Risks Are Rebalancing

Global economic activity remains weak. At roughly 3%, 2016 represents the slowest year for global growth since the Great Financial Crisis (chart 1). The reasons for this underperformance are now well known, though they vary by country. They generally involve the following elements: structural adjustments in many countries, efforts to reduce overcapacity in most, recurring natural disasters, repeated geopolitical events such as 'Brexit', and upcoming national elections and potential policy changes in a number of major countries, including the U.S. In addition to contemporaneous impacts on growth, many of these factors represent significant, and chronic, downside risks to the outlook, layered upon a number of country specific risks (such as those in China, for instance). Against this backdrop, central banks have maintained exceptionally loose monetary policy in an effort to support household spending and corporate investment.

Globally, there is evidence to suggest that households have responded to this stimulus. Global auto sales, for instance, have risen strongly this year and are at record levels (chart 2). The same is true for auto sales in Canada and the U.S. To date, however, capital spending by firms has been disappointing. In the Canadian context, for instance, the weakness in Canadian exports can be tied directly, though partially, to the weakness of U.S. business investment. Encouragingly, there are signs that investment activity in the U.S. may be picking up, as orders for capital goods have been on the rise for three months now, the first time this has occurred since mid-2009. While we do not expect a large pick-up in U.S. business fixed investment at this time, these monthly data point to upside risk to our U.S. forecast. Equally important, they suggest that the long awaited increase in investment may finally be upon us.

Combined with higher-than-expected oil prices, which we think will average $50/bbl in 2016Q4, the potential pick-up in U.S. investment bodes well for Canadian exports. There is a tight link between Canadian exports and U.S. domestic demand, and a pick-up in U.S. business investment could have a sizeable impact on Canadian export prospects. From a Canadian perspective another positive factor is business sentiment, which is improving according to the Bank of Canada's most recent Business Outlook Survey.

Taken together, these upside and downside risks suggest that our North American forecast is balanced, even though we expect growth of about 2% and 2.2% in 2017 and 2018 for Canada and the U.S., respectively. Since these growth rates are well above potential growth for both countries, excess capacity is being absorbed. This should lead to more inflationary pressures, which will require less accommodative monetary policies in both countries. We forecast that the Federal Reserve will raise interest rates by 25 basis points in December 2016 followed by three more rate hikes over the course of next year. Given the greater degree of excess capacity in Canada and the slower pace of growth, we predict the Bank of Canada will raise rates at the end of 2017, by only 25 basis points.

In Europe, the situation remains challenging. Post-Brexit data for the U.K. suggest a much stronger economy than we had anticipated, but we remain of the view that Brexit will come with significant long-term costs for the U.K. economy. In the

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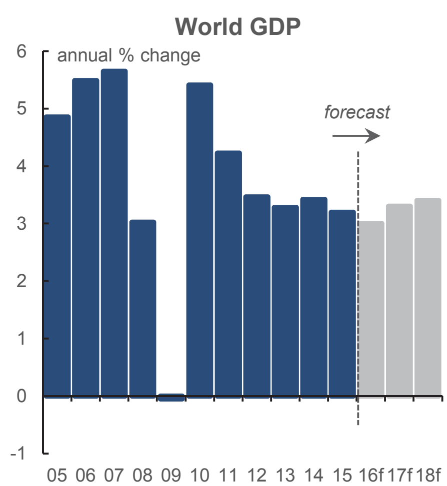
Chart 1



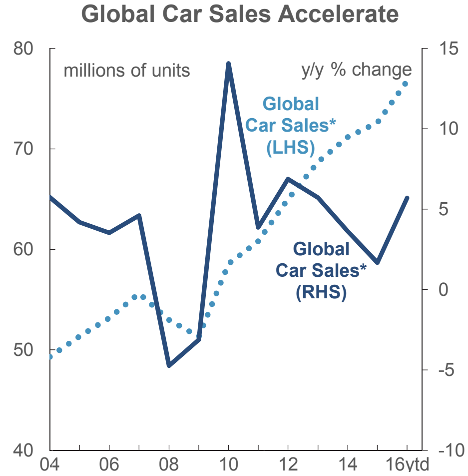
Source: IMF, Scotiabank Economics.

Eurozone, growth will be above potential, at about 1.3% in 2017 and 1.5% in 2018. Political risks are important, and the situation in some countries' banking system remains a concern. Since inflation remains well-below objectives in the Eurozone, we expect that the ECB will continue to maintain accommodative monetary policies through the end of 2018.

The outlook in emerging markets has improved, owing in part to an abatement of the Brazil crisis, a normalization of economic and financial relationships with Argentina, and a continued strong performance in India. A modest acceleration in economic activity is expected in the Pacific Alliance countries, reflecting higher prices for some commodities and stronger global growth. Risks in emerging markets remain, however, as fiscal challenges exist in some countries, others have large external financing requirements, and there is still some chance that an eventual move by the Federal Reserve could trigger a temporary bout of market volatility.

An important caveat to our views with respect to the U.S. election. We have not built into our forecast any of the policies proposed by either candidate. We will do so once the election results are known and the winning candidate begins to implement his/her policy agenda.

Chart 2



Source: Scotiabank Economics, Bloomberg.
*Countries followed by Scotiabank.

Table 1 — Global Real GDP

	2000-15	2016f	2017f	2018f
		(annual % change)		
World (PPP)	3.9	3.0	3.3	3.4
Canada	2.1	1.2	2.0	1.9
United States	1.9	1.5	2.2	2.2
Mexico	2.4	2.4	2.5	2.8
United Kingdom	1.8	2.0	1.0	1.3
Euro zone	1.2	1.4	1.3	1.5
Germany	1.2	1.5	1.2	1.6
France	1.3	1.2	0.9	1.2
Russia	4.6	-1.0	1.3	1.4
China	9.8	6.6	6.2	6.0
India	7.0	7.5	7.6	7.8
Japan	0.9	0.6	0.6	0.5
South Korea	4.4	2.6	2.8	3.0
Indonesia	5.6	5.0	5.3	5.5
Australia	3.0	2.8	2.6	2.5
Thailand	4.1	3.1	3.2	3.1
Brazil	3.4	-3.1	1.2	1.7
Colombia	4.3	2.4	2.8	3.5
Peru	5.4	3.8	4.0	4.2
Chile	4.3	1.7	2.0	2.6

Canada

MORE OF THE SAME, FOR NOW

The Canadian economy is likely to post a solid second-half rebound as activity recovers from the Alberta wildfires, earlier inventory realignments wind down, and fiscal stimulus ramps up. Even so, GDP growth in 2016 will be hard pressed to best 1.2%, little better than last year's 1.1% advance. We expect growth to strengthen to an average of close to 2.0% in 2017-18, supported by infrastructure spending, stronger exports, and a gradual turnaround in oil & gas sector investment.

Consumer spending remains resilient, with real outlays trending around a 2% annual rate. Notwithstanding weak wage gains, household purchasing power and discretionary spending are being supported by targeted federal assistance, low interest rates, and low inflation. Falling gas prices have saved motorists $1.4 billion over the past year, despite increased gas consumption. Meanwhile, a more stable Canadian dollar and a growing cattle herd have reduced earlier food price pressures.

While a couple of Provinces are offering tax/premium relief this year, several other jurisdictions are introducing sizeable tax and levy increases to trim deficits. Thus Ottawa's multiple initiatives, including increased transfers, most notably the new Canada Child Benefit for low- and moderate-income families, and the double-digit cut in Employment Insurance premiums for both employees and employers in 2017, offer a considerable assist to many families.

Looking ahead, however, the combination of high household indebtedness, a lack of pent-up demand and soft employment and income trends could temper consumer buying plans. Business caution is restraining hiring below typical expansionary cycles, though conditions should improve modestly next year as resource-sector layoffs wind down (chart 1).

Recent confidence readings are showing a greater reluctance among households in most parts of the country toward major purchases, consistent with the gearing down in motor vehicle sales over the summer. Meanwhile, a less buoyant housing market is expected to slow sales of household-related durable goods as well as renovation activity. Overall, real consumer spending growth is forecast to moderate in line with underlying real income trends of around 1½%.

Housing activity also is expected to slow over the forecast horizon. Home sales already have fallen sharply in British Columbia amid rapidly deteriorating affordability, and new mortgage rules and taxes targeting high-priced homes and foreign buyers. Deteriorating affordability in and around the Greater Toronto Area, combined with Ottawa's latest round of mortgage tightening measures announced in early October will likely cool demand in this still booming market as well. Any rise in borrowing costs would accelerate the adjustment.

With households limited in their ability to drive notably stronger spending gains, moving beyond the economy's current sluggish growth trend relies critically on a stronger export performance. While non-energy exports have retraced some of

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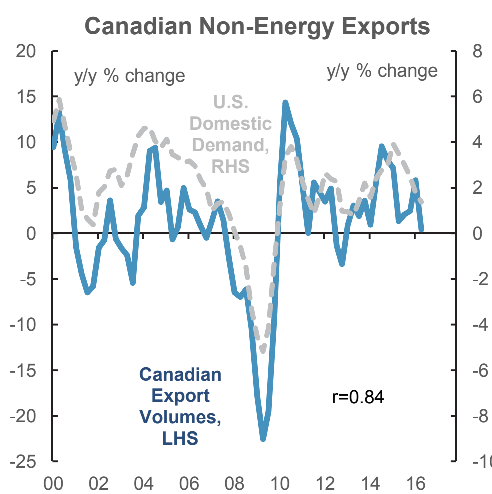
Chart 1

Source: Statistics Canada, Scotiabank Economics.

Chart 2



Source: Statistics Canada, U.S. BEA, Scotiabank Economics.

their early-year weakness, overall volumes remain 5% below the level at the start of the year. An extended drawdown of U.S. inventories is partly to blame for the setback, but the slowdown has been broadly based.

Several factors are contributing to the sluggish and uneven trend in Canadian exports. Notably, the persistent weakness in global investment is restraining demand for industrial materials and equipment — key Canadian export sectors accounting for roughly a third of non-energy shipments. The traditional strong relationship between Canadian exports and U.S. domestic demand remains intact, with the 2.7% average annual growth rate in Canadian non-energy export volumes over the latest four quarters in line with the 2.2% average annual increase in U.S. domestic demand (chart 2).

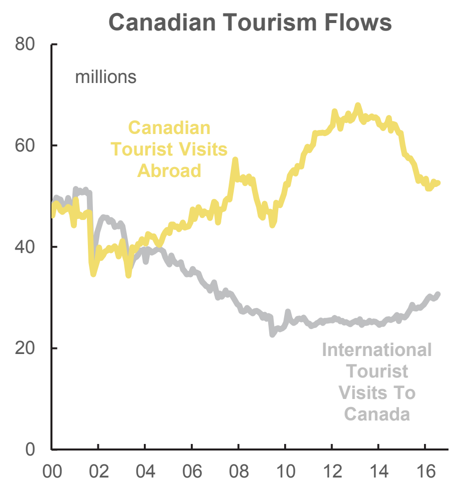
Domestic competitiveness issues, reinforced by weak productivity growth and high unit labour costs, remain a hurdle to a faster export recovery. The improvement in Canada's cost competitiveness stemming from the roughly 15% decline in the value of the Canadian dollar vis-à-vis the U.S. dollar over the past two years has occurred against the backdrop of a broad strengthening in the greenback. Canada's effective exchange rate measured against the currencies of our major trading partners excluding the United States is little changed over this period.

Capacity constraints also are likely holding back export activity. A number of domestic manufacturing industries are operating at or above historical capacity utilization rates, including food products, wood & paper products, plastics & rubber products, furniture and transportation equipment. Global economic uncertainty, weak domestic earnings growth and the rising cost of imported machinery suggest businesses may remain reluctant to commit to new capacity-generating investments, dampening future export potential.

Canadian services exports are outperforming, led by commercial and travel services. A weaker currency and increased air capacity have helped propel a sharp rise in international tourism inflows to their highest level in a decade (chart 3). While Canada's deficit in trade in goods widened to a record level in the second quarter, the deficit in trade in services has narrowed to its lowest level since 2011.

Fiscal policy remains supportive of growth, notwithstanding continued expenditure management among a number of the Provinces. The combination of targeted federal personal income tax cuts, increased federal transfers to households and infrastructure spending at all levels of government are expected to add close to half a percentage point to annual real GDP growth through 2018.

Chart 3



Source: Statistics Canada, Scotiabank Economics.

Table 1 — Quarterly Canadian Forecasts

	2016				2017				2018			
	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic												
Real GDP (q/q, ann. % change)	2.5	-1.6	3.5	1.8	2.0	2.1	2.0	2.0	1.9	1.9	1.8	1.8
Real GDP (y/y, % change)	1.2	0.9	1.2	1.5	1.4	2.4	2.0	2.0	2.0	2.0	1.9	1.9
Consumer Prices (y/y, % change)	1.5	1.6	1.3	1.6	1.9	1.9	2.3	2.2	2.1	2.1	2.1	2.1
Core CPI (y/y % change)	2.0	2.1	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Financial												
Canadian Dollar (USDCAD)	1.30	1.29	1.31	1.33	1.30	1.30	1.25	1.25	1.25	1.25	1.22	1.22
Canadian Dollar (CADUSD)	0.77	0.77	0.76	0.75	0.77	0.77	0.80	0.80	0.80	0.80	0.82	0.82
Bank of Canada Overnight Rate (%)	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25
3-month T-bill (%)	0.45	0.49	0.53	0.50	0.50	0.50	0.55	0.80	0.85	1.05	1.10	1.30
2-year Canada (%)	0.54	0.52	0.52	0.60	0.65	0.75	0.85	1.05	1.25	1.45	1.60	1.70
5-year Canada (%)	0.68	0.57	0.62	0.75	0.90	1.05	1.20	1.35	1.50	1.65	1.80	1.85
10-year Canada (%)	1.23	1.06	1.00	1.15	1.25	1.30	1.45	1.55	1.75	1.90	2.00	2.05
30-year Canada (%)	2.00	1.72	1.66	1.80	1.85	1.95	2.05	2.20	2.30	2.35	2.40	2.45

Transit, water treatment and social infrastructure projects from Phase 1 of the federal government's $60 billion, ten-year infrastructure program should become increasingly visible across Canada over the next two years as they leverage double-digit provincial/municipal capital spending increases. The projects will address maintenance backlogs, near-term opportunities and preparation for the more transformative projects anticipated in Phase 2. Opportunities for private-sector investment are anticipated from some of this infrastructure expenditure, such as stepped-up commercial development close to upgraded transit. The federal government's proposed *Sustainable Development Strategy* also points to mid-term change, with suggestions such as a national carbon price (or equivalent provincial programs) as of 2018.

Key risks to the Canadian outlook remain elevated household debt and overvaluation in the Vancouver and Toronto housing markets. The Federal government's recent move to further tighten macroprudential rules through increased qualifying criteria for insured mortgages should help curb credit demand, mitigating the risk of a disorderly housing adjustment. Notable external risks include the potential that elevated economic uncertainty continues to depress global trade and investment, delaying the long-awaited rotation in Canadian growth from consumers and resource activity to non-commodity exports and investment. On the upside, stronger U.S. domestic demand could lead to an even faster export turnaround.

MONETARY POLICY

The Bank of Canada is forecast to remain on hold at an overnight rate of 0.5% through to this time next year. Starting in late 2017 and over 2018, we forecast a total of three rate hikes. Relative to our forecast for the Federal Reserve, the overnight rate spread would widen to -75 basis points before stabilizing when the Bank of Canada (BoC) begins to follow Fed tightening in lagged fashion in part given a more mature household cycle amidst uncertainties facing the export picture. Independent of other currency drivers, BoC policy relative to Fed policy will be more constructive to the export picture through currency implications. A limit to this policy lag still exists, however, in light of the currency pass-through implications for import prices and hence inflation risk.

That said, in the near term, core inflation has come under intensifying downward pressure since peaking at 2.4% y/y in mid-2015 and it presently sits at 1.8%. This is slightly below the mid-point of the 1-3% inflation target range. The BoC uses core inflation as an operational guide to its 2% headline CPI target. Further downside risk to the traditional measure of core — and trimmed alternatives — raises the risk that the BoC could ease further. Arguing in favour of this is that we don't forecast net disinflationary slack in the Canadian economy — measured by the BoC's twin output gaps — to be eliminated until at least 2018.

Several other considerations argue against easing risk and set a high bar against such expectations. One is financial stability considerations. The federal government recently followed the province of British Columbia in tightening housing finance rules in a quest to cool housing markets. For the BoC to cut rates would position monetary and regulatory policy at loggerheads when Ottawa wants cooler housing markets and lessened financial imbalances. Two is that the BoC may view Federal Reserve hikes as adequate insofar as weakening the Canadian dollar is concerned. Three is that Canada is in the midst of a rebound of uncertain duration; until this duration is established in the absence of transitory factors, a wait-and-see approach may be taken until at least 2017H1. Additionally, greater reliance could be placed upon the prospect of additional fiscal stimulus from the federal government. That could remain the more palatable policy option versus risking a step toward the unproven efficacy of negative interest rates especially if applied to Canada's banking system.

Table 2 — Canada

	2000-15	2016f	2017f	2018f
		(annual % change)		
Real GDP	2.1	1.2	2.0	1.9
Consumer Spending	2.9	2.1	1.8	1.6
Residential Investment	3.8	3.4	-0.9	-1.1
Business Investment	2.5	-6.4	1.9	3.6
Government	2.3	1.7	2.0	1.7
Exports	1.3	0.6	2.8	4.0
Imports	3.0	-0.9	2.6	3.3
Nominal GDP	4.3	1.9	4.3	4.0
GDP Deflator	2.2	0.7	2.3	2.0
Consumer Price Index	2.0	1.5	2.1	2.1
Core CPI	1.8	2.0	2.0	2.0
Pre-Tax Corporate Profits	3.9	-9.0	7.0	5.0
Employment	1.4	0.6	0.8	0.8
Unemployment Rate (%)	7.1	7.0	6.9	6.8
Current Account Balance (C$ bn.)	-13.2	-69.3	-58.5	-49.1
Merchandise Trade Balance (C$ bn.)	28.4	-34.0	-27.2	-20.7
Federal Budget Balance (FY, C$ bn.)	-2.9	-1.0	-30.0	-32.0
per cent of GDP	-0.2	0.0	-1.5	-1.5
Housing Starts (thousands)	199	195	185	182
Motor Vehicle Sales (thousands)	1,639	1,955	1,945	1,930
Industrial Production	0.5	-0.6	1.8	1.6

The Provinces

REPOSITIONING CONTINUES

- **As the drag from Alberta's and Saskatchewan's two-year contraction begins to reverse, national output growth is forecast to strengthen to about 2.0% in 2017 and 2018 with annual employment gains of 0.8%, despite some easing in BC's and Ontario's current vigorous expansions.**
- **The seven oil-consuming Provinces report aggregate deficits of just $3½ billion (0.2% of GDP) for both fiscal 2015-16 (FY16) and FY17.**

The rebalancing of Canada's regional momentum is evident from several metrics, such as positive y/y population gains re-emerging during the first half of 2016 for all provinces, the pan-Canadian expansion in several industries such as tourism and stepped-up infrastructure plans across Canada. Projected growth in 2018 relies upon the seven oil-consuming provinces deepening their net exports and business investment as the three-major oil-producing provinces — Alberta, Saskatchewan and Newfoundland and Labrador — adapt to a prolonged world oil price recovery and slowly diversify. Acknowledging the downside risks for provincial growth, upside potential also exists from proposed projects such as the $6.8 billion Trans Mountain Pipeline expansion.

Assisting Alberta's turnaround are projected annual oil production increases averaging at least 7% over the next two years given new oil sands capacity. The gradual recovery expected for Alberta's oil & gas investment, from levels this year about half the 2014 peak, assumes greater certainty on expanded ocean access for oil via pipelines and the petroleum industry's capacity to rebuild its competitiveness with greater environmental responsibilities. However, another decline, albeit modest, is forecast for Alberta's total business investment next year, even with Fort McMurray's reconstruction, as other industries respond to a downsized energy sector. For Saskatchewan, expansion through 2018 will be restrained by soft potash and uranium prices, while Newfoundland and Labrador's growth will be eroded as projects, such as its fourth offshore oil field, are completed.

Apart from the mining sector, domestic and international expansion should continue across a range of private-sector services and the agri-food outlook is positive as hurdles for canola and other exports are removed. Advances for other merchandise exports, however, likely will remain uneven. For several recent growth drivers, such as Ontario's motor vehicle assembly & parts, activity will remain elevated in 2017 and 2018, but further gains are limited. Ontario data also confirm the constraints on interprovincial exports with the mining sector's slowdown. In forest products, U.S. trade action is a risk as the second year of re-negotiating the *Canada-U.S. Softwood Lumber Agreement* begins. New industry, however, is benefitting from subdued cost pressures with major resource projects no longer ratcheting up expenses. Employers report y/y national wage gains of less than 1.0% this year through July and as of mid-2015, y/y non-residential construction cost increases across seven major CMAs are averaging below 1%.

Limiting Ontario's and BC's growth in 2017-18 is the anticipated step back from this year's frothy housing markets, a shift that will slow an array of linked services and

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Chart 1

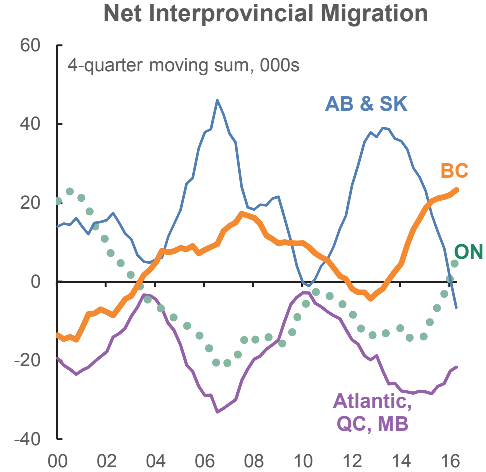
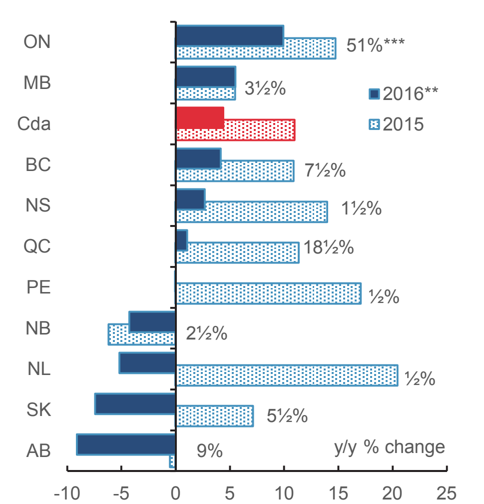


Chart 2



* Ex energy, mining & mineral products.** 2016: Jan. to Aug. *** 2015: % share of national. Source for Charts 1 & 2: Statistics Canada.

goods-producers. In Manitoba, Quebec and the Maritimes, housing markets are working through a soft landing, with unit sales up 6% through September alongside average price increases of just 2½%. The new federal infrastructure program's attention to municipalities, if effectively and efficiently implemented, sets a more sustainable path for our cities, as well as underpinning regional growth.

BC, Quebec and Nova Scotia, expecting surpluses for FY17, will be joined by Ontario, PEI and Saskatchewan planning balanced books for FY18, reinforcing a gradual decline in provincial net debt relative to GDP if new capital spending is prudently managed. Many Provinces' budget estimates incorporate reserves and/or prudent assumptions, a practice that should help to shelter BC's and Ontario's bottom line targets as the outsized revenue contribution from their surging housing markets slows. Going forward, Ottawa's broad agenda, extending from carbon pricing to training, tax reform to a new *Health Accord*, portends significant provincial adjustments. Historically low interest rates will support the upswing in provincial and municipal capital outlays, but they also are expected to complicate governments' pension plan commitments, pressuring both investment returns and assumed discount rates.

Table 1 — The Provinces

annual % change except where noted

Real GDP	**CA**	**NL**	**PE**	**NS**	**NB**	**QC**	**ON**	**MB**	**SK**	**AB**	**BC**
2000-15*	2.1	2.5	1.8	1.3	1.2	1.7	2.0	2.4	2.0	3.0	2.6
2016f	1.2	0.2	1.2	1.3	0.4	1.4	2.6	2.0	-0.5	-2.5	2.8
2017f	2.0	-1.2	1.3	1.2	0.5	1.7	2.3	2.1	1.7	2.1	2.5
2018f	1.9	-0.9	1.1	1.0	0.5	1.7	2.2	2.0	1.9	2.2	2.3
Nominal GDP											
2000-15*	4.3	5.8	4.3	3.3	3.3	3.6	3.7	4.5	6.0	6.7	4.4
2016f	1.9	-1.8	2.5	2.8	1.4	2.8	4.1	3.2	-2.8	-4.3	4.2
2017f	4.3	2.0	2.8	2.8	2.1	3.5	4.3	3.9	4.3	5.6	4.4
2018f	4.0	2.3	2.7	2.6	2.1	3.4	4.1	3.8	4.1	5.2	4.2
Employment											
2000-15	1.4	1.0	1.2	0.7	0.5	1.3	1.3	1.0	1.3	2.5	1.2
2016f	0.6	-1.0	-2.1	-0.5	-0.1	0.6	1.1	-0.2	-0.6	-1.6	3.0
2017f	0.8	-0.7	0.3	0.3	0.1	0.7	1.1	0.5	0.3	0.6	1.2
2018f	0.8	-0.5	0.2	0.3	0.2	0.7	1.0	0.6	0.5	0.8	1.2
Unemployment Rate (%)											
2000-15	7.1	14.3	11.2	8.9	9.6	8.1	7.2	5.1	4.9	4.9	6.6
2016f	7.0	13.0	10.8	8.5	9.7	7.2	6.6	6.1	6.2	7.9	6.0
2017f	6.9	13.3	10.7	8.4	9.6	7.2	6.5	6.0	6.2	7.7	6.0
2018f	6.8	13.5	10.6	8.2	9.4	7.0	6.4	6.0	6.1	7.6	5.9
Housing Starts (units, 000s)											
2000-15	199	2.7	0.8	4.3	3.6	44	71	5.1	5.2	35	28
2016f	195	1.6	0.5	3.3	1.6	37	75	5.3	4.5	23	43
2017f	185	1.5	0.5	3.1	1.6	38	70	5.4	4.4	23	37
2018f	182	1.4	0.5	3.1	1.7	37	68	5.5	4.5	24	36
Motor Vehicle Sales (units, 000s)											
2000-15	1,639	28	6	48	37	410	624	47	45	216	178
2016f	1,955	34	8	55	43	470	801	56	53	220	215
2017f	1,945	32	7	55	43	467	795	56	54	222	214
2018f	1,930	32	6	54	42	463	787	55	55	225	211
Budget Balances, Fiscal Year Ending March 31 ($ millions)											
2000-15	-2,917	60	-39	-31	-146	-953	-5,216	-84	425	1,746	291
2016f**	-987 †	-2,200	-28	-11 †	-261 †	0	-5,029 †	-846 †	-675 †	-6,442 †	730 †
2017f**	-30,000	-1,830	-10	129	-342	0	-4,306	-911	-434	-10,889	1,941
2018f	-32,000	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

* For 2015, real GDP by industry at basic prices and nominal GDP is a forecast. ** FY16 & FY17: Provinces' estimates, SK ex pension accrual adjustment; history: MB:FY04-FY14 and AB:FY05-FY14. † Final for FY16.

United States

GRADUALLY IMPROVING U.S. ECONOMIC MOMENTUM, FOR NOW

There are encouraging signs that the U.S. economy will post a slightly better second-half performance, although U.S. output growth is on track to average only a rather moderate 1.5% this year. Some of the factors restraining growth in recent quarters have loosened their grip, such as the end to a protracted period of inventory destocking. The stronger year-end hand-off, coupled with a further improvement in domestically generated spending, points to U.S. real GDP averaging a somewhat better 2.2% rate in 2017. Consumer spending will be the primary engine of growth, with rising housing activity and a gradual improvement in business investment providing additional support. However, external trade will likely remain a drag on the pace of overall activity, with rising imports offsetting some modest increase in exports to a gradually improving global economy. For 2018, U.S. output growth will likely average 2.2%, with the less favourable longer-term structural factors restraining domestically led spending.

RE-ENERGIZING U.S. BUSINESS INVESTMENT AND A CYCLICAL UPTURN ...

The primary driver of the multi-year and significant retrenchment in U.S. capital expenditures was the sharp downturn in energy-related spending. Oil & gas investment in the U.S. plunged by a cumulative 65% since mid-2014, and it has accounted for much of the retrenchment in overall U.S. capital expenditures in the past year alone. We estimate that this slump trimmed nearly half a percentage point from U.S. economic growth since early-2015. However, the downturn is winding down, with inflation-adjusted business investment edging up in the second quarter, albeit at a very modest 1% annualized rate.

Recent U.S. oil & gas industry data indicate that the number of drilling rigs south of the border has increased 25% since May against the backdrop of improved crude prices and continued efforts by firms to reduce production costs. Initial estimates suggest that energy sector capital expenditures posted a double-digit improvement in the third quarter, with the advance likely to continue to gain momentum and bolster business investment prospects. The oil & gas sector accounted for 8% of overall U.S. business investment prior to the collapse in global oil prices, but fell to less than 3% of aggregate investment by mid-2016.

In addition, new orders for 'core capital equipment' which exclude the more volatile commercial aircraft and defense equipment segments have increased for three consecutive months through August, the longest consecutive advance since mid-2009. While the associated shipments have lagged, overall U.S. industrial activity appears to be in the process of bottoming according to surveys of manufacturing and service-related activity. International ordering also started to pick up in late summer, with the improvement driven by consumer goods, such as motor vehicles and high-tech products. Around the world, passenger vehicle sales jumped by almost 6% y/y through September, the largest increase in three years.

High-tech is driving the recent improvement in U.S. new capital goods orders, with the sector's output rising 3% y/y this year. The auto industry has also been a key contributor to growth, with U.S. vehicle production scheduled to climb to a record

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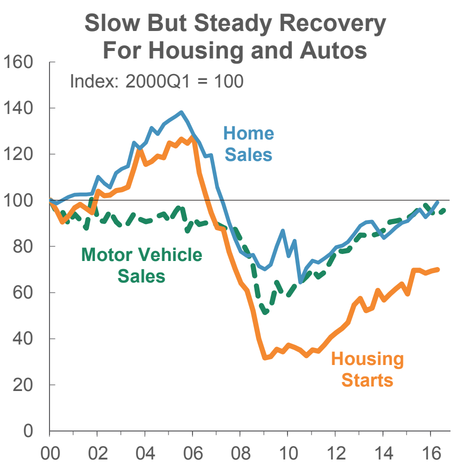
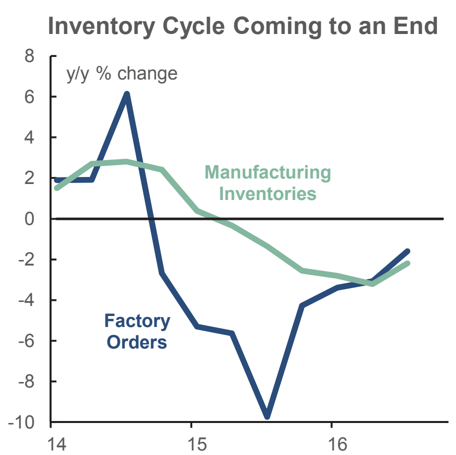
Chart 1



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

Chart 2



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

12.3 million units in 2016, up from an average of 10.7 million between 2011 and 2015. In contrast, activity in most other sectors has until recently been held back by high inventories and weak demand. However, many industries are now on a better footing after recently undergoing a significant inventory drawdown. Durable goods industries have led the destocking, with the inventory-to-sales ratio for high-tech industries recently declining to the lowest level in more than five years. Most sectors have also undergone significant inventory drawdowns in recent months, setting the stage for a renewed upturn in production once stronger demand materializes.

The U.S. corporate profit outlook is also exhibiting signs of turning higher. Profitability in manufacturing has climbed 24% above its late-2015 low. The improvement has been bolstered by the reversal of fortunes in the beleaguered energy sector, but progress is also occurring among an increasing large number of manufacturing sectors. Export-oriented industries are benefiting from emerging signs of improving global trade volumes and the recent stability in the U.S. dollar. There are tentative signs of an earnings revival in the highly competitive retail sector with restructuring well underway.

The housing market is also expected to build momentum, supported by solid job and income gains, improving demographics including a quickening pace of household formation, low inventories, and still-favourable affordability in many regions. In contrast to the auto market which is at record highs, both housing starts and home sales still remain well below the previous peak. Even with next year's projected double-digit increase, building activity will still lag the average of the previous four decades.

... BUT LONGER-TERM STRUCTURAL AND GROWTH-DAMPENING FACTORS PERSIST

Economic activity in the current U.S. expansion remains historically sub-par, notwithstanding periodic bouts of stronger growth. Similar to many systemically relevant countries around the world, the U.S. has become highly susceptible to negative shocks. This can be attributed to the highly integrated nature of the global economy and financial and currency markets, intensifying structural deficiencies, the absence of a meaningful 'growth' cushion, and importantly the increasing lack of policy flexibility.

A lack of synchronization among key sectors of the U.S. economy has worked consistently against broader and stronger output gains during this seven-year cycle. Renewed business spending helped power the early years of recovery, with consumer spending and housing activity hobbled by a multi-year period of de-leveraging and buying caution. As the expansion matured, Americans responded to the significant pent-up demand for 'big-ticket' items, especially with household confidence and spending power steadily improving on the back of continuing hefty jobs gains, rising wages and incomes bolstered by lower prices at the pump, and balance sheets fortified by reduced indebtedness and increased wealth.

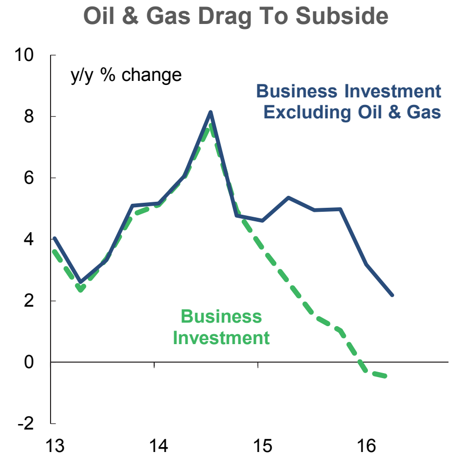
Yet, stronger and broader U.S. growth remains elusive because aggregate business investment has largely stagnated in response to the reduced demand for capital equipment and structures. The hefty U.S. dollar appreciation from 2011-15 also has pared

Table 1 — Quarterly U.S. Forecasts

	2016				2017				2018			
	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic												
Real GDP (q/q, ann. % change)	0.8	1.4	2.8	2.0	2.2	2.3	2.3	2.2	2.2	2.2	2.1	2.1
Real GDP (y/y, % change)	1.6	1.3	1.5	1.8	2.1	2.3	2.2	2.3	2.2	2.2	2.1	2.1
Consumer Prices (y/y, % change)	1.1	1.1	1.2	1.6	2.0	2.1	2.2	2.4	2.3	2.3	2.3	2.3
Core CPI (y/y % change)	2.3	2.2	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Financial												
Euro (EURUSD)	1.14	1.11	1.12	1.05	1.05	1.05	1.10	1.12	1.12	1.12	1.15	1.15
U.K. Pound (GBPUSD)	1.44	1.33	1.30	1.21	1.20	1.20	1.25	1.25	1.30	1.30	1.35	1.35
Japanes Yen (USDJPY)	113	103	101	105	110	110	115	115	117	117	120	120
Fed Funds Rate (%)	0.50	0.50	0.50	0.75	0.75	1.00	1.25	1.50	1.50	1.75	1.75	2.00
3-month T-bill (%)	0.20	0.26	0.27	0.55	0.55	0.80	1.05	1.25	1.30	1.55	1.60	1.80
2-year Treasury (%)	0.72	0.58	0.76	0.90	1.00	1.15	1.30	1.50	1.65	1.80	1.95	2.05
5-year Treasury (%)	1.20	1.00	1.15	1.30	1.35	1.45	1.60	1.80	2.00	2.10	2.20	2.30
10-year Treasury (%)	1.77	1.47	1.59	1.80	1.85	1.90	2.00	2.10	2.30	2.40	2.50	2.55
30-year Treasury (%)	2.61	2.28	2.31	2.50	2.55	2.60	2.65	2.75	2.80	2.85	2.90	2.95

exports and pressured profitability. Although the depressing impact of the oil market rout may be lessening, the U.S. and many of the world's dominant economies are still collectively underperforming as evidenced by the persistent slump in international trade.

Chart 3



Source: BEA, Scotiabank Economics.

U.S. business confidence is also being challenged by the escalating geopolitical tensions globally. There is considerable uncertainty surrounding the upcoming U.S. Presidential election and its implications for international trade and prospective tax policies. There also are many issues roiling the global economy, such as the investment, trade and immigration implications of 'Brexit' for the U.K. and the E.U., prospective national elections in France and Germany in 2017, the referendums surrounding governance issues on the Continent and in Brazil, the potential for even slower growth in China, the impact of the Middle East refugee/migrant influx on the political fortunes of many European nations, as well as lingering social strife and terrorist activities in many countries.

Furthermore, the outlook for the U.S. economy is not as robust as in earlier expansion periods. Persistent weakness in productivity and the marked slowing in working-age population trends have lowered America's longer-term trajectory for output growth. Although there is a 'structural' bias to the problem, the slower-for-longer growth performance has become self-reinforcing since the persistent weakness in business investment has continued to undermine productivity, while the lack of adequate job retraining and concerns over immigration have reinforced less buoyant labour force growth.

MONETARY POLICY

Our forecast continues to anticipate that the Federal Reserve will raise the fed funds target rate and Interest on Excess Reserves (IOER) by 25bps at the December 2016 meeting followed by three hikes next year. By the end of 2018, the fed funds target rate is forecast to rise to 2% for a cumulative six hikes spread across the next eighteen FOMC meetings. We view this as compatible with guidance to expect 'gradual' tightening, but the fatter tail risks lean toward a slower pace of hikes more than a quickened pace.

Table 2 — United States

	2000-15	2016f	2017f	2018f
		(annual % change)		
Real GDP	1.9	1.5	2.2	2.2
Consumer Spending	2.3	2.7	2.7	2.3
Residential Investment	-0.7	5.4	2.9	3.0
Business Investment	2.4	-0.6	2.6	3.6
Government	1.0	0.9	0.9	1.1
Exports	3.8	0.0	2.8	3.1
Imports	3.5	1.0	3.8	3.7
Nominal GDP	4.0	2.9	4.3	4.2
GDP Deflator	2.0	1.4	2.0	2.0
Consumer Price Index	2.2	1.3	2.2	2.4
Core CPI	2.0	2.3	2.3	2.3
Pre-Tax Corporate Profits	5.9	-2.1	5.0	3.0
Employment	0.6	1.7	1.4	1.3
Unemployment Rate (%)	6.3	4.9	4.8	4.8
Current Account Balance (US$ bn.)	-521	-494	-517	-548
Merchandise Trade Balance (US$ bn.)	-668	-753	-804	-856
Federal Budget Balance (US$ bn.)	-529	-538	-565	-615
per cent of GDP	-3.8	-2.9	-2.9	-3.0
Housing Starts (mns)	1.27	1.17	1.30	1.35
Motor Vehicle Sales (mns)	15.4	17.5	17.8	17.9
Industrial Production	0.8	-0.7	2.5	2.0

It is at around that 2% point that we feel markets will view the fed funds target rate as approaching a terminal rate for the cycle. Implied future tightening across the rest of the yield curve will likely be fairly modest in such fashion as to give rise to a flattening yield curve. Uncertainty over the length of the U.S. business cycle, the outlook for the U.S. dollar, and event risk that includes U.S. elections, a potentially 'hard' Brexit, and European elections restrain our willingness to forecast more tightening in this cycle.

Relative scarcity of tradeable fixed income product through ongoing purchase programs at the ECB, Bank of Japan, and the Bank of England combined with continued reinvestment of maturing holdings by the Federal Reserve is expected to be set against the backdrop of continued increase in demand from pensions, life insurance companies, and other traditional buyers of bonds. Conventional monetary policy has always had more limited influences on longer term rates, but unconventional policies that have reduced available supply of fixed income instruments off of central bank balance sheets have further broken the connection between shorter-term conventional rate policies and longer term yields.

Mexico

HEADWINDS AHEAD

- **MXN under pressure decouples from other currencies.**
- **Fiscal stance becomes a pressing concern.**
- **Monetary policy on the move to strengthening macroeconomic fundamentals.**
- **GDP growth forecast revised a bit down.**

The outlook for the Mexican economy just became murkier. To the already highly uncertain global environment, deeply troubled by the U.S. electoral process, the possible implications of Brexit, the challenges of the European financial system and all the geo-political issues; there are some internal concerns starting to show in the expectations ecosystem. The Mexican peso (MXN) has been the adjustment variable of all these shocks and changes, reaching levels close to 20 MXN/USD, which at the end of last year would be unthinkable. Prior to 2016, MXN moved along with many other emergent currencies, reacting mainly to global factors and to the fact that MXN was a good proxy to hedge risk positions in other denominations. But this year, many other LATAM currencies have been appreciating while the MXN keeps depreciating. The first likely explanation of this behavior is the unexpected rise of Donald Trump in the U.S. electoral process, since Mexico is strongly linked to the U.S. economy and Trump has been trumpeting policies that would have negative implications for the Mexican economy if he were elected President. It is possible to pair some significant hikes in the MXN with some events that increased the likelihood of Trump winning. But even in his brightest hour (if he actually had one), Trump has never reached a 50% probability to win, and the most likely scenario is a victory of Mrs. Clinton. So, there should be other factors explaining the continuous weakness of the MXN. We need to look at internal factors.

It seems that the time for Mexico to be flamboyant with economic policy has come to an end. As can be seen in the first graph, since 2009 fiscal policy became more "active". From a basically balanced position in public finances, fiscal deficit appeared and reached levels above 2% of GDP in the first 5 years and levels above 3% of GDP in the last 2 years. As a consequence, public debt increased from levels below 25% of GDP to levels above 40% of GDP in 2015, and is currently on an upward trend form the coming years. The second graph depicts the behavior of public revenues and spending. Revenues have been increasing as a portion of GDP despite the fact that oil revenues plummeted since the end of 2014, due to the huge drop in international oil prices but also to an ever-declining production in Mexico. The fiscal reform implemented in 2014 was just in time to compensate for the severe contraction on oil revenues, especially because it is providing more stable revenues to the government. Now, the spending side is really a matter of concern, not only because it keeps growing faster than the revenues, but because pulling the reins will be a serious challenge for the government, mainly when important electoral times approach and the economy is not performing as expected after the structural reforms. In addition, the main productive State enterprise, PEMEX, has been seriously affected by the fall in oil

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Chart 1

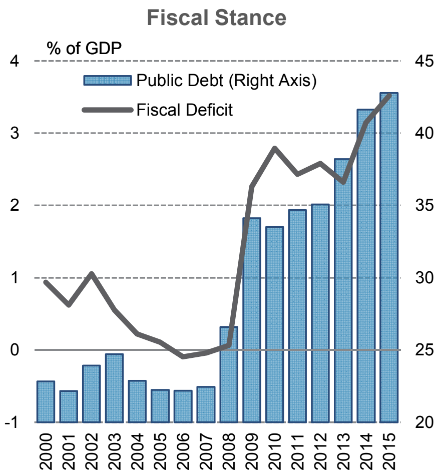
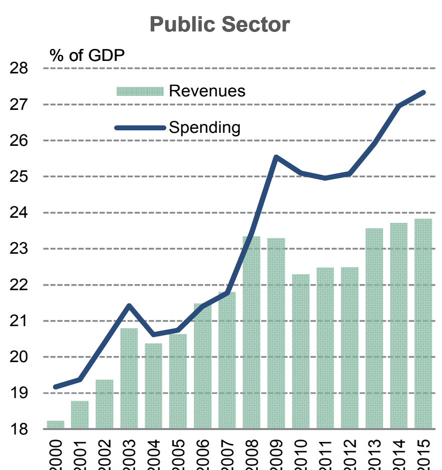
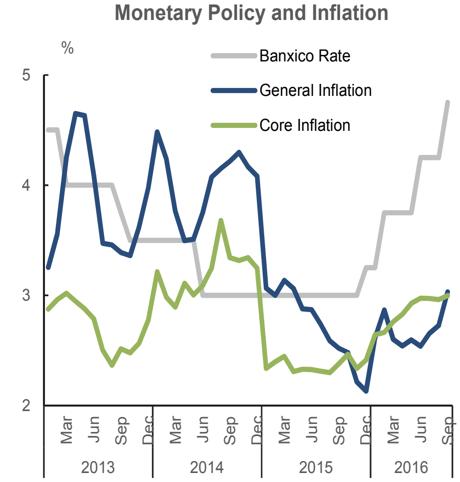


Chart 2



prices, and required financial support by the federal government. PEMEX is yet to announce a new business plan to revamp the company, but it will most likely need some additional financial support from the government in the coming couple of years at least.

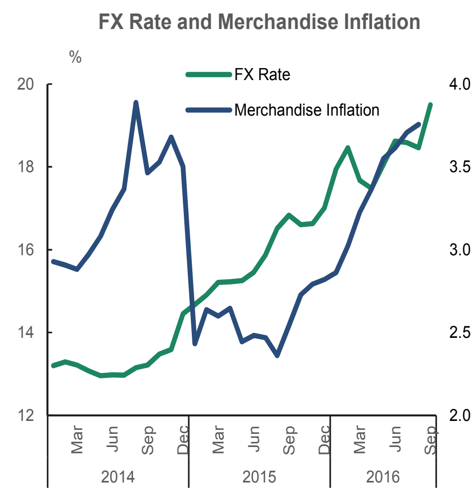
Chart 3



Source: Scotiabank Economics.

Worth noting is that two of the most important rating agencies, Moody's and Standard & Poors, have placed a negative outlook on the Mexican Sovereign Debt, mainly concerned with the growing trajectory of public debt. This message was not neglected by the markets nor by the fiscal authorities in Mexico. In the first announcement of the budget for 2017 (the so called "Pre-Criterios"), the government proposed a spending cut of 311.8 billion pesos (BP), while affirming that they will stabilize the trajectory of public debt and they will take the macroeconomic stability as the first priority. We could not agree more with that objective even though it is clear that one of the most affected budget headings will be that of investment, which will negatively affect the performance of the economy. A few months after that, and after the Trump's visit fiasco, Luis Videgaray was substituted by Jose Antonio Meade as minister of Finance just one day before the economic policy package for 2017 was sent to Congress. In the new proposal, the spending cut was reduced to 239.7 BP, arguing that revenues were expected to be better than anticipated and that there are automatic mechanisms that linked revenues to certain types of spending. After this new proposal, and not neglecting other factors, the peso was once again under heavy pressure, which could be interpreted as a clear message from the markets, that they do not perceive the necessary effort to really put a leash on government debt. If this is the case, then the macroeconomic stability could be at risk in the coming two or three years.

Chart 4



Source: Scotiabank Economics.

Banco de Mexico, on the other hand, had acted more decisively with its monetary policy, decoupling from the Fed and increasing its reference interest rates 175 basis points in less than a year, even though inflation has remained below the official target of 3%. Banxico has been very clear and persistent in saying that it is necessary to "double the effort to maintain healthy macroeconomic fundamentals", and even though they also say that it should not be thought that we are on a rising cycle of interest rates, it seems that interest rates will keep rising over the next year.

So, there are headwinds for the Mexican economy that most likely will keep it from reaching rates of growth more in line with its potential during the next couple of years. Our base scenario had been adjusted accordingly. GDP growth is now expected to reach 2.4% in 2016, 2.5% in 2017 and 2.8% in 2018. For the current year and the next, we are expecting some negative impacts from the government spending cuts, especially in public investment. Total investment of the economy is expected to contract 1.3% this year and 1.9% in the next, also affected by the high levels of uncertainty regarding the global economy. Once the bulk of the fiscal spending adjustment takes place and the U.S. economy starts to perform better, it is expected that Mexican GDP growth will gain some traction in 2018. Worth noting is that a relevant part of this expectation is built on the perception that growth potential of the Mexican economy is above the current levels, mainly after the structural reforms approved and in the process of implementation. The energy reform, for instance, is usually tied to the oil extraction sector, but it is much wider than that. Electricity generation and gas distribution are a couple of activities that are being positively affected by the reforms, and will continue growing in the coming years.

The FX rate will remain subject to high volatility, ending 2016 close to 19.50, then reaching 19.04 by the end of 2017 and 19.28 by the end of 2018. The monetary policy reference interest rate is expected to reach 5.00% by the end of 2016, 6.0% by the end of 2017 and to remain there during 2018. Finally, inflation is expected to revive in the coming months, reaching 3.70% during 2016, 3.9% in 2017 and 3.8% in 2018, with a significant risk to increase well above these expected levels.

United Kingdom

BUSINESS AS NORMAL …

- **Disaster has been averted for now as the U.K. economy has, thus far, managed to shrug off the downside risks to growth associated with the Brexit vote.**
- **Nonetheless, with inflation likely to accelerate towards 2% y/y a year from now, household real income growth is likely to suffer, in turn contributing to a slowdown in GDP growth from 2% y/y down to 1% y/y.**
- **We doubt that the BoE will loosen policy further this year, unless the Q3 GDP data are surprisingly weak.**

DISASTER AVERTED … FOR NOW

It is business as usual for the U.K. economy, for now at least. Monthly data covering the period immediately before the Brexit vote showed that the U.K. completely shrugged off any signs of pre-Brexit vote jitters. While survey data plunged in the immediate aftermath of the vote, that kneejerk reaction has been largely reversed. We are now moving into the period when hard data covering the period since the referendum will be released. While there may be some volatility in these figures, we suspect that imminent disaster has been averted.

NEAR TERM OUTLOOK

We no longer expect a recession. Our LILI model (Leading Indicator for Leading Indicators) points to incredibly accommodative financial conditions thanks in particular to the weak GBP exchange rate and record low bond yields. In turn, that suggests that surveys and hard data could continue to out-perform expectations. The much feared sentiment-driven slump in activity does not appear to be materialising. To be clear, GDP growth for Q3 will most likely be somewhat lower than Q2's 0.6% q/q pace. However, the buoyancy of the Q2 data reflected a one-off supercharged increase in industrial production during April, which was never likely to be repeated.

MEDIUM TERM OUTLOOK

Over the medium term horizon, however, the fundamentals do point to a deceleration in output growth. We expect GDP growth to slow from close to 2% y/y on average in 2016 down to an average of 1% y/y during 2017. In turn, the deceleration is likely to be due to slowing household consumption as the pace of increase in real disposable income growth suffers (chart 1)

More specifically, consumer spending has been the main driving force behind overall GDP growth for the past few years. Most recently, this has been thanks to robust real disposable income growth. Solid employment growth (2%) added to reasonably solid wage inflation (2%) minus near-zero CPI inflation has left households with close to a 4% y/y increase in real incomes. However, a year from now we expect inflation to have accelerated to around 2% and the pace of employment growth to have halved (down to its long run average). That should

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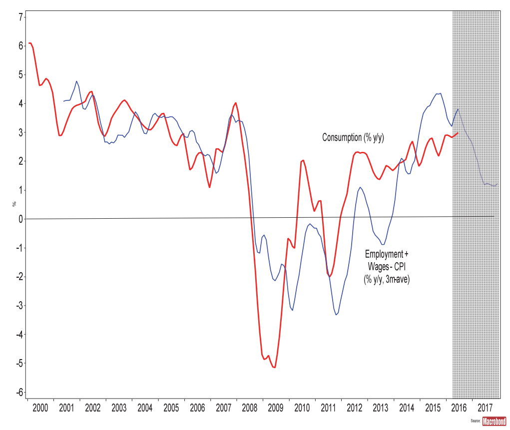
Chart 1

U.K. Consumption vs Real Disposable Income Proxy



drag RPDI growth down from close to 4% y/y towards 1% y/y, taking the wind out of the sails of the consumer. Some slowdown would have been likely irrespective of the Brexit vote; however, the jump in inflation on the back of the weaker GBP exchange rate is exacerbating the situation.

LONGER TERM

Further ahead, it is tempting to assume that GDP growth will revert back towards a trend-like 2% y/y growth rate from 2018 onwards. However, at that point we assume that we will be getting towards the U.K.'s eventual exit from the European Union (assuming that Article 50 is triggered in early-2017). The danger at that point is that the reality of the Brexit situation holds back investment and hiring decisions as well as raising precautionary savings. These argue for aiming low on growth.

Having said that, and having been proven wrong for taking the glass half-empty approach to data surrounding the Brexit vote, it is worthwhile considering the upside risks at that time. In particular, subdued wage inflation has been a recurrent theme in recent years, in turn blamed on near-zero CPI inflation. If CPI inflation does rebound over the next year, dragging wage inflation with it, real disposable income may regain lost ground moving into 2018. Similarly, if the sharp fall in the GBP exchange rate over the past year is sustained, output growth could benefit. In particular, there may be a refocusing of output and demand towards the domestic market given that imported goods are around 15% more expensive. We expect an average annual growth rate of 1½% y/y during 2018, with upside risks.

INFLATION

CPI inflation has clawed its way back into positive territory up to just above ½% y/y over the past twelve months and the upwards trajectory is about to get steeper. We expect inflation to accelerate through 1% at the end of 2016, before reaching 2% y/y a year from now. The acceleration from here is likely to be a combination of petrol price base effects and the pass-through of the rise in imported inflation that has resulted from the weaker GBP exchange rate. We expect the near-15% depreciation in the GBP exchange rate to eventually begin to exert upwards pressure on CPI inflation towards the end of 2016 given the typical lead times. We estimate that the addition to inflation from the currency should be between 1% and 1.5%.

Unless the GBP continues to weaken, the upward pressure from imported inflation will begin to fade at some point. We expect this to be in 2018. At that point, a second year of below trend GDP growth and a fair margin of spare capacity should also help to drag headline inflation back below 2% y/y.

FISCAL POLICY

The new Chancellor will present his first mini-Budget in the Autumn Statement, scheduled for 23 November. Reports suggest that the government's austerity plans will be 'reset' meaning that the narrowing in the budget deficit is likely to slow. We expect the pace of fiscal tightening to slow from around ¾% of GDP per year to closer to zero for the next two years, before the pace steps up again around the end of the decade. Discretionary policy measures are likely to include a further reduction in corporation tax (to dissuade multinational businesses from abandoning the post-Brexit U.K.), infrastructure spending and possibly also a reduction in VAT (which would offset some of the headwinds for real disposable income growth).

One helpful development for the public finances has been the dive in government bond yields on the back of the BoE rate cut and expansion of QE. This should reduce the government's interest burden over the coming year, providing a sizeable 'windfall' for the Chancellor to help support the economy.

MONETARY POLICY

The Bank of England is hard-wired to continue its asset purchase programme through to February 2017. There remains some speculation that the MPC could loosen policy further at the upcoming November meeting. However, in light of the stronger-than-expected run of data in the past month, we doubt that there will be further policy easing at this stage. The main risk to this view is that if the initial print of Q3 GDP (released 27 October) is sufficiently weak, it could provoke a response from the BoE.

Further ahead, the door is likely to remain ajar to further policy easing. In particular, if GDP growth does slow to 1% y/y or lower, the committee may feel compelled to respond. The flipside is that, at that stage, a CPI inflation reading approaching the 2% target is likely to make justifying further policy loosening more challenging.

Eurozone

GROWTH AND INFLATION SET TO PICK UP, YET DOWNSIDE RISKS FROM BREXIT AND FINANCIAL SECTOR CHALLENGES PERSIST

- **After Eurozone economic output experienced a soft patch in the second and third quarter of 2016, the recent rebound in private sector sentiment surveys suggests that Eurozone real GDP growth will likely re-accelerate to roughly 0.5% q/q at the turn of the year.**
- **Looking ahead, Eurozone growth is forecast to cruise at around 1.5% y/y in 2017 and 2018 as stimulus from monetary and fiscal policy and stronger global demand provide an offset to fading support from lower oil prices and a weaker euro. Brexit uncertainty and financial sector challenges, however, continue to pose downside risks to this scenario.**
- **We expect headline Eurozone inflation to register a decent pick-up over the next six months, reaching 1.4% y/y in February 2017, thanks to favourable base effects from energy and food prices. Nevertheless, lagged indirect price effects will likely continue to limit a similar improvement in core inflation, which is forecast to remain at around 1% y/y through year-end.**

COLD SUMMER BEFORE A HOT WINTER

We expect that the Eurozone economic recovery prolonged its soft path over the summer, with real GDP growth forecast to come in at 0.3% q/q in the third quarter off a similar performance in Q2. Indeed, economic data at the beginning of the summer have continued to be mixed, with retail sales showing signs of a modest pick-up, while industrial production has moved down. Therefore, consumer spending should continue to provide some support, although the supply side of the economy is still digesting the negative impact of the uncertainty linked to the financial turmoil seen earlier this year (falling bank share prices, higher credit spreads, etc.), subdued global growth and the political environment following the Brexit vote.

Potential Impact on Eurozone GDP	2014	2015	2016	2017
Eurozone Potential growth (EU estimate) (1)	0.50%	0.80%	1.00%	1.10%
World GDP growth EU Commission)	3.40%	3.10%	3.10%	3.40%
Impact of World demand	0.0%	-0.1%	0.0%	0.1%
Impact of oil prices	0.1%	0.4%	0.4%	0.1%
Impact of EUR/USD	-0.1%	0.5%	0.5%	0.0%
Impact of interest rates	0.1%	0.2%	0.2%	0.1%
Impact of fiscal Policy	0.0%	0.0%	0.2%	0.1%
Impact of Policy Mix + World demand (2)	**0.1%**	**1.0%**	**1.2%**	**0.3%**
Estimated Possible GDP growth : 1+2	**0.6%**	**1.8%**	**2.2%**	**1.4%**
Realised GDP growth	**1.1%**	**1.9%**		

Source: Scotiabank

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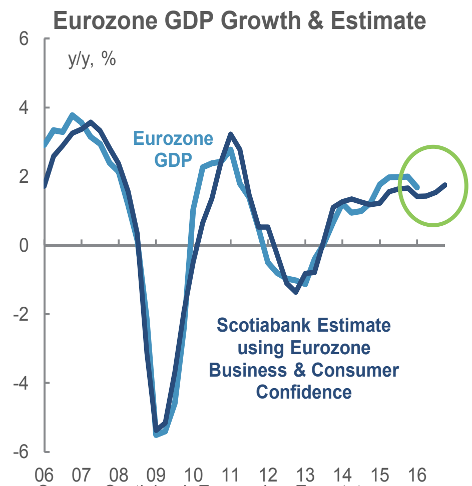
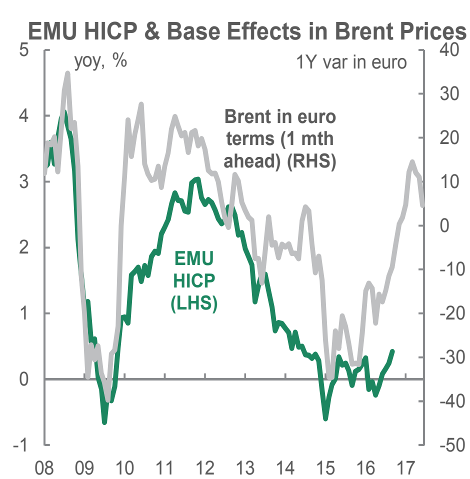
Chart 1



Source: Scotiabank Economics, Eurostat.

Chart 2



Source: Scotiabank Economics, Bloomberg.
*Brent stable at 40 euro

Nonetheless, the recent rebound in both consumer and business confidence points to a re-strengthening in Eurozone economic activity at the end of the year. Looking at traditional elasticity, Eurozone fourth quarter real GDP growth could be set to rise by between 1.7% and 2.0% y/y versus the 1.6% trend currently, which implies a +0.5%/+0.6% q/q increase in Q4. In particular, the lagged impact of credit spread compression — thanks to the implementation of the ECB's corporate bond purchasing program — could offer decent support for investment spending in the coming quarters.

THE EUROZONE ECONOMY TO BALANCE POSITIVE AND NEGATIVE GROWTH FACTORS OVER OUR FORECAST HORIZON

In 2017 and 2018, the Eurozone will have to deal with some headwinds as the strong support offered in recent years by falling oil prices and a weakening euro starts to fade. Meanwhile, the impact of Brexit is forecast to shave 0.2% off Eurozone growth and the fate of Germany's embattled lender Deutsche bank (Europe's fourth largest bank by assets) remains unclear. Indeed, Eurozone potential GDP growth is seen by the EU Commission to be slightly higher than 1% next year. Therefore, if we take into account the negative impact from the factors listed above and add the boost provided by stronger global growth (expected to be up to 3.3% in 2017 from 3.0% this year), the lagged impact of falling interest rates, and slightly more supportive fiscal policy (estimated to add 0.2% to GDP), we believe that Eurozone real GDP growth will advance by 1.5% y/y over the coming two years. This is roughly in line with the ECB staff's latest macroeconomic projections. A stronger growth dynamic could materialize under one of the following scenarios: 1. higher-than-expected global growth; 2. more stimulus from the ECB; 3. more efficiency in the transmission of the monetary policy or; 4. more fiscal support, though several factors will likely limit these developments.

GLOBAL GROWTH, DEALING WITH THE UNCERTAINTY AROUND BREXIT AND DEUTSCHE BANK

The recent improvement in the global PMI manufacturing index suggests that the worst of the subdued trend in global growth may have passed. This has also been reflected by the rebound of the German Ifo. While encouraging, this positive dynamic could be blurred by the potential negative impact of Brexit, with the U.K. Prime Minister, Theresa May, recently revealing plans to launch formal Brexit talks with EU leaders by the end of March 2017. The EU Commission has made the assumption of a potential soft negative impact of 0.2% of GDP on Eurozone GDP growth for next year. However, it did not exclude the risk of having a more negative impact of -0.5% of GDP. In this regard, the swing in the German Ifo will be worth watching to track the potential risk attached to Brexit as recent months have shown a growing correlation in business sentiment between Germany and the U.K. The Eurozone economic outlook is further at risk of ongoing banking sector challenges in key member states, such as Germany and Italy, which could threaten the recovery in credit conditions and loan growth.

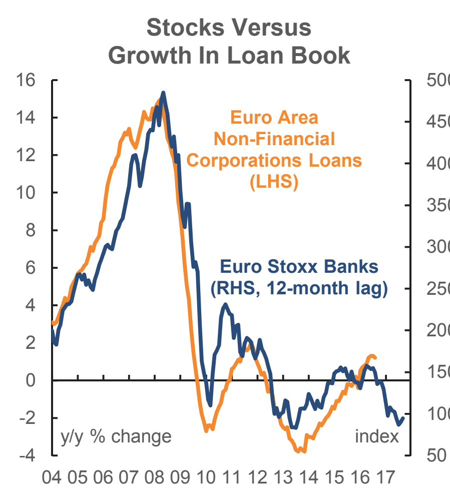
THE ECB LOOKING CLOSE TO THE LIMIT

Latest comments from ECB members suggested that the central bank was comfortable in its current "wait and see" stance and rumours of tapering QE have even started to circulate. We think that at this stage of the economic cycle, with Eurozone core inflation stuck at just 0.8% y/y, declines in bank equity prices, and medium term inflation expectations (measured through 5y in 5y Eurozone inflation swap) close to record lows, the speculation over tapering is premature. We believe that the ECB could announce new monetary stimulus measures in December aimed at prolonging its current QE program of €80bn purchase per month through March 2017 by at least six months. However, given the rising scarcity of German bonds, there is the need to find other options. Further interest rate cuts do not seem likely given their adverse effect on bank profitability, while changing the capital key (buying more bonds from peripherals vs. core countries) is politically difficult. So, we expect the ECB to opt for technical adjustments (like increasing the purchase ceiling for high-rated government and supranational bonds from 33% to 50% of their total issuance), which would suggest a continuation of the ECB's accommodative monetary policy rather than new large-scale stimulus measures.

TRANSMISSION OF THE MONETARY POLICY, FINANCIAL SECTOR CHALLENGES

Ongoing easing in bank credit conditions in the latest ECB lending survey and tighter corporate credit spreads have been cited by ECB president Mario Draghi as an indication that the transmission of the monetary policy has never worked better. Indeed, the gradual improving trend in private credit growth (up 1.5% y/y in September vs. 0.8% y/y last December) bodes well for a re-acceleration in investment spending at the turn of the year.

Chart 3



Source: Scotiabank Economics, Bloomberg, ECB.

However, with regard to the long-term correlation highlighted above, falling banks' share prices since the beginning of the year raises concerns over whether a further acceleration in credit growth is likely over the coming quarters. The last ECB stress test identified ongoing potential banking risks in countries like Italy, but also Germany, where the fragmentation of the banking sectors remains high. Therefore, dealing with specific challenges in these two countries would be an important step in removing banking sector risks and strengthening the transmission of monetary policy. In this regard, the coming referendum on the constitutional reform in Italy could be a good test to gauge the capacity and the credibility of the Italian Prime Minister, Matteo Renzi, to further push for strong reforms in the years ahead.

FISCAL POLICY SHOULD PROVE POSITIVE BUT DO NOT EXPECT TOO MUCH AT THIS STAGE

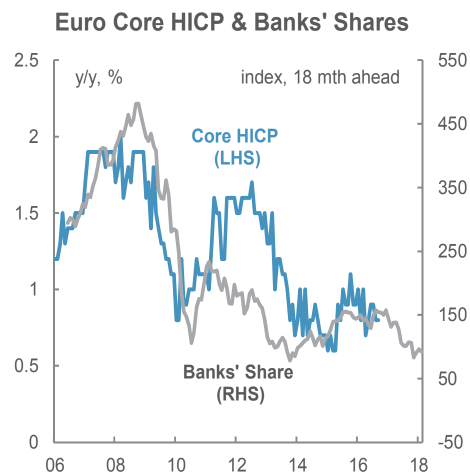
With monetary policy looking close to the limit, attention has shifted towards fiscal policy to offer more support. Clearly, over the past two years, fiscal policy has been more supportive to growth. The structural primary budget balance (excluding the impacts of both the economic cycle and interest rates) has dropped from +1.4% of GDP in 2014 to 1.0% this year. For next year, in view of current budget plans, fiscal policy could be supportive of adding around 0.2% to GDP. While positive, it does not appear to be a "game changer" relative to the trend seen in recent years. It is true that the room for significant fiscal expansion remains limited in the Eurozone. In view of current debt-to-GDP ratios and structural primary budget balances, there is almost no fiscal leeway for countries like Spain and France, whereas Germany and Austria are less constrained. Indeed, Germany seems to be ready for more fiscal stimulus with indications of a possible €15bn tax cut (0.5% of GDP), but not until 2018 after next year's general election.

HEADLINE INFLATION TO ACCELERATE BUT STILL UNCERTAIN PATH FOR CORE INFLATION

Annual headline Eurozone inflation should accelerate by around 1 full percentage point over the coming six months, rising from 0.4% in September to 1.4% in February 2017. This will mainly be driven by favourable base effects from both energy and food prices. Beyond February of next year, we expect that consumer prices will remain range bound, coming in at an average annual rate of around 1.2% y/y in 2017 and 1.4% y/y in 2018. This scenario nonetheless implies a rise in core inflation which, until this point, has failed to show any improvement and has remained stuck at around 0.8% y/y. We suspect that the soft path in core inflation reflects the lagged indirect impact of past lower oil prices on services, particularly transportation and non-durable goods prices. As oil prices have turned up, these factors should start to reverse and contribute to gradually pushing core inflation higher. Also, the closing of the output gap amid ongoing improvements in the labour market should offer further support.

However, renewed concerns surrounding the health of the banking sector and the efficiency of the monetary policy transmission over the medium term could create downside risks to this scenario. We also cannot exclude the risk that ongoing weakness in bank share prices reduces the traditional elasticity between core inflation and both GDP growth and oil prices.

Chart 4



Source: Scotiabank Economics, Bloomberg.

Latin America Capital Flows

STEADY, YET VOLATILE, CAPITAL FLOWS TO LATIN AMERICA IN 2017

- **Global excess liquidity to maintain capital flows into Latin America.**
- **Latin American FX markets sensitive to U.S. political & monetary cycles.**
- **Potentially adverse credit rating revision in Brazil, Mexico & Colombia.**
- **Revival of Brazil fuels asset re-allocation shifts away from Mexico.**

Emerging-market countries account for a growing portion of the global economic GDP map, and as such, foreign capital flows will continue to target the fast-growing markets over the next two years. International asset allocation to emerging-market investments will be subject to a myriad of external and/or domestic socio-political and economic events, yet these will not likely interrupt the flow of funds driven by attractive return potential and by ongoing structural reforms within the core group of developing nations.

The world's top-20 largest economies account for 75% of global GDP (measured in purchasing power parity terms). Led by China and India, and to a lesser extent Indonesia, the fast-growing Asia-Pacific nations represent a dominant 47% of the top-20 group. Brazil and Mexico in the Americas, and the Russian Federation and Turkey in the EuroAsian region also belong to the core group of emerging-market economies, yet growth rates in these four economies still represent a fraction of their Asian counterparts.

The composition of capital flows — and the associated asset classes — varies from region to region. Indeed, Asia-Pacific countries are dominant players in the equity securities markets whereas Latin America remains the core region for fixed-income securities markets. In the latter, the steady development of local-currency-denominated government securities markets, led by Mexico, has increased the relevance of exchange rate (risk and trading) dynamics.

The relentless quest for yield will not suffer major alterations in the year ahead. In fact, there is clear evidence that neither the euro zone nor the United Kingdom nor Japan are in a hurry to tighten monetary conditions in the near term. The U.S. Federal (Fed) Reserve, once the election-related uncertainties dissipate, will initiate a "gradual process" of monetary policy normalization which is unlikely to destroy the attractiveness of high yielding securities in selected emerging market jurisdictions. Nevertheless, we highlight the potential for prolonged credit and currency risk distortion as a result of excessive global liquidity. We are of the view that the recent (government bond) yield spread compression experienced over the past year might be subject to normalization dynamics beginning by the end of the year.

The Latin American (sovereign and corporate) credit markets might be influenced by a series of local and external events in the coming months. The post-election period in the USA will bring clarity to the path for the Fed's intervention policy in US Treasury bond markets, whereas China enters a sensitive political year which

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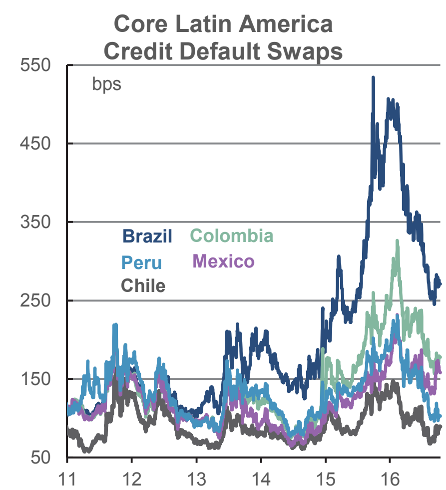
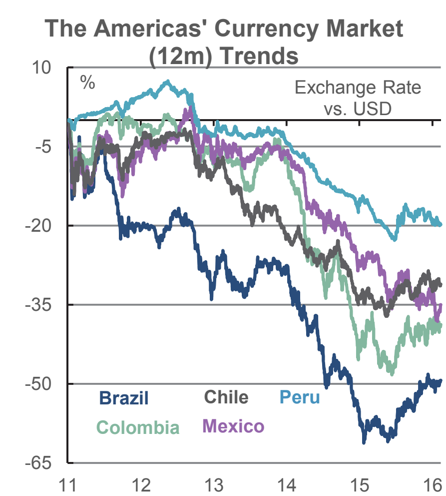
Chart 1



Source: Scotiabank Economics, Bloomberg.

Chart 2



Source: Scotiabank Economics, Bloomberg.

will require both economic growth and financial market stability at home. Regionally, the return of Brazil (and to some extent Argentina) to high-yield fixed-income markets may help de-compress excessive asset allocation to Mexican securities by dedicated high-yield emerging-market investors. While this may, at the time be seen as a negative development fuelling intra-regional moves, a more balanced regional approach to the largest Latin American economies might bring normalcy to sovereign and corporate credit markets in the year ahead. It is worth noting that Brazil has been the best-performing equity and currency market year to date in USD-adjusted terms.

The outlook for sovereign credit ratings also varies from country to country within each emerging-market region. It is relevant to stress that investment-grade credits account for 53% of the market-benchmark EMBIG index. Moreover, Latin American sovereign credits still account for the bulk (40%) of the index, followed by Europe (28%) and Asia (20%). Within the core group of emerging-market countries, only India and Indonesia enjoy a "positive outlook" on their sovereign credit ratings. As for the rest of the systemically relevant emerging-market economies, there is a widespread disconnect between (negative) credit ratings and (positive) market dynamics; indeed, international credit agencies have placed ratings on China, Brazil, Mexico, Russia, Turkey and Colombia on "negative outlook".

In this regard, leverage is largely well contained in the household sector in most countries in the Latin American region, yet public sector finances have been steadily eroding as a result of below-potential growth dynamics, slow progress in containing structural expenditures at the general government level and easy access to external debt channels. This issue is reflected in the concerning widening of the primary deficit in Brazil, the violation of the structural fiscal rule in Colombia and the oil-linked fiscal shock in Mexico.

In anticipation of a renewed wave of financial market volatility and in response to emerging price and currency pressures, a number of core Latin American economies have pre-empted monetary intervention mechanisms by increasing their policy-setting central bank rates (Brazil, Colombia, and recently Mexico). Both Mexico and Colombia have renewed large-scale credit lines with the IMF to reinforce the line of defense against an adverse external financial market shock. Others such as Brazil and Peru count on relatively large international reserves to be deployed for interventionist purposes if need be.

Brazil

ECONOMIC REVIVAL IN LATIN AMERICA'S LARGEST ECONOMY

- **Bullish financial market tone following conclusion of impeachment.**
- **Decisive policy response to the country's fiscal emergency.**
- **Positive trend towards inflation convergence to the target in 2017.**
- **Large-scale infrastructure investment plan to support mid-term growth.**

Brazil is decisively back on global investors' radar screens. Financial market metrics continue to reflect a robust bullish tone so far in 2016. Indeed, the Brazilian real (BRL), having appreciated by 28% vis-à-vis the US dollar (USD) since January 21st, is undoubtedly the world's best-performing currency this year. The outstanding performance registered in foreign exchange markets has also been mimicked in Brazilian debt and equity securities; in fact, the benchmark IBovespa equity market index has increased by 60% year to date in local-currency terms since late January.

There is clear evidence of renewed investor interest in increasing their exposure to Brazilian debt assets. The implied sovereign risk premium discounted in USD-denominated five-year credit default swaps (CDS) has steadily declined from 507 basis points (bps) in January to 245 bps in September. It is worth stressing that there is a disconnect between existing credit ratings and asset price dynamics; in fact, all rating agencies (Standard and Poor's, Moody's and Fitch) maintain a "negative" outlook on Brazil's sovereign debt ratings, "BB", "Ba2", and "BB", respectively. We are of the view that Brazil has become a candidate to receive multiple "upgrade" rating revisions in the year ahead on the back of improved growth fundamentals and reduced macroeconomic imbalances.

The Brazilian economy will return to modest positive rates of expansion in 2017, strongly aided by a recovery in industrial production, a trade surplus position, a more competitive exchange rate (following a 45% devaluation of the BRL over the past five years), a pro-investment infrastructure boom and an only modest recovery in domestic consumption as a result of lower interest rates. Real GDP will likely expand by 1.2% in 2017, following an economic contraction of 3.1% estimated for 2016 as a whole. The recovery process will moderately extend into 2018 (we project a GDP growth rate of 1.7%) depending on the speed of the structural fiscal adjustment and the response to the fiscal stimulus injected by the new administration. In 2018, household consumption and gross capital formation will be the key drivers of expansion. The 12-month consolidated public sector deficit, which reached 9.6% of GDP at the end of August, will gradually converge towards 8% of GDP by the end of 2018 according to the most recent assessment by the International Monetary Fund.

The beginning of a new political cycle following the impeachment proceedings against former President Rousseff marks a structural shift to improve the country's political institutions, something that has been rewarded and applauded by the global financial community. We are of the view that the constitutionally managed change in government, endorsed by the popular vote, represents a stepping stone

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Chart 1

Source: Scotiabank Economics, Bloomberg.

Chart 2

Source: Scotiabank Economics, Bloomberg.

to reform the political regime in place in Brazil over the past decade. Nevertheless, President Michel Temer faces a challenging macroeconomic environment, characterized by a still large fiscal deficit, a double-digit rate of unemployment, and persistently high (albeit declining) consumer price inflation. A top-notch technocratic team will remain committed to coordinate fiscal and monetary policies in order to rebuild domestic confidence and restore consumers' purchasing power.

Brazil, which has been remarkably resilient to disruptive external events such as the U.K. referendum vote and the policy uncertainties connected with the presidential elections in the USA, will not necessarily be immune to potentially disruptive shocks connected with the normalization of monetary policy by the U.S. Federal Reserve (Fed) to gradually commence in the New Year. Nevertheless, we are of the view that movements in the short-term Fed funds rate will have only marginal effects into capital flows into Brazil due to the highly attractive (for foreign portfolio investors) real interest rate context. As long as the Fed does not alter its policy of US Treasury and mortgage-backed securities holdings which would provoke a steepening of the U.S. yield curve, Brazil has the potential to continue to receive sizeable foreign portfolio inflows as a carry-trade investment opportunity.

We also believe that the economic team will do whatever it takes to moderate potential currency market volatility for inflation control purposes through the first half of the year. The most recent consensus survey conducted by the central bank highlights that the Brazilian real is projected to close this year and next at 3.25 and 3.40 per USD, respectively. In addition, foreign capital flows might target an attractive infrastructure development plan recently unveiled by the Temer administration. A still attractive real interest rate environment (short-term inflation-adjusted interest rates are bordering the 9% mark) will act as a powerful anchor of inflationary expectations during the first half of 2017. Headline inflation is projected to decline to 5% y/y by the end of next year, from an estimated 7% y/y in 2016. Derivatives markets clearly discount the launch of a monetary easing phase; indeed, the policy-setting SELIC interest rate will likely be reduced between 200 and 300 bps by the end of 2017.

Colombia

FOREIGN CAPITAL FLOWS SUPPORT STRUCTURAL TRANSFORMATION

- **Colombia to attract sizeable capital flows irrespective of plebiscite vote.**
- **Structural fiscal adjustment as critical economic policy priority.**
- **Visible progress on disinflation dynamics; monetary easing in sight.**
- **Diversification away from energy sector as a positive development.**

The Colombian outlook presents a series of macroeconomic challenges that extend well beyond advances and/or delays in the process leading to peace accords with insurgent groups. Undoubtedly, the outcome of the plebiscite vote conducted on October 2nd has temporarily affected global investors' risk perception of the country's political and institutional context, yet we do not view this as a de-stabilizing event to prevent foreign capital flows into the Colombian economy. Nevertheless, there is a number of pressing economic policy issues that require prompt remedial action to improve the business climate ahead of the beginning of the New Year in order to avoid a credit rating downgrade. These include: the structural fiscal adjustment, the fight against inflation, the correction of the current account deficit and the diversification of economic structures away from energy sector dependence.

The structural fiscal reform to be presented before congress for its approval has become a key policy issue shaping the business climate in the coming months. Following the sharp decline in crude oil prices (between June 2014 and February 2016) and only a modest recovery since then, securing non-energy sources of fiscal revenue is paramount to prevent further erosion of fiscal conditions. As the central bank points out, oil-related fiscal revenue declined from 20% of total receipts in 2013 to virtually zero at present. The production of crude oil will be reduced from 1 million barrels per day to 850,000 barrels per day in the year ahead. Additionally, the financial requirements associated with a future peace settlement might exert further negative pressures into fiscal accounts in the medium term. The consolidated public sector fiscal deficit will likely close the year near the 4% of GDP mark; therefore, restoring fiscal sustainability is of critical relevance.

The Colombian economy is in transition to a new structural framework, with diversification away from energy sector dependence and U.S. market dominance as the key pillars of such structural shift. Following a sharp collapse of external sales (down 26% y/y in the first seven months of 2016), a tight monetary policy implemented by the central bank is successfully contributing to a deceleration in domestic demand and higher unemployment (9% in August) to correct macroeconomic imbalances. Real GDP growth will likely close the year at 2.5% according to the Finance Ministry (somewhat lower than private sector consensus). Looking ahead into 2017, the speed of disinflation, coupled with business and consumers' adjustment to the tax reform will become key determinants of domestic-led economic expansion. Household consumption will retain a pace of expansion of around 2.5% per year in 2017 and 2018. The country's infrastructure program, heavily skewed towards road infrastructure build-up, will also be an investment-driven growth driver through the remainder of the

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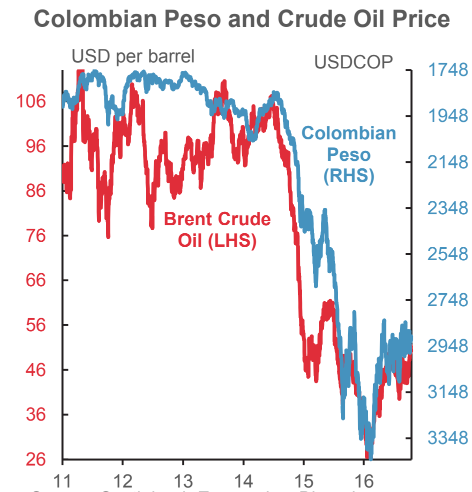
Chart 1



Source: Scotiabank Economics, Bloomberg.

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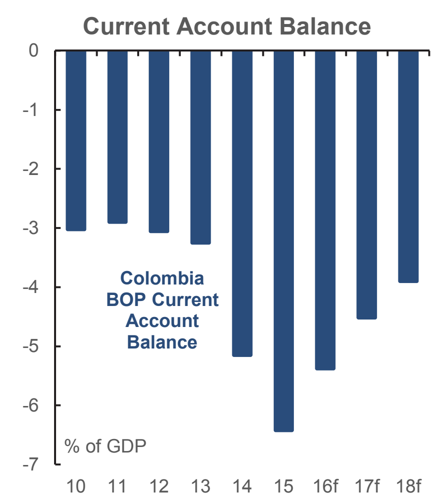

Source: Scotiabank Economics, Bloomberg, IMF.

decade injecting a positive impulse into the construction sector. The consensus forecast points to a 2.8% economic expansion in 2017 and 3.8% in 2018. Following a sharp currency adjustment, the export sector will become a positive growth driver in 2018, which will add to the positive effects from foreign investment into the infrastructure sector and recovery of manufacturing activity.

The combat against inflation remains the single most relevant priority for the Colombian central bank. Following 19 consecutive months of annualized inflation above the upper band of the official 3% ± 1% target range, market participants have begun scrutinizing the efficiency (and/or credibility) of the inflation targeting regime. Indeed, consumer price inflation mostly influenced by supply-side factors and lingering pass-through effects from a sharp currency adjustment, has reached 7.3% y/y in September after peaking at 9% y/y in July. Food inflation declined to 10.6% y/y in September. Looking ahead, recent consensus surveys point to an end-year rate of 7% y/y and 4.2% y/y for 2016 and 2017, respectively. In this regard, the central bank will maintain tight monetary conditions (with the policy rate currently set at 7.75%) until there is a visible and sustainable change in the disinflation trend.

Visible progress in the correction of the current account deficit will likely be in place in 2017-18. The collapse of foreign trade activity due to the oil price shock has been the primary cause of the increase in the current account deficit which skyrocketed to 6.5% of GDP in 2015. The central bank estimates that the external gap will close the year at 5.3% of GDP. Nevertheless, there seems to be a directional shift in this regard as the decline in exports is showing signs of deceleration whereas import contraction remains at the same speed. The current account deficit will converge towards 4% of GDP by the end of 2018. The acute exchange rate adjustment that occurred between July 2014 and February 2016 has injected a competitive currency that will ease the process of economic diversification and current account adjustment over the next 2 years.

International credit rating agencies will closely monitor the improvement in the twin (fiscal and current account) deficit positions in the coming months. Once renegotiated, the final peace agreement will be accompanied by a hefty fiscal cost that will also put pressure on public sector finance. The government's economic team remains firmly committed to an orthodox approach to fiscal and monetary policy, yet the macroeconomic environment is not free of substantial challenges in the coming year.

Colombia will continue to deepen trade and investment ties with existing and new markets as a way to diversify foreign trade markets while securing new sources of foreign direct investment. The four-member "Pacific Alliance" group will ease the connectivity with high-potential markets in the Asia-Pacific region (particularly through bilateral ties with Peru and Chile), while the liaison with Mexico (which accounts for two thirds of the Pacific Alliance GDP) will help reconstruct a more constructive trade and investment relationship with NAFTA zone partners in the year ahead. The outstanding USA-Colombian relations have been endorsed with the IMF approval of a two-year US$11.5 billion flexible credit line last June. Finally, a decisive shift towards a more business-friendly pro-market policy approach by both Brazil and Argentina opens the gates for more engaged trade linkages with the Southern Cone markets.

Peru

ALL EYES ON THE GOVERNMENT

The Pedro Pablo Kuczynski, PPK, regime took over the reins of government on July 28. Since then all eyes have been focused, naturally, on their plans and initial actions. There have been plenty of both, most of which has been well received, driving business confidence to multi-year highs.

The more prominent highlights in terms of the initial measures and intentions include:

The cabinet — Led by Fernando Zavala, Finance Minister in 2005, when PPK was head of the cabinet (Toledo government). One of Zavala's main challenges is to establish friendly, working relationships with the opposition Congress, and with regional and local governments. The cabinet itself is a combination of experience from past administrations and professional expertise in their fields. This may be one of the most competent, and therefore hopeful, cabinets in recent memory.

The Central Bank and monetary policy — Julio Velarde was reappointed President of the Central Bank for a third five-year term. The Executive appointed three additional prestigious names to the Board. Congress has yet to appoint the remaining three of the seven-member board. With Velarde remaining at the helm, we do not foresee significant changes in the way monetary or FX policy will be conducted.

Special legislative powers — Congress recently awarded the Zavala cabinet extraordinary powers to legislate for 90 days on economic, corruption and security issues. This is a positive event, not only because the government will be able to expedite legislation, but also because of the political significance. It allays fears that the majority opposition in Congress, Fuerza Popular (FP) led by Keiko Fujimori, would seek to block government initiatives. While some prominent FP members of Congress have been vocal in their opposition to certain government initiatives, this has not translated into actively blocking proposals in practice.

Economic policy and growth — The economic team, led by Finance Minister Alfredo Thorne, has announced that the policy priority in recovering growth will be two-fold: infrastructure investment and the formalization of informal businesses. Regarding infrastructure, the government has produced a list of 49 more immediate projects in the fiscal budget, totaling just over US$2b for 2017. This is part of projects that have already been tendered (US$18b over a multiyear period). However, it may be easier for the government to advance the non-tendered projects, which are smaller, but are not entangled in red-tape, than to work out the snarls in the tendered projects where delays are already causing contractual non-compliance and costs that may require time-consuming addenda to current contracts. Overall, 2017 may be more of a year in which engines rev up for infrastructure projects, with greater spending beginning in 2018.

The government has been less specific in how it will go about inducing the formalization of informal businesses. The special powers given by Congress include tax changes, such as, but not restricted to, reducing the VAT sales tax

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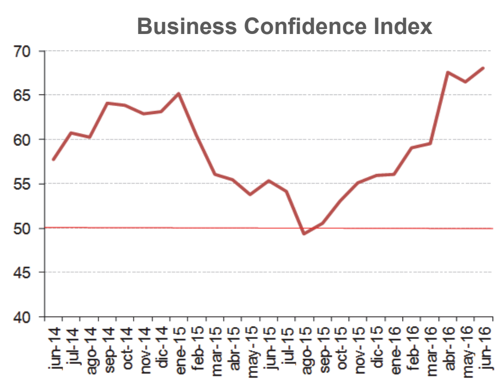
Chart 1

GDP Growth

	2014	2015	2016P	2017P	2018P
GDP	**2.4**	**3.3**	**3.8**	**4.0**	**4.2**
Non-Mining GDP	**2.5**	**1.5**	**2.0**	**3.4**	**4.0**
Domestic Demand	**2.2**	**2.9**	**1.8**	**3.6**	**4.0**
Private Consumption	4.1	3.4	3.5	3.5	3.5
Public Consumption	10.1	9.5	5.9	4.2	4.4
Gross Domestic Investment	-4.7	-0.9	-4.2	3.6	5.1
Private	-1.8	-4.5	-4.4	3.5	4.5
Public	-2.0	-7.5	7.6	5.1	5.0
Exports	**-0.8**	**3.5**	**6.8**	**5.3**	**4.4**

E: Estimated P: Projected.

Chart 2



Source: BCR Elaboration: Research Department - Scotiabank.

(IGV in Peru) that the government hopes will help. Given how tight the fiscal situation is, the initial step is to lower the sales tax from 18% to only 17%, and compensate, at least partially, by raising the income tax rate from 28% to 30%. Other tax measures for small businesses are also being considered, including a tax amnesty to offshore holdings and to business tax debt currently tied up in lawsuits with the tax administration.

Overall, the budget conveys an intention on the part of the government to keep the fiscal house largely in order, something which was not as clear during the campaign period. Fiscal authorities propose bringing the fiscal deficit down to 2.5% of GDP at the end of 2017 and 1.8% in 2018, from 3.4% currently. These targets may not be easy to reach, but the intention to manage the fiscal situation adequately is credible. As part of its fiscal housekeeping, the new government unexpectedly moved to restructure the fiscal debt in late September, issuing local currency 2028 sovereign bonds totaling 10.25 billion Soles and buying back shorter term local bonds and USD global bonds.

The government is relying significantly on the private sector picking up to drive growth in 2017. The fiscal budget that has been submitted to Congress for approval is based on an assumption of 4.8% GDP growth in 2017 (versus our forecast of 4.0%). The budget is relatively conservative in terms of government investment, 5% increase (9.1% in 2016), and consumption, 3% increase (5.7% in 2016). The largest change in growth components is in private sector investment of 5.0%, a turnaround from -1.7% in 2016. Private consumption, 3.7% (3.5% in 2016) and exports 8% (6.9% in 2016) will also contribute. While no forecasted growth component is individually untenable, those linked to the private sector tend to be consistently, albeit mildly, above our and consensus figures. At first glance, the current GDP growth trend, 4.1% for 12-month trailing growth to July, suggests that 4.8% for 2017 is within reach. However, mining will go from contributing 1.8 percentage points to growth in 2016, to only 0.7pp in 2017. This means non-mining GDP would have to go from contributing 2.3pp in 2016 to 4.1pp in 2017 to reach the government figure (and to 3.4pp to reach ours). Although the significant increase in investor confidence provides a basis of support for such an improvement in non-mining GDP, current high levels of excess capacity in a number of industries, plus the continued delay in infrastructure projects, together mean that an improvement this significant will be a challenge.

Overall, 2017 is likely to be a year in which both the private and public sector will still be adapting to the new government. Hopes are high that 2018 will be smoother, and somewhat stronger. We are forecasting 4.2% growth, which may not seem like much of an improvement over 4.0% in 2017, but the mining component will be smaller; we expect non-mining GDP to account for nearly all of the 4.2% growth, compared to 3.4% in 2017. Thus, in 2018 the headline GDP growth figure will be a better indicator of the true strength of economic growth.

Chile

GROWTH: EXPECTATIONS ON EDGE REMAIN THE KEY

Current conditions for the Chilean economy worsened at the margin. As expected three months ago, the trend growth estimate was reduced from 3.5% to around 3% and the economic rhythm slowed a tad more in Q3. There are some statistical factors that allow continued expectations of annual growth of 1.7% 2016, with some recovery in activity in the last quarter (particularly in the last two months). However, this is not a change of trend. On the contrary, stubbornly negative confidence in business and consumers forced a trim of growth expected for next year to 2%, and will keep under pressure any recovery of domestic demand. In our base case, the slow recovery of activity and demand will continue in 2018, to reach a growth of 2.5%. That said, the trend growth (estimated around 3%) would not be reached before 2019. However, there is a balance of risks not clearly biased by now: negative factors coming from subdued terms of trade and domestic uncertainties are pushing down, but on the flipside, there are signs of stabilization in China, stronger capital inflows in emerging markets, and a shift towards to a more growth-focused political consensus that might unleash a positive force for expectations. About the latter, the new energy projects, which mean both a signal of confidence in private sector and lower costs for many activities, plus a sensible fiscal budget for next year are positive, while municipal and general elections (current year and next, respectively) should be seen more as opportunity for an upbeat turn.

INFLATION CONVERGING AND MONETARY POLICY ON THE SIDELINES, BUT IN THE WARM UP

According to the last data, accumulated inflation continued decreasing, falling into the monetary reference range (2% - 4%), pushed down by the stabilization of the exchange rate and less pressure coming from a higher capacity slack. General expectation is a convergence to the centre of the range next year, to stay at that level in following years. Amidst this inflationary outlook, and although current monetary policy is rather stimulating — with the rate at 3.5% and a neutral bias established in August — if inflation expectation for 12 months or its determining factors (like exchange rate or income-salary) shows a more intense retrenchment (closer to or below 2.5%), probability of a cut to 3% in next six months would be pushed up. However, there is not plenty of room to be much more expansionary: unless we see a very positive foreign upturn, a more expansive monetary policy would warrant a higher exchange rate. Beyond the monetary policy, but conditioned by it, the short term rates should stay stable in 2017, in our base case, with a downward biased risk. As far as long term rates are concerned, stable evolution is the most likely scenario, but as risk from domestic inflation and that of an upsurge of U.S. rates decreased, now risks are slightly downward biased, as well. The Government is planning to be more cautious about spending, proposing a real growth of 2.7% (deficit estimated at 3.3% of GDP), but even so will have to issue new debt and will likely lose its condition of net lender. On the other side, it is worth recalling that in a very open economy, the fiscal spending is not so powerful a tool for activity.

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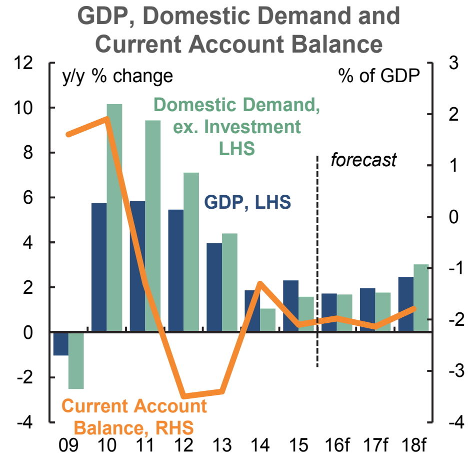
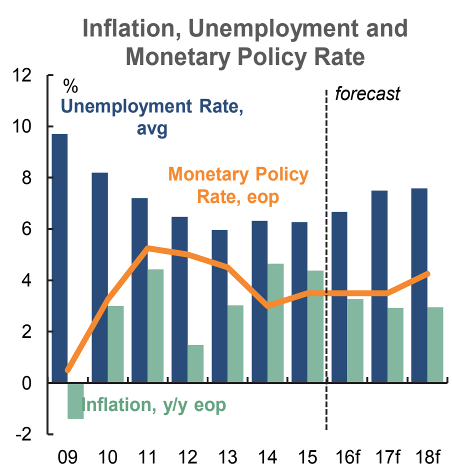
Chart 1



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

Chart 2

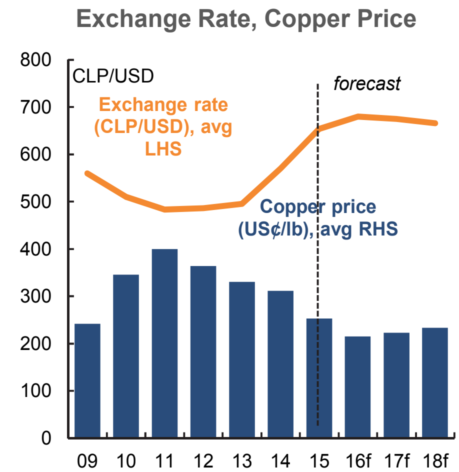


Source: Scotiabank Economics, INE, Banco Central de Chile.

STILL DEMANDING FOREIGN ENVIRONMENT, BUT RISKS SEEM TO LESSEN

Terms of trade have not materially improved in the last months, with copper price in the doldrums and a modest decrease in oil price. However, three major foreign risks eased: (1) copper is showing some support above 2 USD/pound; (2) China seems more able to manage its transition and has also been strong enough to control its exchange rate; and (3) the Fed has shown a more cautious view for its normalization path. Although independent and joint probabilities of these factors of risk are not nil, and must be closely tracked, likelihood of extreme conditions is now lower that three months ago. The flexible exchange rate in Chile (CLP/USD) — the first buffering system of this small and very open economy — has been mirroring this less risky environment combined with still lacklustre foreign conditions, keeping within a bounded range which may stay between 640 and 700 in coming months, depending highly on foreign facts and the domestic monetary policy. Within this range, the exchange rate should be enough to keep competitiveness of exports and harmless for inflation.

Chart 3

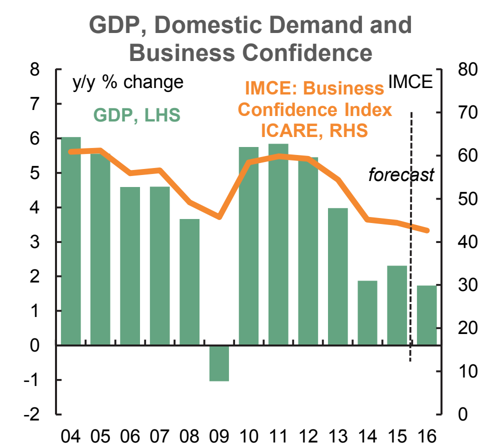


Source: Scotiabank Economics.

DOMESTIC MISTRUST: IT IS NOT THE (FISCAL OR MONETARY) POLICIES, BUT POLITICS…

Although the economy is growing and is expected to continue so, confidence indicators are in recessionary levels for a long time and worsened a tad more in the last three months. On the consumer side, the weakening labour market (a traditional laggard of the Chilean economic cycle) is spoiling slowly. Unemployment rate has not increased very dramatically, but much of that is consequence of less dynamic labor force and self-employment. Consequently, salaries are slowing. These conditions should prevail for one and half years, so a huge recovery in consumption should not be expected in the meanwhile. On the investment side, efforts to improve ongoing or announced reforms have not seemed enough. The Government has taken some measures to improve this condition, but directions have not been quite clear or satisfactory for the market. Even more, a new critical reform has been added to the program: the Pension System. Putting aside that system must be revised because some of its parameters look outdated and corrections are inescapable, and that may even increase strength of a system that has been a pillar of the Chilean development, it is clear that consequences in the short term are not going to be stimulating for domestic spending because, at the end of the day, the question will be how to save more and who is going to decide about it. The low confidence in political institutions, like the Congress, political parties, and the same confidence in the Government, marginally worsened in the last three months, which is not very encouraging for discussion of deep reforms. Hopefully, coming elections might help to reshuffle political forces or their driving ideas.

Chart 4



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

China

CHINA WILL REMAIN KEY SOURCE OF GROWTH AND CONCERN

- **Economic rebalancing and output growth slowdown will continue.**
- **Stimulus is supporting momentum in the short term, yet it is creating larger economic imbalances.**

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STRUCTURAL REFORMS PROCEED CAUTIOUSLY AMID STIMULUS

China's economic transition toward a consumer- and services-oriented economy continues, while investment and the industrial sector are losing their significance as engines of economic growth. As a result, the economy is becoming less trade-dependent. Trade of goods & services was equivalent to 41% of GDP last year, substantially less than the 63% share a decade earlier. While trade will continue to be important for China, the economy is gradually diminishing its exposure to global demand shocks and will rely increasingly on domestic sources of growth.

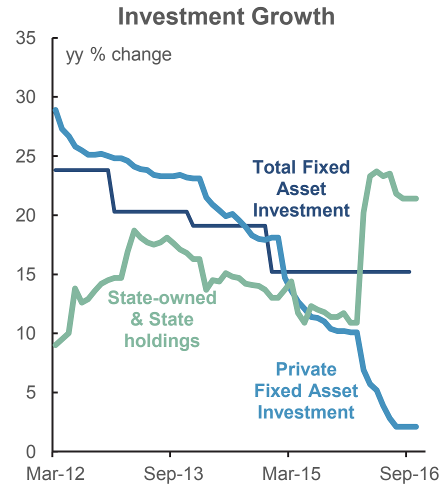
Chinese authorities are committed to supporting the structural change as it will generate more sustainable economic growth. Implementing needed reforms is a complex task and authorities face a critical trade-off; addressing pressing issues such as industrial overcapacity and high corporate debt will result in slower near-term growth but are necessary for China's longer-term prosperity. Hence, Chinese authorities continue to utilize their vast financial means to provide short-term stimulus to the economy so that reforms in the background can proceed smoothly.

Recent high frequency indicators show a modest strengthening of China's growth momentum; indeed, the country is on track to meet the official real GDP growth target of at least 6.5% y/y in 2016. A large part of the momentum reflects the government's fiscal stimulus spending, particularly in infrastructure (chart 1); the public sector continues to be the main source of gains in investment (up by 21% y/y year-to-date), while private sector outlays remain weak (up only 2% y/y in the first eight months of the year). As the private sector accounts for around 60% of total investment, we assess that the current dynamics are not sustainable, leading to gradually slowing output growth rates over the coming quarters. Indeed, we expect China's real GDP expansion to decelerate towards 6% y/y by 2018.

CREDIT GROWTH, BANKING SECTOR HEALTH, AND CAPITAL FLOW LIBERALIZATION ARE SOURCES OF KEY ECONOMIC RISKS

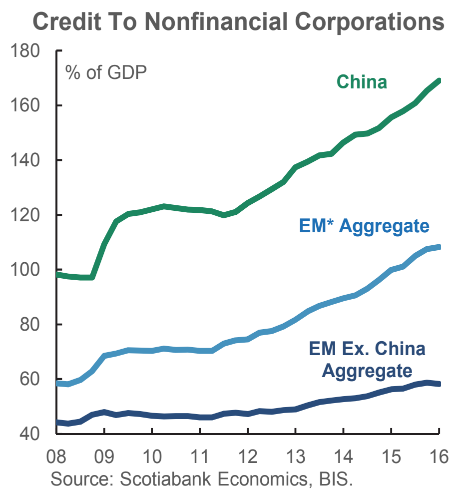
Given the Chinese economy's size and increasing significance to the rest of the world, any abrupt correction of its economic imbalances would cause ramifications globally. One of the key risks to China's outlook stems from the current stimulus drive that is keeping the nation's real GDP growth artificially high. Non-financial corporate debt reached 169% of GDP in the first quarter of 2016, up by 14 percentage points in one year alone (chart 2). Loose credit policies and rapid lending growth, particularly involving state-owned enterprises, are pushing existing economic troubles into the future, because funds may be directed to non-viable projects that have high potential to turn into non-performing loans over the coming years. Indeed, with credit growth exceeding nominal GDP gains by a wide margin, Chinese corporations' future debt servicing ability is questionable.

Chart 1



Source: Scotiabank Economics, Bloomberg.

Chart 2

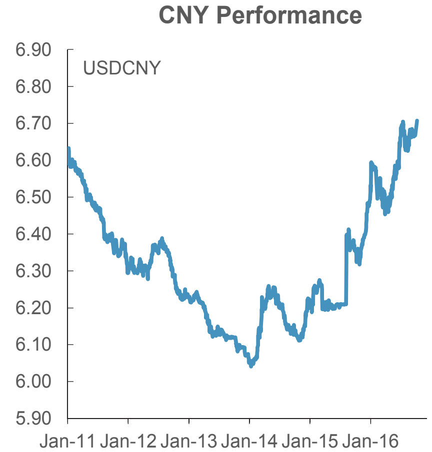


Source: Scotiabank Economics, BIS.
*Countries included in BIS data.

The health of the Chinese banking system is already a cause for concern; the International Monetary Fund estimates that "debt-at-risk" accounts for 15.5% of the total corporate loan portfolio, which might result in losses equivalent to 7% of GDP. The financial system's fragility in the near term is further exacerbated by the fact that the banking sector is in the process of being liberalized. With the sector lacking strong governance and risk management frameworks, newly-introduced competition may prompt intensified distress among its weakest members. Accordingly, we point out that lack of progress by Chinese authorities in recognizing losses within the banking sector and implementing necessary corporate restructurings may trigger a significant correction in the economy later on. Nevertheless, with the Chinese government enjoying vast financial resources and having the ability to intervene effectively due to the centrally-planned economic system, we do not expect the massive debt burden and banking sector fragility to be a near-term threat to the economy.

Another noteworthy area of weakness and risk relates to China's capital flow liberalization process. Progress on this front is important as allowing capital to move in and out of the country would reduce existing imbalances. Opening the capital account would improve the effectiveness of monetary policy, provide Chinese companies and consumers with a larger range of investment alternatives (which would reduce excessive demand for real estate), and make the Chinese banking system more resilient due to balance sheet diversification abroad. However, significant simultaneous advances in capital account liberalization would likely result in capital flowing out of China in the short term (until a balance is found in the medium term after global investors have increased their China exposure). Therefore, reform progress in opening up the economy will likely be very cautious and gradual. Anticipation of capital flow liberalization and the resultant exchange rate adjustment, combined with rather leaky capital controls, is already translating into persistent weakening pressure on the Chinese yuan (chart 3). As a response, the People's Bank of China continues to intervene and manage the value of the currency, allowing it to depreciate gradually. Nevertheless, monetary authorities' biggest challenge is to avoid self-reinforcing market concerns regarding an abrupt depreciation of the yuan.

Chart 3

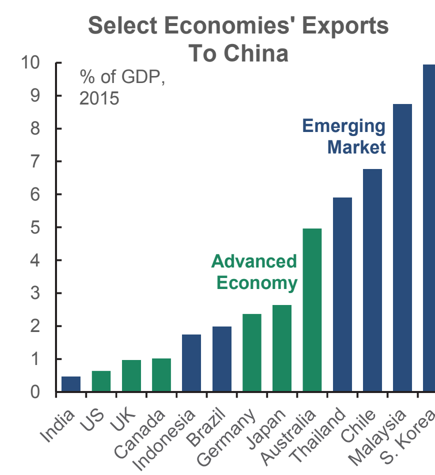


Source: Bloomberg, Scotiabank Economics.

CHINA'S ECONOMIC TRANSITION IMPACTS THE REST OF THE WORLD

China's growth slowdown impacts the rest of the world through such channels as trade (chart 4), commodity prices, and financial linkages. Countries that feed into Chinese industrial and investment demand will be the most adversely affected by the rebalancing (e.g., Taiwan and South Korea), while nations that are exposed to the rising Chinese consumers (New Zealand) will likely be net beneficiaries. In addition, some countries, such as Cambodia and Laos, can benefit from companies shifting production capabilities away from China as its labour costs rise. Moreover, with China being a major consumer of commodities, its slowing investment growth will translate into headwinds for the commodity price recovery, which will adversely impact commodity exporters, such as Australia, Canada, and Brazil. While China is becoming more integrated into the global financial system, any shocks in its banking system are unlikely to trigger direct financial contagion globally. However, financial spillovers via shifts in investor sentiment toward China will have a strong impact on the rest of the world.

Chart 4



Source: Scotiabank Economics, IMF.

Japan

LOW INFLATION AND MUTED GROWTH REMAIN IN SIGHT

- **Japan's economic revival efforts are facing headwinds, prompting reloading of Abenomics.**
- **Accommodative policies remain the norm.**

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YET ANOTHER CHANCE FOR ABENOMICS

The challenges faced by the Japanese economy are not showing signs of fading, forcing the government to reboot its economic revival strategy. Prime Minister Shinzo Abe's "three arrows" of monetary stimulus, fiscal flexibility, and structural reforms are being sharpened once again to prove to the rest of the world that "Abenomics" has not faltered. A new framework for monetary easing was launched in September, and an additional fiscal spending package was approved by the Japanese cabinet in August. These short-term stimulus measures should buy some extra time for implementation of structural reforms, which are the only sustainable way to support economic growth in the medium and long term and end persistent deflation.

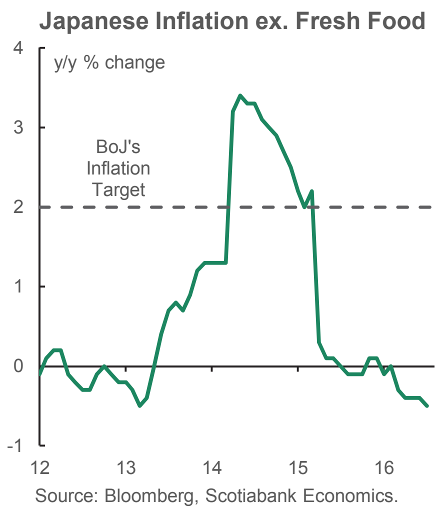
1ST ARROW: MONETARY POLICY

In September, the Bank of Japan (BoJ) introduced a new monetary policy framework of "Quantitative and Qualitative Monetary Easing with Yield Curve Control", which provides the central bank with more policy flexibility and reinforces the existing monetary easing program. The new framework has two key elements: "yield curve control" and "inflation-overshooting commitment". With the former, the BoJ will adjust short-term and long-term interest rates more effectively, while the latter emphasizes monetary authorities' pledge to maintain accommodative policies in place until Japan's 2% inflation target is exceeded in a stable manner.

As per yield curve targeting, the BoJ announced guidelines for short- and long-term interest rates, which will help the central bank to address Japan's current challenge of a flat yield curve. The existing negative interest rate of -0.1% applied to financial institutions' excess current account balances at the BoJ will function as the short-term policy rate. The target for long-term interest rates (10-year government bond yields) was set at "around zero percent", which the BoJ will achieve by adjusting its government bond purchases. Expansion of Japan's monetary base through asset purchases by the BoJ will amount to about ¥80 trillion, though short-term fluctuations will be permitted in order to facilitate necessary yield curve tweaking. Moreover, the central bank made its quantitative easing program more flexible by abolishing the guideline for the average remaining maturity (previously 7-12 years). This should allow the BoJ to focus its purchases on 3-5 year maturities in order to lower medium-term bond yields, which should translate to reduced commercial borrowing costs more effectively and stimulate the economy.

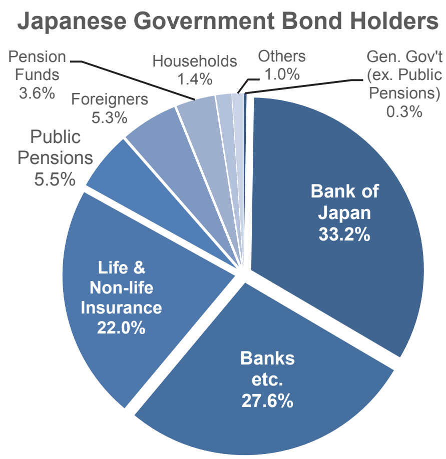
With the Japanese economy facing stubborn deflationary pressures, the BoJ fine-tuned its inflation-targeting approach by opting for a more flexible stance; it did not stipulate an explicit timeline for reaching the 2% y/y target for consumer price

Chart 1



Source: Bloomberg, Scotiabank Economics.

Chart 2



Source: Ministry of Finance Japan, Scotiabank Economics.

inflation (CPI, all items less fresh food). The central bank intends to raise inflation expectations more forcefully by emphasizing that it aims to reach the target "at the earliest possible time" and continue its accommodative policies "as long as necessary" for inflation to overshoot the 2% threshold in a stable manner. Nevertheless, the achievement of the target seems far in the future. In August, prices declined by 0.5% y/y. Given subdued wage growth, low inflation expectations, and the yen's strength, we assess that the inflation target will not be reached by the end of 2018. Against such a backdrop, we assess that the BoJ will be pressured to ease monetary policy further over the coming months, lowering the short-term policy rate deeper into negative territory. In our view, the central bank will not be able fight the yen's strength by further monetary stimulus, as the currency's value continues to be driven by global investor sentiment.

2ND ARROW: FISCAL FLEXIBILITY

While Japan maintains its commitment to achieving sustainable public finances in the longer term, short term fiscal flexibility is considered vital for supporting policymakers' economic revival efforts. Indeed, given subdued consumer spending, the government decided in June to postpone the scheduled increase in the consumption tax rate from April 2017 until October 2019. Furthermore, a second supplementary budget for the current fiscal year was approved by the Japanese cabinet in August, complementing the BoJ's monetary easing. The fiscal package totaled ¥28.1 trillion (equivalent to 5.6% of GDP), with ¥13.5 trillion (2.7% of GDP) representing new stimulus spending. Public outlays will be directed at low-income families and infrastructure.

Japan's fiscal profile remains structurally weak and we assess that there is limited room for further spending measures. The general government fiscal deficit will average close to 5% of GDP in 2016-18, while gross public debt will hover above 250% of GDP. Japanese authorities aim to reach a primary surplus by FY2020 (April-March) in order to stop further debt build-up. This is a challenging task in a lacklustre growth environment. Given that the government is also faced with increasing social security costs stemming from population aging, it has recognized the urgent need for expenditure and institutional reforms as well as efficiency improvements in order to consolidate public finances over the longer term.

Despite bloated public finances, the Japanese government has no difficulty refinancing its debt obligations at vary low rates. This reflects solid domestic appetite for government bonds given Japan's high savings rate and a current account surplus position. Japan does not rely on external financing for its government debt as 90% of it is held domestically, primarily by the BoJ and other government institutions, banks, and pension funds (chart 2). Other countries' central banks form the majority of foreign holders. Accordingly, any debt-related turmoil seems a rather distant possibility in Japan.

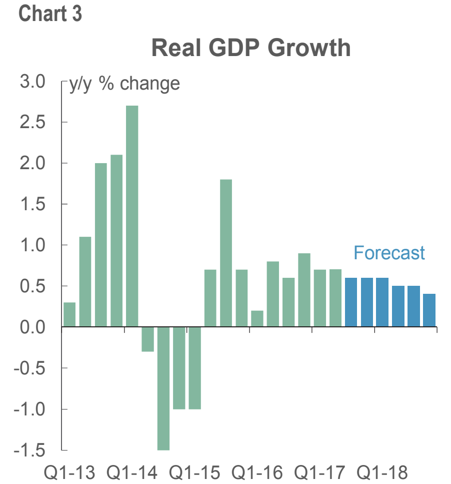
3RD ARROW: STRUCTURAL REFORMS

The victory of Prime Minister Shinzo Abe's Liberal Democratic Party in the July 10th upper house elections gave the government a strong mandate to focus on implementing the third arrow of structural reforms, which has proven rather challenging in the past. Determined to succeed, Prime Minister Abe has pledged that a labour market overhaul is on top of policymakers' agenda.

Japan's sluggish wage gains are one of the key reasons for muted private spending and non-existent inflation. Despite high corporate profits and virtually full employment, wage growth is held back by labour market rigidities. The share of part-time and contract workers — who lack bargaining power — continues to rise in Japan as high employment protection, for instance, functions as a disincentive for companies to hire regular workers. In addition to sluggish wage gains, this labour market duality hampers Japan's productivity via weaker performance incentives and lesser training opportunities for non-regular employees. With the jobless rate at a historically low 3.1%, addressing labour shortages is another critical reform area; the government is working on facilitating higher women's labour force participation and attracting foreign professionals into the country.

Boosting Japan's productivity and labour supply is essential for the economy's future prosperity. Currently, Japan's estimated potential real GDP growth rate is only 0.25% y/y; without successful implementation of structural reforms, the economy will not be able to reach higher growth momentum on a sustainable basis. We expect the Japanese economy to expand by 0.6% y/y in 2016-18, supported by temporary stimulus (chart 3).

Chart 3



Source: Bloomberg, Scotiabank Economics.

India

IMPROVING FUNDAMENTALS UNDERPIN INDIA'S ECONOMIC OUTLOOK

- **India is set to remain the global economic growth leader.**
- **Low inflation allows for accommodative monetary policies.**

SOLID ECONOMIC GROWTH SUPPORTED BY REFORM PROGRESS

India is expected to be the economic growth outperformer among the world's major economies. Momentum will be spurred by domestic demand that is responding to supportive policymaking and structural reforms. Meanwhile, India is less dependent on external demand than most of its peers, which bodes well for the country's prospects at a time of sluggish world trade. The economy's real GDP growth will likely pick up to near-8% y/y in 2018 from 7.6% y/y in 2016-17.

India's policymakers remain firmly committed to improving the ease of doing business in the country, as it is paramount for attracting investment and creating jobs. Progress has been witnessed in this respect; a notable example is the August approval by India's upper house of parliament (Rajya Sabha) of a constitutional amendment that allows a nationwide Goods and Services Tax (GST) to be rolled out. This important tax reform will transform the economy into a single market and improve India's business environment; the GST will cut businesses' transaction costs by synchronizing 11 state and central levies into a nation-wide sales tax. In response to recent reform successes, we anticipate a pick-up in private sector investment in the latter half of the forecast horizon once implementation progresses.

While public outlays by Prime Minister Modi's administration continue to support economic activity and improve road, rail and energy infrastructure, the government's fiscal stance remains reasonably prudent. Therefore, monetary policy will likely remain accommodative for an extended period of time as it carries a larger responsibility of providing stimulus to the economy.

FAVOURABLE INFLATION OUTLOOK AND STIMULATIVE MONETARY POLICY

By historical terms, India's inflation environment is favourable. The headline rate slid to 4.3% y/y in September after averaging 5.5% in the first eight months of the year. We expect inflationary pressures to remain contained in the near term, assisted by normal southwest monsoon rainfall that should keep food price gains in check. In the medium term, price pressures will likely gradually strengthen in line with global energy prices, yet we expect inflation to remain within the Reserve Bank of India's (RBI) 4% ±2% y/y target through 2018.

The RBI's benchmark repo rate was lowered by 25 basis points to 6.25% in October after Governor Urjit Patel took office and the central bank's decision-making framework was reformed. Now, interest rate decisions are made by a 6-member monetary policy committee instead of the Governor alone. We foresee one more rate cut in the first quarter of 2017. In our view, Governor Patel will likely remain committed to the RBI's inflation-targeting framework as it enhances policy credibility, helps anchor inflation expectations, and supports investor confidence.

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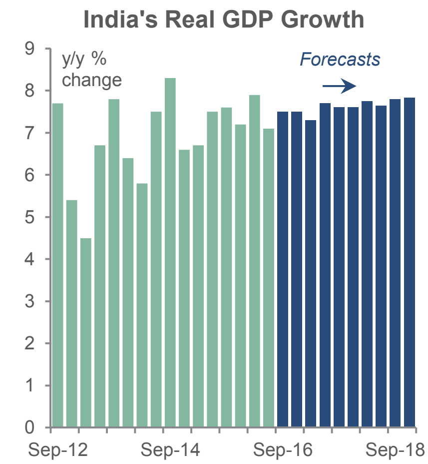
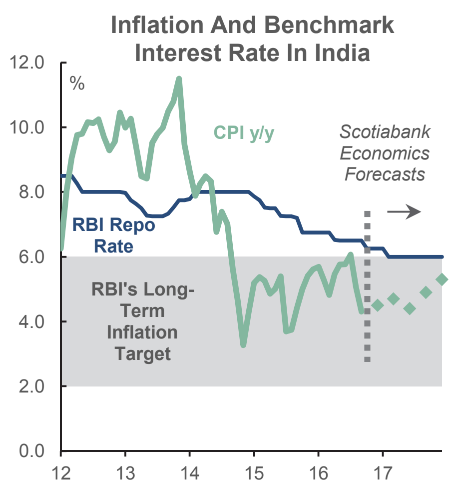
Chart 1



Source: Bloomberg, Scotiabank Economics.

Chart 2



Source: Bloomberg, Scotiabank Economics.

Australia

GROWTH LEADER AMONG ADVANCED ECONOMIES

- **The economy is undergoing a structural change, yet supportive policies make the adjustment smooth.**

SOLID ECONOMIC MOMENTUM DESPITE WEAKER TERMS OF TRADE

Australia is expected to remain the fastest-growing major advanced economy through 2018. Despite its robust performance, Australia will continue to feel the adverse impact of low commodity prices and weaker Chinese import demand. Moreover, the Australian economy is going through a structural change following the end of a recent resource investment boom, and is finding alternative sources of growth from non-mining related domestic demand. During this transition, higher export volumes that reflect mining project completions have propped up real GDP growth, helping the economy record above-trend output gains.

While Australia is adjusting reasonably well to the new economic reality, we assess that a continued mining investment downturn and a lower contribution from net exports will lead to somewhat slower economic momentum in the years ahead. We expect the nation's real GDP growth to decelerate to still-sound 2½% y/y by 2018 from the current pace of around 3%.

GROWTH-SUPPORTIVE POLICIES TO REMAIN IN PLACE

Accommodative monetary conditions will continue to play a key role in supporting domestic demand during the economy's structural transition. Meanwhile, the Reserve Bank of Australia (RBA) is in the midst of leadership change. New Governor Philip Lowe, the central bank's former deputy governor, took office on September 18th, 2016. We expect broad policy continuity under Governor Lowe's leadership; he has emphasized the importance of flexibility with regard to meeting the RBA's 2-3% inflation target and has highlighted that financial stability is an important aspect for monetary policymaking.

Price pressures are set to remain low in Australia. The headline inflation rate dropped to 1.0% y/y in the second quarter, staying well below the 2-3% y/y target. Given muted labour cost pressures, consumer price inflation will likely rise only slightly in the near term, hovering below 1½% y/y through the first quarter of 2017 before approaching the central bank's target range at the end of 2017.

The RBA has noted that a strong Australian dollar is complicating the economy's ongoing structural shift. This, combined with low inflation and policymakers' lessening concerns regarding Australia's housing market imbalances, will likely give the RBA a reason to lower the benchmark Cash Rate by 25 basis points to 1.25% in the first quarter of 2017. The most recent interest rate cut took place in August.

Australia enjoys relatively sound government finances compared to its peers; public debt is hovering slightly above 40% of GDP and budget deficits will likely average 2⅓% of GDP in 2016-18. Therefore, the country's policymakers have fiscal policy space to respond to any external shocks and can effectively complement the RBA's monetary accommodation efforts if needed.

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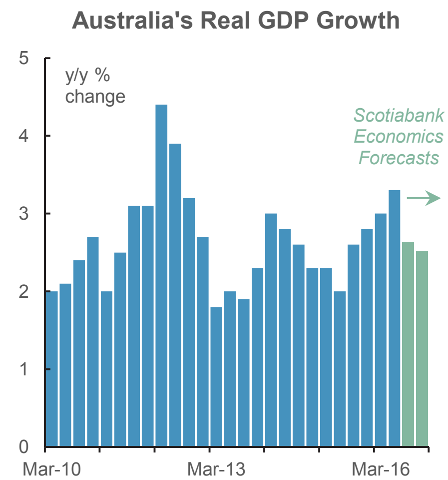
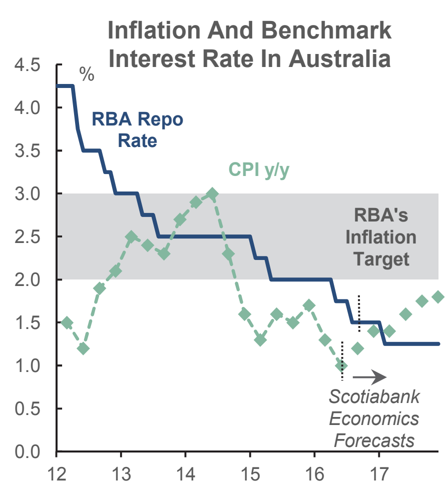


Source: Bloomberg, Scotiabank Economics.

Chart 2



Source: Bloomberg, Scotiabank Economics.

Commodities

- **Oil prices are expected to remain elevated through the fourth quarter of 2016 as markets await specifics concerning OPEC's first (potential) collective supply action since 2008; while the probability of a deal has recently increased, it is unlikely that OPEC will manage to sustainably reduce supply enough to materially affect current imbalances. The supply glut is expected to abate by the latter half of 2017, with prices forecast to rise from $44/bbl average in 2016 to $60 by end-2018.**

- **Base metals remain mixed, with zinc and nickel strength juxtaposed against the roughly flat outlook for copper and aluminum. The recent run-up in metallurgical coal prices is likely to be short-lived as steel profitability suffers and idled mines (N. America/Australia) restart.**

OIL & GAS — OPEC STEPS UP, BUT CAN IT STICK THE LANDING?

The oil market is at an interesting stage in its recovery. The supply glut had been easing through the first half of 2016 before picking up again in the third quarter, and further production gains are expected as disrupted barrels return to the market. Amidst these deteriorating fundamentals, OPEC surprised the market with an in-principle agreement — the cartel's first since 2008 — to cut production to address the oversupply. The details of who cuts and by how much aren't likely to be announced until after the official OPEC meeting on November 30th and there is reason to be skeptical that the cartel can pull its disparate membership together to meet this challenge. However, with this much rhetoric invested, it is likely that we'll see a weak statement of coordination from OPEC in November, but it is unlikely that it will materially affect the current mismatch between supply and demand. **Accounting for faltering base-case fundamentals and the upside risk of an OPEC deal, we expect WTI prices to average $44/bbl in 2016 before gaining to $53 in 2017 and $57 in 2018**.

Looking at the potential for an OPEC deal, it is important to outline the three details we already know: 1) instead of a spot target, OPEC provided a target *range* of 32.5 to 33.0 million barrels per day (Mbpd) from a September level of 33.4 Mbpd; 2) certain members will be exempted from production caps or curtailments — likely Nigeria and Libya (both struggling with internal conflicts) as well as Iran (still recovering from sanctions); 3) cuts aren't likely to materialize until after details are hammered out in the run-up to the official November 30th meeting.

If OPEC cuts production to 32.5 Mbpd — the lower bound of its target range — and further adjusts production to allow for production gains from 'exempted' members (Iran, Libya, and Nigeria) so as to keep cartel-wide output capped at 32.5 Mbpd, this move would likely put the market into its first sustained deficit in over two years. A coordinated and sustained OPEC cut would allow high inventories that were accumulated during the glut to be drawn down and prices would begin to rise. It is also possible that other large non-OPEC producers, namely Russia, will join in the effort — an outcome that has become more probable (though still unlikely) given recent statements of support from Russian president Vladimir Putin. However, even a coordinated action would be unlikely to

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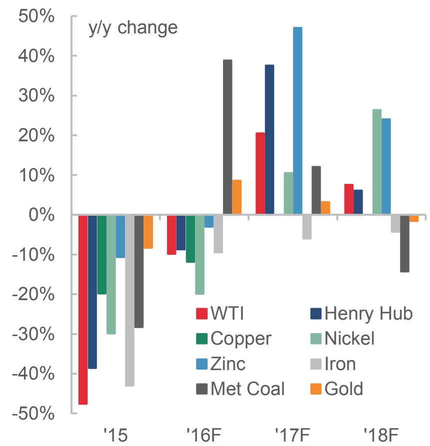
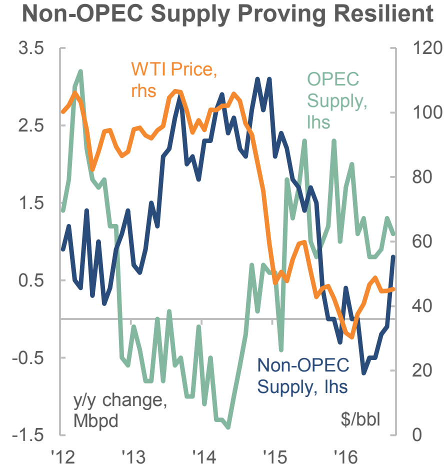
Chart 1



Source: Bloomberg, Scotiabank Economics.

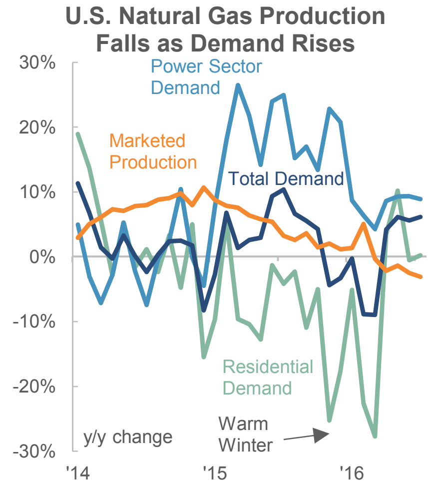
Chart 2



Source: OMI, EIA, Scotiabank Economics.

end the prevailing low-price environment, given the likely U.S. producer response to prices above $55/bbl and certainly above $65, establishing a rough near-term price ceiling. One upside to this scenario would be a smoothing of longer-term price and investment profiles, lessening volatility nearer end-decade when some fear that the current downturn in upstream investment will precipitate a significant supply deficit. **However, we expect the outcome to be slightly less constructive**, with reductions likely to be limited to a loose 33.0 Mbpd — the upper end of the range — if at all and production further inflated by exempted Iranian, Nigerian, and Libyan output recoveries. The longer prices remain low, the worse things get for OPEC producers — not only due to spiraling government deficits, but because the price pressure has notably increased non-OPEC production efficiency, pushing the global cost curve lower and flatter as time elapses. It will be difficult for OPEC to fundamentally change the larger, structural shifts occurring in the oil market, but it can still benefit from the attention provided it by the market. OPEC chatter has already benefitted members, boosting prices by roughly $5/bbl across the curve — worth more than $60 billion in annualized receipts for OPEC members based on current production levels.

Chart 3



Source: EIA, Scotiabank Economics.

The North American natural gas market will benefit from tightening balances through the forecast horizon, with Henry Hub prices expected to average a cycle-low of $2.40/MMBtu in 2016 before gaining to $3.30 in 2017 and $3.50 in 2018. U.S. marketed natural gas production growth has turned negative this year while demand continues to advance (chart 3). Prices fell to as low as $1.49/MMBtu earlier this year after the warmest winter on record reduced seasonal heating demand and inflated storage levels, but surging power sector demand has helped keep overall consumption growth buoyant.

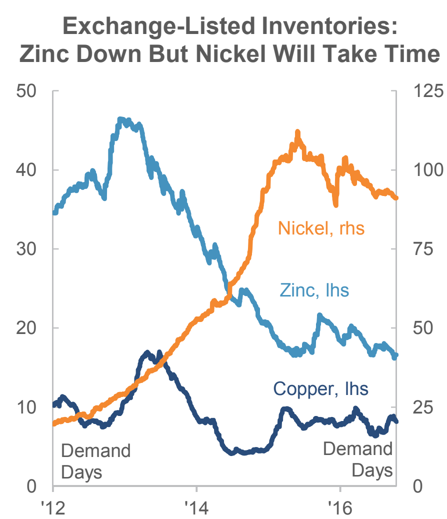
METALS & MINERALS — ZINC RISING, NICKEL STOCKS WEIGH ON RECOVERY TIMELINE, AND COPPER MALAISE

Metals are expected to find their bottom in 2016, though recovery dynamics between individual metals remain mixed. Zinc continues to experience the strongest fundamentals within the base metals, followed by nickel where deficits have emerged but large inventory levels will weigh on near-term price gains. Copper prices, meanwhile, are expected to remain roughly flat through our forecast horizon. Coal prices (particularly of the higher-quality metallurgical variety) are expected to ease after spiking on the back of a confluence of events that tightened seaborne spot markets, while iron ore prices are expected to drift lower through 2018 as significant volumes of new supply come on stream. Gold will continue to benefit from a host of political risks over the coming 18 months but will experience longer-term headwinds as global interest rates rise.

Zinc remains the metal with the strongest near-term fundamentals, and prices are expected to rise from an average of $0.85/lb in 2016 to $1.25 in 2017 and $1.55 in 2018. An acute deficit in zinc concentrate supply has emerged on the back of depletion-prompted closures (>600 ktpa) as well as economic idling of 500 ktpa worth of zinc mine capacity globally. This concentrate deficit has begun working its way into the refined metal market, where stocks have already begun to draw (chart 4). Inventory draw-downs are expected to become pronounced by mid-2017, prompting price increases.

Nickel prices began rising in July on the back of ongoing Filipino mine suspensions and prices are forecast to average $4.30/lb in 2016 before rising to $4.75 in 2017 and $6.00 in 2018. It is worth noting that the recent bounce in nickel prices occurred despite near-record global inventories (chart 4), but these stocks will serve to cap further price gains until sustained deficits can sufficiently draw inventories back to more typical levels. Notwithstanding recent price gains, the majority of global nickel supply is still producing at a loss but little capacity has been pressured out of the market given recovery expectations. Nickel demand growth will remain strong, particularly in the stainless steel sector (largest end use) where there is an increasing preference for more nickel-intensive 300-series stainless.

Chart 4



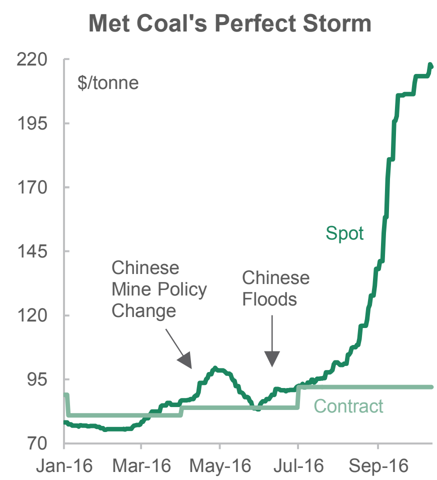
Source: WBMS, LME, SHFE, Comex, Scotiabank Economics.

Copper, now in its sixth consecutive year of surplus supply, is likely to experience 2-3 more years of sustained price pressure before eventually benefiting from anticipated mine deficits around the end of the decade. Copper prices are forecast to remain flat at $2.20/lb through 2018. A wave of new supply has hit the market at the same time that demand growth has moderated, and further capacity additions are expected over the coming two years. With prices settling roughly around cash (plus sustaining capex) costs, there is little reason at present for producers to cut output, but there is also little incentive to invest in new production capacity, raising the odds of a deficit and price spike around the turn of the decade.

Iron ore prices are expected to remain under pressure as a wave of new supply comes on stream in line with previously committed project expansions. We expect prices to gradually slip over the next 2-3 years, **from $50/t in 2016 to $47 in 2017 and $45 in 2018**, as the market adjusts to this growth in mine supply. Given the current low-price environment, major producers are easing the ramp-ups of their new capacity additions, hoping to keep costs low and prevent prices from dropping further (e.g. Vale's 90 Mt S11D mine in Brazil may only be ramped to 75 Mt until prices recover).

Metallurgical (met) coal, an important input for steel production, has been the stand-out surprise of 2016, with spot prices spiking above $200/t compared to a Q3 contract price of $92/t and the sub-$80/t spot lows witnessed earlier this year (chart 5). The impetus for these price gains was a perfect storm of supply disruptions to Chinese steel producers: a government decision to reduce the number of allowable working days at domestic coal mines to 276 per year from 330 previously as part of Beijing's ongoing supply rationalization strategy, with supply losses compounded by significant domestic flooding in June that reduced the availability of inland coal shipments to coastal steel mills and other global output disruptions that further tightened uncommitted tonnage. Less domestic supply pushed Chinese steel-makers onto the thin seaborne spot market, which had a material impact on prices. We expect the period of $200+/t prices to be relatively short-lived as idled or shuttered mines — primarily in Australia and North America — are reopened to capture high margins, and demand is likely to suffer given the erosion of steel producer profitability. **Met coal prices are forecast to average $125/t in 2016, $140 in 2017, and $120 in 2018**.

Chart 5



Source: Bloomberg, Scotiabank Economics.

Gold has experienced renewed strength in 2016 as global yields and future expectations continued to drift lower, with an additional and classic political risk boost on the back of the U.K.'s 'Brexit' referendum vote in June. The future path for gold remains uncertain, supported by rising political uncertainty (multiple European elections and referenda as well as the prospect of an upset in the U.S. presidential election) and blunted by the gradual pressure of anticipated U.S. interest rate normalization. **Gold prices are expected to average $1260/oz in 2016, $1300 in 2017, and $1300 in 2018**.

Table 1 — Commodities

	2000-2015			Annual Average		
	Low	Avg.	High	2016f	2017f	2018f
WTI Oil (US$/bbl)	17	64	145	44	53	57
Brent Oil (US$/bbl)	18	67	146	45	54	58
Nymex Natural Gas (US$/mmbtu)	1.75	5.09	15.38	2.40	3.30	3.50
Copper (US$/lb)	0.60	2.36	4.60	2.20	2.20	2.20
Zinc (US$/lb)	0.33	0.81	2.10	0.85	1.25	1.55
Nickel (US$/lb)	2.00	7.45	24.58	4.30	4.75	6.00
Aluminium (US$/lb)	0.56	0.87	1.49	0.72	0.73	0.74
Iron Ore (US$/tonne)	17	68	187	50	47	45
Metallurgical Coal (US$/tonne)	39	127	330	125	140	120
Gold, London PM Fix (US$/oz)	256	845	1,895	1,260	1,300	1,300

Capital Markets

FISCAL *VERSUS* MONETARY POLICY?

The intertwined risks facing monetary and fiscal policy and the U.S. election significantly overhang our market views. Assumptions we have made on them influence our U.S. yield curve forecasts shown on the next page, and by corollary other richly valued asset classes like stock markets (chart 1).

First, will the U.S. election result in the implementation of aggressive fiscal action that could prove to be destabilizing to bond markets over time and thus possibly halt the Federal Reserve's policy tightening in its tracks? The U.S. election's effects on the bond market significantly stem from the magnitude and composition of potential fiscal expansion following the U.S. election. Estimates of the impact are highly sensitive to a) who wins, b) what truly gets proposed, c) what may pass through Congress after years of budgetary stalemates, d) assumptions on so-called multiplier effects upon economic growth and hence some degree of self-financing revenue gains, and e) uncertainty on the connection between deficits and rates. Chart 2 uses the CBO's long-term base case forecasts for the U.S. government's budgetary balance and debt as a starting point and then incorporates GOP candidate Donald Trump's fiscal policy proposals because they are the more extreme illustration of the risks that could follow the election. By 2026, up to an additional US$10 trillion in debt could be added to the U.S. government's finances and the deficit-to-GDP ratio could double. For our base case assumptions we have gone with much more limited fiscal policy assumptions.

The reason this issue matters by way of forecast risks, however, is because of evidence that sizeable increases in deficits may impact bond yields and thus trickle through to the real economy and impact broader asset classes. Hubbard et al (here) estimate that every one percentage point rise in the U.S. debt/GDP ratio raises inflation-adjusted borrowing costs by 2-3 bps. Orszag and Gale (here) estimated that the same rise in debt would cause a 2-7 bps rise in rates.

Clearly U.S. borrowing costs did not go up as these estimates — that were heavily rooted in pre-crisis realities — would have suggested in response to the doubling of the debt/GDP ratio from 2007 to today. Deleveraging across the private sector of the economy helped to make room for this public borrowing and we anticipate only a modest acceleration in private debt growth over our forecast horizon. A rate shock was also avoided because of central bank actions.

This turns the attention to the importance of central bank commitment to ongoing stimulus measures. If a large jump in public debt issuance were to be repeated absent further private sector deleveraging while global central banks also waver then the consequences for the bond market could be quite destabilizing. Central bankers should, therefore, see limits to what they ask for from governments.

We assume that the Federal Reserve raises rates at a moderate pace that is aided by fiscal policy, the ECB extends asset purchases beyond the currently planned expiration in March of next year, and scarcity of supply of tradeable fixed income instruments will get worse in the medium term with more supply taken off

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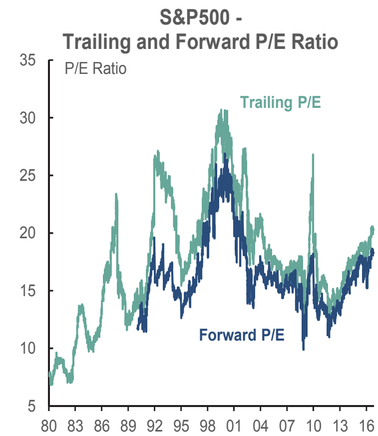
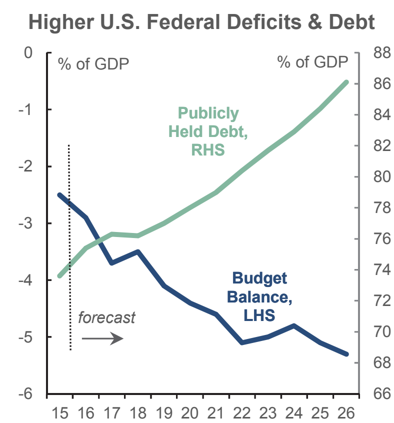
Chart 1



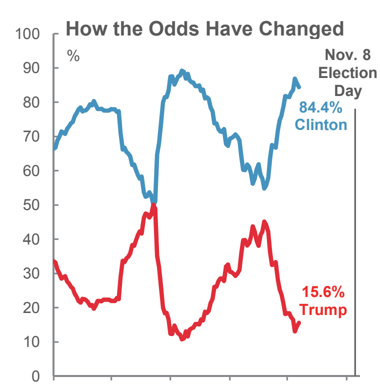
Source: Scotiabank Economics, Bloomberg

Chart 2



Source: U.S. Congressional Budget Office.

Chart 3

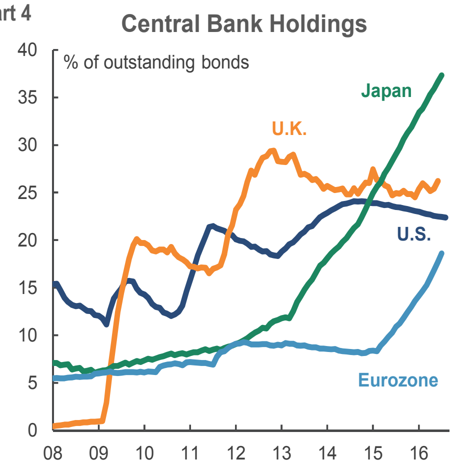


Source: Scotiabank Economics, FiveThirtyEight (Updated October 14, 2016).

market onto global central bank balance sheets including those of the Bank of England and the Bank of Japan (chart 4). These fairly moderate assumptions may occur against the backdrop of traditional USD gains post-election (chart 5).

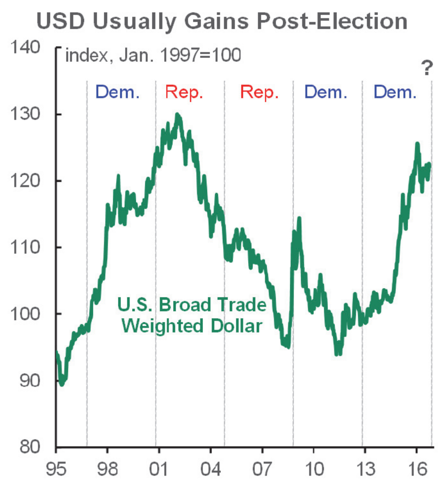
Canadian markets will be significantly driven by such global factors, but the country is more advanced in the debate. The current majority government does not face another election until October 2019. A moderate amount of fiscal stimulus has already been introduced, with more likely to come. This should take some of the pressure off the Bank of Canada and allow it to emphasize a long pause with moderate risk of further rate cuts in future. We expect Canadian government bond yields to remain below the U.S. in part due to weaker growth drivers, a more mature household cycle that may cap Canadian inflation while U.S. inflation gently rises, and more restricted long-term issuance of government bonds.

Chart 4



Source: Scotiabank Economics, Bank of Japan, ONS, FRBNY, US Treasury, ECB.

Chart 5



Source: Scotiabank Economics, Bloomberg.

Table 1 — Scotiabank Economics' Canada-U.S. Yield Curve Forecast

	2016				2017 (end of quarter, %)				2018			
Canada	**Q1**	**Q2**	**Q3**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
BoC Overnight Target Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25
Prime Rate	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.95	2.95	3.20	3.20	3.45
3-month T-Bill	0.45	0.49	0.53	0.50	0.50	0.50	0.55	0.80	0.85	1.05	1.10	1.30
2-year Canada	0.54	0.52	0.52	0.60	0.65	0.75	0.85	1.05	1.25	1.45	1.60	1.70
5-year Canada	0.68	0.57	0.62	0.75	0.90	1.05	1.20	1.35	1.50	1.65	1.80	1.85
10-year Canada	1.23	1.06	1.00	1.15	1.25	1.30	1.45	1.55	1.75	1.90	2.00	2.05
30-year Canada	2.00	1.72	1.66	1.80	1.85	1.95	2.05	2.20	2.30	2.35	2.40	2.45
United States	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
Fed Funds Target Rate	0.50	0.50	0.50	0.75	0.75	1.00	1.25	1.50	1.50	1.75	1.75	2.00
Prime Rate	3.50	3.50	3.50	3.75	3.75	4.00	4.25	4.50	4.50	4.75	4.75	5.00
3-month T-Bill	0.20	0.26	0.27	0.55	0.55	0.80	1.05	1.25	1.30	1.55	1.60	1.80
2-year Treasury	0.72	0.58	0.76	0.90	1.00	1.15	1.30	1.50	1.65	1.80	1.95	2.05
5-year Treasury	1.20	1.00	1.15	1.30	1.35	1.45	1.60	1.80	2.00	2.10	2.20	2.30
10-year Treasury	1.77	1.47	1.59	1.80	1.85	1.90	2.00	2.10	2.30	2.40	2.50	2.55
30-year Treasury	2.61	2.28	2.31	2.50	2.55	2.60	2.65	2.75	2.80	2.85	2.90	2.95

Foreign Exchange

USD RALLY EXPECTED TO EXTEND INTO 2017

We remain constructive on the **U.S. dollar (USD)** outlook moving into the end of the year and into 2017. We expect a 25bps Fed tightening in December to support the USD and a further increase in U.S. rates to underpin broad gains well into 2017. We anticipate another three ¼ point hikes in 2017 whereas the short end of the yield curve has barely priced in one 25bps tightening over the coming 12 months. The U.S. presidential election is liable to sustain market volatility through early November but, assuming a likely win for Hillary Clinton, as current polling suggests, we expect the USD to strengthen on the expectation that the election result will not deflect the Fed from its tightening path. Widening short-term rate spreads will support the USD moving into next year versus its major currency peers. In the longer-term, we expect the USD's mature-looking secular bull trend to moderate in late 2017 as the Fed policy rate nears neutral and other central banks tilt away from accommodative policy settings.

The **pound (GBP)** remains a clear concern for FX investors. The GBP under-performed in Q2 on the Brexit referendum outcome and was the weakest G-10 currency in Q3 as investors considered the implications of the decision. Q4 has started inauspiciously for the GBP, with U.K. government adopting an aggressive position on Brexit negotiations and the GBPUSD suffering a "flash crash" early in October as the market broke under 1.25 in thin, Asian trading, driving the pound more than 6% lower in a matter of minutes before it stabilized. Extended weakness reflects the GBP pattern of adjustment to previous domestic shocks (down 25% following the 2008 financial crisis and down 20% following its Exchange Rate Mechanism exit in 1992). More losses look likely as investors consider the risks and consequences of a no-compromise, so-called "hard Brexit" on the economy. The Bank of England, meanwhile, does not appear overly concerned by the GBP's plight and may only attempt to stabilize the exchange rate in the event of markets turning disorderly (for more than a few minutes) or if domestic inflationary pressures rise as a result of the weak exchange rate. We have lowered our GBPUSD target to 1.20 for early 2017 but feel "overshoot" risks remain significant as investors await the UK government's decision to formally start the EU exit process.

The **euro (EUR)** will weaken versus the USD in response to rising U.S. yields and widening rate differentials. Eurozone-US 2-year bond yield spreads have moved out to a little over 150bps, the largest yield advantage for the USD over the single currency at the short end of the yield curve in ten years and spreads should continue to pressure EURUSD lower towards our 1.05 target through year-end. We see no chance of the European Central Bank reducing stimulus before the planned end to the current asset purchase programme of EUR80bn/month in March 2017. Neither inflationary pressures nor inflation expectations have increased significantly since the ECB programme began. Actually, under these circumstances, an extension of quantitative easing, but incorporating a lower total of monthly asset purchases, seems more likely.

We expect the **Canadian dollar (CAD)** to retain a soft undertone versus the USD in the coming months. Crude oil prices have recovered in response to hopes that OPEC and other oil producers may instill some discipline in output and boost

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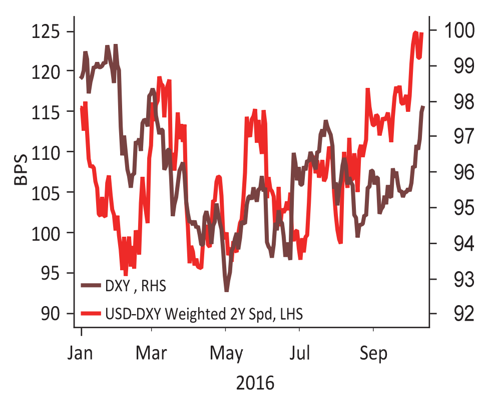
Chart 1

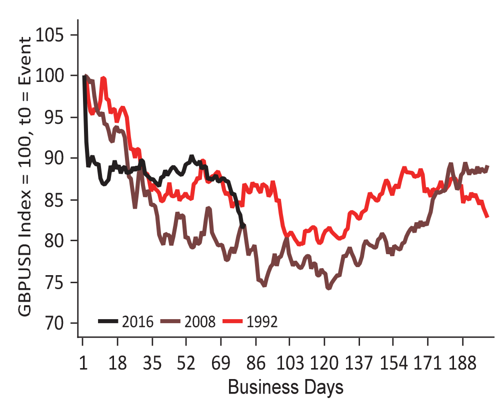
DXY-Weighted Spreads Support USD Gains



Source: Macrobond, Scotiabank FX Strategy

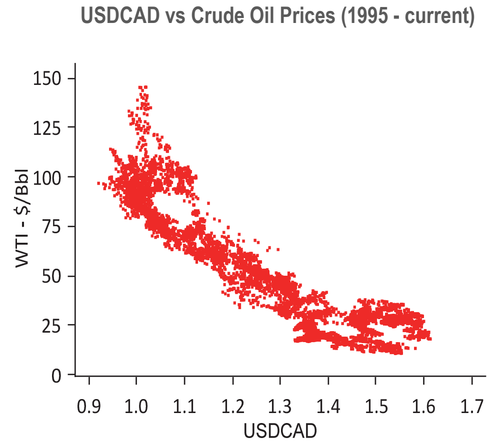
Chart 2

GBP Tracking Previous UK-Centric Adjustments



Source: Macrobond, Scotiabank FX Strategy prices. We do not expect a significant extension of crude oil gains in the coming 12 months but prices holding near $50bbl will help mitigate the impact of rising U.S. interest rates on the CAD to some extent. The CAD retains a fairly consistent, positively correlated relationship with crude oil prices in the longer run. Domestic growth trends remain subdued but we expect the Bank of Canada to remain sidelined until late next year when we anticipate economic momentum, supported by fiscal policy steps, will be sufficient to trigger a 25bps increase in the overnight rate.

Chart 3



Source: Macrobond, Scotiabank FX Strategy

The **yen (JPY)** will under-perform in the longer run. Subdued domestic growth, super-loose monetary policy and poor fiscal dynamics will ensure the JPY remains under pressure in the medium term and suggests that the JPY will not be able to take advantage of an over-extended USD bull run to stabilize or improve in the longer-term. Rising, real long-term yields will help support USDJPY and drive the USD towards the 120 mark through 2018.

For **Asian EM FX**, global risk sentiment, geopolitical tensions and domestic issues will be the primary drivers of performance in near-term. EM Asian currencies will 1) trade in a range on a combination of local political, economic and financial uncertainties and global excess liquidity prior to the U.S. presidential election 2) decline in general versus the dollar in the period between the election and the FOMC meeting scheduled for 13-14 December and 3) rebound broadly following the Fed decision. Geopolitical tensions escalating intermittently on the Korean Peninsula and in Kashmir could undermine the Korean won (KRW) and Indian rupee (INR) respectively.

The KRW, Malaysian ringgit (MYR) and the Singapore dollar (SGD) are the most vulnerable currencies to a Fed rate hike in December. Meanwhile, the high-yielding Indian rupee and the Indonesian rupiah will advance over the medium-term, supported by capital inflows. The death of Thailand's 88-year-old King may cast a shadow over the nation's political and economic outlook and exert downward pressure on the Thai baht (THB).

The USD broke above 6.70 versus the yuan (CNY) in the first session following the CNY joining the IMF's Special Drawing Right basket. While the depreciation pressure on the CNY is likely to intensify in the months ahead, we believe the People's Bank of China will step up efforts to avoid self-reinforcing expectations of CNY depreciation and avert further pressure for competitive devaluations. A relatively stable CNY will be critical in allowing the Fed to raise its benchmark rate in December. Tighter rules on home purchases risks slowing the economy next year and weighing on the CNY value afterwards, however.

With stronger U.S. growth and tighter Fed policy extending into 2017 and 2018, export-driven EM Asian economies will benefit. Meanwhile, global excess liquidity may continue to chase regional assets for higher returns, although possibly to a lesser extent. EM Asian currencies may decline slightly or remain flat in 2017 and post modest gains in 2018.

This has been a volatile few weeks in **Latam FX**, with a number of country-specific themes playing out. In Colombia, the tone soured following the surprise referendum vote that torpedoed the peace deal, but with a combination of firmer oil prices and a quick response by the government to formulate a "Plan B", the peso (COP) looks like its finding its footing. Another factor that could support the COP is fiscal reform, which is expected shortly.

In Mexico, the apparent sudden and sharp fall in support for Donald Trump in the opinion polls has driven a strong move up in the peso (MXN), driving USDMXN back to below 18.0, as perceived risks to NAFTA and other capital flow distortions fade along with the Republican Party's hopes. However, this rebound in the MXN is also likely to affect Banxico monetary policy. The central bank had signaled that the most likely trigger for any additional tightening would be a falling MXN. Adding to MXN support should be the timely bounce in oil which could at least help spark a little more interest in the looming oil block sales — although much depends on how durable the bounce is perceived to be by participants.

Peru and Chile continue display some of the more robust regional FX performances, based on relatively stable copper prices as well as the relative safe-haven status of the two economies. Note, however, that in Chile's case, the loss of net creditor status this year has emerged as a potential source for downward pressure on sovereign ratings.

APPENDIX 1

International	2000-15	2016f	2017f	2018f	2000-15	2016f	2017f	2018f
		Real GDP (annual % change)				Consumer Prices (y/y % change, year-end)		
World (based on purchasing power parity)	3.9	3.0	3.3	3.4				
Canada	2.1	1.2	2.0	1.9	1.9	1.6	2.2	2.1
United States	1.9	1.5	2.2	2.2	2.2	1.6	2.4	2.3
Mexico	2.4	2.4	2.5	2.8	4.5	3.7	3.9	3.8
United Kingdom	1.8	2.0	1.0	1.3	2.2	1.4	2.5	2.0
Euro zone	1.2	1.4	1.3	1.5	1.9	0.8	1.4	1.7
Germany	1.2	1.5	1.2	1.6	1.6	0.9	1.5	1.8
France	1.3	1.2	0.9	1.2	1.7	0.9	1.4	1.6
Russia	4.6	-1.0	1.3	1.4	11.4	7.0	6.3	5.8
China	9.8	6.6	6.2	6.0	2.4	2.0	2.1	2.2
India	7.0	7.5	7.6	7.8	7.2	4.5	5.4	5.7
Japan	0.9	0.6	0.6	0.5	0.0	-0.1	0.7	1.0
South Korea	4.4	2.6	2.8	3.0	2.8	1.2	1.8	2.3
Indonesia	5.6	5.0	5.3	5.5	6.2	3.4	4.5	4.7
Australia	3.0	2.8	2.6	2.5	2.9	1.4	1.9	2.3
Thailand	4.1	3.1	3.2	3.1	2.5	0.8	1.7	2.2
Brazil	3.4	-3.1	1.2	1.7	6.5	7.5	5.3	4.5
Colombia	4.3	2.4	2.8	3.5	5.0	6.5	4.5	3.5
Peru	5.4	3.8	4.0	4.2	2.7	3.0	2.8	2.8
Chile	4.3	1.7	2.0	2.6	3.3	3.3	2.9	2.9

Commodities				
		(annual average)		
WTI Oil (US$/bbl)	64	44	53	57
Brent Oil (US$/bbl)	67	45	54	58
Nymex Natural Gas (US$/mmbtu)	5.09	2.40	3.30	3.50
Copper (US$/lb)	2.36	2.20	2.20	2.20
Zinc (US$/lb)	0.81	0.85	1.25	1.55
Nickel (US$/lb)	7.45	4.30	4.75	6.00
Aluminium (US$/lb)	0.87	0.72	0.73	0.74
Iron Ore (US$/tonne)	68	50	47	45
Metallurgical Coal (US$/tonne)	127	125	140	120
Gold, London PM Fix (US$/oz)	845	1,260	1,300	1,300

APPENDIX 2

North America	2000-15	2016f	2017f	2018f	2000-15	2016f	2017f	2018f
		Canada (annual % change)				United States (annual % change)		
Real GDP	2.1	1.2	2.0	1.9	1.9	1.5	2.2	2.2
Consumer Spending	2.9	2.1	1.8	1.6	2.3	2.7	2.7	2.3
Residential Investment	3.8	3.4	-0.9	-1.1	-0.7	5.4	2.9	3.0
Business Investment	2.5	-6.4	1.9	3.6	2.4	-0.6	2.6	3.6
Government	2.3	1.7	2.0	1.7	1.0	0.9	0.9	1.1
Exports	1.3	0.6	2.8	4.0	3.8	0.0	2.8	3.1
Imports	3.0	-0.9	2.6	3.3	3.5	1.0	3.8	3.7
Nominal GDP	4.3	1.9	4.3	4.0	4.0	2.9	4.3	4.2
GDP Deflator	2.2	0.7	2.3	2.0	2.0	1.4	2.0	2.0
Consumer Price Index	2.0	1.5	2.1	2.1	2.2	1.3	2.2	2.4
Core CPI	1.8	2.0	2.0	2.0	2.0	2.3	2.3	2.3
Pre-Tax Corporate Profits	3.9	-9.0	7.0	5.0	5.9	-2.1	5.0	3.0
Employment	1.4	0.6	0.8	0.8	0.6	1.7	1.4	1.3
Unemployment Rate (%)	7.1	7.0	6.9	6.8	6.3	4.9	4.8	4.8
Current Account Balance (C$, US$ bn.)	-13.2	-69.3	-58.5	-49.1	-521	-494	-517	-548
Merchandise Trade Balance (C$, US$ bn.)	28.4	-34.0	-27.2	-20.7	-668	-753	-804	-856
Federal Budget Balance (FY, C$, US$ bn.)*	-2.9	-1.0	-30.0	-32.0	-529	-538	-565	-615
per cent of GDP	-0.2	0.0	-1.5	-1.5	-3.8	-2.9	-2.9	-3.0
Housing Starts (thousands, mns)	199	195	185	182	1.27	1.17	1.30	1.35
Motor Vehicle Sales (thousands, mns)	1,639	1,955	1,945	1,930	15.4	17.5	17.8	17.9
Industrial Production	0.5	-0.6	1.8	1.6	0.8	-0.7	2.5	2.0
		Mexico (annual % change)						
Real GDP	2.4	2.4	2.5	2.8				
Consumer Price Index (year-end)	4.5	3.7	3.9	3.8				
Current Account Balance (US$ bn.)	-15.8	-30.5	-27.5	-28.4				
Merchandise Trade Balance (US$ bn.)	-6.8	-15.1	-6.9	-8.0				

* FY16 & FY17: ex year-end spending timing adjustments.

Quarterly Forecasts	2016				2017				2018			
Canada	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Real GDP (q/q, ann. % change)	2.5	-1.6	3.5	1.8	2.0	2.1	2.0	2.0	1.9	1.9	1.8	1.8
Real GDP (y/y, % change)	1.2	0.9	1.2	1.5	1.4	2.4	2.0	2.0	2.0	2.0	1.9	1.9
Consumer Prices (y/y, % change)	1.5	1.6	1.3	1.6	1.9	1.9	2.3	2.2	2.1	2.1	2.1	2.1
Core CPI (y/y % change)	2.0	2.1	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
United States												
Real GDP (q/q, ann. % change)	0.8	1.4	2.8	2.0	2.2	2.3	2.3	2.2	2.2	2.2	2.1	2.1
Real GDP (y/y, % change)	1.6	1.3	1.5	1.8	2.1	2.3	2.2	2.3	2.2	2.2	2.1	2.1
Consumer Prices (y/y, % change)	1.1	1.1	1.2	1.6	2.0	2.1	2.2	2.4	2.3	2.3	2.3	2.3
Core CPI (y/y % change)	2.3	2.2	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3

APPENDIX 3

	2016		2017				2018			
Central Bank Rates	Q3	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Americas				(%, end of period)						
Bank of Canada	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25
U.S. Federal Reserve	0.50	0.75	0.75	1.00	1.25	1.50	1.50	1.75	1.75	2.00
Bank of Mexico	4.75	5.00	5.25	5.50	5.75	6.00	6.00	6.00	6.00	6.00
Central Bank of Brazil	14.25	14.00	13.50	13.00	12.50	11.50	11.00	10.50	10.00	9.50
Bank of the Republic of Colombia	7.75	7.75	7.75	7.75	7.50	7.25	6.75	6.50	6.50	6.00
Central Reserve Bank of Peru	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25
Central Bank of Chile	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.75	4.00	4.25
Europe										
European Central Bank	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Bank of England	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Swiss National Bank	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75
Asia/Oceania										
Reserve Bank of Australia	1.50	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.50	1.75
Bank of Japan	-0.10	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15
People's Bank of China	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
Reserve Bank of India	6.50	6.25	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Bank of Korea	1.25	1.25	1.00	1.00	1.00	1.00	1.00	1.25	1.25	1.50
Bank Indonesia	5.00	4.75	4.50	4.50	4.50	4.50	4.50	4.75	4.75	5.00
Bank of Thailand	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.75	1.75	2.00
Currencies & Interest Rates										
Americas			(end of period)							
Canadian Dollar (USDCAD)	1.31	1.33	1.30	1.30	1.25	1.25	1.25	1.25	1.22	1.22
Canadian Dollar (CADUSD)	0.76	0.75	0.77	0.77	0.80	0.80	0.80	0.80	0.82	0.82
Mexican Peso (USDMXN)	19.39	19.50	19.44	18.91	18.78	19.04	19.14	18.96	19.01	19.28
Brazilian Real (USDBRL)	3.26	3.30	3.50	3.50	3.55	3.60	3.50	3.50	3.60	3.70
Colombian Peso (USDCOP)	2882	2950	3000	3100	3125	3150	2750	2750	2750	2750
Peruvian Nuevo Sol (USDPEN)	3.38	3.35	3.36	3.32	3.33	3.35	3.23	3.22	3.20	3.19
Chilean Peso (USDCLP)	657	677	676	675	675	674	652	652	652	651
Europe										
Euro (EURUSD)	1.12	1.05	1.05	1.05	1.10	1.12	1.12	1.12	1.15	1.15
U.K. Pound (GBPUSD)	1.30	1.21	1.20	1.20	1.25	1.25	1.30	1.30	1.35	1.35
Swiss Franc (USDCHF)	0.97	1.05	1.06	1.06	1.02	1.00	1.00	1.00	0.97	0.98
Swedish Krona (USDSEK)	8.58	8.80	9.00	8.45	8.20	8.05	8.05	8.05	8.05	7.67
Norwegian Krone (USDNOK)	7.98	8.30	8.20	8.20	8.00	8.00	7.80	7.60	7.40	7.20
Russian Ruble (USDRUB)	62.9	68.5	68.0	67.5	67.0	66.5	68.0	67.5	67.0	66.5
Asia/Oceania										
Japanese Yen (USDJPY)	101	105	110	110	115	115	117	117	120	120
Australian Dollar (AUDUSD)	0.77	0.75	0.73	0.73	0.72	0.72	0.72	0.72	0.75	0.75
Chinese Yuan (USDCNY)	6.67	6.70	6.70	6.75	6.75	6.80	6.80	6.82	6.82	6.85
Indian Rupee (USDINR)	66.6	67.5	66.5	67.0	67.0	67.5	67.0	67.0	66.0	66.0
South Korean Won (USDKRW)	1101	1140	1120	1140	1140	1150	1140	1140	1120	1120
Indonesian Rupiah (USDIDR)	13042	13100	13000	13250	13250	13300	13250	13250	13100	13100
Thai Baht (USDTHB)	34.6	36.0	36.0	36.5	36.5	37.0	36.5	36.5	36.0	36.0
Canada (Yields, %)										
3-month T-bill	0.53	0.50	0.50	0.50	0.55	0.80	0.85	1.05	1.10	1.30
2-year Canada	0.52	0.60	0.65	0.75	0.85	1.05	1.25	1.45	1.60	1.70
5-year Canada	0.62	0.75	0.90	1.05	1.20	1.35	1.50	1.65	1.80	1.85
10-year Canada	1.00	1.15	1.25	1.30	1.45	1.55	1.75	1.90	2.00	2.05
30-year Canada	1.66	1.80	1.85	1.95	2.05	2.20	2.30	2.35	2.40	2.45
United States (Yields, %)										
3-month T-bill	0.27	0.55	0.55	0.80	1.05	1.25	1.30	1.55	1.60	1.80
2-year Treasury	0.76	0.90	1.00	1.15	1.30	1.50	1.65	1.80	1.95	2.05
5-year Treasury	1.15	1.30	1.35	1.45	1.60	1.80	2.00	2.10	2.20	2.30
10-year Treasury	1.59	1.80	1.85	1.90	2.00	2.10	2.30	2.40	2.50	2.55
30-year Treasury	2.31	2.50	2.55	2.60	2.65	2.75	2.80	2.85	2.90	2.95

Fixed Income Strategy (London, Paris)

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Foreign Exchange Strategy