North American Outlook

BMO Capital Markets
We're here to help.™

A look ahead at the Canadian and American economies

November 26, 2018

Dodging a Bullet

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 another year of moderate growth, though sliding oil prices are a new risk
- The U.S. economy will moderate next year on fading fiscal stimulus and rising interest rates, while increased political uncertainty imparts a downside risk
- Despite a few clouds on the horizon, the Fed and Bank of Canada should continue to gradually return policy rates to neutral levels
- Relief from the USMCA was short-lived for the loonie, which is unlikely to get off the ground unless competitiveness issues are resolved and oil prices firm

Canada

- The United States-Mexico-Canada Agreement (USMCA) **removed a dark cloud over Canada**, especially after the President threatened "*ruination*" with a tariff on auto shipments, which could have sliced a percentage point from GDP growth and tipped Ontario into recession. The new trade deal will support investment on both sides of the border. At the cost of opening 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-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 import content rules (75% North American made and at least 40% made from plants paying an average $16 an hour, more than double Mexico's current rate for assembly workers).
- Assuming a new U.S. Congress ratifies the trade deal, the **USMCA removes a key downside risk to the economic outlook**. Although nagging tariffs on Canadian steel and aluminum could slow GDP by 0.3% over a year, the economy's pulse has actually quickened of late. The goods trade deficit has shrank materially after reaching the second-largest on record in March, and manufacturing is on a solid uphill climb. We estimate **2.0% annualized real GDP growth in Q3**, with the pace firming to **2.1% in Q4** as the Syncrude oil-sands facility returns to full production and as legal cannabis sales filter into the national statistics (lifting growth by up to 0.4%). Supported by construction of the LNG export terminal in British Columbia, **the expansion should continue at 2.0% in 2019**, trimming the jobless rate from 5.8% currently to 5.6% by late next year.
- However, just when the trade fog was beginning to clear, **the recent bear market in oil adds an unwelcome risk to the outlook**. The U.S. price of light crude (WTI) has plunged over 30% in recent weeks, reflecting record production in the U.S. (11.6 million barrels per day and doubling in seven years) and near-record output in Russia and Saudi Arabia. The slide in global oil prices is on top of a massive discount on Canadian heavy crude (Western Canada Select), which is more than double the past-decade norm. The fire-sale price ($16) stems from the growing difficulty of getting record oil production (over 5 million bpd, fourth highest in the world) out of the country due to a paucity of pipelines. A U.S. federal judge's order will further delay construction of the Keystone XL pipeline, which will carry up

to 0.8 million bpd of Alberta's crude to Nebraska and then the Gulf Coast refineries. While we expect WTI prices to recover a small portion of recent losses, any downside surprise would further **delay the economic recovery in the oil-producing provinces**. After bouncing out of recession to lead the country with 4.4% growth last year, **Alberta** will be lucky to expand half as fast this year and will downshift further in 2019.

- The latest oil-price shock arrives just when **interest-sensitive areas of the economy are starting to fade**. A 7% y/y slide in September auto sales was the most this cycle. Apart from a few regions, such as Ottawa, Montreal and London, home sales are well below last year's level amid higher mortgage rates and tougher stress tests. The B.C. government's expansion of housing-tax measures greased a hefty slide in Greater Vancouver sales and a further dip in detached home prices. Saskatchewan and Alberta also remain weak amid an ample supply of listings. However, **sales in most other regions, including Greater Toronto, are closer to their past-decade norm**. The market should find a firmer footing in the year ahead, though higher interest rates will prevent prices from outrunning income.
- The trade deal **paved the way for the Bank of Canada to lift rates on October 24** for the fifth time in 15 months. The Bank strongly signalled a desire to return policy rates to neutral, which, by its own calculation, implies at least 75 basis points of further tightening. The economy is at full employment, growth is near potential and core inflation is on target, but real policy rates are still negative. We **expect three rate increases next year**, taking the overnight rate from 1.75% currently to 2.5% by next summer, and a final move in 2020. This should support a further increase in 10-year Canada yields from the recent 4½-year high of 2.5% to 2.8% in late-2019, leading to more curve flattening.
- **Hopes of a sustained bounce in the Canadian dollar after the new trade deal fizzled quickly as oil prices headed due south**. Versus the strong greenback, the currency is hovering near the top of its eight-month range of C$1.25 to $1.32, and above its purchasing power parity value of $1.29 (according to Statistics Canada). While higher interest rates could support a modest move to $1.28 by year-end 2019, the loonie's wings will stay clipped until the country addresses its competitiveness issues, notably on pipeline capacity. The Federal Government's recent move to improve depreciation allowances is a step in the right direction.

United States

- The midterm elections produced the expected outcome—a divided Congress with Democrats controlling the House. While the **elections have not changed our economic outlook**, they do impart some downside risk. The fiscal policy mix could simply shift from potential further tax cuts to increased infrastructure spending, though the massive deficit will constrain the fiscal purse strings. More certain is an **increase in political instability**, as House oversight committees will more ardently push to investigate the Administration. Protracted fights over funding the government and raising the debt ceiling are likely to come to the fore, undercutting business confidence.

- The **USMCA, however, will support business investment**. Confidence is at multi-decade highs, with the main concern not about demand but how to satisfy it. While capex slowed to a crawl in Q3, this followed 10% annualized growth in the first half of the year in response to tax reform and deregulation.
- Coupled with 4% consumer spending growth and a pickup in government spending, **real GDP rose 3.5% in Q3 after sprinting 4.2% in Q2**. The modest downshift stemmed from a third straight decline in residential construction due to fading affordability and a record real trade deficit due to the strong dollar.
- Although business leaders claim tariffs are raising material prices and disrupting supply chains, there is no clear sign yet that the trade war is having a material impact on the economy. The dollar's appreciation against the renminbi has blunted the loss of purchasing power from import tariffs, though it has compounded the problems exporters are facing with retaliatory tariffs. Still, **the tariffs on about half of China's imports and counter measures by China could clip U.S. GDP by up to 0.4% over a year**.
- Economic **growth is expected to moderate from an estimated 2.9% this year to 2.5% in 2019** amid fading fiscal support, rising interest rates and the ongoing trade war. Late-cycle capacity constraints are also an issue. Consumers will continue to provide most of the thrust, benefitting from 18-year high confidence and a near half-century low jobless rate of 3.7%.
- The **economy is expected to downshift further to 1.7% in 2020**, and this assumes Congress maintains discretionary spending caps at the higher levels mandated in the 2018 Bipartisan Budget Act. If it allows the caps to decline, the economy could slow a further 0.5% in response to this mini-fiscal cliff.
- Some slowing in growth is welcome, as the **economy risks overheating**. More job positions are going begging and more employees are quitting for higher-paying work. While wages are still rising only moderately, the pace will quicken if the unemployment rate falls further. We see it dipping to 3.5% by year-end 2019, the second lowest level since 1953, when wage costs flared.
- The Fed extended its quarterly rate-hiking cadence in September, achieving positive real policy rates for the first time since the financial crisis. It looks set to **move again in December**, with Chair Powell

confirming that further gradual increases are needed to contain inflation. Most FOMC members **expect three more rate hikes in 2019**, taking the fed funds rate above neutral (around 3%). We see the funds rate rising from 2.13% to 3.13% by year-end 2019, with one final move in 2020.

- After touching seven-year highs on tighter Fed policies, solid data and spiraling federal debt, **the 10-year Treasury rate has slipped below 3.1%** on equity market jitters and sliding oil prices. We see it drifting modestly higher to 3.35% in late 2019 and to 3.60% at year-end 2020 as the Fed continues to tighten.

Risks

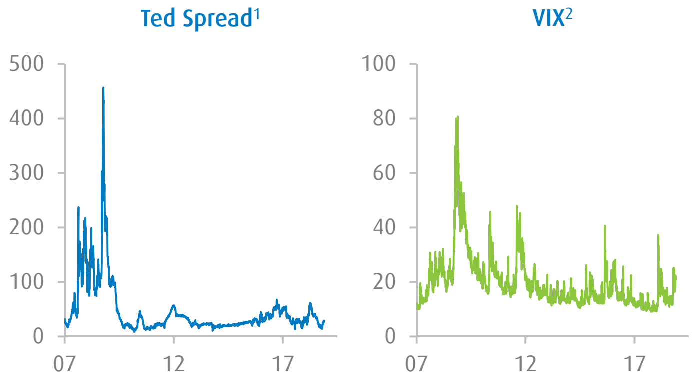
- Although the USMCA clears a big hurdle for the economy (assuming it's ratified), there is still the risk of an **escalating global trade war** as China threatens to retaliate with full force and Europe and Japan are likely to move next into Trump's crosshairs.
- **U.S. inflation could mount** in the face of tight job markets if the economy remains strong. The Fed already sees the need to push policy rates above neutral to keep the economy from 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 out of 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 under 4% in 2018, the government will have limited capacity to cushion an economic downturn without risking a credit-rating downgrade.
- A **Brexit** agreement between Prime Minister May and the EU is a positive step forward, though getting parliamentary approval before the March 2019 deadline will be a big challenge. A "no-deal Brexit" remains a distinct possibility, risking much weaker 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	2.1	2.0	1.8	1.8	1.7	3.0	2.1	2.0
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	3.5	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	1.6	1.8	1.7	2.1	1.6	2.2	1.8
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	197	201	208	207	204	200	220	210	205
Current Account Balance ($blns : a.r.)	-69.9	-63.5	-45.1	-49.4	-50.1	-51.1	-52.2	-52.7	-63.3	-57.0	-51.5
Interest Rates (average for the quarter : %)											
Overnight Rate	1.25	1.25	1.50	1.75	2.00	2.25	2.50	2.50	0.71	1.44	2.31
3-month Treasury Bill	1.14	1.21	1.47	1.65	1.90	2.15	2.35	2.35	0.69	1.35	2.20
10-year Bond	2.24	2.28	2.28	2.45	2.50	2.60	2.70	2.80	1.78	2.30	2.65
Canada/U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	-44	-67	-61	-66	-57	-54	-44	-55	-26	-60	-52
10-year	-52	-64	-65	-65	-62	-59	-56	-53	-55	-62	-58
UNITED STATES											
Real GDP (q/q % chng : a.r.)	2.2	4.2	3.5	2.6	2.4	2.2	2.0	1.9	2.2	2.9	2.5
Consumer Spending	0.5	3.8	4.0	2.7	2.2	2.1	1.9	1.9	2.5	2.7	2.5
Business Investment (non-residential)	11.5	8.7	0.8	3.7	2.2	2.1	2.1	2.0	5.3	6.6	2.7
Consumer Price Index (y/y % chng)	2.3	2.6	2.6	2.2	1.9	2.1	2.1	2.1	2.1	2.4	2.1
Unemployment Rate (%)	4.1	3.9	3.8	3.7	3.6	3.6	3.5	3.5	4.4	3.9	3.5
Housing Starts (mlns : a.r.)	1.32	1.26	1.22	1.24	1.27	1.28	1.28	1.29	1.21	1.26	1.28
Current Account Balance ($blns : a.r.)	-487	-406	-525	-503	-516	-528	-540	-554	-449	-480	-535
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	2.35	2.50	2.70	2.80	2.90	0.95	1.95	2.70
10-year Note	2.76	2.92	2.93	3.15	3.15	3.20	3.25	3.35	2.33	2.95	3.25
EXCHANGE RATES (average for the quarter)											
US¢/C$	79.1	77.5	76.5	76.3	76.1	76.7	77.3	77.9	77.1	77.3	77.0
C$/US$	1.265	1.291	1.307	1.310	1.313	1.303	1.293	1.283	1.298	1.293	1.298
¥/US$	108	109	112	113	113	112	111	110	112	110	111
US$/Euro	1.23	1.19	1.16	1.14	1.13	1.11	1.15	1.20	1.13	1.18	1.15
US$/£	1.39	1.36	1.30	1.28	1.24	1.28	1.33	1.38	1.29	1.33	1.31

Note: Shaded areas represent BMO Capital Markets forecasts

VOLATILITY INCREASES
United States (as of November 23, 2018)



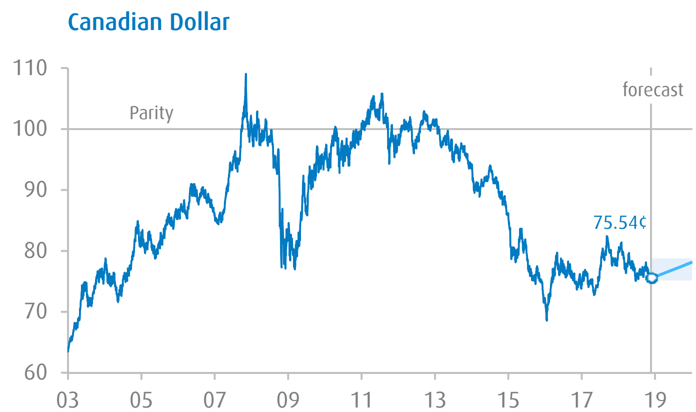
[1] 3-mnth Eurodollar minus 3-mnth T-bills (bps) [2] CBOE market volatility index

BUT CREDIT SPREADS STILL THIN
United States (ppts)

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

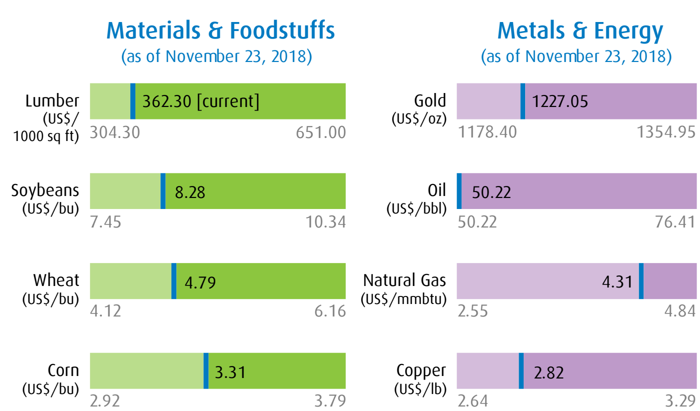
EQUITIES HIT TURBULENCE
(indices : as of November 23, 2018)

LOONIE LISTLESS
(US¢ : as of November 23, 2018)



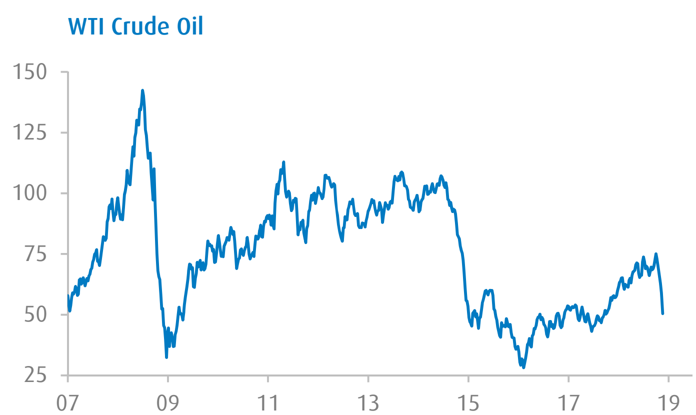
Despite trade deal

OIL AND LUMBER PRICES RETREAT
Commodity price range since start of 2018



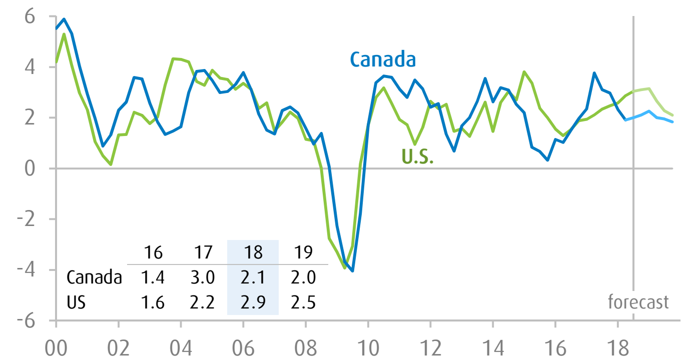
...natural gas sparks

OIL IN BEAR MARKET
(US$/bbl : as of November 23, 2018)



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

Real GDP

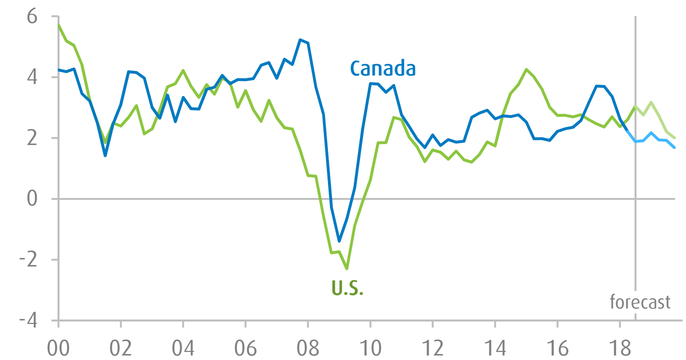


	16	17	18	19
Canada	1.4	3.0	2.1	2.0
US	1.6	2.2	2.9	2.5

Canadian growth more moderate

CANADIAN CONSUMERS GEAR DOWN
(y/y % change)

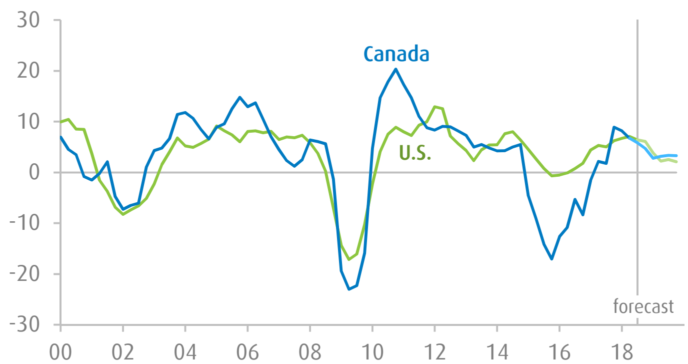
Real Personal Consumption Expenditures



US shoppers on a tear

INVESTMENT REMAINS POSITIVE
(y/y % change)

Real Non-Residential Business Investment

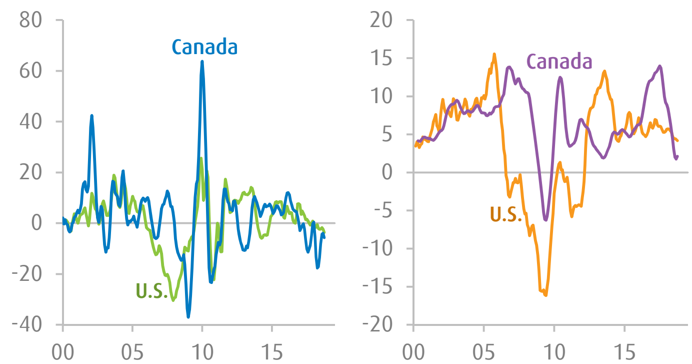


...new trade deal reduces uncertainty

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

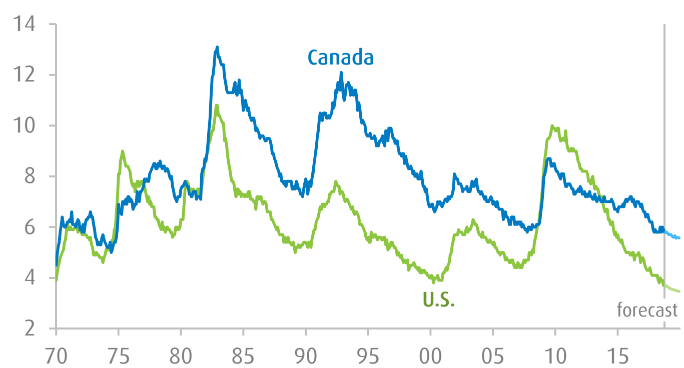
Sales

Prices



FULLY EMPLOYED
(percent)

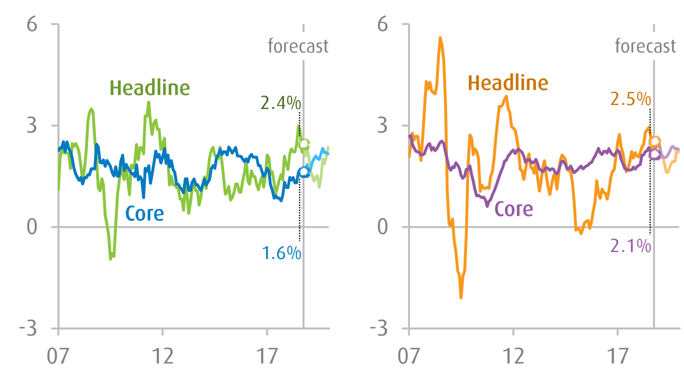
Unemployment Rate



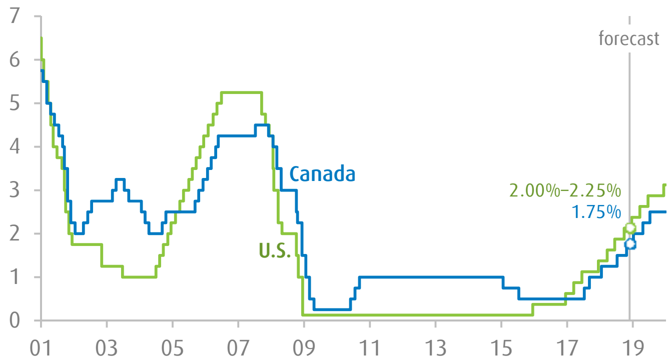
INFLATION STEADY
Consumer Price Index (y/y % change)

Canada

United States



POLICY TIGHTENS
(% : as of November 23, 2018)



RATES RISING SLOWLY
(% : as of November 23, 2018)