North American Outlook

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A look ahead at the Canadian and American economies

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Dodging a Bullet

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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 perk up to 2.5% 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 0.4%). 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,

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 back on 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 from 3.9% in 2018, the government will have limited fiscal capacity to cushion an economic downturn without risking a credit-rating downgrade.
- Recent disappointment on the **Brexit** front (e.g., largely related to the Irish border issue) confirms that the road toward an amicable agreement will be bumpy. The October 17 summit came and went with no discernable progress toward ratifying a deal before the March 29, 2019 deadline. 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.

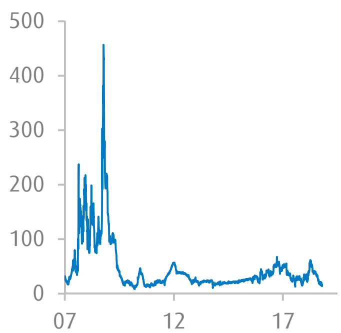
Forecasts

CANADA	2018 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	2.0	2.5	2.0	1.8	1.8	1.7	3.0	2.1	2.1
Consumer Spending	1.0	2.6	1.8	2.3	2.1	1.7	1.7	1.3	3.5	2.2	1.9
Business Investment (non-residential)	11.4	1.9	2.4	4.0	3.4	3.3	3.2	3.2	2.8	6.4	3.2
Consumer Price Index (y/y % chng)	2.1	2.3	2.7	2.0	1.8	2.0	1.8	2.2	1.6	2.2	2.0
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	198	202	208	207	204	200	220	211	205
Current Account Balance ($blns : a.r.)	-69.9	-63.5	-53.4	-53.2	-53.6	-54.6	-55.6	-56.1	-63.3	-60.0	-55.0
Interest Rates (average for the quarter : %)											
Overnight Rate	1.25	1.25	1.50	1.75	2.00	2.25	2.50	2.50	0.71	1.44	2.31
3-month Treasury Bill	1.14	1.21	1.47	1.80	2.00	2.20	2.40	2.40	0.69	1.40	2.25
10-year Bond	2.24	2.28	2.28	2.45	2.55	2.65	2.80	2.90	1.78	2.30	2.70
Canada/U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	-44	-67	-61	-49	-49	-49	-41	-52	-26	-55	-48
10-year	-52	-64	-65	-62	-58	-53	-49	-45	-55	-61	-51
UNITED STATES											
Real GDP (q/q % chng : a.r.)	2.2	4.2	3.0	2.7	2.6	2.2	2.0	1.9	2.2	2.8	2.5
Consumer Spending	0.5	3.8	3.4	2.2	2.2	2.1	1.9	1.9	2.5	2.6	2.4
Business Investment (non-residential)	11.5	8.7	1.6	2.4	2.2	2.1	2.1	2.0	5.3	6.6	2.5
Consumer Price Index (y/y % chng)	2.3	2.6	2.6	2.3	2.1	2.2	2.1	2.1	2.1	2.5	2.1
Unemployment Rate (%)	4.1	3.9	3.8	3.7	3.6	3.6	3.5	3.5	4.4	3.9	3.6
Housing Starts (mlns : a.r.)	1.32	1.26	1.22	1.24	1.30	1.31	1.31	1.32	1.21	1.26	1.31
Current Account Balance ($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$/Euro	1.23	1.19	1.16	1.17	1.17	1.19	1.22	1.24	1.13	1.19	1.20
US$/£	1.39	1.36	1.30	1.28	1.23	1.27	1.33	1.38	1.29	1.33	1.31

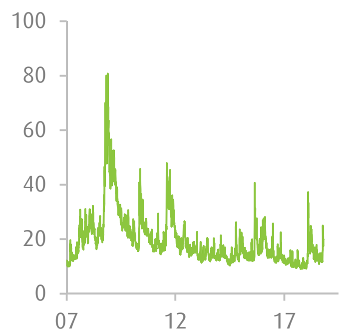
Note: Shaded areas represent BMO Capital Markets forecasts

VOLATILITY INCREASES
United States (as of October 19, 2018)

Ted Spread[1]



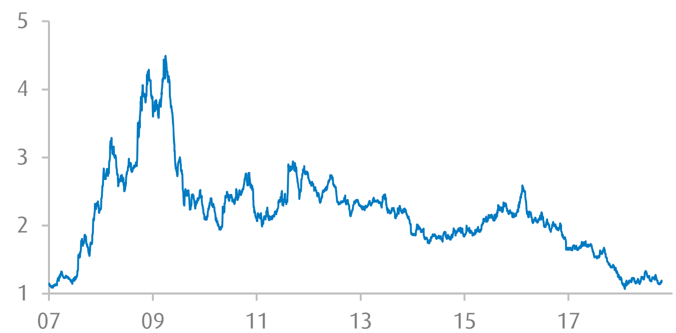
VIX[2]



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

BUT CREDIT SPREADS STILL THIN
United States (ppts)

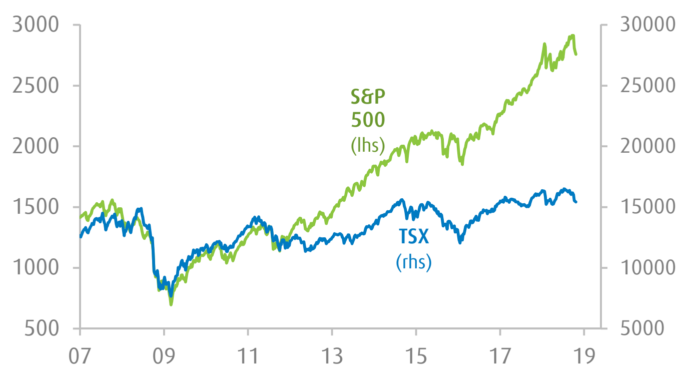
Corporate Bond Spreads[1]



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

EQUITIES HIT TURBULENCE
(indices : as of October 22, 2018)

Equities

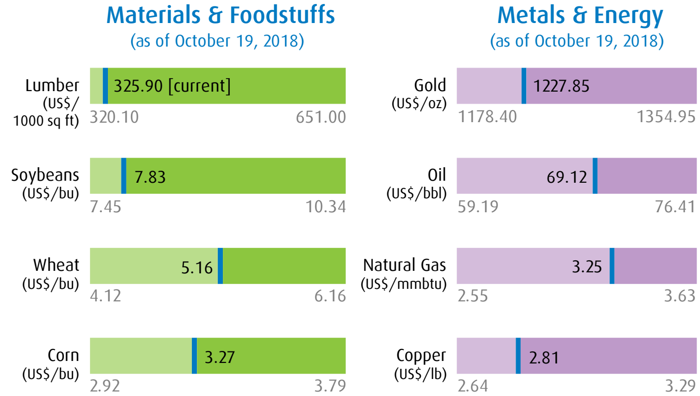


LOONIE LISTLESS
(US¢ : as of October 22, 2018)

Canadian Dollar

Despite trade deal

LUMBER PRICES RETREAT
Commodity price range since start of 2018



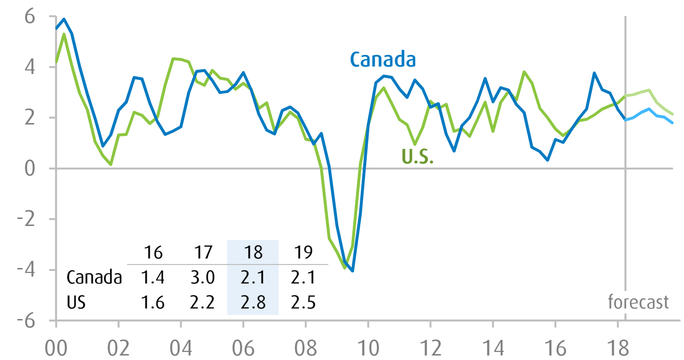
WORLD OIL PRICES AT 4-YEAR HIGH
(US$/bbl : as of October 22, 2018)

WTI Crude Oil

...but not in Canada

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

Real GDP

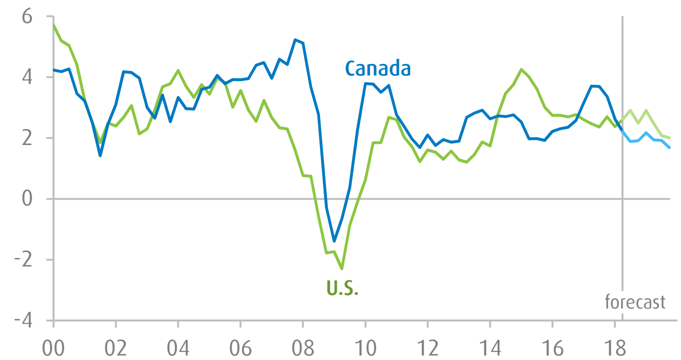


	16	17	18	19
Canada	1.4	3.0	2.1	2.1
US	1.6	2.2	2.8	2.5

Canadian growth more moderate

CANADIAN CONSUMERS GEAR DOWN
(y/y % change)

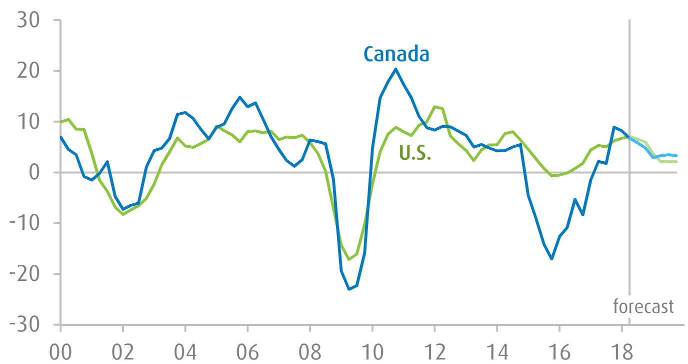
Real Personal Consumption Expenditures



US shoppers on a tear

INVESTMENT STURDY
(y/y % change)

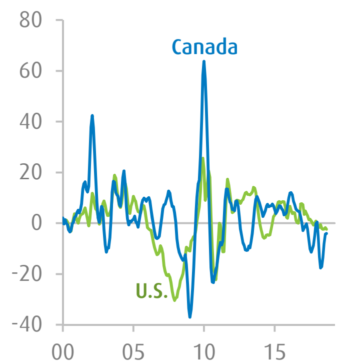
Real Non-Residential Business Investment



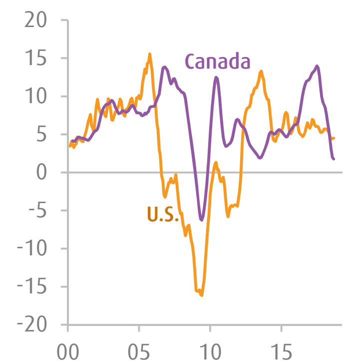
...new trade deal reduces uncertainty

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

Sales

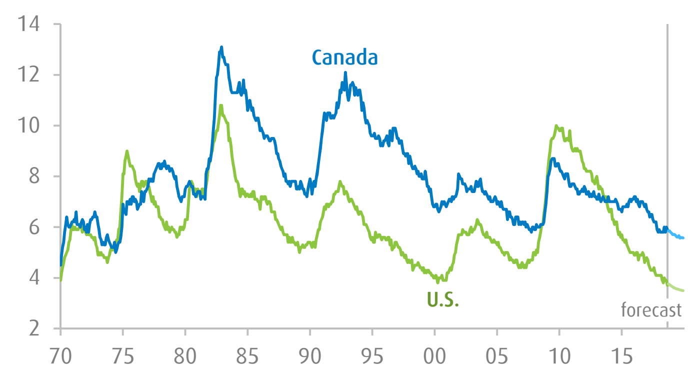


Prices



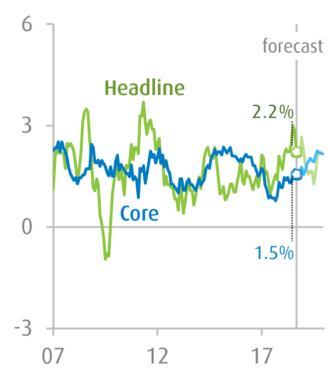
FULLY EMPLOYED
(percent)

Unemployment Rate

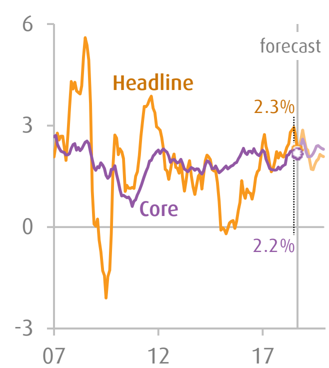


INFLATION FIRMS
Consumer Price Index (y/y % change)

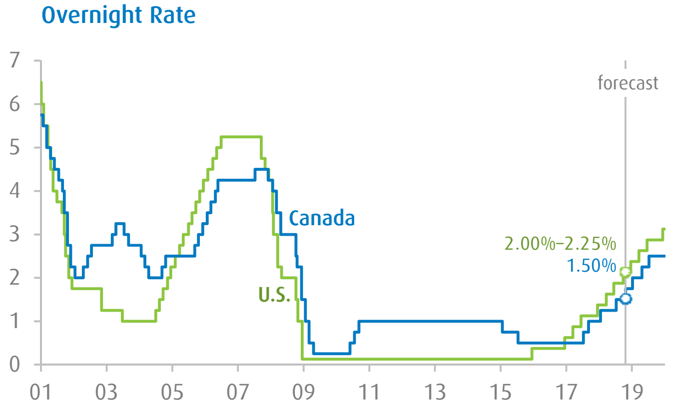
Canada



United States



POLICY TIGHTENS
(% : as of October 22, 2018)



RATES ON THE RISE
(% : as of October 22, 2018)