North American Outlook

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A look ahead at the Canadian and American economies

March 9, 2018

The Stimulus-Protectionist Games

ECONOMIC RESEARCH
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KEY MESSAGES

- Tax cuts and a surprisingly large dollop of fiscal spending will boost U.S. economic growth, at the risk of fanning inflation and interest rates
- Import tariffs won't help the inflation or growth outlooks
- The Fed is expected to raise policy rates every quarter this year, partly to counteract fiscal stimulus
- Canada's economy won't match last year's gold medal act, though it should perform fairly well given robust U.S. and global demand
- A cautious Bank of Canada will raise rates just two more times this year, and fewer if NAFTA talks fall apart or a global trade war erupts
- The C$ will be hard pressed to make headway even against a sagging greenback until trade risks abate

United States

- The **U.S. economy grew for a 34th quarter in a row in Q4 and by a solid 2.5% annual rate**. For all of 2017, real GDP rose 2.3%, a major step up from 1.5% the prior year. There were no weak links in the economic chain. Investment rebounded 4.7%, as firms added much-needed capacity. Consumers spent at a sturdy 2.7% rate, bolstered by surging wealth, solid job gains and increased borrowing. A weaker dollar and firmer global demand lifted exports 3.4%. Housing markets caught a second wind late in the year as home sales hit decade highs. The ownership rate is now rising for the first time in 13 years as more millennials take the plunge. The biggest hurdle is supply with listings at record lows.
- **Recent data suggest growth stayed healthy at 2.6% in Q1**. Housing starts jumped 10% in January, consumer confidence hit 18-year highs and the ISM non-manufacturing index scaled 13-year peaks. Moreover, hiring has accelerated, with payrolls surging the most in over a year in February. On the soft side, retail sales, factory orders and home sales faded after a strong quarter and the trade deficit ballooned to nine-year highs. Still, gains in after-tax income will boost consumer spending this quarter, while businesses should take advantage of full expensing of new equipment.
- **Fiscal and monetary policies are pulling the economy in two directions**. The largest tax cuts in three decades are expected to add 0.4 ppts to GDP growth this year and 0.1 ppts next year, while nearly $300 billion of new federal spending in the Bipartisan Budget Act could add 0.7 ppts and 0.2 ppts, respectively. Although some offset will emerge from higher imports and interest rates, **we upped our annual GDP growth call to 2.8% in 2018** (from 2.6% previously) and to 2.5% in 2019 (from 2.0%).
- Unfortunately, the President's announced **import tariffs** on steel and aluminum risk slowing the economy by clipping purchasing power by up to 0.2%. Further weakness is likely if the situation escalates into a global trade war, with adverse effects on supply chains and business efficiency.
- The **fiscal jolt and trade tiff will complicate the Fed's job of normalizing policy.** While wages and prices remain in check—core PCE prices are up 1.5% and unit labour costs are 1.7% higher in the past year—underlying pressures could overwhelm the calming effects from automation, e-commerce and globalization. Average hourly

earnings have turned higher, partly because of minimum wage hikes, while the Beige Book finds companies in "*most*" districts are raising compensation. We look for the **fed funds rate to rise each quarter this year,** with the midpoint of the target range ending at 2.38%, before climbing to 2.88% in late 2019—close to neutral. Recent upbeat comments from new Chair Powell suggest a **March 21 move is a near certainty** barring a major disruption in financial markets.

- **Despite recent market volatility, Treasuries are under pressure due to inflation concerns**. The market will need to digest more supply (to fund a ballooning budget shortfall), while the Fed is reining in demand for notes (and shrinking its balance sheet by over $400 billion in 2018). The 10-year Treasury yield, which has increased nearly half a percentage point this year to four-year highs of over 2.9%, is expected to rise further to **3.1% by year-end, before reaching 3.5% in late 2019.** This assumes core PCE inflation drifts only moderately higher to 2.2% next year.
- After cresting at 14-year highs last year, **the trade-weighted U.S. dollar has fallen 6% in the past year**, while clawing back some of its losses on the recent tariff threat. Barring a global trade war, the dollar is expected to weaken modestly further due to a strengthening global economy and rising U.S. trade and budget deficits.

Canada

- Although Canada's economy led the G7 nations with annual growth of 3.0% in 2017, much of the credit went to one-off factors. A recovering energy patch, enhanced child-benefit payments and speculative demand in Southern Ontario's housing market juiced GDP at a 4.2% annual rate in the first half of the year. Growth **slowed to 1.6% in the second half as these forces faded**. For the year, consumers led the way with a 3.5% spurt in spending, as the fastest job gains in 14 years drove the jobless rate to four-decade lows. Business investment rebounded 2.6% after hefty declines the prior two years. In contrast, despite firmer global demand, **exports struggled to gain traction** for a second straight year.
- With the economy showing little momentum in the current quarter and trade already looking to slice further into growth, **we lowered our 2018 outlook to 2.0%** (from 2.2% previously). Although financial conditions remain supportive and resource prices are likely to rise modestly, higher interest rates and tougher mortgage rules will restrain consumer spending and housing activity. Household credit growth is moderating. Canada's real goods trade balance was little changed in January, while non-energy export volumes fell more than 3% in the past year, extending a decade of stagnation. The latter is a testament to the loss of competitiveness for many companies as they

deal with new regulations, rising mandated labour costs and new environmental protections.

- The **ongoing risk of trade protectionism, made all the more real by the latest tariff threat, will impede investment**. While Canada will receive a temporary exemption from the tariffs, a longer reprieve will be granted only if NAFTA talks go the President's way. Steel and aluminum exports to the U.S. account for 1.1% of Canada's GDP, so some reduction in volumes could shave growth a few tenths.
- **British Columbia is expected to lead the nation in growth** for the third time in four years, supported by a sturdy housing market and shipments to fast-growing Asia. Still, like most provinces, its growth will downshift in 2018. The good news is that many regions have already achieved full employment, with Quebec's jobless rate recently touching record lows.
- Tougher mortgage **rules look to deepen the correction in Greater Toronto's detached housing market**, where prices are down moderately from a year ago to February and roughly 12% since the spring. By contrast, the region's condo market remains resilient, with prices still up 19% y/y amid lean inventories. More affordable condos and townhouses are benefiting from a shift toward less expensive housing. This drove Canadian housing starts to the third highest level in five years in February. Unlike Toronto and even higher-priced Vancouver, **housing markets in the rest of the country remain affordable** and healthy, and should see little impact from the new mortgage rules. In fact, house prices in **Ottawa and Montreal** have picked up and could lead the nation this year. That said, **B.C.** will need to digest **new housing measures** announced by the provincial government, including an increase in the foreign buyers' tax to 20% from 15% and an expansion of the tax to areas beyond metro Vancouver, as well as a speculation tax on nonresident owners.
- Following 75-basis points of rate increases since the summer, the **Bank of Canada will stay "*cautious in considering future policy adjustments*"** given trade policy risks and the sensitivity of indebted households to higher credit costs and tougher mortgage rules. We **expect two more rate hikes this year** (in July and October), with the overnight rate rising to 1.75%. Three more moves in 2019 would take rates closer to neutral levels at 2.5%.
- Trump's tariff blitz sacked the **Canadian dollar**, driving it briefly below 77 cents US (C$1.299). Given a still large current account deficit (around 3% of GDP), the loonie will likely only revisit 80 cents US (C$1.25) if the greenback sags further and NAFTA talks end well.

Risks

- The **import tariffs** on steel and aluminum could lift U.S. inflation about 0.2%, while the erosion in purchasing power could similarly dent GDP. A full-scale trade war would magnify the inflation and growth impacts (mini-stagflation?) by severely disrupting global supply chains and undermining business confidence.
- **If NAFTA is repealed, each country would likely revert to WTO trade rules.** In this event, Canadian GDP could be as much as 1% lower over five years, a relatively modest hit for an economy that's expected to grow nearly 10%. A weaker currency and lower interest rates would help cushion the blow. Trade-intensive industries such as motor vehicles and food processing would be more heavily impacted, as would Ontario's economy. If the U.S. doesn't play by WTO rules and imposes punitive tariffs on a wide range of Canadian shipments, the economy could slip into recession.
- With fiscal stimulus pouring into the economy, the dollar weakening and oil prices holding above $60 a barrel, the **risk of resurgent U.S. inflation and aggressive Fed tightening is rising**. This combination has triggered most recessions in the postwar era.
- As the **U.S. budget deficit** heads toward $1.2 trillion next year (or more than 5% of GDP), the government will have little fiscal capacity to address the next downturn.
- A further **equity market correction** could send the wealth effect spinning in reverse, undercutting consumers and growth.
- **Italy's recent parliamentary election** saw growing support for populist parties and an unclear path to a coalition government, implying ongoing political uncertainty. Meantime, the inability of the U.K. to re-establish amicable trade relations with the EU in **Brexit** talks could result in slower European growth.
- On the **positive side**, tensions between the U.S. and **North Korea** have eased with the latter agreeing to halt nuclear missile tests while holding diplomatic talks with the U.S. and South Korea. In addition, support from the Social Democrats has allowed Angela Merkel to continue leading a **German coalition government** for a fourth term.

Forecasts

CANADA	2017 I	2017 II	2017 III	2017 IV	2018 I	2018 II	2018 III	2018 IV	ANNUAL 2016	ANNUAL 2017	ANNUAL 2018
Real GDP (q/q % chng : a.r.)	4.0	4.4	1.5	1.7	1.8	2.3	2.1	1.9	1.4	3.0	2.0
Consumer Spending	3.5	4.6	3.7	2.1	2.0	2.3	2.0	1.8	2.4	3.5	2.4
Business Investment (non-residential)	12.1	9.5	5.4	8.2	2.3	2.8	2.4	2.4	-9.4	2.6	4.3
Consumer Price Index (y/y % chng)	1.9	1.3	1.4	1.8	2.0	2.3	2.4	2.2	1.4	1.6	2.2
Unemployment Rate (%)	6.6	6.5	6.2	6.0	5.8	5.8	5.7	5.6	7.0	6.3	5.7
Housing Starts (000s : a.r.)	222	207	223	229	222	217	204	198	198	220	210
Current Account Balance ($blns : a.r.)	-54.6	-62.4	-74.4	-65.4	-58.8	-56.8	-55.0	-53.5	-65.4	-63.9	-56.0
Interest Rates (average for the quarter : %)											
Overnight Rate	0.50	0.50	0.83	1.00	1.25	1.25	1.50	1.75	0.50	0.71	1.44
3-month Treasury Bill	0.47	0.54	0.81	0.92	1.15	1.20	1.45	1.70	0.49	0.69	1.35
10-year Bond	1.71	1.51	1.95	1.96	2.30	2.40	2.55	2.65	1.25	1.78	2.45
Canada/U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	-13	-37	-25	-30	-43	-65	-58	-51	17	-26	-54
10-year	-73	-75	-30	-41	-48	-50	-46	-42	-59	-55	-46

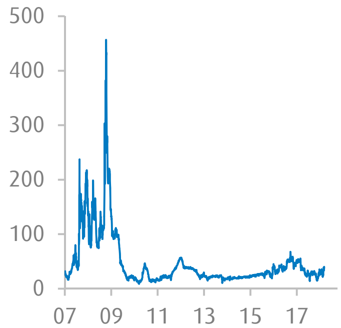
UNITED STATES	2017 I	2017 II	2017 III	2017 IV	2018 I	2018 II	2018 III	2018 IV	ANNUAL 2016	ANNUAL 2017	ANNUAL 2018
Real GDP (q/q % chng : a.r.)	1.2	3.1	3.2	2.5	2.6	2.8	2.9	2.9	1.5	2.3	2.8
Consumer Spending	1.9	3.3	2.2	3.8	2.2	2.9	2.5	2.2	2.7	2.7	2.7
Business Investment (non-residential)	7.1	6.7	4.7	6.6	2.5	3.5	2.8	2.4	-0.6	4.7	4.0
Consumer Price Index (y/y % chng)	2.6	1.9	2.0	2.1	2.4	2.8	2.9	2.6	1.3	2.1	2.7
Unemployment Rate (%)	4.6	4.3	4.3	4.1	4.1	3.9	3.8	3.7	4.9	4.4	3.8
Housing Starts (mlns : a.r.)	1.24	1.17	1.17	1.26	1.30	1.29	1.27	1.26	1.18	1.21	1.28
Current Account Balance ($blns : a.r.)	-454	-498	-402	-507	-535	-556	-576	-593	-452	-465	-565
Interest Rates (average for the quarter : %)											
Fed Funds Target Rate	0.71	0.96	1.13	1.21	1.46	1.71	1.96	2.21	0.40	1.00	1.83
3-month Treasury Bill	0.60	0.90	1.06	1.23	1.60	1.85	2.00	2.20	0.32	0.95	1.90
10-year Note	2.44	2.26	2.24	2.37	2.75	2.90	3.00	3.05	1.84	2.33	2.95

EXCHANGE RATES (average for the quarter)	2017 I	2017 II	2017 III	2017 IV	2018 I	2018 II	2018 III	2018 IV	ANNUAL 2016	ANNUAL 2017	ANNUAL 2018
US¢/C$	75.6	74.4	79.9	78.6	79.1	78.1	79.1	79.9	75.5	77.1	79.1
C$/US$	1.323	1.345	1.253	1.272	1.264	1.280	1.265	1.252	1.326	1.298	1.265
¥/US$	114	111	111	113	108	106	105	105	109	112	106
US$/Euro	1.07	1.10	1.18	1.18	1.23	1.24	1.25	1.25	1.11	1.13	1.24
US$/£	1.24	1.28	1.31	1.33	1.39	1.41	1.42	1.43	1.35	1.29	1.41

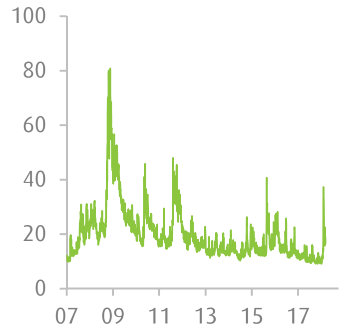
Note: Shaded areas represent BMO Capital Markets forecasts

VOLATILITY RETURNS
United States (as of March 8, 2018)

Ted Spread[1]



VIX[2]



[1] 3-mnth Eurodollar minus 3-mnth T-bills (bps) [2] CBOE market volatility index

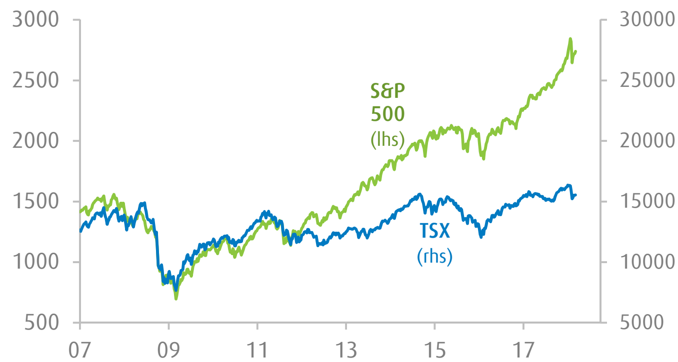
CREDIT SPREADS STILL COMPRESSED
United States (ppts)

Corporate Bond Spreads[1]

[1] 15-year BoA Merrill Lynch AA Corporate Yield less 10-year Treasury Yield

EQUITIES DIP
(indices : as of March 8, 2018)

Equities

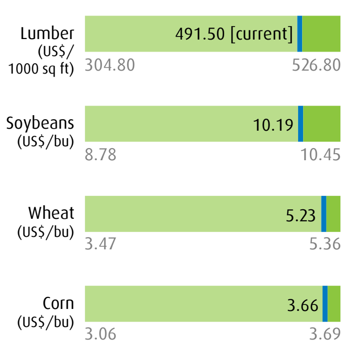


LOONIE RANGE-BOUND
(US¢ : as of March 8, 2018)

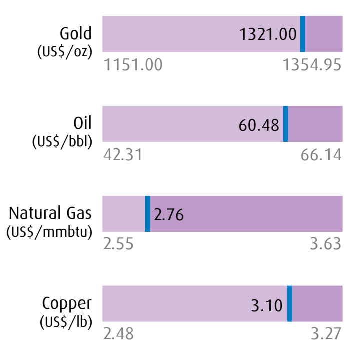
Canadian Dollar

RESOURCE PRICES FIRM
Commodity price range since start of 2017

Materials & Foodstuffs
(as of March 8, 2018)



Metals & Energy
(as of March 8, 2018)



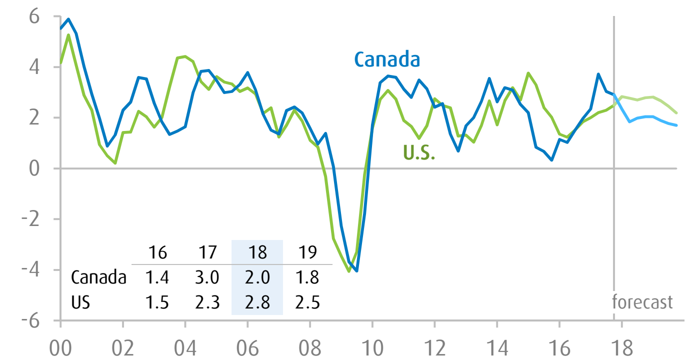
Apart from natural gas

OIL PRICES AT THREE-YEAR HIGHS
(US$/bbl : as of March 8, 2018)

WTI Crude Oil

US ECONOMY GETS FISCAL JOLT
(y/y % change)

Real GDP

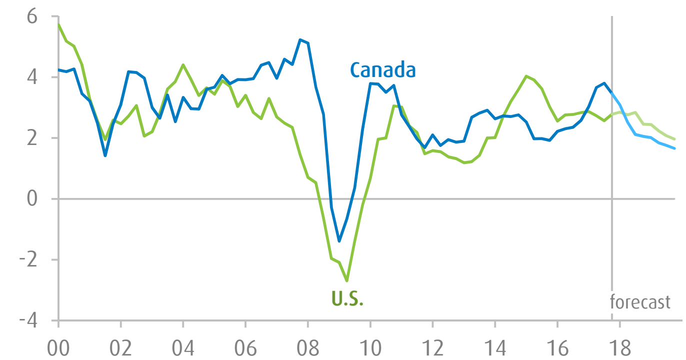


	16	17	18	19
Canada	1.4	3.0	2.0	1.8
US	1.5	2.3	2.8	2.5

Canadian growth peaks

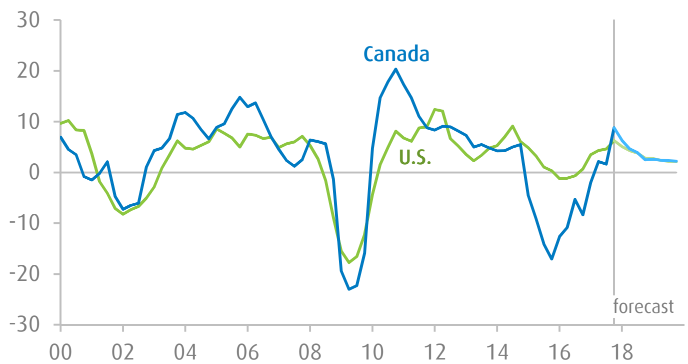
CONSUMERS SPENDING FREELY
(y/y % change)

Real Personal Consumption Expenditures



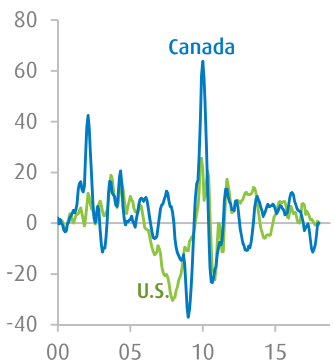
BUSINESS INVESTMENT HEALTHY
(y/y % change)

Real Non-Residential Business Investment

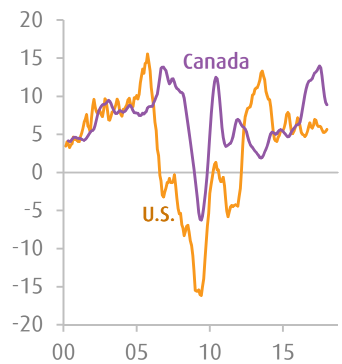


HOME PRICES RISING
Existing Homes (y/y % change : 3-month m.a.)

Sales

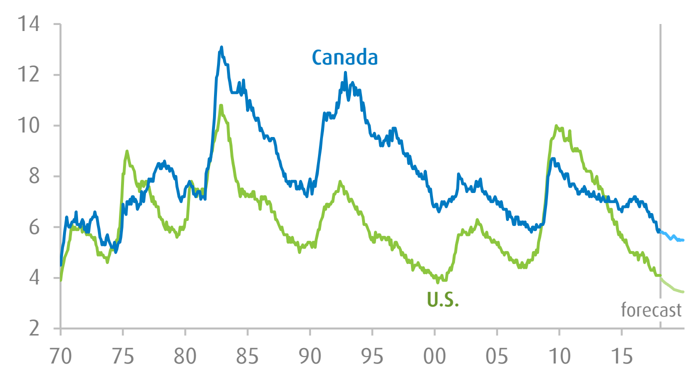


Prices



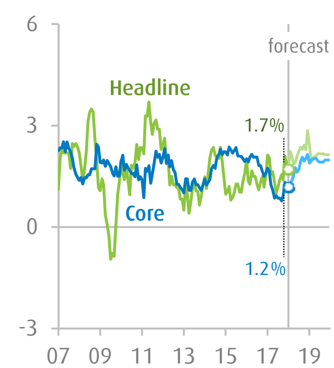
FULLY EMPLOYED
(percent)

Unemployment Rate

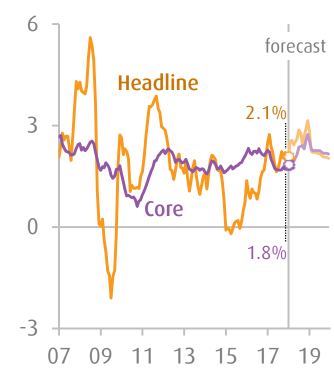


INFLATION BOTTOMS
Consumer Price Index (y/y % change)

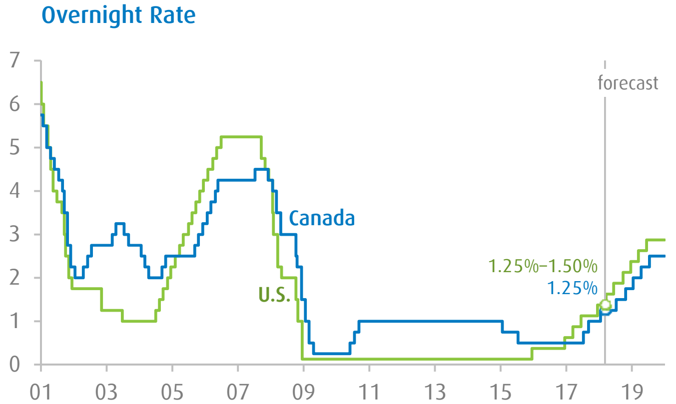
Canada



United States



MONETARY POLICIES TIGHTEN
(% : as of March 8, 2018)



LONG-TERM RATES RISE
(% : as of March 8, 2018)