Markets vs Economists

- **Global growth has clearly peaked, as long expected, but signs of weaker growth should not be confused with signs that the expansion is in its dying days.**
- **Central banks that have been on a tightening path will remain on this path this year.**

The decline in equity markets (chart 1) and movements in certain parts of the yield curve over the last few months suggests a clear disconnect between economic prospects as evaluated by markets and those forecast by economists. Economists, including us, have long predicted a slowdown from the strong growth rates registered in 2017–18. Central banks in a few countries have been altering policy settings to engineer just that. That growth is expected to slow this year, and that we are seeing signs of this now is therefore not surprising. Our forecast currently calls for global growth to slow from 3.7% in 2018 to 3.5% in 2019. However, the evolution of equity markets through the Fall, along with movements in the yield curve suggest a much greater markdown in growth is anticipated, including possibly a recession in some countries. There is clearly a disconnect. Either growth outcomes will disappoint relative to the consensus view of economists, or markets will adjust their expectations to reflect better economic outcomes.

Who's got it right? By and large, indicators in Canada and the US, and isolated indicators in the UK and Europe, suggest that there is still momentum in the economy. Job growth has surprised to the upside, dramatically so in Canada and the US over the last two months of 2018. Indicators of business sentiment, whether looking at ISM surveys or other metrics, have deteriorated, but still generally suggest economies are growing. Our own recession probability model for Canada, which considers a range of economic and financial variables, suggests the risk of a recession remains very low.

As is now commonly said, expansions do not die of old age. Something must trigger a pronounced slowdown or a recession. In advanced economies, these factors have historically been oil price shocks and over-tightening by central banks. This is in part why markets have been so mindful of prospects for Fed policy over recent months: will the Fed tighten the economy into a recession, as central banks have done in the past? We think this is extremely unlikely given that real policy rates in the US are barely above zero and those in Canada are still negative. As noted by Derek Holt in the *Capital Markets* section, to trigger a recession, rates would need to rise well above our forecasts for the Fed or BoC.

The most likely trigger for a substantial markdown in global growth remains, in our view, an escalation of the China-US trade war. We have long thought the conflict was more likely to de-escalate than escalate, but it became clear late last year that markets were finally starting to worry about the consequences of the trade skirmish and were fearful of the way forward. An escalation of the trade conflict has the potential to impart substantial costs on the countries involved, along with the rest of the world. If this were to happen, market gloom would be validated ex-post. Signs now point more firmly to a de-escalation, or at the very least no further escalation,

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CONTENTS

Chart 1

Sources: Scotiabank Economics, Bloomberg.

of the trade conflict. US and Chinese negotiators met in China, and the talks seem to be going well, if we take President Trump at his word.

As this China-US conflict wanes, so does, in our view, the greatest risk to the global outlook. Uncertainty is peaking in 18Q4 and 19Q1, although other risks will remain prominent in the first months of this year—such as the Brexit saga. We believe that the risk landscape will improve through the first quarter as more certainty around the China-US relations takes shape, and markets come to understand that Fed Chair Powell will not sink the US economy. As this happens, the underlying strength and resilience of the global economy will become more apparent, and central banks that were in tightening mode will likely resume doing so.

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Table 1

Global Real GDP	2000–17	2017	2018e	2019f	2020f
		(annual % change)			
World (PPP)	3.9	3.8	3.7	3.5	3.4
Canada	2.1	3.0	2.1	1.8	2.0
United States	2.0	2.2	2.9	2.4	1.7
Mexico	2.2	2.1	2.0	1.6	2.3
United Kingdom	1.9	1.8	1.4	1.5	1.5
Eurozone	1.4	2.4	1.9	1.7	1.7
Germany	1.4	2.2	1.5	1.6	1.6
France	1.4	2.2	1.5	1.5	1.7
China	9.3	6.9	6.6	6.2	6.0
India	7.0	6.3	7.5	7.3	7.5
Japan	0.9	1.9	0.8	1.1	0.8
South Korea	4.1	3.1	2.7	2.7	2.6
Australia	2.9	2.4	3.0	2.7	2.5
Thailand	4.0	3.9	4.1	3.8	3.5
Brazil	2.5	1.1	1.1	2.3	2.5
Colombia	3.9	1.8	2.5	3.3	3.6
Peru	5.0	2.5	3.7	4.0	4.0
Chile	3.9	1.5	3.9	3.2	3.2

Sources: Scotiabank Economics, Statistics Canada, BEA, BLS, IMF, Bloomberg.

Canada

TEMPORARY WEAKNESS

- **Growth is on a much more solid footing than assumed by markets. Growth will remain around potential through 2020. The risk of a recession is very low.**
- **The very sharp rebound in the price of Canadian oil since late Fall, coupled with global oil prices quickly rising off their Christmas Eve lows, suggest the impact of lower oil prices may not be as large as feared.**
- **With underlying measures of inflation at roughly 2%, the Bank of Canada will remain on its path to normalize policy as interest rate increases so far have not had the feared outsized impacts.**

The Canadian economy remains on solid footing, and is far from being on the edge of a precipice, as could be inferred from developments in financial markets over the last few weeks. While true that the global decline in equity prices and the concomitant decline in oil prices is cause for concern, economic indicators here (and in the US) remain generally positive. Fundamentals remain sound, with growth expected to hover slightly below 2% this year, roughly in line with the economy's potential. Underlying measures of inflation will remain around the 2% targeted by the Bank of Canada. To keep inflation around this target, Governor Poloz will need to gradually remove the remaining monetary stimulus by bringing rates to their neutral level of 2.75% by 2020Q1.

A TALE OF TWO PERSPECTIVES

The generalized decline in markets and increases in volatility since the Fall, the tumble in oil prices, developments on the Brexit front and Trump-related developments have captured the headlines in recent weeks. These are naturally weighing on consumer and business sentiment, and are causing some to question how much longer the global expansion will last. Are we on the cusp of a major slowdown in growth, as can be inferred from some financial indicators, or simply entering a period of slowing, but still good growth? We believe the latter, and think markets have over-reacted to reasonably minor changes to the outlook. The reversal in equity markets seen in the last couple of week is consistent with that view, as are the results of our recession probability model for Canada which uses economic and financial information to quantify the risk.

From a Canadian perspective, much is being made of the rapid drop in oil prices and the widening of the differential of the price received for Canadian oil late last year. As the Bank of Canada notes, the USD20–30 drop in international oil prices represents a serious terms of trade shock to Canada given how much oil we produce. What's more, lack of egress capacity and a shutdown of refineries in the US forced the price paid for Western Canada Select to fall to nearly $15 in November, while the price of bitumen was briefly negative. Since then, these refineries have re-opened, international oil prices have rebounded sharply (chart 1), and the Alberta government has forced oil companies to cut their

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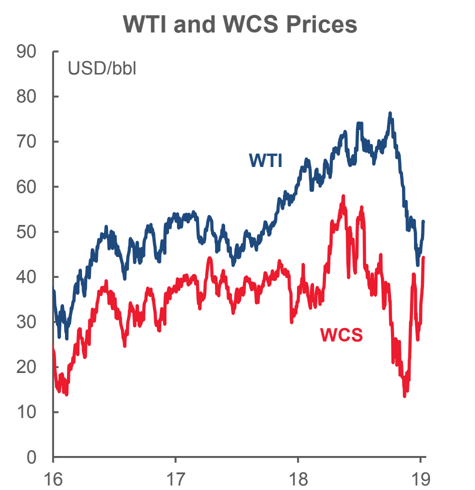
Canada	2017	2018e	2019f	2020f
Real GDP (annual % change)	3.0	2.1	1.8	2.0
CPI (y/y %, eop)	1.8	2.0	1.7	2.2
Central bank policy rate (%, eop)	1.00	1.75	2.50	2.75
Canadian dollar (CADUSD, eop)	0.80	0.73	0.79	0.81

Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

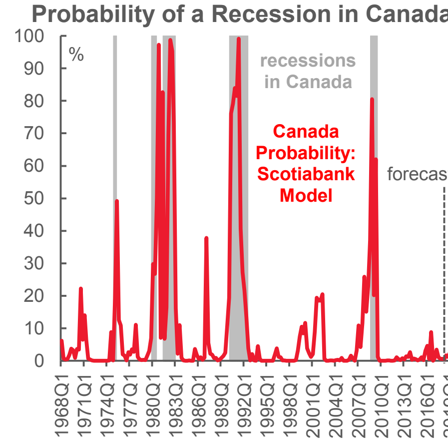
production by 9% to reflect the limited egress capacity and to drain inventories. While a government-mandated cut in production will unquestionably reduce output in the oil patch and real GDP, the price of Western Canada Select has more than made up for lost ground and is now generally above levels seen in 2016–17. **This suggests that the impact of the decline in oil prices may not be as sharp for Canada as the Bank of Canada believes**. That being said, the fall in oil prices since last summer and the production cutbacks in the oil patch will have a depressing impact on growth in 18Q4 and 19Q1, when production cutbacks peak. As the cutbacks are temporary and will be scaled back as rail capacity rises, we see much of the impact of oil market developments as having a temporary impact on growth.

A second concern is the impact of the decline in equity markets on Canadian confidence and spending. The 10% or so decline in the S&P TSX Composite index is a shock that reduces Canadian wealth, which in turn will reduce consumer spending. The extent of this impact is a function of two factors: the size of the decline in wealth and its persistence. Since we think markets have over-reacted to economic data and political developments, we assume financial wealth will gradually rise to levels that are more consistent with underlying economic fundamentals. The pickup in equity indices over the last two weeks is a sign that this is already underway. This suggests the impact of the decline may not be as large as feared by some. Further, the impact of financial wealth on spending is much smaller in Canada than in the US. Chart 3, derived from our macro-econometric model, demonstrates this clearly.

While these factors are causing us to shave our forecast down to 1.8% in 2019 and to boost it to 2.0% in 2020, it is important to note that these growth rates are roughly in line with potential growth rates. The modest decline in growth from the 2.1% observed in 2018 is not a material deterioration in the outlook, and speaks to the still generally positive fundamentals:

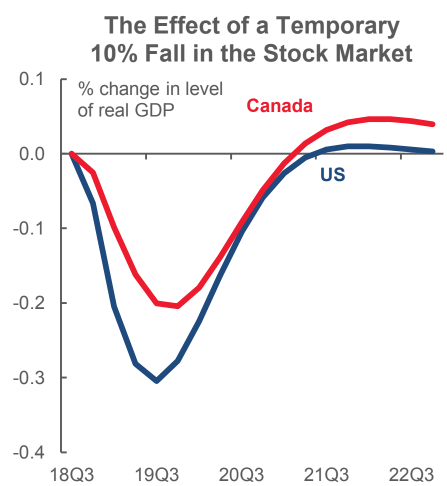
- **Monetary policy remains highly accommodative, with the real policy rate still negative**, and nominal rates well below the Bank of Canada's estimated neutral rate range of 2.5–3.5%
- **Human stimulus, more commonly known as population growth, is rising at its most rapid pace in almost 10 years on the back of rising immigration (chart 4).**
- **Employment growth remains strong, with an acceleration in job growth through 2018.** This has provided a boost to wages and salaries which rose by almost 3% in 18Q3, the most recent period for which we have data. This will help reduce the impact of the fall in wealth on consumer activity, though retail sales fell sharply in October, the most recent month for which we have data. Car sales are also falling, though they have come off extremely high levels.
- **Canadian household balance sheet remains relatively healthy.** The debt to net-worth ratio is at roughly where it was in 2007 (chart 5). While debt service is going up in line with the rise in interest rates, it is moving gradually and there is as yet very little evidence this is causing widespread challenges for households. The proportion of mortgages in arrears is near historical lows and is well below the levels seen before rate increases began.
- In manufacturing, real unfilled orders are up 8% y/y (chart 6), while unfilled orders as a proportion of shipments are at their highest level in 2 years.

Chart 2



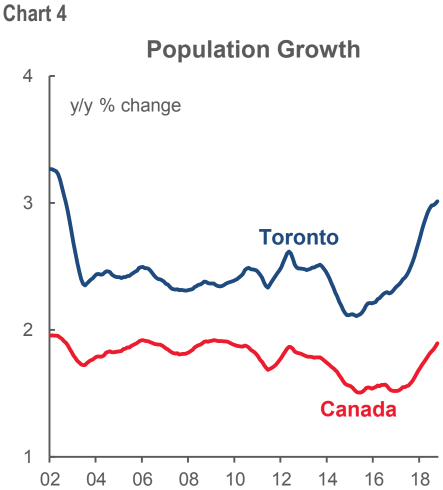
Sources: Scotiabank Economics, Haver Analytics.

Chart 3



Source: Scotiabank Economics.

Chart 4



Sources: Scotiabank Economics, Statistics Canada.

There are notable areas of weakness however:

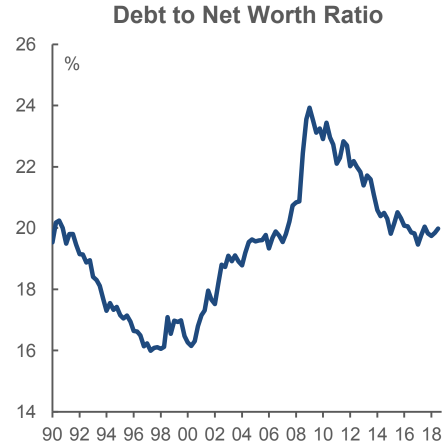
- **As noted, developments in the oil industry are currently acting as a drag on growth.** This will affect export growth, where non-oil export growth has disappointed in the latter half of the year. Capacity constraints in exporting industries are a likely factor underlying that, although there has been a broad-based slowdown in global trade this year.

- **The housing sector has cooled relative to last year, with sales and starts falling relative to 2017.** However, residential construction remains healthy across much of Canada. The pace of sales and price gains has largely stabilized since a modest recovery during the summer months, which coincided with accelerating economic growth and still-low interest rates and followed a strong initial response to the stricter mortgage qualification tests that came into effect on January 1st. We continue to expect that the Canadian housing market will experience a period of relative price stability into 2019, albeit with some regional variation. National housing starts are projected to ease from 213,000 units in 2018 and average just north of 200,000 units in 2019–20, roughly 10% below the peak build rate of 2017.This will lead to a decline in residential investment relative to 2018.

- **Likewise, it is clear that business investment is moderating following the rapid pace set in early 2018.** The second half of 2018 was characterized by extreme levels of uncertainty. Was NAFTA going to be renegotiated? Would the US trade war with China get out of hand? Were markets signaling a risk of recession? These factors likely depressed business investment late last year and we believe they will continue to suppress investment in the first months of 2019 as uncertainty remains elevated. Capacity constraints are important however, and unfilled orders are piling up. Firms will either need to increase the pace of hiring in an extremely tight labour market, or increase their capital stock to meet this demand.

Canadian capacity pressures remain significant, even though traditional measures of capacity such as the output gap suggest it is hovering around zero. These pressures are most evident in the labour market, where job vacancies are at a historical

Chart 5



Sources: Scotiabank Economics, Statistics Canada.

Chart 6

Sources: Scotiabank Economics, Statistics Canada.

Table 1

Quarterly Canadian Forecasts	2018		2019				2020			
	Q3	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic										
Real GDP (q/q ann. % change)	2.0	1.7	0.9	2.4	2.2	1.9	2.2	2.0	1.5	1.5
Real GDP (y/y % change)	2.1	2.1	1.9	1.8	1.8	1.9	2.2	2.0	1.9	1.8
Consumer prices (y/y % change)	2.7	2.0	1.8	1.5	1.6	1.7	1.9	2.1	2.2	2.2
Avg. of new core CPIs (y/y % change)	2.0	1.9	1.9	1.9	2.0	2.0	2.0	2.0	2.0	2.0
Financial										
Canadian Dollar (USDCAD)	1.29	1.36	1.32	1.30	1.27	1.27	1.25	1.25	1.23	1.23
Canadian Dollar (CADUSD)	0.77	0.73	0.76	0.77	0.79	0.79	0.80	0.80	0.81	0.81
Bank of Canada Overnight Rate (%)	1.50	1.75	1.75	2.00	2.25	2.50	2.75	2.75	2.75	2.75
3-month T-bill (%)	1.58	1.65	1.80	2.05	2.30	2.55	2.80	2.80	2.80	2.80
2-year Canada (%)	2.21	1.86	2.00	2.20	2.45	2.65	2.85	2.85	2.85	2.85
5-year Canada (%)	2.34	1.89	2.10	2.30	2.55	2.75	2.95	2.95	2.95	2.95
10-year Canada (%)	2.43	1.97	2.20	2.35	2.60	2.80	3.00	3.00	3.00	3.00
30-year Canada (%)	2.42	2.18	2.35	2.50	2.75	2.90	3.10	3.10	3.10	3.10

Sources: Scotiabank Economics, Statistics Canada, Bloomberg.

high of 550,000 job vacancies, a rise of nearly 40% over the last two years. **Labour shortages are an acute constraint to business activity,** and while this is a brake on growth, it reflects the high rate of Canadian economic activity. The puzzle continues to be on the wage side, where wage pressure remains somewhat muted. It is still unclear why this is the case, though there is evidence that workers paid an hourly wage, and thus likely less attached to their employer, are reaping the benefits of the strength in labour demand, as their wages have been growing even once the increase in minimum wages last year is taken into account. On the industrial side, capacity utilization rates are well above the post-recession average though they remain below historical averages.

Inflation remains well behaved in Canada. Its evolution continues to be in line with the predictions of our macro-econometric model. Underlying measures of inflation are, for all intents and purposes, at the BoC's 2% target (the actual reading is 1.9%) and are expected to remain there through our forecast horizon as the BoC gradually tightens rates to keep inflation at its target. There is of course a risk that inflationary pressures diminish over time if wage pressures attenuate or growth disappoints, but we currently expect neither of these outcomes.

Table 2

Canada	2000–17	2017	2018e	2019f	2020f
	(annual % change, unless noted)				
Real GDP	2.1	3.0	2.1	1.8	2.0
Consumer spending	2.9	3.5	2.2	1.9	1.8
Residential investment	3.6	2.4	-1.1	-0.4	0.9
Business investment	2.2	2.2	4.8	1.1	6.2
Government	2.2	2.7	3.0	1.5	1.6
Exports	1.3	1.1	3.1	2.5	2.4
Imports	3.0	4.2	3.2	1.0	3.1
Nominal GDP	4.3	5.6	4.1	3.4	4.3
GDP Deflator	2.1	2.6	2.0	1.6	2.3
Consumer price index (CPI)	1.9	1.6	2.3	1.7	2.1
CPI ex. food & energy	1.6	1.6	1.9	1.9	2.0
Pre-tax corporate profits	0.0	20.1	5.0	6.1	2.1
Employment	1.4	1.9	1.3	1.1	0.7
Unemployment rate (%)	7.1	6.3	5.8	5.7	5.9
Current account balance (CAD bn)	-19.4	-60.1	-58.6	-55.8	-56.5
Merchandise trade balance (CAD bn)	22.3	-24.6	-22.0	-24.3	-28.5
Federal budget balance* (FY, CAD bn)	-3.6	-17.8	-19.0	-18.1	-19.6
percent of GDP	-0.2	-0.9	-0.9	-0.8	-0.8
Housing starts (000s)	200	220	213	202	200
Motor vehicle sales (000s)	1,678	2,034	1,984	1,930	1,900
Industrial production	0.0	4.9	2.4	-0.7	2.3
WTI oil (USD/bbl)	62	51	65	58	62
Nymex natural gas (USD/mmbtu)	4.83	3.02	3.07	3.25	3.25

Sources: Scotiabank Economics, Statistics Canada, CMHC, Bloomberg.

There are plenty of risks to the outlook. **Given how late we are in the economic cycle, these risks are naturally more tilted to the downside than the upside.** The dominant negative risk continues to be an escalation of the US-China trade war. Current signs point to our long assumed détente on this front, but as with all things related to President Trump, there are always risks that things get out of hand. We also see lots of volatility coming out of the Trump administration, as the President reacts to his re-election prospects and investigations by the House of Representatives into his personal and business affairs. The President's response to these developments could create uncertainty and financial market volatility, with potential feedback on the US and the rest of the world. **Risks aren't uniquely tilted to the downside.** It may well be that the estimated impact of oil prices on our economy is overstated, or even that oil prices continue the impressive bull run they have been on for the last two weeks. We may also be underestimating the rate at which population is rising and the economic consequences of that. Finally, it's possible that business investment picks up more sharply than we assume as the range of factors causing uncertainty wane in the first few months of this year.

The Provinces

- **We still forecast moderating expansions in most provinces during 2019–20, with BC maintaining the top spot due to major project activity and a weaker 2019 Alberta outlook representing the most significant revision.**
- **Several Provinces foresee improved FY19 budget balances at mid-year and are embracing more stimulative fiscal policy, but softer oil prices and the ongoing carbon tax skirmish complicate deficit reduction plans.**

OIL PRODUCTION CUTS TO WEIGH ON EXPANSION

Alberta output restrictions on large oil producers, enacted by the provincial government to alleviate a record light-heavy oil price differential, constitute the most significant change since our October *Global Outlook*. Higher heavy oil prices relative to the WTI benchmark should allay the backlog of shipments built up amid a yawning discount, but cuts will weigh on oil & gas sector output. Accordingly, we have lowered our 2019 Alberta growth forecast by 1 ppt, to 1.5%. The province is expected to add just 0.2 ppts to national growth in 2019, far less than the 0.7 ppt boost last year and the 0.9 ppt average during 2010–14 (chart 1).

Most elsewhere, our provincial outlook remains characterized by a broad-based easing of economic growth through 2020, with the key drivers largely intact. We still expect softer household spending in most regions, anchored by greater consumer caution brought about by slower employment gains and rising interest rates. We also continue to foresee more modest export gains as the US expansion returns to a more sustainable pace. Central Canada should bear the brunt of this effect given its elevated share of shipments bound for the American market, especially in 2020 as US growth slows more substantially.

A handful of provinces will likely buck the trend of softer growth. BC should be aided by the CAD 40 bn LNG Canada venture. Stronger job creation plus stable major project activity underlie Saskatchewan's higher forecast growth profile for 2019–20. Newfoundland and Labrador should benefit from stepped-up oil production and work on an offshore drilling platform extension.

The surge in machinery and equipment (M&E) outlays that contributed to early-year advances in multiple provinces is cooling as expected. Real M&E investment fell back in Quebec in Q3-2018 and in Ontario and across the rest of Canada in Q2-2018 (chart 2), mirroring falling national capacity utilization rates. Pressures to expand plants and upgrade equipment remain in place across much of the country, but we look for a further moderation of M&E spending this year with many firms appearing to have already addressed their capacity limits.

Labour shortages are spreading and intensifying. Job vacancy rates trended higher early this year in Central Canada, BC and Alberta to a lesser extent, but Statistics Canada's *Job Vacancy and Wage Survey* has since reported substantial climbs across Atlantic Canada and the Prairies (chart 3, p.2). Labour market tightness tends to put upward pressure on wages, but skills mismatches also limit firms' ability to grow. National immigration target increases through 2021 should help to alleviate these pressures alongside a robust newcomer selection process

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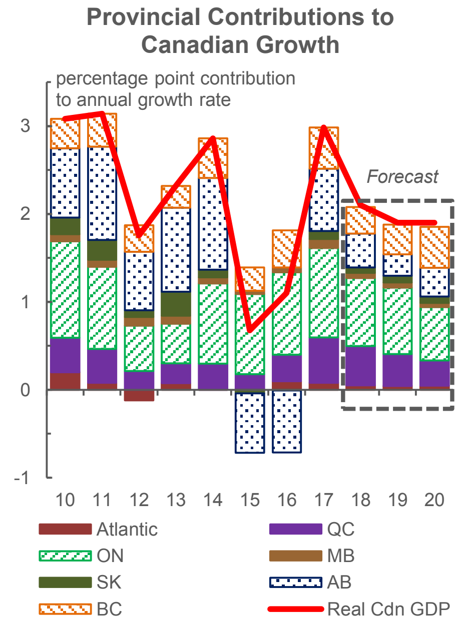
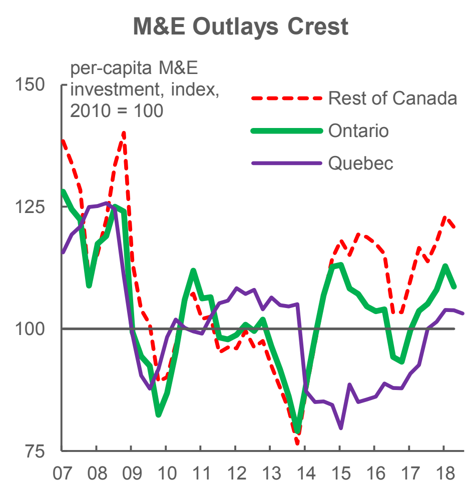
Chart 1



Sources: Scotiabank Economics, Statistics Canada.

Chart 2



Sources: Scotiabank Economics, Statistics Canada.

and tailored regional programs. We continue to monitor the situation in Quebec, but question the wisdom of cutting 2019 newcomer admissions by more than 20% versus last year in light of slowing population growth and an extremely tight labour market.

Another key threat to provincial economic prospects comes via heightened global protectionist vitriol. The possibility of a Sino-US trade war could hamstring export gains across Canada—from jurisdictions in Atlantic and Central with strong ties to the American market to BC where a significant share of shipments are bound for Asia. Moreover, US tariffs remain in place on steel and aluminum imports. Yet we remain optimistic that cooler heads will prevail on both fronts. The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) also takes effect this year, and provides new market access in South America and the Pacific Rim, regions generally not well served by Canadian exporters (chart 4).

REVENUE BUMP, OIL PRICES, CARBON TAX ALTER FISCAL LANDSCAPE

Economic conditions and accounting revisions underlie improved fiscal year 2018–19 (FY19) balance projections in a number of Provinces (chart 5). Prior years' adjustments following updated tax return data, stronger growth forecasts, or both, are expected to lift revenues higher than expectations in several regions. Quebec foresees a further padding of its coffers through FY21 via updated financial forecasting methods. Nova Scotia and Saskatchewan are exceptions, with softer taxable income profiles through FY19. Though impermanent, these are positive developments with revenue generation likely to become more challenging as the economic cycle matures.

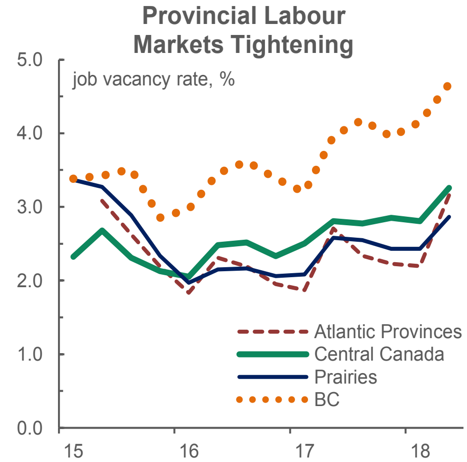
Buoyed by better fiscal results, some Provinces are moving to spur business investment and offer pocketbook relief. Quebec, mirroring federal measures and responding to US tax reform, is allowing full depreciation expensing for select outlays until 2024, with further tax support for seniors and families. Ontario will also parallel federal policy vis-a-vis expensing of new depreciable assets and introduced a tax credit for low-income individuals. Prince Edward Island will hike its Basic Personal Amount (BPA) beyond the boost already outlined and reduce taxes on small business and new capital investment in 2019. New Brunswick plans to phase out its small business tax and levies on secondary properties. As well, we believe the next BC budget will devote further attention to costs and fees given the government's focus on improving affordability.

Oil price movements present a risk to debt and deficit reduction plans in Alberta. Light crude prices—the rise of which is responsible for upward revisions to non-renewable resource royalty forecasts—have been trending downward. Diminished economic activity stemming from oil production cuts could dampen hiring and corporate profits, and, by extension, tax receipts. Add to this costly rail cars purchased to further alleviate the light-heavy discount and expenditure restraint planned from FY20 onward and there is little room to manoeuver in the event of a revenue slump.

Other net oil-producing provinces are more insulated from the current Western Canadian oil price predicament. Saskatchewan's economic base is less tilted towards heavy oil production and it has the advantage of diversification across several resource sectors. Newfoundland and Labrador's fiscal blueprint relies on even greater spending control, but its oil has the benefit of tidewater access.

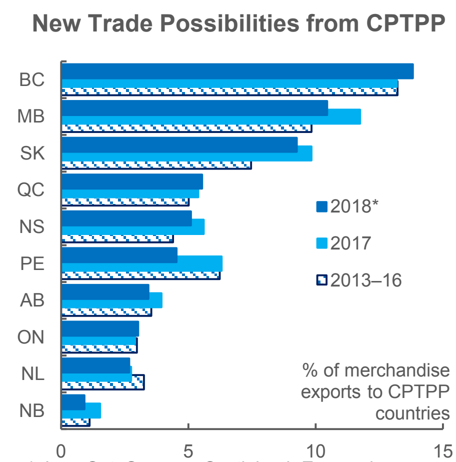
Opposition to the federal carbon tax—set to take effect this year—has also led to some revised fiscal blueprints. Ontario forfeits CAD 1.5 bn in FY19 revenues after aborting its cap-and-trade system, with the fiscal hit mitigated as related spending is

Chart 3



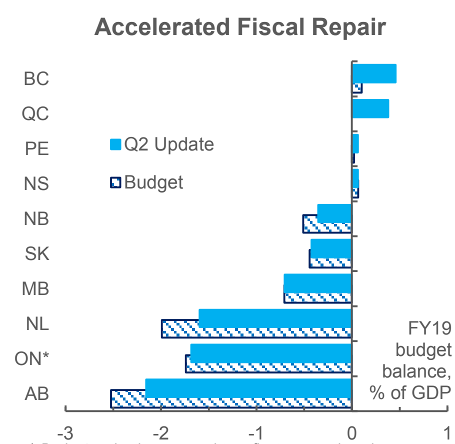
Sources: Scotiabank Economics; Statistics Canada, *Job Vacancy and Wage Survey*.

Chart 4



* Jan.–Oct. Sources: Scotiabank Economics, Industry Canada.

Chart 5



* *Budget* projection restated to reflect accounting changes from Province's *Independent Financial Commission of Inquiry*. Sources: Scotiabank Economics, Budget Documents.

cancelled; it will instead incent private-sector investment in clean technology. Manitoba axed its proposed carbon tax but scrapped a Basic Personal Amount hike planned for the 2019 tax year to offset foregone proceeds. New Brunswick's rejection of the federal plan is part and parcel of its efforts to lower the cost of living and will be balanced with scaled-back infrastructure outlays to achieve fiscal balance by 2020. Saskatchewan continues to resist a price on carbon on the grounds that it will hinder the adoption of lower-carbon technologies, and has set sector-specific emissions targets.

The federal government is offering new supports for business competitiveness alongside its headline move to accelerate the pace at which firms can depreciate capital investments. It will allocate CAD 800 mn more than that previously allotted over the next five fiscal years to the *Strategic Innovation Fund* to spur research and development and attract new investment. A new *Export Diversification Strategy*—investing CAD 1.1 bn during FY19–24—has the objective of boosting Canadian overseas exports by 50% by 2025. These measures may provide some assistance for tech sector development in tandem with initiatives already underway in some provinces. They will be further complemented with federal funding of CAD 230 mn for the AI and Manufacturing Superclusters and CAD 153 mn each for the Protein, Ocean and Digital Technologies Superclusters over the next

Table 1

The Provinces	(annual % change except where noted)										
Real GDP	**CA**	**NL**	**PE**	**NS**	**NB**	**QC**	**ON**	**MB**	**SK**	**AB**	**BC**
2000–17	2.1	2.4	1.8	1.3	1.2	1.8	2.0	2.3	2.0	2.8	2.7
2017	3.0	0.9	3.5	1.5	1.8	2.8	2.8	3.2	2.2	4.4	3.8
2018e	2.1	-0.5	2.0	1.2	1.1	2.3	2.1	1.8	1.5	2.3	2.4
2019f	1.8	1.5	1.6	1.0	0.9	1.8	1.9	1.8	1.8	1.5	2.6
2020f	2.0	0.7	1.1	0.9	0.9	1.6	1.6	1.5	1.8	2.4	3.5
Nominal GDP											
2000–17	4.3	5.6	4.2	3.3	3.4	3.7	3.9	4.4	5.4	5.9	4.7
2017	5.6	4.3	4.8	2.9	4.3	5.0	4.1	5.4	4.8	10.0	6.9
2018e	4.1	2.9	3.9	3.1	2.8	4.4	3.5	3.6	3.9	5.0	4.8
2019f	3.5	3.8	3.6	2.8	2.6	3.4	3.4	3.7	3.8	2.9	4.8
2020f	4.2	3.9	3.0	2.8	2.5	3.7	3.7	3.5	4.4	5.2	6.0
Employment											
2000–17	1.4	0.6	1.1	0.6	0.4	1.3	1.3	1.0	1.1	2.2	1.5
2017	1.9	-3.7	3.1	0.6	0.4	2.2	1.8	1.7	-0.2	1.0	3.7
2018	1.3	0.5	3.0	1.5	0.3	0.9	1.6	0.6	0.4	1.9	1.1
2019f	1.1	0.1	1.1	0.3	0.2	0.9	1.3	0.6	0.8	1.0	1.2
2020f	0.7	0.0	0.7	0.2	0.2	0.6	0.7	0.6	0.6	1.0	1.0
Unemployment Rate (%)											
2000–17	7.1	14.3	11.1	8.8	9.5	7.9	7.0	5.1	5.0	5.3	6.5
2017	6.3	14.8	9.8	8.4	8.1	6.1	6.0	5.4	6.3	7.8	5.1
2018	5.8	13.8	9.4	7.6	8.0	5.5	5.6	6.0	6.1	6.6	4.7
2019f	5.7	13.5	9.4	7.6	7.9	5.4	5.4	5.9	6.0	6.6	4.7
2020f	5.9	13.4	9.5	7.6	7.9	5.6	5.5	5.9	6.0	6.7	4.7
Housing Starts (units, 000s)											
2000–17	200	2.5	0.8	4.3	3.4	44	72	5.2	5.2	34	29
2017	220	1.4	0.9	4.0	2.3	46	79	7.5	4.9	29	44
2018	213	1.1	1.1	4.8	2.3	47	79	7.4	3.6	26	41
2019f	202	1.4	0.8	3.9	2.0	42	74	6.1	4.6	30	38
2020f	200	1.4	0.8	3.8	2.0	41	72	6.1	5.0	31	37
Motor Vehicle Sales (units, 000s)											
2000–17	1,657	29	6	48	38	413	635	47	45	216	180
2017	2,041	33	9	59	42	453	847	62	56	245	235
2018	1,984	28	8	51	38	449	853	67	47	226	217
2019f	1,930	30	8	48	35	430	826	60	48	220	225
2020f	1,900	30	8	47	34	420	810	55	48	215	233
Budget Balances, Fiscal Year Ending March 31 (CAD mn)											
2017	-19,000	-1,148	-1	151	-117	2,361	-991	-764	-1,218	-10,784	2,737
2018	-19,000	-911	75	230	67	2,622	-3,700	-695	-303	-8,023	301
2019f	-18,100	-547	4	27	-131	1,650	-14,544	-518	-348	-7,512	1,350

Sources: Scotiabank Economics, Statistics Canada, CMHC, Budget documents; Quebec budget balance figures are after Generations Fund transfers.

United States

DON'T BLAME THE ECONOMY

- **As widely anticipated by most economic forecasts, the temporary boost from the Tax Cuts and Jobs Act (TCJA) and increased federal government spending has started to wane, with US economic growth slowing below potential during 2019–20.**
- **The unforced errors from Washington, including stepped up sabre-rattling on trade, the government shutdown, and executive leadership churn have heightened uncertainty and driven weeks of chaotic repricing in asset markets, but should do limited additional damage to consumption, investment, and growth.**
- **The US is expected to set in July a new record for its longest-ever expansion. The risk of a recession taking hold during the next two years remains low.**

SLOWDOWN EXPECTED IN 2019

After two quarters of exceptional growth driven by the White House's early-2018 fiscal stimulus package, the high-flying American economy is, as expected, coming back to Earth. While growth in Q4 is expected to hit close to 3% q/q in seasonally adjusted annualized terms, we see activity continuing to decelerate into 2019 and 2020, as the growth impact from the 2018 tax reforms and spending package wanes.

Despite the recent correction in equity markets, our forecast for the US is little changed from last quarter: we continue to project GDP growth at 2.4% in 2019, with a dip just below the US's 1.9% potential to 1.7% in 2020 as quarterly growth gradually slows (table 1).

- According to ***The Scotiabank Global Macro Model*** the swoon in equity markets would have to be substantially more prolonged to make a serious dent in our forecast of US growth.
- In addition, we have been marking down our US forecast on account of trade uncertainty since mid-2018. Since the equity market correction seemed to have been triggered by concerns about an escalating China-US trade spat, we see the stock market fall as validating our forecast, not implying additional weakness.

While we still expect three 25 bps hikes by the Fed in 2019, leaving the upper limit of the fed funds target at the cyclical peak of 3.25% in Q4-2019 (see ***Monetary Policy and Capital Markets***), tighter financial conditions and moderation in global growth led us to delay the first hike to Q2-2019 compared to Q1-2019 expected in our December monthly forecast **update**.

In the absence of major policy shocks, we do not see a recession looming in our baseline forecast: the US output gap is expected to close over the projection horizon, with growth dipping below that of potential GDP.

- On existing data, the odds of a US recession over the next 12 months have edged up only slightly in the NY Fed's recession probability model (chart 1).

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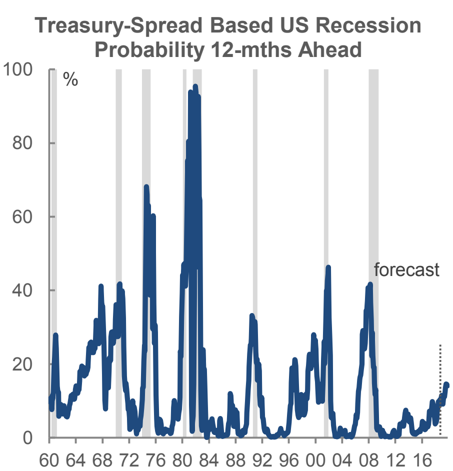
United States	2017	2018e	2019f	2020f
Real GDP (annual % change)	2.2	2.9	2.4	1.7
CPI (y/y %, eop)	2.1	2.0	2.1	2.3
Central bank policy rate (%, eop)	1.50	2.50	3.25	3.25
Canadian dollar (USDCAD, eop)	1.26	1.36	1.27	1.23

Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, FRBNY. Shaded areas represent recession periods.

FORECAST RESTS ON BALANCE OF POLICY RISKS

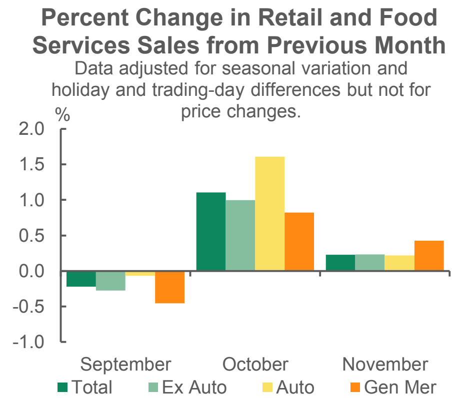
Our forecast for a gradual slowing of the US economy rests on three key assessments.

- First, we do not expect the US trade spat with China to intensify further, since it would impose pointed costs on US consumers and industry in the run-up to the 2020 US presidential election.

- Second, the current budget impasse and the government shutdown are likely to be resolved more quickly than the current rhetoric out of Washington implies; although past government shutdowns have caused limited damage to growth, suspensions in government services antagonize voters and impose hardships on federal employees. Incentives are aligned to find a face-saving compromise, and there is a wide spectrum of ways for both sides to claim victory.

- Finally, to the extent that, in the words of the US Federal Reserve chair J. Powell, financial markets ran "well ahead of the data", we expect market volatility to subside in line with the still-robust outlook for the US economy in the absence of further policy shocks.

Chart 2



Sources: Scotiabank Economics, U.S. Census Bureau, Advanced Monthly Retail Trade Survey, December 14, 2018.

The remainder of this section lays out our assessments for the US real economy that underpin this outlook.

FUNDAMENTALS ARE STILL BROADLY SOLID

The US economy's major indicators are showing some pockets of softness, but, overall, the recent data point to the underlying resilience of this extended late-cycle expansion (table 3), as shown by the broad set of numbers that feed into most major surprise indices and GDP nowcast models. While backward-looking indicators are relatively solid (industrial production was up nearly 4% from a year ago in November, including strong growth in durable goods)—some forward-looking indicators were more mixed.

- Manufacturing PMI took a 5.2-point dive in December on the back of weaker new orders, which brought the overall index down the most month-on-month since 2008.

Personal consumption expenditure (PCE) inflation was just below the Federal Reserve's 2% target with support from strong employment gains, unemployment rate at a historic low and the economy in excess demand, as well as wage gains that are

Table 1

Quarterly US Forecasts	2018		2019				2020			
	Q3	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic										
Real GDP (q/q ann. % change)	3.4	2.7	2.1	1.8	1.8	1.7	1.7	1.7	1.6	1.7
Real GDP (y/y % change)	3.0	3.1	3.1	2.5	2.1	1.9	1.8	1.7	1.7	1.7
Consumer prices (y/y % change)	2.6	2.0	1.6	1.6	1.7	2.1	2.3	2.3	2.3	2.3
CPI ex. food & energy (y/y % change)	2.2	2.1	2.0	2.0	2.1	2.1	2.1	2.1	2.1	2.1
Core PCE deflator (y/y % change)	2.0	1.9	2.0	1.9	2.0	2.0	2.0	2.0	2.0	2.0
Financial										
Euro (EURUSD)	1.16	1.15	1.17	1.22	1.26	1.30	1.30	1.30	1.32	1.32
U.K. Pound (GBPUSD)	1.30	1.28	1.32	1.35	1.37	1.40	1.42	1.42	1.45	1.45
Japanese Yen (USDJPY)	114	110	110	110	108	108	107	107	105	105
Fed Funds Rate (upper bound, %)	2.25	2.50	2.50	2.75	3.00	3.25	3.25	3.25	3.25	3.25
3-month T-bill (%)	2.20	2.36	2.40	2.65	2.90	3.15	3.15	3.15	3.15	3.15
2-year Treasury (%)	2.82	2.49	2.75	2.90	3.10	3.30	3.30	3.30	3.30	3.30
5-year Treasury (%)	2.95	2.51	2.80	3.00	3.20	3.35	3.35	3.35	3.40	3.45
10-year Treasury (%)	3.06	2.68	2.90	3.10	3.30	3.40	3.45	3.45	3.50	3.55
30-year Treasury (%)	3.21	3.01	3.10	3.25	3.50	3.50	3.60	3.60	3.65	3.65

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

running ahead of price increases. These pay increases are feeding directly through to higher incomes and increased consumer confidence, which together have catalyzed stronger retail sales so far in Q4 in advance of the holiday season (chart 2), underpinned by a consumer credit expansion after years of household balance-sheet clean-up and lower debt-service burdens (chart 3). Although our rate path for the Fed is expected to raise the cost of servicing household debt, the nominal disposable income growth of over 4% should ensure that consumption growth remains robust, albeit moderating.

INVESTMENT AND MANUFACTURING SLOWING DESPITE CORPORATE TAX CUTS

Despite the significant fiscal measures introduced in support of the business sector, such as lower corporate tax rates passed in the TCJA of 2017, investment spending by businesses has been relatively muted just as we expected. Following a spike in growth in the first half of 2018, partly explained by the oil and gas sector expansion and partly by the tax cuts, growth in business investment moderated in Q3-2018.

- Non-residential structures investment declined unexpectedly in Q3-2018, while spending on machinery and equipment moderated (chart 4), even as capacity utilization in most manufacturing sectors has ticked up above its post-GFC average (see selected manufacturing industries in chart 5).

- Nevertheless, one bright spot in 2018 were sales of motor vehicles, a big-ticket item, which remained robust mostly as a result of demand from businesses. Solid December auto sales closed 2018 at 17.2mn vehicles sold, the third highest year on record.

The overall muted response of business investment to the tax stimulus may be due to i) a relatively small share of overseas profits repatriated to the US (over $500bn in Q1-Q3 of 2018, compared to up to $3tn estimated to be parked overseas, see chart 6), ii) a preference for share buybacks using the extra funds, with S&P500 companies deploying over $500bn for that purpose in Q1-Q3, and iii) the uncertainty caused by the erratic trade policy actions by the US administration, which is making businesses leery of committing funds to expand US capacity, in particular for companies that depend on international trade (e.g. multinationals).

Going forward we expect business investment to moderate further, in line with slowing consumer and export demand and higher interest rates.

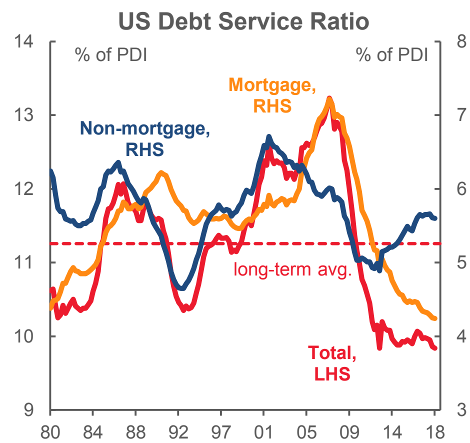
MIXED PICTURE IN RESIDENTIAL REAL ESTATE

Residential real estate is one of the weaker pockets in the recent US economic data and near-term outlook.

- Residential real estate investment declined in three quarters so far in 2018, with housing starts averaging 1.26mn (SAAR) up to November and below the 1.5–1.6 mn units needed to fill underlying demand.

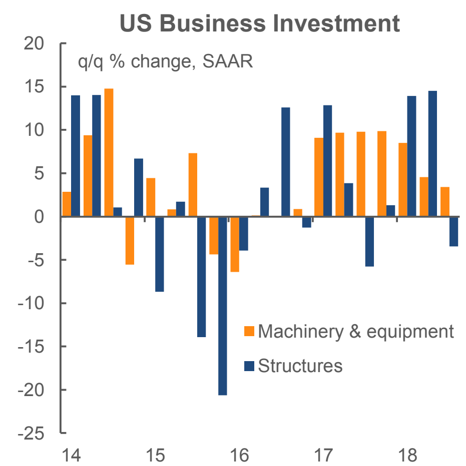
- Although house price growth slowed to 5.0% y/y in October, home affordability remains a challenge with the National Association of Realtors' (NAR) housing affordability index at or near its lowest levels since 2008 in the four major markets it surveys (chart 7).

Chart 3



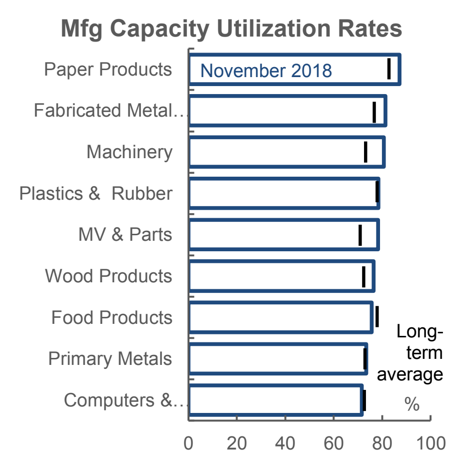
Sources: Scotiabank Economics, US Federal Reserve.

Chart 4



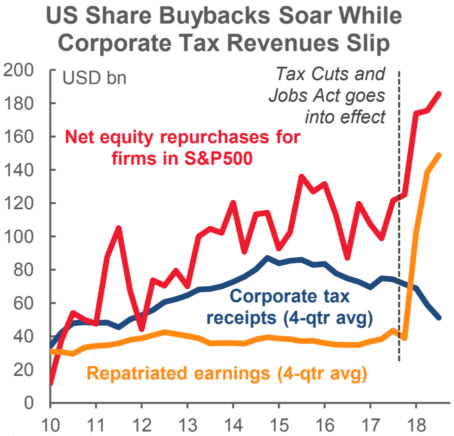
Sources: Scotiabank Economics, BEA.

Chart 5



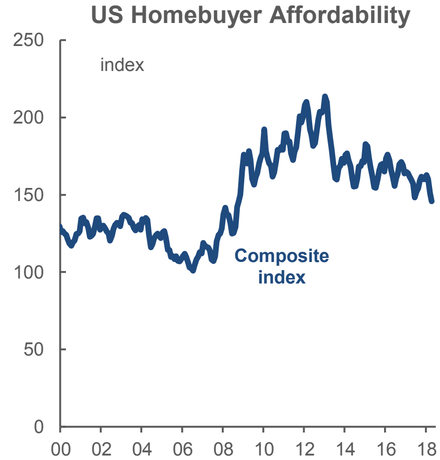
Sources: Scotiabank Economics, BEA

Chart 6



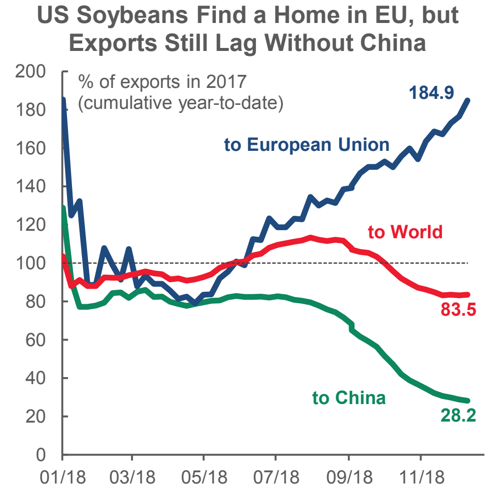
Sources: Scotiabank Economics, BEA US Treasury, Bloomberg.

Chart 7



Sources: Scotiabank Economics, NAR.

Chart 8



Sources: Scotiabank Economics, USDA.

- Home sales peaked in November 2017 and new and existing unit sales have continued to drift down since then, particularly at the lower end of the market where inventory is constrained in part by the drag that higher rates exert on refinancing and move-up purchases.

BALANCE OF PAYMENTS DRAG

Despite the professed desire to reduce the US trade deficit, the US administration's fiscal policies combining expansionary tax cuts and increased spending, on the back of a strong US dollar, instead consistently widen US trade deficits by underpinning increasing imports.

On the other hand, the administration's trade policies, to the extent that they induce a backlash by the US trade partners, lead to weaker exports going forward. This dynamic was in full view in Q3-2018:

- US exports declined by close to 5% Q/Q SAAR as the US lost export market share, for example in China. Chart 8 shows that as US-China trade tensions flared in the middle of 2018, soybeans exports from the US to China started to underperform relative to 2017, albeit partly offset by exports to the European Union.

- Total imports of goods and services, on the other hand, increased by over 9% Q/Q SAAR in part in expectation of tariffs being imposed.

We project that trade tensions between China and the US are set to continue in 2019. However, we do not think that an all-out trade war, with rising tariffs covering an ever-enlarging share of bilateral trade, is likely, since it would impose significant costs on US consumers and businesses in the context of looming elections and jittery capital markets. While an eventual resolution is expected, and the arrival of the US delegation in Beijing on January 7th is an

Table 2

United States	2000–17	2017	2018e	2019f	2020f
	(annual % change, unless noted)				
Real GDP	2.0	2.2	2.9	2.4	1.7
Consumer spending	2.4	2.5	2.7	2.6	1.9
Residential investment	-0.3	3.3	0.0	0.7	1.9
Business investment	3.0	5.3	6.8	3.1	2.2
Government	1.0	-0.1	1.7	2.3	1.6
Exports	3.7	3.0	4.0	1.6	1.9
Imports	3.7	4.6	4.7	4.0	2.9
Nominal GDP	4.0	4.2	5.2	4.5	3.8
GDP Deflator	1.9	1.9	2.2	2.1	2.0
Consumer price index (CPI)	2.2	2.1	2.4	1.8	2.3
CPI ex. food & energy	2.0	1.8	2.1	2.0	2.1
Core PCE deflator	1.7	1.6	1.9	2.0	2.0
Pre-tax corporate profits	5.3	3.2	8.1	4.2	1.9
Employment	0.7	1.6	1.6	1.3	1.0
Unemployment rate (%)	6.1	4.4	3.9	3.7	3.8
Current account balance (USD bn)	-501	-449	-480	-571	-641
Merchandise trade balance (USD bn)	-680	-807	-884	-985	-1068
Federal budget balance (USD bn)	-540	-665	-805	-1,000	-1,045
percent of GDP	-3.7	-3.4	-3.9	-4.7	-4.7
Housing starts (mn)	1.26	1.20	1.26	1.25	1.26
Motor vehicle sales (mn)	15.6	17.1	17.2	16.8	16.7
Industrial production	0.7	1.6	3.9	3.1	2.1
WTI oil (USD/bbl)	62	51	65	58	62
Nymex natural gas (USD/mmbtu)	4.83	3.02	3.07	3.25	2.80

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

encouraging sign, we believe exports will continue to grow at an anaemic pace due to globally moderating export demand and the strong US dollar. In addition to stronger import growth over the projection horizon, weak exports mean that net trade is expected to subtract from GDP growth over 2019–20.

OUTPUT GAP CLOSING

Looking forward, with the economy at full employment, we expect a broad moderation across most GDP components, including consumption, government spending, investment, and trade (table 2 on previous page). The declining impact of the fiscal stimulus on growth in 2020, rising federal funds rate and weakening demand in US trade partners imply that US GDP is likely to start reverting to the level of potential output in 2019. As a result, the output gap, which is likely to peak at 0.7% of GDP in 2019, is expected to halve in 2020. Diminishing excess demand should reduce inflationary pressures at the same time as oil prices rise, keeping core PCE inflation stable at 2.0% in 2019–20 and total PCE inflation rising to 2.1% in 2020.

RISKS GOING FORWARD

While we think risks are balanced going forward, there are a number of risk factors on the positive and negative side of the ledger.

- A failure to reach an agreement and reopen the US government can become more of a drag on growth if a progressively larger share of government services becomes disrupted.

Trade risks still loom large in the forecast.

- China-US trade truce expires at the end of February. In the absence of constructive steps to resolve the impasse, an escalation of the conflict is possible, which provides a downside risk to the US economy. On the other hand, a successful resolution of the trade spat poses an upside risk to the US and global economies.

- The auto tariffs review is expected in mid-February, which could provide a possible trigger for a trade conflict between the US and a broader set of trade partners.

On a positive note, there could be a window of opportunity for the Congress and the administration to agree on a further increase in spending, in particular related to the infrastructure program.

Table 3

US Economic Indicators

% change (unless otherwise specified)	1-month	3-month	12-month	Recent Evolution[1]
Real GDP	--	0.8	3.0	
Prices				
Consumer price index	0.0	0.4	2.2	
Consumer price index ex. food and energy	0.2	0.5	2.2	
Personal consumption expenditure price index	0.1	0.4	1.8	
Core personal consumption expenditure price index	0.1	0.4	1.9	
Labour Market				
Employment	0.2	0.5	1.8	
Unemployment rate (level change, ppt)	0.2	0.2	-0.2	[2]
Private sector average hourly earnings	0.4	0.8	3.2	
Initial jobless claims	-7.3	0.5	-12.6	[2]
Continuing jobless claims	5.3	4.2	-8.1	[2]
Retail, Wholesale & Trade				
Trade balance (level change, USD bn)	-0.9	-5.1	-8.5	[2]
Retail sales	0.2	1.1	4.2	
Wholesale inventories	0.8	2.5	6.9	
Vehicle sales	0.6	0.6	-1.5	[2]
Housing Sector				
Housing starts	3.2	-1.9	-3.6	
Existing home sales	1.9	-0.2	-7.0	
New home sales	-8.9	-10.2	-12.0	
S&P CoreLogic Case-Shiller 20-city home price index	0.0	0.1	5.0	
Industrial Sector				
Industrial production	0.6	0.6	3.9	
Durable goods orders	0.8	-3.6	5.3	
Factory orders	-2.1	0.8	6.9	
Business inventories	0.6	1.6	5.2	
ISM manufacturing (level change, ppt)	-5.2	-5.7	-5.2	[2]
ISM non-manufacturing (level change, ppt)	-3.1	-4.0	1.6	[2]
Household Sector				
Consumer confidence	-6.1	-5.3	4.1	[2]
Nominal personal income	0.2	1.0	4.2	
Nominal Personal spending	0.4	1.3	4.7	
Nominal consumer credit	0.6	1.5	4.3	
Financial Markets				
10-year treasury yield (level, %)	2.70[3]	3.16	2.56	[2]
S&P 500	-2.6	-7.8	-6.5	[2]
WTI oil	1.5	-29.2	-18.5	[2]
Trade-weighted USD[4]	-0.6	0.5	7.5	[2]

[1]January 2017 – present, y/y % change.
[2]January 2017 – present, levels.
[3]Current yield.
[4]Federal Reserve trade-weighted broad US dollar.
Sources: Scotiabank Economics, Bloomberg.

US & Canadian Monetary Policy & Capital Markets

- **After a Q1 delay, the Federal Reserve is forecast to hike three more times this year;**
- **The Bank of Canada is also forecast to hike three more times in 2019;**
- **Bond yields are forecast to rise (charts 1, 2);**
- **Assessing the evidence and risks to the interplay between market developments, the economy and monetary policy.**

THE FEDERAL RESERVE—A CASE FOR CONTINUED TIGHTENING

A cumulative three rate hikes are forecast over the duration of this year to a peak fed funds upper limit of 3.25% before the Federal Reserve then moves to the sidelines over the duration of the horizon. At such a point, the Fed is likely to be at or slightly above its neutral policy rate. This is a slower path than the steady pattern of four hikes in each of the past two years. The Fed shifts to the sidelines in 2019Q1 and returns with hikes in Q2 conditioned upon a broad narrative that points to US economic resilience and settling of external risks. As with Fed guidance it is 'patient', 'flexible', 'watching' and 'waiting', so are we, but within limits while closely monitoring an unstable US government and external risks.

The balance sheet is expected to continue to decline at an unchanged pace throughout our forecast horizon. A steady theoretical US$50 billion per month of Treasuries and MBS at a 60/40 split is forecast to roll-off, subject to the available amounts each month. This should set the balance sheet on the path depicted in chart 3 with assets dropping to about US$3 trillion by about mid-2020. Leading up to that point, a more serious debate will probably unfold about the optimal level of the balance sheet for today's economy and given innovations in the payment system and hence where to stop shrinkage. As balance sheet normalization matures, the FOMC may attempt to 'twist' the Treasury curve by shortening the average maturity of holdings in order to have the flexibility to lengthen the maturity of holdings should future economic and market conditions require such a step. The effects of shortening average maturities could be to bull steepen the Treasury curve as a partial effect and as a risk to our slope forecasts over time.

Against the popular contention that the Fed's unwinding balance sheet has sparked recession worries, chart 4 demonstrates what has happened to the 10 year Treasury term premium. While many anticipated a rising term premium as the Fed's balance sheet shrank, **the term premium never really increased** during the period of so far very limited balance sheet reductions. Indeed, it has again declined back toward the lowest levels on record. Equity market volatility continues despite the fact that bond markets have priced out rate hikes and the term premium is shaking off balance sheet shrinkage. That's a tip to the US administration to look elsewhere when assigning blame for market instability—starting with a reflection upon its own trade and fiscal policies.

No further changes to the spread between the interest on excess reserves

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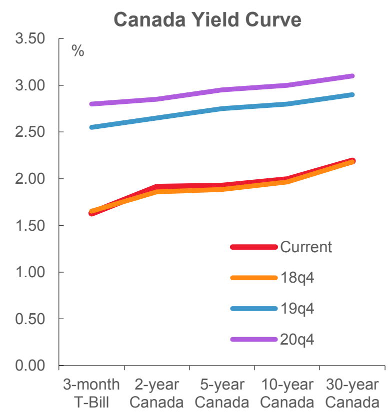
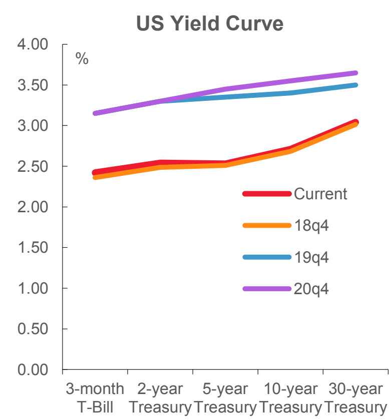
Chart 1



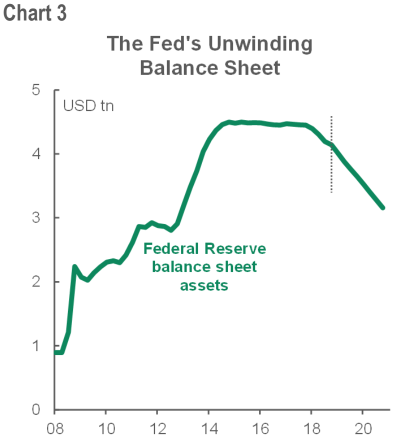
Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Chart 3



Sources: Scotiabank Economics, Haver Analytics.

relative to the upper limit of the fed funds target range are expected. Recall that it is the IOER that is the de facto policy rate this cycle as interest paid on reserves that banks hold at the Fed is the anchor point for short-term market rates through arbitrage constraints. The FOMC has multiple tools available to address any upward pressure upon market rates relative to the effective fed funds rate as reserves in the banking system diminish—including further relative IOER cuts, traditional open market operations, ending portfolio redemptions at relatively high levels of reserves, and other possible tools that are being explored. No change in IOER-EFF spread, but the flexibility to control short-term market rates is our base case assertion.

Scotiabank Economics' forecast for combined conventional and unconventional policy moves had always been a little more conservative than the FOMC. Recall that prior to December 2018, the FOMC consensus signaled there would be four rate hikes in 2019–20 and then it removed one hike in the December 2018 'dot plot' to now forecast three more hikes until calling it quits. Throughout 2018, we had felt that late cycle, geopolitical and trade policy risks would make it difficult for the FOMC to deliver as aggressively on its proposed rate path and we've consistently argued that the neutral rate lies around 2.75% which is where the FOMC now sees it. A more cautious turn by the Fed now brings Scotia's lower forecast in full alignment with the Fed's revised forecast. **This is important to note in that while we could all be proven wrong as the year unfolds, it leans against the contention that if the Fed has turned more cautious, so perhaps should we.**

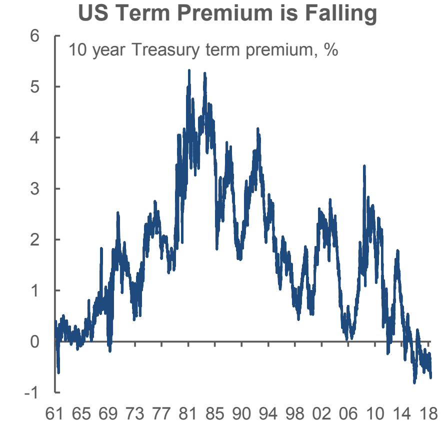
Should we then revise our own forecast lower yet? We are reticent to go any further toward markets that have not only priced out any further rate hikes but that have begun to entertain rate cuts over recent weeks. Either no hikes or rate cuts are difficult to envisage and need a lot to go awfully wrong that at this point we are not prepared to assume. Indeed, the consequence to our forecast is to short the front-end of the US Treasury curve and the full Treasury curve remains moderately over-valued in our view.

The core of the debate centres upon whether monetary policy and financial markets have over-tightened conditions to drive the US toward the point of recession within our forecast horizon. For many reasons, that's difficult to accept.

As one supporting argument, the US economy has transitioned toward **the greatest amount of excess aggregate demand in nearly two decades** (chart 5). The CBO's output gap stood at 1.3% as of 2018Q3 and is likely around 1½% now. Core inflation has risen toward the Fed's 2% target over the past year and at 1.9% has recently only slightly eased.

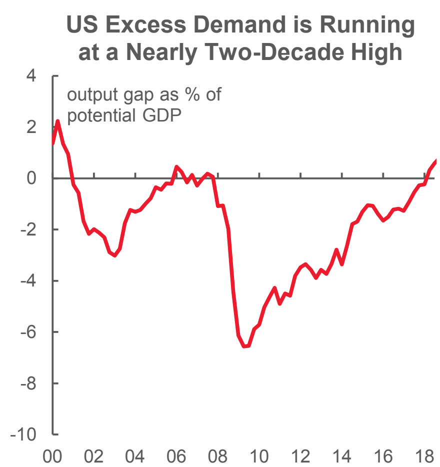
It is important to note that the estimated one percentage point rise in the output gap just since the end of Q1 into material excess demand **should carry lagged positive influences upon price pressures** that should persist over 2019–2020. Also, **wage increases are running at about a nine-year high and should reinforce price pressures through combined augmented Phillips curve and wage Phillips curve approaches.** That assertion should hold even at flatter levels of tightness than historically in the relationship between the unemployment rate and wage growth as well as the relationship between the unemployment rate and price inflation. As commodity price pressures have eased and dragged down headline inflation on first round effects, it is feasible that second round effects could raise core prices excluding

Chart 4



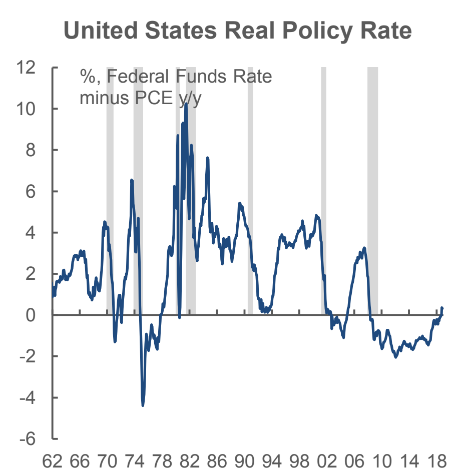
Sources: Scotiabank Economics, New York Federal Reserve.

Chart 5



Sources: Scotiabank Economics, Congressional Budget Office.

Chart 6



Sources: Scotiabank Economics, Federal Reserve, Bureau of Economic Analysis.

food and energy by positively impacting inflation-adjusted wages and household budget constraints. And on the dollar's influences, the Fed's research tends to point to disinflationary effects that begin to peter out within six months after appreciation stabilizes. Our house forecast expects a softer USD over this year.

Therefore, we think that output gaps and labour costs will come to reinforce a turn in the disinflationary effects of broad dollar appreciation on the path toward gently higher core inflation. That would require gently greater policy tightening in order to contain upside inflation risks.

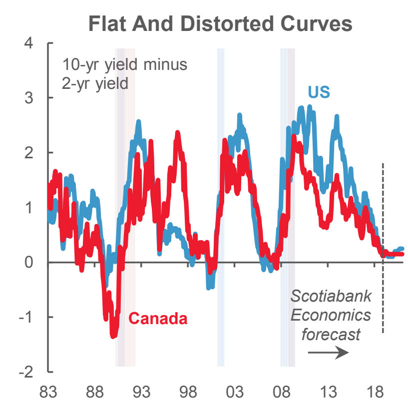
Added inflation risk stems from the potential for turning back the clock on decades of liberalizing the world trade order with negative implications for productivity, the broad supply side of the global economy—and hence ultimately inflation. One-off tariffs offer fleeting influences upon headline inflation and might even sap pricing power on second round effects. But sustained tariff battles and isolationism jeopardize the stability of inflation expectations over time which is why **central bankers warn of the possibility that protectionism returns the world to stagflation** and that the Fed's dual mandate would be conflicted between the risk to unemployment versus the need to preserve stable prices. For now, we're maintaining cautious optimism toward how trade tensions will ultimately settle but warning of the risks given a dishearteningly unstable US administration.

Also note that despite concerns about over-tightening Fed policy, **a recession has never followed as low of an inflation-adjusted fed funds policy rate as we have at present** (chart 6). Using headline PCE inflation, the real fed funds rate presently sits at just +45bps while using core PCE inflation results in a real policy rate of about +35bps. Then shave both estimates by 10bps now versus the past given that IOER is the relevant policy rate this cycle and it rests 10bps below the fed funds upper limit. A recession with a real policy rate of 25–35bps??

It would also be unusual for a recession to follow the current slope of the US Treasury yield curve that itself is distorted by global central bank bond buying programs (chart 7). Ditto for the slope of the corporate bond curve that is steeper than the sovereign curve (chart 8). The NY Fed's model of recession probabilities within one year is based upon the slope of the yield curve and now stands at about 16% (here). While it has been an imperfect model, **today's curve-based probability of recession is the lowest of recessions in decades.**

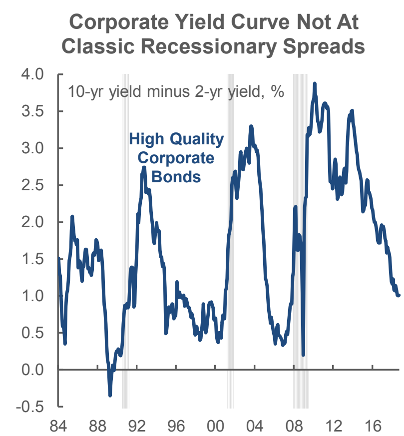
On equity market signals, charts 9 and 10 serve as a reminder of the fact that **equity sell-offs vastly over-predict economic downturns.** Declines to date in the S&P500 of around 12% are not historically followed by recessions. Harsher market declines of over 15% a) over-predict recessions by a wide margin, and b) are usually coincident to recessions by the NBER definitions. It's worth noting that one reason for these observations is that most equities are narrowly held, and when valuations soften this tends to coincide with automatic stabilizers kicking in, such as lower bond yields or gasoline prices that we are now witnessing. Further, the dominant driver of consumption is cash flow that

Chart 7



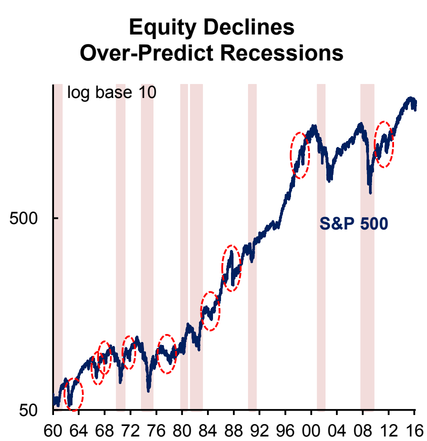
Sources: Scotiabank Economics, Bank of Canada, Federal Reserve Board, NBER, CD Howe Institute.

Chart 8



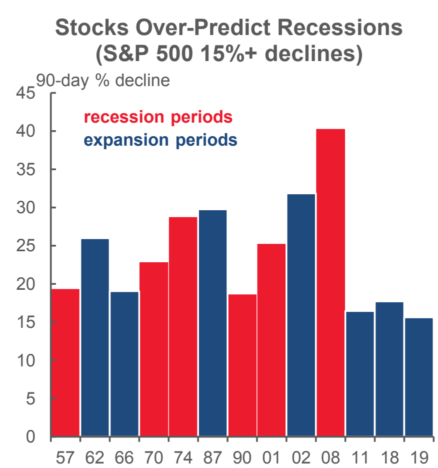
Sources: Scotiabank Economics, US Treasury.

Chart 9



Source: Scotiabank Economics, Bloomberg.
Shaded bars indicate recession periods.

Chart 10



Sources: Scotiabank Economics, Bloomberg.

is vastly more important than changes in paper wealth. Strong job gains and rising wage pressures offer cash flow supports.

But does reverse causation hold? In other words, apart from predicting downturns, **will recent equity market weakness *cause* a downturn?** Modelling efforts suggest it may slightly soften growth with more impact if greater risk aversion sustainably arises. This paper by Fed economists, however, is more doubtful toward a substantially positive wealth effect over recent years and by corollary whether a negative wealth effect could arise in future. It is more likely that reasonably more attractive valuations have been restored to global equities (chart 11).

As for what fundamentals are saying about recession risk, **it would be unusual to get a pronounced recession amidst evidence of very healthy household balance sheets.** Consumer credit flows have been strengthening recently. The saving rate—out of disposable income—has not been depleted with wealth gains being spent; rather, it has held around a steady 6% rate for years now (chart 12). Combined with the lowest share of income going toward debt payments on record (chart 13) and solid income and job growth, the signs of serious challenges that would affect about two-thirds of the economy represented by consumers are scant.

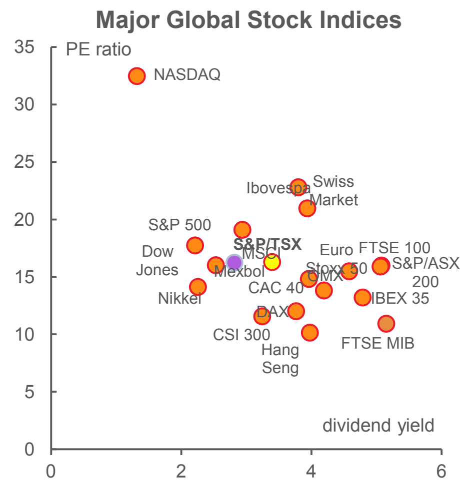
As for corporate credit risk, there is no doubt that it is being re-priced from an overshoot on appetite for risk but our view is that this returns us to more reasonable valuations rather than signaling the end of the expansion. Chart 14 offers one such depiction. In fact, the US high yield index has regained much of the recent sell-off.

While the focus thus far has been squarely upon addressing linkages between financial market developments and transmission mechanisms to the economy and monetary policy alongside evidence of sound US economic fundamentals, I'll end with a discussion on the ECB-like challenges facing the Fed. President Trump may wish to have his growth bias favoured by much easier Fed policy—by contrast to his past criticisms of loose monetary policy before he became President—but the Fed can't be seen to be rewarding the Trump administration's many, varied and costly intransigencies. **A moral hazard problem hangs over monetary policy in that turning more dovish could relax pressure upon the administration to back away from its deeply protectionist bias and volatile ways and the cost this is imposing upon markets.** Instead, staying the course with tightening monetary policy could impose needed discipline upon the unhelpful chaos in the White House and to the long-run benefit of both the US and world economies. At issue is the US equivalent to the downside of Mario Draghi's 'whatever it takes' moment that stabilized markets and made for rock bottom borrowing costs for governments at the high long-run price of forestalling necessary fiscal and regulatory reforms within the Eurozone that could have benefitted long-run growth. Should the Trump administration wish to calm markets, it should instead a) stop threatening the Fed, b) strike a trade deal with China, c) become less isolationist and c) end the government shutdown and related risks heading up to the March 1st debt ceiling deadline.

THE BANK OF CANADA—A TEMPORARILY INTERRUPTED HIKE PATH

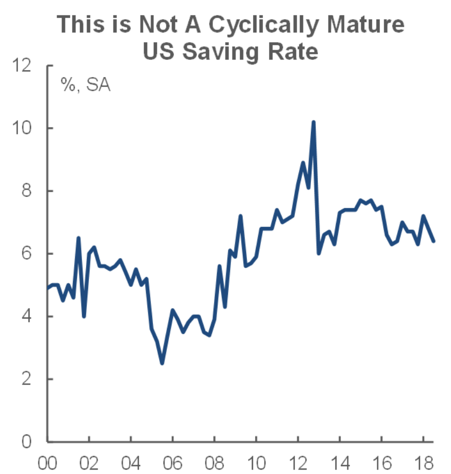
Our forecast for the Bank of Canada is relatively aggressive with three hikes predicted over the duration of this year and possibly one more in 2020 before the central bank calls it quits this cycle. At such a pace, the BoC would be at a neutral rate range into

Chart 11



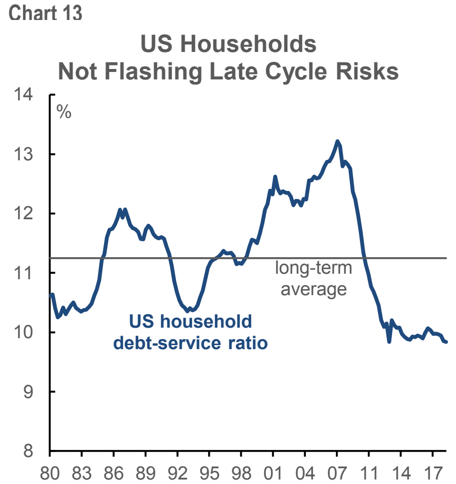
Sources: Scotiabank Economics, Bloomberg.

Chart 12



Sources: Scotiabank Economics, Bureau of Economic Analysis.

Chart 13



Sources: Scotiabank Economics, Bloomberg, Federal Reserve.

early 2020. The risks to this forecast are skewed toward fewer hikes and/or taking longer to deliver such a pace of tightening rather than a quicker pace. **Our prime forecast objective, however, is to convey to markets that they are potentially ignoring the Bank of Canada's rate hike signals to their peril in that they have removed virtually all prospects of further rate hikes.**

Indeed the strong message from the BoC of late has been that rate hikes are interrupted, not abandoned. Please go here for a recap and interpretation of their latest forecasts and communications. We could well see the BoC returning with a hike as soon as the second quarter of this year due in part to Governor Poloz's recent guidance that "the economy will be back to where it was a few months ago within a few months."

Clearly a fair portion of the outlook for the Bank of Canada is dependent upon the matters addressed in the discussion of the outlook for Federal Reserve policy. Several of the arguments already addressed and that pertain to the interplay between financial markets and the economy and monetary policy are portable to the BoC context. Absent a US recession with a confident Federal Reserve able to tighten policy further, the Bank of Canada can by corollary be less concerned about the implications to tightening Canadian monetary policy for the currency and knock-on effects upon export competitiveness and inflation risk.

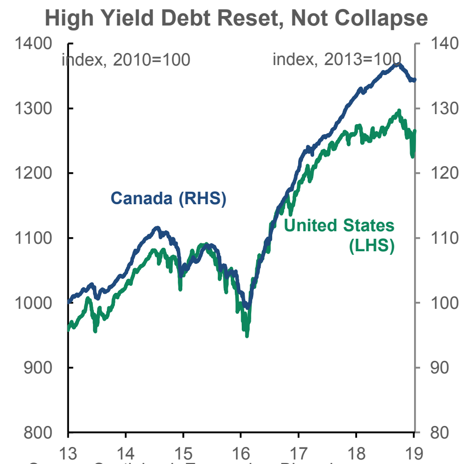
A key distinction between the central banks, however, is that **the inflation-adjusted cost of borrowing remains negative in Canada** (chart 15 versus chart 6) and the Federal Reserve has been reducing unconventional stimulus on top of raising rates. Easier monetary policy conditions in Canada have relative room to catch up to the Federal Reserve but have not. This has been a reason behind repeated bouts of weakness in the Canadian dollar that has only recently improved partly as domestic oil prices have recovered. **An economy near capacity and with a record low in the unemployment rate is not screaming out for negative real rates.**

This argument is applicable to the Canadian dollar as well. **The currency remains undervalued** by classic long-run equilibrium models such as purchasing power parity that provide rough guidance toward long-run valuations (chart 16). Canada—unlike the US—is not dealing with a richly valued currency. Instead, a weak currency may put upward pressure upon imported inflation especially if sustained and built upon.

As further evidence of arguably lax financial conditions, **the BoC should take comfort in measures of credit spreads versus seeking shelter from harshly adverse market conditions.** Like the US, the Canadian high yield bond market has only wound back a prior overshoot but remains in rich territory (chart 14 again). Mortgage bond spreads remain relatively narrow (chart 17). Provincial bond spreads have widened but remain at healthy levels that have returned to early 2017 conditions that make for more attractive relative valuations as opposed to evidence of a riskier blow out in spreads (chart 18).

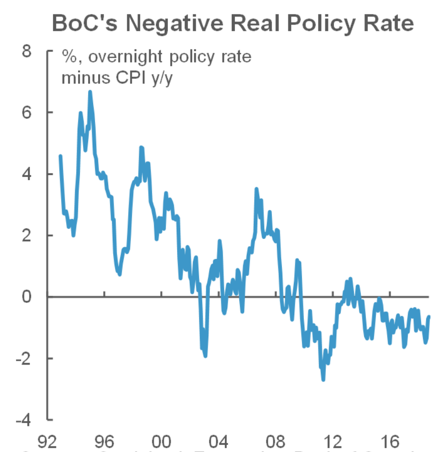
Like the US, the slope of the Canadian bond yield curve is not flashing recession signals (chart 19). The Canadian curve over-predicts downturns and while it remains flat through to the belly, there remain mildly positive 2s10s and 90s10s spreads that themselves are indirectly distorted as a cycle predictor by the imported effects of global central bank bond buying programs.

Chart 14



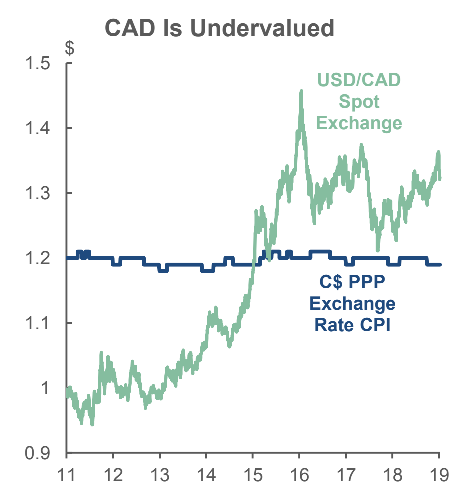
Source: Scotiabank Economics, Bloomberg.

Chart 15



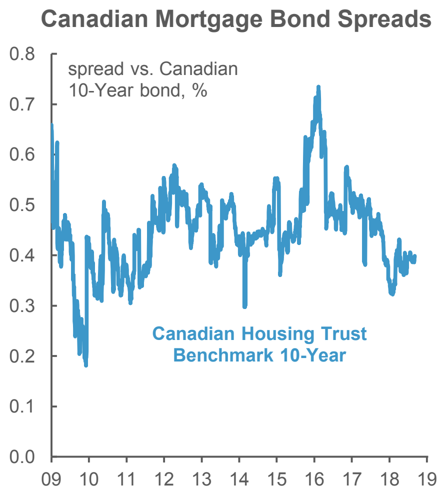
Sources: Scotiabank Economics, Bank of Canada, Statistics Canada.

Chart 16



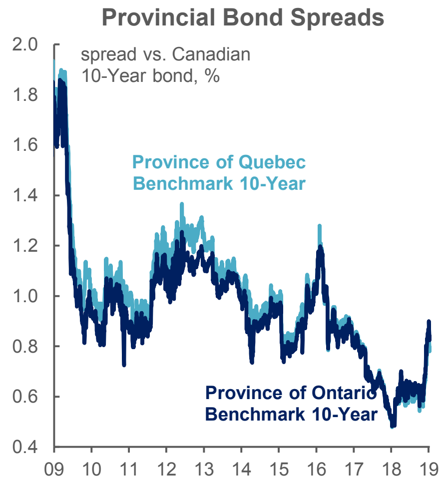
Sources: Scotiabank Economics, Bloomberg.

Chart 17



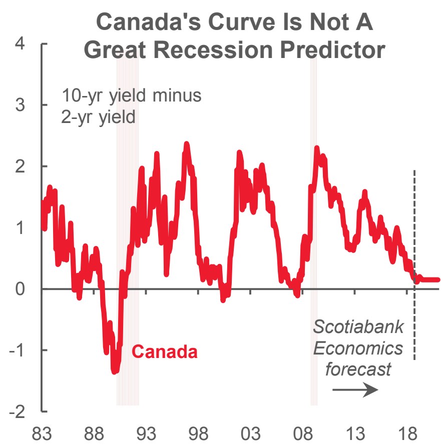
Source: Scotiabank Economics, Bloomberg.

Chart 18



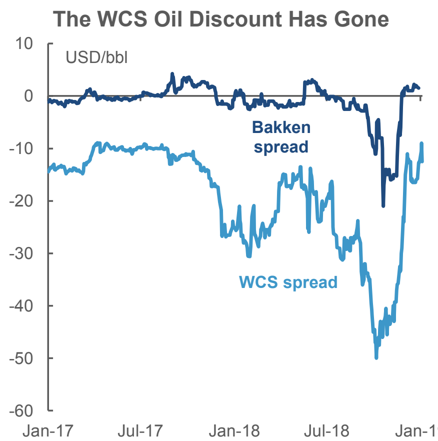
Source: Scotiabank Economics, Bloomberg.

Chart 19



Sources: Scotiabank Economics, Bank of Canada, Federal Reserve Board, NBER, CD Howe Institute.

Chart 20



Sources: Scotiabank Economics, Bloomberg.

The new information that has temporarily knocked the BoC off tightening plans, however, principally concerns developments in energy markets. The evidence of tightened conditions has been fleeting. The plunge in oil prices and particularly the discount to domestic oil prices caused fear of a return to the conditions in 2014–15 when the BoC ultimately eased in the face of falling commodity prices. The mechanism by which such developments affect the outlook is through selling Canadian commodity exports at lowered prices and suffering an erosion of purchasing power in world markets. The negative hit to the terms of trade—the ratio of export to import prices—results in lowered national income. In turn, that gets distributed through lower profits and household incomes and worsened fiscal balances. In turn, that can rein in activity measures like consumption, housing, and business investment. By corollary, that widens slack and dampens price pressures, thereby inciting relatively looser monetary policy.

When lower oil prices hit the Canadian economy, Alberta responded through deep mandated production cuts roughly at an 8% clip to start the year. That will drag down activity variables and create a little more near-term slack.

This time—dare we say—is nevertheless different to the BoC. For one thing, the drivers have been different, as transportation bottlenecks have struggled with a surge in output as prior projects came on stream. Such bottlenecks are easing. For another, **the correction to Canadian oil prices has already turned around in the other direction.** The discount suffered by Western Canada Select to WTI is shown in chart 20. From its widest point of -US$50 on October 11th, the differential has shut to just -US$8. That's a level of tightness not seen in about four and a half years. The WCS price itself has risen by about US$30 from the November low to the highest level since early September and hence before the meltdown began. This should result in the so-called terms of trade recovering quite rapidly (chart 21). **The BoC is therefore inclined to look through—cautiously and correctly—this correction and not treat it the same as the earlier episode.** We need to deal with the reality of the production cuts and the concomitant slack in the economy, but remain cautiously optimistic that this will be a fleeting effect with GDP growth being quickly restored to higher rates over the duration of the year. The fact that the energy industry is a much smaller influence upon the economy now versus 2014–15 is another consideration and one that is supported by multiple measures. One such measure is that investment in the energy sector has already been running at less than half what it was at the peak (chart 22).

Throughout it all, the non-energy sector of the economy is performing well as evidenced by wages that are rising considerably faster in non-energy provinces.

Chart 21

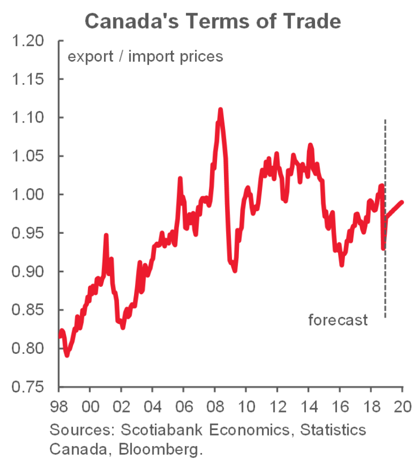


Chart 22

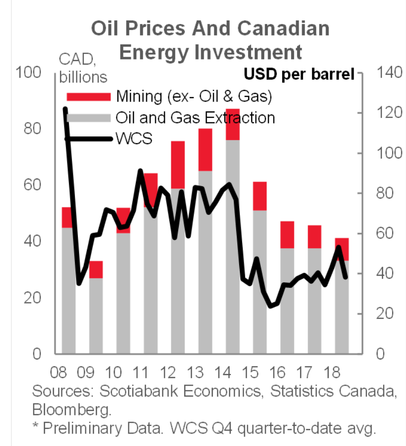


Chart 23

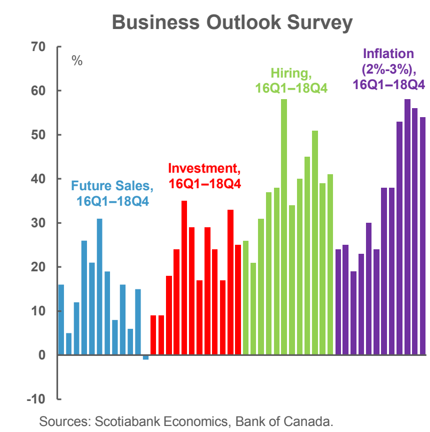


Chart 24

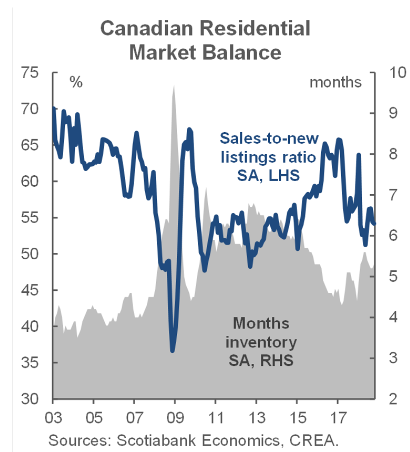


Chart 25

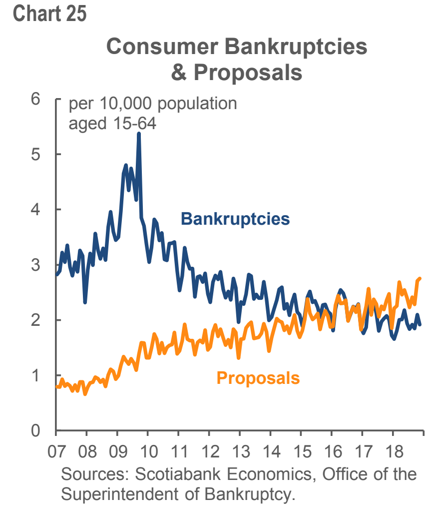
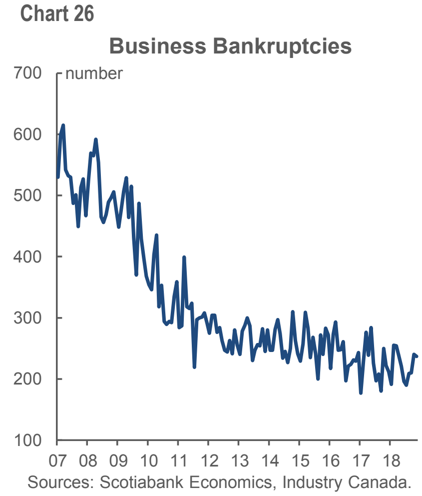


Chart 26



Against this backdrop, while much of the popular coverage of conditions facing the economy dwells on negatives, **there are many important positives.** The CUSMA, CPTPP and CETA trade deals maintain and build upon liberalized trade to the benefit of Canadian industry. Often times the public discussions about risks to the outlook seem to forget that the biggest risk—disrupted trade policy—has been averted in favour of moderate liberalization. This is probably not yet fully reflected in what are nevertheless generally resilient readings for business conditions (chart 23).

Further, over 170,000 jobs have been created in just four months albeit with frustratingly softer wage growth than stateside. Should investment pick up—and it should indeed in response to Federal investment incentives introduced in the October mini-budget—then productivity growth may follow and with that wage gains. With an investment pickup should come traction in export growth as capacity expansion feeds sales abroad. An investment pickup may also prove complementary to job growth. Thus, 2019–20 could unleash a virtuous cycle.

Given such expectations, we're of the view that the imbalances in **the housing market will prove to be manageable in a soft landing scenario.** Inventories and sales-to-listing ratios remain healthier than the problems that plagued markets coming off the 1980s expansion (chart 24). Tightened macroprudential rules by OSFI and some Canadian provinces should have transitory effects with a return to modest growth in housing markets fed by employment gains.

A key concern that could restrain the Bank of Canada is nevertheless the impact of higher borrowing costs upon consumer credit quality and the implications for the broader economy and financial system. The BoC should indeed be cautious, but there is the high risk of being overly so. Consumer bankruptcies remain very well behaved and largely nonresponsive to higher borrowing costs. Indeed, **consumer bankruptcies have never been lower** than they've trended around over the recent past (chart 25). Insolvencies, however, are made up of bankruptcies and proposals. Consumer *proposals* have increased—and are often misinterpreted as bankruptcies—but recall that they are "an offer to creditors to settle debts under conditions other than the existing terms." There can be many varied reasons for proposals, but the fact they are occurring without leading to bankruptcy showcases the relative ability of the Canadian banking system to adapt in a soft landing scenario. Proposals are worked out through a willingness to restructure payments and debt without necessarily forcing the client into bankruptcy and seizing uncertain net asset values minus related costs. One extreme example of the differences in the Canadian system is that strategic defaults generally don't exist in Canada; walking away with impunity is generally not an option, versus working out one's obligations in a mutually satisfactory way. I've generally found over time that the unique features of the Canadian banking system remain under-appreciated by many but not all foreign fast money accounts.

Also note that business bankruptcies are also very well behaved toward cycle lows but that doesn't get much attention (chart 26)! Business *proposals* have increased in the latest month, but the volatility of the series discounts any single observations with a cautious eye toward the trend.

In all, a solid case can be made for how overall financial conditions are too easy for an economy with Canada's broad characteristics and that the Bank of Canada should be careful but not frozen by concern over the ability of the credit quality cycle to absorb further tightening.

CONCLUSION—MONITORING RISKS, READY TO REVISE IF NECESSARY

Our forecasts for each country's central bank actions will remain sensitive to monitoring major global risks including three developments with at present March timelines. First is our assumption that volatility may increase but a negotiated Brexit settlement will eventually arrive as the currently defined March 29th deadline approaches. That deadline may be extended which could prolong uncertainty but UK politics are too unstable to have a firm read on the risks at this juncture.

Second is that a negotiated settlement will be achieved by the US and China that averts a negative outcome as the 90 day tariff moratorium expires on March 1st. Pain in Chinese fundamentals and US earnings is being inflicted upon both boxers in the ring and into a US Presidential election year we expect pressure to be more acute upon the US administration to settle down policy risks. Years of conflicting ambitions are ahead as superpowers tussle for supremacy but near-term calm may be restored.

Third is that eventually a negotiated outcome will arise that ends the record long US government shutdown, restores funding and ideally raises the debt ceiling in advance of the March 1st deadline or at least well before the point at which the US Treasury depletes high cash balances and exhausts extraordinary powers around a mid-summer timeframe.

Like the Fed and the BoC and others, our own forecasts will be sensitive to these developments. Throughout it all, we expect them

Table 1

Scotiabank Economics' Canada-US Yield Curve Forecast

	2018	2019				2020			
		(end of quarter, %)							
Canada	**Q4**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
BoC Overnight Target Rate	1.75	1.75	2.00	2.25	2.50	2.75	2.75	2.75	2.75
Prime Rate	3.95	3.95	4.20	4.45	4.70	4.95	4.95	4.95	4.95
3-month T-bill	1.65	1.80	2.05	2.30	2.55	2.80	2.80	2.80	2.80
2-year Canada	1.86	2.00	2.20	2.45	2.65	2.85	2.85	2.85	2.85
5-year Canada	1.89	2.10	2.30	2.55	2.75	2.95	2.95	2.95	2.95
10-year Canada	1.97	2.20	2.35	2.60	2.80	3.00	3.00	3.00	3.00
30-year Canada	2.18	2.35	2.50	2.75	2.90	3.10	3.10	3.10	3.10
United States	**Q4**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Fed Funds Target Rate	2.50	2.50	2.75	3.00	3.25	3.25	3.25	3.25	3.25
Prime Rate	5.50	5.50	5.75	6.00	6.25	6.25	6.25	6.25	6.25
3-month T-bill	2.36	2.40	2.65	2.90	3.15	3.15	3.15	3.15	3.15
2-year Treasury	2.49	2.75	2.90	3.10	3.30	3.30	3.30	3.30	3.30
5-year Treasury	2.51	2.80	3.00	3.20	3.35	3.35	3.35	3.40	3.45
10-year Treasury	2.68	2.90	3.10	3.30	3.40	3.45	3.45	3.50	3.55
30-year Treasury	3.01	3.10	3.25	3.50	3.50	3.60	3.60	3.65	3.65

Sources: Scotiabank Economics, Bloomberg.

Mexico

DÉJÀ VU

- **Mexico faces a complex backdrop, marked by a more challenging external outlook and domestic uncertainty regarding the direction of macro policy under the new government.**
- **The 2019 Economic Program considers a profound reallocation of public spending and a shift in policy priorities. Even though the new government will commit to fiscal discipline, the big question is its ability to adhere to the budget.**
- **We expect subpar growth in 2019 at around 1.6%, on the back of increased domestic uncertainty, raised market concerns, and the impact of high interest rates.**
- **On Banxico, we expect one more 25bp hike in 1H19, with the policy rate at 8.50% at year-end 2019.**

Mexico voted in 2018 to shake the political status-quo and choose Andres Manuel Lopez Obrador (AMLO) as the new President, also giving his movement a majority in Congress that is very close to having the power to change the Constitution. AMLO's main campaign message was to bring corruption to an end, which will liberate a lot of wasted resources that will be used by the Government to promote a higher and more inclusive economic growth. In his view, "neo-liberalism" is responsible for Mexico's anemic growth and thus it should be reverted. His reading is nostalgic for the economic performance of the 60's, when Mexico grew at an average rate of 6% with a tamed inflation, and when the government had a heavy (and authoritarian) hand on the economy. It seems that his Presidency will try to revive that model, where the Government will somehow take many economic decisions and where the President will take all the important ones in the National Palace. It seems that we have forgotten all the wasted years of the late 70's and 80's, when our country struggled to correct all the distortions and problems created by the previous "model" of a "heavy hand" Government, and that the world has dramatically changed since then.

Some of the new government's ideas of more inclusive governance raise concerns. The denominated *public consultations* to determine whether to proceed with the implementation of public projects have already been used to justify the cancellation of the new airport in Texcoco and some other decisions. This new political mechanism was far from being representative, since only around 1% of the electorate voted, putting aside economic efficiency criteria and favoring ideological beliefs. The Texcoco decision injected a huge uncertainty into the economic landscape that is expected to take a heavy toll on investment in coming years. Additionally, AMLO's ambivalent stance on energy reform means that the pace and scope of its implementation will likely be reassessed, since new oil auctions have been halted and programmed farm-outs deferred until the second half of 2019.

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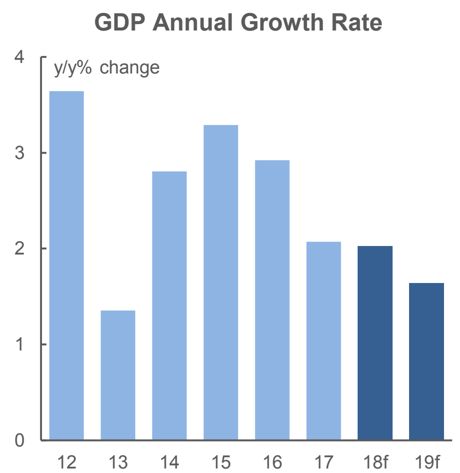
Mexico	2017	2018e	2019f	2020f
Real GDP (annual % change)	2.1	2.0	1.6	2.3
CPI (y/y %, eop)	6.8	4.8	4.3	3.8
Central bank policy rate (%, eop)	7.25	8.25	8.50	7.50
Mexican peso (USDMXN, eop)	19.66	19.65	21.36	21.81

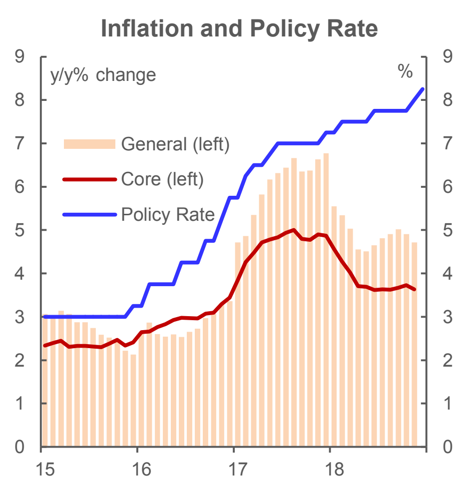
Source: Scotiabank Economics.

Chart 1



f: forecasted. Sources: Scotiabank Economics, INEGI

Chart 2



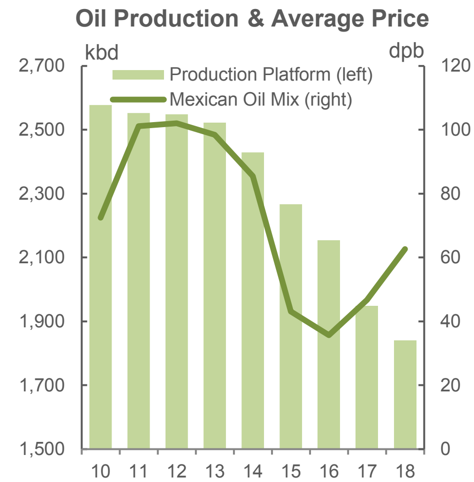
Frequency: Monthly
Sources: Scotiabank Economics, INEGI.

These announcements quickly raised market concerns, reflected in a significant deterioration of financial variables. With regard to the foregoing, the Mexican currency experienced a large depreciation over the past months, while the increase in the country's risk showed that investors were demanding higher risk premiums on Mexican assets. Moreover, after the decision to cancel the new airport project the country's risk perception sharply rose and 10y M Bono interest rates reached levels not seen since the financial crisis (+9.24%), while Mexico's 10y CDS also surged to levels similar to those registered after Trump's victory.

On the positive side, the new deal reached among the Mexican, Canadian and US governments for an updated free trade agreement contributed to reduce uncertainty regarding the rules of trade engagement among the three countries. Even though the new agreement might face some resistance in the US Congress, our baseline scenario assumes legislative approval in all three countries sooner than later.

The approved Economic Program for 2019 gave markets some relief and was taken positively by investors, since underlying macro assumptions were, on balance, not far-fetched, while official public finances estimates suggest the new government will commit to fiscal discipline, with a primary surplus of 1% of GDP and total debt-to-GDP would remain unchanged at 45.3%.

Chart 3



Sources: Scotiabank Economics, PEMEX.

In broad terms, the budget considers a profound reallocation of public spending, with a significant rebalancing of resources among institutions and autonomous agencies, as well as a shift in policy priorities. Moreover, the government prioritized fiscal consolidation although it has little room to manoeuver. Additionally, even if tax revenues growth (+7.0% in real annual terms compared to those expected at year-end 2018) and cuts in operational expenditures (around 0.7% of GDP) might seem slightly optimistic, the big question is the ability or desire of the government to adhere to the budget. Impacts on economic activity stemming from public resources reallocation are yet to be seen.

The main projects that the new administration contemplates for the 2019 Expenditure Budget add MXN 251.6 billion. The projects can be divided into three main categories: First, social programs, which basically consists of giving monetary aid to people in need, including the *pension for people with disabilities* (MXN 7 billion) and *pension for the well-being of the elderly* (MXN 100 billion). Second, the government prioritized public infrastructure programs such as the *Mayan train* (MXN 6.0 billion), *modernization and rehabilitation of airport and connectivity infrastructure* (MXN 18 billion), and finally the *reconstruction plan* which aims to restore the earthquake-affected zones (MXN 8 billion). Third, employment and production programs were also considered, including the *young population building the future* (MXN 44.3 billion) which will provide scholarships to undergraduates and internships to graduate students. Finally, the Energy Plan presented by AMLO considered the construction of a new refinery in Dos Bocas, Tabasco, for a total amount of MXN 50 billion.

OUTLOOK

Turning to the economic outlook, 2019 looks quite challenging for the Mexican economy and our central macro scenario adjusts to incorporate the domestic uncertainty exacerbated by the new government policies, amid a more complex external outlook and tighter financial conditions.

On the external side, we consider that downside risks to the outlook have increased. Even though the global expansion is expected to continue at a good pace in 2019, there are mounting concerns of a possible deceleration that could be faster than anticipated, both in advanced and emerging market economies. In addition to the further weakening in economic activity stemming from the maturing of cyclical forces, we believe the ongoing trade tensions, increased geopolitical risks and tighter global financial conditions could dent business sentiment and trigger financial market volatility which would add additional pressure on emerging markets.

On the domestic side, we expect uncertainty to prevail under the new political framework, significantly affecting both investment and private consumption. A significant delay of public spending is expected for this year, since the natural learning process of a new administration will be aggravated by the dramatic changes the new government is implementing, such as the Federal Law of Public Servants Salaries, which established wage ceilings to senior public servants, discouraging quite a few from a career in the public sector. This loss of human capital is likely to dent government's efficiency. Even fiscal discipline is targeted in the Economic Program for 2019; there is execution risk regarding the government's ability to operate the new budget, as well as spillover effects on the economy derived from the reallocation of public resources.

In this sense, we anticipate weak growth in economic activity and employment, as well as slightly higher levels of interest rates and upward pressures on the exchange rate. Moreover, private consumption is expected to further decelerate on the heels of uncertainty and increased market concerns. In our assessment, private investment is poised to register a contraction on the back of the above-mentioned factors along with some loss of investors' confidence, which would not be easily repaired and presents a high chance of deteriorating even further. Worth noting is that even the Finance Ministry is expecting a zero growth in investment for 2019 in their macroeconomic framework.

On the other hand, we foresee the external market to continue to be the most dynamic sector. Even if industrial activity slows somewhat in the US, we expect exports to show positive prints endorsed by the weakness of the Mexican currency. We also note an opportunity for this sector to increase market share, as tariffs imposed on US imports from China could help to make Mexican exports more attractive to North American buyers. Finally, the inflation outlook is likely to improve slightly in 2019, with headline inflation falling to 4.34%. In contrast, we expect some resistance for core inflation to decrease due to the recent spillover effects by the currency weakening.

Brazil

SUBDUED GROWTH & MODEST REFORMS IN STORE

- **We expect the Brazilian economy to grow at a fairly modest pace of 2.3% in 2019, with both industrial production and domestic demand setting a cap on growth. Public spending should remain little changed, with the new government's reform agenda being: a) not very ambitious, and b) facing political headwinds. Without fiscal adjustment, crowding out will remain a problem, and without reform, productivity will continue to limit growth.**

- **Among the few reforms for which we see a positive outcome is central bank (BCB) independence. Granting the central bank more formal autonomy, combined with President Temer's TJLP (long-term reference rate for BNDES lending) reform, could combine to lower the BCB's neutral real policy rate, which is one of the few positive structural changes we see in the Brazilian economy. However, despite these improvements, we have more aggressive BCB hike expectations than both the DI (local IRS) curve and the BCB's Focus survey.**

GROWTH TO REMAIN SUBDUED

The BCB's Focus survey has growth for 2019 at 2.55%, which is slightly above our forecast of 2.3% for the year. Given the country's low investment rates (almost permanently below 18% of GDP), a slowing global economy, and lower and more volatile commodity prices, Brazil's potential growth rate is a shadow of what it was in the early 2000s. As of now, we haven't seen any major productivity-boosting proposals from the new administration, and we believe that fiscal adjustment efforts and pension reform will only improve the fiscal deficit marginally—meaning that public sector "crowding out" will remain an issue.

Brazil's industrial production has improved somewhat over the past year, but has only expanded at an average 2.3% annual rate for the last 12 months for which we have data. With global growth slowing and domestic interest rates heading higher—it is unlikely that industrial activity will accelerate markedly in the near term. If anything, there seems to have been a slowing over recent months. Similarly, domestic consumer demand has also accelerated somewhat over recent months, but its pace is also at subdued levels. Overall, there isn't much evidence to argue that growth may accelerate—barring a material unexpected external shock, be it from commodity prices, or external demand.

On the reform front, as we have argued for a few months, we see little chance that the new government will be able to deliver much beyond: 1) a modest pension reform (basically only affecting public sector workers—with our base case being it affects "new workers", and the upside surprise being "all workers"), b) the BCB independence bill (giving board members tiered fixed terms), and c) some modest progress on public company capitalizations and, as the positive surprise scenario, some additional privatized stakes in companies such as Eletrobras. All told, we see these reforms as good news, but a far cry from what is needed on both the productivity and public finance fronts.

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Brazil	2017	2018e	2019f	2020f
Real GDP (annual % change)	1.1	1.1	2.3	2.5
CPI (y/y %, eop)	3.0	4.1	5.2	5.4
Central bank policy rate (%, eop)	7.00	6.50	8.25	8.75
Brazilian real (USDBRL, eop)	3.31	3.88	4.27	4.52

Source: Scotiabank Economics.

Chart 1

Sources: Scotiabank Economics, Bloomberg, IBGE.

MONETARY POLICY PUZZLE

Brazil has among the highest neutral monetary policy rates in the world, which were estimated somewhere in the 4.5%–5.5% range. The reasons for this are several, including: 1) a low savings rate, 2) credit market segmentation, 3) a fiscal risk premium, 4) inflation inertia due to indexation, and 5) the lack of a formally independent Brazilian Central Bank—which means the political cycle interferes with the monetary one. The good news on this front is:

- The TJLP reform passed by President Temer, which can reduce the segmentation of the Brazilian credit market. One of the reasons for this segmentation was that BNDES gave large amounts of loans at what was a highly subsidized interest rate (the TJLP) but, rather than give those loans to players without credit market access, it gave them to "national champions". This had the effect of taking out the prime borrowers from the market, leaving a riskier lending pool for public markets.

- Although we are skeptical that Bolsonaro's will be a super-reformer government, our base case is that we will see a modest version of the pension reform, alongside the "BCB independence" bill as the main deliveries of the new administration. The BCB is expected to get fixed-term board members with tiered mandates, meaning it would become less vulnerable to shifts in the executive.

Our sense is that these two measures combined mean a partial unwind of the drivers of Brazil's high interest rates. We don't think they are enough to compress "real neutral rates" to the 1.5%–2.5% that exist in Colombia (and up to recently existed in Mexico), but we would not be surprised by Brazil's real neutral rates gradually falling to 3.5%–4.5% as the segmentation of lending markets fades and the BCB is granted formal independence. Hence, watching for the approval of the BCB bill is key, as is looking at inflation dynamics to see whether current expectations for the SELIC rate are accurate.

In terms of inflation dynamics, we've had good news regarding IGP-DI inflation [a composite of wholesale prices (60%), consumer prices (30%) and construction costs (10%)] as it dipped from a peak of 10.5% to around 8.5%. However, much of the decline was related to the rebound of the BRL around election time, and our sense is that disappointment over reforms is one important potential source of risk for the currency during the next quarter. Looking at manufacturing PPI, we continue to see stubborn cost pressures, with producer inflation sitting at 14%. Despite higher IGP-DI and manufacturing PPI, IPCA remains fairly well behaved, printing at 4.05% in November. We believe the key for inflation dynamics remaining in check will to an important degree be BRL, and whether FX inflation pass-though remains supportive for disinflation (Brazil has a relatively high FX-inflation pass-through of 20–30%), as once inflation gets going—which can be triggered by the currency—the country still has many pro-cyclical inflation drivers, meaning it is tough to stop.

Based on the DI-rates market, there will be roughly 25bps of hikes delivered by the BCB in 2019. This would mean that with inflation at consensus (4.0%), the year would end with policy settings still in loose territory (only 2.75% real rates). Assuming that the reforms delivered help "real neutral rates" compress, we still think DI rates are underpricing the BCB's hike cycle, and the timing of it. Our base case is that the BCB will kick off its tightening cycle at the start of Q2-2019, and that the SELIC rate will end 2019 at 8.25%, with IPCA inflation ending 2019 at 5.2%, rather than the BCB's Focus survey consensus forecast of 4.01% .

On the FX front, like many emerging markets currencies, the Brazilian real benefited from the paring down of the Fed's expected hike cycle in the December FOMC meeting. However, going forward we expect market participants to be focused on whether Bolsonaro's government can deliver on reforms, for which we see limited results. Hence, we see USD/BRL heading higher as Q1-2019 comes to a close. In addition, an external risk to monitor is US equities, as a continued drop could see cheaper valuations add a source of competition for asset allocations to EM.

Colombia

FISCAL REFORM DOES THE JOB, BANREP BEHIND THE CURVE?

- **Although the government's fiscal reform was further watered down in its passage through Congress, it should do the job to solidify Colombia's investment grade. In addition, cuts to corporate taxes should boost private investment, and thus could increase long-run potential growth.**
- **On the flip side, we are not sold on the central bank's (BanRep) estimates that "neutral real rates" are close to 1.4%, and we fear BanRep may be behind the curve on its hikes, particularly due to its ignoring of tightening global conditions, as well as its expectations that the economy will be back at potential this year.**

FISCAL REFORM—UNDERWHELMING, BUT DOES THE JOB

Although the tax reform the government submitted in October was further diluted in its process through the legislative, it appears to be just enough to get the job done so that fiscal targets for 2019–2020 are met. The reform is estimated to boost fiscal revenues by about 80–90bps of GDP, which is lower than the 140bps of GDP the Duque government looked for, but should be more than enough to preserve the government's investment grade rating. In our view, the bad news about the process was basically the "lost opportunity" of making a true fiscal change that reduces the fiscal dependence on oil—which has traditionally meant that a US$10/bl drop in the price of oil hits the fiscal balance with a 40bps of GDP deterioration.

On the growth front, the negative impact will be that in order to comply with the fiscal targets set under the fiscal rule, given the 50–60bps of GDP dilution in the fiscal reform, it will be necessary to cut spending by that much. The positive news is that the Duque government did deliver on private sector tax burden reductions, so we could see some boosts to private investment—particularly if we are wrong on BanRep's more aggressive than consensus rate hikes, and if oil prices stabilize.

How much were corporate taxes cut?

- Income taxes will fall from 37% in 2018, to 33% in 2019, 32% in 2020, and 31% in 2021, and 30% from 2022 onwards.
- Corporates will also get VAT tax breaks on their investment.
- The government will also set a 15% tax on dividends over COP10.2mn, which could boost corporate investment.

Finance Minister Carrasquilla expects these corporate tax cuts to boost potential growth by 40bps in the long run—which we think is possible. On the flip side, two elements of the tax reform can have more uncertain impacts:

- Temporary 4% bank income tax boost for 2019, which drops to 3% for 2020 and 2021 could affect the banking sector.

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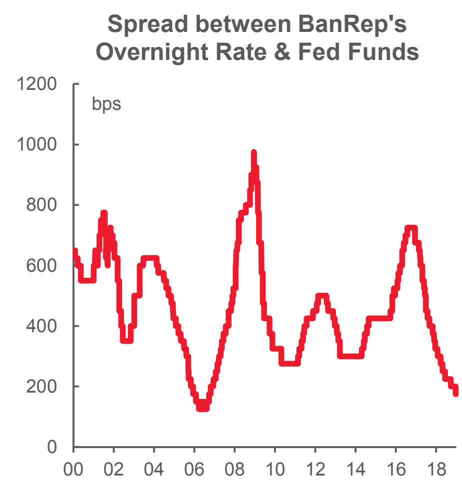
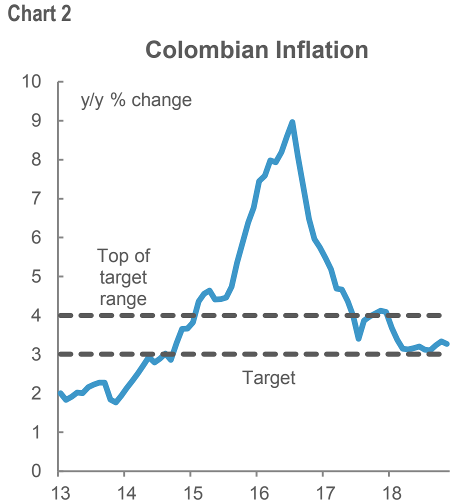
Colombia	2017	2018e	2019f	2020f
Real GDP (annual % change)	1.8	2.5	3.3	3.6
CPI (y/y %, eop)	4.1	3.2	4.8	4.1
Central bank policy rate (%, eop)	4.75	4.25	5.75	6.75
Colombian peso (USDCOP, eop)	2,986	3,254	3,210	3,185

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

- A temporary 1% wealth tax that extends to 2021 on net worth over COP5bn could cause some capital flight—but this could be offset by an extension on the amnesty for foreign asset repatriation.

All told, the tax reform was good, if unspectacular news—which we see as enough to secure the country's investment grade going forward.

GROWTH FINALLY PICKING UP

On the growth front, we are finally seeing the economy gaining traction, and we expect Colombia to grow around potential for this year (3.3%), and accelerate further in 2020 and 2021 (to 3.6% and 3.7% respectively). The latest data for both retail sales (+6.5% y/y) and industrial production (+5.8% y/y) were arguably too strong to be maintained, but nonetheless show an economy that is on a much stronger path. It is notable that for all of 2018, we saw a consistently strengthening industrial sector. Retail sales had been moving sideways, but at a strong rate. Our main concern on the growth front is the impact that weaker oil prices could have on investment, but we think that risk is more than offset by stronger domestic demand. At this stage the economy is now strong enough to support tighter monetary policy.

BANREP'S RATE HIKE CYCLE, BEHIND THE CURVE?

BanRep's Echavarria said he sees Colombia's real neutral rates as being fairly close to 1.4% and sees current growth as below potential. Our take is that the country's potential growth is somewhere between 3.0% and 3.5%, and we see real neutral rates as being around 2.0% and 2.5%—hence we agree Colombian growth is still sub-potential, but we think the central bank is falling somewhat behind the curve on the inflation front. The logic being that with the monetary policy transmission lag being around 18 months, and Colombia not having "global monetary policy autonomy" (i.e., it does not operate in isolation of the global monetary policy cycle), BanRep is playing with fire in falling so far behind the curve with respect to the Fed. The BanRep overnight–Fed Funds spread is currently at 175bps, and with the FOMC expected to deliver 25bps more hikes before consensus expects BanRep to lift-off, the spread between the two would get to its lowest ever.

At the moment, inflation dynamics remain supportive, with CPI for November printing at 3.27% (in the upper half of the target range, and moving sideways), but our fear is that continued weakness in COP risks pushing inflation higher, at the same time as the economy continues to gather momentum—reaching its potential growth rate this year. Hence, due to our view that BanRep is already falling behind due to the 18 month monetary policy transmission lag, we have a higher-than-consensus inflation forecast for 2019 (4.8%), and a more aggressive tightening cycle than local rates are pricing in (we call for 250bps in hikes by Q2-2020, while local rates are only pricing in between 100bps and 125bps in hikes over the next 2 years).

COP is the worst performing major emerging markets currency since the start of October, losing over 7.5% during the fourth quarter of 2018. Behind the losses are falling oil prices, alongside the low carry on the currency due to BanRep's loose monetary policy stance—which is driving a closing gap vs the Fed. Our sense is that the "fiscal reform" did not do enough to boost a sentiment-driven bounce in the peso, meaning that going forward, the currency remains at the mercy of global oil price swings and carry differentials—the latter of which looks set to swing further against the peso over the coming months. Hence, we have the peso weakening gradually although a shift in BanRep's stance should help stabilize the peso if it comes. However, based on the most recent communication from the central bank, we have seen no indication they are turning less dovish.

Peru

2019: SIMILAR TO 2018 BUT WITH MORE UPSIDE

- **Peru goes into 2019 with robust consumption and a strong labor market.**
- **Mining projects add to otherwise modest private investment growth.**
- **Government investment will be the swing factor, with both strong upside and downside risks.**
- **Surprisingly strong fiscal accounts in 2018 provide a healthy platform for 2019.**
- **Monetary policy may stay on hold for longer, given low inflation and uncertainty in global financial markets.**

GDP growth is ending 2018 on a strong note. 4Q2018 GDP growth should be close to 5%, with full-year GDP likely surpassing our forecast of 3.7%, and approaching 4.0%.

Our GDP forecast for 2019 is 4.0%. Our general view is that growth will be similar to 2018, with contributions from a few important investment projects, led by the US$5.3b Quellaveco copper project. Progress in certain infrastructure projects, such as the Lima Airport, may also contribute.

One particularly encouraging aspect of 2018, which should carry over into 2019, is that the main drivers of growth were private domestic demand and non-resource sectors. In particular, 2018 is ending with signs of a somewhat broader portfolio of private investment projects in the pipeline, and a formal private labor market growing above 4.0%, which should sustain consumption growth of 3.5% in 2019 (from 3.4% in 2018). A booming agro-industry has been a particularly strong contributor to formal jobs growth.

Our forecast of 6.5% private investment growth in 2019 is a modest improvement over 2018, and far from the double-digit growth experienced before 2014. However, we are being a bit cautious, given the global uncertainty in 2019, especially concerning metal prices. We see upside to this figure. The current business environment has been fairly sanguine in the face of domestic political turbulence; and mining will contribute. We expect mining investment to increase 13% in 2019, a bit more modest than the 20% we estimate for 2018.

Meanwhile, government investment growth is much more uncertain. In the past two years, political disorder has arguably had a greater impact on public investment than on private investment. However, the number of changes in authorities, from the president down to cabinet members, that occurred in 2018 was atypical, and should not recur (we hope!) in 2019. So, as the current government becomes more settled, public investment should improve. So, then, why are we forecasting that public investment growth will slow to 2.8% in 2019 from 8.8% in 2018? The reason is that two-thirds of the public investment budget is in the hands of regional and local governments, which have just been renewed

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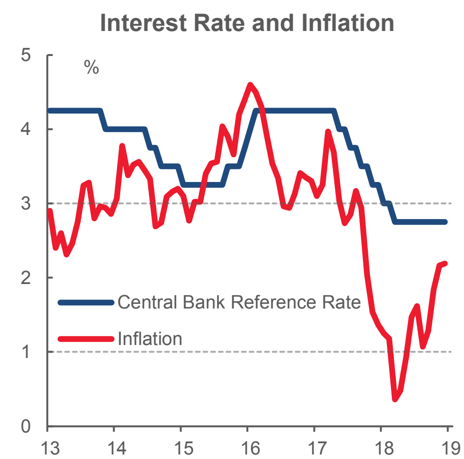
Peru	2017	2018e	2019f	2020f
Real GDP (annual % change)	2.5	3.7	4.0	4.0
CPI (y/y %, eop)	1.4	2.2	2.4	2.5
Central bank policy rate (%, eop)	3.25	2.75	3.25	3.50
Peruvian sol (USDPEN, eop)	3.24	3.37	3.30	3.25

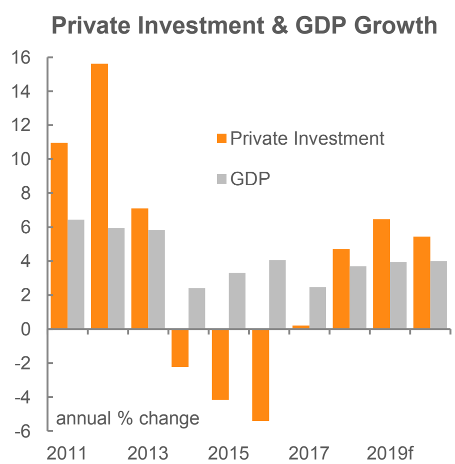
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Central Bank of Peru, INEI.

Chart 2



Sources: Scotiabank Economics, Central Bank of Peru.

after recent elections. Typically, regional and local government investment plummets in the years that new authorities take office, due to high rotation and weak institutional frameworks.

To be sure, there will be risks in 2019, including possible pressure on metal prices, the uncertainty of political events, and volatility and uncertainty in global financial markets, with the FX market a particular concern. However, these risks already existed, to a large extent, in 2018, and yet GDP growth was fairly robust, perhaps better than one might have expected under the circumstances.

One concern that many had at the start of 2018 and which has dissipated since is the fiscal deficit which, instead of ballooning to 3.5% (from 3.1% in 2017) as the government, and much of the market, had forecast, actually declined to an estimated 2.8%. The improvement is linked to stronger-than-anticipated tax revenue, especially sales tax linked to domestic demand, which is fine, but also to much-too-low public sector investment. In 2019, we expect the deficit to fall a bit further, to 2.5% as both factors should persist to some extent. Hopefully we will be wrong, and public sector investment will come in greater than we are expecting.

Inflation ended 2018 at 2.2%, just off the mid-point of the Central Bank's target range (1% to 3%). There are no demand pressures in the making that could increase inflation. So, barring any weather-related supply shocks, inflation should continue comfortably within range. We are making only a small adjustment in our forecast, lowering 2019 inflation from 2.5% to 2.4%, to account for lower fuel prices.

What does this mean for monetary policy? We don't see the Central Bank in any hurry to move rates. Both inflation and GDP growth are at reasonable levels. The reference rate, at 2.75%, is still a bit low in historical terms and compared to the CB's own concept of a neutral rate (1.75% in real terms, or over 3.5% in nominal terms), which is the main reason that we continue to believe that the CB will raise its policy rate twice, to 3.25%. However, our conviction has become weaker over time, due to global markets uncertainty, and we see a scenario in which the CB does not raise its rate at all as no longer out of the question.

The PEN is by far the most difficult forecast to make. In 2018 the market was not governed by fundamentals so much as by short-term capital flows, which have taken into account broader emerging market risk. It's not easy to justify the 4% PEN depreciation in 2018: metal prices were, on average, very similar to 2017; Peru had a comfortable trade surplus; both the current account and the fiscal account improved; and not one ratings agency changed its views on Peru. Granted, the political situation was messy, but this did not really seem to be the driver behind the PEN. The real driver was the USD and global events. This raises the question of whether fundamentals will reassert themselves in 2019, whether the USD will correct or not, and how metal prices will behave. Lots of questions and uncertainty. However, to be consistent with house-view expectations for the USD and commodity prices, and our own view that the weakening PEN overshot its mark in 2018, we believe the PEN should strengthen in 2019. We are, therefore, not changing our forecast of 3.30 at year-end 2019, but warn that uncertainty is particularly high. In any event, any rebound is not likely to happen soon, as the current depreciation trend is strong. There is a good chance that the PEN will continue to weaken early in 2019, perhaps surpassing the 3.40 mark, before it begins to strengthen.

A final word on the political situation and corruption investigations that have been such big issues. Peru has gone through two years of political turbulence. However, in the process, the Vizcarra regime has gained strength, and the opposition parties in Congress have weakened. Also, in the process, economic policy has not varied. Both factors lead us to believe, without too large a quota of wishful thinking, that 2019 should be a politically calmer year. But, calmer does not mean calm. There will continue to be noise, especially surrounding the corruption investigations. However, the noise should not endanger governability nor economic policy. Which, in the end, is what matters.

Chile

GROWTH EASED IN H2 AND SLOWDOWN COULD CONTINUE IN Q1 2019

- **We expect an expansion of 3.9% in 2018 and 3.2% for 2019, with a rather low velocity in Q1 and a progressive improvement later. Many forecasts in the market should be trimmed toward that level.**
- **Market inflation expectations have been cut due to both specific and general effects. Our forecast for 2019 remains at 3%. We expect the Central Bank will increase its MPR to 3% in January, followed by a couple of similar hikes (one at the end of Q2 and other in H2), to end the year at 3.5%.**
- **Business confidence index fell back into the pessimistic zone in recent months. Both foreign and domestic conditions have dented the sentiment in Chile in H2: lingering weakness in copper price; US dollar strengthening; higher risk aversion; some figures and political facts did not fulfill expectations, like growth closer to 4% than to 4.5% and the delay of income tax and labor market reforms that would be critical for stronger growth.**
- **Long term rates should resume a mild uptrend, while a limited appreciation of the domestic currency (vs. USD) continues being our central scenario. Risks for our base case are high at this point, but at the same time, we think there are stabilization factors developed in recent quarters that may prevent severe deviations.**

MACRO UPDATE: LACKLUSTER CONDITIONS DRAIN GROWTH AND INFLATION

Recent data for the economy have been below market expectation. In November the economic activity expanded 3.1% y/y while preliminary indicators suggest some improvement in December would allow GDP to reach 3.2% y/y in Q4 and 3.9% for the whole year, though probability of a result just above that (4%) remains in the cards. However, a slowdown is expected for 2019, probably to 3.2% or a little more. Headwinds remain negative for the growth: copper price has not headed up as many analysts expected, international risk aversion is still high, and a slow improvement of domestic conditions for economic reforms and labor market are weighing on business expectations that fell back to the pessimistic zone in November, as we anticipated in the October report.

Despite that, some investment leading indicators have been more positive, with the most important public compilation showing a significant increase of investment for 2019 and 2020. On the other hand, consumption is showing signs of a slowdown recently. We must highlight the contraction in car sales, for the first time in two years, which will press on total consumption figures. Labor market is not expected to help too much: employment growth should remain subdued and unemployment rate will likely decrease slowly in the coming years (due to the assumption that growth of the economy is not going to be higher than potential, that is estimated between 3% and 3.5%, and that labor reform accomplished in previous government is likely to be a drag on hiring and it is not clear when will be

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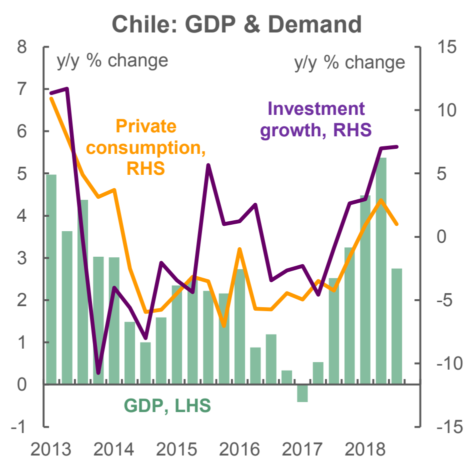
Chile	2017	2018e	2019f	2020f
Real GDP (annual % change)	1.5	3.9	3.2	3.2
CPI (y/y %, eop)	2.3	2.6	3.0	3.0
Central bank policy rate (%, eop)	2.50	2.75	3.50	4.00
Chilean peso (USDCLP, eop)	615	694	650	640

Source: Scotiabank Economics.

Chart 1

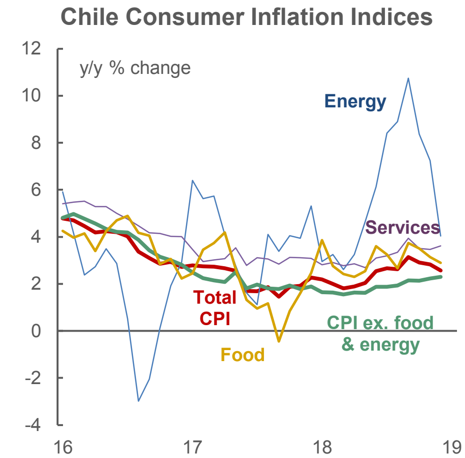


Sources: Scotiabank Economics, Central Bank of Chile (BCCh).

fixed). Inflation remains well contained, and it is not expected to reach the monetary policy target (3%) before the end of 2019 or later. Among factors dragging down inflation expectations are the plunge of oil prices and the softer-than-expected domestic demand. The Central Bank (BCCh) kept the monetary policy rate at 2.75% in December (an expansive level) but retained the upward bias and most of the market expects a 25bp hike on January 30th. We think that increase will be followed by a similar hike in June and one more in H2, nothing more intense. A neutral MPR (between 4% and 4.5%, according to the BCCh) would not be reached before 2020. Fiscal Policy is expected to be more conservative than in previous years, with an expansion of 3.2% approved in the law for 2019 (vs. the law for 2018), to reach a deficit of 1.7% of GDP. Because spending in 2018 was higher than estimated by budget, the actual expansion of spending in 2019 (that is, compared with the actual spending in 2018) would be considerably less than that, just around 1.4%.

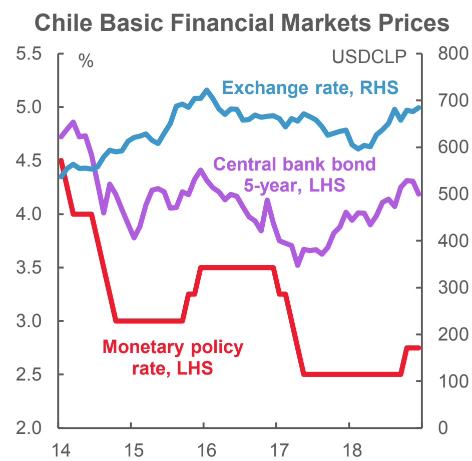
With this domestic and foreign backdrop, long term rates have retrenched at the end of 2018 and will likely stay low at least in Q1, when the adjustment of market expectation is expected to conclude. However, we continue expecting a moderate uptrend for the rest of the year as the economic growth (though not extraordinary) helps to continue reducing productive gaps and monetary policy expectation should be progressively less dovish as the year passes. As far as exchange rate (USDCLP) is concerned, the wide trading range should be the rule again. We estimate that the recent increase, somewhat aligned with quantitative factors, is more a reaction to the international volatility than a change of trend. Accordingly, we continue expecting a moderate appreciation of the Chilean peso to end 2019 around 650 and 2020 around 640. Forecasted critical factors, like copper price, international USD value and lower risk aversion should moderately help to achieve that.

Chart 2



Sources: Scotiabank Economics, Instituto Nacional de Estadísticas (INE).

Chart 3



Sources: Scotiabank Economics, Central Bank of Chile (BCCh).

POLITICAL PANORAMA: NOT A STORM BUT CLOUDS AND WARM BREEZE

All indications are that the honeymoon between the new Government and voters is coming to an end. Popularity of the President has been decreasing for some weeks in a row. Part of that is attributed to the lack of economic recovery. Additionally, some upsurge of labor unrest (justified or instigated) and specific problems with native communities in one region of the country have become a cause of political cost. However, 2019 will be critical to achieve improvements: it is the last year without elections in the current period and critical reforms (income tax, labor market and pension system) have to be approved and started to be accomplished. Despite the recent setbacks in popularity, based on political ability shown in the first year, we remain optimistic about the probability of positive (though not optimal) results which would allow for improvement in economic growth in coming years, with some supportive spillover effects also in the very short term.

RISKS: LOWER PROBABILITY OF LESS DEVIATED SCENARIOS

The probability of alternative scenarios to our base case (both positive and negative ones) is relatively higher than at other times. China, copper price and Fed rate trajectory will be the most important, while domestically the ability of the Government to create alliances with moderate center-left opposition is critical. However, consequences of those risk scenarios should not be as dramatic since some "buffering factors" have rooted and/or developed, like a Government highly committed to economic development and with greater political capacity than in the period 2010-2014, alongside more market-friendly Governments in the region.

United Kingdom

UNCERTAINTY RULES THE DAY

- **Growth should be stable at around 1.5% IF a hard Brexit is avoided, as we assume. A hard Brexit would have substantial negative impacts on the UK outlook.**

Will they or won't they? Brexit and the conditions under which an exit is negotiated, or not, are the dominant forces affecting the UK outlook. We continue to believe a negotiated settlement will ultimately pass, even though the odds of the deal currently on the table passing appear to be slim, and there appears to be no appetite by the European side to re-open the current agreement. We are of the view that the economic costs of a hard Brexit come March are sufficiently negative for the UK that that will not come to pass. Whether a hard Brexit is avoided through an acceptance of the current agreement, a modification of the current deal, or even a second referendum remains to be seen. Nevertheless, the UK is at close to peak uncertainty on Brexit-related matters, and this is undoubtedly weighing on the outlook. Moreover, volatility in markets should continue to remain high, and while economic developments in the UK are generally not that important from a global perspective, the outsized importance of UK financial markets implies that Brexit developments may have a lasting impact on global financial markets so long as the situation remains fluid.

Despite this elevated level of headline uncertainty, actual measures of uncertainty in the UK appear to be falling a bit (chart 1), and as a consequence, we continue to forecast growth of roughly 1.5% over the next two years. Retail spending has accelerated through the fall as has wage growth, and PMIs suggest a strengthening industrial expansion, even as indicators of business confidence have deteriorated. This forecast is exceptionally conditional on political developments. A hard Brexit would require a sharp markdown in growth forecasts, likely triggering a recession. On the other hand, an implemented agreement could see forecasts revised up as Brexit-related uncertainty fades and pent-up demand for investment and consumer goods is unleashed. Developments through mid-January will be critical in assessing our view that a hard Brexit will be avoided.

Assuming our 'middle of the road' scenario, we expect the Bank of England to remain on hold through most of 2019. Inflation is slightly above the BoE's 2% target, reflecting to some degree past weakness of the pound and its impact on domestic prices. The output gap is basically flat, and while wage growth was very strong in 3Q-2018 suggesting additional tightening will be required over time, we do not see the BoE tightening interest rates in the current environment. Developments on the Brexit front could have a heavy influence on the BoE's policy settings.

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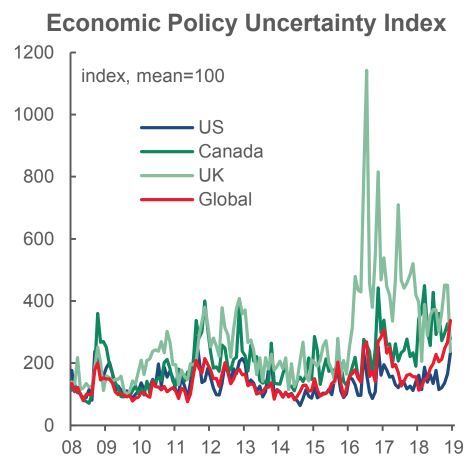
United Kingdom	2017	2018e	2019f	2020f
Real GDP (annual % change)	1.8	1.4	1.5	1.5
CPI (y/y %, eop)	2.7	2.2	2.1	2.0
Central bank policy rate (%, eop)	0.50	0.75	1.00	1.00
UK pound (GBPUSD, eop)	1.35	1.28	1.40	1.45

Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, PolicyUncertainty.com, EPU, PU, Haver Analytics.

Eurozone

GROWTH TO SLOW FURTHER IN 2019

- **Clear signs of a slowdown in manufacturing, but growth is expected to exceed potential in 2019–20.**
- **ECB to remain on the sidelines for through the year.**

As in other major advanced economies, real GDP growth in Europe is set to slow in 2019. From its 2018 pace of 1.9%, we forecast a modest slowdown to 1.7% on the back of what appear to be a reasonably widespread slowing of industrial activity (chart 1), the impacts of financial market volatility, and continued unrest in France. The consumer sector is anticipated to remain resilient to broader global developments, as job growth is expected to remain strong, and the most recent indicators for the retail sector suggest very robust activity.

Though growth is slowing, it is expected to remain slightly above our estimate for potential output growth of about 1.5%. Since growth is likely to remain above its non-inflationary pace, inflationary pressures may gather steam, though the decline in oil prices should lead to a decline in headline inflation in 2019. Setting oil prices aside, excess demand and the exchange rate pass-through of a weaker euro in the second half of 2018 will add modestly to inflation in 2019, though we anticipate a strengthening of the euro as the year progresses, owing largely to structural weaknesses in the USD relating to the rising trade and fiscal deficits. Taken together, we forecast HICP inflation in Europe to decelerate to 1.6% in 2019 from the 1.9% pace set in 2018. Excluding energy prices, HICP inflation should rise from 1.1% in 2018 to 1.3% in 2019.

As these inflation readings remain well below 2%, we continue to believe the ECB will take a very gradual approach to raising policy rates. It has formally ended purchases of securities under its Quantitative Easing Program that began in 2015. While the ECB will no longer purchase additional securities, it will continue to reinvest funds from maturing securities, keeping some downward pressure on rates until at least 2021. At present, the first increase of the Main Refinancing Rate of this cycle is only expected in early 2020. As a consequence, real policy rates will remain deeply negative and accommodative for the foreseeable future.

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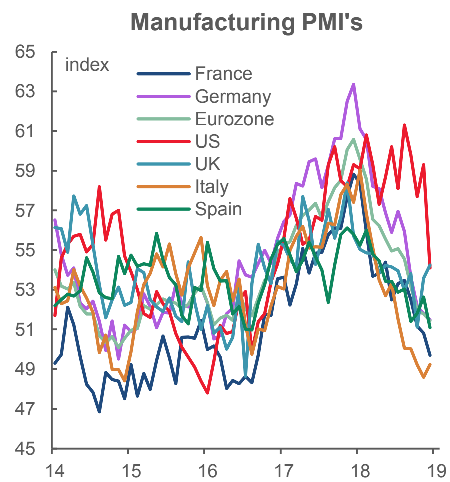
Eurozone	2017	2018e	2019f	2020f
Real GDP (annual % change)	2.4	1.9	1.7	1.7
CPI (y/y %, eop)	1.4	1.9	1.6	1.7
Central bank policy rate (%, eop)	0.00	0.00	0.00	0.50
Euro (EURUSD, eop)	1.20	1.15	1.30	1.32

Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

China

- **China's economic growth continues to slow on the back of a trade dispute with the US, authorities' deleveraging efforts, and ongoing structural changes in the economy.**
- **China's contained inflation outlook allows monetary policy to become more growth-supportive.**
- **The government's economic agenda for 2019 promises fiscal stimulus and progress on structural reforms.**

CHINESE ECONOMY FACING STRONG DECELERATING FORCES

The Chinese economy is under downward pressure on the back of three key considerations: 1) China's economic development and structural transition 2) the trade conflict between the US and China; and 3) Chinese authorities' deleveraging efforts. We discuss each of these factors in the following.

1) The Chinese economy is moving from investment- and industrial-sector-focused activity to being driven by the consumer and the services sector, resulting in slower output growth. It is a natural phenomenon for any economy that gradually transitions to a more advanced level of economic development. This long-term structural change has been taking place in the Chinese economy for several years already and will continue for many years to come.

2) The ongoing trade dispute between the US and China continues to be the biggest downward risk for China's economic outlook. High-frequency data show increasing signs of weakness in trade-related sectors; business sentiment in the manufacturing sector has deteriorated with the associated purchasing managers' indices having dropped below the 50 threshold which implies contracting activity (chart 1). Industrial production growth has continued to decelerate, industrial profits are declining, and weaker retail sales gains suggest that consumer confidence has been hit by the trade conflict despite continued rapid income growth. Against this backdrop, we expect Chinese policymakers to adopt more stimulative fiscal and monetary policies to cushion the trade conflict's impact on economic growth (see discussion on next page).

We assess that China has very strong economic incentives (as does the US) to aim for a prompt resolution to the conflict. Accordingly, we are cautiously optimistic about the 90-day trade dispute truce that was obtained following the bilateral meeting between Chinese President Xi Jinping and the US President Donald Trump in early December. The two leaders agreed to continue their dialogue in order to ease trade tensions. As a result, the US refrained from raising tariff rates in January from 10% to 25% on USD 200 bn of imports from China, while China agreed to start purchasing more agricultural, energy and industrial products from the US in order to reduce the US's bilateral trade deficit with China. Over the 90-day negotiation period, talks will focus on China's structural changes with respect to forced technology transfer, intellectual property protection, non-tariff barriers, cyber security, services, and agriculture. While the truce is a welcome development for the global economy, we highlight that deep divisions

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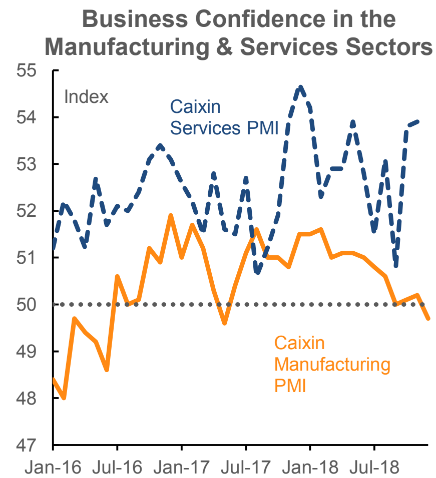
China	2017	2018e	2019f	2020f
Real GDP (annual % change)	6.9	6.6	6.2	6.0
CPI (y/y %, eop)	1.8	1.9	2.4	2.3
Central bank policy rate (%, eop)	4.35	4.35	4.35	4.35
Chinese yuan (USDCNY, eop)	6.51	6.88	6.70	6.50

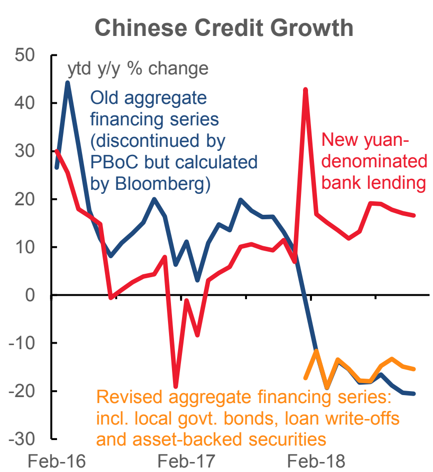
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Boomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg, The People's Bank of China.

between the two countries remain in place. Nevertheless, both countries have expressed willingness to work toward a mutually constructive agreement by the early-March deadline that would prevent the trade dispute from escalating further. Nevertheless, associated risks remain high and trade tensions—even if an escalation is averted—will likely remain in place for the foreseeable future.

3) Chinese authorities continue their efforts to deal with the country's sizeable debt burden. The ongoing deleveraging efforts—focusing on the shadow banking sector—aim to contain the economy's financial risks and imbalances that have accumulated over the years of fast credit growth, little transparency, and inadequate pricing of risk. Despite the economy's headwinds, Chinese authorities seem—at least for the time being—determined to continue to limit shadow banking activities, though we foresee the deleveraging efforts becoming less stringent over the course of 2019. China's aggregate financing metrics dropped by 15–20% y/y in the first 11 months of 2018 (chart 2). Meanwhile, more traditional bank lending continues to grow robustly, by 17% y/y in the January–November period; we expect monetary authorities to encourage banks to ramp up their lending over the coming months to support the economy.

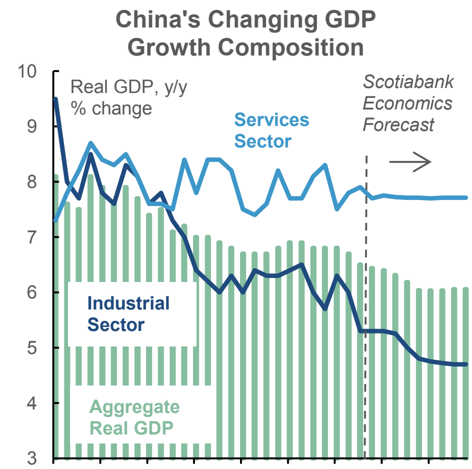
The recent developments in the Chinese economy have been in line with our expectations. Accordingly, our growth forecasts for China have not changed since the last Global Outlook. We estimate that China's output grew by 6.6% in 2018. Economic expansion is expected to decelerate over the course of 2019 toward 6% y/y by the end of the year, with growth averaging 6.2% in 2019 as a whole (chart 3). In 2020, output gains will likely average 6% y/y; we believe that the Chinese government will implement various measures to prevent growth from slowing below the 6% mark given that a more significant slowdown would put its income-per-capita goals for the end of the decade at risk.

CONTAINED INFLATION AND TARGETED MONETARY STIMULUS

Inflationary pressures remain contained in China. We expect headline inflation to average slightly less than 2½% y/y over the next two years. Low price pressures will allow monetary policy to become more accommodative to support the slowing economy. Indeed, the shift in a policy bias is evident in the recent removal of the word "neutral" from official statements describing the People's Bank of China's (PBoC) monetary policy stance. According to the central bank, its "prudent" monetary policy in 2019 will be more forward-looking, flexible and targeted, and it will be "not too loose, not too tight".

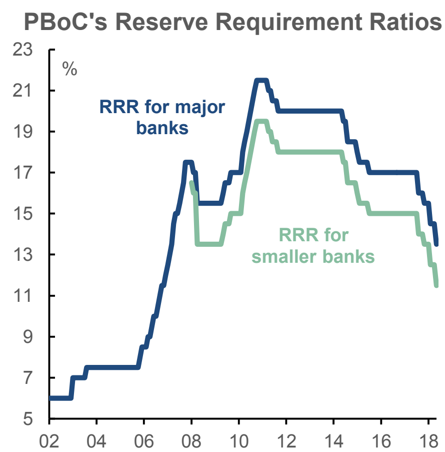
The PBoC will use various tools—such as open market operations, reserve requirements, as well as standing and medium-term lending facilities—to provide the financial system with ample liquidity ensuring that sectors with favourable growth prospects will continue to have access to funding. Indeed, on January 4 the PBoC announced a 100 basis point cut in banks' reserve requirement ratios (RRR) that will be implemented over the course of January, taking the ratio to 13.5% for major banks and 11.5% for smaller banks (chart 4). The prior cut had taken place in October 2018. The PBoC estimates that the newest policy step will inject USD 116 bn of liquidity into the Chinese banking system. In early-January, the central bank also relaxed the assessment criteria for lower RRRs in order to enhance lending to small and micro enterprises. We assess that the reserve requirements are still relatively high, providing monetary authorities with room to ease monetary policy further, if needed.

Chart 3



Sources: Scotiabank Economics, Bloomberg.

Chart 4



Sources: Scotiabank Economics, the People's Bank of China, Bloomberg.

Chart 5

Sources: Scotiabank Economics, Bloomberg.

Meanwhile, we do not expect the PBoC to lower the benchmark one-year deposit and lending rates—which have remained unchanged at 1.50% and 4.35%, respectively, since October 2015—over the coming quarters, given that lowering the Chinese policy rates at the time of rising rates in the US would add to financial instability risks.

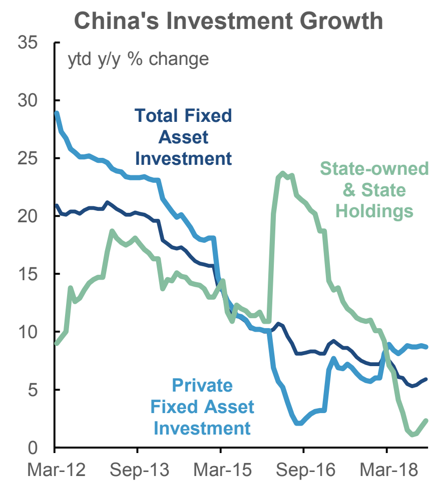
We expect the PBoC to aim to keep the Chinese yuan (CNY) relatively stable over the course of 2019. We assess that it is highly unlikely that the Chinese policymakers would allow the yuan to weaken significantly following last year's sizeable depreciation against the US dollar (chart 5), given that further weakness would be increasingly destabilizing for the Chinese financial system. As the USDCNY exchange rate will remain politically sensitive over the coming months, we expect the PBoC to defend the CNY assertively should it approach the USDCNY 7.0 mark.

EXPANSIONARY FISCAL POLICY AND STRUCTURAL REFORM PROGRESS

Following the conclusion of the 2018 Central Economic Work Conference at the end of December, the Chinese government unveiled its economic blueprint for 2019. The administration will focus on counter-cyclical adjustments to promote economic stability and high-quality development. The country's fiscal policy stance is set to become bolder, and will include large-scale tax cuts and various fee reductions that will support spending by both corporations and consumers. In addition, a "substantial" increase in the issuance of special-purpose local government bonds was announced, with public outlays aimed at infrastructure, rural development, programmes to boost high-quality manufacturing, and the development of the services sector. Against the more expansionary fiscal policy backdrop that includes higher infrastructure spending, we expect to see some stabilization in China's fixed asset investment growth, which has been on a notable downward trend in recent years (chart 6). In fact, public fixed investment outlays have already shown a slight pickup over the past few months in response to the headwinds faced by the economy.

On the structural reform front, China will further clean up ineffective "zombie" companies, deepen capital market reforms, and implement measures to promote a healthy property market. Importantly, the government's economic agenda also includes elements that are in line with the US demands, such as a plan to further open up Chinese markets for foreign companies and to reform China's intellectual property rights framework. Indeed, we have argued before that China will likely offer the US such concessions to ease the trade conflict given that these reforms are necessary irrespective of pressure from the US if China wants to successfully advance its industrial and economic development strategies.

Chart 6



Sources: Scotiabank Economics, Bloomberg.

Japan

- **Loose monetary policy to remain in place while the consumption tax rate hike in 2019 is set to cause volatility in output growth and inflation.**

JAPAN'S ECONOMIC GROWTH FACES TEMPORARY HICCUPS

Japan's economic growth outlook continues to be supported by expansionary fiscal and monetary policies. Against the stimulative backdrop, we believe that corporations' solid profits and sound balance sheets will lead to fixed investment gains despite some weakening in business confidence (chart 1) caused by the US-China trade conflict. Meanwhile, tight labour market conditions should buttress income growth and household spending prospects. While we expect Japan's net exports to contribute to growth over the coming quarters, the external sector remains vulnerable to the ongoing trade tensions given that China and the US are Japan's two main export markets.

The Japanese economy is expected to regain momentum after hitting a speed bump in the third quarter of 2018. The country's real GDP growth stalled to 0.1% y/y (-0.6% q/q non-annualized) in the third quarter, following a reasonably solid performance in the first half of 2018 when Japan's output grew by 1.3% y/y. The weak third-quarter outcome reflected natural disasters, such as flooding and typhoons in Western Japan and an earthquake in Hokkaido that caused airport closures and disruptions to industrial activity and supply chains. We estimate that Japan's real GDP growth rebounded in the final quarter of 2018, taking the nation's output expansion to 0.8% in 2018 as a whole.

The economy is set to propel ahead reasonably well in the first half of 2019. Growth will likely accelerate notably in the third quarter as consumers and businesses bring forward their spending in anticipation of the consumption tax rate increase (from 8% to 10%), which is scheduled for October 2019. The tax hike will likely cause a temporary contraction in output (in q/q terms) in the final quarter of 2019, before the economy returns to its potential growth trajectory of 1.0% y/y. We expect Japan's real GDP growth to average 0.9% y/y in 2019–20.

LOOSE MONETARY CONDITIONS TO REMAIN IN PLACE THROUGH 2020

Japan will not be joining other major central banks in their monetary normalization efforts as the country's inflation outlook remains muted. Inflation is set to stay below the Bank of Japan's (BoJ) 2% y/y target through 2020. In the near-term, headline inflation will likely hover slightly below 1% y/y until the consumption tax rate hike will trigger a temporary pickup in the final months of 2019 (chart 2). The CPI excl. fresh food—the BoJ's preferred measure—is set to remain equally low.

Following the December 20 monetary policy meeting, the BoJ maintained the short-term policy rate at -0.1% and left the asset purchase program unchanged. The BoJ will continue to adjust the amount of bond purchases depending on market developments, aiming to keep the 10-year bond yield close to 0%. Given that the forthcoming consumption tax rate hike may adversely impact Japan's economic growth trajectory, we foresee the BoJ keeping monetary easing in place through 2020 under the framework of "Quantitative and Qualitative Monetary Easing with Yield Curve Control".

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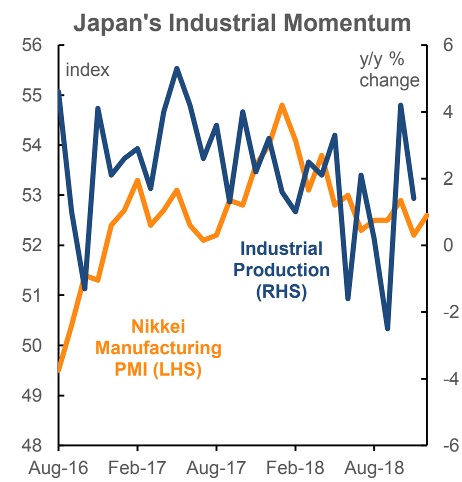
Japan	2017	2018e	2019f	2020f
Real GDP (annual % change)	1.9	0.8	1.1	0.8
CPI (y/y %, eop)	1.0	0.8	2.3	1.0
Central bank policy rate (%, eop)	-0.10	-0.10	-0.10	-0.10
Japanese yen (USDJPY, eop)	113	110	108	105

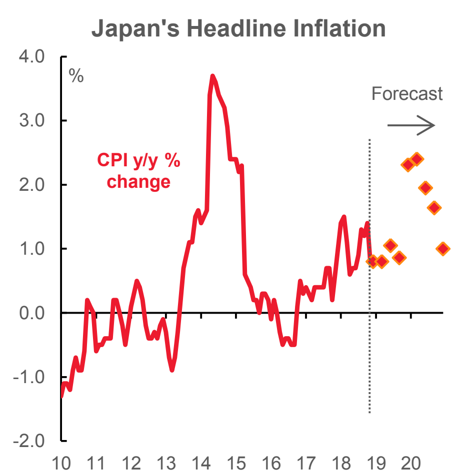
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

India

- **India's economic growth continues to be driven by domestic demand.**
- **Leadership change calls central bank independence into question.**
- **Political and policy uncertainties will dampen investor sentiment.**

ECONOMIC GROWTH OUTLOOK

The Indian economy continues to grow reasonably well, despite concerns regarding slowing global momentum. High frequency data point to solid business sentiment across the manufacturing and services industries (chart 1), which imply sound prospects for further investment growth. Meanwhile, household spending will be underpinned by rising disposable incomes that reflect higher wages and lower energy prices. Additionally, the country's fiscal outlays—particularly on infrastructure and the rural economy—continue to support economic growth, while monetary conditions will likely become more growth-oriented than we anticipated earlier. The Indian economy is domestically-focused, with its exports of goods and services equivalent to only 19% of GDP; this should insulate India from any significant adverse impacts stemming from global trade uncertainties.

India's real GDP grew by 7.1% y/y in the third quarter, slowing from the 8.2% pace recorded in the April–June period (chart 2). Regardless, India is set to remain a growth leader among major economies over the foreseeable future. We estimate that output grew by 7.5% in 2018 as a whole. Similar momentum will likely be maintained in 2019–20, with real GDP growth forecast to average 7.4% y/y.

INFLATION AND MONETARY POLICY OUTLOOK

India's inflation outlook is rather complicated with low headline inflation and high core inflation (chart 3). Lower food prices have pushed headline inflation toward 2% y/y, compared with over 5% at the beginning of 2018. Meanwhile, core inflation remains elevated at close to 6% y/y. We have revised our inflation forecast slightly higher for 2019 and 2020, reflecting our assumption that the Reserve Bank of India (RBI) will take a more lax approach to inflation-targeting and the government will ramp up spending ahead of the 2019 general elections. Moreover, while current low oil prices will put downward pressure on headline inflation in the near term, we expect oil prices to rebound over the course of 2019 with Brent crude averaging close to USD 70 per barrel in 2019. We estimate that India's inflation will accelerate in the second half of 2019, closing the year at 5.6% y/y. While the headline inflation rate is expected to remain within the RBI's 4% ±2% target through 2020, it will likely stay close to the upper band.

The outlook for India's monetary policy is changing following the resignation of the RBI's Governor Urjit Patel on December 10, 2018. The resignation is debatably a reflection of the tumultuous relationship between the RBI and the Indian government, following recent disagreements over desirable monetary conditions. The government seems to prefer a stimulative monetary policy stance while the RBI has been mainly focusing on inflation-targeting, as per its mandate. On December 12, Shaktikanta Das was appointed as Governor of the RBI. Given his

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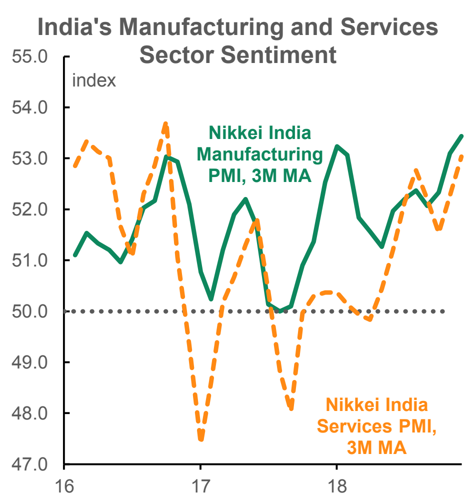
India	2017	2018e	2019f	2020f
Real GDP (annual % change)	6.3	7.5	7.3	7.5
CPI (y/y %, eop)	5.2	2.5	5.6	5.0
Central bank policy rate (%, eop)	6.00	6.50	6.75	6.75
Indian rupee (USDINR, eop)	63.9	69.8	68.0	66.0

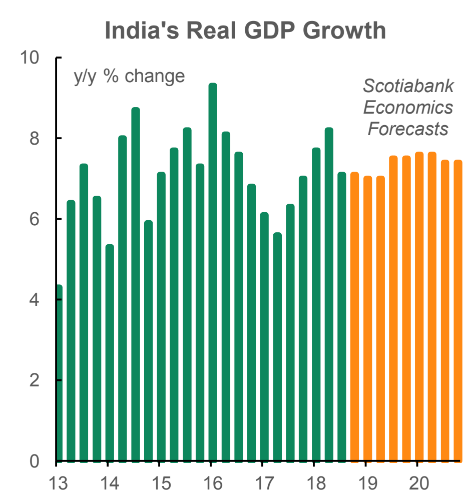
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

background in India's Ministry of Finance and his ties to Prime Minister Narendra Modi, concerns regarding the RBI's potentially eroding independence have risen. We highlight that the RBI's inflation-targeting framework, independence in adjusting monetary conditions, and policy credibility have been essential elements for building investor confidence toward Indian assets in recent years. As India's 2019 general elections approach, the government may place the RBI under increasing pressure to stimulate the economy. We will be studying Governor Das' policy bias carefully over the near term and note that the risk of India returning to a high-inflation era has risen.

Against this changing backdrop, we have revised our forecast for the RBI's benchmark interest rates. We now expect only one 25 basis point hike over our forecast horizon; we anticipate the policy repo rate to be raised to 6.75% in the final quarter of 2019 (chart 3), which reflects the fact that we foresee India's inflation peaking in the final months of the year. Following the scheduled monetary policy meeting that concluded on December 5, the benchmark repo and reverse repo rates were left unchanged at 6.50% and 6.25%, respectively, while the monetary policy stance of "calibrated tightening" was kept in place. Under Governor Patel, the RBI had raised the policy rates by a total of 50 basis points at its June and August 2018 meetings.

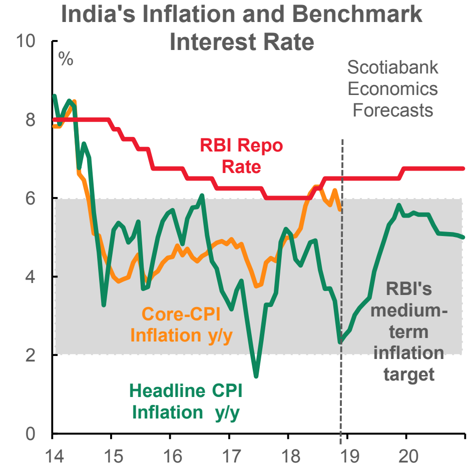
Indian monetary conditions will likely be relatively stimulative in 2019–20. Authorities are taking measures to maintain adequate levels of liquidity in the country's capital markets. Indeed, the RBI has scaled up its liquidity injections by purchasing higher amounts of government bonds through open market operations, resulting in lower government bond yields. The central bank is also continuing its efforts to clean up financial institutions' balance sheets—e.g. through a recently-announced program to restructure micro-, small- and medium-size enterprise accounts that have become stressed—which will promote the flow of credit in the economy. At the same time, the RBI continues to pay close attention to non-bank financial companies and housing finance companies that have struggled with a liquidity crunch in recent months and will continue to intervene if needed, including by acting as the lender of last resort.

ELEVATED UNCERTAINTIES AND FUNDAMENTAL WEAKNESSES

Political and policy uncertainties will remain high in India ahead of the general elections that are due by May 2019. Given setbacks in several state ballots at the end of last year, Prime Minister Modi's Bharatiya Janata Party (BJP)—which has been in power since the 2014 election—may ramp up fiscal spending to boost its popularity. Indeed, we assess that the central government's fiscal deficit target of 3.3% of GDP for the current fiscal year (April–March) is at risk because of the expected fiscal slippage. The fiscal shortfall remains significantly bigger at the general government level, likely to average 6½% of GDP in 2019–20 (chart 4). Accordingly, weak public finances will continue to be India's main fundamental weakness, limiting the government's future ability to cushion the impact of any potential adverse shocks.

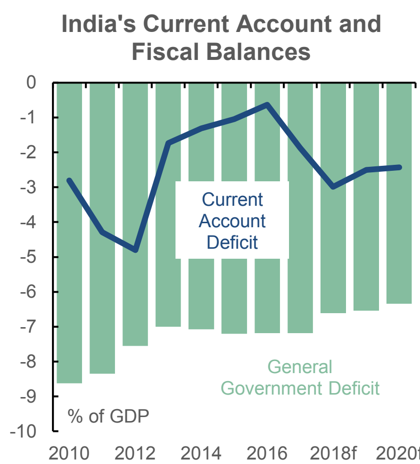
In addition to political uncertainties and fiscal vulnerabilities, India's current account deficit will remain a key concern. Softer international oil prices is a welcome development for India as lower prices reduce the country's oil-import bill and narrow the trade deficit; nevertheless, we expect the current low prices to be a temporary phenomenon. India's current account deficit will likely remain at 2½% of GDP in 2019. As net foreign direct investment inflows are not sufficient to finance the gap, India will continue to rely on more volatile portfolio inflows and external debt to meet the deficit financing needs. Accordingly, the Indian rupee will remain sensitive to sudden changes in global investor risk appetite.

Chart 3



Sources: Scotiabank Economics, Bloomberg.

Chart 4



Sources: Scotiabank Economics, IMF.

South Korea

- **Moderate economic growth maintained amidst elevated uncertainties.**
- **Fiscal and monetary policies will continue to be growth-supportive.**

ECONOMIC GROWTH OUTLOOK

The South Korean economy will likely continue to propel ahead at a reasonable, yet unspectacular, pace. We have made only minor downward revisions to our South Korean growth forecasts over the past quarter. The country's real GDP growth is estimated to have averaged 2.7% y/y in 2018 and a similar pace—which is in line with the economy's potential—is expected to be maintained through 2020 (chart 1). The South Korean economy continues to be driven by private and public consumption as well as net exports, while fixed investment has recently shown signs of weakness—a development that needs to be monitored carefully.

The externally-oriented South Korean economy, which exports a substantial amount of intermediate goods (over 60% of total exports), is adversely impacted by China's slowing economic growth, ongoing trade tensions between the US and China, and the trade conflict's ripple effects through regional supply chains. For instance, shipments to China—South Korea's main export destination—are lower than in the year before with vital semiconductor exports under pressure. In addition to rising trade-related uncertainties, the nation's consumer confidence has been dented by concerns regarding job security. Indeed, employment growth has been lackluster on the back of minimum wage hikes (of 16% in 2018 and 11% in 2019) that create challenges for small businesses. Nevertheless, the government's expansionary fiscal policies and the Bank of Korea's (BoK) bias to maintain accommodative monetary conditions will continue to provide needed support for domestic demand over the coming quarters.

INFLATION AND MONETARY POLICY OUTLOOK

South Korea's inflationary pressures are set to remain contained in the foreseeable future. Nevertheless, headline inflation will likely rebound somewhat in the near term (chart 2), returning to the BoK's 2% y/y inflation target around mid-2019 from the temporary dip to 1.3% in December that reflected lower energy prices and slower food inflation. With strong demand-driven inflationary pressures expected to remain absent through 2020, the central bank will be able to maintain a relatively loose monetary policy stance through our forecast horizon.

The BoK raised the Base Rate by 25 basis points to 1.75% following the monetary policy meeting at the end of November, marking the first hike since November 2017. Despite the tightening move, BoK Governor Lee Ju-yeol highlighted that the policy rate remains below its neutral level. The decision was justified by the central bank's focus on financial stability in the face of persistently rapid credit growth by South Korean households, elevated risk aversion globally, the risk of capital outflows, and tightening monetary conditions in the US and in several other economies. Continued focus on financial stability, combined with our expectation for gradually rising inflation, points to another 25 basis point hike in the fourth quarter of 2019, which we expect to be the final rate increase in the BoK's current tightening cycle.

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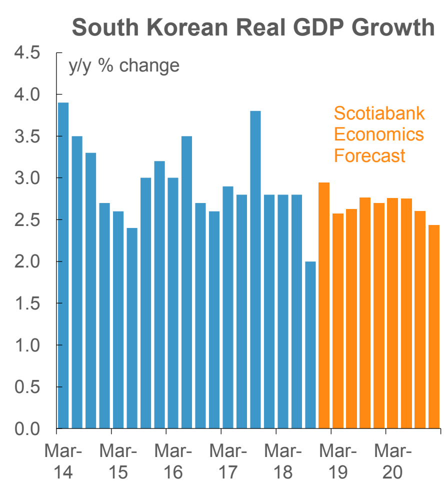
South Korea	2017	2018e	2019f	2020f
Real GDP (annual % change)	3.1	2.7	2.7	2.6
CPI (y/y %, eop)	1.4	1.3	2.4	2.2
Central bank policy rate (%, eop)	1.50	1.75	2.00	2.00
South Korean won (USDKRW, eop)	1,067	1,116	1,085	1,070

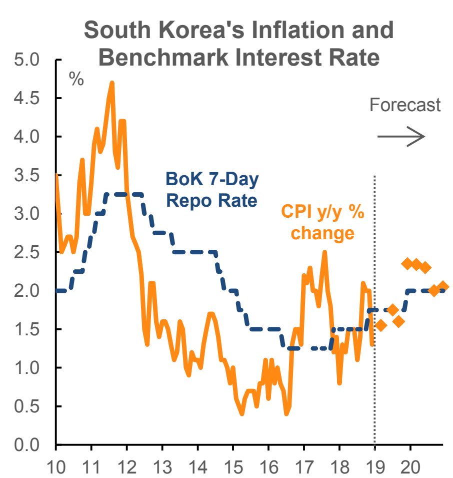
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Australia

- **Economic growth is slowing, yet Australia is set to outperform other major advanced economies.**
- **Solid labour market and low interest rates limit house price correction.**

STRONG GROWTH BY ADVANCED-ECONOMY STANDARDS

Australia's output growth will likely outperform other major advanced economies' momentum through 2020 despite concerns related to the Chinese economy and the domestic residential housing market. We expect Australia's real GDP growth to average 2.6% y/y in 2019–20—in line with the economy's potential growth—following an estimated 3% advance in 2018. The nation's output growth slowed to 0.3% q/q (2.8% y/y) in the third quarter of 2018 following an average gain of 0.6% q/q (3.1% y/y) in January–June. Economic activity is driven by public outlays and net exports, while fixed investment continues its cautious advances. Household spending growth is showing signs of easing; while the consumer will remain a key contributor to growth, prospects are moderated by high household debt and a possible adverse wealth effect caused by lower house prices. However, a solid labour market and strong consumer confidence will provide some counterbalance.

SOLID LABOUR MARKET LESSENS HOUSING MARKET CONCERNS

Australia's labour market remains strong (chart 1); over the past year, monthly job creation has averaged 24,000 positions, with two-thirds of them in the full-time category. Surveys of hiring intentions point to further employment gains. At 5%, unemployment is in line with the Reserve Bank of Australia's (RBA) estimate for the economy's NAIRU (non-accelerating inflation rate of unemployment), implying that labour market slack has virtually disappeared. This should boost incomes over the coming quarters. Wages rose 2.3% y/y in the third quarter, exceeding the inflation rate of 1.9%. However, somewhat softer household spending prospects will likely keep demand-driven inflation in check. While we forecast a slight pickup in wage and price gains, headline inflation is expected to remain in the RBA's 2–3% target range through 2020. Therefore, the RBA will not rush to tighten monetary policy; we do not expect a rate hike until the second half of 2019.

Australia's residential property prices are declining after years of strong gains. By the third quarter, prices at the national level were 3% below their late-2017 peak (chart 2), yet large variations exist between regions with Sydney and Melbourne leading the declines. The softer market is mainly a result of stricter lending criteria for investor, interest-only, and high loan-to-value loans, which authorities put in place to limit the growth of riskier types of housing lending. Given that the labour market is sound, interest rates are low, loan quality is robust, and credit growth to owner-occupiers remains solid, we do not consider the softer housing market a significant risk to the economy. Only if the economy faced a shock that led to a notable weakening in households' debt-servicing ability—e.g. via an increase in unemployment—we would become more concerned about the outlook. Indeed, the RBA's recent Financial Stability Review pointed out that the housing slowdown is a "positive development for financial stability" as the tightening in lending standards has improved the quality of households' balance sheets.

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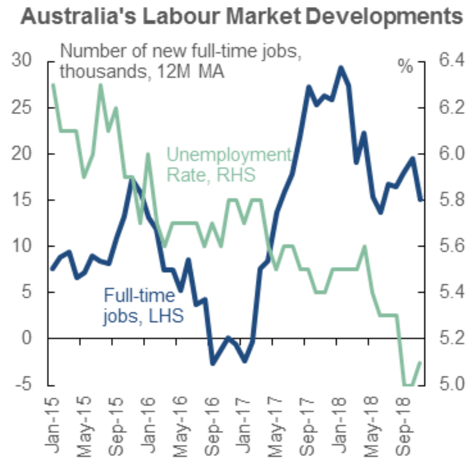
Australia	2017	2018e	2019f	2020f
Real GDP (annual % change)	2.4	3.0	2.7	2.5
CPI (y/y %, eop)	1.9	2.0	2.3	2.6
Central bank policy rate (%, eop)	1.50	1.50	1.75	2.00
Australian dollar (AUDUSD, eop)	0.78	0.70	0.78	0.78

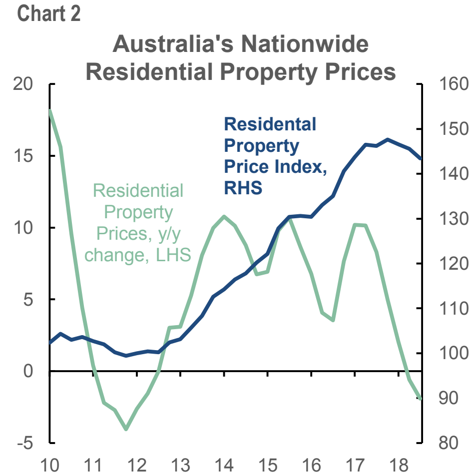
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Australian Bureau of Statistics.

Chart 2



Sources: Scotiabank Economics, Australian Bureau of Statistics, Bloomberg.

Commodities

PRICES TO RISE THROUGH 2019 FOLLOWING VOLATILE 2018 FALLBACK

- **The prices of industrial commodities are expected to broadly rise over the coming two years, though a slightly weaker global economic outlook slows the march higher relative to our last outlook (chart 1).**
- **While we are now pricing in mildly slower global growth, we do not believe that the market's trade fears will be realized and commodities are expected to receive a broad boost as the market unwinds those concerns over the coming months.**
- **Oil prices are currently digesting a bout of bearish sentiment and WTI is expected to rise back into the high-$50s in 2019 and gradually toward $65/bbl in the following years.**
- **The October oil price collapse reflected the repricing of Iranian production assumptions following Washington's volatile hawk-dove flip-flopping on the severity of nuclear sanctions.**
- **We maintain our outlook for rising industrial metals prices, though current trade concerns have pushed anticipated price increases out by about a year for most metallic commodities; gold prices are expected to remain steady, caught between rising rates and a weakening US dollar.**

Well that was a bumpy sleigh ride. Markets experienced extreme volatility through December and big daily movements in the value of equities, bonds, and commodities have remained a feature of trading into the first few weeks of the New Year. The relationship between risk assets has tightened, giving the market's broad macro narrative a far greater say in commodity price formation than material-specific factors related to supply and demand. This herd behaviour is expected to pass, however, and we anticipate that fundamental factors will reassert themselves in 2019 as inventory movements provide ample reason for commodity differentiation. Slower global growth will present mild headwinds to the commodity complex, though we believe that the worst of the market's fears regarding the US-China trade war will fail to materialize. Virtually all industrial commodities are forecast to rise from recently destressed levels—WTI crude from $45/bbl in early January to average $58/bbl in 2019, copper from sub-$2.55/lb to $3.00/lb, etc.—as trade-related bearishness unwinds, speculative positioning normalizes, and physical realities like falling inventory levels highlight the need for higher prices.

SLOWING DOWN ISN'T SO BAD WHEN WE'VE BEEN SPEEDING

Make no mistake—the global economy is indeed slowing, coming off an incredibly robust and synchronized burst of economic momentum in 2017-18 (chart 2). Economies like the United States and Canada have been growing so quickly relative to their theoretical potential that central banks, fearing mounting inflationary pressures, have begun tightening interest rates. China, too, is seeing an organic slowdown—particularly in heavy industries like construction—as the

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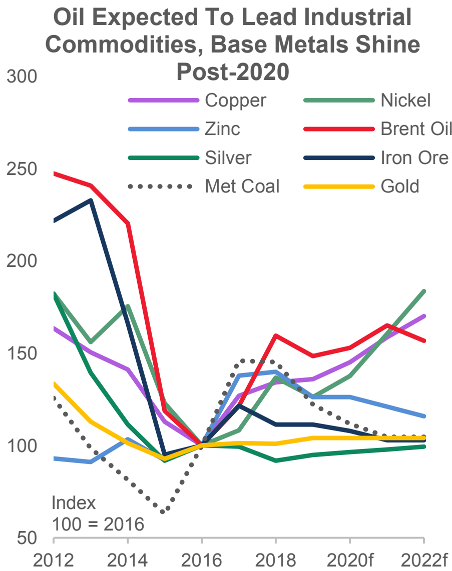
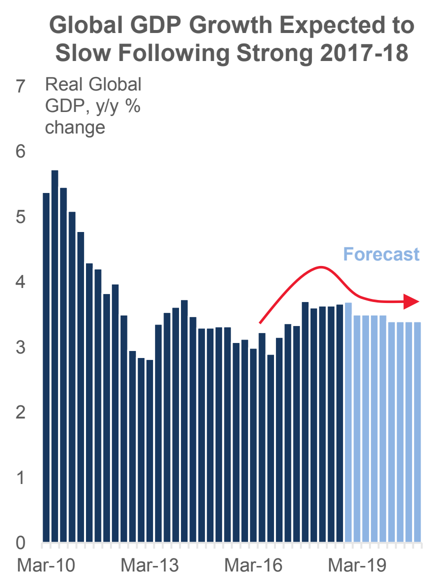
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, IMF.

government pivots away from stimulus-fuelled expansion toward prudent and gradual deleveraging. Even the trade war with Washington hasn't rattled Beijing off its deleveraging priorities, despite a notable slowdown in export-oriented sectors like manufacturing. China has embarked on a path of mild monetary stimulus and select infrastructure spending (e.g. recent $125bn rail project allocation), but we don't expect to we'll see an all-out fiscal effort of the sort that supported the global economy—and particularly the industrial commodity sector—in 2008–09 and 2015–16. **Stimulative Chinese economic policy is likely to support consumer activity over industrial expansion, which means less materials-intensive spending on a smaller pool of deployed capital.**

Taken together, Beijing's commitment to its deleveraging mandate and lack of materials-intensive stimulus, coupled with gradually easing growth through the rest of the world, has prompted us to modestly downgrade the demand and thus price outlook for most industrial commodities. The direction of rebalancing, however, remains the same and metals and energy commodities are expected to embark on a gradual climb higher through the end of the decade.

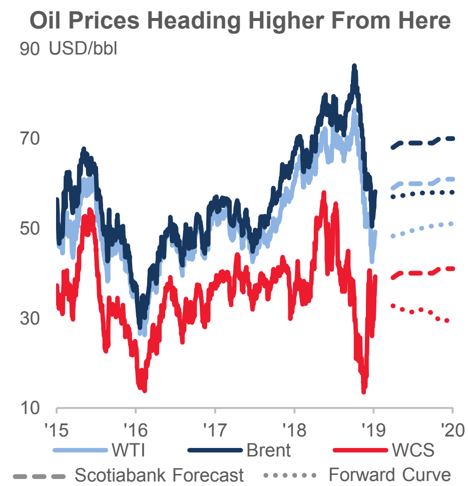
ENERGY: OIL BUFFETED BY POLICY VOLATILITY, HEADING HIGHER IN 2019

Last year saw oil markets whipped between extreme bullishness that brought Brent crude prices above $86/bbl and a subsequent bear raid that took prices more than 40% to $50/bbl on Christmas Eve. Despite the volatility, our structural view of the oil market remains unchanged—the US shale patch has made prices much above $65/bbl (WTI) untenable for prolonged periods of time and Brent crude is expected to trade at roughly $70/bbl on a long-run basis. However, US policy volatility wreaked havoc in the oil market through the latter half of 2018 as hawkish rhetoric regarding Iranian sanctions spooked the market higher and forced OPEC+ to quickly lift supply, only for the White House to back down when the November deadline passed—in large part, according to President Trump, due to those higher oil prices. The policy reversal left the market with surplus crude, which when combined with the general market sell-off resulted in a precipitous decline in spot prices, far lower than we believe is required to balance the near-term market. **WTI contracts are currently trading around $50/bbl and we expect prices to rise to average $58/bbl in 2019 (down from $72/bbl in our last quarterly outlook) and $62/bbl in 2020 (down from $69/bbl, see chart 3).**

The market is working through a transitory supply glut that began in the latter half of 2018 and is expected to fall away by the latter half of 2019. However, this glut is far smaller, at roughly 200 million barrels from 2Q18 to 2Q19, than the supply bulge that tanked oil prices in 2014–16, which totaled almost one billion barrels between 2Q14 and 2Q16 (chart 4). Similarly, US petroleum inventory flow data have moved mildly bearish and stocks ended the year roughly where they began relative to a 100 Mbbl draw in 2017, but remain in a far stronger position than the 350 million barrel build between April 2014 and August 2016 (chart 5).

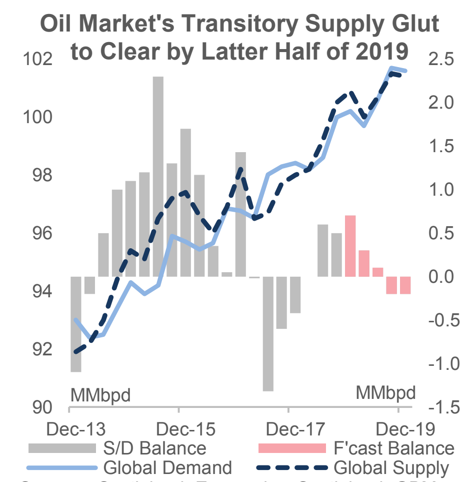
Oil demand is expected to remain healthy and advance by 1.6 MMbpd y/y in 2019, though the market's current economic concerns likely have spot contracts pricing in slower demand growth in the 1.2–1.3 MMbpd range. Most of the economic anxiety is directed toward Asian markets, where the China-US trade dispute looms large. Oil demand growth in China is now tilted heavily toward consumer fuels like gasoline and jet fuel rather than industrial-favourite diesel, which has been the traditional driver of

Chart 3



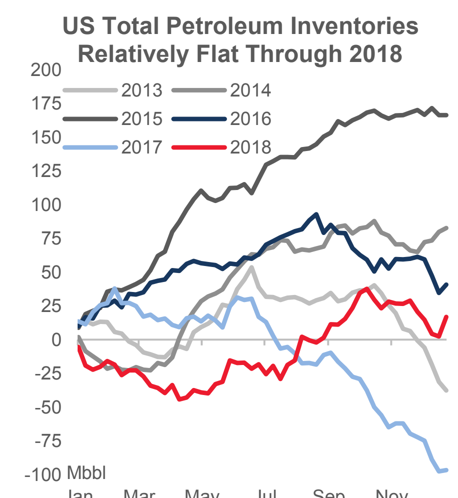
Sources: Scotiabank Economics, Bloomberg.

Chart 4



Sources: Scotiabank Economics, Scotiabank GBM, IEA, EIA, JODI, OPEC.

Chart 5



Sources: Scotiabank Economics, EIA.

rising Chinese petroleum use. A weaker Chinese consumer is thus a key risk to the oil demand outlook, made more acute by Apple's recent announcement that blamed the "magnitude of [China's] economic deterioration" for faltering sales forecasts in the world's largest smartphone market. Car sales are also contracting for the first time in nearly 30 years, which could have a more direct impact on fuel demand. The rest of Asia also appears to be feeling the weight of the pain in the region's largest economy—the combined oil demand growth in India and China, which are expected to account for roughly half of the world's increased consumption in 2019 and 2020, fell from more than 1 MMbpd y/y around the end of 2017 to the less than 200 kbpd y/y a year later (chart 6). Global demand growth, on a 12-month moving basis, has fallen from around 1.9 MMbpd this past spring to less than 1.3 MMbpd by the end of 2018. We expect that a reacceleration of Asian petroleum demand will lift combined Chinese-Indian consumption growth to around 700 kbpd and global demand growth back around 1.6 MMbpd.

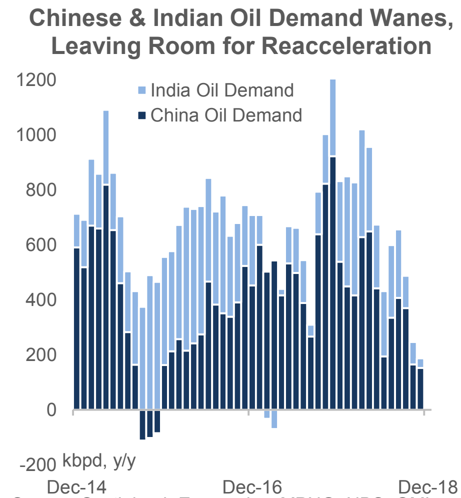
While the late-2018 selloff began in large part on concerns about surging US shale supply and higher-than-needed OPEC output, we expect that 2019 will see a return to supply concerns. Supply growth over the coming year will be primarily driven by the pace of US shale expansion in a sub-$60/bbl WTI price environment, OPEC+'s return to supply discipline, and developments in Canada's oil sands—where mandatory output cuts took effect on January 1st—as well as Brazil, where perennial production optimism has frequently been revised lower.

Case in point, the US shale patch, where 2019 supply growth was forecast to exceed 1.5 MMbpd y/y as global oil prices hovered in the mid-$80s, is beginning to worry about cash flow once again. While most shale players are in a far better position today than when prices last dipped below $50/bbl, the growth strategy prompted by high oil prices is looking precarious and a renewed focus on costs and competitiveness is expected. Fit-for-50 capex budgets that were rapidly falling out of fashion six months ago are being dusted off once again.

OPEC and allied producers, meanwhile, have stepped on the brakes and begun winding back production. The volatility of OPEC policy-making reflects the volatility of US foreign policy, and pressure on OPEC has shifted from "more supply, now" when prices were nearing $90/bbl in early-October to "cuts are necessary for market balance" today. OPEC only agreed to begin lifting production after many cried out for the Saudis and the Russians to step in to fill a supply gap caused by US sanctions against Iran and a lagging shale rebound. Less than a month later the oil price had collapsed and the Kingdom pulled an abrupt 180-degree-turn after efforts to jawbone the price higher failed to stop the bleeding—the latest comments out of Riyadh indicate that the OPEC kingpin still desires Brent prices around $80/bbl. Following the policy turnaround, OPEC production fell roughly 0.5 MMbpd m/m in December representing the producer group's largest monthly decline since its last agreed-upon cut took effect in January 2017 (chart 7). US, Russian, and Saudi Arabian oil wells were pushing out all-time record volumes of crude in the closing quarter of 2018, which was seen as necessary to offset declines in Venezuelan output and soon-to-be-cratering production in Iran as US sanctions block the purchase of Iranian crude.

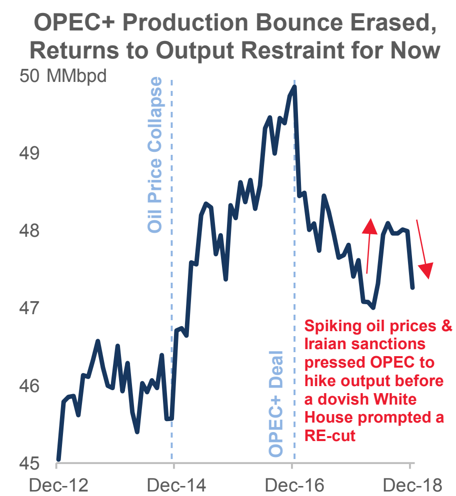
Albertan oil production cuts totalling 325 kbpd (8.7%) took effect on January 1st, quickly addressing the glut of oil trying to leave the province on bottlenecked pipelines and helping bring WCS discounts from a peak of more than $50/bbl under WTI a few months ago to around $10/bbl today (chart 8). Discounts collapsed

Chart 6



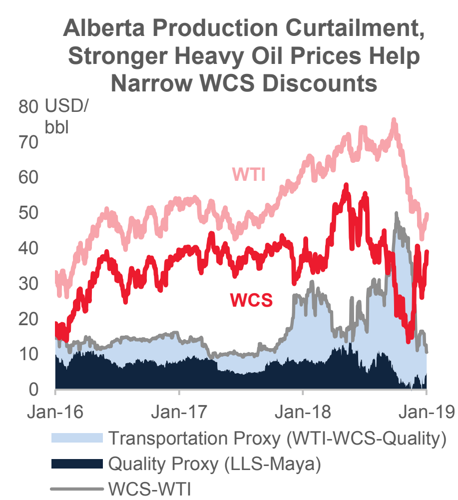
Source: Scotiabank Economics, MPNG, NBS, OMI.

Chart 7



Source: Scotiabank Economics, OPEC, OMI.

Chart 8



Source: Scotiabank Economics, Bloomberg.

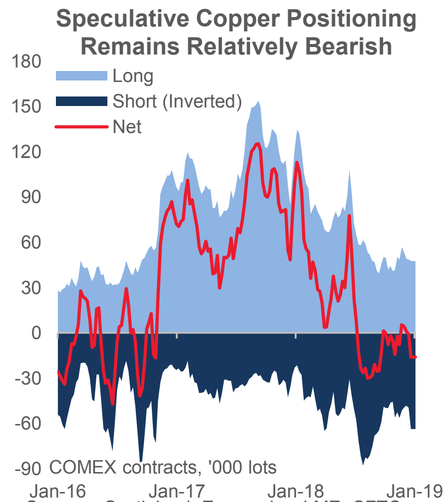
below the $20/bbl level that many associated with oil-by-rail breakeven costs, assisted by a much-narrower quality discount witnessed around the US Gulf Coast—less than $3/bbl relative to a typical discount of nearer $10/bbl. Production is expected to remain constrained around current levels through late-Spring, when inventory declines are expected to trigger a gradual loosening of output restrictions. Oil-by-rail shipments continue to rise and future capacity will be aided by the Alberta Government's 120 kbpd oil-by-rail capacity purchase commitment, likely surpassing a half-million barrels per day of throughput by year-end up from the record-setting 327 kbpd of Western Canadian crude that exited the country in October. **WCS discounts are expected to average $20/bbl in 2019–20, materially tighter to WTI following the rollout of the Alberta government's production curtailment policy**. The risk to this outlook is for spreads to remain tighter, in the mid-teens, given the current favourable heavy oil pricing environment around the US Gulf Coast.

METALS & MINERALS:

Metals prices were the first casualties of the market's soured macro sentiment— as is so often the case—and the value of metals like copper, nickel, and zinc fell back in June on the back of heightened trade war rhetoric, well ahead of oil's October rout. Some of this fallback was justified—copper prices, for instance had run ahead of what we believe was fundamentally justified, and the price of zinc was returning to earth from a rally that had lifted prices to the highest level in a decade. However, as with crude oil, industrial metals prices have also fallen below where commodity-specific fundamentals would justify.

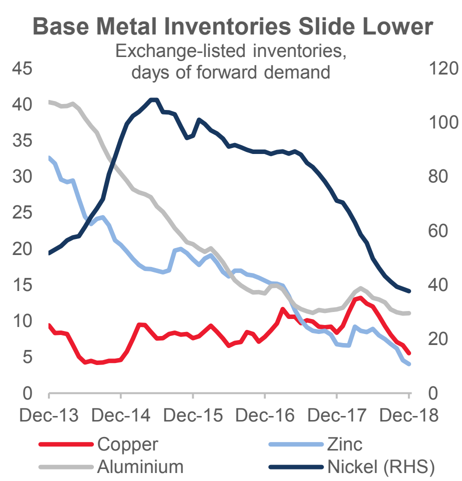
The unexpectedly strong growth of 2017–18 pushed commodities into overdrive and prices outperformed our initial expectations on frothy market sentiment. Copper, for instance, leapt from sub-$2.20/lb in 2016 to more than $3.30/lb by the end of 2017 as investors betting on a faster global economy channeled their thesis through speculative copper bets (chart 9). These gains were well ahead of the gradual climb toward $3/lb that we believed was fundamentally justified, and we expected some of that froth to fall away. The latest price collapse, however, brought copper contracts sharply lower to the mid-$2 range; this too far, too fast price route occurred just as mounting supply deficits over the next few years call for a price above $3/lb to incentivize much-needed mine investment. Many other industrial commodities—most

Chart 9



Sources: Scotiabank Economics, LME, CFTC.

Chart 10



Sources: Scotiabank Economics, WBMS, LME, SHFE, COMEX.

Table 1

Commodities	2000–2017			Annual Average			
	Low	Avg.	High	2017	2018	2019f	2020f
WTI Oil (USD/bbl)	17	62	145	51	65	58	62
Brent Oil (USD/bbl)	18	65	146	55	72	67	69
WCS - WTI Discount* (USD/bbl)	-43	-16	-6	-13	-26	-20	-20
Nymex Natural Gas (USD/mmbtu)	1.64	4.83	15.38	3.02	3.07	3.25	2.80
Copper (USD/lb)	0.60	2.38	4.60	2.80	2.96	3.00	3.20
Zinc (USD/lb)	0.33	0.84	2.10	1.31	1.33	1.20	1.20
Nickel (USD/lb)	2.00	7.12	24.58	4.72	5.95	5.50	6.00
Aluminium (USD/lb)	0.56	0.87	1.49	0.89	0.96	0.90	0.90
Iron Ore (USD/tonne)	17	67	187	72	70	65	63
Metallurgical Coal (USD/tonne)	39	131	330	187	206	175	160
Gold, London PM Fix (USD/oz)	256	890	1,895	1,257	1,268	1,300	1,300
Silver, London PM Fix (USD/oz)	4.07	14.80	48.70	17.05	15.71	16.25	16.50

* 2008–16 average.
Sources: Scotiabank Economics, Bloomberg.

notably crude oil—have followed a similar pattern: overshooting fundamentals through mid-2018 before sentiment shifted and prices fell into fundamentally oversold territory.

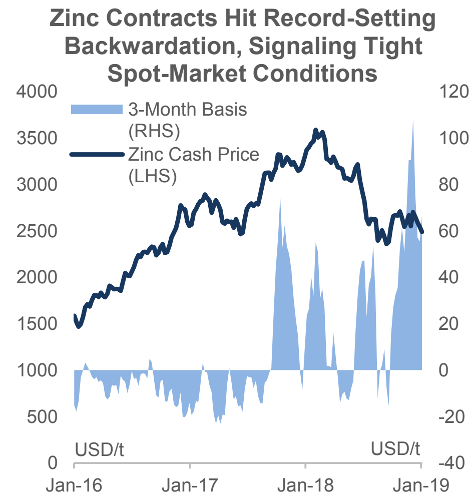
This isn't to say that prices can't stay this low—most producers are still making money at these prices so there is no immediate need for higher prices—but we forecast that these markets will experience growing supply deficits over the coming years and prices need to rise to incentivize necessary future production capacity. Commodity price cycles—particularly on the metals front—move on long timescales and prices can remain below where they would optimally clear until impossible-to-ignore supply deficits force prices higher. Given that it typically takes a half-decade or more for a planned mine to move from the drawing board to production-ready, lower-than-necessary prices today will result in a period of higher-than-ideal prices in the hope of more quickly incenting needed metal onto the market.

In spite of the metals price rout, base metals continue to experience falling inventories. The volume of copper held in the storage sheds of major exchanges has fallen from 13 days of forward consumption in the first quarter of 2018 to 5 days today, zinc inventories remain extremely low at less than 4 days vs a recent high of 15 days in 1Q17, and acute supply deficits in nickel markets have allowed inventories to fall to 36 days from an unheard of 108 days in mid-2015 (chart 10).

Zinc prices are certainly justified in their initial fallback after a rally earlier this year took contracts to their highest level since 2007, though the extent and rapidity of the price decline does not seem to reflect the pace of supply rebalancing that has thus far taken place. While high prices did their job and brought significant volumes of new mine supply to the market, that concentrate—i.e. precursor to refined metal—tonnage has yet to work its way into the refined metal market. Physical market indicators continue to reflect this reality and the degree of backwardation—the premium of prompt shipments to deliveries for three months from now—in the zinc market reached all-time highs in December (chart 11) despite weaker spot pricing. We believe that zinc prices have fundamental support for one more bounce, likely in the first half of 2019, before new mine supply finally begins working its way into the refined market and zinc begins its gradual fall back to long-term incentive pricing, currently pegged at roughly $1.00/lb.

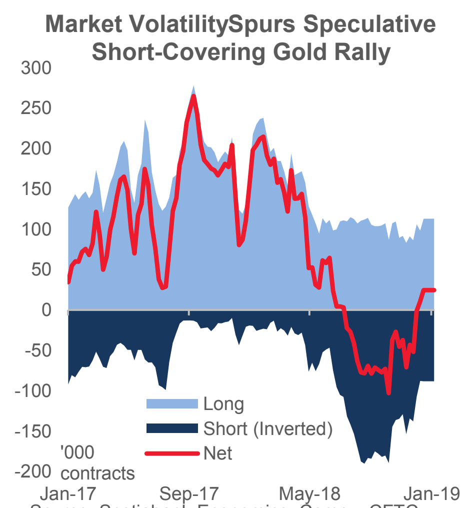
Gold prices recovered through the end of 2018 as the outlook for the global economy darkened. Risk bids returned to bullion as equity price volatility rose and interest rate hike expectations began to fall. Speculators had built up a historically large short position in gold contracts into the beginning of 4Q18 (chart 12), betting that bullion would fall amid soaring equity returns, robust global growth, and a stubbornly strong US dollar. This shorting helped pull gold prices below $1,200/oz before the rapid unwinding of those bets helped propel bullion back toward $1,300/oz in the opening weeks of 2019. We expect that gold will trade flat around $1,300/oz over the next two years as the market's interest rate expectations begin to rise and the US dollar falls back along our longer-term forecast path for the greenback.

Chart 11



Sources: Scotiabank Economics, LME.

Chart 12



Source: Scotiabank Economics, Comex, CFTC.

Foreign Exchange

The US dollar (USD) ended 2018 having accumulated broad gains against all of its major currency peers except the yen (JPY) since January 1. In contrast to our expectation that the USD would extend the reversal and decline seen in 2017, the currency has found support from rising US interest rates and stronger US growth dynamics amid fiscal stimulus. Less robust growth or rising uncertainties elsewhere—reflecting trade or Brexit concerns, for example—have weighed on sentiment amongst other currencies but supported demand for the safe-haven JPY, meanwhile. Rather surprisingly, the USD was one of last year's best investments. A recent Bloomberg report noted that risk-adjusted returns for the world's most significant assets reflected the "worst cross asset performance in more than a century" but the USD was one of the few global investment vehicles that offered a positive, risk-adjusted return in 2018.

We have moderated our outlook for the USD somewhat for the year ahead but we still rather expect the currency to resume the secular slide that we think began with 2017's significant decline. While the USD has benefitted from rising interest rates and solid US growth dynamics, we think a lot of good news is factored into the exchange rate at current levels from an economic perspective. Our forecast calls for a gradual slowing in US growth this year, extending more markedly into 2020 to below 2%. We do expect the Fed to tighten interest rates a little more in 2019 but markets are skeptical and the forward yield curve reflects a strengthening conviction that the Fed is nearing the end of its tightening cycle now.

We think there are some longer run headwinds accumulating for the USD which support our bearish assessment of its outlook. Firstly, the USD remains relatively elevated against most of its major currency peers from a purchasing power parity perspective and we expect the USD to "mean revert" lower as domestic growth slows and the Fed tightening cycle peaks. Interest rate differentials will narrow against the USD as other central banks "catch up" with the Fed. Secondly, we think the accumulation of US current account and (especially) fiscal deficits will weaken the USD in the medium- to longer run, reflecting the pattern of trade in the USD over the past 30 years or more; when US structural imbalances have deteriorated, the USD has generally under-performed. We expect combined deficits to reach around 7%/GDP this year. Finally, we continue to believe that the 2017 peak represented the high point in the longer-term USD bull trend. Price action then turned negative for the USD overall and signaled a major trend reversal in our opinion.

Given these structural and secular challenges, international investors may already be edging away from the USD. While currency investors usually favour currencies with high or rising interest rates, the flat yield curve means that USD-denominated assets are much less attractive for foreign investors when taking into account the cost of hedging against USD depreciation. Also, the International Monetary Fund's Q3 data on global FX reserves showed that the USD's proportion of FX reserve assets declined to 61.9%, down from 62.4% in Q2, over a period in which the USD itself strengthened broadly. The USD's share of reported FX reserves has declined to its lowest in nearly five years.

We expect the Canadian dollar CAD to improve after a disappointing 2018, where its return versus the USD (-7.5% at writing) is no better than the S&P 500. While the economy has held up quite well after slowing from a strong start to the year, the

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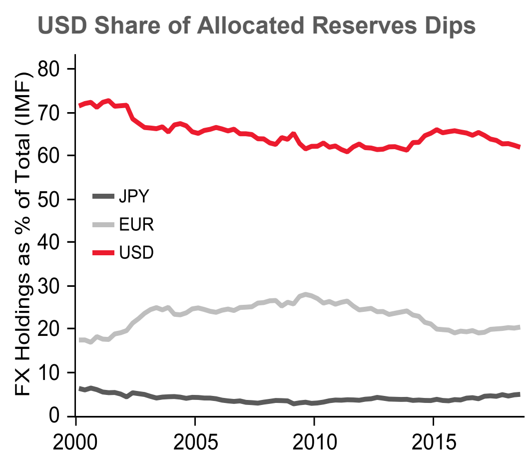
Chart 1



Sources: Macrobond, Scotiabank FICC Strategy.

renegotiation of NAFTA and, more recently, the slide in oil prices have weighed on the CAD's performance generally. Weak equity markets, with a number of the world's major stock indices in or near "bear market" territory, has further weighed on the higher beta commodity currencies as investors mark down global growth expectations. The CAD may start soft in the early part of the New Year (on average over the past 20 years, January has delivered the strongest monthly USD returns versus the CAD of the year) but we think USD gains towards the 1.38 area (near the 2017 high) should see bargain-hunting demand for the CAD. We expect oil prices to recover as global supply/demand rebalances and, despite the recent dovish lilt to its communications, we expect the Bank of Canada (BoC) to tighten interest rates a little more aggressively than the Fed (three 25bps hikes in 2019 for the BoC versus just two more from the Fed). Higher energy prices and a narrowing in US-Canada rate differentials will support CAD gains over the balance of the year.

We remain broadly positive on prospects for the euro (EUR), pound (GBP) and yen (JPY). The Eurozone economy slowed in the latter half of 2018 and policy makers are sounding increasingly cautious on the outlook. But we look for above-potential rates of expansion in the coming quarters, keeping inflation on an upward track and the European Central Bank on course to shift—gradually—towards policy normalization later next year. We expect this process to help boost the EUR more materially in H2 2019 towards USD1.30. Downside risks to that view revolve around any escalation in EU/US trade tensions and the impact of Brexit on the European economy. We assume a relatively smooth Brexit which will allow the GBP to improve into 2019 as "worst-case" fears subside—even if the economic impact of leaving the Eurozone is likely to be negative. However, we continue to acknowledge the considerable risks and uncertainties —for both the UK and the Eurozone—associated with a "no deal" Brexit which the UK government is presenting as the only alternative to its highly unpopular divorce plan.

We expect the JPY to strengthen modestly against a broadly softer USD this year but to underperform against the EUR and GBP. The Bank of Japan (BoJ) is liable to maintain policy accommodation for some time to come. Recent comments from central bank policy makers suggest growing concerns that the BoJ will not achieve its inflation target. As a consequence, we expect the BoJ to continue targeting a 0% nominal rate for 10-year government bonds. While that might suggest the JPY is susceptible to the USD against the backdrop of a tightening Fed, the JPY has been immune to wider US-Japan yield spreads this year. Reflecting declining Japanese participation in the US Treasury bond market, Japanese holdings of US Treasury bonds have weakened to the smallest since late 2011. Given the significant risks and uncertainties that lie ahead, the JPY's role as the "go to" safe haven in times of market volatility cannot be ignored.

The Mexican peso (MXN) remains well supported into the start of 2019 with an impressive 7% gain from its early December low. Sentiment has recovered following the airport referendum from Q4 and market participants have responded positively to the most recent Banxico hike and communication flagging upside risk to inflation. We anticipate one additional Banxico hike in Q1 2019 but foresee MXN weakening throughout our forecast horizon, reflecting a challenging outlook for global financial conditions in the context of continued balance sheet normalization from the Fed. The Brazilian real (BRL) is up over 4% in the first few sessions of 2019, reflecting solid sentiment and hopes relating to the new administration's reform agenda. Fiscal developments will be closely scrutinized; however, much of the recent strength in the currency has been attributed to expectations for greater central bank independence. We remain cautious on the reform agenda and maintain a bearish outlook for BRL into the end of 2020. We have a neutral outlook for the Colombian peso (COP), reflecting a constructive forecast for oil prices offset by concerns that the central bank (BanRep) may be falling behind the curve on inflation. We are constructive on the outlook for the Chilean peso (CLP) given our expectations for solid growth, stabilizing inflation and a recovery in copper prices. Peru is expected to lead its Pacific Alliance peers in real GDP growth throughout our forecast horizon, which should deliver strength in the sol (PEN) through 2019 and into 2020.

Easing US-China trade tensions will likely boost risk appetite and buoy EM Asian currencies in the first quarter, particularly export-driven currencies such as the South Korean won (KRW), Taiwanese dollar (TWD) and Thai baht (THB). The PBoC has pledged again to keep the yuan exchange rate basically stable and we expect the Chinese yuan (CNY & CNH) to trade towards 6.60–6.70 on expectations of the US and China reaching a trade deal by the March 1 deadline. While the geopolitical situation on the Korean Peninsula could weigh on the KRW intermittently, the TWD is prone to weakness if cross-strait relations deteriorate ahead of the island's general election due in early 2020.

The high-yielding Indian rupee (INR) and Indonesian rupiah (IDR) will advance if investors are more convinced that the Fed policy cycle is close to a peak. Weak oil prices are also supportive. However, we note that volatility may increase in the INR, IDR and THB ahead of general elections scheduled for April–May, 17 April and 24 February respectively in India, Indonesia and Thailand. While the Hong Kong dollar (HKD) is likely to rally on narrowing yield advantage of the USD, the EUR's potential strength will prop up the Singapore dollar (SGD) given a tight correlation between them. The Malaysian ringgit (MYR) and Philippine peso (PHP) will likely underperform regional peers in the first quarter on account of soft oil prices and deteriorating current account balances respectively.

APPENDIX 1

International	2000–17	2017	2018e	2019f	2020f	2000–17	2017	2018e	2019f	2020f
	Real GDP (annual % change)					Consumer Prices (y/y % change, year-end)				
World (based on purchasing power parity)	3.9	3.8	3.7	3.5	3.4					
Canada	2.1	3.0	2.1	1.8	2.0	1.9	1.8	2.0	1.7	2.2
United States	2.0	2.2	2.9	2.4	1.7	2.2	2.1	2.0	2.1	2.3
Mexico	2.2	2.1	2.0	1.6	2.3	4.4	6.8	4.8	4.3	3.8
United Kingdom	1.9	1.8	1.4	1.5	1.5	2.0	2.7	2.2	2.1	2.0
Eurozone	1.4	2.4	1.9	1.7	1.7	1.8	1.4	1.9	1.6	1.7
Germany	1.4	2.2	1.5	1.6	1.6	1.5	1.7	1.7	1.4	1.8
France	1.4	2.2	1.5	1.5	1.7	1.4	1.2	1.6	1.6	1.7
China	9.3	6.9	6.6	6.2	6.0	2.3	1.8	1.9	2.4	2.3
India	7.0	6.3	7.5	7.3	7.5	6.8	5.2	2.5	5.6	5.0
Japan	0.9	1.9	0.8	1.1	0.8	0.1	1.0	0.8	2.3	1.0
South Korea	4.1	3.1	2.7	2.7	2.6	2.5	1.4	1.3	2.4	2.2
Australia	2.9	2.4	3.0	2.7	2.5	2.7	1.9	2.0	2.3	2.6
Thailand	4.0	3.9	4.1	3.8	3.5	1.9	0.8	0.4	1.8	2.0
Brazil	2.5	1.1	1.1	2.3	2.5	6.5	3.0	4.1	5.2	5.4
Colombia	3.9	1.8	2.5	3.3	3.6	5.1	4.1	3.2	4.8	4.1
Peru	5.0	2.5	3.7	4.0	4.0	2.7	1.4	2.2	2.4	2.5
Chile	3.9	1.5	3.9	3.2	3.2	3.3	2.3	2.6	3.0	3.0

Commodities	2000–17	2017	2018e	2019f	2020f
	(annual average)				
WTI Oil (USD/bbl)	62	51	65	58	62
Brent Oil (USD/bbl)	65	55	72	67	69
WCS - WTI Discount* (USD/bbl)	-16	-13	-26	-20	-20
Nymex Natural Gas (USD/mmbtu)	4.83	3.02	3.07	3.25	2.80
Copper (USD/lb)	2.38	2.80	2.96	3.00	3.20
Zinc (USD/lb)	0.84	1.31	1.33	1.20	1.20
Nickel (USD/lb)	7.12	4.72	5.95	5.50	6.00
Aluminium (USD/lb)	0.87	0.89	0.96	0.90	0.90
Iron Ore (USD/tonne)	67	72	70	65	63
Metallurgical Coal (USD/tonne)	131	187	206	175	160
Gold, London PM Fix (USD/oz)	890	1,257	1,268	1,300	1,300
Silver, London PM Fix (USD/oz)	14.80	17.05	15.71	16.25	16.50

* 2008-16 average.
Sources: Scotiabank Economics, Statistics Canada, BEA, BLS, IMF, Bloomberg.

APPENDIX 2

North America	2000–17	2017	2018e	2019f	2020f	2000–17	2017	2018e	2019f	2020f
	Canada (annual % change, unless noted)					United States (annual % change, unless noted)				
Real GDP	2.1	3.0	2.1	1.8	2.0	2.0	2.2	2.9	2.4	1.7
Consumer spending	2.9	3.5	2.2	1.9	1.8	2.4	2.5	2.7	2.6	1.9
Residential investment	3.6	2.4	-1.1	-0.4	0.9	-0.3	3.3	0.0	0.7	1.9
Business investment	2.2	2.2	4.8	1.1	6.2	3.0	5.3	6.8	3.1	2.2
Government	2.2	2.7	3.0	1.5	1.6	1.0	-0.1	1.7	2.3	1.6
Exports	1.3	1.1	3.1	2.5	2.4	3.7	3.0	4.0	1.6	1.9
Imports	3.0	4.2	3.2	1.0	3.1	3.7	4.6	4.7	4.0	2.9
Nominal GDP	4.3	5.6	4.1	3.4	4.3	4.0	4.2	5.2	4.5	3.8
GDP deflator	2.1	2.6	2.0	1.6	2.3	1.9	1.9	2.2	2.1	2.0
Consumer price index (CPI)	1.9	1.6	2.3	1.7	2.1	2.2	2.1	2.4	1.8	2.3
CPI ex. food & energy	1.6	1.6	1.9	1.9	2.0	2.0	1.8	2.1	2.0	2.1
Pre-tax corporate profits	0.0	20.1	5.0	6.1	2.1	5.3	3.2	8.1	4.2	1.9
Employment	1.4	1.9	1.3	1.1	0.7	0.7	1.6	1.6	1.3	1.0
Unemployment rate (%)	7.1	6.3	5.8	5.7	5.9	6.1	4.4	3.9	3.7	3.8
Current account balance (CAD, USD bn)	-19.4	-60.1	-58.6	-55.8	-56.5	-501	-449	-480	-571	-641
Merchandise trade balance (CAD, USD bn)	22.3	-24.6	-22.0	-24.3	-28.5	-680	-807	-884	-985	-1068
Federal budget balance* (FY, CAD, USD bn)	-3.6	-17.8	-19.0	-18.1	-19.6	-540	-665	-805	-1,000	-1,045
percent of GDP	-0.2	-0.9	-0.9	-0.8	-0.8	-3.7	-3.4	-3.9	-4.7	-4.7
Housing starts (000s, mn)	200	220	213	202	200	1.26	1.20	1.26	1.25	1.26
Motor vehicle sales (000s, mn)	1,678	2,034	1,984	1,930	1,900	15.6	17.1	17.2	16.8	16.7
Industrial production	0.0	4.9	2.4	-0.7	2.3	0.7	1.6	3.9	3.1	2.1
	Mexico (annual % change)									
Real GDP	2.2	2.1	2.0	1.6	2.3					
Consumer price index (year-end)	4.4	6.8	4.8	4.3	3.8					
Current account balance (USD bn)	-14.9	-19.1	-24.7	-28.4	-26.5					
Merchandise trade balance (USD bn)	-7.2	-11.0	-16.4	-20.9	-17.0					

Sources: Scotiabank Economics, Statistics Canada, CMHC, BEA, BLS, Bloomberg.

Quarterly Forecasts	2018		2019				2020			
Canada	Q3	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Real GDP (q/q ann. % change)	2.0	1.7	0.9	2.4	2.2	1.9	2.2	2.0	1.5	1.5
Real GDP (y/y % change)	2.1	2.1	1.9	1.8	1.8	1.9	2.2	2.0	1.9	1.8
Consumer prices (y/y % change)	2.7	2.0	1.8	1.5	1.6	1.7	1.9	2.1	2.2	2.2
Avg. of new core CPIs (y/y % change)	2.0	1.9	1.9	1.9	2.0	2.0	2.0	2.0	2.0	2.0
United States										
Real GDP (q/q ann. % change)	3.4	2.7	2.1	1.8	1.8	1.7	1.7	1.7	1.6	1.7
Real GDP (y/y % change)	3.0	3.1	3.1	2.5	2.1	1.9	1.8	1.7	1.7	1.7
Consumer prices (y/y % change)	2.6	2.0	1.6	1.6	1.7	2.1	2.3	2.3	2.3	2.3
CPI ex. food & energy (y/y % change)	2.2	2.1	2.0	2.0	2.1	2.1	2.1	2.1	2.1	2.1
Core PCE deflator (y/y % change)	2.0	1.9	2.0	1.9	2.0	2.0	2.0	2.0	2.0	2.0

Sources: Scotiabank Economics, Statistics Canada, BEA, BLS, Bloomberg.

APPENDIX 3

	2018	2019				2020			
Central Bank Rates	**Q4**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Americas				(%, end of period)					
Bank of Canada	1.75	1.75	2.00	2.25	2.50	2.75	2.75	2.75	2.75
US Federal Reserve (upper bound)	2.50	2.50	2.75	3.00	3.25	3.25	3.25	3.25	3.25
Bank of Mexico	8.25	8.50	8.50	8.50	8.50	8.50	8.00	7.75	7.50
Central Bank of Brazil	6.50	6.50	7.00	7.50	8.25	8.75	8.75	8.75	8.75
Bank of the Republic of Colombia	4.25	4.25	4.75	5.25	5.75	6.25	6.75	6.75	6.75
Central Reserve Bank of Peru	2.75	2.75	3.00	3.25	3.25	3.50	3.50	3.50	3.50
Central Bank of Chile	2.75	3.00	3.25	3.25	3.50	3.75	4.00	4.00	4.00
Europe									
European Central Bank	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.50	0.50
Bank of England	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00
Asia/Oceania									
Reserve Bank of Australia	1.50	1.50	1.50	1.75	1.75	2.00	2.00	2.00	2.00
Bank of Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
People's Bank of China	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
Reserve Bank of India	6.50	6.50	6.50	6.50	6.75	6.75	6.75	6.75	6.75
Bank of Korea	1.75	1.75	1.75	1.75	2.00	2.00	2.00	2.00	2.00
Bank of Thailand	1.75	1.75	1.75	1.75	2.00	2.00	2.00	2.00	2.00
Currencies and Interest Rates									
Americas				(end of period)					
Canadian dollar (USDCAD)	1.36	1.32	1.30	1.27	1.27	1.25	1.25	1.23	1.23
Canadian dollar (CADUSD)	0.73	0.76	0.77	0.79	0.79	0.80	0.80	0.81	0.81
Mexican peso (USDMXN)	19.65	20.03	20.13	20.60	21.36	21.50	21.36	21.46	21.81
Brazilian real (USDBRL)	3.88	4.12	4.18	4.24	4.27	4.35	4.41	4.47	4.52
Colombian peso (USDCOP)	3,254	3,336	3,417	3,325	3,210	3,198	3,265	3,262	3,185
Peruvian sol (USDPEN)	3.37	3.35	3.31	3.32	3.30	3.31	3.27	3.28	3.25
Chilean peso (USDCLP)	694	650	650	650	650	650	640	640	640
Europe									
Euro (EURUSD)	1.15	1.17	1.22	1.26	1.30	1.30	1.30	1.32	1.32
UK pound (GBPUSD)	1.28	1.32	1.35	1.37	1.40	1.42	1.42	1.45	1.45
Asia/Oceania									
Japanese yen (USDJPY)	110	110	110	108	108	107	107	105	105
Australian dollar (AUDUSD)	0.70	0.75	0.77	0.77	0.78	0.78	0.78	0.78	0.78
Chinese yuan (USDCNY)	6.88	6.80	6.60	6.70	6.70	6.60	6.60	6.50	6.50
Indian rupee (USDINR)	69.8	69.0	67.0	68.0	68.0	67.0	67.0	66.0	66.0
South Korean won (USDKRW)	1,116	1,090	1,080	1,085	1,085	1,080	1,080	1,070	1,070
Thai baht (USDTHB)	32.5	32.0	31.6	31.8	31.8	31.6	31.6	31.4	31.4
Canada (Yields, %)									
3-month T-bill	1.65	1.80	2.05	2.30	2.55	2.80	2.80	2.80	2.80
2-year Canada	1.86	2.00	2.20	2.45	2.65	2.85	2.85	2.85	2.85
5-year Canada	1.89	2.10	2.30	2.55	2.75	2.95	2.95	2.95	2.95
10-year Canada	1.97	2.20	2.35	2.60	2.80	3.00	3.00	3.00	3.00
30-year Canada	2.18	2.35	2.50	2.75	2.90	3.10	3.10	3.10	3.10
United States (Yields, %)									
3-month T-bill	2.36	2.40	2.65	2.90	3.15	3.15	3.15	3.15	3.15
2-year Treasury	2.49	2.75	2.90	3.10	3.30	3.30	3.30	3.30	3.30
5-year Treasury	2.51	2.80	3.00	3.20	3.35	3.35	3.35	3.40	3.45
10-year Treasury	2.68	2.90	3.10	3.30	3.40	3.45	3.45	3.50	3.55
30-year Treasury	3.01	3.10	3.25	3.50	3.50	3.60	3.60	3.65	3.65

Sources: Scotiabank Economics, Bloomberg.

Foreign Exchange Strategy