North American Outlook

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A look ahead at the Canadian and American economies

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Tariff-ic, For Now

ECONOMIC RESEARCH
1-800-613-0205 • economics.bmocapitalmarkets.com
Sal Guatieri, Senior Economist
416-359-5295
sal.guatieri@bmo.com

KEY MESSAGES

- Despite trade angst, the U.S. economy is steaming forward on fiscal juice.
- Strong U.S. demand and a cheap loonie are offsetting higher rates and stricter housing policies to keep Canada's economy grinding ahead.
- Restrictive policy measures and cooler house prices have reduced the risk of a correction in Canada's housing market.
- The Fed is outpacing the Bank of Canada toward the policy exits. Both will keep walking in the year ahead.
- Protectionism and overheating are the two key threats to North America's expansion.

United States

- A **trade war broke out this summer**. Three-way NAFTA talks paused, though Mexico and the U.S. are currently meeting to resolve the contentious auto-content issue. Canada and Mexico still oppose several other key U.S. demands, such as the five-year "sunset clause" and axing the dispute resolution system. U.S. metal tariffs were expanded to more countries in June. Duties on $34 billion of China's goods took effect in July; and, before the ink was dry, the Administration proposed a levy on another $200 billion of goods, while President Trump threatened to double the stakes further. Other countries countered with tariffs on a wide range of U.S. goods. Most alarming, the Administration is considering duties on autos, which would toss a giant monkey wrench into tightly-wound global supply chains. While a recent truce by the U.S. and EU is welcome, talks to roll back tariffs and avoid new ones could stall, as a deal will need to be ratified by all 28 EU nations (including Italy, which recently pledged to derail the EU-Canada trade deal).
- **The tariff toll to-date is modest but it will mount if further rounds are launched**. We estimate the imposed tariffs will reduce U.S. GDP by ¼% over a year or two, while proposed and counter duties could magnify the hit to 1¼%.
- **Fiscal stimulus has so far masked trade protectionism to propel the economy forward**. Although business surveys cite growing concerns about the tariff impact on material costs and supply chains, investment and hiring have actually strengthened. Nonresidential investment surged an annualized 8.8% in the first two quarters of the year, the most in six years, while nonfarm payrolls had their best half-year since 2015.
- After slowing in Q1, real **GDP snapped back with purpose in Q2**. The annual 4.1% rate was the fastest in nearly four years and almost double the post-recession trend (2.3%). Driven by tax cuts, the economy fired on most cylinders. Consumer spending surged 4.0% on a broad upswing in sales. Business investment jumped 7.3% on a double-digit advance in structures, led by a booming oil industry. Spending on IT gear and software also stayed strong. Meantime, exports leaped 9.3%, as China advanced soybean purchases ahead of retaliatory tariffs. But residential construction fell for a second quarter due to peaking sales and labour shortages. Though firming, home completions are low relative to the number of households.

- **Growth should stay close to 3% in the second half of 2018**. The fiscal push from tax cuts and federal spending could add 1% to GDP this year. While rising interest rates and gas prices are pinching consumers, a pickup in disposable income (5.1% y/y in Q2) to three-year highs is providing ballast. Revised data on personal savings suggest households (at least those running small businesses) have a thicker financial cushion than reported previously. Corporate profits are soaring, a plus for investment. The expansion is well on track to becoming the longest on record at just over a decade by next July.
- Still, a number of firms have lowered their outlooks due to the tariff rift, and July data on work hours and purchasing manager surveys is on the light side. Notably, **interest-sensitive areas of the economy are cresting**, with sales of autos and homes below last year's levels. Home sales are slowing due to ebbing pent-up demand and affordability, while an upturn in record-low listings has reined in price growth. As interest rates rise and the fiscal push fades, **GDP growth will slow to 2.5% in 2019**.
- Chairman Powell's July testimony and the August 1st policy announcement suggest that **"*further gradual increases*"** are in the cards due to the "*strong*" economy. The plan is to lift rates by 1¼ ppts by the end of 2019 to prevent the economy from overheating, according to the median FOMC forecast. Of course, a brewing trade war could interfere with this plan. But, "*for now*", the Fed is on track to normalize rates. Core PCE inflation is close to target (and we see it peaking at 2.3%), while joblessness is testing half-century lows and growth is still outrunning potential. Wages are edging higher, with the employment cost index (2.8% y/y) rising the fastest in a decade. Yet, real policy rates remain slightly negative. **We see two more Fed rate hikes this year, with the next one in September**.
- Despite steady pressure on the tightening trigger, long-term rates have moved sideways in response to trade risks and some pullback in oil prices. The 10-year Treasury yield is close to 3% after hitting 7-year highs (3.11%) in May. While we trimmed our year-end forecasts to 3.1% this year and 3.25% next year, we **still see yields tracking policy rates, inflation and the budget deficit higher**, especially given ever larger borrowing requirements due to Fed redemptions.

Canada

- Canada is hoping not to be left at the NAFTA altar. It **has more to lose than the U.S. if a deal falls through or the trade war escalates.** We estimate the imposed tariffs to-date could reduce GDP by almost ½%, while proposed duties, notably on autos, could ratchet the toll up to 1½%. This would lift the jobless rate, though the Bank of Canada could step in to cushion the blow.

- **So far, Canada's economy is doing fairly well**. Although companies are nervous about trade policies, they continue to spend and hire. Nonresidential investment jumped almost 11% in Q1 (annualized) after spiking 8% in Q4, while industry employment rose 2.4% y/y in May (386,000), even faster than U.S. payrolls (1.6%).

- **GDP likely grew 3.3% in Q2** after cruising no faster than 1.7% in the prior three quarters. Recovering oil prices, strengthening U.S. demand and a steadier housing market are providing support. Oil and gas production jumped 10% in the past year to May. Real goods exports surged 16% annualized, suggesting trade will add mightily to Q2 growth for the first time in a year. Manufacturing is also awakening from a long slumber amid thriving food processing, though waning auto demand is causing clutch trouble.

- Rising interest rates, tougher mortgage rules and provincial policy measures have **cooled the Vancouver and Toronto housing markets, though both show signs of steadying**. Detached home sales in the two cities plunged earlier this year when the new stress tests took effect. Toronto's benchmark prices, though down 11% from the peak, are finding a floor. Lower-priced condos in the region remain popular, though demand and price gains have slowed from last year's frothy pace. In other regions, activity is supported by healthy affordability and the fastest population increase in 27 years (due to a near 400,000 surge in net international migration). **Ottawa and Montreal continue to strengthen** on solid demand from young millennials and foreign investors. By contrast, Saskatchewan and Alberta continue to struggle with inventories stacked up during the oil price crash.

- This late in the cycle, Canada's economy will need a burst of productivity to sustain the recent upturn. Barring that, **growth will likely slow to 1.8% in 2019** from an estimated 2.0% in 2018. Consumer spending has downshifted along with borrowing, steadying a still-high debt ratio.

- **All provinces look to gear down this year**. After bouncing out of recession with 4.9% growth in 2017, Alberta will likely slow to 2.1% in 2018. This would allow **British Columbia** to regain top spot on the national leader-board, even as growth slips to 2.5% in response to higher business taxes. After the fastest pace in 17 years, **Quebec** will slow to 2.2% in 2018, despite lower taxes. **Ontario** will grow just 1.9%, as trade concerns have sapped business confidence. The newly-elected Progressive Conservative party is trying to turn sentiment around, while getting a grip on the province's finances.

- After lifting rates four times since mid-2017, the **Bank of Canada will likely wait until October before moving again**. Its latest press statement said higher rates "*will be warranted to keep inflation near* *target*". Still, it will continue to follow "*a gradual approach*", suggesting the current overnight target rate (1.5%) could take until 2020 to return to its neutral range of between 2.5% to 3.5%.

- The **Canadian dollar keeps spinning its wheels.** After motoring above 80 cents (US) earlier this year, it has careened between 75 and 78 cents in recent months. Record trade deficits, trade tensions and a firmer greenback have offset higher oil prices to keep the loonie boxed into a narrow lane. **It likely won't revisit 80 cents until late next year**, assuming the trade fog clears.

Risks

- We place **low odds of about 15% on a U.S. recession occurring within a year**. True, the 10s-2s yield curve has flattened, but it's far from inverted. That said, as interest rates rise and stimulus fades, the economy will be more vulnerable to shocks, such as a trade war.
- A **full NAFTA deal is unlikely this year**. If talks fail, alternative scenarios would range from the status quo, to a so-called Zombie NAFTA tied up in endless negotiations, to an outright termination. In the event that the agreement ends, the outcomes would range from modestly weaker growth if WTO trade rules are upheld, to a recession in Canada and Mexico and weaker U.S. growth if more punitive measures are taken.
- **Inflation risks are tilted to the upside** given very tight U.S. labour markets, loose fiscal policies and mounting import duties.
- As the **U.S. budget deficit** nears $1 trillion, the government will have less fiscal room to address a downturn without avoiding a downgrade.
- **Brexit** could slow Europe's economy. While "soft" Brexit forces have gained the upper hand following the resignation of key ministers in the May government, the road toward a deal that retains free-trade ties with the EU will be bumpy ahead of the March 2019 deadline. A "no-deal Brexit" is a distinct possibility.
- On the plus side, **Italy's new government** has toned down calls to abandon the euro and increase deficit spending. Meantime, the world awaits **North Korea's** follow-through on denuclearization talks, as well as which way Iran will now turn.
- Closer to home, while the **Vancouver and Toronto housing markets** remain vulnerable to a shock, the risk of a correction has been reduced by policy measures that curbed earlier excesses.

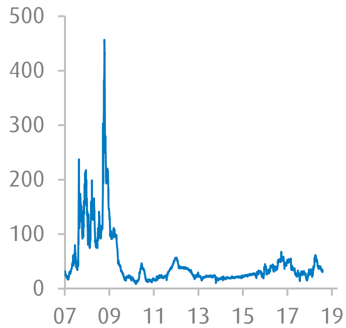
Forecasts

CANADA	2018 I	2018 II	2018 III	2018 IV	2019 I	2019 II	2019 III	2019 IV	Annual 2017	Annual 2018	Annual 2019
Real GDP (q/q % chng : a.r.)	1.3	3.3	1.3	2.2	1.8	1.7	1.7	1.6	3.0	2.0	1.8
Consumer Spending	1.1	2.0	1.6	2.0	1.8	1.7	1.7	1.4	3.5	2.0	1.8
Business Investment (non-residential)	10.9	4.3	2.4	2.4	2.6	2.3	2.0	2.0	2.8	6.6	2.5
Consumer Price Index (y/y % chng)	2.1	2.3	2.3	2.1	1.8	2.1	2.2	2.1	1.6	2.2	2.1
Unemployment Rate (%)	5.8	5.9	5.9	5.7	5.7	5.7	5.6	5.6	6.3	5.8	5.6
Housing Starts (000s : a.r.)	225	219	210	208	208	207	204	200	220	215	205
Current Account Balance ($blns : a.r.)	-78.0	-62.5	-64.3	-63.2	-62.8	-62.9	-63.1	-63.2	-63.3	-67.0	-63.0
Interest Rates (average for the quarter : %)											
Overnight Rate	1.25	1.25	1.50	1.75	1.75	2.00	2.25	2.25	0.71	1.44	2.06
3-month Treasury Bill	1.14	1.21	1.45	1.70	1.70	1.95	2.15	2.15	0.69	1.35	2.00
10-year Bond	2.24	2.28	2.35	2.50	2.60	2.65	2.75	2.80	1.78	2.35	2.70
Canada/U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	-44	-67	-62	-59	-74	-70	-60	-60	-26	-58	-66
10-year	-52	-64	-64	-58	-55	-51	-47	-44	-55	-60	-49
UNITED STATES											
Real GDP (q/q % chng : a.r.)	2.2	4.1	2.8	2.9	2.6	2.2	2.0	1.8	2.2	2.8	2.5
Consumer Spending	0.5	4.0	2.5	2.2	2.2	2.1	1.9	1.8	2.5	2.5	2.2
Business Investment (non-residential)	11.5	7.4	3.5	2.4	2.2	2.1	2.1	2.0	5.3	6.6	2.7
Consumer Price Index (y/y % chng)	2.3	2.6	2.7	2.4	2.2	2.2	2.2	2.1	2.1	2.5	2.2
Unemployment Rate (%)	4.1	3.9	3.8	3.7	3.7	3.6	3.6	3.5	4.4	3.9	3.6
Housing Starts (mlns : a.r.)	1.32	1.26	1.29	1.28	1.27	1.28	1.28	1.28	1.21	1.29	1.28
Current Account Balance ($blns : a.r.)	-496	-391	-448	-467	-476	-488	-502	-514	-449	-450	-495
Interest Rates (average for the quarter : %)											
Fed Funds Target Rate	1.46	1.71	1.96	2.21	2.46	2.71	2.88	2.88	1.00	1.83	2.73
3-month Treasury Bill	1.58	1.88	2.10	2.25	2.45	2.65	2.75	2.75	0.95	1.95	2.65
10-year Note	2.76	2.92	2.95	3.10	3.15	3.20	3.20	3.25	2.33	2.95	3.20
EXCHANGE RATES (average for the quarter)											
US¢/C$	79.1	77.5	76.6	78.0	78.7	79.1	79.5	79.9	77.1	77.8	79.3
C$/US$	1.265	1.291	1.306	1.283	1.271	1.265	1.258	1.252	1.298	1.286	1.261
¥/US$	108	109	111	110	110	109	109	108	112	110	109
US$/Euro	1.23	1.19	1.17	1.18	1.18	1.20	1.22	1.24	1.13	1.19	1.21
US$/£	1.39	1.36	1.31	1.29	1.26	1.30	1.34	1.39	1.29	1.34	1.32

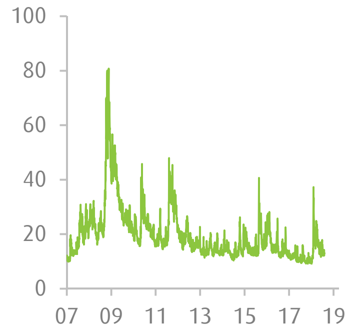
Note: Shaded areas represent BMO Capital Markets forecasts

VOLATILITY LOW
United States (as of August 2, 2018)

Ted Spread[1]



VIX[2]



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

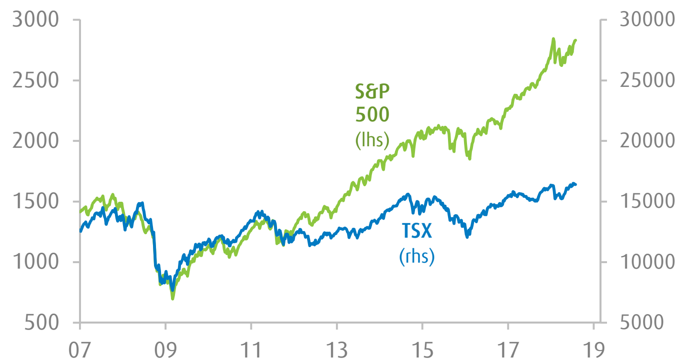
CREDIT SPREADS STILL NARROW
United States (ppts)

Corporate Bond Spreads[1]

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

EQUITIES AT NEW HIGHS
(indices : as of August 3, 2018)

Equities



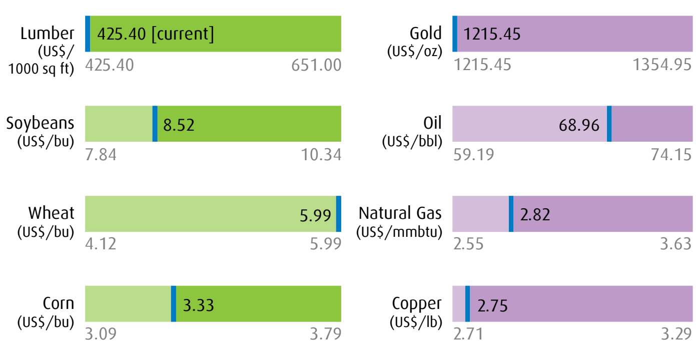
LOONIE LANGUISHES
(US¢ : as of August 3, 2018)

Canadian Dollar

GOLD AT ONE-YEAR LOW
Commodity price range since start of 2018

Materials & Foodstuffs
(as of August 2, 2018)

Metals & Energy
(as of August 2, 2018)

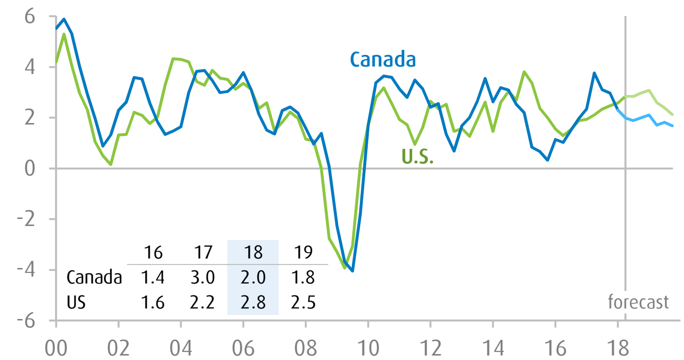


OIL PRICES IN NEW HIGHER RANGE
(US$/bbl : as of August 3, 2018)

WTI Crude Oil

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

Real GDP

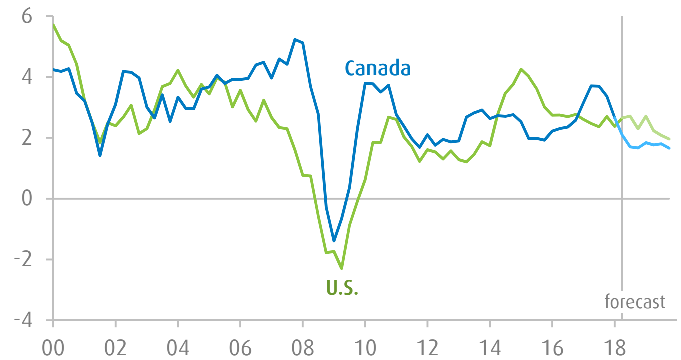


	16	17	18	19
Canada	1.4	3.0	2.0	1.8
US	1.6	2.2	2.8	2.5

Canadian growth moderates

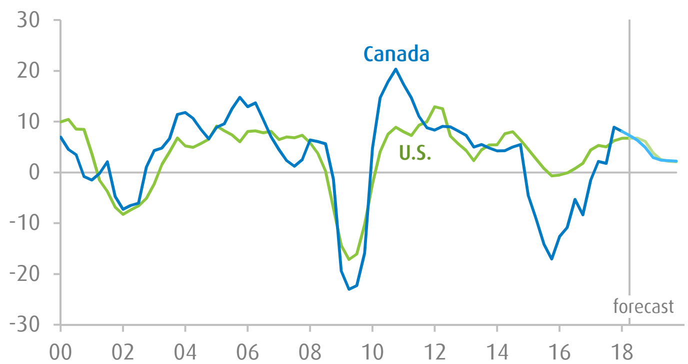
CANADIAN CONSUMERS GEAR DOWN
(y/y % change)

Real Personal Consumption Expenditures



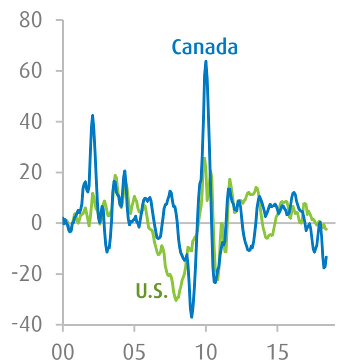
BUSINESS INVESTMENT STURDY
(y/y % change)

Real Non-Residential Business Investment

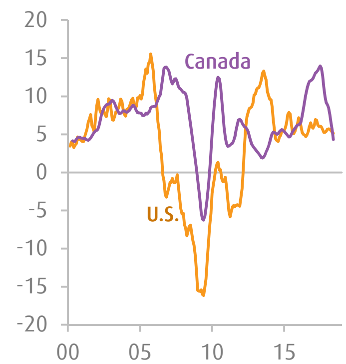


HOME SALES COOL
Existing Homes (y/y % change : 3-month m.a.)

Sales

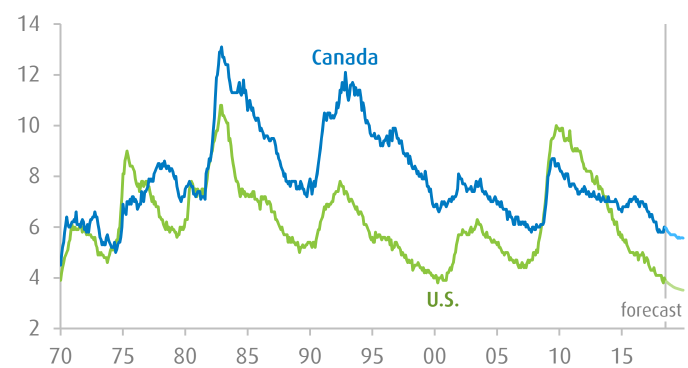


Prices



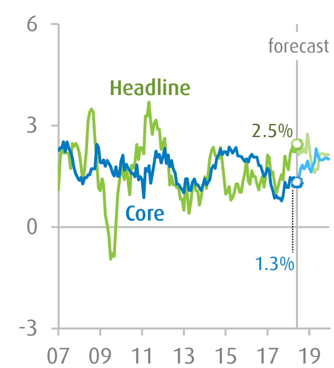
FULLY EMPLOYED
(percent)

Unemployment Rate

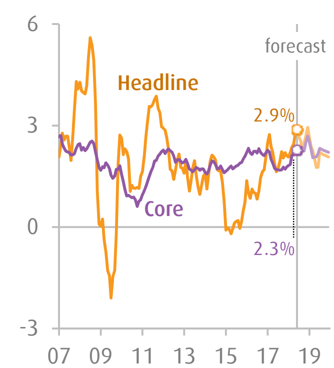


INFLATION FIRMS
Consumer Price Index (y/y % change)

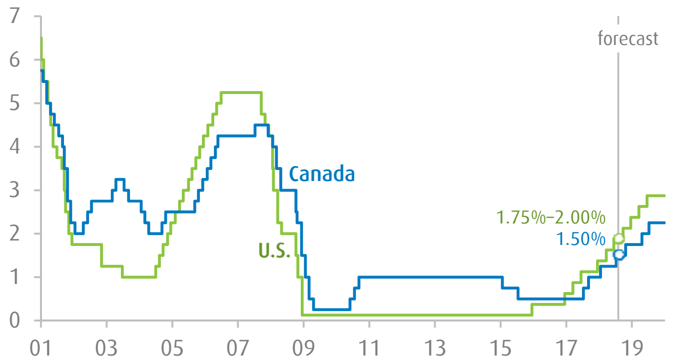
Canada



United States



MONETARY POLICY TIGHTENS
(% : as of August 3, 2018)



LONG-TERM RATES TREND HIGHER
(% : as of August 3, 2018)

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