5 Defining Factoids for 2018, 5 Defiant Forecasts for 2019

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Despite a late-year whirlwind of financial market volatility and a bevy of geopolitical risks, **2018 unfolded reasonably close to plan from an economic and central bank perspective**. Probably the biggest "surprise" was the **mismatch between still-healthy economic growth**—especially in the U.S.—and **weakness in stocks and commodities**. A key feature was the **clear separation** between a stimulus-buoyed U.S. economy and somewhat slower growth almost everywhere else. That divergence was also largely reflected in monetary policies, and thus exchange rates, as the **U.S. dollar rose against all currencies**, save the yen. **Trade tensions** dominated the year, morphing from U.S. metals tariffs, then to NAFTA cum USMCA, and finally to the U.S./China showdown—none of which have been fully resolved yet. Canadian equities just couldn't find satisfaction; even as trade woes were finally soothed, oil prices cracked and then global growth questions mounted. In Europe, just as concerns over Italy's budget finally faded, France was wracked by the raucous Yellow Vest protests. Meanwhile, **Brexit** moved closer to a cliff-edge solution, keeping U.K. markets and the economy dangling. And, finally, **bitcoin** was one asset that actually went about as many expected, tanking over 80% from its peak a year ago. Besides the bitcoin bubble bursting, **here are five more important facts that defined 2018**:

1. **We are headed for the first year of losses for both the S&P 500 and the 10-year Treasury in modern times.** With a handful of trading days left, either bonds or stocks could pull out a last-minute revival (10s are close to even), but both are poised to lose money this year. The pain spread beyond the two big liquid-asset classes, as there were few places to hide in this year's challenging markets. It's no coincidence that financial assets struggled heavily when the Fed's unwinding of QE hit its stride. The hurt was especially acute for U.S.-based investors, as declines in overseas markets were compounded by weakness in most currencies against the dollar. Example: Brazilian stocks had a world-leading 12% gain in local-currency terms, but were down 4% in US$-terms. In other words, **it was the rare year when cash literally was king**. A fair point is that the negative outing for almost all financial markets in 2018 was almost a reversal of the unbelievably calm and robust conditions in the prior year.

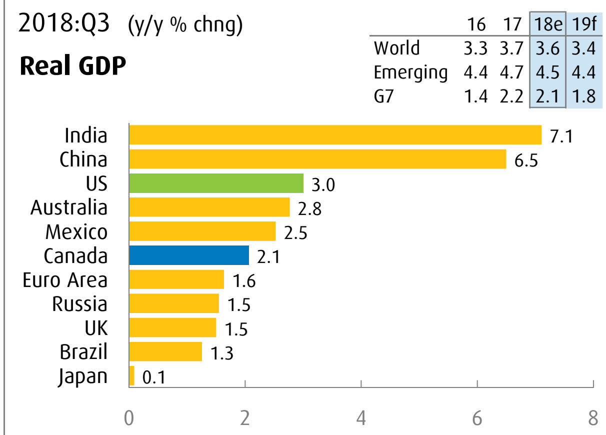
2. **Some bond yields fell in 2018.** Yields sagged sharply to end the year amid the Q4 equity market correction and sliding oil prices. While the focus was on a possible Treasury curve inversion, in some markets this was enough to chop yields below end-'17 levels. Two prime cases—Canada and Germany. Even with three BoC rate hikes, **10-year GoC yields are now below where they started 2018**, while 30s are down 9 bps. Meantime, Bund yields are well down amid a flight to quality within the Euro Area, and due to the fact that the ECB is still at least nine months from even starting to raise rates. We can't say the same for the Treasury market where 100 bps of tightening, a swollen budget deficit and a declining Fed balance sheet have pushed up all yields by at least 30 bps this year.

3. **Commodity prices declined almost across the board, even as global growth topped potential and core inflation pressures rose.** Some of the pullback

reflected relentless North American supply gains for oil, some a surprisingly strong U.S. dollar, and some commodity-specific factors. But the big picture is that resource prices dipped broadly, with all five sectors of the BoC's Commodity Price Index dropping this year. Perhaps **the most spectacular example was lumber**, which fired up 45% to a record high above $650/mbf in May amid U.S. tariffs, only to be chopped in half by October amid the U.S. housing slowdown. On net, lumber prices are now down almost 30% since the start of the year, despite the fact that U.S. housing starts did manage to rise modestly to their best average level in a decade.

Chart 1

Global GDP: Past the 'Best Before'



Sources: BMO Economics, Haver Analytics

4. **The U.S. dollar was up against almost every major currency in the world in 2018.** A record trade deficit? Prospects for a $1 trillion budget deficit? Ongoing political drama, a possible government shutdown and the likelihood of gridlock next year? Coming off a tough 2017, many of the stars seemed to line up poorly for the U.S. dollar at the start of the year. But the fiscal-juiced growth bounce, a determined Fed, and some cooling in much of the rest of the world was all the greenback needed to get back in rally mode. Notably, **the U.S. was a rarity among all the major economies, with growth accelerating in 2018**—the only others that likely managed that feat were Australia, Switzerland, Israel and Greece(!). (For trivia buffs, Ireland will probably post the fastest growth in the OECD at almost 6%, but that marked a slowdown from 7.2% in 2017.) It was an especially tough year for emerging market currencies, low-lighted by runs on Argentina and Turkey, which saw losses of 50% and 30%, respectively, this year.

5. **Canada's population posted the largest increase in more than 60 years.** Favourite factoid for 2018: the population of Canada rose by more than one person per minute in the past year (there are 525,600 minutes in a non-leap year), the largest increase since 1957. In percentage terms, the rise was less staggering at 1.44% y/y, but that's still the fastest since the early 1990s. And, yet, there was no surge in spending—auto sales fell on an annual basis for the first time since 2009, while home sales had their second biggest slide in the past 20 years. The rapid population increases put a duller glow on Canada's recent GDP gains, with the per capita advances actually near the back of the G7 pack in the past year.

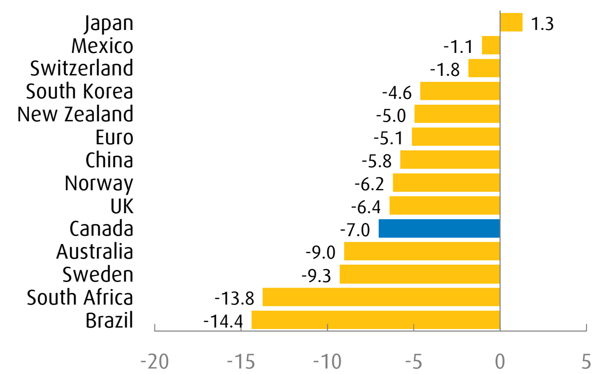
Before turning to the forecasts for 2019, note that we scored either 7 or 8 out of 10 on the calls last year (judges still disputing one, see sidebar). **Here are five major trends we see unfolding over the next year, and five associated forecast reaches**:

1. **The U.S. expansion will become the longest on record** (since at least 1850), surpassing the 10-year upturn from 1991-2001. This is not as obvious a call as it may have looked just a few short weeks ago, given the sudden spate of recession chatter. But, we still believe the economy will manage to keep growing beyond July, setting a new record for cycle longevity. Growth in 2019 will need to overcome: a) the financial turbulence that has whipped up since early October; b) less push from fiscal stimulus; c) deeper political drama; and, d) trade tiffs. Note that the reported annual average growth rates (2.9% in 2018 and 2.4% for 2019) mask a sharper slowdown in the quarterly pattern, with GDP likely dipping just

below 2% in the second half of next year. **Stretch call:** Not only will the U.S. again lead the G7 growth ranks next year, but it will have the best gains for the decade (even topping Canada, which stumbled after a strong early lead).

2. **The U.S. will post its lowest misery index in more than 60 years.** With both inflation and the unemployment rate poised to ease in 2019, the misery index (the simple sum of the two) could drop below 5.5% next year (2% CPI inflation and a 3.5% jobless rate). The lowest since the 1950s was an average of 5.4% in 2015 (when oil prices crashed, crushing inflation), and a monthly reading of 5.0% that September. With crude skidding again, we could challenge both those levels in 2019. **Stretch call:** The news darkens later in the year, as the U.S./China trade battle reheats—we don't agree with the apparent consensus that this issue gets resolved in 2019.

Chart 2
Global Currencies: All Fall
Since End-2017 (% chng vs US$: as of Dec. 21, 2018, 10:30 am)



Sources: BMO Economics, Bloomberg

3. **The U.S. dollar pulls another 180, and begins to weaken through 2019.** This is driven by cooling U.S. growth, prospects for the end of Fed tightening, and global growth stabilizing. **Stretch call:** The **pound will rebound in the second half of 2019.** This is not an optimistic call on Brexit per se, but instead reflects the reality that a lot of bad news is already built into the pound—the certainty of a bad outcome may be better than the current endless uncertainty. Moreover, the economy will have three quarters to work its way through even the worst outcome for Brexit. We look for the pound to edge up near $1.30 by year-end.

4. **The Fed and BoC hike more than the market expects in 2019.** Given how markets have rapidly peeled back the amount of expected tightening for next year in recent weeks, this is no giant leap. Markets now look for less than one rate hike from each of the central banks, so even one hike apiece will hurdle this low bar! We look for two hikes from each, which would leave rates at the low end of neutral (2.5%-to-3.5%) for the Fed and a shade below for the Bank of Canada. **Stretch call:** These are the only rate hikes in the industrialized world. Okay, not much of a stretch with only the BoE, Norges Bank and Riksbank joining the Fed and the BoC in 2018; but, given oil's slide, trade frictions, and Brexit uncertainty, it could be another year of sidelined short-term rates globally.

5. **The TSX outperforms the S&P 500.** Admittedly, this may be a case of winning by not losing; but, after a double-digit decline in the TSX this year, we look for a small turnaround. From trade uncertainty, to a housing cooldown, to record WCS differentials, it was a challenging year for Toronto equities (although many markets suffered even mightier setbacks). In fact, the TSX has underperformed the S&P in seven of the past eight years, with only 2016 the outlier. But this drought followed a long stretch of outperformance; i.e., there is persistence. Typically, it's fairly straightforward—when real commodity prices are rising, the TSX shines. However, with trade uncertainty reduced (USMCA) and a lot of bad news on energy factored in, next year could see a rare win for the TSX, at least on a relative basis. **Stretch call:** We would be remiss to ignore the fact that 2019 is an election year in Canada (Alberta in May, Federal in October). We would not dare to opine on that front, but will simply say that both will matter for markets.

Judging last year's calls, briefly:

1. *OECD jobless rates will hit a record low, and wages will finally waken.* Yes, and sort of in the U.S.
2. *The Fed will again do at least what they say, maybe more.* Yes, four hikes were more than expected a year ago.
3. *NAFTA founders, the BoC trails the Fed, the C$ suffers.* The latter two were correct; NAFTA lives on as the USMCA, presumably.
4. *The U.S. trade deficit will widen, to a record high, despite protectionist measures.* Bullseye.
5. *Alberta bonds will outperform, while Quebec jobless rates will hit the lowest in the country.* Still a close call and almost.