

Canada

WORKING THROUGH THE SOFT PATCH

- Above-potential growth to resume in Q2 as the factors contributing to the soft patch in 18Q4 and 19Q1 are reversing.
- The sharp improvement in equity markets, a very significant increase in oil prices, continued strength in employment, and rising unfilled orders point to growth momentum as early as 19Q2.
- We don't read too much into the yield curve. The risk of a recession remains very low.

Perhaps the best way to characterize the divergence of views about the Canadian economy is to ask if the glass half full or half empty. Canada is clearly experiencing a soft patch. Growth in the final quarter of 2018 was unquestionably weak. Data so far in the first quarter suggest stronger, though still well-below-potential growth. How long will the soft patch last? Those that think the softness will continue point to signs of slowing growth in the US and Europe, declines in global trade volumes, an inversion of the yield curve, and declines in business and consumer confidence. While these factors are acting to hold back growth to some extent, fundamentals remain generally solid and our models continue to suggest that the probability of a recession in Canada is very low (chart 1). Moreover, a number of factors suggest activity will rebound as early as the second quarter and remain well above our estimate of potential growth (1.7%) through the remainder of the year and into 2020.

The root cause of our optimism lies in the reversal of the factors that led to a reduction in the growth forecast for Canada last fall. At that time, equity markets were correcting sharply on account of worries that the China-US trade war would amplify and that the Federal Reserve was on auto-pilot and would raise rates despite market-based fears that the economy might trip into recession. These concerns led to a global correction in equity markets (chart 2). Canada was not immune to this chill in equity markets. The associated reduction in financial wealth was compounded by weakness in the housing market, which led to declines in housing wealth. The decline in wealth acted as a brake on consumption, but also effectively increased the cost of equity capital for firms looking to invest, while increasing uncertainty about the outlook as a number of observers noted the decline in equity markets was a sure sign of recession to come.

Compounding these factors were acute egress challenges for western Canadian oil, as pipeline capacity remained woefully lacking, in an environment of weakening global oil prices. The net result was a precipitous fall in the price of Western Canadian Select (WCS) in absolute terms and also in relation to international oil benchmarks (chart 3). This too was a wealth shock for the Canadian economy. The Alberta government's response to limit oil production in the province as of January 1 led to a decline in the number of barrels produced in Alberta, even as the industry had started to curtail production of their own accord in the final months of 2018. This too, contributed to the gloominess felt by analysts.

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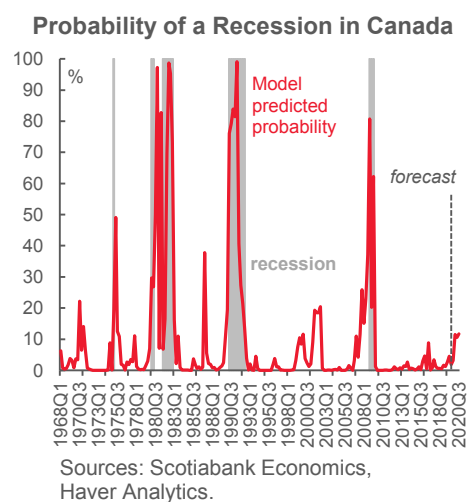
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Canada	2017	2018	2019f	2020f
Real GDP (annual % change)	3.0	1.8	1.6	2.1
CPI (y/y %, eop)	1.8	2.0	1.5	2.0
Central bank policy rate (% eop)	1.00	1.75	2.00	2.25
Canadian dollar (CADUSD, eop)	0.80	0.73	0.78	0.81

Source: Scotiabank Economics.

Chart 1



The decline in equity and housing wealth along with the decline in oil prices and production led us to shave half a percentage point from our Canadian growth forecast in 2019.

What a difference a few months make

Since that major downgrade to Canadian growth, equity markets have roared back and are hovering near all-time highs, and WCS is \$40 higher than the lows hit last November. Both developments are powerful drivers of activity and highlight the temporary nature of the soft patch Canada is experiencing, even though the oil curtailment will have a lasting impact on the number of barrels produced in Alberta. Our current forecast for WCS sees it averaging \$44/bbl in 2019 (it is currently around \$54/bbl), well above the average for 2018 and the highest level since 2014.

According to our model, every 10 percent move in the price of oil adds about 0.1 percentage points to the level of Canadian GDP (chart 4), so the increase relative to last year will have a meaningful impact on growth as we progress through the year. Moreover, if our forecast is overly pessimistic, there is scope for an even greater oil-related bump this year and next in spite of the chronic lack of pipelines.

Looking beyond financial markets, there are quite a few signs of resilience in hard economic data. The Canadian labour market

is on fire, with nearly 50k full-time jobs created in February alone, and nearly 400k jobs created in the last 12 months (chart 5). The availability of labour remains a top concern of businesses, with nearly 40% of firms surveyed by the Bank of Canada reporting labour shortages that are impacting their ability to meet demand. Labour shortages appear to be finally translating into wage pressures, as wage growth has accelerated to its most rapid pace in a year (chart 6).

Taken together, the very strong jobs growth and increasingly rising wages suggest labour income growth is solid and should be supportive of consumption going forward. An early indication of this could be the pick-up in auto sales observed so far this year (chart 7). We expect to see consumption pick up later in 2019 and into 2020. The effect of tightened housing rules and the hangover from past rounds of fiscal stimulus delivered via the Canada Child Benefit should be maturing so that solid wage and income gains, and very strong recent job growth, should begin to drive our projection of an improving consumption outlook into 2020. Consumption spending should also find support from a recent turnaround in household credit growth, which appears to have found its bottom in mid-2018. Residential mortgage borrowing has led a trend pick-up in overall month-on-month credit expansion through February 2019. Household balance sheets remain solid, with high asset-liability ratios, strong equity positions in real-estate holdings, and stable consumer bankruptcies. Moreover, it continues to be the case that less than half of Canadian households have mortgages, which dampens the impact of possible further rate increases by the Bank of Canada. HELOC balances have significantly increased in recent months, outpacing growth in other forms of household credit, but the share of HELOC balances used to finance debt consolidation and repayments has fallen since 2016.

Chart 2



Chart 3

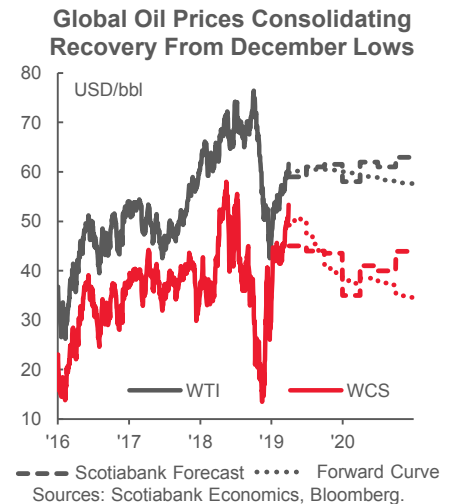


Chart 4

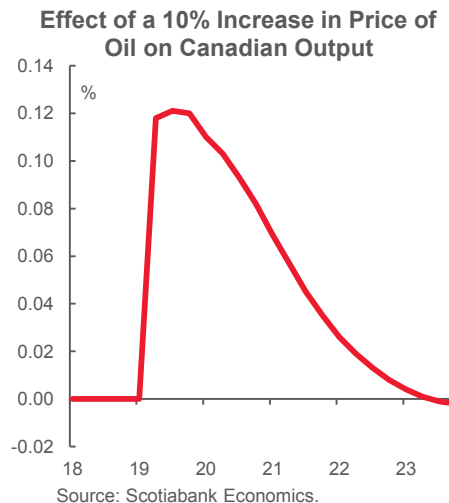
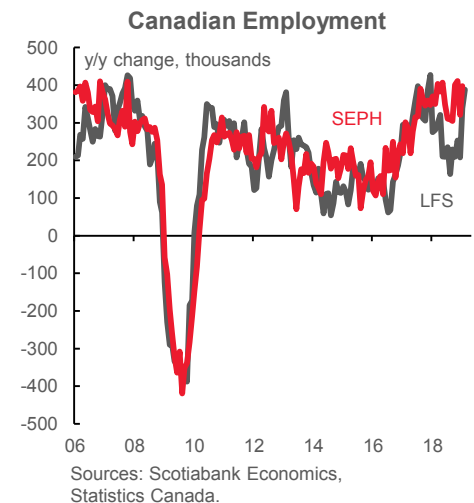


Chart 5



The strength of employment demand likely reflects in part still robust sales combined with serious capacity constraints (chart 8). According to the Bank of Canada once again, nearly 60% of firms they survey report they would have some or significant difficulty in meeting increases in demand. These capacity pressures should trigger greater capital spending by firms, but that has yet to happen as business investment fell in each of the last three quarters of 2018. The proximate cause of this decline in investment appears to be the ongoing egress challenges in the oil patch, along with concerns about the sustainability of the expansion given myriad developments over the last year. To date, firms have been able to tap labour markets to increase production, but with acute labour shortages and wages on the rise, firms are re-thinking the capital to labour mix. As a result, Statistics Canada reports that firms surveyed from September 2018 to January 2019—the period of peak uncertainty—are now planning to increase capital outlays at the most rapid pace since 2014 (chart 9). We are still maintaining a reasonable cautious view on business investment in Canada in 2019 (with growth of 0.5%), but expect that to accelerate significantly in 2020 as natural resource projects pick up.

Chart 6
Canada: Average Hourly Earnings For Salaried Employees



Chart 7
Canadian Vehicle Sales



Chart 8
Canadian Unfilled Orders



Chart 9
Canada Capital Expenditures Intentions vs Actuals

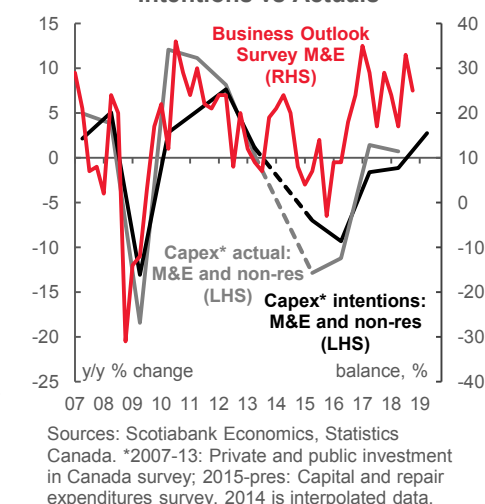


Table 1

Quarterly Canadian Forecasts	2018		2019				2020			
	Q3	Q4	Q1e	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic										
Real GDP (q/q ann. % change)	2.0	0.4	1.1	2.2	2.4	2.4	2.4	1.9	1.5	1.2
Real GDP (y/y % change)	1.9	1.6	1.5	1.5	1.5	2.0	2.3	2.3	2.0	1.7
Consumer prices (y/y % change)	2.7	2.0	1.4	1.4	1.4	1.5	1.8	2.0	2.1	2.0
Avg. of new core CPIs (y/y % change)	2.0	1.9	1.8	1.8	1.8	1.9	1.9	1.9	2.0	2.0
Financial										
Canadian Dollar (USDCAD)	1.29	1.36	1.33	1.32	1.30	1.28	1.25	1.25	1.23	1.23
Canadian Dollar (CADUSD)	0.77	0.73	0.75	0.76	0.77	0.78	0.80	0.80	0.81	0.81
Bank of Canada Overnight Rate (%)	1.50	1.75	1.75	1.75	1.75	2.00	2.00	2.25	2.25	2.25
3-month T-bill (%)	1.58	1.65	1.67	1.75	1.80	2.00	2.05	2.25	2.25	2.25
2-year Canada (%)	2.21	1.86	1.55	1.70	1.80	2.05	2.10	2.30	2.30	2.30
5-year Canada (%)	2.34	1.89	1.52	1.75	1.90	2.10	2.20	2.35	2.35	2.35
10-year Canada (%)	2.43	1.97	1.62	1.80	2.00	2.20	2.35	2.45	2.45	2.45
30-year Canada (%)	2.42	2.18	1.89	2.10	2.20	2.40	2.50	2.75	2.75	2.75

Sources: Scotiabank Economics, Statistics Canada, Bloomberg.

Work on LNG Canada's Kitimat project is expected to add meaningfully to growth as the year progresses, with a peak effect on growth in 2020, at which point we think construction related activity will add about 0.2 percentage points to national growth. Moreover, other firms are now considering adding to their current LNG plans, suggesting some degree of upside risk to activity throughout the forecast horizon.

While we believe signs point to a rebound as early as Q2, there are of course risks that this doesn't happen. Global growth is unquestionably slowing, and risks to the outlook are tilted to the downside. Despite survey evidence suggesting otherwise, firms could hold off on capital spending as they did for much of last year. Our outlook builds in a very modest increase of 0.5% in business investment in 2019 so we aren't counting on that as a driver of growth, but concerns about the outlook and the turbulent political climate in Canada could lead firms to scale back investment further despite their stated intentions. Canadian export performance remains disappointing, and global trade flows suggest little reason for optimism that this will turn around, even though Alberta's oil output will rise through the year. On the household side, even though job growth has been very strong, and there are signs that wage growth is picking up again, debt and debt service remain high, and the housing market remains flat. Given the late stage of the cycle, it may be that households choose to spend income gains on debt reduction rather than consumer goods.

Table 2

Canada	2000–17	2017	2018	2019f	2020f
	(annual % change, unless noted)				
Real GDP	2.1	3.0	1.8	1.6	2.1
Consumer spending	2.9	3.5	2.1	1.5	1.9
Residential investment	3.6	2.4	-2.3	-2.9	2.1
Business investment	2.2	2.2	2.0	0.5	6.8
Government	2.2	2.7	2.7	1.2	1.7
Exports	1.3	1.1	3.3	2.4	2.3
Imports	3.0	4.2	2.9	0.3	3.1
Nominal GDP	4.3	5.6	3.6	2.6	4.6
GDP Deflator	2.1	2.6	1.7	0.9	2.4
Consumer price index (CPI)	1.9	1.6	2.3	1.4	2.0
CPI ex. food & energy	1.6	1.6	1.9	1.8	2.0
Pre-tax corporate profits	0.0	20.1	0.5	-4.7	2.1
Employment	1.4	1.9	1.3	1.6	0.7
Unemployment rate (%)	7.1	6.3	5.8	5.8	5.9
Current account balance (CAD bn)	-18.7	-59.4	-58.7	-60.9	-62.8
Merchandise trade balance (CAD bn)	22.9	-23.9	-21.5	-30.1	-35.5
Federal budget balance* (FY, CAD bn)	-3.6	-17.8	-19.0	-18.1	-19.6
percent of GDP	-0.2	-0.9	-0.9	-0.8	-0.8
Housing starts (000s)	200	220	213	202	200
Motor vehicle sales (000s)	1,678	2,034	1,984	1,930	1,900
Industrial production	0.0	4.9	2.6	0.6	2.2
WTI oil (USD/bbl)	62	51	65	59	61
Nymex natural gas (USD/mmbtu)	4.83	3.02	3.07	2.90	2.90

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

The Provinces

SUMMARY

- As a result of weaker-than-previously anticipated growth in Q4-2018 and Q1-2019, we have edged down our forecast expansions for a number of provinces this year, and modestly raised projected advances for 2020.
- Nevertheless, most provincial economies are still on firm footing, and we continue to look for BC to lead provincial economic growth through 2020. Labour shortages and protectionist sentiment remain key risks.
- Several Provinces have progressed on fiscal consolidation plans, and newly released and upcoming financial blueprints underline a range of policy priorities.

LOOK PAST LATE-2018 SOFT PATCH, FUNDAMENTALS REMAIN SOLID

The slowdown in economic growth witnessed across Canada was felt in several regions. Real non-residential business investment, which was a key factor behind national-level weakness, fell 3.9% (q/q ann.) in Quebec in Q4-2018. The dip continued the retreat in that province after gains in 2017 and early last year that were largely attributable to capacity pressures; capital outlays thus far have followed a similar pattern in Ontario (chart 1). Alberta drilling activity, likely influenced by softer oil prices, slowed substantially in November and then fell by more than 20% y/y in December to reach the second-lowest ever recorded level for the latter month.

While a slower expansion in late 2018 provides a weak hand-off for 2019, we foresee a return to healthy growth in H2. To complement federal accelerated depreciation measures, BC, Ontario, and Nova Scotia have allocated funds for further capital expenditure write-offs, and Quebec added generous provincial-level incentives in December. Work will likely begin in earnest on the Kitimat LNG export terminal this year; this should boost capital outlays by nearly \$14 bn in BC over 2019–20, and lift the province to the top of the growth table in both years. Firm full-time job creation in most regions thus far in 2019 should also support consumer outlays as monetary stimulus is withdrawn (chart 2).

Heavy oil production limits, implemented to alleviate the light-heavy oil price discount, continue to underlie our Alberta forecast. The cuts are expected to dampen key oil and gas sector output this year. Construction delays for the Line 3 pipeline will also likely weigh on price differentials throughout the forecast period and prolong the province's investment recovery. Outside the oil patch, there is more cause for optimism; work is expected to progress this year on petrochemicals facilities and a potato processing plant.

Stable, albeit more moderate export gains are also key to our forecast of a return to healthy economic growth. We expect resolution of ongoing Sino-US trade tensions to result in US demand for imports from most provinces that largely mirrors a more moderate, but still healthy expansion south of the border. We also anticipate exemptions to US import tariffs on steel and aluminum

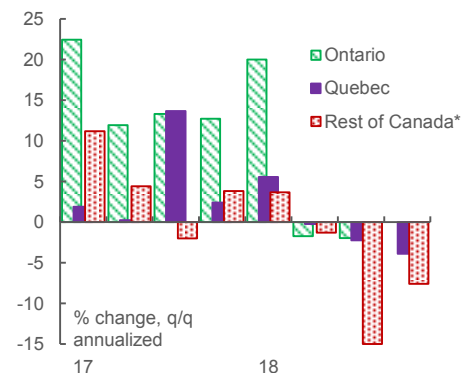
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Chart 1

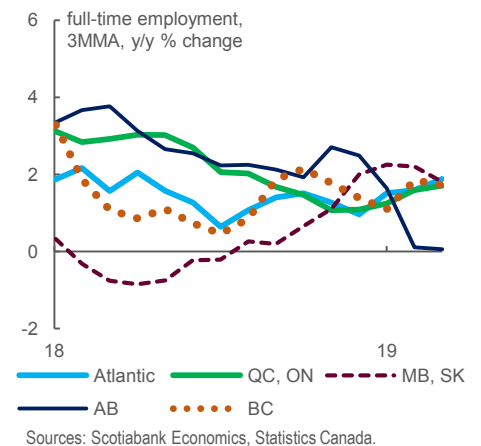
Business Investment Retreats



* Q4-2018 figure is for Canada less Quebec. Sources: Scotiabank Economics, Statistics Canada, Ontario Finance, Institut de la Statistique du Québec.

Chart 2

Healthy Full-Time Job Creation In Most Regions



Sources: Scotiabank Economics, Statistics Canada.

products. The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) will provide new market access in the Pacific Rim. Exports to China are also forecast to assist economic growth in multiple jurisdictions, from BC where trade linkages to the country are strong (chart 3), to Newfoundland and Labrador as oil production rises, to Manitoba as soybean sales stabilize.

Labour shortages remain in place across multiple jurisdictions and continue to present barriers for firms that intend to hire and expand. Job vacancy rates averaged more than 3% in half of the provinces in 2018. Increases to Ottawa's newcomer admission targets through 2021 are constructive given the present tightness and expectations of population aging, especially in regions with a low immigrant population share (chart 4). In light of persistent labour shortages and a more moderate growth environment, we remain skeptical of the merits of Quebec's planned immigration cut. However, new programs that aim to lift immigrant integration are auspicious, and may help to improve newcomer labour market outcomes alongside further success with respect to attraction of net non-permanent residents.

We foresee relatively stable home sales and price growth in Ontario and BC after 2018's stress-test-led soft patch. Sales-to-new listings ratios still point to more muted home price rises in the Greater Golden Horseshoe over the next year than at the early 2017 market peak, though there is evidence that tightness and affordability pains have spread elsewhere in Ontario. BC sales continue to adjust to taxes enacted last year plus measures that target the high end market as of January 1, 2019. Elevated immigration and steady job creation should keep prices and rents elevated relative to incomes in both regions, even as still-high builder margins combined with government policy to incite near-record construction.

Cities in Canada's net oil-producing regions continue to grapple with an overhang of units accrued since the commodity price correction. Substantial building and home value increases are not expected until that glut is absorbed.

Elsewhere, housing construction and price gains are set to move with job creation and underlying demographics. Ownership and rental market tightness in Montreal and Ottawa reflect strong economic conditions rather than fundamental supply-demand imbalances, and should abate as growth cools in Central Canada.

BUDGET SEASON 2019 HIGHLIGHTS DISPARATE FISCAL PATHS

A number of Provinces will deploy surpluses to fortify policy plans already underway. As efforts to lift the supply of affordable housing progress, BC will direct stronger-than-anticipated revenue gains to enhanced child care benefits that build on fee reductions and investments in child care spaces announced in 2018. Nova Scotia, buoyed by a sizeable consolidation adjustment, will raise FY20 spending beyond prior plans, with a focus on health care and education. Quebec will allot an FY19 windfall to lower childcare costs and school tax rates paid by homeowners. It will maintain the accelerated borrowing retirement schedule unveiled in December to ramp up debt reduction completed since FY15 (chart 5).

Other jurisdictions will likely wait to loosen the purse strings. New Brunswick aims to balance the books and curtail net debt in FY20 via funding reductions across several government departments, but will review the competitiveness of its tax system. Amid uncertain energy sector conditions, Saskatchewan will contain spending and limit new measures to boutique personal income tax credits on its path to balance by FY20.

Chart 3

The Provinces' Asian Trade Ties

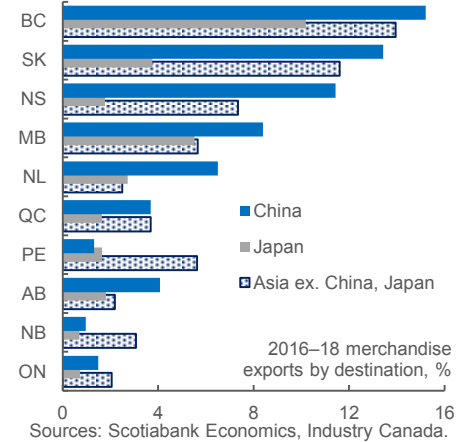


Chart 4

Net Immigration as a Share of Population

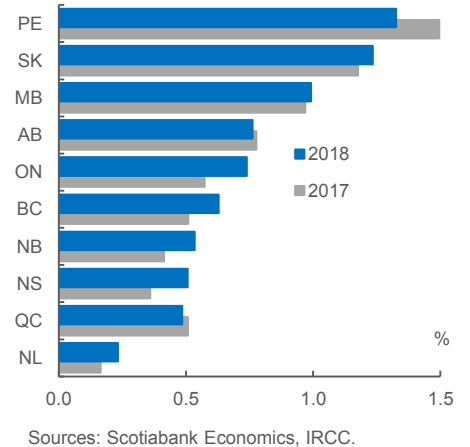
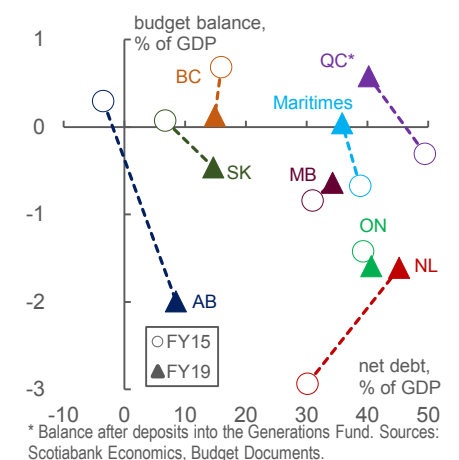


Chart 5

The Provinces' Fiscal Paths



Blueprints in Alberta and Newfoundland and Labrador should stay anchored to expenditure restraint. The latter's FY23 surplus target currently rests on a 1.4% average annual total spending contraction beyond FY19. Alberta's recent financial update—released in the shadow of an election—revised FY20–21 spending plans \$8 bn higher than expected last year, in respect of outlays on crude-by-rail transportation to provide additional takeaway capacity until pipelines are built. A return to black ink relies on flat total spending during FY23–24. Regardless of the incoming government, Alberta's medium fiscal planning will require a balance between expenditure management and attention to the viability of large energy projects.

Campaign priorities look to be key for near-term fiscal policy elsewhere. Ontario's budget is the first for the new administration, and includes steps to reduce the Province's sizeable debt and deficit, as well as pocketbook relief and support for businesses. Manitoba recently reduced its Provincial Sales Tax to 7% from 8%, which fulfills a touchstone pledge from the 2016 election. With balanced books and an election only weeks away, PEI has outlined new pocketbook and small business tax relief and stepped-up infrastructure spending.

Table 1

The Provinces		(annual % change except where noted)									
	CA	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
Real GDP											
2000–17	2.1	2.4	1.8	1.3	1.2	1.8	2.0	2.3	2.0	2.8	2.7
2017	3.0	0.9	3.5	1.5	1.8	2.8	2.8	3.2	2.2	4.4	3.8
2018e	1.8	-0.6	2.0	1.2	1.1	2.1	1.8	1.8	1.4	2.1	2.2
2019f	1.6	1.3	1.5	1.0	0.8	1.7	1.7	1.6	1.6	1.2	2.4
2020f	2.1	0.9	1.1	0.9	0.9	1.7	1.7	1.5	1.7	2.5	3.5
Nominal GDP											
2000–17	4.3	5.6	4.2	3.3	3.4	3.7	3.9	4.4	5.4	5.9	4.7
2017	5.6	4.3	4.8	2.9	4.3	5.0	4.1	5.4	4.8	10.0	6.9
2018e	3.6	2.7	3.8	3.0	2.8	4.1	2.8	3.6	3.6	4.5	4.4
2019f	2.6	3.2	3.4	2.7	2.4	2.2	2.3	3.4	3.5	1.8	4.3
2020f	4.6	4.3	3.1	2.9	2.6	3.8	4.0	3.4	4.4	5.3	6.5
Employment											
2000–17	1.4	0.6	1.1	0.6	0.4	1.3	1.3	1.0	1.1	2.2	1.5
2017	1.9	-3.7	3.1	0.6	0.4	2.2	1.8	1.7	-0.2	1.0	3.7
2018	1.3	0.5	3.0	1.5	0.3	0.9	1.6	0.6	0.4	1.9	1.1
2019f	1.6	1.2	0.9	1.3	0.3	1.2	1.8	1.3	1.2	1.1	2.1
2020f	0.7	0.0	0.7	0.2	0.2	0.6	0.7	0.6	0.6	1.0	1.0
Unemployment Rate (%)											
2000–17	7.1	14.3	11.1	8.8	9.5	7.9	7.0	5.1	5.0	5.3	6.5
2017	6.3	14.8	9.8	8.4	8.1	6.1	6.0	5.4	6.3	7.8	5.1
2018	5.8	13.8	9.4	7.6	8.0	5.5	5.6	6.0	6.1	6.6	4.7
2019f	5.7	12.8	9.3	7.0	8.0	5.3	5.7	5.9	5.9	6.5	4.5
2020f	5.9	12.7	9.5	7.1	8.0	5.5	5.8	5.9	5.9	6.7	4.7
Housing Starts (units, 000s)											
2000–17	200	2.5	0.8	4.3	3.4	44	72	5.2	5.2	34	29
2017	220	1.4	0.9	4.0	2.3	46	79	7.5	4.9	29	44
2018	213	1.1	1.1	4.8	2.3	47	79	7.4	3.6	26	41
2019f	202	1.3	0.8	3.9	1.8	43	73	6.1	4.2	28	39
2020f	200	1.4	0.8	3.8	2.0	41	72	6.1	5.0	31	37
Motor Vehicle Sales (units, 000s)											
2000–17	1,657	29	6	48	38	413	635	47	45	216	180
2017	2,041	33	9	59	42	453	847	62	56	245	235
2018	1,984	28	8	51	38	449	853	67	47	226	217
2019f	1,930	30	8	48	35	430	826	60	48	220	225
2020f	1,900	30	8	47	34	420	810	55	48	215	233
Budget Balances, Fiscal Year Ending March 31 (CAD mn)											
2017	-19,000	-1,148	-1	151	-117	2,361	-991	-764	-1,218	-10,784	2,737
2018	-19,000	-911	75	230	67	2,622	-3,700	-695	-303	-8,023	301
2019e	-14,900	-547	14	28	5	2,500	-13,549	-470	-348	-6,930	374

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

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