North American Outlook

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A look ahead at the Canadian and American economies June 11, 2019

Tariff Man to the Rescue (not)

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KEY MESSAGES

- The biggest threat to the North American economy—an escalating trade war—has flared higher
- Consequently, we have trimmed our growth outlooks and believe the U.S. and Canadian economies will struggle to grow at long-run potential in the year ahead
- The Fed is expected to cut rates in July and October. The Bank of Canada will stand pat for now, barring a further escalation in protectionism

- The **trade war has taken an abrupt turn for the worse**. Just when things were looking up after the U.S. government lifted metals tariffs on Canada and Mexico and delayed auto tariffs on the EU and Japan, trade talks between the U.S. and China ended abruptly in recriminations, leading to a new round of protectionist measures. And, the trade war threatens to expand on a surprisingly new front: with Mexico. In late May, the President announced a tariff on all Mexican goods starting at 5% effective June 10 and rising to 25% by October if Mexico did not take measures to stem the inflow of illegal migrants. The two sides subsequently struck a deal to avoid the tariffs, but the threat looms if there is any backsliding on Mexico's part.
- **Estimates of tariff effects on GDP** are fraught with difficulty. Our analysis considers **three main channels**: 1) the loss of purchasing power from import taxes; 2) retaliatory actions against U.S. exports; and, 3) the adverse effect on business confidence, supply chains and investment. But the analysis excludes the effect of currency changes and policy responses. The U.S. dollar is up 8% against the renminbi in the past year, which worsens the impact of retaliatory actions on exports, but reduces the loss of spending power for American shoppers. Meantime, long-term borrowing costs have fallen amid growing fears of weaker growth and rising expectations of easier monetary policy.
- **And what are the economic effects?** We estimate the tariff measures in place between the U.S. and China will reduce U.S. GDP by 0.3% over a year or so. Earlier duties on U.S. imports of metals, solar panels and washing machines likely trimmed 0.1% from output, though some of this will be regained from the recent removal of tariffs on Canadian and Mexican steel and aluminum. The wrangle with Mexico, should it rematerialize, could carve another 0.4% from U.S. output, taking the tariff toll up to 0.8%. And it could get much worse. A threat to impose a 25% duty on all other goods purchased from China could add 0.3% to the damage. Moreover, although delaying its decision, the White House threatens to slap duties on auto imports (apart from Canada and Mexico) that could reduce output by another 0.3%. **All in, current and potential tariffs could result in 1.4% less U.S. GDP or roughly two million jobs.**
- We **trimmed our forecast** and now see U.S. growth averaging just 1.6% for the remainder of this year and in 2020**. That's slightly below potential** (which the FOMC pegs at around 1.9%), meaning the jobless rate will drift higher next year. We will need to use a larger cleaver if the trade war escalates again or if the data suggest it is taking a bigger bite out of investment and the economy than we estimate.

- Given that its shipments to the U.S. are about four-times larger than the other way around and make up over 3% of its economy, **China faces more casualties in a trade war**. Earlier duties are estimated to reduce its GDP by 0.5%, while the recent hike to a 25% rate could raise the toll to 0.9%. **The damage would nearly double to 1.7% if all of China's shipments to the U.S. were hit with a 25% tax**—a major speed bump even for an economy growing upwards of 6%.
- **Mexico would be the worst off if a 25% tariff is imposed on its exports to the U.S.** Our analysis suggests the tariff battle could slice the country's GDP by more than 2% next year, enough to lead to a contraction that pushes the jobless rate higher and even more migrants across the U.S. border.
- Though not taking part in the trade battle between its biggest foreign customer and largest buyer of global resources, **Canada will suffer collateral damage**. The **estimated slowing in U.S. GDP from current tariffs with China and possibly Mexico could translate into 0.4% less Canadian output**, based on the close historical relationship between the two countries. China's ban on some Canadian canola and pork shipments could chip off another 0.1% from output. And if the U.S. economy slows further in response to new tariffs, then Canada's economy could slow by a further 0.3%, bringing the **combined impact to 0.8% or 150,000 workers.** Downward pressure on commodity prices won't help, either. It's a good thing that U.S. metals tariffs have ended, as their slowing impact on GDP was around 0.3%.
- A strong jump in March will help Canadian GDP rebound to above 2% annualized in Q2 after little advance the prior two quarters. Still, we see **growth averaging just 1.7% for the rest of this year and in 2020**, close to potential and implying some upward pressure on the jobless rate if strong gains in the workforce persist. However, a further escalation in the trade war would warrant a more material downward revision.
- Apart from firms in protected industries, there are **few winners when countries unfurl the protectionist banner**. While the U.S. may extract concessions from China that eventually lead to a trade deal that supports its economy, the casualties on the ground are starting to mount. We can only hope both sides call a ceasefire. While the **trade war might not, by itself, lead to recession**, it could push jobless rates higher and equity markets lower. That combination, in turn, could undermine confidence, spurring even weaker growth.
- We **now expect two quarter-point rate cuts by the Fed**, in July and October. With the economy losing momentum due to fading policy stimulus and growing trade tensions, the Fed is unlikely to ignore the potential threat of more damage to come, especially with inflation pressures on mute (case in point, the decline in unit labour costs). We also see the 10-year Treasury yield slipping to 2.0% by year end. That hardly covers inflation, but it's better than paying some other governments (Germany, Japan, Sweden, Denmark) to hold your money for a decade.
- The **bar for a Bank of Canada rate cut is higher** than for the Fed, as real policy rates are already negative, inflation is close to the target, and easier policy could fan the housing flames à la 2015. We still see the Bank standing pat unless the trade war has a more pronounced effect on the economy.

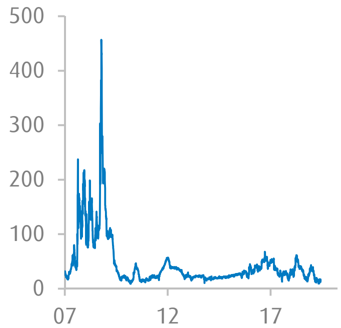
Forecasts

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.)	1.5	2.5	2.1	0.3	0.4	2.5	1.9	1.4	1.9	1.4	1.6
Consumer Spending	1.3	1.9	1.3	1.0	3.5	1.8	1.6	1.4	2.1	2.0	1.5
Business Investment (non-residential)	7.3	-0.9	-11.8	-9.5	13.5	3.8	2.0	2.1	1.9	0.7	2.4
Consumer Price Index (y/y % chng)	2.1	2.3	2.7	2.0	1.6	2.2	2.0	2.3	2.3	2.0	2.1
Unemployment Rate (%)	5.8	5.9	5.9	5.7	5.8	5.5	5.5	5.5	5.8	5.6	5.6
Housing Starts (000s : a.r.)	224	218	197	217	187	215	209	208	214	205	200
Current Account Balance ($blns : a.r.)	-65.5	-61.5	-40.6	-66.5	-69.4	-59.3	-57.8	-59.6	-58.5	-61.5	-58.1
Interest Rates (average for the quarter : %)											
Overnight Rate	1.25	1.25	1.50	1.75	1.75	1.75	1.75	1.75	1.44	1.75	1.75
3-month Treasury Bill	1.14	1.21	1.47	1.66	1.65	1.65	1.65	1.65	1.37	1.65	1.65
10-year Bond	2.24	2.28	2.28	2.32	1.86	1.60	1.45	1.40	2.28	1.60	1.45
Canada/U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	-44	-67	-61	-70	-79	-70	-46	-21	-60	-54	-20
10-year	-52	-64	-65	-71	-80	-73	-62	-59	-63	-68	-61
UNITED STATES											
Real GDP (q/q % chng : a.r.)	2.2	4.2	3.4	2.2	3.1	1.3	1.8	1.7	2.9	2.4	1.6
Consumer Spending	0.5	3.8	3.5	2.5	1.3	2.8	2.1	2.0	2.6	2.4	2.0
Business Investment (non-residential)	11.5	8.7	2.5	5.4	2.3	1.8	1.9	1.8	6.9	3.1	1.9
Consumer Price Index (y/y % chng)	2.2	2.7	2.6	2.2	1.6	1.9	1.9	2.1	2.4	1.9	2.1
Unemployment Rate (%)	4.1	3.9	3.8	3.8	3.9	3.6	3.6	3.6	3.9	3.7	3.7
Housing Starts (mlns : a.r.)	1.32	1.26	1.23	1.19	1.20	1.23	1.24	1.22	1.25	1.22	1.23
Current Account Balance ($blns : a.r.)	-496	-414	-506	-538	-472	-497	-500	-513	-488	-495	-530
Interest Rates (average for the quarter : %)											
Fed Funds Target Rate	1.46	1.71	1.96	2.21	2.38	2.38	2.13	1.88	1.83	2.19	1.88
3-month Treasury Bill	1.58	1.87	2.08	2.36	2.44	2.35	2.10	1.85	1.97	2.20	1.85
10-year Note	2.76	2.92	2.93	3.03	2.65	2.35	2.05	2.00	2.91	2.25	2.05
EXCHANGE RATES (average for the quarter)											
US¢/C$	79.1	77.5	76.5	75.7	75.2	74.5	74.9	75.5	77.2	75.1	76.4
C$/US$	1.265	1.291	1.307	1.322	1.329	1.342	1.335	1.324	1.296	1.332	1.309
¥/US$	108	109	112	113	110	110	107	108	110	109	109
US$/Euro	1.23	1.19	1.16	1.14	1.14	1.12	1.13	1.12	1.18	1.13	1.13
US$/£	1.39	1.36	1.30	1.29	1.30	1.29	1.24	1.25	1.34	1.27	1.28

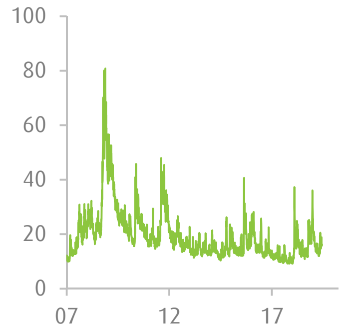
Note: Shaded areas represent BMO Capital Markets forecasts

VOLATILITY UP SLIGHTLY
United States (as of June 10, 2019)

Ted Spread[1]



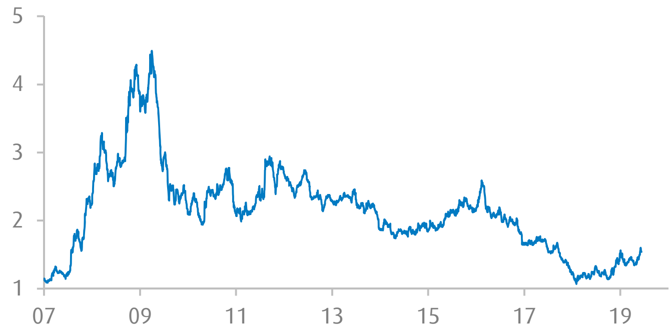
VIX[2]



[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 VOLATILE
(indices : as of June 10, 2019)

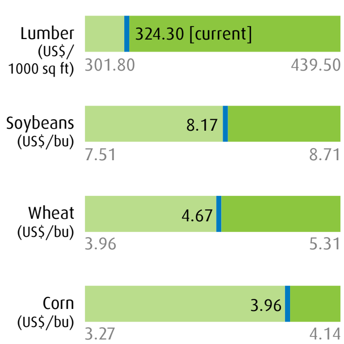
Equities

LOONIE LANGUISHES
(US¢ : as of June 10, 2019)

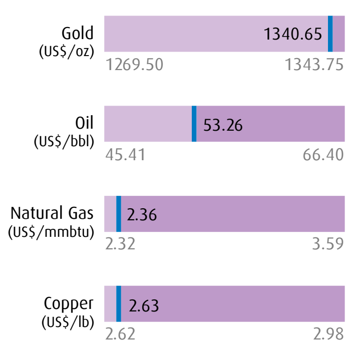
Canadian Dollar

CORN POPS, LUMBER LIMPS
Commodity price range since start of 2019

Materials & Foodstuffs
(as of June 10, 2019)



Metals & Energy
(as of June 10, 2019)

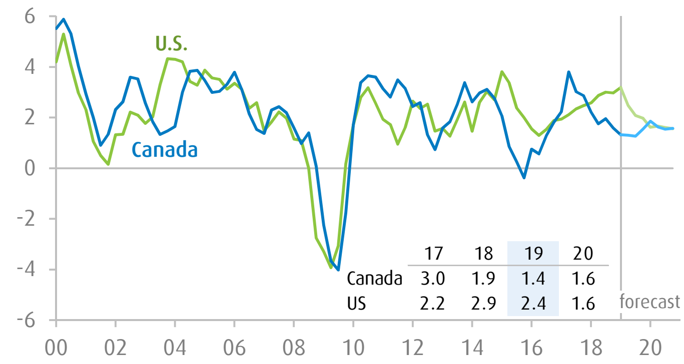


OIL PRICES RETREAT
(US$/bbl : as of June 10, 2019)

WTI Crude Oil

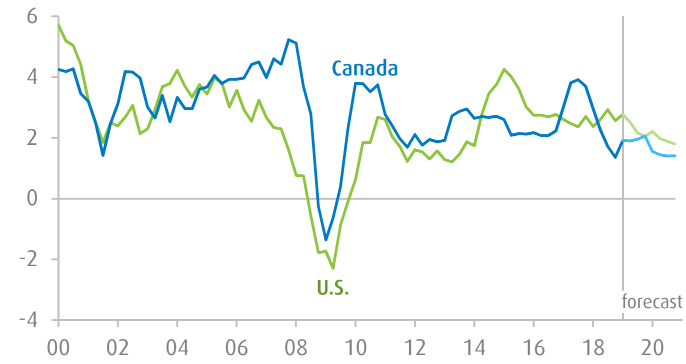
GROWTH MODERATES
(y/y % change)

Real GDP



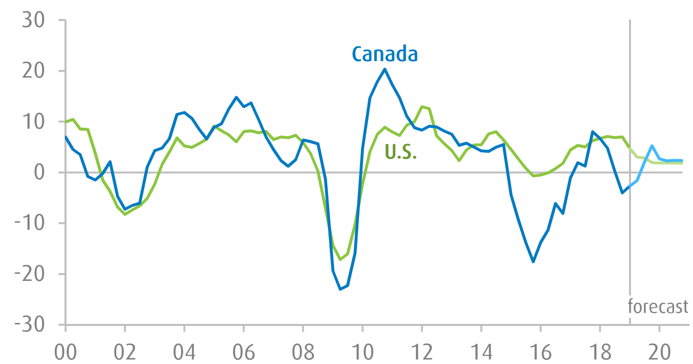
CONSUMERS DOWNSHIFT
(y/y % change)

Real Personal Consumption Expenditures



INVESTMENT WEAKENS
(y/y % change)

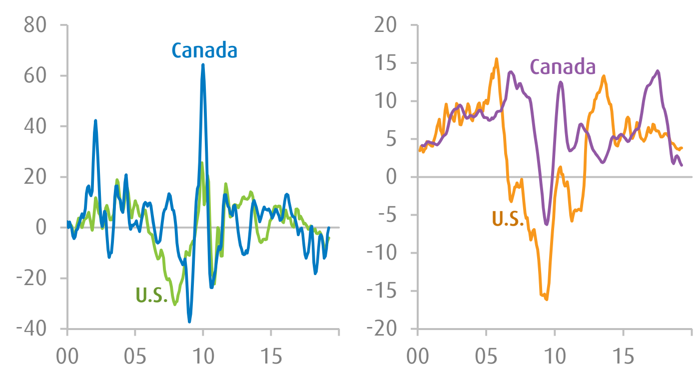
Real Non-Residential Business Investment



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

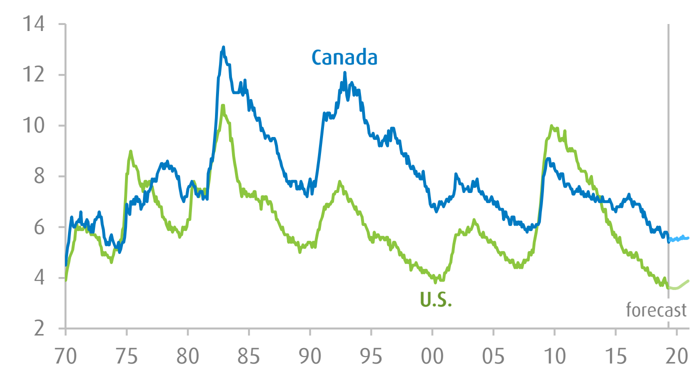
Sales

Prices



FULLY EMPLOYED
(percent)

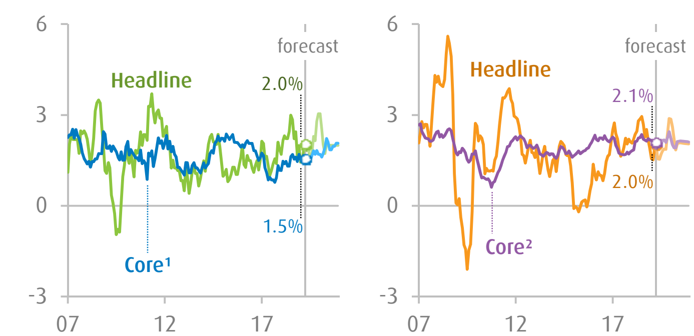
Unemployment Rate



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

Canada

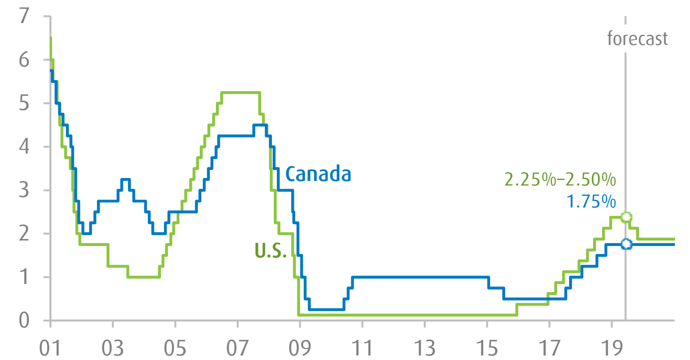
United States



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

FED TO CUT RATES
(% : as of June 10, 2019)

Overnight Rate



LOW FOR EVEN LONGER
(% : as of June 10, 2019)

10-Year Bonds