North American Outlook

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A look ahead at the Canadian and American economies

September 11, 2018

Half'a Nafta?

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KEY MESSAGES

- Despite growing trade angst, the U.S. economy is steaming forward on fiscal juice.
- Strong U.S. demand and a low loonie have offset higher interest 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. We expect limited contagion from emerging market problems.

United States

- The **U.S.-Mexico bilateral trade deal** raises more questions than it answers; in particular, will Congress approve it (doubtful) and will Canada be part of a trilateral deal? Current talks between the U.S. and Canada aim for a deal before October 1. Given key sticking points, notably on dispute resolution and dairy-supply management, the talks are likely to go down to the wire.
- **Meantime, a broader trade war continues to fester.** The U.S. tariff toll on the economy, so far, 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 duties on automobiles and on another $200 billion of China's goods 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. **Real GDP soared an annual 4.2% in Q2,** the fastest in nearly four years and almost double the post-recession trend (2.3%). Driven by tax cuts, the economy fired on nearly all cylinders. Consumer spending surged 3.8% on broad strength. Business investment jumped 8.5% on a second straight double-digit advance in structures, led by a booming oil industry. Spending on IT gear and software also stayed strong. Meantime, exports leaped 9.1%, as China advanced soybean purchases ahead of retaliatory tariffs. But residential construction fell for a second quarter due to peaking sales and labour shortages. Nonfarm payrolls had their best half-year since 2015, and have slowed only somewhat in the summer.
- **GDP growth should stay close to 3% in the second half of the year, just a tad below the first-half pace**. 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% y/y in Q2) to three-year highs is providing support. Revised data on personal savings suggest households 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 tariff concerns. Importantly, **interest-sensitive areas of the economy are peaking**, 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**.

- Fed Chair Powell's congressional testimony and the August 1st policy announcement suggest that **"*further gradual increases*"** in rates are in the cards. 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 back to the 2% target and we see it cresting at 2.3%. 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 on September 26**.
- Despite steady pressure on the Fed's tightening trigger, long-term rates have been range-bound in response to trade policy risks, a pullback in oil prices, and concern that market turbulence in Turkey and Argentina will infect other emerging markets. The 10-year Treasury yield has pulled back to below 3% after hitting 7-year highs of 3.11% in May. Nonetheless, **yields should track policy rates, inflation and the budget deficit higher**, especially given ever larger borrowing requirements due to Fed redemptions. We see the 10-year yield rising to 3.1% by year-end and to 3.25% at the end of 2019.

Canada

- Canada has much **more to lose than the U.S. if a NAFTA 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 lift the toll to 1½%. This would raise the jobless rate, forcing the Bank of Canada to shift gears.
- **So far, Canada's economy is faring well**. Recovering oil prices and strengthening U.S. demand are providing support. **Real GDP rebounded 2.9% annualized in Q2**, after doing no better than 1.7% in the previous three quarters. Real exports surged 12% after making little headway in the past year. Despite less borrowing, consumer spending picked up to a 2.6% annual pace. While companies are nervous about trade policies, they continue to spend and hire. Nonresidential investment advanced after a double-digit gain in Q1. Industry employment has risen 2.1% y/y to June, even outrunning U.S. payrolls. Oil and gas output is up 8% in the past year to June.

Manufacturing has turned higher amid thriving food processing, though waning auto demand has capped the gains.

- **Growth will likely slow to a 1.3% pace in Q3**, partly due to a shutdown at Syncrude. The timelier (though less reliable) Labour Force Survey showed a large employment retreat in August, returning the jobless rate to 6.0% from a four-decade low of 5.8%. With interest rates headed higher, Canada's economy will need a burst of productivity to sustain growth above its current year-on-year trend of 1.9%. We **expect 1.8% growth in 2019**.

- **All provinces will gear down this year**. After bouncing out of recession with a 4.9% gain in 2017, Alberta will likely slow to 2.4% 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 expand just 2.0%, as trade concerns have sapped business confidence. The recently-elected Progressive Conservative party is trying to turn sentiment around, while getting a grip on the province's finances.

- Rising interest rates, tougher mortgage rules and provincial policy measures have **cooled the Vancouver and Toronto housing markets, though the latter has stabilized**. Detached home sales in the two cities plunged earlier this year when the new stress tests took effect, and remain very weak in Vancouver (down 37% y/y to August). Firmer sales in Toronto have put a floor under benchmark prices after they slid 11% from their peak. 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 growth in 27 years, courtesy of record 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 excess inventories.

- After raising rates four times in the year to July, the **Bank of Canada will likely move again in October assuming NAFTA talks go well**. The September 5 press statement reaffirmed that higher policy rates "*will be warranted*", though the Bank will continue to "*take a gradual approach, guided by incoming data*". The latter suggests the current overnight target rate (1.5%) could take until 2020 to return to a more neutral level of 2.5%. While CPI inflation is near seven-year highs (3.0%) due to elevated gasoline prices, the core measures are averaging 2% and show no sign of accelerating. Wage growth has also moderated recently.

- The **Canadian dollar continues to struggle against the mighty greenback.** After motoring above 80 cents (US) earlier this year, it has careened between 75 and 78 cents in recent months. Trade deficits, protectionist fears 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**, and only if the trade fog clears.

Risks

- A collapse of NAFTA talks and, worse, a **25% tariff on Canadian motor vehicles** could see its economy slow by over one percentage point, while Ontario (where U.S. purchases of vehicles and parts account for 30% of exports) would flirt with recession.
- We place **low odds of about 15% on a U.S. recession occurring within a year**. While the 10s-2s yield curve has flattened, it's far from inverted. That said, the economy will become increasingly vulnerable to a shock, such as a trade war, as interest rates rise and fiscal stimulus fades.
- Emerging market instability in several countries, namely **Turkey**, Argentina, Venezuela, Brazil and South Africa, has gotten the attention of investors. High inflation, large budget and trade deficits, and misaligned economic policies are at play. Still, **we believe the risks of broader contagion are limited**, as these problems appear largely isolated to a handful of nations.
- **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.

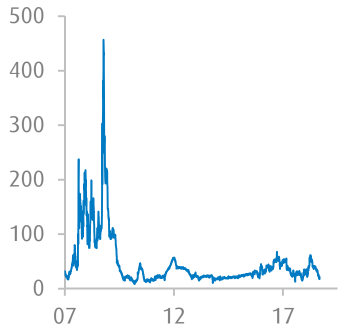
Forecasts

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.)	1.4	2.9	1.3	2.2	1.8	1.7	1.7	1.6	3.0	2.0	1.8
Consumer Spending	1.0	2.6	1.7	2.0	1.8	1.7	1.7	1.4	3.5	2.1	1.8
Business Investment (non-residential)	11.4	1.9	2.4	2.4	2.6	2.3	2.0	2.0	2.8	6.3	2.3
Consumer Price Index (y/y % chng)	2.1	2.3	2.7	2.5	2.2	2.4	2.2	2.1	1.6	2.4	2.2
Unemployment Rate (%)	5.8	5.9	5.9	5.8	5.7	5.7	5.6	5.6	6.3	5.9	5.6
Housing Starts (000s : a.r.)	225	219	209	208	208	207	204	200	220	215	205
Current Account Balance ($blns : a.r.)	-69.9	-63.5	-65.8	-64.8	-64.2	-64.4	-64.7	-64.7	-63.3	-66.0	-64.5
Interest Rates (average for the quarter : %)											
Overnight Rate	1.25	1.25	1.50	1.75	1.75	2.00	2.25	2.25	0.71	1.44	2.06
3-month Treasury Bill	1.14	1.21	1.50	1.70	1.75	1.95	2.15	2.15	0.69	1.40	2.00
10-year Bond	2.24	2.28	2.30	2.50	2.60	2.70	2.75	2.80	1.78	2.30	2.70
Canada/U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	-44	-67	-59	-57	-71	-68	-59	-59	-26	-57	-64
10-year	-52	-64	-62	-56	-53	-49	-46	-43	-55	-59	-48
UNITED STATES											
Real GDP (q/q % chng : a.r.)	2.2	4.2	2.8	2.9	2.6	2.2	2.0	1.8	2.2	2.8	2.5
Consumer Spending	0.5	3.8	2.6	2.2	2.2	2.1	1.9	1.8	2.5	2.5	2.2
Business Investment (non-residential)	11.5	8.5	3.2	2.4	2.2	2.1	2.1	2.0	5.3	6.8	2.7
Consumer Price Index (y/y % chng)	2.3	2.6	2.6	2.4	2.2	2.2	2.2	2.1	2.1	2.5	2.2
Unemployment Rate (%)	4.1	3.9	3.8	3.7	3.7	3.6	3.6	3.5	4.4	3.9	3.6
Housing Starts (mlns : a.r.)	1.32	1.25	1.22	1.30	1.31	1.32	1.33	1.33	1.21	1.27	1.32
Current Account Balance ($blns : a.r.)	-496	-391	-468	-483	-496	-509	-521	-533	-449	-460	-515
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	1.87	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	2.90	3.05	3.15	3.20	3.20	3.25	2.33	2.90	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	1.305	1.282	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$/Euro	1.23	1.19	1.16	1.17	1.18	1.20	1.22	1.24	1.13	1.19	1.21
US$/£	1.39	1.36	1.30	1.28	1.26	1.30	1.34	1.39	1.29	1.33	1.32

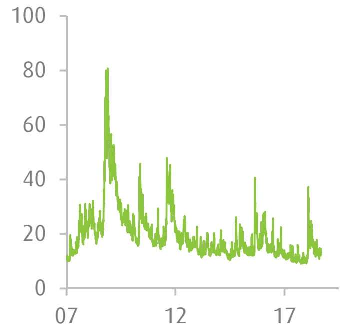
Note: Shaded areas represent BMO Capital Markets forecasts

VOLATILITY LOW
United States (as of September 6, 2018)

Ted Spread[1]



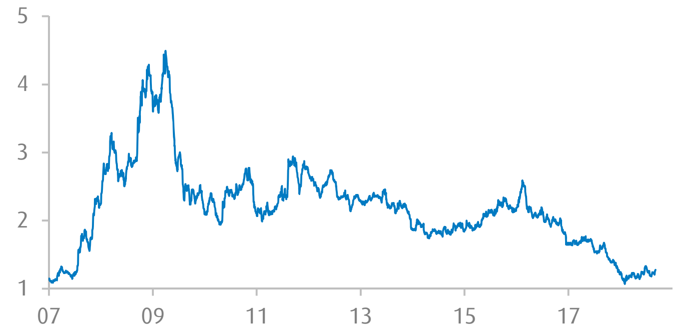
VIX[2]



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

CREDIT SPREADS STILL NARROW
United States (ppts)

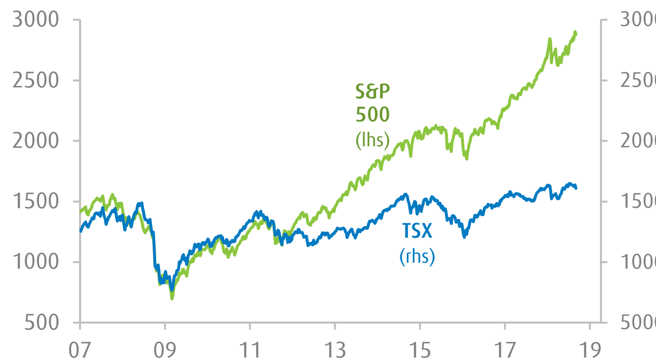
Corporate Bond Spreads[1]



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

EQUITIES AT NEW HIGHS
(indices : as of September 6, 2018)

Equities



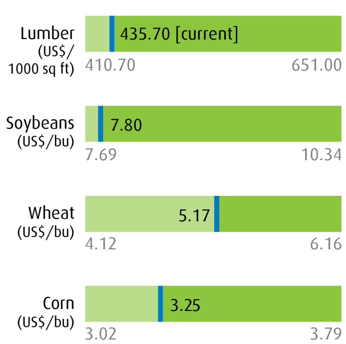
LOONIE LANGUISHES
(US¢ : as of September 6, 2018)

Canadian Dollar

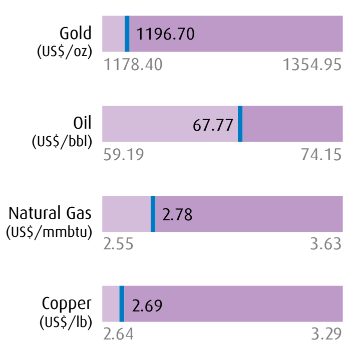
Awaiting NAFTA deal

GOLD AND COPPER PRICES RETREAT
Commodity price range since start of 2018

Materials & Foodstuffs
(as of September 6, 2018)



Metals & Energy
(as of September 6, 2018)

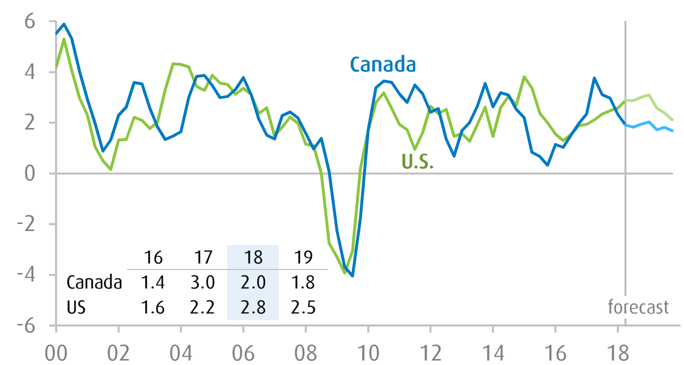


OIL PRICE RALLY LOSES STEAM
(US$/bbl : as of September 6, 2018)

WTI Crude Oil

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

Real GDP

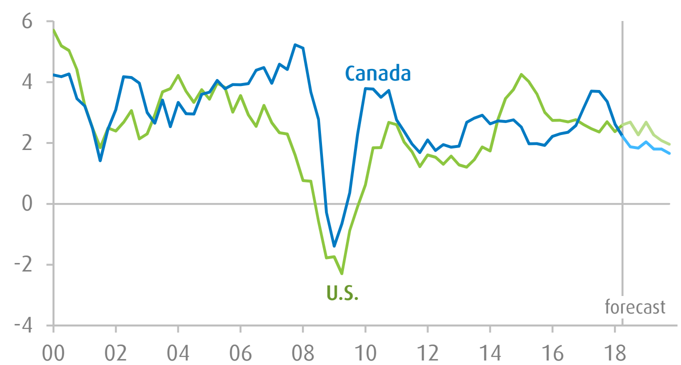


	16	17	18	19
Canada	1.4	3.0	2.0	1.8
US	1.6	2.2	2.8	2.5

Canadian growth moderates

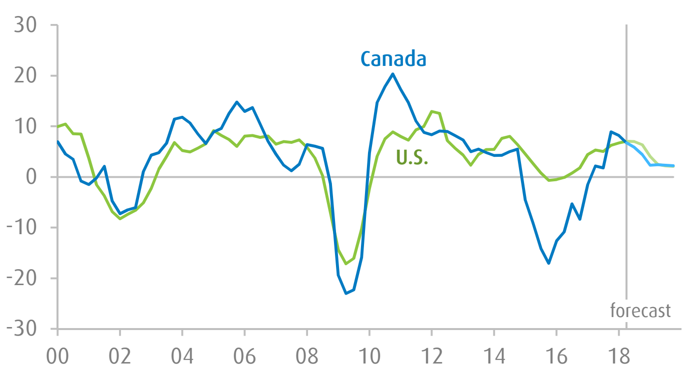
CANADIAN CONSUMERS GEAR DOWN
(y/y % change)

Real Personal Consumption Expenditures



BUSINESS INVESTMENT STURDY
(y/y % change)

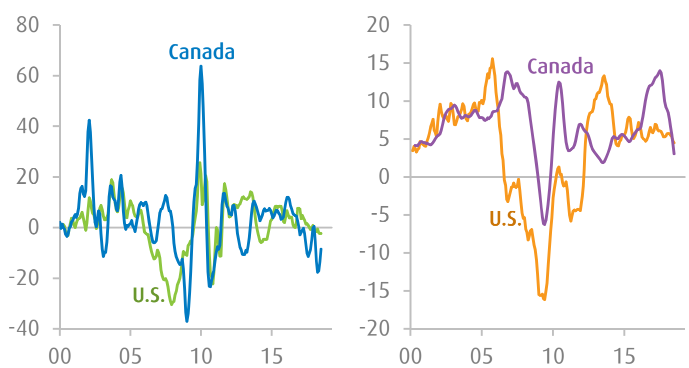
Real Non-Residential Business Investment



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

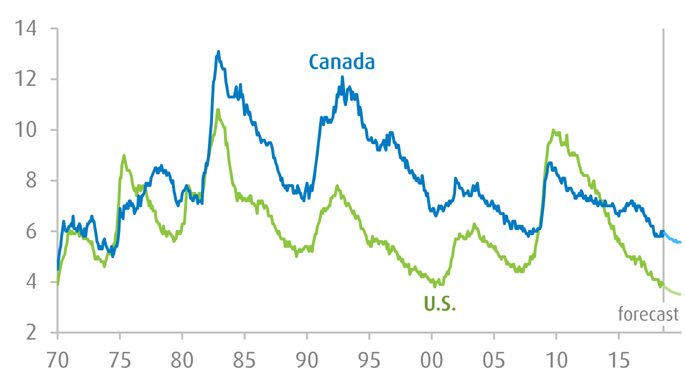
Sales

Prices



FULLY EMPLOYED
(percent)

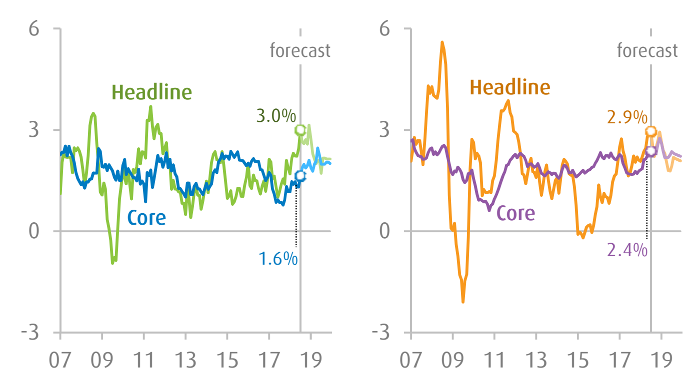
Unemployment Rate



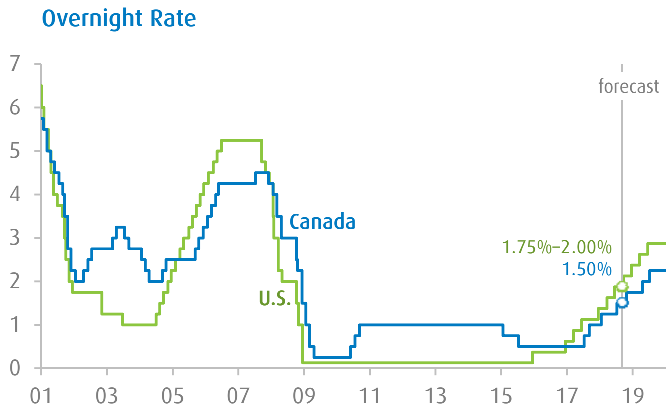
INFLATION FIRMS
Consumer Price Index (y/y % change)

Canada

United States



MONETARY POLICY TIGHTENS
(% : as of September 6, 2018)



BUT LONG-TERM RATES STEADIER
(% : as of September 6, 2018)