North American Outlook

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A look ahead at the Canadian and American economies February 4, 2019

The Big Fade

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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 are key risks to the North American economy.
- We now expect just one more rate hike from the Fed and BoC this cycle (in December).
- Even if oil prices firm, the C$ will continue to languish due to competitiveness issues.

Canada

- The **Canadian economy performed largely as expected in 2018** with estimated annual growth of 2.0% 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 positive intentions to increase spending and hiring.
- **Growth is expected to ebb further to 1.8% in 2019** due to Alberta's oil production cuts, slower global demand and GM's Oshawa plant closure. Fortunately, OPEC's oil output cuts have helped stabilize oil prices, and we look for a further partial recovery in the price of WTI to an average of $59 in 2019. Meantime, Alberta's cuts and record rail shipments have sliced the discount on Canadian crude. Still, growth in business spending is expected to slip below 2% in 2019, despite support from the accelerated depreciation allowance and (the assumed) approval of the USMCA by the U.S. Congress. Due to elevated debt, consumer spending growth will downshift further to below 2%. Despite support from the fastest population growth in 27 years, home sales are expected to weaken moderately further this year, while housing starts should decelerate from elevated levels. Nonetheless, the **jobless rate should continue to hover near four-decade lows of 5.6%.**
- After raising rates 75 basis points in 2018, the **Bank of Canada has turned cautious** as it assesses the impact of lower oil prices and tighter financial conditions on the economy. Low inflation—all three of the Bank's core measures are slightly below the 2% target—reduces the sense of urgency. Assuming some further recovery in oil prices and financial markets, the **Bank could raise policy rates one last time in December**, to 2.0%. Under this scenario, the 10-year Canada yield should climb only modestly further to 2.1% 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 take flight in 2019 due to the slow pace of economic expansion, though a partial recovery in oil prices could prod it toward 75.5 cents (C$1.325) by year-end.

United States

- The U.S. **economy surprised modestly to the upside last year** 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 rising to 4.0% in January due to the government shutdown and increased labour force participation. The economy created 2.67 million jobs in 2018, the third best year for workers this century, and it rang in the New Year in style with 304,000 more positions.
- **Alas, the economy won't repeat this high-wire 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 rising. The earlier **government shutdown**, the longest on record, will shave 0.3 ppts from Q1 growth, and possibly more if it resumes in mid-February.
- The **trade war is another cause for concern**, even as recent talks between the U.S. and China have been moderately encouraging. While a strong dollar has largely shielded consumers and businesses from the aggregate effects of tariffs, the damage could mount if the talks fail and the current 10% tariff on $200 billion of China's goods is lifted to 25% on March 2. 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 slice 0.5 ppts from growth in 2019.
- The lift from tax cuts and new federal spending, which likely added a full percentage point to GDP growth in 2018, will fade to 0.2 ppts in 2019 (the increase reflects households receiving larger tax refunds than last year). **Further stimulus is limited by a budget shortfall fast approaching $1 trillion**. On the monetary side, the Fed has pushed real policy rates above zero for the first time in a decade. While consumer spending has yet to slow, the interest-sensitive housing market has clearly downshifted.

- Along with nagging tariffs, slowing profits, and growing labour shortages, **companies will need to contend with more political instability**. The earlier government shutdown is just a sample of the drama that will be served up by a divided Congress and a combative Administration prior to next year's election. The **debt ceiling**, which will be reinstated on March 1 after a year-long suspension, will need to be raised by nearly $2 trillion (or suspended again) by autumn to avoid a payment default and possible credit-rating downgrade.
- While the economy will slow in 2019, all is not lost. The **jobless rate is expected to ease to 3.5%** in the second half of the year, matching the second lowest level since 1953. Equity markets have retraced a good portion of earlier losses. Recent lower mortgage rates will give the housing market a much-needed lift. **Recession odds this year are likely no more than one in four**. By July, the current expansion should become the longest on record (dating back to 1850) at over a decade. Strong employment, firmer wages, lower gas prices, and a record-low debt-service burden remain **solid pillars of household spending**. In fact, auto sales ended last year on a high note, though they reversed in January. Businesses will continue to add capacity (largely via automation) to address worker shortages. For now, the fundamentals look reasonably healthy, suggesting the economy will merely downshift to a more sustainable pace than contract.
- Importantly, amid "muted inflation pressures" and global "cross currents", the **Fed has signaled a lengthy pause** before taking the next policy step (in either direction). **We now see it moving just one more time** (instead of twice), raising the fed funds target rate midpoint to 2.63% in December. This will pressure 10-year Treasury rates just modestly higher to 2.85% by year-end.

Risks

- An escalation of the trade war or renewed decline in equity markets would pose bigger challenges for the North American economy. Another downturn in oil prices would hurt Canada's economy.
- U.S. fiscal policy could turn restrictive this year if Congress fails to pass legislation to avoid automatic spending cuts of about $100 billion (0.5% of GDP) starting in October.
- With the U.K. parliament rejecting Prime Minister May's withdrawal agreement with the EU, the drama will come to a head before the March 29 deadline. A "no-deal" outcome is one option (among many) that could lead to a much weaker U.K. economy, though the impact on North America should be limited.

Forecasts

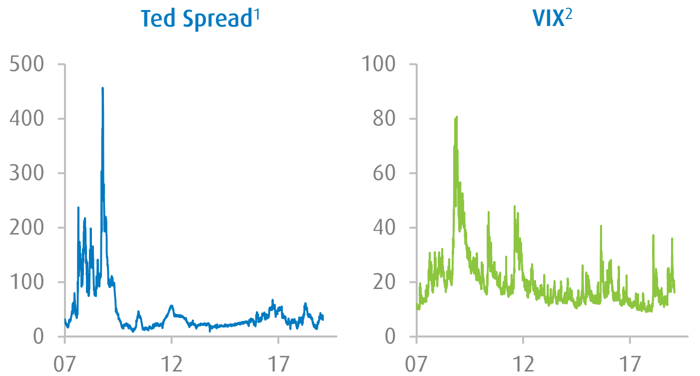
CANADA	2018 I	2018 II	2018 III	2018 IV	2019 I	2019 II	2019 III	2019 IV	ANNUAL 2017	ANNUAL 2018	ANNUAL 2019
Real GDP (q/q % chng : a.r.)	1.7	2.9	2.0	1.2	1.0	2.5	2.2	1.9	3.0	2.0	1.8
Consumer Spending	1.5	2.3	1.2	1.3	2.1	1.6	1.6	1.4	3.6	2.2	1.6
Business Investment (non-residential)	13.0	1.0	-7.1	3.0	3.8	3.8	3.2	2.9	2.5	5.1	1.9
Consumer Price Index (y/y % chng)	2.1	2.3	2.7	2.0	1.5	1.8	1.7	2.0	1.6	2.3	1.8
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.)	224	218	197	217	210	207	204	200	220	214	205
Current Account Balance ($blns : a.r.)	-69.3	-66.7	-41.4	-56.4	-55.8	-56.2	-57.5	-58.4	-60.1	-58.5	-57.0
Interest Rates (average for the quarter : %)											
Overnight Rate	1.25	1.25	1.50	1.75	1.75	1.75	1.75	1.83	0.71	1.44	1.77
3-month Treasury Bill	1.14	1.21	1.47	1.66	1.65	1.65	1.65	1.80	0.69	1.37	1.65
10-year Bond	2.24	2.28	2.28	2.32	1.95	2.00	2.05	2.10	1.78	2.28	2.00
Canada/U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	-44	-67	-61	-69	-80	-80	-80	-79	-26	-60	-80
10-year	-52	-64	-65	-71	-76	-76	-75	-75	-55	-63	-76
UNITED STATES											
Real GDP (q/q % chng : a.r.)	2.2	4.2	3.4	2.6	1.6	2.5	2.0	1.9	2.2	2.9	2.4
Consumer Spending	0.5	3.8	3.5	3.5	2.3	2.4	2.1	2.0	2.5	2.7	2.7
Business Investment (non-residential)	11.5	8.7	2.5	4.4	3.0	2.6	2.1	2.0	5.3	6.8	3.3
Consumer Price Index (y/y % chng)	2.3	2.6	2.6	2.2	1.8	2.0	2.0	2.1	2.1	2.4	2.0
Unemployment Rate (%)	4.1	3.9	3.8	3.8	3.9	3.7	3.6	3.5	4.4	3.9	3.6
Housing Starts (mlns : a.r.)	1.32	1.26	1.23	1.24	1.26	1.24	1.23	1.21	1.21	1.26	1.24
Current Account Balance ($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	2.38	2.38	2.46	1.00	1.83	2.40
3-month Treasury Bill	1.58	1.87	2.08	2.36	2.40	2.40	2.40	2.60	0.95	1.97	2.45
10-year Note	2.76	2.92	2.93	3.03	2.70	2.75	2.80	2.85	2.33	2.91	2.80
EXCHANGE RATES (average for the quarter)											
US¢/C$	79.1	77.5	76.5	75.7	75.2	75.3	75.4	75.4	77.1	77.2	75.3
C$/US$	1.265	1.291	1.307	1.322	1.330	1.328	1.327	1.325	1.298	1.296	1.328
¥/US$	108	109	112	113	109	109	110	110	112	110	109
US$/Euro	1.23	1.19	1.16	1.14	1.14	1.15	1.16	1.17	1.13	1.18	1.15
US$/£	1.39	1.36	1.30	1.29	1.31	1.33	1.32	1.31	1.29	1.34	1.32

Note: Shaded areas represent BMO Capital Markets forecasts

North American Outlook

BMO Capital Markets

VOLATILITY RISES
United States (as of February 1, 2019)



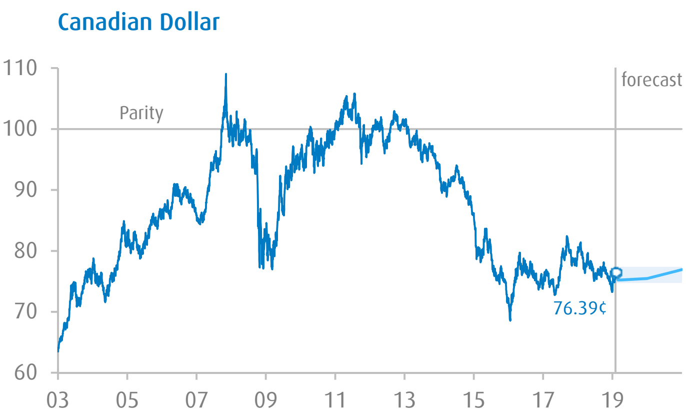
[1] 3-mnth Eurodollar minus 3-mnth T-bills (bps) [2] CBOE market volatility index

CREDIT SPREADS WIDEN
United States (ppts)

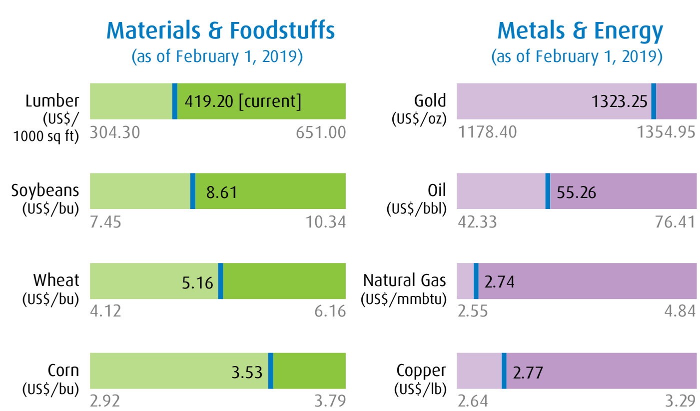
[1] 15-year BoA Merrill Lynch AA Corporate Yield less 10-year Treasury Yield

EQUITIES OFF TO GOOD START THIS YEAR
(indices : as of February 1, 2019)

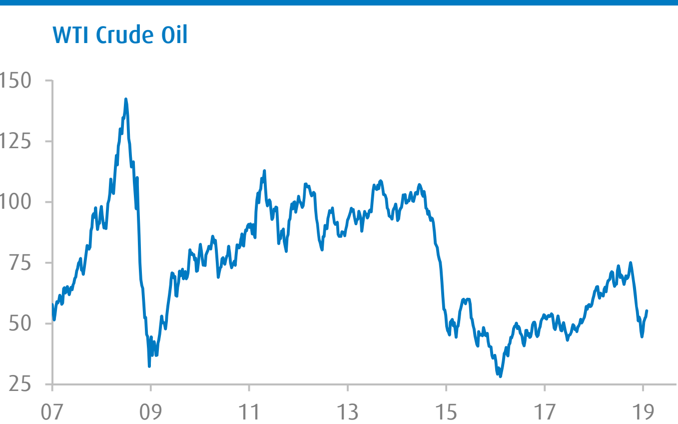
LOONIE LANGUISHES
(US¢ : as of February 1, 2019)



NATURAL GAS FIZZLES
Commodity price range since start of 2018

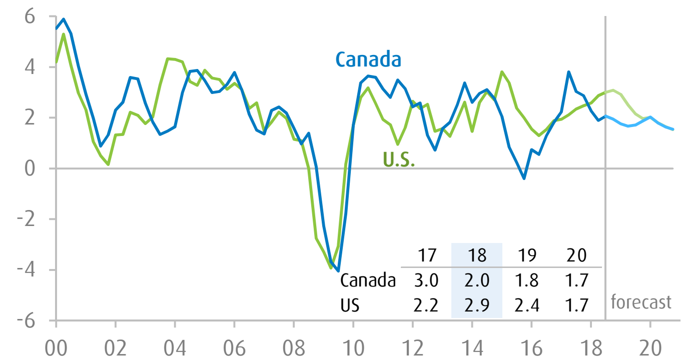


OIL PRICE BOUNCES OFF 16-MONTH LOW
(US$/bbl : as of February 1, 2019)



GROWTH TO MODERATE
(y/y % change)

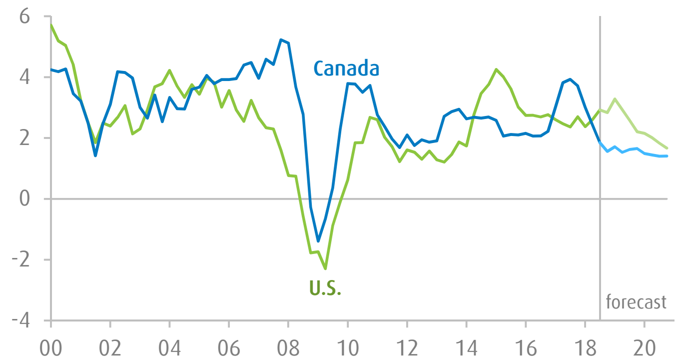
Real GDP



	17	18	19	20
Canada	3.0	2.0	1.8	1.7
US	2.2	2.9	2.4	1.7

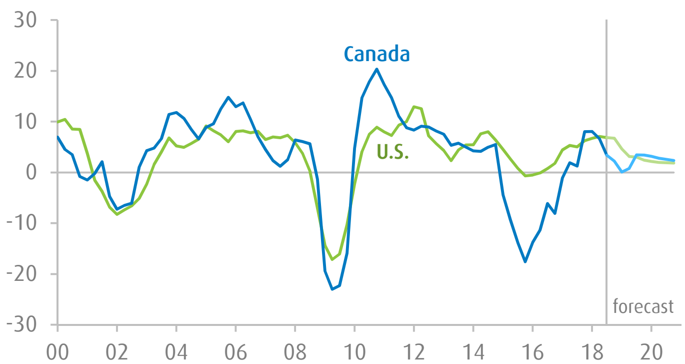
US CONSUMERS DRIVING EXPANSION
(y/y % change)

Real Personal Consumption Expenditures



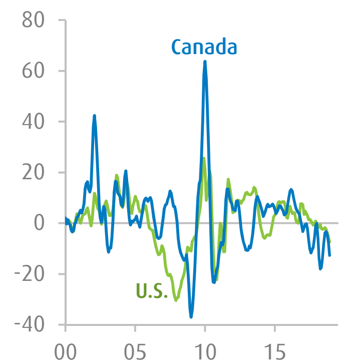
INVESTMENT TO MODERATE
(y/y % change)

Real Non-Residential Business Investment

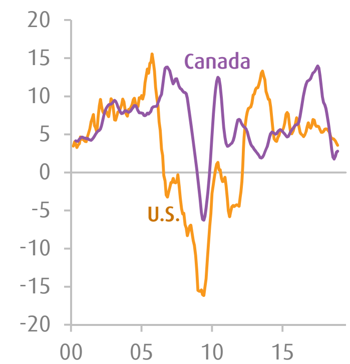


HOUSING MARKET COOLS
Existing Homes (y/y % change : 3-month m.a.)

Sales

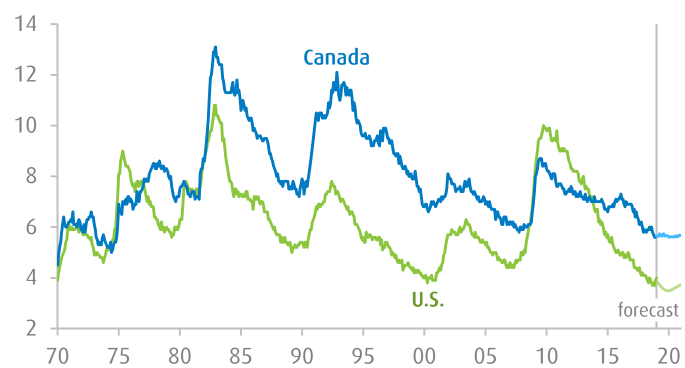


Prices



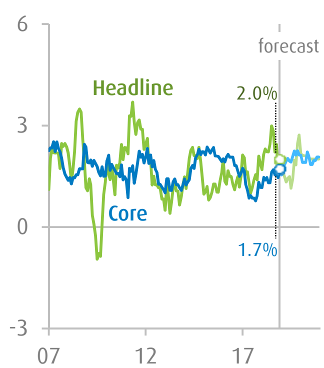
FULLY EMPLOYED
(percent)

Unemployment Rate

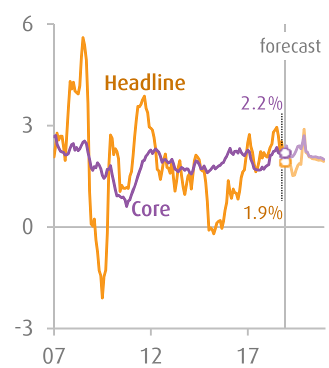


INFLATION SUBDUED
Consumer Price Index (y/y % change)

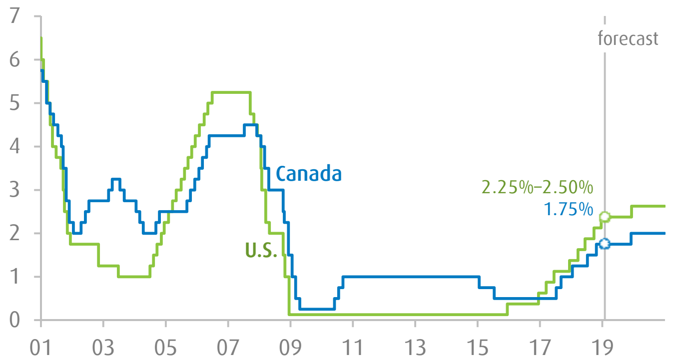
Canada



United States



NEARING END OF TIGHTENING CYCLE
(% : as of February 1, 2019)



RATES TO RISE SLIGHTLY FURTHER
(% : as of February 1, 2019)