BMO Capital Markets
We're here to help.™

BMO CAPITAL MARKETS ECONOMICS

Focus

A weekly financial digest

Douglas Porter, CFA, Chief Economist, BMO Financial Group

March 15, 2019

Feature Article
Page 9

Do Deficits (Still) Matter?

U.K. Parliament Votes to Delay Brexit

China Provides Some Stimulus Details

Global Stocks Rally

Bond Yields Fall Again, Even As Oil Firms

BMO Capital Markets Economics
economics.bmocapitalmarkets.com • 1-800-613-0205
Please refer to page 18 for important disclosures

Don't Fear the Re-cession

Douglas Porter, CFA
Chief Economist
douglas.porter@bmo.com
416-359-4887

No, I'm not saying a recession can't happen in North America over the next 18 months. And, no, this isn't meant to downplay the real damage an economic downturn can cause. It's meant more as a reminder that we shouldn't leap to attention every time a growling bear mouths the R word—"we" as in analysts, investors, the media. A classic example is what just unfolded in the past few months. It's amazing how, after reaching a fevered pitch around the turn of the year, recession chatter suddenly faded fast as we entered 2019, following neatly in line with the rapid rally in equities. After cresting in the final weeks of December, Google searches for the word "recession" have all but receded back to near normal levels.

The economic data and financial markets have largely played along with the fading concerns. While there is little debate that global growth is cooling, it's a long way from an outright downturn. Instead, we look for global GDP to simmer down to 3.3% this year from an above-potential pace of 3.6% last year. More specifically in the U.S., the consensus on 2019 GDP growth has slipped only modestly since last Fall, from 2.7% to 2.4% now (we have shaved our call to 2.3%). This week's round of data, while far from stellar, also helped put recession fears further to bed, with a small rebound in core retail sales in January, decent durable orders, and some further recovery in sentiment for both small business and consumers. Meantime, equities churned out yet another solid weekly advance after their first semi-serious setback in almost three months last week. By Friday, the S&P 500 had punched up to its highest level since early October.

This lengthy preamble is aimed at softening the blow before noting a couple key warning flares that markets sent into the air this week. First, while equities may be sending the all-clear signal, the bond market most certainly is not. For example, the benchmark 10-year Treasury yield continues to run in precisely the opposite direction of stocks, dropping below 2.6% this week and thereby testing its lowest level in more than a year. This persistent drop in yields is despite a steady back-up in oil prices, which is actually nudging up inflation expectations. Real yields are driving the bus—for the 10-year area, they have dropped below 0.7%, the lowest in more than a year and hardly a vote of confidence in the growth outlook.

The second warning signal comes from Canada's very own bond market. For the first time in over a decade, we have a full-on yield curve inversion—the 10-year GoC yield now sits at 1.73%, breaking below the Bank of Canada's overnight rate of 1.75%. While Canada's yield curve has sent many false positive signals over the decades, most of those were in the bad old days of the 1980s and 1990s, when the BoC was occasionally forced to crank rates higher to defend the currency. That is clearly not the case here. Meanwhile, the 5-year bond yield has absolutely plummeted: Since peaking last Fall at nearly 2.5%, it has plunged almost 90 bps to barely 1.6% today. As well, 30-year yields are testing the 2% threshold, and are now at a whopping and record 100 bp spread versus like-dated U.S. yields. The market is now pricing in almost a 50% chance of a BoC rate cut at some point in 2019—again, not exactly a vote of confidence in the economic outlook.

Despite these obvious warning signals, we would revert to the initial contention that the underlying backdrop just doesn't point to such dire circumstances. Always remember that recessions are actually quite rare events, and it takes a lot to tip an economy into a full-scale recession. While many are pointing out that the U.S. expansion is about to become the longest ever at 10 years this summer, there is nothing set in stone about the length of the cycle. Australia is working on a record 27 years without a recession. Even Canada went 16 years between official downturns at one point (between 1992 and 2008). One completely random Canadian example: If someone *(ahem)* had started their career on Bay Street in, oh, let's say 1984, they would have only seen just two recessions in almost 35 years. And, someone starting in 1994—*25 years ago!*— would have seen only one full-blown recession. The point is that it is entirely possible that this expansion could live for many more years yet.

Having said all that, and hopefully not having given this cycle the kiss of death, growth clearly struggled around the turn of the year, especially in Canada. We suspect that GDP will do well to stay out of the red in Q1 amid the deep oil production cuts and harsh winter weather. Accordingly, the consensus call on Canadian 2019 GDP growth has dropped 0.6 ppts since late last year to just 1.4% now (we are at 1.3%). However, the combination of firming sentiment, stronger oil prices, lessening oil curtailments, and perhaps even some mild fiscal stimulus from next week's Federal Budget all suggest that growth will improve modestly in the spring and summer.

Perhaps the most notable aspect of the renewed retreat in bond yields is that it is occurring against a backdrop of a steady comeback in oil prices. Even with a small pullback on Friday, WTI knocked down yet another weekly gain. At more than $58, prices are close to a four-month high and have managed 30% gains from the lows hit around the turn of the year. No surprise, gasoline prices are now being pulled along for the ride, and U.S. pump prices are now back to about flat versus year-ago levels. That's a different world from the double-digit declines seen in the opening weeks of the year, declines that helped chop headline CPI inflation to 1.5% in February. Meantime, ex-energy inflation has been holding just above 2%, and that pace will soon reassert itself in the headline measure if oil prices remain firm. The main message is that the recent run of mild inflation readings looks set to disappear soon.

FOMC Preview: Lower Plotted Dots, Patience Talked Lots

Michael Gregory, CFA
Deputy Chief Economist
michael.gregory@bmo.com
416-359-4747

After lifting policy rates in the previous five quarter-ending months, we expect no move on March 20 as the Fed **continues its new *"patient"* approach** to monetary policy. The approach was first signalled on January 4 by Chairman Powell in a panel discussion and formally amplified at the January 30 FOMC meeting. We look for the key phrase to be repeated again: *"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…"* We also look for the Statement to note the very weak tone to household spending and business fixed investment at the turn of the year along with some subsequent signs of a rebound.

We're expecting a formal announcement, likely in a separate press release, that the Fed **intends to stop shrinking its balance sheet by Q4 of this year** (when there'll still be around $1.2 trillion of reserves and $3.4 trillion of total assets), and continue the current reduction cadence until then—so no tapering of the pace. Once ended, although we anticipate maturing Treasuries and redeeming MBS will be offset solely by T-bill purchases, this announcement could come later (say, June) given the Fed's proclivity to consult with market participants first.

In the Summary of Economic Projections (SEP), **we expect the median forecast for policy rates through 2021 will drop by 25 bps**, to 2.625% from 2.875% for 2019, and to 2.875% from 3.125% for both 2020 and 2021. In December, among the 17 participants, 2 were in the no rate-hike camp for 2019, 4 forecasted one move, 5 predicted two moves (which was the median projection of 2.875%), and 6 were in the three rate-hike camp. It will take 3 net new participants in the one-and-done-or-none group to pull down the median projection to 2.625% for 2019. While most of the switches should come from the two-hike crowd, we wouldn't be surprised to see some coming from the three-hike camp. For 2020 and 2021, it will take only one at-the-median projection decreasing a quarter-point to pull down the metric to 2.875%.

Changes to the longer-run median projection are more uncertain because of potential technical adjustments to the individual forecasts. Since the December SEP, the Fed has announced that it will continue with an *"ample supply of reserves"* regime over the long run, and thus keep targeting the fed funds rate within a range as opposed to eventually returning to a point target. The latter was the assumption underlying the FOMC's longer-run projections, and we suspect at least some (and potentially all) participants will shift their longer-run forecasts accordingly. It's uncertain whether a current 2.75% call (which is the median) will become the top of a 2.50%-to-2.75% range or the bottom of a 2.75%-to-3.00% range. We judge the odds favour the former, so we wouldn't be surprised to see the median longer-run projection lowered by 1/8%.

Elsewhere in the SEP, we are on the alert for only a couple of changes: a downgrade (by at least 1/10%) of the 2.3% median call for 2019 real GDP growth due to the poor start to the year, and a downgrade of the longer-run unemployment rate from 4.4% given the absence of more meaningful wage inflation (the jobless rate has hovered at or below 4.0% for the past year). As for the press conference, the quarterly installments have lost some of their significance with this year's shift to every-meeting pressers, and we suspect Chairman Powell will echo his recent congressional testimony. MJG

Tug of Wage War

There are few more crucial issues for the U.S. economy than the direction of wages. In a nutshell, if wages spark, inflation embers will ignite, forcing the Fed to more forcefully lift rates and risking a sharper slowdown.

Sal Guatieri
Senior Economist
sal.guatieri@bmo.com
416-359-5295

So far, wages haven't followed the usual playbook. Although the pace of compensation has picked up in response to growing labour shortages, it hasn't fueled enough heat to even warm inflation, let alone ignite it. True, almost all key wage measures are running close to cycle highs, with average hourly earnings and the

Atlanta Fed's (smoothed) wage growth tracker both rising 3.4% y/y, and the employment cost index and business-sector hourly compensation growing 2.9%. However, the latter is running just 1½ percentage points faster than productivity (on an average four-quarter basis), so unit labour costs are still tugging inflation below the target. That's why the core PCE rate remains a tad shy of the bullseye nearly ten years after the recession ended.

The reasons for restrained wage growth are well known. Fear of displacement from robots, algorithms and AI has dissuaded workers from seeking higher pay. The gig economy has increased job competition in some industries such as transportation and travel accommodation. After a lengthy spell of joblessness, workers likely still feel deep emotional scars from the Great Recession. Inflation expectations anchored to the 2% target have benchmarked wage settlements. Though starting to show a pulse, productivity growth remains lame, dissuading companies from increasing pay. Intense global competition means wage-control is essential for staying in business.

These structural factors have acted to flatten the so-called Phillips curve, loosening the usually strong link between the jobless rate and wage growth. Still, unless the law of supply and demand has been repealed, the curve isn't flat. At low-enough rates of joblessness (we suspect below 3½%, though it could be less), the upward thrust from worker shortages will overwhelm the downward pull from structural forces, causing unit labour costs to run faster than 2% and inflation to exceed the target. Record job openings and surveys of business leaders suggest labour market pressures are building, a trend that will only increase if the jobless rate dips to 3.5% later this year, as we expect. This, in turn, should tilt inflation a bit higher and pull the Fed off the sidelines one more time. However, with economic growth likely to slow below potential next year, any further inflation pressure will subside, keeping the Fed on hold and recession risks at bay. Sal

Debt Endures

Benjamin Reitzes
Canadian Rates &
Macro Strategist
benjamin.reitzes@bmo.com
416-359-5628

A former Bank of Canada Governor once said that, while asset prices may rise and fall, debt endures. Indeed, worrying about household debt has been a pastime for policymakers, pundits, and Canada watchers for about a decade. That was a key theme again this week with the household debt ratios hitting a new high in Q4 and Bank of Canada Senior Deputy Governor Wilkins opining on the build-up of debt globally in a Vancouver speech.

Debt ratios hitting a new record high in Q4 wasn't shocking, as income growth was moderate in the quarter. The latter fact is what policymakers should be most concerned about. The debt ratios have two parts, debt and income. It's going to take a long time to work down the debt accumulated over the past decade, so a big improvement there isn't likely. U.S. households delevered early in this cycle through defaults, but that's not a path Canada wants to follow. The other method to bring debt ratios lower is strong income growth. Unfortunately, income growth has struggled in recent years, with the oil shock hammering incomes in 2016, and some deceleration recently in-line with softer GDP growth.

The other interesting tidbit from the national balance sheets was that the debt service ratio climbed to effectively match the record high hit in 2007Q4. The key difference is that policy interest rates were 4.5% in 2007Q4 versus 1.75% now. **That amplifies the point that Canadian households are much more sensitive to interest rates this time around and there is a clear constraint on how far the BoC can raise rates**. Indeed, the data suggest the BoC won't be pushing rates higher anytime soon as it's unlikely it will want to put any more pressure on households. The debt service ratio has more potential drivers. Debt, noted above, is one, but again, that's unlikely to move materially. Interest rates and income are the other two. Households may get some reprieve on rates, as market rates have tumbled since the start of the year. And, that leaves income once again.

Key Takeaway: One common thread when looking at debt ratios is that income growth is key. The only way debt ratios can fall meaningfully is through stronger income growth, which comes alongside stronger GDP growth. With household consumption accounting for nearly 60% of GDP, expect the debt burden to be a lasting constraint on the Bank of Canada and policy rates. *B.A.A.R.*

TSX Going It Alone

Robert Kavcic
Senior Economist
robert.kavcic@bmo.com
416-359-8329

Canada's economy is flagging, yet the TSX is flying. Paradox? Maybe not when you consider that the TSX is a bit of a strange animal in the equity world. There's little doubt that the Canadian economy has run into a rough patch. Real GDP barely grew in 2018Q4, and will struggle to do so again in 2019Q1. While part of that reflects the impact of mandated temporary oil production cuts, weakness has also (and of more concern) spread into housing and consumer spending. Deflationary home prices and psychology have spread pretty much everywhere west of Winnipeg, while Toronto's market is still in a dogfight. The household debt-to-disposable income ratio hit a record high in Q4, not because credit growth strengthened (it decelerated), but because income growth slowed even more. Meantime, the household debt service ratio essentially matched a 27-year high despite still below-neutral rates, while the equity share of overall real estate holdings is now falling outright. Yes, these latter measures are aggregates and may mask some of the true strength and weakness at the individual level, but it's not exactly an environment that screams strong economic growth, rate hikes or an equity rally. Still, the TSX is holding onto a hefty 12% year-to-date gain. Here are a few reasons:

All's well that starts well: Part of the strength simply reflects the starting point. Recall that stocks were hammered into the end of 2018, and the bottom just happened to coincide with the turn of the calendar. Indeed, the TSX is still down from mid-2018, the end of 2017, and is up only about 3% from five years ago. That said, Canadian stocks have outperformed the S&P 500 this year, and that's something.

It's always about oil: Canadian oil prices have rallied more than 60% this year on stronger underlying WTI prices and a tighter differential. A simple answer, but usually the right one.

Rate-sensitives are helping: Relative TSX performance doesn't usually correlate that well with relative economic growth anyway, given the sector makeup of the index. The TSX has been acting more rate sensitive, with its biggest recent rallies (this year, mid-2018 and late-2017) coming alongside notable declines in GoC yields. In fact, utilities, banks and real estate have all posted double-digit gains this year on both sides of the border, but those sectors combined account for a sizeable 40% of the TSX versus just 20% of the S&P 500. Consider the flip side, when the market is keying in on growth—technology, industrials and consumer discretionary make up 40% of the S&P 500 versus just 20% in the TSX.

Valuation tailwind: One of the reasons we thought the TSX could post a rare run of good relative performance this year was that valuations were favourable heading into 2019. By December, the gap in forward earnings yields between the TSX and S&P 500 was the widest in favour of Canada in a decade. Domestically, the TSX forward earnings yield was the widest versus 10-year GoCs since 2012 (and that relationship has been incredibly tight in recent years). The recent run in Canadian stocks has taken a good chunk out of these valuations spreads, but not all yet. Rob K.

Priscilla Thiagamoorthy
Economic Analyst
priscilla.thiagamoorthy@bmo.com
416-359-6229

	Good News	Bad News
Canada ▪ BoC Sr. Dep. Gov Wilkins: "*our number one domestic financial vulnerability*" remains high household debt	**Manufacturing Sales Volumes** +1.4% (Jan.)	**Existing Home Sales** -9.1% (Feb.) **MLS Home Price Index** -0.1% y/y (Feb.) **Manufacturing New Orders** -11.9% (Jan.) **Household Debt-to-Disposable Income** +0.38 ppts to 174.0% (Q4) **New Motor Vehicle Sales** -6.9% y/y (Jan.) **New Housing Price Index** -0.1% (Jan.)—first drop since Feb. '18 **Manpower Survey—Net Outlook** -2 ppts to +10% (Q2)
United States ▪ Fed Chair Powell sticks to the script: "*we don't feel any hurry*" to change policy	**Retail Sales** +0.2% (Jan.) **Durable Goods Orders** +0.4% (Jan.)—and **core** +0.8% **Construction Spending** +1.3% (Jan.) **Job Openings** climbed to 7,581k (Jan.) **NFIB Small Business Optimism Index** +0.5 pts to 101.7 (Feb.) **Empire State Manufacturing Survey** +0.1 pts to an ISM-adjusted 52.6 (Mar.) **U of M Consumer Sentiment** +4.0 pts to 97.8 (Mar. P)	**Industrial Production** +0.1% (Feb.)—**Capacity Utilization** -0.1 ppts to 78.2% **Consumer Prices** slowed to +1.5% y/y (Feb.) **Producer Prices** eased to +1.9% y/y (Feb.) **Import Prices** -1.3% y/y (Feb.) **New Home Sales** -6.9% to 607,000 a.r. (Jan.) **Manpower Survey—Net Outlook** -1 ppt to +19 (Q2) **Initial Claims** +6k to 229k (March 9 week)
Japan ▪ BoJ on hold and more dovish as global economy slows	**Producer Prices** +0.8% y/y (Feb.) **Tertiary Industry Index** +0.4% (Jan.)	**Machine Tool Orders** -29.3% y/y (Feb. P) **Core Machine Orders** -2.9% y/y (Jan.)
Europe ▪ British lawmakers vote to delay Brexit… uncertainty still looms ▪ U.K. government cuts 2019 GDP growth forecast to 1.2% in Spring Statement... from 1.6%	**Euro Area—Industrial Production** +1.4% (Jan.) **Italy—Industrial Orders** +1.8% (Jan.) **U.K.—Monthly Real GDP** steady at +0.2% (3 mths to Jan.)—**Services GDP** +0.5% **U.K.—Industrial Production** +0.6% (Jan.)	**Germany—Industrial Production** -0.8% (Jan.) **Germany—Trade Surplus** narrowed to €18.5 bln (Jan.) **U.K.—Trade Deficit** widened to £13.1 bln (Jan.) **U.K.—RICS House Price Balance** -28% (Feb.)
Other ▪ China's Premier Li pledges not to let economic data "*slide out of their proper range*"; confirms VAT cut in April ▪ Oil firms ahead of OPEC meeting	**China—Fixed Asset Investments** +6.1% y/y (Jan.-to-Feb.) **Foreign Direct Investment** +6.6% y/y (Feb.)	**China—Consumer Prices** +1.5% y/y (Feb.) **China—Industrial Production** slowed to +5.3% y/y; and **Retail Sales** to +8.2% y/y (Jan.-to-Feb.) **China—Aggregate Yuan Financing** eased to 703.0 bln (Feb.)—and **New Yuan Loans** 885.8 bln **China—M2 Money Supply** slowed to +8.0% y/y (Feb.) **Australia—Westpac Consumer Confidence** -4.8% (Mar.) **Australia—NAB Business Confidence** -2 pts to 2 (Feb.)

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

Do Deficits (Still) Matter?

Douglas Porter, CFA
Chief Economist
douglas.porter@bmo.com
416-359-4887

"Our national debt is approaching $1 trillion. A few weeks ago, I called such a figure incomprehensible." Ronald Reagan, 1980. (The debt recently surpassed $22 trillion.)

"Deficits are like putting dynamite in the hands of children. They can get out of control very quickly." Nassim Nicholas Taleb

"Christmas is a time when kids tell Santa what they want and adults pay for it. Deficits are when adults tell the government what they want and their kids pay for it." Richard Lamm

"Reagan proved deficits don't matter." Dick Cheney, 2002

It's budget season in much of the industrialized world, with the U.K. unveiling its fiscal plan this week amid the Brexit chaos, Canada on deck next week, and many key provinces to soon follow. The White House also unveiled its proposed 2020 Budget this past Monday; while markets yawned as the plan was predictably declared dead on arrival, the most striking aspect to the coverage of the proposal was the near absence of commentary on the deficit projections.

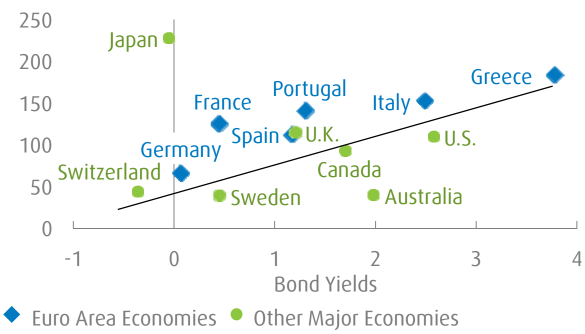
There was a time in the not-so-distant past that official forecasts of multi-year trillion-dollar shortfalls in Washington (or close to 5% of GDP) would have been *the* major focus, especially coming at this advanced stage of the business cycle. Instead, investors continue to show little concern, as long-term bond yields have receded over the past year, and are barely above underlying inflation in the U.S.—and below it in many other major economies. In an environment of sometimes negative real interest rates, it's tough not to sympathize at least a trace with Dick Cheney's contention and/or the Modern Monetary Theory, which posits that deficits and debt don't matter so long as a country can borrow in its own currency. (Contrary to some opinion, the MMT, as it has come to be known, does not stand for Mostly Malarkey Today.) However, we would counter with another quote—*"deficits don't matter, until they do"*.

Scanning around the industrialized world, there still is a relatively clear link between the stock of outstanding government debt and borrowing costs (*Chart 1*). That link is almost air-tight within the economies in the Euro Area, where bond yields are seemingly a direct function of public sector debt levels. The picture gets a little murkier when looking at the major economies that can borrow in their own currencies, with Japan a massive outlier on the one side (high debt, low yields) and Australia a bit of an outlier on the other side (low debt, somewhat higher yields). Japan can be partly explained by its somewhat unique circumstances—decades of deflation, dismal demographics, and the fact the country not only

Chart 1
Debt vs. Yields

2019

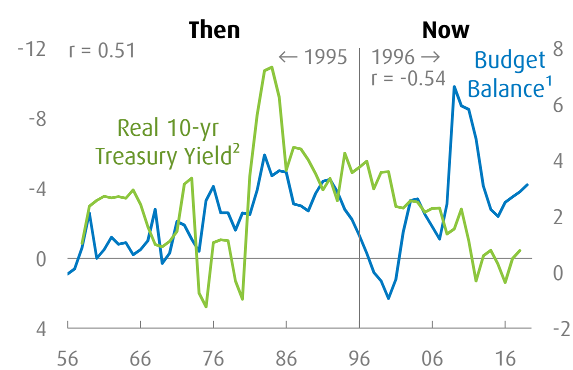
Gross Government Debt vs. Bond Yields



Debt: (gross debt/GDP) Yields: (10-yr Government Bonds : % : as of March 15) Sources: BMO Economics, Haver Analytics

Chart 2
Deficits Once Mattered...

United States



[1] (lhs : inverted : % of GDP); [2] (rhs : %)
Sources: BMO Economics, Haver Analytics

borrows in its own currency, but borrows entirely from its own resources (and remains a massive net creditor).

But while there remains a relatively tight fit in most cases between bond yields and government debt levels (or, essentially all accumulated deficits over the years), that doesn't detract from the fact that the previously strong link between current budget deficits and borrowing costs has weakened notably in the past 20 years. Taking the U.S. as an example, *Chart 2* suggests that there was such a link—up until the mid-1990s, and then it mysteriously weakened, and has all but since disappeared. (Sidebar: Some could argue that the causality runs the other way; that is, higher real interest rates cause bigger deficits through rising borrowing costs. While true, deficits have tended to lead rates over time, rather than vice-versa.)

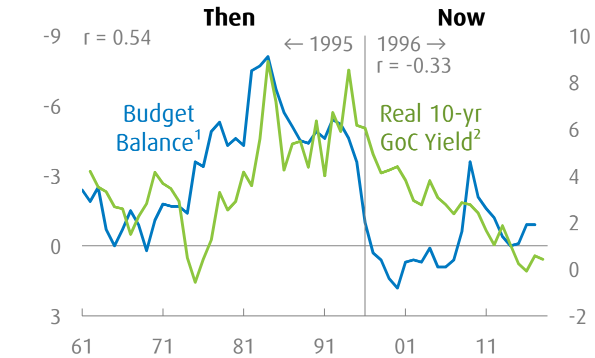
It's a very similar story in Canada, with the same point at which the relationship between current deficits and real interest rates weakened (and also the case that deficits tend to lead bond yields (*Chart 3*)). What makes this a bit more interesting in Canada's case is that the mid-1990s happened to coincide with the point at which governments finally got control of budget deficits, and thus they 'stopped mattering'. This was perhaps a case of 'deficits mattered, until they no longer did'.

Digging below the federal government picture, however, reveals that deficits still do very much matter at the sub-national level. Similar to the situation within the Euro Area, borrowing costs for Canada's provinces are largely a direct function of deficits and debt levels (which we proxy with our own credit scores). As *Chart 4* suggests, Quebec now has comparable and sometimes even lower borrowing costs than neighbouring Ontario—a huge change from decades of higher costs—largely reflecting the fact that provincial debt levels have recently crossed paths as well between the two. While we can all discuss the niceties of the MMT, there is little debate that for jurisdictions that don't have the luxury of controlling the printing presses and are instead part of a larger currency zone—euro area members, provinces, states—deficits and debt do, indeed, matter.

And, as *Chart 5* displays, debt levels for all of the Canadian provinces combined are now essentially in line with the accumulated deficits of the federal government, for the first time on record. Taking these two items together for provinces—deficits matter and record high debt ratios—suggests that their fiscal policy considerations are very different than for the federal government at this point; i.e., there still is considerable pressure on many provinces to gain control of their finances. But before granting Ottawa a free pass, we would assert that it, too, should prudently martial its resources at this advanced stage of the business cycle, as it will

Chart 3
...Even More So in Canada

Canada

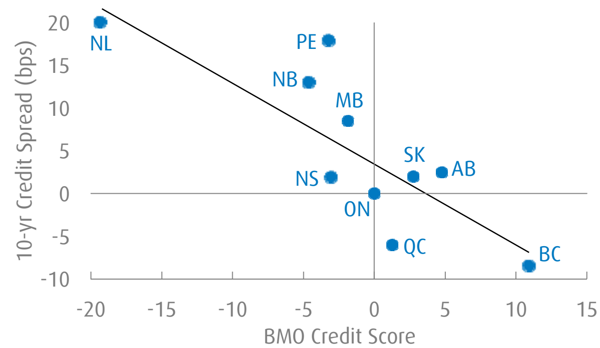


[1] (lhs : inverted : % of GDP); [2] (rhs : %)
Sources: BMO Economics, Haver Analytics

Chart 4
For Provinces, Deficits Matter

Canada — Current

Credit Spread vs. Fundamentals[1]

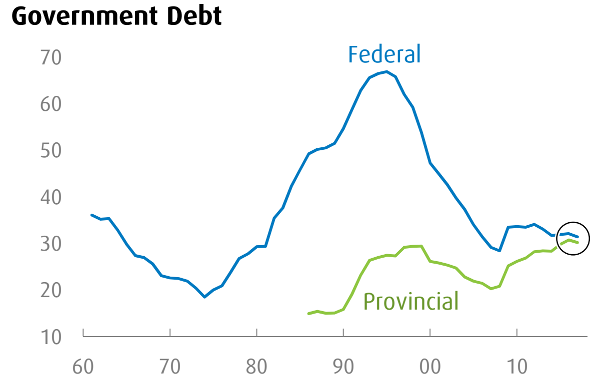


[1] Difference vs. Ontario Source: BMO Economics

Chart 5
Deficits Matter, for Provinces

Canada (% of GDP)

Government Debt



Sources: BMO Economics, Haver Analytics

increasingly be called on to assist the provinces and their challenges with mounting health-care costs in the future.

At least overall government debt levels in Canada have been stable in recent years; actually receding as a share of GDP in net terms (netting public sector assets, such as pension funds). That has patently not been the case in the U.S., where gross government debt has punched well above 100% of GDP, and has more than tripled by that measure in the four decades since Ronald Reagan declared debt levels incomprehensible (*Chart 6;* ironically, U.S. debt was actually brushing a multi-decade low as a share of GDP when Reagan was fretting).

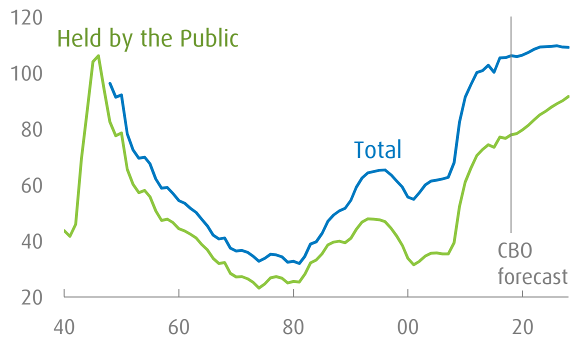
Current low borrowing costs, which are well below trend nominal GDP growth rates, do provide some breathing room for U.S. finances. Government interest costs now consume 1.6% of GDP, roughly half the peak in the 1980s and early 1990s. (In Canada, the swing has been even more extreme, with Ottawa's interest costs plunging to barely 1% of GDP now versus a peak of more than 6% in the early 1990s (*Chart 7*).) But we would simply note that long-term borrowing costs were also consistently below U.S. nominal GDP trends for much of the 1960s and 1970s—until they weren't in the 1980s, and then deficits became a major constraint (*Chart 8*).

Bottom Line: Even for economies that can freely borrow in their own currency, the strength of government finances still ultimately matters for borrowing costs. While the link is weaker, and today's sustained low interest rates do afford more breathing room for current fiscal policy, those same low yields are also sending an important signal about the economy's lower potential to churn out revenues in the future. Insofar as governments have room to manoeuvre, either courtesy of surprisingly low interest costs or late-cycle revenue gains, the focus should fall on steps to strengthen the economy's medium-term growth outlook, such as targeted infrastructure.

Chart 6
Debt: Tempting Fate

United States (% of GDP)

Gross Federal Debt

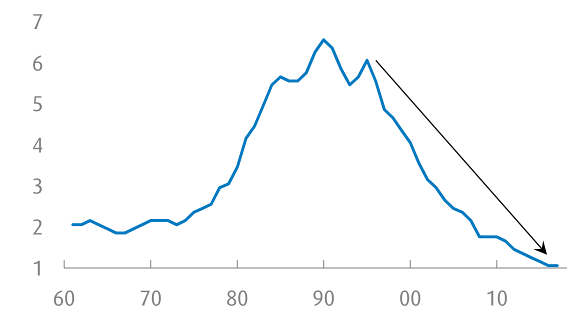


Sources: BMO Economics, Haver Analytics

Chart 7
Ottawa's Interest Burden: The True Fiscal Dividend

Canada (% of GDP)

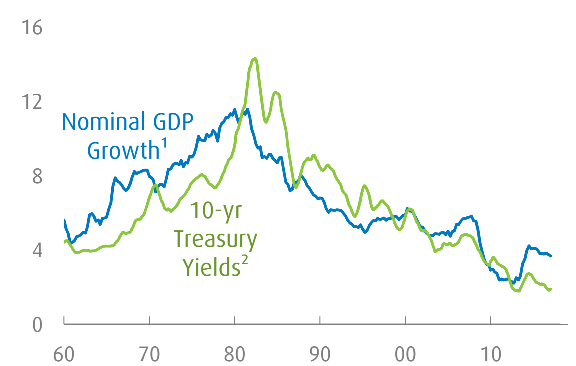
Federal Government Interest Payments



Sources: BMO Economics, Haver Analytics

Chart 8
Low Yields Leave Leeway... For Now

United States



[1] (5-yr trend : a.r.); [2] (% : 12-mth m.a.)

Sources: BMO Economics, Haver Analytics

Economic Forecast Summary for March 15, 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.)	1.3	2.6	2.0	0.4	0.0	2.5	2.2	1.9	3.0	1.8	1.3
Consumer Price Index (y/y % chng)	2.1	2.3	2.7	2.0	1.5	1.7	1.6	1.8	1.6	2.3	1.6
Unemployment Rate (percent)	5.8	5.9	5.9	5.7	5.8	5.8	5.7	5.7	6.3	5.8	5.7
Housing Starts (000s : a.r.)	224	218	197	217	202	211	206	200	220	214	205
Current Account Balance ($blns : a.r.)	-69.0	-63.4	-40.4	-61.9	-57.3	-57.7	-59.1	-60.0	-60.1	-58.7	-58.5
Interest Rates					(average for the quarter : %)						
Overnight Rate	1.25	1.25	1.50	1.75	1.75	1.75	1.75	1.83	0.71	1.44	1.77
3-month Treasury Bill	1.14	1.21	1.47	1.66	1.65	1.65	1.65	1.85	0.69	1.37	1.70
10-year Bond	2.24	2.28	2.28	2.32	1.90	1.90	2.00	2.05	1.78	2.28	1.95
Canada-U.S. Interest Rate Spreads					(average for the quarter : bps)						
90-day	-44	-66	-61	-70	-79	-81	-81	-79	-26	-60	-80
10-year	-52	-64	-65	-72	-80	-84	-80	-76	-55	-63	-80
UNITED STATES											
Real GDP (q/q % chng : a.r.)	2.2	4.2	3.4	2.6	1.2	2.5	2.0	1.9	2.2	2.9	2.3
Consumer Price Index (y/y % chng)	2.2	2.7	2.6	2.2	1.6	1.6 ↓	1.7	1.8 ↓	2.1	2.4	1.7
Unemployment Rate (percent)	4.1	3.9	3.8	3.8	3.9	3.7	3.5	3.5	4.4	3.9	3.6
Housing Starts (mlns : a.r.)	1.32	1.26	1.23	1.15	1.22	1.24	1.23	1.21	1.21	1.24	1.23
Current Account Balance ($blns : a.r.)	-487	-405	-499	-528	-566	-579	-592	-602	-449	-480	-585
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	2.45	2.45	2.45	2.65	0.95	1.97	2.50
10-year Note	2.76	2.92	2.93	3.03	2.70	2.75	2.80	2.85	2.33	2.91	2.75
EXCHANGE RATES					(average for the quarter)						
US¢/C$	79.1	77.5	76.5	75.7	75.2	74.8	75.1	75.4	77.1	77.2	75.1
C$/US$	1.27	1.29	1.31	1.32	1.33	1.34	1.33	1.33	1.30	1.30	1.33
¥/US$	108	109	112	113	110	112	111	111	112	110	111
US$/Euro	1.23	1.19	1.16	1.14	1.13	1.13	1.14	1.15	1.13	1.18	1.14
US$/£	1.39	1.36	1.30	1.29	1.30	1.32	1.32	1.31	1.29	1.34	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

Robert Kavcic
Senior Economist
robert.kavcic@bmo.com
416-359-8329

Benjamin Reitzes
Canadian Rates &
Macro Strategist
benjamin.reitzes@bmo.com
416-359-5628

Federal Budget 2019

Tuesday, 4:00 pm

The 2019 Federal Budget will be tabled on March 19th, and it will effectively serve as the final campaign document heading into an election on October 21st. Ottawa's shift back into deficit over the past three years has been noteworthy, moving from what was effectively a balanced budget in 2015, to an $18.1 billion shortfall currently expected for FY18/19—a big increase in program spending has accounted for all of the deterioration.

That said, the fiscal situation is certainly not dire, with the deficit weighing in at a modest 0.8% of GDP. Also, Ottawa's $3 billion risk adjustment is enough, at this point, to absorb a chunk of the downside from a weaker near-term economic growth forecast. We currently see 1.3% real GDP growth in 2019 versus 2.0% assumed in the fall update, and a softer deflator as well, but interest rates are tracking lower too. And, the fiscal year-to-date balance through December is running about $9 billion better than the same period a year prior. These factors considered, Ottawa is hardly in bad shape. Meantime, Ottawa has held to its promise of keeping its new fiscal anchor, the debt-to-GDP ratio, steady (it is actually on pace to dip for a second straight year). But, the concern with this measure is that it's an anchor that is destined to break. Given we are late in the economic cycle, the next downturn will immediately weaken the denominator, sending that metric higher. From a longer-term credit perspective, it would be prudent to see this ratio falling more significantly late in the cycle.

On the policy front, if history is any guide, Ottawa will likely prioritize program spending over tax relief. The recent chatter has centred on areas such as expanded universal pharmacare, skills training, measures for seniors, and support for housing affordability. On the latter, there have been some hints that Ottawa could bring back 30-year amortizations for first-time buyers and expand the Home Buyers' Plan, but the details at this point are minimal. At any rate, these measures could be 'selling features' in the budget that come with a small immediate dollar figure attached to them—on the last point, we suspect Ottawa will not want to run even deeper deficits at this stage.

Consumer Price Index

Friday, 8:30 am

Feb. (e)	**+0.6% (+0.2% sa)**	**+1.4% y/y**
Consensus	*+0.6%*	*+1.4% y/y*
Jan.	+0.1%	+1.4% y/y

Core CPI Measures (y/y)

	Trimmed Mean	Weighted Median	Common Comp.
Feb.			
Jan.	+1.9%	+1.8%	+1.9%

Canadian inflation is expected to be up a chunky 0.6% in February, with a number of factors pushing prices higher. February is the seasonally strongest month of the year and a similar-size gain last year will keep the yearly gain at a timid 1.4%. Note that March could see an uptick though, as gasoline prices are up sharply so far. Turning back to February, gasoline prices were up modestly, mortgage interest costs are expected to continue climbing (though that trend will likely slow this year), and travel services are expected to rise sharply (consistent with historic seasonality). There are a couple of quirks in this report: air fares look to retrace the rest of the December surge and rent is expected to be firmer than in recent years. Statscan has changed its methodology for both sub-indices, resulting in more seasonality in airfares (the change was made in March 2018), and anticipated higher inflation for rent (the change only came into effect last month). Our call pegs the seasonally-adjusted CPI at +0.2%.

The Bank of Canada's core CPI measures have hovered around 2% over the past year, consistent with the target. We're looking for the core measures to hold steady, with the risks tilted to the downside as prices have trended softer in recent months, consistent with the softness in broader activity.

Retail Sales
Friday, 8:30 am

		Ex. Autos
Jan. (e)	**+0.4%**	**+0.5%**
Consensus	*+0.4%*	*+0.2%*
Dec.	-0.1%	-0.5%

Retail sales likely bounced back in January after falling in six of the prior eight months. January has been a strong month for core sales the past three years, suggesting there's some seasonality not being adjusted for, perhaps as gift cards shift spending into the new year. Auto sales were solid according to dealer reports, though that doesn't always feed through to the retail figures. Decent weather may also have supported activity in the month (though February was pretty nasty). The headline would be even stronger if gasoline prices weren't down about 2% in seasonally-adjusted terms. Lastly, goods prices were down 0.1% in January, suggesting volumes saw a good gain in the month, enough to push the yearly change back above 2% with a favourable year-ago comparable helping. Despite our call for a decent headline, don't mistake this for the start of a new spending boom as high debt levels are going to be a persistent constraint on spending growth for the foreseeable future.

United States

Michael Gregory, CFA
Deputy Chief Economist
michael.gregory@bmo.com
416-359-4747

Existing Home Sales
Friday, 10:00 am

Feb. (e)	**5.08 mln a.r.**	**(+2.8%)**
Consensus	*5.10 mln a.r.*	*(+3.2%)*
Jan.	4.94 mln a.r.	(-1.2%)

Existing home sales are expected to increase 2.8% to 5.08 million (annualized) in February, just the second positive result in the past year and still down more than 9% from a year ago. Pending home sales were up a strong 4.6% in January, which, along with generally firmer new home sales in recent months, suggests demand is starting to stabilize after a weak 2018. Last year suffered from the mix of eroding affordability (e.g., 30-year mortgage rates hitting 7¾-year highs in November) and tax changes that limited the deductibility of large mortgage interest payments. However, affordability is now improving, with mortgage rates dropping more than 60 bps from their autumn peak and house price gains slowing. Meantime, sturdy job and wage growth continues to support incomes.

		Mar 15 [1]	Mar 8	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	1.64	1	-3	1
	United States	2.43	2.44	-1	2	8
	Japan	-0.15	-0.12	-3	7	0
	Eurozone	-0.31	-0.31	0	0	0
	United Kingdom	0.84	0.85	0	-3	-7
	Australia	1.85	1.86	-2	-13	-25
2-Year Bonds	Canada	1.62	1.65	-4	-16	-24
	United States	2.46	2.46	0	-6	-3
10-Year Bonds	Canada	1.71	1.76	-5	-18	-25
	United States	2.63	2.63	0	-3	-5
	Japan	-0.04	-0.04	0	-1	-4
	Germany	0.08	0.07	1	-2	-16
	United Kingdom	1.23	1.19	4	7	-4
	Australia	1.98	2.03	-5	-12	-34
Risk Indicators	VIX	13.0	16.1	-3.1 pts	-1.9 pts	-12.4 pts
	TED Spread	19	16	3	-7	-26
	Inv. Grade CDS Spread [2]	58	65	-6	-5	-29
	High Yield CDS Spread [2]	343	368	-25	-2	-107
					(percent change)	
Currencies	US¢/C$	74.91	74.54	0.5	-0.8	2.2
	C$/US$	1.335	1.342	—	—	—
	¥/US$	111.48	111.17	0.3	0.9	1.6
	US$/€	1.1337	1.1235	0.9	0.4	-1.1
	US$/£	1.327	1.302	2.0	3.0	4.0
	US¢/A$	70.88	70.45	0.6	-0.7	0.6
Commodities	CRB Futures Index	183.20	180.67	1.4	1.0	7.9
	Oil (generic contract)	58.22	56.07	3.8	4.7	28.2
	Natural Gas (generic contract)	2.82	2.87	-1.7	7.3	-4.2
	Gold (spot price)	1,303.55	1,298.40	0.4	-1.4	1.6
Equities	S&P/TSX Composite	16,149	15,996	1.0	2.0	12.7
	S&P 500	2,814	2,743	2.6	1.4	12.3
	Nasdaq	7,680	7,408	3.7	2.8	15.7
	Dow Jones Industrial	25,681	25,450	0.9	-0.8	10.1
	Nikkei	21,451	21,026	2.0	2.6	7.2
	Frankfurt DAX	11,632	11,458	1.5	2.9	10.2
	London FT100	7,221	7,104	1.6	-0.2	7.3
	France CAC40	5,384	5,231	2.9	4.5	13.8
	S&P ASX 200	6,175	6,204	-0.5	1.8	9.4

[1] = as of 11 am [2] = One day delay

Global Calendar
March 18 – March 22

BMO Capital Markets®

Japan

Monday March 18

Trade Balance
Feb. '19 (e) +¥305.1 bln
Feb. '18 -¥963.8 bln

Industrial Production
Jan. F (e) -3.7% unch y/y
Dec. -0.1% -1.9% y/y

Tuesday March 19

Wednesday March 20

Machine Tool Orders
Feb. F (e) -29.3% y/y
Jan. -18.8% y/y

BoJ Minutes from Jan. 22-23 meeting

Thursday March 21

Markets Closed

Friday March 22

	CPI	Core CPI
Feb. (e)	**+0.3% y/y**	**+0.8% y/y**
Jan.	+0.2% y/y	+0.8% y/y

CPI ex. Food & Energy
Feb. (e) +0.4% y/y
Jan. +0.4% y/y

Manufacturing PMI
Mar. P
Feb. 48.9

Department Store Sales
Feb.
Jan. -2.9% y/y

Euro Area

Monday March 18

EURO AREA

Trade Surplus
Jan. (e) €15.0 bln
Dec. €15.6 bln

Tuesday March 19

EURO AREA

Labour Costs
Q4
Q3 +2.5% y/y

GERMANY

ZEW Survey—Expectations
Mar. (e) -11.5
Feb. -13.4

Wednesday March 20

GERMANY

Producer Price Index
Feb. (e) +0.1% +2.8% y/y
Jan. +0.4% +2.6% y/y

Thursday March 21

EURO AREA

Consumer Confidence
Mar. A (e) -7.1
Feb. -7.4

ECB Economic Bulletin

EU Summit (Mar. 21-22)

Friday March 22

EURO AREA

Manufacturing PMI
Mar. P (e) 49.5
Feb. 49.3

Services PMI
Mar. P (e) 52.5
Feb. 52.8

Composite PMI
Mar. P (e) 52.0
Feb. 51.9

U.K.

Monday March 18

Rightmove House Prices
Mar.
Feb. +0.7% +0.2% y/y

Tuesday March 19

Employment (3m/3m)
Jan. (e) +120,000
Dec. +167,000

Avg. Wkly Earnings Ex. Bonus (3 mma)
Jan. (e) +3.4% y/y
Dec. +3.4% y/y

Jobless Rate (3 mma)
Jan. (e) 4.0%
Dec. 4.0%

	Jobless Claims	Claimant Count Rate
Feb.		
Jan.	+14,200	2.8%

3rd parliamentary vote on Brexit deal tentatively scheduled

Wednesday March 20

Consumer Price Index
Feb. (e) +0.5% +1.9% y/y
Jan. -0.8% +1.8% y/y

Core CPI
Feb. (e) +1.8% y/y
Jan. +1.9% y/y

Producer Price Index—Output
Feb. (e) +0.1% +2.2% y/y
Jan. unch +2.1% y/y

Thursday March 21

Retail Sales (incl. Fuel)
Feb. (e) -0.4% +3.3% y/y
Jan. +1.0% +4.2% y/y

8:00 am ET BoE Monetary Policy Meeting and Minutes

Friday March 22

Other

Monday March 18

Tuesday March 19

AUSTRALIA

RBA Minutes from Mar. 5 Policy Meeting

Wednesday March 20

Thursday March 21

AUSTRALIA

Employment
Feb. (e) +15,000
Jan. +39,100

Jobless Rate
Feb. (e) 5.0%
Jan. 5.0%

Friday March 22

[D] = date approximate

Upcoming Policy Meetings | BoE: May 2, June 20, Aug. 1 | ECB: Apr. 10, June 6, July 25

North American Calendar
March 18 – March 22

BMO Capital Markets®

Canada

Monday March 18

8:30 am — **Int'l Securities Transactions**

	Inflows	Outflows
Jan.		
Dec.	-$19.0 bln	-$0.4 bln

New dates for previously delayed releases:

- **Mar. 27:** Merchandise Trade Balance (Jan.)
- **Apr. 17:** Merchandise Trade Balance (Feb.)
- **May 9:** Merchandise Trade Balance (Mar.)

Tuesday March 19

4:00 pm — **Federal Budget**

New Brunswick Budget

10:30 am — 3-, 6- & 12-month bill auction $13.0 bln (new cash $3.8 bln)

Wednesday March 20

Saskatchewan Budget

Thursday March 21

8:30 am — **ADP Employment Report**
Feb.
Jan. +35,400

8:30 am — **Wholesale Trade**
Jan. (e) **+0.8%**
Dec. +0.3%

Quebec Budget

Noon — 2-year bond auction $3.0 bln

3-year bond auction announcement

Friday March 22

8:30 am — **Consumer Price Index**

Feb. (e)	**+0.6% (+0.2% sa)**	**+1.4% y/y**
Consensus	*+0.6%*	*+1.4% y/y*
Jan.	+0.1%	+1.4% y/y

8:30 am — **Trimmed Mean Core CPI**
Feb.
Jan. +1.9% y/y

8:30 am — **Weighted Median Core CPI**
Feb.
Jan. +1.8% y/y

8:30 am — **Common Component Core CPI**
Feb.
Jan. +1.9% y/y

8:30 am

	Retail Sales	Ex. Autos
Jan. (e)	**+0.4%**	**+0.5%**
Consensus	*+0.4%*	*+0.2%*
Dec.	-0.1%	-0.5%

United States

Monday March 18

10:00 am — **NAHB Housing Market Index**
Mar. (e) **63**
Consensus *63*
Feb. 62

11:30 am — 13- & 26-week bill auction $87 bln

New dates for previously delayed releases:

- **Mar. 26:** Housing Starts, Building Permits (Feb.)
- **Mar. 27:** Goods & Services Trade (Jan.); Current Account (Q4)
- **Mar. 29:** New Home Sales (Feb.)
- **Apr. 1:** Retail Sales (Feb.), Business Inventories (Jan.)
- **Apr. 2:** Durable Goods Orders (Feb.)
- **Apr. 8:** Factory Orders (Feb.)
- **Apr. 17:** Goods & Services Trade Balance (Feb.), Wholesale Trade (Feb.)
- **Apr. 18:** Retail Sales (Mar.), Business Inventories (Feb.)
- **Apr. 19:** Housing Starts, Building Permits (Mar.)
- **Apr. 29:** Personal Income (Feb.), Personal Spending (Jan.)
- **May 3:** Advanced Indicators (Mar.) [Jan.-Feb. cancelled]
- **May 9:** Goods & Services Trade (Mar.)

Tuesday March 19

10:00 am — **Factory Orders**
Jan. (e) **+0.3%**
Consensus *+0.3%*
Dec. +0.1%

FOMC Meeting Begins

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

Wednesday March 20

7:00 am — **MBA Mortgage Apps**
Mar. 15
Mar. 8 +2.3%

2:00 pm — **FOMC Announcement and Summary of Economic Projections**

2:30 pm — **Fed Chair Powell's Press Briefing**

Thursday March 21

8:30 am — **Initial Claims**
Mar. 16 (e) **225k (-4k)[C]**
Mar. 9 229k (+6k)

8:30 am — **Continuing Claims**
Mar. 9
Mar. 2 1,776k (+18k)

8:30 am — **Philadelphia Fed Index**
Mar. (e) **3.0**
Consensus *6.0*
Feb. -4.1

10:00 am — **Quarterly Services Survey (Q4 A)**

10:00 am — **Leading Indicator**
Feb. (e) **+0.1%**
Consensus *+0.1%*
Jan. unch

11:00 am — 13-, 26- & 52-week bill, 2-, 5- & 7-year note, 2[R]-year FRN auction announcements

11:30 am — 4- & 8-week bill auction

1:00 pm — 10[R]-year TIPS auction $11 bln

Friday March 22

9:45 am — **Markit PMI (Mar. P)**

10:00 am — **Existing Home Sales**
Feb. (e) **5.08 mln a.r. (+2.8%)**
Consensus *5.10 mln a.r. (+3.2%)*
Jan. 4.94 mln a.r. (-1.2%)

10:00 am — **Wholesale Inventories**
Jan. (e) **+0.1%**
Consensus *+0.1%*
Dec. +1.1%

2:00 pm — **Budget Balance**
Feb. '19 (e) **-$227 bln**
Feb. '18 -$215 bln

Sunday March 24

Fed Speaker: Chicago's Evans (9:45 pm)

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

Upcoming Policy Meetings | Bank of Canada: Apr. 24, May 29, July 10 | FOMC: Apr. 30-May 1, June 18-19, July 30-31