# Green Look

ECONOMIC RESEARCH
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## KEY MESSAGES

- The Lazarus-like recovery in equity markets has calmed some of the economic headwinds, though both the U.S. and Canada will slow this year due to fading policy support
- Weaker global demand, tame inflation and uncertain trade policies will dissuade further rate hikes from the Fed and Bank of Canada
- An escalation of the trade war is the biggest threat to the North American expansion, though recent news from the U.S./China front is encouraging

## United States

- Tuning out a drumbeat of dreary data, equity bulls have stampeded back, with the worst December since 1931 followed by the best January/February since 1987. Previous recession fears have ebbed as the Fed looks to have ended its tightening cycle, driving borrowing costs sharply lower.
- Also calming investor nerves was **progress on U.S./China trade talks**. The March 1 deadline for hiking the tariff on $200 billion of China's goods was deferred indefinitely and, pending further progress on structural reforms and enforcement measures, the two countries aim to seal a deal by late April. This would remove one of the biggest thorns in the side of the global economy. Still, unresolved trade issues include USMCA ratification, metals tariffs, and a threatened U.S. duty on European autos.
- The trade skirmish with China has greased a record increase in the U.S. goods trade deficit. In fact, China, which accounts for over half of the shortfall, has all but stopped buying American oil after importing a record amount last summer. Fanned by soft global demand and a strong greenback, the trade gap is gnawing away at U.S. growth. It's one reason **real GDP slowed to a 2.2% (annualized) pace in Q4** from 3.4% in Q3. Residential construction was another weight, while the government shutdown shaved a tenth from growth. However, consumer spending rose a healthy 2.5% in the quarter, despite plunging in December. Even better was a **5.4% surge in nonresidential investment**, suggesting the trade war hasn't curbed spending plans. As a result, private domestic demand grew a sturdy 2.6% in Q4, only a modest step down from 3.0% in Q3.
- But **growth looks to ebb further to 1.2% in Q1.** The week year-end handoff from consumer spending, a likely inventory drawdown and lingering "residual seasonality" will weigh, while the longest-running government shutdown (which ended January 25th) will shave about 0.2 ppts from growth. Possible lighter tax refunds this year, due to less withholding tax, imply some downside risk.
- **Since some of the headwinds are temporary, growth should rebound to 2.5% in Q2**. A sharp rebound in home sales recently suggests housing markets are regaining a footing after the seven-year-long recovery stumbled badly last year, benefitting from the biggest decline in mortgage rates in a decade. Demographics also remain supportive, with the homeownership rate turning higher as more millennials take the plunge. Meantime, sturdy income growth, elevated

wealth and a light debt-service load will underpin consumers. On the fiscal front, federal spending will enjoy a post-shutdown bounce in Q2, and many states plan to increase spending or cut taxes this year amid a surge in revenues.

- After growing 2.9% in 2018, the economy will moderate to **a more sustainable 2.3% rate this year** and to 1.7% in 2020 amid fading policy stimulus. The jobless rate should still slip to 3.5% later this year, the second lowest level since 1953. Payrolls have risen for a record 101 straight months, and, come July, the economic expansion will enter the history books as the longest-running since at least the mid-19th century.
- In a sea-change shift, the **Fed strongly signaled at its March 20 policy meeting that rate hikes are on hold this year**, while leaning toward just one move next year (down from a combined three moves expected in this period at the December meeting). It also announced a quicker end to paring its balance sheet (October 1). Combined with an expected slower economy, we **expect no further Fed rate hikes through the end of 2020.**
- With market expectations leaning toward a Fed rate cut, the **10-year Treasury yield has fallen almost 30 basis points this year** to 2.4%, below the 3-month rate. We expect it to increase modestly to 2.6% by year-end amid stable Fed policy and a mild rise in core inflation due to wage pressures.
- A **sustained inversion of the yield curve** could flag trouble for the economy. Long-term rates fell below short-term rates prior to each of the last seven recessions, with only one false alarm in the mid-60s. However, we suspect the curve will revert to a more normal positive slope when markets reassess the odds of an easing in monetary policy.
- Apart from concerns about trade policy, the economy faces a few **political land mines**. A divided Congress may not agree to suspend over $120 billion in **automatic spending cuts** that are set to kick in on October 1st (a legacy of the 2011 congressional deal to raise the debt ceiling). As well, Congress could balk at lifting the recently-reinstated **debt ceiling** before the fall, at which time the Treasury will run out of shuffling measures to pay its bills, risking a rating downgrade.

## Canada

- Canadian stocks also bolted out of the gates this year, racking up their best two-month start in three decades, and both global and Canadian oil prices have reversed a good chunk of earlier declines. But this **welcome news pales against a backdrop of a weak economy**. Real GDP rose just 0.4% in Q4 after expanding 2.0% in Q3. Unlike U.S. companies feasting on lower taxes and a lighter regulatory touch, Canadian businesses have slashed spending by double-digit rates in the past two quarters, with notable weakness in the energy sector. As well, consumers are spending at the slowest pace since the recession (1.3% y/y in real terms), as higher interest rates and elevated debts have sown the weakest household credit growth in 35 years (3.1% y/y in January). Despite a welcome rebound in January GDP, oil output cuts will **keep growth weak at 0.7% in Q1.**

- While the **housing market is finding a steadier footing** after last year's slide, activity and prices continue to sag in Vancouver and the oil-producing provinces. However, the fastest population gains in 28 years (1.4%) should provide support, and we look for steadier sales and prices across the nation this year.
- After slowing to 1.8% last year from 3.0% in 2017, the **economy is projected to grow just 1.5% in 2019**. Planned layoffs totaling more than 4,000 auto workers at GM in Oshawa and Fiat-Chrysler in Windsor this year won't help the economy, and neither will China's decision to stop buying Canadian canola. However, extra spending announced in the March federal budget could add 0.2 ppts to growth. The jobless rate should hold near a four-decade low (averaging 5.7%), though further slippage in growth would send it marching higher.
- Amid a cooling economy, below-target inflation and unresolved trade issues, we now expect **the Bank of Canada to stand pat on rates rather than hike later this year.** Meantime, the 10-year Canada rate has fallen to 1.5%, below the policy rate of 1.75%. We see it rising to just 1.6% at year-end, not far from the record low (0.95%) reached in 2016.
- The **Canadian dollar remains flightless**, as support from firmer oil prices has been offset by a weaker economy and near-record trade deficit. The currency will struggle to make any headway, given chronic competitiveness issues, including the uncertain and lengthy approval process for launching major construction projects, such as much-needed pipelines.
- Legislative failure to ratify the USMCA, weaker growth in China (the world's largest commodities consumer), and a slower U.S. economy are potential **risks** facing the Canadian economy.

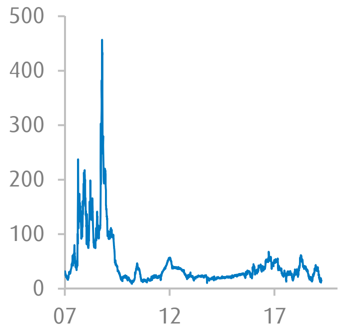
## Forecasts

| 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.) | 1.3 | 2.6 | 2.0 | 0.4 | 0.7 | 2.3 | 2.2 | 1.5 | 3.0 | 1.8 | 1.5 |
| Consumer Spending | 1.5 | 1.7 | 1.3 | 0.7 | 2.1 | 1.6 | 1.6 | 1.4 | 3.6 | 2.1 | 1.5 |
| Business Investment (non-residential) | 7.0 | -1.4 | -10.8 | -10.9 | 4.5 | 3.8 | 3.2 | 2.9 | 2.5 | 1.7 | -1.3 |
| Consumer Price Index (y/y % chng) | 2.1 | 2.3 | 2.7 | 2.0 | 1.5 | 1.8 | 1.7 | 1.9 | 1.6 | 2.3 | 1.7 |
| Unemployment Rate (%) | 5.8 | 5.9 | 5.9 | 5.7 | 5.8 | 5.8 | 5.7 | 5.7 | 6.3 | 5.8 | 5.7 |
| Housing Starts (000s : a.r.) | 224 | 218 | 197 | 217 | 202 | 211 | 206 | 200 | 220 | 214 | 205 |
| Current Account Balance ($blns : a.r.) | -69.0 | -63.4 | -40.4 | -61.9 | -56.8 | -57.0 | -58.2 | -60.0 | -60.1 | -58.7 | -58.0 |
| **Interest Rates (average for the quarter : %)** | | | | | | | | | | | |
| Overnight Rate | 1.25 | 1.25 | 1.50 | 1.75 | 1.75 | 1.75 | 1.75 | 1.75 | 0.71 | 1.44 | 1.75 |
| 3-month Treasury Bill | 1.14 | 1.21 | 1.47 | 1.66 | 1.65 | 1.65 | 1.65 | 1.65 | 0.69 | 1.37 | 1.65 |
| 10-year Bond | 2.24 | 2.28 | 2.28 | 2.32 | 1.85 | 1.60 | 1.70 | 1.80 | 1.78 | 2.28 | 1.75 |
| **Canada/U.S. Interest Rate Spreads (average for the quarter : bps)** | | | | | | | | | | | |
| 90-day | -44 | -67 | -61 | -70 | -79 | -76 | -76 | -76 | -26 | -60 | -77 |
| 10-year | -52 | -64 | -65 | -71 | -80 | -83 | -82 | -80 | -55 | -63 | -81 |
| **UNITED STATES** | | | | | | | | | | | |
| Real GDP (q/q % chng : a.r.) | 2.2 | 4.2 | 3.4 | 2.2 | 1.2 | 2.5 | 2.1 | 1.9 | 2.2 | 2.9 | 2.3 |
| Consumer Spending | 0.5 | 3.8 | 3.5 | 2.5 | 0.9 | 2.7 | 2.1 | 2.0 | 2.5 | 2.6 | 2.2 |
| Business Investment (non-residential) | 11.5 | 8.7 | 2.5 | 5.4 | 2.3 | 3.0 | 2.1 | 2.0 | 5.3 | 6.9 | 3.4 |
| Consumer Price Index (y/y % chng) | 2.2 | 2.7 | 2.6 | 2.2 | 1.6 | 1.6 | 1.7 | 1.8 | 2.1 | 2.4 | 1.7 |
| Unemployment Rate (%) | 4.1 | 3.9 | 3.8 | 3.8 | 3.9 | 3.7 | 3.5 | 3.5 | 4.4 | 3.9 | 3.6 |
| Housing Starts (mlns : a.r.) | 1.32 | 1.26 | 1.23 | 1.19 | 1.21 | 1.24 | 1.24 | 1.22 | 1.21 | 1.25 | 1.23 |
| Current Account Balance ($blns : a.r.) | -496 | -414 | -506 | -538 | -506 | -526 | -538 | -548 | -449 | -488 | -530 |
| **Interest Rates (average for the quarter : %)** | | | | | | | | | | | |
| Fed Funds Target Rate | 1.46 | 1.71 | 1.96 | 2.21 | 2.38 | 2.38 | 2.38 | 2.38 | 1.00 | 1.83 | 2.38 |
| 3-month Treasury Bill | 1.58 | 1.87 | 2.08 | 2.36 | 2.45 | 2.45 | 2.45 | 2.45 | 0.95 | 1.97 | 2.45 |
| 10-year Note | 2.76 | 2.92 | 2.93 | 3.03 | 2.65 | 2.40 | 2.50 | 2.60 | 2.33 | 2.91 | 2.55 |
| **EXCHANGE RATES (average for the quarter)** | | | | | | | | | | | |
| US¢/C$ | 79.1 | 77.5 | 76.5 | 75.7 | 75.2 | 74.8 | 75.1 | 75.4 | 77.1 | 77.2 | 75.1 |
| C$/US$ | 1.265 | 1.291 | 1.307 | 1.322 | 1.330 | 1.337 | 1.332 | 1.327 | 1.298 | 1.296 | 1.331 |
| ¥/US$ | 108 | 109 | 112 | 113 | 110 | 111 | 110 | 110 | 112 | 110 | 110 |
| US$/Euro | 1.23 | 1.19 | 1.16 | 1.14 | 1.14 | 1.13 | 1.14 | 1.15 | 1.13 | 1.18 | 1.14 |
| US$/£ | 1.39 | 1.36 | 1.30 | 1.29 | 1.30 | 1.31 | 1.31 | 1.30 | 1.29 | 1.34 | 1.31 |

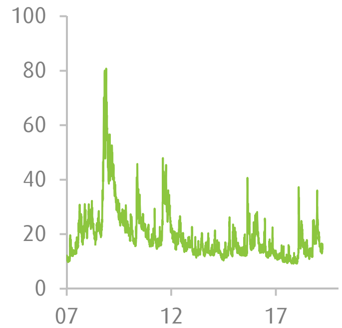
Note: Shaded areas represent BMO Capital Markets forecasts

## VOLATILITY EBBS
United States (as of March 28, 2019)

**Ted Spread[1]**



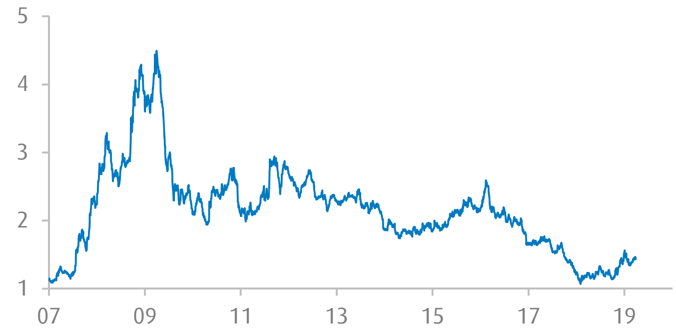

**VIX[2]**




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

## CREDIT SPREADS STABILIZE
United States (ppts)

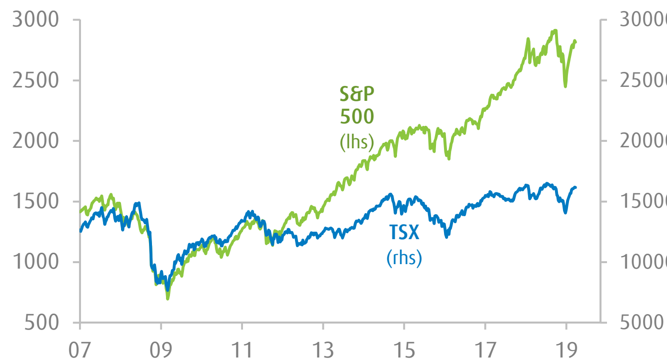
**Corporate Bond Spreads[1]**




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

## EQUITIES REBOUND
(indices : as of March 28, 2019)

**Equities**

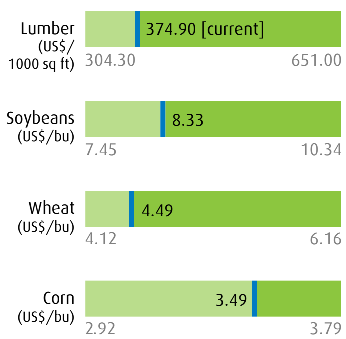



## LOONIE LANGUISHES
(US¢ : as of March 28, 2019)

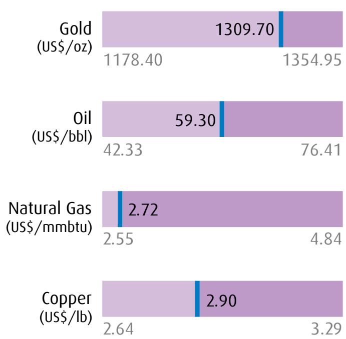
**Canadian Dollar**


## NATURAL GAS FIZZLES
Commodity price range since start of 2018

**Materials & Foodstuffs**
(as of March 28, 2019)




**Metals & Energy**
(as of March 28, 2019)

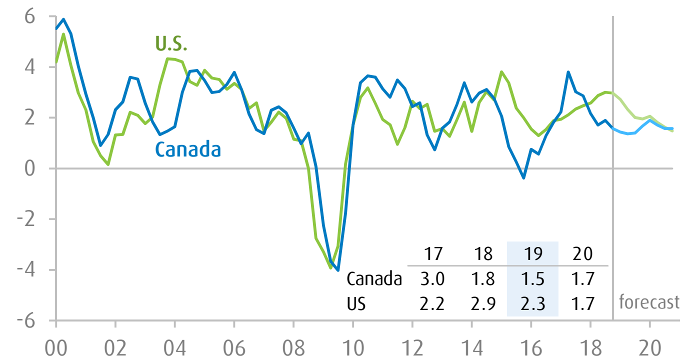



## OIL PRICES FIRM
(US$/bbl : as of March 29, 2019)

**WTI Crude Oil**

## GROWTH MODERATES
(y/y % change)

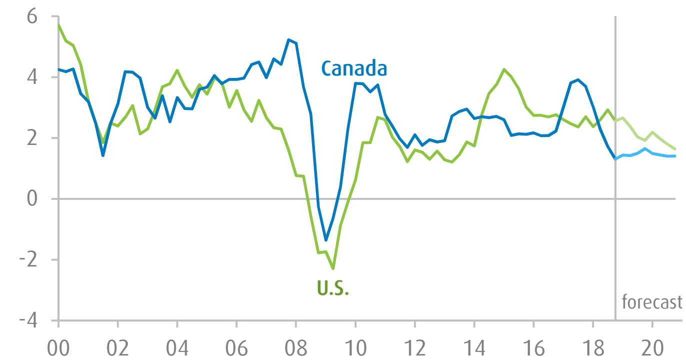
### Real GDP




| | 17 | 18 | 19 | 20 |
|---|---|---|---|---|
| Canada | 3.0 | 1.8 | 1.5 | 1.7 |
| US | 2.2 | 2.9 | 2.3 | 1.7 |

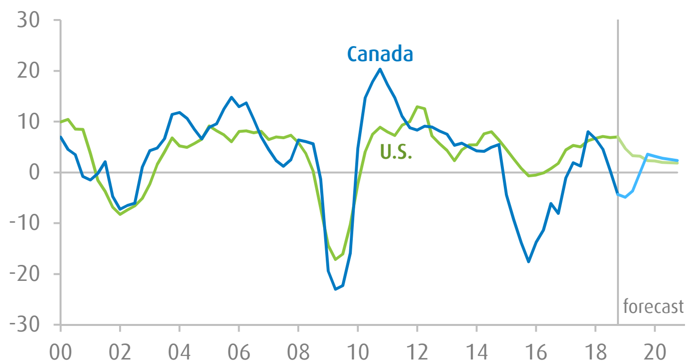
## CONSUMER SPENDING DOWNSHIFTS
(y/y % change)

### Real Personal Consumption Expenditures



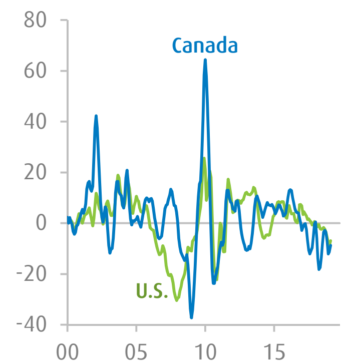

## CANADIAN INVESTMENT WEAK
(y/y % change)

### Real Non-Residential Business Investment

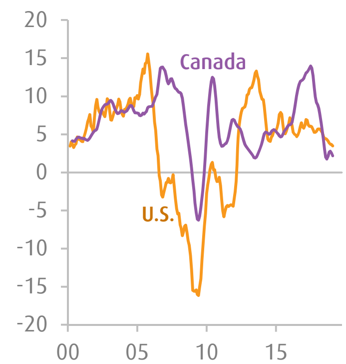



## HOUSING COOLS
Existing Homes (y/y % change : 3-month m.a.)

### Sales

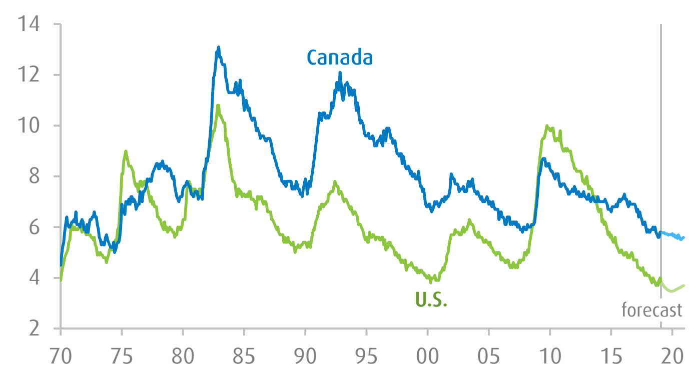



### Prices



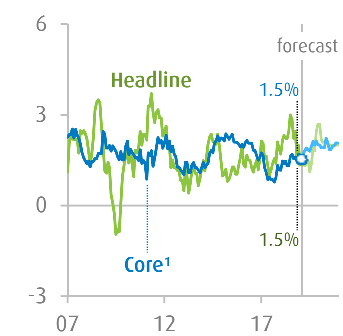

## FULLY EMPLOYED
(percent)

### Unemployment Rate

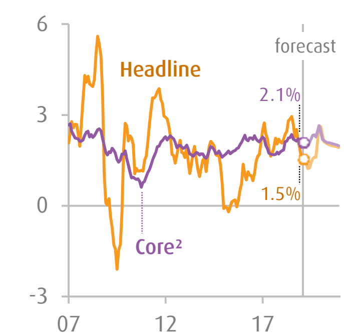



## INFLATION MUTED
Consumer Price Index (y/y % change)

### Canada

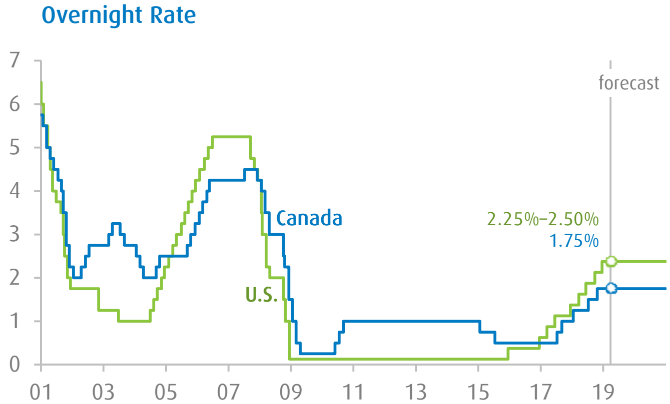



### United States




¹ core = CPI ex 8 most volatile components & indirect taxes ² core = CPI ex food & energy

### THAT'S ALL FOLKS
(% : as of March 28, 2019)




### RATES PEAKING
(% : as of March 28, 2019)