North American Outlook

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A look ahead at the Canadian and American economies

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Certain Marvel

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KEY MESSAGES

- The U.S. economy and labour markets remain resilient
- Canada's economy is struggling amid a loss of competitiveness
- Rising productivity helps to suppress U.S. inflation and rates
- Central banks to stay patient
- Canadian dollar on the defensive

United States

- Step back for a minute and stare in wonder at an **amazing economic spectacle**. Apart from the first half of 2015, the U.S. economy is growing the fastest in 13 years (3.2% y/y in Q1); the current expansion will enter the record books as the longest running in July; sturdy hiring has pushed the jobless rate to half-century lows (3.6%); and, equity markets are near all-time highs. But, here's the kicker: Investors expect the Fed to *reduce* interest rates this year. This Goldilocks tale is made possible by tame prices (at 1.6%, core PCE inflation is at 1½-year lows) and a central bank now seeking to push inflation *above* the 2% target to compensate for a decade of undershooting.
- We've long talked about the structural forces squeezing inflation: automation, e-commerce and globalization. And now we might be seeing in the data the long-awaited payoff from rapid investment in digital technologies. Business-sector productivity rose 2.4% in the past year to Q1, a big step-up from the past-decade mean (1.3%). Should this pace continue, the economy could expand faster than once thought without sparking inflation. In fact, **2½% might be the new speed limit** if the labour force continues to grow 0.8%. This would be materially higher than the Fed's 1.9% median call for potential GDP growth.
- While Q1 GDP growth (3.2% a.r.) exceeded expectations, it won't last. Activity was juiced by bulging inventories and diving imports, the former in response to weaker consumer spending and the latter due to earlier efforts by U.S. firms to avoid possible new tariffs on China's goods. By contrast, **private domestic demand increased just 1.3%**, the least in almost six years. However, here, too, transitory factors dominated. Delayed paycheques for federal workers amid the partial shutdown, an equities-led plunge in confidence, and lower tax refunds slowed personal spending to a 1.2% rate. The shutdown itself hived off 0.3% from GDP, as nondefense federal spending plunged 6%. Meantime, a horrendous winter caused residential construction to contract for a fifth straight quarter, despite lower mortgage rates. Trade policy uncertainty weighed on business confidence, slowing nonresidential investment, albeit to a still-decent 2.7%. Even without these speed bumps, the economy would have slowed this year in response to fading policy stimulus. Still, the **underlying trend appears healthy**—this is not an economy veering toward recession.
- Importantly, **final domestic demand should strengthen in Q2** given a strong bounce in March personal spending, an upturn in capital goods orders and a recent rebound in home sales. Strength in discretionary

items (e.g., restaurant outings, recreational goods) speaks to still-solid consumer confidence. Meantime, businesses will continue to invest in automation, even after spending on information processing gear and software grew at a near-10% rate in the past two years. While GDP growth could slip to 1.5% in Q2 given a likely reversal in inventories and imports, it should firm in the second half of the year.

- The Q1 growth surprise lifted our **2019 annual estimate modestly to 2.5%**. While we left our 2020 forecast unchanged at 1.7%, it now faces some upside risk should productivity stay strong.
- **We do not expect the Fed to cut rates** as long as core inflation drifts moderately higher and the jobless rate stays low. After the May 1 FOMC meeting, Chair Powell said there was no convincing case to move rates in either direction. He also dashed rate-cut hopes by noting that most of the recent decline in inflation was likely due to temporary factors, such as lower clothing prices and airfares.
- Alongside a steady Fed, we **expect long-term rates to remain stable**, with the 10-year Treasury ending 2019 at 2.6%. Some further slowing in growth next year could reduce the rate further to 2.4% in late 2020, close to the current fed funds midpoint target rate. Apart from recent years, one would need to travel back to the mid-1950s to see rates at current levels. Not a miracle, but wonderful all the same, and low enough to keep the expansion rocking around the clock.
- While the economic outlook is much brighter than five months ago, it’s worth pondering **what might go wrong**. Fed rate cuts could pump inflation or risk appetites and an asset bubble. Trade protectionism could mount if upcoming talks with Europe falter. Although the U.S. and China appeared close to signing a deal, recent threats by the President to impose new tariffs have cast doubts.

Canada

- Investors also expect the Bank of Canada to chop rates this year, though not due to too-low inflation—the core rate is practically sitting on the 2% target—but **because of a downbeat economy**. Real GDP barely grew in Q4 and looks to do just slightly better in Q1. Mandated oil output cuts are a factor, but the bigger issue is that even non-energy exports have backfired recently due to a slowing global economy, fading competitiveness and trade tensions with both the U.S. (metals) and China (agriculture). Consumers are in no mood to drive the expansion, as they are now borrowing at the slowest rate in 35 years to get a handle on record debt burdens. Meantime, the housing market is merely steadying after last year’s slump in the face of higher interest rates and tougher lending rules, and remains weak in some regions, notably Vancouver and the oil-producing provinces.

- **Canada does have a few things going for it, though**. The first is the recovery in oil prices and a sharp decline in the discount on Canadian crude, which is now about half its norm. While this won't overcome regulatory hurdles and spur new investment, it will pump much-needed revenue into the coffers of energy producers and Alberta's Government. The second is the fastest population growth in a quarter century, driven by strong international migration. This has boosted labour force growth and eased worker shortages, in turn encouraging hiring. Outside the energy patch, business investment intentions remain positive, according to the Business Outlook Survey. The federal government's accelerated depreciation allowance was a helpful initial step in bridging the competiveness gap.
- The **bad news is that wages and productivity are depressed,** with the former rising about 2% in the past year and the latter stalling after a listless decade. Zero real wage gains provide little support to consumers, while zero productivity undercuts competitiveness further. Consequently, although GDP growth is expected to pop above 2% in Q2, in part due to some easing in oil output restrictions, we still see a **slower 1.5% pace in 2019**, down from 1.8% in 2018 and not much faster than the population is growing. This risks an upturn in the jobless rate from current four-decade lows.
- With so much stacked against it the **Canadian dollar will do well to hold its own** against a firm greenback. We see it hovering below 75 cents (US) for most of 2019, barring a further climb in oil prices which we deem unlikely given record U.S. shale production.
- Given the sluggish economy, the **Bank of Canada has backed away (at least for now) from plans to lift rates further.** While Governor Poloz continues to warn that the current 1.75% policy rate remains below the neutral range of 2.25%-to-3.25%, the tightening hurdle appears high, barring an upside growth surprise. At the same time, a rate cut is unlikely given that core inflation is on target and growth is expected to improve at least somewhat this summer. We see a standoff, with rates on hold for the next two years.
- Legislative failure to ratify the USMCA, weaker growth in resource-gobbling China, and growing trade tensions between Canada and China are several downside risks to the Canadian economy. USMCA ratification appears unlikely until after the presidential election, which will weigh on business spending. The country's best hope for an upside surprise is if the U.S. economy outperforms.

Forecasts

CANADA	2018 I	2018 II	2018 III	2018 IV	2019 I	2019 II	2019 III	2019 IV	ANNUAL 2018	ANNUAL 2019	ANNUAL 2020
Real GDP (q/q % chng : a.r.)	1.3	2.6	2.0	0.4	0.7	2.3	2.2	1.5	1.8	1.5	1.7
Consumer Spending	1.5	1.7	1.3	0.7	2.2	1.6	1.6	1.4	2.1	1.5	1.4
Business Investment (non-residential)	7.0	-1.4	-10.8	-10.9	3.7	3.8	3.2	2.9	1.7	-1.5	2.7
Consumer Price Index (y/y % chng)	2.1	2.3	2.7	2.0	1.6	2.0	1.9	2.2	2.3	1.9	2.1
Unemployment Rate (%)	5.8	5.9	5.9	5.7	5.8	5.7	5.7	5.7	5.8	5.7	5.6
Housing Starts (000s : a.r.)	224	218	197	217	187	213	210	208	214	205	200
Current Account Balance ($blns : a.r.)	-69.0	-63.4	-40.4	-61.9	-54.4	-53.3	-53.3	-55.0	-58.7	-54.0	-52.0
Interest Rates (average for the quarter : %)											
Overnight Rate	1.25	1.25	1.50	1.75	1.75	1.75	1.75	1.75	1.44	1.75	1.75
3-month Treasury Bill	1.14	1.21	1.47	1.66	1.65	1.70	1.70	1.70	1.37	1.70	1.70
10-year Bond	2.24	2.28	2.28	2.32	1.86	1.75	1.80	1.85	2.28	1.80	1.75
Canada/U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	-44	-67	-61	-70	-79	-77	-76	-76	-60	-77	-72
10-year	-52	-64	-65	-71	-80	-80	-78	-77	-63	-78	-74
UNITED STATES											
Real GDP (q/q % chng : a.r.)	2.2	4.2	3.4	2.2	3.2	1.5	2.0	1.9	2.9	2.5	1.7
Consumer Spending	0.5	3.8	3.5	2.5	1.2	2.6	2.1	2.0	2.6	2.3	1.9
Business Investment (non-residential)	11.5	8.7	2.5	5.4	2.7	4.0	2.1	2.0	6.9	3.7	2.1
Consumer Price Index (y/y % chng)	2.2	2.7	2.6	2.2	1.6	2.1	2.1	2.3	2.4	2.0	2.2
Unemployment Rate (%)	4.1	3.9	3.8	3.8	3.9	3.6	3.6	3.5	3.9	3.6	3.6
Housing Starts (mlns : a.r.)	1.32	1.26	1.23	1.19	1.19	1.22	1.24	1.22	1.25	1.22	1.23
Current Account Balance ($blns : a.r.)	-496	-414	-506	-538	-468	-483	-499	-512	-488	-490	-535
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	1.83	2.38	2.38
3-month Treasury Bill	1.58	1.87	2.08	2.36	2.44	2.45	2.45	2.45	1.97	2.45	2.40
10-year Note	2.76	2.92	2.93	3.03	2.65	2.55	2.60	2.60	2.91	2.60	2.50
EXCHANGE RATES (average for the quarter)											
US¢/C$	79.1	77.5	76.5	75.7	75.2	74.5	74.8	75.3	77.2	75.0	76.3
C$/US$	1.265	1.291	1.307	1.322	1.329	1.342	1.336	1.328	1.296	1.334	1.311
¥/US$	108	109	112	113	110	111	111	110	110	111	109
US$/Euro	1.23	1.19	1.16	1.14	1.14	1.12	1.13	1.14	1.18	1.13	1.16
US$/£	1.39	1.36	1.30	1.29	1.30	1.30	1.31	1.31	1.34	1.31	1.33

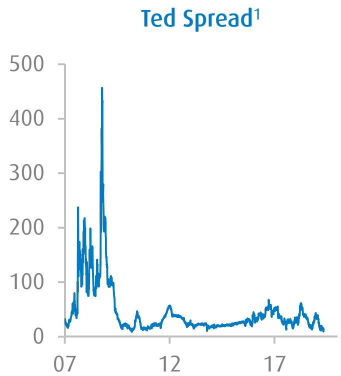
Note: Shaded areas represent BMO Capital Markets forecasts

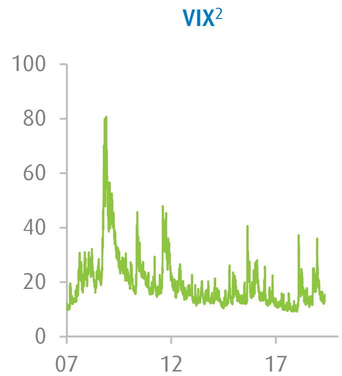
North American Outlook

BMO Capital Markets

May 7, 2019

VOLATILITY EBBS
United States (as of May 6, 2019)



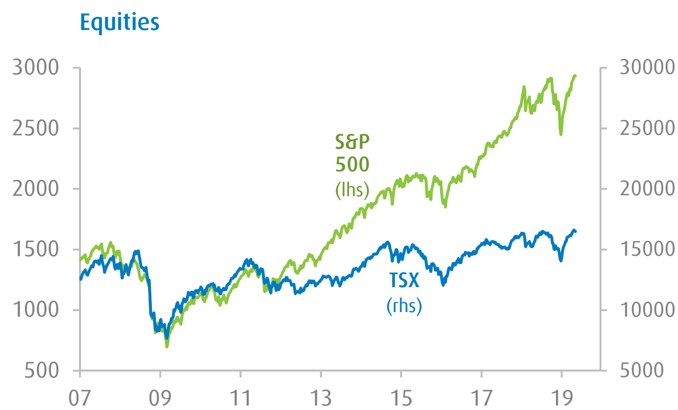


[1] 3-mnth Eurodollar minus 3-mnth T-bills (bps) [2] CBOE market volatility index

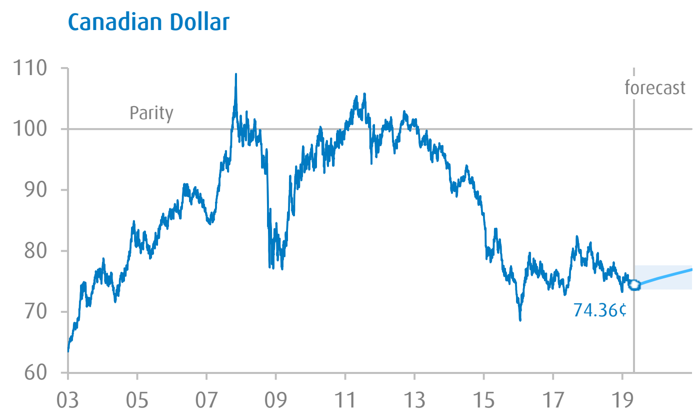
CREDIT SPREADS STABILIZE
United States (ppts)

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

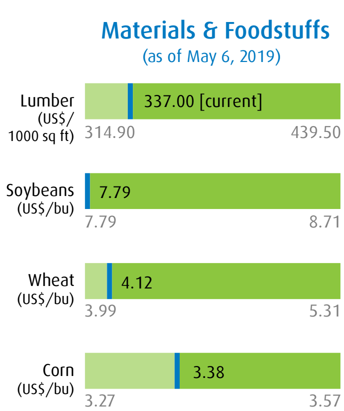
EQUITIES REBOUND
(indices : as of May 6, 2019)

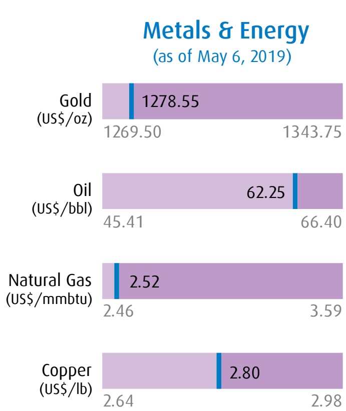


LOONIE LANGUISHES
(US¢ : as of May 6, 2019)

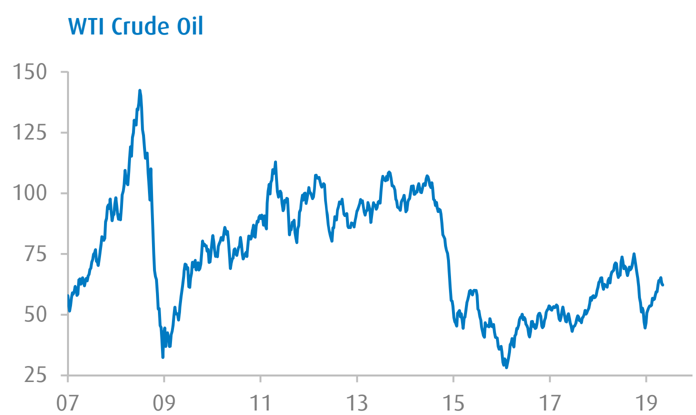


NATURAL GAS FIZZLES, CROPS DROP
Commodity price range since start of 2019



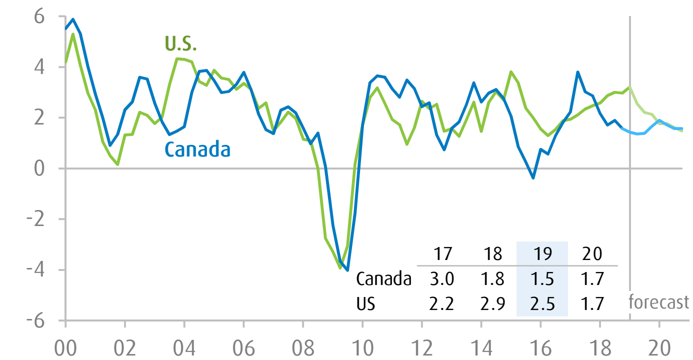


OIL PRICES RECOVER
(US$/bbl : as of May 6, 2019)



GROWTH TO MODERATE
(y/y % change)

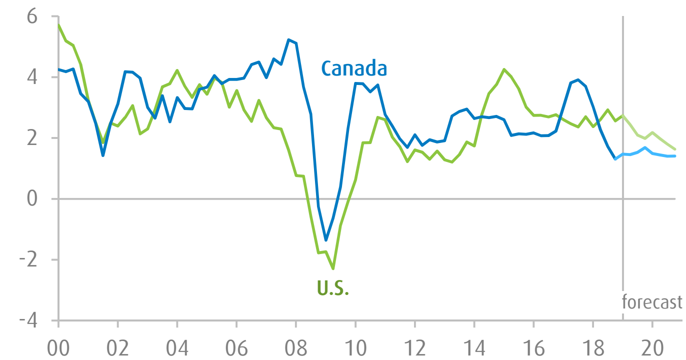
Real GDP



	17	18	19	20
Canada	3.0	1.8	1.5	1.7
US	2.2	2.9	2.5	1.7

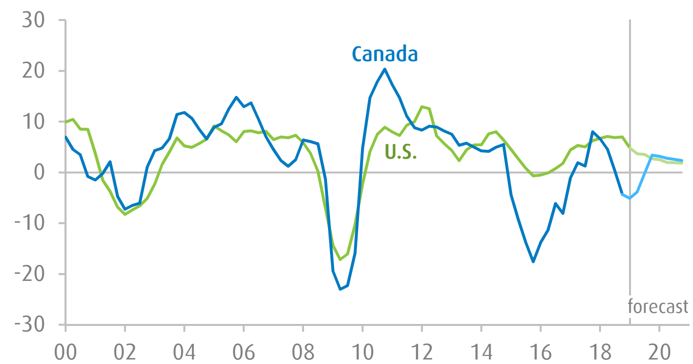
CONSUMER SPENDING DOWNSHIFTS
(y/y % change)

Real Personal Consumption Expenditures



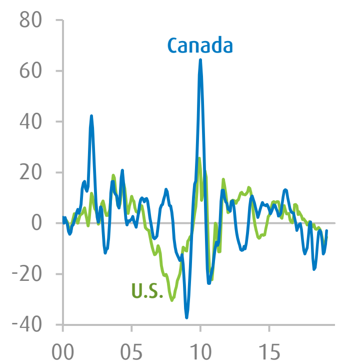
CANADIAN INVESTMENT WEAK
(y/y % change)

Real Non-Residential Business Investment

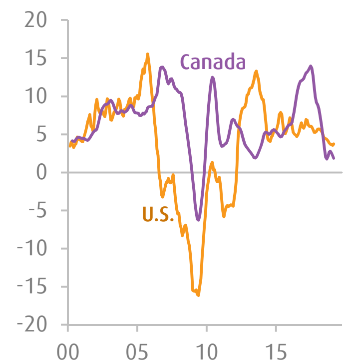


HOUSING STABILIZES
Existing Homes (y/y % change : 3-month m.a.)

Sales

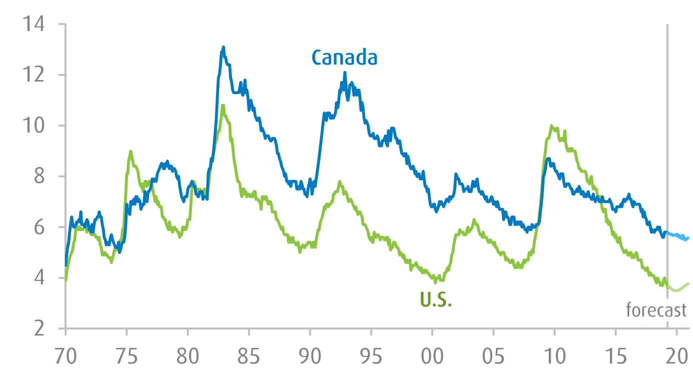


Prices



FULLY EMPLOYED
(percent)

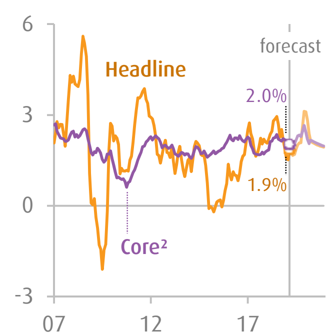
Unemployment Rate



INFLATION ON MUTE
Consumer Price Index (y/y % change)

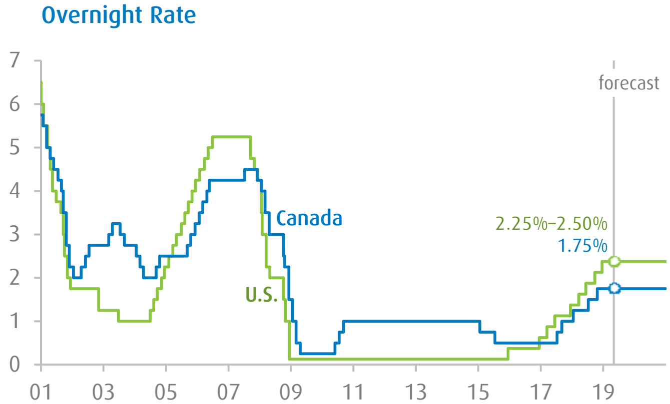
Canada

United States

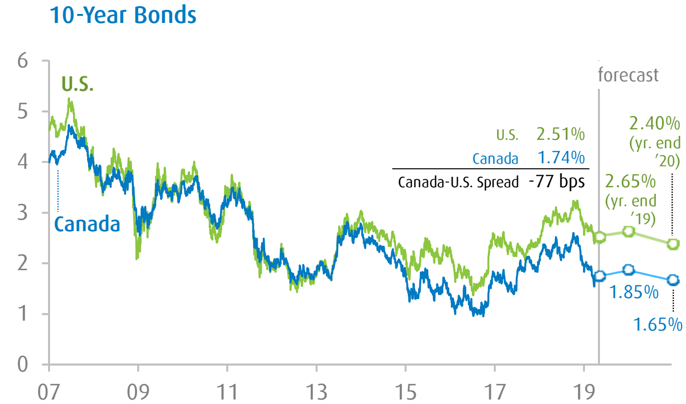


[1] core = CPI ex 8 most volatile components & indirect taxes [2] core = CPI ex food & energy

THAT'S ALL FOLKS
(% : as of May 6, 2019)



LOW FOR LONG
(% : as of May 6, 2019)



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