Another Year, Another Setback

The U.K.'s decision to leave the European Union represents a major economic shock to the U.K. and Europe. It will lower business and household confidence in the U.K. and Europe, while also potentially fanning the flames of referenda in other countries given the electoral cycle across the continent. Despite the importance of the shock to Europe, we expect its impact outside of the region to be relatively contained, as the U.S., China and India remain on reasonably solid footing. On balance, our global growth forecast has been marked down from 3.1% to 3.0% in 2016, and from 3.5% to 3.3% in 2017.

The most immediate impact of Brexit has been felt in financial markets, with some currencies and government bond yields adjusting rapidly to increased uncertainty and the potential economic consequences. The British Pound has depreciated substantially against the USD, while the Euro has also fallen. Led by Shaun Osborne, our currency strategists (pages 43-45) believe the Pound has more room to fall, to 1.25, as the U.K. navigates uncharted waters over the next quarters. Government bond yields have fallen sharply as well, with 10-year U.S. Treasuries yielding below 1.40%, their lowest levels ever, and yields on European and Japanese 10-year debt becoming even more negative. As Derek Holt explains on pages 41-42, yields are likely to decline further and remain extremely low for some time given the demand for safe assets, and the need for continued monetary policy support in most advanced economies. We now expect the yield on U.S. Treasuries to fall to 1.2%.

The economic impact of Brexit will be focused on the U.K. and Europe and should see a reduction in investment and household spending in both areas, with the impact expected to be more pronounced in the U.K. Our U.K. strategist, Alan Clarke, predicts a minor recession for the U.K. late this year, followed by no growth for 2017 (pages 16-17). For Europe, this could not come at a worse time, as economic prospects in many Euro Area countries had been improving and surprising to the upside. Our European strategist Frédéric Prêtet has shaved half a percentage point off his Eurozone growth forecast for 2017, to about 1% (pages 18-20). The Bank of England has already signaled that it may need to loosen monetary policy in response to the change in the outlook, and we expect a 50 bp cut to their policy rate in July. The ECB is also likely to respond to the additional weakness.

Despite these major revisions to prospects across the Atlantic, the real economic impact on the rest of the world should be muted. The U.S. economy is relatively closed by advanced economy standards and is far more dependent on domestic demand than foreign activity. As Aron Gampel and Carlos Gomes explain in pages 9-13, the fundamentals of the U.S. economy are relatively solid despite weak trend growth. In particular, the household sector continues to drive demand, with both auto and home sales suggesting there is room for continued expansion. The key impact felt from Brexit will be channeled through a stronger USD, leading to weaker exports and investment. Our U.S. forecast remains unchanged for 2016, at 1.9%, but we have shaved our forecast down by 0.1 percentage points in 2017 to 2.2% to account for Brexit-related effects. The elevated global uncertainty

CONTACTS

Jean-François Perrault, SVP & Chief Economist
416.866.4214
Scotiabank Economics
jean-francois.perrault@scotiabank.com

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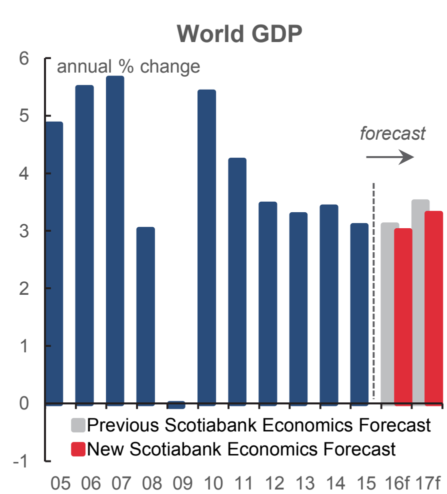
Chart 1



Source: IMF, Scotiabank Economics.

and stronger USD should lead the Federal Reserve to delay tightening to the second quarter of next year, with only three hikes expected in 2017.

Given the limited impact on the U.S. economy and relatively small trade linkages (about 7% of Canadian exports go to the EU), Adrienne Warren predicts little direct effects from Brexit on Canada (pages 3-6). We expect growth of 1.3% this year and 2.0% in 2017 as the economy continues to adjust to the terms-of-trade shock. The pick-up in growth in 2017 will be driven by an acceleration in non-energy exports that benefit from the strength in U.S. domestic demand and the past depreciation of the dollar, an expected increase in infrastructure spending next year, and rebuilding in Fort McMurray. As our commodity economist Rory Johnston explains on pages 37-39, we expect the price of WTI to rise to about $55/bbl in 2017. This will provide an additional boost to growth, but we continue to expect little investment in the oil patch in 2017 given breakeven costs. Variation in provincial outcomes will persist, as Mary Webb notes on pages 7-8, with oil-producing provinces lagging B.C., Ontario and Québec in 2016, but growth differentials should narrow as oil prices rise next year. Given the persistence of downside risks to the global economy, we believe the Bank of Canada has the flexibility to wait until the fourth quarter of 2017 before it begins to normalize policy, even though inflation is expected to be at roughly 2% through next year. The Canadian dollar is forecast to be about 77 cents per USD by the end of 2016, and appreciate to about 80 cents next year as oil prices rise.

As Tuuli McCully notes in pages 29-36, Asian economies are also likely to be only modestly affected by Brexit in a direct manner. China's economic transition continues, with growth expected to slow to 6.1% in 2017. Export growth is forecast to weaken as a result of the situation in Europe, and this, in conjunction with the challenges associated with structural transformation is going to prompt Chinese authorities to provide additional policy support to the Chinese economy. The Yuan should depreciate marginally through the end of 2017. India will be the region's star performer, with growth of 7.5% forecast for 2016 and 2017. India's economy is largely domestically oriented, and as such is unlikely to be seriously affected by developments in the U.K. and Europe. Nevertheless, a number of structural impediments to growth remain and there are risks that these could curtail India's robust expansion. Japan's economy is likely to be the one most affected by Brexit, as the Yen benefits from safe-haven flows. We expect additional policy support from the Bank of Japan and the Government to reduce the impact of this shock, but expect the Yen to remain at about 105 per USD through the remainder of the year, before depreciating to 115 per USD by end-2017.

Prospects in Latin America remain mixed, as detailed by our Latin American team, led by Pablo Bréard, on pages 21-28. Given the importance of the U.S. economy to the region, and the expected improvement in many commodity prices, developments in the U.K. and Europe should not impose too much of a drag on the region. The Pacific Alliance countries should perform reasonably well compared to other regions, but growth will be well-below trend. The Mexican economy will have to contend with a weaker currency as it is the bellwether for emerging market assets. The Banco de Mexico has already hiked interest rates by 50 bps in an attempt to contain the inflationary impacts of the depreciation, and more rate hikes are expected. Chile will be the weakest economy in the Pacific Alliance, as it continues to adapt to the decline in commodity prices, and confidence remains depressed owing to the reforms being implemented by the Government. Brazil remains in a deep recession, but there is hope that the temporary stability provided by the Temer administration will trigger a mild expansion of the private sector later in 2016 and into 2017. Risks, however, remain large particularly on the fiscal side.

Table 1 — Global Real GDP

	2000-14	2015	2016f	2017f
		(annual % change)		
World (PPP)	3.9	3.3	3.0	3.3
Canada	2.2	1.1	1.3	2.0
United States	1.9	2.4	1.9	2.2
Mexico	2.3	2.5	2.4	2.8
United Kingdom	1.8	2.2	1.3	0.0
Euro zone	1.2	1.6	1.4	1.1
Germany	1.2	1.7	1.5	1.2
France	1.3	1.2	1.4	1.1
Russia	4.6	-3.7	-1.0	1.5
China	9.7	6.9	6.5	6.1
India	7.0	7.3	7.5	7.5
Japan	0.9	0.6	0.6	0.6
South Korea	4.4	2.6	2.6	2.8
Indonesia	5.6	4.8	5.0	5.3
Australia	3.0	2.5	2.6	2.6
Thailand	4.1	2.8	3.0	3.2
Brazil	3.4	-3.8	-3.8	0.5
Colombia	4.3	3.1	2.4	2.8
Peru	5.4	3.2	3.8	3.6
Chile	4.3	2.1	1.7	2.2

Canada

STILL AWAITING EXPORT-LED GROWTH

- **Resilient consumer spending and housing-related activity and continuing, albeit uneven, export gains are underpinning modest output growth in the face of ongoing declines in resource sector investment.**
- **Further fiscal stimulus and a reduced drag from the energy sector alongside the recent rebound in crude oil prices should bolster growth prospects in the latter half of the year and into 2017.**
- **Recent events in Europe (i.e. Brexit) are assumed to have only a small impact on domestic growth, primarily through a slightly softer export profile.**

ECONOMIC OUTLOOK

The Canadian economy appears on track for another year of modest expansion. GDP growth is forecast to average just 1.3% in 2016, up from last year's 1.1% advance, but a full percentage point below the post-recession average annual gain of 2.3%. Business investment remains the weak link in the outlook, subtracting almost a full percentage point from growth this year. Output growth is expected to pick up to 2.0% in 2017, supported by infrastructure spending, improving export momentum and a stabilization in energy sector investment.

Quarterly output trends remain highly volatile, impacted by unseasonable weather, inventory adjustments and unforeseen events such as the Alberta wildfires. Following a strong start to the year, GDP is expected to have contracted modestly in Q2, in large part due to the fallout from the wildfires. This is expected to give way to a solid rebound in the current quarter as crude oil shipments recover.

Consumer spending remains quite resilient, notwithstanding significant regional variation. Confidence and purchasing power are being supported by moderate employment and income gains, low borrowing costs and low gas prices. Household expenditures on energy and interest payments (but excluding principal repayments) as a share of personal disposable income fell to a record low 12.5% in Q1, compared with a long-term average of 15.6% (Chart 1).

In addition to the federal personal income tax cut for the middle class this past January, household confidence and spending could get a boost from the mid-year roll-out of increased federal aid for low- and middle-income Canadians. The latter includes the new Canada Child Benefit plus greater support for Veterans, First Nations, single Seniors and post-secondary students.

However, households will be hard pressed to maintain the recent spending momentum, with consumer expenditures already at a record share of nominal GDP (Chart 2). Labour market conditions remain soft, with most goods-producing sectors still cutting back their payrolls. While we anticipate a modest pickup in employment growth in 2017 as the pace of energy-sector layoffs wanes, competitive pressures in both domestic and export markets are expected to slow the recovery in wage and income gains.

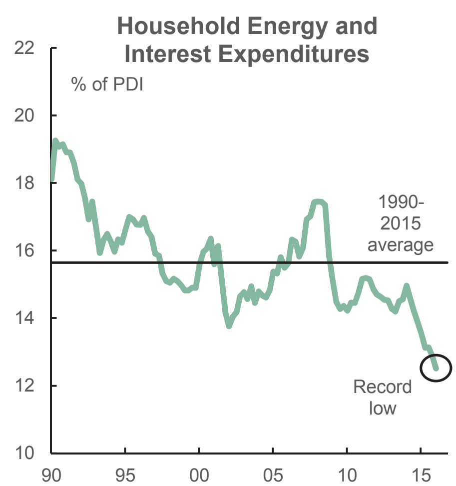
CONTACTS

Derek Holt
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

Adrienne Warren
416.866.4315
Scotiabank Economics
adrienne.warren@scotiabank.com

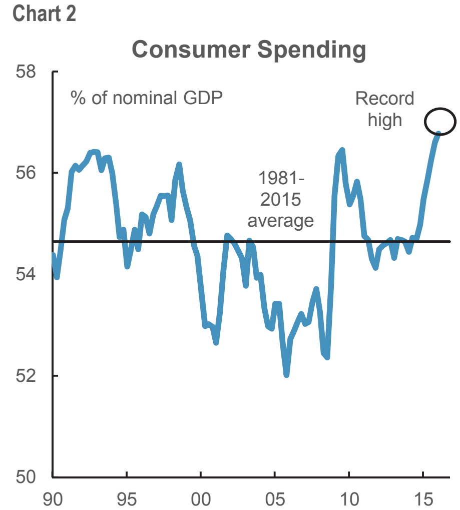
Mary Webb
416.866.4202
Scotiabank Economics
mary.webb@scotiabank.com

Chart 1



Source: Statistics Canada,Scotiabank Economics.

Chart 2



Source: Statistics Canada, Scotiabank Economics.

There is likely little pent-up demand for major household purchases. Motor vehicle sales, for example, adjusted for the size of the vehicle-buying population, are near their highest level of the past 25 years. Any rise in borrowing costs would add to consumer caution given elevated household debt levels. Overall, nominal spending is forecast to track underlying income gains of around 3%, with households maintaining their aggregate savings rate around the 4% average level of the past decade.

Residential investment also is expected to moderate over the forecast horizon. National home sales are currently supported by elevated activity in B.C. and Ontario, especially in and around Vancouver and Toronto. However, both markets are beginning to show early signs of levelling off as rapid and sustained price gains erode affordability. The potential for fixed mortgage rates to drift higher and/or for additional macroprudential tightening also would slow activity in these high-priced markets.

A softer resale market outlook combined with the need for inventory management is expected to slow new homebuilding. Softening rent growth and rising rental vacancy rates point to a reduced pace of apartment construction, a major driver of starts in recent years (Chart 3). Housing starts are projected to total close to 190,000 units in 2016 and 180,000 units in 2017, down from 196,000 last year.

Our growth forecast for the latter half of this year and into 2017 hinges critically on the performance of non-energy exports. Energy export volumes — which account for 23% of total merchandise shipments — are expected to be largely flat in 2016, before recovering modestly in 2017.

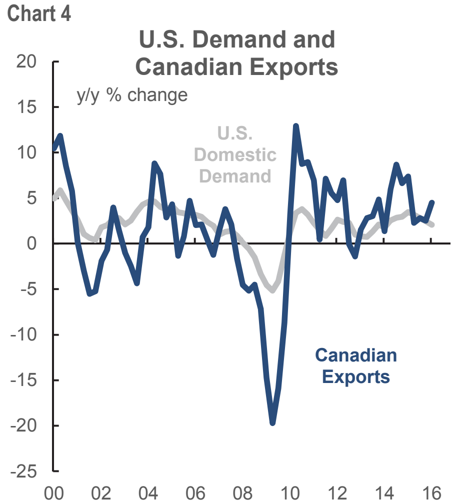
Notwithstanding some recent deceleration in underlying export trends, healthy U.S. consumer demand combined with the lagged effects of the roughly 15% depreciation in the Canadian dollar since 2014 should continue to drive improvement in Canadian non-energy exports (Chart 4). Non-energy export volumes over the first five months of the year are up 4% from a year earlier, led by agri-food products, forest products, autos & parts and consumer goods.

However, several factors are contributing to the relatively slow and uneven export recovery. Weak global industrial activity and business investment are restraining demand for industrial materials and equipment — key Canadian export sectors accounting for more

Chart 3

Source: CMHC, Scotiabank Economics.

Chart 4



Source: Statistics Canada, BEA, Scotiabank Economics.

Table 1 — Quarterly Canadian Forecasts

	2015		2016				2017			
	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic					(average)					
Real GDP (q/q, ann. % change)	2.2	0.5	2.4	-0.8	3.2	2.0	2.1	2.1	1.9	1.9
Real GDP (y/y, % change)	1.0	0.3	1.1	1.1	1.3	1.7	1.6	2.4	2.0	2.0
Consumer Prices (y/y, % change)	1.2	1.3	1.5	1.7	2.0	2.2	2.3	2.1	2.1	2.2
Core CPI (y/y % change)	2.2	2.0	2.0	2.1	2.1	2.1	2.1	2.0	2.0	2.0
Financial					(end of period)					
Canadian Dollar (USDCAD)	1.33	1.38	1.30	1.29	1.30	1.30	1.28	1.28	1.25	1.25
Canadian Dollar (CADUSD)	0.75	0.72	0.77	0.77	0.77	0.77	0.78	0.78	0.80	0.80
Bank of Canada Overnight Rate (%)	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75
3-month T-bill (%)	0.44	0.51	0.45	0.49	0.50	0.50	0.50	0.50	0.55	0.80
2-year Canada (%)	0.52	0.48	0.54	0.52	0.45	0.50	0.55	0.70	0.80	1.10
5-year Canada (%)	0.80	0.73	0.68	0.57	0.50	0.60	0.70	0.85	1.00	1.30
10-year Canada (%)	1.43	1.39	1.23	1.06	0.80	0.90	1.00	1.05	1.20	1.40
30-year Canada (%)	2.20	2.15	2.00	1.72	1.40	1.50	1.60	1.60	1.60	1.75

than a quarter of goods shipments. The ongoing inventory correction in the United States has temporarily stalled U.S. imports of non-resource manufactured goods.

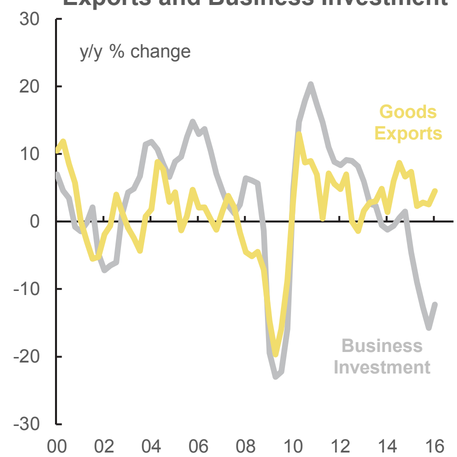
Domestic competitiveness remains an ongoing challenge, reinforced by persistently weak productivity growth and relatively high unit labour costs. Canada's share of U.S. manufacturing imports has slumped by nearly 25% over the past decade. Capacity constraints also appear to be holding back exports. A number of industries outside of the energy and mining/metals sectors are operating at or above historical utilization rates, including forest products, food manufacturing, transportation equipment, computer & electronic products, and furniture products.

We anticipate continued steady growth in service exports, led by increased tourism demand. Canada's traditional deficit in international tourism has narrowed steadily over the past year as a weaker Canadian dollar prompts more Canadians to vacation at home, while attracting more foreign visitors to Canada. Combined with only modest import growth, net export volumes should add a full percentage point to GDP growth in 2016, and remain a positive contributor to the economy next year.

Business investment is being dragged lower by large cutbacks in the capital intensive energy-sector, which accounts for about 20% of total private sector investment. Oil & gas-related capital spending is forecast to decline 25% this year, following a 40% retrenchment in 2015. Outlays are expected to stabilize in 2017 with WTI oil prices averaging around US$55/bbl, up from an average of $45/bbl in 2016. Mid-cycle breakeven costs for the Alberta oil sands range from US$40-$70/bbl, while non-oil sands plays across Canada and the United States require US$30-60/bbl. Further cutbacks in mining investment are projected through 2017 amid weak demand and global oversupply.

Investment outside of the resource sector has continued to disappoint. Uncertainty over the domestic and global economic outlook is constraining capital spending plans despite low borrowing costs, improving corporate earnings and tightening manufacturing capacity rates. A weaker Canadian dollar also appears to be impacting investment decisions, with the price of imported machinery & equipment up 10% over the past year.

Chart 5 **Exports and Business Investment**



Source: Statistics Canada, Scotiabank Economics.

Strengthening exports should underpin a modest pickup in capital spending in the latter half of the year based on historical correlation (Chart 5), though investment intentions remain soft. The outlook for non-residential construction is mixed. While industrial activity should benefit from strengthening exports, rising office and retail vacancy rates will limit new commercial development.

Federal funding is expected to leverage increased infrastructure investment through 2017 across all levels of government, reflecting Ottawa's transit, social capital and environment priorities and its near-term focus on asset rehabilitation. The substantial funding emerging from federal and provincial climate change policy also should step-up capital outlays. Overall, federal fiscal stimulus is forecast to add close to half a percentage point to real GDP growth in fiscal 2016-17 (FY17) and again in FY18.

The extent and timing of inventory realignments remain somewhat of a wildcard in our outlook. Manufacturers, wholesalers and retailers have drawn down their inventories over the past several quarters, exerting a sizeable drag on overall GDP growth. The economy-wide stock-to-sales ratio has begun to edge lower, but is still above recent trends, notably in manufacturing (Chart 6). This

Table 2 — Canada

	2000-14	2015	2016f	2017f
		(annual % change)		
Real GDP	2.2	1.1	1.3	2.0
Consumer Spending	3.0	1.9	1.9	1.7
Residential Investment	3.8	3.8	3.3	-0.8
Business Investment	3.4	-10.2	-7.6	2.1
Government	2.3	1.8	1.2	2.2
Exports	1.2	3.4	2.1	3.2
Imports	3.2	0.3	-1.0	2.6
Nominal GDP	4.6	0.5	2.2	4.3
GDP Deflator	2.3	-0.6	0.9	2.2
Consumer Price Index	2.0	1.1	1.9	2.2
Core CPI	1.8	2.2	2.1	2.0
Pre-Tax Corporate Profits	5.3	-15.8	-5.5	7.0
Employment	1.4	0.8	0.6	0.8
Unemployment Rate (%)	7.1	6.9	7.1	7.1
Current Account Balance (C$ bn.)	-10.0	-62.6	-68.9	-58.9
Merchandise Trade Balance (C$ bn.)	31.8	-22.5	-28.1	-20.7
Federal Budget Balance (FY, C$ bn.)	-3.2	1.9	-5.0	-27.0
per cent of GDP	-0.2	0.1	-0.3	-1.3
Housing Starts (thousands)	199	196	188	180
Motor Vehicle Sales (thousands)	1,622	1,898	1,955	1,945
Industrial Production	0.7	-1.1	0.6	2.0

suggests further inventory adjustment will be needed to bring stock-to-sales ratios back to the desired level.

KEY RISKS

From a domestic standpoint, key risks to our Canadian outlook for 2016-2017 include elevated levels of household debt, and overvaluation in the Vancouver and Toronto housing markets. We believe these risks are manageable in the context of moderate growth and low interest rates. However, an adverse shock to the economy, such as a much weaker job market, or higher interest rates, could prompt a bigger pullback in consumer and housing activity. Key external forecast risks include the potential for a larger slowdown in Chinese growth and commodity prices on the downside, and stronger U.S. import demand on the upside.

The impact of the historic vote by U.K. citizens to leave the EU poses another risk to the outlook. Canada's direct export exposure to the U.K. is relatively modest, with the latter accounting for just 3% of goods exports, and the remainder of the EU taking a further 4% share. However, to the extent that it leads to increased global economic uncertainty and financial market volatility, it could have negative spillovers to business investment and household spending. Ratification of the Canada-EU Comprehensive Economic and Trade Agreement (CETA) could face potential delays.

MONETARY POLICY

Our forecast is for the Bank of Canada to be on hold for the rest of this year and most of next before possibly beginning to raise its overnight policy rate at the end of 2017. Hiking earlier would require a great deal to go right, whereas hiking later requires only a few matters governing the outlook to deteriorate.

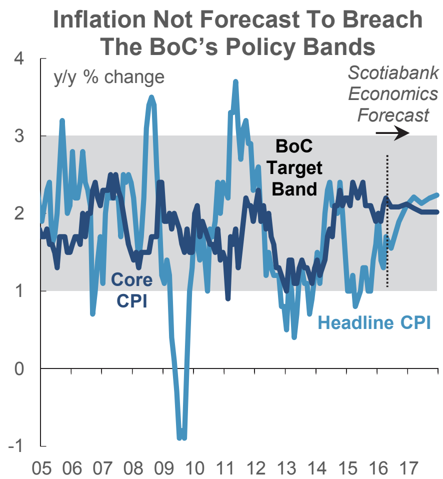
Disinflationary spare capacity is projected to persist throughout our forecast horizon using the blend of metrics that the Bank of Canada employs. Our forecasts therefore anticipate little upward pressure on the BoC's 2% inflation target and 1-3% policy band around it (Chart 7) such that highly stimulative monetary policy will be necessary to insulate against what could otherwise be downside risks to inflation projections. Labour markets will likely continue to operate shy of full employment conditions including a cyclically and structurally depressed labour force participation rate, survey evidence pointing to low and waning labour shortages reported by employers, modest wage growth, and a high share of part-time employees. Industrial capacity utilization remains several percentage points below where it averaged over the decade leading up to the global financial crisis. We forecast the BoC's two main measures of the 'output gap' to be in mild conflict by the end of next year with one measure signalling balanced conditions and the other continuing to signal net spare capacity for an average outcome pointing toward continued slack (Chart 8).

Additional long-pause arguments include a very elevated housing market and consumer cycle that would face the risk of a damaging correction in the face of tightened monetary policy or market-driven fixed-term borrowing costs. A more modest outlook for Federal Reserve rate hikes — we now think the Fed holds policy this year and hikes three times next year — limits the extent to which the BoC can rely upon the currency to support export growth. High global event risk including U.S. elections later this year, European elections next year, a protracted period of post-Brexit uncertainty hanging over Europe, and constant geopolitical tensions across multiple markets continue to pose elevated risk to the international backdrop. In all, our view is that the Bank of Canada will require great distance from downside risks and shocks to the economy before it is comfortable hiking interest rates and so we don't believe that markets should be focused upon the risk of a hiking cycle for a long while yet.

Chart 6

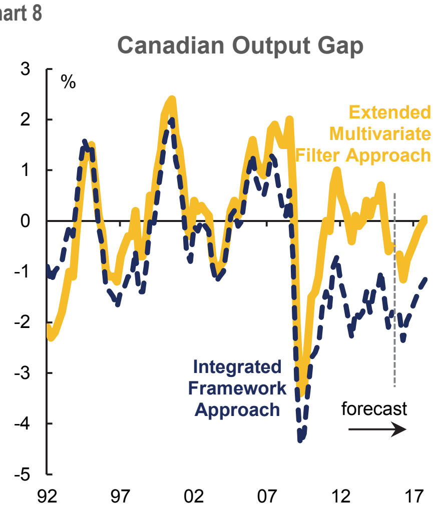
Source: Statistics Canada, Scotiabank Economics.

Chart 7



Source: Statistics Canada, Scotiabank Economics.

Chart 8



Source: Scotiabank Economics, Bank of Canada.

The Provinces

ONGOING REALIGNMENT

- **Several metrics, such as net interprovincial migration, testify to the rebalancing of regional economic growth.**
- **A further narrowing of the seven oil-consuming Provinces' combined deficit this fiscal year and next should edge their net debt lower relative to GDP.**

The pace of the provincial adjustment to soft oil and other mineral prices is significant, albeit uneven. The tragic Fort McMurray wildfires steepened Alberta's output decline during the first half of this year. Rebuilding, however, will offer a partial offset during the second half, keeping the projected real GDP decline for Alberta in 2016 close to 1½%. In 2017, reconstruction plus some further firmness in oil prices should support output expansion despite the continuing fall-out from the petroleum sector's restructuring. For the two other major oil-producing provinces, weak potash and uranium prices complicate Saskatchewan's recovery while Newfoundland and Labrador's real GDP, aided this year by slightly higher offshore oil production, is forecast to trend lower over the following few years as its fourth offshore oil field and then the Muskrat Falls hydroelectricity project are completed. The three major oil-producing provinces target diversification beyond resource extraction, but their existing base across other industries, though expanding, remains relatively small and global competition is intense, even with a softer Canadian dollar.

British Columbia, followed by Ontario, are expected to lead provincial growth through 2017. Their continuing income expansion from private-sector services, ranging from tourism to information technology, is indicated by this sector's healthy employment gains through May. Strengths this year among the other oil-consuming provinces include Manitoba's bus production, Nova Scotia's and BC's shipbuilding contracts, and the fishery's buoyant export prices. Specific risks include re-negotiation of the *Canada-U.S. Softwood Lumber Agreement* and, more generally, the assumption of stronger business investment through 2017.

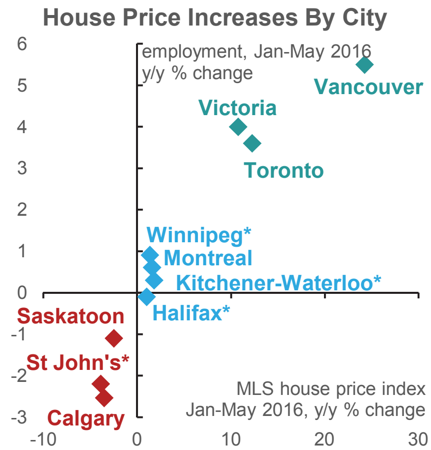
We expect declining affordability to help gradually cool the early-2016 surge in Vancouver's, Victoria's and Toronto's housing markets, despite their solid employment growth this year (Chart 1). Housing activity in Manitoba and east of Ontario is forecast to stabilize at lower levels. The reversal of net interprovincial migration into Alberta in 2015 Q4 and 2016 Q1 has spurred net in-migration to Ontario and particularly B.C. and trimmed other provinces' net population outflows. Combined with stepped-up federal and provincial attention to international immigration, more modest annual declines are now projected for working-age residents in Atlantic Canada where the age profile is older. A large share of the workers across Canada commuting to Alberta have returned home, and the average 2.4% y/y decline in Alberta's average weekly wages since mid-2015 is a factor moderating compensation gains across the rest of Canada.

Provincial *Budgets* this spring indicate a combined deficit for fiscal 2016-17 (FY17) widening to almost $18 billion, after narrowing to $10.2 billion in FY15. The

CONTACTS

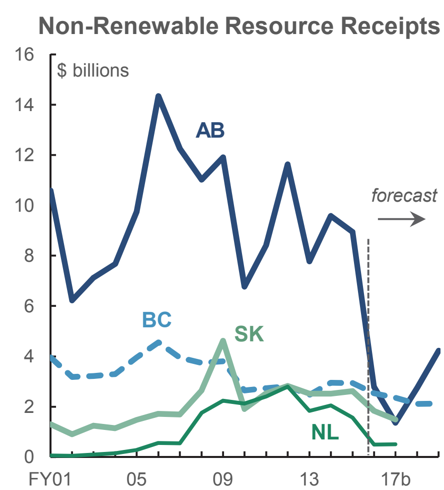
Mary Webb
416.866.4202
Scotiabank Economics
mary.webb@scotiabank.com

Chart 1



*Average MLS sale price.
Source: CREA, Statistics Canada.

Chart 2



Source: Budget Documents.

deterioration mirrors a surge of nearly $13 billion in red ink over the two years in Alberta, Newfoundland and Labrador and, to a lesser extent, Saskatchewan, as their resource receipts tumbled (Chart 2). Across the other seven Provinces, the projected $5.2 billion deficit in FY17 is half their FY15 shortfall. For FY17, BC, Quebec and Nova Scotia project black ink, joined by Ontario, Saskatchewan and Prince Edward Island in FY18.

For the seven oil-consuming Provinces, net debt relative to GDP is expected to trend lower over the next two years. Progress in stabilizing provincial debt burdens has been slowed by ambitious capital plans in many jurisdictions, in part a response to new federal funding. Also encouraging infrastructure investment is historically low interest rates and subdued non-residential construction costs. In 2016 Q1, these costs were below year-earlier levels in Calgary and Edmonton and less than 2% higher in several other major cities. Nevertheless, sustaining balanced books will likely be challenging for most Provinces. Multi-year restraint already has included hiking fees and taxes, reforming employee pension plans, restructuring agencies and holding employee compensation growth close to zero for significant periods.

Table 1 — The Provinces

annual % change except where noted

Real GDP	CA	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
2000-14	2.2	2.8	1.8	1.4	1.2	1.8	1.9	2.4	2.3	3.5	2.6
2015*	1.1	-2.2	1.5	0.8	1.9	1.1	2.5	2.3	-1.4	-4.0	3.0
2016f	1.3	0.1	1.4	1.3	0.6	1.5	2.5	2.2	-0.2	-1.7	2.7
2017f	2.0	-1.2	1.3	1.2	0.6	1.7	2.3	2.1	2.0	2.2	2.6
Nominal GDP											
2000-14	4.6	6.9	4.4	3.4	3.3	3.7	3.7	4.6	6.7	8.0	4.4
2015e	0.5	-8.9	2.9	2.2	3.1	2.6	4.1	3.6	-5.3	-11.0	4.6
2016f	2.2	-1.8	2.9	2.7	1.9	3.1	4.2	3.6	-2.2	-3.6	4.3
2017f	4.3	2.0	2.9	2.8	2.0	3.6	4.3	3.9	4.9	5.7	4.7
Employment											
2000-14	1.4	1.1	1.4	0.7	0.6	1.3	1.3	1.0	1.3	2.6	1.2
2015	0.8	-1.0	-1.1	0.1	-0.6	0.9	0.7	1.5	0.5	1.2	1.2
2016f	0.6	-0.8	-1.0	0.2	-0.8	0.6	1.1	0.3	-0.3	-1.3	2.0
2017f	0.8	-0.8	0.4	0.3	0.2	0.7	1.1	0.8	0.5	0.6	1.1
Unemployment Rate (%)											
2000-14	7.1	14.4	11.2	8.9	9.6	8.1	7.2	5.0	4.9	4.8	6.7
2015	6.9	12.8	10.4	8.6	9.8	7.6	6.8	5.6	5.0	6.0	6.2
2016f	7.1	13.4	10.6	8.6	9.9	7.5	6.7	5.9	6.1	7.8	6.4
2017f	7.1	13.8	10.5	8.5	9.8	7.4	6.7	5.8	5.9	7.5	6.4
Housing Starts (units, 000s)											
2000-14	199	2.7	0.8	4.4	3.7	44	71	5.1	5.2	35	27
2015	196	1.7	0.6	3.8	2.0	38	70	5.5	5.1	37	31
2016f	188	1.7	0.5	2.7	1.6	38	72	4.9	4.5	23	40
2017f	180	1.6	0.5	3.0	1.8	38	68	5.4	4.4	23	34
Motor Vehicle Sales (units, 000s)											
2000-14	1622	28	5	48	37	408	615	46	44	215	176
2015	1898	35	8	54	43	444	761	56	54	236	207
2016f	1955	34	8	55	43	470	801	56	53	220	215
2017f	1945	32	7	55	43	467	795	56	54	222	214
Budget Balances, Fiscal Year Ending March 31 ($ millions)											
2000-14	-3,238	130	-40	-24	-130	-968	-4,876	-53	450	1,809	195
2015	1,911	-986	-20	-144	-389	-725	-10,314	-452	62	1,115	1,683
2016r**	-5,000	-2,200	-28	-71	-466	0	-5,686	-1,011	-427	-6,442 +	377
2017f**	-27,000	-1,830	-10	127	-347	0	-4,306	-911	-434	-10,421	264

* Real GDP by industry, basic prices. ** FY16 & FY17: Provinces' estimates, SK ex pension accrual adjustment; history: MB:FY04-FY14 and AB:FY05-FY14.
+ Final for FY16.

United States

SWIMMING AGAINST THE TIDE OF WEAKER INTERNATIONAL GROWTH

- **Continuing gains in consumer spending and housing activity are helping to keep the U.S. on a moderate growth trajectory. Relatively buoyant increases in jobs and wages, combined with historically low interest rates and prices at the gasoline pumps, are underpinning the purchasing power of Americans.**

- **U.S. business investment, in contrast, has lost considerable momentum, although the retrenchment in capital expenditures attributable to the lingering slump in energy prices is abating. However, there are increasing downside risks to industrial activity, highlighted by slumping durable goods orders and the likelihood of further weakness in exports associated with the downgraded expectations for global growth.**

- **The Federal Reserve will likely keep policy on hold this year, and slow the pace of interest rate normalization next year owing to the increased uncertainty and volatile financial market conditions in the aftermath of the U.K.'s Brexit vote. This uncertainty is already contributing to strong 'safe-haven' flows into the U.S. dollar, which will weigh on U.S. growth and inflation prospects. The yield on 10-year U.S. Treasuries is expected to fall to 1.2%.**

THE U.S. ECONOMY REMAINS ON A MODERATE GROWTH TRAJECTORY

The U.S. economy will remain a relative outperformer among the advanced nations, with output growth underpinned by a comparatively stronger domestic spending profile. Developments in the U.K. and Europe will reduce U.S. growth prospects marginally through trade and currency linkages, but the main impact will be to delay increases in the Federal Funds rate.

U.S. output growth is expected to average 1.9% in 2016, slightly below the 2.1% average increase in the first six years of the current cycle, and almost a full percentage point below the 2.8% average advance in the prior expansion that preceded the Great Recession. While consumer expenditures and residential construction should continue to post relatively solid gains (Chart 1), underpinned by quite supportive financial and lending conditions, slumping exports and business investment attributable to the weakness in international growth and a strong U.S. dollar are dragging on the economy's overall growth performance. Some modest improvement in these lagging sectors should help the U.S. economy regain some increased traction next year, with U.S. output growth projected to advance by a slightly better but still historically soft 2.2% gain in 2017.

The inability to generate and sustain much stronger U.S. growth reflects a number of factors. Some are temporary, such as the spillover from bad weather, strikes and national disasters. But other factors are structural and longer lasting. These include the reduced growth potential stemming from an older workforce and much weaker productivity trends, widening household

CONTACTS

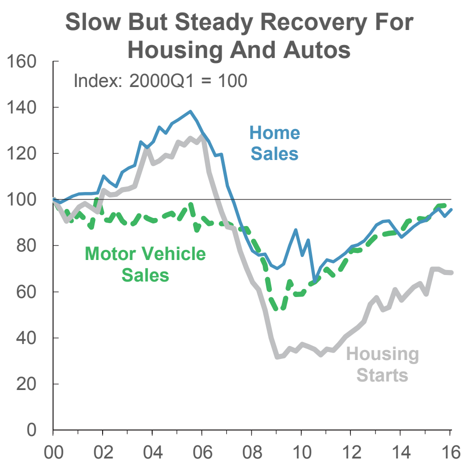
Aron Gampel
416.866.6259
Scotiabank Economics
aron.gampel@scotiabank.com

Carlos Gomes
416.866.4735
Scotiabank Economics
carlos.gomes@scotiabank.com

Derek Holt
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

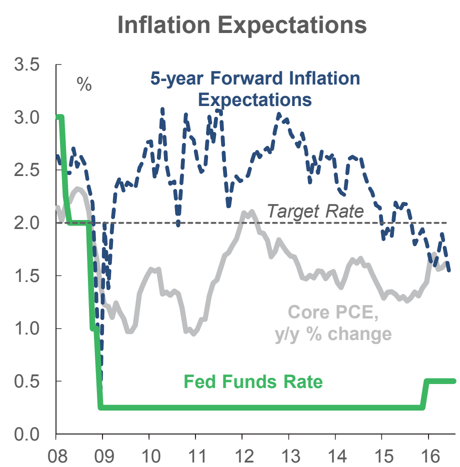
Mary Webb
416.866.4202
Scotiabank Economics
mary.webb@scotiabank.com

Chart 1



Source: BEA, NAR, U.S. Census Bureau, Scotiabank Economics.

Chart 2



Source: Bloomberg, Scotiabank Economics.

income and wealth disparities, and a bias to save more in the wake of the economic fallout from the 2008-09 financial crisis. In addition, the multi-year strengthening trend in the U.S. dollar has helped erode competitiveness which, along with the meaningful slowdown in global growth and trade flows, has weakened exports.

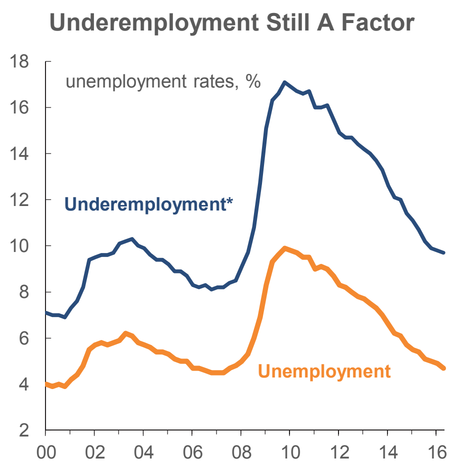
This year got off to a slow start, the product of a weak handoff from the softening pace of activity throughout the second half of 2015, coupled with a further retrenchment in energy-related investments and overall exports associated with the ongoing economic and commodity price turbulence around the world. Although U.S. real GDP is expected to rebound in the April-June period back into the 2½-3% annualized growth range — buoyed by the resumption in consumer spending, further gains in housing activity, and signs of stabilization in manufacturing output — maintaining or increasing this momentum through the end of the year and beyond may well prove challenging. The recent slump in U.S. employment growth, coupled with reduced service-sector gains and the continuing softness in business investment, will limit the improvement in domestic activity. The persistent sluggishness in global trade is moderating the extent of the rebound in U.S. manufacturing and exports. At the same time, the heightened uncertainty surrounding the U.K's decision to leave the European Union and the upcoming campaign for the U.S. Presidency is likely to keep many U.S. households and businesses in a cautious spending mood.

CONSUMER AND RESIDENTIAL SPENDING STILL LEAD …

The U.S. economy is characterized by significant performance imbalances among sectors. Domestically generated growth remains stronger than activity tied to exports and industrial activity. Consumer expenditures and residential construction accounted for virtually all of the U.S. economy's growth in volume terms over the past 2½ years, posting annual growth averaging 3.3% compared with only 0.3% in the remainder of the economy.

The fundamentals underpinning U.S. consumer spending are still quite supportive. The level of 'underemployment' is continuing to trend lower and post new-cycle lows, piggybacking on the continuing job gains which have amounted to over 14 million net positions created during this cycle (Chart 3). Tightening labour markets have helped to raise wages and salaries, and along with higher minimum wage gains and relatively low and stable inflation, have contributed to inflation-adjusted disposable income gains that are running slightly above an annualized 3%. These trends should be reinforced over the summer as the pace of hiring reverts back to a somewhat stronger trajectory that prevailed prior to the unexpected slowdown in

Chart 3



*U6 Includes marginally attached & underemployed workers. Source: BLS, Scotiabank Economics.

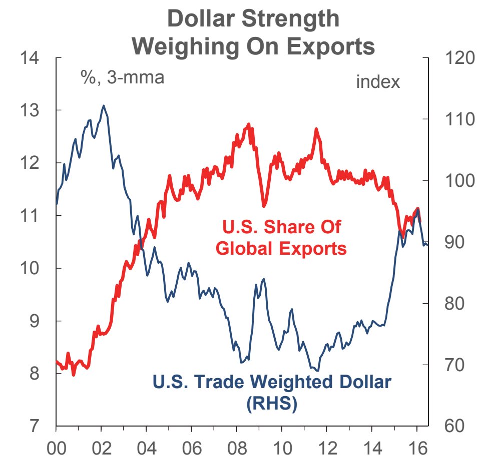
Table 1 — Quarterly U.S. Forecasts

	2015		2016				2017			
	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic					(average)					
Real GDP (q/q, ann. % change)	2.0	1.4	1.1	2.8	2.0	2.0	2.3	2.3	2.3	2.2
Real GDP (y/y, % change)	2.1	2.0	2.1	1.8	1.8	2.0	2.3	2.1	2.2	2.3
Consumer Prices (y/y, % change)	0.1	0.4	0.8	1.0	1.4	2.0	2.4	2.3	2.3	2.3
Core CPI (y/y % change)	1.8	2.0	2.3	2.2	2.3	2.3	2.3	2.3	2.3	2.3
Financial					(end of period)					
Euro (EURUSD)	1.12	1.09	1.14	1.11	1.05	1.05	1.05	1.07	1.10	1.12
U.K. Pound (GBPUSD)	1.51	1.47	1.44	1.33	1.25	1.25	1.27	1.27	1.30	1.35
Japanes Yen (USDJPY)	120	120	113	103	105	105	110	110	115	115
Fed Funds Rate (%)	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.25
3-month T-bill (%)	-0.02	0.16	0.20	0.26	0.25	0.30	0.35	0.60	0.85	1.10
2-year Treasury (%)	0.63	1.05	0.72	0.58	0.50	0.65	0.85	1.00	1.30	1.60
5-year Treasury (%)	1.36	1.76	1.20	1.00	0.85	1.00	1.10	1.25	1.45	1.80
10-year Treasury (%)	2.04	2.27	1.77	1.47	1.20	1.30	1.40	1.50	1.75	2.00
30-year Treasury (%)	2.85	3.02	2.61	2.28	2.00	2.10	2.20	2.25	2.30	2.40

the spring. Spending power should remain supported by 'lower-for-longer' borrowing costs and prices at the gasoline pumps. Combined interest- and energy-related expenses represent less than 14% of personal disposable income, 5 percentage points lower than the almost 19% peak recorded in 2008.

U.S. consumer expenditures on goods & services are expected to advance by an average of 2.7% in both 2016 and 2017, representing roughly 90% of overall growth. There is still some upside potential for 'big-ticket' sales. New motor vehicle purchases should continue to grow, though the rate of increase should moderate to an annualized level of 17.7 and 18.0 million units this year and next now that sales have surpassed highs set at the start of the millennium. Replacement demand is still a driving force with the average age of a vehicle on U.S. roads at a record 11½ years. Similarly, sales of new and existing homes should continue to trend higher. Demographic factors are very supportive with an increasing number of employed 'millennials' bolstering household formation and the demand for dwellings. Confidence is being reinforced by steady employment and wage gains, lower financing costs with the 30-year mortgage rate dropping to just under 3.5%, and increased credit availability. U.S. home construction is set to increase at a double-digit pace this year and next to annualized rates of 1.24 and 1.38 million units respectively with the inventory of unsold homes at a 30-year low. Renovation activity continues to build momentum as the expanding number of homeowners focus on upgrades to their residences.

Chart 4



Source: Bloomberg, IMF, Scotiabank Economics.

Nonetheless, the outlook for U.S. consumer spending has been marked down slightly, reflecting the elevated uncertainty around the world and reduced growth performances in most regions. U.S. households are likely to be more cautious spenders in this environment. The negative spillover from the U.S. energy-related problems — significantly lower shale oil production and the hefty contraction in business investment — has resulted in a slower pace of job creation and service-sector activity. Although the overall unemployment rate dropped in May to a cycle-low of 4.7%, it was the result of an unexpected and unwelcome slide in labour force participation. Moreover, the upcoming Presidential election will likely be waged on populist and anti-globalization platforms by the presumptive party nominees that could potentially aggravate consumer anxieties.

The rebound in housing-related activity has been tempered as well. Affordability has eroded in many cities/regions where job markets have typically been much stronger, and home price appreciation has been more evident. As well, record student debt burdens for both 'Generation X-ers' (born between1965 and 1980) and 'Millennials' (born after 1980) are an impediment to even stronger home sales, although supportive of a further build-up of the stock of rental accommodation.

… WHILE INDUSTRIAL ACTIVITY AND TRADE STILL LAG

Net trade continues to be a recurring drag on U.S. growth. This reflects both the persistent weakness in U.S. exports, and until recently, relatively solid imports. Reduced demand for U.S.-made products is directly attributable to the global slowdown, while the strong U.S. dollar has undermined competitiveness and shipments since the U.S. has reported a larger fall-off in exports than most of its major international trading partners (Chart 4).

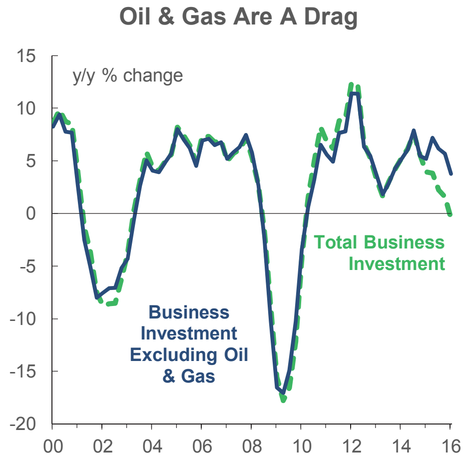
Export growth has throttled back sharply over the past year due to the double-digit slide in the prices of crude oil and other commodities, foodstuffs for example, and the associated retrenchment in resource-based manufacturing. Exports have

Table 2 — United States

	2000-14	2015	2016f	2017f
		(annual % change)		
Real GDP	1.9	2.4	1.9	2.2
Consumer Spending	2.3	3.1	2.7	2.7
Residential Investment	-1.7	8.9	9.6	5.0
Business Investment	2.4	2.8	-0.9	2.9
Government	1.0	0.7	1.0	0.8
Exports	4.0	1.1	1.0	2.8
Imports	3.4	4.9	1.4	3.9
Nominal GDP	4.0	3.5	3.2	4.3
GDP Deflator	2.1	1.0	1.3	2.0
Consumer Price Index	2.4	0.1	1.6	2.4
Core CPI	2.0	1.8	2.2	2.3
Pre-Tax Corporate Profits	6.3	-3.1	-3.0	5.0
Employment	0.5	2.1	1.7	1.4
Unemployment Rate (%)	6.4	5.3	4.8	4.7
Current Account Balance (US$ bn.)	-525	-463	-507	-544
Merchandise Trade Balance (US$ bn.)	-661	-763	-760	-812
Federal Budget Balance (US$ bn.)	-535	-439	-500	-530
per cent of GDP	-3.9	-2.4	-2.7	-2.7
Housing Starts (mns)	1.29	1.11	1.24	1.38
Motor Vehicle Sales (mns)	15.2	17.3	17.7	18.0
Industrial Production	0.8	0.3	-0.9	2.5

dropped in every manufacturing subsector this year, except for transportation equipment. The downturn is most evident in exports of machinery (especially those geared to the construction industry, as well as mining and oil & gas) and food products, with both sectors posting double-digit slumps. These two industries account for more than one-third of the slowdown in overall U.S. manufacturing exports this year — more than double their 16% share of exports. U.S. exports of higher value-added products such as high-tech equipment have declined a more modest 4% on a y/y basis.

Chart 5



Source: BEA, Scotiabank Economics.

The ongoing weakness in U.S. exports and industrial activity has put increasing pressure on corporate profitability, notwithstanding Washington's extension of several business and tax credits including accelerated depreciation. Earnings have dropped by a sizeable 5.7% y/y in Q1, with the significant correction in crude oil prices from mid-2014 until early this year accounting for more than half of the overall slump. However, the fall-off in earnings has moderated from an 11.5% slide in the final months of 2015, as the price of crude oil has jumped by more than 50% since mid-February. While businesses continue to face an ongoing squeeze on margins, we expect earnings growth to resume later this year, and advance by roughly 5% in 2017 alongside the gradual firming up in U.S. and global economic activity.

U.S. businesses have been pulling back on capital expenditures, especially in resource-related sectors. Investment by the oil & gas and agricultural sectors in machinery and logistics equipment has slumped by more than 30% over the past year, accounting for nearly all of the slowdown in business spending. While investment has also moderated in other industries, excluding the oil & gas sector spending continues to increase 4% y/y (Chart 5) and is even faster in some high value-added sectors, such as the high-tech and medical industries. The sluggish growth trajectory will continue well into the second-half of the year as businesses attempt to reverse the run-up in inventory-to-sales ratios which are evident across virtually all sectors, retailers, manufacturers and wholesalers alike. Building upon, or at least sustaining the recent rebound in the price of crude oil, is key to ending the sizeable inventory correction. Nevertheless, the elevated uncertainty surrounding the global economic outlook in this post-Brexit period will reinforce a 'wait-and-see' attitude towards major U.S. business investment decisions.

DOWNSIDE AND UPSIDE RISKS

Elevated financial market volatility and increased economic uncertainty following the U.K referendum result to 'leave' EU membership will dampen U.S. and global growth prospects already weakened by persistent structural challenges. Inflation pressures will be slow to build momentum (Chart 2). The November 8th Presidential election has the potential to add to the heightened level of economic uncertainty in the U.S. The presumptive nominees of both major political parties have espoused platforms which include populist and protectionist policies that could aggravate U.S. fiscal imbalances and impair existing trading relationships. The U.S. federal deficit is already on course to widen relative to GDP in fiscal 2016, the first deterioration since 2009, as revenue growth slips to less than 3% alongside the allowed increase in discretionary expenditures.

A faster deceleration in China's growth would add to the downside risks to the U.S. outlook. Reduced import demand would negatively impact U.S. exports of valued-added goods & services. Commodity prices and overall inflation would come under increased downside pressure. Any significant weakness in the yuan would have a destabilizing effect on the globe's financial markets.

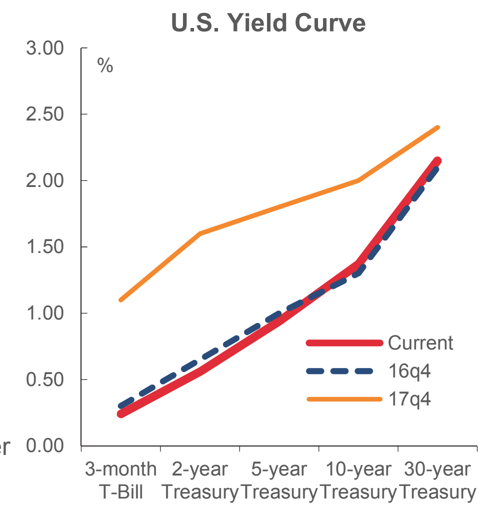
Although we expect the Fed to defer rate hikes for the time being, there is a risk that rising U.S. wage pressures could trigger a faster pace of inflation and renewed interest rate increases. In the event, the U.S. dollar would likely strengthen further and add to the drag on exports and industrial activity in the absence of a more discernible pickup in economic activity in Japan, the U.K. and the Eurozone.

On a more positive note, any reduction in the myriad of the globe's geopolitical problems would help to reduce U.S. spending caution. Some post-election resolution on a range of policy issues, from constructively adjusting Obamacare to corporate tax restructuring, could offer some upside potential to U.S. growth. Moreover, the trend in U.S. output growth could be stronger-than-expected if domestic-led spending — housing activity in particular — builds even greater momentum on the back of 'low-for-longer' borrowing costs. A further rise in the price for crude oil would substantially improve prospects for business investment.

U.S. FINANCIAL MARKET FORECASTS

We forecast the Federal Reserve to remain on hold until at least next spring with a first hike projected in the second quarter and followed by two more over the second half of the year. This is a significant change in the forecast pace of rate increases that nevertheless remains less rate bullish than markets at present. Our revised forecast is driven less by concern over U.S. domestic fundamentals and more by the likely pressures upon the U.S. dollar and the escalation of risks facing the international backdrop. Both forces arise through the outcome of the U.K. referendum that raises event risk and applies additional downward pressure upon European and global growth. The effect incites previously unexpected easing measures by other global central banks including the Bank of England, ECB and Bank of Japan that impact the outlook for the Federal Reserve.

Chart 6



Source: Scotiabank Economics, Bloomberg.

The result makes the so-called "carry trade" out of yet lower-yielding assets abroad into higher-yielding assets in the United States (and Canada, Australia, emerging markets, etc.) more favourable and with concomitant upward pressure upon the USD which further reinforces our long-held USD bias.

As such, longer-term U.S. Treasuries will remain overwhelmingly driven by central bank policy measures. Lower yields abroad raise demand for higher-yielding Treasuries and adjust their prices upward in a low-for-long yield environment that has us projecting that the yield on U.S. 10-year Treasuries will fall to 1.2% before rising to only 2% by the end of next year. There is downside risk to that terminal forecast. A proxy relationship between nominal U.S. 10-year Treasury yields and nominal GDP growth that worked better as a rough valuation framework until more modern times should have yields trading between one and two orders of magnitude higher than where they are at present. This is the main point regarding the very limited use of historical relationships to predict sovereign bond yields today. The forces that have separated this relationship are principally driven by the following:

a) A steep decline in neutral policy rates.

b) Global central banks have induced relative scarcity of tradable bonds through their quantitative easing ("QE") programs that will only become more acute through 2017.

c) Central banks have driven policy rates negative in Europe ex-U.K. and Japan which drags down the global term structure of interest rates.

d) The ECB's move to allow financial institutions to borrow down toward the negative deposit rate makes everything with yields above this negative funding cost more attractive even if yielding a negative return in a case of how two negatives can indeed make a positive.

We are assuming that such forces will persist throughout our forecast horizon as global developments and central bank policy abroad have unfolded in unanticipated ways. Now more than ever the global bond market is in uncharted waters.

Mexico

CONTACTS

Mario Correa
5255.5123.2683 (Mexico)
Scotiabank Mexico
mcorrea@scotiacb.com.mx

UNDER A DIFFERENT LIGHT?

- **Mexican Peso under pressure given Brexit-related uncertainty.**
- **Domestic consumption will outperform other sectors of the economy.**

UNCERTAIN ECONOMIC OUTLOOK

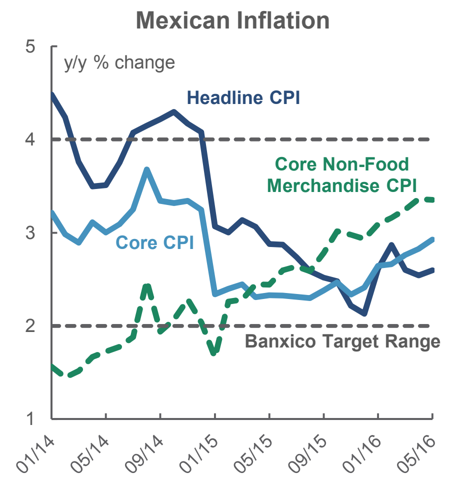
The acclaimed poet Mario Benedetti once said: "when we thought that we had all the answers, suddenly all the questions changed". Of course he was most likely thinking about life, though there is a striking resemblance to the economic outlook for Mexico, and perhaps for many other countries. The recent Brexit vote cast a veil of fog on the economic horizon for the global economy and for international financial markets. While Mexico is relatively insulated from economic risks in Europe, with the E.U. region accounting for less than 5% of all Mexican exports, the Peso suffers harshly due to global risk events since it acts as a proxy for emerging markets currencies and the country is highly integrated to global financial markets. For Mexico, this event represents a tougher financial environment, less abundant capital flows and serious challenges for economic policymakers. It is quite unclear how deep and lasting the effects of Brexit will be, so the economic outlook for Mexico is subject to a higher than usual degree of uncertainty. It is very likely that we will be revising the macroeconomic framework in the coming months as we learn more about this and other pending issues.

For the time being, Mexico presents fair economic prospects for the remainder of this year and next. GDP is expected to show sub-par growth of 2.4% this year followed by 2.8% in 2017, with a very contrasting performance among economic sectors. Domestic market sectors are expected to perform better, driven by increases in population, the gradual recovery of the middle and high income classes, the positive trend in job creation and the abundance of credit to the formal sectors of the economy. Therefore, private consumption is expected to grow by 3.1% in 2016 and 3.2% in 2017. Among the areas of growth in the economy, the outperforming sectors — growing above 3% annually — will be commerce & hospitality, transportation, warehousing & telecommunications, and financial services & insurance. As the U.S. economy recovers and the effects of a depreciated currency in Mexico kick in, manufacturing production is expected to improve. On the other hand, sectors related to the harshly hit oil industry are expected to underperform, mainly mining and the chemical industry.

In a tougher global environment, it is clear that Mexico needs to strengthen its macroeconomic fundamentals. As a consequence, there is a significant fiscal adjustment under way, in order to reach a primary budget surplus to curb down public debt. This adjustment means a significant cut in public spending, which is expected to have a deep impact on public investment and a negative effect on total investment.

As a result of harsher conditions in global markets, the MXN is expected to remain under pressure at undervalued levels. It should be noted that the FX forecast is subject to a great deal of uncertainty, and is likely to show wild movements in the

Chart 1



Source: Scotiabank Economics, INEGI.

Chart 2

Source: Scotiabank Economics, Bloomberg.

remainder of the year. Under current circumstances, we expect the Mexican peso to oscillate heavily and average 18.6 pesos per dollar in the 2nd half of the year, and around 18.0 pesos in 2017.

TIGHTENING MONETARY POLICY

Inflation has remained contained for more than a year, though there are pressures building on merchandise prices due to currency depreciation. Once the favorable shocks that are restraining inflation fade, it is likely that we will observe an increase in prices in the second half of 2016 and during 2017 though close to Banco de Mexico's 2-4% range. Of note is the clear upward trend in the core non-food merchandise component of the CPI.

As a consequence of uninterrupted pressures on the exchange rate, and the growing risk that this depreciation will translate into higher inflation expectations and inflation dynamics, we are expecting Banco de Mexico to act more decisively on monetary policy, thus increasing its reference interest rate to shield the economy from external factors and preserve the macroeconomic stability of the country. We are thus expecting the overnight interest rate to reach 4.50% by year's end and 5.50% by the end of 2017.

MARKET SENTIMENT DRIVEN BY EXTERNAL FORCES

As is the case with many other countries, Mexican financial markets will be mainly reacting to external developments, primarily to monetary policy actions of the U.S. Federal Reserve. It is likely that every time the Fed increases its reference interest rate, Banco de Mexico will follow. However, prospects for U.S. monetary policy are also uncertain, particularly following the Brexit vote. We are expecting a non-hiking Fed for the remainder of 2016, but if the Fed proves to be more aggressive and increases interest rates this year, it is likely that Banco de Mexico response will be even firmer.

U.S. economic growth is also a relevant factor for the Mexican economy, since more than 80% of the country´s exports go north of the Rio Bravo. Auto sales in the U.S. are a key driver of manufacturing output in Mexico, thus any significant weakening in vehicle purchases will be significantly felt on Mexican industrial activity, exports and pace of economic growth.

Given his radical comments on trade and bilateral relations, if Mr. Trump becomes elected as the next U.S. President, it is likely that Mexican markets will be severely affected. This possibility lingers as one of the main risk factors for the Mexican economy.

International oil prices are another relevant factor for market sentiment, since public finances are still heavily dependent on oil revenues, and the explicit backing up of Pemex will be more costly with lower oil prices.

KEY NEAR-TERM DOMESTIC ISSUES

The close link between Pemex and Mexico´s public finances highlights the importance that the state oil firm presents a convincing financial and operating adjustment plan in the face of a new reality in the oil industry. Only then, could the public finances be sustainable and beyond the suspicions of rating agencies and financial market participants.

The Federal government has anticipated a significant budget cut that will warrant fiscal soundness in coming years, with details yet to be revealed. The 2017 budget will need to be convincing enough for the markets to believe that macroeconomic stability is not at stake and Mexico can successfully navigate through the difficulties that lie just ahead in the global economy.

United Kingdom

CONTACTS

Alan Clarke
44.207.826.5986 (London)
Fixed Income Strategy
alan.clarke@scotiabank.com

BREXIT UNCERTAINTY LIKELY TO CAUSE RECESSION

- **We have revised down our GDP growth forecast substantially in light of the outcome of the Brexit vote. We expect a mild recession in 2016 followed by a flat economy in 2017.**

- **The sharp weakening in the GBP exchange rate points to a sharper acceleration in inflation than previously thought, with CPI inflation reaching 2% y/y by the middle of 2016.**

- **The Bank of England Governor has signalled that policy easing is likely during the summer. We expect 50 bps of rate cuts in July, with additional QE also possible in August.**

The U.K.'s decision to leave the EU has thrown the U.K. economic outlook into doubt. We have revised down our GDP growth projection substantially; down to 1.3% y/y for 2016 and 0.0% y/y for 2017. Both compare to close to 2.0% y/y previously. While that is an abrupt downward shift, it is based on only a very mild and short recession. There is considerable uncertainty around that central case; the downturn could plausibly be rather more, or less severe. Upcoming survey indicators on investment intentions and consumer confidence will give us the best early clues.

Indeed, the main sources of downside for the growth outlook are: shrinking investment and softer growth in consumer spending;. These are offset to some extent by a bigger contribution from net trade.

More specifically, investment projects that were in the pipeline are likely to be put on hold for a prolonged period, or cancelled outright. The main reason to expect investment to shrink is uncertainty. Until it becomes clear what trading relationships the U.K. may ultimately have with the rest of the world, or whether the U.K. will actually end up leaving the EU, firms are likely to sit on their hands. In contrast to the collapse in investment during 2008-09, we do not expect the situation to be exacerbated by a seizure in the financial system. Our starting point is a drop in investment around half as big as the fall that we saw in 2008-09 — i.e. a contraction of between -5% y/y and -10% y/y by mid-2017.

Meanwhile, we expect consumer confidence to fall in the months ahead, provoking an increase in the savings ratio. In turn that should cause the pace of consumer spending growth to decelerate.

Close to 50% of the adult population will have been disappointed by the outcome of the referendum. Given the subsequent violent financial market reaction and numerous reports of 'leave' voters who now regret doing so, the setback for confidence could be even bigger.

Furthermore, household disposable income growth is likely to suffer, reinforcing the brake on consumer spending growth. In particular, employment growth is likely to stall as firms refrain from hiring amid the increased uncertainty. Restraint in wage inflation could amplify this effect. Last but not least, an increase in the outlook for

Chart 1

U.K. GDP Growth With Updated Forecast

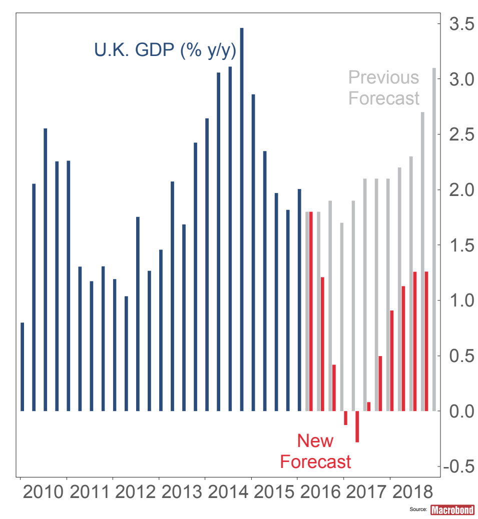
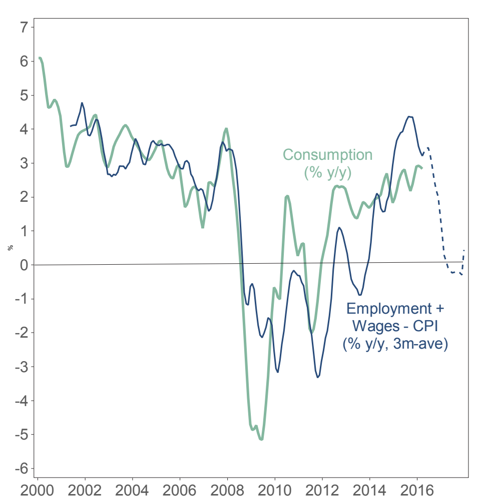


Chart 2

U.K. Consumption vs Real Disposable Income Proxy



inflation on the back of the GBP weakness (more details below) would mean a three-way hit for household disposable income. The net result is a somewhat slower path for consumer spending growth.

One possible partial offset is that, since import growth is highly correlated with domestic demand growth, the deceleration in domestic demand that we forecast would also imply a slowdown in import growth (which is a boost to GDP growth). Meanwhile, at face value, the sharp weakening in the GBP exchange rate should be a boost to exports. However, this would backfire if global demand growth suffers in light of the shockwaves from the Brexit vote.

INFLATION

We have adjusted our profile for CPI inflation upwards, largely due to the sharp fall in the GBP exchange rate. Perhaps the most significant lesson since the financial crisis has been not to underestimate the impact of major exchange rate movements (in either direction) on inflation.

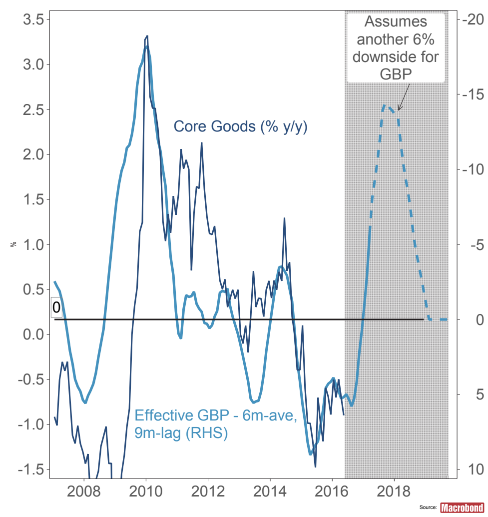
The most immediate impact of the weakening in the GBP exchange rate is likely to be a rise in road fuel prices. This should become visible almost immediately and add around 0.1% to headline inflation, with the effect lasting for a year.

In isolation, the near 15% depreciation in the trade-weighted GBP exchange rate since late last year points to an acceleration in core inflation of just over 1%. The lag between the GBP and inflation does vary, but we would assume around a 6 month delay in pass-through. Hence our judgement is that the boost to inflation from higher import costs will start to become evident from the autumn onwards.

However, the situation is not black and white. Given the assumption that the U.K. is headed for recession, retailers' pricing power is likely to be impeded. That is likely to be particularly true for services components of the CPI which reflect domestically generated inflation. These components account for close to half of the weight in the overall CPI basket, and could hold back the rise in overall inflation. So while we have shifted our profile for inflation somewhat, our sense is that the market is aiming even higher and could be disappointed.

Chart 3

U.K. Core Goods Inflation vs GBP Exchange Rate



MORE ACCOMMODATIVE MONETARY AND FISCAL POLICIES TO COME

The Bank of England Governor, Mark Carney, has signalled that policy loosening is likely during the summer. The only dilemma now is how much and when? The Governor's speech suggested that it was doubtful that Bank Rate would fall below zero since that could cause more harm than good. Hence the emphasis of monetary policy is likely to shift to further quantitative easing once conventional interest rate ammunition has been exhausted. That is, of course, if the Bank's inflation projection justifies it. In the very near term, we believe that the BoE has 3 options:

1. Do nothing in July, then cut Bank Rate in August;
2. Cut Bank Rate by 25 bps in July, followed by a further 25 bp cut in August as well as QE; or
3. Cut Bank Rate by 50 bps in July, followed by QE in August.

We put a low probability on option 1. Mark Carney called this speech and made a pretty blunt hint that interest rates are going to be cut. To deliver nothing at the July MPC meeting would be a disappointment. Our judgement is that it is a very close call between options 2 and 3. But on balance, we favour option 3. We expect a 50 bp rate cut in July, followed by further QE at the August MPC meeting.

Meanwhile, the path for fiscal policy will depend on the stance of the next Chancellor. The current front-runner to be the next Prime Minister, Theresa May, has said that her Government will abandon plans to reach a budget surplus by the end of the parliament. In other words, the severity of the austerity programme is likely to be substantially reduced. At present, the structural deficit is projected to narrow by around ¾% of GDP per year. We suspect that, at the very least, the Budget will turn neutral in the very near term amid near zero GDP growth. Thereafter a more moderate pace of fiscal consolidation will resume.

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Eurozone

BREXIT UNCERTAINTY PRESENTS DOWNSIDE RISKS TO GROWTH AND INFLATION

- **We have downwardly revised our growth forecast in light of the outcome of the U.K.'s Brexit vote. We now expect Eurozone real GDP to advance by 1.4% in 2016 and 1.1% in 2017, down from a prior estimate of 1.5% and 1.6%, respectively.**
- **Inflation is expected to modestly accelerate in the second half of this year and into 2017 on the back of positive base effects from energy prices. However, the slower growth trajectory due to Brexit has dampened our outlook for Eurozone inflation, which is forecast to remain below the European Central Bank's (ECB) close to, but below, 2% target through 2018.**
- **Against a backdrop of softer growth and medium-term inflation expectations, the ECB will likely unveil further monetary stimulus as early as its September meeting in the form of an additional cut to its deposit rate and a modest change in the capital key to facilitate greater leeway on government bond purchases. The ECB could also look at options to extend its quantitative easing program, possibly by tying its duration to an inflation target.**

GROWTH PROSPECTS WEAKEN AMID BREXIT JITTERS

The Eurozone's economic recovery remains volatile, which will be further exacerbated by Brexit over the coming quarters. Following a stronger-than-expected real GDP growth print in the first quarter (+0.6% q/q), the Eurozone economy will likely experience a soft patch in Q2. Indeed, the weak trend in both industrial production and retail sales (Chart 1) at the end of the first quarter already creates a negative carryover entering into Q2 and, at this stage, we expect second quarter growth to slow to around 0.2% q/q. However, beyond this, the recovery seen in various business surveys over the past two months (Eurozone PMI manufacturing, German Ifo) as well as in consumer confidence points to a reacceleration during the summer with Q3 real GDP growth likely to edge back up to around 0.4% q/q.

However, the Brexit vote is a deflationary shock and will negatively impact business confidence in the months to come. Its magnitude is difficult to assess, but upcoming business surveys will provide the first clue on potential short-term risk. In this context, Eurozone economic activity could once again enter into a soft patch in Q4 and in the first half of 2017, likely led by lower investment spending, as corporates turn more cautious. A correction could also be felt through trade channels while consumers may be less willing to spend if recent improvements in the labour market fade.

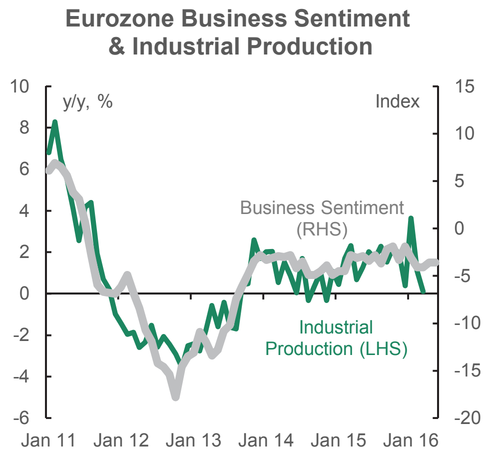
The negative impact from Brexit on the Eurozone economy (Chart 2) is forecast to be relatively marginal this year. The U.K.'s vote to leave the EU has prompted us to modestly lower our Eurozone real GDP growth forecast for 2016 to 1.4%, down from a prior estimate of 1.5%. Recent comments from ECB President Mario Draghi suggest that the impact of Brexit could lower growth by a cumulative 0.3% to 0.5% over the coming three years. We assume that the impact will be greater and that most of the correction will be felt in 2017. Accordingly, we have lowered our real GDP growth forecast for next year to 1.1% from a prior call of 1.6%.

CONTACTS

Erika Cain
416.866.4205
Scotiabank Economics
erika.cain@scotiabank.com

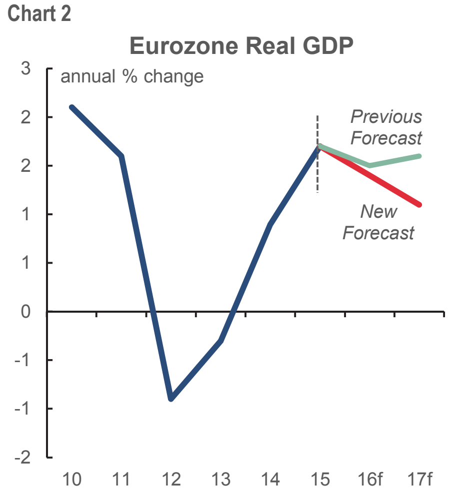
Frédéric Prêtet
33.1.703.77705 (Paris)
Fixed Income Strategy
frederic.pretet@scotiabank.com

Chart 1



Source: Bloomberg, Scotiabank Economics.

Chart 2



Source: Eurostat, Scotiabank Economics.

While the ECB's asset purchase program has helped limit the asymmetric financial shock in core and peripheral Eurozone countries (yields on peripheral sovereign bonds have remained relatively anchored vs. yields in core countries), the impact on sentiment and economic activity across euro area states could vary due to:

- The countries' trade relationship with the U.K.: On this issue, geographic proximity matters in general, with the countries closest to the U.K. encompassing the strongest economic links, and therefore, facing the greatest downside risks to growth from reduced trade flows. As such, Ireland, the Benelux and Northern Europe will likely prove more sensitive to trade bottlenecks than southern countries, with the exception of Malta & Cyprus, which rely relatively more on U.K. demand. Furthermore, given the traditional sensitivity of the German car industry to the U.K. economy, the next German Ifo surveys will be worth watching to assess the risks posed by Brexit to the country's vital auto sector.
- The strength of the banking sectors. Indeed, financial sector profitability is likely to be sensitive to the drop in interest rates, the lack of recovery in the credit cycle, rising costs due to re-allocation, and less M&A flows. It is worth noting that the plunge in equity markets since the referendum has been mainly driven by falling bank share prices. This increases the risk of a retightening in credit conditions mainly in Eurozone peripherals countries with relatively weak banking sector fundamentals, particularly with banks still dealing with a high burden of bad loans. However, bank funding costs for high quality borrowers remain historically low and the central bank will continue to ensure ample financial sector liquidity.
- Political risks: The EU and the Eurozone have already experienced various political risks in recent years, which have fuelled economic and financial market volatility. While the Spanish elections in June following the Brexit vote yielded stronger than expected support for the conservative party, there is still a high risk of political paralysis as demands from nationalist/populist parties across the EU could grow as they also attempt to secure a special status in the European economic and trade bloc. In this regard, there are numerous important elections in the year to come in key Eurozone countries like Italy, the Netherlands, France, and Germany, which could further exacerbate business and consumer uncertainty.

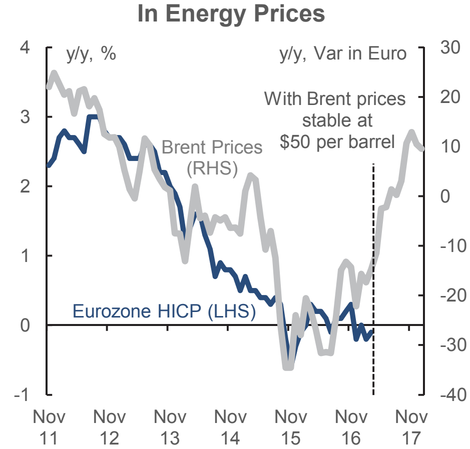
INFLATION TO GRADUALLY ACCELERATE YET AT A SLOWER PACE FOLLOWING BREXIT

After Eurozone inflation moved back into positive territory at 0.1% y/y in June, the Brexit vote has refuelled concerns of deflationary risk in the Eurozone. Indeed, medium-term inflation expectations have moved lower, with the highly watched 5y in 5y inflation swap falling to a record low of 1.3%, well below the ECB's inflation target of close to, but below, 2%.

Despite this unwelcomed decline, we believe that the ECB will maintain a wait and see approach in order to assess the full impact of Brexit before unveiling further monetary stimulus. However, the ECB's September meeting is an important one to watch as the ECB staff's new macroeconomic projections will be released and should provide the first assessment of the potential downside risks to inflation. It is worth highlighting that, before the U.K. referendum, the ECB was in the process of starting to revise its inflation forecasts upwards, albeit at a very modest pace. Indeed, the ECB's inflation forecast in its latest quarterly macroeconomic projections report for June was revised up slightly to 0.2% y/y this year from 0.1% in March, while 2017 and 2018 were left unchanged at 1.3% and 1.6%, respectively. Looking ahead to September, the factors that we believe could facilitate further changes to these forecasts are broadly neutral.

Chart 3

Eurozone HICP & Base Effects In Energy Prices



Source: Bloomberg, Scotiabank Economics.

- Energy: Despite the Brexit vote, Brent prices have shown some resilience and have remained relatively stable in euro terms. As such, the impact of significant favourable base effects from energy prices on inflation in the second half of 2016 and the beginning of 2017 still looks valid (Chart 3).
- The exchange rate: Despite rising volatility in FX markets, the euro nominal exchange rate has remained roughly stable over the past month. Therefore, at this stage, it should not have a significant impact on the Eurozone inflation outlook.
- Growth: We believe that reduced growth momentum presents the largest downside risk on inflation. While the magnitude of the shock remains uncertain and is difficult to quantify at this time, recent comments from the ECB president suggest that a 0.5% cut in GDP growth for the coming three years could be the central bank's baseline scenario. The elasticity between GDP growth and inflation is not stable over time and is highly dependent on the nature of the shock on economic activity (past ECB studies suggest

that a negative shock from investment has less impact on inflation than a demand shock). In our assessment, we have used a recent elasticity suggesting that a 1% drop in Eurozone GDP growth over a three year horizon could lower inflation by around 0.7%. So, the above-mentioned 0.5% GDP drop could impact medium-term inflation by around 0.3%-0.4% over the forecasted horizon.

In this context, short-term ECB inflation forecasts will likely remain roughly unchanged and we believe there is not a sufficient argument to change our expectations of Eurozone inflation moving up to a year-end rate of 0.8% y/y in 2016 and 1.2%-1.3% early next year. Inflation will likely remain stuck around this level through the end of 2017, at 1.4%. However, it is true that the ECB might be forced to cut its medium-term inflation forecasts, possibly by 0.1% in 2017 and, more significantly in 2018, by 0.2%-0.3%.

EXPECTATIONS FOR ADDITIONAL MONETARY STIMULUS ARE ON THE RISE AGAIN

From a monetary policy standpoint, an entrenched low inflation regime will not be seen as satisfactory and would likely trigger new stimulus. This would also be a way to mitigate the elasticity between the negative impacts of GDP growth on inflation.

What are the stimulus options? We believe that the ECB will likely have to extend its QE program and could move towards using more open ended language on the program's duration by tying it to an inflation target. However, the challenge is that government bonds in some countries are limited in supply and further constrained by capital key requirements. Indeed, there are not enough German bunds to be bought. Therefore, in view of the rally in government bonds, and the associated decline in yields, following the Brexit vote, the ECB's ability to prolong the length of its QE program beyond March 2017 or increase the scale of monthly purchases to more than €80bn could be difficult under the program's current format (yields above the deposit rate of -0.4%, 33% limit on each issuance, 2Y/30Y maturities). As such, the options could be:

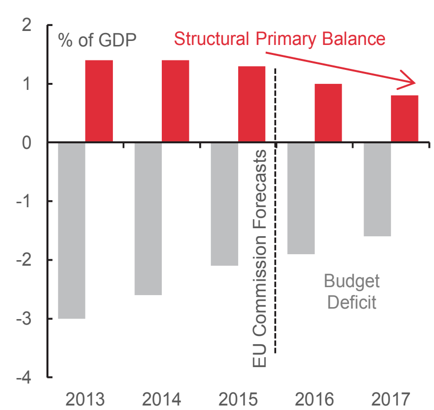
1. **Cutting the deposit rate further.** However, this could damage banks' profitability. As a result, the ECB could be forced to adopt a multi-tiered deposit rates system.
2. **Changing the capital key.** While a small adjustment could be tolerated, it could create some tensions inside the ECB board from a country like Germany. Indeed, this would suggest the central bank is ready to carry a greater "credit risk" than the Eurozone's average. However, one of the possibilities for the ECB could be to use "a mini OMT (outright monetary transactions)". Following the recent ruling from the German constitutional court which judged the OMT in line with the ECB mandate, there could be more leeway from the ECB on this front, focussing on shorter maturities (up to 4Y/5Y) in order to limit the credit risk.
3. **Extending the list of assets being purchased.** Possible options could be to buy bank loans or to broaden the scope of the ECB's QE on the ABS program. So far, the ECB only buys securities above a certain threshold. However, the impact has been relatively muted with the amount bought each month just around €1-€1.5bn. Both options could offer support to the banking sector as well as some leeway to prolong the QE program at a time when the available supply of German bunds is becoming more and more scarce as yields are falling. However, as the EU financial regulations have moved from a "bail out" to a "bail in" process to solve future banking crisis, central bank intervention could be viewed as backing off tighter regulations imposed in recent years.
4. **Shifting to other instruments.** This could refuel the debate on "helicopter money" although, at this stage, it could look premature. The ECB will likely want to be sure that the Eurozone is entering into a new recession/deflationary cycle before considering this option.

In view of all these constraints, option 1, and possibly 2, could be the easiest and the quickest to put in place, which would in turn fuel a further rally in short dated bonds.

FISCAL POLICY SET TO BECOME SLIGHTLY MORE SUPPORTIVE OF GROWTH

Thanks to the ongoing cyclical improvement and lower interest payments as yields have continued to move lower, the Eurozone aggregate budget deficit should see a further reduction from -2.1% of GDP in 2015 to -1.8% this year (Chart 4). However, compared to the previous years, the pace of improvement is slowing down as austerity is being phased out and fiscal policy is turning slightly expansionary for the first time in many years. The EU Commission expects the primary cyclically adjusted budget balance to move from a surplus of 1.3% of GDP last year to 0.8% in 2017 due to tax cuts and increased government spending to accommodate the influx of asylum seekers. This means less of a drag on GDP growth from fiscal policy over the coming two years. Deficit increasing policy measures will also halt the improving trend seen in the Eurozone's aggregate structural balance in recent years. After being broadly neutral in 2015, the EU commission projects that the structural budget deficit will widen to -1.3% of GDP in 2016 from -1.0% in 2015.

Chart 4 **Eurozone Budget Balance**



Source: Bloomberg, Scotiabank Economics.

Brazil

DEEP MACROECONOMIC ADJUSTMENT & LEADERSHIP IN TRANSITION

- **The country's central bank attempts to tackle high inflation with economically restrictive increases in its policy rate, amid elevated unemployment and depressed business and consumer confidence.**
- **Brazilian Real expected to remain broadly stable following a large appreciation this year making it the best performing emerging market currency in 2016.**

THE FISCAL SITUATION HAS DETERIORATED SIGNIFICANTLY

The transition government inherits an economy in deep recession with an unsustainable fiscal deficit, exacerbated by a profound confidence crisis. Real GDP contracted by 5.4% y/y in the first quarter of the year, marking the eighth consecutive quarterly decline in annual terms. We estimate the Brazilian economy will contract by 3.8% this year before returning to modest positive growth in 2017. Industrial production is in steep decline, contracting by 10% in the 12 months to April 2016. The combined effect of high unemployment (11.2% as of April, the highest in core Latin America) and persistently high inflation (9.3% y/y in May) has put households in retrenchment mode, prolonging the recession. Gross fixed capital formation and private consumption collapsed by 17.5% y/y and 6.3% y/y, respectively, over the same period.

Fiscal consolidation is paramount. The consolidated public sector balance registered a deficit of 10% of GDP as of April, while the primary deficit (excluding debt service) was 2.3% of GDP. The external sector is a clear reflection of the deep economic contraction under way. Total imports have collapsed by 30% while exports fell by 9% in the 12-month period ending in May. The sharp import compression has been a major contributor to reduce the balance of payments' current account deficit to 2.4% of GDP by the end of the first quarter of the year, an impressive adjustment from the 4.5% of GDP imbalance recorded 12 months ago. Looking ahead, we project that the current account gap will continue to narrow to close the year at 1.2% of GDP.

REGIME CHANGE SHOULD STABILIZE SITUATION

Presidential elections are scheduled for October 2018. A new (elected) President will take office on January 1st, 2019. The (up to) 180-day impeachment period will end with a vote by the Senate to terminate Dilma Roussef's elected mandate (she is now suspended). A two-third majority is required to end Dilma's term. Any vote count below that will mean that Dilma will return as President. Our base case assumes that the Senate vote is likely to occur likely by October. Interim President Michel Temer will succeed her as President to complete the presidential term until the end of 2018. There is also a probability that Temer may also face corruption allegations. Under this scenario, the head of the Lower House will be named acting President until December 2018. After the Senate vote on impeachment, he becomes a legitimate President in accordance with the Constitution.

CONTACTS

Pablo Bréard
416.862.3876
Scotiabank Economics
pablo.breard@scotiabank.com

Juan Manuel Herrera
416.862.3174
Scotiabank Economics
juanmanuel.herrera@scotiabank.com

Chart 1

Source: Scotiabank Economics, IBGE.

Chart 2

Source: Scotiabank Economics, IBGE.

RELATIVE EXCHANGE RATE STABILITY AFTER EXTERNAL MACROECONOMIC CORRECTION

The external sector adjustment is proceeding well. The current account deficit will approach the 1% of GDP deficit mark in the coming 18 years, courtesy of acute import compression and massive currency devaluation (now completed). The exchange rate environment will stabilize in the coming months leading to real FX rate appreciation over a 12-month period. Finally, Brazil counts on sizable FX reserves equivalent to 23% of GDP and 31 months of imports (the best FX reserves metric within Latin America). The fiscal adjustment remains the Achilles heel and Damocles sword of the economic outlook. It is in this front that we could also see progress after the final impeachment vote. The 12-month overall fiscal deficit at 10.1% of GDP (May) is NOT sustainable and will require massive current expenditures reduction, increase of taxes and perhaps selected privatization initiatives.

IMPROVED MARKET PERCEPTION OF CREDIT RISK DEFIES RATING AGENCIES' POSITION

Financial market metrics portray an improvement in Brazil's creditworthiness despite an adverse macroeconomic environment. As a systemically relevant emerging-market economy, Brazil will remain affected by external factors shaping global risk aversion such as political developments in the U.K. and the U.S. as well as corporate debt stress in China. Nevertheless, there is a general consensus that the central bank is aptly prepared to weather externally induced shocks in the months to come. Please note that all international credit agencies maintain a "negative" outlook on Brazil's sovereign credit ratings. On the interest rate outlook, Brazil executed a pre-emptive tightening policy when the rest of the world (developed and developing) was in easing mode. The current real interest rate environment in Brazil is the highest in the world. The tightening stance is slowly having the effect of lowering inflationary expectations, following a swift currency overshooting of the Brazil real as a result of the commodity price collapse (now ended). Looking ahead, "normalization in Brazil" means lowering, not increasing, interest rates. The current central bank reference short-term rate (SELIC) at 14.25% implies a real (adjusted by expected inflation) rate of 8.1% (the highest in the G10 economies).

FOREIGN POLICY REVISITED IN ORDER TO FAVOR DEEPER REGIONAL INTEGRATION

For decades, the Brazilian diplomatic corps (commonly referred as Itamarati) had been considered one of the best quality foreign-policy institutions in the Americas. The advent of the Labour Party, under both the administrations of former President Lula da Silva and suspended President Dilma Rousseff, led to a sharp erosion in the credibility of Brazilian foreign policy. The recent appointment of Jose Serra as Foreign Affairs Minister, extremely well received by both political and economic analysts, should be interpreted as a positive step towards rebuilding a more pragmatic Brazilian diplomacy. The reconstruction of a mutually beneficial bilateral relation between Brazil and the U.S. is of utmost relevance in the coming years. The election of President Mauricio Macri in Argentina is an encouraging development to make of Mercosur a more pragmatic trade/investment bloc in the Western Hemisphere. Of course, China will continue to play a relevant role in Brazil's international economic relations, yet the Brazil-China partnership will not be a deterrent to craft a more pragmatic multilateral approach to regional integration beyond the Southern Cone Market mechanism.

Colombia

STRUCTURAL TRANSFORMATION FOLLOWING TERMS-OF-TRADE SHOCK

- **With mining, oil and gas accounting for 70% of Colombian merchandise exports in 2014, the severe drop in commodity prices has harshly affected the country's economic performance; expanding at its slowest pace since 2009.**
- **As Colombia transitions from a reliance on energy exports, the government looks to carry out important fiscal reforms to balance the large current and fiscal account deficits.**
- **Inflation remains high, though prices will trend lower with an appreciation in the Colombian Peso and fading residual effects of El Niño.**

CHALLENGING GROWTH OUTLOOK AHEAD OF FISCAL ADJUSTMENT

The Colombian economy faces a challenging outlook. The welcomed transformation of the country's economic structure as a result of the severe terms-of-trade shock has highlighted the critical need to improve its competitiveness and diversify foreign trade markets. First quarter data highlighted the deceleration in economic activity as real GDP expanded by 2.5% y/y, down from 3.4% y/y in the fourth quarter of last year. Despite moderating economic growth, labour market conditions show a modest improvement, with the unemployment rate continuing on a general downward trend. We project real GDP to grow at an annual average rate of 2.6% in 2016-17.

MONETARY RESPONSE TO INFLATION BUILD-UP

The Central Bank of Colombia does not appear to be overly concerned about the prospects of eventual monetary policy normalization by the U.S. Federal Reserve. Colombian monetary authorities are conducting their policy in a very orthodox and well-communicated fashion. The escalation of inflationary pressures as well as the steady deterioration in inflation expectations has justified multiple decisions to increase the Banco de la República's (Banrep) intervention rate by 300 bps to 7.5% over the past ten months. Undoubtedly, the steady erosion in price stability has led many to question the effectiveness of the current inflation target range of 3% ± 1%. In inflation-adjusted terms, Banrep's policy rate remains in negative territory. The annual pace of consumer price inflation has steadily increased from 2.1% in January 2014 to 8.6% in June. The acute depreciation of the Colombian Peso as a result of the severe fall in the country's terms of trade and the effect of El Niño droughts on food prices have been at the core of such increases in inflation. The potential increase in the U.S. Fed funds' rate is not a material issue of concern now, given that the central bank continues to react to an adverse inflation scenario. Undoubtedly, further monetary tightening will take its toll in terms of economic activity in the year ahead.

TRANSFORMATION OF ECONOMIC STRUCTURES AFTER OIL CRASH

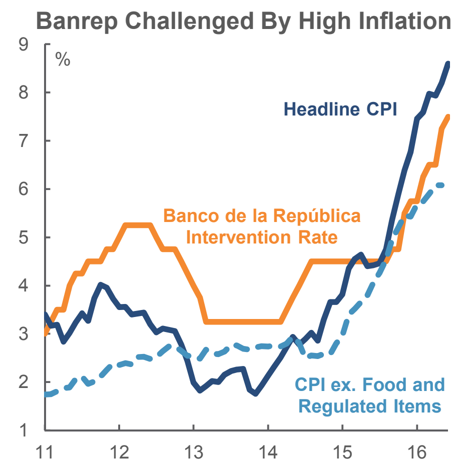
The Colombian economy is undergoing a profound structural change to diversify away from energy sector dependence. In fact, the sharp decline in crude oil prices

CONTACTS

Pablo Bréard
416.862.3876
Scotiabank Economics
pablo.breard@scotiabank.com

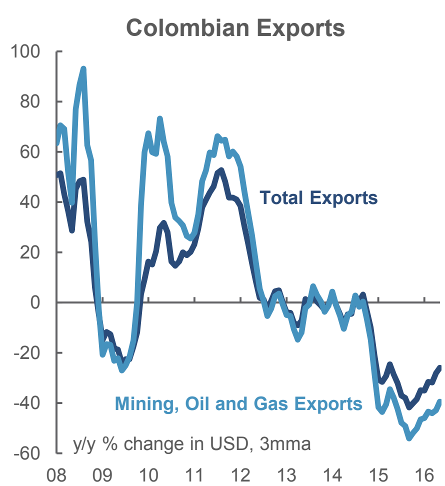
Juan Manuel Herrera
416.862.3174
Scotiabank Economics
juanmanuel.herrera@scotiabank.com

Chart 1



Source: Scotiabank Economics, DANE, Banco de la República de Colombia.

Chart 2



Source: Scotiabank Economics, DANE.

(despite the recovery in the past 4 months) led to a severe contraction in total exports (down 20% y/y in May), with only timid signs of recovery from an annual drop of 43% in September 2015. The import compression, down 17% in May, was insufficient to prevent further erosion in the balance of payments. The current account deficit, which closed last year at 6.5% of GDP, has been a major cause of deterioration in sovereign credit quality and a primary reason for a downgrade to the country's rating outlook. Looking ahead, though, the sharp exchange rate adjustment has revived the once moribund non-tradable non-oil sector of the economy.

SOVEREIGN DEBT RISK ALERT ACTIVATED; ALL INVESTOR EYES ON FISCAL REFORM

Colombia is not a major player (i.e., sovereign credit) in global fixed-income markets, accounting solely for 3.2% of the benchmark emerging market EMBIG (diversified) index. However, the country's economic leadership is embarked on boosting tradable debt issuance to increase access to a deeper pool of private-sector financing. Therefore, global investors' perception of Colombia's sovereign credit risk, as measured by the cost of insurance of government bonds implied in credit default swap (CDS), is influenced by exogenous factors beyond local control. In fact, Colombian CDS (averaging 225 bps) reflect a marked improvement in credit quality since mid-February, in clear defiance to the downgrade revision by Standard and Poor's (S&P) last February (the outlook on Colombia's "BBB+" rating was downgraded to "negative"). S&P and other market participants are eagerly awaiting the announcement and eventual approval of a structural fiscal reform, likely to happen in the second half of the year. The country's widening twin deficits (fiscal and current account) have been at the core of such negative market and rating agency moods. Absent a swift fiscal reform package, the country's rating will be vulnerable to further downgrade revisions. The external sector also remains in a relatively precarious condition, with a current account deficit estimated at around 6% of GDP, weighing on Colombia's currency and debt outlook as a Damocles sword. We are of the view that a comprehensive plan to restore fiscal sustainability and stable balance of payments conditions will likely require the ongoing rebalancing of the economy, which may lead to a temporary economic contraction.

ROBUST U.S. SUPPORT TO PEACE PROCESS REINFORCED BY IMF ASSISTANCE

Last June, the IMF awarded Colombia a two-year flexible credit line (FCL) of US$11.5 billion. The authorities have steadily repeated that there is no intention to draw on the FCL and that the IMF facility will be treated as a precautionary arrangement. Global market participants have, perhaps, a dissenting view on the subject. To date, Mexico, Colombia and Poland are the only countries that have had access to the IMF's FCL. Of utmost relevance to the U.S. is advancing the hemisphere's security agenda. Escalating illegal-drugs-related violence in many countries in the region remains a core issue of the bilateral relations agenda with the U.S.. In this regard, Colombia continues to gradually advance the process of negotiations of a lasting peace-settlement arrangement with the insurgent FARC group, under close monitoring by the U.S. diplomatic corps. President Juan Manuel Santos has promised the people of Colombia to conduct a plebiscite aimed at endorsing the peace process under way. The fiscal implications of a final peace agreement for the next generation, a contentious issue in the negotiation agenda, should not be taken lightly.

Peru

FUTURE GROWTH DEPENDENT ON A RECOVERY IN PRIVATE INVESTMENT

- **Acceleration in growth will require a recovery in private investment**
- **Inflation to remain slightly above the BCRP's target range, but slowing growth will allow the central bank to remain on hold**

CONTACTS

Guillermo Arbe
511.211.6052 (Peru)
Scotiabank Peru
guillermo.arbe@scotiabank.com.pe

ECONOMIC OUTLOOK

Peru's economy has been performing well under challenging circumstances. Although metal prices have improved in recent months, it will still be the fourth consecutive year of deteriorating terms of trade. Peru's GDP grew at a pace of 3.9% in the year-to-April, in line with our expectations of 3.8% growth for the full year. However, Peru's economic expansion since 2015 has relied heavily on new copper projects. This impact will subside gradually late in 2016 and into 2017, which is why we are forecasting GDP growth to slow mildly to 3.6% next year, somewhat below the market consensus of 4.0%. In 2017, we estimate that mining will add 0.6 percentage points to GDP growth, compared to 1.8pp in 2016. Thus, excluding mining, growth will indeed be greater in 2017 versus 2016.

We are also conservative with respect to private investment growth. After falling in 2014 (-2.1%) and 2015 (-4.3%), private sector investment continued to decline, by 4.1% y/y in Q1 2016. The outlook for the rest of 2016 is not much better if the current sharp slowdown in commercial bank loans is any indication. Even if investment improves in the second half of the year, we should see a third yearly decline in 2016, forecast at -1.6%. We expect only a very modest rebound, of 2.4%, in 2017.

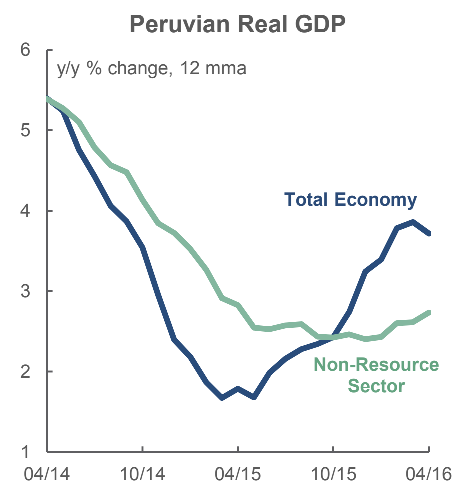
However, the risk in private investment is to the upside, following the results of the June presidential elections. The election of Pedro Pablo Kuczynski, who is well respected by the business community, should help turn around investor sentiment and in turn investment growth, though the impact is more likely to be felt in 2017. Although business confidence indicators have started to improve, we have yet to see a clear impact on demand for loans or actual investment spending. It may take some time to recover the investment-jobs-domestic demand cycle which was so strong from 2005 to 2012.

MONETARY POLICY ON HOLD

Twelve-month inflation in June came in at 3.3%, falling fairly steadily since reaching a high of 4.6% in January. As a result, the Central Bank, which raised its reference interest rate each month from December to February, from 3.50% to 4.25%, has no motivation to continue doing so.

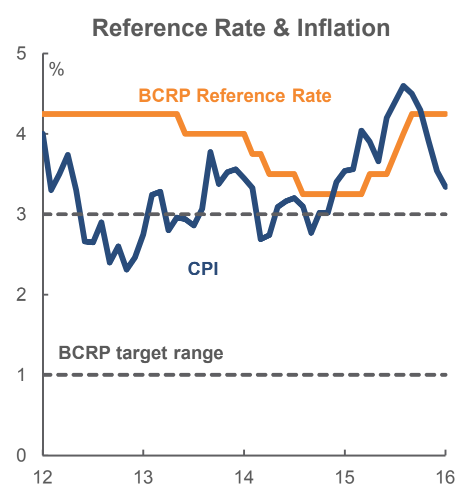
Inflation late last year was due to the pass-through of FX depreciation and, to a lesser extent, the impact of El Niño on agricultural prices. Both factors have now dissipated and are not likely to reappear strongly. As a result, inflation is likely to continue drifting slowly in the 3.1%-3.3% range. Inflation expectations, which the Central Bank monitors closely, are currently at 3.2% for 2016. Thus, with domestic demand underperforming overall GDP growth, but both current and expected

Chart 1



Source: Scotiabank Economics, BCRP.

Chart 2



Source: Scotiabank Economics, BCRP, INEI.

inflation hovering above the Central Bank's 3% target range ceiling, the Central Bank is likely to keep its reference rate stable at the current level. The key to the equation is the evolution of the exchange rate. As long as the FX rate is fairly stable, inflationary pressures are not likely to revive and the Central Bank will not move rates.

The term of the current Central Board of Directors ends with the change of government on July 28. Julio Velarde, the President of the Central Bank, has announced his willingness to continue, and Pedro Pablo Kuzcynski has signaled his agreement to his continuation. Therefore, the Central Bank's approach to monetary policy is not likely to change.

MARKET-SENSITIVE ISSUES

Peru's financial markets were relatively, and somewhat surprisingly, unfazed by Brexit, more so than other regional markets. This relative resilience, at least so far, of Peru's FX and bond markets in the face of Brexit, may have to do with the markets taking into account the differing performance and expectations of precious metals compared to other commodities. Although USD strengthened globally with Brexit, the change in perception that Brexit has produced in the timing and aggressiveness with which the Fed will raise its policy rate could potentially be positive for markets far removed from Brexit and its fallout, such as those in Latin America. Finally, the positive press coverage and expectations regarding the election of Pedro Pablo Kuzcynski may also have contributed to relative financial market stability in Peru, although there has been little noise in markets in this regard.

Going forward, the direction of financial markets will obey changing opinions regarding Fed policy and commodity price movements. Meanwhile, the result of the presidential election should already be priced in by now. One additional factor that may weigh on markets is if local pension funds, AFPs, become more aggressive in selling USD-denominated assets and switching to PEN-denominated assets. Recent legislation allowing for people to access their entire pension fund upon retirement means that pension funds will need to have more liquidity in Peruvian soles than previously expected and it appears that the funds have yet to position themselves sufficiently for this new situation.

INCOMING PRESIDENT TO SPUR GROWTH

The most important domestic issue for the country is the election of Pedro Pablo Kuzcynski (PPK) as president. He will be sworn in on July 28 for the 2016-2021 period. The PPK regime may be able to speed up the recovery of investment by accelerating spending on tendered infrastructure projects and by tendering new projects.

PPK has outlined an economic plan that includes lowering the sales tax, from 18% to 15%, and continuing to decrease the income tax from 30% in 2015 to 28% currently and 26% by 2018. Considering these plans to both increase spending and lower taxes, PPK's plan is fiscally aggressive. This is acknowledged by an admission to allow the fiscal deficit to rise above the current legal ceiling of 3% of GDP, and to take public sector debt from 23% currently to as much as 30% of GDP. PPK hopes that this will stimulate growth of 5% by 2018, upon which the fiscal deficit will be self-correcting.

There are two risks to the plan. The first is that both raising the fiscal deficit ceiling and changing the VAT rate will require the acceptance of Congress. In the new Congress, Fuerza Popular (led by Keiko Fujimori) has a clear majority of 73 out of 130 seats. Although Fuerza Popular is pro-market, making the current Congress perhaps the most pro-market one in recent history, it may not see eye-to-eye with the government on measures that increase the fiscal deficit. The second risk is that rating agencies may not appreciate the fiscal developments, and market risk perception may be affected, thereby leading to higher interest rates.

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Chile

BALANCED ECONOMY, BUT SLOWER GROWTH FOR LONGER

- **Reforms are depressing business and consumer confidence and leading to weak economic activity.**
- **Inflation is on track to reach the central bank's target following a bounce-back in the Chilean peso coupled with modest demand-driven increases in prices.**

BOTH SUPPLY AND DEMAND CURBED BY A PLETHORA OF FACTORS

Since 2014, the Chilean economy has been expanding below potential growth, which is officially estimated at around 3.5%, though will probably be reduced closer to 3% in coming revisions. For the current year, the expectation for growth is around 1.7%, though downside risks dominate. A modest acceleration is expected in 2017, to 2.0%, with a chance of reaching potential growth in 2019. The change in relative prices has meant that non-tradable sectors have lost part of their attractiveness, while the tradable sector (ex. mining) is showing better profit margins. This disparity should intensify in upcoming quarters. The pace of growth in wages is moderating (after being a significant drag on net returns during the commodity boom period) and there are reasons to expect that the cost of non-fuel energy might have peaked in the current cycle. On the demand side, consumption should remain slow for at least a year and a half due to an ongoing deterioration of the labor market. Consumer confidence has remained in the doldrums for a long time and there are good reasons to expect its recovery to be slow. Investment is enduring a three-year contraction, the longest since the early 1970's (though not its deepest). Investment has been dented, not only by terms of trade, as was the case in other cycles, but also by depressed business confidence. This has meant that, although most of the correction has been focused on the mining sector, its effects on the rest of the economy cannot be overlooked since the re-allocation process has been less fluid than in the past. Indeed, the situation is highlighted by the Central Bank of Chile (BCCh), which also expects a renewed contraction in investment this year.

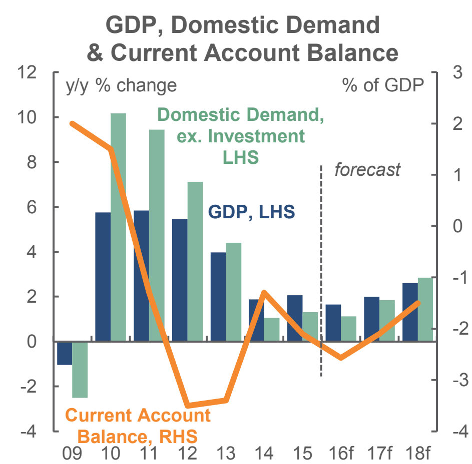
INFLATION PRESSURE FADING… MONETARY POLICY ACCOMODATIVE FOR LONGER

As a part of a convergence to a new economic and foreign exchange balance, year-over-year inflation jumped above 4% in April 2014 and has remained at, or over, 4% since. Currently, inflation is moderately trending downwards. Given that the real exchange rate adjustment seems complete and the labor market is weakening, conditions bode well for a stronger slowdown in coming quarters, with inflation expected to reach 3.3% in December 2016 and close to BCCh's 3% mid-point target soon after. Since inflation expectations in the Central Bank's two-year time frame have remained well anchored to 3%, inside the 2-4% target range, and the downtrend may become more intense, BCCh began unwinding its extremely supportive monetary policy, increasing its monetary policy rate twice last year (to 3.5% from 3%). Given that inflation is mildly receding and growth in activity and spending is subdued, a new hike looks unlikely before March 2017. Considering these economic and monetary conditions, short term interest rates — highly

CONTACTS

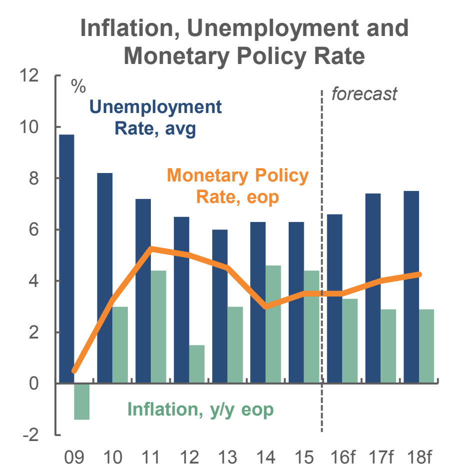
Benjamin Sierra
56.2.2619.4974 (Chile)
Scotiabank Chile
benjamin.sierra@scotiabank.cl

Chart 1



Source: Scotiabank Economics, INE, Banco Central de Chile.

Chart 2



Source: Scotiabank Economics, INE, Banco Central de Chile.

conditioned by the MPR — would remain at their current level up to Q2 2017, with some moderate and gradual increases expected later. Long term rates should remain under some pressure due to the widening output gap and declining inflation, but an earlier-and-very-mild recovery could start in Q4 2016. An alternative scenario should not be fully ruled out: if inflation recedes more intensively than expected in the coming months, the CLP exchange rate remains stable and growth in real wages markedly slows, more expansionary monetary policy could lie ahead.

AN OXYMORON: HEALTHY CONDITIONS BUT SENSITIVE TO FOREIGN FACTORS

Despite the plunge in the terms of trade, the Chilean's economy foreign conditions look pretty solid. The domestic adjustment has been strong and long lasting enough to keep the current account deficit limited. Our forecast is of around 2.6% of GDP for the current year and decreasing (many in the market, including the Central Bank, are forecasting an even smaller deficit). Of course, there are three major external risks: (1) most importantly, an additional copper price drop; (2) a dramatic slowdown or currency devaluation (or both) in China; and (3) a significantly more hawkish Fed. Unfortunately, there is a risk of a "perfect storm" as the correlation between these risks is not zero. Fortunately, that would be the case only if the latter triggered the rest (which seems the least likely). Taking these risks into account, the Chilean peso exchange rate will likely keep a relatively wide trading range for the rest of the year, between 652 and 722 CLP per USD, likely reaching this cycle's apex. Currently, a rate around 690 seems closely aligned with historical parameters, but international factors (like copper prices and risk aversion, among others) will keep volatility high (as has been the case in reaction to Brexit). Note that copper is by far the most important determinant of the exchange rate, and, having a very close correlation with business expectations (indeed, it seems to determine part of it), it is important to keep an eye on copper prices, which are determined by its own market conditions and other factors like USD.

DOMESTICALLY, EXPECTATIONS REMAIN KEY

On the other hand, expectations are also determined by domestic confidence. Though the Chilean economy is not in a recession, confidence indices show a contracting economy. A number of reforms — income tax, labor market, education, constitution, etc. — that are being accomplished by the ruling government (a wide coalition from center to extreme left whose mandate ends in March 2018 led by the most unpopular president in 26 years) have helped to sour the mood of businesses, while inflation and a weakening labor market have in turn affected consumers. In addition to a disliked President, both the legislative and judicial powers are even more poorly thought of. Although the country's institutions function better than in most other Latin American countries and corruption levels are recognizably lower, there is a lack of enthusiasm among Chileans, which is mirrored by polls and high levels of electoral abstention. Without a bounce-back in confidence, a domestically-induced recovery in consumption and investment looks unlikely. Elections running until the end of 2017 could change confidence dynamics. Municipal elections, taking place in October, usually offer a good guidance for general elections, presidential and congressional, which are scheduled to take place in November 2017. The negative risk lies in the rise of populism or electoral options opposite to modern solutions, with the flip side being that the pro-market opposition wins or even the center-left ruling coalition returns to its original mandate. Considering current domestic conditions and recent developments in other important countries in the region, the positive scenario seems more probable. If the country's business and consumer confidence heals, the outlook for growth in 2017 should improve significantly.

China

CONTACTS

Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

OUTPUT GROWTH STILL TRENDING LOWER

- **Brexit related weakness in Europe will lead to slower Chinese export growth, shaving 0.1 percentage points from growth next year.**
- **The Chinese economy continues its structural transition; sound policymaking and successful structural reform implementation will be critical for supporting the economy's smooth adjustment.**
- **We expect Chinese authorities to unveil further fiscal and monetary stimulus in order to maintain a favourable economic environment in the context of global uncertainties and domestic structural changes.**
- **The Chinese economy's fundamental imbalances and complex reform implementation pose risks to the outlook.**

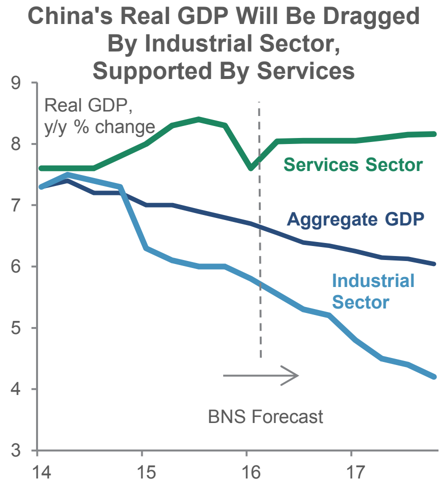
SOUND POLICYMAKING WILL BE VITAL FOR CHINA'S ECONOMIC TRANSITION

China will maintain a rapid pace of economic expansion by global standards over the coming quarters. However, its economic transition away from external demand-driven growth continues and remains one of the key sources of global uncertainties. China is moving to a more advanced stage of economic development where services, consumers, and productivity gains play an increasingly important role in supporting national output as the reliance on industry and investment-driven growth is no longer sustainable. In this context, reforming the centrally-planned economic model is vital for meeting the government's goal of creating a "moderately prosperous society" that is more globally integrated and market-focused. The complex reforms required to support such rebalancing are unprecedented globally due to the Chinese economy's size and significance to the rest of the world. Accordingly, Chinese policymaking — whether it succeeds or fails — will be one of the most critical factors shaping the global economic outlook.

The natural byproduct of the aforementioned economic transition is slower economic growth. Nevertheless, recent stimulus injections by the government have stabilized the economy for the time being, which has eased market participants' near term concerns regarding the speed of the slowdown in growth. At the same time, however, weaker economic prospects in the U.K. and the rest of Europe will adversely impact China's export sector performance. We expect Chinese real GDP expansion to decelerate to around 6.5% this year and to 6.1% in 2017 from 6.9% in 2015. The economy's ongoing structural changes are evident: over the past couple of years, the services sector has become an increasingly significant part of the economy and now accounts for over half of the nation's output. We expect the growth rate of services to continue to exceed that of the industrial sector by a wide margin over the coming years (Chart 1).

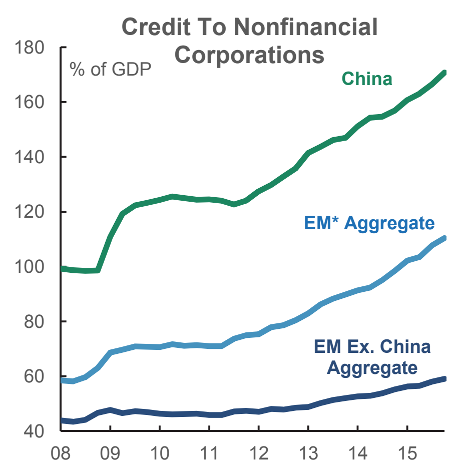
China has now reached a stage of development in which sustainable economic growth requires a more mature and liberalized banking system that would be able to allocate financial resources more effectively. In addition, reforms strengthening

Chart 1



Source: Scotiabank Economics, Bloomberg.

Chart 2



Source: Scotiabank Economics, BIS.
*Countries included in BIS data.

the quality of governance are essential in order to integrate China closely to the global economy. Amid the execution of its pressing reform agenda, which we assess holds a high degree of implementation risk, the Chinese government will aim to maintain a relatively stable economic environment to mitigate the risk of disruptive market volatility by employing its significant fiscal and monetary firepower to underpin growth. As such, we expect government and central bank intervention to remain the norm over the forecast horizon.

Chinese policymakers will likely unveil additional fiscal stimulus measures over the coming months. In our view, public outlays will serve as the main policy avenue to deal with the strong decelerating forces that the Chinese economy is facing, given that monetary easing stimulates lending and has already resulted in a ballooning of private sector credit (Chart 2). Moreover, fiscal stimulus will play an important part in limiting rising social discontent, which might represent a threat to the existing political order amid massive structural changes that the nation is experiencing. In our view, China has the necessary fiscal means to support the economy in transition; its fiscal deficit will likely average 2.8% of GDP in 2016-17 while the public sector debt is set to remain below 50% of GDP.

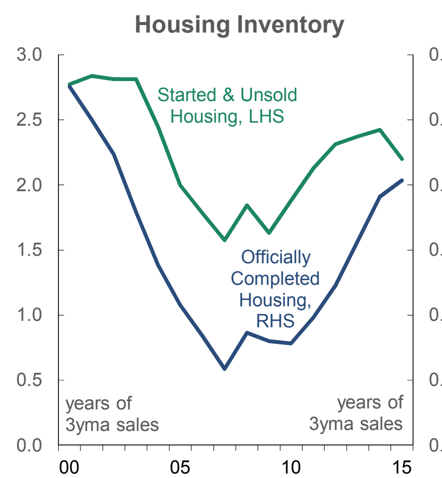
Accommodative monetary conditions will complement fiscal stimulus. We expect further cautious monetary easing to be implemented over the coming months particularly in the form of targeted policy measures, such as open market operations that are a relatively discrete way of guiding domestic interest rates lower. The People's Bank of China has loosened monetary policy by reducing banks' reserve requirement ratio five times since February 2015 to the current level of 17% — with the most recent cut on March 1st — in order to support money supply and credit growth as well as maintain liquidity in the banking system. We expect two more reserve requirement cuts, totalling 100 bps, over the coming months. Key interest rates were lowered in October 2015, when the central bank took the one-year loan and deposit rates to 4.35% and 1.50%, respectively. We anticipate the key rates to be reduced by 25 bps by the end of the year. China's inflation outlook remains manageable and allows for further injections of stimulus; we expect consumer price gains to hover near 2% y/y through 2017.

FUNDAMENTAL IMBALANCES AND REFORM IMPLEMENTATION POSE RISKS TO THE OUTLOOK

The majority of risks surrounding the Chinese outlook — and global prospects accordingly — tie back to government policy and policy-induced imbalances in the centrally-planned economy. Implementing policies to fix the existing disparities, while avoiding creating new ones, is challenging.

A recent rapid rise in private sector debt represents one of these sizable imbalances and places China's medium-term outlook at risk. The non-financial corporate debt-to-GDP ratio has risen by 30 percentage points over the past three years to 170% of GDP, comparing unfavourably with an emerging market average (excl. China) of 60% of GDP (Chart 2). Loose credit policies have led to the rapid lending growth that far exceeds nominal GDP gains, thereby questioning Chinese corporations' future debt servicing ability. In addition, excessive credit supply resulted in funding of nonviable projects, which are now emerging as troubled loans within the banking system. While we don't expect the massive debt burden to be a near-term threat to the Chinese economy, it may trigger a significant correction in the economy later on should policymakers delay the recognition of losses within the banking sector and necessary corporate restructurings.

Chart 3



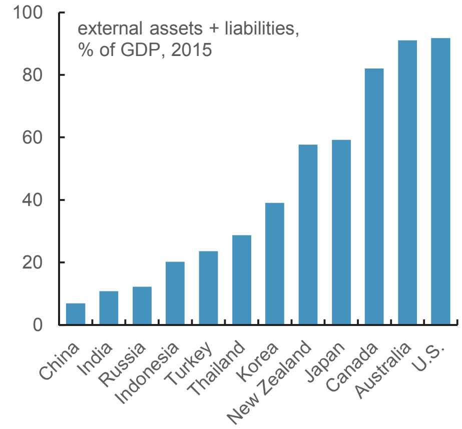
Source: Scotiabank Economics, Oxford Economics.

The fundamental weaknesses in the vital real estate sector — which directly accounts for 15% of economic activity — continue to pose a medium-term risk to the Chinese economy. Loose monetary and credit policies combined with a lack of investment alternatives domestically have translated to a renewed surge in property prices and a pick-up in housing construction. The real estate sector's recovery is boosting the economy's near-term prospects; nevertheless, we assess that the policy-induced recovery is not sustainable and only pushes fundamental problems, such as the high housing inventory overhang (Chart 3), low affordability, and developers' fragile financial standing, further into the future.

Continued capital flow liberalization in China is set to bring about bouts of global risk aversion due to the complexity of the process. Opening the capital account is the next natural reform step given the fact that renminbi internationalization has progressed and domestic interest rates have been liberalized. China's capital account remains relatively closed when compared to other economies (Chart 4), yet the country has recently taken a significant liberalization step by allowing foreign investors to access its bond market. Further capital account reforms will help ease structural imbalances by providing Chinese companies and consumers with a larger range of investment alternatives, making the Chinese banking system more resilient due to balance sheet diversification abroad and improving the effectiveness of monetary policy.

Chart 4

Capital Account Openness



Source: Scotiabank Economics, IMF International Investment Position.

Elevated financial market volatility in early 2016 forced massive government intervention and prompted Chinese authorities to back-pedal on capital account liberalization by temporarily tightening existing controls following substantial capital outflows. Despite some weakening of such flows over the past few months, China's capital account remains under pressure and the renminbi continues to face a depreciatory bias. Accordingly, successful capital flow liberalization will require very careful and incremental policymaking. Given potential banking sector fragility and the lack of sophisticated pricing of risk and risk management techniques, we assess that the liberalization of short term capital flows in particular carries substantial implementation risks. The sheer size of the Chinese economy, its influence on investor sentiment, and the current precarious standing of the global economy, suggests close monitoring of these risks is warranted.

Japan

WEAK GROWTH, STRONG YEN

- **Japan's export-oriented economy will be adversely impacted by weaker output growth prospects in Europe, which reflect the outcome of the U.K.'s vote to leave the European Union and related global uncertainties. We expect Japan's real GDP to advance by 0.6% y/y in 2016-17.**
- **Combating persistent deflationary pressures will remain an important policy goal, yet the Japanese yen's strengthening bias will make the task even more challenging. We do not expect the 2% y/y inflation target to be met in the foreseeable future.**
- **Further monetary and fiscal stimulus will likely be unveiled over the coming months to support the economy's near-term momentum; meanwhile, structural reforms will be important in improving longer-term economic growth prospects.**

NEW POLICY ACTIONS WILL REBOOT JAPAN'S ECONOMIC REVIVAL STRATEGY

Japanese policymakers remain committed to reviving the economy and ending deflation. Nevertheless, persistent challenges remain in meeting these goals, as Japan's economic prospects remain weak and the inflation outlook is muted. This is prompting new policy actions on fiscal, monetary, and structural reform fronts.

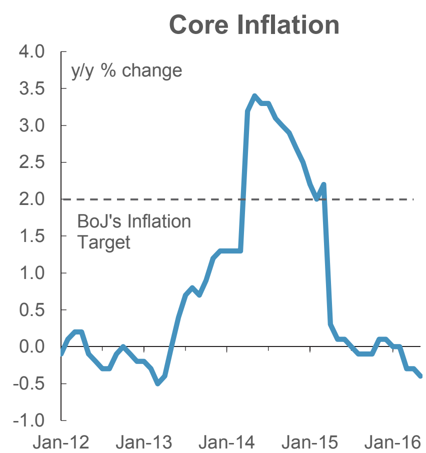
Deflationary pressures have re-emerged. Japan's core consumer price inflation (CPI excl. fresh food) has been back in negative territory since March (Chart 1). The Bank of Japan (BoJ) expects core inflation to stay slightly negative or around 0% y/y in the near term, yet it remains optimistic that the inflation rate will eventually accelerate and reach the 2% y/y target during the fiscal year 2017 (April 2017-March 2018). In contrast, we do not anticipate the inflation target to be met in the foreseeable future given subdued wage growth and muted inflation expectations that reflect consumers' persistent deflationary mindset. Safe-haven flows due to Brexit uncertainty could exacerbate these challenges by maintaining unwanted appreciation pressure on the Japanese yen, which in turn will pass-through to lower import prices. We expect inflation to accelerate to 0.5% y/y by the end of the year and remain below 1% through 2017.

The Japanese economy has barely grown over the past year (Chart 2). In addition, near-term growth prospects remain muted and are subject to downside risks. Indeed, the country's exports and production activity will remain sluggish, adversely impacted by weak global trade and yen strength. Japanese exporters also look set to face further headwinds in the months ahead given the results of the U.K. referendum. In addition to the resultant drag on the attractiveness of Japan's exports from ensuing yen strength, much weaker growth prospects in the U.K. as well as to a lesser extent in key Eurozone countries pose a threat to Japan's vital trade sector given that 15% of its goods exports are destined for Europe. Furthermore, while consumer spending is supporting output growth on

CONTACTS

Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

Chart 1



Source: Bloomberg, Scotiabank Economics.

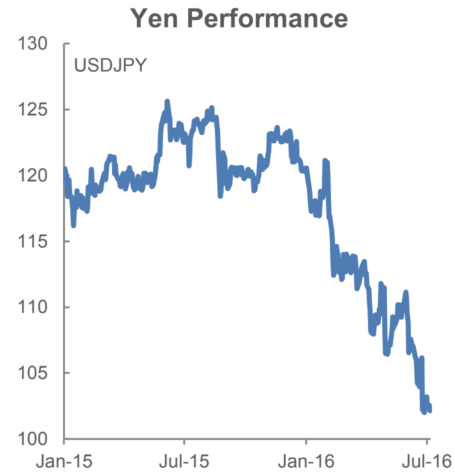
Chart 2

Source: Bloomberg, Scotiabank Economics.

the back of fiscal transfers and low commodity prices, the country's shrinking labour force continues to dampen long-term household consumption prospects. Higher corporate profits, however, should translate to rising business investment over the coming quarters, yet external growth uncertainties and unfavourable currency dynamics could limit the upside potential. We expect Japan's output to grow by 0.6% y/y in 2016-17 following a similar advance in 2015.

Against a backdrop of lackluster economic momentum, deflationary pressures, and the yen's recent strengthening bias (Chart 3), we believe that the Japanese economy is in need of further monetary stimulus to complement its more accommodative fiscal stance. Indeed, Prime Minister Shinzo Abe announced in June that the consumption tax rate hike, scheduled for April 2017, will be postponed until October 2019 and that a second supplementary budget will be unveiled in the near term, which will likely include other growth friendly policy initiatives. Moreover, the government is under pressure to push ahead with structural reforms, particularly related to the labour market that would ease constraints on both businesses and consumers. A near-term injection of fresh monetary stimulus, possibly unveiled in July, would augment the fiscal boost and provide an offset to externally generated downside risks on economic growth.

Chart 3



Source: Bloomberg, Scotiabank Economics.

At present, the BoJ continues to implement its policy of "Quantitative and Qualitative Monetary Easing with a Negative Interest Rate"; it is increasing Japan's monetary base by ¥80 trillion annually through large-scale asset purchases of government bonds, exchange-traded funds, and real estate investment trusts. In addition, the BoJ continues to apply an interest rate of -0.1% to financial institutions' excess deposits at the central bank. Fresh monetary stimulus will likely take the policy rate deeper into negative territory. Japanese monetary authorities might also introduce targeted measures for financial institutions to encourage bank lending or increase and broaden its quantitative easing program to include purchases of investment-grade non-financial corporate bonds into the list of eligible assets similar to the European Central Bank. However, further expansion of quantitative easing may not be the most effective tool for stimulating the economy due to the BoJ's sizable government bond purchases since the start of the easing program in April 2013. At present, the central bank holds over 30% of outstanding government debt securities.

India

STRUCTURAL REFORMS PARAMOUNT TO MAINTAINING SOLID GROWTH

- **The Indian economy is domestically-oriented, helping the country to weather the shock resulting from the U.K.'s vote to leave the European Union.**

- **Domestic policymaking and structural reform implementation are key factors shaping India's economic outlook.**

- **We expect inflation targeting to remain as monetary policy priority even after the change in the central bank's leadership.**

A FAVORABLE ECONOMIC OUTLOOK

India is the fastest growing major economy in the world. Against the backdrop of muted global economic momentum and weak trade activity, the Indian economy is able to outperform because it differs from its regional peers by being more dependent on domestic demand instead of exports. This makes the country more resilient to external demand shocks, such as the Brexit vote, and responsive to domestic policymaking. Another factor supporting India's growth outlook is the country's favourable demographic fundamentals (chart 1). With many advanced economies as well as China grappling with the increasing burden of an aging population and the associated expected decline in labour force participation, India is set to become the world's youngest economy by 2020, with 50% of the population currently below the age of 25.

The fundamental strength of the Indian economy has improved in recent years. In addition to favourable output growth dynamics, India's external vulnerabilities have receded alongside lower energy prices, fiscal consolidation, and prudent monetary policy. Indeed, the sharp reduction in the country's oil import bill has generated a marked improvement in India's current account deficit, which has fallen to 1¼% of GDP in 2015 from nearly 5% in 2012. Meanwhile, the government has maintained its promise for further consolidation and aims to narrow the central government deficit to 3½% of GDP in FY2016/17 (April-March). The Reserve Bank of India's (RBI) sound monetary policy focusing on inflation targeting combined with higher policy credibility have resulted in a moderation in consumer price inflation from a peak of 11.2% y/y in November 2013 to 5.8% in May.

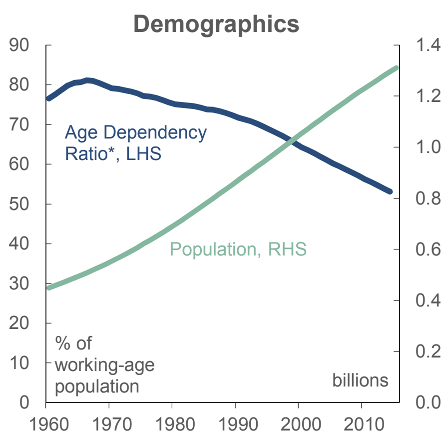
Despite these favourable developments, uncertainty remains over whether Indian policymakers can stay on track to boost the country's economic prospects by delivering on much-needed structural reforms. Even though Prime Minister Narendra Modi's Bharatiya Janata Party (BJP)-led government holds a majority in the lower house, its minority position in the upper house slows policy execution and reform implementation. Regardless, the administration has introduced some critical reforms over the past two years, including subsidy amendments, easing rules on foreign investment, advocating for manufacturing, and drawing up a national bankruptcy law. The landmark Insolvency and Bankruptcy Bill, approved during the recent budget session of parliament, is expected to increase creditor rights, boost financial sector resilience by shoring up high levels of non-performing

CONTACTS

Erika Cain
416.866.4205
Scotiabank Economics
erika.cain@scotiabank.com

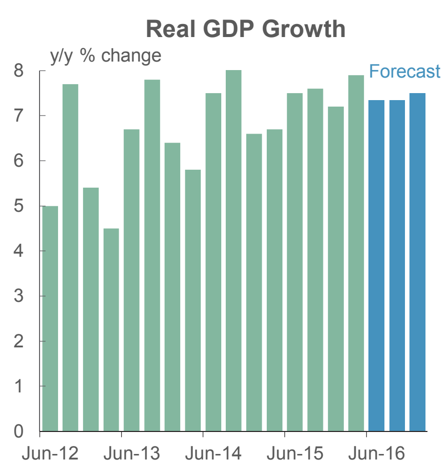
Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

Chart 1



Source: Worldbank, Scotiabank Economics.
*The number of dependents (aged 0-14 and >65) / total population (aged 15-64).

Chart 2



Source: Bloomberg, Scotiabank Economics.

loans, improve access to credit, and lower borrowing costs. However, more progress on the reform front is needed to improve India's physical and institutional infrastructure in order to enhance the country's business environment. The Goods and Services Tax Bill — an important tax reform proposal — has yet to be approved in parliament. Meanwhile, India is subject to a bout of investor concerns regarding monetary policy continuity following RBI Governor Raghuram Rajan's recent decision to step down in September. Governor Rajan's efforts to develop a credible monetary policy framework have been an essential element in improving investor confidence towards India. In addition to policies that underpin the business environment directly, the government remains under significant social pressure; in order to improve the lives of ordinary Indians, it has to support an economic environment that can absorb the 12 million people that enter the workforce each year.

INDIA'S ECONOMIC GROWTH IS DRIVEN BY HOUSEHOLD SPENDING

Despite India's economic growth outperformance, real GDP expansion is set to remain below its estimated potential growth of 8-10% y/y in the foreseeable future; we expect output to advance by 7½% y/y in 2016 and 2017 (chart 2). Activity will be driven by domestic consumption, with consumer spending power bolstered by higher wages, relatively low inflation, and increased benefits for government employees. The Modi administration's commitment to improving road, rail and energy infrastructure will provide further support. Nevertheless, the country is expected to continue to struggle with a lack of adequate private-sector investment until the ease of doing business improves further. Indeed, a revival in investor appetite will likely prove elusive against a backdrop of stressed corporate balance sheets, idle capacity, and initiatives led by the RBI urging banks to adequately declare non-performing loans on their balance sheets. While the latter will likely act as a strain on growth in 2016, the successful execution of the government's Insolvency and Bankruptcy law could provide considerable support to the India's economy and financial resilience in the medium term.

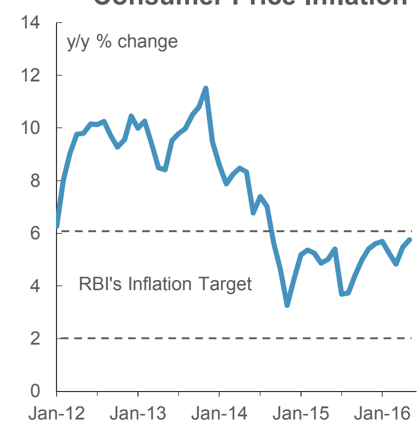
The southwest monsoon, which delivers around 70% of India's annual rainfall, will be critical for India's near term economic outlook given its impact on rural incomes. Following two consecutive years of drought, the outlook for the monsoon season is promising with rainfall forecasted to be above-average. Such a positive supply shock would boost India's ailing primary sector and underpin a much-needed recovery in rural consumption where two thirds of the population reside. A pick-up in agriculture output would act as a counterbalance to the drag on growth from the loss of momentum in manufacturing activity that reflects weak global trade dynamics.

NEAR-TERM INFLATION DYNAMICS SHAPE MONETARY POLICY DIRECTION

Higher food prices have resulted in a recent uptick in inflation (chart 3). The headline inflation rate reached 5.8% y/y in May, up from 4.8% two months earlier. Regardless, it remains in line with the long-term consumer price inflation target of 4% ±2 percentage points. We expect the headline rate to hover slightly below the 6% upper limit at the end of 2016.

In our view, the government's reasonably prudent fiscal policy stance will not pose a threat to India's inflation outlook; instead, the monsoon outcome will impact price dynamics and the resultant monetary policy direction. Should the rainfall turn out to be normal with inflation stabilizing over the coming months, we expect the RBI to inject further cautious monetary stimulus to the economy over the coming months (chart 4). Indeed, monetary policy will carry larger responsibility for stimulating economic activity given that government spending will remain relatively cautious. Nevertheless, RBI Governor Rajan continues to emphasize the importance of maintaining inflation-focused monetary policy beyond his term. The recently established inflation target enhances policy credibility and helps anchor inflation expectations, doing its part in creating a more attractive environment for investment. Most recently in April, the RBI reduced the policy repo rate by 25 bps to 6.50% — adding to the executed interest rates cuts totaling 125 bps in 2015 — and implemented various liquidity measures to make monetary policy transmission more effective.

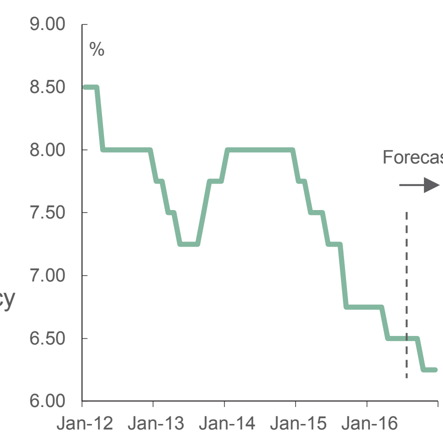
Chart 3 Consumer Price Inflation



Source: Bloomberg, Scotiabank Economics.

Chart 4

RBI's Benchmark Interest Rate



Source: Bloomberg, Scotiabank Economics.

Australia

CONTACTS

Tuuli McCully
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

THE AUSTRALIAN ECONOMY IS IN THE MIDST OF TRANSITION

- **Australia's economic performance continues to depend on international commodity prices and demand from China.**
- **Accommodative monetary policy is set to support growth amidst low inflation.**

ACCOMMODATIVE MONETARY POLICY WILL SUPPORT THE ECONOMY

Australia's economic outlook is challenged by three key factors: 1) decreasing mining investment; 2) low commodity prices and the resultant sharp deterioration in Australia's terms of trade; and 3) China's slowing economic growth.

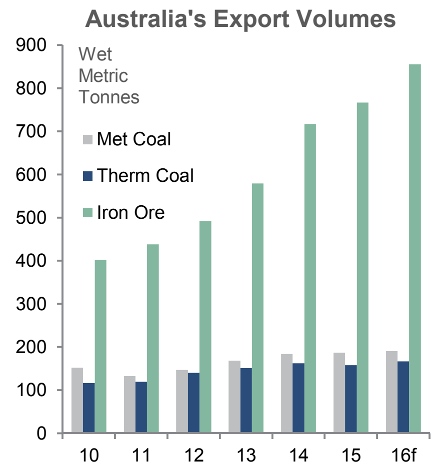
Following the end of a recent resource investment boom, the economy is going through a structural adjustment. The share of mining investment as a percent of GDP reached a peak of 8% in 2012 after which it has declined to 4% and is expected to drop further. However, following project completions, Australia's mining capacity has increased significantly, which is producing higher export volumes (Chart 1). Iron ore volumes — representing a quarter of Australia's total exports — have doubled over the past five years and the country now accounts for more than half of the world's iron ore shipments. Similarly, export capacities of coal and liquefied natural gas have risen by 40-50% over the past five years.

Global uncertainties, such as the Brexit outcome, will be reflected in international commodity prices. Given that Australia sells less than 6% of its exports to Europe, it will feel the impact of uncertainties in Europe mainly through the commodity price channel. Nevertheless, the economic consequences of low prices are partially offset by Australia's higher export volumes. While the price of iron ore has increased markedly since its low point at the end of 2015, it is still 75% below its peak levels five years earlier. Meanwhile, thermal and metallurgical coal prices are 50-70% below 2011 levels. A gradual price recovery is expected over the coming years.

China is Australia's key export destination as the country purchases more than a third of Australia's shipments abroad. China's fixed capital investment boom has supported strong demand for commodities. Nevertheless, the Chinese economy is in the process of rebalancing toward a more service-led growth model, which reduce its reliance on Australian commodities. This will require a diversification of the Australia's trading partners.

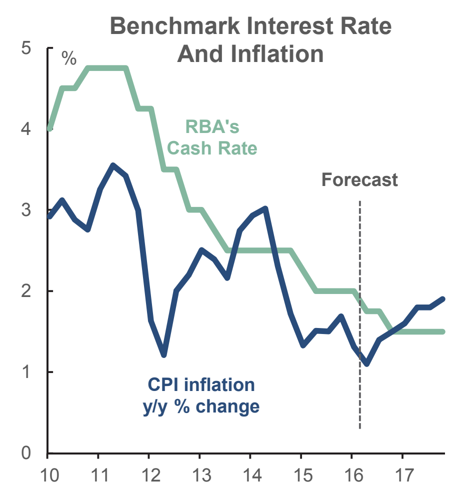
We expect supportive policies to be implemented in Australia to smooth the domestic adjustment as the economy seeks alternative sources of growth from non-resource investment, household spending, and the services sector. Indeed, the domestic side of the economy is set to underpin growth momentum, with real GDP expansion averaging 2⅔% y/y in 2016-17. Given low inflation — we expect price gains to remain below the Reserve Bank of Australia's (RBA) 2-3% y/y inflation target through 2017 — and persisting global uncertainties, we anticipate the RBA to ease monetary policy further, taking the benchmark cash rate to 1.50% by the end of 2016 (Chart 2). The most recent rate cut took place in May.

Chart 1



Source: AME Group, Scotiabank Economics.

Chart 2



Source: Bloomberg, Scotiabank Economics.

Commodities

CONTACTS

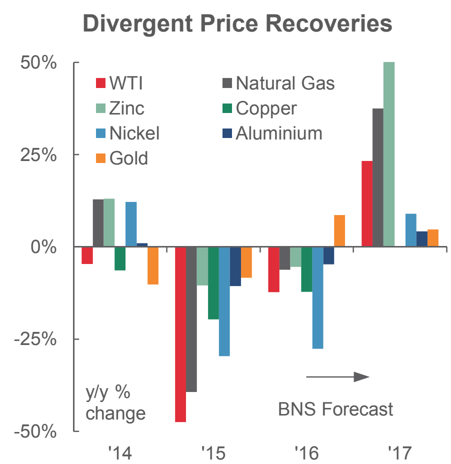
Rory Johnston
416.862.3908
Scotiabank Economics
rory.johnston@scotiabank.com

COMMODITY PRICES ARE LIKELY TO FIND THEIR BOTTOM IN 2016

- **Oil prices are expected to maintain modest upward momentum through 2017 as non-OPEC production, led by the U.S. shale patch, continues to decline on the back of weak upstream investment, while demand continues advancing at a healthy pace.**
- **Zinc remains the outperformer in our forecast, with significant mined supply reductions contrasting with the slower production responses across the other base metals.**
- **Post-Brexit USD strength will weigh broadly on commodity prices, but fundamentals will continue to drive inter-commodity differentiation.**

The commodities industry continues to struggle against cyclical headwinds. A prolonged period of high prices brought with it a flood of new supply across the energy and mining sectors which, coupled with moderating demand conditions, precipitated the current stretch of low prices plaguing producers today. Higher prices are expected to follow as the industry tightens its collective belt and prioritizes cost control over future growth, with 2016 expected to be the low-point for energy commodities and the base metals. Our global growth outlook has been downgraded slightly in the wake of the Brexit vote, weighed down by uncertainty and weaker investment across Europe. As a result, oil and most of the base metals are now forecast to be slightly lower in 2017 relative to where we saw balances moving prior to this revision (e.g. WTI at $55/bbl vs. $60/bbl prior), but the general trend remains intact. Crude oil, natural gas, zinc, and gold are expected to outperform over the next 18 months while copper, nickel, aluminium, iron ore, and metallurgical coal are likely to experience further price pressure through the end of the forecast horizon (Chart 1).

Chart 1

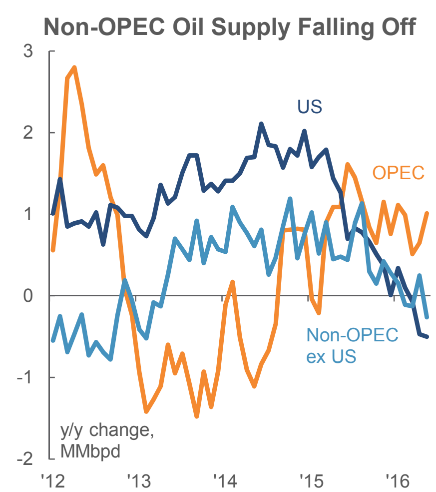


Note: WTI $/bbl; Nymex Natural Gas US$/MMBtu; Gold US$/oz; Base Metals US$/lb.
Source: Bloomberg, Scotiabank Economics.

OIL & GAS — NON-OPEC DECLINES CONSTRAIN GLOBAL SUPPLY

The oil market is expected to enter into sustained physical balance by the latter half of 2017 as healthy global demand continues to outpace anemic supply growth. **We see prices grinding higher as physical balances tighten, with WTI prices averaging US$45/bbl in 2016 and $55/bbl in 2017**, but volatility will remain elevated. Global petroleum demand is expected to advance by roughly 1.3 million barrels per day (MMbpd) in 2016 with roughly half of that driven by China and India, slowing slightly to 1.1 MMbpd in 2017 as prices rise and some of the lower-hanging demand potential in low-income countries is exhausted. Global supply growth will remain constrained as non-OPEC production contractions offset OPEC output gains. While production declines are most dramatic in the U.S. shale patch, non-OPEC ex U.S. output is also on a clear downward trajectory (Chart 2), adversely impacted by natural declines and the lacklustre appetite for upstream investment globally.

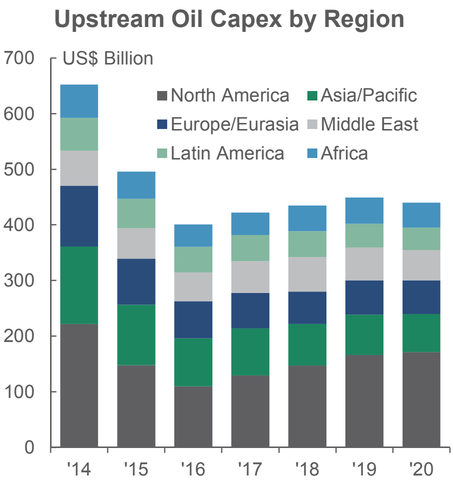
Chart 2



Source: EIA, Scotiabank Economics.

In the near term, the outlook for U.S. shale production continues to dominate headlines and analyst attention. Some argue that U.S. shale producers have supplanted Saudi Arabia as the new source of global swing supply due to tight oil's relatively short investment cycle, but a dependence on leverage and access to credit markets complicates the relationship between price and production, limiting the elasticity of the shale patch. Recent higher prices of around $50/bbl have pulled some U.S. oil rigs back into service and temporarily slowed the production decline in the lower-48, but rig counts will need to be much higher if the trend is to be arrested or, eventually, reversed. The latest slew of unplanned oil supply disruptions are also receiving significant attention, accomplishing what two years of major oil producer meetings have not — namely, artificially tighten near-term physical oil balances and help shift investor sentiment from overwhelmingly bearish earlier this year to moderately bullish today. Some of these disruptions, like the wildfire-induced shutdowns in Alberta, are inherently transitory and the result of natural disasters or other "bad luck" events. Others, like the attacks on Nigerian energy infrastructure or the evolving crisis in Venezuela, are more political economic in nature, with the collapse in oil prices exposing the dilapidated state of local economies and the long-run effects of poor governance. These disruptions could serve to hasten or prolong the rebalancing of the oil market, depending on the pace and direction of resolution.

Chart 3

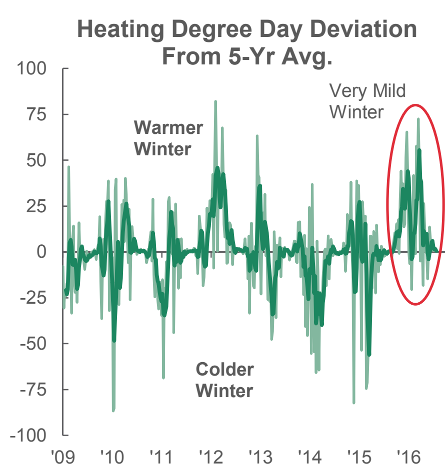


Source: Wood Mackenzie, Scotiabank Economics.

Petroleum demand has continued to surprise to the upside, jumping more than 1.7 MMbpd last year (roughly 60% faster than the average of the preceding four years) and tracking to gain 1.5 MMbpd in the first half of 2016 before slowing slightly in the subsequent months. The biggest surprise came from India, which saw petroleum product consumption rise 8% y/y (300 kbpd) in 2015 and 10% y/y (400 kbpd) year-to-date through May. It is unlikely that this rapid pace of demand growth will continue as prices rise, but it does confound the conventional view that oil demand is relatively price inelastic. In the longer-run, depressed upstream capital expenditure will prove the overriding supply concern after roughly US$1 trillion worth of projects planned for 2016-2020 were shelved in the wake of the oil price collapse, according to Wood Mackenzie (Chart 3). Some of the impact of these cuts will be cushioned by cost deflation as demand for service firms/labour declines, cost discipline improves amidst tight margins, and local costs are deflated by weak petrocurrencies, but we will inevitably see realized future supply suffer relative to pre-2015 expectations. This scarce supply narrative must then be weighed against the potential for further investments in relatively cheaper OPEC supply as large reserve countries (e.g. Saudi Arabia) may begin to shift from a long-term wealth maximization strategy to an attempt to monetize reserves sooner in order to channel revenue into post-petroleum industry investments.

North American natural gas prices are expected to finally gain some lasting momentum, with the Henry Hub spot forecast to average $2.40/MMBtu in 2016 and rising markedly to $3.30/MMBtu in 2017. Supply will remain constrained due to the unattractive price environment while exports are likely to increase and domestic demand is anticipated to continue rising. The coming winters are expected to spur considerably higher heating demand relative to last winter, which was abnormally warm (Chart 4), and natural-gas fired power generation capacity is seen growing extensively through 2018 according to the EIA's planned start-up schedule.

Chart 4



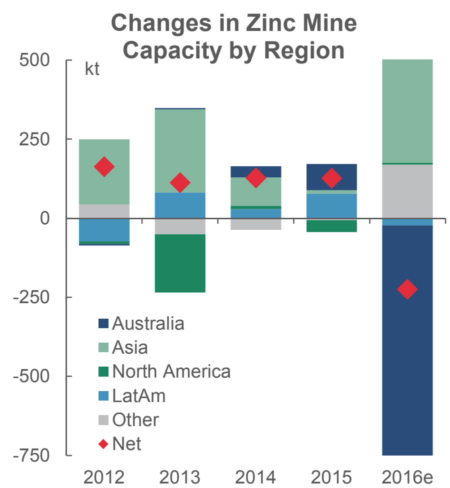
Source: NOAA, Scotiabank Economics.

METALS & MINERALS — SUPPLY RESPONSES MAKE ALL THE DIFFERENCE

Base metals are also expected to finally find a bottom in 2016 after a half-decade of falling prices. **Zinc continues to demonstrate the strongest fundamentals within the base metals group and we see prices averaging $0.85/lb in 2016 before rallying to average $1.25/lb in 2017** as a pronounced concentrate supply deficit begins to work its way into the refined metal market. The closure of the Century (Australia) and Lisheen (Ireland) zinc mines late last year coupled with Glencore's decision to idle another 500 kt of production until prices recover translates to a loss of more than a million tonnes of annualized concentrate supply in 2016, roughly 8% of last year's output (Chart 5). Prices are expected to rise over the coming years until sufficient supply can be incentivized back onto a starved market. The prospects for the other three base metals aren't quite so sanguine, however, with a combination of poor demand conditions and stubborn supply responses weighing on the outlook through next year. **Copper prices are forecast to remain flat through 2017, averaging $2.20/lb.** Significant volumes of supply were idled in 2015 in response to low prices but producers are looking far more resilient in 2016 and curtailments are unlikely to move the needle. Global consumption growth will remain positive but lackluster and is expected to advance by roughly 2-2.5% y/y through 2016-17, an improvement over last year's contraction but almost half the average growth rate experienced since the global financial crisis. **Nickel prices are expected to remain subdued and average $3.90/lb in 2016 before gaining slightly to $4.25/lb in 2017**. We see the market entering into a small refined metal deficit this year and next after almost a decade of sustained surplus, but exceptionally high inventory levels will need to be worked off before prices will see any sustained rally above the $4.50/lb level. The combined volume of visible inventories held on the major metals exchanges and industry estimates of off-exchange stocks is equivalent to more than eight months of global demand. **Aluminium prices are anticipated to stay relatively range bound, averaging $0.72/lb in 2016 and $0.75/lb in 2017**, unlikely to break above the $0.80-0.90/lb level until later in the decade given sustained refined surpluses and rising inventories. **Iron ore delivered to northern China is expected to remain flat at $45/t in both 2016 and 2017**, while **hard coking coal shipped from Vancouver to Asia is forecast to rise only modestly from $83/t in 2016 to $86/t in 2017**. The steel industry will remain in a difficult position due to chronic Chinese overcapacity which, combined with significant supply gains from iron ore producers, will keep most elements of the steel complex — from the mine through to end-use products — depressed for the foreseeable future.

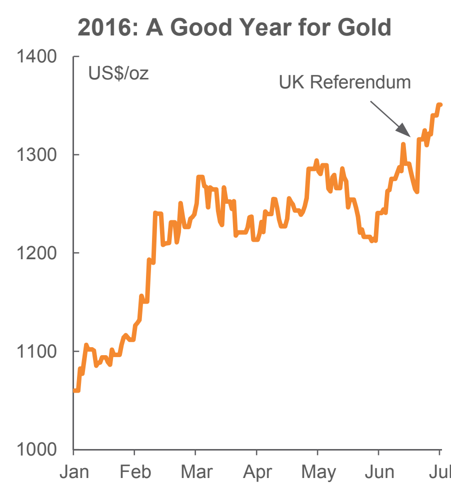
Finally, **gold has regained its lustre and is forecast to average $1,260 per troy ounce in 2016 and $1,320 in 2017** on the back of increased demand for safe-haven assets following the Brexit vote on June 23rd (Chart 6). Heightened uncertainty regarding the future of the European Union and the potential for subsequent '-exit' referenda across the continent will support a healthy appetite for bullion as a hedge against further political instability.

Chart 5



Source: Wood Mackenzie, Scotiabank Economics.

Chart 6



Source: Bloomberg, Scotiabank Economics.

Table 1 — Commodities

	2000-2014 Low	2000-2014 Avg.	2000-2014 High	Annual Average 2015	Annual Average 2016f	Annual Average 2017f
WTI Oil (US$/bbl)	17	65	145	49	45	55
Brent Oil (US$/bbl)	18	68	146	54	46	56
Nymex Natural Gas (US$/mmbtu)	1.83	5.25	15.38	2.63	2.40	3.30
Copper (US$/lb)	0.60	2.35	4.60	2.49	2.20	2.20
Zinc (US$/lb)	0.33	0.80	2.10	0.87	0.85	1.25
Nickel (US$/lb)	2.00	7.59	24.58	5.36	3.90	4.25
Aluminium (US$/lb)	0.56	0.88	1.49	0.75	0.72	0.75
Iron Ore (US$/tonne)	17	68	187	55	45	45
Metallurgical Coal (US$/tonne)	39	129	330	102	83	86
Gold, London PM Fix (US$/oz)	256	824	1,895	1,160	1,260	1,320

Inflation

CONTACTS

Dov Zigler
212.225.6631 (New York)
Scotiabank Economics
dov.zigler@scotiabank.com

A TALE OF STABILIZING COMMODITY PRICES

We project three main inflation trends in the economies that we cover — almost all of which stem from a view that commodity prices are stabilizing and will impact year-on-year inflation prints in 2016 and 2017. Those three trends are: a) reflation in G-10 economies, b) abating FX pass-through in Latam, and c) stable growth and inflation in China. We expect that this should favour inflation-linked securities in the U.K., the U.S. and Canada. Inflation risk premia in Latam are elevated and there is a risk that they persist even if inflation edges down.

Reflation in the G10 — In the U.S. and to a lesser extent Europe and developed Asia, we are projecting an uptick in inflation over our forecast horizon as falling commodity prices from late 2014 to early 2016 morph into stabilizing commodity costs (energy in particular) in H2 2016 and into 2017. We are looking for oil prices to remain in the USD50/barrel area, lifting year-on-year CPI to 2% y/y in Canada and the U.S. and near 1% y/y in Western Europe by year-end 2016. This will allow core CPI, which has actually been solid in 2016 in North America and has shown signs of life in Europe this year (Chart 1), to shine through in 2017 — although of course, the risk of global economic weakness around Brexit jeopardizes this forecast somewhat. An appreciated USD could limit upside on U.S. CPI; Brexit-induced slowing in economic growth in the Eurozone could weigh on European CPI; while in the U.K., post-Brexit depreciation should initially boost inflation.

Abating FX Pass-Through Inflation in Latam — Perhaps the bigger impact on inflation from stability in commodity prices will be in Latam, where economies have been experiencing very high levels of inflation (and where sensitivity of inflation to commodity prices is often high). CPI in the Andean countries ran between 4% and 7% in 2015 — and at 10.7% y/y in Brazil. The cause was FX depreciation and import price inflation. We expect that stabilizing commodity prices this year and next will in turn stabilize local FX in the Andean countries and Brazil. This should bring inflation down to more manageable levels in 2017, although post-Brexit volatility is posing at least some risks to this forecast.

Stable Growth in China and India — Our view on inflation and commodities ties in to a view on growth in China and India. We expect that growth in both countries will be stable near current levels, resulting in ongoing absorption of excess supply. We think that Chinese deflation worries have long been overstated: the relatively high food price content in Chinese inflation indices overstates deflation risk.

The biggest risk in our forecast is in Latam, where the legacy of past currency depreciation and inertial inflation could cause elevated inflation prints and prevent an abatement in the powerful inflation impulse that is still working its way through major South American economies. This could cause inflation to persist at elevated levels for longer than we anticipate, and in turn, lift inflation risk premia in Latam.

In the United States and Canada, there is a distinct possibility that rising wages in the United States and persistent robust services sector inflation could actually result in inflation *upsides*, even if GDP disappoints modestly. The risk in North America seems to be that our forecast is directionally correct, but could be understated. The result is that we continue to think that developed market inflation breakevens are underrepresenting inflation risks over our forecast horizon.

Table 1

Inflation (y/y % change, avg)

	2015	2016f	2017f
U.S.	0.4	2.0	2.3
Canada	1.3	2.1	2.2
U.K.	0.2	1.0	1.6
Eurozone	0.2	0.8	1.5
Germany	0.3	0.9	1.7
France	0.2	0.7	1.4
Japan	0.2	0.5	0.7
Brazil	10.7	7.0	5.5
Mexico	2.1	3.6	3.9
Colombia	6.8	7.0	4.0
Chile	4.4	3.3	2.9
China	1.6	2.1	2.3
India	5.6	5.8	5.6

Table 2

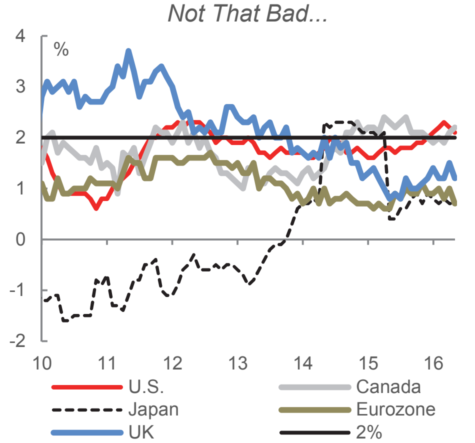
10-yr Inflation Breakevens

	2015 avg	Jan 5, 2016	Jul 5, 2016
U.S.	1.7	1.6	1.4
Canada	1.6	1.5	1.3
U.K.	2.5	2.4	2.3
Eurozone	-0.4	-0.3	-0.7
Germany	1.1	1.0	0.8
France	1.2	1.0	0.8
Japan	0.9	0.7	0.3
Brazil	7.0	8.9	6.0
Mexico	3.0	2.9	3.2
Colombia	3.6	4.7	4.1
Chile	3.0	3.0	3.0

Source: Bloomberg, Prices as of 6/30/2016

Chart 1

Developed World Core CPI
Not That Bad...



Source: Scotiabank Economics, Bloomberg.

Capital Markets

Three thematic issues derived from stock and bond markets position our thoughts surrounding base case projections and risks to our macroeconomic forecasts.

1. ARE STOCKS OVER-VALUED?

Stocks are not cheap, but they are also not obviously over-valued. While multiple risks overhang markets — including several on the events calendar — and such risks could lead to market instability, we don't see valuation signals that suggest that our broad macro forecasts should at this juncture incorporate the risk that stocks could stay depressed for an extended period in growth-dampening fashion. In short, a possible correction with many potential catalysts would be from reasonably fair value levels and thus likely to bring investors back seeking value in a reach-for-yield, post-Brexit world. Witness charts 1-6 showing eight valuation models that we apply to the S&P500 index including: price-to-trailing earnings per share; price-to-forward-earnings per share; price-to-cyclically-smoothed-earnings per share; price-to-book value per share; dividend yields; the bonds versus equities framework advanced by Benjamin Graham and adopted in varying forms by the Fed and private economists; and Tobin's 'Q'. In particular, witness chart 3 showing the large spread between the earnings yield on the S&P500 versus the 10-year Treasury yield.

2. WHICH MARKET IS RIGHT ON INFLATION EXPECTATIONS?

A fascinating conundrum exists in the markets for sovereign bonds versus instruments designed to provide market insight into long-run inflation expectations and one of those markets is probably dead wrong. This is a strong caution to those who believe markets always know best.

Sovereign bonds may be implying that bond traders believe both growth and inflation will remain much lower than anyone forecasts for an extended period of time. This is borne out by the 1.4% 10-year Treasury yield range that prices in a combination of low long-run growth and inflation.

Alternatively, various market-based measures of inflation expectations are in the 1.4-1.9% range, and two of which are shown in chart 7. The net outcome between what the inflation market is saying and what nominal Treasury yields are indicating implies no economic growth but persistent inflation over the longer term which is a scenario we cannot accept in devising our forecasts.

Our broad macro forecasts err on the side of assuming that the inflation expectations market is closer to the mark whereas nominal sovereign bonds are richly over-valued for reasons that bear little resemblance to fundamentals and have everything to do with central bank distortions.

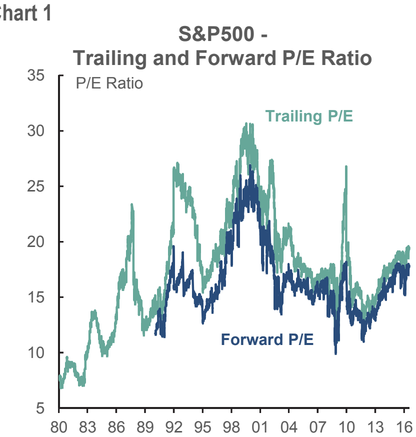
3. WHAT IS DRIVING SOVEREIGN BOND VALUATIONS?

And so what is driving sovereign bond valuations? Our forecasts assume that the drivers are principally focused upon central bank policy that we do not foresee shifting materially over the majority of our forecast horizon. Global central banks' policies have had three principal effects on the bond market.

CONTACTS

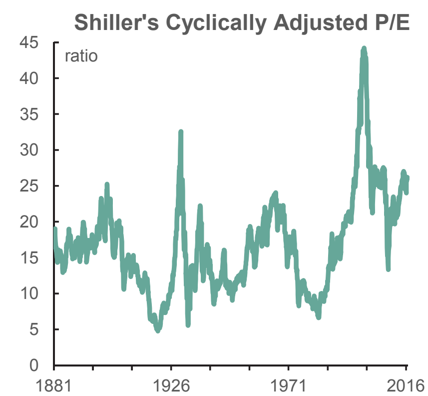
Derek Holt
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

Chart 1



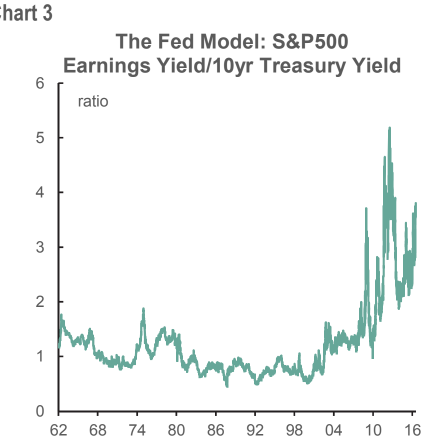
Source: Scotiabank Economics, Bloomberg

Chart 2



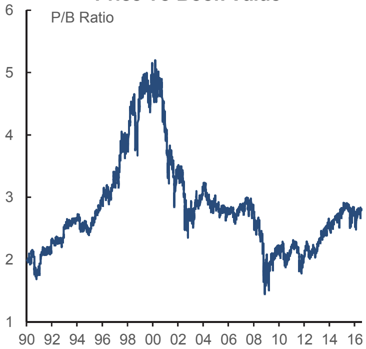
Source: Scotiabank Economics, Shiller, Robert, "Irrational Exuberance", Princeton University Press, 2005.

Chart 3



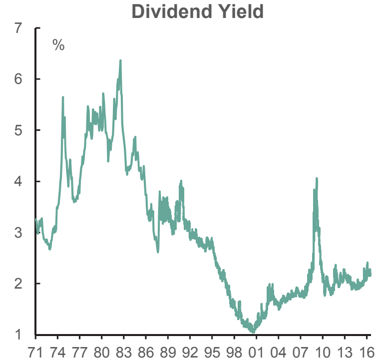
Source: Scotiabank Economics, Bloomberg.

Chart 4 S&P500: Price To Book Value



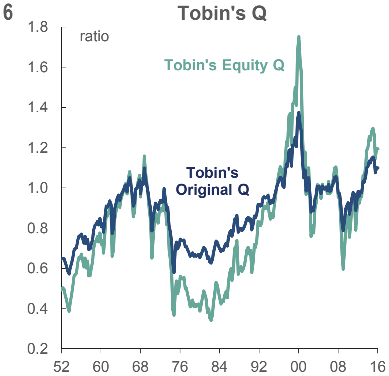
Source: Scotiabank Economics, Bloomberg

Chart 5 S&P500: Dividend Yield



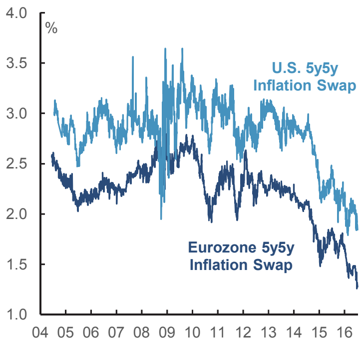
Source: Scotiabank Economics, Bloomberg

Chart 6 Tobin's Q



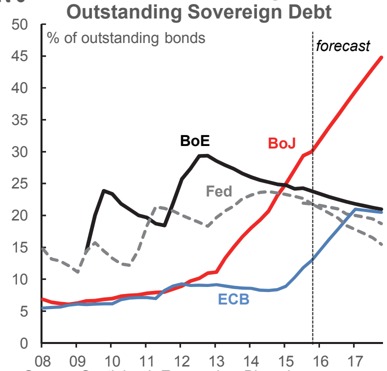
Source: Scotiabank Economics, U.S. Federal Reserve Board.

Chart 7 What Markets Think Of U.S. And Eurozone Inflation 5 Years Ahead



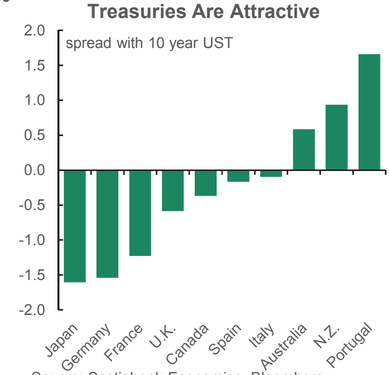
Source: Scotiabank Economics, Bloomberg.

Chart 8 Central Bank Holdings of Outstanding Sovereign Debt



Source: Scotiabank Economics, Bloomberg.

Chart 9 Relative To Most Others, Treasuries Are Attractive



Source: Scotiabank Economics, Bloomberg.

1. **Negative policy rates:** On January 29, 2016 the Bank of Japan cut its main policy rate from +0.1% to -0.1%. In June 2014, the ECB cut its main deposit facility rate to -0.1% and over subsequent meetings cut it to -0.4% by March of this year. At its March meeting, the ECB also introduced lending programs allowing financial institutions to borrow down toward this negative deposit rate. Through arbitrage activity, all short-term market rates generally converged toward these negative policy rates. By extension, in a reach for yield environment and especially post-Brexit, every higher-yielding instrument became more attractive. German 10 year yields, for example, went from about 1.4% around mid-2014 down to a negative yield now. In essence, markets are violating the general edict that two negatives can't make a positive by pursuing an attractive positive spread between the negative policy rates and longer-term sovereign bonds. Additional factors have included slower growth in the supply of new bonds, steadily rising demand from investor classes such as pensions and life cos., and European dysfunction that always benefits Germany's borrowing costs as a relative beacon of safety in Europe. **We expect these negative policy rates to persist over our forecast horizon and to anchor sovereign bond curves (see forecast tables).**

2. **QE programs:** Chart 8 shows the projected shares of the Treasury, gilts, European government bond, and Japanese government bond markets that we think will wind up being held by central banks over our forecast horizon based upon current program guidance and debt issuance projections. By removing tradable supply from the market, central banks have put downward pressure on yields. **We expect further stimulus and continued BoJ and ECB bond buying and continued Fed reinvestment to suppress the magnitude by which sovereign bond yields are forecast to rise.**

3. **Carry trade:** As a consequence to central bank policies, global investors have been engaged in a search for yield out of very low European and Japanese bond markets and into markets not characterized by negative policy rates or continued new purchases of bonds. This includes the U.S. where QE programs are marked by reinvestment but not new flows and no negative policy rate, Canada which has never pursued either QE or negative rates, and likewise for markets like Australia albeit with more of a question mark over Australia's AAA status than over, say, Canada's AAA. Chart 9 shows the attractiveness of the spread between 10 year Treasuries and comparable 10 year sovereign bonds elsewhere. This positive spread is also assumed to be among the factors we use to forecast U.S. dollar strength over time as low European and Japanese yields anchor Treasury and Canadian yields but history is replete with examples of limited global rate divergence.

Foreign Exchange

BREXIT FALLOUT HELPS SUPPORT THE USD

We are bullish on the outlook for the U.S. dollar (USD) in the medium-term. This is a position we have maintained all year, even as the USD's overall performance against its major currency peers has been disappointing from our perspective. Clarity on some of the issues that have undermined the USD bull case recently and renewed challenges abroad should give the USD a lift and extend what remains a mature secular bull trend into the end of the year at least.

U.S. growth disappointed in Q1 but the economy appears to be recovering well through the middle of the year and is expected to continue expanding moderately. Growth momentum will contrast with even more weaker prospects elsewhere (Europe especially, after recent events). However, external growth risks will restrain the Fed's ability to move interest rates as aggressively as we had previously expected. We now expect the Fed to move rates up only modestly in 2017. Ordinarily, a significant downgrade of the Fed outlook would entail a downward revision to the USD outlook. However, events in Europe suggest to us that **the USD is still liable to appreciate overall against many of its major peers**. Downside risks to the USD revolve around potential frustrations with Fed policy stasis and uncertainty prompted by the U.S. presidential election cycle.

We are cautious on prospects for the commodity currencies. Prices for raw material should stabilize over the balance of the year but other challenges are likely to emerge. We expect the Canadian dollar (CAD) to end 2016 a little weaker than current levels (at 1.30) but caution that volatility is likely to remain elevated in the CAD. Short-term, USD gains to the CAD1.35/1.40 range are possible, with the Canadian economy struggling to overcome the impact of the recent wildfires in the oil patch and global growth headwinds strengthening again. Weakness in the trade sector is another potential hurdle for the CAD. We expect the New Zealand dollar and the Australian dollar to track the CAD near-term but under-perform in the longer run, given risks for additional domestic monetary policy easing.

The U.K.'s decision to leave the European Union (EU) will have significant ramifications for the markets. The referendum result prompted a significant adjustment in the pound (GBP) but **we think more losses lie ahead and target GBPUSD falling to 1.25 into year-end.** The U.K. is facing a protracted period of uncertainty about how the exit will be negotiated. This will weigh on major investment decisions and growth. A mild recession is likely and we expect the Bank of England to take pre-emptive easing action. The political scene is quite volatile and unclear with both the ruling Conservative and opposition Labour party dealing with leadership issues. A snap election is possible by October. Sovereign ratings downgrades in response to Brexit may focus investors' attention on the U.K.'s large current account deficit. A sudden stop to foreign investment inflows which finance the shortfall would further exacerbate pressures on the GBP.

The Euro (EUR) will not escape the Brexit fallout. At a very high level, the result places a large question mark over prospects for deeper integration in the

CONTACTS

Shaun Osborne
416.945.4538
Foreign Exchange Strategy
shaun.osborne@scotiabank.com

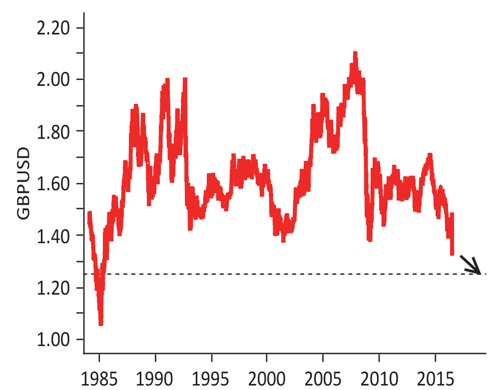
Qi Gao
65.6305.8396 (Singapore)
Foreign Exchange Strategy
qi.gao@scotiabank.com

Eduardo Suárez
5255.9179.5174 (Mexico)
Foreign Exchange Strategy
eduardo.suarez@scotiabank.com

Eric Theoret
416.863.7030
Foreign Exchange Strategy
eric.theoret@scotiabank.com

Chart 1

GBPUSD Expected to Reach 1.25 on Brexit



Source: Macrobond, Scotiabank FX Strategy

European Union in the future; Brexit "contagion" risks are not insignificant for other countries (France is facing a presidential election in 2017). Eurozone growth prospects were feeble before the referendum and look even bleaker now. European Central Bank President Draghi suggested that Brexit will cut Eurozone GDP by 0.3-0.5 percentage points over the next three years. In an already low growth environment, that is significant. Weak growth momentum may prompt renewed concerns about the stability of the banking system. We think EURUSD remains on track to reach 1.05 by year-end.

Yen (JPY) appreciation in response to heightened volatility has raised the domestic alarm that further gains could derail growth and dampen already weak inflation impulses. Soft growth prospects, prompting the government to delay the second round of consumption tax hike (planned for 2017), and weak confidence in the domestic economic outlook suggest that the BoJ may have to undertake another round of stimulus. **We have revised our USDJPY outlook down in response to the lowered Fed forecast profile and heightened global uncertainty**. We now look for USDJPY to end 2016 at 105.

For Asian EM FX, global risk sentiment will be the primary external driver of performance over the rest of this year. Near-term, EM Asian currencies are expected to benefit from ample external liquidity and reflationary policies in place (or to be implemented) following the U.K.'s decision to leave the EU.

The Korean won (KRW), Malaysian ringgit (MYR) and the Singapore dollar (SGD) are the most vulnerable currencies if the consequences of Brexit unfold in a disorderly way. In addition, we are concerned about recent signs that China's economy is losing steam and we expect the Chinese yuan (CNY) to decline modestly versus the USD this year amid persistent capital outflows. The Reserve Bank of India (RBI) has pledged to curb extreme movements in local FX market. India will announce the new RBI governor by July 15, while a new monetary policy committee is likely to be formed prior to August bi-monthly monetary policy review. As the RBI governor alone sets monetary policy currently, the committee's participation in the process will raise the likelihood of a rate cut next month.

On June 28, Indonesia's Parliament passed a tax amnesty bill into law with the program started July 1. It is expected to draw in capital inflows supporting the Indonesian rupiah (IDR). Bank Negara Malaysia has introduced a new methodology in USDMYR spot fixing based on market transaction data which takes effect on July 18 (the official closing for the onshore MYR market has also been extended an hour to 6pm local time). These measures will help develop and strengthen Malaysian financial markets. We note that Thai baht (THB) strength is not in the regulators' interest and remain bearish on the THB in the medium-term, considering lingering domestic political issues and the upcoming relaxation of overseas investment controls.

Table 1 — July 2016 Forecasts

	Today	Q116	Q216	Q316f	Q416f	Q117f	Q217f	Q317f	Q417f	YoY '15	YTD	to Y/E	YoY '17
CADUSD	0.77	0.77	0.77	0.77	0.77	0.78	0.78	0.80	0.80	-16.0%	6.2%	0.2%	4.0%
USDCAD	1.30	1.30	1.29	1.30	1.30	1.28	1.28	1.25	1.25				
EURUSD	1.11	1.14	1.11	1.05	1.05	1.05	1.07	1.10	1.12	-10.2%	1.7%	-5.0%	6.7%
GBPUSD	1.29	1.44	1.33	1.25	1.25	1.27	1.27	1.30	1.35	-5.4%	-14.1%	-3.2%	8.0%
USDJPY	101.0	112.6	103.2	105.0	105.0	110.0	110.0	115.0	115.0	-0.4%	19.1%	-3.8%	-8.7%
EURCHF	1.08	1.09	1.08	1.10	1.10	1.11	1.11	1.12	1.12	10.5%	0.7%	-1.7%	-1.8%
USDCHF	0.98	0.96	0.98	1.05	1.05	1.06	1.04	1.02	1.00	-0.8%	2.5%	-6.6%	4.8%
EURSEK	9.47	9.24	9.39	9.24	9.24	9.14	9.04	9.02	9.02	3.0%	-3.2%	2.5%	2.5%
USDSEK	8.57	8.12	8.46	8.80	8.80	8.70	8.45	8.20	8.05	-7.5%	-1.5%	-2.6%	9.3%
USDNOK	8.49	8.27	8.36	8.30	8.30	8.20	8.20	7.80	7.80	-15.7%	4.2%	2.3%	6.4%
AUDUSD	0.75	0.77	0.75	0.75	0.75	0.73	0.73	0.72	0.72	-10.9%	2.6%	0.2%	-4.0%
NZDUSD	0.71	0.69	0.71	0.71	0.70	0.68	0.68	0.66	0.66	-12.4%	3.8%	-1.5%	-5.7%
USDCNY	6.69	6.45	6.65	6.68	6.70	6.70	6.75	6.75	6.75	-4.4%	-2.9%	-0.1%	-0.7%
USDHKD	7.76	7.76	7.76	7.76	7.76	7.76	7.76	7.76	7.76	0.1%	-0.1%	0.0%	0.0%
USDINR	67.5	66.2	67.5	67.0	68.0	68.0	68.0	67.0	67.0	-4.7%	-1.9%	-0.8%	1.5%
USDIDR	13209	13239	13210	13100	13650	13650	13650	13500	13500	-10.2%	4.4%	-3.2%	1.1%
USDMYR	4.05	3.90	4.03	4.00	4.15	4.15	4.15	4.05	4.05	-18.6%	6.1%	-2.4%	2.5%
USDPHP	47.1	46.0	47.2	46.8	47.5	47.5	47.5	47.0	47.0	-4.7%	-0.4%	-0.9%	1.1%
USDSGD	1.35	1.35	1.35	1.34	1.39	1.39	1.39	1.37	1.37	-6.6%	4.8%	-2.6%	1.5%
USDKRW	1166	1143	1152	1140	1200	1200	1200	1180	1180	-7.2%	0.8%	-2.9%	1.7%
USDTWD	32.4	32.2	32.3	32.0	32.5	32.5	32.5	32.0	32.0	-3.7%	1.5%	-0.3%	1.6%
USDTHB	35.2	35.1	35.1	35.0	35.5	35.5	35.5	35.0	35.0	-8.7%	2.3%	-0.8%	1.4%

LATAM FX has been trading much less on fundamentals than technical factors this year, with issues such as yield and liquidity serving as better proxies for performance than macro fundamentals. With these drivers likely to remain in place in an environment of "nervous yield-chasing", we expect high carry LATAM FX to outperform lower carry currencies.

Investors cannot, however, ignore (local, as well as global) political risk. The Brazilian real (BRL) is a very clear example. President Rousseff's impeachment and, more recently, corruption accusations against members of acting-President Temer's cabinet have been key drivers of BRL performance. The Mexican peso (MXN) is good example of sensitivity to global political risk, given recent focus on the U.K. referendum and, more importantly, the U.S. presidential election. These issues have driven a sharp depreciation of the MXN, not only due to concerns about globalization being rolled back but also because the MXN's characteristics make it an attractive proxy-hedge vehicle (a liquid, globally-traded EM currency which is highly correlated to risk proxies). We think the MXN is undervalued, but we doubt it will see a substantial recovery as long as global uncertainty lingers (U.S. elections, China growth worries, etc).

The Andean currencies have not really behaved as a block. As tends to be the case, Peru's sol (PEN) has been a less sensitive or low beta currency. This is due partly to a central bank which is very active in FX and partly because resilient Peruvian growth — despite softer commodity prices — has been supportive for sentiment. In contrast, the Colombian peso (COP) has become a very high beta currency, with concerns over oil price dependence, public finances and a still very wide current account gap weighing during risk-off periods. However, having a high carry has also made it a long of choice during recoveries in risk appetite. Chilean peso's (CLP) main drivers have been commodity prices.

APPENDIX 1

International	2000-14	2015	2016f	2017f	2000-14	2015	2016f	2017f
	Real GDP (annual % change)				Consumer Prices (y/y % change, year-end)			
World (based on purchasing power parity)	3.9	3.3	3.0	3.3				
Canada	2.2	1.1	1.3	2.0	2.0	1.3	2.2	2.2
United States	1.9	2.4	1.9	2.2	2.3	0.4	2.0	2.3
Mexico	2.3	2.5	2.4	2.8	4.6	2.1	3.6	3.9
United Kingdom	1.8	2.2	1.3	0.0	2.2	0.2	1.4	2.0
Euro zone	1.2	1.6	1.4	1.1	1.9	0.2	0.8	1.4
Germany	1.2	1.7	1.5	1.2	1.6	0.3	0.9	1.5
France	1.3	1.2	1.4	1.1	1.7	0.2	0.9	1.4
Russia	4.6	-3.7	-1.0	1.5	11.4	12.9	6.7	6.2
China	9.7	6.9	6.5	6.1	2.4	1.6	2.1	2.3
India	7.0	7.3	7.5	7.5	7.2	5.6	5.8	5.6
Japan	0.9	0.6	0.6	0.6	0.0	0.2	0.5	0.7
South Korea	4.4	2.6	2.6	2.8	2.8	1.3	1.2	2.0
Indonesia	5.6	4.8	5.0	5.3	6.2	3.4	4.1	4.7
Australia	3.0	2.5	2.6	2.6	2.9	1.7	1.5	1.9
Thailand	4.1	2.8	3.0	3.2	2.5	-0.9	1.2	2.0
Brazil	3.4	-3.8	-3.6	0.5	6.5	10.7	7.0	5.5
Colombia	4.3	3.1	2.4	2.8	5.0	6.8	7.0	4.0
Peru	5.4	3.2	3.8	3.6	2.7	4.4	3.1	3.0
Chile	4.3	2.1	1.7	2.0	3.3	4.4	3.3	2.9

Commodities	2000-14	2015	2016f	2017f
	(annual average)			
WTI Oil (US$/bbl)	65	49	45	55
Brent Oil (US$/bbl)	68	54	46	56
Nymex Natural Gas (US$/mmbtu)	5.25	2.63	2.40	3.30
Copper (US$/lb)	2.35	2.49	2.20	2.20
Zinc (US$/lb)	0.80	0.87	0.85	1.25
Nickel (US$/lb)	7.59	5.36	3.90	4.25
Aluminium (US$/lb)	0.88	0.75	0.72	0.75
Iron Ore (US$/tonne)	68	55	45	45
Metallurgical Coal (US$/tonne)	129	102	83	86
Gold, London PM Fix (US$/oz)	824	1,160	1,260	1,320

APPENDIX 2

North America	2000-14	2015	2016f	2017f	2000-14	2015	2016f	2017f
	Canada (annual % change)				United States (annual % change)			
Real GDP	2.2	1.1	1.3	2.0	1.9	2.4	1.9	2.2
Consumer Spending	3.0	1.9	1.9	1.7	2.3	3.1	2.7	2.7
Residential Investment	3.8	3.8	3.3	-0.8	-1.7	8.9	9.6	5.0
Business Investment	3.4	-10.2	-7.6	2.1	2.4	2.8	-0.9	2.9
Government	2.3	1.8	1.2	2.2	1.0	0.7	1.0	0.8
Exports	1.2	3.4	2.1	3.2	4.0	1.1	1.0	2.8
Imports	3.2	0.3	-1.0	2.6	3.4	4.9	1.4	3.9
Nominal GDP	4.6	0.5	2.2	4.3	4.0	3.5	3.2	4.3
GDP Deflator	2.3	-0.6	0.9	2.2	2.1	1.0	1.3	2.0
Consumer Price Index	2.0	1.1	1.9	2.2	2.4	0.1	1.6	2.4
Core CPI	1.8	2.2	2.1	2.0	2.0	1.8	2.2	2.3
Pre-Tax Corporate Profits	5.3	-15.8	-5.5	7.0	6.3	-3.1	-3.0	5.0
Employment	1.4	0.8	0.6	0.8	0.5	2.1	1.7	1.4
Unemployment Rate (%)	7.1	6.9	7.1	7.1	6.4	5.3	4.8	4.7
Current Account Balance (C$, US$ bn.)	-10.0	-62.6	-68.9	-58.9	-525	-463	-507	-544
Merchandise Trade Balance (C$, US$ bn.)	31.8	-22.5	-28.1	-20.7	-661	-763	-760	-812
Federal Budget Balance (C$, US$ bn.)	-3.2	1.9	-5.0	-27.0	-535	-439	-500	-530
per cent of GDP	-0.2	0.1	-0.3	-1.3	-3.9	-2.4	-2.7	-2.7
Housing Starts (thousands, mns)	199	196	188	180	1.29	1.11	1.24	1.38
Motor Vehicle Sales (thousands, mns)	1,622	1,898	1,955	1,945	15.2	17.3	17.7	18.0
Industrial Production	0.7	-1.1	0.6	2.0	0.8	0.3	-0.9	2.5
	Mexico (annual % change)							
Real GDP	2.3	2.5	2.4	2.8				
Consumer Price Index (year-end)	4.6	2.1	3.6	3.9				
Current Account Balance (US$ bn.)	-14.5	-31.9	-29.7	-34.0				
Merchandise Trade Balance (US$ bn.)	-6.3	-14.6	-15.0	-14.4				

Quarterly Forecasts	2015		2016				2017			
Canada	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Real GDP (q/q, ann. % change)	2.2	0.5	2.4	-0.8	3.2	2.0	2.1	2.1	1.9	1.9
Real GDP (y/y, % change)	1.0	0.3	1.1	1.1	1.3	1.7	1.6	2.4	2.0	2.0
Consumer Prices (y/y, % change)	1.2	1.3	1.5	1.7	2.0	2.2	2.3	2.1	2.1	2.2
Core CPI (y/y % change)	2.2	2.0	2.0	2.1	2.1	2.1	2.1	2.0	2.0	2.0
United States										
Real GDP (q/q, ann. % change)	2.0	1.4	1.1	2.8	2.0	2.0	2.3	2.3	2.3	2.2
Real GDP (y/y, % change)	2.1	2.0	2.1	1.8	1.8	2.0	2.3	2.1	2.2	2.3
Consumer Prices (y/y, % change)	0.1	0.4	0.8	1.0	1.4	2.0	2.4	2.3	2.3	2.3
Core CPI (y/y % change)	1.8	2.0	2.3	2.2	2.3	2.3	2.3	2.3	2.3	2.3

APPENDIX 3

	2015		2016				2017			
Central Bank Rates	Q3	Q4	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Americas			(%, end of period)							
Bank of Canada	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75
U.S. Federal Reserve	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.25
Bank of Mexico	3.00	3.25	3.75	4.25	4.25	4.50	4.75	5.00	5.25	5.50
Central Bank of Brazil	14.25	14.25	14.25	14.25	14.25	14.25	14.00	13.50	13.00	12.50
Bank of the Republic of Colombia	4.75	5.75	6.50	7.50	7.25	7.25	7.25	6.75	6.25	5.75
Central Reserve Bank of Peru	3.50	3.75	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25
Central Bank of Chile	3.00	3.50	3.50	3.50	3.50	3.50	3.75	3.75	4.00	4.00
Europe										
European Central Bank	0.05	0.05	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bank of England	0.50	0.50	0.50	0.50	0.00	0.00	0.00	0.00	0.00	0.00
Swiss National Bank	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75
Asia/Oceania										
Reserve Bank of Australia	2.00	2.00	2.00	1.75	1.75	1.50	1.50	1.50	1.50	1.50
Bank of Japan	0.10	0.10	-0.10	-0.10	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20
People's Bank of China	4.60	4.35	4.35	4.35	4.10	4.10	4.10	4.10	4.10	4.10
Reserve Bank of India	6.75	6.75	6.75	6.50	6.25	6.25	6.25	6.25	6.25	6.50
Bank of Korea	1.50	1.50	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.50
Bank Indonesia*	n/a	n/a	n/a	5.25	5.00	5.00	5.00	5.00	5.00	5.25
Bank of Thailand	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.75
Currencies & Interest Rates										
Americas			(end of period)							
Canadian Dollar (USDCAD)	1.33	1.38	1.30	1.29	1.30	1.30	1.28	1.28	1.25	1.25
Canadian Dollar (CADUSD)	0.75	0.72	0.77	0.77	0.77	0.77	0.78	0.78	0.80	0.80
Mexican Peso (USDMXN)	16.92	17.21	17.28	18.28	18.55	18.52	18.27	17.79	17.84	18.07
Brazilian Real (USDBRL)	3.95	3.96	3.59	3.21	3.90	3.90	4.20	4.10	4.00	4.00
Colombian Peso (USDCOP)	3087	3175	3002	2920	3200	3275	3250	3275	3300	3350
Peruvian Nuevo Sol (USDPEN)	3.23	3.41	3.31	3.29	3.35	3.35	3.36	3.32	3.33	3.28
Chilean Peso (USDCLP)	696	709	668	663	697	704	703	702	702	701
Europe										
Euro (EURUSD)	1.12	1.09	1.14	1.11	1.05	1.05	1.05	1.07	1.10	1.12
U.K. Pound (GBPUSD)	1.51	1.47	1.44	1.33	1.25	1.25	1.27	1.27	1.30	1.35
Swiss Franc (USDCHF)	0.97	1.00	0.96	0.98	1.05	1.05	1.06	1.04	1.02	1.00
Swedish Krona (USDSEK)	8.37	8.44	8.12	8.46	8.80	8.80	8.70	8.45	8.20	8.05
Norwegian Krone (USDNOK)	8.52	8.84	8.27	8.36	8.30	8.30	8.20	8.20	7.80	7.80
Russian Ruble (USDRUB)	65.4	72.5	66.9	63.9	67.5	68.5	68.0	67.5	67.0	66.5
Asia/Oceania										
Japanese Yen (USDJPY)	120	120	113	103	105	105	110	110	115	115
Australian Dollar (AUDUSD)	0.70	0.73	0.77	0.75	0.75	0.75	0.73	0.73	0.72	0.72
Chinese Yuan (USDCNY)	6.36	6.49	6.45	6.65	6.68	6.70	6.70	6.75	6.75	6.75
Indian Rupee (USDINR)	65.6	66.2	66.2	67.5	67.0	68.0	68.0	68.0	67.0	67.0
South Korean Won (USDKRW)	1185	1175	1143	1152	1140	1200	1200	1200	1180	1180
Indonesian Rupiah (USDIDR)	14653	13788	13239	13210	13100	13650	13650	13650	13500	13500
Thai Baht (USDTHB)	36.4	36.0	35.1	35.1	35.0	35.5	35.5	35.5	35.0	35.0
Canada (Yields, %)										
3-month T-bill	0.44	0.51	0.45	0.49	0.50	0.50	0.50	0.50	0.55	0.80
2-year Canada	0.52	0.48	0.54	0.52	0.45	0.50	0.55	0.70	0.80	1.10
5-year Canada	0.80	0.73	0.68	0.57	0.50	0.60	0.70	0.85	1.00	1.30
10-year Canada	1.43	1.39	1.23	1.06	0.80	0.90	1.00	1.05	1.20	1.40
30-year Canada	2.20	2.15	2.00	1.72	1.40	1.50	1.60	1.60	1.60	1.75
United States (Yields, %)										
3-month T-bill	-0.02	0.16	0.20	0.26	0.25	0.30	0.35	0.60	0.85	1.10
2-year Treasury	0.63	1.05	0.72	0.58	0.50	0.65	0.85	1.00	1.30	1.60
5-year Treasury	1.36	1.76	1.20	1.00	0.85	1.00	1.10	1.25	1.45	1.80
10-year Treasury	2.04	2.27	1.77	1.47	1.20	1.30	1.40	1.50	1.75	2.00
30-year Treasury	2.85	3.02	2.61	2.28	2.00	2.10	2.20	2.25	2.30	2.40

* As of August 19, Bank Indonesia will replace the 12-month reference rate with a new benchmark interest rate, the 7-day reverse repo rate.

Fixed Income Strategy (London, Paris)

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Foreign Exchange Strategy