Inflection Point

- **Global growth remains strong, but rash trade policy decisions are a clear and present danger to the expansion.**
- **US economic growth is accelerating and the Fed is on track to raise rates to 3% by end-2019. Recent trade actions are harming some US firms and increasing the cost of doing business. We now include a modestly negative impact from trade-related uncertainty in our US forecast for 2019.**
- **Canadian growth is moderating, but capacity pressures are increasing. The Bank of Canada will raise rates another 125 basis points, to 2.5%, by end-2019.**
- **We continue to believe a revamped NAFTA will be ratified in 2019, though NAFTA-related uncertainty will act as a modest drag on growth, as will the tariffs on steel and aluminum. The greater risk to the Canadian outlook now appears to be trade skirmishes between the US, China and a broad range of other countries, particularly if auto tariffs are implemented.**

Global growth remains remarkably strong as trade is facilitating mutually-reinforcing expansion across much of the world. This virtuous expansion is now at risk as a result of trade policy decisions in the United States. The aggressive US stance on trade is leading to a rise in input costs and in the price of consumer and capital goods that will eventually feed into inflation and increase business uncertainty. This will force businesses in the US to reconsider investment decisions. While the global economy remains sufficiently robust to deal with reasonably minor trade skirmishes such as the tariffs on steel and aluminum, we fear we have reached an inflection point, where all future trade actions could dampen global growth in a meaningful way while raising inflation. The escalating risk of a trade war represents a clear and present danger to the expansion, but we are hopeful that cooler heads will prevail given the costs of escalated actions.

Against this still-strong global backdrop, inflationary pressures are on the rise, more so in some countries than others. In advanced economies, central banks in Canada, the US and the UK are expected to continue tightening in response to observed and expected inflation. In Europe, where growth remains well above potential, inflationary pressures are rising but remain more muted as core inflation measures remain well below the rising headline inflation data. With growth expected to remain above potential through the year, the ECB has signaled that it would end its quantitative easing program at year-end, as a precursor to an eventual rise in policy rates. In Japan, growth will likely slow somewhat from the rapid expansion registered last year. While the economy is now firmly in excess demand, inflation remains well below the Bank of Japan's objective, and has recently been moving farther away from it. This will keep the Bank of Japan from changing its policy stance for the foreseeable future.

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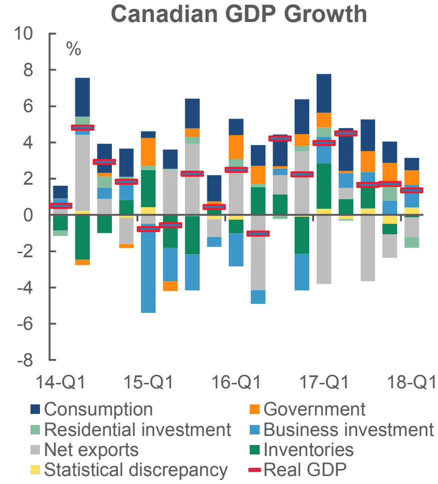
CONTENTS

Chart 1

Contribution to Canadian GDP Growth



Sources: Scotiabank Economics, Statistics Canada.

Commodity prices continue to benefit from strong economic growth and increasingly tight conditions across upstream production capacity as well as supporting supply chains. OPEC+ announced that it would move to increase effective production by 600–1,000 kbpd through the latter half of 2018 to alleviate some of the ongoing tightness that had pushed Brent crude prices as high as $80/bbl in early June. In line with this revised path of expected OPEC+ supply and factoring for the stronger-than-anticipated demand that pressed the group to lift production earlier than initially expected, we have raised our oil price forecasts for 2018/19. Brent crude is now forecast to average $74/bbl in 2018 and $77/bbl in 2019, while WTI prices are expected to lag Brent and differentials will remain wider than normal given tight pipeline capacity between Cushing and the USGC. The outlook for metals remains mixed. Base metal markets have been upgraded on even-tighter mine supply while bulk commodities ease and gold remains range-bound. Trade risks loom large for non-oil commodities, as suggested by recent moves in metals prices.

Table 1

Global Real GDP	2000–16	2016	2017	2018f	2019f
	(annual % change)				
World (PPP)	3.9	3.2	3.7	3.8	3.7
Canada	2.1	1.4	3.0	2.0	2.1
United States	1.9	1.5	2.3	2.8	2.3
Mexico	2.2	2.9	2.0	2.1	2.5
United Kingdom	1.8	1.9	1.8	1.7	1.9
Eurozone	1.3	1.8	2.6	2.5	2.3
Germany	1.3	1.9	2.2	3.0	3.0
France	1.3	1.2	2.2	2.5	2.0
China	9.4	6.7	6.9	6.6	6.3
India	7.1	7.9	6.3	7.5	7.5
Japan	0.9	1.0	1.7	1.1	0.9
South Korea	4.2	2.9	3.1	2.8	2.8
Australia	3.0	2.6	2.2	2.8	2.5
Thailand	4.0	3.3	3.9	4.1	3.6
Brazil	2.6	-3.5	1.0	2.3	2.5
Colombia	4.0	2.0	1.8	2.5	3.5
Peru	5.1	4.0	2.5	3.5	4.0
Chile	4.0	1.3	1.5	3.7	3.9

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

Over the last year, the US economy has enjoyed a combination of moderate growth, strengthening leading indicators, modest inflation, and gradually rising interest rates. The US economy has been in a sweet spot of benign data and policy that have allowed the current eight-and-a-half-year run of uninterrupted growth to become the second longest US expansion in history in June. We still expect the expansion to extend and become the longest on record in July 2019, but the current policy mix in the US clouds expectations beyond that point.

US economic policies are now firmly at cross purposes. The White House's corporate tax cuts and stepped-up spending should push real GDP growth to 2.8% this year, well above estimates of potential. Unemployment is now down at historical lows. But inflation has accelerated substantially since January: core PCE inflation is now at its target, with further risks to the upside. Rising protectionism threatens to undo many of the US's real-economy gains.

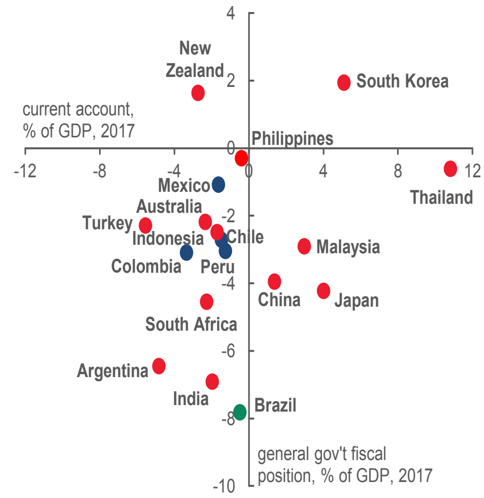
Concerns regarding trade policies are playing out in real time, as US equity markets react to the escalating protectionist rhetoric. The uncertainty surrounding trade policy in the US and potential responses by US trade partners will continue to weigh on financial markets, and likely act as a drag on growth into 2019. We have, for the first time, pulled down our US forecast in 2019 to account for uncertainty on the trade file. If actions escalate, we will mark down our forecasts further. As we indicated here, an all-out trade war, possibly triggered by the imposition of auto tariffs, would push the US into recession.

Against this background, the Federal Reserve will continue to normalize its policy settings. The US economy is operating above sustainable rates, and price pressures are a concern. We forecast that the Fed will largely look through trade-related uncertainty and remain on a tightening path, with an additional 3 rate increases this year and another 2 next year, for an end-2019 rate of 3%.

Our central view on the Canadian economy remains little changed from the previous quarter. Despite the recent cooling in the data and fattening tail risks related to US protectionism, the *Scotiabank Global Macroeconomic Model* (SGMM) continues to forecast real growth around 2% this year supported by solid domestic and US demand and rising oil prices, but this includes negative adjustments to reflect trade-related uncertainties. Absent these adjustments, growth would be closer to 2.3%. The sources of Canadian growth may finally be evolving toward a more sustainable mix (chart 1) with a lighter emphasis on household consumption and real estate, and a greater contribution from investment and trade that could help boost productivity. Aggregate growth could still surprise to the upside if current trade tensions are resolved more quickly than projected and competitiveness concerns begin to be addressed.

Chart 2

Current Account & Government Fiscal Positions



Sources: Scotiabank Economics, IMF.

Recent economic developments have tended to disappoint, with jobs numbers, building permits, sales of manufactured goods, retail sales, and inflation all coming in somewhat lower than consensus and, in general, our own forecasts. At around 2.2% (SAAR), our tracking for 2018Q2 growth is only slightly below the 2.5% forecast in the Bank of Canada's April Monetary Policy Report. These data need to be set against the backdrop of a real economy that is at or above full capacity, tight labour markets, rising wages, strengthening investment growth, and inflation set to remain above the Bank of Canada's 2% target.

While the Bank of Canada is right to lose a little sleep over trade, our baseline is consistent with further policy normalization. We continue to expect two more 25 bps increases during 2018 in the Bank of Canada's target overnight rate, with the first of these coming this month, and three additional 25 bps increases during 2019. If our forecast is accurate, this would represent a very gradual pace of tightening, with less than one move per quarter through the end of next year. That would leave the overnight rate at 2.5% by the end of next year and either in line with or not far from the estimated neutral rate, and still very low by historical standards. Adjusted for inflation, the real policy rate would only be about 0.5% at that time, well below the growth of real GDP. There is the risk of going at a slower pace should NAFTA developments take a much deeper turn for the worse than has been apparent to date or anticipated, but there is also the opposite risk of overshooting the long-run neutral rate if this cycle's wage and price pressures continue to evolve in a fashion that further jeopardizes the BoC's inflation mandate. Markets appear to be underpricing the extent of policy moves by the BoC. Given the rise in the price of oil, and what is likely to be a more pronounced increase in rates by Governor Poloz, the Canadian dollar should appreciate gradually as the year progress, ending the year around 1.28 (or 78 cents), if trade tensions remain contained as we expect.

Prospects in Asia remain reasonably strong, though trade tensions between the US and China have the potential to significantly affect the region. In China, economic activity continues to be robust, though growth this year will slow relative to 2017 owing in part to lesser policy stimulus. An escalation of the trade dispute with the US would have negative impacts on the Chinese economy, but Chinese authorities have a range of tools at their disposal to blunt the impact of a more aggressive US trade policy. Principal among these is the exchange rate, which the Chinese authorities are allowing to depreciate. Our forecast assumes cooler heads prevail on the trade side and that an all-out trade war is averted given the damage it would cause in both China and the US.

A key challenge facing emerging markets this year is the transition to a more hawkish stance on the part of the Federal Reserve. Capital flows to emerging markets have fallen, though this has been concentrated in high-risk countries, such as those with high current account and fiscal deficits (chart 2). The countries of the Pacific Alliance have been generally insulated from these movements. Growth prospects are improving in all these countries, as economic activity is expected to accelerate relative to last year. This is most true in Chile and Peru, where the rise in commodity prices and enthusiasm for new political administrations are leading to large increases in growth rates relative to 2017. In Colombia, high oil prices are providing a strong impulse to business investment, which will be further strengthened as confidence in the new administration takes hold. Strengthening business activity will add to already buoyant household spending. In Mexico, the domestic economy remains strong, and activity continues to benefit from robust growth in the US and the rest of the world. The political transition is key to Mexican prospects. We expect the AMLO administration to maintain the general thrust of economic policies of the previous government, but there are risks of a more dramatic shift in orientation. Were that to occur, we would need to re-evaluate our forecast for Mexico.

The foundations of the global expansion remain solid, and we remain optimistic that trade tensions will not lead to a full-blown trade war. This however, assumes that the Trump administration internalizes the potential damage caused to the American economy and adopts a less confrontational approach on trade. America is at an inflection point. The Administration has the opportunity to extend what is already one of the longest economic expansions on record. Continued attacks on its own businesses and trading partners risk cutting the expansion short.

Canada

EXPECTING THE BEST, PREPARING FOR THE WORST

- **Our stable Canadian outlook rests on a central view that an escalation of US protectionism into a global trade war remains unlikely, notwithstanding recent rhetoric. We continue to expect NAFTA talks to resume and reach a benign conclusion in 2019.**
- **A US move to impose auto tariffs would be the tipping point toward a global trade war featuring a cascading set of retaliations that would push the US and most of its major trading partners, including Canada, into recession by 2020.**

MIXED MESSAGES

Despite the recent cooling in the data and fattening tail risks related to US protectionism, our central view on the Canadian economy remains little changed from the previous quarter. The *Scotiabank Global Macroeconomic Model* (SGMM) continues to forecast real growth around 2% this year and next (table 1), supported by consistent domestic and US demand. The sources of Canadian growth may finally be evolving toward a more sustainable mix with a lighter emphasis on household consumption and residential real estate, and a greater contribution from business investment and trade that could help boost productivity. Aggregate growth in 2018 could still surprise to the upside at 2.3% rather than our current 2.0% forecast if the negative effects of existing trade tensions are lifted more quickly than currently projected (table 2) and competitiveness concerns are addressed.

Rising oil prices, following US withdrawal from the Iran accord, have lifted sentiment on both the energy industry and Canada more generally. The Alberta oil patch received additional assurances from the federal government's announcement that it intends to purchase the Trans Mountain pipeline. Nevertheless, as the ***Commodities*** section details, we have widened our forecast WCS discount for 2018–19 as capacity out of Western Canada is expected to remain exceedingly tight despite the breathing room now provided through mid-August by the recent power outage at Alberta's Syncrude facility.

Other recent economic developments have, however, been undeniably downbeat. Economic activity in Q2-2018 has tended to disappoint, with jobs numbers, building permits, sales of manufactured goods, retail sales, and inflation all coming in somewhat lower than consensus and, in general, our own forecasts. Q2-2018 GDP growth is tracking around 2.2% SAAR, below the 2.5% forecast in the Bank of Canada's April ***Monetary Policy Report*** (MPR). Moreover, the Syncrude disruption is expected to subtract up to 0.2 ppts from Q/Q SAAR real GDP growth in Q3-2018, before a corresponding rebound in the last quarter of 2018 to leave our projection for Canada's annual real GDP growth rate for 2018 at 2.0%. But these data need to be set against the backdrop of a real economy that continues to expand at near-full capacity, tight labour markets, rising wages, strengthening investment growth, and inflation set to remain above 2%.

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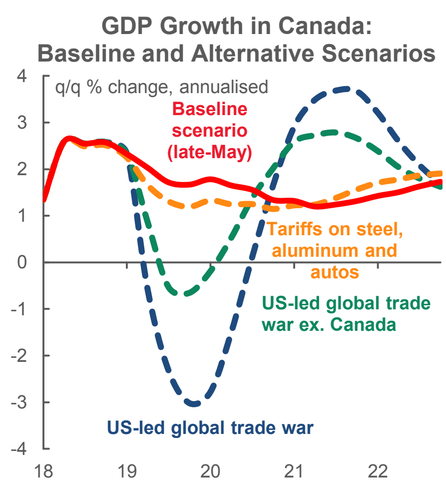
Canada	2017	2018f	2019f
Real GDP (annual % change)	3.0	2.0	2.1
CPI (y/y %, eop)	1.8	2.7	2.1
Central bank policy rate (%, eop)	1.00	1.75	2.50
Canadian dollar (CADUSD, eop)	0.80	0.78	0.80

Source: Scotiabank Economics.

Chart 1



Source: Scotiabank Economics.

Although US tariffs dominate discussions on Canada's economic prospects, our baseline forecasts continue to reflect our expectation that a further substantial escalation in trade tensions will be avoided. The economic and political logic underpinning NAFTA remains compelling for all three countries. Parties from all sides, including possible members of a future Mexican government, indicate that they expect talks to resume soon, with a view to sustained progress toward a deal.

The introduction of new US tariffs on autos and parts is likely to be stayed. Auto tariffs would invite such wide-ranging retaliatory duties that the US and its major trading partners, including Canada, would be pushed into recessions by 2020, just as the current US president is expected to seek re-election. While our baseline reflects the high probability we assign to a trade war being avoided, our recent paper ***NAFTA: Steeling Ourselves for the Macro Costs of Tariffs*** models the macroeconomic implications of several scenarios where the US withdraws from NAFTA and/or moves ahead with more tariffs (chart 1). Short of an all-out, auto-tariff-induced trade war, Canada's growth prospects are encouraging.

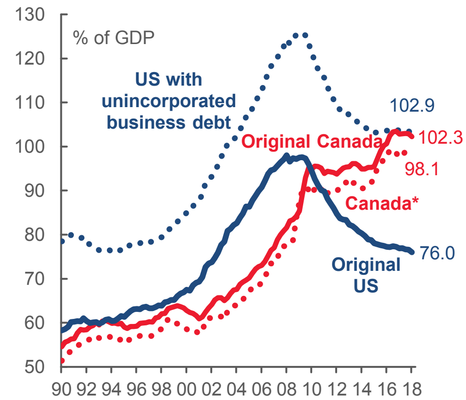
While the Bank of Canada is right to lose a little sleep over trade, our baseline is consistent with further policy normalization. We continue to expect two more 25 bps increases during 2018 in the Bank of Canada's target overnight rate, with the first of these coming this month, and three additional 25 bps increases during 2019 to take the policy rate to 2.50% by end-2019, as detailed in the ***Monetary Policy & Capital Markets*** section.

CANADIAN CONSUMERS CURB THEIR ENTHUSIASM

Canadian consumers continue to moderate their activity after 2017 recorded the strongest growth in household expenditures since 2010. Tight labour markets, low unemployment at 5.8% (table 3), strong wage growth, and further mandated minimum-wage increases should continue to provide support for consumer spending. However, a weaker-than-expected start to 2018 amidst slowing credit growth has nudged us to mark down our forecast for 2018 consumption growth from 2.6% in our last quarterly outlook to 2.1% (table 3). Total retail sales were down by 1.2% m/m in April, brought

Chart 2

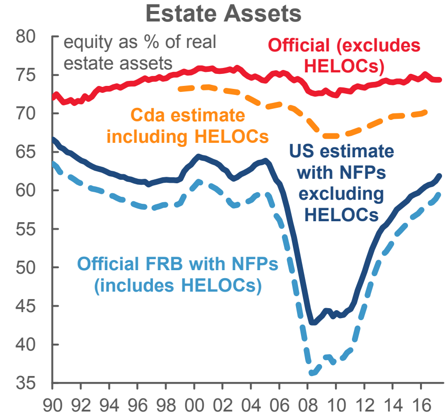
Household Credit Market Debt



* Adjusted for US concepts and definitions.
Sources: Scotiabank Economics, BEA, Federal Reserve Board, Statistics Canada.

Chart 3

High Percentage of Equity in Real Estate Assets



Sources: Scotiabank Economics, OSFI, FCAC, Statistics Canada, Federal Reserve Board.

Table 1

Quarterly Canadian Forecasts	2017	2018				2019			
	Q4	Q1	Q2e	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic									
Real GDP (q/q ann. % change)	1.7	1.3	2.2	2.2	2.5	2.1	2.0	1.9	1.8
Real GDP (y/y % change)	3.0	2.3	1.7	1.9	2.1	2.2	2.2	2.1	2.0
Consumer prices (y/y % change)	1.8	2.1	2.2	2.6	2.7	2.5	2.4	2.2	2.1
Avg. of new core CPIs (y/y % change)	1.7	1.9	1.9	2.0	2.1	2.2	2.2	2.2	2.2
Financial									
Canadian Dollar (USDCAD)	1.26	1.29	1.31	1.28	1.28	1.25	1.22	1.22	1.25
Canadian Dollar (CADUSD)	0.80	0.78	0.76	0.78	0.78	0.80	0.82	0.82	0.80
Bank of Canada Overnight Rate (%)	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.25	2.50
3-month T-bill (%)	1.06	1.15	1.26	1.55	1.80	2.05	2.30	2.30	2.50
2-year Canada (%)	1.69	1.78	1.91	2.05	2.30	2.40	2.50	2.55	2.60
5-year Canada (%)	1.87	1.97	2.07	2.25	2.45	2.55	2.60	2.65	2.70
10-year Canada (%)	2.05	2.09	2.17	2.40	2.55	2.60	2.65	2.70	2.75
30-year Canada (%)	2.27	2.23	2.20	2.50	2.70	2.80	2.85	2.90	2.95

Sources: Scotiabank Economics, Statistics Canada, Bloomberg.

lower mainly by a decrease in auto sales, although retail activity still dropped by 0.1% m/m exclusive of autos. Poor weather conditions appeared to play some role in the decline, but a more substantial rebalancing of household economics also appears to be at work as rising interest rates, tighter lending standards, and NAFTA anxieties may be prompting more considered spending and saving decisions.

Credit data imply that Canadians are responding to encouragements by policy makers to improve the soundness of their accounts. Growth rates in household, consumer, mortgage, and auto credit have all declined in recent quarters as, amongst other things, interest rates have risen, credit rules have tightened, lending standards have been raised, and growth has slowed. In Q1-2018, for instance, new mortgage flows hit their lowest level since Q2-2014.

Table 2

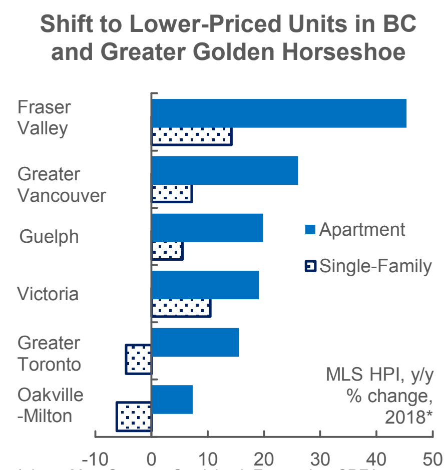
Real GDP growth: impact of policy developments

	2018f	2019f
Model-based projections based on fundamentals	**2.3**	**2.3**
Less: adjustments for policy developments	**-0.3**	**-0.2**
B-20 mortgage rules	-0.1	0.0
Steel & aluminum tariff	0.0	-0.1
NAFTA uncertainty	-0.1	0.0
Global protectionism	-0.1	-0.1
Current baseline	**2.0**	**2.1**

Source: Scotiabank Economics.

Household balance sheets still compare favourably with those of our US neighbours. The headline ratio of household credit-market debt to personal disposable income has continued edging down from a record high of 170.5% in Q3-2017 to 168.0% in Q1-2018. Reconfigured on terms comparable with the parallel US headline figure, at 162.2% the Canadian ratio remains below the US peak of 168.4% in 2007. Canada's economy-wide household credit to GDP ratio remains lower than the comparable figure in the US even after a decade of American financial repair (chart 2). The ratio of household liabilities to assets has always been more modest in Canada than in the US, and Canadians' equity in the real-estate component of those assets remains consistently stronger than in the US (chart 3). Looking forward, Canadians' vulnerability to further interest rate increases is somewhat contained by the fact that less than half of Canadian households have any exposure to mortgage and/or HELOC borrowing.

Chart 4



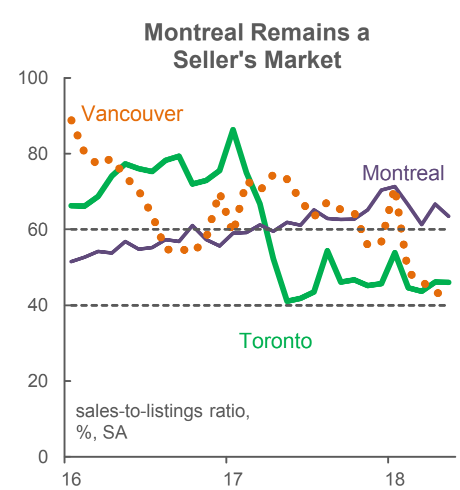
* Jan. - May. Sources: Scotiabank Economics, CREA.

HOUSING ACTIVITY RESPONDS TO POLICY CHANGES

Monetary-policy tightening and the B-20 mortgage stress test rules that took effect January 1, 2018 continued to dampen home-buying activity in Q2, with country-wide corrections in unit sales volumes. The drop in transactions has been concentrated in the greater Toronto and Vancouver areas. The two cities are relatively sensitive to the new regulations owing to their already-elevated home prices and their relatively high shares of uninsured mortgages. Both metropolitan areas witnessed year -on-year residential unit sales declines of more than 20% in both April and May, which fed into a 16.2% y/y decrease in nation-wide unit sales in May.

The Canada-wide average sale price was down 6.4% y/y in May, weighed down by a 6.8% y/y decrease in Toronto. Prices, however, have remained firm once one adjusts for the shift in the composition of sales from single-detached homes to more affordable unit types, such as apartments and townhomes. The Composite MLS Home Price Index (HPI) implies that unit-type adjusted prices are still up 1.0% y/y in May. Over the last year, price increases for apartment properties have outpaced those for single-detached homes in and around Canada's higher-priced metropolitan areas (chart 4).

Chart 5



Sources: Scotiabank Economics, CREA.

We look for the pace of home sales to recover in the second half of this year and continue on an upward trajectory in 2019. The rebound is expected to be led by developments in and around the Greater Toronto and Greater Vancouver areas, which continue to witness healthy economic expansions, and to a lesser extent Montreal, where the local market remains tipped in favour of sellers (chart 5). Markets in the rest of the country are largely balanced, with the exception of major cities in the Western net oil-producing provinces, which are still absorbing inventory accumulated since the last oil-price correction in mid-2014.

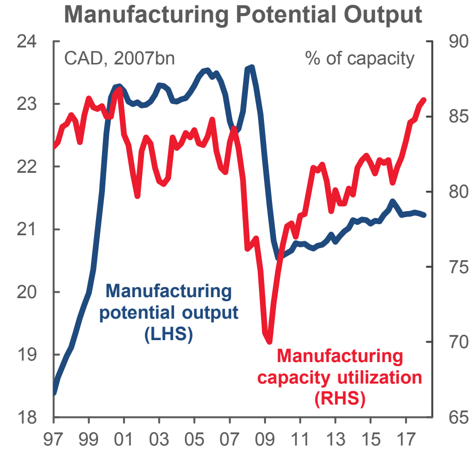
Housing starts are projected to come down gradually from 220,000 units in 2017 to 213,000 in 2018 and 200,000 units in 2019. Housing construction is expected to slow modestly in Southern BC and the Greater Golden Horseshoe this year before cooling more substantially in 2019, when the slowdown is likely to be focused on Quebec as it comes off a cycle peak. In Alberta, net interprovincial migration is expected to turn modestly positive, adding to elevated international immigration, helping to absorb existing excess housing inventory. Over the next year and a half, even as job creation eases and rising interest rates reduce affordability, increased immigration and still-high home prices should put a floor under building activity.

INDUSTRY HITS INVESTMENT-INDUCING CAPACITY CONSTRAINTS

Canadian manufacturing sales have been supported in recent years by a combination of robust domestic consumption growth and increased demand from the United States that has received an additional boost from federal tax cuts and increased public spending. Real manufacturing shipments, excluding petroleum products, were 2.7% higher in the first four months of 2018 compared with the same period in 2017. At the same time, in Q1-2018 manufacturing utilization rates hit their highest levels since mid-2000 at 86.1% of total capacity (chart 6).

Manufacturing production processes have become stretched as investment growth has, until recently, been relatively weak. Since the 2008 global financial crisis, firms have seemed reluctant to boost capital expenditure (capex) when the strength of the recovery has intermittently been in doubt. More recently, investment in plant and equipment has been tempered by the commodity-price downturn in 2014–15. Uncertainty about trading arrangements with the US since end-2016 has likely further inhibited investment decisions.

Chart 6



Sources: Scotiabank Economics, Statistics Canada.

Export-sensitive sub-sectors have seen some of the steepest increases in operating rates in response to strengthening and synchronizing global demand, particularly from the US (chart 7). In machinery manufacturing, where over three-quarters of total production is destined for the US, capacity utilisation has risen from 70% in the second quarter of 2016 to 90.2%. Similarly, the computer and electronics industry, which sends around 75% of its output south of the border, is currently operating at just under 90% of total capacity.

Some firms appear to have attempted to substitute labour for new physical capacity in order to increase production and fill burgeoning order books—and have nearly exhausted available labour pools in the process. Manufacturing employment increased by 2% last year, its fastest annual increase since 2000, and the unemployment rate in Canadian manufacturing now sits near its all-time low at 3.4%. However, labour productivity growth was negative in the first quarter of 2018 (chart 8) as the substitution of labour for capital encountered deeply diminishing returns. As Canadian manufacturing hits the limits of labour-capital substitution, capex becomes the

Table 3

Canada	2000–16	2016	2017	2018f	2019f
	(annual % change, unless noted)				
Real GDP	2.1	1.4	3.0	2.0	2.1
Consumer spending	2.9	2.3	3.4	2.1	2.0
Residential investment	3.7	3.4	2.8	0.1	0.4
Business investment	2.2	-8.8	2.7	6.8	2.6
Government	2.2	2.7	2.6	2.6	1.5
Exports	1.3	1.0	1.1	2.5	3.7
Imports	2.9	-1.0	3.6	4.5	2.6
Nominal GDP	4.2	2.0	5.4	4.3	4.7
GDP Deflator	2.1	0.6	2.3	2.3	2.5
Consumer price index (CPI)	1.9	1.4	1.6	2.4	2.3
CPI ex. food & energy	1.6	1.9	1.6	1.8	2.0
Pre-tax corporate profits	3.6	-1.9	19.9	4.8	4.3
Employment	1.3	0.7	1.9	1.2	1.0
Unemployment rate (%)	7.1	7.0	6.3	5.8	5.7
Current account balance (CAD bn)	-17.1	-65.4	-63.3	-71.0	-60.2
Merchandise trade balance (CAD bn)	25.1	-25.9	-24.0	-30.1	-22.5
Federal budget balance* (FY, CAD bn)	-2.8	-1.0	-17.8	-20.0	-18.0
percent of GDP	-0.2	0.0	-0.9	-0.9	-0.8
Housing starts (000s)	199	198	220	213	200
Motor vehicle sales (000s)	1,657	1,949	2,041	2,000	1,950
Industrial production	0.6	0.1	5.2	2.4	1.0
WTI oil (USD/bbl)	63	43	51	68	71
Nymex natural gas (USD/mmbtu)	4.94	2.55	3.02	2.93	2.90

Sources: Scotiabank Economics, Statistics Canada, CMHC, Bloomberg. * Canada ex risk adjustment of $1.5bn & $3.0bn for FY18 & FY19.

alternative route to expand output—which likely explains the expansions of 8.7% y/y in Q4-2017 and 8.2% y/y in Q1-2018 in spending on non-residential structures, machinery and equipment, and intellectual property.

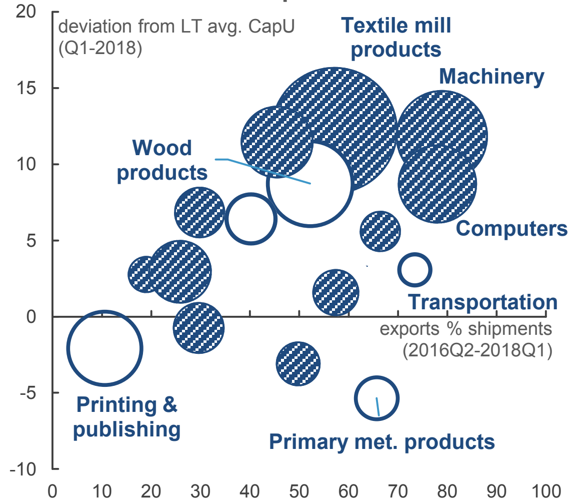
Notwithstanding this recent boost, non-residential capital spending still sits 14% below its late-2014 high owing to reduced activity in the energy sector. In contrast, business investment outside the energy sector is returning to prior peaks.

Despite the uncertainty induced by growing US protectionism and NAFTA's still-pending status, the combination of strong US demand, tight domestic labour markets, and abundant financial capital make conditions ripe for further growth in business investment. We project an annual increase of 6.8% in 2018 (table 3), the strongest growth in business investment since 2011. We expect investment expenditure to continue growing into 2019, albeit at a softer pace of around 2.6%. Trade-policy worries will likely mean that spending on machinery, equipment, and intellectual property will dominate investment decisions, while commitments to non-residential structures could require greater clarity on the near-term outlook before being approved.

Efforts to enhance Canada's competitiveness would be timely to convert capacity constraints into firm investment decisions. Attention has been focused on how US tax changes have more or less eliminated the former gap between US and Canadian statutory and effective corporate tax rates, but the link between tax rates and business investment has always been imperfect. More targeted measures focused on stimulating investment through tax deductions on accelerated depreciation schedules, enhanced tax credits, smoother immigration processes for skilled talent, simpler permitting and regulatory compliance, and better public infrastructure could all stimulate private capex and boost Canadian productivity. Moreover, they would provide a smart reply to US tariffs that, unlike retaliatory tariffs, wouldn't hurt Canadian industry and consumers.

Chart 7

Capacity Utilisation Rate, Exports-Intensity and Real Exports Growth

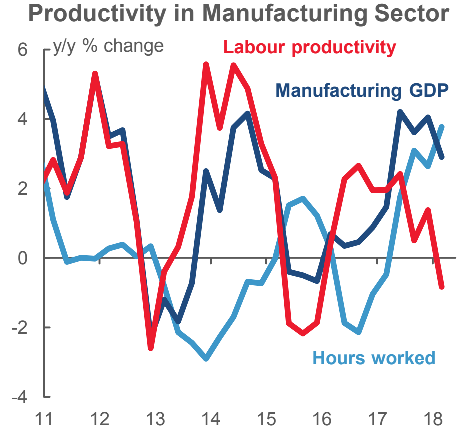


Circle size = % change in real exports, Q2-16 to Q1-18.
Clear circle = –'ve growth; Shaded circle = +'ve growth.
Min: wood products -11%; Max: textile mill products +25%

Sources: Scotiabank Economics, Statistics Canada.

Chart 8

Hours Worked, Output and Productivity in Manufacturing Sector



Sources: Scotiabank Economics, Statistics Canada.

FISCAL POLICY STILL PRO-CYCLICAL

For the third consecutive year, current and capital spending in 2018 across all levels of government is expected to contribute 0.6 ppts to national real GDP growth (over one-quarter of economy-wide growth). This projection reflects the federal government's assumption of a larger role in many policy areas where it has used its spending power to leverage provincial and municipal outlays that might otherwise not have occurred: additional expenditure in social housing, mental health, and water treatment particularly stand out. Federal transfers ramped up late in fiscal 2017–18 to support these programs. In some sectors, such as infrastructure, the roll-out of spending is now planned to be slower than initially announced, but the spring *Budget* outlined federal initiatives in R&D and other areas to fill this gap.

In 2019, growth in government spending is expected to moderate, trimming the public sector's contribution to real GDP growth to a still-solid 0.3 ppts. Provincial and local governments are expected to limit further increases in taxes and other levies in order to make life more affordable for moderate-income households. This will steepen the challenge of sustaining balanced operating budgets and encourage careful expenditure management. In this context, several Provinces are also pursuing initiatives to minimize the impact on household finances and business competitiveness of Ottawa's pending carbon-pricing framework. Specific measures are focused on both the application of carbon pricing and in the use of the resulting revenues.

Federal deficits for fiscal 2018–19 and 2019–20 are expected to exceed Ottawa's spring *Budget* estimates (table 1). The Provinces' fiscal 2018–19 plans indicate an aggregate shortfall this year that is set to widen once again beyond CAD 15 bn, assuming significant red ink from Ontario's new administration. Consequently, though borrowing by a number of Provinces is now largely constrained to fund capital investment, their combined net debt is expected to rise toward 34% of their aggregate GDP, above the prior peak in the mid-1990s.

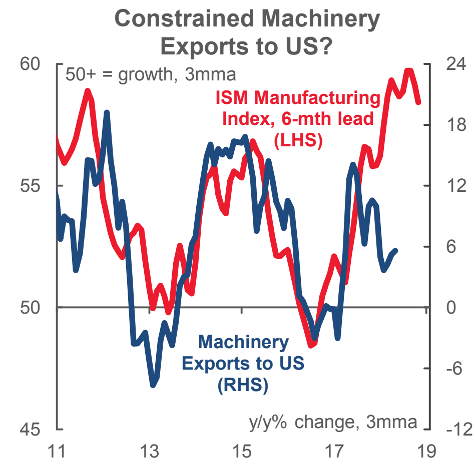
TRADE: STARKLY DIFFERENT POSSIBILITIES

Rising industrial production in the US has lifted demand for Canadian-made machinery, with exports of these products to the US up by 4.6% in the first four months of 2018 compared with the same period in 2017, though this represents a bit of a slowdown from the 8% y/y expansion recorded over the entirety of last year. Although manufacturing sentiment (i.e., the broad purchasing managers' index, PMI) in the US is currently sitting at its highest level since 2004, stretched capacity in Canada's machinery fabrication sector may be limiting shipments south of the border (chart 9). As new production capacity in the industry comes online, machinery exports should bounce back from what is expected to be a temporary, though marked, slowdown.

Exports of steel and aluminum products to the US soared as American companies hoarded product ahead of the imposition of so-called Section 232 'national security' tariffs, from which Canada was exempt until May 31st (chart 10). This specious national-security justification for the tariffs is being invoked purely to allow the US president to impose tariffs under one of the office's narrow powers that do not require Congressional approval. While the 10% tariff imposed on Canadian aluminum imported into the US is lower than the 25% duty now applied to steel products, the US remains relatively more dependent on foreign aluminum for its domestic consumption than it does for steel: around 60% of aluminum consumed in the US comes from abroad compared with about a fifth of steel, but steel products are more specialized. This implies that the US tariffs are likely to have a limited impact on Canadian steel and aluminum exports to the US, but should undermine US competitiveness through higher costs for US industry and consumers.

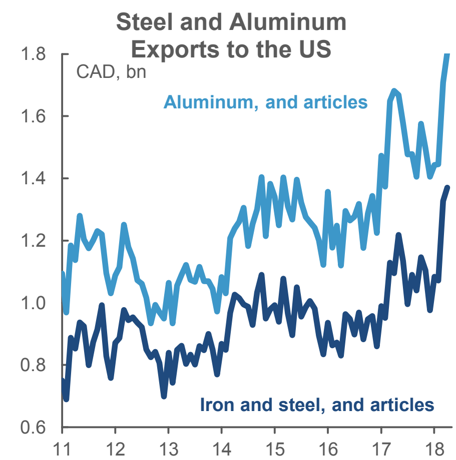
We expect the tariffs on steel and aluminum to be short-lived—similar US tariffs imposed in 2002 lasted 20 months and cost the US far more jobs than they protected. An exemption would likely be re-authorized for Canada when a consensus is reached on revising NAFTA, which in our baseline remains programmed for early-2019. In the meantime, the US tariffs and the Canadian retaliation are forecast to shave about 0.1 ppts from Canadian GDP growth during 2019. Given the US stockpiling of Canadian steel and aluminum earlier this year, demand for these products is expected to soften throughout the remainder of 2018. There is likely to be a less pronounced slump in aluminum than steel, despite more than 21,000 requests for tariff exemptions by affected US companies.

Chart 9



Sources: Scotiabank Economics, ISM Statistics Canada.

Chart 10



Sources: Scotiabank Economics, Statistics Canada.

Table 4

Impact of US Protectionism on Canadian Economy: Deviation from Baseline Forecast

	2018	2019	2020	2021	2022
Tariffs on Autos, Steel and Aluminium Scenario					
GDP growth, ppts difference	0.0	-0.2	-0.4	-0.1	0.2
Monetary policy rate, ppts difference	0.00	-0.06	-0.20	-0.21	-0.11
Core CPI inflation, ppts difference	0.0	0.0	-0.1	-0.1	0.0
CADUSD, annual average % difference	0.0	-0.8	-1.6	-1.6	0.0
Global Trade War (20% tariffs on trade with US)					
GDP growth, ppts difference	0.0	-1.3	-3.5	1.0	1.6
Monetary policy rate, ppts difference	0.00	-0.30	-1.21	-0.98	-0.23
Core CPI inflation, ppts difference	0.0	0.3	-0.5	-0.5	0.0
CADUSD, annual average % difference	0.0	-2.4	-10.7	-12.1	-2.4

Source: Scotiabank Economics "Steeling Ourselves for the Macro Costs of Tariffs" (June 14, 2018).

Canada's trade skirmish with the US is set to escalate in ways that could quickly turn it into a full-on trade war that could tip both countries into recession (table 4). Canada is imposing from July 1 retaliatory tariffs on US steel and aluminum products, as well as a range of consumer goods produced in politically-sensitive US Congressional districts with a view to inflicting economic pressure ahead of the November US midterm elections. The US Administration has threatened to ratchet up the conflict by imposing a further 25% tariff on motor vehicles and parts imports from the rest of the world. As Canada's second-largest export sector (after energy products), and the export sector that depends most heavily on NAFTA's tariff preferences (96% of exports to the US pass under NAFTA), auto tariffs would hit the Ontario economy particularly hard and dampen Canadian growth in 2019 and 2020 (see chart 1 again).

Auto tariffs would be a disaster for the industry on both sides of the Canada-US border. The tariffs' extra costs and the ensuing impact on vehicle affordability would pull auto sales down from around record highs in both countries. North American auto supply chains would be impaired, and the Canadian growth rate would be cut by 0.4 ppts in 2020, as shown in table 4 (see table 3 in the ***US section*** for more details on the impact on the American economy), and the level of Canadian GDP would be down 0.6 ppts. Sustained imposition of the mooted auto tariffs could force entire parts of the industry to be moved offshore given the intense integration of vehicle and parts production across Canada, the US, and Mexico.

Global tariffs on US auto imports would invite such a wide-ranging trade war that our baseline remains that these duties will not be imposed. American industry has made it clear that they don't want this 'protection'. US workers are already seeing the first layoffs linked to the Section 232 steel and aluminum tariffs. And our modelling implies that US politicians from key Congressional districts would be expected to see even larger job losses just as they and the current president come up for re-election in 2020.

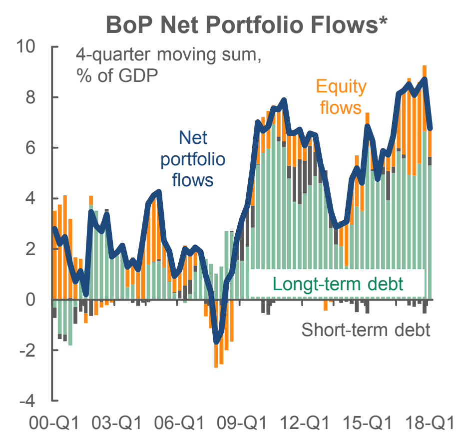
In what we *still* view as an unlikely event that the US imposes auto tariffs and the rest of the world responds, a trade war would quickly unfold that would push Canada into recession in the second half of 2019 and into 2020 (again, table 4 and chart 1). Growth would drop into mildly negative territory in the second half of 2019, and -1.8% in 2020, a recession about half as deep as the post-2008 downturn. Unemployment, however, would be expected to head back up to 9%, similar to levels a decade ago, owing to the sectoral impact of the trade conflict. The US and Mexico would also be pushed into a recession by 2020, but the impact on the US would be the mildest amongst the three 'amigos'.

INTERNATIONAL CAPITAL FLOWS: BETTER THAN THE HEADLINES

In the year-to-April, net inward flows into Canada have slowed from the record-setting pace recorded in 2017 (chart 12), dragged down by a decline in net flows into Canadian federal government debt (chart 13). With a shrinking deficit, the federal government has not had to tap bond markets for financing to the same extent that it did last year. Additionally, the spread of US Treasuries over Canadian government paper has widened since late-September. Expectations that the Federal Reserve is set to hike a total of four times in 2018—one more hike than forecast for the Bank of Canada—has decreased the relative attractiveness of Canadian government bonds.

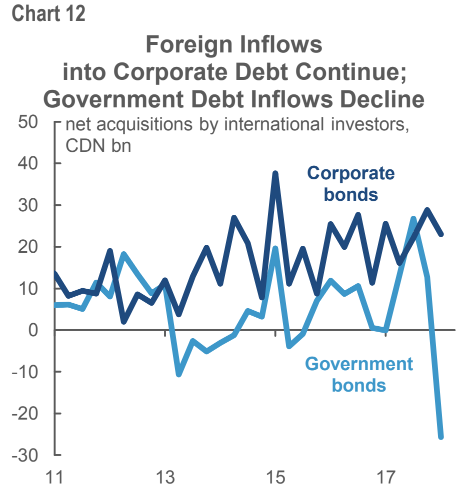
In Q1-2018, net direct investment flows into Canada from non-residents reached their highest level since the third quarter of 2015. International investors made large outlays in the Canadian manufacturing sector, where net non-resident inflows exceeded CAD 10 bn for the first time in the post-crisis period. The balance of net direct investment flows by *both* residents and non-residents into and out of Canada turned positive in Q1-2018 for the first time in 10 consecutive quarters.

Chart 11



* > 0 = inflow to Canada, < 0 = outflow from Canada. Sources: Scotiabank Economics, Statistics Canada.

Chart 12



Sources: Scotiabank Economics, Statistics Canada.

SUMMING UP: MOOSE OR MOUSE, CANADA SLEEPS BESIDE AN ELEPHANT

The entire direction of our Q3 Canadian outlook hinges sensitively on the low probability we assign to a further escalation in trade tensions between the US and its major trading partners. Two main possibilities lie ahead:

- Our baseline forecast for the Canadian economy, in which NAFTA is renovated or retained uncompromised, is unflashy and straightforward: Canadian growth moves somewhat above potential, increasing wage and price pressures support further monetary policy normalization, consumer spending moderates, households gradually deleverage their balance sheets, and investment-led improvements in the composition of growth gently sustain Canadian output in the face of US tax cuts; or

- If the US elephant moves to further restrict imports, particularly through tariffs on autos and parts, and touches off a global trade war, the likely outcome is starkly worse: recession across North America by 2020.

US action on auto tariffs will be the key fork in the road that leads us toward one of these binary outcomes.

The Provinces

- **British Columbia and Alberta retain growth leadership through 2019, but expansion is forecast to continue across all provinces despite US trade actions contributing to elevated uncertainty.**
- **After the combined provincial deficit widens in fiscal 2018–19 (FY19), propelled by Ontario's return to red ink, aggregate deficit reduction is expected to restart (chart 1).**

RESILIENT BUT SLOWING GROWTH

Data to date in 2018 confirm continuing momentum across most Provinces, with manufacturing orders still climbing, infrastructure spending proceeding and a long-awaited business investment recovery gaining traction. At least half of the provincial economies this year and next will likely operate above their longer-term growth rates, maintaining upward pressure on wages and prices. In most regions this year business investment is forecast to be a key source of growth, with government spending a continued support. In 2018, rising imports to meet consumer and capital demand are forecast to erode net exports; next year easing import growth should boost net exports. In the seven net oil-consuming provinces, late-cycle consumers are expected to become more circumspect through 2019.

Machinery & equipment (M&E) purchases are forecast to drive business investment this year in most provinces, starting to reverse the decline in M&E stocks since 2011 outside of the major oil-producing provinces (chart 2). Through April, seven provinces reported y/y increases in machinery imports, building on the growth in Q4–2017. Capacity constraints, spurring investment to meet stepped-up demand, are especially tight in most regions in manufacturing, notably in forest products, rubber & plastics, machinery and petroleum refining.

For Canadian machinery and related industries, adding to domestic orders is robust US industrial production alongside enhanced US tax incentives for M&E. Through April, double-digit y/y growth in machinery sales is estimated for Ontario, Alberta, Saskatchewan and PEI. As machinery and related output gains moderate in 2019, advances are anticipated in other industries, including bus production, and aerospace. Food manufacturers are expected to address current record-high capacity rates with new capital, including major new plants in Manitoba and Alberta.

Non-residential construction is expected to provide a significant but smaller push to growth in 2018–19. In seven provinces, industrial & commercial building activity has climbed for two consecutive quarters, with business services and tech activity aiding space absorption. Major projects range from large hydro installations to pipelines to port infrastructure. In Alberta, investment in conventional oil & gas remains buoyant after the 2017 rebound exceeding 50%, but oil sands investment is expected to be subdued this year and a sizeable pick-up in non-residential, non-energy construction awaits 2019. After delays, Phase 1 of the federal infrastructure plan is leveraging transit, social and green capital investments across large and small centres.

Though eroded by higher imports, petroleum and non-energy exports are expected to shift higher in 2018. Oil production is expected to ramp up at Hebron, Newfoundland

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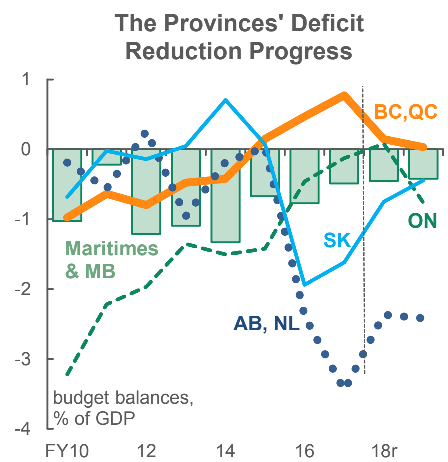
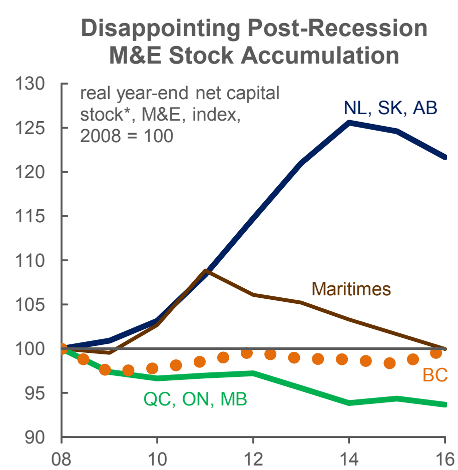
Chart 1



Sources: Budget documents; Statistics Canada; nominal GDP forecasts: Scotiabank Economics

Chart 2



* Geometric depreciation. Sources: Scotiabank Economics, Statistics Canada.

and Labrador's fourth offshore field, and in Alberta, an increase north of 5% is anticipated. At Alberta's major Syncrude oil sands facility, output as of late June is expected to be disrupted for at least five to six weeks. With a subsequent rebound anticipated, Alberta's real GDP growth is edged slightly lower to 2.4%. Potential volatility in the light-heavy oil price differential due to pipeline capacity constraints is a risk through 2019, though the recent approval for the Line 3 pipeline refurbishment is encouraging. Firmer prices and new capacity should boost metal mining shipments in Newfoundland and Labrador, Nova Scotia, Quebec and BC. For aluminum producers in Quebec and BC, and steel and softwood lumber output in multiple provinces, US tariffs near term are expected to have little volume impact, largely translating into higher prices south of the border. In Ontario, motor vehicles assembled are expected to fall 6¼% in 2018 and slip lower in 2019, with downside risk if the US proceeds with tariffs on Canadian autos.

Strength in services exports is highly visible in tourism and the tech sector. After record numbers of international visitors for many regions during the sesquicentennial celebrations in 2017, further y/y increases are reported in seven provinces as of April 2018. Real GDP in information & communications technology (ICT) advanced 14.7% nationally over 2011–17, outstripping the 8.5% rise for other industries. This sector includes industries with a significant export component, from engineering services to specialized manufacturing. For 2011–17, the sector expanded by more than 16% in five provinces, with Central Canada and BC gaining 10% or more since 2014 (chart 3).

Consumers in early 2018 were less buoyant than a year earlier, with y/y gains in cumulative retail sales through April weakening in every province (chart 4). In high-flying BC, the cumulative y/y rise in full-time employment through May cooled to 1.1% and the 4.7% retail sales gain through April was solid but only about half the 9.3% jump a year ago. From this soft start, consumer outlays in most provinces are likely to strengthen during H2–2018. Next year, however, easing housing activity and real consumption should become increasingly evident across the seven net oil-consuming provinces given our expectation for slower job creation and higher interest rates to exacerbate prior regulatory tightening. By contrast, household spending in the three oil-producing provinces is expected to firm after the setback from lower oil prices.

The pickup in average weekly wages through April (chart 5) points to annual increases of 2% or higher in a majority of provinces. Minimum wage hikes are contributing to these gains, especially in Ontario, Alberta and BC where increases are over 10%. In 2019, the forecast rise in weekly wages should moderate only slightly given continuing skills shortages. Rising headline CPI inflation is expected to absorb much of the regional wage increases, with only Central Canada likely to witness significant purchasing power gains in both 2018 and 2019.

Housing starts, revised higher for 2018 and 2019, reflect Quebec and PEI maintaining their elevated 2017 pace this year and increased attention to affordable units. For centres in Southern BC and Ontario's Greater Golden Horseshoe, affordability is expected to remain an issue through the forecast period given the cumulative supply shortage at more modest price points. Limited ownership options are compounded by constrained rental availability, though this year's rise in multi-unit starts in both regions should start to alleviate the upward pressure on rents. In Alberta's and Saskatchewan's major cities, new building is forecast to remain relatively muted as the existing inventory overhang is reduced. Over the next two years, Halifax is expected to absorb substantial new condominium and commercial space and Winnipeg housing starts are forecast to cool from a 30-year peak in 2017.

Chart 3

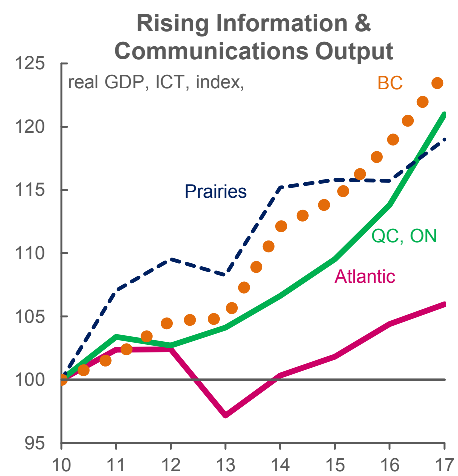
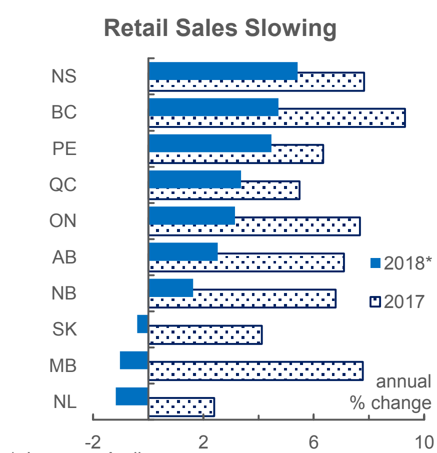
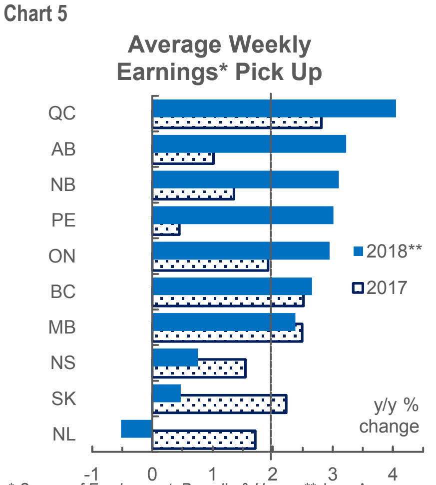


Chart 4



* January - April.

Chart 5



* *Survey of Employment, Payrolls & Hours.* ** Jan - Apr.

Sources for charts: Scotiabank Economics, Statistics Canada.

THE PROVINCES' FISCAL PATHS DIVERGE

The Provinces' revenue and expenditure outlooks are presently clouded as Ontario's new government assesses accounting adjustments and the impact of its platform commitments, New Brunswick and Quebec face Fall elections, and the federal government, Alberta, PEI and Newfoundland and Labrador visit the polls in calendar 2019. Several trends should persist, such as BC's careful balancing of multiple, multi-year program and infrastructure priorities and the current fiscal repair focus of the three major oil-producing Provinces and Manitoba. Over the next two years, the economic backdrop is expected to be less conducive to fiscal repair with slower output growth, public-sector compensation catch-up pressure, and higher interest rates. Several Provinces are grappling with appropriate support for communities affected by US trade actions; the varied proposals from the Provinces related to the Pan-Canadian carbon price are expected to shift to centre stage this Fall; and ambitious program policy suggestions such as national pharmacare await resolution. With large surpluses expected to be harder to achieve, trimming net debt burdens will probably require attention to other liabilities. Alberta, for example, is reducing its FY19 *Capital Plan* by 28½%, scaling back public-sector construction activity as the province's private-sector activity recovers.

Table 1

The Provinces	(annual % change except where noted)										
Real GDP	**CA**	**NL**	**PE**	**NS**	**NB**	**QC**	**ON**	**MB**	**SK**	**AB**	**BC**
2000–16	2.1	2.5	1.7	1.3	1.2	1.7	2.0	2.3	2.0	2.7	2.8
2016	1.4	1.9	2.3	0.8	1.2	1.4	2.6	2.2	-0.5	-3.7	3.5
2017*	3.0	2.1	3.2	1.2	1.9	3.1	2.8	2.9	2.9	4.9	3.9
2018f	2.0	0.5	1.9	1.2	1.0	2.1	2.0	1.9	1.6	2.4	2.5
2019f	2.1	1.2	1.6	1.0	0.9	1.9	2.0	1.9	2.0	2.5	2.5
Nominal GDP											
2000–16	4.2	5.6	4.2	3.4	3.3	3.6	3.8	4.4	5.3	5.9	4.5
2016	2.0	2.6	4.0	2.8	3.6	2.7	4.3	2.3	-4.0	-4.9	4.8
2017e	5.4	5.6	4.7	3.1	3.2	4.5	4.8	4.3	5.4	7.9	5.9
2018f	4.3	4.1	3.8	3.2	2.8	3.9	4.1	3.9	4.1	5.4	5.0
2019f	4.7	4.0	3.9	3.1	2.9	4.3	4.4	4.2	4.7	5.7	5.1
Employment											
2000–16	1.3	0.8	1.0	0.6	0.4	1.3	1.3	0.9	1.1	2.3	1.4
2016	0.7	-1.5	-2.3	-0.4	-0.1	0.9	1.1	-0.4	-0.9	-1.6	3.2
2017	1.9	-3.7	3.1	0.6	0.4	2.2	1.8	1.7	-0.2	1.0	3.7
2018f	1.2	-0.8	1.9	0.6	0.4	1.4	1.4	0.7	0.0	1.6	1.3
2019f	1.0	-0.5	0.9	0.3	0.2	0.9	1.0	0.7	0.5	1.1	1.2
Unemployment Rate (%)											
2000–16	7.1	14.3	11.2	8.8	9.6	8.0	7.1	5.1	5.0	5.1	6.6
2016	7.0	13.4	10.7	8.3	9.5	7.1	6.5	6.1	6.3	8.1	6.0
2017	6.3	14.8	9.8	8.4	8.1	6.1	6.0	5.4	6.3	7.8	5.1
2018f	5.8	14.7	9.9	8.0	8.0	5.5	5.5	5.6	5.9	6.8	4.8
2019f	5.7	14.6	10.1	7.9	8.0	5.4	5.4	5.5	5.8	6.7	4.8
Housing Starts (units, 000s)											
2000–16	199	2.6	0.8	4.3	3.5	44	72	5.1	5.2	34	28
2016	198	1.6	0.5	3.7	1.8	39	75	5.3	4.8	25	42
2017	220	1.4	1.0	4.0	2.3	46	80	7.6	5.0	29	44
2018f	213	1.4	1.0	3.9	1.9	46	77	6.2	4.2	29	42
2019f	200	1.3	0.9	3.8	2.1	41	71	6.3	4.5	30	39
Motor Vehicle Sales (units, 000s)											
2000–16	1,657	29	6	48	38	413	635	47	45	216	180
2016	1,949	33	9	54	44	458	807	55	51	220	218
2017	2,041	33	9	59	42	453	847	62	56	245	235
2018f	2,000	32	8	58	40	445	821	61	56	248	231
2019f	1,950	30	8	56	39	434	791	60	56	250	226
Budget Balances, Fiscal Year Ending March 31 (CAD mn)											
2000–16**	-2,803	-93	-38	-30	-153	-768	-5,115	-142	307	1,064	319
2016	-987	-2,206	-13	-13	-261	2,191	-3,515	-839	-1,520	-6,442	811
2017	-17,770	-1,148	-1	150	-119	2,361	-991	-764	-1,218	-10,784	2,737
2018f***	-20,000	-812	1	134	-115	850	642	-726	-595	-8,023	151
2019f***	-18,000	-683	1	29	-189	0	-6,704	-521	-365	-8,802	219

Sources: Scotiabank Economics, Statistics Canada, CMHC, Budget documents. * Real GDP by industry, basic prices. ** MB:FY04–FY16; AB:FY05–FY16. *** Federal & Provinces' FY18 & FY19: Budget documents. Federal FY19: ex risk adjustment of $3.0bn.

United States

IN A HOT ECONOMY, COOLER HEADS EXPECTED TO PREVAIL

- **Growth is expected to peak in Q2 as fiscal stimulus in an already hot economy translates into stronger consumption, solid industrial indicators, tighter labour markets, and stronger price pressures.**
- **The potential for additional policy mistakes remains the clearest, entirely unnecessary threat hanging over our baseline outlook. We expect domestic political pressure on the White House to prevent a move to an all-out trade war with China and/or the US's major allies that would, if realized, tip the US into a recession in late-2019 and into 2020.**

US POLICY MISTAKES THE GREATEST THREAT TO FURTHER GROWTH

Over the last year, the US economy has enjoyed a benign combination of moderate growth, strengthening leading indicators, modest inflation, and gradually rising interest rates. Positive data surprises have been seen as a germane indication that monetary policy normalization would proceed, while negative data surprises have been taken as an indicator that accommodative monetary-policy conditions would be maintained. This sweet spot has allowed the current eight-and-a-half year run of uninterrupted growth to become the second longest US expansion in history in June. **We still expect the expansion to extend and become the longest on record in July 2019, but the current policy mix in the US significantly clouds expectations for the second half of 2019 and beyond.**

US economic policies are now firmly at cross purposes to one another. The White House's major tax changes and stepped-up spending should push real GDP growth to 2.8% this year (chart 1, table 1), well above estimates of potential growth around 2%. This compares to the 2.6% real growth rate projected in our May 3 ***Monthly Forecast Tables***. Unemployment is now down at historical lows. For 2019, real GDP growth is forecast to come in at a solid 2.3%, despite trade tensions and related uncertainty, which are together assumed to subtract 0.1 ppts from growth next year.

In the midst of mixed policy signals from the White House and some divergence in global growth, the Fed is expected to remain focused on US domestic price pressures, which have intensified over the past quarter. Compared with our Q2 ***Global Outlook***, we have added another increase in the fed funds rate in 2018, for a total of two rate increases between now and end-2018, and two more in 2019. This would, as detailed in the ***Monetary Policy & Capital Markets*** section, bring the fed funds rate to 3.0% by end-2019. Yield curves are expected to continue flattening, but the *Scotiabank Global Macroeconomic Model (SGMM)* does not anticipate a recession in the forecast horizon. This baseline does, however, assume that further protectionist pressures from the White House are curtailed either through negotiation or pushback from Congress, the business community, and citizens, such that the current trajectory pointing toward a misbegotten, all-out trade-war is diverted.

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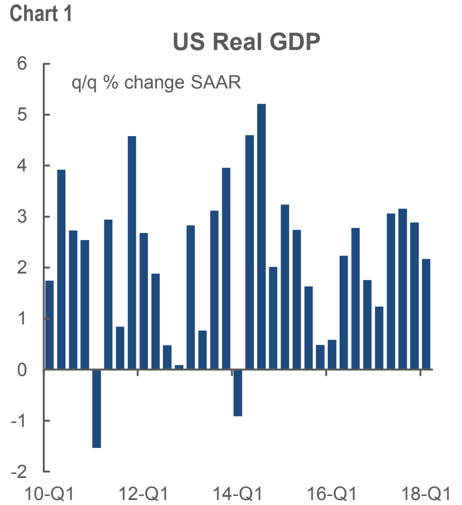
United States	2017	2018f	2019f
Real GDP (annual % change)	2.3	2.8	2.3
CPI (y/y %, eop)	2.1	2.4	2.4
Central bank policy rate (%, eop)	1.50	2.50	3.00
Canadian dollar (USDCAD, eop)	1.26	1.28	1.25

Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, BEA.

MORE PRUDENT HOUSEHOLDS SET TO SAVE SOME WAGE GAINS

US labour markets are tight and likely to get tighter. JOLTS job openings now exceed unemployed workers for the first time this century, which is expected to provide added upward pressure on compensation. Participation rates are likely to continue rising to post-crisis highs as demand pulls more people back into the labour force. Building on healthy job creation in 2017, employment is expected to continue growing in 2018 and 2019 (table 2) even as the unemployment rate is expected to continue plumbing new lows.

Nominal wages are expanding at a healthy clip with rising hours lifting the pace of weekly earnings growth to 3% y/y in May. Concurrent increases in inflation, however, have eroded a large share of this increase, with real weekly earnings rising by only 0.3% y/y and real hourly wages declining slightly by 0.1% y/y. Survey indicators point, however, to further acceleration in wage growth in the months ahead.

Household finances remain on firm ground. The Fed's household mortgage debt-service ratio, at just under 4.5%, is at its lowest level since 1980. Private consumption is set to gradually moderate over 2018–19 (table 2), despite projections for strong wage gains, as households continue to put their balance sheets on more sustainable footings. Some saving is likely to be precautionary, however, as households anticipate changes in health care costs owing to, amongst other things, changes to 'Obamacare' coverage.

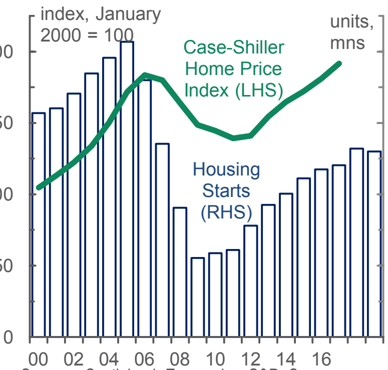
REAL ESTATE: POST-RECESSION INVENTORY SHORTAGE SET TO PERSIST

Measures of housing affordability continue to erode. While still manageable, price-to-rent ratios and price-to-income ratios are higher than at any time since the 2008 crisis, driven by fundamental supply and demand dynamics, higher materials prices, increased costs stemming from 20% US tariffs on Canadian softwood lumber, and rising interest rates.

A substantial shortfall in supply accrued since the last recession is expected to continue through 2019. Housing starts forecast at 1.30–1.32 mn units this year and next (chart 2) are set to undershoot the 1.5–1.6 mn unit annual average that most

Chart 2

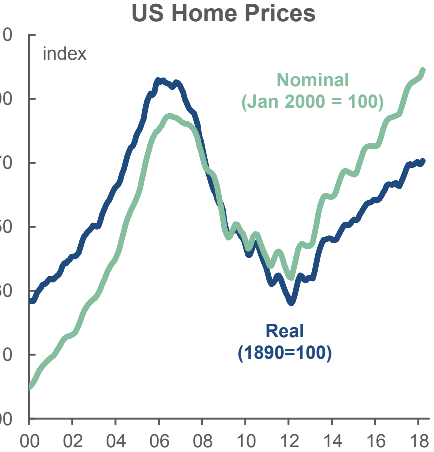
Still Historically Weak Building Activity Pushing Prices Up



Sources: Scotiabank Economics, S&P, Census Bureau.

Chart 3

US Home Prices



Sources: Scotiabank Economics, Robert Shiller, Haver Analytics.

Table 1

Quarterly US Forecasts	2017	2018				2019			
	Q4	Q1	Q2e	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic									
Real GDP (q/q ann. % change)	2.9	2.0	3.6	2.5	2.4	2.2	2.0	2.0	2.0
Real GDP (y/y % change)	2.6	2.8	2.9	2.8	2.6	2.7	2.3	2.1	2.0
Consumer prices (y/y % change)	2.1	2.3	2.4	2.4	2.4	2.4	2.4	2.4	2.4
CPI ex. food & energy (y/y % change)	1.7	1.9	2.2	2.3	2.3	2.3	2.3	2.4	2.4
Core PCE deflator (y/y % change)	1.5	1.6	1.9	2.0	2.1	2.1	2.1	2.1	2.1
Financial									
Euro (EURUSD)	1.20	1.23	1.17	1.17	1.20	1.22	1.25	1.30	1.35
U.K. Pound (GBPUSD)	1.35	1.40	1.32	1.30	1.32	1.32	1.35	1.37	1.40
Japanese Yen (USDJPY)	113	106	108	110	110	110	110	108	105
Fed Funds Rate (upper bound, %)	1.50	1.75	2.00	2.25	2.50	2.50	2.75	2.75	3.00
3-month T-bill (%)	1.38	1.70	1.92	2.20	2.45	2.50	2.70	2.75	3.00
2-year Treasury (%)	1.88	2.27	2.53	2.60	2.70	2.80	2.90	3.00	3.10
5-year Treasury (%)	2.21	2.56	2.73	2.85	2.90	2.95	3.00	3.10	3.20
10-year Treasury (%)	2.40	2.74	2.84	3.00	3.05	3.10	3.15	3.20	3.30
30-year Treasury (%)	2.74	2.97	2.96	3.15	3.20	3.30	3.35	3.40	3.45

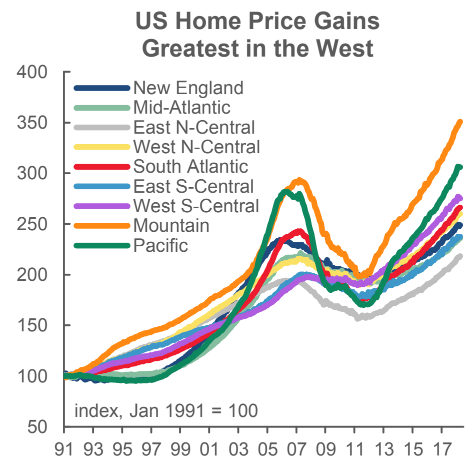
Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

estimates imply would be consistent with underlying demand. The supply deficit's persistence is expected to push prices up further (chart 3), particularly in the western US (chart 4), and drive home values beyond the record for the nominal Case-Shiller index recorded in March.

Rapidly rising material costs are expected to weaken construction activity over the next two years and exacerbate supply-demand dynamics further. Western Spruce-Pine-Fir prices have hit record levels following a 48% y/y increase from January to May 2018. The National Association of Home Builders (NAHB) estimates that recent lumber price increases have added nearly USD 9k to the cost of an average new single-family home since January 2017.

Even as housing starts fail to keep up with demand, overall demand pressure is expected to step up further as robust labour markets and tax changes boost personal incomes. However, on new mortgages, the ceiling for the mortgage interest deduction is lowered from USD 1 mn to USD 750k and the interest deduction for home equity loans of up to USD 100k is eliminated.

Chart 4



Sources: Scotiabank Economics, FHFA, Haver Analytics.

First-time homebuyers are, however, likely to encounter increased difficulty in entering the real-estate market, with a significant erosion in availability and affordability amongst entry-level homes. Higher interest rates are discouraging refinancing and move-up buying, which has extended average homeownership durations to record levels and reduced the pool of entry-level properties available for purchase.

US MANUFACTURING AND INDUSTRY: ORDERS BACKLOG, RISING PRICES

The US manufacturing sector is set to post its strongest annual expansion since 2011 with gains in nearly all industrial sectors powering a steep increase in manufacturing jobs that is outpacing the rest of the economy for the first time since January 2012 (chart 5). The recent tax changes and highs in post-recession consumer confidence are both helping to drive domestic demand. Foreign orders for US manufactures are, however, likely to pull back owing to weakening business sentiment abroad and increasing reciprocal protectionism.

Capacity pressures remain relatively subdued across the sector at around 75% of potential output, though certain industries are facing production crunches as orders rise. Fabricated metals and machinery manufacturing have seen a notable surge in their respective operating rates since mid-2016 (chart 6) as new orders for these products have increased by 14% y/y and 6.3% y/y, respectively, on average year-to-date. The pace of growth in orders has resulted in a rising share of firms reporting an increase in order backlogs, from as low as 12% in late-2015 to around a third of firms in May. Similar to Canada, investment outlays in non-residential structures and equipment have posted large year-on-year increases and have expanded at their fastest pace since mid-2014 at 8.1% y/y in Q1-2018.

The US tariffs on steel and aluminum, in conjunction with rising global demand for basic production inputs, has resulted in a steep increase in prices paid for

Table 2

United States	2000–16	2016	2017	2018f	2019f
	(annual % change, unless noted)				
Real GDP	1.9	1.5	2.3	2.8	2.3
Consumer spending	2.4	2.7	2.8	2.6	2.3
Residential investment	-0.4	5.5	1.8	1.8	2.1
Business investment	2.3	-0.6	4.7	6.2	2.8
Government	1.0	0.8	0.1	2.2	2.5
Exports	3.6	-0.3	3.4	4.3	2.7
Imports	3.4	1.3	4.0	5.0	3.4
Nominal GDP	3.9	2.8	4.1	5.0	4.6
GDP Deflator	2.0	1.3	1.8	2.1	2.3
Consumer price index (CPI)	2.2	1.3	2.1	2.4	2.4
CPI ex. food & energy	2.0	2.2	1.8	2.2	2.3
Core PCE deflator	1.7	1.8	1.5	1.9	2.1
Pre-tax corporate profits	5.5	-2.1	4.4	5.1	1.7
Employment	0.7	1.8	1.6	1.4	1.1
Unemployment rate (%)	6.2	4.9	4.4	3.8	3.7
Current account balance (USD bn)	-504	-433	-449	-516	-574
Merchandise trade balance (USD bn)	-672	-751	-807	-908	-984
Federal budget balance (USD bn)	-532	-585	-665	-840	-1,030
percent of GDP	-3.7	-3.1	-3.4	-4.1	-4.8
Housing starts (mn)	1.27	1.17	1.20	1.32	1.30
Motor vehicle sales (mn)	15.5	17.5	17.1	17.1	17.0
Industrial production	0.6	-2.0	1.6	3.0	1.9
WTI oil (USD/bbl)	63	43	51	68	71
Nymex natural gas (USD/mmbtu)	4.94	2.55	3.02	2.93	2.90

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

these goods. Producer prices for steel and aluminum have risen by around 12% since January (chart 7). The Department of Commerce published its Section 232 investigation into steel and aluminum imports in February and demand appears to have been pulled forward since then to avoid the duties introduced on June 1. The Commerce Department has received more than 21,000 requests for exemptions from the tariffs as nearly every industry except US steel producers themselves has registered opposition to the duties. Decisions on these exemption applications could be delayed for months or years: there are roughly 700 requests for every Commerce staff member tasked with processing them.

All in all, year-on-year corporate earnings growth is likely to slow in the second half of 2018 as rising input costs and higher interest rates begin to crimp growth in nonfinancial corporate profits. After a relatively strong rebound in business investment projected for 2018, we expect expenditure on replacing and expanding capacity to slow in 2019 (table 2).

FISCAL STIMULUS DRIVES ELEVATED GROWTH AND WIDER DEFICITS

Our forecast remains relatively unchanged from last quarter. We expect stepped-up federal government spending plus the recent major tax changes to provide, on average, about a half-percentage-point of fiscal lift to US real GDP growth in 2018 and again in 2019. **Across all levels of government, public spending is expected to add 0.37 ppts to US GDP growth this year and 0.41 ppts in 2019, thereby ending an eight-year trend of modest or negative contributions to growth from government expenditure.**

Looking at the details of federal spending, outlays receive an additional boost this year from more than USD 100 bn in emergency non-defense spending to address hurricane and wildfire damage. This offers an offset to expected delays in the design and initiation of new federal initiatives under the USD 300 bn spending package.

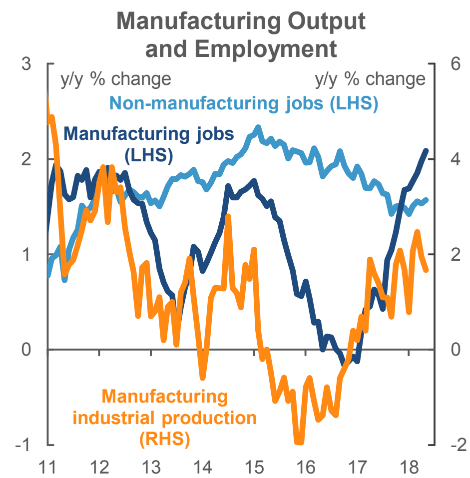
Growth in individual State-level public expenditures will continue to vary widely. In aggregate, however, mid-year spending reductions in fiscal 2018 have been far smaller than a year earlier. We expect State outlays, adjusted for inflation, to strengthen modestly in fiscal 2019 as firmer revenue collection following stronger economic growth encourages the States to address near-term spending priorities.

The White House's cut in the general corporate income tax rate from 35% to 21% in January is already causing a steep year-on-year drop in federal corporate income tax receipts (chart 8). As the States consider statutory adjustments to protect their tax receipts, other federal changes are expected to affect their operating balances, such as the removal of the federal individual penalty for individuals who do not have health insurance.

TRADE GAINS AMIDST THE GATHERING TARIFF STORM

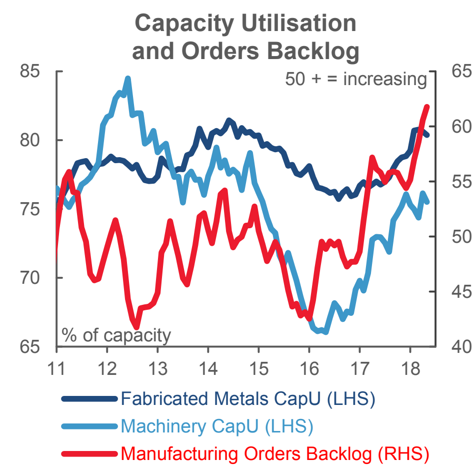
US exports are set for a strong performance in 2018, although trade disputes are likely to dent sales abroad if the US administration continues on its current protectionist path. We expect US goods exports to expand at a strong clip in 2018, at or slightly above the pace set last year. Increased demand by US consumers for foreign goods against a backdrop of an expanding fiscal deficit (chart 8 again) and

Chart 5



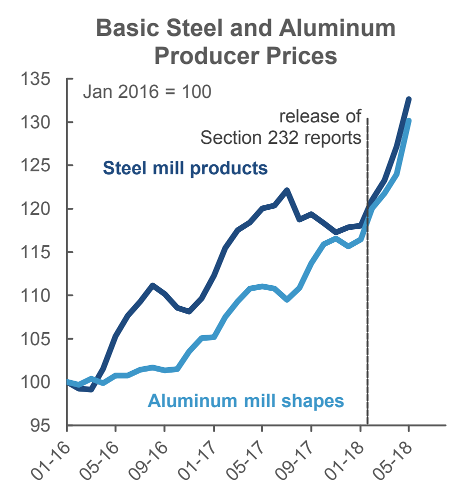
Sources: Scotiabank Economics, BLS, BEA.

Chart 6



Sources: Scotiabank Economics, Federal Reserve Board, ISM.

Chart 7



Sources: Scotiabank Economics, BLS.

aggregate dissavings will, however, prolong the ongoing widening of the US trade deficit.

Following the imposition of tariffs on steel and aluminum imports on so-called 'national security' grounds, a handful of affected nations have, or intend to, retaliate with reciprocal measures designed to hit equal flows, in value terms, of US exports. Most of these countries are also seeking review of the US tariffs at the WTO. These reciprocal tariffs are not limited to US metals exports, but also include other industrial and consumer goods, with a view to hitting politically-sensitive regions of the US. At the time of publication, the EU, China, and Mexico are collecting duties on about USD 9 bn worth of US exports; Canada followed suit on July 1 on over $12bn of imports from the US. Canada and Mexico are unlikely to escape the tariffs on steel and aluminum products until the renegotiation of NAFTA is concluded, which we don't expect before 2019 (chart 9).

The Commerce Department has also launched an investigation into the national security implications of imports of motor vehicles and parts. The White House threatens to impose tariffs of up to 25% on auto-sector imports under the same Section 232 of the 1962 *Trade Expansion Act* that the White House used to implement steel and aluminium imports.

Using our comprehensive *Scotiabank Global Macroeconomic Model*, we assess the impact of these protectionist measures in our report ***Steeling Ourselves for the Macro Costs of Tariffs***. Under one of the paper's alternative scenarios, the incidence of the steel and aluminum tariffs imposed on June 1 is expected to fall mainly on US industry and consumers; combined with possible US duties on autos and parts imposed in 2019 under Section 232 processes, US GDP growth would be hit by only about a combined 0.1 ppts in 2019 and 2020.

We believe, however, that a US move against cars and parts imports does not represent a stable equilibrium. Instead, it would set off a wider trade war as other countries retaliate with an array of tariffs. In a trade war scenario, the US economy would fall into recession in late-2019 and record a shallow annual contraction in 2020—just in time for the next Presidential election, which should itself give the White House pause.

China's nearly-immediate, symmetric, response to the 10% US tariff imposed on up to USD 50 bn of Chinese goods imported into the US has been followed by threats by President Trump to up the value of Chinese goods subjected to the

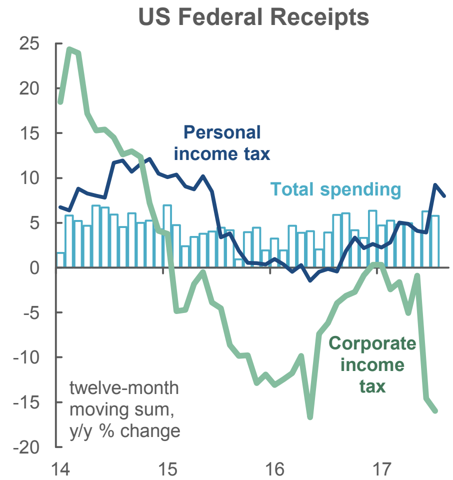
Table 3

Impact of US Protectionism on US Economy: Deviation from Baseline Forecast

	2018	2019	2020	2021	2022
Tariffs on Autos, Steel and Aluminium Scenario					
GDP growth, ppts difference	0.0	-0.1	-0.1	0.0	0.1
Monetary policy rate, ppts difference	0.00	-0.03	-0.07	-0.03	0.00
Core CPI inflation, ppts difference	0.0	0.0	0.0	0.0	0.0
Global Trade War (20% tariffs on trade with world)					
GDP growth, ppts difference	0.0	-1.0	-2.0	0.8	0.7
Monetary policy rate, ppts difference	0.00	-0.63	-1.19	-0.38	0.18
Core CPI inflation, ppts difference	0.0	0.0	-0.3	-0.1	0.1

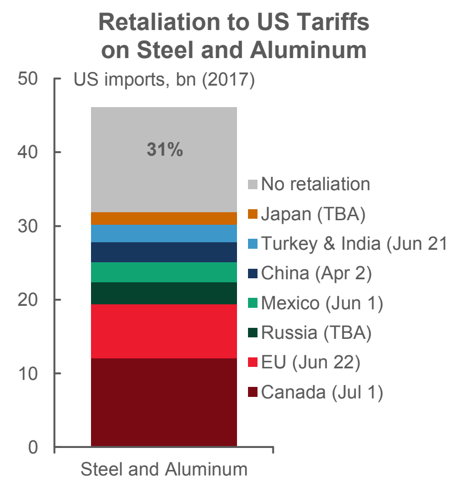
Source: Scotiabank Economics "Steeling Ourselves for the Macro Costs of Tariffs" (June 14, 2018).

Chart 8



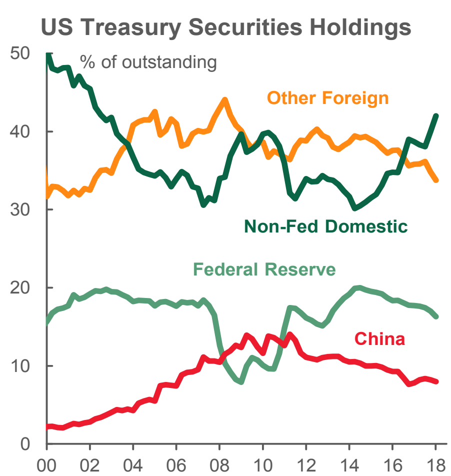
Source: US Treasury.

Chart 9



Sources: Scotiabank Economics, USITC.

Chart 10



Sources: Scotiabank Economics, US Treasury.

US tariff by an additional USD 200bn. At a total of USD 250 bn in affected US imports from China, Beijing would find it difficult to retaliate in kind: USD 250 bn is close to USD 100 bn greater than the total value of Chinese merchandise imports from the US. China has and will respond through additional means.

China has already begun intensifying non-tariff barriers through stepped-up standards inspections and more onerous administrative requirements on trade. The Chinese government may also complicate the operations of US multinationals stationed in China, where they generated USD 356 bn in revenue during 2015, the latest year for which data are available. Beijing may additionally act on its currency and reserves. It could alter its purchases of US Treasury securities, of which it owns 8% of the total amount outstanding (chart 10), but it is unlikely to boycott the market entirely considering the hit this might imply to the value of China's own holdings. Some substitution of other USD-denominated international sovereign debt for USTs may, however, be pursued. Similarly, China's scope to push down the value of the RMB is limited by the fear that such a move would stoke a renewed round of capital outflows, but it has already indicated that it will loosen monetary conditions by dropping banks' reserve requirement ratios by 50 bps on July 5.

A US-China trade war would cause a substantial hit to the global economy because of the multiple trade and financial links between the two countries. We expect mounting US political and business opposition to the White House's protectionist bent to prevent the imposition of the threatened auto tariffs and an escalation of the present trade skirmish into an all-out war. Congressional efforts have already begun, although so far unsuccessfully, to limit the White House's discretion to impose tariffs under Section 232. It is concerning, however, that Congress did not take any action to curtail the White House's scope of action under the President's Trade Promotion Authority (TPA, aka 'Fast Track') during its April–June renewal period.

SUMMING UP: MAINTAINING FAITH IN THE SYSTEM AND THE CURRENT PRESIDENT'S SELF-INTEREST

The outlook for the US—and by extension, the global economy—hinges on some strong assumptions about the robustness of the American political system to curb a move toward a major policy mistake. We continue to believe that rising efforts in the US Senate and House, supported by regional political and business leaders, will prevent a further intensification of recent moves by the White House to slap tariffs on widening slices of US commerce with the rest of the world. If further duties are avoided, our baseline projections laid out here should not be meaningfully impaired by the existing tariffs on steel and aluminium.

The White House threat to add further tariffs on autos and parts imports represent, however, a meaningful negative inflection point. If these tariffs are realized, it would be difficult to prevent a further spiral into a US-led global trade war as other countries retaliate in myriad ways, which would plunge both the US and its major trading partners into recession beginning in the second half of 2019 and into 2020, just as the US will be heading into Presidential, Congressional, State, and local elections. Political, business, and diplomatic pressure should, therefore, be focused on preventing a mistaken crossing of this economic Rubicon.

US & Canadian Monetary Policy & Capital Markets

- **The Bank of Canada is still forecast to raise its policy rate five more times between now and the end of 2019 including twice more this year.**
- **The Federal Reserve is forecast to raise the fed funds target range four more times by the end of 2019 including the addition of one more forecast rate hike this year to two more by the end of 2018. Peak balance sheet run-off by this Fall adds 1-2 more equivalent hikes.**
- **The Federal Reserve's pace of balance sheet unwinding will peak this Fall and impose unconventional policy tightening in addition to rate hikes.**
- **There are no material changes to our US or Canadian bond market forecasts.**

BANK OF CANADA—SLIPPING BEHIND, REGARDLESS OF NAFTA

There are no changes to our Bank of Canada (BoC) forecast for five rate hikes between now and the end of 2019. This includes two more increases this year—bringing the year's total to 3 hikes including January's and an ending rate of 1.75%—and three more next year. That would leave the overnight rate at 2.5% by the end of next year and either in line with or not far from the estimated neutral rate. There is the risk of going at a slower pace should NAFTA developments take a much deeper turn for the worse than has been apparent to date or anticipated, but there is also the opposite risk of overshooting the long-run neutral rate if this cycle's wage and price pressures continue to evolve in a fashion that further jeopardizes the BoC's inflation mandate. Such a neutral rate would remain low by historical standards because of various drivers of slower non-inflationary growth limits this cycle versus prior cycles including a relatively large household debt overhang. Relatively more of the pressure upon market rates is expected through shorter-term interest rates as longer-term borrowing costs are more advanced along the path of adjusting to tighter monetary policy this cycle (chart 1, table 1). This continues to drive expectations for a flatter borrowing curve over time—particularly under 2 years—and one that means greater pressure upon variable rate borrowers than fixed rate debt.

Inflation is running at about a four-year high and back to before the slide in commodity prices in 2014–15. Headline inflation is tracking above the 2% target and core measures are just beneath. The recent rise has been based upon a combination of tightening capacity limits that increase pricing power in the overall economy, real wage gains that increase purchasing power, overall base effects, gas price increases, and minimum wage pass-through effects. Some of these effects would and should be looked through by the BoC but many are more durable and some of them —like currency weakening, tariffs, gas, and minimum wages—offer second round pass-through effects deeper into the CPI basket. Given a multitude of factors driving inflation higher, it is going to be dicey to dismiss every one of them as idiosyncratic and/or temporary; indeed, past episodes of unmoored inflation expectations have often started off by providing too many excuses to look through inflationary pressures.

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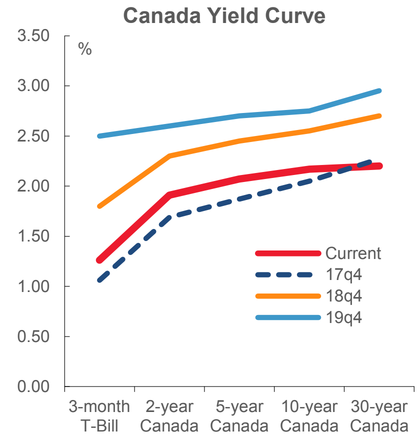
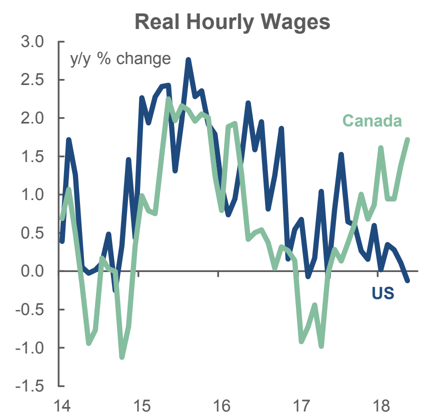
Chart 1



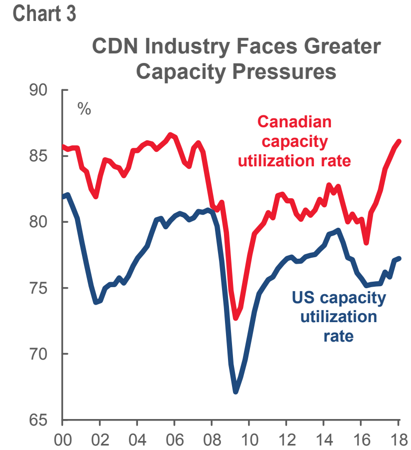
Source: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Statistics Canada, BLS.

Chart 3



Sources: Scotiabank Economics, Federal Reserve Board, Statistics Canada.

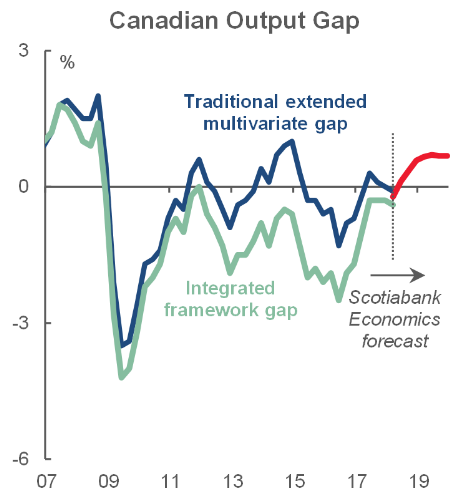
Further upward pressure on inflation could easily be forthcoming as capacity limits become more binding but also due to currency and tariff adjustments, additional pass-through effects of minimum wage hikes, plus tightening wage influences. Steel and auto tariffs and Canada's retaliation across a broad range of US imports are estimated to add a modest 0.1% to inflation and subtract under 0.1% from GDP growth over coming months. Auto tariffs are a bigger risk to CPI pressures but we are not yet prepared to treat this as a serious gambit by the US administration. The currency's sharp depreciation from around 1.21 on a USDCAD basis last September to over 1.33 today will also carry modest pass-through consequences into import prices and then the CPI basket. Scotia's René Lalonde estimates that a *persistent* 10% depreciation in the currency adds 0.6% to CPI within six months and 0.1% to the average of the core inflation measures. It is typically treated as a transitory development but one that can spawn spillover effects across items within the basket.

The consequence is that inflation is pushing deeper into the upper half of the BoC's 1–3% "flexible" target range and could well keep rising. One cannot dismiss the risk that inflation breaches the upper end of the target range by year-end. Now combine that with wage pressures that are exceeding inflation (chart 2) and the message is that the wage and price dynamic is at serious risk of putting the BoC behind its inflation mandate.

Several related considerations will be explored. **One is that we believe risks such as a trade shock would have to be quite severe in order to lead the BoC to allow inflationary pressures to build without tightening policy.** At this point in time we don't judge the risk of the abrogation of the NAFTA agreement as a serious one, in large part because Congress—not the executive branch—controls trade agreements and the Trump administration could not execute a notification of intent to withdraw. What is key in this regard is that trade policy uncertainty operates very differently as a macroeconomic influence when the economy is already at capacity limits, especially industrial capacity (chart 3). There is an option to invest when trade uncertainty exists at a point of slack in the economy. When trade uncertainty exists at the point of full capacity utilization—let alone excess utilization—then the element of choice diminishes. A business can choose to invest and hire in order to expand capacity to meet incremental demand in a solidly performing global economy, or it may raise prices more aggressively in order to ration demand. The only other alternative is to sit back and watch others eat its lunch.

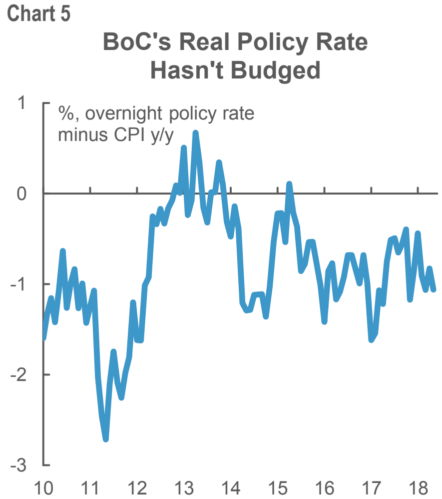
Secondly, growth is unimpressive. Current tracking for Q2 GDP growth is only about 1.7% using monthly income-based GDP accounts at a very preliminary stage but this is expected to improve somewhat and it wouldn't take much to do so. Further, quarterly expenditure-based GDP should perform better than current tracking of the monthlies. This follows actual Q1 growth of 1.3% on a quarterly expenditure accounts basis. Nevertheless, growth is roughly trending at or slightly below the BoC's estimated 1.5–2.1% range for the economy's potential growth rate. Some of this disappointment in early Q2 tracking may be transitory (here and here for instance) but a combination of weak growth and persistent varying transitory factors nevertheless leaves behind continued growth disappointments. The risk of further escalation of retaliatory tariffs could also well prove to be a growth headwind. This will limit the move by the economy into excess aggregate demand conditions at least in the near-term, though we continue to forecast that the economy will continue to transition toward improved growth as temporary headwinds dissipate and to therefore migrate

Chart 4



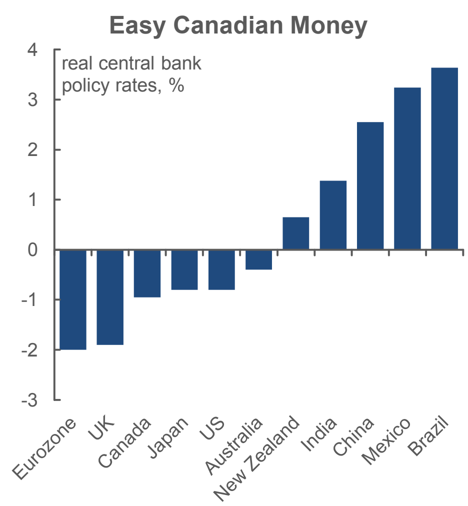
Sources: Scotiabank Economics, Bank of Canada.

Chart 5



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

Chart 6



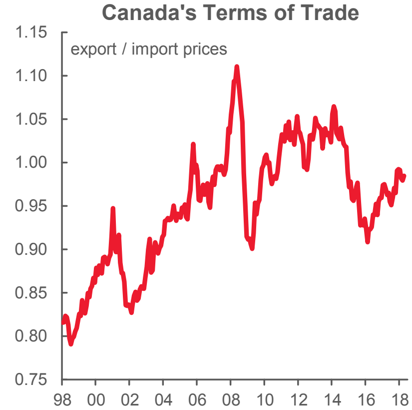
Sources: Scotiabank Economics, Bloomberg.

toward excess demand from its current balanced state over the forecast horizon (chart 4).

So what is the BoC to do when confronted with the risk of building wage and price pressures and soft or little growth that may be labelled a stagflation scenario? Stick to its guns on the growth outlook which is in line with ours for one. Respect its mandate for another, but tread carefully from decision to decision. We continue to forecast a rate hike in July. There may be rising pressure into an election year for fiscal and regulatory policies to mitigate the distribution effects across sectors of various trade-related risks. **Not acting to tighten monetary policy in the face of rising wage and price pressures risks unmooring inflation expectations and causing greater longer-term risks to the economy and financial system.** That, in turn, risks disavowing the BoC's role in the building price pressures.

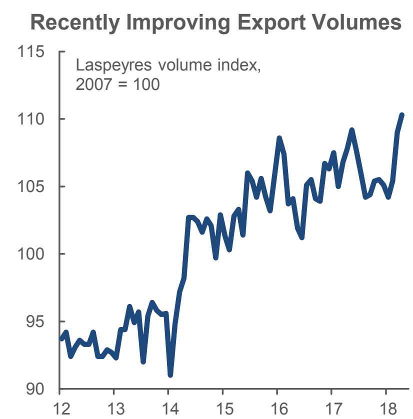
A third related consideration involves how to view broad monetary conditions. Overall, the real policy rate is among the lowest in the world (chart 5). Left unchecked, Canada's real policy rate would become lower than the Eurozone's and much lower than Japan's (chart 6). While the BoC would also look at the real rate using inflation expectations, it is also true that the real policy rate has not tightened as the nominal rate has been raised using market-derived measures of inflation expectations instead of actual inflation. The real policy rate is what matters to any attempt to forecast real GDP growth and the broad framework for spare capacity and inflationary pressures. Governor Poloz has hiked three times to date in order to keep conditions from easing on a real rate basis, with the real policy rate staying roughly constant at around -100bps. Monetary conditions have not tightened when judged through this lens. All that three rate hikes to date have achieved is to prevent monetary policy conditions from easing in real rate terms. Canadian dollar depreciation, tight credit spreads in products like mortgage and provincial bonds, as well as elevated high-yield debt indices continue to point to easy if not easing broader financial conditions.

Chart 7



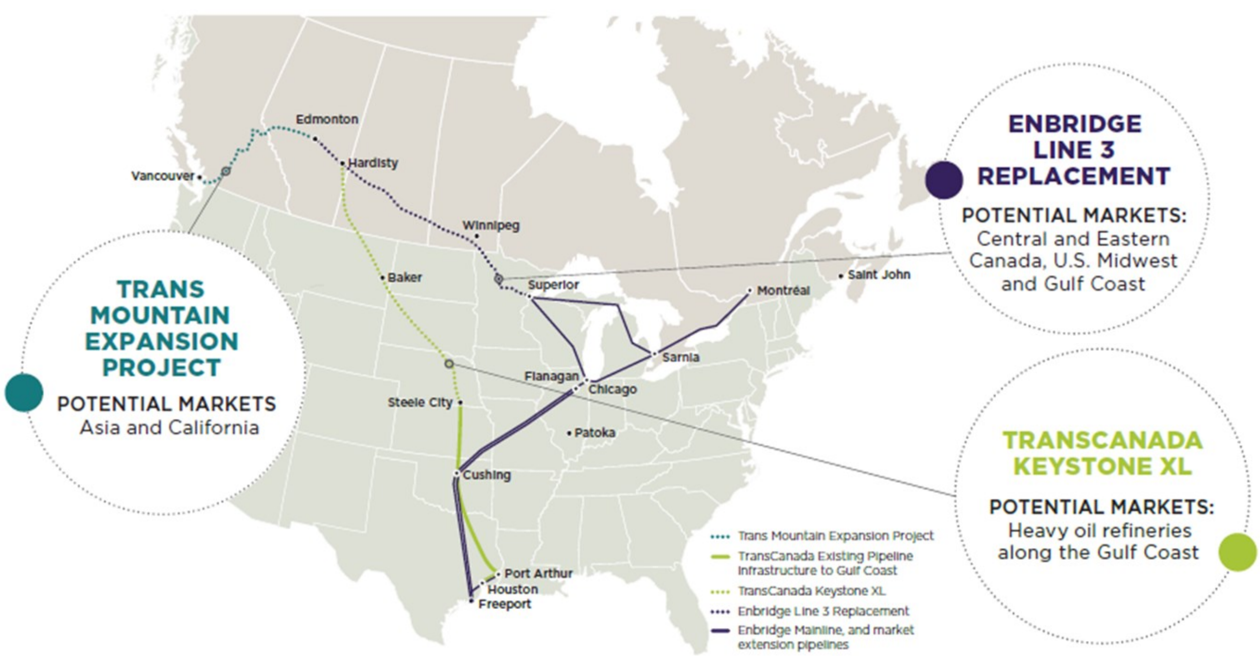
Sources: Scotiabank Economics, Statistics Canada.

Chart 9



Sources: Scotiabank Economics, Statistics Canada.

Chart 8

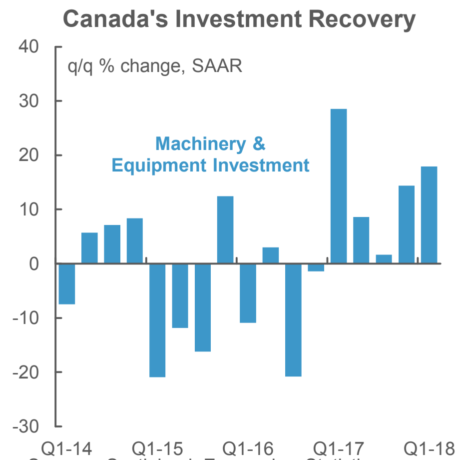


A fourth related matter is that the terms of trade have improved rather significantly over the past year (chart 7). The faster rise in export prices relative to import prices has occurred as commodity prices have recovered over time and the Canadian dollar has depreciated. Being able to sell exports at prices that are rising more quickly than imports induces positive dynamics for income growth. This carries positive effects for gross national income that then trickle down into more positive developments for household incomes, corporate profits and government revenues. Recall that when the shoe was on the other foot over 2014H2 into 2015 as commodity prices fell and the terms of trade worsened, the BoC's response was to ease monetary policy. As the terms of trade have improved, this counsels the opposite policy response.

A fifth related matter concerns production bottlenecks that are particularly focused upon the energy sector due to a shortage of pipeline capacity. A first consideration when evaluating this effect is that bottlenecks can prove to be inflationary. An inability to invest in upstream capacity due to downstream capacity limits means a greater likelihood that improved free cash flow positions are relatively more likely to be distributed to workers and shareholders, some of which may be spent. A second consideration, however, entails viewing pipeline capacity limits as relatively transitory. Three major pipelines—TransMountain, Keystone XL and Line 3 (chart 8)—are expected to become operational around a 2020–2021 horizon. In other words, by next year, the alleviation of production bottlenecks begins to be a material consideration for the BoC within the monetary policy horizon of 1–2 years. Upstream investment will face a greater need to invest in advance of this improvement in pipeline capacity.

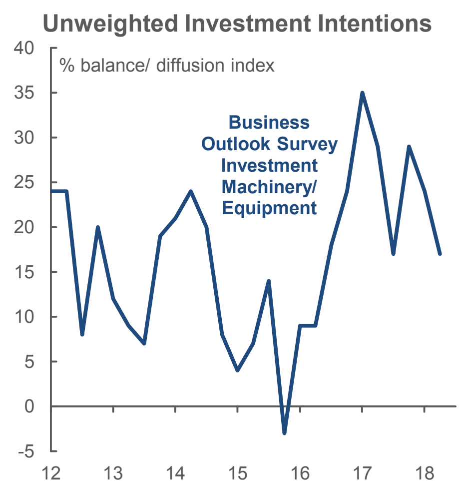
A sixth related consideration for present purposes is that the BoC is tentatively observing the long-awaited rotation of the sources of growth away from reliance upon consumers and housing markets and proportionately more toward exports and investment. Export volumes have been sharply improving (chart 9) and the currency's depreciation may provide a further assist. Business investment has also been improving (chart 10) and intentions point to expectations for more to come (chart 11). Canada ranked #2 in the world for foreign direct investment confidence across global corporations in this 2018 survey partly due to the new Invest Canada agency and significant trade agreements including CETA with the EU, the

Chart 10



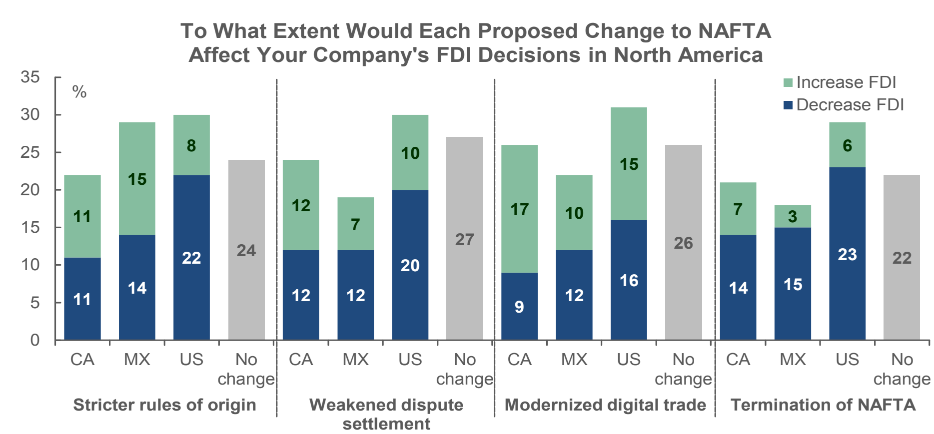
Sources: Scotiabank Economics, Statistics Canada.

Chart 11



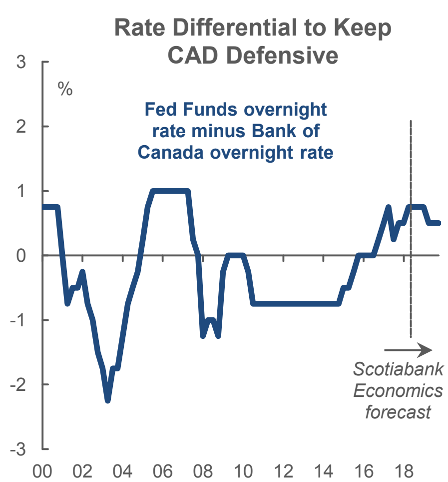
Sources: Scotiabank Economics, Bank of Canada.

Chart 12



Source: ATKearney.

Chart 13



Sources: Scotiabank Economics, Federal Reserve Board, Bank of Canada.

TPP ex-US and with South Korea. The same FDI survey also signalled that firms would either maintain or increase investment plans in Canada under various NAFTA-related scenarios except for full termination (chart 12). As exports and investment return, the economy can adapt to a softer growth profile for consumption and a modest expected drag effect from housing. For more on the general macroeconomic outlook see pages 4–11 of the *Global Outlook*.

Finally, that the Federal Reserve remains confident about tightening monetary policy allows the BoC considerable leeway to tighten policy from the standpoint of the effects on the Canadian dollar. The BoC is well behind the Fed's pace of tightening that has raised the policy rate faster from a lower initial starting depth to a higher present level alongside unwinding unconventional US monetary policy stimulus, and this helps to explain why the USD has strengthened versus CAD. The next section will consider the outlook for US rates, but for now, the implication for Canada is that the negative shorter-term interest rate differential may widen relative to our prior forecast round as we've tentatively added one more Fed rate hike (chart 13). That has motivated us to weaken the outlook for the Canadian dollar which further insulates against trade policy risks. The prospect of currency depreciation should trade policy developments markedly worsen is the country's first line of defence. Indirectly, the Trump administration's possible further escalation of trade policy uncertainty would manipulate the Canadian dollar to a weaker position as a flexible exchange rate regime does what it must.

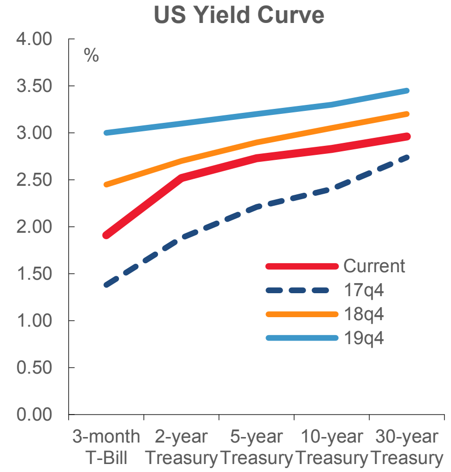
FEDERAL RESERVE—RETAINING OPTIONALITY ALONG A MORE HAWKISH PATH

We've tentatively added one more rate hike compared to our prior forecast round and now expect the Federal Reserve to raise twice more this year, bringing the total to four hikes in 2018 including the two that have already been delivered. Two more hikes then continue to be forecast in 2019 that would bring the policy rate to 3% by the end of 2019. That would equal the FOMC's estimate of the longer-run neutral rate as the Treasury curve bear flattens (chart 14), though the FOMC consensus has signalled an overshoot on the policy rate into 2020 when it anticipates two more rate hikes to 3.5%. Throughout it all, the Fed's pace of balance sheet unwinding is assumed to remain on auto-pilot as the pace of balance sheet reduction accelerates to its maximum monthly rate this Fall (chart 15). By the end of 2020, the balance sheet will be under US$3 trillion which means that purchases under the QE3 program will have been fully reversed. **The combined degree of Federal Reserve policy tightening through conventional and unconventional tools is estimated to be equivalent to between five and six 25bp increases in the Fed funds target range by the end of 2019. This combined pace of policy tightening exceeds the Bank of Canada's forecast rate increases.**

Because this view—unlike our BoC forecast—is on-consensus and in line with the FOMC's revised 'dot plot', the value to a write-up comes from guidance over the direction of risks. On that note, while another hike has been added to our forecast for this year and linear uninterrupted paths for conventional and unconventional policy tightening are being communicated by the FOMC, **such plans over time are likely to be proven to be relatively aggressive.**

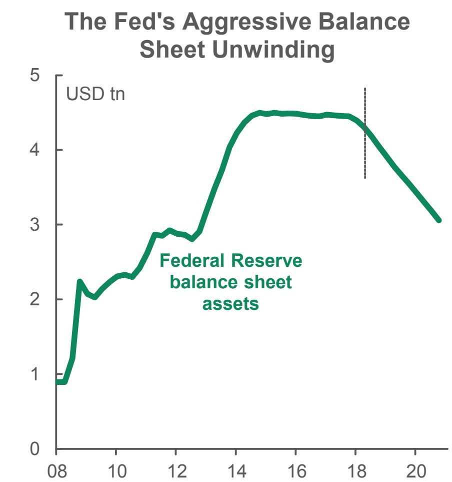
First, conviction toward expedited policy tightening this year is moderated by the fact that Chair Powell himself tamped down a literal interpretation of revised FOMC projections in what was tantamount to one of the lowest conviction hawkish turns

Chart 14



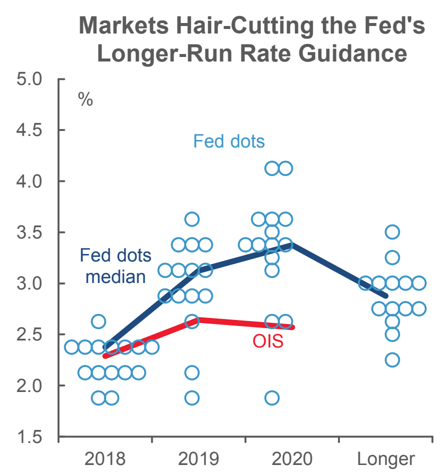
Sources: Scotiabank Economics, Bloomberg.

Chart 15



Sources: Scotiabank Economics, Haver Analytics.

Chart 16



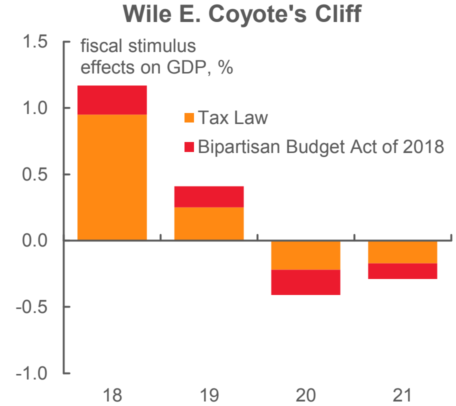
Sources: Scotiabank Economics, Bloomberg.

signalled by a central bank head in quite some time. Indeed, Powell appeared to douse the dots, so to speak, when he stated in the recent press conference **that "most participants did not revise their projections."** In so doing, Powell distanced himself from the addition of an extra rate hike this year. Indeed, it took only one FOMC participant to go from predicting one more rate hike to two more this year in order to swing the median projection toward an added rate hike as highlighted in chart 16. The takeaway is that the FOMC has left the door wide open to two more hikes this year but also wide open to just one more hike pending further developments.

Second, a key assumption to the Fed's exit plans is a linear path of relatively strong above-potential growth. Near-term GDP growth, however, must be weighed against former Chair Bernanke's warning about the 2020 environment when he recently spoke in conversation at the American Enterprise Institute (here). **Bernanke's warning that fiscal stimulus "is going to hit the economy in a big way this year and next year, and then in 2020, Wile E. Coyote is going to go off the cliff" is something the FOMC consensus should take into account.** Bernanke went on to remark that "What you are getting is a stimulus at the very wrong moment. The economy is already at full employment." Most estimates of the fiscal impulse to GDP growth this year and next from the Tax Cuts and Jobs Act and the February spending bill are then followed by modest fiscal drag effects into 2020 (chart 17). As fiscal stimulus turns to fiscal drag—and assuming it is not extended into the 2020 election year—adding to rate hikes before then could risk over-tightening by the Fed.

Having said this, we find talk of US recession risk to be too cavalier. Household imbalances are hardly apparent with a debt service burden near a record low and a wealth-adjusted saving rate at a record high. Corporate credit quality remains strong including when interest coverage is shocked for the Fed's 'dot plot' (here). Fiscal stimulus will turn to only mild fiscal drag in 2020 and that assumes Congress doesn't add another spending bill into the 2020 Presidential election.

Chart 17



Sources: Scotiabank Economics, Joint Committee on Taxation, Central Budget Office, "The Tax Cuts and Jobs Act: A Boost to Growth or Missed Opportunity?" - Jason Furman.

Chart 18

Sources: Scotiabank Economics, Statistics Canada, BLS.

Table 1

Scotiabank Economics' Canada-US Yield Curve Forecast

	2017	2018				2019			
				(end of quarter, %)					
Canada	**Q4**	**Q1**	**Q2**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
BoC Overnight Target Rate	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.25	2.50
Prime Rate	3.20	3.45	3.45	3.70	3.95	4.20	4.45	4.45	4.70
3-month T-bill	1.06	1.15	1.26	1.55	1.80	2.05	2.30	2.30	2.50
2-year Canada	1.69	1.78	1.91	2.05	2.30	2.40	2.50	2.55	2.60
5-year Canada	1.87	1.97	2.07	2.25	2.45	2.55	2.60	2.65	2.70
10-year Canada	2.05	2.09	2.17	2.40	2.55	2.60	2.65	2.70	2.75
30-year Canada	2.27	2.23	2.20	2.50	2.70	2.80	2.85	2.90	2.95
United States	**Q4**	**Q1**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Fed Funds Target Rate	1.50	1.75	2.00	2.25	2.50	2.50	2.75	2.75	3.00
Prime Rate	4.50	4.75	5.00	5.25	5.50	5.50	5.75	5.75	6.00
3-month T-bill	1.38	1.70	1.92	2.20	2.45	2.50	2.70	2.75	3.00
2-year Treasury	1.88	2.27	2.53	2.60	2.70	2.80	2.90	3.00	3.10
5-year Treasury	2.21	2.56	2.73	2.85	2.90	2.95	3.00	3.10	3.20
10-year Treasury	2.40	2.74	2.84	3.00	3.05	3.10	3.15	3.20	3.30
30-year Treasury	2.74	2.97	2.96	3.15	3.20	3.30	3.35	3.40	3.45

Sources: Scotiabank Economics, Bloomberg.

Third, increasing policy tightening this year is not supported by recent inflationary pressures that communicate a sense of urgency. Recent US inflation sits roughly on the Fed's target and we believe the Fed will tolerate a moderate and temporary overshoot of its 2% inflation goal.

Fourth, the inflation outlook is unlikely to get the same assist from dollar depreciation that it has over recent quarters. The broad dollar index's depreciation from the beginning of 2017 through to earlier this year likely contributed a fair portion of the pick-up in core PCE inflation. The dollar's appreciation since then may point to topped-out inflation with downside risk later this year and into next year. Recall that the Federal Reserve's research estimates that every 10% depreciation/appreciation in the USD in trade-weighted broad dollar terms translates into a 0.5% rise/fall in core inflation within six months and 0.3% within one year as the transitory effects begin to dissipate.

Fifth, wage growth remains range-bound. May's 2.7% y/y nominal figure is well within the mostly 2.4–2.8% range of the past two and a half years. Only 2015 into 2016H1 saw an acceleration. In real terms, however, the **real average hourly earnings growth rate is 0% which is the second lowest print of the past five and a half years (chart 18).** Wage gains are not pointing toward fanning inflation risk. Indeed, if anything, it's the opposite.

One added uncertainty concerns global trade tensions that are being led by the US administration. I generally agree with the Federal Reserve's assessment of modest influences thus far, but the degree of uncertainty going forward counsels fairly wide bands around forecasts for many variables in the context of the increased uncertainty that the Trump administration has imposed upon the longer-run outlook for the global and domestic economies.

Mexico

IF-THEN

- **A number of uncertainties are affecting the economic outlook in the next quarter. The results of the Presidential election could bring a significant change to economic policy in the context of global policy uncertainty. Accordingly, our macroeconomic forecasts are best characterized as "if-then" statements and could change materially in coming months.**
- **Currently, the high uncertainty levels are having some impact on the economy, so we are making some adjustments to incorporate more cautious behavior by consumers, weaker investment, a higher path for the MXN and a significant change in the trade balance.**

Mexico held its most consequential elections in recent memory on July 1. While focus has been on the presidential campaign, which was decisively won by AMLO, 3,400 government officials at federal and local levels were also elected, AMLO had built his campaign on the premise that it is time to change the so called neo-liberal model that, according to his narrative, has not worked and has only produced poverty and inequality.

It is not at all clear, at this time, what his administration will change. There have been many reassuring messages, such as the maintenance of fiscal discipline, that there will be no growth in public debt and the central bank's autonomy will be respected. On the other hand, there have also been troubling messages, particularly around his desire to stop or rollback some of the structural reforms, or that large social promises will be fulfilled by increasing public spending and direct participation by government in the economy. It is worth noting that there is virtually no fiscal space in Mexico, as the International Monetary Fund has said, and if the new administration puts pressure on the public finances despite its pledge to maintain fiscal discipline, there could be negative reactions in financial markets. Maintaining market confidence will be important, with about US$11bn of foreign currency debt coming due in 2019, which will have to be rolled.

Financial markets are largely assuming a scenario in which economic policy is not significantly changed due to constraints of reality and pragmatism. Markets will carefully parse his first few speeches, cabinet choices and early policy decisions to assess how AMLO may change Mexico's policy orientation.

The political process in Mexico is not the only factor that will affect the performance of the economy. There are many key issues that could be defined in the coming months with the potential to radically change the economic outlook. Perhaps the most important of these issues is the NAFTA renegotiation process, which continues at a slower pace, since a new agreement will need to be processed and signed by the new government. Unfortunately, the economic outlook could get dramatically darker if the US President decides to terminate the agreement. Although this is an outcome that we continue to believe is unlikely, the risk exists, even as signs of a trade war with China become more prominent. In

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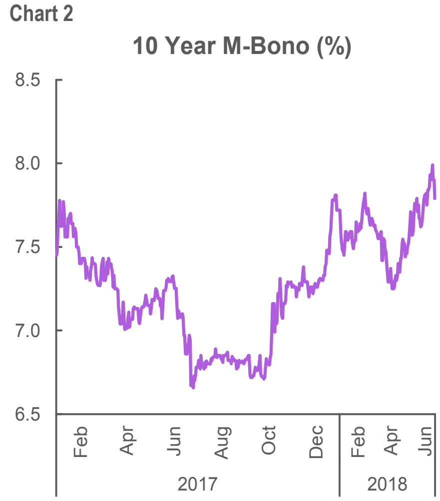
Mexico	2017	2018f	2019f
Real GDP (annual % change)	2.0	2.1	2.5
CPI (y/y %, eop)	6.8	4.2	3.8
Central bank policy rate (%, eop)	7.25	8.00	8.00
Mexican peso (USDMXN, eop)	19.66	20.20	20.48

Source: Scotiabank Economics.

Chart 1

Source: Banco de Mexico.

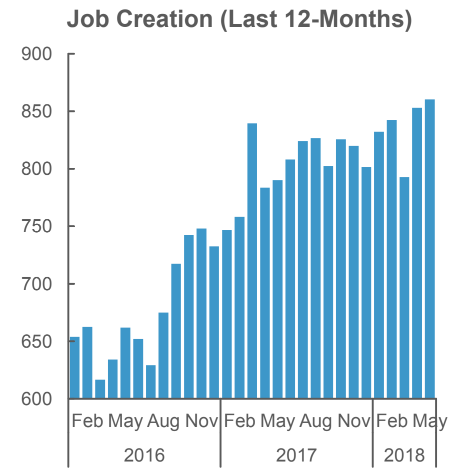
Chart 2



Source: Banco de Mexico.

addition to this, the global financial environment for emerging markets has been deteriorating, not only because the US government is increasingly protectionist, but also because global interest rates could be under pressure from the monetary policy normalization in developed countries coupled with higher financial requirements in the US.

Chart 3



Source: INEGI.

There is then a high level of uncertainty over the economic outlook, and our financial variables are reacting to it, as can be seen in the MXN behavior in the last weeks, as depicted in chart 1; and in the yield of the 10 year M Bono, in chart 2. We have adjusted our macroeconomic framework to incorporate this more uncertain future, as well as the most recent economic data. Accordingly, we are now expecting more modest GDP growth rates for 2018 and 2019 (2.0% and 2.5%, respectively), since private consumption may be not as strong and investment could be weaker. Despite the latter, job creation is doing quite well, as can be seen in chart 3, so we are expecting strong numbers for this year and the next (852K and 865K). Our forecast for the MXN now recognizes a higher path, reaching 20.20 MXN/USD by the end of this year and 20.48 by the end of next year.

A couple of the relevant unknowns are inflation and interest rates. If the peso remains under pressure, then there could be higher inflation, which in turn will require further action from Banco de Mexico's monetary policy through higher interest rates. For the time being, we keep thinking inflation will end 2018 slightly above the upper level of the reference range for the monetary policy, while next year could get into this range. We are still expecting two more interest rates hikes by Banco de Mexico this year, and one more in 2019, reaching 8.25%. If everything goes well, then Banco de Mexico could start cutting a bit its interest rate in the last quarter of 2019. However, our interest rate forecast has a clear upward bias. One interesting revision could be observed in our trade balance that is now presenting a smaller deficit—thanks to the strength of the global economy and to the impulse provided by a weaker currency. As a consequence, the current account deficit is also lower.

We still assume that reason will prevail, meaning that NAFTA will not be terminated and eventually a renewed and better NAFTA will be signed in 2019, and that the new President will maintain reasonably unchanged economic policies without dramatic changes to the structural reforms. If these assessments are incorrect, then our forecasts could change materially in the coming months. The most sensitive variables would be the exchange rate and interest rates, where there is an upward bias in the most likely outcomes. These are uncertain times, and as Niels Bohr once said: "making predictions is extremely difficult, especially about the future".

Brazil

A CLOUDY (STORMY?) HORIZON

- **Brazilian markets have experienced among the heaviest pressure in the Emerging Markets space over the past couple of months, arguably only being more stable than Turkey and Argentina. The 5yr node of the curve has widened about 200bps in a 2-month span, and the Brazilian real (BRL) is down over 10%. The BRL's fall risks affecting inflation dynamics.**
- **Brazil's central bank (BCB) is at risk of falling behind the curve, refusing to hike rates, despite surging PPI inflation, rising IPCA inflation, and very loose fiscal settings.**
- **The BCB's FX war-chest remains strong, leaving space for further intervention, but it cannot sustain the recent pace of swap sales, or it risks undermining one of Brazil's few remaining buffers—strong reserve liquidity.**
- **On the political front, the outlook remains cloudy, and a "positive scenario", where we get a reformist government with strong legislative support today appears far from a base case.**

MARKET VOLATILITY RISKS CONTAMINATING FUNDAMENTALS FURTHER

Brazilian assets have come under severe pressure, with BRL down -10.2% over the past couple of months, and the 5yr part of the yield curve widening 200bps. The price action has suggested a strong deterioration in liquidity, as buyers have remained mostly absent in risk-off days. The gapping price action points towards uncertainty over the October presidential elections adding to concerns that urgent issues such as pension reform and fiscal adjustment may not be part of the agenda for the next administration or that, even if they are, the new government may lack a strong enough mandate to make necessary adjustments. A risk is that the pressure on the BRL and longer-end rates could force the BCB to tighten rates earlier than it would like, which could in turn derail the already faltering macro rebound.

GROWTH STILL AMONG THE BETTER NEWS, BUT LOSING MOMENTUM

Although the most recent print of monthly economic activity is still strong (+3.7% y/y for April), some indicators are starting to flash warning signs (i.e., retail sales for April were a soft +0.6% y/y), and consensus for the year is at +2.45% y/y—with a downward trend in more recent polls (expectations peaked at +2.7% y/y back in April). Our sense is that this seeming deceleration in the Brazilian economy is what's stopping the BCB from turning more hawkish, despite the escalating risks on the inflation front.

There are a number of factors that we think will at some point serve as a drag on growth, potentially worsening in 2018-H2: even without the BCB formally tightening, we have seen a sharp move higher and a steepening of the Brazilian yield curve, which should hit still highly indebted households (their debt burden as

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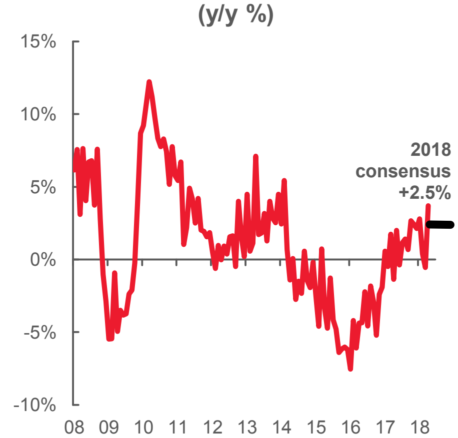
Brazil	2017	2018f	2019f
Real GDP (annual % change)	1.0	2.3	2.5
CPI (y/y %, eop)	3.0	4.1	4.6
Central bank policy rate (%, eop)	7.00	7.25	9.00
Brazilian real (USDBRL, eop)	3.31	3.90	3.70

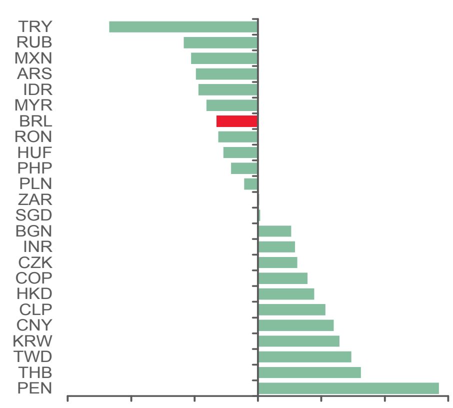
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

a % of disposable income remains above 21%, with a short average life, meaning rate-resets hit quickly). We also see higher inflation hurting consumer confidence as we move further into the year, as we expect it to erode real wages. In addition, uncertainty over the elections, as well as higher interest rates should also hurt the corporate sector. We don't see these two shocks yet dragging growth below 2%, as base effects and high commodity prices should remain supportive, but they are enough to make us among the more pessimistic out there on growth prospects (we are 20bps below consensus for 2018, and 30bps below consensus for 2019).

BCB UNDER PRESSURE TO STABILIZE BRL

With the BRL down sharply, and Brazil's FX-inflation pass-through relatively high (about 20%–30%) markets are starting to price rate hikes into the DI curve (local interest rate swaps). As of mid-June, the curve was pricing in about 100bps of hikes by year-end. We think part of this may not necessarily reflect actual expectations of policy tightening by the BCB, but rather is the result of loss of investor appetite for local assets pressuring rates higher. However, we do think that with PPI inflation drifting much higher (now at 7.4% y/y in April), CPI also moving higher (consensus for IPCA's print this week is at 3.56%, a 90bps move higher from the previous month if confirmed), pent up FX-inflation pass-through potentially being about 200bps–300bps, and the government expected to post a fiscal deficit of around -8.3% of GDP (in the General Government Overall Balance), the odds that the BCB is falling behind the curve are rising. To be on "neutral settings", our estimates suggest that the SELIC should currently sit somewhere between 8.0% and 8.5% based on inflation expectations and the "transmission lag", and our sense is that could be biased to the low side, given the risk of a higher-inflation surprise is material—in part due to the lax fiscal stance. Brazil is one of the LATAM economies where once an upward inflation spiral catches on, it can become self-reinforcing.

From a real effective exchange rate perspective (REER, see chart 2), the BRL is cheap, but not materially so—it's within 1 standard deviation of "fair-value"—the lack of particularly attractive valuations, combined with low-ish interest rates make the BRL vulnerable still. The good news, is that the BCB still has some ammo to step in and support the BRL. At the moment, the central bank's outstanding position in swaps is around US$65bn, and with FX reserves of around US$360bn, there is still ammo to protect the real. However, it is also true that the pace at which it is increasing its swaps position is concerning—in one week in June, the swaps position increased by US$26bn!! According to the IMF's Reserve Adequacy Metric (see table below), the country's FX reserves are among its few remaining buffers—it cannot afford to squander them.

Emerging market reserve adequacy

Country	ARA metric	Country	ARA metric
Brazil	1.55	Chile	0.82
China	0.86	Colombia	1.26
India	1.51	Mexico	1.07
Russia	2.77	Peru	2.74
South Africa	0.64		

ARA metric: the IMF's measure of reserve adequacy is considered adequate when it stands between 1.0 and 1.5. The measure is based on a series of metrics that includes short term debt coverage, imports, etc.

We expect BRL to continue weakening further, as real yields get eroded by rising inflation, at the same time as political uncertainty and lack of progress on fiscal consolidation and urgent reforms (i.e., pensions) hit appetite for Brazilian assets. It's possible that in the coming months, the BRL could be seen as a carry-currency for MXN longs, given that the yield differentials between the two have compressed—especially on a quality-adjusted basis. We continue to see USD/BRL drifting higher—getting to 3.90 by year end, and we don't discount that, as the election draws closer, we could see temporary moves above 4.0, although in those moves we expect the BCB will intervene heavily through swaps, and in more extreme scenarios—potentially even in spot. We do see the BCB kicking-off an earlier-than-consensus rate hike cycle, but to some degree they will be chasing inflation, rather than getting ahead of it. As a result, we see inflation drifting higher and faster than consensus, but we also don't yet see it getting out of hand—although this is a risk if the BCB remains too complacent on the inflation front.

POLITICS—BLURRY OUTLOOK, WITH SEEMINGLY LOW ODDS OF A PRO-REFORM GOVERNMENT WITH A MANDATE

It's still very hard to call how the elections can play out given former President Lula remains the most popular politician, and the door has not been fully shut on his presidency. In addition, second place in the polls seems to belong to right-leaning populist Jair Bolsonaro. Many locals we have spoken to believe that ultimately the "establishment vote" will consolidate behind a single name, which will carry the election. However, there are risks that the anti-establishment (i.e. Bolsonaro and the PT) could do the same, and consolidate the "blow up the system vote". Bolsonaro's campaign has been relatively short on details, but he has said he would pursue tax-cuts and spending restraint, but has made no commitment to "urgent" issues such as fiscal consolidation, tax reform, and pension reform, without which the country's fiscal position will remain extremely vulnerable, and arguably in a continued fast-deterioration trend. We would argue that even the "optimistic scenario", where the establishment vote consolidates behind a single candidate to carry the election is not without risks. With what seems like quite fragmented politics in the pro-market parties, a government with a robust reformist mandate that can make the reforms to stabilize deteriorating fiscal dynamics does not appear to be anywhere near a base case.

Colombia

- **With the elections out of the way, and the results mostly in line with expectations, it is now time for the details to be fleshed out in terms of Duque's campaign agenda. Some of the proposals are likely to be welcomed by markets—but as always the devil is in the details. One of the areas we'd like clarity on is how the government plans to deal with the country's heavy oil dependence both in external and fiscal accounts.**
- **Twin deficits have materially compressed, but heavy oil dependency remains, meaning the country is still at risk if the issue is not addressed. This to us is the key issue that Duque needs to address soon, as there is no certainty that the external environment (i.e. oil prices) will remain as supportive as it currently is.**
- **We expect the economy to hit its potential growth rate in 2019, accompanied by inflation moving back to the top-half of the central bank's (BanRep) target range. As that move happens, we expect BanRep to start tightening rates very late in 2018, and to start "following the Fed" more closely.**

ELECTION RESULTS IN LINE WITH PRE-VOTE POLLS

The results of the second round of Colombia's Presidential election were very aligned with pre-vote polls. Center-right/right-leaning Ivan Duque won the election by securing 54% of the vote in the second round (vs Petro with 42%), now putting focus on the specifics of the government plan—which was broad in its coverage, but with scant details. In terms of proposals, the Duque campaign included the following, within a very long list of promises:

- Fiscal simplification, cutting the number of taxes and reducing exemptions, with the overall tax burden on companies falling. The idea makes sense, but the details and the legislative capacity to push this through will be key.
- Adjusting the fiscal rule to strengthen it and ensure that there is no permanent debt build-up. This is an important point. We would argue that Chile's rule is fairly effective, a move in that direction would be welcome.
- Strengthening fiscal federalism. We haven't seen many LATAM economies succeed in this.
- Creating new funding mechanisms to channel savings to productive activities: are they planning to create vehicles to channel pension fund savings to firms and infrastructure?

Details are scant, with some key elements that need to be clarified, including: 1) which taxes will be changed/eliminated in the process of fiscal simplification, 2) what is the net impact on the overall fiscal revenue, and how does this reduce dependence on oil-related revenues, 3) how will the fiscal rule be strengthened—

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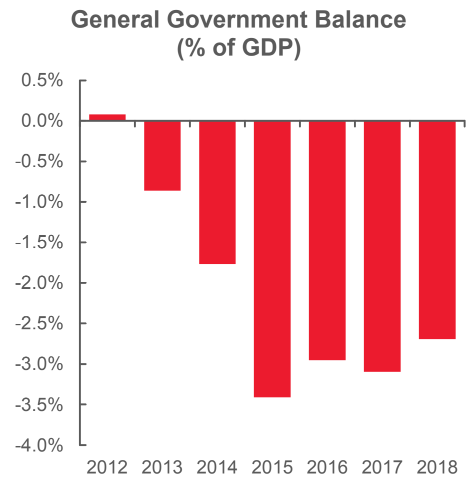
Colombia	2017	2018f	2019f
Real GDP (annual % change)	1.8	2.5	3.5
CPI (y/y %, eop)	4.1	3.3	3.4
Central bank policy rate (%, eop)	4.75	4.50	5.50
Colombian peso (USDCOP, eop)	2,986	3,000	2,850

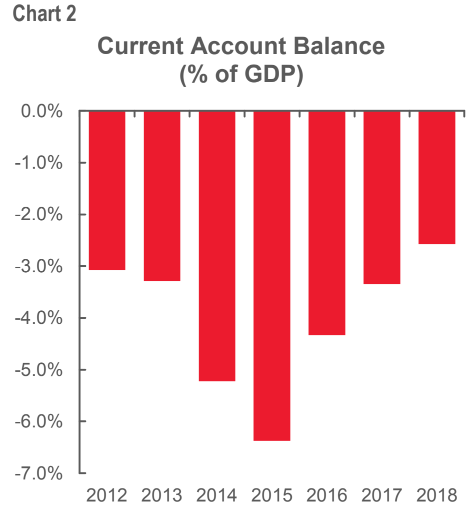
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, IMF.

Chart 2



Sources: Scotiabank Economics, IMF.

will its supervisory body be made stronger and more independent, and, 4) is Colombia planning to use vehicles similar to Mexico's FIBRAs and CKDs to channel pension system savings to private equity, infrastructure, etc? (this report highlights how successful they were—although there is likely to be growing pains).

VULNERABILITIES HAVE SUBSIDED, BUT REMAIN LATENT

So far, during the ongoing sell-off, the strongest pressure on EM markets has been focused on countries with weak fundamentals, such as wide current account deficits, a shaky fiscal stance, and/or low real rates/high inflation. Colombia is no longer in the group that has particularly large "twin deficits" (fiscal and current account), but we would caution that both are still relatively wide, and vulnerable to a shock of lower oil prices—which is not by any means part of our "house call", but which cannot be discarded as a risk for the next couple of years.

Colombia is rated: Baa2 (Moody's), BBB- (S&P's), and BBB (Fitch), which means it still has a "notch of margin" before becoming junk by 2 of the 3 main rating agencies (with the third it is right at the limit). Looking at the country's debt burden (gross general government debt is expected to close 2018 just south of 50% of GDP), as well as institutions—such as BanRep, which we see as credible, we don't think a junk status is close to being justified at the moment. However, we would also say it does not have a huge amount of margin, and dealing with the vulnerabilities in the current benign external environment is much better than during an adverse shock. As we noted above, one of the main risks we see for Colombia, which we don't expect, but can't discard either, is a potential drop in the price of oil:

- From the fiscal side, a US$10/bbl drop in the price of crude roughly translates to a 40bps of GDP deterioration in the country's fiscal stance. The rebound in oil prices helped Colombia's fiscal deficit by about 100bps of GDP, to a still not ideal 2.5% of GDP expected for 2018. The continued high reliance on oil of public finances is a risk.
- Oil represents 31% of Colombian exports, and as we saw with the 2014 oil price shock, a drop in the price risks re-widening the country's current account gap. The country lacks "integrated clusters", and as a result has un-correlated imports and exports, which leads to the current account being quite sensitive to oil price swings.

MONETARY POLICY AND GROWTH

We expect the Colombian economy to gradually gain traction over the coming months, as high oil prices support investment in the sector, at the same time as election uncertainty fades—boosting private sector confidence. It's worth noting that up to now, consumer confidence has been strong (last print at 28.7), but we have seen industrial confidence remain very weak (last print at 2.0). Our sense is that as confidence in the industrial side drifts higher—supported by a more benign external environment (i.e. stronger global trade and oil prices), we will also see investment pick up. An indication that things are materially improving on the industrial side was last month's industrial production print which came in at a very impressive +10.5% y/y (+5.6% y/y consensus), and, alongside continued 5.0%–7.0% retail sales (the recent range for the print), suggests the economy is settling down into a more solid and broader-based growth rebound.

At the same time, as the Colombian economy continues to strengthen towards its potential growth rate—which we see being reached next year, we expect inflation to also start moving higher towards the upper half of BanRep's target range, but we also expect the central bank to shift tack responsibly, moving back into tightening mode at the very end of this year. Contrary to what has been the case until now, we expect BanRep to start "accompanying the Fed" (hiking alongside the Fed, more like Banxico); the sharp increase in foreign holdings in TES (from the low 20%s to the high 20%s share) should to some degree force BanRep to give up some policy independence with regard to the Fed in order to preserve rate-market stability.

Peru

ROOM FOR OPTIMISM

- **An all-around improving economy.**
- **Strong 2Q GDP growth, led by the private sector, with robust growth continuing going forward.**
- **Positive surprises in fiscal and external accounts.**
- **Stable monetary policy, with inflation under control.**

Things are definitely looking up, on multiple fronts, in Peru. Well, at least on multiple economic fronts. Politics are still a concern.

Since our last *Global Outlook* report, GDP growth has surprised to the upside, employment growth has improved significantly, inflation has dropped, the fiscal deficit has plummeted, and external accounts have been stronger than expected. There have been few areas of disappointment. Outside of the expected slowdown in mining output growth (but not in mining investment growth), all disappointments have come from government stimulus policy.

Given the wealth of favourable news, we've raised our GDP growth forecasts for 2018 from 3.3% to 3.5%, with some upside still possible, and for 2019 from 3.7% to 4.0%. This reflects our opinion that the growth trend has changed direction, slowly but clearly. A (still) favourable world growth environment has certainly helped.

The second quarter is coming in particularly strong, with 7.8% growth, YoY, in April, leading us to raise our growth forecast for 2Q2018 from 4.0% to 4.8%. To put this in perspective, GDP growth has accelerated from 2.5%, YoY, in 4Q2017 to 3.2% in 1Q2018, to nearly 5% in 2Q2018. Note, however, that 2Q will be the last quarter to benefit from a low YoY base comparison, due to El Niño in 2017, so growth should slow in future quarters. However, even if one excludes all exceptional factors (El Niño last year, an unusually strong fishing season), GDP growth would still have been in a healthy 3.5% to 4.0% range. Non-resource manufacturing growth of 12.4% was especially revealing of the strength of demand, both export and domestic.

Not everything is positive, though. Government spending has continued to lag, and will not be the driver of growth it was initially meant to be. The multiple changes at the Ministry of Finance, and in the cabinet in general, has delayed the investment spending Schedule and raises questions over how post-Niño reconstruction will be confronted. Thankfully, the private sector has taken up the slack. Private investment (5.3% growth in 1Q) and domestic demand (4.0%) have clearly become the main drivers of growth. The private sector is rebounding nicely from the 2017 shocks, and has proven more resilient than expected in light of political turbulence and corruption investigations. Non-resource manufacturing has risen 4.1% YOY in the year to April breaking a three-year downtrend—yet another sign that the tide has turned.

CONTACTS

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Peru	2017	2018f	2019f
Real GDP (annual % change)	2.5	3.5	4.0
CPI (y/y %, eop)	1.4	2.0	2.5
Central bank policy rate (%, eop)	3.25	2.75	3.25
Peruvian sol (USDPEN, eop)	3.24	3.18	3.12

Source: Scotiabank Economics.

Table 1

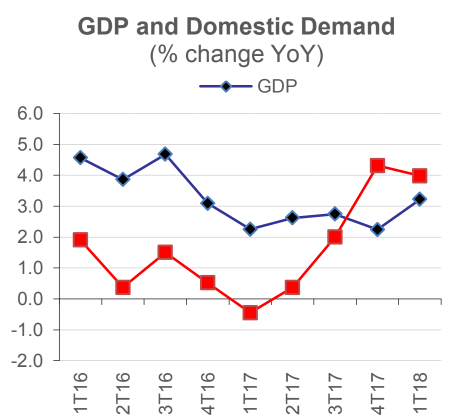
GDP and Domestic Demand Growth Rates

	2017	2018P	2019P
GDP	**2.5**	**3.5**	**4.0**
Domestic Demand	**1.6**	**3.5**	**4.0**
Private Consumption	2.5	2.8	3.3
Public Consumption	1.0	4.4	2.0
Gross Fixed Investment	-0.3	5.2	6.6
Private	0.3	4.1	6.2
Public	-2.3	9.8	8.0
Exports	**7.2**	**3.8**	**3.8**

P: Projected.

Sources: Research Department - Scotiabank Peru.

Chart 1



Sources: BCR Elaboration: Research Department-Scotiabank Peru.

To compound the good news, Peru's fiscal deficit in the twelve months to May fell to 2.4% of GDP, from 2.7% in April (and 3.2% at the start of 2018). The improvement is for the right reasons, as tax revenue rose 22.5%, YoY, in May, compared to government spending, up 8.9%. Note that May is the second and last month in the major tax season, which has been very strong this year. We had already lowered our fiscal deficit figure for full-year 2018 to 3.2% from 3.5%, but even 3.2% now seems a bit high. None of these figures take into account the new increase in excise taxes, which should only have a mild impact on revenue growth.

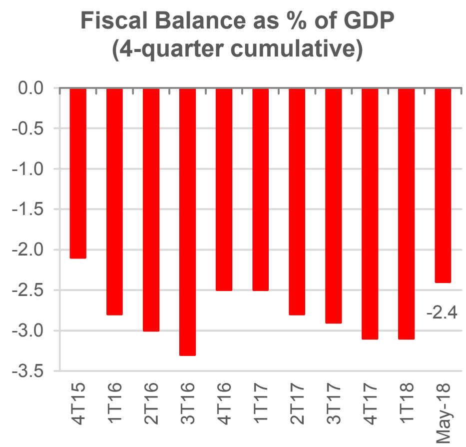
The recent fiscal figures have allayed some of the concerns the markets have had that the fiscal deficit could get out of hand, and that Peru's fiscal debt could surpass 30% of GDP in a few years time. As always, these concerns may resurface if metal prices were to decline sharply, which is always a risk for Peru.

What is less of a (direct) risk for the country is the impact of trade wars. Peru does not produce the type of manufactured goods that could see new tariffs applied. The risk for Peru is the indirect impact that would occur it trade wars hurt world growth, but also potential impacts on metals prices given the recent concerns about US trade policy being priced into those markets.

Peru's economy has suffered less than feared from domestic political turbulence, largely because politics have not altered proper economic management. Since 2016, there have been four ministers of finance, and yet there is no sense of disruption in the general guidelines of economic policy. The latest appointment, Carlos Oliva, has been well received by the markets, which view him as mainstream and with sufficient experience as former vice-minister at the Ministry of Finance in 2011-2016.

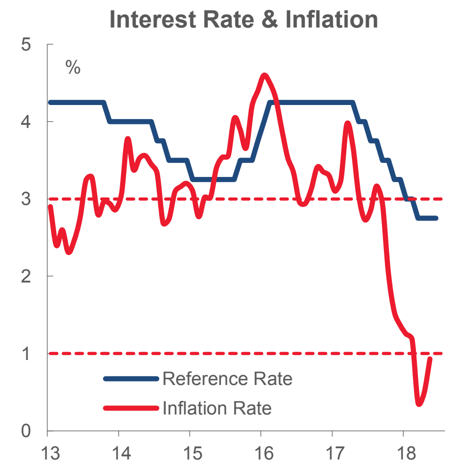
Meanwhile, the Central Bank (CB) ended its expansionary policy, which had taken its reference rate from 4.25% in April 2017, to 2.75% currently. Inflation is rebounding mildly, and should return to the 2% middle of the Central Bank target range fairly soon. We expect the CB reference rate to remain stable for the remainder of the year. The CB should be in no hurry to start raising rates again, despite a narrowing gap between the CB and Fed rates. Historically, the CB has maintained a period of rate stability before changing policies.

Chart 2



Sources: BCR Elaboration: Research Department - Scotiabank Peru.

Chart 3



Sources: BCR, INEI, Scotiabank Economics.

We haven't changed our year-end FX rate forecast of 3.18… yet. However, our doubts about the duration of USD strength are giving us pause. Fundamentals continue to point to a stronger PEN, with a foreign trade surplus consistently coming in stronger than expected. But, fundamentals have taken a back seat to USD strength, and commodity price volatility, in recent weeks. Although the PEN has, as always, been more stable that its regional peers, it has not been immune to the forces in play for regional currencies, and has been fluctuating in the upper half of the 3.20-3.30 band that has formed over the past year and a half. We're tempted to take another look at our year-end forecast; however, it's still early in the year, and we want more certainty that the current strength in the USD is more than just temporary before making any revision.

Chile

TAXIING IS OVER; A SHAKY TAKEOFF IS UNDERWAY

- **A faster-than-expected recovery is underway, despite a more challenging external environment.**
- **We have raised our forecast for GDP growth in 2018 to 3.7%, and consider the risks to be tilted to the upside as business sentiment and activity are rebounding strongly post-election.**
- **We anticipate slightly stronger inflation than the Central Bank, but have for now kept our year-end target for the policy rate at 3%, slightly higher than the 2.75% priced in markets. Given our view on growth, commodity prices and interest rates, we forecast the peso (CLP) will appreciate a bit less than expected in our previous forecast, ending the year at 602.**

MACRO UPDATE: RISKIER ENVIRONMENT AND BETTER DOMESTIC DATAFLOW

The Chilean economy has generally been unaffected by the Fed-induced reassessment of emerging market prospects. We think this will remain the case owing to: (1) Chile's risk factors are comparatively low (low foreign debt and current account deficit, for example), (2) strong institutional frameworks, including a completely flexible exchange rate, an independent monetary authority, a government pledged to improvement of fiscal conditions and growth, and (3) exports to the most troubled economies in the region are generally low.

Domestically, dataflow has been strengthening. Confidence indices remain strong, and are expected to remain so as suggested by an increasing amount of qualitative supporting information. This set of conditions is strong enough to raise our GDP growth by one tenth to 3.7% and to keep a moderate upward skew. As we have been saying for a long time, this recovery will be of "classic style", that is, led by investment, though not necessarily in big projects, and an inventory rebuild.

The stubbornly strong exchange rate and rising oil prices led the Central Bank and markets to raise inflation expectations substantially to 2.8% this year. In order to accommodate those factors, but also due to an expected faster recovery in non-tradable products (services) we raised our inflation forecast from 2.8% to 2.9%. Most of the market brought forward the first MPR (currently at 2.5%) rate hike to December, while we still keep our view that the rate could be at 3% at the end of the year. The bar is high for the Central Bank to raise rates more than we expect, as it will seek to allow the recovery to become more fully entrenched prior to raising rates.

Though we expect some relief for the peso in coming months, the risk of a further appreciation in the exchange rate owing to increased optimism in Chile cannot be discounted. We have incorporated only a modest amount of additional appreciation, as we now expect the peso to close the year at 602 CLP/USD.

CONTACTS

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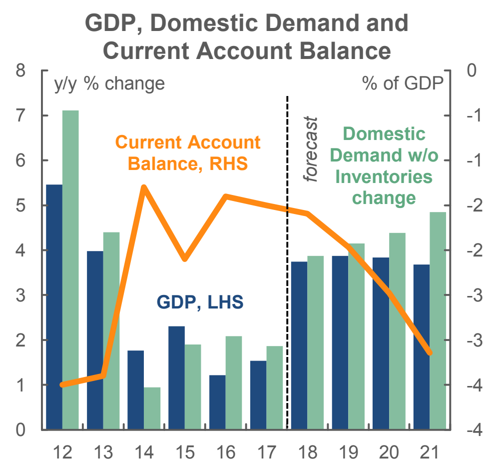
Chile	2017	2018f	2019f
Real GDP (annual % change)	1.5	3.7	3.9
CPI (y/y %, eop)	2.3	2.9	3.0
Central bank policy rate (%, eop)	2.50	3.00	3.50
Chilean peso (USDCLP, eop)	615	602	590

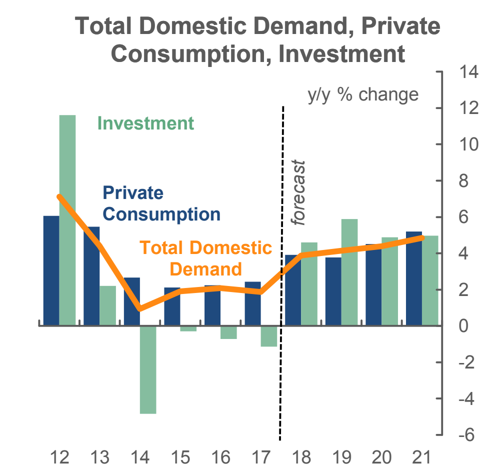
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Banco Central de Chile.

Chart 2



Source: Scotiabank Economics, Banco Central de Chile.

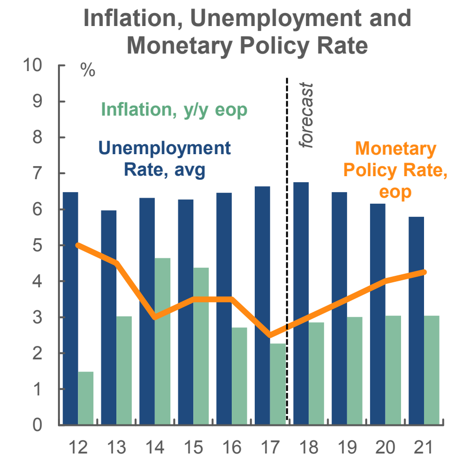
POLITICAL PANORAMA: A CAREFUL BUT DECIDED GOVERNMENT

We have seen little change on the political front. The Government continued with its plan to: take actions to unleash investment (severely contained in previous years by terms of trade, institutional challenges, and lack of confidence); achieve a wide consensus with the opposition for long-term reforms, and; re-orient public finances towards more sustainable levels. So far, results have not been evident, but many actions show they are moving in that direction in a very decided way. For example, political support for a corporate tax cut was impossible to get, and was replaced by a simplification of the tax reform to be proposed in short order. Some limited fissures in the Government coalition have been looming, but negative consequences for themselves and the President's leadership should be enough to avoid more noise. The most relevant center-left opposition seems open-minded to negotiate, trying to avoid political costs of crippling actions.

MAIN RISKS: TERMS OF TRADE AND POLITICAL AGREEMENTS ARE THE KEY

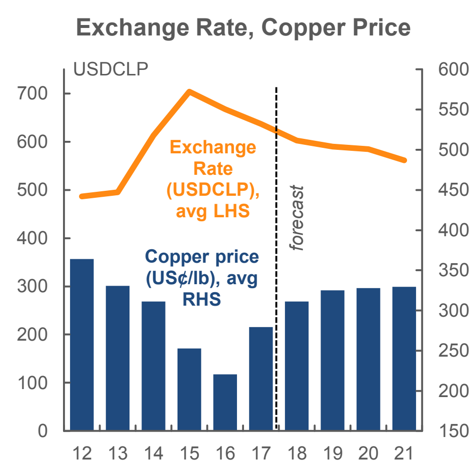
Main risks for the Chilean economy remain the same: from abroad, changes in terms of trade are, by far, the most important. An escalation in trade uncertainty could lead to declines in metals prices despite the strong fundamentals, as has been observed in recent days. Other risks, like restrictions to international commerce, could be serious, but over a longer term. As said, risks coming from changes in Fed policy seem very limited if kept within sensible limits and should not have a major impact on Chile's terms of trade. On the domestic front, the main risks concern the Government's ability to deliver on its mandate and improve public finances.

Chart 3



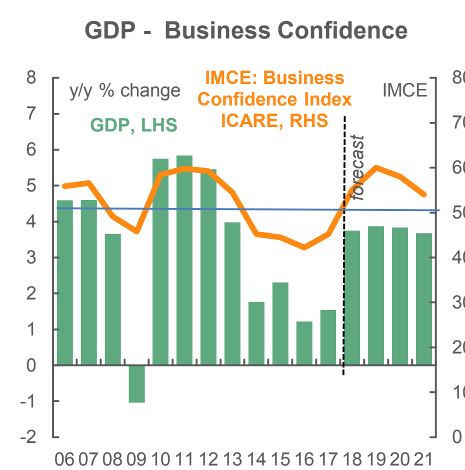
Sources: Scotiabank Economics, INE, Banco Central de Chile.

Chart 4



Sources: Scotiabank Economics, Reuters Eikon.

Chart 5



Sources: Scotiabank Economics, Banco Central de Chile, IMCE: ICARE-UAI.

United Kingdom

- **UK GDP growth is expected to resume a trend-like pace of 1½% this year—solid if unspectacular.**
- **CPI inflation has been much lower than most expected. Following a brief pause in mid-summer, we expect the downwards trajectory to resume through to year-end.**
- **We expect the BoE to hike Bank Rate at the August meeting on the back of signs that Q1's weakness was transitory and a near-term upwards surprise on inflation.**

GROWTH

We expect a trend-like expansion in the UK economy this year of around 1½% y/y. Against a backdrop of zero real household disposable income growth during the first half of the year as well as ongoing Brexit uncertainty; trend-like growth would be an achievement. However, that is damning with faint praise; a good outcome for growth these days is to grow in line with potential. Above potential growth is not on anyone's radar, despite ongoing accommodative monetary policy.

The first quarter of 2018 was plagued by adverse weather conditions, holding back the quarterly growth rate to just above zero. We expect normal service to be resumed during Q2, with output expanding by just under ½% q/q. We have not assumed any making up for lost output during Q1; merely a resumption of trend-like growth. We are moderately more optimistic about the pace of expansion over the second half of the year, mainly a reflection of the likely improvement in household real disposable incomes.

In the very near term, the focus is likely to be on the introduction of the new monthly GDP estimates from the Office for National Statistics. While we expect a robust Q2 GDP reading, the monthly GDP print for the 3 months to May is likely to be barely above zero. On the face of it, this would imply that the surprise weakness during the first quarter of the year was not just a weather effect and that something more fundamental might be at work. However, our judgement is that this outcome needs to be read with caution and the Q2 GDP reading released a month later will be a far better representation.

INFLATION

Inflation has fallen broadly in line with our forecast, but has been well below others' expectations during the first half of the year. We believe that downward trend is now being interrupted temporarily on the back of higher energy prices. Nonetheless, we expect the downwards trend to resume from the second half of summer onwards, dragging CPI inflation down to 2% y/y by end-year. We forecast that inflation will continue falling into 2019, reaching a low-point of 1¾% y/y.

All of the action has come from the exchange-rate-sensitive components of the CPI. More specifically, the surge in inflation over 2017 reflected the increase in imported inflation on the back of the sharp fall in the GBP exchange rate.

CONTACTS

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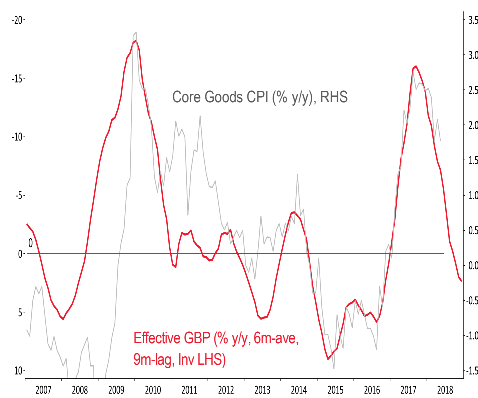
United Kingdom	2017	2018f	2019f
Real GDP (annual % change)	1.8	1.7	1.9
CPI (y/y %, eop)	2.9	1.9	1.9
Central bank policy rate (%, eop)	0.50	0.75	1.00
UK pound (GBPUSD, eop)	1.35	1.32	1.40

Source: Scotiabank Economics.

Chart 1

GBP exchange rate points to further slowdown for exchange rate sensitive components



Sources: Macrobond, Scotiabank FICC Strategy.

However, since the GBP has stopped falling (and in fact is a little stronger) the uplift from imported inflation is now fading. So, while inflation has proven lower than expected so far this year, there is plenty more downside to come from this source (chart 1).

The exchange rate sensitive (core goods) portion of the inflation basket is only half the story. The domestically generated (services) portion of the basket should be little affected by gyrations in the GBP. The lazy assumption among some forecasters is that the acceleration in wage inflation since late last year is a sign that services inflation will also gain altitude. We disagree. While there are some components of services inflation which do correlate with wage inflation (such as maintenance of the house or car—with high labour input content) these components are the exception rather than the rule.

Meanwhile, the components of services inflation which account for the bulk of the weight within services tend to be uncorrelated with wage inflation. Moreover, we have a lot of information about these weighty components. For example, rent (which accounts for almost 20% of the overall CPI) has been very muted since the former Chancellor's policy of a 1% per year cut in social housing rent over a 4-year period. This is a known-known which has nothing to do with wage inflation which is almost guaranteed to maintain a drag on services inflation. Similarly, recreation and personal services (which includes package holidays and restaurants) also appear more likely to subtract from inflation rather than add to it.

The bottom line is that we expect services inflation to drift sideways at best for the next six to twelve months. Combined with the ongoing slump in core goods inflation, this should help headline CPI inflation to fall below the Bank of England's 2% by early 2019.

MONETARY POLICY

The Bank of England refrained from hiking Bank Rate at the May meeting in order to observe whether the weakness in the data during Q1 was transitory. We believe that growth will resume a trend-like pace during Q2, that inflation will exceed that Bank's near-term projection and that slack will continue to erode. As such, we continue expect the MPC to hike Bank Rate at the August meeting.

We believe that there is a narrow window of opportunity for the Committee to raise rates this year. By November, we expect CPI inflation to be at, or slightly below target. So while it has never been about current inflation, it would be hard for the MPC to argue the case for raising Bank Rate when inflation is already at or below target and on a falling trajectory. Furthermore, by November the MPC is scheduled to be reviewing its view on the likely impact of Brexit, which could imply further caution on monetary policy. Given our sub-target CPI forecast for 2019, there is a good chance that monetary policy remains on hold through next year.

BREXIT / PUBLIC FINANCES / POLITICS

The UK and EU sides of the negotiations are gridlocked with regards to customs arrangements, especially along the Northern Ireland border. Until that issue is resolved, it will be hard to move on to more concrete plans, including what tariffs may apply or regarding the issue of trade in services between the two economies.

A key waypoint in the process is scheduled to be October (although there are already signs of slippage to later in the year). On current plans, UK MPs will vote on whatever deal has been agreed between the UK and the EU. To be clear, this is not a case of whether the UK remains in the EU or leaves; rather it is a case of accepting the deal that has been agreed, or rejecting that deal. Currently MPs are hammering out what might happen if we go down the 'no deal' route. A second referendum is still possible, as is a cliff-edge Brexit.

As long as the transition deal that has been agreed remains intact, there should be no tangible changes once the UK leaves the EU in March 2019. For now the main impact on the economy is coming from confidence, uncertainty or preparations for Brexit. Meanwhile the full blown direct consequences of leaving the EU should only materialise just over two years from now when the transition deal expires. However, there has been some suggestion that the transition period could be extended.

Eurozone

- **The end of ECB QE is in sight. However, we think that talk of an ECB hike is premature, with 2020 the earliest opportunity.**
- **Headline inflation is now in line with the ECB's price stability mandate, but is unlikely to rise further. Meanwhile, core inflation is still languishing around 1%, but should creep higher as economic slack narrows.**
- **Above-trend growth, albeit not as robust as previously hoped, should continue over the forecast horizon.**

MONETARY POLICY

The end of QE is in sight. The ECB has announced a further tapering off in its asset purchase programme. From September to December, the ECB will halve the monthly pace of asset purchases, down from EUR30bn per month to EUR15bn per month. After that point (based on the current economic outlook) the purchases will come to an end. These further purchases should take the total size of the Asset Purchase Programme to over EUR2.5 trillion which represents over 22% of eurozone GDP.

True to form, no sooner is the end of policy easing in sight than we get speculation about the timing of the first ECB rate hike. We believe this is premature. Having delivered an unprecedented injection of policy easing, the Governing Council is not going to be in a rush to withdraw this accommodation. As such, we doubt that we will see a rate hike at least until 2020.

INFLATION

The economic backdrop is largely supportive of the ECB's decision to back away from asset purchases. In particular, headline HICP inflation has rebounded to 1.9% y/y—essentially meeting the ECB's price stability mandate. However, underneath the surface, core CPI inflation remains at a lowly 1.1% y/y and has struggled to remain above 1% y/y over the past year. Given the ongoing fall in unemployment and above-trend GDP growth, there is good reason to believe that core inflation will gain altitude over the coming year or so (chart 1). Much of the acceleration in headline inflation has come from non-core inflation, in turn partly a reflection of base effects. Core inflation has only been a secondary source of upside pressure. If overall inflation is to stay elevated, let alone rise further, it will require more support from core components.

GROWTH

Upstream survey indicators continue to point to above-trend GDP growth, albeit less buoyant than was the case six months ago. Indeed, we interpret the surveys as pointing to growth of 2 to 2½% y/y this year and next, well above the trend pace of close to 1% but below the 3% y/y suggested when surveys were at their peaks. In comparison with 6 months ago, consumer sentiment remains as elevated as it has been this cycle, pointing to robust household consumption

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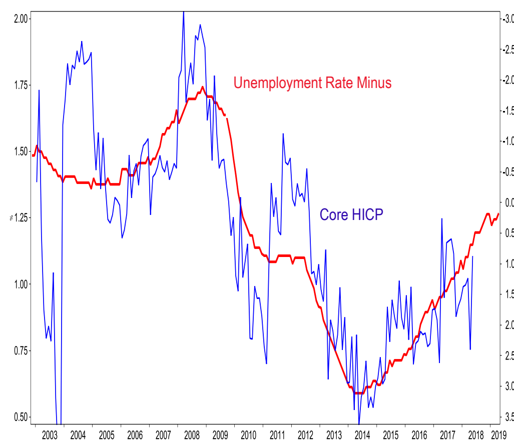
Eurozone	2017	2018f	2019f
Real GDP (annual % change)	2.6	2.5	2.3
CPI (y/y %, eop)	1.4	1.5	1.5
Central bank policy rate (%, eop)	0.00	0.00	0.00
Euro (EURUSD, eop)	1.20	1.20	1.35

Source: Scotiabank Economics.

Chart 1

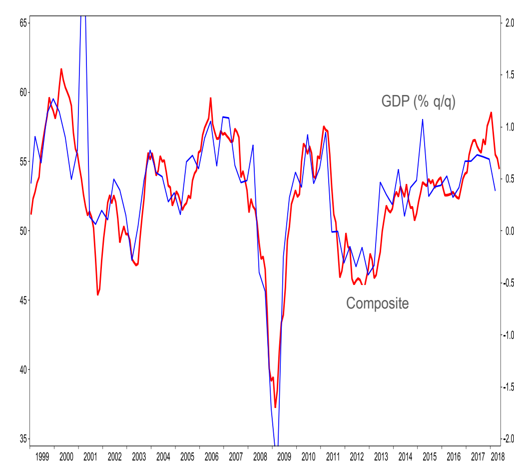
Eurozone core inflation vs unemployment relative to the NAIRU



Sources: Macrobond, Scotiabank.

Chart 2

Eurozone GDP growth vs composite PMI



Sources: Macrobond, Scotiabank.

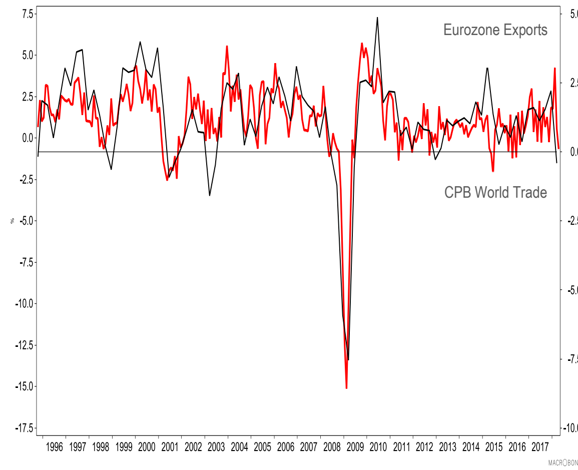
growth. Meanwhile, the composite PMI has lost ground (both on the manufacturing and services sides of the economy). The fall in the manufacturing PMI points to less support from investment over the coming quarters.

Last but not least, the CPB World Trade Volumes series has suffered a tangible setback, having previously pointed to an elevated pace of eurozone export growth (chart 3).

Overall, robust growth combined with headline inflation on target with prospects for core inflation to accelerate suggests that the ECB's work is done. There should be a prolonged period of unchanged monetary policy once the purchases are completed at the end of this year, before a rate hike becomes plausible in 2020. Political flashpoints do threaten to challenge this goldilocks outlook for the eurozone. However, as the recent Italian political jitters demonstrated, the region has learnt from past mistakes and has learnt to nip things in the bud when a situation arises.

Chart 3

Eurozone exports vs CPB world trade volumes



Sources: Macrobond, Scotiabank.

China

- **The US-China trade conflict clouds the economic outlook, but we are not yet marking down our growth forecasts.**
- **Monetary authorities try to find a balance between deleveraging and growth-supportive policies.**
- **Significant structural changes are advancing, driven by government-orchestrated policies.**

ECONOMIC GROWTH OUTLOOK

China's economic outlook continues to be reasonably encouraging; while the country's real GDP growth will likely decelerate to more sustainable levels, it will remain solid by emerging market standards. Simultaneously, the economy's structural transition will proceed from investment- and industrial-sector-focused activity to being driven by the consumer and the services sector. Accordingly, growth in fixed asset investment continues to slow (chart 1), maintaining the trend of recent years. Meanwhile, an expanding middle class and rising incomes—Chinese nationwide nominal wages rose by 9.0% y/y in the first quarter of 2018 (chart 2)—will underpin household spending growth. Furthermore, sound labour market conditions—the unemployment rate is currently at 3.86% (chart 2)—and contained inflation are underpinning disposable incomes. We expect Chinese output to grow by 6.6% y/y this year, followed by a 6.3% gain in 2019 (chart 3).

A further escalation of the trade dispute between the US and China is one of the key downside risks to China's economic growth outlook. Indeed, the US is China's main export destination, purchasing 21% of Chinese goods shipments abroad. Trade will remain a key contributor to growth given that the country's exports of goods and services are equivalent to 20% of GDP. Nevertheless, the external sector's importance to the economy has diminished markedly in recent years; in 2006 exports amounted to almost 40% of GDP. Trade tensions between the US and China have intensified once again following the US administration's announcement that it will move ahead with imposing tariffs on roughly US$250 billion worth of imports from China. If implemented, these tariffs will likely lead to retaliation by China followed by another response from the US. While tariffs on imports and exports will harm the Chinese economy, the country's policymakers likely have more ability to manage the economic impacts of these tariffs than do US policymakers. We will update our forecasts for China as the dimensions of the trade tensions become more clear.

INFLATION AND MONETARY POLICY OUTLOOK

China's inflation outlook continues to be manageable. Consumer prices are currently rising by 1.8% y/y (chart 4). We expect inflation to accelerate slightly in the second half of 2018—driven by higher transport prices—and close the year at 2.1% y/y. Somewhat stronger price gains are expected to materialize over the course of 2019, taking the headline inflation rate to 2½% y/y.

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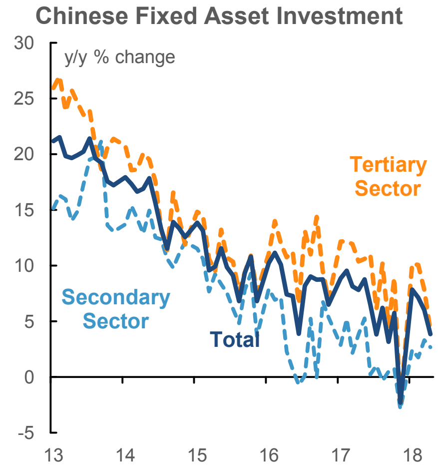
China	2017	2018f	2019f
Real GDP (annual % change)	6.9	6.6	6.3
CPI (y/y %, eop)	1.8	2.1	2.5
Central bank policy rate (%, eop)	4.35	4.35	4.85
Chinese yuan (USDCNY, eop)	6.51	6.45	6.30

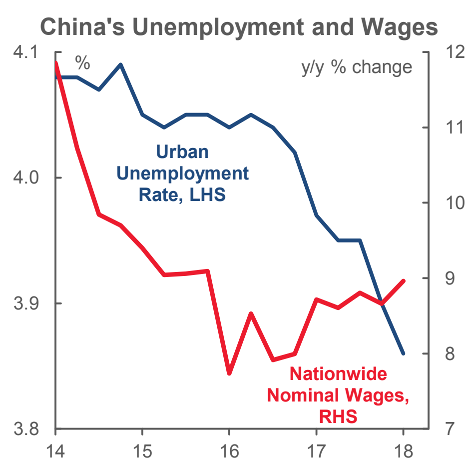
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, National Bureau of Statistics of China.

Chart 2



Sources: Scotiabank Economics, National Bureau of Statistics of China, Bloomberg.

Monetary conditions will remain accommodative in China over the coming quarters in order to support output growth while the country's authorities continue to focus on deleveraging and containing financial risks in the economy. Balancing these objectives will drive monetary policy actions by the People's Bank of China (PBoC). The central bank will likely continue to raise interest rates on its open market operations; the 7-day reverse repo rate (the PBoC's de-facto policy rate) has been raised several times since early 2017 (chart 4) with the most recent hike in March 2018. Simultaneously, the PBoC will continue to provide the financial system with ample liquidity; we expect further reductions in the reserve requirement ratios over the coming quarters following the most recent cut announced at the end of June.

The Chinese administration continues to address systemic risks stemming from the rapid increase in corporate debt over recent years. Accordingly, credit growth has recently decelerated toward more sustainable levels (chart 5). Particular efforts have been directed to curbing shadow banking activity while ensuring that sectors with favourable growth prospects will continue to have access to funding. Aggregate financing—which includes the less-transparent credit products—has declined by 15% y/y over the past six months. However, the deleveraging process has not been without its challenges: following a series of corporate defaults, the PBoC extended the implementation period for tighter rules on asset management business until end-2020 (from mid-2019) in order to better manage the potentially tumultuous transition. We assess that repricing of risk will continue in China in the foreseeable future as implicit guarantees are gradually eliminated and the financial system adopts an appropriate risk management framework. Bouts of volatility during this process can be expected.

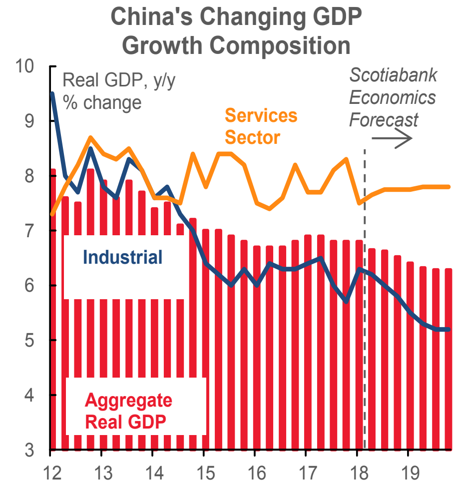
POLICY OUTLOOK

The Chinese economy is in the midst of massive structural changes, which are orchestrated by synchronized government policies. The "Made in China 2025" industrial strategy has recently drawn attention in the US given the plan's aim to form China into a high-technology powerhouse like Germany, the US, and Japan. While being contentious in the US, the plan is sensible from China's economic development point of view; reflecting the fact that Chinese wages have been rising fast in recent years and manufacturers of low-value-added goods are finding it harder to compete globally, the "Made in China 2025" strategy aims to move the economy up in the manufacturing value chain, thereby helping China escape the middle-income trap.

Another policy priority for the Chinese government is the Belt and Road Initiative, a massive infrastructure development plan that will connect Eurasian countries by land and sea. The initiative will help China to address its domestic industrial overcapacity through capacity cooperation with central Asian countries, thereby underpinning the "Made in China 2025" strategy's value-chain climb. At the same time, the Belt and Road plan will increase China's economic, financial, and political power within the region as well as globally.

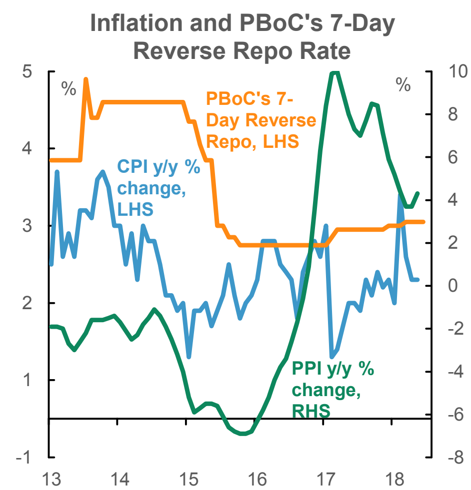
Financial liberalization represents another key policy focus area and is closely connected to the two other strategies. For instance, a gradual opening of China's capital account will promote investment flows that can transfer technology and know-how to support the "Made in China 2025" strategy, while the Belt and Road Initiative will advance the internalization of the renminbi. We expect further reform steps regarding capital account liberalization to be unveiled in the near future, integrating China more deeply into the global economy and capital markets.

Chart 3



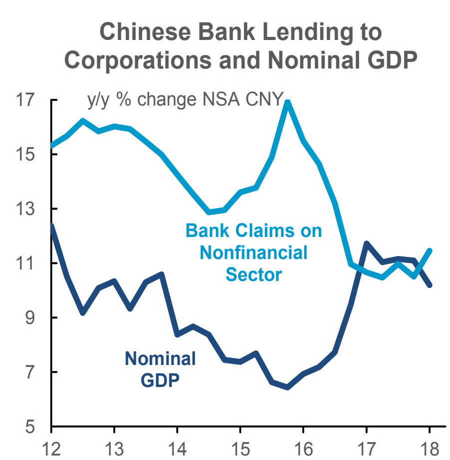
Sources: Scotiabank Economics, Bloomberg.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

Chart 5



Sources: Scotiabank Economics, National Bureau of Statistics of China, BIS.

Japan

- **The Japanese economy is approaching sustainable levels of expansion, with real GDP growth near potential through 2019.**
- **Persistently muted inflationary pressures will keep accommodative monetary policies in place in the foreseeable future.**

ECONOMIC GROWTH OUTLOOK

Japan's economic growth momentum is showing signs of softening after a period of rapid (by Japanese standards) gains (chart 1). Real GDP contracted by 0.2% q/q in the January–March period, marking the first quarterly decline since the final quarter of 2015. In year-over-year terms, output increased by 1.1% following an average gain of 1.7% y/y in 2017. While we do not expect the economy to dip into recession—i.e. to record a second consecutive quarterly contraction in output—the pace will likely continue to converge toward more sustainable rates. The Bank of Japan (BoJ) estimates that the economy's current potential growth rate is 0.9% y/y and that its output gap has been positive since the end of 2016.

We believe that robust global activity will support the export-oriented Japanese economy over the coming quarters despite persistent trade-related uncertainties that warrant close monitoring. Japan's stronger employment conditions are expected to underpin household spending prospects, though the tighter labour market has yet to push wages higher in a notable fashion. Fixed investment growth should find support from corporations' healthy balance sheets and growth-oriented fiscal and monetary policies. We expect Japanese real GDP growth to average 1.0% y/y in 2018–2019, virtually in line with the economy's potential.

INFLATION AND MONETARY POLICY OUTLOOK

Japan continues to struggle with meeting the BoJ's inflation target of 2% y/y. Headline inflation rate has dropped back to 0.7% y/y from the recent peak of 1.5% y/y recorded in February. The CPI excluding fresh food—the BoJ's preferred measure—is currently at 0.7% y/y (chart 2) while the measure that leaves out both food and fuel remains low at 0.3% y/y, highlighting the absence of demand-driven inflation. We estimate that headline inflation will barely reach 1% y/y by the end of this year. The planned hike in the consumption tax rate from 8% to 10% in October 2019 will take inflation above the 2% mark in late 2019, yet the uptick will be temporary, similar to the development in 2014 when the tax rate was raised from 5% to 8%. The key factor impacting future demand-driven price pressures is wage inflation; nevertheless, with real wages remaining stagnant, the likelihood of inflation reaching the target in a sustainable fashion is rather small.

Recent soft GDP and inflation data suggest that the BoJ will not be normalizing monetary policy any time soon. With Haruhiko Kuroda continuing as the BoJ's Governor for the next five years, we expect the central bank to maintain the current policy stance of "Quantitative and Qualitative Monetary Easing with Yield Curve Control" through 2019. The BoJ's monetary authorities recognize that "there is still a long way to go" before inflation will reach the target, making it appropriate to "pursue powerful monetary easing with persistence".

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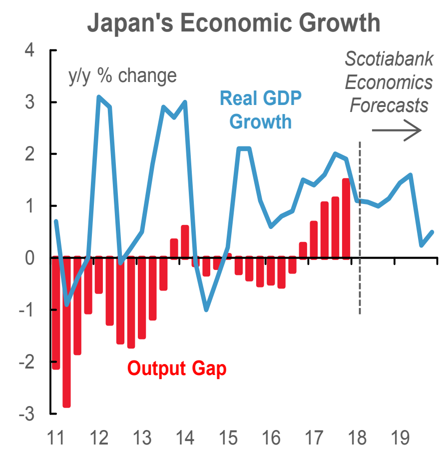
Japan	2017	2018f	2019f
Real GDP (annual % change)	1.7	1.1	0.9
CPI (y/y %, eop)	1.0	1.0	2.3
Central bank policy rate (%, eop)	-0.10	-0.10	-0.10
Japanese yen (USDJPY, eop)	113	110	105

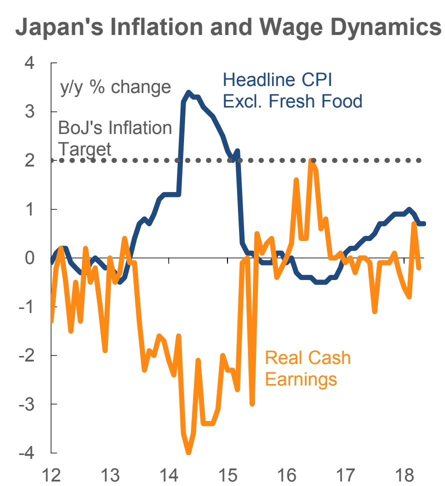
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bank of Japan, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

India

- **Favourable growth traction in India, reflecting solid domestic demand.**
- **Monetary tightening under way due to intensifying inflation.**

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ECONOMIC GROWTH OUTLOOK

The Indian economy's growth signals are robust after a period of subdued performance in recent quarters. First quarter real GDP growth was solid at 7.7% y/y following a 7.0% gain in the final three months of 2017 (chart1). A pick-up in credit expansion is mirrored in reviving investment activity. Consumer spending prospects should get support from the expected normal rainfall during the southwest monsoon that will boost the large agricultural sector's output and rural incomes as well as from employment gains that reflect solid business conditions and industrial sector momentum. In addition, the nation's fiscal policy stance remains growth-supportive with a focus on the rural economy and infrastructure. Given favourable growth traction, Indian monetary authorities estimate that the country's output gap has nearly closed. In our view, the economy's growth outlook is rather encouraging on the back of improved fundamentals, implemented reforms, and favourable demographics. We forecast that the nation's real GDP will grow by 7½% y/y over the next two years following a 6.3% advance in 2017.

INFLATION AND MONETARY POLICY OUTLOOK

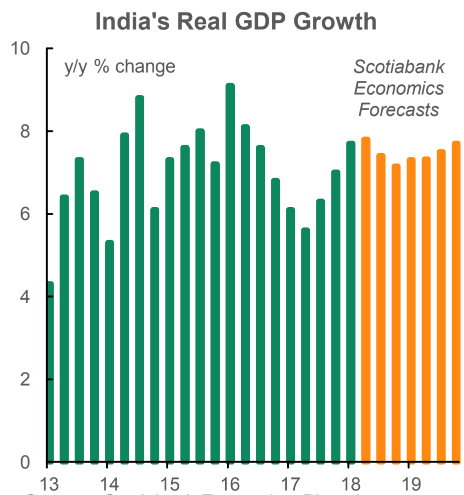
A monetary tightening phase has commenced in India following the Reserve Bank of India's (RBI) bi-monthly policy meeting on June 4–6. The benchmark repo and reverse repo rates were raised by 25 basis points to 6.25% and 6.00%, marking the first hike since January 2014. Given that the Indian economy is at the early stages of recovery following disruptive reform implementations over the past year and a half, the RBI will likely tighten monetary policy cautiously. We expect the next interest rate hike to take place in the fourth quarter of 2018 (chart 2).

The key reason behind the RBI's rate hike decision was India's worsening inflation outlook. Headline inflation picked up to 4.9% y/y in May from 4.6% a month earlier, continuing to hover above the midpoint of the central bank's medium-term target of 4% ±2% y/y. We estimate that headline inflation will pick up further in the near term before easing to 4⅔% by year-end. In recent months, monetary authorities have shown particular concern about the upward trajectory of core inflation. Following the June monetary policy meeting, they pointed out that core inflation has seen "an abrupt acceleration", which suggests "a hardening of underlying inflationary pressures". Indeed, annual core inflation has accelerated more notably than the headline print, reaching the 6% mark in May. Increasing housing rental prices, which reflect the impact of higher housing rent allowances given to government employees, and miscellaneous costs (such as household goods, health, transport, education, and personal care) are the key drivers of core inflation. We assess that the RBI's gradual monetary tightening will help limit future demand-driven price pressures, keeping inflation within the RBI's target through 2019. Moreover, we believe that the decisive action will strengthen the RBI's policy credibility regarding its inflation-targeting monetary policy framework, thereby strengthening investor sentiment toward Indian assets.

India	2017	2018f	2019f
Real GDP (annual % change)	6.3	7.5	7.5
CPI (y/y %, eop)	5.2	4.6	5.6
Central bank policy rate (%, eop)	6.00	6.50	6.50
Indian rupee (USDINR, eop)	63.9	67.0	65.0

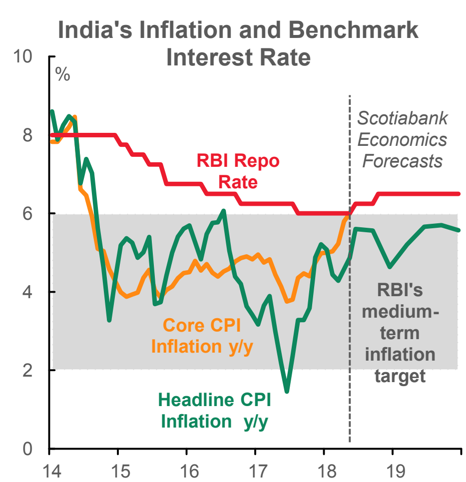
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

South Korea

- **Solid domestic demand continues to propel the economy.**
- **Cautious monetary normalization will continue as inflation picks up.**

ECONOMIC GROWTH OUTLOOK

The South Korean economy continues to perform well on the back of solid domestic demand—consumer spending, fixed investment, and public spending. While consumer sentiment remains reasonably sound, recent business confidence indicators are showing some signs of softness on the back of ongoing global trade tensions; the purchasing managers' index for the manufacturing sector has been in contractionary territory (below 50) in recent months (chart 1). Given the external sector's importance to the economy, we will carefully monitor global trade developments over the coming months and adjust our forecasts accordingly. The nation's real GDP grew by 2.8% y/y in the first quarter of 2018, in line with the pace recorded in the final quarter of last year. We expect South Korea's output to rise by 2¾% y/y in 2018–19 following a 3.1% expansion in 2017.

South Korea's fiscal policy stance continues to be growth-supportive. Indeed, the parliament passed a US$3.5bn supplementary budget on May 21. President Moon Jae-in's government will direct the additional spending on measures that will reduce youth unemployment; joblessness among young South Koreans remains elevated at around 10%. Despite such accommodative policies, South Korea's government finances are robust, providing the administration room to maneuver should global trade tensions escalate and adversely impact the economy's growth prospects. According to the International Monetary Fund, South Korea's fiscal surplus—general government net lending—will average 2% of GDP in 2018–19. Meanwhile, gross public debt is expected to hover at a relatively low level of 38% of GDP over the next two years.

INFLATION AND MONETARY POLICY OUTLOOK

South Korea's headline inflation is expected to accelerate gradually from the current level of 1½% y/y. We expect the inflation rate to reach the Bank of Korea's (BoK) 2% inflation target in the second half of 2018 (chart 2). Taking a cautious approach to monetary normalization, the BoK has opted to leave the benchmark interest rate unchanged at 1.50% since the most recent hike in November 2017. Reflecting our inflation forecast and the fact that South Korea's output gap has turned positive, we assess that the economy is ready for further cautious monetary tightening by the BoK in the third quarter of the year. Nevertheless, our view is based on the assumption that global trade tensions do not escalate further in the very near term and that the geopolitical situation on the Korean Peninsula continues to stabilize. Indeed, the BoK has stated that it will pay close attention to geopolitical and trade developments when conducting monetary policy. Following the historic summit between the US President Donald Trump and Supreme Leader of North Korea Kim Jong-un—which was held on June 12 in Singapore—we are cautiously optimistic about an improving geopolitical climate as the meeting outcome suggests that eventual denuclearization of the Korean Peninsula is a possibility.

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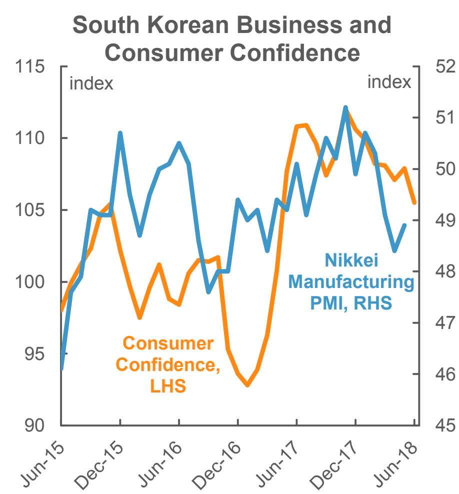
South Korea	2017	2018f	2019f
Real GDP (annual % change)	3.1	2.8	2.8
CPI (y/y %, eop)	1.5	2.1	2.5
Central bank policy rate (%, eop)	1.50	2.00	2.25
South Korean won (USDKRW, eop)	1,067	1,080	1,060

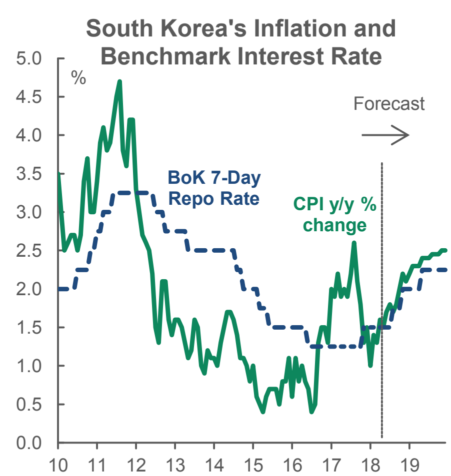
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Australia

- **Solid domestic demand maintains real GDP growth at potential amid a weaker price outlook for Australia's key commodities.**
- **Fiscal outlook is improving on the back of higher revenues.**
- **Monetary conditions will remain growth-supportive despite gradual tightening.**

ECONOMIC GROWTH OUTLOOK

The Australian economy is performing reasonably well, driven by domestic demand. The country's fixed investment gains are boosted by public infrastructure projects while business confidence remains sound, leading to solid gains in non-mining business investment. Such strong momentum will offset the impact from softer residential investment growth that reflects the ongoing cooling in the housing market (chart 1). The outlook for the Australian consumer is two-fold: strong recent employment gains are supporting confidence yet still-weak wage gains and high household debt levels will limit spending growth. Conditions in the Australian labour market continue to tighten gradually. Following very strong employment gains in 2017, this year started on a somewhat softer note. Regardless, full-time job gains over the June 2017–May 2018 period have averaged 15,000 jobs per month (chart 2). Job advertisements and surveys on companies' hiring intentions point to further above-average employment gains over the coming months, which should feed modest wage pressures in the economy.

The outlook for the external side of the economy is shaped by developments in China and in commodity markets. Despite higher export volumes, net exports will likely not provide a notable contribution to Australia's real GDP growth over the coming quarters. This reflects our expectation for lower prices of iron ore and coal together with slower growth in commodities demand in China. Iron ore and coal make up a third of Australia's total exports; meanwhile, China purchases a third of Australia's total exports and over half of its combined shipments of the two key commodities.

The Australian economy started 2018 with strong momentum. Real GDP grew by 3.1% y/y in the first quarter of 2018 following a 2.4% advance in the final three months of 2017 (chart 3). We estimate that the economy will expand by 2⅔% y/y in 2018–19, virtually in line with the country's potential growth.

FISCAL OUTLOOK

Australia's Treasurer Scott Morrison delivered the Federal Budget for fiscal year 2018–19 (July–June) on May 8, 2018. The country's budget deficit (i.e. the underlying cash balance) is expected to narrow from an estimated AUD18.2bn (1.0% of GDP) in FY2017–18 to AUD14.5bn (0.8% of GDP) in FY2018–19. The government remains committed to returning public finances to a balanced position in FY2019–20 (with the underlying cash balance at +0.1% of GDP) and to a surplus position by FY2020–21 (of 0.5% of GDP). A key measure in the Budget is a seven-

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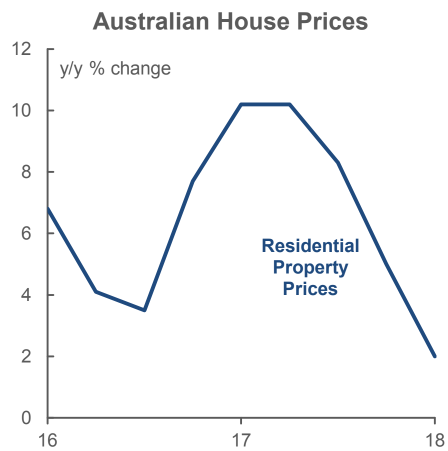
Australia	2017	2018f	2019f
Real GDP (annual % change)	2.2	2.8	2.5
CPI (y/y %, eop)	1.9	2.2	2.6
Central bank policy rate (%, eop)	1.50	1.75	2.25
Australian dollar (AUDUSD, eop)	0.78	0.73	0.77

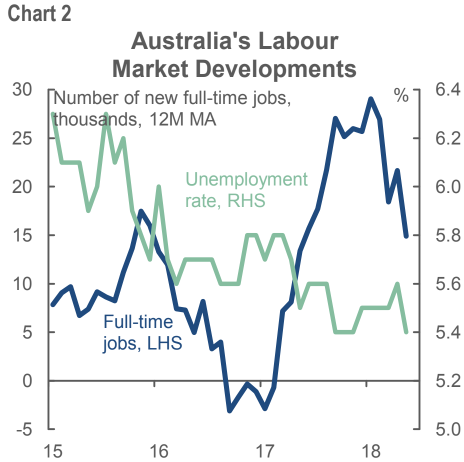
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Australian Bureau of Statistics.

Chart 2



Sources: Scotiabank Economics, Australian Bureau of Statistics.

year scheme to lower personal income taxes for low- and middle-income earners. Tax cuts are possible partially because of higher income tax collection that reflects rapid employment gains and improved corporate performance. While we assess that Australia's planned fiscal path is favourable, we note that the government's underlying economic forecasts may turn out to be overly optimistic. The budget expects real GDP to grow by 3% y/y through FY2021–22. Moreover, the Treasury expects wage growth to pick up significantly, reaching 3¾% y/y by FY2019–20.

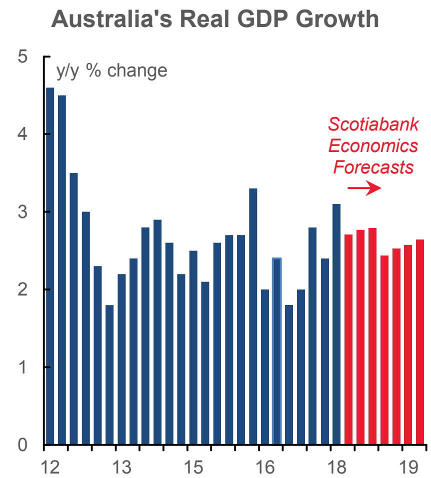
Australia's improved budgetary outlook was welcomed by international credit rating agencies Standard & Poor's and Moody's. The former pointed out that there is now less pressure on Australia's "AAA" sovereign credit rating, yet it maintained a "negative" outlook on the rating due to uncertainties related to global trade tensions and emerging market vulnerabilities. Moody's maintains Australia's triple-A rating with a "stable" outlook.

INFLATION AND MONETARY POLICY OUTLOOK

The Reserve Bank of Australia's (RBA) monetary policy stance will remain accommodative over the coming quarters. The benchmark Cash Rate Target has remained at 1.50% since August 2016. The RBA's policymakers expect that both headline and underlying inflation will accelerate gradually over the course of 2018 to slightly above 2% y/y; the headline inflation measure remained unchanged at 1.9% y/y in the first quarter of 2018 (chart 4). We expect headline inflation to hover below the mid-point of the RBA's 2–3% target range through 2018. Price gains will likely strengthen in 2019, reaching 2⅔% y/y by the end of the year. Wage inflation, at 2.1% y/y in the first quarter, will likely accelerate gradually over the coming quarters. According to the RBA, Australian businesses have reported that labour shortages are limiting output, yet such capacity constraints have yet to filter through to higher wage gains.

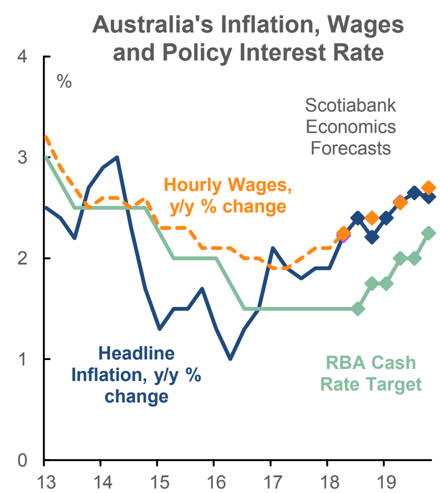
We maintain our forecast that the RBA will join global central banks and begin a cautious monetary normalization phase in the final quarter of 2018 on the back of expected gradual strengthening in wage pressures that will feed demand-driven inflation. Indeed, the RBA's policymakers have recently indicated that it is "more likely that the next move in the cash rate would be up, rather than down". Regardless of modest tightening through 2019, monetary conditions will remain growth-supportive in Australia.

Chart 3



Sources: Scotiabank Economics, Bloomberg.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

Commodities

OPEC+ LIFTS PRODUCTION, METALS COMPLEX PARTS WAYS

- **Commodities prices continue to benefit from strong economic growth and increasingly tight conditions across both upstream production capacity as well as supporting supply chains.**
- **While supply-side fundamentals remain supportive for most commodities, far and away the largest risk to our outlook is US-led and rapidly escalating trade tensions. The trade policy path currently being pursued by the White House presents a clear and present threat to the global economy and the prices of industrial commodities, with risk tilted more heavily toward metal than energy products.**
- **OPEC+ announced that it would move to increase effective production by 600–1,000 kbpd through the latter half of 2018 to alleviate some of the tightness that had pressed crude prices as high as $80/bbl in early June.**
- **In line with this revised path of expected OPEC+ supply and factoring for the tighter conditions that pressed the group to lift production earlier than expected, we have raised our oil price forecasts for 2018/19. Brent crude is now forecast to average $74/bbl in 2018 and $77/bbl in 2019, while WTI prices are expected to lag Brent given tight pipeline capacity between Cushing, OK and the export facilities on the US Gulf Coast.**
- **The outlook for metals remains mixed, with base metal markets seeing upgrades on even-tighter mine supply while bulk commodities ease and gold remains range-bound.**

ENERGY: OPEC+ ANNOUNCES SUPPLY SUPPORT FOR TIGHT MARKET

Brent crude prices hit $80/bbl in early June before Saudi Arabia and Russia signaled that they intended to lift production following the OPEC+ meetings on June 22–23. Despite contradictory and discordant chatter ahead of the gathering of major oil producers, **OPEC+ announced that the group will lift effective production by 600–1,000 kbpd through the second half of 2018.** Accounting for additional OPEC+ output and the robust consumption growth that demanded such a supply boost, we maintain our expectation that oil markets will remain in mild deficit through the end of 2019 and that prices will remain well-supported over the next two years. **Accordingly, we now expect Brent crude prices to average $74/bbl in 2018 and $77/bbl in 2019 (chart 1), with WTI lagging behind ($68/bbl in 2018, $71/bbl 2019) due to increasingly chronic infrastructure bottlenecks en route to export facilities on the US Gulf Coast**.

OPEC+ Lifts Output to Offset Involuntary Over-Compliance

Following meetings on June 22nd and 23rd, OPEC+ announced a nominal aggregate production increase of 1 MMbpd (chart 2) in a bid to alleviate part of the recent market tightness that pushed Brent prices as high as $80/bbl in early June for the first time since 2014. But while the market may see upwards

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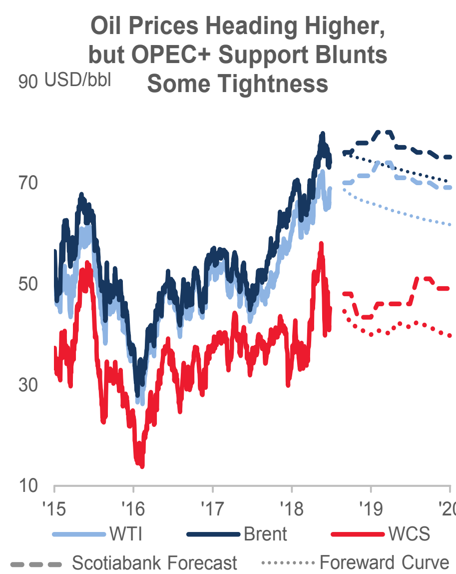
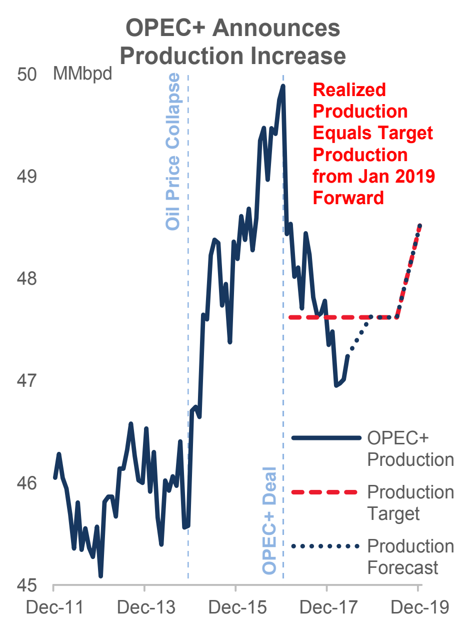
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Source: Scotiabank Economics, OPEC, OMI.

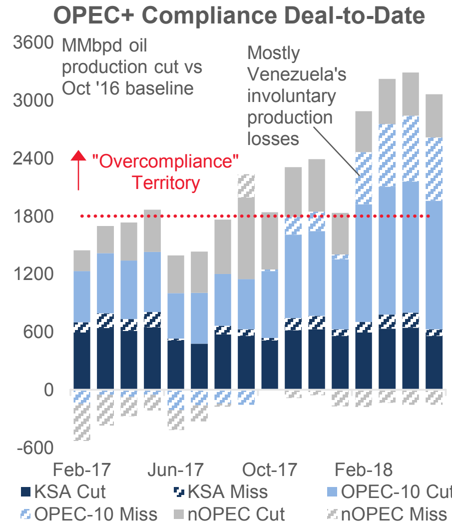
of 1 MMbpd of fresh crude from producers like Saudi Arabia and Russia through year-end, this was only made necessary by production weakness throughout the rest of the alliance, where total compliance now exceeds 150% (chart 3). Venezuelan output—down more than 500 kbpd y/y—is collapsing, Angolan and Mexican production is sliding beyond committed cuts, and US sanctions against Iran could cut 400 kbpd from the regime's export volumes by the end of 2018. Bringing OPEC+ compliance back to 100% moves us back to the 2H18 production path we expected in our March Outlook, down 1.8 MMbpd from October 2016 levels rather than the 2.7 MMbpd falloff we have averaged year-to-date. We also maintain our view that the market will require further OPEC+ supply next year and that the collective ceiling will see a 900 kbpd increase through the latter half of 2019.

It is important to note that this is not an increase in the targeted level of production by the group, but rather an attempt to offset involuntary production losses in countries like Venezuela (chart 4). The "hike" intends to bring OPEC+ production back to a level commensurate with the initial 1.8 MMbpd cut that was agreed upon in late-2016 and took effect in January 2017. The operative phrase in the group's official statement is "overall conformity level", with disagreement between members as to what that functionally means. Some, most notably Iran, argued that the agreement refers to individual conformity, and that a 1 MMbpd "paper barrel" increase distributed proportionally throughout the alliance would result in a 500 kbpd "real" increase in production given that some members are unable to lift output for technical or political reasons. Others, including Saudi Arabia and Russia with plenty of spare capacity to tap, have interpreted the agreement as establishing a collective ceiling on production, and that those who can lift supply are able to "fill in" quota space for those who can't.

Given that producers with spare capacity will determine the ultimate efficacy of this supply increase, however, the collective ceiling interpretation is likely the view that will win out and tips the likely outcome nearer 1 MMbpd than Iran's 500 kbpd estimate. The collective ceiling interpretation also theoretically shields the market against further expected declines in Venezuelan supply or the potential loss of Iranian barrels due to the pending snapback of US sanctions, as producers like Saudi Arabia would be within their interpreted rights to fill in for that widening gap. However, in our view, a full 1 MMbpd hike from spare capacity producers would require the disruption of Iranian exports, which are currently expected to fall by 400 kbpd by year end but could see smaller declines in part due to the escalating trade tensions between Washington and Beijing.

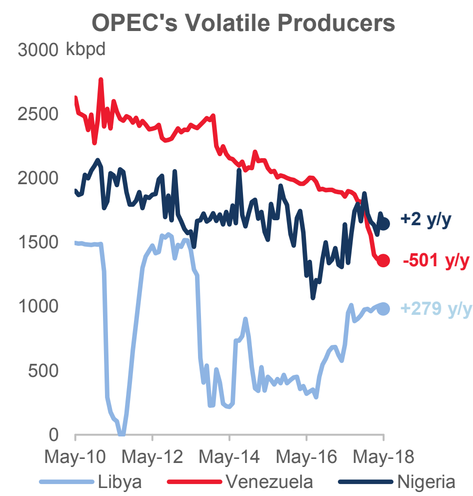
Following the resumption of US sanctions against Iran related to the regime's nuclear program, the market has tried to determine how much production will be lost due to curtailed market access, particularly concerning European customers. We expected that about 400 kbpd of Iranian supply would be at risk due to US sanctions, but assumed that China and India wouldn't materially increase imports from Iran despite suppliers likely willing to offer enticing discounts. Mounting US-China trade tensions complicate matters, however, as the latest round of retaliatory tariffs from China included a 25% levy on US energy products. With 350 kbpd of American crude currently heading to China, these displaced barrels may increase the incentive to source more barrels from Iran—the symbolic finger-in-the-eye of the US would likely be a happy side effect for Beijing given the acrimonious state of diplomatic relations between the two global powers. This is expected to further exacerbate the discount currently ailing WTI, with barrels likely needing to be diverted to consumers where transportation costs are higher and thus netbacks lower.

Chart 3



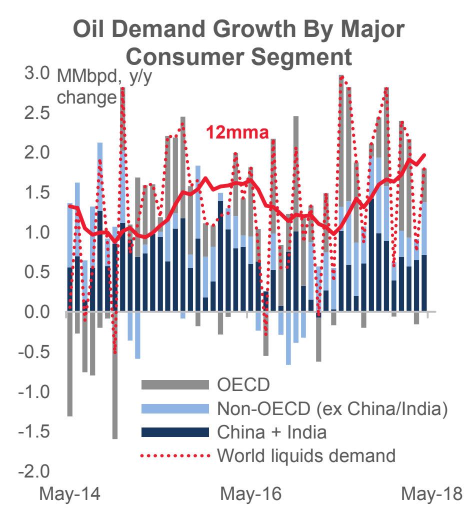
Sources: Scotiabank Economics, OPEC, OMI.

Chart 4



Sources: Scotiabank Economics, OMI.

Chart 5



Sources: Scotiabank Economics, OMI.

Robust Oil Demand Has Been the Real Saviour of the Oil Price

While most commentary focuses on the supply side of the oil market's ledger, demand has been the real stand-out performer supporting crude prices over the past year. Oil production growth has remained fairly robust on the back of continued gains in the US shale patch but demand growth is roaring, sitting around 2 MMbpd (12mma, chart 5) or almost twice the pace the market would consider normal. This demand growth is broadly based, but China, India, and non-OECD Asia remain key contributors despite recent moves to reduce petroleum price subsidies through the region. The chance that higher oil prices weigh on global economic activity, or that the world economy faces headwinds in the form of rising trade disputes, tips risks to the current pace of oil demand growth to the downside. However, we continue to expect strong consumption growth going forward of around 1.6–1.7 MMbpd on a steadying of the global economy and the passing of some of these recent policy risks.

Oil Market Balance, What Art Thou?

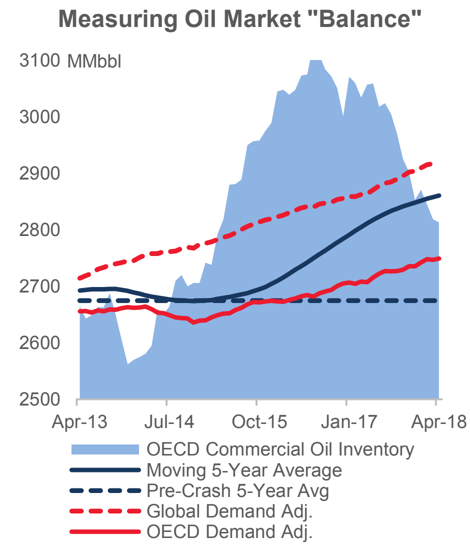
As oil prices recover and OPEC+ lifts production to alleviate some of the current spot supply tightness, both futures contracts and the producer group are reacting to perceptions that the oil market has "rebalanced" or is at least on the doorstep of finding "balance" once again. While no official metric of market balance exists, most market participants including OPEC+ leadership look to trends in OECD commercial petroleum inventories as an indicator of the market's health. OECD inventory statistics are transparent and relatively timely compared to the movements of crude in-and-out of non-OECD tank farms, making them a reliable—though incomplete—snapshot of the market.

A measure of oil market balance requires that it factor for cumulative surpluses or deficits rather than simply spot market supply surpluses or deficits. To factor for cumulative stock inflows or outflows, many use the deviation of OECD commercial inventories from their five-year average level. This is the metric that OPEC+ has communicated it is watching as the key oil market data-point that drives its decision making. However, as chart 6 illustrates, the five-year average is a moving target that has been made easier to reach by the prolonged post-2014 supply glut. It is also informative to view inventories relative to where they averaged before the market collapse (2010–2014), or the duration of either OECD or global demand that the inventories could cover. All these indicators provide perspective on the state of the oil market today, and while not all paint as rosy a picture as the simple 5-year moving average, they all either point to either a tight market or a market on the doorstep of tightness, which confirms the market's current bullish disposition.

METALS: BASE OUTPERFORM ON STEADY DEMAND & TIGHT MINE SUPPLY

Metals markets have broadly felt the adverse effects of bellicose trade rhetoric and mounting tariff walls, but fundamentals are expected to drive the three main metals markets—base, bulk, and precious—in three very different directions going forward. Base metals are forecast to outperform on robust demand and tightening mine supply. Bulk commodities, meanwhile, are expected to settle into a lower price path given flat-to-declining demand and relatively plentiful, low-cost seaborne supply. Between the two industrial metals complexes, precious metals are forecast to remain anchored around a range-bound gold price, though silver, which has underperformed expectations, is forecast to rise on stronger industrial demand.

Chart 6



Notes: "pre-crash" refers to 2010-14 period; OECD/global demand cover averaged 29.5/57.8 days through 2010-14; adjustments use 12mma demand with same coverage.
Sources: Scotiabank Economics, IEA, OMI.

Chart 7

Sources: Scotiabank Economics, LME.

Base Metals: Outperforming on Strong Demand, Tight Mine Supply

Base metals are benefiting from robust global economic tailwinds, tightening mine supply, and a host of metal-specific factors—labour negotiations, electric vehicle (EV) narrative support, etc. After years of underperformance, nickel is a great example of this trend as rapidly expanding supply deficits have already eroded more than one-fifth of the inventory overhang that has been suppressing prices. The prospects for copper also continue to improve and our forecast has been upgraded accordingly.

The nickel market has been one of the best commodity performers this year after a decade of surplus supply and declining prices. LME nickel prices are up 75% since last June to over $7/lb amid widening supply deficits and rapidly falling exchange-listed inventories (chart 7). While inventories remain high relative to base metals peers, exchange-listed tonnage has fallen by one-fifth in the past year. Adding to favourable fundamentals, the fervour around nickel has been supercharged by the EV battery demand narrative. But today's nickel market is still a mainly stainless steel market and deficits are emerging due to classic drivers like weak supply after poor price performance and strong demand in line with broad economic growth. **While we maintain a constructive view of the nickel market, we think that prices will likely linger around this $7/lb mark for the next 18 months, with prices now forecast to average $6.50/lb in 2018 and $7.00/lb in 2019**. However, near-term price risk is tilted to the down given the rapidity of nickel's recent rise and heightened trade-related risks—many of the products targeted by the back-and-forth US-China tariffs contained nickel, typically in the form of stainless steel.

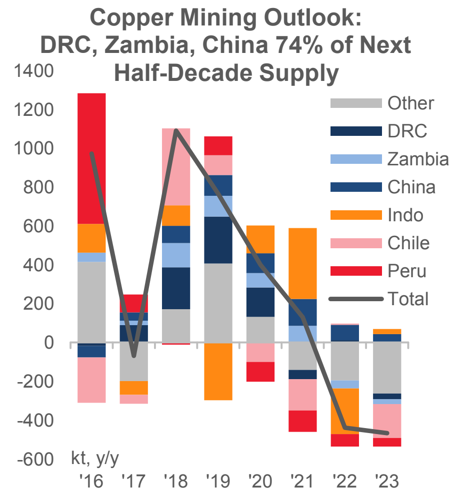
Copper prices are expected to average $3.10/lb in 2018 before rising to $3.25/lb in 2019 on gradually widening supply-side deficits (chart 8), though prices are currently receiving a boost beyond these levels on fears of another strike at Chile's Escondida mine, the world's largest copper project that is alone expected to supply 5% of total copper ore in 2018. A breakdown in the negotiations last year resulted in a 44-day work stoppage—the largest such disruption in modern Chilean history—before the union used a legal provision to extend the existing contract until July 2018. While last year's disruption didn't seem to contribute much of a boost to the already frothy copper market, physical balances are much tighter today and a similar disruption is likely to have a more pronounced effect on spot markets—copper prices briefly moved into backwardation

Table 1

Commodities	2000–2016			Annual Average			
	Low	Avg.	High	2016	2017	2018f	2019f
WTI Oil (USD/bbl)	17	63	145	43	51	68	71
Brent Oil (USD/bbl)	18	66	146	45	55	74	77
WCS - WTI Discount* (USD/bbl)	-43	-17	-6	-14	-13	-23	-23
Nymex Natural Gas (USD/mmbtu)	1.64	4.94	15.38	2.55	3.02	2.93	2.90
Copper (USD/lb)	0.60	2.35	4.60	2.21	2.80	3.10	3.25
Zinc (USD/lb)	0.33	0.81	2.10	0.95	1.31	1.45	1.45
Nickel (USD/lb)	2.00	7.26	24.58	4.36	4.72	6.50	7.00
Aluminium (USD/lb)	0.56	0.86	1.49	0.73	0.89	0.95	1.00
Iron Ore (USD/tonne)	17	67	187	58	72	63	60
Metallurgical Coal (USD/tonne)	39	127	330	114	187	190	160
Gold, London PM Fix (USD/oz)	256	869	1,895	1,251	1,257	1,311	1,300
Silver, London PM Fix (USD/oz)	4.07	14.67	48.70	17.14	17.05	18.00	19.00

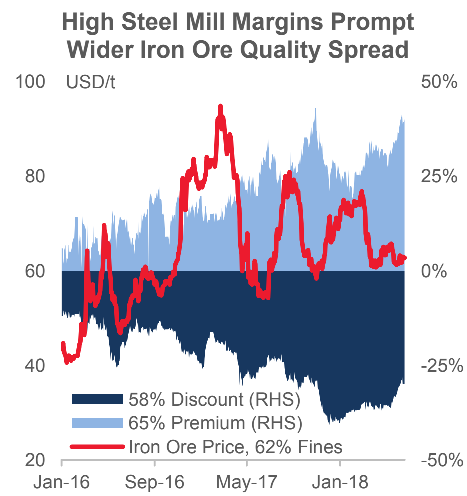
* 2008–16 average.
Sources: Scotiabank Economics, Bloomberg.

Chart 8



Sources: Scotiabank Economics, Wood Mackenzie.

Chart 9



Sources: Scotiabank Economics, Bloomberg.

from the protracted contango experienced by contracts since 2016, signaling just how tight spot markets are today. Despite recent concerns, we don't believe that we will see another significant work stoppage at Escondida this year and we anticipate that the union and management will come to an agreement through the summer.

We remain constructive on the zinc outlook given persistent supply tightness and increasingly low exchange-listed inventories, though demand is expected to suffer from price-induced substitution and weaker construction activity in China. Zinc is more tilted toward construction demand than other metals like copper and nickel given ties to the steel sector, and is the only base metal that doesn't appear to be receiving an offsetting demand boost from Chinese manufacturing for export markets. **Accordingly, we have reduced our peak zinc price expectation and prices are now expected to average $1.45/lb in 2018 and $1.45/lb in 2019**.

Bulks: Flat Steel Sector Demand Pushes Quality Considerations to the Fore

The outlook for bulk commodities remains less buoyant than the rest of the metals complex. Steel sector demand is flat and efficient seaborne supply remains plentiful. Iron ore prices need to fall in order to push high-cost, low-quality supply (mostly in China) off the market to make room for further supply gains in Australia and Brazil, which dominate the seaborne market with low-cost, high-quality product. Coking coal is experiencing similar demand challenges, but prices have received support from a series of disruptions to Australian supply, from Cyclone Debbie last year to the ongoing threat of rail capacity curtailment in Queensland.

Iron ore prices are expected to average $60/t through the next half-decade, far from the market excitement of the base metals. However, while the price outlook for iron ore appears staid, the growing importance of ore quality highlights a central trend in the broader metals complex. Beijing's policy of excess capacity rationalization pushed for the closure of more than a quarter billion tonnes of either inefficient or illegal smelting capacity. Add to this China's "Blue Sky" environmental policies, which forced industries—including steel smelters—to operate at reduced capacity through the winter months in an effort to alleviate endemic smog in major coastal cities. In little more than a year, China has shuttered a quarter billion tonnes of annual steel smelting capacity and forced many of the remaining smelters to reduce throughput rates, dramatically shrinking the global steel smelting curve and boosting margins. Higher profits push up utilization rates through the rest of the smelting industry, which shifts to maximizing the productivity of limited capacity. In such an environment, smelters prefer higher quality ore (65% > 62% > 58%) because a producer can source more steel per ton of processed ore, and the natural premium or discount between differentiated grades grows larger (chart 9).

High coking coal prices further inflame iron ore quality differentials as lower grades require more coke per ton of steel. **While we expect that coking coal prices will begin to ease back toward $150/t over the next two years, prices have benefitted from a series of Australian supply shocks** including cyclone-induced flooding and, most recently, potential limits on the throughput on regional rail lines. The dispute—between Aurizon, the country's largest rail freight provider, and the Queensland Competition Authority (QCA), which regulates Aurizon—concerns allowable revenue on the Central Queensland Coal Network. The QCA capped revenues below what was factored for in Aurizon's business plan (A$3.9 billion vs A$4.9 billion planned), and Aurizon has stated that it will attempt to comply by reducing coal throughput on its tracks. The reduction could impact as much as 20 Mt of seaborne coking coal supply, more than the 16 Mt of supply disrupted by Cyclone Debbie in April 2017 that pushed prices above $300/t.

Precious Metals: Silver Expected to Outperform Range-Bound Bullion

Silver is expected to outperform gold through the forecast horizon as industrial tailwinds help silver close the gap with range-bound bullion. **Our gold outlook remains unchanged and prices are expected to remain anchored around $1,300/oz through the balance of the decade**. Rising interest rates around the world present the key headwind for gold prices as the opportunity cost of holding non-yielding bullion rises, and prices received another knock back on the US dollar's recent and unexpected rally. Tailwinds for gold come in the form of a seemingly inexhaustible series of political risk triggers, flat-to-declining equity market performance, and the anticipated resumption of secular weakening path for the US dollar.

Silver, meanwhile, has thus far underperformed expectations, averaging below $17/oz relative to our forecast for prices to rise toward $19/oz. We believe a large part of silver's current weakness stems from lingering physical demand malaise from India's 2016 demonetization drive and the fact that silver contracts have failed to attract the same risk-haven demand that has supported gold. Going forward, we expect that recuperating physical bar demand and rising industrial consumption will help tighten markets and push speculators, who remain net short silver, out of the market. **Silver prices are expected to average $18/oz this year and rise to $19/oz in 2019** on the dual precious/industrial nature of its demand base.

Foreign Exchange

The US dollar (USD) retains a firm undertone and has rather out-performed relative to our (and others) expectations over the past quarter. The currency weakened steadily through late 2017 and into early 2018 amid fears over dysfunction in Washington and a growing appreciation among investors for the improving fundamental prospects outside of the USA. The USD's recent rebound has been quite abrupt, however, driven by position-adjustment initially but fueled more recently by a jolt of political concerns in Europe and the ongoing focus on trade discussions between the US and its major trading partners.

Moreover, the US economy retains a positive undertone and Fed policymakers now appear to be leaning towards the idea that policy tightening this year could amount to four hikes. We have added one additional rate hike to our forecast for 2018 (now four hikes in total for 2018), which will help underpin USD sentiment in the near term. We do think the USD is looking quite fully priced from a fundamental perspective at this point but we have adjusted some of our forecasts to reflect the strong USD performance recently and the threat that anticipated weakness is more of a story for 2019 than this year. Longer-term risks remain evident for the USD in the form of structural negatives (wider US fiscal imbalances) and bearish, longer-term secular pressures.

While we remain positive on the longer term outlook for the Canadian dollar (CAD), the ongoing focus on Canada's trade relationship with the USA has clearly clouded some positive developments on the fundamental front. A somewhat capricious approach to trade negotiations in Washington leaves the outlook for NAFTA uncertain and investors have cooled on the CAD as a consequence. But current CAD levels are pricing in all but the most adverse of scenarios that we can envisage on the trade front and our base case remains that a deal will be concluded eventually and that the CAD will recover.

Fundamentally, we note that tighter Canadian labour markets are driving wages and prices higher while business investment has made a strong recovery over the past year or so. This should, all else remaining equal, allow the Bank of Canada (BoC) to continue to adjust interest rates modestly higher in the coming months. The BoC does risk falling a little further behind the Fed in the next few months, however, and persistently wide short-term rate spreads suggest that USDCAD is more likely to end the year at 1.28 now (from our previous forecast of 1.25).

The global economic cycle, reflecting positive growth prospects and rising, if still low, inflation pressures, represents a "sweet spot" for commodity prices. Price gains in energy, lumber etc. have driven a significant improvement in Canada's terms of trade—fully reversing the deterioration seen in 2015/16 amid the slump in crude oil. This is a powerful economic positive for the Canadian economy and would, ordinarily, constitute a significant source of strength for the CAD. Positive terms of trade and supportive fundamental developments should restrain downside pressure on the CAD and trigger a quick rebound in the currency once the trade outlook is clearer.

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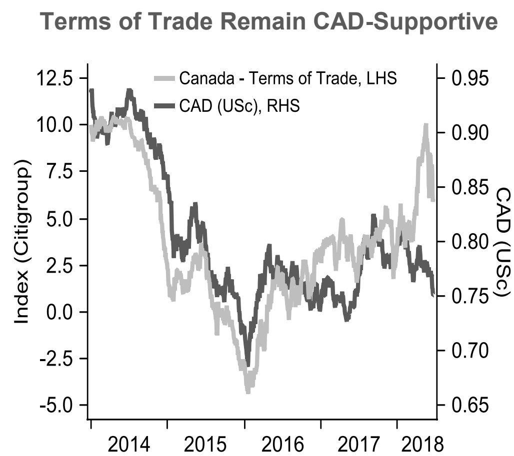
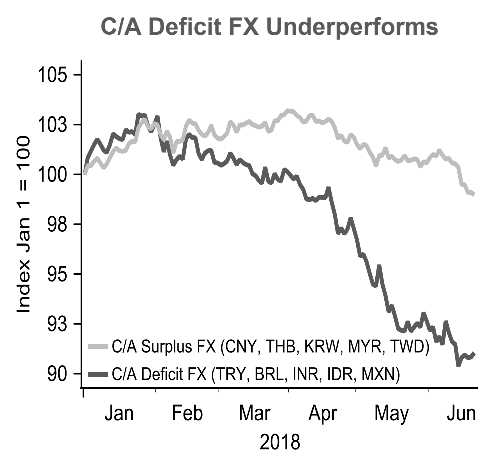
Chart 1



Sources: Macrobond, Scotiabank FICC Strategy.

Chart 2



Sources: Macrobond, Scotiabank FICC Strategy.

European currencies have borne the brunt of the USD rebound over the past quarter but we think the euro (EUR) in particular is looking somewhat oversold. Italian and Spanish political developments weighed on sentiment recently but concerns have moderated for now. We are constructive on Eurozone growth despite a "soft patch" in activity at the start of the year. Meanwhile, measured inflation and inflation expectations are ticking higher, supported by rising energy prices. The European Central Bank confirmed that its asset purchase program will conclude at year-end, ahead of a modest tightening in interest rates in 2019. Surprisingly, this message (while not unexpected) was greeted with renewed pressure on the currency. We have reduced our near-term outlook for the EUR and now expect spot to end 2018 at 1.20; our 2019 forecast remains unchanged (1.35).

The pound (GBP) is soft and looks somewhat vulnerable still in the near-term. UK rate hike expectations have receded after the Bank of England balked at raising rates in May and the UK government is struggling to develop a workable Brexit policy. We rather think near-term risks for the GBP remain negative but we also think that longer run valuation considerations should help limit GBP losses below 1.30 versus the USD. We have reduced our 2018 year-end forecast for GBPUSD to 1.32 and our end 2019 forecast to 1.40.

We expect the Mexican peso (MXN) to end this year near current levels but the MXN's recent performance has been soft, with the USD testing the MXN21 area amid a rise in broader market volatility and NAFTA-related concerns. The July Presidential election is also starting to factor in investor decision-making on the MXN. Domestic and external risks suggest that the MXN will struggle to improve materially in the near-term. Despite heightened regional FX volatility (centered on Brazil and Argentina) most other major Latin American currencies had been somewhat more resilient to the recent gains in the USD. The Peruvian sol (PEN) has been supported by positive economic data that have helped keep the PEN's losses contained around 1.5% versus the USD over the past quarter. More recently, heightened global trade tensions and somewhat softer crude oil and copper prices have tended to weigh more on the Colombian and Chilean pesos, respectively.

We are bearish on the Japanese yen (JPY), primarily because we expect the Bank of Japan will retain significant policy accommodation over our forecast horizon amid stubbornly low inflation. The JPY may continue to attract temporary, safe-haven demand. Regional currency prospects continue to be clouded by geo-political and trade risks. However, rising interest rates and generally tighter monetary conditions do represent a clear and present threat to the more highly leveraged (current account deficit) economies, as economies have to compete more aggressively for funding and investors shift exposure to "safer", surplus currencies which have tended to out-perform in recent months.

We expect the Chinese yuan to remain in a broader range in the near-term but trends in the currency generally are liable to mirror developments in the major currencies' performance versus the USD. The offshore Chinese yuan (CNH) will likely continue to trade at a discount to the onshore yuan (CNY) amid an escalation in US-China trade tensions. We do not expect the Chinese authorities to engineer a weaker yuan to retaliate against the US at this stage. Meanwhile, the South Korean won (KRW), Taiwanese dollar (TWD) and Thai baht (THB) are more susceptible to external demand shocks than other regional currencies.

Taiwan's listed companies are set to pay cash dividends worth around TWD 1.29tn in the June–August period, which will impose upward pressure on USDTWD. India's trade deficit widened to USD 14.62bn in May from a month ago, intensifying ongoing concern over the nation's deteriorated external balance. We remain bearish on the Indian rupee (INR), Indonesian rupiah (IDR) and Philippine peso (PHP) as all the three economies are facing twin deficit problems. Bank Indonesia (BI) will raise its policy rate again on 28 June to defend the IDR exchange rate in our opinion. The Malaysian ringgit (MYR) will continue to follow a broader market tone with a relatively lower volatility, while benefitting somewhat from resilient oil prices.

Given that the Fed will stick to its gradual path of tightening and the ECB has pledged to remain accommodative, regional market sentiment will improve sharply should China successfully de-escalate trade tensions with the US and avert tit-for-tat trade measures. In the medium term, however, we remain cautious on prospects as global liquidity tightens.

APPENDIX 1

International	2000–16	2016	2017	2018f	2019f	2000–16	2016	2017	2018f	2019f
	Real GDP (annual % change)					Consumer Prices (y/y % change, year-end)				
World (based on purchasing power parity)	3.9	3.2	3.7	3.8	3.7					
Canada	2.1	1.4	3.0	2.0	2.1	1.9	1.4	1.8	2.7	2.1
United States	1.9	1.5	2.3	2.8	2.3	2.2	1.8	2.1	2.4	2.4
Mexico	2.2	2.9	2.0	2.1	2.5	4.4	3.4	6.8	4.2	3.8
United Kingdom	1.9	1.8	1.7	1.5	1.9	2.0	0.7	2.7	2.0	1.8
Eurozone	1.3	1.8	2.4	2.3	2.3	1.8	1.1	1.4	1.9	1.7
Germany	1.3	1.9	2.2	3.0	3.0	1.5	1.7	1.7	1.6	1.9
France	1.3	1.2	2.2	2.5	2.0	1.4	0.6	1.2	1.5	1.5
China	9.4	6.7	6.9	6.6	6.3	2.3	2.1	1.8	2.1	2.5
India	7.1	7.9	6.3	7.5	7.5	6.9	3.4	5.2	4.6	5.6
Japan	0.9	1.0	1.7	1.1	0.9	0.1	0.3	1.0	1.0	2.3
South Korea	4.2	2.9	3.1	2.8	2.8	2.6	1.3	1.5	2.1	2.5
Australia	3.0	2.6	2.2	2.8	2.5	2.8	1.5	1.9	2.2	2.6
Thailand	4.0	3.3	3.9	4.1	3.6	2.0	1.1	0.8	1.1	2.0
Brazil	2.6	-3.5	1.0	2.3	2.5	6.7	6.3	3.0	4.1	4.6
Colombia	4.0	2.0	1.8	2.5	3.5	5.1	5.8	4.1	3.3	3.4
Peru	5.1	4.0	2.5	3.5	4.0	2.8	3.2	1.4	2.0	2.5
Chile	4.0	1.3	1.5	3.7	3.9	3.4	2.7	2.3	2.9	3.0

Commodities	2000–16	2016	2017	2018f	2019f
	(annual average)				
WTI Oil (USD/bbl)	63	43	51	68	71
Brent Oil (USD/bbl)	66	45	55	74	77
WCS - WTI Discount* (USD/bbl)	-17	-14	-13	-23	-23
Nymex Natural Gas (USD/mmbtu)	4.94	2.55	3.02	2.93	2.90
Copper (USD/lb)	2.35	2.21	2.80	3.10	3.25
Zinc (USD/lb)	0.81	0.95	1.31	1.45	1.45
Nickel (USD/lb)	7.26	4.36	4.72	6.50	7.00
Aluminium (USD/lb)	0.86	0.73	0.89	0.95	1.00
Iron Ore (USD/tonne)	67	58	72	63	60
Metallurgical Coal (USD/tonne)	127	114	187	190	160
Gold, London PM Fix (USD/oz)	869	1,251	1,257	1,311	1,300
Silver, London PM Fix (USD/oz)	14.67	17.14	17.05	18.00	19.00

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

APPENDIX 2

North America	2000–16	2016	2017	2018f	2019f	2000–16	2016	2017	2018f	2019f
	Canada (annual % change, unless noted)					United States (annual % change, unless noted)				
Real GDP	2.1	1.4	3.0	2.0	2.1	1.9	1.5	2.3	2.8	2.3
Consumer spending	2.9	2.3	3.4	2.1	2.0	2.4	2.7	2.8	2.6	2.3
Residential investment	3.7	3.4	2.8	0.1	0.4	-0.4	5.5	1.8	1.8	2.1
Business investment	2.2	-8.8	2.7	6.8	2.6	2.3	-0.6	4.7	6.2	2.8
Government	2.2	2.7	2.6	2.6	1.5	1.0	0.8	0.1	2.2	2.5
Exports	1.3	1.0	1.1	2.5	3.7	3.6	-0.3	3.4	4.3	2.7
Imports	2.9	-1.0	3.6	4.5	2.6	3.4	1.3	4.0	5.0	3.4
Nominal GDP	4.2	2.0	5.4	4.3	4.7	3.9	2.8	4.1	5.0	4.6
GDP deflator	2.1	0.6	2.3	2.3	2.5	2.0	1.3	1.8	2.1	2.3
Consumer price index (CPI)	1.9	1.4	1.6	2.4	2.3	2.2	1.3	2.1	2.4	2.4
CPI ex. food & energy	1.6	1.9	1.6	1.8	2.0	2.0	2.2	1.8	2.2	2.3
Pre-tax corporate profits	3.6	-1.9	19.9	4.8	4.3	5.5	-2.1	4.4	5.1	1.7
Employment	1.3	0.7	1.9	1.2	1.0	0.7	1.8	1.6	1.4	1.1
Unemployment rate (%)	7.1	7.0	6.3	5.8	5.7	6.2	4.9	4.4	3.8	3.7
Current account balance (CAD, USD bn)	-17.1	-65.4	-63.3	-71.0	-60.2	-504	-433	-449	-516	-574
Merchandise trade balance (CAD, USD bn)	25.1	-25.9	-24.0	-30.1	-22.5	-672	-751	-807	-908	-984
Federal budget balance* (FY, CAD, USD bn)	-2.8	-1.0	-17.8	-20.0	-18.0	-532	-585	-665	-840	-1,030
percent of GDP	-0.2	0.0	-0.9	-0.9	-0.8	-3.7	-3.1	-3.4	-4.1	-4.8
Housing starts (000s, mn)	199	198	220	208	196	1.27	1.17	1.20	1.32	1.30
Motor vehicle sales (000s, mn)	1,657	1,949	2,041	2,000	1,950	15.5	17.5	17.1	17.1	17.0
Industrial production	0.6	0.1	5.2	2.4	1.0	0.6	-2.0	1.6	3.0	1.9
	Mexico (annual % change)									
Real GDP	2.2	2.9	2.0	2.1	2.5					
Consumer price index (year-end)	4.4	3.4	6.8	4.2	3.8					
Current account balance (USD bn)	-14.8	-23.3	-19.4	-27.4	-29.9					
Merchandise trade balance (USD bn)	-7.2	-13.1	-11.0	-4.6	-6.7					

Sources: Scotiabank Economics, Statistics Canada, CMHC, BEA, BLS, Bloomberg. * Canada federal deficit ex risk adjustment of $3.0bn for FY19.

Quarterly Forecasts	2017	2018				2019			
Canada	Q4	Q1	Q2e	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Real GDP (q/q ann. % change)	1.7	1.3	2.2	2.2	2.5	2.1	2.0	1.9	1.8
Real GDP (y/y % change)	3.0	2.3	1.7	1.9	2.1	2.2	2.2	2.1	2.0
Consumer prices (y/y % change)	1.8	2.1	2.2	2.6	2.7	2.5	2.4	2.2	2.1
Avg. of new core CPIs (y/y % change)	1.7	1.9	1.9	2.0	2.1	2.2	2.2	2.2	2.2
United States									
Real GDP (q/q ann. % change)	2.9	2.0	3.6	2.5	2.4	2.2	2.0	2.0	2.0
Real GDP (y/y % change)	2.6	2.8	2.9	2.8	2.6	2.7	2.3	2.1	2.0
Consumer prices (y/y % change)	2.1	2.3	2.4	2.4	2.4	2.4	2.4	2.4	2.4
CPI ex. food & energy (y/y % change)	1.7	1.9	2.2	2.3	2.3	2.3	2.3	2.4	2.4
Core PCE deflator (y/y % change)	1.5	1.6	1.9	2.0	2.1	2.1	2.1	2.1	2.1

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

APPENDIX 3

	2017	2018				2019			
Central Bank Rates	Q4	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Americas			(%, end of period)						
Bank of Canada	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.25	2.50
US Federal Reserve (upper bound)	1.50	1.75	2.00	2.25	2.50	2.50	2.75	2.75	3.00
Bank of Mexico	7.25	7.50	7.75	7.75	8.00	8.25	8.25	8.25	8.00
Central Bank of Brazil	7.00	6.50	6.50	6.75	7.25	8.00	8.50	9.00	9.00
Bank of the Republic of Colombia	4.75	4.50	4.25	4.25	4.50	4.75	5.00	5.25	5.50
Central Reserve Bank of Peru	3.25	2.75	2.75	2.75	2.75	3.00	3.00	3.25	3.25
Central Bank of Chile	2.50	2.50	2.50	2.75	3.00	3.25	3.25	3.50	3.50
Europe									
European Central Bank	0.00	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	0.75	0.75	0.75	0.75	0.75	1.00
Asia/Oceania									
Reserve Bank of Australia	1.50	1.50	1.50	1.50	1.75	1.75	2.00	2.00	2.25
Bank of Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
People's Bank of China	4.35	4.35	4.35	4.35	4.35	4.60	4.60	4.85	4.85
Reserve Bank of India	6.00	6.00	6.25	6.25	6.50	6.50	6.50	6.50	6.50
Bank of Korea	1.50	1.50	1.50	1.75	2.00	2.00	2.25	2.25	2.25
Bank of Thailand	1.50	1.50	1.50	1.50	1.75	1.75	2.00	2.00	2.25
Currencies and Interest Rates									
Americas			(end of period)						
Canadian dollar (USDCAD)	1.26	1.29	1.31	1.28	1.28	1.25	1.22	1.22	1.25
Canadian dollar (CADUSD)	0.80	0.78	0.76	0.78	0.78	0.80	0.82	0.82	0.80
Mexican peso (USDMXN)	19.66	18.18	19.81	20.19	20.20	20.32	20.13	20.19	20.48
Brazilian real (USDBRL)	3.31	3.31	3.86	3.85	3.90	3.85	3.80	3.75	3.70
Colombian peso (USDCOP)	2,986	2,794	2,926	2,950	3,000	2,950	2,900	2,850	2,850
Peruvian sol (USDPEN)	3.24	3.23	3.28	3.20	3.18	3.18	3.14	3.15	3.12
Chilean peso (USDCLP)	615	604	653	624	602	599	596	593	590
Europe									
Euro (EURUSD)	1.20	1.23	1.17	1.17	1.20	1.22	1.25	1.30	1.35
UK pound (GBPUSD)	1.35	1.40	1.32	1.30	1.32	1.32	1.35	1.37	1.40
Asia/Oceania									
Japanese yen (USDJPY)	113	106	108	110	110	110	110	108	105
Australian dollar (AUDUSD)	0.78	0.77	0.73	0.73	0.73	0.75	0.77	0.77	0.77
Chinese yuan (USDCNY)	6.51	6.28	6.50	6.45	6.45	6.40	6.40	6.30	6.30
Indian rupee (USDINR)	63.9	65.2	68.0	67.0	67.0	66.0	66.0	65.0	65.0
South Korean won (USDKRW)	1,067	1,064	1,100	1,080	1,080	1,070	1,070	1,060	1,060
Thai baht (USDTHB)	32.6	31.2	33.0	32.5	32.5	32.0	32.0	31.5	31.5
Canada (Yields, %)									
3-month T-bill	1.06	1.15	1.26	1.55	1.80	2.05	2.30	2.30	2.50
2-year Canada	1.69	1.78	1.91	2.05	2.30	2.40	2.50	2.55	2.60
5-year Canada	1.87	1.97	2.07	2.25	2.45	2.55	2.60	2.65	2.70
10-year Canada	2.05	2.09	2.17	2.40	2.55	2.60	2.65	2.70	2.75
30-year Canada	2.27	2.23	2.20	2.50	2.70	2.80	2.85	2.90	2.95
United States (Yields, %)									
3-month T-bill	1.38	1.70	1.92	2.20	2.45	2.50	2.70	2.75	3.00
2-year Treasury	1.88	2.27	2.53	2.60	2.70	2.80	2.90	3.00	3.10
5-year Treasury	2.21	2.56	2.73	2.85	2.90	2.95	3.00	3.10	3.20
10-year Treasury	2.40	2.74	2.84	3.00	3.05	3.10	3.15	3.20	3.30
30-year Treasury	2.74	2.97	2.96	3.15	3.20	3.30	3.35	3.40	3.45

Sources: Scotiabank Economics, Bloomberg.

Fixed Income Strategy (London)

www.gbm.scotiabank.com

Foreign Exchange Strategy