Will Stimulus Trump Protectionism?

United States

- With the election finally over, we can now take stock of the possible impact. President-elect Trump’s proposals lean toward major, broad-based tax cuts, increased spending on infrastructure, renegotiating trade deals, reforming health care insurance, reducing immigration, and cutting regulation. This comes at the risk of a larger budget deficit and disruptions to trade. Slapping high tariffs on Mexican and Chinese goods would slash the purchasing power of Americans. Whether the Republican-led Congress opts to scale back the bulk of his proposals will ultimately decide the economic outcome. Until then, uncertainty will remain high.

- For now, we propose to wait and see whether Trump’s tough talk on trade translates into action, and are keeping our forecast for the economy and short-term interest rates unchanged. **We still look for GDP growth to pick up from about 1.6% this year to 2.2% in 2017.** However, if Congress can blunt some of the new president’s worst impulses on trade protectionism, while approving a healthy dose of fiscal stimulus, we would be tempted to raise our growth estimate. Also note that an all-Republican government will have a lighter touch on the regulation front, notably in the energy sector and possibly financial services and health care. In particular, the oil and coal industries could see a marked increase in investment if restrictions are loosened.

- The rally in equity markets and sharp upturn in long Treasury yields post-election suggest **investors are betting on a positive economic outcome** in anticipation of fiscal stimulus and, hopefully, less partisan gridlock to resolve issues such as the debt ceiling. The Committee for a Responsible Federal Budget estimates Trump’s tax plan could cut federal revenues by about $6 trillion over a decade, or 3% of GDP per annum. So, even if just a fraction of the tax cuts are passed into legislation (and recall there are still many relative fiscal hawks in Congress), the economy will still get a material fiscal jolt. Trump also talked about doubling Clinton’s infrastructure plan, which would add a moderate fillip. Encouraging U.S.-based companies to repatriate overseas profits would also strengthen business investment. The upbeat market response also assumes that uncertainty related to trade protectionism (and possible retaliatory action), the budget deficit and foreign policies will be kept to a minimum.

**KEY MESSAGE**

- Trump’s victory does not significantly change our outlook for the U.S. economy or interest rates, but the risks to both are now on the upside.

- Canada’s economy will benefit if the U.S. Congress approves Trump’s positive economic proposals (notably tax cuts) while restraining his more contentious measures (notably protectionism). The economy has a lot to gain, and lose, from the new Administration.
• **Going into the election, the economy caught a tailwind.** Following three subpar quarters, real GDP roared back with a near 3% advance in the third quarter of 2016. Leading the rebound was a large increase in exports (led by crops, notably soybeans), stronger commercial construction, and continued healthy personal spending. Meantime, weak state government spending, a weather-related hit to residential construction, and a fourth straight quarterly decline in business capex held the economy back. The latter likely reflected election-related uncertainty.

• Assuming markets remain calm, Trump’s victory won’t stand in the way of a **well-telegraphed Fed rate hike on December 14**. The Fed was looking for only “some” further progress toward its goals in November before raising rates. Since then, wage growth and inflation have tipped upward, while the unemployment rate has inched lower. Barring a serious setback in upcoming data (notably November payrolls), the Fed will likely raise rates, one year after its last move. Beyond December, a patient FOMC will likely wait half a year before taking the next cautious step on its normalization path, though we could see a more aggressive gait if fiscal policy becomes much more expansionary.

• Yields on 10-year **Treasury notes** have jumped 50 bps to almost 2.4% since the election. Investors sense that fiscal policy is about to supplant monetary policy as the main driver of the economy. We now see clear upside risks to our bond yield outlook, though structural forces (e.g., aging populations and elevated global debt) should temper the increase. We expect the 10-year yield to rise to 2.6% by late 2017.

## Canada

• **Increased uncertainty about the outlook for its largest trading partner could cloud Canadian business confidence.** If Trump carries out his threat to withdraw from NAFTA, Canadian exporters and importers would be hurt by disruptions to tightly-integrated supply chains across borders. The relative increase in U.S. competitiveness from corporate tax cuts could also undermine exporters, especially if Canadian firms need to pay more to address climate change.

• Still, if U.S. demand increases on expansionary fiscal policy, **Canada’s main economic engine—exports—would receive a welcome boost**. Goods exports to the U.S. account for one-fifth of Canadian GDP. The increased likelihood that the Keystone XL pipeline will be approved will also support Canada’s oil producers by providing a more cost-effective means of transporting oil to Gulf-coast refineries and reducing the price disadvantage for Canadian producers.
Canada’s economy looks to have rebounded sharply after Q2’s wildfire-related contraction. However, concerns about its slow underlying trend continue unabated amid weakness in non-energy export volumes (down in four of the past five months to September). Without exports to drive the expansion, real GDP appears stuck on the same 1¼% growth track as the past two years. That’s a tad less than potential growth, and explains why the jobless rate (7.0%) is no lower today than three years ago. The steady national jobless rate, however, masks wide regional variations, as rates have trended down in half of the provinces (British Columbia, Ontario, Quebec, Nova Scotia and New Brunswick) and up in the other half (led by oil-producers Alberta and Saskatchewan). Amid escalating office vacancies, Calgary now has the highest jobless rate of Canada’s major cities (10%).

With consumer spending hampered by high debts and business investment stuck in a rut, Canada will need a big export push to grow even 1.9% in 2017. Though still modest, this pace will at least chip away at the jobless rate. Firmer oil prices (we see $58 a barrel by late 2017 versus $45 recently, assuming OPEC nations agree to freeze production on November 30th) should also help Alberta and Saskatchewan return to positive growth in 2017 after contracting 3.6% and 1.3%, respectively, in 2015.

Recent data show four distinct trends in Canada’s housing market. Vancouver is rapidly cooling, with sales down 39% y/y and prices rolling over in October. Conversely, Toronto is heating up, with sales rising 12% y/y and prices accelerating 20%. Demand pressures are spilling into surrounding areas as first-time buyers “drive to qualify” for coveted detached homes. Finally, the downturn in Calgary’s market is finally abating. Looking ahead, we expect the new mortgage-insurance rules will reduce sales and price growth particularly in Vancouver and Toronto, the two regions where affordability is already weak.

The new U.S. Administration should have little impact on the Bank of Canada, for now. The increased uncertainty about U.S. policies will reinforce the Bank’s steady policy stance, at least until we get clarity on which of Trump’s proposals are put into action. Although Governor Poloz and officials “actively discussed” adding stimulus in October, they still saw the risks to the inflation outlook as “roughly balanced”. This means that weak data, notably on exports, are needed to trigger a rate cut. At the same time, with the Bank not expecting the economy to reach full employment until mid-2018, there is no rush to raise rates. We expect it to hold steady until mid-2018, before tightening slowly.

A looming Fed rate hike and weak exports have dragged the Canadian dollar below 75 cents US, down more than five cents
since April. We expect the loonie to remain under pressure as interest-rate spreads widen in the two countries in 2017.

Other Risks

- **Canadian household debt**: According to the BIS, Canada’s debt service ratio is elevated relative to other countries, implying a growing vulnerability to adverse shocks. Given current positive economic growth in most regions, financial stress remains low, apart from some upturn in delinquency rates in Alberta and Saskatchewan. However, if households need to reduce spending to manage debt during the next economic downturn, the slump will be prolonged.

- **Vancouver and Toronto housing markets**: While Vancouver’s housing market is quickly cooling, Toronto’s is still heating up, possibly because the new property transfer tax in metro Vancouver is driving more non-resident buyers to Toronto. Escalating prices are not only pushing more families to take on bigger mortgages, they are driving more people further away from the metropolitan region, adding to commuting costs and financial strains. High home prices put both markets at risk of a correction if interest rates or joblessness rise, or if the tide of foreign money recedes.

- **Italian constitutional referendum**: Italy’s December 4 vote on parliamentary reform could pave the way for Prime Minister Renzi’s economic reforms or, if it is defeated, his resignation. The latter would open the door for anti-EU parties to form the next Italian government. This, along with Brexit negotiations and elections in France and Germany, could lead to a broader fracturing of the Euro Area, unsettling markets and slowing the global economy.
### Forecasts

#### CANADA

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#### UNITED STATES

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#### Interest Rates

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#### Canada/U.S. Interest Rate Spreads

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#### Exchange Rates

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Note: Shaded areas represent BMO Capital Markets forecasts.
MARKET VOLATILITY NORMAL, SO FAR
United States (as of November 25, 2016)

Ted Spread ¹
VIX ²

All eyes on the new U.S. government

...AND CREDIT RISK IS MODERATE
United States (ppt)

Corporate Bond Spreads ¹

OIL PRICES OFF RECENT HIGHS
Commodity price range since start of 2016

Canadian Dollar Sags
(US¢ : as of November 25, 2016)

-6 -4 -2 0 2 4 6
00 02 04 06 08 10 12 14 16
Canada 2.5 1.1 1.2 1.9 17
U.S. 2.4 2.6 1.6 2.2

U.S. ECONOMY COULD GET A DECENT FISCAL BOOST
(y/y % change)

Real GDP

-6 -4 -2 0 2 4 6
00 02 04 06 08 10 12 14 16
Canada 14 15 16 17
U.S. 2.4 2.6 1.6 2.2

AMERICAN CONSUMERS LEAD THE WAY
(y/y % change)

Real Personal Consumption Expenditures

-6 -4 -2 0 2 4 6
00 02 04 06 08 10 12 14 16
Canada U.S.
OIL-LED DOWNTURN IN INVESTMENT SHOULD FADE
(y/y % change)

Real Non-Residential Business Investment

TORONTO NOW LEADING CANADIAN HOME PRICES
Existing Homes (y/y % change : 3-month m.a.)

Sales

Prices

U.S. LABOUR MARKET NEARS FULL EMPLOYMENT
(percent)

Unemployment Rate

INFLATION HAS BOTTOMED
Consumer Price Index (y/y % change)

Canada

United States

FED TO LIFT RATES IN DECEMBER
(%) : as of November 25, 2016

Overnight Rate

LONG BOND RATES TO STAY RELATIVELY LOW
(%) : as of November 25, 2016

10-Year Bonds

Bank of Canada on hold until mid-2018

But upside risk post-election
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