

Dodging a Bullet

Canada

- The United States-Mexico-Canada Agreement (USMCA) **removes a dark cloud hanging over the heads of businesses**, especially after the President threatened “*ruination*” with a tariff on Canadian auto shipments. That could have sliced a percentage point from GDP growth and tipped Ontario close to recession. The new trade deal will support investment, on both sides of the border. At the cost of opening up more of its dairy industry to U.S. farmers, reducing its ability to sign free-trade deals with “non-market” economies (read China), and challenging its retailers by raising duty- and tax-free limits on U.S. online purchases, Canada retains the current system for settling trade disputes, the ability to bid on U.S. government contracts, and unfettered access to the U.S. automotive market without facing duties unless exports far surpass current levels. The country may even see a small shift in auto parts production from Mexico, as that low-cost nation will take the brunt of new content rules (75% North American input and at least 40% from plants paying a minimum of \$16 an hour). Businesses won’t have to worry about the deal possibly expiring for at least 16 years, as opposed to the U.S.’s initial demand of 5 years. For Canada, while the new trade deal pulls the scrimmage line back a few yards (alas, Canadians won’t be able to watch American Super Bowl ads), it avoids a major fumble in the end zone.
- Assuming the deal passes Congress, the **USMCA removes a key downside risk to our outlook**. Although nagging tariffs on Canadian steel and aluminum could slow GDP by up to 0.4% over a year, the economy’s pulse has actually quickened of late. The goods trade balance swung toward surplus in August for the first time since late 2016, and manufacturing is on a solid upward track. A decent increase in July GDP led us to **raise our Q3 growth call to 2.0% annualized**. Activity should speed up to 2.7% in Q4 as the Syncrude oil-sands facility returns to full operation and as legal cannabis sales enter the national statistics (lifting growth by up to 0.5%). Combined with the recently green-lighted LNG export terminal in British Columbia, **we have bumped up our growth estimates for 2018 and 2019 to 2.1%**. That’s good enough to trim the jobless rate from 5.9% currently to 5.6% by late next year.
- Although exports are finally punching above their weight, the **interest-sensitive areas of the economy are fading**. A 7.4% y/y slide in September auto sales was the most since the recession. Apart from a few regions, namely Ottawa, Montreal, Windsor and London,

ECONOMIC RESEARCH

1-800-613-0205 • economics.bmocapitalmarkets.com

Sal Guatieri, Senior Economist

416-359-5295

sal.guatieri@bmo.com

KEY MESSAGES

- The new North American trade deal should support Canadian business confidence and one more year of moderate growth
- The U.S. economy doesn’t need more help than it’s already getting from fiscal policy, and remains at risk of overheating
- We now see an extra rate hike from the Fed and Bank of Canada next year, though both should refrain from jamming on the brakes if inflation stays calm
- Relief from the trade pact was short-lived for the loonie, and it will have a hard time taking flight until competitiveness issues are resolved

home sales are well below last year's level amid higher mortgage rates and tougher stress tests. B.C.'s expansion of housing tax measures greased a 44% y/y plunge in Greater Vancouver sales in September and a further slide in detached home prices.

Saskatchewan, and to a lesser extent Alberta, also remains weak, despite rising oil prices. However, **sales in most other regions, including Greater Toronto, have steadied at near their past-decade mean, suggesting the worst is over.** The market should find a firmer footing in the year ahead, though rising interest rates should prevent prices from outpacing family income.

- The new trade deal **clears the road for the Bank of Canada to raise rates on October 24** for the fifth time since mid-2017. Furthering the cause is that the economy is at full employment, core inflation is slightly above target, and real policy rates are still negative. We now expect three rate increases in 2019, rather than two, taking the overnight rate from 1.5% currently to 2.5% by year-end 2019. This should support a further increase in 10-year Canada yields from the recent 4½-year high of 2.5% to 2.9%, implying more curve flattening.
- **Hopes of a sustained bounce in the Canadian dollar post-trade deal failed to pan out**, despite WTI oil prices hitting 4-year highs. The currency is hovering around the mid-point of its seven-month range from C\$1.25 to \$1.32, and near its purchasing power parity value of \$1.29 (says Statistics Canada). From a relative price standpoint, it's not overvalued. However, higher corporate tax rates and hydro costs than in the U.S., and limited pipeline capacity leading to a supply glut and a record discount on Canadian heavy crude, speak to a loss of competitiveness. So, while rising interest rates could support a move to \$1.25 by year-end 2019, the loonie's wings could stay clipped for some time.

United States

- By reducing uncertainty, the USMCA should support business investment, albeit at a slower pace than in the first half of the year when tax reforms took effect. Business confidence is at multi-decade highs, with the main concern not about insufficient demand but the inability to satisfy it. Coupled with a likely second straight quarter of consumer spending growth north of 3%, growth in business spending should more than offset a steadier housing market and higher trade deficit to lift **real GDP 3.0% annualized in Q3**, soft only by comparison with Q2's 4.2% sprint. (A surge in soybean exports ahead of China's retaliatory tariffs added over 0.5 percentage points to Q2 growth.) If anything, recent data suggest the **economy is gaining steam**, with the ISM non-manufacturing index at 21-year highs,

consumer confidence at 18-year peaks and the jobless rate at 48-year lows of 3.7%.

- While U.S. businesses are warning about the adverse effect of tariffs on material prices and supply chains, there is no clear sign (according to Fed Chair Powell) that the trade war is having a material effect on the economy. The dollar's appreciation against the renminbi is helping. This could change, however, as tariffs on about half of China's imports (and retaliatory actions) could clip U.S. GDP by up to 0.4% over a year. Still, that's a minor speedbump for an economy hitting its full stride. We **expect real GDP to expand 2.8% this year, before slipping to 2.5% next year** amid fading fiscal support, rising interest rates and the ongoing trade war. Late-cycle capacity constraints will also weigh.
- **Overheating risks will rise the longer the economy outruns potential** of 2% or less. More job positions are going begging and more employees are quitting for higher-paying work. Wages are rising only moderately, but the pace will quicken if the unemployment rate continues to fall. We see it dipping to 3.5% by year-end 2019, the second lowest since 1953, when wage costs flared.
- The Fed extended its quarterly rate-hiking pattern in September, achieving positive real policy rates for the first time since the financial crisis. It **is well on track to move again in December**, with Chair Powell confirming that further gradual increases are necessary to contain inflation, a view acknowledged by even a few of the more dovish policy makers. Most FOMC members **expect three more rate hikes in 2019, taking the fed funds rate above neutral (around 3%)**. We pulled forward an expected move and now see the funds rate rising from 2.13% to 3.13% by year-end 2019.
- While not a tantrum, bond holders are in a huff. Dashed hopes of a Fed pause, strong economic data, firmer inflation, record equity values (before the recent setback), spiraling federal debt and fading Fed reinvestments have **sent the 10-year Treasury rate spiking to 7-year highs** of 3.2%, up from 2.4% at the start of the year. Fittingly, a 10-basis point jump in yields on October 3rd was the largest since the day after Trump was elected President. It's not lost among investors that loose fiscal policy is one reason the economy could overheat. We have bumped up our year-end 2019 call to 3.35%.

Risks

- Although the USMCA clears a hurdle for the economy, there is still the risk of an **escalating global trade war** as China threatens to retaliate with full force and Europe and Japan are likely to move next into Trump's crosshairs.

- **U.S. inflation has risen to the top of our recession-triggers list** amid tight job markets and loose fiscal policies. The Fed already sees the need to push policy rates above neutral to prevent overheating, and rates will rise much faster if inflation does spark.
- Earlier turbulence in a few **emerging market economies** (Turkey, Argentina, Brazil and South Africa) has simmered down. Still, rising U.S. interest rates could pull more capital away from these regions, worsening their plight and sending ripples across their borders.
- With the **U.S. budget deficit** headed toward \$1 trillion or 4.7% of GDP in fiscal year 2019, the government will have limited fiscal capacity to cushion an economic downturn without risking a credit-rating downgrade.
- Despite some positive moves on the **Brexit** front (e.g., relating to the Irish border issue), the road toward an amicable agreement remains bumpy. All eyes are on the October 17 EU summit. Ratification of a deal by the U.K. and European parliaments before the March 29, 2019 deadline is far from certain. A “no-deal Brexit” remains a distinct possibility, risking slower growth in the U.K. and, to a lesser extent, the Euro Area.
- **Italy’s plan to increase spending and the budget deficit** raises concerns about its fiscal stability (with a debt burden already at 130% of GDP) and its future role inside the Euro Area.
- Although the risk of a material housing correction has been reduced by policy measures designed to curb earlier excesses in the **Vancouver and Toronto housing markets**, both will remain vulnerable to a sharp increase in interest rates or joblessness until valuations improve. This will require a sustained period in which the wide gulf between prices and incomes narrows.

Forecasts

CANADA	2018				2019				ANNUAL		
	I	II	III	IV	I	II	III	IV	2017	2018	2019
Real GDP (q/q % chng : a.r.)	1.4	2.9	2.0	2.7	2.0	1.8	1.8	1.7	3.0	2.1	2.1
Consumer Spending	1.0	2.6	1.7	2.9	2.1	1.7	1.7	1.3	3.5	2.2	2.1
Business Investment (non-residential)	11.4	1.9	2.4	2.4	3.4	3.3	3.2	3.2	2.8	6.3	2.9
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	196	210	208	207	204	200	220	212	205
Current Account Balance (\$blns : a.r.)	-69.9	-63.5	-53.4	-53.3	-53.7	-54.6	-55.6	-56.1	-63.3	-60.0	-55.0
Interest Rates (average for the quarter : %)											
Overnight Rate	1.25	1.25	1.50	1.75	2.00	2.25	2.50	2.50	0.71	1.44	2.31
3-month Treasury Bill	1.14	1.21	1.47	1.80	2.00	2.20	2.40	2.40	0.69	1.40	2.25
10-year Bond	2.24	2.28	2.28	2.45	2.55	2.65	2.80	2.90	1.78	2.30	2.70
Canada/U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	-44	-67	-61	-49	-49	-49	-41	-52	-26	-55	-48
10-year	-52	-64	-65	-62	-58	-53	-49	-45	-55	-61	-51
UNITED STATES											
Real GDP (q/q % chng : a.r.)	2.2	4.2	3.0	2.7	2.6	2.2	2.0	1.9	2.2	2.8	2.5
Consumer Spending	0.5	3.8	3.4	2.2	2.2	2.1	1.9	1.9	2.5	2.6	2.4
Business Investment (non-residential)	11.5	8.7	2.3	2.4	2.2	2.1	2.1	2.0	5.3	6.7	2.6
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	3.6	3.6	3.5	3.5	4.4	3.9	3.6
Housing Starts (mlns : a.r.)	1.32	1.26	1.24	1.30	1.31	1.32	1.33	1.33	1.21	1.28	1.32
Current Account Balance (\$blns : a.r.)	-487	-406	-512	-516	-528	-541	-550	-560	-449	-480	-545
Interest Rates (average for the quarter : %)											
Fed Funds Target Rate	1.46	1.71	1.96	2.21	2.46	2.71	2.88	2.96	1.00	1.83	2.75
3-month Treasury Bill	1.58	1.87	2.08	2.25	2.50	2.70	2.80	2.90	0.95	1.95	2.70
10-year Note	2.76	2.92	2.93	3.05	3.15	3.20	3.25	3.35	2.33	2.90	3.25
EXCHANGE RATES (average for the quarter)											
US\$/C\$	79.1	77.5	76.5	77.9	78.7	79.1	79.5	79.9	77.1	77.7	79.3
C\$/US\$	1.265	1.291	1.307	1.284	1.271	1.265	1.258	1.252	1.298	1.287	1.261
¥/US\$	108	109	112	112	112	111	111	110	112	110	111
US\$/Euro	1.23	1.19	1.16	1.18	1.17	1.19	1.22	1.24	1.13	1.19	1.20
US\$/£	1.39	1.36	1.30	1.28	1.23	1.27	1.33	1.38	1.29	1.33	1.31

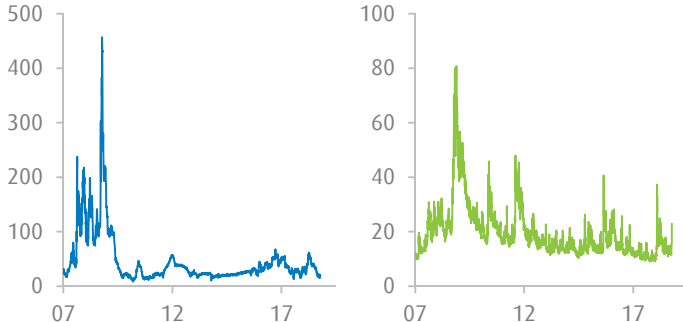
Note: Shaded areas represent BMO Capital Markets forecasts

VOLATILITY LOW

United States (as of October 10, 2018)

Ted Spread¹

VIX²

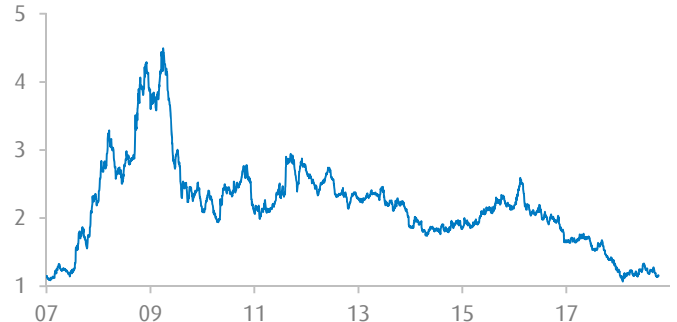


¹ 3-mnth Eurodollar minus 3-mnth T-bills (bps) ² CBOE market volatility index

CREDIT SPREADS THIN

United States (ppts)

Corporate Bond Spreads¹



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

U.S. EQUITIES HIT NEW HIGHS

(indices : as of October 10, 2018)

Equities



TSX lags

LOONIE LISTLESS

(US¢ : as of October 10, 2018)

Canadian Dollar



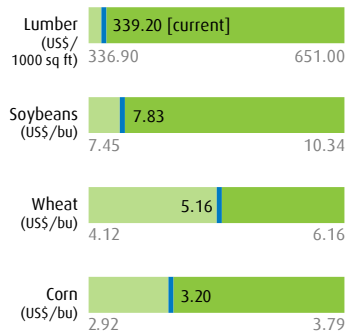
Despite trade deal and rising oil prices

LUMBER AND GOLD PRICES RETREAT

Commodity price range since start of 2018

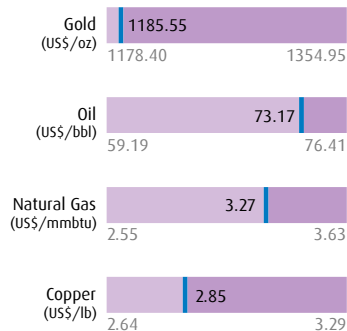
Materials & Foodstuffs

(as of October 10, 2018)



Metals & Energy

(as of October 10, 2018)



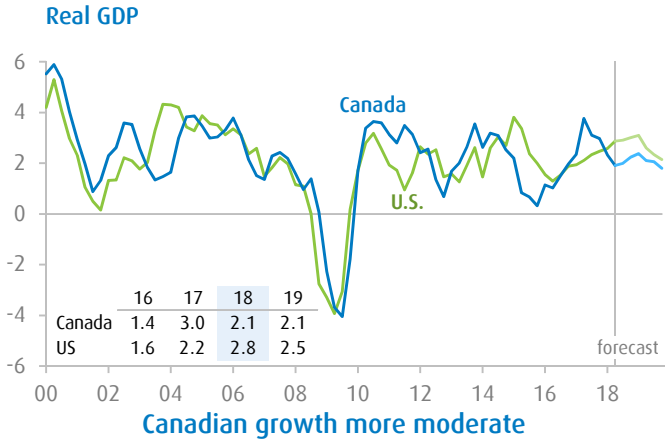
OIL PRICES AT 4-YEAR HIGH

(US\$/bbl : as of October 10, 2018)

WTI Crude Oil



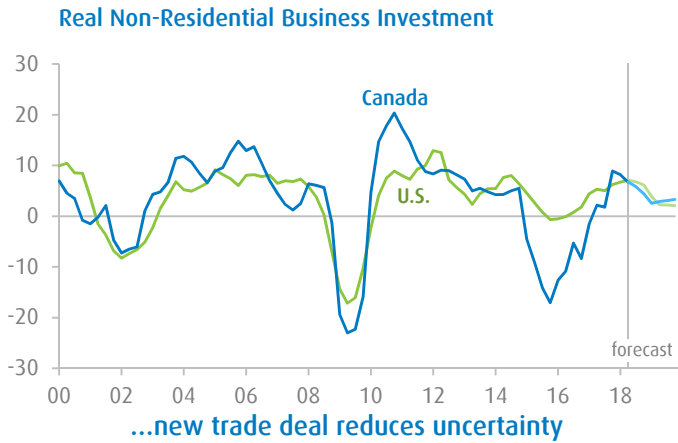
FISCAL JOLT FOR US ECONOMY (y/y % change)



CANADIAN CONSUMERS GEAR DOWN (y/y % change)

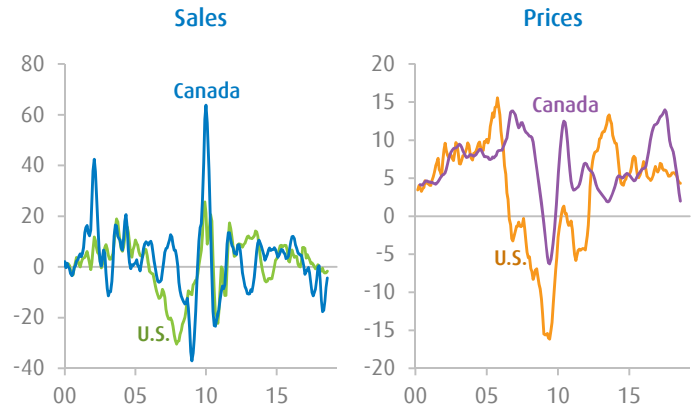


INVESTMENT STURDY (y/y % change)

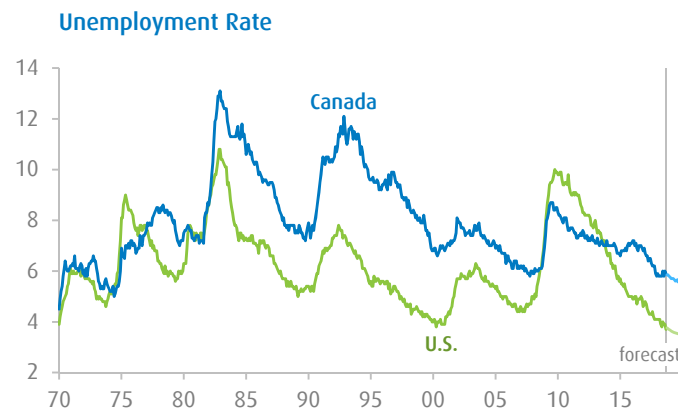


HOUSING WEAKENS

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

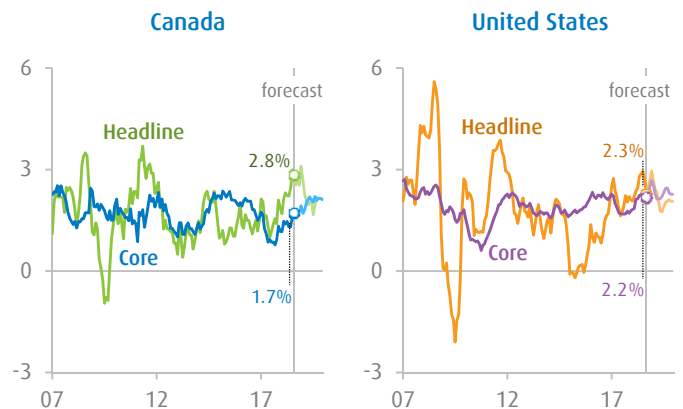


FULLY EMPLOYED (percent)



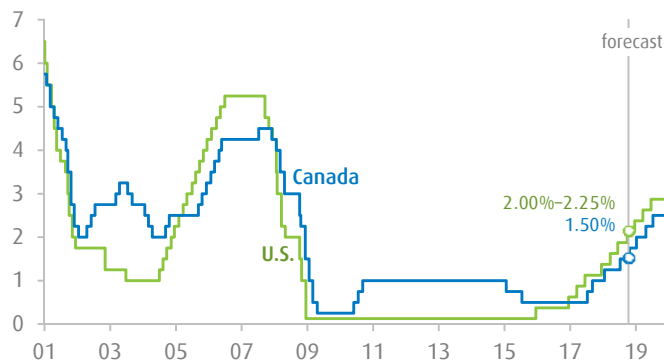
INFLATION FIRMS

Consumer Price Index (y/y % change)



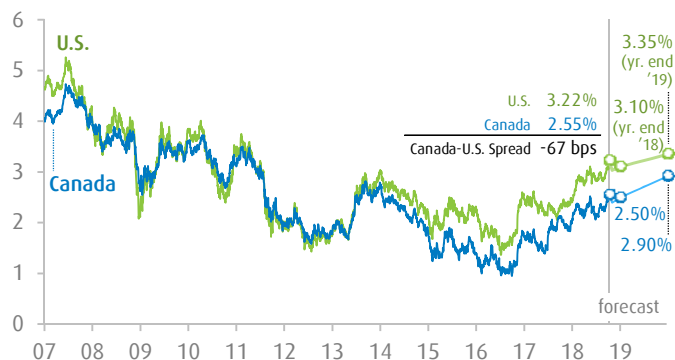
POLICY TIGHTENS (% : as of October 10, 2018)

Overnight Rate



RATES ON THE RISE (% : as of October 10, 2018)

10-Year Bonds



General Disclosure

"BMO Capital Markets" is a trade name used by the BMO Financial Group for the wholesale banking businesses of Bank of Montreal and its subsidiaries BMO Nesbitt Burns Inc., BMO Capital Markets Limited in the U.K. and BMO Capital Markets Corp. in the U.S. BMO Nesbitt Burns Inc., BMO Capital Markets Limited and BMO Capital Markets Corp are affiliates. This document is issued and distributed in Hong Kong by Bank of Montreal ("BMO"). BMO is an authorized institution under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) and a registered institution with the Securities and Futures Commission (CE No. AAK809) under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong). BMO does not represent that this document may be lawfully distributed, or that any financial products may be lawfully offered or dealt with, in compliance with any regulatory requirements in other jurisdictions, or pursuant to an exemption available thereunder. This document is directed only at entities or persons in jurisdictions or countries where access to and use of the information is not contrary to local laws or regulations. Their contents have not been reviewed by any regulatory authority. Bank of Montreal or its subsidiaries ("BMO Financial Group") has lending arrangements with, or provide other remunerated services to, many issuers covered by BMO Capital Markets. The opinions, estimates and projections contained in this report are those of BMO Capital Markets as of the date of this report and are subject to change without notice. BMO Capital Markets endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Capital Markets makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Capital Markets or its affiliates that is not reflected in this report. The information in this report is not intended to be used as the primary basis of investment decisions, and because of individual client objectives, should not be construed as advice designed to meet the particular investment needs of any investor. This document is not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such information be considered as investment advice or as a recommendation to enter into any transaction. Each investor should consider obtaining independent advice before making any financial decisions. This document is provided for general information only and does not take into account any investor's particular needs, financial status or investment objectives. BMO Capital Markets or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Capital Markets or its affiliates, officers, directors or employees have a long or short position in many of the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should assume that BMO Capital Markets or its affiliates may have a conflict of interest and should not rely solely on this report in evaluating whether or not to buy or sell securities of issuers discussed herein.

Dissemination of Research

Our publications are disseminated via email and may also be available via our web site <http://economics.bmocapitalmarkets.com>. Please contact your BMO Financial Group Representative for more information.

Conflict Statement

A general description of how BMO Financial Group identifies and manages conflicts of interest is contained in our public facing policy for managing conflicts of interest in connection with investment research which is available at http://researchglobal.bmocapitalmarkets.com/Public/Conflict_Statement_Public.aspx.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

BMO Financial Group (NYSE, TSX: BMO) is an integrated financial services provider offering a range of retail banking, wealth management, and investment and corporate banking products. BMO serves Canadian retail clients through BMO Bank of Montreal and BMO Nesbitt Burns. In the United States, personal and commercial banking clients are served by BMO Harris Bank N.A., Member FDIC. Investment and corporate banking services are provided in Canada and the US through BMO Capital Markets. BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A., BMO Ireland Plc, and Bank of Montreal (China) Co. Ltd. and the institutional broker dealer businesses of BMO Capital Markets Corp. (Member SIPC), BMO Nesbitt Burns Securities Limited (Member SIPC) in the U.S., BMO Nesbitt Burns Inc. (Member Canadian Investor Protection Fund) in Canada, Europe and Asia, BMO Capital Markets Limited in Europe, Asia and Australia and BMO Advisors Private Limited in India.

"Nesbitt Burns" is a registered trademark of BMO Nesbitt Burns Inc., used under license. "BMO Capital Markets" is a trademark of Bank of Montreal, used under license. "BMO (M-Bar roundel symbol)" is a registered trademark of Bank of Montreal, used under license.

® Registered trademark of Bank of Montreal in the United States, Canada and elsewhere.

™ Trademark Bank of Montreal in the United States and Canada.

© COPYRIGHT 2018 BMO CAPITAL MARKETS CORP.

A member of BMO Financial Group