North American Outlook

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A look ahead at the Canadian and American economies

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The Big Fade

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Canada

- The **Canadian economy performed largely as expected in 2018** with estimated annual growth of around 2.1% falling just shy of our call at the start of the year. This would mark a sharp slowdown from the prior year's 3.0% pace as three driving forces—the oil price recovery, supportive financial conditions and enhanced child benefit payments—all faded. Rising interest rates corralled household credit to the slowest pace since 1983, slicing the rate of consumer spending almost in half to around 2%. New auto sales reversed 8% in 2018 from record highs. After bolting out of the gate, business investment slowed, initially due to mounting uncertainty about NAFTA and then to rising concern about a global trade war. Tougher mortgage rules also took the wind out of the previous high-flying Vancouver and Toronto housing markets. On the plus side, exports benefitted from stronger U.S. demand and a weaker currency, while the federal government kept the spending taps open, despite a sizeable budget deficit. Moreover, the recent Business Outlook Survey showed surprisingly positive sentiment and intentions to increase spending and hiring.

- **Growth is expected to ebb further to 1.8% in 2019** owing to depressed oil prices, Alberta's mandatory crude output cuts, a slower U.S. and global economy, and GM's Oshawa plant closure. While Alberta's output cuts have helped shrink the discount on Western Canadian Select crude to a more normal \$16 from a record above \$50, the main issue is that WTI prices fell 25% in 2018 amid a whopping 40% plunge in the last three months of the year to \$46 a barrel. OPEC reductions should support a partial recovery in WTI prices this year to an average of \$59. Led by weakness in the energy sector, growth in business spending is expected to slip below 2% in 2019 from an estimated 5% in 2018, despite support from the accelerated depreciation allowance and (the assumed) approval of the USMCA by the new U.S. Congress. Consumer spending growth will downshift further to below 2%. Home sales and prices are unlikely to rise this year, while housing starts should decelerate from elevated levels that have been supported by the fastest population growth in 27 years. The good news is that the economy should expand enough to keep **the jobless rate hovering near its four-decade low of 5.6%.**

- After raising rates 75 basis points in 2018, the **Bank of Canada has turned cautious** as it tries to discern the impact of lower oil prices and tighter financial conditions on the economy. Low inflation—all three of the Bank's core measures stood at 1.9% in November—provides the luxury of time. Assuming some recovery in oil prices and financial

KEY MESSAGES

- The U.S. and Canadian economies will downshift in 2019 as past stimulus wanes and financial conditions deteriorate.
- A potential escalation in the trade war and U.S. political tensions, along with a deeper correction in equities and credit markets, are key risks to the U.S. economy. A further slide in oil prices would also hammer Canada.
- These risks imply a slower pace of monetary tightening in 2019. We now see just two (instead of three) rate hikes from the Fed and BoC, while markets expect even less.
- Even if oil prices recover somewhat, the C$ will continue to languish due to competitiveness issues, with energy transportation topping the list of challenges.

markets, the **Bank could raise policy rates in April and October**, with a final move in 2020 to the low end of a neutral range (2.5%-to-3.5%). Under this scenario, the 10-year Canada yield, which ended 2018 below where it started, could climb from 1.9% recently to 2.3% by year-end.

- The **Canadian dollar fell 8% against the mighty greenback in 2018**, undercut by the downturn in oil prices and ongoing competitiveness issues, such as the lack of pipeline capacity. The currency will struggle to get off the ground in 2019, though a partial recovery in oil prices could prod it toward 75 cents (C$1.34) by year-end from 73.3 cents (C$1.364) at the start of the year.

United States

- The U.S. **economy surprised modestly to the upside in 2018** as businesses responded more forcefully to tax cuts and deregulation. Barring a soft Q4 (we see 2.6%), real GDP likely grew the fastest since 2005, with the estimated 2.9% advance marking a big step up from the post-recession mean of 2.3%. The jobless rate touched a 49-year low of 3.7% in November before popping to 3.9% in December on greater labour-force participation. The economy created 2.6 million jobs in 2018, even more than the 2.2 million in 2017.
- **However, the economy won't repeat this stellar act in 2019**. Annual growth is projected to slow to 2.4% (and more tellingly to 2.0% from 3.1% on a Q4/Q4 basis). Highly expansionary fiscal and monetary policies, and supportive wealth effects, are fading, just when capacity constraints are becoming more binding and political instability is set to ratchet higher.
- The **trade war is another headwind**, notably if it opens on new fronts such as Europe and Japan. While a strong dollar has largely shielded consumers and businesses from the aggregate effects of import tariffs, the damage could mount if trade talks between the U.S. and China fail. While the tariff toll on GDP is likely to be limited to 0.4%, this assumes no further escalation apart from the planned 15-ppt hike in the tariff rate on $200 billion worth of China's goods on March 1. Due to slower global demand and the trade-weighted dollar's 8% rise in 2018 to 16-year highs, some further widening in the U.S. trade deficit (now at nine-year highs) is expected to carve 0.5 ppts from growth in 2019.
- The lift from tax cuts and new federal spending, which added a full percentage point to GDP growth in 2018, will fade to just 0.2 ppts in 2019. **New fiscal stimulus is limited by a budget shortfall fast approaching $1 trillion**. On the monetary side, with December's move, the Fed has pushed real policy rates comfortably above zero for the first time in a decade. The median FOMC member plans to raise rates **twice more in 2019 and a final time in 2020, in line with our**

view. While this is a slower pace of tightening than the quarterly cadence of the past year, it does imply more pain for the housing market, which is already groaning under the weight of the past escalation in prices and lower limits on mortgage interest deductibility. Mortgage rates will rise further as the 10-year Treasury rate climbs from 2.7% recently to 3.0% by year-end.

- Along with nagging tariffs, slowing profits, and growing labour shortages, **companies will need to contend with more political instability**. The current partial government shutdown is likely just a sample of the drama that will be served up by a divided Congress and a combative Administration. The debt ceiling will need to be raised or suspended later this year to avoid a payment default and possible credit-rating downgrade.
- While the economy will surely slow in 2019, all is not lost. The jobless rate is expected to ease to 3.5% in the second half, matching the second lowest level since 1953. **Recession odds this year are likely no more than one in four**, meaning there's a good chance the expansion will become the longest on record (dating back to 1850) at over 10 years should it last until July. Strong employment, firmer wages, lower gasoline prices, and a record-low debt-service burden are sturdy pillars for household spending. In fact, auto sales ended the year on a high note. Businesses will continue to add capacity (largely via automation) to address worker shortages. Subdued inflation will limit further Fed rate increases. For now, the fundamentals look reasonably healthy, suggesting the economy is merely downshifting to a more sustainable rate. And, if productivity turns higher, growth might even top expectations again.

Risks

- A more heated trade war or deeper dive in equities and oil prices would pose bigger headaches for the North American economy.
- If oil prices drop further, top-producers Alberta, Saskatchewan and Newfoundland & Labrador will underperform the 1½% growth rate expected for each province this year.
- U.S. fiscal policy could turn outright restrictive if Congress fails to pass legislation to avoid automatic spending cuts of about $100 billion (0.5% of GDP) starting in October.
- The Brexit drama will come to a head before the March 29 deadline, with "no-deal" the most likely option (among many) at this point. An acrimonious divorce could further rattle global equities, undermining household wealth and spending.

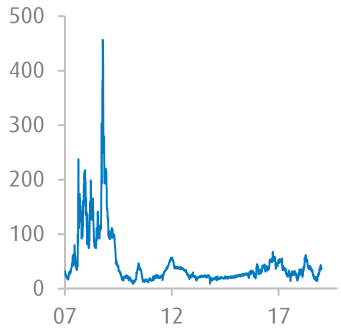
Forecasts

CANADA	2018 I	II	III	IV	2019 I	II	III	IV	ANNUAL 2017	2018	2019
Real GDP (q/q % chng : a.r.)	1.7	2.9	2.0	1.5	1.0	2.5	2.2	1.9	3.0	2.1	1.8
Consumer Spending	1.5	2.3	1.2	1.6	2.1	1.6	1.6	1.4	3.6	2.2	1.7
Business Investment (non-residential)	13.0	1.0	-7.1	3.0	3.8	3.8	3.2	2.9	2.5	5.1	1.9
Consumer Price Index (y/y % chng)	2.1	2.3	2.7	1.9	1.4	1.7	1.6	2.0	1.6	2.2	1.7
Unemployment Rate (%)	5.8	5.9	5.9	5.7	5.6	5.7	5.7	5.7	6.3	5.8	5.7
Housing Starts (000s : a.r.)	225	219	197	211	210	207	204	200	220	213	205
Current Account Balance ($blns : a.r.)	-69.3	-66.7	-41.4	-56.7	-56.3	-56.7	-58.0	-58.9	-60.1	-58.5	-57.5
Interest Rates (average for the quarter : %)											
Overnight Rate	1.25	1.25	1.50	1.75	1.75	2.00	2.00	2.25	0.71	1.44	2.00
3-month Treasury Bill	1.14	1.21	1.47	1.66	1.70	1.90	2.00	2.15	0.69	1.37	1.95
10-year Bond	2.24	2.28	2.28	2.32	1.95	2.05	2.20	2.30	1.78	2.28	2.10
Canada/U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	-44	-67	-61	-69	-73	-77	-87	-85	-26	-60	-81
10-year	-52	-64	-65	-71	-73	-72	-70	-69	-55	-63	-71
UNITED STATES											
Real GDP (q/q % chng : a.r.)	2.2	4.2	3.4	2.6	1.9	2.4	2.0	1.9	2.2	2.9	2.4
Consumer Spending	0.5	3.8	3.5	3.5	2.4	2.3	2.1	2.0	2.5	2.7	2.8
Business Investment (non-residential)	11.5	8.7	2.5	3.8	3.0	2.6	2.1	2.0	5.3	6.8	3.2
Consumer Price Index (y/y % chng)	2.3	2.6	2.6	2.2	1.8	2.0	2.0	2.1	2.1	2.4	2.0
Unemployment Rate (%)	4.1	3.9	3.8	3.8	3.7	3.6	3.5	3.5	4.4	3.9	3.6
Housing Starts (mlns : a.r.)	1.32	1.26	1.23	1.24	1.26	1.24	1.23	1.21	1.21	1.26	1.24
Current Account Balance ($blns : a.r.)	-487	-405	-499	-509	-535	-547	-563	-573	-449	-475	-555
Interest Rates (average for the quarter : %)											
Fed Funds Target Rate	1.46	1.71	1.96	2.21	2.38	2.54	2.71	2.88	1.00	1.83	2.63
3-month Treasury Bill	1.58	1.87	2.08	2.36	2.45	2.65	2.85	3.00	0.95	1.97	2.75
10-year Note	2.76	2.92	2.93	3.03	2.65	2.80	2.90	3.00	2.33	2.91	2.85
EXCHANGE RATES (average for the quarter)											
US¢/C$	79.1	77.5	76.5	75.7	74.2	74.2	74.5	74.7	77.1	77.2	74.4
C$/US$	1.265	1.291	1.307	1.322	1.348	1.347	1.343	1.339	1.298	1.296	1.344
¥/US$	108	109	112	113	112	111	111	110	112	110	111
US$/Euro	1.23	1.19	1.16	1.14	1.14	1.13	1.14	1.16	1.13	1.18	1.14
US$/£	1.39	1.36	1.30	1.29	1.24	1.23	1.26	1.29	1.29	1.34	1.26

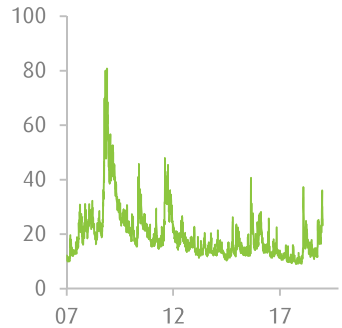
Note: Shaded areas represent BMO Capital Markets forecasts

VOLATILITY RISES
United States (as of January 3, 2019)

Ted Spread[1]



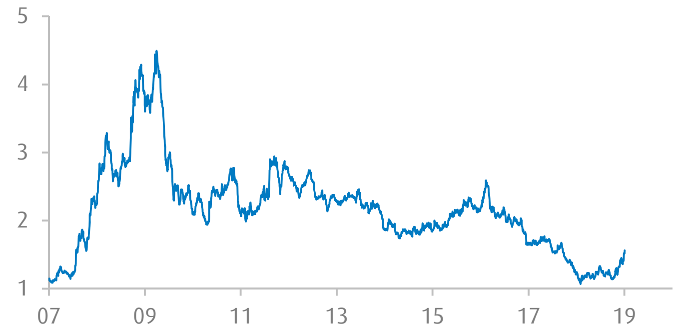
VIX[2]



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

CREDIT SPREADS WIDEN
United States (ppts)

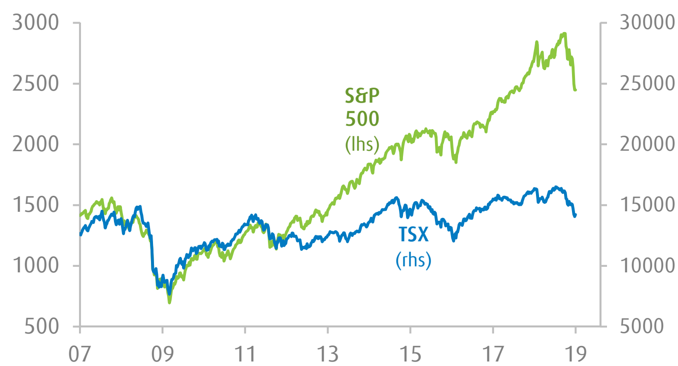
Corporate Bond Spreads[1]



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

EQUITIES CORRECT
(indices : as of January 3, 2019)

Equities



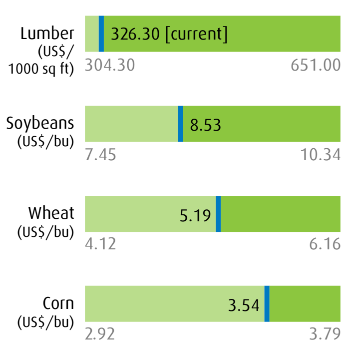
LOONIE LANGUISHES
(US¢ : as of January 3, 2019)

Canadian Dollar

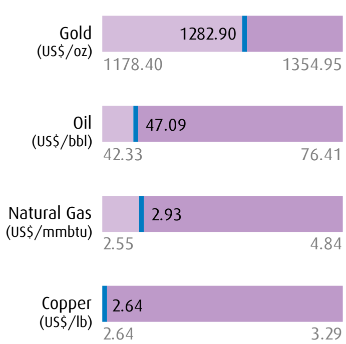
Despite trade deal

OIL, LUMBER AND COPPER IN RETREAT
Commodity price range since start of 2018

Materials & Foodstuffs
(as of January 3, 2019)



Metals & Energy
(as of January 3, 2019)

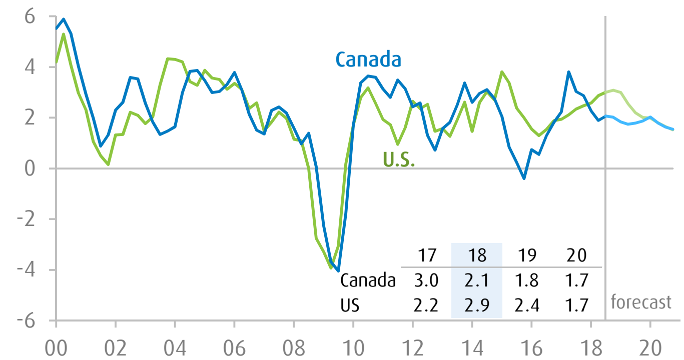


OIL PRICE NEAR 16-MONTH LOW
(US$/bbl : as of January 4, 2019)

WTI Crude Oil

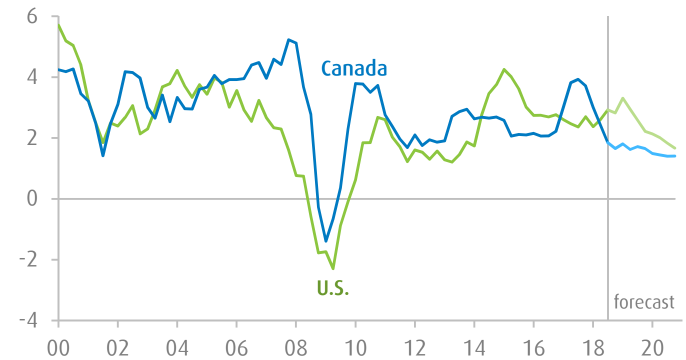
GROWTH TO MODERATE
(y/y % change)

Real GDP



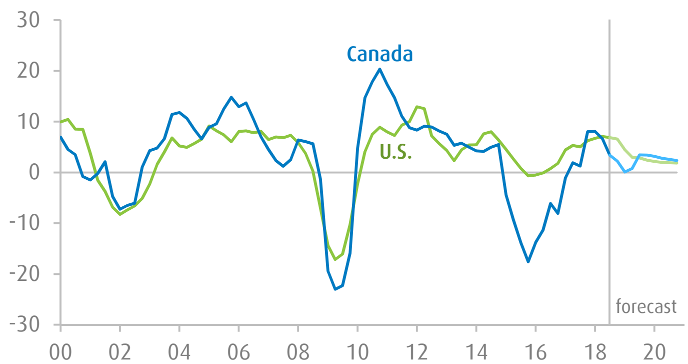
US CONSUMERS STILL SPENDING FOR NOW
(y/y % change)

Real Personal Consumption Expenditures



INVESTMENT TO MODERATE
(y/y % change)

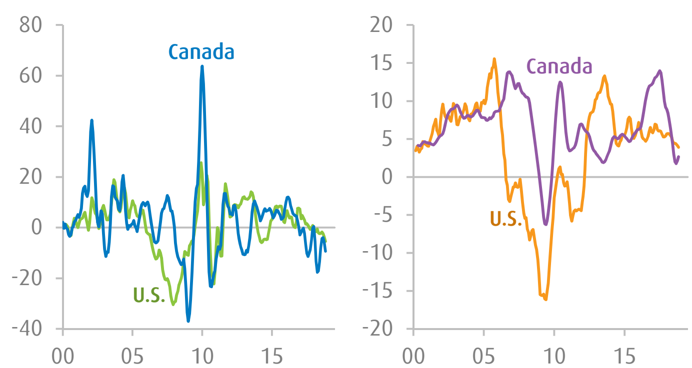
Real Non-Residential Business Investment



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

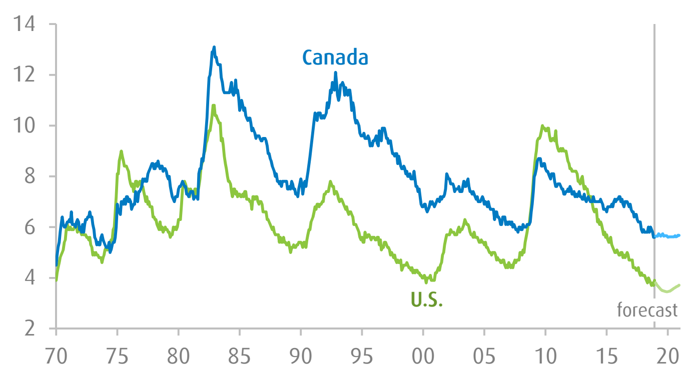
Sales

Prices



FULLY EMPLOYED
(percent)

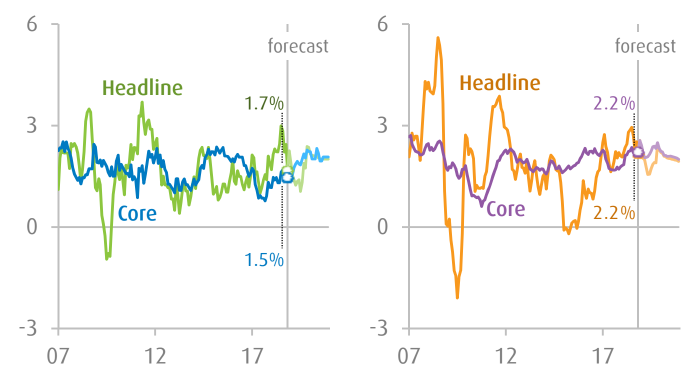
Unemployment Rate



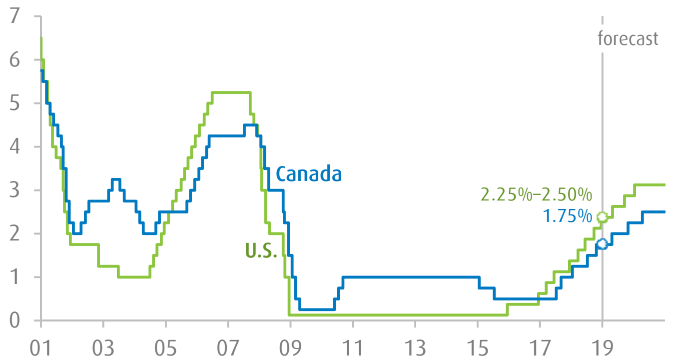
INFLATION SUBDUED
Consumer Price Index (y/y % change)

Canada

United States



NEARING END OF TIGHTENING CYCLE
(% : as of January 3, 2019)



RATES TO RISE MORE SLOWLY
(% : as of January 3, 2019)