North American Outlook

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A look ahead at the American and Canadian economies

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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 have sidelined the Fed and Bank of Canada, though each will likely take one final kick at the tightening can in December
- A possible 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 ebbed when the Fed downshifted into neutral policy gear**. Powell and Co. won't bullheadedly hike rates in the face of slower growth, global "*crosscurrents*" and "*muted inflation*". Many policymakers no longer see the need to raise rates again unless inflation perks up. As well, balance-sheet runoff will end this year, sooner than many thought.
- 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 leaders plan to meet in late March to seal a deal. This would remove one of the biggest thorns in the side of the global economy. Still, other prickly 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 2.6% (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 2.8% in the quarter, despite falling the most in nine years in December. Even better was a **6.2% surge in nonresidential investment**, suggesting the trade war hasn't curbed spending plans. As a result, private domestic demand grew a strong 3.1% in Q4, slightly faster than in Q3.
- But **growth looks to ebb further to 1.2% in Q1.** The week year-end handoff from consumer spending and housing starts (which plunged 11% in December), 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 income tax withheld from paycheques, imply some downside risk.
- **Since some of the headwinds are temporary, growth should rebound to 2.5% in Q2**. Hidden in the murky economic waters are two pearls. Nonfarm payrolls soared 304,000 in January, the most in nearly

a year, suggesting businesses don't expect the recent soft patch to last. And, pending home sales jumped nearly 5% in January, spurred by the one-half percentage-points drop in mortgage rates since November. This flags some stability in housing markets after the seven-year-long recovery stumbled badly last year. Demographics also remain supportive, with the homeownership rate turning higher as more millennials take the plunge. Meantime, sturdy gains in personal income (4.3% y/y in January), elevated wealth and a light debt-service load will underpin consumers, especially since confidence has rebounded with the upswing in equities. On the fiscal front, federal spending will see a post-shutdown bounce in Q2, while many states plan to increase spending or cut taxes amid a surge in revenues.

- After growing 2.9% in 2018 (the best year since 2005), the economy will moderate to **a more sustainable rate of 2.3% 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 expanded for a record 100 straight months, while, come July, the economic expansion will enter the history books as the longest-running since at least the mid-19th century.
- The **Fed should remain sidelined until December**, before pulling the rate trigger one last time as inflation drifts modestly higher. With the policy rate expected to peak at around 2.6%, the 10-year Treasury yield should level off near 2.85% by year-end, the lowest at the end of a tightening cycle on record.
- Apart from other danger zones on the trade front, the economy faces a few **political land mines**. A divided Congress might 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 may balk at lifting the recently-reinstated **debt ceiling** before the fall, at which time the Treasury will run out of shuffling measures to pay 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 stalling economy**. Real GDP rose just 0.4% in Q4 (yes, annualized) 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).

- **Worse, we have drawn in a giant goose egg in the Q1 GDP column**, partly due to Alberta's mandated oil output cuts. Although the housing market is finding a steadier footing after last year's slide due to higher mortgage rates and new stress tests, activity and prices continue to sag in Vancouver (still one of the least affordable cities in the world) and in the oil-producing provinces (still facing a glut of unsold homes from the 2015 oil-price shock). While the fastest population growth in 28 years (1.4%) should lead to steadier sales and prices nationwide this year, the days when they drove the expansion are long gone.
- After slowing to 1.8% last year from 3.0% in 2017, the **economy is projected to expand just 1.3% this year** (revised down from 1.8% previously). The annual rate could get sliced further if growth doesn't improve to an expected 2.5% in Q2. While the jobless rate will likely remain near a four-decade low this year (averaging 5.7%), another downside growth surprise would see it marching higher.
- At least prior to the soggy Q4 results, the Bank of Canada was putting on a brave face and still leaning toward pushing rates to more neutral levels, though it was clearly in no rush. With the economy cooling (Q4 growth was nearly a full percentage point below the Bank's estimate), core inflation hovering just below the 2% target, and ongoing uncertainty around trade policies, **the Bank could stand pat until December, before hiking a final time to 2.0%.** The 10-year Canada rate should rise modestly to 2.1% at year-end, though this would still be just 1.1 percentage points above the all-time low reached in 2016.
- The **Canadian dollar remains flightless**, as support from firmer oil prices and the Bank's mild tightening bias has been offset by a weaker economy and current account deficit (2.8% of GDP). 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 several potential **risks** facing the Canadian economy.

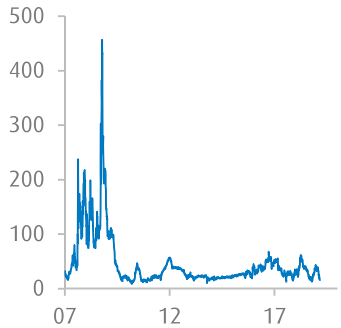
Forecasts

	2018				2019				ANNUAL		
UNITED STATES	I	II	III	IV	I	II	III	IV	2017	2018	2019
Real GDP (q/q % chng : a.r.)	2.2	4.2	3.4	2.6	1.2	2.5	2.0	1.9	2.2	2.9	2.3
Consumer Spending	0.5	3.8	3.5	2.8	1.6	2.7	2.1	2.0	2.5	2.6	2.5
Business Investment (non-residential)	11.5	8.7	2.5	6.2	2.9	3.0	2.1	2.0	5.3	7.0	3.7
Consumer Price Index (y/y % chng)	2.2	2.7	2.6	2.2	1.6	1.7	1.7	1.9	2.1	2.4	1.7
Unemployment Rate (%)	4.1	3.9	3.8	3.8	3.9	3.7	3.6	3.5	4.4	3.9	3.6
Housing Starts (mlns : a.r.)	1.32	1.26	1.23	1.17	1.21	1.24	1.23	1.21	1.21	1.24	1.22
Current Account Balance ($blns : a.r.)	-487	-405	-499	-528	-566	-579	-592	-602	-449	-480	-585
Interest Rates (average for the quarter : %)											
Fed Funds Target Rate	1.46	1.71	1.96	2.21	2.38	2.38	2.38	2.46	1.00	1.83	2.40
3-month Treasury Bill	1.58	1.87	2.08	2.36	2.40	2.40	2.40	2.60	0.95	1.97	2.45
10-year Note	2.76	2.92	2.93	3.03	2.70	2.75	2.80	2.85	2.33	2.91	2.75
CANADA											
Real GDP (q/q % chng : a.r.)	1.3	2.6	2.0	0.4	0.0	2.5	2.2	1.9	3.0	1.8	1.3
Consumer Spending	1.5	1.7	1.3	0.7	2.1	1.6	1.6	1.4	3.6	2.1	1.5
Business Investment (non-residential)	7.0	-1.4	-10.8	-10.9	2.2	3.8	3.2	2.9	2.5	1.7	-1.9
Consumer Price Index (y/y % chng)	2.1	2.3	2.7	2.0	1.5	1.7	1.6	1.8	1.6	2.3	1.6
Unemployment Rate (%)	5.8	5.9	5.9	5.7	5.8	5.8	5.7	5.7	6.3	5.8	5.7
Housing Starts (000s : a.r.)	224	218	197	217	209	207	204	200	220	214	205
Current Account Balance ($blns : a.r.)	-69.0	-63.4	-40.4	-61.9	-57.3	-57.7	-59.1	-60.0	-60.1	-58.7	-58.5
Interest Rates (average for the quarter : %)											
Overnight Rate	1.25	1.25	1.50	1.75	1.75	1.75	1.75	1.83	0.71	1.44	1.77
3-month Treasury Bill	1.14	1.21	1.47	1.66	1.65	1.65	1.65	1.85	0.69	1.37	1.70
10-year Bond	2.24	2.28	2.28	2.32	1.95	2.00	2.05	2.10	1.78	2.28	2.00
Canada/U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	-44	-67	-61	-70	-77	-76	-76	-76	-26	-60	-76
10-year	-52	-64	-65	-71	-77	-76	-76	-75	-55	-63	-76
EXCHANGE RATES (average for the quarter)											
US¢/C$	79.1	77.5	76.5	75.7	75.4	75.3	75.4	75.4	77.1	77.2	75.4
C$/US$	1.265	1.291	1.307	1.322	1.327	1.328	1.327	1.325	1.298	1.296	1.327
¥/US$	108	109	112	113	110	110	110	110	112	110	110
US$/Euro	1.23	1.19	1.16	1.14	1.14	1.15	1.16	1.17	1.13	1.18	1.15
US$/£	1.39	1.36	1.30	1.29	1.29	1.32	1.32	1.31	1.29	1.34	1.31

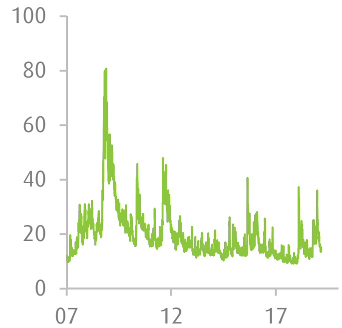
Note: Shaded areas represent BMO Capital Markets forecasts

VOLATILITY EBBS
United States (as of March 1, 2019)

Ted Spread[1]



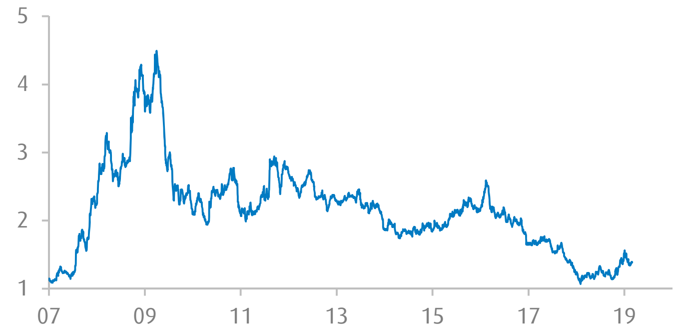
VIX[2]



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

CREDIT SPREADS STABILIZE
United States (ppts)

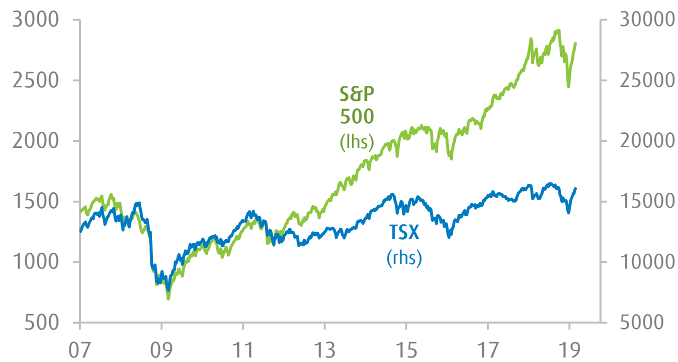
Corporate Bond Spreads[1]



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

EQUITIES REBOUND
(indices : as of March 1, 2019)

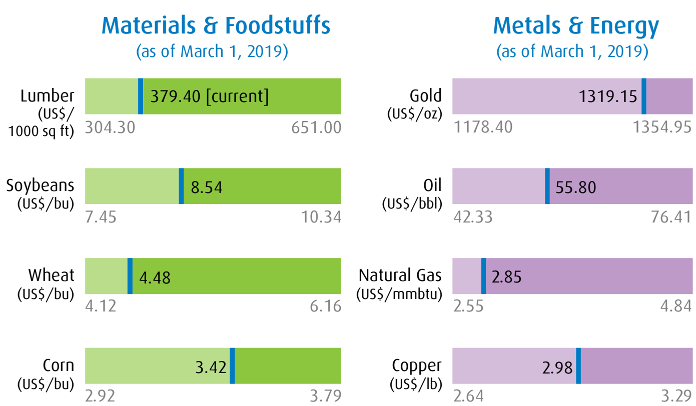
Equities



LOONIE LANGUISHES
(US¢ : as of March 1, 2019)

Canadian Dollar

NATURAL GAS FIZZLES
Commodity price range since start of 2018

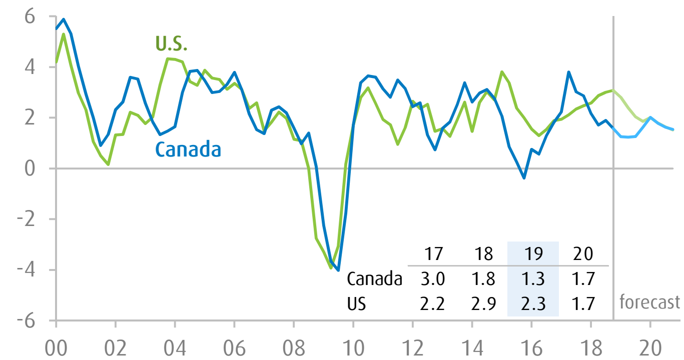


OIL PRICES FIRM
(US$/bbl : as of March 1, 2019)

WTI Crude Oil

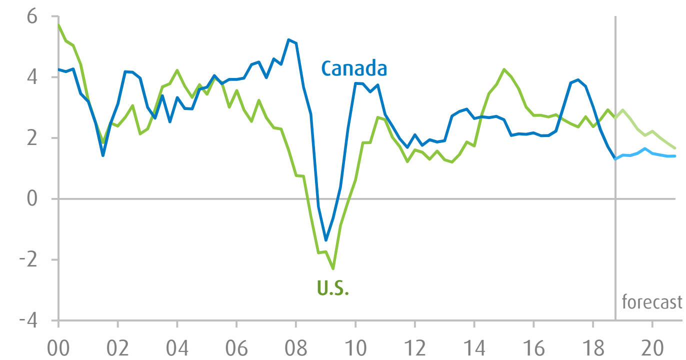
GROWTH MODERATES
(y/y % change)

Real GDP



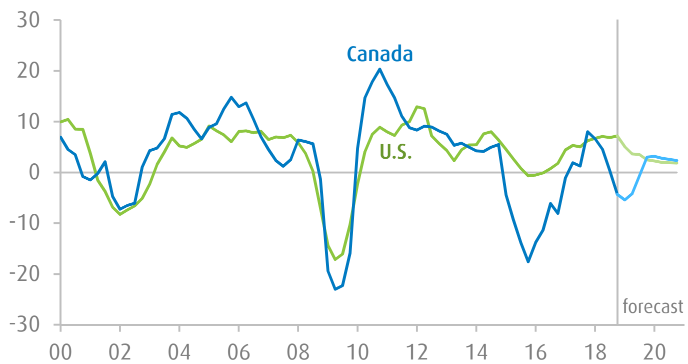
US CONSUMERS KEEP SPENDING
(y/y % change)

Real Personal Consumption Expenditures



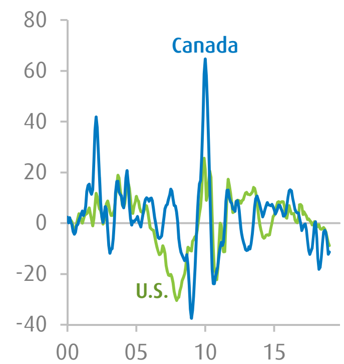
INVESTMENT SLOWS
(y/y % change)

Real Non-Residential Business Investment

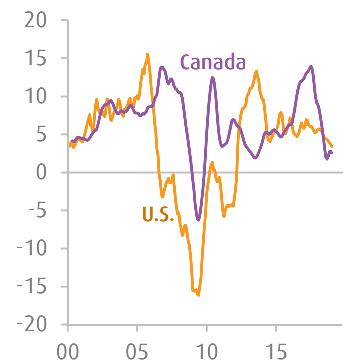


HOUSING COOLS
Existing Homes (y/y % change : 3-month m.a.)

Sales

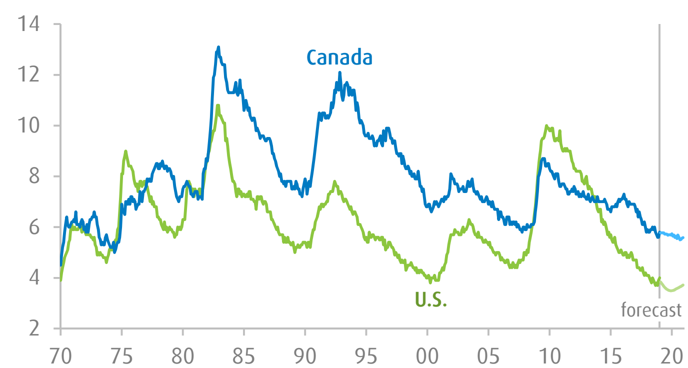


Prices



FULLY EMPLOYED
(percent)

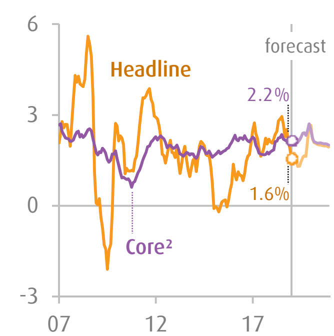
Unemployment Rate



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

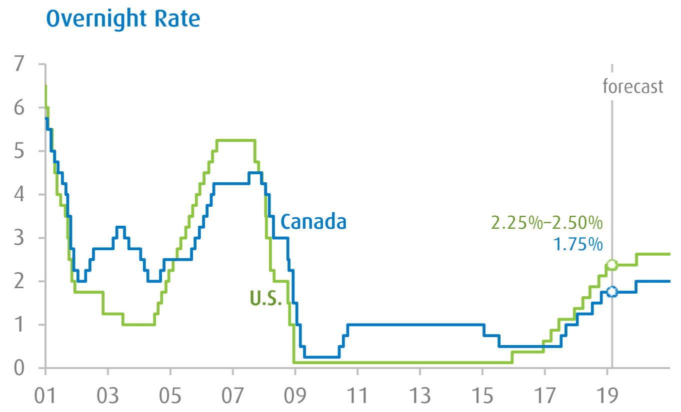
Canada

United States



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

ONE AND DONE
(% : as of March 1, 2019)



RATES PEAKING
(% : as of March 1, 2019)