North American Outlook

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A look ahead at the Canadian and American economies

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Tough Act to Follow

ECONOMIC RESEARCH
1-800-613-0205 • economics.bmocapitalmarkets.com
Sal Guatieri, Senior Economist
416-359-5295
sal.guatieri@bmo.com

Canada

- Canada's economy was the envy of the G7 nations last year, **but it will grow more moderately in 2018**. Still, in the words of our central bank Governor, this is the year the economy returns "*home*", or the "*intersection*" of full employment and 2% inflation.
- **Consumers led the way in 2017, lifting spending nearly 4%**, as the fastest job gains in a decade overshadowed debt concerns. A recovering energy sector helped investment rebound from the prior year's downturn. Residential construction remained solid, led by surging demand for condos in Vancouver and Toronto. On the downside, exports struggled to gain traction, despite firmer global demand, as the currency rebounded from earlier 11-year lows. Consequently, **GDP growth downshifted to around 2% in the second half of the year** from 4% in the first half. Still, the above-potential pace **pulled the jobless rate down to its second lowest level (5.9%) since 1974**.
- **The pace of expansion is expected to moderate from around 3.0% in 2017 (the best in six years) to 2.2% in 2018**, holding above the post-recession trend. The downshift will stem from fading support from three earlier drivers: stimulative financial conditions, enhanced child benefit payments, and the sharp recovery in oil-producing regions. In addition, higher interest rates and tougher mortgage rules will slow the housing market. On the plus side, resource prices should remain firm as the global economy strengthens. Canadian exporters will slightly benefit from the extra dollars the U.S. government will leave in the pocketbooks and coffers of American households and companies. Longer term, Canadian companies will need to contend with a relative loss of competitiveness against U.S. firms.
- **British Columbia is expected to reclaim its title as the fastest growing province** for the third time in four years, after likely losing it to a resurgent Alberta last year. Still, like most regions, it will grow more moderately in 2018. The good news is that many provinces are already nearing full employment, with Quebec's jobless rate the lowest since at least 1976 and Ontario's taking aim at this feat.
- No single issue is likely to affect Canada's economy more in 2018 than the **resolution of NAFTA talks**. We currently place equal odds on one of three scenarios unfolding: the deal survives with only moderate changes; it is withdrawn by the U.S. administration but remains in effect until politicians/businesses resolve the issue in

KEY MESSAGES

- Less supportive financial conditions mean Canada's economy will be hard pressed to match last year's stellar performance, though it should continue to outrun potential
- Tax cuts for American businesses and consumers should herald another year of solid growth, ensuring the second longest expansion on record
- The Fed and BoC are expected to lift policy rates three times in 2018, with upside risk for the former if inflation ignites
- Firmer resource prices should support the C$ against a softer US$ this year, though the loonie likely won't make much headway unless NAFTA concerns fade

Congress/court; or, it is repealed after six months' notice by the U.S. government. If the "zombie" NAFTA scenario unfolds, weaker business confidence and investment will see Canada's economy slow more than expected. **If NAFTA is repealed, the three nations would probably resort to WTO trade rules.** In the event, we estimate that Canadian GDP will grow up to 1% less than otherwise over five years, a relatively modest impact on an economy projected to grow about 9% in the same period. A weaker currency and lower interest rates would help cushion the blow. More trade-intensive industries, such as motor vehicles and food processing, would be disproportionately impacted, notably harming Ontario's economy. The larger concern is if the U.S. ignores WTO rules and imposes punitive tariffs on Canadian exports, a scenario that could lead to a temporary recession.

- Another concern relates to the housing market's response to **new mortgage rules** that took effect January 1. The Bank of Canada estimates that a higher qualifying rate on uninsured loans (provided by federally regulated lenders) could impact up to 12% of borrowers in the Toronto region. Although some buyers will resort to alternative lenders, others will turn to less expensive (i.e., smaller or more distant) homes. The new rules risk deepening the correction in Toronto's detached housing segment, where prices have already dropped 12% since the spring. Ontario's Fair Housing Plan (including a 15% tax on non-resident buyers) had a chilling effect on buyer psychology, while unleashing a torrent of listings. By contrast, Toronto's condo market remains resilient, with prices up 23% in the past year amid wafer-thin inventories. The condo segment could even benefit from a shift toward less expensive homes. Unlike Toronto (and even higher-priced Vancouver), **housing markets in the rest of the country remain affordable** and should be little affected by the rule changes. In fact, housing inflation in Ottawa and Montreal picked up last year and could lead the nation this year.

- Since unwinding the 2015 rate cuts last summer, a cautious **Bank of Canada has held its fire**, wary of below-target inflation, slower economic growth, souring trade talks, and concern that indebted households can't handle much higher interest rates. However, Governor Poloz recently said the Bank is "*growing increasingly confident that the economy will need less monetary stimulus over time*" and that the word "*caution does not mean sitting back and doing nothing*." This opens the door for a possible January 17 rate hike. Still, barring a strong December jobs report (due January 5), **we believe the Bank will wait until March to pull the trigger**, partly because Q4 GDP growth looks to have underwhelmed expectations. We look for **three rate increases in 2018**, taking the overnight rate to 1.75% by year-end.

- Fueled by a strong economy and firm resource prices, the **Canadian dollar** appreciated 7% against a sagging greenback in 2017. However, excluding the U.S. dollar, the currency's trade-weighted value slipped in response to NAFTA concerns and a groaning trade deficit. These factors, together with unfavourable interest-rate spreads against the U.S., should hold back the loonie in 2018. We **see it ending the year at C$1.27** (US$0.787), compared with recent levels of C$1.25 (US$0.80).

United States

- The **U.S. economy ended a solid year on a high note**, growing close to 3% annualized in Q4. Activity is firing on all cylinders even before tax cuts take effect. For 2017 as a whole, real GDP likely grew 2.3%, largely matching our estimate at the start of the year. The longest unbroken string of nonfarm payroll gains (86 months) on record has pushed the jobless rate to a 17-year low of 4.1% in November.
- The **economy's momentum last year was provided by businesses, consumers and exporters**. Nonresidential investment grew almost 5% in 2017 after contracting the prior year, as companies sought to expand capacity in the face of a closing output gap. An upswing in capital goods orders suggests capex stayed strong at year end. Consumers spent at a near 2.7% rate, bolstered by surging wealth, steady employment gains and increased borrowing. It's no coincidence that consumer confidence and the jobless rate are at their best levels in 17 years. A weaker greenback and firmer global demand lifted exports about 3% last year. While housing markets slowed in the summer, they have caught a second wind with sales of existing and new homes at decade highs. The fewest number of available resale homes on record has American homebuilders even more upbeat than during the housing bubble.
- **Easier fiscal policy and tighter monetary policy will pull the economy in opposite directions in 2018**. Due to narrowing credit spreads, a softer greenback and surging equity and house prices, financial conditions have rarely been more supportive of the economy, adding an estimated two percentage points to GDP growth last year. A $7 trillion increase in household wealth accounted for most of the increase in consumer spending and is a key reason the personal savings rate is at a decade low (2.9%). However, barring another boffo year for stock markets, the wealth effect will fade as interest rates drift higher, suggesting the lift from financial conditions will halve in 2018. Consequently, the pace of **GDP is expected to moderate to 2.3% in 2018** (on a Q4/Q4 basis) from around 2.6% in 2017, even as the average annual rate improves to 2.6% from 2.3%.

Importantly, **GDP should continue to outrun its long-run potential** of around 1.8%.

- The **biggest tax cuts since 1981 are expected to add 0.4 percentage points to annual GDP growth**. The reduction in corporate tax rates will put American companies on par with major trading partners in Europe and Canada. Meantime, the ability to fully expense investments should extend the upswing in business spending. A tax break to repatriate foreign earnings will also help, even if companies do not need the funds to finance investments given resurgent profits and record liquid assets. Companies may use some of their tax windfall to lift worker pay or lower prices—a win-win for households. Proposed federal infrastructure spending could provide another fillip. On the downside, uncertainty about trade protectionism risks undermining business confidence and spending.

- **Fiscal stimulus will complicate the Fed's task of normalizing monetary policy**. While wages and prices remain tame—the core PCE rate is at 1.5% y/y, while unit labour costs are actually falling—late-cycle inflation pressures could begin to overwhelm the restraining effect of structural forces such as automation, e-commerce and globalization. Indeed, wages are now rising faster in states with extremely low jobless rates, foreshadowing trends at the national level if worker shortages worsen. A more hawkish group of FOMC voters (after the annual rotation of District presidents) is expected **to lift the fed funds rate three times in 2018** (in March, June and December, as per last year), taking the midpoint of the target range to 2.13% by year-end.

- The Fed's balance sheet is also expected to shrink by more than $400 billion in 2018, further pressuring Treasury yields. After going nowhere in 2017, the **10-year yield will likely end this year at 2.8%**, up 35 bps from recent levels. The moderate increase and implied further flattening of the yield curve is predicated on CPI inflation rising only modestly to 2.4% this year.

- The Fed's rate hikes will support the greenback in 2018, though **we expect the currency to weaken** amid rising U.S. budget and trade deficits, as well as improved conditions in the rest of the world.

- Barring a shock (*see below*), the U.S. **expansion should continue through the spring to become the second longest on record**. And if it continues until mid-2019—as we currently expect—it will surpass the ten-year run from 1991 to 2001. This would be a remarkable turn of events following the biggest economic crisis since the Depression.

Risks

Apart from longstanding concerns about Canadian household debt/housing markets and trade protectionism, several other issues could disrupt the North American economy in 2018, including:

- A partial **shutdown of the U.S. government** when the current stopgap funding bill expires on January 19.
- A payment **default by the U.S. government** if Congress fails to raise the debt-ceiling before the spring (possibly sooner given less tax revenue). A default, coupled with a ballooning budget deficit, could lead to another downgrade of the U.S. credit rating.
- An escalation in tensions between the U.S. and **North Korea** over the latter's nuclear program would rattle equity markets and business confidence.
- An **asset market correction**. After soaring 19% in 2017 and posting positive total returns for 14 straight months (a record), the S&P 500 is vulnerable to a pullback. We haven't lost sleep over the manic cryptocurrency market. With a (wildly fluctuating) market cap of around $500 billion, or 0.6% of global GDP, it's not big enough to derail the expansion. However, our concern would increase if the crypto bubble keeps inflating and draws leveraged "investors" into the game.
- Though encouraged by recent progress, the failure of **Brexit** talks to reestablish amicable trade relations could slow the U.K. economy and hamper the Euro Area recovery.
- The **Catalan independence** movement in Spain has regained momentum following recent elections. Meantime, **Italy's election** in March could usher in a euro-skeptic party. Both events could undermine confidence in the Euro Area.
- **Inflation risks** are all but forgotten by investors, but with oil prices above $60 a barrel and labour markets tight almost everywhere there is some risk that prices could rise faster than expected in 2018, fanning interest rate increases.

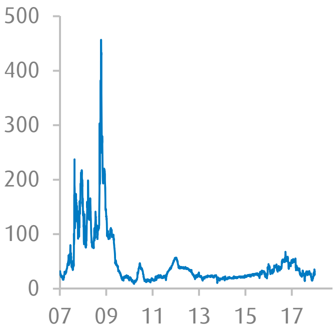
Forecasts

CANADA	2017 I	2017 II	2017 III	2017 IV	2018 I	2018 II	2018 III	2018 IV	ANNUAL 2016	ANNUAL 2017	ANNUAL 2018
Real GDP (q/q % chng : a.r.)	3.7	4.3	1.7	2.2	2.2	1.9	2.0	2.0	1.4	3.0	2.2
Consumer Spending	3.7	5.0	4.0	2.1	2.3	1.9	1.9	1.8	2.4	3.7	2.5
Business Investment (non-residential)	10.6	8.2	3.7	2.3	2.2	2.0	2.3	2.6	-9.4	1.4	2.8
Consumer Price Index (y/y % chng)	1.9	1.3	1.4	1.7	1.8	2.1	2.2	2.1	1.4	1.6	2.0
Unemployment Rate (%)	6.7	6.5	6.2	6.0	6.0	5.9	5.8	5.7	7.0	6.4	5.8
Housing Starts (000s : a.r.)	223	207	223	228	215	209	200	198	198	220	205
Current Account Balance ($blns : a.r.)	-54.5	-62.4	-77.4	-71.6	-68.2	-64.6	-62.0	-59.3	-65.4	-66.5	-63.5
Interest Rates (average for the quarter : %)											
Overnight Rate	0.50	0.50	0.83	1.00	1.08	1.25	1.50	1.75	0.50	0.71	1.40
3-month Treasury Bill	0.47	0.54	0.81	0.92	1.05	1.20	1.45	1.70	0.49	0.69	1.35
10-year Bond	1.71	1.51	1.95	1.96	2.00	2.15	2.30	2.40	1.25	1.78	2.20
Canada/U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	-13	-37	-25	-30	-37	-42	-29	-16	17	-26	-31
10-year	-73	-75	-30	-41	-47	-44	-41	-38	-59	-55	-42
UNITED STATES											
Real GDP (q/q % chng : a.r.)	1.2	3.1	3.2	2.9	2.5	2.5	2.2	2.0	1.5	2.3	2.6
Consumer Spending	1.9	3.3	2.2	3.1	3.3	2.9	2.5	2.2	2.7	2.7	2.9
Business Investment (non-residential)	7.1	6.7	4.7	6.1	4.4	3.5	2.8	2.4	-0.6	4.6	4.4
Consumer Price Index (y/y % chng)	2.6	1.9	2.0	2.1	2.0	2.6	2.6	2.3	1.3	2.1	2.4
Unemployment Rate (%)	4.7	4.4	4.3	4.1	4.0	3.9	3.8	3.8	4.9	4.4	3.9
Housing Starts (mlns : a.r.)	1.24	1.17	1.17	1.27	1.29	1.30	1.27	1.26	1.18	1.21	1.28
Current Account Balance ($blns : a.r.)	-454	-498	-402	-466	-492	-513	-533	-543	-452	-455	-520
Interest Rates (average for the quarter : %)											
Fed Funds Target Rate	0.71	0.96	1.13	1.21	1.46	1.71	1.88	1.96	0.40	1.00	1.75
3-month Treasury Bill	0.60	0.90	1.06	1.23	1.45	1.65	1.75	1.85	0.32	0.95	1.65
10-year Note	2.44	2.26	2.24	2.37	2.45	2.60	2.70	2.80	1.84	2.33	2.65
EXCHANGE RATES (average for the quarter)											
US¢/C$	75.6	74.4	79.9	78.6	77.5	76.9	77.5	78.4	75.5	77.1	77.6
C$/US$	1.323	1.345	1.253	1.272	1.290	1.300	1.290	1.275	1.326	1.298	1.289
¥/US$	114	111	111	113	114	114	115	116	109	112	115
US$/Euro	1.07	1.10	1.18	1.18	1.17	1.16	1.19	1.21	1.11	1.13	1.18
US$/£	1.24	1.28	1.31	1.33	1.34	1.34	1.34	1.36	1.35	1.29	1.35

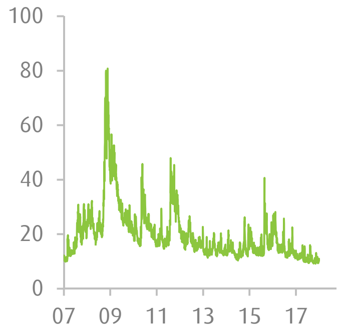
Note: Shaded areas represent BMO Capital Markets forecasts

MARKET VOLATILITY UNUSUALLY LOW
United States (as of December 29, 2017)

Ted Spread[1]



VIX[2]



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

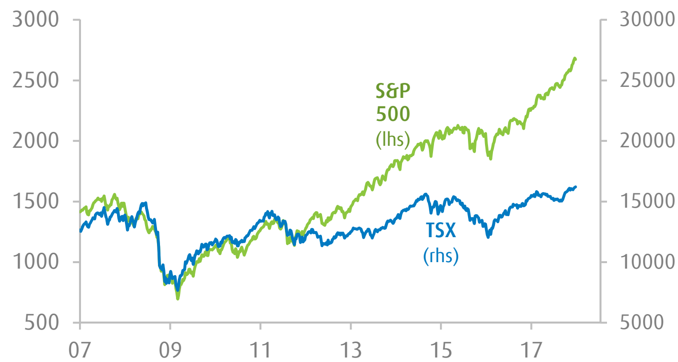
CREDIT SPREADS REMAIN THIN
United States (ppts)

Corporate Bond Spreads[1]

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

EQUITIES AT NEW HIGHS
(indices : as of December 29, 2017)

Equities

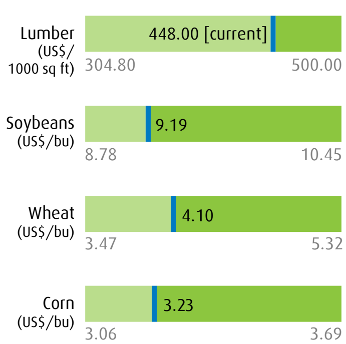


LOONIE RANGEBOUND
(US¢ : as of January 2, 2018)

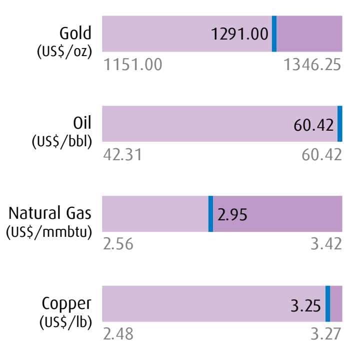
Canadian Dollar

FIRMER RESOURCE PRICES APART FROM AG
Commodity price range since start of 2017

Materials & Foodstuffs
(as of December 29, 2017)



Metals & Energy
(as of December 29, 2017)

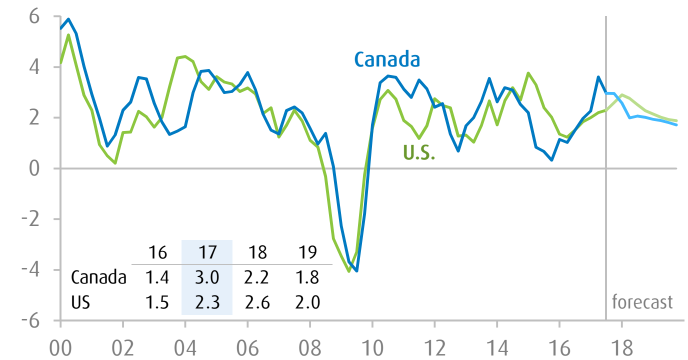


OIL PRICES AT TWO-YEAR HIGHS
(US$/bbl : as of January 2, 2018)

WTI Crude Oil

CANADIAN GROWTH PEAKS
(y/y % change)

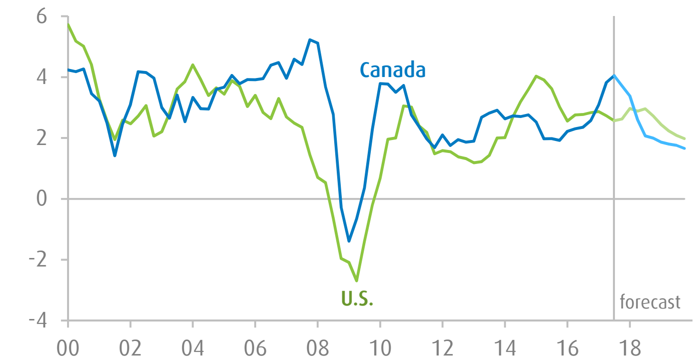
Real GDP



While U.S. gains momentum

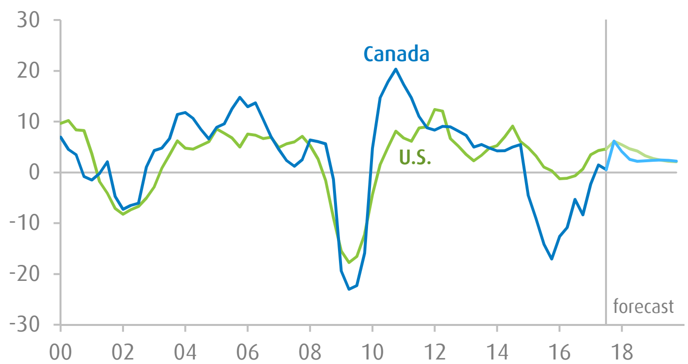
CONSUMERS KEEP SPENDING
(y/y % change)

Real Personal Consumption Expenditures



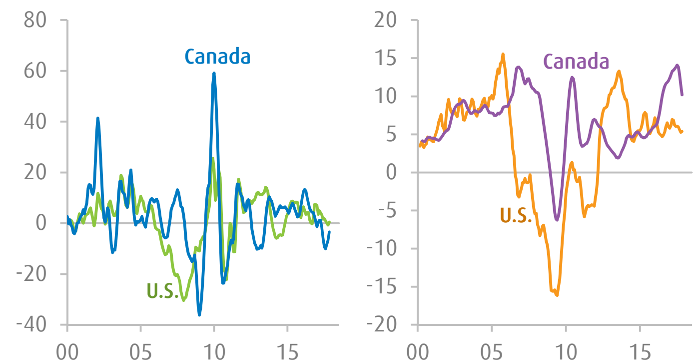
BUSINESS INVESTMENT HEALTHY
(y/y % change)

Real Non-Residential Business Investment



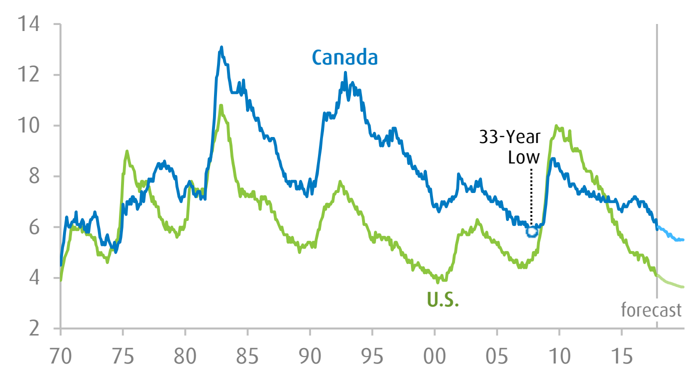
HOME PRICES RISING
Existing Homes (y/y % change : 3-month m.a.)

Sales **Prices**



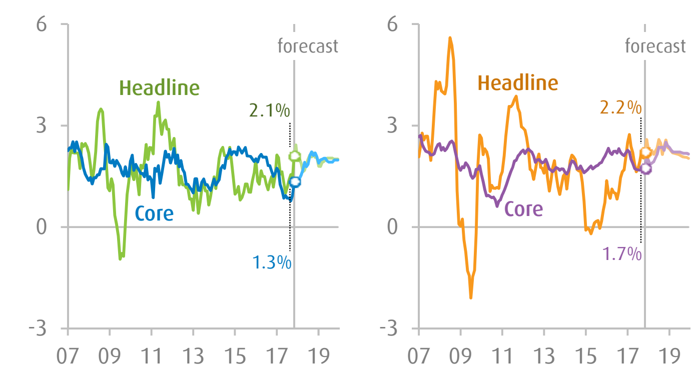
NEAR FULL EMPLOYMENT
(percent)

Unemployment Rate

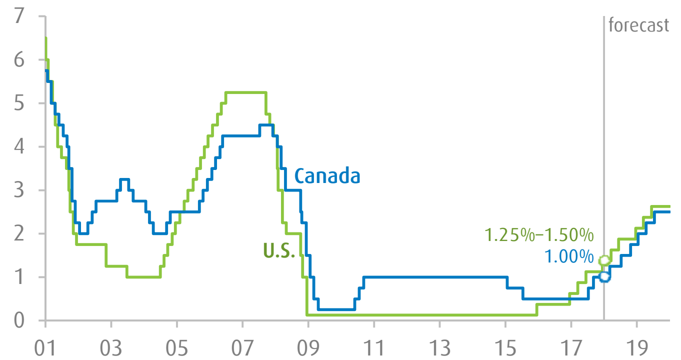


INFLATION SUBDUED
Consumer Price Index (y/y % change)

Canada **United States**



MONETARY POLICIES LARGELY IN SYNC
(% : as of January 2, 2018)



LONG RATES TURN HIGHER
(% : as of January 2, 2018)