

United States

GROWTH HAS PEAKED

- Fiscal stimulus and efforts to pull trade forward to avoid new duties are papering over the incipient damage from tariffs and inconsistent policy-making. Real GDP growth in 2018 remains on track toward 2.9% for the year, the fastest annual expansion since 2015 and well above our 2.0% estimate of underlying potential. As 2018's government-induced spike fades, growth is expected to taper rapidly toward potential by 2020.
- On pure momentum, the US's post-2008 expansion is on-track to become the longest in the country's post-war history by mid-2019. The main threat to the US outlook remains the possibility of increased protectionism.

COOLING BEGINS, BUT STILL ON-TRACK FOR RECORD-LONG EXPANSION

The US continues to lead major developed market growth, tracking 2.9% in 2018, as a result of the late-cycle fiscal boost it has received from federal tax changes and additional public spending during 2018. While this additional expansionary impulse is expected to wane going into 2019—with US growth projected to decelerate to 2.4% in 2019 and 1.7% in 2020—the US economy is not forecast to head into recessionary territory in our forecast horizon given that the sources of growth are widely spread across the major components of the US economy (chart 1).

Our baseline forecasts incorporate a move to boost the 10% duty imposed on September 24 on 'phase II' of USD 200 bn of annual US imports from China to 25% on January 1, 2019 (chart 2). In our forecasts, 25% US tariffs on USD 250 bn of Chinese imports shave at least 0.1 ppts from headline growth in 2019.

Under our baseline forecasts, we do not expect Washington to impose further duties on the remaining USD 267 bn of 'phase III' imports it takes in annually from China. About a third of this last tranche of tariffs would hit a range of popular consumer goods just as the White House would be preparing for the 2020 elections.

On the US economy's current policy mix and growth trajectory, we forecast that the Fed will raise the upper bound of its target fed funds rate from its current 2.25% to a peak of 3.25% by Q3-2019. See the [US & Canadian Monetary Policy & Capital Markets](#) report for our view on North American policy rates and yields.

GROWTH PROSPECTS CONTINGENT ON TRADE POLICY

Growth continues to advance robustly above underlying potential and remains broadly-based, with the trade deficit providing the only substantial dampener on the GDP expansion. After US growth clocked in at 2.2% in Q1 and 4.2% in Q2 q/q annualised—the fastest expansion in four years—we expect it to average around 2.8% q/q in the second half of 2018 (table 1). Post-hurricane reconstruction should provide a small addition to growth in Q4 and Q1-2019, but does not otherwise affect our outlook. The conclusion of the successor to NAFTA—the US-Mexico-Canada Agreement (USMCA)—has little material impact

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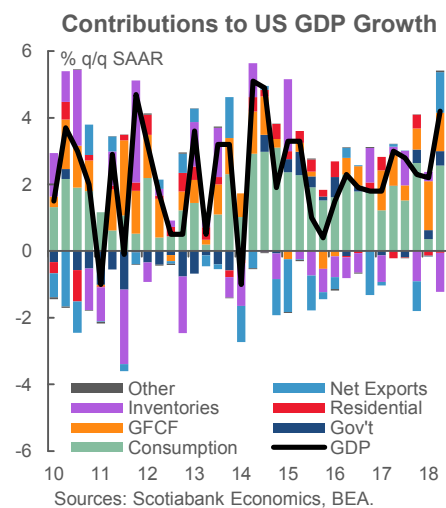
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United States	2017	2018f	2019f	2020f
Real GDP (annual % change)	2.2	2.9	2.4	1.7
CPI (y/y %, eop)	2.1	2.4	2.2	2.1
Central bank policy rate (% eop)	1.50	2.50	3.25	3.25
Canadian dollar (USDCAD, eop)	1.26	1.28	1.22	1.22

Source: Scotiabank Economics.

Chart 1



on our growth outlook as it had been anticipated in our prior baseline.

Fed Chair Jerome Powell noted on October 2 that “there’s no reason to think this cycle can’t continue for quite some time, effectively indefinitely.” But this doesn’t mean growth won’t slow heading into 2019 as the effects of this year’s fiscal stimulus begin to dissipate. Real GDP growth is expected to decelerate to 1.8% q/q annualised by Q4 of 2019 and to a below-potential 1.5% by Q4-2020 (table 1 again).

The US growth outlook remains contingent on the future imposition of tariffs on China and other trade partners.

A decision to follow through on Phase III of 25% tariffs on Chinese imports would knock at least another 0.1 ppts from our forecast for growth in 2019.

TIGHT LABOUR MARKETS, BUT RELATIVELY MODERATE WAGE GAINS

US labour markets continue to advance with the lowest unemployment rate since 1970 and hiring averaging around 200k positions each month. With the ratio of job-seekers to vacancies near all-time lows, quit rates at 17-year highs, and still-strong hiring intentions outside of industries directly hit by tariffs, the Fed’s wage growth tracker should remain at or above 3% y/y in the coming quarters.

Consumption was variable in the first half of 2018, with a poor 0.5% q/q expansion in Q1 succeeded by a breakout 3.8% q/q annualised growth rate in Q2 (table 2). With inflation nearly on par with nominal wage increases, consumption growth is expected to remain solid, but come down below 2.0% q/q annualised through 2019 as federal fiscal stimulus wanes, households continue modest efforts to raise their savings, and higher interest rates dampen purchases of big-ticket items that usually require financing. Auto sales, typically sensitive to interest rates and oil prices, continue to show signs of having peaked at last year’s record level of 17.0 mn units and are not expected to go any higher in 2018–19 owing to higher borrowing costs (table 2 again).

Chart 2

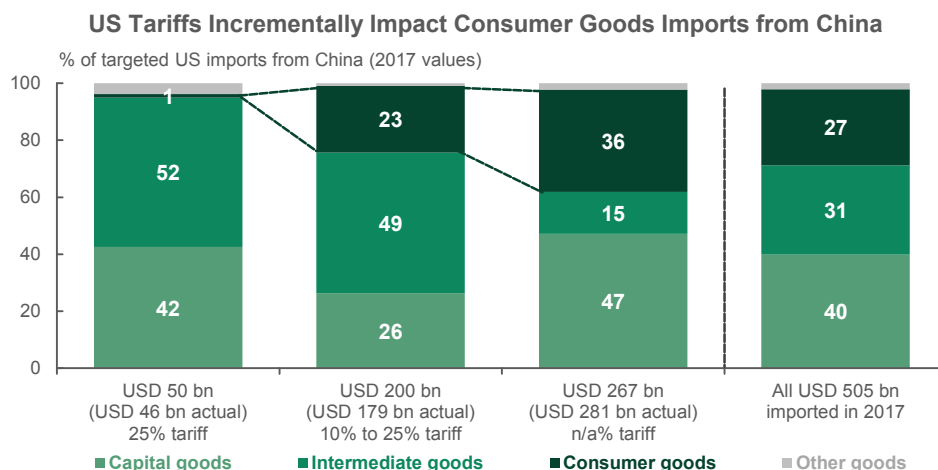


Table 1

Quarterly US Forecasts	2018		2019				2020			
	Q3e	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic										
Real GDP (q/q ann. % change)	3.2	2.5	2.1	2.0	1.9	1.8	1.7	1.7	1.6	1.5
Real GDP (y/y % change)	3.0	3.0	3.0	2.4	2.1	1.9	1.9	1.8	1.7	1.6
Consumer prices (y/y % change)	2.6	2.4	2.2	2.2	2.2	2.2	2.1	2.1	2.0	2.1
CPI ex. food & energy (y/y % change)	2.2	2.3	2.1	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Core PCE deflator (y/y % change)	2.1	2.1	2.2	2.2	2.2	2.1	2.1	2.0	2.0	2.0
Financial										
Euro (EURUSD)	1.16	1.20	1.22	1.24	1.26	1.30	1.30	1.30	1.32	1.32
U.K. Pound (GBPUSD)	1.30	1.32	1.32	1.35	1.37	1.40	1.42	1.42	1.45	1.45
Japanese Yen (USDJPY)	110	110	110	110	108	108	107	107	105	105
Fed Funds Rate (upper bound, %)	2.25	2.50	2.75	3.00	3.25	3.25	3.25	3.25	3.25	3.25
3-month T-bill (%)	2.20	2.45	2.70	2.95	3.20	3.20	3.20	3.20	3.20	3.20
2-year Treasury (%)	2.82	3.00	3.00	3.10	3.30	3.30	3.30	3.30	3.30	3.30
5-year Treasury (%)	2.95	3.15	3.05	3.15	3.35	3.35	3.40	3.40	3.45	3.45
10-year Treasury (%)	3.06	3.25	3.15	3.20	3.40	3.40	3.50	3.50	3.55	3.55
30-year Treasury (%)	3.21	3.40	3.30	3.30	3.50	3.50	3.60	3.60	3.65	3.65

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

RISING HOME PRICES, BUT FALLING SALES

Home prices continue to climb across the US. The national Case-Schiller Home Price Index rose (nsa y/y) for the 78th consecutive month in July, though it remained more than 11% below the peak achieved in 2006 on an inflation-adjusted basis (chart 3). The National Association of Realtors' (NAR) housing affordability index has sat at or near its lowest level since 2008 throughout 2018 in all four major US areas surveyed; however, affordability is better than it was during much of the period prior to the 2008 global financial crisis (chart 4)

Falling home sales—reflected in a national-level 1.9% y/y ytd decline in purchases of existing homes through August plus decreases in every region but the South—are a consequence of rising prices and relatively limited supply. Weakness is concentrated amongst lower-end houses, while homes valued below USD 250k are driving the bulk of the sales declines amongst existing properties. This is occurring even as the late-cycle economic expansion is generating the aforementioned wage gains for lower-income earners (chart 5). Reductions to the ceiling for interest deductions on new mortgages and the cap on state and local income tax exemptions introduced in January may also be leading to some weakness in home sales.

Rising bond yields are also contributing to weak affordability and home sales activity. The average 30-year fixed mortgage rate has recently hovered around a seven-year high. Higher rates continue to discourage existing owners from undertaking refinancing and move-up purchases, leaving a dearth of available inventory on the lower-end of the market.

We expect an exacerbation of the existing housing supply shortfall to push prices higher, further weakening affordability and home sales. Housing starts averaged 1.27 mn units (SAAR) as of August this year—a pace that, if maintained, would represent a post-recession high—but this is well short of the 1.5–1.6 mn units associated with the existing level of underlying demand. We expect starts to moderate to 1.25–1.26 mn units over 2019–20, with job creation and household incomes forecast to ease across the country, and three Fed rate hikes over 2018–19 likely to weigh on building activity.

Rising material costs may also discourage residential construction. Builder confidence, as measured by the National Association of Home Builders (NAHB) index, has firmed up. Yet, rising construction costs, often cited lately as a challenge for builders, should be exacerbated by recently announced US tariffs on Chinese imports. We expect lumber prices to remain at historically elevated levels in the USD 350–400 range throughout the forecast period, though the early-2018 spike in lumber costs appears to have faded and will likely be increasingly absorbed by an appreciating US dollar.

MANUFACTURING CONTINUES TO POST GAINS

The US manufacturing sector is forecast to post its steepest annual increase since 2011 this year, which will be followed by a robust, though softer expansion in 2019. Amidst post-recession highs in consumer and business optimism stemming from the aforementioned solid employment growth and recently-legislated

Chart 3

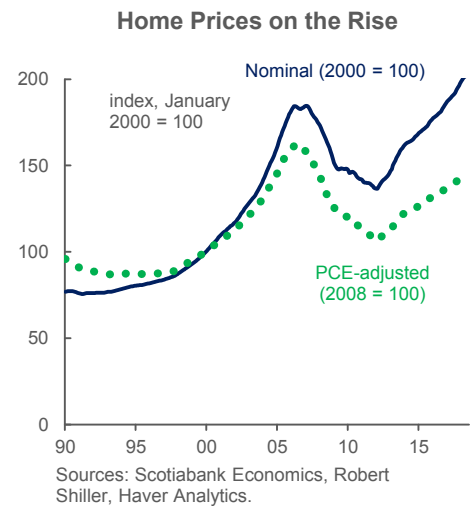


Chart 4

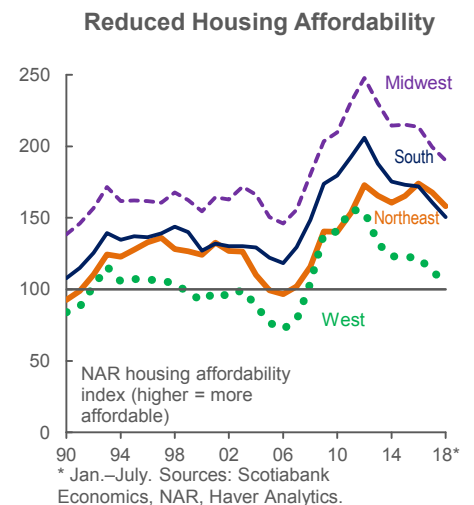
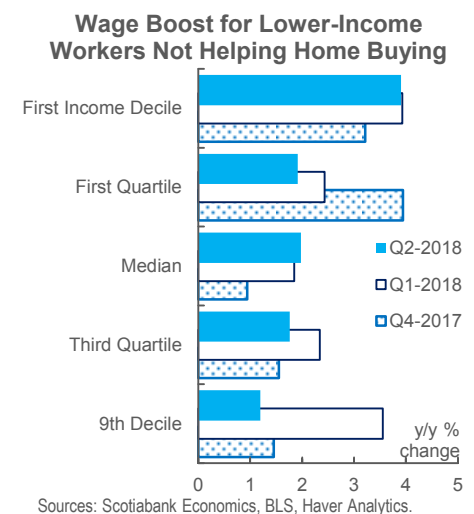


Chart 5



corporate tax cuts, domestic demand for US manufactures has supported robust gains in the industry. However, the intensifying US-initiated trade spat with China is likely to dampen sectoral sales and may pose bigger risks to manufacturing output from spillovers into household and enterprise confidence. Furthermore, despite resilient industry sentiment domestically, the rise of US protectionism has halted recent lifts to business optimism in some of the US's largest trading partners such as the European Union.

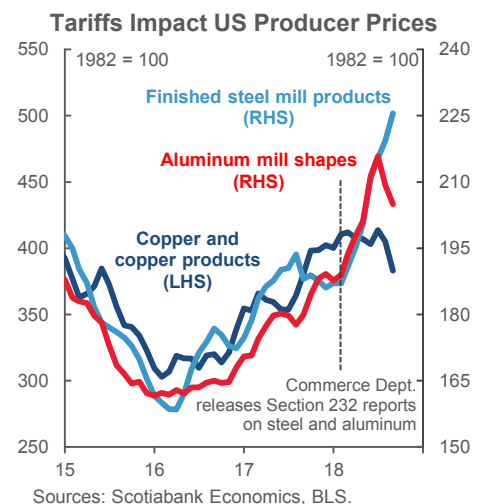
Despite a strong expansion in manufacturing output, operating rates in the manufacturing sector have climbed only slowly since late-2016 and remain around their post-recession averages (chart 6). Private fixed investment in machinery and equipment has increased by 13% in real terms since Q3-2016 after two years of practically flat outlays, and employment in the manufacturing industry is growing at its fastest rate since the mid-90s. This increase in productive capacity in the sector has managed to keep operating pressures at bay, although certain sub-industries have seen a pointed turn-around in operating rates that may be limiting their sales. Owing to the rise in business investment, a surge in demand for machinery has pushed the capacity utilisation rate in the sector from as low as 66% in mid-2016 to 77.8% in August.

Unfilled orders, excluding transportation manufacturing, have posted five consecutive months of 5% or higher year-on-year growth, a first such run since 2012. As manufacturers attempt to keep up with rising demand, inventory levels are slowly lagging shipments with the inventory-to-sales ratio ticking down from 1.44 in February 2016 to 1.34 in August 2018. Adjusted for inflation, manufacturing inventories of finished goods have remained relatively flat for the last two or so years, after rising without pause between 2010 and 2016. This implies that the late-stage economic expansion currently underway has exceeded manufacturers' expectations and led to a lagged response toward increasing their productive capacity.

US import tariffs on both Chinese industrial goods, and various steel and aluminum products, combined with rising demand for materials worldwide, have led to a strong increase in producer prices which may begin to take a toll on corporate profits (chart 7). Prices paid for durable manufacturing inputs have climbed by close to 10% y/y in recent months, nearing the pace observed in 2011. Since December 2017, prices of steel mill products and aluminum mill shapes have increased by 19.5% and 9.2% respectively—close to the corresponding tariff rates of 25% and 10%. In comparison, copper and brass mill shapes have seen a decrease in prices of 5.6% during the same period. Some US automakers have also noted an erosion in profits stemming from the so-called 'national security' metals tariffs. Ford, the second largest automaker in the US, has claimed that the tariffs have cost the company around USD 1 bn in profits. For instance, while prices for electronic equipment in autos have climbed by 0.6% since December, those of motor vehicle bodies and trailers have increased by 3.4% during the same period.

US manufacturers may breathe a sigh of relief over the conclusion of the NAFTA renegotiations, which could be followed by an exemption from the Sec. 232 metals tariffs on steel and aluminum imports from Canada and Mexico. North America accounts for 26% and 42% of all US imports of tariffed steel and aluminum products, respectively. Roughly 67% of total steel and 55% of total aluminum imports were exempt from the initial March imposition of the Sec. 232 tariffs (charts 8 and 9, left-hand sides). By October, these exempt shares had shrunk to 16% and 4% respectively, mainly due to the removal of exemptions for Canada, Mexico, and the European Union. Certain countries then came to agreements with the US to limit their metals shipments to defined quotas. Australia is the only country whose exports are fully exempt from Sec. 232 duties on both steel and aluminum. Over the summer, Argentina, Brazil, and Korea agreed to steel quotas that, across the three countries, averaged 85% of their 2017 exports to the US; these agreements ensure that their current exports continue to enter the US free of tariffs. In the case of

Chart 6

Chart 7


aluminum, 70% of imports from Argentina are also exempt. If Canadian and Mexican steel and aluminum products were also to win exemptions, possibly in exchange for an agreement on quotas of, say, 85% of 2017 flows, the share of US imports exempted from the Sec. 232 tariffs would rise to 41% of total annual imports of steel, and 39% of total annual aluminum imports. If the EU also successfully negotiated an 85% exemption, the exempt share would rise to 59% for steel and 45% for aluminum (charts 8 and 9, right-hand sides).

The newly-negotiated USMCA could lead to an increase in auto parts output in the US owing to the high-wage share requirement for motor vehicles exports. Canada, Mexico, and the US agreed to increase the regional content share requirement in autos from 62.5% to 75%—under a four-year phase-in period beginning in 2020—and incorporated a clause in the new deal that mandates that 40% of the value of a vehicle traded within the region must originate from factories where the average wage is USD 16/hr. Since employees in the Mexican motor vehicle manufacturing sector earn, on average, around USD 3/hr, certain auto producers in Mexico will require a greater share of US, or Canadian, auto parts. However, tighter rules of origin requirements will likely result in higher auto prices due to increased input costs, which could ultimately dent North American competitiveness and see some production moved overseas.

INVESTMENT PEAK AT THE HEART OF ECONOMY-WIDE GROWTH PEAK

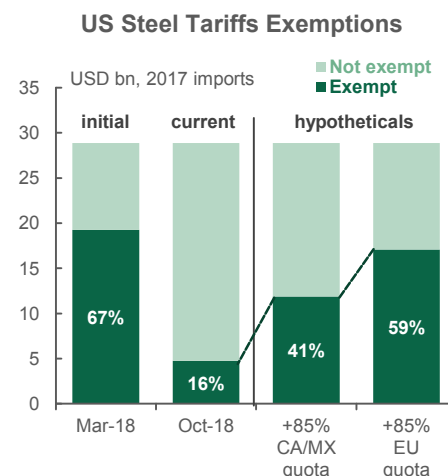
Business investment accelerated in the first half of 2018—capital expenditures came up by 6.7% y/y in Q1 and 7.1% y/y in Q2. We forecast investment to continue at a slower, but still robust, pace in the back half of 2018 as relatively tight labour markets force firms to spend on plant and equipment—rather than chase scarce workers—in order to meet order demand. Mirroring the greater economy's broadly-based growth profile, capital-spending growth was driven by a wider range of activities in the first half of 2018 than in the previous year. The tax incentives provided by Washington at the beginning of the year through full expensing on equipment purchases under the US Tax Cuts and Jobs Act and cuts in corporate income tax rates may also have provided a small boost to some specific forms of investment. Intellectual property investment in H1-2018 surged and contributed as much to investment growth as capital expenditure in the energy sector (see the [Commodities](#) section of *Global Outlook*). For 2018 as a whole, business investment is forecast to register 6.9% growth, its fastest expansion in several years.

Weaker business investment underlies our forecast of moderating growth heading into 2019 and 2020. Annual capital spending growth is forecast to decline to 3.1% and 2.3%, respectively (table 2 again).

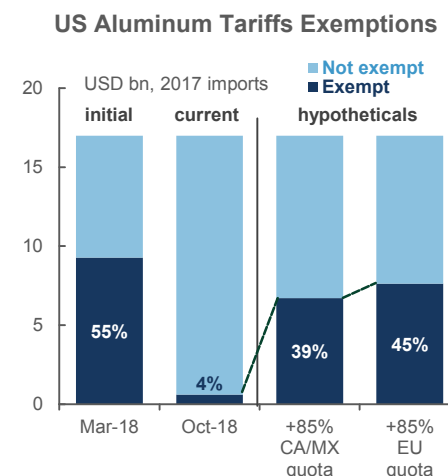
US POLICY DRIVING RECORD TRADE DEFICITS

The Trump Administration's policy stance, with its mix of expansionary tax cuts and increased spending, combined with a strong US dollar, underpins increasing imports and consistently wider US trade deficits with the rest of the world. In the second quarter of 2018, US merchandise export volumes rose by 13.5% q/q annualised, which represented their fastest pace of growth since late-2013. The surge in exports appears to have been boosted by a frontloading of orders from the US ahead of reciprocal tariffs on these goods. Exports of agricultural products and beverages rose by an annualised rate of 110% q/q in real terms. On the other hand, US goods' imports fell by 0.4% q/q.

The US administration's trade conflict with China is set to continue for the foreseeable future as the US has yet to articulate clear demands to which China could respond. Meanwhile, the US trade deficit with China hit a record USD 34 bn in September as the domestic fiscal stimulus continues to fuel imports. The US began charging an additional 10% duty on USD 200

Chart 8


Sources: Scotiabank Economics, US ITC.

Chart 9


Sources: Scotiabank Economics, US ITC.

bn in imports from China in late-September, which is set to rise automatically to 25% on January 1, 2019. US importers may, for now, not feel the pain of the new wave of tariffs on China owing to a depreciation of around 7% in the Chinese yuan year-to-date, which is helping to offset a large share of the tariffs. However, a number of firms may bring forward imports from China before year-end in order to avoid the forthcoming hike in tariffs. As the US administration's tariffs expand to a larger share of imports from China, the impact on consumer prices is set to become more direct. Around 1% of the initial USD 50 bn phase of tariffs comprised consumer goods, compared to 23% in the second phase which notably left out a number of prominent consumer electronics such as smart watches. Consumer goods represent 36% of the remaining third phase of USD 267 bn in US imports from China, which the President has threatened to slap with tariffs if China retaliates to the US's existing duties.

In response to the Administration's tariffs, China has imposed its own duties ranging from five to 10 percent on imports from the US on USD 60 bn worth of goods, on top of an initial USD 50 bn worth of trade which faces 25% duties. China is nevertheless running out of room on tit-for-tat import tariffs measures as the country imported only about USD 150 bn from the US last year. The Chinese authorities may deploy alternative retaliatory non-tariff actions such as efforts to complicate the operations of US multinational enterprises operating in China or by increasing border-processing times for US goods.

Canadian and Mexican motor vehicles and parts exports to the US were granted an exemption up to a specified level of shipments from would-be tariffs under 'national security' concerns. Under USMCA, up to 2.6 mn passenger vehicles and all light trucks from each of Canada and Mexico would be immune from the Section 232 tariffs, if imposed, while up to USD 32.4 bn in Canadian parts and 108 bn in Mexican parts would also be free from these duties. Both the vehicles and parts thresholds are far from current North American export levels to the US and are unlikely to be breached any time soon (chart 10). Passenger vehicle imports from Mexico may touch this ceiling sometime in the latter years of the next decade if they continue on their current growth trajectory. However, by then, a future US administration may be willing to negotiate an increase in this threshold.

CAPITAL REPATRIATIONS LARGE, BUT UNDERPERFORM EXPECTATIONS

US firms repatriated a total of USD 464 bn in the first two quarters of the year in response to the US tax overhaul that gives them the opportunity to claim, and bring home, foreign profits accumulated abroad in exchange for a one-time tax payment. For comparison, the two-quarter total is slightly more than the sum of repatriated profits in the previous four years combined. US corporate income tax reform lowered the tax rate paid on these assets from 35%—the previous corporate income tax rate—to 15.5% on cash and 8% on non-cash or illiquid assets, as the US administration attempts to incentivise domestic investment. Still, the less than half a billion USD in funds—which showed a quarter-on-quarter decrease from USD 295 bn in Q1 to USD 170 bn in Q2 (chart 11)—and any future foreign profits declared are unlikely to satisfy President's Trump's expectations of repatriations "over USD 4 trillion but close to USD 5 trillion". Furthermore, it remains unclear just how large a share of repatriated profits will be invested in firms' US operations or put toward share buybacks. An analysis by the Federal Reserve found evidence that repatriated profits in Q1-2018 resulted in a sharp increase in buybacks amongst the fifteen firms with the most cash abroad compared with the remainder of those listed in the S&P 500; the Fed could not, however, identify a clear increase in capital

Table 2

United States	2000–17	2017	2018f	2019f	2020f
	(annual % change, unless noted)				
Real GDP	2.0	2.2	2.9	2.4	1.7
Consumer spending	2.4	2.5	2.6	2.4	1.8
Residential investment	-0.3	3.3	0.5	1.3	1.9
Business investment	3.0	5.3	6.9	3.1	2.3
Government	1.0	-0.1	1.8	2.3	1.6
Exports	3.7	3.0	4.6	2.3	2.0
Imports	3.7	4.6	4.0	3.0	2.7
Nominal GDP	4.0	4.2	5.4	5.0	4.1
GDP Deflator	1.9	1.9	2.5	2.6	2.3
Consumer price index (CPI)	2.2	2.1	2.5	2.2	2.1
CPI ex. food & energy	2.0	1.8	2.2	2.2	2.2
Core PCE deflator	1.7	1.6	2.0	2.2	2.0
Pre-tax corporate profits	5.3	3.2	6.6	2.8	1.9
Employment	0.7	1.6	1.6	1.2	1.0
Unemployment rate (%)	6.1	4.4	3.9	3.8	3.8
Current account balance (USD bn)	-501	-449	-445	-487	-540
Merchandise trade balance (USD bn)	-680	-807	-848	-904	-974
Federal budget balance (USD bn)	-540	-665	-805	-1,000	-1,045
percent of GDP	-3.7	-3.4	-3.9	-4.6	-4.7
Housing starts (mn)	1.26	1.20	1.27	1.26	1.26
Motor vehicle sales (mn)	15.6	17.0	17.0	16.8	16.7
Industrial production	0.7	1.6	3.5	2.5	2.1
WTI oil (USD/bbl)	62	51	68	72	72
Nymex natural gas (USD/mmbtu)	4.83	3.02	2.93	2.93	2.93

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

expenditures.

FOREIGN APPETITE FOR US DEBT STABLE

China’s holdings of US Treasury (UST) securities have edged down slightly in recent months to USD 1.171 tn from a 2018-high of USD 1.188 tn in March. In light of the tariffs imposed by the Trump Administration on imports from China, there has been speculation over an unwinding of Chinese holdings of USTs in response to US protectionism. China remains the largest holder of US treasuries (USTs) followed by **Japan** at USD 1.035 tn. While the recent decline in Chinese holdings is not significant, China’s share of foreign-held USTs has, however, decreased from as high as 28% in mid-2011 to 19% in July 2018. Still, the US’s public debt has risen from USD 19.9 tn at the beginning of President Trump’s term in January 2017 to USD 21.5 tn in August. The additional USD 1.4 tn in marketable Treasury securities issued during this presidency far exceeds the concurrent USD 0.3 tn increase in foreign holdings of USTs; international investors’ appetite for US debt may be waning slightly.

OUTLOOK REMAINS HIGHLY POLICY DEPENDENT

As we have signalled for the last few quarters, the main threat to what would otherwise be a propitious mix of solid US growth and moderate inflation remains a set of fiscal and trade policy choices by the White House that are pushing the US economy toward excess demand, unpredictable protectionism, and increasing price pressures. Fed Chair Powell recently characterised the current US situation as “a remarkably positive set of economic circumstances” that may be “too good to be true”. Long expansions—and this one is set to become the longest on record—are typically undone by overly stimulative policy decisions that prompt precipitous tightening by monetary authorities. The US outlook continues to hinge on whether the White House validates Chair Powell’s skepticism, or takes a more prudent course on its efforts to remake US trade relations and ensure positive economic conditions into the next electoral cycle.

Chart 10 US Imports of Passenger Vehicles from North America

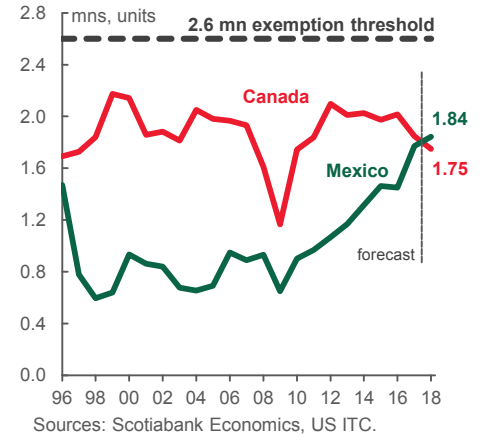
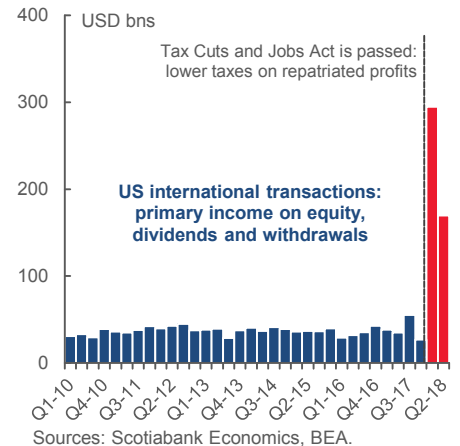


Chart 11 US Firms Repatriate Under USD 500bn in First Half of 2018



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