Canadian Outlook: 5 Big Questions for 2017

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How quickly things change. In the span of two weeks, the narrative around the Canadian economy swung from deep pessimism to potential optimism. On December 23rd, the unexpected contraction in October GDP reinforced the view that the economy faces an uphill climb. However, the tide turned last week with the very strong jobs report, coupled with the surprising trade surplus, suggesting that Canada isn't in nearly as bad a shape as was commonly thought. The truth is likely somewhere in the middle. The worst of the oil shock seems to have passed, but the outlook isn't all sunshine and lollipops; plenty of challenges remain. **Looking at 2017, here are five big questions facing the Canadian outlook**:

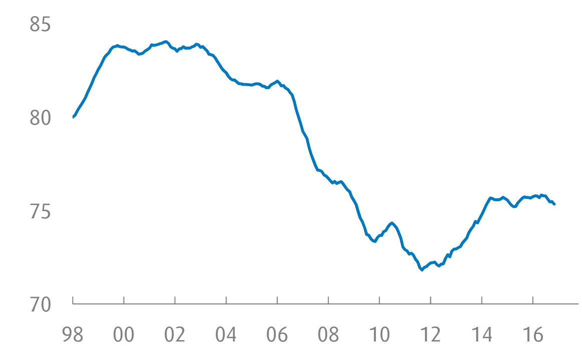
1) President Trump… Perhaps the biggest uncertainty facing the Canadian economy is the changing U.S. administration. Inauguration is January 20th and with it will come big changes in U.S. policy. Given what we've seen and heard from President-elect Trump, predicting what will come next is exceptionally difficult, but we know where his biases lie. Tax reform is a clear priority, though whether this is net stimulative is a question. Tax cuts will likely be accompanied by base broadening and other revenue-raising measures. Recall that a Republican Congress spent the past six years fighting Obama on the debt ceiling and spending.

Protectionism is a key risk for Canada (*Chart 1*). One measure that's under discussion is the border-adjustment tax. Without going into a comprehensive walk-through, this is effectively a tax on imports. The rumoured 20% tax rate would be a potentially major issue for Canada and the global economy more generally. The biggest impact would likely be on the loonie, which we anticipate would depreciate to offset a big chunk of the tax (other currencies would behave similarly). Even so, increased protectionism is clearly a negative for the outlook.

Chart 1
Most Export Eggs in One Basket

(% share of total exports)

Canadian Exports to the U.S.



Sources: BMO Economics, Haver Analytics

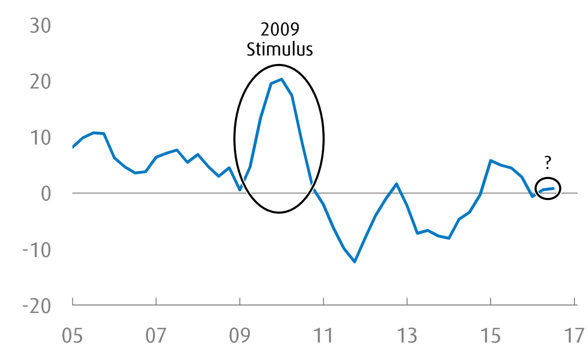
Other U.S. policy uncertainties include potential infrastructure spending and regulatory relief for business (e.g. more lax environmental regulation, the possible elimination of the Volcker Rule and loosening of Dodd-Frank, etc.). The latter could be a big boost to growth in a number of sectors. Expect some clarity on many of these issues by mid-year.

2) Federal Infrastructure… Canada's Liberal government ran on a stimulus platform, but there's been scant evidence of any spending yet, with government investment up 0.8% y/y as of Q3. That compares with the 15%-to-20% y/y surge from the 2009/10 stimulus (*Chart 2*). Given the size of the funds allocated to spending, it's probably just a matter of time before we see the boost to growth, but it is clearly a lengthy process. And, with the government now forecasting fiscal deficits through 2050 (a huge swing from the massive surpluses projected just a few years ago and a lengthy subject for another time), there may be less room for this type of spending than previously thought. Indeed, don't be surprised if there's no additional spending on infrastructure in next year's budget.

Chart 2
Where's the Stimulus?

Canada (y/y % chng)

General Government Real Investment



Sources: BMO Economics, Haver Analytics

3) Commodity Prices… One can't help but be impressed by the strength in commodity prices over recent months (*Chart 3*). The broad-based late-year rally was driven by post-election growth optimism and, in turn, prompted a more upbeat outlook for inflation. The OPEC agreement to cut production provided a nice lift to the energy space as well. Oil prices appear to be holding in a higher range now of around $50 to $55, after falling into the low-$40s in mid-November. If these gains hold, that would be a positive for Canada. We've already seen some oil firms lift their 2017 capital budgets. And, the negativity that has pervaded resource-producing provinces is finally fading, with some tepid signs of growth emerging from the latest Business Outlook Survey. Notably, Alberta's employment picture has turned more positive in recent months (*Chart 4*).

4) Exports… Perpetually disappointing export volumes have befuddled policymakers. Historically, at this point in the cycle, with the U.S. economy expanding at a decent rate for a few years (for the most part), Canadian exports would be growing. However, that hasn't been the case this cycle. Perhaps the softness was driven by the commodity price plunge and the resulting weakness in U.S. business investment. The latter has a solid correlation with Canadian exports over the past decade (*Chart 5*). So, our forecast for firmer U.S. business investment in 2017 suggests it could be a better year for exports. We already saw a big gain in November. Could this be the start of a better trend, or another head-fake similar to the temporary spike we saw at the turn of last year?

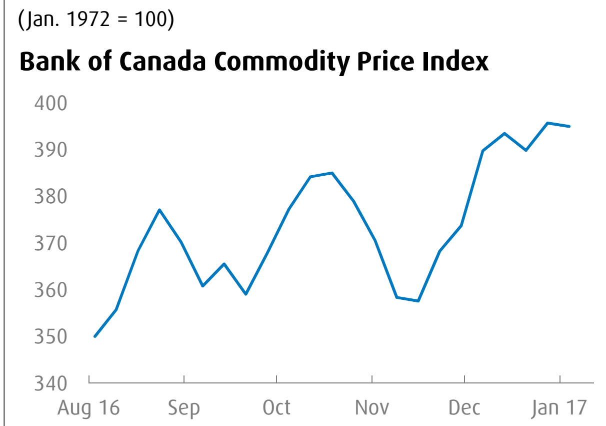
5) Cap & Trade/Carbon Tax… Flying under the radar is the cap & trade or carbon taxes being implemented in Alberta and Ontario. In addition, the federal government has mandated that any province without either a carbon tax or cap & trade program will be subject to a minimum $10/ton carbon tax in 2018, rising to $50 by 2022. The measures will raise energy prices and hurt Canadian competitiveness. The question is how much of a set-back they cause. Ontario already suffers from relatively higher electricity prices, while Alberta needs all the help it can get, as it continues to climb out of the commodity-collapse driven hole. This could put a dent in exports and growth more broadly. The B.C. approach of a carbon tax offset by other tax cuts would have been far more preferable.

*The outlook for housing and household debt is a perennial area of uncertainty as well for Canada, but given our extensive coverage of the topic elsewhere, we've chosen not to focus on it here.

Bottom Line: While the Canadian data have suddenly taken a turn for the better, the economy will face a number of uncertainties in 2017. We're forecasting GDP growth will accelerate to 2% this year, but that can quickly change as the above questions are answered.

Chart 3

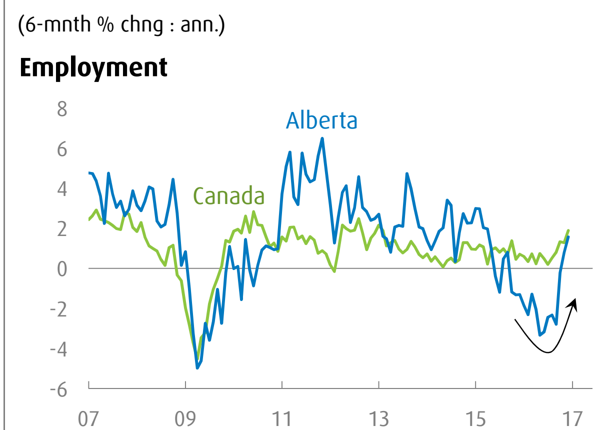
Trumped-Up Rally



Sources: BMO Economics, Haver Analytics

Chart 4

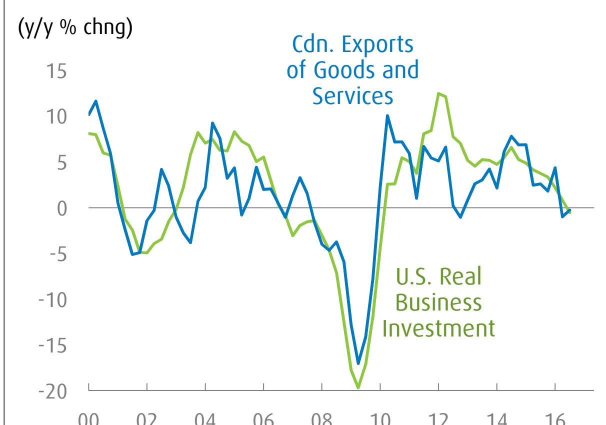
Commodity Patch Bottoming



Sources: BMO Economics, Haver Analytics

Chart 5

Tied at the Hip



Sources: BMO Economics, Haver Analytics

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