

The Law of Small Numbers

Douglas Porter, CFA, Chief Economist • douglas.porter@bmo.com • 416-359-4887

The economic data generally took a back seat to geopolitical developments this week, as the U.S. withdrawal from the Iran nuclear pact—and the subsequent surge in oil—the countdown to a tight NAFTA deadline, and even a shock election result in Malaysia cast a long shadow on markets. Probably the single most important development was the push in oil prices above \$70, and this week's Focus feature (following the end of this article) takes an in-depth look at the implications. **The unifying theme to this week's parade of economic reports was that they generally landed on the low side of expectations**, but in almost every case there was a classic “yes, but...” response. Here are some of the most noteworthy examples from this past week:

Consumer prices: Probably the stand-out report this week was the highly anticipated U.S. CPI for April, and it came in on the small side. In particular, core CPI edged up just 0.1%, holding the yearly rise steady at 2.1% and blunting the 3- and 6-month underlying trends to 1.8% and 2.4%, after some scarier figures earlier this year. Headline prices were a non-threatening +0.2%, even with a big push from energy. In a similar vein, China also reported soft-ish April inflation, with CPI cooling to a below-expected result of 1.8% y/y. *Yes, but...* with oil prices firing higher yet, labour markets tight, and year-over-year trends near or above 2% already, one month doesn't change the bigger picture on underlying inflation.

U.S. wages: Much is being made of the microscopic rise in real average hourly earnings in the past year, which are now up just 0.2% y/y. *Yes, but...* this cooldown is being driven by higher inflation, not slower nominal wage growth. The key “small number” at this point is the tiny 3.9% U.S. jobless rate. And, with the U.S. now sporting more job openings (6.5 million) than job seekers, for the first time on record, don't expect wages to stay slow for long.

Canadian jobs: From a Canadian lens, this week's key report was Friday's April jobs data, but it was also a damp squib. Employment dipped 1,100 in the month, and the jobless rate only stayed steady at 5.8% because the part rate fell again. Accordingly, after building expectations of a BoC rate hike as early as the May 30 decision, the market walked those odds right back down again after the report. *Yes, but...* the details of the release were fine, with solid full-time and private sector job gains, and wages powering up to a hefty 3.6% y/y pace. And, the headline tally was liked blunted by the horrid weather last month, with the 18,900 drop in construction weighing. We still believe the Bank is on track to hike in July, assuming a non-negative outcome for NAFTA talks.

The yield curve: After a mild steepening at the start of the week, the U.S. Treasury curve got back to the flattening program late in the week, especially after the mild CPI result. The gap between 10s and 2s is now just 43 bps, less than half of where it stood a year ago and compared with more than 260 bps as recently as 2014. Canada's curve now carries an almost identical gap on 10s-2s. *Yes, but...* while the curve is flatter, it's not particularly flat. The extremes were the steepness of the curve in recent years, when central banks had the foot to the floor. As we so often note, the Treasury curve was



flatter than current levels for much of the 1995-99 period, and the U.S. economy and financial markets thrived through that episode. In other words, we're still far from the danger zone on the slope of the yield curve.

The TSX: It's been a tough relative go of it for Canadian stocks in recent years. Just as a simple example, the Dow now stands more than 50% above the index level of the TSX (almost 25k versus roughly 16k), yet less than seven years ago they were equal (in late 2011). Over that particular stretch, the Dow has risen at better than an 11% annualized clip, while the TSX has crawled at less than a 5% pace. Adding insult, the TSX remains underwater so far this year. *Yes, but...* there is finally a ray of sunlight for the burdened TSX. Thanks to the comeback in oil, it was working on a six-day winning streak by Friday, was finally close to breaking even for the year, and managed to push above the 16,000 level for the first time since late January.

Rate hikes: The number of central banks actually raising interest rates at this point is few and far between. Since the Bank of Canada's January hike, we can point to the Fed, and, and... Argentina? With the Bank of England gracefully stepping aside this week, that suggests it may be only the Fed that hikes through the rest of Q2 (with the June 13 meeting still very much looking like a "go"). *Yes, but...* we still see the BoC on track for Q3, the BoE is likely delayed not derailed, and with oil on the march, we suspect others will not be as far behind as currently expected on the rate-hike treadmill.

The overriding conclusion is that while the latest round of economic data were on the sluggish side—and, indeed, global growth may be passing its peak—taut job markets and rising oil prices suggest price pressures will build.

One other example of a small number, with a "yes, but": There is now just one Canadian-based team remaining in the playoffs between both the NHL and the NBA. *Yes, but...* it's a good one and a big one. The Winnipeg Jets are the largest team in the NHL by some measures (though we would hasten to point out that another semi-finalist, Tampa Bay, is also the smallest team in the league). And, the Jets also had the best season record among the remaining teams, despite the fact that they are the only non-divisional winner among the final four. According to third-party sources—*we would never pay attention to this kind of thing, to be clear*—the Jets are now the second favourites to win the Stanley Cup (just behind Tampa), and are thus within shouting distance of becoming the first Canadian team to win in 25 years. Go Jets.

General Disclosure

"BMO Capital Markets" is a trade name used by the BMO Financial Group for the wholesale banking businesses of Bank of Montreal and its subsidiaries BMO Nesbitt Burns Inc., BMO Capital Markets Limited in the U.K. and BMO Capital Markets Corp. in the U.S. BMO Nesbitt Burns Inc., BMO Capital Markets Limited and BMO Capital Markets Corp are affiliates. This document is issued and distributed in Hong Kong by Bank of Montreal ("BMO"). BMO is an authorized institution under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) and a registered institution with the Securities and Futures Commission (CE No. AAK809) under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong). BMO does not represent that this document may be lawfully distributed, or that any financial products may be lawfully offered or dealt with, in compliance with any regulatory requirements in other jurisdictions, or pursuant to an exemption available thereunder. This document is directed only at entities or persons in jurisdictions or countries where access to and use of the information is not contrary to local laws or regulations. Their contents have not been reviewed by any regulatory authority. Bank of Montreal or its subsidiaries ("BMO Financial Group") has lending arrangements with, or provide other remunerated services to, many issuers covered by BMO Capital Markets. The opinions, estimates and projections contained in this report are those of BMO Capital Markets as of the date of this report and are subject to change without notice. BMO Capital Markets endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Capital Markets makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Capital Markets or its affiliates that is not reflected in this report. The information in this report is not intended to be used as the primary basis of investment decisions, and because of individual client objectives, should not be construed as advice designed to meet the particular investment needs of any investor. This document is not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such information be considered as investment advice or as a recommendation to enter into any transaction. Each investor should consider obtaining independent advice before making any financial decisions. This document is provided for general information only and does not take into account any investor's particular needs, financial status or investment objectives. BMO Capital Markets or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Capital Markets or its affiliates, officers, directors or employees have a long or short position in many of the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should assume that BMO Capital Markets or its affiliates may have a conflict of interest and should not rely solely on this report in evaluating whether or not to buy or sell securities of issuers discussed herein.

Dissemination of Research

Our publications are disseminated via email and may also be available via our web site <http://economics.bmocapitalmarkets.com>. Please contact your BMO Financial Group Representative for more information.

Conflict Statement

A general description of how BMO Financial Group identifies and manages conflicts of interest is contained in our public facing policy for managing conflicts of interest in connection with investment research which is available at http://researchglobal.bmocapitalmarkets.com/Public/Conflict_Statement_Public.aspx.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

BMO Financial Group (NYSE, TSX: BMO) is an integrated financial services provider offering a range of retail banking, wealth management, and investment and corporate banking products. BMO serves Canadian retail clients through BMO Bank of Montreal and BMO Nesbitt Burns. In the United States, personal and commercial banking clients are served by BMO Harris Bank N.A., Member FDIC. Investment and corporate banking services are provided in Canada and the US through BMO Capital Markets. BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A, BMO Ireland Plc, and Bank of Montreal (China) Co. Ltd. and the institutional broker dealer businesses of BMO Capital Markets Corp. (Member SIPC), BMO Nesbitt Burns Securities Limited (Member SIPC) in the U.S., BMO Nesbitt Burns Inc. (Member Canadian Investor Protection Fund) in Canada, Europe and Asia, BMO Capital Markets Limited in Europe, Asia and Australia and BMO Advisors Private Limited in India.

"Nesbitt Burns" is a registered trademark of BMO Nesbitt Burns Inc., used under license. "BMO Capital Markets" is a trademark of Bank of Montreal, used under license. "BMO (M-Bar roundel symbol)" is a registered trademark of Bank of Montreal, used under license.

© Registered trademark of Bank of Montreal in the United States, Canada and elsewhere.

™ Trademark Bank of Montreal in the United States and Canada.

© COPYRIGHT 2018 BMO CAPITAL MARKETS CORP.

A member of BMO Financial Group

Oil & the Canadian Economy: This Time *is* Different

Douglas Porter, CFA, Chief Economist and **Robert Kavcic**, Senior Economist

- Oil prices punched well above \$70/barrel this week for the first time since they cracked lower in November 2014. In the wake of news that the U.S. Administration will withdraw from the Iranian nuclear deal, WTI is now up 50% from just one year ago.
 - Our economic forecast assumes that oil prices will ease only slightly over the next 18 months, with **WTI averaging \$67 this year** and \$65 next, versus \$51 last year and \$43 in 2016.
 - These levels compare with an average of \$59 over the past 45 years, measured in today’s dollars. In other words, prices are back above “normal” levels, and the analysis below looks at the many implications for the Canadian economy of this upswing.
-
- The recovery in oil prices is a **net positive for the Canadian economy**, while a very mild drag on U.S. growth. However, both relationships are weaker than in previous cycles. For the U.S., the surge in shale production has slashed import dependency and rendered oil price changes as nearly a neutral factor for the growth outlook.
 - For Canada, the rebound may be less of a driver than in the past since it is unlikely to spur much new oil investment, given the ongoing uncertainty over pipeline capacity. Accordingly, we are not yet nudging our growth projections for either country, and still look for Canada to grow just 2.0% this year (and 1.8% in 2019) versus 2.8% for U.S. GDP (and 2.5% next year).
 - This underperformance by Canadian growth stands in stark contrast to past episodes of rising oil prices—typically, the move seen over the past year would imply Canadian growth outpacing the U.S. by roughly 1 percentage point, not the other way around.
-
- From a **regional perspective**, the rally in oil provides a much-needed tailwind for Alberta, Saskatchewan and Newfoundland & Labrador. But, our view remains that growth in these provinces will settle in around longer-term potential, rather than outperforming by a wide margin again.
 - These provinces will, however, see an income boost (i.e., nominal GDP), which will support employment and consumer spending. Indeed, our index that tracks a range of such indicators is showing convergence with most other provinces.
 - For the rest of Canada, higher oil prices are technically a net drag, but the current run is unlikely to have a major impact, especially given it is comes absent a strengthening loonie.

Chart 1
Breakout

(US\$/bbl : as of May 11, 2018)

WTI Crude Oil Price



Sources: BMO Economics, Haver Analytics

Chart 2
Where’s the Growth?

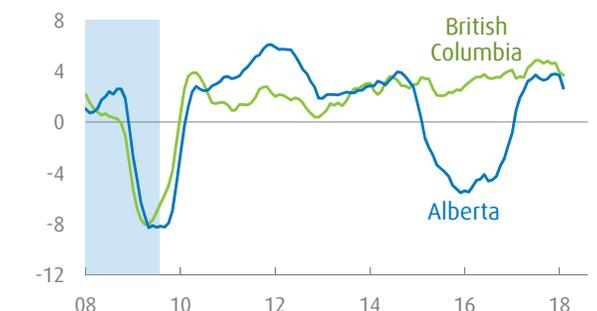


¹ (lhs: diff. in y/y % chng : ppts) ² (rhs: US\$: y/y chng : adv. 1 qtr.)
Sources: BMO Economics, Haver Analytics

Chart 3
Regional Convergence

(y/y % chng)

BMO Economic Performance Index



Shading marks period of Canadian recession
Sources: BMO Economics, Haver Analytics

- **The loonie** would normally be one of the biggest winners from the rise in oil prices; instead, it has gone mostly sideways in the past six months. Even as oil hit a 3½-year high this week, the Canadian dollar tested two-month lows at around 77 cents (nearly \$1.30/US\$) before rebounding above 78 cents. Still, traditional relationships suggest that the currency should be almost 10 cents stronger with oil at these levels.
 - What’s holding the currency back? First, there is the above-mentioned factor that Canada is unlikely to see the normal growth dividend from higher oil prices.
 - The loonie is also being held back by a generally stronger U.S. dollar (the C\$ is strong on the crosses), as well as some renewed trade jitters. In the event of a NAFTA deal, we expect a pop in the loonie of upwards of 3%.
-
- Oil has uncharacteristically done little to help **relative TSX performance**. Part of this likely reflects uncertainty over pipeline capacity and, until recently, a deep discount faced by Canadian producers. The latter has improved sharply to more normal levels in the past month, yet the TSX remains the worst-performing major market, down 1% on the year.
 - The rally in oil should eventually help—energy is still 20% of the index—if and when these issues get cleared up.
 - The bigger issue for the TSX is a distinct lack of exposure to technology and consumer discretionary, two sectors that have led performance in the U.S., while financials have taken a breather as housing cools.

- While the loonie and equities are not behaving as they normally would in the face of rising oil, **bond yields** for the most part are going according to plan.
- **Canadian 10-year yields are up more than 80 bps in the past year**, even slightly out-distancing the 75 bp cumulative rate hikes by the Bank of Canada in that period. Tens are now almost back to where they stood before oil prices collapsed in mid-2014, and have actually risen more than U.S. yields from a year ago.
- Two-year yields, meantime, have vaulted more than 120 bps in the past year, moving virtually in lockstep with the upswing in two-year Treasuries over that period.

Chart 4 Oil and C\$: Separation Anxiety

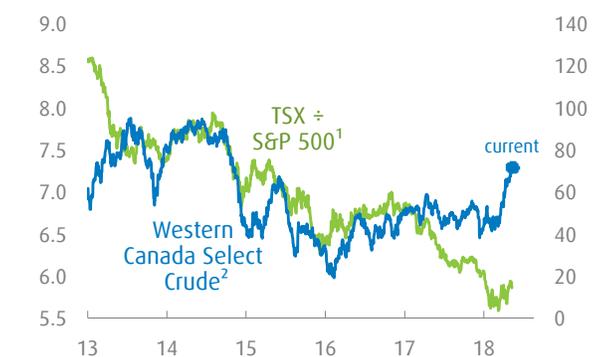
(as of May 10, 2018)



¹ 1st expiring contract (lhs : US\$/bbl) ² (rhs : US\$/C\$)
Sources: BMO Economics, Haver Analytics

Chart 5 The TSX: No Fuel

(as of May 11, 2018)



¹ (lhs : ratio) ² (rhs : C\$/bbl)
Sources: BMO Economics, Haver Analytics, Bloomberg

Chart 6 Oil and Bonds: On the Up and Up

(as of May 10, 2018)

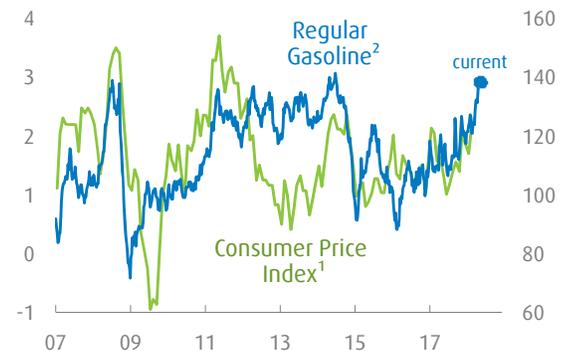


¹ 1st expiring contract (lhs : US\$/bbl) ² (rhs : %)
Sources: BMO Economics, Haver Analytics

- Higher oil prices generally equal higher interest rates, all things being equal. The link is that **inflation and nominal GDP growth are higher than they otherwise would be** in the face of rising oil prices.
 - Over the past 12 months, higher energy prices have directly added 0.4 percentage points to headline Canadian inflation (ex-energy CPI is now at 1.9% y/y), and the tally looks to rise in the next few months. The comparable U.S. figures are 0.5 ppts and 2.0% y/y.
 - The Bank of Canada based their latest forecast (in the April MPR) on an assumption of WTI at \$60 and WCS at \$40, and was still expecting headline CPI inflation of 2.4% by the end of this year. Based on recent oil prices alone, Q4 inflation could be closer to 2.7%, marking a seven-year high.
-
- Against this backdrop, the **rise in oil prices increases the odds that the Bank of Canada will resume its tightening campaign**. Of course, the Bank famously cut interest rates twice in the wake of the oil price collapse in 2015, so it's not a great leap to draw the connection in the opposite direction.
 - However, the case for rate hikes based on oil alone is not strong—the rebound has been much more gradual than seen during the collapse, the growth impact is much less direct now due to the pipeline capacity issues, and natural gas prices remain depressed.
 - We continue to look for the Bank to hike rates twice in the second half of the year, and then follow through with three additional moves in 2019, bringing the overnight rate to 2.5% at that point—right at the low end of what is considered neutral. While higher oil prices have not prompted a change in that view (yet), we have stopped highlighting the downside risk to our BoC rate call.
-
- On the fiscal front**, the 2018 federal budget assumed \$56 WTI in 2018, and \$57 over the next two years. While Ottawa doesn't collect royalties, the boost to nominal GDP, through the deflator, could reach as much as a percentage point—that would lift tax revenues roughly \$2 bln, based on budget sensitivities.
 - This increases the padding underneath Ottawa's \$18.1 bln FY18/19 deficit projection, which already includes a \$3 bln contingency, leaving upside potential in the fiscal plan.
 - The oil-producing provinces were also conservative with their oil price assumptions, with all three pegging WTI (or equivalent) in the high-\$50 range. Assuming the WCS differential and C\$ also hold around current levels for the full fiscal year, these provinces could be looking at combined \$4 bln of revenue upside (the bulk in Alberta), all else equal.

Chart 7
Inflation: Driven by Gasoline

Canada (as of May 10, 2018)



¹ (lhs : y/y % chng) ² volume wtd. avg. (rhs : CAD¢/L)
Sources: BMO Economics, Haver Analytics

Chart 8
BoC: Oil Looms Large

(as of May 11, 2018)

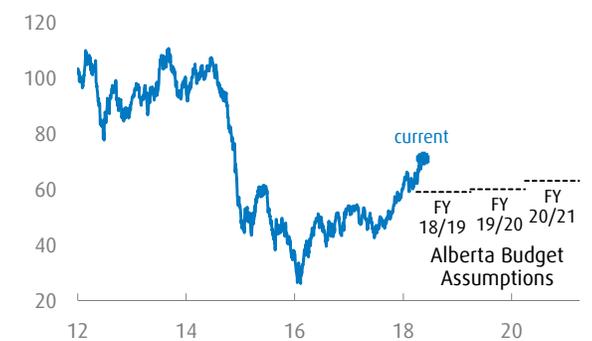


¹ (lhs : %) ² 1st expiring contract (lhs : US\$/bbl)
Sources: BMO Economics, Haver Analytics

Chart 9
Government Finances: Greased

(US\$/bbl : as of May 11, 2018)

WTI Crude Oil Price



Sources: BMO Economics, Haver Analytics, Alberta budget

General Disclosure

"BMO Capital Markets" is a trade name used by the BMO Financial Group for the wholesale banking businesses of Bank of Montreal and its subsidiaries BMO Nesbitt Burns Inc., BMO Capital Markets Limited in the U.K. and BMO Capital Markets Corp. in the U.S. BMO Nesbitt Burns Inc., BMO Capital Markets Limited and BMO Capital Markets Corp are affiliates. This document is issued and distributed in Hong Kong by Bank of Montreal ("BMO"). BMO is an authorized institution under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) and a registered institution with the Securities and Futures Commission (CE No. AAK809) under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong). BMO does not represent that this document may be lawfully distributed, or that any financial products may be lawfully offered or dealt with, in compliance with any regulatory requirements in other jurisdictions, or pursuant to an exemption available thereunder. This document is directed only at entities or persons in jurisdictions or countries where access to and use of the information is not contrary to local laws or regulations. Their contents have not been reviewed by any regulatory authority. Bank of Montreal or its subsidiaries ("BMO Financial Group") has lending arrangements with, or provide other remunerated services to, many issuers covered by BMO Capital Markets. The opinions, estimates and projections contained in this report are those of BMO Capital Markets as of the date of this report and are subject to change without notice. BMO Capital Markets endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Capital Markets makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Capital Markets or its affiliates that is not reflected in this report. The information in this report is not intended to be used as the primary basis of investment decisions, and because of individual client objectives, should not be construed as advice designed to meet the particular investment needs of any investor. This document is not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such information be considered as investment advice or as a recommendation to enter into any transaction. Each investor should consider obtaining independent advice before making any financial decisions. This document is provided for general information only and does not take into account any investor's particular needs, financial status or investment objectives. BMO Capital Markets or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Capital Markets or its affiliates, officers, directors or employees have a long or short position in many of the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should assume that BMO Capital Markets or its affiliates may have a conflict of interest and should not rely solely on this report in evaluating whether or not to buy or sell securities of issuers discussed herein.

Dissemination of Research

Our publications are disseminated via email and may also be available via our web site <http://economics.bmocapitalmarkets.com>. Please contact your BMO Financial Group Representative for more information.

Conflict Statement

A general description of how BMO Financial Group identifies and manages conflicts of interest is contained in our public facing policy for managing conflicts of interest in connection with investment research which is available at http://researchglobal.bmocapitalmarkets.com/Public/Conflict_Statement_Public.aspx.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

BMO Financial Group (NYSE, TSX: BMO) is an integrated financial services provider offering a range of retail banking, wealth management, and investment and corporate banking products. BMO serves Canadian retail clients through BMO Bank of Montreal and BMO Nesbitt Burns. In the United States, personal and commercial banking clients are served by BMO Harris Bank N.A., Member FDIC. Investment and corporate banking services are provided in Canada and the US through BMO Capital Markets. BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A, BMO Ireland Plc, and Bank of Montreal (China) Co. Ltd. and the institutional broker dealer businesses of BMO Capital Markets Corp. (Member SIPC), BMO Nesbitt Burns Securities Limited (Member SIPC) in the U.S., BMO Nesbitt Burns Inc. (Member Canadian Investor Protection Fund) in Canada, Europe and Asia, BMO Capital Markets Limited in Europe, Asia and Australia and BMO Advisors Private Limited in India.

"Nesbitt Burns" is a registered trademark of BMO Nesbitt Burns Inc., used under license. "BMO Capital Markets" is a trademark of Bank of Montreal, used under license. "BMO (M-Bar roundel symbol)" is a registered trademark of Bank of Montreal, used under license.

© Registered trademark of Bank of Montreal in the United States, Canada and elsewhere.

™ Trademark Bank of Montreal in the United States and Canada.

© COPYRIGHT 2018 BMO CAPITAL MARKETS CORP.

A member of BMO Financial Group