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BMO CAPITAL MARKETS ECONOMICS

Focus

A weekly financial digest

Douglas Porter, CFA, Chief Economist, BMO Financial Group

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U.S. Stocks Best January in 30 Years

Forecast changes:

- **One and done .... removed mid-year 2019 rate hike for the BoC and FOMC ... December moves only**

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Super Bull LIII

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"In my view, while market volatility will continue to ebb and flow, these fluctuations are not likely to have important implications for policy." Jerome Powell, November 14, 2014

"And if risk taking does not threaten financial stability, it is not the Fed's job to stop people from losing (or making) money". Jerome Powell, January 7, 2017

"Everyone has a plan until they've been hit." Joe Louis

In a mere six weeks, **the FOMC pulled the equivalent of a full 90 degree turn**—from tightening on auto-pilot in December, to an extended pause by January. While Chair Powell, and others, had certainly hinted that patience was the new policy virtue since the start of the year, the full extent of that newfound patience only came entirely into view with this week's statement and press conference. Besides openly suggesting that the case for further rate hikes had weakened, and that there was flexibility on the balance sheet unwind, the Fed also dispensed with any official bias to tighten. This new, milder 2019 version of the FOMC, with the deep-freeze on rates, further fired up the spirited recovery in almost all markets. To wit, after suffering through its worst December since the 1930s (down 9.2%), the S&P 500 roared back with a 7.9% surge in the opening month, its best January since 1987. (It would be impolite to mention what also happened to stocks later in 1987…)

The reasons for the sudden about-face in the Fed's tone can be put in four main baskets:

1) Slower global growth
2) Policy uncertainty
3) Lower inflation expectations
4) Tighter financial conditions

Now, before assuming that the pause is about to become permanent—and perhaps even give way to rate cuts—**let's consider those four baskets, in reverse order**. The big rebound in markets, lower yields and a softer dollar have already begun to wash away some of the tightening in financial conditions. The deep slide in inflation expectations late last year was almost entirely due to the plunge in oil prices—prices that have since popped $10/barrel and are, again, close to long-run norms. Policy uncertainty will linger, but at least we may have a few questions answered soon on each of the shutdown (restart on Feb 16?), trade with China (tariffs cranked on March 2?), and Brexit (hard exit on March 29?).

That leaves probably the **most important** item on the list—**slower global growth**—and the one change that Powell allowed had "*important implications for us*". A veritable wave of disappointing overseas data has washed ashore this year, including a broad cooling in China, weak PMIs in Europe, a technical recession in Italy, and even some serious slippage in Canada's domestic demand. But, in most cases, we are seeing some special factors weighing on top of a moderate cyclical cooldown, with the U.S./China trade battle providing extra aggravation. And while there is still plenty of event risk on that latter front, the tone from negotiators remains positive, and the markets continue to take the worst case off the table.

Meantime, there is **the underlying resilience of the U.S. economy quietly churning away in the background**. It's even further in the background than normal, due to the paucity of reliable economic releases, courtesy of the 35-day shutdown. But the indicators on hand remain mostly solid. At the top of the list is employment, with January adding 304,000 new jobs and wages rising 3.2% y/y. While the figures were slightly polluted by the shutdown (including the further rise in the jobless rate to 4.0%), the big picture is that the critical job market is showing precisely zero signs of fading. As just one example, the economy has added almost 1 million jobs in the past four months alone—that takes us back to the start of October, precisely when markets began to fret about a weaker economic outlook. As well, the manufacturing ISM partially rebounded in January to a sturdy 56.6 after a deep dive in December, led by a snap-back in new orders.

On balance, we would assert that **the market**, and perhaps even the Fed, **is getting ahead of itself in fully removing odds of further rate hikes**. Looking at past cycles, there have been many episodes of lengthy pauses (and even some small mid-cycle rate trims) that were then followed by another series of rate hikes. **Tightening cycles are rarely neat and tidy**—the one exception was the 2004-06 cycle (a 25 bp hike every meeting for 17 meetings), and it ended in near-disaster. But we are in the business of projecting what the Fed *will do*, not what it *should do*, and there is simply no denying the Fed's newfound caution. As Michael details below, **we have accordingly taken out one Fed rate hike from our 2019 outlook, now looking for just one more rate hike in December**. The key point, though, is that **we continue to believe that the Fed is much more likely to hike further than to cut rates**, especially in light of a drum tight job market, better prospects for U.S./China trade, and the firmness in oil prices.

We **took a similar scalpel to our Canadian rate forecast this week**, as Ben details below. The reasoning rhymes with the Fed call, but doesn't repeat it verbatim. As we outlined in last week's Focus, we are of the view that neutral rates in Canada could be as low as 2%, so the current overnight rate of 1.75% is almost there. Add on disappointing domestic spending trends, the BoC's ongoing concern about a weak housing market (which we don't fully share), persistent questions about the fate of NAFTA 2.0, as well as a less aggressive Fed, and you are left with little reason for the Bank to step down hard on the brakes. Similar to the U.S., though, we continue to believe that **the underlying bias is to lift rates somewhat higher from here, and there truly is as much upside risk to our "one rate hike in 2019" call as there is downside**.

To conclude, we would note that the TSX just had its best month in a decade (popping 8.5%), 10-year GoC yields are below inflation at under 2%, the Canadian dollar is highly competitive at 76.4 cents, and credit conditions remain robust—in other words, overall financial conditions are supportive. And, with a federal election bearing down on us this October, fiscal policy is likely to be mildly supportive as well this year. At a time when the domestic job market is also at its tightest in decades, this augurs for an eventual return to further snugging from the Bank of Canada.

At the profound risk of alienating the entire state of Louisiana, as well as the anti-Patriots brigade, some of us are actually pretty pleased with this year's Super Bowl matchup. Full confession, I have been a Rams fan for many a year—think Roman Gabriel…no?...John Hadl…no?...Pat Haden…not yet?…Vince Ferragamo…nothing? It's been a long slog. And, one has to at least admire the amazing consistency of the Brady/Belichick efforts of the past two decades. Whatever the circumstances of how they got here, it should be a good game. Heart over head, Rams 23 Pats 21.

Fed Patience is a Virtue

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Heading into this week's FOMC meeting, we were expecting that the forward guidance on rates and net risk assessment would become more ambiguous, to signal a *"patient and flexible and wait and see"* policy approach ahead. Our expectations were exceeded (big time), which caused us to change our Fed forecast (more on this later).

The FOMC dropped its forward guidance all together. Recall it was: *"The Committee judges that some further gradual increases in the target range for the federal funds rate will be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective over the medium term"*. It also dropped the net risk assessment completely. Again, recall it was: *"The Committee judges that risks to the economic outlook are roughly balanced, but will continue to monitor global economic and financial developments and assess their implications for the economic outlook"*. Both of these policy guideposts were modified at the December meeting, which is one reason why we judged that further modification was in store. Instead, they were replaced by the phrase:

"The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes. In light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes."

Importantly, there was no indication whether any *"future adjustments"* would be increases, and the language was ambiguous enough not to exclude decreases. As such, going from signalling continued, but less regular, rate hikes just six weeks ago to signalling that the current rate-tightening cycle could be over and the possibility that the next move could be a rate cut was a radical change. As Chair Powell mentioned, the catalyst for the change was that, despite sturdy economic performance and a positive outlook, *"over the past few months we have seen some cross-currents and conflicting signals about the outlook."* These include signs of slowing global economic growth, particularly for China and Europe, and uncertainties surrounding issues such as Brexit, U.S.-China trade talks and the impact of the partial government shutdown. Also, *"financial conditions tightened considerably late in 2018, and* *remain less supportive of growth"* and *"some surveys of business and consumer sentiment have moved lower, giving reason for caution"*.

It's noteworthy that *"muted inflation pressures"* were paired with *"global economic and financial developments"* as the two critical factors prodding policy patience. Up to November, core PCE inflation had shown no sign of breaking out of the 1.8%-to-2.0% range in place since March, and the latest shorter-term measures both posted softer readings (3-month: 1.7% annualized, 6-month 1.5%). This is despite wage growth picking up (the major metrics are all testing cycle highs) and tariffs adding to costs. Meanwhile, the slide in oil prices over the past year should dampen inflation.

Having such benign inflation readings so late in the business cycle likely means that there's more slack in the economy than assumed and/or the secular forces of disinflation (such as technology-enabled disruption) are continuing to counter cyclical inflationary pressures. In any event, both argue for increased Fed caution, particularly with the current fed funds target range already butting up against the bottom of the FOMC's projections of the neutral policy rate (thanks to December's rate hike). Indeed, while improvements on the "*cross-currents and conflicting signals"* front would make the Fed feel more comfortable about raising rates again, we judge that it's going to be inflation performance that dictates whether we get more rate hikes. Even Powell said, *"I would want to see a need for further rate increases, and for me a big part of that would be inflation"*.

And we do expect inflation will creep up a bit this year, reflecting a mounting positive output gap in the wake of continued above-potential (>1.9%) growth and a falling unemployment rate (to 3.5% by year-end), with wages already mildly accelerating. And, importantly, amid still sturdy consumer demand, a touch better ability of businesses to pass on some of their higher costs. We look for core PCE inflation to run in a slightly higher 2.0%-to-2.3% range as the year unfolds. Previously, we judged this would be sufficient to get the Fed to raise rates a couple more times (in June and December), with the net risk being that there would be fewer actions. However, the FOMC's very dovish pronouncements this week have led us to factor-in this net downside risk into our call; we now look for only one rate hike in December. The lower fed funds profile also pulls down our projection for 10-year Treasury yields; it remains persistently below 3%.

Finally, the FOMC made another major policy announcement; it is now committed to maintaining an *"ample supply of reserves"* and a bigger balance sheet indefinitely. The notion of one day returning to active management of reserves and a point target for the fed funds rate, as in pre-crisis times, is no longer. Mainly because of regulatory changes and more conservative risk management practices, banks now have a fundamentally and profoundly higher demand for reserves. As such, the FOMC anticipates ending its balance sheet normalization process earlier than what was envisaged when it started in October 2017, to avoid ever constraining this demand. The Fed will release more details on this in the months ahead. MJG

Policy Freeze

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The Canadian economy stumbled in November, with real GDP contracting 0.1%. We outlined the weaker growth backdrop in this space last week, so we're not going to rehash all the details. Suffice it to say that the plunge in oil prices late last year hit growth, and the oil production cuts will likely weigh heavily in January. We got a tidbit of good news this week though, with Alberta announcing that 20% of the production cuts are going to be unwound in February, bringing 75k bpd back online. That should offset at least a bit of the January weakness, and will help Q1 a bit as well.

One of the other notable points from the November GDP report was that retail and construction activity are down from a year ago, two of only three sectors in negative territory (agriculture is the third). This reinforces the theme that consumer spending and housing are no longer going to be the drivers of Canadian growth. Indeed, those are the most interest-sensitive sectors in the economy and suggest there's little need to tighten policy further in the near term. The lagged effect of prior hikes will still take some time to fully diffuse through the economy.

Given the above backdrop and sudden dovish turn by the Fed, we've pared our BoC call. **We're now looking for just one more hike from the Bank in December 2019**. The lengthy pause is driven by sluggish domestic and global growth, along with benign inflation through this year. We have no further moves in 2020, as, barring a broad upturn in global growth and commodity prices, the Bank won't want to put any more pressure on heavily indebted households and the broader housing market. *B.A.A.R.*

Hiring is Great but Wages are Second Rate

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The U.S. economy pumped out a net 2.67 million jobs in 2018 and kicked off a new year in high style with another 304,000 positions. Last year was the third best for workers this century. The unemployment rate fell to a half-century low of 3.7% before popping to 4.0% due to the government shutdown and an increase in labour force participation. The latter for prime-age workers (age 25 to 54) has climbed to 82.6% from 81.8% a year ago and is closing in on pre-recession levels. The total participation rate of 63.2%, though hooking up recently, has largely moved sideways in the past five years due to retiring baby boomers. The employment rate among prime-age workers has risen steadily to 79.9%, close to its pre-recession peak of 80.3%. Our jobs report "scorecard" ranked 2018 as the second best year for labour markets since 2011, second only to 2014 when payrolls ballooned 3.0 million.

Since the economy likely grew the fastest in 13 years in 2018 due to the fiscal jolt, the strong demand for workers is understandable. Harder to explain is why they weren't paid more despite widespread labour shortages. To be sure, average hourly earnings are now growing the fastest in a decade at just over 3% y/y. But this measure is dogged by employment shifts between positions and industries. The employment cost index, which controls for this effect, was up a more moderate 2.9% in Q4 (suggesting the average wage gain is flattered by an increase in higher-paying positions and/or jobs in higher-paying industries). Automation anxiety, the gig economy, mediocre productivity and a worsening skills mismatch (why pay workers more if they don't bring the necessary skills to the job?) likely go some way to explaining why workers are discouraged from seeking pay increases or why employers are wary of paying more to retain and attract workers. Though elevated, the quits rate (2.3% of total employed) is still little changed in the past year, which is not what you would expect if workers thought they could command more pay by switching jobs.

Barring a change in labour productivity, compensation will need to accelerate by about 0.5 ppts to pressure unit labour costs (which are currently running at 1.6% on a smoothed four-quarter basis) sufficiently to risk a sustained breach of the Fed's 2% inflation target. However, if the current gradual rate of change in wages persists, material upward pressure may not emerge for another few years. While we still expect core PCE inflation to peak at 2.3% later this year, this assumes wage growth gains a tempo. If not, the Fed will have even more reason to bide its time.

The January Effect

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Equity markets rebounded sharply to start the year, with the S&P 500 jumping 7.9% in January, the best month since 2015 and the strongest January in 32 years. Of course, this follows the 'nightmare before Christmas', which left the index finishing the year with its worst month since the financial crisis. As such, the broad U.S. equity market is still roughly 8% below its September high and still tucked below its 200-day moving average. Meantime, Canadian investors have finally caught a break, with the TSX surging 8.5% in January (best month in a decade) to lead most of the major-market indices. What was the driver? For one, the low-liquidity program-driven selling, like that heading into Christmas, left the market ripe for a technical bounce. South of the border, all sectors were positive and no fewer than five notched double-digit gains in the month, including banks, energy and industrials, which were all deeply negative last year. In Canada, all sectors were up too, including the heavyweight banks and energy, the latter benefiting from a now narrow Canadian oil price discount, while health care (i.e., cannabis) surged 43%. Fundamentally, with markets sensing that we've been nearing a potential cyclical tipping point, a decisively dovish shift by the Federal Reserve capped off the month, stoking expectations that this already-long expansion can run further.

With that in mind, is the equity-market lore (as goes January, so goes the rest of the year) true? Historically (since 1960), the January direction has successfully predicted the rest-of-year direction 64% of the time. While that looks solid on the surface, we wouldn't boast about the statistical significance, and there have been a few notorious misses (think 1987). Another approach is to look at past Januarys that have started with a 5% or better jump, as we saw this year. In those cases (there have been 11 of them), the S&P 500 has followed through with gains through the rest of the year 82% of the time, with a solid average gain of 12%, and an impressive six of those years coming in around 20%. Of course, last year was an outlier, with the index sliding 11% after a 5.6% pop to start 2018. At any rate, there's a hint of truth to the January-effect lore, especially when the first month is very strong, but given the small sample, we'd prefer to focus on the fundamentals such as how Fed policy evolves this year.

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Canada

- BoC Sr. Dep. Gov Wilkins sees some labour market slack despite solid job gains

Good News

Conference Board's Consumer Confidence +6.7 pts to 109.7 (Jan.)

Raw Materials Prices +3.8% (Dec.)

Bad News

Real GDP at Basic Prices -0.1% (Nov.)

SEPH Average Hourly Wages slowed to +2.9% y/y (Nov.)

Industrial Product Prices -0.7% (Dec.)

Markit Manufacturing PMI -0.6 pts to 53.0 (Jan.)

United States

- Pres.Trump says "*tremendous progress*" made with China on trade
- FOMC on hold and unexpectedly turns dovish
- Wall Street has best January in 30 years

Good News

Nonfarm Payrolls +304,000 (Jan.)

Average Hourly Earnings +3.2% y/y (Jan.)

Employment Cost Index +2.9% y/y (Q4)

Construction Spending +0.8% (Nov.)

Wholesale Inventories +0.3% (Nov.)

New Home Sales +16.9% to 657,000 a.r. (Nov.)

Manufacturing ISM +2.3 pts to 56.6 (Jan.)

Chicago Fed National Activity Index +0.27 (Dec.)

Global Investors bought a net $1.2 bln U.S. securities (Nov.)

Bad News

Jobless Rate +0.1 ppts to 4.0% (Jan.)—shutdown-related

S&P Case-Shiller Home Prices slowed to +4.7% y/y (Nov.)

Pending Home Sales -2.2% (Dec.)

Conference Board's Consumer Confidence -6.4 pts to 120.2 (Jan.)

U of M Consumer Sentiment revised up to 91.2 (Jan.)—still weak

Initial Claims +53k to 253k (Jan. 26 week)

Japan

- Labour shortage deepest in 45 years

Good News

Retail Sales +0.9% (Dec. P)

Jobless Rate -0.1 ppts to 2.4% (Dec. P)

Manufacturing PMI revised up to 50.3 (Jan.)—still lowest in over 2 years

Bad News

Industrial Production -0.1% (Dec. P)

Consumer Confidence -0.8 pts to 41.9 (Jan.)

Europe

- Italy falls into recession as Euro Area slows
- U.K. Parliament votes to replace the Irish backstop with an alternate arrangement

Good News

Euro Area—Real GDP +0.2% q/q (Q4 A)

Euro Area—Jobless Rate steady at 7.9% (Dec.)

Euro Area—Private Sector Credit +3.4% y/y (Dec.)

Germany—Jobless Rate steady at 5.0% (Jan.)

Germany—GfK Consumer Confidence +0.3 pts to 10.8 (Feb.)

France—Real GDP +0.3% q/q (Q4 A)

France—Jobless Rate steady at 9.1% (Dec.)

France—Consumer Confidence +5 pts to 91 (Jan.)

Italy—Consumer Confidence +0.8 pts to 114.0 (Jan.)

Italy—Jobless Rate -0.2 ppts to 10.3% (Dec. P)

U.K.—Nationwide House Prices +0.3% (Jan.)

Bad News

Euro Area—Consumer Prices slowed to +1.4% y/y (Jan. A)—but **core** +1.1% y/y

Euro Area—Economic Confidence -1.2 pts to 106.2 (Jan.)

Germany—Retail Sales -4.3% (Dec.)

Germany—Unemployment -2,000 (Jan.)—below expected

France—Consumer Spending -1.5% (Dec.)

Italy—Real GDP -0.2% q/q (Q4 A)

U.K.—Manufacturing PMI -1.4 pts to 52.8 (Jan.)

U.K.—GfK Consumer Confidence unch at -14 (Jan.)

Other

- China agrees to buy more U.S. soybeans and other goods in "*sign of good faith*"

Good News

China—Manufacturing PMI +0.1 pts to 49.5; **Non-manufacturing PMI** +0.9 pts to 54.7; **Composite PMI** +0.6 pts to 53.2 (Jan.)

Australia—Consumer Prices +0.5% q/q (Q4)

Australia—NAB Business Confidence steady at 3 (Jan.)

Bad News

China—Caixin Manufacturing PMI -1.4 pts to a 3-year low 48.3 (Jan.)

Mexico—Real GDP slowed to +1.8% y/y (Q4 P)

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

2020 Commodity Forecast Rollout

Earl Sweet, Aaron Goertzen, Carl Campus, Alexandros Koustas

Commodity markets undoubtedly had a challenging year in 2018, as outsized declines in crude oil and forest products contributed to an 8.9% year-over-year drop in the BMO Commodity Price Index in December. Below, we outline the performance of each segment and provide our outlook for the next two years.

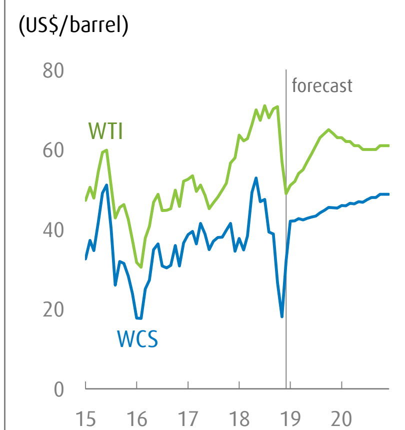
Crude Oil: Volatility was the defining feature of the global oil market in 2018, stoked by swings in OPEC+ strategy, monetary policy expectations, and heightened trade and geopolitical stresses. After having risen to $76 in early October, West Texas Intermediate (WTI) plunged to $46 by mid-December after Saudi Arabia and Russia ramped up production in the autumn. To avoid another rout, Saudi Arabia quickly reversed course, unilaterally slashing output by about 0.5mmb/d in December and, on December 7th, OPEC+ agreed to remove 1.2mmb/d from the market for six months starting in January. This contributed to a moderate recovery in WTI to around $55 currently. Assuming OPEC+ follows through with its latest production curtailment agreement and global oil demand grows in the vicinity of 1.3-1.4mmb/d, the market should achieve balance by the second half of this year. Thus, we expect WTI to rise to an average of $59 in 2019 and $61 in 2020.

The discount on Western Canadian Select (WCS), a heavy oil benchmark, blew out from an average of 25% of WTI in 2017 to 63% in October due to a confluence of factors, including: insufficient pipeline capacity to deliver growing Alberta oil output to clients, extended downtime at some refineries, and temporary pipeline outages. WCS collapsed to as low as US$13.50 in mid-November. Since then, increased rail transport of oil, the ramping up of the Whiting refinery, the temporary production supply cap imposed by the Alberta government, and now the U.S. sanctions on Venezuelan oil have led to a sharp recovery in WCS to the $45 mark. It is projected to average US$43.60/barrel in 2019 and US$47.40 in 2020.

Natural Gas: Henry Hub rose to an annual average of US$3.17 per million BTU (mmbtu) in 2018 from $2.99 in 2017. Though U.S. natural gas production shot up by an estimated 11%, it was outpaced by demand, with both domestic consumption and exports growing by 12%. Prices temporarily spiked with the early onset of cold weather in the autumn and below-average inventories, but have since retreated to about $3 despite the deep freeze enveloping the middle and eastern parts of the continent. With supply growth likely to remain strong while consumption slows from its heated pace in 2018, we forecast Henry Hub to average $3.00/mmbtu in 2019 before rising to $3.10 in 2020.

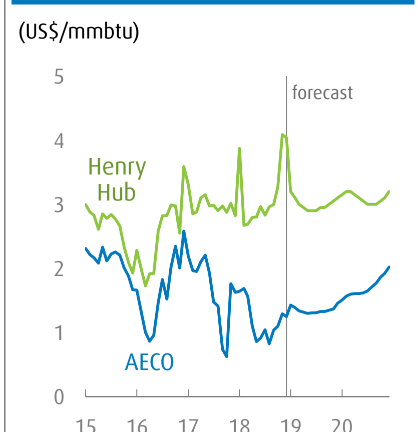
The discount on Canadian natural gas is also very high, averaging 67% during the final three quarters of 2018, far above its 19.7% average during 2010-2017. The current exceptionally large discount will slowly decline as export infrastructure to the U.S. Midwest, Northwest, and California expands. Further out, the demand for Western Canadian gas will rise as Alberta power producers convert coal generating capacity to natural gas and LNG Canada begins exports of liquefied natural gas. However, in 2019, the discount is projected to remain elevated, at 55% of Henry Hub. Accordingly, we project that AECO will average US$1.35/mmbtu this year before rising to $1.70 in 2020.

Chart 1
Crude Oil Prices



Sources: BMO Economics, Haver Analytics

Chart 2
Natural Gas Prices



Sources: BMO Economics, Haver Analytics

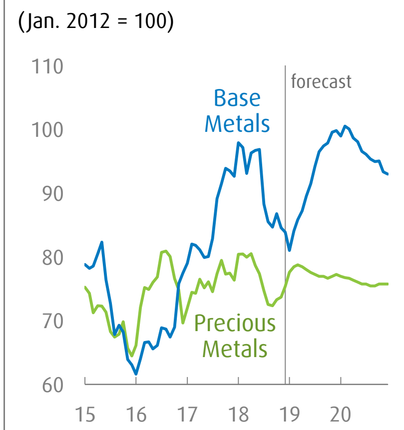
Precious metals found support toward the end of 2018 as geopolitical risks heated up and equities sharply corrected. Continued uncertainties related to U.S./China trade relations, Brexit, and a merely temporary end to the longest U.S. government shutdown in history are just some of the risks lingering below the surface, providing moderately positive support for precious metals in the first half of 2019. We expect **gold** to average $1285 in 2019, before downshifting modestly to $1260 in 2020, and silver to rise from an average $15.71/oz in 2018 to a projected $16.20 in 2019 and $17.20 in 2020.

Following a couple years of solid gains, **base metals** underperformed in 2018 as escalating trade tensions and slower global growth prospects overshadowed relatively tight supplies. **Nickel** prices were strong in the early going as plunging inventories, sanction concerns, and battery-demand prospects temporarily jolted prices above the US$7.00/lb mark. However, as sentiment turned, prices nosedived more than 30% from the June peak into year-end, before showing some signs of life in early 2019. After averaging $5.95/lb in 2018, nickel is expected to moderate to an average of $5.70 in 2019, before rising to $5.90 in 2020. **Aluminum** was particularly choppy in 2018 as U.S. import tariffs, Russia-related sanctions, and alumina refinery disruptions ratcheted prices to a multi-year high in April. Meantime, the subsequent 26% decline knocked prices down to a nearly two-year low. Still, as supply deficits persist and inventories remain low, aluminum is expected to firm to an average of $0.95/lb in 2019 and $0.99 in 2020. Given the close ties between **copper** and global growth, the red metal also had a rather rough go in 2018, though China's increasingly stringent scrap import restrictions and a lack of new mine supply should allow prices to rise from an average $2.96/lb in 2018 to $3.10 in 2019 and $3.30 in 2020. After peaking early in 2018, **zinc** underperformed its fellow base metals, sliding nearly 35% from February to September before renewed supply pressures helped stabilize prices. Still, we expect the average zinc price to decline from $1.33/lb in 2018 to $1.20 in 2019 as increased production returns balance to the market, before rising moderately to $1.23 in 2020.

The **forest products** index experienced unprecedented volatility in 2018. Transitory supply issues wreaked havoc on a drum-tight tariff-trapped market ahead of the summer building season, vaulting prices of framing lumber to record levels. But, a softening in fundamentals — namely soggy housing starts and a downward grind in home sales activity — unleashed the greatest crash in framing lumber prices on record. Wood product markets will likely face less volatile, albeit softer, conditions in 2019, with the U.S. housing cycle now appearing to have passed its peak. We see housing starts moderating to 1.24 million units in 2019, a sharp drop-off from the 1.32 million unit annualized pace that triggered the early-2018s price spike.

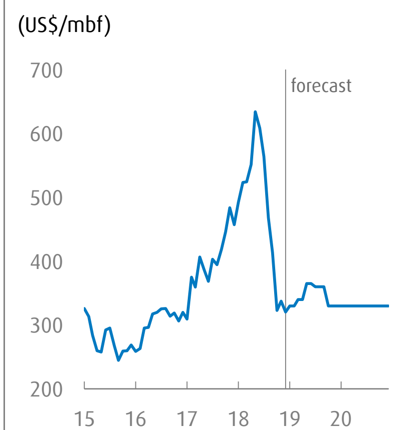
The structural decline in B.C.'s softwood lumber production (due to reductions in the yearly allowable cut) was underappreciated by traders in the early months of last year. However, the shortfall was more than reversed by a late-year surge by Western and Southern U.S. production. Naturally, sustained increases in output in the order of 4%-to-5% a year from U.S. producers will pressure pricing if housing activity moderates as outlined in our forecast. And, while home building accounts for only about one-third of the framing lumber market, other end-uses are highly correlated — namely renovations and furniture. On balance, we believe that softening demand and marginal production increases will lead to a broad weakening in prices, with Western **Spruce-Pine-Fir** declining roughly 30% on an annual basis to average US$345/mbf

Chart 3
Metal Prices



Sources: BMO Economics, Haver Analytics

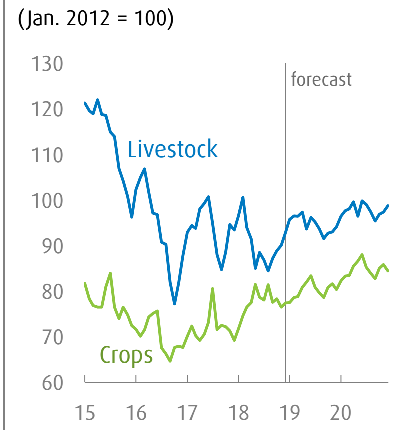
Chart 4
Spruce-Pine-Fir Prices



Sources: BMO Economics, Haver Analytics

in 2019. Conditions in the **oriented strand board** (OSB) market were similarly volatile in 2018. An uninspiring end of the year saw North Central OSB dip to its lowest level in three years at just over US$200/msf. While the downswing might be slightly overblown, we do not anticipate much price recovery in 2019 given OSB's heavy dependency on home construction and the addition of 2900msf, or 12%, of capacity over the past several months. It bears repeating that annual figures are significantly distorted by base effects, but our OSB forecast is for a 37% decline, with North Central prices averaging $220/msf in 2019.

Chart 5
Agricultural Prices



Sources: BMO Economics, Haver Analytics

In the **agriculture** space, most key crop prices were flat-to-lower in 2018 given already-high stockpiles, generally supportive global growing conditions, and in the oilseed space, China's new 25% tariff on U.S. soybeans. Given the downdraft in soybeans, the price of **canola**—Canada's highest-earning crop—ended 2018 on a sour note, down 8.3% y/y and flirting with multi-year lows (in U.S. dollar terms). This occurred despite relatively strong demand conditions, especially in the U.S. market, where real consumer spending on food has grown robustly over the past few years. With overseas soybean production rising rapidly in response to demand from China, there is now a risk that oilseed markets will face a prolonged glut if and when U.S./China trade relations normalize. As a result, canola prices are expected to decline from an average of US$389/tonne in 2018 to $380 in 2019, but should recover to the $400 range in 2020 assuming that global crop yields revert to trend. **Wheat** prices were up an impressive 26% y/y in December, distancing themselves further from the decade-lows plumbed in 2016. Unlike corn and soybeans, the supply of wheat actually tightened in 2018 thanks to a rotation of global acreage away from the crop (given depressed prices at the start of the year) and weather-related challenges in some growing regions. But, despite the improvement, wheat stockpiles remain elevated and prices remain lacklustre. Looking ahead, wheat should benefit somewhat as global corn and soybean yields fall back toward trend, even though wheat acreage will likely edge higher this year. Overall, wheat prices are expected to rise from an average of US$4.95/bushel in 2018 to $5.30 in 2019 and $5.60 in 2020.

In the livestock segment, **hog** prices had a tough year in 2018 and at one point traded below the US$50 per hundredweight (cwt) mark—which, setting aside a brief period in 2016, was their lowest level since the global recession. Even with a rebound in the latter months of the year, hog prices were down 12.6% y/y in December. With food demand in good shape, the decline resulted from a continued increase in supply, with the U.S. hog herd up nearly 17% over the past five years—significantly faster than can be sustained by population and export growth. Hog prices have also been negatively affected by ongoing U.S. trade skirmishes. Fortunately, the shakier pricing environment has started to spur supply restraint, so hog prices are expected to increase from an average of US$65.26/cwt in 2018 to $68 in 2019 and $77 in 2020. Compared to the hog sector, the U.S. **cattle** industry has been more cautious on herd expansion, with the head count up just 7.3% over the past five years. As a result, cattle prices were little-changed in 2018 as a whole (despite a drought-driven drop mid-year) and increased 1.2% y/y in December. Although the U.S. cattle and beef industry has also been the target of foreign tariffs, it is not especially reliant on trade, which has helped contain the damage. Overall, the cattle market appears fairly balanced. Cattle prices are expected to increase from an average of US$114.64/cwt in 2018 (and $119.83 in December) to $120 in 2019 and $122 in 2020.

Economic Forecast Summary for February 1, 2019

BMO Capital Markets Economic Research

	2018				2019				Annual		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2017	2018	2019
CANADA											
Real GDP (q/q % chng : a.r.)	1.7	2.9	2.0	1.2	1.0	2.5	2.2	1.9	3.0	2.0	1.8
Consumer Price Index (y/y % chng)	2.1	2.3	2.7	2.0	1.5	1.8	1.7	2.0	1.6	2.3	1.8
Unemployment Rate (percent)	5.8	5.9	5.9	5.7	5.6	5.7	5.7	5.7	6.3	5.8	5.7
Housing Starts (000s : a.r.)	224	218	197	217	210	207	204	200	220	214	205
Current Account Balance ($blns : a.r.)	-69.3	-66.7	-41.4	-56.4	-55.8	-56.2	-57.5	-58.4	-60.1	-58.5	-57.0
Interest Rates					(average for the quarter : %)						
Overnight Rate	1.25	1.25	1.50	1.75	1.75	1.75	1.75 ↓	1.83 ↓	0.71	1.44	1.77 ↓
3-month Treasury Bill	1.14	1.21	1.47	1.66	1.65	1.65 ↓	1.65 ↓	1.80 ↓	0.69	1.37	1.65 ↓
10-year Bond	2.24	2.28	2.28	2.32	1.95 ↓	2.00 ↓	2.05 ↓	2.10 ↓	1.78	2.28	2.00 ↓
Canada-U.S. Interest Rate Spreads					(average for the quarter : bps)						
90-day	-44	-66	-61	-70	-80 ↑	-80 ↑	-80 ↑	-79 ↑	-26	-60	-80 ↑
10-year	-52	-64	-65	-72	-76 ↓	-76 ↓	-75 ↓	-75 ↓	-55	-63	-76 ↓
UNITED STATES											
Real GDP (q/q % chng : a.r.)	2.2	4.2	3.4	2.6	1.6	2.5	2.0	1.9	2.2	2.9	2.4
Consumer Price Index (y/y % chng)	2.3	2.6	2.6	2.2	1.8	2.0	2.0	2.1	2.1	2.4	2.0
Unemployment Rate (percent)	4.1	3.9	3.8	3.8	3.9 ↑	3.7 ↑	3.6 ↑	3.5	4.4	3.9	3.6
Housing Starts (mlns : a.r.)	1.32	1.26	1.23	1.24	1.26	1.24	1.23	1.21	1.21	1.26	1.24
Current Account Balance ($blns : a.r.)	-487	-405	-499	-509	-535	-547	-563	-573	-449	-475	-555
Interest Rates					(average for the quarter : %)						
Fed Funds Target Rate	1.46	1.71	1.96	2.21	2.38	2.38 ↓	2.38 ↓	2.46 ↓	1.00	1.83	2.40 ↓
3-month Treasury Bill	1.58	1.87	2.08	2.36	2.40 ↓	2.40 ↓	2.40 ↓	2.60 ↓	0.95	1.97	2.45 ↓
10-year Note	2.76	2.92	2.93	3.03	2.70 ↓	2.75 ↓	2.80 ↓	2.85 ↓	2.33	2.91	2.80 ↓
EXCHANGE RATES					(average for the quarter)						
US¢/C$	79.1	77.5	76.5	75.7	75.2 ↑	75.3 ↑	75.4 ↑	75.4	77.1	77.2	75.3 ↑
C$/US$	1.27	1.29	1.31	1.32	1.33	1.33	1.33	1.33	1.30	1.30	1.33
¥/US$	108	109	112	113	109	109	110	110	112	110	109 ↓
US$/Euro	1.23	1.19	1.16	1.14	1.14 ↓	1.15	1.16	1.17	1.13	1.18	1.15
US$/£	1.39	1.36	1.30	1.29	1.31 ↑	1.33	1.32	1.31	1.29	1.34	1.32 ↑

Blocked areas represent BMO Capital Markets forecasts

Up and down arrows indicate changes to the forecast ↑↓

Spreads may differ due to rounding

Canada

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Building Permits
Wednesday, 8:30 am

Dec. (e)	**-1.0%**
Nov.	+2.6%

Housing Starts
Friday, 8:15 am

Jan. (e)	**210,000 a.r. (-1.6%)**
Consensus	*205,500 a.r. (-3.7%)*
Dec.	213,419 a.r. (-4.9%)

Employment
Friday, 8:30 am

Jan. (e)	**-0.03% (-5,000)**
Dec.	+0.04% (+7,800)
	Unemployment Rate
Jan. (e)	**5.7%**
Dec.	5.6%
	Average Hourly Wages
Jan. (e)	**+1.8% y/y**
Dec.	+2.0% y/y

Building permits are expected to drop 1% in December, continuing the up and down pattern in the series. A big gain in non-residential permits in November leaves room for some retracement, though there's some upside for residential. Meantime, housing starts have remained surprisingly strong despite the pullback in existing home sales, rebounding in Q4 from a near two-year low in activity in Q3. We look for starts to decline 1.6%, but remain healthy at 210,000 units annualized, driven by strong immigration.

The Labour Force Survey reported solid job gains in Q4 for a third consecutive year. We're expecting some payback in Q1, though not to the extent we saw last year. Indeed, that move was driven in part by changes in labour laws. Look for a 5,000 drop in employment to start 2019. The big increase in manufacturing jobs in December could see some retracement, while wholesale/retail trade and public administration could see a positive reversal.

Note that, despite our call, the huge decline last January means job growth will accelerate 3-to-4 ticks to around 1.4% y/y. However, that's still well below the SEPH which was +2.4% y/y in November. The last couple of times the spread between the two surveys was this wide was 2005/06 and 2000… not far from recessions. This dynamic more likely reflects the fact that we're closer to the peak of the cycle than an imminent downturn. Tighter labour markets likely drive multiple-job holders, which is one logical explanation of the spread between the surveys.

The anticipated drop in employment will likely push the jobless rate up a tick to 5.7%, since it was only just barely 5.6% in December. Wage growth looks to slow a couple of ticks to 1.8% y/y, as last year's minimum wage hike makes for a tough year-ago comparable.

United States

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Non-manufacturing ISM (NMI)
Tuesday, 10:00 am

Jan. (e)	**57.0**
Consensus	*57.5*
Dec.	58.0

The non-manufacturing index is expected to retreat for a second month after hovering above the lofty 60 mark earlier. Regional surveys of services activity by the Philadelphia and Richmond Feds were weak, while consumer confidence was rocked by volatile equity markets and the government shutdown. Providing some offset will be record oil production (nearing 12 million barrels per day) and a likely upturn in residential construction and resales due to the recent drop in mortgage rates. Other positives include: the new orders sub-index remains high, 16 of 18 industries expanded last month (indicating broad strength), and respondents remained upbeat despite tariffs and worker shortages. Look for the ISM index to slip to 57.0 in January, flagging slower but still decent underlying economic growth.

		Feb 1 [1]	Jan 25	Week Ago	4 Weeks Ago	Dec. 31, 2018
					(basis point change)	
Canadian Money Market	Call Money	1.75	1.75	0	0	0
	Prime Rate	3.95	3.95	0	0	0
U.S. Money Market	Fed Funds (effective)	2.50	2.50	0	0	0
	Prime Rate	5.50	5.50	0	0	0
3-Month Rates	Canada	1.65	1.63	2	3	1
	United States	2.39	2.37	2	-2	4
	Japan	-0.26	-0.21	-6	-8	-11
	Eurozone	-0.31	-0.31	0	0	0
	United Kingdom	0.91	0.92	-1	1	0
	Australia	2.05	2.08	-3	-1	-4
2-Year Bonds	Canada	1.84	1.88	-4	-1	-2
	United States	2.52	2.61	-9	2	3
10-Year Bonds	Canada	1.97	1.98	-1	4	0
	United States	2.69	2.76	-7	2	1
	Japan	-0.02	-0.01	-1	2	-2
	Germany	0.17	0.19	-3	-4	-7
	United Kingdom	1.25	1.30	-6	-3	-3
	Australia	2.21	2.21	0	-3	-11
Risk Indicators	VIX	16.3	17.4	-1.1 pts	-5.1 pts	-9.1 pts
	TED Spread	34	38	-4	-6	-11
	Inv. Grade CDS Spread [2]	66	72	-6	-18	-21
	High Yield CDS Spread [2]	354	375	-20	-79	-96
					(percent change)	
Currencies	US¢/C$	76.49	75.65	1.1	2.3	4.3
	C$/US$	1.307	1.322	—	—	—
	¥/US$	109.54	109.55	0.0	0.9	-0.1
	US$/€	1.1460	1.1406	0.5	0.6	-0.1
	US$/£	1.308	1.320	-0.9	2.8	2.5
	US¢/A$	72.56	71.79	1.1	2.0	2.9
Commodities	CRB Futures Index	180.72	180.68	0.0	4.2	6.4
	Oil (generic contract)	55.26	53.69	2.9	15.2	21.7
	Natural Gas (generic contract)	2.74	3.07	-10.8	-10.0	-6.8
	Gold (spot price)	1,317.96	1,303.15	1.1	2.6	2.8
Equities	S&P/TSX Composite	15,508	15,366	0.9	7.5	8.3
	S&P 500	2,708	2,665	1.6	7.0	8.0
	Nasdaq	7,265	7,165	1.4	7.8	9.5
	Dow Jones Industrial	25,069	24,737	1.3	7.0	7.5
	Nikkei	20,788	20,774	0.1	6.3	3.9
	Frankfurt DAX	11,181	11,282	-0.9	3.8	5.9
	London FT100	7,020	6,809	3.1	2.7	4.3
	France CAC40	5,019	4,926	1.9	6.0	6.1
	S&P ASX 200	5,863	5,906	-0.7	4.3	3.8

[1] = as of 1:55 pm   [2] = One day delay

Global Calendar
February 4 – February 8

BMO Capital Markets®

<table>
<tr><th></th><th>Monday February 4</th><th>Tuesday February 5</th><th>Wednesday February 6</th><th>Thursday February 7</th><th>Friday February 8</th></tr>
<tr><td>Japan</td>
<td></td>
<td>Services PMI
Jan.
Dec. 51.0

Composite PMI
Jan.
Dec. 52.0</td>
<td></td>
<td></td>
<td>Household Spending
Dec. (e) +0.9% y/y
Nov. -0.6% y/y

Current Account Surplus
Dec. ’18 (e) ¥458.5 bln
Dec. ’17 ¥796.5 bln

Bank Lending Ex-Trsuts
Jan.
Dec. +2.5% y/y</td></tr>
<tr><td>Euro Area</td>
<td>EURO AREA
Producer Price Index
Dec. (e) -0.7% +3.1% y/y
Nov. -0.3% +4.0% y/y

ITALY
Consumer Price Index
Jan. P (e) -1.9% +0.9% y/y
Dec. -0.1% +1.2% y/y</td>
<td>EURO AREA
Services PMI
Jan. F (e) 50.8
Dec. 51.2

Composite PMI
Jan. F (e) 50.7
Dec. 51.1

Retail Sales
Dec. (e) -1.6% +0.5% y/y
Nov. +0.6% +1.1% y/y</td>
<td>GERMANY
Factory Orders
Dec. (e) +0.3% -6.7% y/y
Nov. -1.0% +4.3% y/y</td>
<td>EURO AREA
ECB Economic Bulletin
EC Publishes Economic Forecasts

GERMANY
Industrial Production
Dec. (e) +0.7% -3.3% y/y
Nov. -1.9% -4.7% y/y

FRANCE
Trade Deficit
Dec. (e) €4.0 bln
Nov. €5.1 bln

ITALY
Retail Sales
Dec.
Nov. +0.7% +1.6% y/y</td>
<td>GERMANY
Trade Surplus
Dec.
Nov. €19.0 bln

FRANCE
Industrial Production
Dec. (e) +0.7% -1.4% y/y
Nov. -1.3% -2.1% y/y

Manufacturing Production
Dec. (e) +1.1% -1.2% y/y
Nov. -1.4% -2.2% y/y

ITALY
Industrial Production
Dec. (e) +0.4% -2.7% y/y
Nov. -1.6% -2.6% y/y</td></tr>
<tr><td>U.K.</td>
<td>Construction PMI
Jan. (e) 52.5
Dec. 52.8</td>
<td>Services PMI
Jan. (e) 51.0
Dec. 51.2

Composite PMI
Jan. (e) 51.4
Dec. 51.4</td>
<td></td>
<td>7:00 am ET BoE Monetary Policy Announcement, Minutes and Quarterly Inflation Report
7:30 am ET BoE Governor Carney’s Press Conference</td>
<td></td></tr>
<tr><td rowspan="2">Other</td>
<td colspan="5">CHINA
Markets Closed</td></tr>
<tr>
<td>CHINA
Caixin Services PMI
Jan. (e) 53.4
Dec. 53.9

Caixin Composite PMI
Jan.
Dec. 52.2

AUSTRALIA
Building Approvals
Dec. (e) +2.0% -10.9% y/y
Nov. -9.1% -32.8% y/y</td>
<td>AUSTRALIA
Trade Surplus
Dec. (e) A$2.2 bln
Nov. A$1.9 bln

Retail Sales
Dec. (e) unch
Nov. +0.4%

RBA Monetary Policy Meeting</td>
<td>BRAZIL
Central Bank of Brazil Monetary Policy Meeting</td>
<td>MEXICO
Central Bank of Mexico Monetary Policy Meeting

INDIA
RBI Monetary Policy Meeting</td>
<td>AUSTRALIA
RBA Statement on Monetary Policy</td></tr>
</table>

D = date approximate

Upcoming Policy Meetings | BoE: Mar. 21, May 2, June 20 | ECB: Mar. 7, Apr. 10, June 6

North American Calendar
February 4 – February 8

BMO Capital Markets®

Canada

Monday February 4

Cdn. Merchandise Trade Balance (originally scheduled for Tuesday, Feb. 5) will be rescheduled due to the U.S. government shutdown

Tuesday February 5

10:30 am — 3-, 6- & 12-month bill auction $12.5 bln (new cash $3.3 bln)

Wednesday February 6

8:30 am	**Building Permits**	
Dec. (e)	**-1.0%**	
Nov.	+2.6%	

8:35 am — BoC Deputy Governor Lane speaks at the Peterson Institute for International Economics in Wash. D.C.

10:00 am	**Ivey PMI (s.a.)**
Jan.	
Dec.	59.7

Thursday February 7

Noon — 2-year bond auction $3 bln

5-year bond auction announcement

Friday February 8

8:15 am	**Housing Starts**
Jan. (e)	**210,000 a.r. (-1.6%)**
Consensus	*205,500 a.r. (-3.7%)*
Dec.	213,419 a.r. (-4.9%)
8:30 am	**Employment**
Jan. (e)	**-0.03% (-5,000)**
Dec.	+0.04% (+7,800)
8:30 am	**Unemployment Rate**
Jan. (e)	**5.7%**
Dec.	5.6%
8:30 am	**Average Hourly Wages**
Jan. (e)	**+1.8% y/y**
Dec.	+2.0% y/y

United States

Monday February 4

10:00 am	**Factory Orders**
Nov. (e)	**+0.4%**
Consensus	*+0.3%*
Oct.	-2.1%

Fed Speaker: Cleveland's Mester (7:30 pm)

11:30 am — 13- & 26-week bill auction $84 bln

Releases marked by * pending reschedule as U.S. government reopens for 3 weeks

Previously delayed data:

Rescheduled—
- Budget Balance (Dec.) — Feb. 13
- Business Inventories (Nov.) — Feb. 14
- Real GDP by Industry (Q3) — Feb. 21

Pending—
- Retail Sales (Dec.)
- Housing Starts (Dec.)
- Building Permits (Dec.)
- Durable Goods Orders (Dec.)
- New Home Sales (Dec.)
- Homeowner Vacancy Rate (Q4)
- Real GDP (Q4 A)
- Personal Spending (Dec.)
- Construction Spending (Dec.)

Sunday February 3

Fed Speaker: Minneapolis' Kashkari (10:40 am)

Tuesday February 5

9:45 am	**Markit Services/Composite PMI (Jan. F)**
10:00 am	**Non-manufacturing ISM (NMI)**
Jan. (e)	**57.0**
Consensus	*57.0*
Dec.	58.0

9:00 pm — State of the Union Address

11:00 am — 4- & 8-week bill auction announcements

1:00 pm — 3-year note auction $38 bln

Wednesday February 6

7:00 am	**MBA Mortgage Apps**	
Feb. 1		
Jan. 25	-3.0%	
8:30 am	**Productivity**	**Unit Labour Costs**
Q4 P (e)	**+1.0% a.r.**	**+2.2% a.r.**
Consensus	*+1.7% a.r.*	*+1.6% a.r.*
Q3	+2.3% a.r.	+0.9% a.r.
8:30 am	**Goods & Services Trade Deficit**	
Dec. (e)*	**$52.0 bln**	
Nov. (e)	**$54.0 bln**	
Consensus	*$54.0 bln*	
Oct.	$55.5 bln	

Fed Speaker: Governor Quarles (6:05 pm)

7:00 pm — Fed Chair Powell hosts a Teacher Town Hall Meeting in Wash. D.C.

1:00 pm — 10-year note auction $27 bln

Thursday February 7

8:30 am	**Initial Claims**
Feb. 2 (e)	**220k (-33k)[c]**
Jan. 26	253k (+53k)
8:30 am	**Continuing Claims**
Jan. 26	
Jan. 19	1,782k (+69k)
3:00 pm	**Consumer Credit**
Dec. (e)	**+$15.0 bln**
Consensus	*+$16.0 bln*
Nov.	+$22.1 bln

Fed Speakers: Vice Chair Clarida (9:30 am); St. Louis' Bullard (7:30 pm)

11:00 am — 13- & 26-week bill, 30[R]-year TIPS auction announcements

11:30 am — 4- & 8-week bill auction

1:00 pm — 30-year bond auction $19 bln

Friday February 8

10:00 am	**Wholesale Inventories**
Dec. (e)*	**+0.2%**
Nov.	+0.3%

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

Upcoming Policy Meetings | Bank of Canada: Mar. 6, Apr. 24, May 29 | FOMC: Mar. 19-20, Apr. 30-May 1, June 18-19