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Focus

A weekly financial digest

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- **BoC... 3 rate hikes in 2019 (Jan [new!], Apr, July)**
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38 Years Old, Never Kissed a Bond Bear

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North American long-term government bond yields hit their all-time high on September 30, 1981, with the 10-year Treasury topping out at 15.84% and Canadian yields of 10 years and over maxing out at 18.14% that same day. It's pretty much been all downhill for yields since that point. While it would be an exaggeration to say that the bond bull has been consistently charging through that entire period, anyone now in their 38th year would have never experienced a true bear market in bonds. Oh, there were some serious years of sell-offs—1983, 1987, 1994, 1999, 2009 and 2013 all saw 10-year yields rise by more than 100 bps—but the mega downtrend was never seriously challenged. Until now.

It's been highly dangerous to declare the bond bull dead for decades now, with many pundits humbled by prematurely opining on its demise. But the sustained nature of the back-up from the record lows of two years ago, and the clear risk of more, makes this episode different. This week saw old resistance levels crack, as the benchmark 10-year Treasury jumped 18 bps to over 3.2%, hitting its highest level since the Spring of 2011. A big chunk of the curve vaulted above the 3% threshold, with 5-years joining in and thus hitting their highest level since pre-Lehman days of a decade ago.

The latest rise in yields was driven by a combination of **robust U.S. economic data, fresh highs for U.S. equities, and four-year highs on oil prices**. True, each of these factors took a step back late in the week—September payrolls were nothing special at +134,000, stocks stumbled, as did oil—but the big picture very much stayed in place. Loaded on top of a robust economy, Fed Chair Powell chimed in a few times this week with a hawkish message, notably that policy could easily be driven above neutral (i.e., fed funds above 3%). In addition, there's the increasingly ugly supply side of the equation, with Washington staring down a $1 trillion budget deficit this fiscal year (which started Monday) and the Fed now hitting its maximum stride in quantitative tightening.

The **rest of the world was not spared** from the back-up in yields. While the Italian budget machinations provided some drama in Europe, yields pushed higher around the continent, with even bunds rising 10 bps to 57 bps. But **one of the biggest jumps in yields was seen in Canada**. After hitting an all-time low of 0.95% just a little more than two years ago, 10-year GoCs have since vaulted 166 bps to 2.61%, with 18 bps added in just the past week alone. The USMCA deal sparked the initial selling wave—washing away the biggest source of uncertainty for Canada, and thus ramping up BoC tightening odds across the board—but the Treasury sell-off piled on.

Domestic factors certainly support the back-up in Canadian yields. Employment was solid in September (+63,300, jobless rate down a tick to 5.9%), trade posted its first surplus in almost two years, and forecasters busily revised up their 2019 growth projections on the relief of the USMCA and the just-announced $40 billion LNG project in British Columbia. Given that the risks to Canadian growth forecasts are now to the upside, headline and core CPI are basically in sync with U.S. trends, and global oil prices are rising (WTI at $75), it's increasingly tough to justify the meaty U.S.-Canada bond yield spreads (now 63 bps for 10s and a honking 82 bps for 30s). While a better fiscal position can partly support that gap, we believe the trend will be toward a narrower spread over the next year—in other words, Canada is now looking to venture much deeper into bear country.

While Canada's rate structure and outlook were shifted heavily by the trade deal, other domestic markets moved on with pace. A staggering piece of trivia—to be hauled out in the years to come—is that the Canadian dollar actually fell this week, and the TSX was actually down slightly (-0.9% as this is written). That's in a week when oil was strong, jobs were solid, the LNG project advanced and a North American trade deal was secured. Of course, a major caveat is that Canadian oil prices are reeling, with the WTI-WCS spread reaching a record high of over US$40. Imagine where we would be on the loonie and stocks if the economic and trade news was bad!

Sometimes in the forecasting business you just have to admit that reality is diverging significantly from what you projected—i.e., you were wrong. Some broad samples (not from us, mind you) would include: "It's different this time"; "an inverted yield curve is due to special factors and doesn't mean much"; "Clinton in 2016"; "U.K. remain in 2016"; "the Leafs will win in pick-a-year-since-1967"; and "the Bank can't possibly hike for a second consecutive meeting with no communications". Adding to the list, a week ago we opined: *"Absent a last-minute miracle, it looks like lengthy NAFTA negotiations will blow through yet another supposed deadline this weekend."*

Well, the ground appeared to shift almost the moment that the ink on the quill was hitting the paper on Friday. It was announced later that day that the Mexico-U.S. deal was not going to Congress after all, and the incoming Mexican President (AMLO) again stressed that any deal should include Canada. Beyond the keen eye of the media, intense negotiations were going on all the while, and the real horse-trading over the weekend began. So, miracles do apparently happen. Curiously, Friday was the same day that the passing of Marty Balin, co-founder of **Jefferson Airplane** (later Starship), was announced. How in the world does this pertain to NAFTA? Balin may be best known for his great comeback song with Jefferson Starship, the 1975 gem "Miracles".

Should Stocks Yield to Bond Sell-off?

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The back-up in 10-year Treasury yields, to the highest level since the Spring of 2011, is bound to raise some questions about equity valuations, and stocks already started to see momentum fizzle late in the week. Indeed, the spread between the forward earnings yield on the S&P 500 and the 10-year Treasury yield has now compressed to the lowest level since we were emerging from the financial crisis, and more than a full percentage point below the 5-year average. On the surface, that argues for some caution as stocks become more expensive relative to their risk-free alternative. However, a few factors could ease the concern. First, while bond yields have risen, so have earnings expectations—a lot. This has helped limit the deterioration in relative valuations that we would otherwise see with yields jumping 100 bps in a year. Also, keep in mind that we are coming off a very favourable post-recession valuation base. Indeed, despite the recent contraction, the spread is still wider than the range the market settled into during the 2003-to-2007 bull market. Finally, although most stand-alone equity valuation metrics are stretched, this could as much reflect what's happening on the yield side of the equation—that is, Treasuries becoming less overvalued as monetary policy normalizes.

From a Canadian perspective, the forward earnings yield gap versus the S&P 500 has widened to the highest level of the cycle so far, leaving the TSX relatively cheap versus its U.S. counterpart. Recall that the earnings yield gap between the TSX and S&P 500 reached similar levels, but in the opposite direction (i.e., Canada was expensive) around late-2010, and the subsequent underperformance of Canadian stocks really hasn't let up since. Could this be a value trap? Sure. The TSX simply doesn't have the exposure to what is working right now at this stage of the cycle—technology and consumer discretionary—while it has plenty of exposure to banks, which tend to lag when credit growth slows and the yield curve flattens. Meantime, while energy is working elsewhere, Canada's sector is being held back by the record discount for Canadian crude. But, could we be setting up for a solid run in Canada? Sure. Sentiment toward Canada could very well turn with a major trade risk now removed, and any relief on the oil price front would provide some fuel. Relative valuations certainly won't prevent a positive run for Canada. Rob K.

U.S. Goods on Sale for Canadians

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The new trade deal raises the value of goods that Canadians can buy from American online stores that qualify for **duty-free access from C$20 to $150**. And goods under $40 are now exempt from sales taxes. The eight-fold increase in duty-free limits on "express shipments" does not apply to other countries (besides Mexico), nor does it impact the current cross-border exemption for Canadians returning from abroad, which is nil for visits of less than 24 hours, $200 for stays of over 24 hours and $800 for journeys beyond 48 hours.

The U.S. initially pushed Canada to raise the limit to US$800, or over C$1,000, but Canadian negotiators pushed back. The prior limit of $20 was the lowest among industrial nations and had not changed since 1985, well before e-commerce took off in the 1990s. The U.S. raised its threshold in 2016 from US$200 to $800, **but has now lowered it to $100**, as quid pro quo for Canada not agreeing to the initial demand. Mexico's limit was doubled to US$100. There are no restrictions on country of origin for the goods.

The higher duty-free limit will benefit Canadian consumers and many businesses. Consumers will save on customs fees and enjoy faster delivery times. A Nanos poll, sponsored by the Canadian American Business Council, found that 76% of Canadians supported a higher threshold. Parcel delivery firms should see an increase in orders. Small- and medium-sized firms that buy U.S. supplies online will save on administration costs and face fewer delivery delays, reducing supply chain uncertainty. An earlier C.D. Howe study found that raising the threshold to C$100 would lead to a tiny net economic benefit of $453 million, or 0.02% of GDP.

Although a win for consumers and many businesses, **the higher duty-free limits will further ding retailers.** Not only will they see sales from Canadian shoppers drop, but Americans will be less eager to hit the "buy" icon as well given the sharply reduced U.S. threshold. Canadian retailers, whether online or not, must collect sales taxes based on the buyer's province. For low-valued items, more Canadians may look to U.S. shops simply to avoid the tax. A study conducted by consulting firm PWC for the Retail Council of Canada found that raising the duty-free threshold to US$200 (with no change to sales taxes) could reduce GDP by $4.5 billion in 2019, or 0.2%. While the lowly loonie will likely dissuade some Canadians from buying American goods at the moment, retailers will be challenged if the currency (say because of rising oil prices) strengthens well beyond its purchasing power parity level of around C$1.29. (At this exchange rate, the average cost of buying goods in either country is similar, at least according to Statistics Canada.)

The new duty-free limits, though supporting the competitiveness of some Canadian businesses, will add to the challenge of others, namely goods retailers. Until Canada's broader competitiveness issues are addressed, the loonie could remain flightless.

U.S. Labour Market:
"We haven't had that spirit here since 1969"

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It's official. The U.S. economy is now sporting the lowest unemployment rate since December 1969 (when it was 3.5%). It dropped a couple tenths to 3.7% last month, falling below the prior April 2000 low-water mark of 3.8%. Corroborating the '60s theme, during September, the four-week average of initial jobless claims ran at its lowest level since—you guessed it—December 1969.

The U.S. labour market is, historically, extremely tight. The jobless rate data started in January 1949, 849 months ago. It's been below 3.7% for only 56 of those months (just 6.6% of the time), clustered during 1951-53 and 1968-69. These past intervals were characterized by high and accelerating wage growth. But, last month's reading on average hourly earnings was 2.8% y/y, which dipped a tenth from August's cycle high, continuing to display only slight signs of picking up as the jobless rate has been dropping toward 48-year lows. This "flat" relationship between labor market slack and wage inflation, a.k.a. the Phillips curve, was the theme of Fed Chair Powell's speech this week. He said: *"I do not see it as likely that the Phillips curve is dead, or that it will soon exact revenge. What is more likely, in my view, is that many factors, including better conduct of monetary policy over the past few decades, have greatly reduced, but not eliminated, the effects that tight labor markets have on inflation."*

Apart from better-conducted monetary policy, Powell didn't elaborate much on the *"many factors"*. We've likened the current situation to a tug-of-war between the cyclical forces of inflation and the secular forces of disinflation, with the latter being such a strong opponent that the former is only able to pull the rope very slowly to its side. On the disinflation side you've got globalization, which gathered strength after China entered the WTO in 2001. There is also an aging population, owing to which higher-paid older workers are being replaced by lower-paid younger workers and retirees are spending less than during their working years. Finally, there's the ubiquitous influence of technology-enabled disruption—the further digitalization of distribution and automation of production. The key is that **these secular forces of disinflation aren't going away anytime soon, but neither are the cyclical forces of inflation**. Instead, the tug-of-war will continue, and the Fed is going to be keeping a keen eye on which side is gaining ground. Policy normalization continues because the cyclical forces have the slight upper hand. But, the normalization process itself remains gradual because the secular forces are such a strong offset. MJG

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	Good News	Bad News
Canada ▪ USMCA replaces NAFTA in 11th hour deal ▪ LNG project in B.C. moves ahead ▪ CAQ party wins majority in Quebec	**Employment** +63,300 (Sep.) **Jobless Rate** -0.1 ppts to 5.9% (Sep.) **Merchandise Trade Surplus** $526 mln (Aug.)—but on import slump	**Average Hourly Wages** cooled to +2.4% y/y (Sep.) **Auto Sales** -7.4% y/y (Sep.) **Markit Manufacturing PMI** -2 pts to 54.8 (Sep.) **Ivey PMI** -11.5 pts to 50.4 (Sep.)
United States ▪ Bond rout sends Treasury yields to highest since mid-2011 ▪ Fed Chair Powell is *"remarkably positive"* on economic outlook; still "*a long way*" to neutral	**Average Hourly Earnings** +0.3% (Sep.) **Jobless Rate** -0.2 ppts to 3.7% (Sep.)—48-yr low **Non-manufacturing ISM** +3.1 pts to 61.6 (Sep.) —second-highest on record **Factory Orders** +2.3% (Aug.) **Auto Sales** jumped to 17.4 mln a.r. (Sep.) **Initial Claims** -8k to 207k (Sep. 29 week)	**Nonfarm Payrolls** +134,000 (Sep.) —but upward revisions **Goods & Services Trade Deficit** widened to $53.2 bln (Aug.) **Manufacturing ISM** -1.5 pts to 59.8 (Sep.) **Construction Spending** +0.1% (Aug.) —below expected **Conference Board's CEO Confidence Index** -8 pts to 55 (Q3)
Japan ▪ Nikkei touches 27-yr high	**Household Spending** +2.8% y/y (Aug.)—fastest pace in 3 yrs **Consumer Confidence Index** +0.1 pts to 43.4 (Sep.)	**Manufacturing PMI** revised lower to 52.5; **Services PMI** -1.3 pts to 50.2; **Composite PMI** -1.3 pts to 50.7 (Sep.) **Tankan Large Mfg. Index** -2 pts to 19 (Q3)
Europe ▪ Italy's PM Conte confirms reduced deficit target in 2020, and 2021… sticking with 2.4% in 2019 ▪ GBP strengthens on possible British proposal to avoid hard Irish border	**Euro Area—Jobless Rate** -0.1 ppts to 8.1% (Aug.) **Euro Area—Producer Prices** +0.3% (Aug.) **Germany—Factory Orders** +2.0% (Aug.) **Italy—Jobless Rate** -0.5 ppts to 9.7% (Aug. P) **Italy—Retail Sales** +0.7% (Aug.) **U.K.—Manufacturing PMI** +0.8 pts to 53.8 (Sep.) **U.K.—Unit Labour Costs** +2.0% y/y (Q2) **U.K.—Nationwide Home Prices** +0.3% (Sep.)	**Euro Area—Retail Sales** -0.2% (Aug.) **Germany—Retail Sales** -0.1% (Aug.) **France—Jobless Rate** +0.1 ppts to 9.3% (Aug.) **France—Trade Deficit** widened to €5.6 bln (Aug.) **U.K.—Services PMI** -0.4 pts to 53.9; **Construction PMI** -0.8 pts to 52.1; **Composite PMI** -0.1 pts to 54.1 (Sep.)
Other ▪ Rupee sinks to record low after RBI unexpectedly stays on hold ▪ RBA, Mexico on hold	**China—Non-manufacturing PMI** +0.7 pts to 54.9 (Sep.) **Australia—Retail Sales** +0.3% (Aug.) **Australia—Trade Surplus** widened to A$1.6 bln (Aug.)	**China—Manufacturing PMI** -0.5 pts to 50.8 (Sep.) **China—Caixin Manufacturing PMI** -0.6 pts to 50.0 (Sep.) **Australia—Building Approvals** -9.4% (Aug.)

Indications of stronger growth and a move toward price stability are good news for the economy.

NAFTA 2.0
How Do You Spell Relief? U-S-M-C-A

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Overview

After 13 months of sometimes fractious negotiations and waves of uncertainty for Canada's economy, policymakers and financial markets, we have an agreement to replace NAFTA. The **U.S. and Canada have agreed in principle on a new deal,** which both leaders have endorsed, but which must be ratified by all three legislatures including a new U.S. Congress. Clearly, this is a major relief for Canada, lifting a heavy cloud of uncertainty from the outlook and opening the door for increased investment. **The one change we are making to our forecast as a result of the deal is an additional Bank of Canada rate hike in 2019 (in January).** Bond yields jumped following the announcement, while the Canadian dollar initially strengthened to just over 78 cents, though we remain sceptical about its long-term prospects.

From Canada's perspective, the biggest concession appears to be giving the U.S. access to just under 3.6% of the dairy market, in exchange for the preservation of the dispute resolution mechanism and some assurances, however technical, that Canada would not be hit by a 25% tariff on autos under Section 232. In a nutshell, **Canada was forced to make concessions, but is coming out quite clean considering the array of potentially negative options and threats that were on the table**. Below are the major elements and key takeaways from Canada's perspective.

What's in the Deal and Why It Matters

- **Name and lifespan:** The deal will be called the **United States-Mexico-Canada Agreement**, or **USMCA**. **Canada is largely agreeing to the major elements of the U.S.-Mexico deal**, unless stated otherwise. More specifically, the **new trilateral deal will last for 16 years**, with a review to be made at the six-year mark. At that point, the three countries can extend the agreement or begin formal negotiations to fix any irritants. However, as before, any party can still decide at any time to exit the agreement after six months' notice.
- **Chapter 19: The dispute settlement mechanism** for countervailing and anti-dumping duties, a.k.a. **Chapter 19** in the original NAFTA and not part of the U.S.-Mexico deal, is retained. (It will apparently now be known as **Chapter 10**.) This was a Canadian red-line issue and was the sticking point on bilateral negotiations as far back as the original FTA in the late 1980s. In other words, this was a big deal for Canada.
- The **state-to-state dispute resolution mechanism** (NAFTA's **Chapter 20**) was already retained in the U.S.-Mexico deal. The investor-state dispute settlement mechanism (NAFTA's **Chapter 11**) will be eliminated between Canada and the U.S. (A scaled back version was retained with Mexico covering oil and gas, infrastructure and telecommunications.)

- **Supply management: U.S. dairy farmers** will get access to just under 3.6% of Canada's protected market, slightly above the 3.25% that the Asia/Pacific nations received under the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). Canada has agreed to eliminate its Class 6 and Class 7 milk categories within six months. Given that Canada's dairy market is growing by roughly 1% per year, and that the import quotas will be phased in over six years, Ottawa believes that the industry can adjust to the changes. Even so, the federal government intends to compensate dairy farmers. It's important to note that poultry and egg producers are also relinquishing market share in Canada, with poultry opening up by almost 5% over a six-year period and egg producers ceding 1.3% with no phase-in period.

- **Autos:** Automotive production will be subject to higher North American content provisions for duty-free shipments across the three countries, with a minimum 40% coming from USMCA jurisdictions that pay workers at least US$16 per hour. This clearly helps Canada (and the U.S.) versus Mexico. There's a "side letter" guarantee that potential U.S. Section 232 tariffs on **automotive products** will not be applied to Canada or Mexico up to a certain limit. Canada agreed to a 2.6 million passenger vehicle duty-free limit per annum and US$32.4 billion in parts (light trucks are exempt). These are not binding constraints as Canada currently produces just under 2 million light vehicles for its domestic and export markets, and currently exports just over C$20 bln (or roughly US$16 bln) in parts. Effectively, this portion of the agreement is more of a safeguard that Canada will not become a high-volume producer in the future; given that Canada's vehicle production has been trending lower for more than 15 years, this was a low-probability likelihood. We would judge the overall effect of the agreement on autos with the U.S. and Mexico as a net positive for Canada.

- **U.S. steel and aluminum tariffs:** These remain in place for the time being, as do Canada's retaliatory tariffs. It looks like a quota here might also be the way out, but this issue may not be settled until the agreement is officially approved by all three nations. A broader concern is that the deal does not limit the U.S. Administration from imposing Section 232 tariffs on other Canadian industries, apart from autos.

- **De minimis threshold value on imported online goods:** The deal raised the threshold value of Canadian imported goods purchased online (or via mail order) that qualify for duty-free access from C$20 to C$150. Imported goods valued at less than C$40 will also be exempt from sales taxes. The higher threshold value comes with both benefits (to consumers and businesses) and costs (to retailers). Canadian consumers will enjoy lower prices and faster delivery times due to less customs processing. Canadian businesses buying U.S. supplies online will save on administration costs and face fewer delivery delays, reducing uncertainty. However, Canadian retailers will lose out due to the relative loss of competitiveness. Notably, the minimum threshold value for Americans shopping on Canadian online sites was slashed from US$800 to US$100.

- **Prescription drugs:** Canada will extend the patent protection for certain **prescription drugs** (biologic drugs) from 8 to 10 years, matching what Mexico had already agreed to. This is the one portion of the deal that is a clear negative for Canada, since it will add to drug costs with little upside in return.

- **Cultural:** Previous protections for Canadian **cultural industries** are retained. However, Canada made concessions on copyrights (out to 70 years after death, from 50 years currently), which were beyond TPP proposals.
- **Restrictions on Canada's ability to forge free-trade deals with "non-market" countries**: The deal gives the U.S. and Mexico the right to review any trade deals that Canada forges with non-market countries (read China), and to abrogate the USMCA with six months' notice if unsatisfied. This clause could discourage Canada (and/or Mexico) from signing a free-trade deal with China, curbing its ability to diversify shipments away from the U.S.
- **Establishing a Tri-nation Macroeconomic Committee**: The Committee will consult to prevent each USMCA member from embarking on a perceived "competitive devaluation". Since Canada has long abandoned the practice of using foreign exchange intervention to "manage" its currency, this might not be a big deal. Still, it could see the Bank of Canada second-guess policy decisions given the potential impact on the loonie. While the Committee seems innocuous, could it have challenged the BoC's rate cut in early 2015 (during the oil shock)?
- **Eliminates "Proportionality" clause in energy production**: The elimination of this clause is favourable for Canada's energy industry, as it had the potential to limit its ability to reduce shipments to the U.S. and hence diversify sales to other faster-growing regions, such as Asia. The rapid rise in U.S. oil production in the past decade made this clause from the original FTA all but redundant from a U.S. perspective. Canada will also have more flexibility to alter the mix of its energy production, perhaps in favour of natural gas over oil.
- **Timing:** The plan is for Prime Minister Trudeau, President Trump and President Pena Nieto to **sign the USMCA at the end of November**. Unless the new deal can then be rushed through in the lame duck session in December (highly unlikely), it will need to be ratified by the new U.S. Congress in 2019.

Implications for Markets and the Economy

- **The economy:** This deal was mostly about minimizing the negative impact on Canada's economy that could have resulted from the harshest U.S. demands. While Canada made some concessions, the biggest positive from this deal is that it will remove a massive cloud of uncertainty for policymakers and businesses. **We had been assuming that an agreement would *eventually* be reached, but the deal heavily reduces lingering uncertainty surrounding our 2019 outlook.** There is now upside **risk to our call of 2.1% GDP growth next year**, which we further bumped up this week on news of the LNG deal.
- **The Bank of Canada:** NAFTA and broader trade uncertainties have been a key issue for the BoC over the past year. Indeed, the September policy statement said *"the Bank is also monitoring closely the course of NAFTA negotiations and other trade policy developments, and their impact on the inflation outlook."* Suffice it to say that this deal, along with recent solid data, all but cements a rate hike on October 24, barring a shock over the next three weeks.

Looking further out, a major downside risk appears to have been cleared. Governor Poloz has stressed the *"gradual"* rise in rates, but that narrative may well change with a deal in hand. **We are now calling for three rate hikes in 2019 (January, April, and July)**. Effectively, the BoC will now be just matching the Fed's rate hikes through next year, leaving overnight spreads in place.

- **The loonie:** Accompanying the broad move higher in Canadian bond yields, the currency initially appreciated moderately on news of the deal. This was more or less the market scrubbing out risk of a negative outcome. There could be modest further near-term currency strength as some of the negative sentiment around Canada unwinds, but the longer-term picture is still challenging. Canada continues to struggle from a competitiveness perspective and the USMCA doesn't change that. Broader policy changes are needed to address this issue, meaning any further strength will be relatively limited. **Prior to the deal, we were looking for 78.5 cents ($1.275) for the end of this year and 80 cents (or $1.25) for the end of 2019. We remain generally comfortable with that call,** although similar to the growth outlook, there is now some upside bias to that forecast—especially if Canadian oil prices can better reflect the recent gains in world prices.

- **Stocks:** A limited TSX reaction to the deal likely reflects the fact that much of the index was never all that exposed to a negative NAFTA outcome to begin with (we often argue that the index is not an ideal reflection of the underlying Canadian economy). And, the deal does little to address other weights, such as the record oil-price differential and slowing credit growth. As such, this will be more of a case-by-case basis for equities in areas such as auto parts (which rose on relief after the announcement), some industrial products and dairy. The bigger picture is that Canadian equities are relatively cheap versus their U.S. peers, with the forward earnings yield gap recently trending around the widest level of the cycle—if the trade deal improves sentiment toward Canada more broadly, it could help narrow that gap.

- **Government finances:** Ottawa made it immediately clear that it will offer some support to dairy, poultry and egg producers as an offset to the concessions made in this trade deal. Look for an announcement in the Fall Economic Statement or Budget 2019, if not earlier. It remains to be seen what the dollar figure for any such support would be. In the wake of past CETA and TPP deals (which each opened up slightly less market share than the USMCA will), the prior government served up roughly $4 billion of support over 10-15 years, through income guarantee and quota-value guarantee programs. The good news is that Ottawa's finances are tracking somewhat better than expected in the current fiscal year (a surplus of $4.4 billion in the first four months of FY18/19, versus a deficit of $109 million in the same period a year ago), leaving some flexibility on this front without seriously denting federal finances.

Economic Forecast Summary for October 5, 2018

BMO Capital Markets Economic Research

	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4	Annual 2017	Annual 2018	Annual 2019
CANADA											
Real GDP (q/q % chng : a.r.)	1.4	2.9	2.0 ↑	2.7	2.0 ↑	1.8 ↑	1.8 ↑	1.7 ↑	3.0	2.1	2.1 ↑
Consumer Price Index (y/y % chng)	2.1	2.3	2.7	2.5	2.2	2.4	2.2	2.1	1.6	2.4	2.2
Unemployment Rate (percent)	5.8	5.9	5.9	5.8	5.7	5.7	5.6	5.6	6.3	5.9	5.6
Housing Starts (000s : a.r.)	225	218	206	210	208	207	204	200	220	215	205
Current Account Balance ($blns : a.r.)	-69.9	-63.5	-53.4 ↑	-53.3 ↑	-53.7 ↑	-54.6 ↑	-55.6 ↑	-56.1 ↑	-63.3	-60.0 ↑	-55.0 ↑
Interest Rates (average for the quarter : %)											
Overnight Rate	1.25	1.25	1.50	1.75	2.00 ↑	2.25 ↑	2.50 ↑	2.50 ↑	0.71	1.44	2.31 ↑
3-month Treasury Bill	1.14	1.21	1.47	1.80 ↑	2.00 ↑	2.20 ↑	2.40 ↑	2.40 ↑	0.69	1.40	2.25 ↑
10-year Bond	2.24	2.28	2.28	2.45	2.55	2.65	2.80	2.90	1.78	2.30	2.70
Canada-U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	-44	-66	-61	-49 ↑	-49 ↑	-49 ↑	-41 ↑	-52 ↑	-26	-55 ↑	-48 ↑
10-year	-52	-64	-65	-62 ↓	-58 ↓	-53 ↓	-49 ↓	-45 ↓	-55	-61 ↓	-51 ↓
UNITED STATES											
Real GDP (q/q % chng : a.r.)	2.2	4.2	3.0	2.7	2.6	2.2	2.0	1.9 ↑	2.2	2.8	2.5
Consumer Price Index (y/y % chng)	2.3	2.6	2.6	2.4	2.2	2.2	2.2	2.1	2.1	2.5	2.2
Unemployment Rate (percent)	4.1	3.9	3.8	3.7	3.6 ↓	3.6	3.5 ↓	3.5	4.4	3.9	3.6
Housing Starts (mlns : a.r.)	1.32	1.26	1.24	1.30	1.31	1.32	1.33	1.33	1.21	1.28	1.32
Current Account Balance ($blns : a.r.)	-487	-406	-512 ↓	-516 ↑	-528 ↓	-541 ↓	-550 ↓	-560 ↓	-449	-480	-545 ↓
Interest Rates (average for the quarter : %)											
Fed Funds Target Rate	1.46	1.71	1.96	2.21	2.46	2.71	2.88	2.96 ↑	1.00	1.83	2.75 ↑
3-month Treasury Bill	1.58	1.87	2.08	2.25	2.50 ↑	2.70 ↑	2.80 ↑	2.90 ↑	0.95	1.95	2.70 ↑
10-year Note	2.76	2.92	2.93	3.05	3.15	3.20	3.25 ↑	3.35 ↑	2.33	2.90	3.25 ↑
EXCHANGE RATES (average for the quarter)											
US¢/C$	79.1	77.5	76.5	77.9	78.7	79.1	79.5	79.9	77.1	77.7	79.3
C$/US$	1.27	1.29	1.31	1.28	1.27	1.26	1.26	1.25	1.30	1.29	1.26
¥/US$	108	109	112	112 ↑	112 ↑	111 ↑	111 ↑	110 ↑	112	110	111 ↑
US$/Euro	1.23	1.19	1.16	1.18	1.17 ↓	1.19 ↓	1.22	1.24	1.13	1.19	1.20 ↓
US$/£	1.39	1.36	1.30	1.28 ↑	1.23 ↓	1.27	1.33 ↑	1.38	1.29	1.33	1.31 ↑

Blocked areas represent BMO Capital Markets forecasts

Up and down arrows indicate changes to the forecast ↑↓ Spreads may differ due to rounding

Canada

Housing Starts
Tuesday, 8:15 am

Sep. (e)	**210,000 a.r. (+4.5%)**	
Consensus	*207,000 a.r. (+3.0%)*	
Aug.	200,980 a.r. (-2.3%)	

Building Permits
Wednesday, 8:30 am

Aug. (e)	**+2.0%**
July	-0.2%

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Housing starts are expected to rise to 210k annualized in September, a touch below the year-to-date average. The prior two months were on the soft side of recent norms, following the massive number of new units that broke ground in June. Beneath the volatility, the strongest rate of population growth since the early-1990s and millennial household formation are supporting robust construction activity. And, the strength in residential construction has been spread relatively well across most of the country. The value of building permits is expected to rise 2% in August.

United States

Consumer Prices
Thursday, 8:30 am

Sep. (e)	**+0.2%**	**+2.4% y/y**
Consensus	*+0.2%*	*+2.4% y/y*
Aug.	+0.2%	+2.7% y/y
	Ex. Food & Energy	
Sep. (e)	**+0.2%**	**+2.3% y/y**
Consensus	*+0.2%*	*+2.3% y/y*
Aug.	+0.1%	+2.2% y/y

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Firm gasoline prices should support a 0.2% increase in the September CPI, though the yearly rate is likely to retreat a few notches to 2.4%, further distancing itself from the near 7-year peak of 2.9% in the summer. A similar advance in core prices (following the largest monthly plunge in clothing prices since 1949), should lift the annual core rate a notch to 2.3%, putting it slightly below recent 10-year highs but up from 1.7% in September 2017. Given additional tariffs on China, some pass-through is likely amid strength in consumer spending and labour markets. However, a firm dollar, especially against the renminbi, is helping to allay the protectionist pressure. While the Fed's preferred price measure, core PCE inflation, has steadied at 2.0%, we expect it to drift moderately higher in the year ahead, keeping policymakers on a steady tightening course.

		Oct 5 [1]	Sep 28	Week Ago	4 Weeks Ago	Dec. 31, 2017
					(basis point change)	
Canadian Money Market	Call Money	1.50	1.50	0	0	50
	Prime Rate	3.70	3.70	0	0	50
U.S. Money Market	Fed Funds (effective)	2.25	2.25	0	25	75
	Prime Rate	5.25	5.25	0	25	75
3-Month Rates	Canada	1.52	1.59	-7	0	46
	United States	2.21	2.20	2	8	84
	Japan	-0.28	-0.13	-15	-14	-12
	Eurozone	-0.32	-0.32	0	0	1
	United Kingdom	0.80	0.80	0	0	28
	Australia	1.93	1.93	0	0	15
2-Year Bonds	Canada	2.31	2.21	10	20	62
	United States	2.90	2.82	7	19	101
10-Year Bonds	Canada	2.58	2.43	16	30	54
	United States	3.22	3.06	15	28	81
	Japan	0.15	0.12	3	4	11
	Germany	0.56	0.47	9	17	13
	United Kingdom	1.70	1.57	12	24	51
	Australia	2.71	2.67	5	17	8
Risk Indicators	VIX	14.4	12.1	2.3 pts	-0.5 pts	3.4 pts
	TED Spread	20	20	-1	0	-12
	Inv. Grade CDS Spread [2]	61	60	1	1	11
	High Yield CDS Spread [2]	340	333	7	8	34
					(percent change)	
Currencies	US¢/C$	77.26	77.47	-0.3	1.7	-2.9
	C$/US$	1.294	1.291	—	—	—
	¥/US$	113.78	113.70	0.1	2.5	1.0
	US$/€	1.1519	1.1604	-0.7	-0.3	-4.0
	US$/£	1.307	1.303	0.3	1.2	-3.3
	US¢/A$	70.71	72.24	-2.1	-0.5	-9.5
Commodities	CRB Futures Index	199.35	195.16	2.1	4.7	2.8
	Oil (generic contract)	74.61	73.25	1.9	10.1	23.5
	Natural Gas (generic contract)	3.14	3.01	4.2	12.9	6.2
	Gold (spot price)	1,202.57	1,192.50	0.8	0.5	-7.7
Equities	S&P/TSX Composite	15,997	16,073	-0.5	-0.6	-1.3
	S&P 500	2,901	2,914	-0.5	1.0	8.5
	Nasdaq	7,861	8,046	-2.3	-0.5	13.9
	Dow Jones Industrial	26,597	26,458	0.5	2.6	7.6
	Nikkei	23,784	24,120	-1.4	6.6	4.5
	Frankfurt DAX	12,135	12,247	-0.9	1.5	-6.1
	London FT100	7,338	7,510	-2.3	0.8	-4.5
	France CAC40	5,363	5,493	-2.4	2.1	1.0
	S&P ASX 200	6,185	6,208	-0.4	0.7	2.0

[1] = as of 10:30 am   [2] = One day delay

Global Calendar
October 8 – October 12

BMO Capital Markets®

	Monday October 8	Tuesday October 9	Wednesday October 10	Thursday October 11	Friday October 12
Japan	**Markets Closed**	**Current Account Surplus** **Aug. '18 (e) ¥1.9 trln** Aug. '17 ¥2.4 trln	**Core Machine Orders** **Aug. (e) -3.7% +11.0% y/y** July +11.0% +13.9% y/y **Machine Tool Orders** **Sep. P** Aug. +5.1% y/y	**Producer Price Index** **Sep. (e) +0.2% +2..9% y/y** Aug. unch +3.0% y/y **Bank Lending Ex-Trusts** **Sep.** Aug. +2.2% y/y	**Tertiary Industry Index** **Aug. (e) +0.3%** July +0.1%
Euro Area	**GERMANY** **Industrial Production** **Aug. (e) +0.3% -0.1% y/y** July -1.1% +1.1% y/y	**GERMANY** **Trade Surplus** **Aug.** July €15.8 bln	**FRANCE** **Industrial Production** **Aug. (e) +0.4% +1.5% y/y** July +0.7% +1.8% y/y **ITALY** **Industrial Production** **Aug. (e) +0.8% -1.8% y/y** July -1.8% -1.3% y/y	**EURO AREA** **ECB Minutes from Sep. 13 meeting** **FRANCE** **Consumer Price Index** **Sep. F (e) -0.2% +2.5% y/y** Aug. +0.5% +2.6% y/y	**EURO AREA** **Industrial Production** **Aug. (e) +0.3% -0.3% y/y** July -0.8% -0.1% y/y **GERMANY** **Consumer Price Index** **Sep. F (e) +0.4% +2.2% y/y** Aug. unch +1.9% y/y
U.K.			**Monthly Real GDP 3m/3m** **Aug. (e) +0.1% +0.6%** July +0.3% +0.6% **Industrial Production** **Aug. (e) +0.1% +1.0% y/y** July +0.1% +0.9% y/y **Manufacturing Production** **Aug. (e) +0.1% +1.1% y/y** July -0.2% +1.1% y/y **Trade Deficit Non-EU** **Aug. (e) £10.9 bln £3.1 bln** July £10.0 bln £2.8 bln	**RICS House Price Balance** **Sep. (e) +2%** Aug. +2%	
Other	**CHINA** **Foreign Reserves** [D] **Sep. (e) $3.1 trln** Aug. $3.1 trln **Foreign Direct Investment** [D] **Sep.** Aug. +1.9% y/y **Caixin Services PMI** **Sep. (e) 51.4** Aug. 51.5 **Caixin Composite PMI** **Sep.** Aug. 52.0 **BRAZIL** **General Election (October 7)**	**CHINA** **Aggregate Yuan Financing** [D] **Sep.** Aug. 1.52 trln **New Yuan Loans** [D] **Sep. (e) 1.34 trln** Aug. 1.28 trln **M2 Money Supply** [D] **Sep. (e) +8.5% y/y** Aug. +8.2% y/y **AUSTRALIA** **NAB Business Confidence** **Sep.** Aug. 4	**AUSTRALIA** **Westpac Consumer Confidence** **Oct.** Sep. -3.0%	**CHINA** **Trade Surplus** [D] **in USD in CNY** **Sep. (e) $24.6 bln n.a.** Aug. $27.9 bln 179.75 bln **G20 Finance Ministers and Central Bank Governors Meeting in Indonesia (Oct.11-12)**	

[D] = date approximate

Upcoming Policy Meetings | BoE: Nov. 1, Dec. 20, Feb. 7 | ECB: Oct. 25, Dec. 13, Jan. 24

North American Calendar
October 8 – October 12

BMO Capital Markets®

Canada

Monday October 8

Thanksgiving Day (markets closed)

Tuesday October 9

8:15 am	**Housing Starts**
Sep. (e)	**210,000 a.r. (+4.5%)**
Consensus	*207,000 a.r. (+3.0%)*
Aug.	200,980 a.r. (-2.3%)

Wednesday October 10

8:30 am	**Building Permits**
Aug. (e)	**+2.0%**
July	-0.2%

Noon — 2-year bond auction $3.0 bln

Thursday October 11

8:30 am	**New Housing Price Index**	
Aug. (e)	**+0.1%**	**+0.5% y/y**
July	+0.1%	+0.5% y/y

10-year bond auction announcement

Friday October 12

United States

Monday October 8

Columbus Day (stock markets open, bond markets closed)

Tuesday October 9

6:00 am	**NFIB Small Business Economic Trends Survey**
Sep. (e)	**108.0**
Consensus	*108.8*
Aug.	108.8

Fed Speakers: New York's Williams (10:35 am, 9:15 pm); Philadelphia's Harker (1:00 pm)

11:30 am	13- & 26-week bill auction $90 bln
1:00 pm	4-week bill auction $40 bln
1:00 pm	52-week bill auction $26 bln

Wednesday October 10

7:00 am	**MBA Mortgage Apps**	
Oct. 5		
Sep. 28	unch	
8:30 am	**PPI Final Demand**	
Sep. (e)	**+0.2%**	**+2.7% y/y**
Consensus	*+0.2%*	*+2.8% y/y*
Aug.	-0.1%	+2.8% y/y
8:30 am	**PPI Final Demand ex. F&E**	
Sep. (e)	**+0.2%**	**+2.4% y/y**
Consensus	*+0.2%*	*+2.6% y/y*
Aug.	-0.1%	+2.3% y/y
8:30 am	**Wholesale Inventories**	
Aug. F (e)	**+0.8%**	
July	+0.6%	

Fed Speakers: Chicago's Evans (12:15 pm), Atlanta's Bostic (6:00 pm)

11:30 am	3-year note auction $36 bln
1:00 pm	10[R]-year note auction $23 bln

Thursday October 11

8:30 am	**Initial Claims**	
Oct. 6 (e)	**210k (+3k)[C]**	
Sep. 29	207k (-8k)	
8:30 am	**Continuing Claims**	
Sep. 29		
Sep. 22	1,650k (-13k)	
8:30 am	**Consumer Prices**	
Sep. (e)	**+0.2%**	**+2.4% y/y**
Consensus	*+0.2%*	*+2.4% y/y*
Aug.	+0.2%	+2.7% y/y
8:30 am	**CPI Ex. Food & Energy**	
Sep. (e)	**+0.2%**	**+2.3% y/y**
Consensus	*+0.2%*	*+2.3% y/y*
Aug.	+0.1%	+2.2% y/y
2:00 pm	**Budget Balance[D]**	
Sep. '18		
Sep. '17	+$7.9 bln	

G20 Finance Ministers and Central Bank Governors Meeting in Indonesia (Oct. 11-12)

11:00 am	13- & 26-week bill, 30[R]-year TIPS auction announcements
1:00 pm	30[R]-year bond auction $15 bln

Friday October 12

8:30 am	**Import Prices**	
Sep. (e)	**+0.2%**	**+3.1% y/y**
Consensus	*+0.2%*	*+3.2% y/y*
Aug.	-0.6%	+3.7% y/y
10:00 am	**University of Michigan Consumer Sentiment**	
Oct. P (e)	**101.0**	
Consensus	*100.8*	
Sep.	100.1	

Moody's rates U.S. Sovereign Debt

Fed Speakers: Chicago's Evans (9:30 am); Atlanta's Bostic (12:30 pm); Gov. Quarles (10:30 pm)

[C] = consensus [D] = date approximate [R] = reopening

Upcoming Policy Meetings | Bank of Canada: Oct. 24, Dec. 5, Jan. 9 | FOMC: Nov. 7-8, Dec. 18-19, Jan. 29-30