North American Outlook

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A look ahead at the Canadian and American economies

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Sunny With Fog Patches

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Canada

- **The Canadian economy is running near potential**. Real GDP slowed to a 1.6% rate in the second half of 2017, and looks to have done no better early this year. Temporary support from the oil recovery, enhanced child benefits and Southern Ontario's housing boom have faded, while financial conditions have tightened. With the economy essentially at full employment and the population already running the fastest in 26 years, sustaining better growth will require improvements in productivity and competitiveness.
- **Following a 3.5% spurt last year, consumer spending is slowing in response to rising interest rates**. Household credit has rolled over, rising 5.3% y/y in March versus 5.9% last summer. Retail sales have weakened and auto sales are plateauing.
- After rebounding last year, **investment looks to cool due to uncertain trade policies and diminished competitiveness**. Direct capital flows have shifted toward the U.S. with a net outflow of nearly $70 billion last year. Canada posted a record goods trade deficit in March, despite an inexpensive currency and rising oil prices. In fact, export volumes have gone nowhere for three years. The bulk of the goods deficit is with China and in the auto industry, the latter being a notable shift from earlier decades when large surpluses were the norm. Trade looks to subtract from real GDP for five straight quarters for the first time since the mid-70s.
- Rising interest rates, stricter mortgage rules and other policy measures have **corralled Vancouver and Toronto's high-priced housing markets**. Still, the more affordable condo market remains piping hot in these cities, especially at the lowest-price points (studio and one bedroom). Across the rest of the country, all property types are affordable and activity remains healthy. **Ottawa and Montreal are strengthening** amid healthy affordability and increased demand from non-residents. However, Alberta and Saskatchewan continue to struggle with inventories build up during the oil shock.
- Stronger U.S. demand and federal infrastructure spending should allow for some modest improvement in Canada's GDP growth in coming quarters. Encouragingly, manufacturing has turned up after lying dormant for several years. Growth of **2.0% this year will reduce the jobless rate to 5.5% for the first time since 1974**.
- **All provinces will downshift this year**. **Alberta** could see growth sliced from a province-leading 4.9% last year (albeit after two years

KEY MESSAGES

- Fiscal stimulus will add steam to the U.S. economy this year, at the risk of propelling inflation.
- Stronger U.S. demand will help Canada's economy slightly outrun its potential in the face of elevated household debts, restrictive housing policies and fading competitiveness.
- The Fed will outwalk the Bank of Canada toward the exits, lifting rates each quarter this year.
- Trade protectionism and overheating are the two biggest threats to the North American expansion.

in recession) to 2.2% this year. This would allow **B.C.** to reassert itself as the nation's leader, benefitting from exports to fast-growing Asia. However, after four straight years of cruising above 3%, even B.C. will moderate to 2.4% amid a flurry of tax increases (corporate, personal, housing, carbon and payroll). Following the fastest pace (3.1%) in 17 years, **Quebec** is expected to moderate to 2.2% this year. Still, with companies ramping up investment amid tax relief, la belle province should once again top **Ontario** (2.0%), where business confidence is sagging.

- The **Bank of Canada** has kept policy rates stable since January amid slower economic growth, trade policy risks and tougher mortgage rules. However, with the economy running out of slack, **rates are likely to rise in July**, assuming some clarity on the trade front. While elevated household debt warrants a go-slow approach to rate hikes, inaction can also heighten financial risks by encouraging more debt accumulation, according to Governor Poloz. We expect the current policy rate (1.25%) to reach the low end of the Bank's estimated neutral range (2.5%) by late 2019.
- Like the economy, the **Canadian dollar is stuck in low gear.** After motoring above 81 cents (US) earlier this year, it has skidded back to a range of 76 to 79 cents. That's close to "fair value" on a purchasing power basis, estimated by Statistics Canada at 77.5 cents for goods. Record trade deficits, NAFTA uncertainty and a resurgent greenback have offset higher oil prices to keep the currency spinning its wheels. **A relief rally should NAFTA talks end well might lift it to 80 cents US by year-end**.

United States

- **The U.S. economy will speed up this year.** Although GDP slowed in the first quarter, the economy didn't weaken. Here's why: First, real GDP almost always downshifts at the start of the year given quirky seasonal adjustment. Second, at 2.3%, growth still exceeded potential. Third, the slowing was largely in two areas that posted big gains in Q4—consumer spending and residential construction. Fourth, exports and capex stayed strong, up 4.3% and 6.1%, with the latter spread across industries (i.e., it wasn't just an oil story).
- Firmer retail and home sales flag a better second quarter, even as softer machinery orders indicate some moderation in capex. **With fiscal stimulus estimated to add around 1% to GDP this year, growth should strengthen to 2.8%** from 2.3% last year. Despite rising late-cycle imbalances, the current expansion (now the second longest since at least the mid-1800s) is on track to surpass the 91-01 run and become the longest ever by next summer.

- **The fiscal jolt has put a spring in the Fed's tightening step**. Policy rates are widely expected to rise in June, and we see further moves in each quarter until mid-2019. With core PCE inflation (1.9%) a hair below target and the jobless rate (3.9%) a hair above half-century lows, the Fed's dual mandate is a fait accompli. Its focus now should be on returning policy rates to neutral (closer to 3%) to prevent the economy from overheating.
- The **trade-weighted dollar's** 10% depreciation in the past year ended with a 3% jump in the past month, as fiscal stimulus and firmer inflation warrant a more deliberate Fed response, while many other central banks are still looking for the exits. Although rising trade and budget deficits will restrain the dollar, the risks skew to the upside.

Risks

- Positive comments from officials in all three **NAFTA** nations, and a one-month extension of the metal tariffs exemptions, have raised hopes of a deal, at least in principle, by month's end. However, if talks fail, the consequences could range from the status quo (if Congress vetoes a repeal), to a so-called Zombie NAFTA (that is held up in court for years), to an outright termination. In the event that NAFTA is repealed, the outcomes range from just modestly weaker growth if governments abide by WTO trade rules, to a recession in Canada and Mexico and much weaker U.S. growth if governments resort to more punitive protectionist measures.
- Business surveys cite growing concern about material costs and supply chain disruptions arising from **import tariffs on steel and aluminum** and the U.S.-China tariff tiff. While the duties proposed to-date are insufficient to materially harm either economy, several rounds of retaliation would quickly ramp up the damage.
- Trade protectionism, loose fiscal policy and $70 oil imply heightened **risks for inflation and interest rates**, the usual cause of recessions.
- **Oil prices** could climb further as the U.S. reinstates sanctions on **Iran**. This would not only raise inflation risks but also weaken the U.S. expansion. Every 10% increase in oil prices slows growth by about 0.1 ppt.
- With the **U.S. budget deficit** approaching $1 trillion next year (or nearly 5% of GDP), the government will have little scope to cushion the next downturn without avoiding a credit-rating downgrade.
- **Brexit uncertainty** has undermined U.K. growth and could slow the European economy. Pro- and anti-Brexit forces within the U.K. parliament have debated whether to pull the region out of the EU

customs union. This issue will largely determine whether the U.K. faces a “soft” or “hard” Brexit.

- A fractured government means **Italy** could head back to the polls this summer, raising the risk that a coalition of populist, Euro-skeptic parties will run the country.
- On a positive note, North and South **Korea** have agreed to a denuclearization deal, allaying tensions between North Korea and the U.S. ahead of a crucial leaders’ meeting.

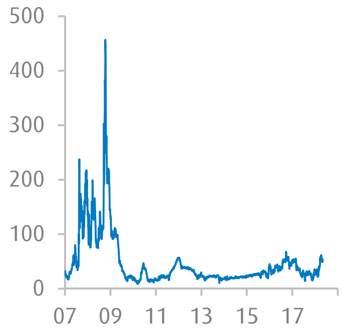
Forecasts

CANADA	2017 I	2017 II	2017 III	2017 IV	2018 I	2018 II	2018 III	2018 IV	ANNUAL 2017	ANNUAL 2018	ANNUAL 2019
Real GDP (q/q % chng : a.r.)	4.0	4.4	1.5	1.7	1.5	2.3	2.1	1.9	3.0	2.0	1.8
Consumer Spending	3.5	4.6	3.7	2.1	2.5	1.8	2.0	1.8	3.5	2.5	1.8
Business Investment (non-residential)	12.1	9.5	5.4	8.2	3.4	3.4	2.4	2.4	2.6	4.7	2.4
Consumer Price Index (y/y % chng)	1.9	1.3	1.4	1.8	2.1	2.4	2.5	2.3	1.6	2.3	2.1
Unemployment Rate (%)	6.6	6.5	6.2	6.0	5.8	5.8	5.7	5.5	6.3	5.7	5.5
Housing Starts (000s : a.r.)	222	207	223	229	224	218	220	218	220	220	210
Current Account Balance ($blns : a.r.)	-54.6	-61.3	-74.4	-65.4	-72.1	-64.2	-62.6	-61.2	-63.9	-65.0	-60.0
Interest Rates (average for the quarter : %)											
Overnight Rate	0.50	0.50	0.83	1.00	1.25	1.25	1.50	1.75	0.71	1.44	2.31
3-month Treasury Bill	0.47	0.54	0.81	0.92	1.14	1.20	1.45	1.70	0.69	1.40	2.20
10-year Bond	1.71	1.51	1.95	1.96	2.24	2.30	2.40	2.50	1.78	2.35	2.80
Canada/U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	-13	-37	-25	-30	-44	-66	-58	-51	-26	-55	-33
10-year	-73	-75	-30	-41	-52	-62	-61	-58	-55	-59	-53
UNITED STATES											
Real GDP (q/q % chng : a.r.)	1.2	3.1	3.2	2.9	2.3	2.8	2.9	2.9	2.3	2.8	2.5
Consumer Spending	1.9	3.3	2.2	4.0	1.1	3.0	2.5	2.2	2.8	2.5	2.2
Business Investment (non-residential)	7.1	6.7	4.7	6.8	6.1	3.2	2.8	2.4	4.7	4.9	2.3
Consumer Price Index (y/y % chng)	2.6	1.9	2.0	2.1	2.3	2.7	2.8	2.5	2.1	2.6	2.1
Unemployment Rate (%)	4.6	4.3	4.3	4.1	4.1	3.9	3.8	3.7	4.4	3.9	3.5
Housing Starts (mlns : a.r.)	1.24	1.17	1.17	1.26	1.32	1.28	1.30	1.28	1.21	1.29	1.28
Current Account Balance ($blns : a.r.)	-451	-495	-406	-513	-543	-556	-572	-591	-466	-565	-625
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	1.00	1.83	2.73
3-month Treasury Bill	0.60	0.90	1.06	1.23	1.58	1.85	2.05	2.20	0.95	1.90	2.55
10-year Note	2.44	2.26	2.24	2.37	2.76	2.95	3.05	3.10	2.33	2.95	3.35
EXCHANGE RATES (average for the quarter)											
US¢/C$	75.6	74.4	79.9	78.6	79.1	78.7	79.3	79.8	77.1	79.2	81.1
C$/US$	1.323	1.345	1.253	1.272	1.265	1.270	1.262	1.253	1.298	1.262	1.234
¥/US$	114	111	111	113	108	108	107	106	112	107	104
US$/Euro	1.07	1.10	1.18	1.18	1.23	1.22	1.23	1.24	1.13	1.23	1.27
US$/£	1.24	1.28	1.31	1.33	1.39	1.39	1.40	1.42	1.29	1.40	1.45

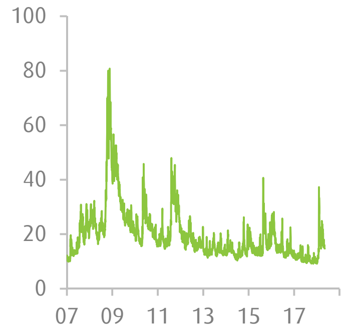
Note: Shaded areas represent BMO Capital Markets forecasts

VOLATILITY RETURNS
United States (as of May 4, 2018)

Ted Spread[1]



VIX[2]



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

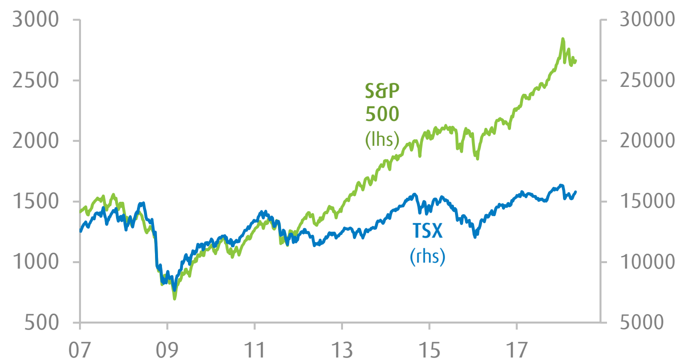
CREDIT SPREADS STILL LOW
United States (ppts)

Corporate Bond Spreads[1]

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

EQUITIES WOBBLE
(indices : as of May 8, 2018)

Equities

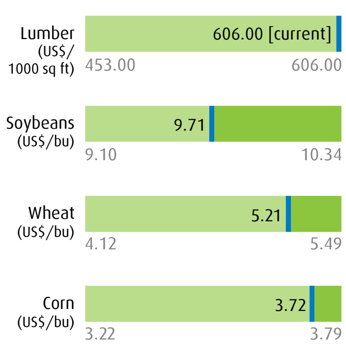


LOONIE NEAR FAIR VALUE
(US¢ : as of May 8, 2018)

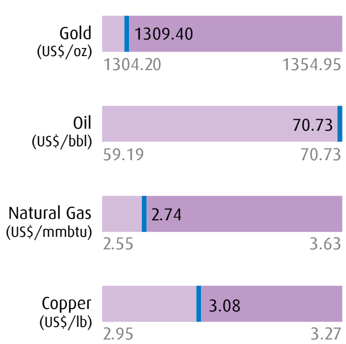
Canadian Dollar

LUMBER PRICES HIT THE ROOF
Commodity price range since start of 2018

Materials & Foodstuffs
(as of May 7, 2018)



Metals & Energy
(as of May 7, 2018)



...no thanks to softwood lumber duties

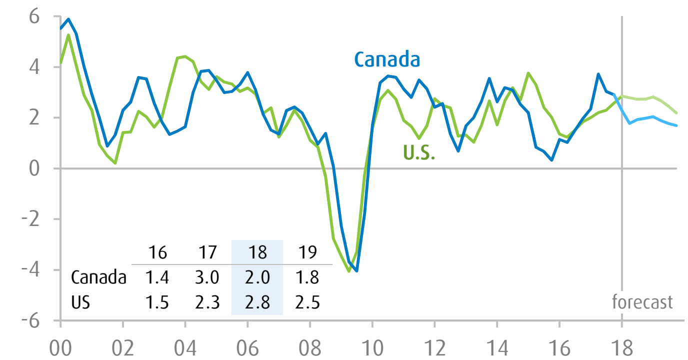
OIL PRICES NEAR 4-YEAR HIGHS
(US$/bbl : as of May 8, 2018)

WTI Crude Oil

...no thanks to Iran sanctions

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

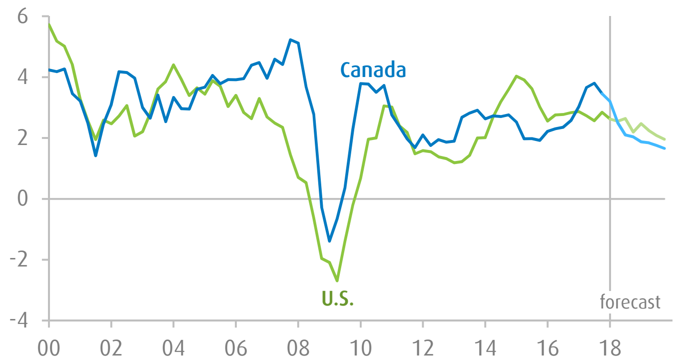
Real GDP



Canadian growth cools

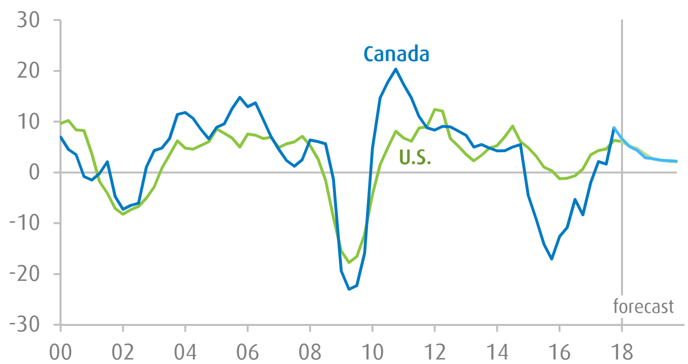
CANADIAN CONSUMERS TO DOWNSHIFT
(y/y % change)

Real Personal Consumption Expenditures



BUSINESS INVESTMENT HEALTHY
(y/y % change)

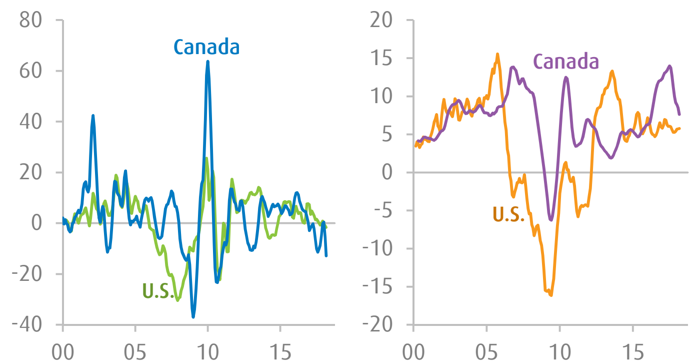
Real Non-Residential Business Investment



CANADIAN HOUSING MARKET SLOWS
Existing Homes (y/y % change : 3-month m.a.)

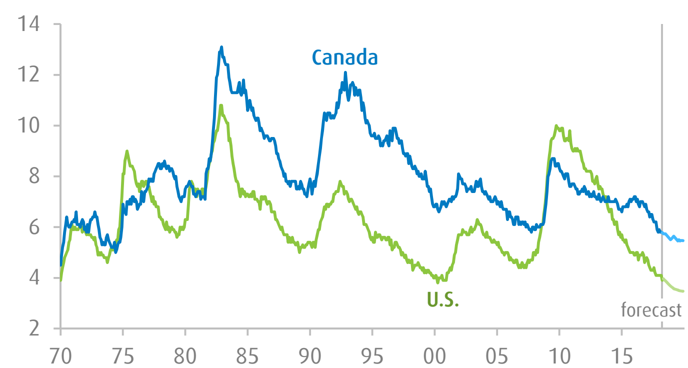
Sales

Prices



FULLY EMPLOYED
(percent)

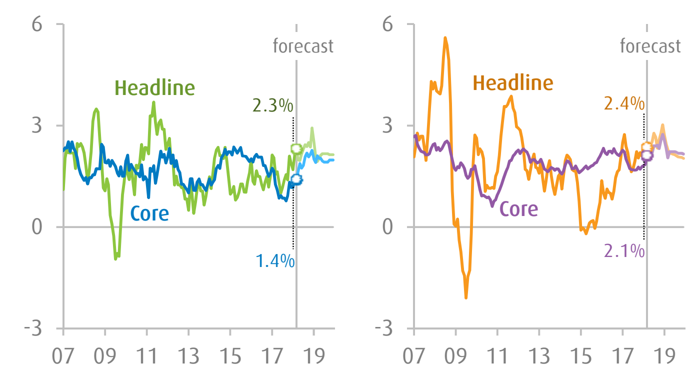
Unemployment Rate



INFLATION PERKS UP
Consumer Price Index (y/y % change)

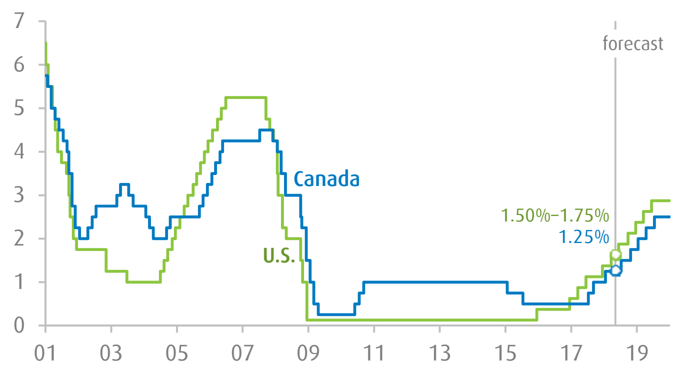
Canada

United States



MONETARY POLICY TIGHTENS
(% : as of May 8, 2018)

Overnight Rate



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

10-Year Bonds