPY) but both the GBP and the EUR have been overshadowed by developments in the UK's Brexit talks. The Eurozone economy slowed last year and, while some economic data has indicated that growth may be stabilizing, the European Central Bank's (ECB) latest projections suggest soft growth and inflation trends are likely to persist. Indeed, the March policy meeting saw the ECB defer the start of policy normalization until next year and announce another round of long-term bank loans. We had expected the EUR to pick up more support in H2 this year as the policy normalization process neared but we now expect a delayed strengthening in the EUR—and a lower end point for the EUR over our forecast horizon.

Using similar techniques and inputs (that is to say, relative fiscal and current account balances, real long-term yields and productivity forecasts) to the USDCAD regression model noted above, EURUSD could rise to 1.30 through H2 2020 on the basis of our current economic forecasts. We now expect EURUSD to rise to 1.24 over that period.

A resolution to the UK's Brexit impasse—our base case remains a smooth "divorce"—will boost business investment, lift the housing market and, amid rising wages, may refocus attention on the Bank of England's appetite to tighten domestic monetary policy, if only modestly in the months ahead. We rather think the policy status quo is likely to be maintained. The six month delay should spark a relief rally in the GBP and push GBPUSD up to the 1.38/1.40 area in the next few months.

We expect the JPY to gain versus the USD over the forecast horizon. We anticipate the scope of JPY strengthening against a weakening USD will be restrained by the Bank of Japan (BoJ) maintaining an aggressively accommodative monetary policy stance (amid stubbornly low inflation). But the outlook for JPY strengthening has been enhanced by the more dovish tilt to central bank policy communication that has emerged from the Fed and ECB especially in recent weeks. The prospect of stabilizing—or even somewhat narrower—long-term US-Japan rate differentials over our forecast timeframe should lift the JPY. Our longer-term quantitative fair value work suggests that relative, expected fundamentals imply USDJPY will ease to a little below JPY100 over the next two years. We retain a formal forecast of JPY105 for end 2020.

Pacific Alliance currencies have appreciated modestly so far this year overall as global financial conditions eased. We remain cautious on the prospects for the Mexican peso (MXN), however, and expect modest depreciation versus the USD over our forecast horizon. The MXN has weathered recent worries about local and sovereign debt, thanks to looser US financial conditions (recovering US equity markets and lower short-term rates) and gains in crude oil. Those concerns remain alive, however, and may be exacerbated by external (trade and border tensions) and internal (restructuring Federal government) risks which suggest a further deceleration in domestic activity. We expect the Colombian peso to range trade around the 3000 levels versus the USD over the medium term. Short-term gains (driven by seasonal repatriation and firmer crude oil prices) may be overshadowed by longer-run focus on soft inflation and the likelihood that the central Bank will sit on its hands until later this year at least before thinking about tightening monetary policy. In Peru, solid underlying fundamentals are supportive of the sol (PEN) and are reflected in the PEN's near 2% gain so far this year. We are cautiously positive on the outlook for the PEN. Inflation has been rising but there is little sign that the central bank is thinking of tightening monetary policy which may mean the exchange rate takes some of the price strain. Trends in the Chilean peso (CLP) remain strongly influenced by volatility in copper in the short run, at least. The domestic economic backdrop is positive for the CLP but the central bank recently downgraded (modestly) its growth and inflation outlook for this year and we think policy makers can take their time to assess the need for higher interest rates. We expect modest gains for the CLP this year.

Global reflation policies are also supportive for EM Asian currencies in general, particularly the high-yielding ones such as the Indian rupee (INR) and Indonesian rupiah (IDR) given mounting negative-yielding debt. In the near term, however, both the INR and the IDR are likely to range trade in the run-up to the general elections set for April–May in India and 17 April in Indonesia.

The Chinese yuan (CNY & CNH) will likely trade towards 6.60–6.70 on the expectation that the US and China will reach a trade deal by the end of May and end the costly trade dispute. In addition, China's economic recovery will likely gain momentum in the months ahead as the nation's official manufacturing PMI rebounded strongly to 50.5 in March from a three-year low of 49.2 in February.

While easing US-China trade tensions could buoy EM Asian currencies further, the South Korean won (KRW) and the Taiwanese dollar (TWD) could remain relatively contained amid rising concerns over the geopolitical situation on the Korean Peninsula and cross-strait relations respectively. Meanwhile, the export-driven Thai baht (THB) is likely to advance as the Bank of Thailand (BoT) sounds relatively hawkish compared to other regional central banks.

The Hong Kong dollar (HKD) is likely to rally on the narrowing yield advantage of the USD. Meanwhile, the EUR's potential strength will likely prop up the Singapore dollar given a tight correlation between them. As we expected earlier, the monetary authority kept the width, slope and center of its current S$NEER policy band unchanged. According to our estimate, the band is now running with a width of +/-2.0% and an annual slope of 1.0%. The Malaysian ringgit (MYR) and the Philippine peso (PHP) will likely underperform somewhat on the back of potential monetary easing by the Bank Negara Malaysia and the Bangko Sentral ng Pilipinas.

APPENDIX 1

International	2000–17	2017	2018	2019f	2020f	2000–17	2017	2018	2019f	2020f
	Real GDP (annual % change)					Consumer Prices (y/y % change, year-end)				
World (based on purchasing power parity)	3.9	3.8	3.7	3.2	3.3					
Canada	2.1	3.0	1.8	1.6	2.1	1.9	1.8	2.0	1.5	2.0
United States	2.0	2.2	2.9	2.4	1.9	2.2	2.1	2.2	1.9	2.2
Mexico	2.2	2.1	2.0	1.4	1.3	4.4	6.8	4.8	4.0	3.8
United Kingdom	1.9	1.8	1.4	1.1	1.2	2.1	3.0	2.1	1.9	2.0
Eurozone	1.4	2.4	1.8	1.1	1.5	1.8	1.3	1.5	1.2	1.6
Germany	1.4	2.2	1.4	0.9	1.4	1.4	1.4	1.6	1.6	1.7
France	1.4	2.2	1.5	1.3	1.4	1.4	1.2	1.6	1.3	1.6
China	9.3	6.8	6.6	6.2	6.0	2.3	1.8	1.8	2.2	2.3
India	7.1	6.7	7.3	7.0	7.3	6.8	5.2	2.1	5.1	5.0
Japan	0.9	1.9	0.8	0.8	0.7	0.1	1.0	0.3	2.3	1.0
South Korea	4.1	3.1	2.7	2.5	2.5	2.5	1.4	1.3	1.3	1.6
Australia	2.9	2.4	2.8	2.5	2.5	2.7	1.9	1.8	2.0	2.2
Thailand	4.1	4.0	4.1	3.8	3.5	1.9	0.8	0.4	1.5	1.6
Brazil	2.5	1.1	1.1	1.9	2.2	6.5	3.0	3.8	3.9	4.9
Colombia	3.9	1.8	2.6	3.4	3.8	5.1	4.1	3.2	3.2	3.1
Peru	5.0	2.5	4.0	4.0	4.0	2.7	1.4	2.2	2.4	2.5
Chile	3.9	1.5	4.0	3.2	3.2	3.3	2.3	2.6	2.8	3.0
Commodities										
	(annual average)									
WTI Oil (USD/bbl)	62	51	65	59	61					
Brent Oil (USD/bbl)	65	55	72	67	68					
WCS - WTI Discount* (USD/bbl)	-16	-13	-26	-15	-21					
Nymex Natural Gas (USD/mmbtu)	4.83	3.02	3.07	2.90	2.80					
Copper (USD/lb)	2.38	2.80	2.96	3.00	3.20					
Zinc (USD/lb)	0.84	1.31	1.33	1.25	1.20					
Nickel (USD/lb)	7.12	4.72	5.95	5.75	6.00					
Aluminium (USD/lb)	0.87	0.89	0.96	0.90	0.90					
Iron Ore (USD/tonne)	67	72	70	77	70					
Metallurgical Coal (USD/tonne)	131	187	206	185	160					
Gold, London PM Fix (USD/oz)	890	1,257	1,268	1,300	1,300					
Silver, London PM Fix (USD/oz)	14.80	17.05	15.71	16.00	17.00					

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

APPENDIX 2

North America	2000–17	2017	2018	2019f	2020f	2000–17	2017	2018	2019f	2020f
	Canada (annual % change, unless noted)					United States (annual % change, unless noted)				
Real GDP	2.1	3.0	1.8	1.6	2.1	2.0	2.2	2.9	2.4	1.9
Consumer spending	2.9	3.5	2.1	1.5	1.9	2.4	2.5	2.6	2.4	2.1
Residential investment	3.6	2.4	-2.3	-2.9	2.1	-0.3	3.3	-0.3	-1.2	1.2
Business investment*	2.2	2.2	2.0	0.5	6.8	3.0	5.3	6.9	3.6	2.4
Government	2.2	2.7	2.7	1.2	1.7	1.0	-0.1	1.5	1.8	1.7
Exports	1.3	1.1	3.3	2.4	2.3	3.7	3.0	4.0	1.9	2.0
Imports	3.0	4.2	2.9	0.3	3.1	3.7	4.6	4.5	3.2	2.8
Nominal GDP	4.3	5.6	3.6	2.6	4.6	4.0	4.2	5.2	4.3	3.9
GDP deflator	2.1	2.6	1.7	0.9	2.4	1.9	1.9	2.3	1.9	1.9
Consumer price index (CPI)	1.9	1.6	2.3	1.4	2.0	2.2	2.1	2.4	1.7	2.2
CPI ex. food & energy	1.6	1.6	1.9	1.8	2.0	2.0	1.8	2.1	2.1	2.1
Pre-tax corporate profits	0.0	20.1	0.5	-4.7	2.1	5.3	3.2	7.8	3.4	1.9
Employment	1.4	1.9	1.3	1.6	0.7	0.7	1.6	1.7	1.4	1.0
Unemployment rate (%)	7.1	6.3	5.8	5.8	5.9	6.1	4.4	3.9	3.9	4.0
Current account balance (CAD, USD bn)	-18.7	-59.4	-58.7	-60.9	-62.8	-501	-449	-488	-542	-603
Merchandise trade balance (CAD, USD bn)	22.9	-23.9	-21.5	-30.1	-35.5	-680	-807	-891	-949	-1026
Federal budget balance (FY, CAD, USD bn)	-3.6	-17.8	-19.0	-18.1	-19.6	-540	-665	-779	-1,091	-1,101
percent of GDP	-0.2	-0.9	-0.9	-0.8	-0.8	-3.7	-3.4	-3.8	-5.1	-5.0
Housing starts (000s, mn)	200	220	213	202	200	1.26	1.20	1.25	1.25	1.26
Motor vehicle sales (000s, mn)	1,678	2,034	1,984	1,930	1,900	15.6	17.1	17.2	16.8	16.7
Industrial production	0.0	4.9	2.6	0.6	2.2	0.7	2.3	4.0	2.8	1.8
	Mexico (annual % change)									
Real GDP	2.2	2.1	2.0	1.4	1.3					
Consumer price index (year-end)	4.4	6.8	4.8	4.0	3.8					
Current account balance (USD bn)	-15.0	-19.4	-22.2	-27.4	-26.1					
Merchandise trade balance (USD bn)	-7.2	-11.0	-13.7	-17.5	-19.3					

Sources: Scotiabank Economics, Statistics Canada, CMHC, BEA, BLS, Bloomberg. *For Canada it includes capital expenditures by businesses and non-profit institutions.

Quarterly Forecasts	2018		2019				2020			
Canada	Q3	Q4	Q1e	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Real GDP (q/q ann. % change)	2.0	0.4	1.1	2.2	2.4	2.4	2.4	1.9	1.5	1.2
Real GDP (y/y % change)	1.9	1.6	1.5	1.5	1.5	2.0	2.3	2.3	2.0	1.7
Consumer prices (y/y % change)	2.7	2.0	1.4	1.4	1.4	1.5	1.8	2.0	2.1	2.0
Avg. of new core CPIs (y/y % change)	2.0	1.9	1.8	1.8	1.8	1.9	1.9	1.9	2.0	2.0
United States										
Real GDP (q/q ann. % change)	3.4	2.2	1.7	2.5	2.1	2.1	1.7	1.7	1.7	1.7
Real GDP (y/y % change)	3.0	3.0	2.8	2.4	2.1	2.1	2.1	1.9	1.8	1.7
Consumer prices (y/y % change)	2.6	2.2	1.7	1.6	1.7	1.9	2.1	2.2	2.2	2.2
CPI ex. food & energy (y/y % change)	2.2	2.2	2.1	2.1	2.2	2.1	2.1	2.1	2.1	2.1
Core PCE deflator (y/y % change)	2.0	1.9	1.8	1.8	1.9	1.9	2.0	2.0	2.0	2.0

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

APPENDIX 3

	2018	2019				2020			
Central Bank Rates	**Q4**	**Q1**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Americas				(%, end of period)					
Bank of Canada	1.75	1.75	1.75	1.75	2.00	2.00	2.25	2.25	2.25
US Federal Reserve (upper bound)	2.50	2.50	2.50	2.50	2.50	2.75	2.75	2.75	2.75
Bank of Mexico	8.25	8.25	8.25	8.25	8.25	8.25	8.00	7.75	7.50
Central Bank of Brazil	6.50	6.50	6.50	6.75	7.25	7.75	8.25	8.50	8.50
Bank of the Republic of Colombia	4.25	4.25	4.25	4.50	4.50	4.75	4.75	4.75	4.75
Central Reserve Bank of Peru	2.75	2.75	2.75	2.75	2.75	2.75	2.75	2.75	2.75
Central Bank of Chile	2.75	3.00	3.00	3.25	3.25	3.50	3.75	3.75	3.75
Europe									
European Central Bank	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bank of England	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00
Asia/Oceania									
Reserve Bank of Australia	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
Bank of Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
People's Bank of China	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
Reserve Bank of India	6.50	6.25	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Bank of Korea	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Bank of Thailand	1.75	1.75	1.75	1.75	1.75	1.75	.	1.75	1.75
Currencies and Interest Rates									
Americas				(end of period)					
Canadian dollar (USDCAD)	1.36	1.33	1.32	1.30	1.28	1.25	1.25	1.23	1.23
Canadian dollar (CADUSD)	0.73	0.75	0.76	0.77	0.78	0.80	0.80	0.81	0.81
Mexican peso (USDMXN)	19.65	19.43	19.90	20.48	21.26	21.40	21.26	21.36	21.71
Brazilian real (USDBRL)	3.88	3.92	3.91	3.97	4.18	4.08	4.11	4.07	4.18
Colombian peso (USDCOP)	3,254	3,189	3,105	3,150	3,120	3,050	3,100	3,182	3,167
Peruvian sol (USDPEN)	3.37	3.32	3.31	3.32	3.30	3.31	3.27	3.28	3.25
Chilean peso (USDCLP)	694	680	650	650	650	640	640	640	640
Europe									
Euro (EURUSD)	1.15	1.12	1.17	1.19	1.20	1.22	1.22	1.24	1.24
UK pound (GBPUSD)	1.28	1.30	1.35	1.37	1.40	1.42	1.42	1.45	1.45
Asia/Oceania									
Japanese yen (USDJPY)	110	111	110	108	108	107	107	105	105
Australian dollar (AUDUSD)	0.70	0.71	0.73	0.75	0.75	0.77	0.77	0.78	0.78
Chinese yuan (USDCNY)	6.88	6.71	6.60	6.70	6.70	6.60	6.60	6.50	6.50
Indian rupee (USDINR)	69.8	69.1	67.0	68.0	68.0	67.0	67.0	66.0	66.0
South Korean won (USDKRW)	1,116	1,135	1,100	1,120	1,120	1,100	1,100	1,080	1,080
Thai baht (USDTHB)	32.5	31.7	31.6	31.8	31.8	31.6	31.6	31.4	31.4
Canada (Yields, %)									
3-month T-bill	1.65	1.67	1.75	1.80	2.00	2.05	2.25	2.25	2.25
2-year Canada	1.86	1.55	1.70	1.80	2.05	2.10	2.30	2.30	2.30
5-year Canada	1.89	1.52	1.75	1.90	2.10	2.20	2.35	2.35	2.35
10-year Canada	1.97	1.62	1.80	2.00	2.20	2.35	2.45	2.45	2.45
30-year Canada	2.18	1.89	2.10	2.20	2.40	2.50	2.75	2.75	2.75
United States (Yields, %)									
3-month T-bill	2.36	2.39	2.40	2.40	2.40	2.65	2.65	2.65	2.65
2-year Treasury	2.49	2.26	2.45	2.50	2.60	2.80	2.80	2.80	2.80
5-year Treasury	2.51	2.23	2.50	2.60	2.70	2.85	2.85	2.85	2.85
10-year Treasury	2.68	2.41	2.65	2.75	2.85	2.95	2.95	2.95	2.95
30-year Treasury	3.01	2.82	3.00	3.10	3.20	3.25	3.25	3.25	3.25

Sources: Scotiabank Economics, Bloomberg.

Foreign Exchange Strategy