The Perils of Trumponomics

- **President Trump's policies are leading to softer US and global growth, with risks that additional erratic policymaking will undermine the outlook further.**
- **The Federal Reserve is expected to cut rates by 75 bps this year as it tries to raise inflation and guard against further downside risks.**
- **In sharp contrast, Canadian growth prospects are improving from a weak start to the year. The Bank of Canada should keep rates at current levels even as the Federal Reserve cuts its policy rate.**

President Trump has not yet made America greater. Following two years of fiscally induced sugar highs, the US economy is slowing rapidly as that stimulus wanes and Trump's trade policies, threats, and bluffs begin to weigh on US economic activity. Markets are now convinced that the Federal Reserve will cut rates aggressively to offset some of these shocks, boost inflation, and insure against possible future damages caused by the President's interventions. This might only serve to amplify the risks that the Federal Reserve is trying to manage, as President Trump may find himself emboldened knowing that the Fed will work to minimize the damage.

For an assessment of the effectiveness of Trump's actions and clues on their possible further direction, one need look only at the trade balance (chart 1), which has deteriorated sharply during his presidency. Much of the President's policy focus in Making America Great Again was improperly geared towards reducing the trade deficit. This was the motivation in threatening to tear-up NAFTA, it was part of the motivation behind the trade conflict with China, and it is the motivation underlying threats to impose tariffs on imported autos. As Trump gears up for re-election, he will have to contend with a trade deficit that is 15% higher than when he took office. He has failed to make progress on his central pledge to reduce America's trade deficit. Since he believes the US trade deficit is the result of unfair practices by America's trading partners, he will naturally place the blame on them.

This has begun and is likely to amplify in the period leading up to the election. Trade and policy unpredictability will rise, even if there is a détente in the US-China trade conflict. He may shift his focus to exchange rate policies, and has already laughably accused the European Central Bank of manipulating its currency as it contemplates easier policy in light of a slowdown in growth and weak inflation. Tariff Man, as he has called himself, may move ahead with threatened tariffs on Japanese and European auto imports later in the fall. And while he has declared that Mexico is doing well in stemming the flow of refugees and immigrants at the US border, he may yet have a change of heart and impose tariffs later this year. These bluffs, threats and policies are creating unnecessary uncertainty in the US and elsewhere and are unquestionably leading to slower growth than could otherwise be the case. He is endangering the very expansion he is trying to keep alive. The potential of further action in light of the widening trade deficit suggests that uncertainty, and its costs, will increase as we near the US election.

It is against this background that the Federal Reserve is expected to cut rates by 25 bps in July and by another 50 bps by year-end. Core PCE inflation is well below its objective, as are market-based measures of inflation expectations. This merits

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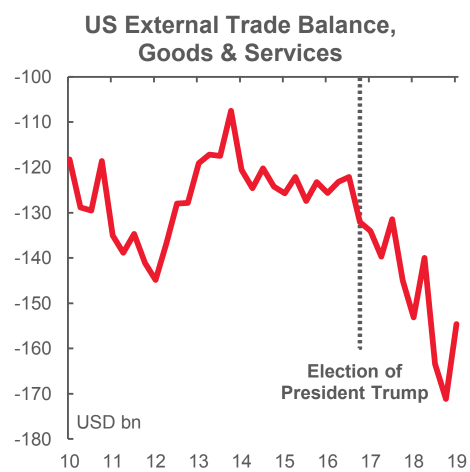
Chart 1



Sources: Scotiabank Economics, BEA.

more accommodative monetary policy. We think about 50 bps of easing is required to return inflation to target in a reasonably timely fashion. Chairman Powell has made it clear that he is also considering taking out insurance against current and potentially future adverse developments. At this time, we think 25 bps of insurance is warranted, but this is clearly conditional on how risks evolve. While there is some question about the path of US monetary policy going forward, what is certain is that the President's attacks on the Fed will continue, as he will look to assign blame for the slowdown in activity to anyone but him.

The Bank of Canada is unlikely to follow the Fed as it cuts rates. At the moment, Canada is the Northern Star. In contrast to the US, Canadian growth is accelerating in the second quarter, and we expect Canadian growth to outpace that of the US for the remainder of the year. Despite the clear risks coming from the US, confidence is rising (chart 2), job growth remains stellar, population growth continues to rise, and capital spending by firms is picking up in light of strong sales and capacity constraints. Moreover, inflation is at the Bank of Canada's target level, real interest rates are negative and well below neutral. As a result, we think it unlikely at this point that Governor Poloz will lower rates if the Fed proceeds as we currently expect. The Bank of Canada appears to be firmly on hold.

Table 1

Global Real GDP	2000–17	2017	2018	2019f	2020f
		(annual % change)			
World (PPP)	3.9	3.8	3.7	3.1	3.2
Canada	2.1	3.0	1.9	1.4	2.0
United States	2.0	2.2	2.9	2.5	1.6
Mexico	2.2	2.1	2.0	0.9	1.1
United Kingdom	1.9	1.8	1.4	1.1	1.2
Eurozone	1.4	2.4	1.9	1.1	1.3
Germany	1.4	2.2	1.4	0.7	1.2
France	1.4	2.3	1.7	1.3	1.3
China	9.3	6.8	6.6	6.2	6.0
India	7.1	6.9	7.4	6.5	7.0
Japan	0.9	1.9	0.8	0.8	0.6
South Korea	4.9	3.2	2.7	2.0	2.7
Australia	2.9	2.4	2.8	2.3	2.6
Thailand	4.1	4.0	4.1	3.2	3.4
Brazil	2.5	1.1	1.1	0.9	1.8
Colombia	3.9	1.4	2.6	3.2	3.6
Peru	5.0	2.5	3.9	3.1	3.7
Chile	3.9	1.5	4.0	3.2	3.2

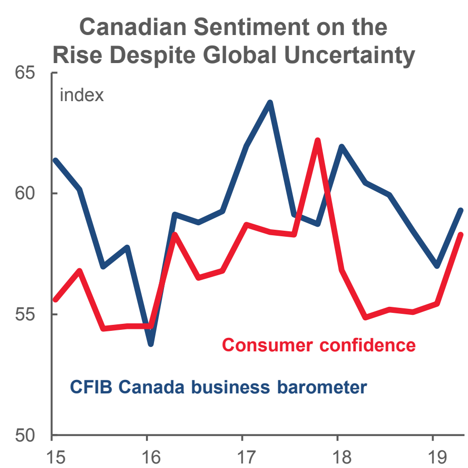
Sources: Scotiabank Economics, Statistics Canada, BEA, BLS, IMF, Bloomberg.

With lower US policy rates and unchanged Canadian rates, the upward pressure on the Canadian dollar we have observed since the beginning of the year is likely to continue. We expect USDCAD to depreciate to 1.28 (about 78 cents) by year-end, as we still view the Canadian dollar as undervalued relative to fundamentals. There is nevertheless a good chance that Trump-induced worries lead to a periodic flight to safety into US assets, as has generally happened since his inauguration. This would further frustrate adjustment of the US trade balance, but would also push currencies, including the Canadian dollar, temporarily down against the greenback.

The general increase in uncertainty is global phenomenon (chart 3), even though its roots are firmly planted in the US. Growth is weakening on both sides of the Channel in Europe. Some central banks have already cut interest rates to boost inflation or raise growth. Commodity prices have fallen as unease has risen. In the Pacific Alliance Countries, these developments, along with domestic political challenges, are leading to weaker-than-expected private and public investment, even though growth is expected to remain well above that achieved in advanced economies.

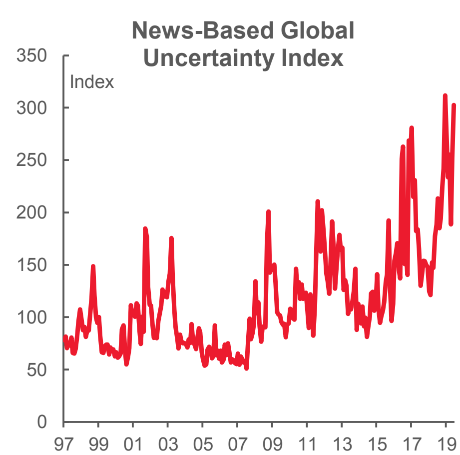
With any luck, our assessment of risks going forward is overly pessimistic, and US sabre-rattling on the policy front will diminish. The resulting decline in fear and uncertainty would give the US and global economies a shot in the arm, though it will be impossible to reverse all of the damage done.

Chart 2



Sources: Scotiabank Economics, CFIB, Nanos Research Corporation, Bloomberg.

Chart 3



Sources: Scotiabank Economics, PolicyUncertainty.com.

Canada

NORTHERN STAR (FOR NOW…)

- **In contrast to the US, Canadian growth is accelerating sharply going into the second quarter, following a solid gain in domestic demand to start the year.**
- **Fast, and accelerating, population growth, and remarkably strong employment growth are providing a solid underpinning to consumer spending and the housing market.**
- **Positive export data suggest that the ongoing strength in domestic demand will be buttressed by net exports in the second quarter, and possibly beyond.**
- **Canadian inflation is at the Bank of Canada's target, in sharp contrast to the US, where it has moved away from the Fed's objective. This gives the BoC room to keep rates on hold if inflation remains on target.**
- **Downside risks remain important and are all linked to US-centric developments, with worries about US trade policy ongoing despite the pause with China.**

THE OUTLIER

Recent Canadian developments stand in sharp contrast to events in much of the rest of the world. Whereas US growth is clearly decelerating, Canadian growth is on an upswing, with recent indicators pointing to a very sharp rebound from a somewhat sluggish start to the year. Canadians appear to be, for the time being, largely insulated from the broader malaise facing the global economy as consumer and business confidence has improved sharply in recent quarters, owing to strong sales and job creation (chart 1). While there are a number of factors suggesting that the growth rebound observed will persist through 2020, there is a risk that a divergence between Canadian and US outcomes may not last.

Underlying much of the strength in activity has been a remarkably strong job market, where job gains so far this year have already outstripped those in 2018 by a wide margin (chart 2). Canadians are benefitting from strong hiring and rising wage growth that together helped boost consumption growth to 3.5% q/q saar in 2019Q1, more than double the rate of the two preceding quarters. Small- and medium-sized businesses continue to cite shortages of skilled and un/semi-skilled labour as the factors that most limit their ability to increase sales or production, but firms are still managing to hire. Year-on-year average wage growth is now running at 3.8%, well above inflation and two full percentage points higher than late last year. Although household debt burdens and debt-service ratios are high, consumer sentiment has rebounded. Household credit growth has steadily accelerated from the second half of 2018, driven by a revival of residential lending as Canadians have adjusted to the tighter qualification standards instituted under 2018's B-20 reforms, and a continued rise in population growth (to its highest rate in over 15 years).

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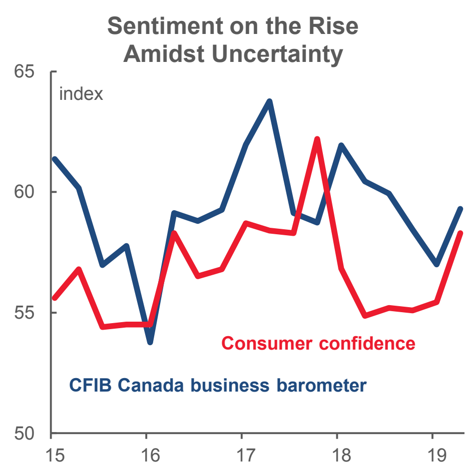
Canada	2017	2018	2019f	2020f
Real GDP (annual % change)	3.0	1.9	1.4	2.0
CPI (y/y %, eop)	1.8	2.0	1.9	1.9
Central bank policy rate (%, eop)	1.00	1.75	1.75	1.75
Canadian dollar (CADUSD, eop)	0.80	0.73	0.78	0.80

Source: Scotiabank Economics.

Chart 1

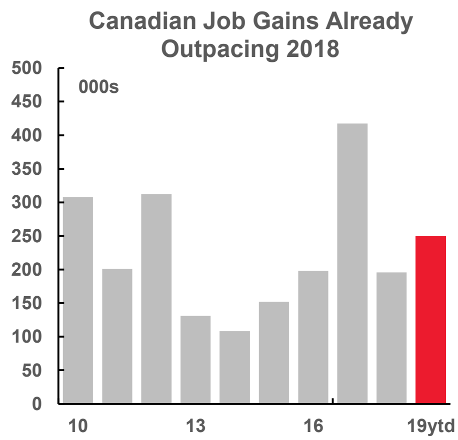


Sources: Scotiabank Economics, CFIB, Nanos Research Corporation, Bloomberg.

Much of the weakness in housing markets appears to be behind us now as the impact of the B-20 reforms and a range of provincial and municipal measures designed to cool housing markets wane. The very simple fact is that with rapid population growth, housing supply has not kept up with demand in much of the country. In the most expensive markets of Toronto and Vancouver, a clear shift in household purchasing patterns is visible, as families rotate from the single-family home market to more affordable townhomes and condos. This is likely to continue as a natural response to affordability challenges in these cities. Prospects for housing markets remain generally good: household income is rising, jobs are plentiful, supply remains generally constrained, and longer-term mortgage costs have fallen by 30 basis points so far this year given the decline in global yields.

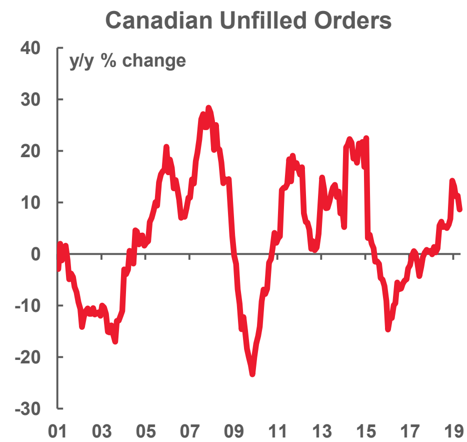
The strength in hiring flows from what remains a generally solid business environment. In many sectors and regions, firms are operating flat-out, with Canada-wide growth in unfilled order books still near the fastet rates in five years (chart 3) and capacity utilization rates remaining at or above long-term averages. Canadian wholesalers saw their strongest two-month gain during March–April in over three years. It appears, however, that the Trump trade battles and uncertainty

Chart 2



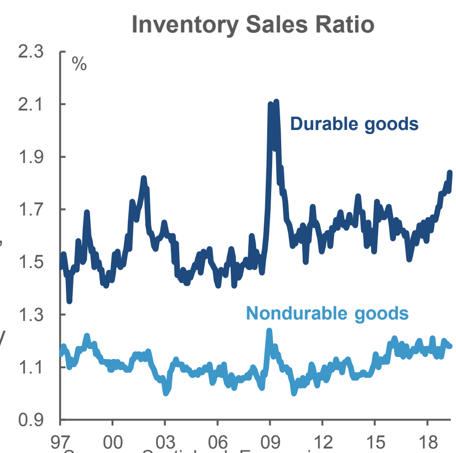
Sources: Scotiabank Economics, Statistics Canada.

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

Chart 4



Sources: Scotiabank Economics, Statistics Canada.

Chart 5

Sources: Scotiabank Economics, Statistics Canada, Netherlands Bureau for Economic Policy Analysis.

Table 1

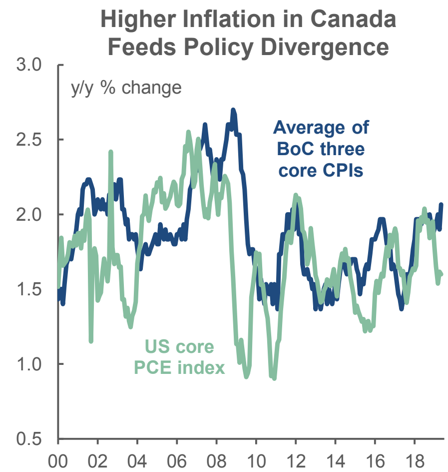
Quarterly Canadian Forecasts	2018	2019				2020			
	Q4	Q1	Q2e	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic									
Real GDP (q/q ann. % change)	0.3	0.4	2.5	1.5	2.3	2.4	2.0	1.5	1.7
Real GDP (y/y % change)	1.6	1.3	1.3	1.2	1.7	2.2	2.0	2.0	1.9
Consumer prices (y/y % change)	2.0	1.6	2.1	1.8	1.9	2.1	2.1	2.0	1.9
Avg. of new core CPIs (y/y % change)	1.9	1.9	2.1	2.0	2.0	2.0	2.0	2.0	2.0
Financial									
Canadian Dollar (USDCAD)	1.36	1.33	1.31	1.31	1.28	1.28	1.28	1.25	1.25
Canadian Dollar (CADUSD)	0.73	0.75	0.76	0.76	0.78	0.78	0.78	0.80	0.80
Bank of Canada Overnight Rate (%)	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
3-month T-bill (%)	1.65	1.67	1.65	1.65	1.65	1.65	1.65	1.65	1.65
2-year Canada (%)	1.86	1.55	1.47	1.50	1.40	1.35	1.35	1.35	1.35
5-year Canada (%)	1.89	1.52	1.39	1.45	1.40	1.40	1.40	1.40	1.40
10-year Canada (%)	1.97	1.62	1.46	1.50	1.55	1.60	1.65	1.65	1.70
30-year Canada (%)	2.18	1.89	1.68	1.70	1.80	1.90	2.00	2.05	2.10

Sources: Scotiabank Economics, Statistics Canada, Bloomberg.

about prospects for the global economic outlook are pushing some of Canada's output into rising stockpiles with inventory-sales ratios still at the highest levels in a decade (chart 4).

With profit margins in Canadian industry a full two percentage points above their historical average, capacity constraints and the increased scarcity of labour are leading firms to increase capital spending, with outlays on machinery and equipment rising by almost 40% q/q saar in Q1. Survey data point to investment strength for the remainder of the year and we continue to believe the LNG Canada project in Kitimat will be a big driver of business investment this year and next.

Chart 6



Sources: Scotiabank Economics, Statistics Canada, Bureau of Economic Analysis.

The acceleration in investment is occurring at the same time as a pickup in Canadian exports, whose growth has risen sharply since March. We have long held the view that a key factor accounting for lacklustre export performance in recent years had been surprisingly sluggish growth in business investment given high capacity utilization rates. While it is too early to link the upside surprises in export growth to the surge in business investment so far this year, they are indicative that this thesis may hold. Export growth stands in contrast to global developments, which generally point to slower growth as the year has progressed, and stands even more sharply in contrast to global trade flows, which have remained quite sluggish (chart 5).

For the remainder of the year, we expect further export growth to be held in check by a higher Canadian dollar and global trade developments. So far this year, the Canadian dollar is the best performing G-10 currency against the US dollar owing to the rise in oil prices and large drop in US interest rates relative to Canada. We expect further strength in the loonie as the Bank of Canada stands pat in the face of an anticipated rate cut in the US. This will limit export growth. Moreover, global trade uncertainty will remain elevated throughout the year, as President Trump continues to sabre-rattle on the trade front and global growth slows further.

Inflation is effectively at the Bank of Canada's 2% target, as the average of the three measures of core inflation utilized by the BoC is now at 2.1% y/y. This is the highest reading since 2012 despite the likely existence of modest economy-wide excess supply. We expect inflation to remain around 2% over the forecast horizon as the impact of output gap closure and rising unit labour costs is generally offset by the pass-through from a stronger exchange rate. Our model continues to capture the movements in Canadian inflation well.

The performance of inflation in Canada relative to the US (chart 6) is of greater importance. Whereas Canadian inflation is on target, it has generally moved away from the Federal Reserve's target, given the impact of past USD dollar strength, low unit-labour cost growth, and a few temporary factors that drove US inflation down. This should allow the BoC to remain on hold as the Federal Reserve cuts rates to, in part, push inflation higher.

As has been the case for several quarters, **the dominant risks to the Canadian outlook lie beyond our borders.** President Trump's policies are having clear and tangible negative impacts on the US and the broader global economy. While a pause appears to have been agreed-to with China, and the President has backed-off his threat of Mexican tariffs, the US trade deficit is becoming larger which may fuel Trump's affinity for tariffs and damaging trade rhetoric.

Table 2

Canada	2000–17	2017	2018	2019f	2020f
	(annual % change, unless noted)				
Real GDP	2.1	3.0	1.9	1.4	2.0
Consumer spending	2.9	3.5	2.1	2.0	1.9
Residential investment	3.6	2.4	-1.5	-3.6	1.3
Business investment	2.2	2.2	2.2	0.2	5.5
Government	2.2	2.7	3.0	1.6	1.7
Exports	1.3	1.1	3.2	1.7	2.4
Imports	3.0	4.2	2.9	1.5	2.8
Nominal GDP	4.3	5.6	3.6	2.7	4.2
GDP Deflator	2.1	2.6	1.7	1.3	2.1
Consumer price index (CPI)	1.9	1.6	2.3	1.8	2.0
CPI ex. food & energy	1.6	1.6	1.9	1.9	2.0
Pre-tax corporate profits	0.0	20.1	0.5	-4.1	2.1
Employment	1.4	1.9	1.3	2.1	1.0
Unemployment rate (%)	7.1	6.3	5.8	5.7	5.9
Current account balance (CAD bn)	-18.7	-59.4	-58.5	-57.6	-55.9
Merchandise trade balance (CAD bn)	22.9	-23.9	-22.0	-26.1	-28.0
Federal budget balance* (FY, CAD bn)	-3.6	-17.8	-19.0	-11.8	-19.8
percent of GDP	-0.2	-0.9	-0.9	-0.5	-0.8
Housing starts (000s)	200	220	213	202	199
Motor vehicle sales (000s)	1,678	2,036	1,983	1,935	1,915
Industrial production	0.0	4.9	2.9	0.4	1.9
WTI oil (USD/bbl)	62	51	65	56	55
Nymex natural gas (USD/mmbtu)	4.83	3.02	3.07	2.71	2.75

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

United States

- **The US economic expansion is set to surpass previous records on the back of continuing growth in domestic demand, but activity is slowing as the impact of fiscal stimulus wanes.**
- **Nevertheless, the risk of a trade war has increased and in the event of a severe global trade conflict we expect a US recession and significant monetary easing.**
- **However, weak inflation as well as uncertainty are likely to be the main reasons for a dovish outlook for the Fed.**

GROWTH OUTLOOK

This month the US sets a new record for the longest uninterrupted economic expansion in its recorded history. We forecast that this expansion will continue over the next few years, although the rate of growth is likely to slow: GDP growth is expected to decline from 2.5% in 2019 to 1.6% in 2020, as the impact of the 2018 fiscal stimulus declines and uncertainty takes its toll on investment and trade. Underlying this outlook is the quarterly profile for GDP growth that is expected to be below potential until Q4-2020 (table 1), which drives the output gap down from excess demand of 0.6% on average in 2019 to 0.2% in 2020.

Notwithstanding a weak start to 2019, **US consumption** is expected to remain robust over 2019–20, with growth averaging 2.2% in 2019 and 1.9% in 2020, supported by healthy household finances, low debt servicing costs, strong growth in personal disposable incomes (3.9% y/y in May), tight labour markets, and consumer confidence near post-crisis highs.

In contrast, **business investment** growth was relatively muted in Q1-2019 at 4.4% q/q saar, compared to 6.9% in 2018, and is likely to slow further, even as most major industrial sectors are operating at or beyond their long-term average capacity utilization rates, and credit supply remains ample with real interest rates still low by historic standards.

The relatively subdued investment outlook, with capital spending growth averaging 4.0% in 2019 and 2.3% in 2020, is in part due to uncertainty about the future of US trade policy and the viability of integrated international supply chains, which appear to be putting expenditure plans on hold. All of this could turn around on a dime with a change in protectionist actions and policy volatility from the White House, but these chronic conditions are unlikely to lift entirely under this administration.

Given our benign baseline macro forecast, we incorporate 75 bps of easing by the Federal Reserve due mainly to the weak inflation outlook, with the insurance motive in the face of trade uncertainty playing a supporting role.

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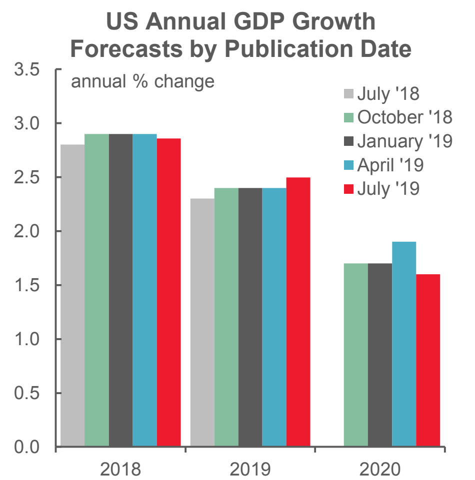
United States	2017	2018	2019f	2020f
Real GDP (annual % change)	2.2	2.9	2.5	1.6
CPI (y/y %, eop)	2.1	2.2	1.7	2.1
Central bank policy rate (%, eop)	1.50	2.50	1.75	1.75
Canadian dollar (USDCAD, eop)	1.26	1.36	1.28	1.25

Source: Scotiabank Economics.

Chart 1



Source: Scotiabank Economics.

TRADE WAR, WHAT IS IT GOOD FOR?

On trade uncertainty, our base case remains that the trade dispute between the US and China will not escalate substantially during the latter part of 2019 as the economic costs of imposing further tariffs against China should deter the White House from taking action, especially with the 2020 US presidential campaign in sight. However, our conviction behind this call weakened in early June following the breakdown in Sino-US talks and in light of the US's late-May tariff threat on Mexico. Rising uncertainty led us to downgrade our US GDP growth forecast in 2020 by about 0.2 ppts in our last forecast tables published on June 7th and this impact remains unchanged in the current forecast.

So far, the impact of the US-China trade war has been most noticeable in declining trade between the two countries (chart 2), while, on the aggregate, US consumer prices have not (yet) been materially affected. Given that the uncertainty around the outlook for trade has increased, in this section we consider two alternative scenarios.

Chart 2

Sources: Scotiabank Economics, US Customs Bureau.

- Scenario 1 is a relatively contained China-US trade war, where the US imposes a 25% tariff on the remainder of Chinese imports (USD 300 bn), drawing a 25% tariff in retaliation from China. This would lead to US GDP growth being weaker by a cumulative 0.5 ppts during 2019–20 and an additional 25 bps rate cut in 2020 (see box 1, charts and table B.1 at the back of this section). The impact on inflation is likely to be small in this scenario.

- In Scenario 2, if the US imposes 25% duties on all countries, which retaliate with similar tariffs. The US economy would likely fall into recession in the first half of 2020, forcing the Fed to cut its policy rate by 100 to 125 bps relative to our current baseline that already incorporates 75 bps of easing. In the same scenario, Canada falls into a severe recession as well, with GDP contracting by 1.6% in 2020, which would require the BoC to lower its policy rate to the effective lower bound by the end of 2020.

Thus, the likely spillovers into Canada from a severe growth downturn in the US, including a significantly lower overnight rate, are at odds with OIS pricing of less than one cut in Canada and four in the US, and point to other explanations for the dovishness in US rates markets.

Table 1

Quarterly US Forecasts	2018	2019				2020			
	Q4	Q1	Q2e	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic									
Real GDP (q/q ann. % change)	2.2	3.1	1.8	1.9	1.4	1.5	1.5	1.9	2.1
Real GDP (y/y % change)	3.0	3.2	2.6	2.2	2.1	1.6	1.6	1.6	1.7
Consumer prices (y/y % change)	2.2	1.6	1.6	1.6	1.7	2.0	2.0	2.0	2.1
CPI ex. food & energy (y/y % change)	2.2	2.1	2.0	2.0	2.0	2.1	2.2	2.2	2.2
Core PCE deflator (y/y % change)	1.9	1.7	1.6	1.6	1.7	1.8	1.9	1.9	1.9
Financial									
Euro (EURUSD)	1.15	1.12	1.14	1.13	1.15	1.19	1.22	1.24	1.24
U.K. Pound (GBPUSD)	1.28	1.30	1.27	1.25	1.25	1.28	1.30	1.32	1.40
Japanese Yen (USDJPY)	110	111	108	108	108	107	107	105	105
Fed Funds Rate (upper bound, %)	2.50	2.50	2.50	2.00	1.75	1.75	1.75	1.75	1.75
3-month T-bill (%)	2.36	2.39	2.09	1.85	1.60	1.60	1.60	1.60	1.60
2-year Treasury (%)	2.49	2.26	1.76	1.70	1.70	1.80	1.80	1.80	1.80
5-year Treasury (%)	2.51	2.23	1.77	1.75	1.80	1.90	1.90	1.90	1.90
10-year Treasury (%)	2.68	2.41	2.00	2.10	2.20	2.35	2.40	2.45	2.45
30-year Treasury (%)	3.01	2.82	2.53	2.65	2.70	2.85	2.85	2.90	2.90

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

WHAT IS DRIVING US INFLATION?

In addition to the risks to the macroeconomic outlook presented by erratic US trade policy, a tepid and decelerating inflation rate has been a concern for the Federal Reserve. Core and total PCE inflation have averaged 1.6% and 1.4%, respectively, through May of this year, continuing a broader pattern of disappointingly weak inflation in the US. Total PCE inflation has averaged 1.85% since 2000, below the Federal Reserve's 2.0% target, mainly due to subdued inflation in the aftermath of the global financial crisis (post-2007 average PCE inflation has been 1.55%).

The more recent weakness can be partly explained by a few temporary factors such as lower prices for wireless services in 2017 and a plunge in transportation services inflation more recently (chart 3). Sequential temporary negative shocks to prices in various sectors can point to a weak underlying trend in aggregate inflation, and can also help de-anchor inflation expectations. Hence they are still being carefully watched by policymakers. In fact, market-based inflation expectations have been declining recently, a worry for FOMC participants noted in Chairman Powell's opening remarks at his June 19th press conference (see chart 4).

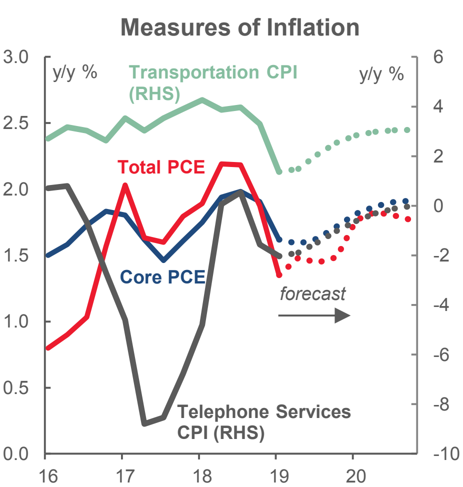
Table 2

United States	2000–17	2017	2018	2019f	2020f
	(annual % change, unless noted)				
Real GDP	2.0	2.2	2.9	2.5	1.6
Consumer spending	2.4	2.5	2.6	2.2	1.9
Residential investment	-0.3	3.3	-0.3	-1.9	0.8
Business investment	3.0	5.3	6.9	4.0	2.3
Government	1.0	-0.1	1.5	2.0	1.6
Exports	3.7	3.0	4.0	2.0	1.8
Imports	3.7	4.6	4.5	1.8	2.9
Nominal GDP	4.0	4.2	5.2	4.2	3.3
GDP Deflator	1.9	1.9	2.3	1.6	1.6
Consumer price index (CPI)	2.2	2.1	2.4	1.7	2.0
CPI ex. food & energy	2.0	1.8	2.1	2.0	2.2
Core PCE deflator	1.7	1.6	1.9	1.6	1.9
Pre-tax corporate profits	5.3	3.2	7.8	0.2	1.9
Employment	0.7	1.6	1.7	1.5	1.0
Unemployment rate (%)	6.1	4.4	3.9	3.8	3.9
Current account balance (USD bn)	-500	-440	-491	-543	-606
Merchandise trade balance (USD bn)	-680	-805	-887	-894	-971
Federal budget balance (USD bn)	-540	-665	-779	-896	-892
percent of GDP	-3.7	-3.4	-3.8	-4.2	-4.0
Housing starts (mn)	1.26	1.20	1.25	1.24	1.26
Motor vehicle sales (mn)	15.6	17.1	17.2	16.8	16.7
Industrial production	0.7	2.3	4.0	1.9	1.7
WTI oil (USD/bbl)	62	51	65	56	55
Nymex natural gas (USD/mmbtu)	4.83	3.02	3.07	2.71	2.75

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

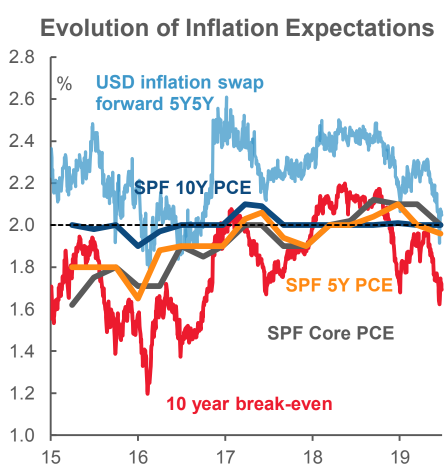
Our forecast for total and core PCE inflation is consistent with these weak inflation expectations going forward and is based on our newly-estimated US Phillips Curve (see here for more details). Our US Phillips Curve captures the impact on core PCE inflation of such fundamental factors as: year-over-year inflation in the unit labour cost as a measure of cost-push inflationary pressure; the output gap, partly based on potential output from the Congressional Budget Office (chart 5); the real price of oil; and the real-effective exchange rate. In addition, we include y/y price inflation for transportation and telephone services to control for temporary factors, which significantly improves the forecasting ability of the equation since 2016 (see chart 6).

Chart 3



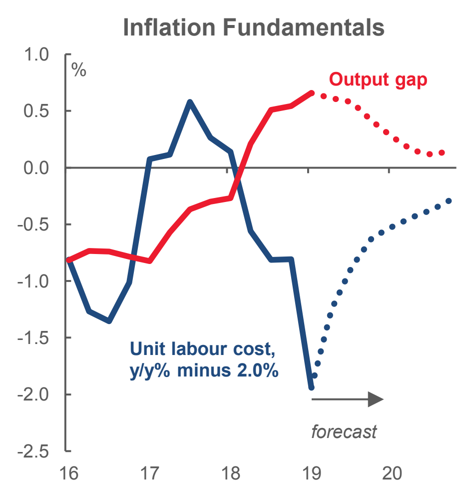
Sources: Scotiabank Economics, BLS.

Chart 4



Sources: Scotiabank Economics, Survey of Professional Forecasters, Bloomberg.

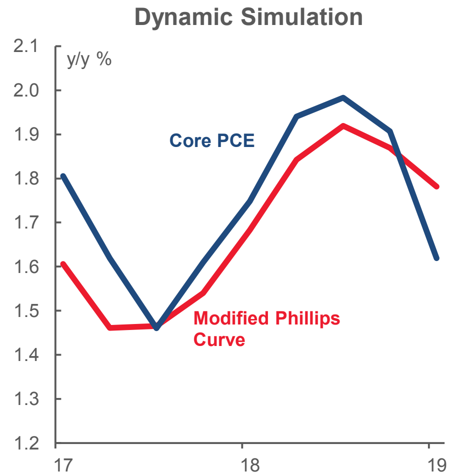
Chart 5



Sources: Scotiabank Economics.

Over the forecast horizon, core PCE inflation is expected to average just 1.6% in 2019, before rising to 1.9% in 2020 on the back of the additional monetary stimulus which helps bring inflation closer to the target. Conditional on the 75 bps of monetary easing, the fundamental drivers identified above are expected to push inflation slightly higher: the output gap is expected to be a persistent inflationary tailwind through early-2020 as the US economy remains in substantial excess demand, partly offset by the weak labour cost inflation, which remains far below 2.0% and provides disinflationary pressure. In contrast, the temporary factors mentioned above, such as prices for phone and transportation services, continue to push inflation down over the projection horizon.

Chart 6



Source: Scotiabank Economics.

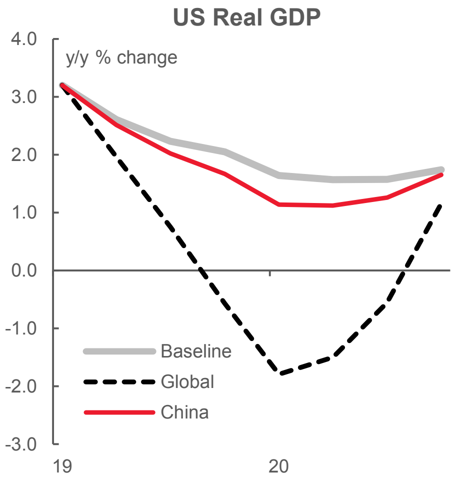
In our forecast, the weak inflation outlook is enough to warrant a 50 bps cut by the Federal Reserve and we introduce an additional 25 bps of easing as insurance, especially in the context of trade policy uncertainty and falling inflation expectations. Financial markets are even more dovish, expecting at least 100 bps of cumulative easing in the next few years (see *US & Canadian Monetary Policy & Capital Markets*), possibly due to a combination of an even weaker inflation outlook and trade risks to growth.

While in the US both risks to growth and inflation concerns could underlie significant monetary easing expected by the financial markets from the Federal Reserve, inflation worries fit the facts slightly better.

- First, with a few exceptions, the macroeconomic activity data in the US has remained relatively benign.
- Second, any significant US growth concerns, in particular from a global trade war, would undermine confidence in Canadian growth due to tight trade and financial links between the two countries. This would likely imply significantly lower expectations for the overnight rate path, which is inconsistent with barely one interest rate cut by the BoC over the next few years expected by the markets.
- Finally, if inflation is the main concern, our model simulations show that if inflation were to decline abruptly to 1.3% over the next few quarters in the absence of a US growth slowdown, the Federal Reserve would cut the Fed Funds rate by 100 bps, while the Bank of Canada would not have alter its policy stance, provided Canadian inflation held up.

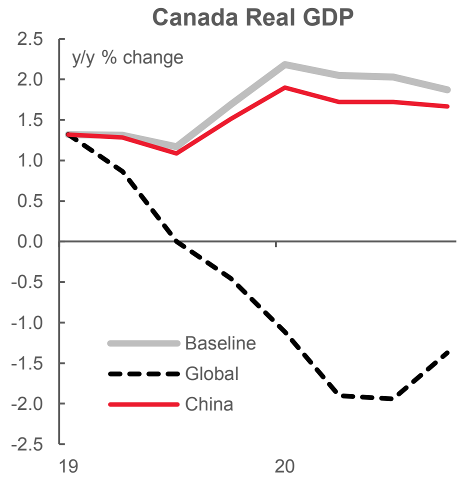
Box 1

Chart B.1



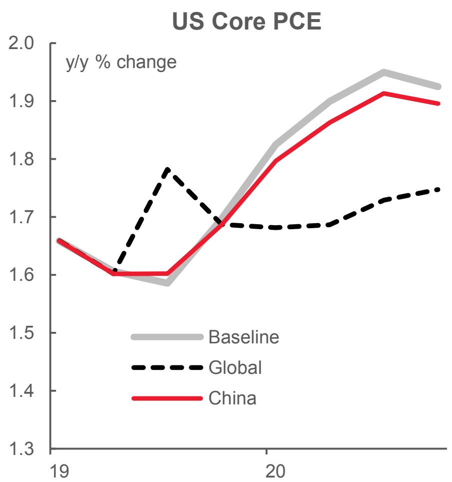
Source: Scotiabank Economics.

Chart B.2



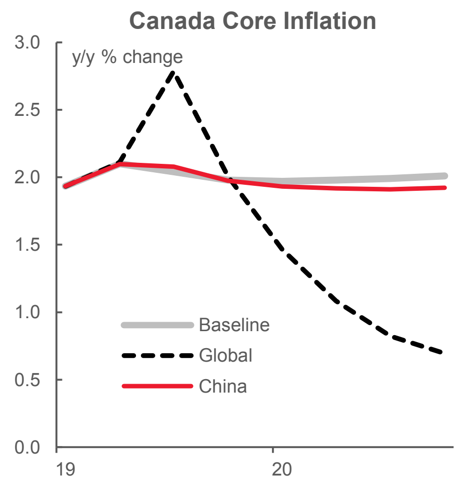
Source: Scotiabank Economics.

Chart B.3



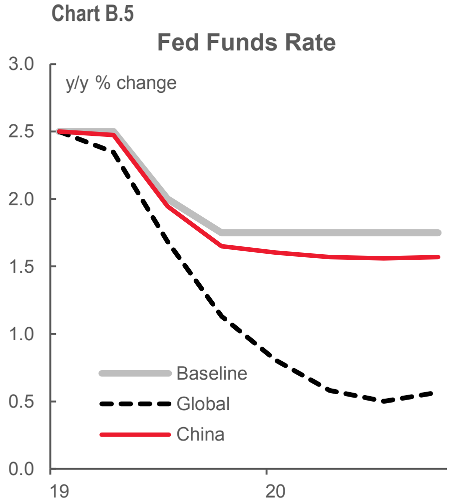
Source: Scotiabank Economics.

Chart B.4



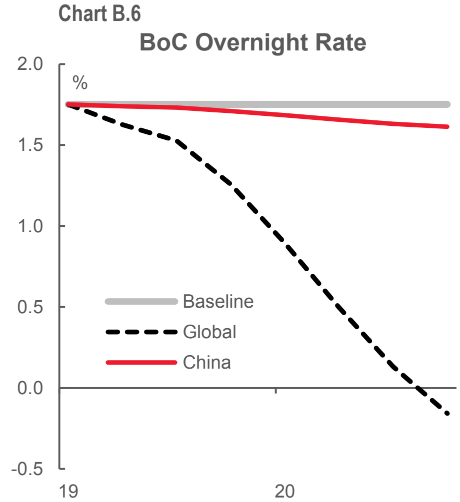
Source: Scotiabank Economics.

Chart B.5



Source: Scotiabank Economics.

Chart B.6



Source: Scotiabank Economics.

Table B.1

US	2019	2020
Real GDP (annual % change)		
Baseline	2.50	1.60
China	2.33	1.26
Global	1.31	-0.71
Core PCE (annual % change)		
Baseline	1.60	1.90
China	1.60	1.87
Global	1.65	1.71
Fed Funds Rate (%)		
Baseline	1.75	1.75
China	1.70	1.58
Global	1.48	0.61

CANADA	2019	2020
Real GDP (annual % change)		
Baseline	1.40	2.00
China	1.33	1.72
Global	0.46	-1.62
Core inflation (annual % change)		
Baseline	2.00	2.00
China	2.01	1.93
Global	2.20	1.03
BoC Overnight Rate (%)		
Baseline	1.75	1.75
China	1.73	1.65
Global	1.54	0.34

Source: Scotiabank Economics.

US & Canadian Monetary Policy & Capital Markets

- **The Federal Reserve is forecast to cut three times this year and then hold at 1.75%.**
- **The Bank of Canada is forecast to hold its policy rate for now.**
- **The US Treasury yield curve is expected to bear steepen (chart 1) as markets scale back pricing for more cuts than we anticipate and price in more favourable circumstances for growth and inflation expectations.**
- **Canada's yield curve will remain inverted as markets may face greater uncertainty over the policy rate outlook later this year (chart 2).**

FEDERAL RESERVE—MANAGING DISAPPOINTMENT VS. EXUBERANCE

The Federal Reserve is forecast to cut its fed funds target rate by 75 basis points in three quarter point moves over the remaining four meetings this year and to then hold the rate constant at 1.75% over 2020. Our prior forecast round depicted this forecast in the market yields from 2s through 5s but this forecast round adds cuts to the administered rates given our higher conviction on timing. What changed to motivate cuts?; Why cutting more could risk greater damage than good; How stocks could manage less easing than priced; and How more easing than either forecast or priced may not benefit the risk trade are all discussed below.

WHAT CHANGED?

So what changed to add to conviction? Quite a lot actually. **The case for rate cuts has gone from a somewhat heretical tail bet on speculative foundations to one that is more informed.**

Starting in May, Fed funds futures contracts began pricing in earnest the prospect of rate cuts as soon as the July meeting. Prior to the May developments, the rate cut view was marginally priced and unconvincing as it appeared primarily rooted in fairly simple thinking toward the maturity of the US economic expansion and how a bust must follow a generally tepid but record-long expansion thereby requiring more accommodative policy. That a marginally positive real policy rate was overly restrictive following eight consecutive quarters of strong trend growth that pushed the US economy into excess aggregate demand conditions seemed illogical. Rate cuts prior to May were a tail bet and appeared to conflict with the nonconventional policy easing that the Fed announced at the March FOMC when it completely changed its balance sheet unwinding strategy.

THE FED'S REACTION FUNCTION SHIFTED

The Federal Reserve has altered its reaction function. It had spoken of a symmetrical inflation target for a long time, but never did much of anything about it as rate hikes were advanced during the period when years of FOMC forecasts for inflation simply expected it to rise to the 2% target and not overshoot.

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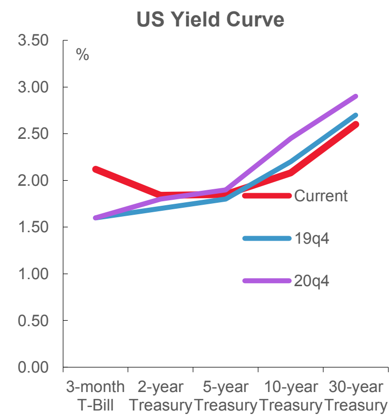
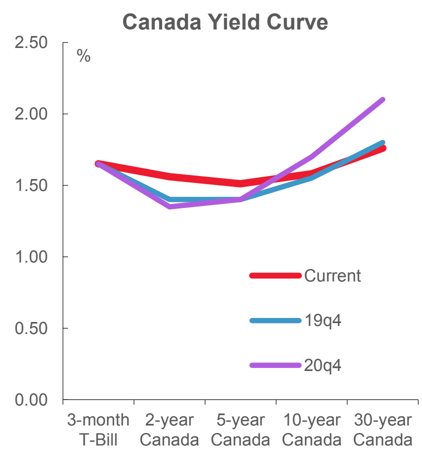
Chart 1



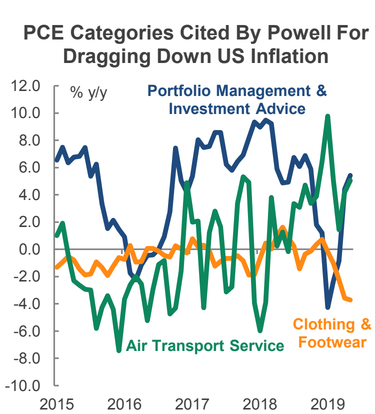
Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Chart 3



Sources: Scotiabank Economics, BEA.

Communications this year have gradually signalled a more serious focus upon emphasizing symmetry through allowing inflation to overshoot the 2% inflation target for a time. This view appears to be particularly championed by the likes of Vice Chair Clarida. The logic for doing so stems from the constraints of operating in a low rate environment with limited room to ease compared to past cycles. The easing constraint makes it more important to the Fed to step in front of falling inflation expectations the minute they register and err more on the side of overshooting its inflation target through deliberate action. That's especially true given the mixed inflation picture of late. Core PCE remains soft despite evidence that what were thought to be transitory downward influences have since been improving (chart 3), while trimmed mean inflation measures arguably trim out far too much.

TRADE POLICY AND GEOPOLITICS HAVE DISAPPOINTED EXPECTATIONS

Since at least May, however, the broader geopolitical framework has disappointed our house expectations and this has begun to have a more pronounced impact upon global growth. In terms of uncertainty about growth and markets, this is the dominant driver of the shift toward Fed rate cuts. A sound global economic expansion was placed in jeopardy by sequential policy missteps that impaired confidence in the outlook primarily through belligerently protectionist US trade policy and mismanagement of Brexit outcomes. In short, politics damaged the economics and it fell to central bankers to mop up the mess again. Moral hazard problems run deep as Fed easing could enable further protectionism.

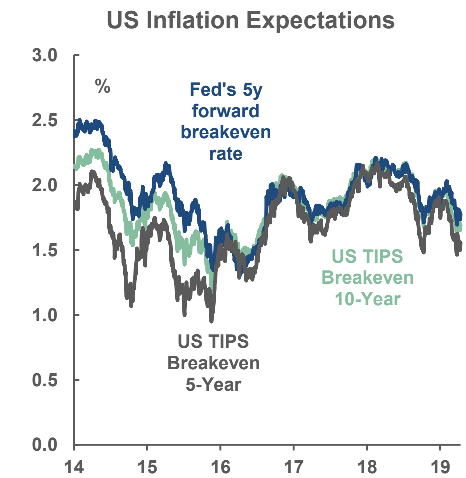
What specifically changed relative to our assumptions? Brexit has dragged on for longer and with much greater uncertainty than we had judged. A US-China trade deal that would achieve near-term trade peace appeared to be achievable until either China scuttled the agreement or walked away because the US was still insisting on tariffs after an agreement as it did with NAFTA. We also still do not have passage of the USMCA deal in Congress and did not anticipate Trump's Mexican stand-off in late May and early June that impaired c-suite confidence. Further, geopolitical tensions in the Middle East have risen and the threat of auto tariffs remains for longer than anticipated. Such concerns triggered greater evidence of a global slowdown in investment and trade. They also invoked automatic market stabilizers such as safe-haven seeking in Treasuries that sparked curve inversion aided by falling market-based measures of inflation expectations (chart 4). The drop in discount rates lifted risk assets including equities on the assumption that the Fed would have to respond.

LIMITED EASING

Notwithstanding these points, the information we have at present does not give us comfort toward forecasting more than three rate cuts. For one thing, **cumulative cut guidance from the Fed remains highly conditional** as illustrated by the most recent dot plot (chart 5) that shows no cuts this year and only one next year.

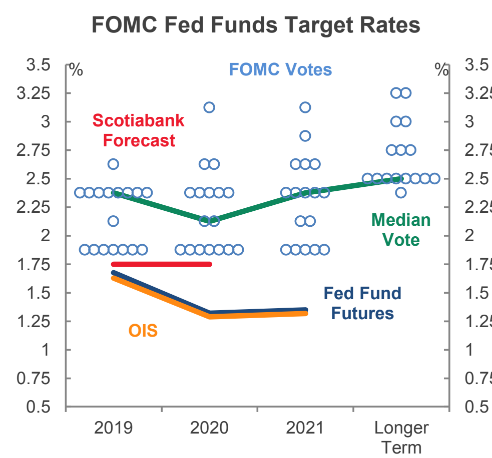
Further, we don't think easing to boost inflation would be met with much success. Work done by Scotia's René Lalonde and Nikita Perevalov with our proprietary macroeconometric models indicates limited chance of success to easing for the sake of boosting inflation expectations. Chart 6 depicts the results of four scenarios for no change and immediate full rate cuts of -50bps, -100bps and -150bps. All three cut scenarios are much more generous than markets have priced. Through an augmented Phillips curve model, the impact upon inflation over the medium- to longer-

Chart 4



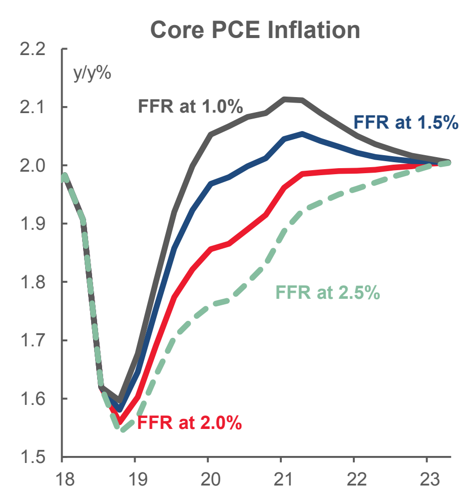
Source: Scotiabank Economics, Bloomberg.

Chart 5



Sources: Scotiabank Economics, Federal Reserve System.

Chart 6



Sources: Scotiabank Economics.

run is limited to something between barely achieving 2% core PCE inflation to a slight transitory overshoot of one or two tenths of a percentage point. Given that these rate scenarios are more extreme than anything being conveyed by the Fed or priced by markets, the probability of achieving such inflation outcomes is even more remote.

If massive easing doesn't boost inflation, then why bother with any easing? For one, the 90s10s slope that is a predictor of recession risk would likely swing from being negative (hence inverted) to slightly positive as the bills yield falls with fed funds. For another, a steeper curve could be reinforced by raising market inflation expectations somewhat and with that the nominal 10 year Treasury yield. The combined effects could restore a term premium and lessen bond market signals of recession risk. **A steeper yield curve is thus a key part of our forecasts.**

Going with deeper cuts could tilt the Fed's risk-reward calculus more aggressively toward courting greater financial stability worries. Hello, 1%, you were so kind to the financial system in 2003–04 and thereafter! I'll return to this issue in the next section.

Our projected three rate cuts would still put monetary policy below estimates of the neutral rate (around 2.5%) into expansionary territory with the US economy operating with excess demand through a positive output gap, the lowest unemployment rate since December 1969 and inflation not far from target. The assumption that the Trump administration will seek to achieve moderate improvement in trade policies by getting the USMCA deal passed in Congress and striking some accord with China continues to be fairly reasonable into a Presidential election year. So does the forecast assumption that core PCE inflation will come under marginally greater upward pressure over 2019H2 into 2020 and CPI recently supported this view (here). In other words, fifty might do just fine for insurance purposes but be careful toward other motives for greater easing.

MANAGING DISAPPOINTMENT

This forecast nevertheless implies that the rates complex will ultimately be disappointed with three instead of four cuts. **While bad for bonds, such disappointment need not be quite as disconcerting to risk assets as one might think but it requires President Trump to meet the Fed halfway after having caused many of the present challenges.**

In the most reduced form, stocks are driven by three things. One concerns discount rate assumptions that the Fed can influence, but not dictate, with the BAA corporate bond yield being a reasonable discount rate proxy over time. That discount rate is also influenced by other considerations such as term premia, carry and hedging arguments relative to other global markets, and spread determinants that are partly a function of the risk cycle. The second is risk appetite as measured by multiples attached to a projected earnings stream and informed by other proxy measures such as the VIX measure of equity market volatility. Third is earnings growth. With this understanding, **one scenario is that modest but below-market monetary policy accommodation could combine with our forecast for stabilizing world growth that could benefit earnings per share and also improved risk appetite conveyed through earnings multiples if trade policy settles down in order to leave stock market levels unchanged or even higher.**

MANAGING EXUBERANCE

Further, on its own, giving the bond market what it wants or possibly more with at least four rate cuts may not even support risk assets as much as one thinks or at all. It's conceivable that the Fed would grow more concerned about financial stability issues as was the case when they cut down to 1% in 2003–04 and unleashed a torrent of speculative behaviour. The Fed may not be overly fussed by speculative pressure now, but it knows the risks of that episode repeating. It misjudged transmission mechanisms into risky behaviour and by the time it caught on it over-reacted by raising the policy rate by more than four percentage points and thus played a heavy role in driving the Global Financial Crisis.

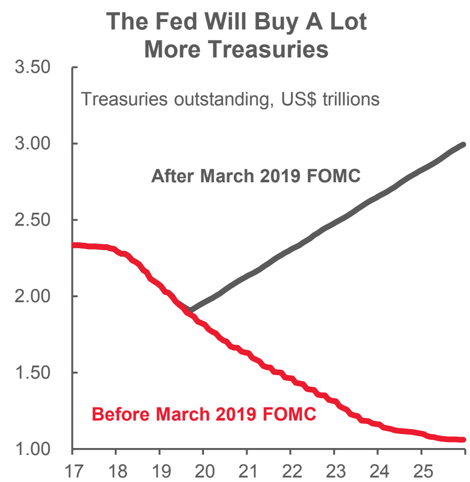
To counter such transmission mechanisms into parts of the economy and markets where it doesn't want stimulus to land, this time the Fed could employ a whole new suite of tools it did not have back then. One such tool would be to raise the CCyB. At this moment the risks may be the other way, but cutting aggressively could change that. The last time the Fed reaffirmed its commitment to the counter cyclical capital buffer of 0% was in December 2017. Go here for a global overview of the CCyB by country. Today's Basel III framework provides regulators with a new suite of tools to mitigate speculative froth in a low rate environment. While overall evidence of financial stability risks is mixed but generally not alarming now, it is also not absent. Each of consumer credit outstanding and commercial and industrial loans have grown by 12% since the November 2016 election, or 2–3 times inflation, with mortgage debt up by 8–9%. Pursuing as many rate cuts as markets have priced if not more could well tilt this balance toward greater stability concerns and systemic risks to the financial system and the economy. **Would stocks rally if the CCyB was hiked as rates were cut four or more times?** The net effects upon banks and credit dependent channels of the economy are unclear.

LEAVE THE BALANCE SHEET ALONE

Our forecast also assumes that balance sheet policy is unlikely to materially change. After September, the SOMA holdings of Treasuries, MBS and agencies, FRNs and TIPS will flat-line instead of shrink, and the Treasury portfolio will rise sharply instead of continuing along the pre-March plan toward shrinking (chart 7). There is a risk that the Fed slightly expedites its plan to cease unwinding its balance sheet from the end of September 2019 to when it cuts the policy rate. The de minimis gain to markets that have already priced in the plans that were introduced at the March meeting and that began to be implemented in May by rolling over MBS flows into Treasuries argues against changing anything. Then again, the risks associated with expediting plans are also de minimis so one could argue the opposite. **On balance, we feel that the Federal Reserve is content with decisions it has made on balance sheet management, wary of creating the impression that it will fiddle with the balance sheet in erratic fashion, and will rely upon its policy rate to incrementally adjust to circumstances.** One remaining possibility is nevertheless to introduce a **standing repo facility** with a rate set marginally above the fed funds rate as a market backstop to funding pressures. This would add to the steps taken to widen the spread between Interest on Excess Reserves (IOER) and fed funds with IOER as an anchor-point to weigh down market rates through arbitrage on reserves. It would also add to the powers of the NY Fed's market desk to engage in open market operations to control short-term rates given ongoing pressure.

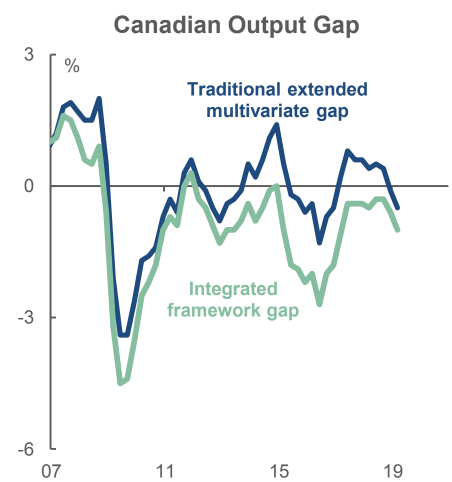
For a further summary cheat sheet of the pros and cons to policy easing see the appendix.

Chart 7



Sources: Scotiabank Economics, FRB New York.

Chart 8



Sources: Scotiabank Economics, Bank of Canada.

BANK OF CANADA—MORE POTENTIAL TO SHOCK MARKETS

Our forecast at this point is for the Bank of Canada to remain on hold over 2019–20, but we're less certain of the underlying narrative in light of material global developments since our last Global Outlook. Developments since then have led us to swing risks to our base case outlook more toward the risk of easing.

The Bank of Canada's problem is the opposite of the Fed's which is also arguably what makes it more interesting to explore. It is opposite to the Fed's because, by contrast, it is a truism to remark that when little is expected of the BoC, it's harder for it to disappoint markets and easier for a policy shift to be impactful.

THE CASE FOR STANDING PAT

Markets have only priced in about a one in three chance for a single quarter-point rate cut by year-end. A full cut is priced in bonds over the longer term through a mildly inverted yield curve including the spread between the overnight rate and the two year GoC yield. Conventional wisdom posits that the BoC doesn't need to ease for the following reasons:

- The BoC is **starting at a more relaxed policy stance than the Fed** with slightly negative real rates and below its neutral rate. This gives the BoC more of a policy buffer against downside risks;
- **Core inflation is on- if not a smidge above-target** at 2.1% y/y while the Fed's preferred gauge is well below 2% at 1.6%.

- **Canadian dollar weakness is the flip side to the implications of US dollar strength.** The CAD rally of about a nickel since early June has been backed by firmer commodity prices. Further CAD appreciation may be limited if the Fed cuts because US monetary policy easing is already significantly priced in;
- **Canada's economy is on the rebound** in Q2 whereas the US is decelerating;
- **Domestic trade policy risks are less negative for Canada** now given the CUSMA deal that is pending passage in the US and Canada (but passed in Mexico) and the reversal of steel and aluminum tariffs and reciprocal actions;
- **Housing markets are stabilizing** in Canada, driven by job growth, lower mortgage rates and distance from B20;
- **Canada's job market has remained very strong this year** including the details behind the most recent jobs tally such as explosive hours worked, stronger wage growth and gains in payroll employment (here);
- Canada has imported bond market easing driven by Fed rate expectations and **can ride along the Fed's coat tails.**

These are all valid points, but they don't make the call a slam dunk by any means. They may just suggest a Canadian version of patience that has yet to be exhausted as apparently is the case with the Fed. The BoC 'cut' thesis is worth exploring relative to a consensus that sounds convinced it is implausible.

1. Slack

Canada has excess capacity in the economy that the BoC expects to persist, whereas the US is in a state of excess aggregate demand (chart 8). This makes a stronger case for easing in Canada and to give a nudge to the closure of slack.

2. Dead Cat Bounce?

Canada's Q2 economic rebound from a temporary soft patch in Q4/Q1 could well prove as transitory as the soft patch itself. Present tracking suggests Q2 growth around 2.5% after no growth over Q4/Q1. One indication of potentially renewed growth disappointment in Q2 came through recent trade figures (recap here).

3. Bloated inventories

Amidst evidence of slack there is disconcerting evidence of over-production. Inventory levels remain very high at manufacturers, wholesalers and economy-wide (chart 9). Was a tepid Q2 GDP rebound only due to over-production that has gone straight to inventories and by hiring excess workers? We've seen this movie!

4. Confidence in the outlook

The BoC's confidence in the outlook was steadily deteriorating this year and it cannot have increased since the last statement given geopolitical, trade, and global macro data.

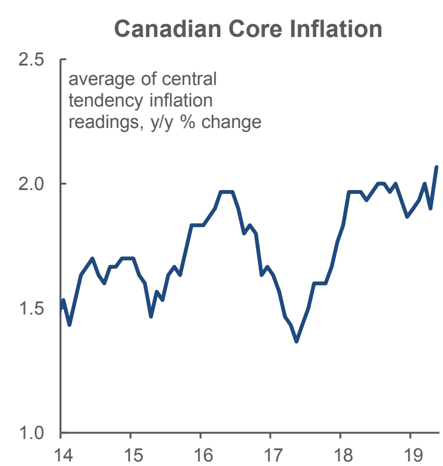
Chart 9

Sources: Scotiabank Economics, Statistics Canada.

Chart 10

Sources: Scotiabank Economics, Bloomberg.

Chart 11



Sources: Scotiabank Economics, Statistics Canada.

5. Insurance

Piece together points so far and Canada has a decent case for an insurance cut.

6. Inflation

Much like elsewhere, market-derived measures of inflation expectations have plummeted in Canada (chart 10). We think inflation will remain near target, but the BoC has not durably hit 2% for years (see chart 11). If 2% is a symmetrical target in Canada, then the case for overshooting is at least as strong as in the US.

7. Bond market signals

Canada's rates curve is inverted and, while it is distorted and serves as a poorer signal of recession risk than in the US, it nevertheless fits a picture of concern. The 90s10s slope is inverted by over 30bps and the 2s10s curve is very flat. There remains a reward for term extension on the corporate lending book (chart 12).

8. Commodities and the terms of trade

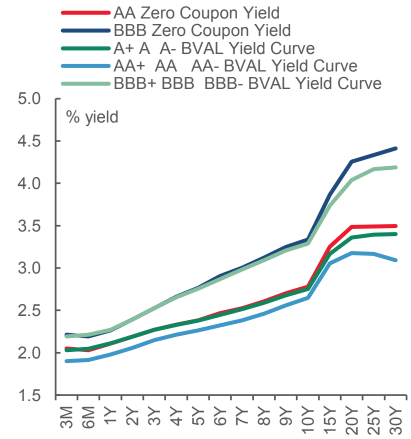
As chart 13 demonstrates, Canada's terms of trade remains healthier than it was toward the end of last year. Nevertheless, risk to this through the commodities picture remains elevated through US-China trade policy developments.

9. Relative Central Banks

The BoC does not need to bend to foreign central banks' policy goals, but the odds of coordinated easing clearly rise as more central banks participate.

In fact, several of the arguments presented above sound an awful lot like they did a decade ago when Canada spent some time in denial that external risks would take Canada's prospects down with them. At that time, Ottawa was in denial that global risks would come home to roost and the Bank of Canada was still raising its overnight rate under Governor Dodge in late 2007.

Chart 12 **Canadian Corporate Bond Market Is Still Rewarding Term Extension**



Sources: Scotiabank Economics, Bloomberg.

Chart 13 **Canada's Terms of Trade**

Sources: Scotiabank Economics, Statistics Canada.

Table 1

Scotiabank Economics' Canada-US Yield Curve Forecast

	2018	2019				2020			
				(end of quarter, %)					
Canada	**Q4**	**Q1**	**Q2**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
BoC Overnight Target Rate	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Prime Rate	3.95	3.95	3.95	3.95	3.95	3.95	3.95	3.95	3.95
3-month T-bill	1.65	1.67	1.65	1.65	1.65	1.65	1.65	1.65	1.65
2-year Canada	1.86	1.55	1.47	1.50	1.40	1.35	1.35	1.35	1.35
5-year Canada	1.89	1.52	1.39	1.45	1.40	1.40	1.40	1.40	1.40
10-year Canada	1.97	1.62	1.46	1.50	1.55	1.60	1.65	1.65	1.70
30-year Canada	2.18	1.89	1.68	1.70	1.80	1.90	2.00	2.05	2.10
United States	**Q4**	**Q1**	**Q2**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Fed Funds Target Rate	2.50	2.50	2.50	2.00	1.75	1.75	1.75	1.75	1.75
Prime Rate	5.50	5.50	5.50	5.00	4.75	4.75	4.75	4.75	4.75
3-month T-bill	2.36	2.39	2.09	1.85	1.60	1.60	1.60	1.60	1.60
2-year Treasury	2.49	2.26	1.76	1.70	1.70	1.80	1.80	1.80	1.80
5-year Treasury	2.51	2.23	1.77	1.75	1.80	1.90	1.90	1.90	1.90
10-year Treasury	2.68	2.41	2.00	2.10	2.20	2.35	2.40	2.45	2.45
30-year Treasury	3.01	2.82	2.53	2.65	2.70	2.85	2.85	2.90	2.90

Sources: Scotiabank Economics, Bloomberg.

APPENDIX

Federal Reserve Cheat Sheet

Arguments *For* Easing	Arguments *Against* Easing
GDP growth will weaken to a one-handled pace that just isn't good enough	The US economy is strong with low unemployment and continued growth that doesn't need help
There are downside risks to mild projected GDP growth that require accommodation even if no recession lurks	There are also upside risks to growth, such as if trade disputes are settled
Bond markets are signalling recession probabilities in line with actual past recessions	Bond markets are distorted and markets often over react such that policymakers should craft policy independently
Don't disappoint market pricing for cuts that would tighten financial conditions	Markets have gone too far and easing could inflame bubbles
Trade policy risks have been worse than anticipated for longer and will remain elevated. The damage has already been done to trade and investment	Trump will settle down into an election year
Look through potential tariff effects on inflation as transitory and in favour of growth drivers of the dual mandate, or view tariffs as ultimately deflationary like the 1930s. Bernanke vowed to never repeat the Fed's mistake back then.	Tariff effects could be inflationary if presented as a persistent supply shock such that easing would inflame inflation risk
The Fed's 2% inflation goal is symmetrical, meaning that ten years of failed model-based forecasts for higher inflation will now position the Fed to risk an overshoot of 2% as an average goal and not a ceiling to prove it is serious about its target	2% is still the target, trying to overshoot may not work or it could be problematic with unintended consequences to the bond market.
Inflation expectations are falling as a threat to Fed goals	Falling inflation expectations depend upon the measure and they are at best imperfect guides.
Fed-speak sounds more open to easing and don't fight the Fed	Powell hasn't said much of late and wait for the more open June FOMC debate
The Fed will give into Trump's pressure tactics	The Fed is independent, will pursue its Congressional dual mandate and might even exert its independence by defying Trump
The Fed may want to act faster and more pre-emptively in the face of increased risks this time	The Fed remains slow moving and will take its time and monitor further developments like the G20, OPEC meeting etc.
USD strength has many drivers and it has tightened financial conditions while putting downside pressure on inflation pass-through that requires Fed counter-action.	USD strength may be transitory if it is driven by trade policies that could settle down.
Other central banks like the PBOC, ECB, BoJ and BoE are shoving dollar strength onto the Fed which requires relative central bank adjustments	Currency markets face many varied drivers with monetary policy just one of them and duelling central banks yield subpar outcomes compared to global coordination
The Fed has to respect its Congressional dual mandate and do whatever it thinks is necessary.	Easing would bow to Trump and by bailing him out it could embolden him in such fashion as to worsen the outlook for trade policy
Weak payrolls in May were a warning shot as hiring confidence has been drained and don't risk waiting to find out	Volatile jobs could bounce higher next time so wait for a trend
The unemployment rate can go lower without stoking materially faster wage and price pressures that have eluded the Fed to date. Estimates for the natural rate of unemployment keep pushing lower so let's test it further.	Where the natural rate of unemployment rests is uncertain and this may be a dangerous pursuit
The US economic expansion is long in the tooth and the risk of accidents is naturally higher, requiring pre-emptive action	Expansions don't die of old age
The Fed is central banker to the world and easing could benefit multiple regions to the indirect benefit of the US economy and global financial stability	Monetary policy must be conducted strictly in terms of what is necessary for the US while letting the rest of the world adjust and adapt
Monetary policy can still ignite aggregate demand	Monetary policy would be like pushing on a string in the face of confidence-sapping trade wars that push us into a liquidity trap
The Fed has plenty of ammunition in the tank through varied tools in order to counter future risks even if it gives away a few rate cut bullets now	Don't prematurely give away precious room for conventional easing and QE policies are less and less effective over time

Mexico

WINTER IS COMING… THANKS TO A PERFECT STORM

- **Our growth forecasts have been significantly adjusted to reflect a more uncertain outlook stemming from a combination of domestic factors and US-related policies that could even turn into a recession if things go wrong.**
- **Increased uncertainty over the energy sector policy is pointing to a further deterioration of the sovereign credit ratings.**
- **We are reducing our real GDP growth forecast for 2019 even further to 0.9%. We expect sluggish economic activity to carry into 2020 with growth subdued at around 1.1%. Material downside risks to this forecast are possible.**

UNEXPECTED EVENTS AFFECTED THE OUTLOOK

The outlook for the Mexican economy is weaker than in the latest quarterly *Global Outlook* report, with economic activity cooling down faster than expected. This is best seen in the Global Indicator of Economic Activity (IGAE), which grew only 0.5% y/y in the January–April period, the slowest pace in the decade (see graph to the right).

In an already uncertain environment, some unexpected shocks struck and added more uncertainty and anxiety to economic agents' perspectives. The most relevant of these events was the unprecedented threat of the White House to impose tariffs on all Mexican exports if Mexico didn't take additional actions to stop illegal immigration flows from Central America. Those tariffs would start at 5% and increase until 25% as long as Mexico's government remain non-compliant, thus representing a "nuclear option" on bilateral trade. The Mexican government conceded to US demands and made significant changes to the migration policy; however, the threat remains present and could re-appear even if Trump has congratulated Mexico on its efforts thus far

Another unfavorable event was the deterioration in Mexico's credit rating by two rating agencies. Fitch chopped sovereign debt by one notch, from BBB+ to BBB, and downgraded Pemex to junk territory (BB+), while Moody's lowered Mexico's rating outlook to negative from stable, arguing that "unpredictable policymaking is undermining investor confidence and medium-term economic prospects".

Government actions on the energy sector remain as one of the key concerns, since they are pointing towards a further deterioration of the sovereign credit profile. State-owned enterprises, Pemex and the Federal Electricity Commission (CFE), which are financially fragile, may be asked to invest in projects of questionable value, exposing these institutions, and the Mexican government, to greater financial/fiscal risk. Pemex's oil production has been in sharp decline in recent years, and it has yet to stabilize (-10% y/y in May 2019). Moreover, rating agencies have pointed out that the planned capital investment in upstream activities will still fall short of replacing reserves in the next couple of years.

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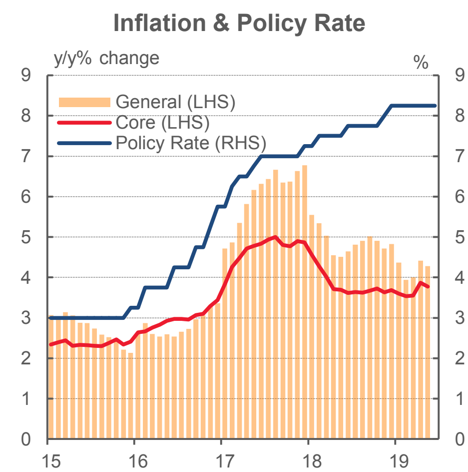
Mexico	2017	2018	2019f	2020f
Real GDP (annual % change)	2.1	2.0	0.9	1.1
CPI (y/y %, eop)	6.8	4.8	4.1	4.1
Central bank policy rate (%, eop)	7.25	8.25	8.25	7.50
Mexican peso (USDMXN, eop)	19.66	19.65	20.87	21.44

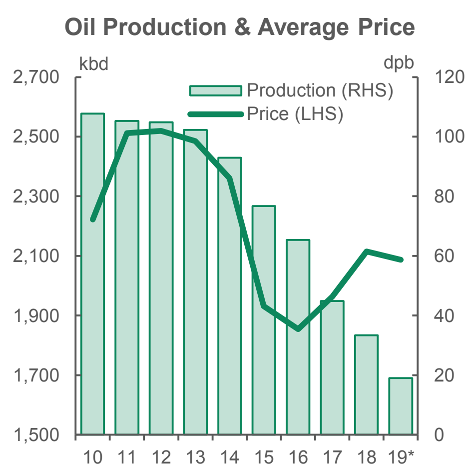
Source: Scotiabank Economics.

Chart 1



Frequency: Monthly
Sources: Scotiabank Economics, INEGI.

Chart 2



Sources: Scotiabank Economics, PEMEX.
* Data up to May 2019.

Instead, the government's intention to proceed with the construction of the Dos Bocas refinery project has been clear, and after rejecting private sector bids, as participants' offers seemed too expensive, the government committed to complete the project over the next 3 years for an estimated USD 8 billion, which seems excessively optimistic. It is foreseeable that Moody's and S&P will follow Fitch's downgrade on Pemex if the company does not present a convincing business plan, perhaps reversing its current path. Release of said business plan has been postponed on several occasions.

Rating agencies' possible decisions to cut Mexico's sovereign credit rating would depend on two key factors: first, the impact of a more-pronounced deceleration of real GDP growth on tax collection, which could undermine the fiscal outlook and further deteriorate economic growth prospects in the medium-term; and second, an increased risk of higher contingent liabilities for the sovereign due to a deterioration in Pemex's financial position, requiring additional government support with the potential to erode public finances.

Another unfortunate event for investors was the recent fight between the CFE and pipeline builders and operators, such as IEnova and Trans Canada. The CFE wants to modify existing contracts and recover a significant amount of the money already spent.

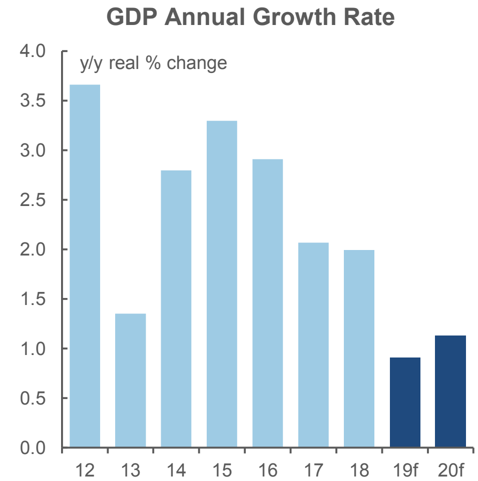
These developments add to the concerns analysts and market participants have had about the direction of policymaking of the AMLO administration, which has translated into downward revisions of GDP growth estimates for 2019. Growth expectations by private sector specialists surveyed by Banco de Mexico stood at 1.1% in June.

On the positive side, the USMCA has been approved in the Mexican Senate, albeit it still requires legislative approval in the US and Canada. Although a delay seems increasingly likely, we still expect a favorable outcome, which shall contribute to reduce trade-related uncertainty. Another positive, at least for financial markets, has been the dramatic change in the tone of the US Federal Reserve on monetary policy.

RECENT DYNAMICS IN THE ECONOMY HAVE TURNED THE BALANCE OF RISKS FOR GROWTH MORE UNCERTAIN AND DOWNSIDE BIAS HAS INCREASED

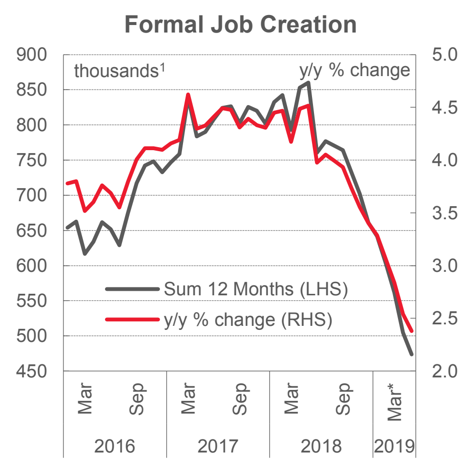
A slowdown in economic activity was anticipated in the first half of 2019, mainly driven by a softer global expansion, a significant delay in public spending, and unfavorable domestic developments, such as last year's economic policy reversals, that undermined consumers' confidence and dented business sentiment. Nonetheless, recent data and developments have changed the outlook for the worse. Signs of weakness in economic activity are quickly proliferating, as the latest available data confirmed that the economy has been losing steam at a faster pace. Real GDP grew only 1.2% y/y in 1Q-2019, down from 1.7% in 4Q-2018. This slowdown was driven mainly by a deceleration in services activity, which accounts nearly for 63% of GDP, from 2.7% to 1.9% y/y, its weakest gain since 4Q-2013. Moreover, industrial activity contracted for the second straight quarter (from -0.9% to -0.7% y/y), on the back of weakening manufacturing activity, with the ongoing decline in oil production and budget-related declines in government spending reflected in a drop of mining and construction activities. On the demand side, investment contracted -0.9% y/y in Q1-2019, while private consumption barely grew 1.1% y/y, its smallest gain in almost 6 years.

Chart 3



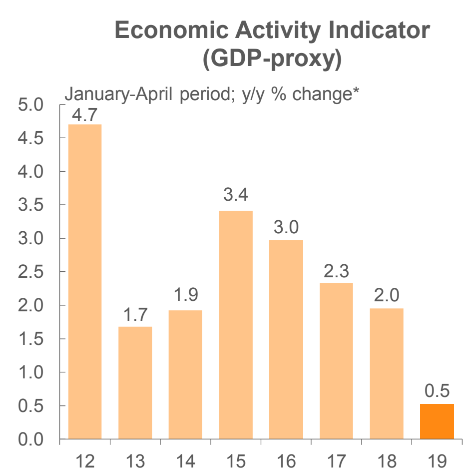
f: forecasted. Sources: Scotiabank Economics, INEGI.

Chart 4



Sources: Scotiabank Economics, Social Security Ministry database. * Data up to May 2019.
1/ New insured workers

Chart 5

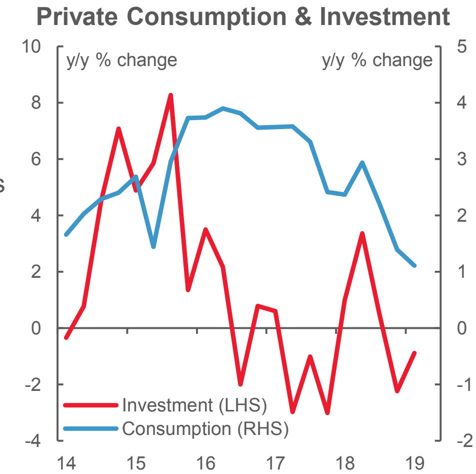


Sources: Scotiabank Economics, INEGI.
* Corresponds to the average growth for the first 4 months of each year.

Higher-frequency indicators have shown a more important slowdown than previously expected. The labor market is rapidly cooling down given the less positive economic outlook. The growth of new insured workers softened in May for a 10th month in a row, recording only 3,073 new jobs in the month and a total 473,928 new jobs in the previous 12 months, the lowest reading since 2014. On the other hand, real wage growth has been accelerating with some wide ups and downs through the year, perhaps affected by the magnitude of the strong minimum wage increase of 17% at the beginning of the year. This of course will add to cost-related pressures on inflation if wage increases keep exceeding productivity gains.

The recent resignation of Carlos Urzúa as Finance Minister is a negative event for the outlook, especially because of the way it happened and the messages he sent. This will add to the already elevated uncertainty that is hampering economic perspectives. The newly appointed Finance Minister/Secretary, Arturo Herrera, is well-regarded by the markets and has reaffirmed the commitments to keep a disciplined fiscal policy and macroeconomic stability. He will have a tough job in a complicated environment.

Chart 6



f: forecasted. Sources: Scotiabank Economics, INEGI.

Looking forward, we anticipate a challenging year for Mexico's economy amid renewed macro headwinds coming from both external and domestic factors. As a result, we are downgrading the 2019 GDP growth forecast even further to 0.9%. We anticipate weaker growth in consumption and job creation stemming from lingering uncertainty and undermined confidence. Moreover, we expect a deeper investment contraction, despite the political efforts to boost private investment, as the lack of policy coherence and discretionary decisions continue to weigh on business sentiment, while budget-related spending plans are poised to restrict public capital expenditure even further. On the other hand, exports will remain a growth engine, albeit their growth pace is poised to ease due to a softer US manufacturing activity, and overall, a weaker external demand. With regards to monetary policy, we still expect Banxico to maintain a prudent stance and hold interest rates through the year, as we expect inflation to remain above the official target for more time than previously anticipated and core inflation to remain stubbornly above target. In this respect, our year-end inflation estimate has been revised upwards, as rapid wage gains stemming from minimum wage revisions are starting to kick-in. Finally, we still expect the Mexican peso to come under pressure despite the better-than-expected performance in H1-2019, acting as shock absorber amid a more adverse backdrop.

In our assessment, the balance of risks for growth has become more uncertain and it is clearly tilted to the downside, with a growing probability of a recession. We expect sluggish economic activity to carry into 2020 with growth subdued at around 1.1%. We believe that the performance of the economy will continue to be under par. On the internal side, it is likely that investor and consumer confidence will continue to erode if policymaking remains unpredictable or is perceived as unreasonable, while on the external side heightened volatility and increased risk aversion on global markets could further weaken investors' sentiment towards EMs. Lastly, the US presidential election will be in the spotlight and it is quite likely that Mexico continue to be Trump's favorite punching bag, so the Mexican peso will be under pressure.

Brazil

GOOD NEWS, BUT IS IT ENOUGH?

- **Although a closed economy such as Brazil would seem to be relatively isolated from global trade war fallout, its already-sluggish performance and highly indebted public and private sectors should make Brazil more vulnerable than it appears at first glance.**
- **On the public finance front, news on pension reform has been relatively positive—if we assumed that only about 50% of the initial planned savings would materialize. However, a reform that saves BRL 700–800 bn over 10 years (about 1 percentage point of GDP per year) is still far from correcting a fiscal deficit of around 7% of GDP.**
- **We are somewhat off-consensus on BRL, the SELIC rate, and IPCA inflation. The main reason is that we don't think that the reform "does enough" to offset a negative turn in sentiment towards emerging markets (EM). In particular, with markets already pricing in 100 bps of FOMC rate cuts and being quite complacent on global trade and Brexit risks, among others, we think risks for the BRL are tilted towards negative—which in turn shifts our expectations on IPCA and the SELIC.**

BRAZIL'S SMALL TRADE SHARE—FALSE SENSE OF CERTAINTY?

Napoleon Bonaparte is quoted as having said "China is a sleeping giant. Let her sleep, for when she wakes she will move the world". Well, that giant did awake, and moved the world for the better part of what we've seen of the 21st century—while the other titan (the United States) mostly let the Asian giant assert itself by engaging through the rules-based international system. That friendly engagement is now under threat with the arrival of President Trump—and with it, certainty over global trade is being eroded. One of the key questions at this stage is how the struggle between the US and China on the trade front will play out and whether one will be trampled in the process. On one hand, Brazil is often seen as a satellite of China by EM investors, being one of the major providers for the Asian giant's voracious commodity appetite. On the other, it could be argued that being a relatively closed economy, Brazil would be less exposed to the global trade conflict's escalation. Which is the right answer? Is Brazil a safe haven in a global trade war or a front line casualty?

- **Brazil's isolation**: Brazil is a closed economy, and hence the direct impact of a trade war on the economy appears small. Compared to the other large economies in LATAM, as well as India and China, Brazil's trade share as a % of GDP is the smallest (see chart 1). Brazil's low integration to global trade is a hurdle for the economy's competitiveness, as the barriers that avoid a deeper integration also keep Brazilian firms from having access to better and more competitive inputs for its production chains. However, being a closed economy could also mean Brazil is relatively isolated from the fallout of a global trade conflict.

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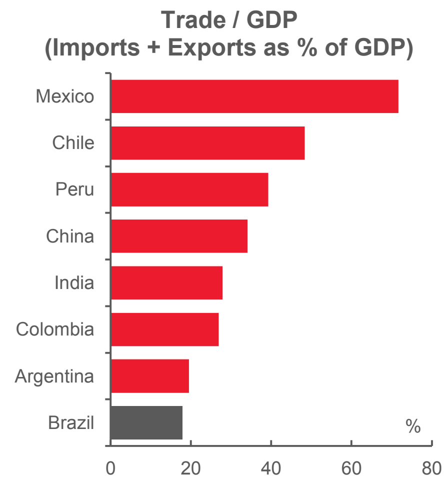
Brazil	2017	2018	2019f	2020f
Real GDP (annual % change)	1.1	1.1	0.9	1.8
CPI (y/y %, eop)	3.0	3.8	4.3	4.6
Central bank policy rate (%, eop)	7.00	6.50	7.00	8.50
Brazilian real (USDBRL, eop)	3.31	3.88	4.18	4.18

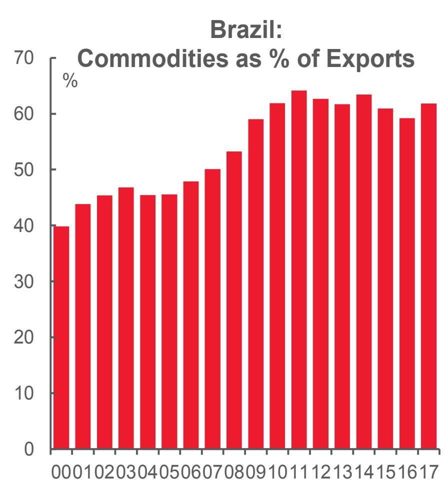
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, UNCTAD, IMF.

Chart 2

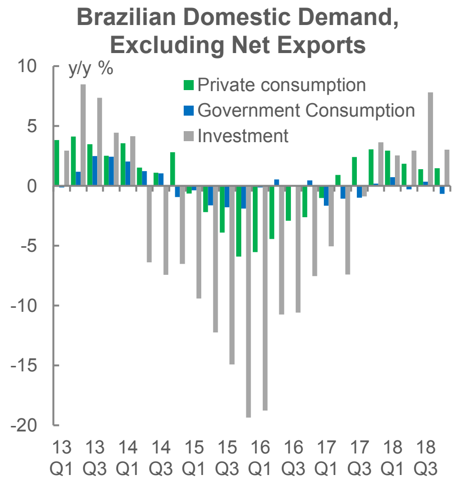


Sources: Scotiabank Economics, UNCTAD.

- **Spillovers from commodity prices**: Although exports are a small share of Brazil's economy, commodities represent a large share of exports (chart 2). If the US-China trade conflict were to deepen, and trigger a harder landing of the Chinese economy, we could see a relatively important impact on Brazil. Commodities account for over 60% of Brazilian exports and these represent around 6% of GDP. This shock and the one we discussed above could become more important given that the Brazilian economy at this moment is already very soft—and doesn't have robust domestic demand to serve as an offset to external headwinds.

- **Weak domestic demand**: On this front, the Brazilian economy has improved from the long recession of 2014–17. However, even today, most of the components of domestic demand remain underwhelming at best (see chart 3). Private consumption has only managed 4 quarters of >2.5% expansions in the past 20 quarters, while government consumption has barely had 1 quarter at 2% in the same timespan—and additional fiscal consolidation is needed. Investment has finally shown signs of life, but remains a marginal share of GDP (<20%).

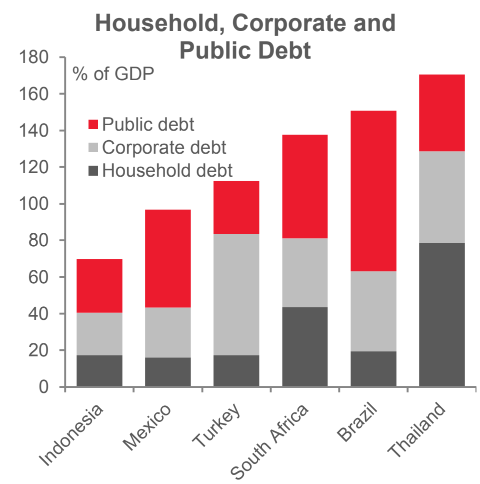
Chart 3



Sources: Scotiabank, BCB.

- **Exchange rate volatility**: A few weeks back, Bank for International Settlements (BIS) General Manager Carstens gave an important speech where he clarified the different role of exchange rates in EMs and DMs. In it, he argued that while in developed economies a weaker FX provides a positive boost to economic activities, in the emerging world the impact is the opposite. His arguments include: "*It's worth remembering that a large depreciation [*of the exchange rate*] and economic downturn are often followed by a sharp rise in inflation, despite the slowdown in economic activity. The extent of such second-round effects depends, in turn, on how well inflation expectations are anchored to the central bank's target*." He also argues that in EMs, a weaker FX has a tightening effect on financial conditions: "*In EMEs, the exchange rate also affects domestic economic activity through financial conditions, further complicating the central bank's task. EMEs' exposure to financial channels of the exchange rate arises from two key features of their financial structure: (i) EME borrowers, especially corporates, rely heavily on foreign currency borrowing; and (ii) foreign investors' large holdings of EME local currency sovereign debt. Through both channels, exchange rate appreciation tends to loosen domestic financial conditions, exerting an expansionary effect on domestic economic activity.*" Going a bit against the views of Central Bank policy of recent years, where exchange rates were seen as the ultimate shock absorbers, Carstens argued that "*The exchange rate may hence increasingly act as a transmitter and amplifier of financial shocks, rather than as an absorber of real shocks*". To that, we would add that in a country where exports are concentrated in raw materials, and on the import side we have a large share of consumer and capital goods, if China were to take a strong growth hit from a trade war—triggering a correction in commodity prices—Brazil could suffer an additional contractionary impulse through terms of trade.

Chart 4



Sources: Scotiabank Economics, OECD, IMF.

Overall, we think Brazil is more exposed to a global trade war than it would appear at first glance—just by looking at the trade share of GDP. The biggest risk for Brazil is not so much direct trade links, given its relatively closed economy. The risks to Brazil come from the fragile situation of the economy due to high indebtedness (see chart 4) and already very troubling fiscal path (more on this later), as well as an economy that has been struggling to get back onto a positive growth path for several years now. If the external boost to both commodity prices and demand for Brazilian commodities were to soften, the economy would suffer.

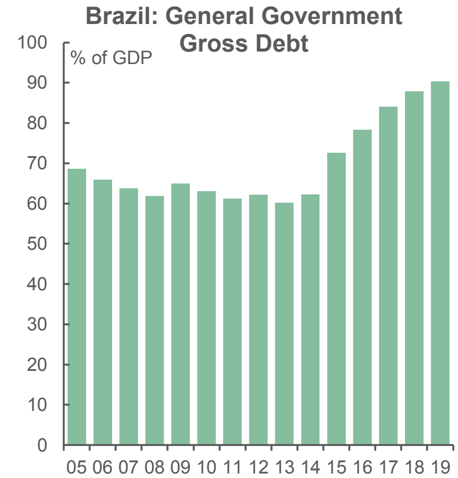
BRAZIL'S PUBLIC FINANCE SITUATION MAKES IT VULNERABLE TO A MORE PRONOUNCED SLOWDOWN:

Expectations on the pension reform have slightly improved over the past couple of months, with expected savings from the bill currently ranging from BRL 700 bn–800 bn over 10 years, relative to the BRL 600 bn expected a couple of months back. This still falls short of the BRL 1,200 bn the bill initially sought. The problem is that with a gross general government deficit expected to remain around 7% of GDP (without pension savings) (see chart 5) and the savings from the bill being only about 1% of GDP per year, there is still a lot of homework for the government to do—even if the reform's passage could give some additional relief by leading to a modest decline in clearing interest rates in the country. The trend of policy in Brazil has undoubtedly improved over the past couple of years—we doubt there are many market players who would contradict that. The question is whether enough is being done to offset the structural deterioration path the country is currently on. As chart 6 shows, the country's public debt has been on a very concerning trajectory and, even though the pace of deterioration pace is slowing, enough has not been done.

The largest deviation in our forecasts from "consensus" is on the monetary policy and inflation fronts. Consensus and DI rates are looking for an easing cycle from the Central Bank of Brazil (BCB) (DI rates are pricing 3 x 25 bps cuts by year-end). Our main concern there centers on our expectation that the external environment may not be friendly enough to allow it. As we write this, markets are pricing in 100 bps of cuts by the FOMC, which is very supportive for EMs. Our sense is that markets are already incorporating a very favorable EM outlook and, with the number of risks out there, we think risks at this stage are biased toward the downside—hence our weakening path for BRL, our less positive IPCA inflation forecasts, and our less dovish expectations for the SELIC rate.

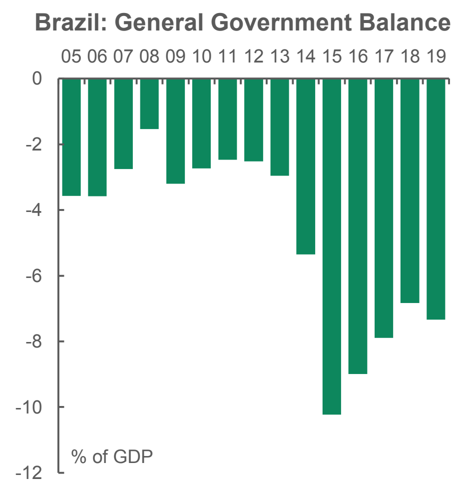
We have a slightly slower growth pattern for Brazil than consensus, in part because we are less constructive on the possibility that the BCB will be able to deliver on rate cuts to stimulate the economy. The outlook for rate cuts is quite binary, and to an important degree depends on the external environment. By 2020, we have the Brazilian economy oscillating around 2.0%, which we take as the country's potential growth rate—until investment rates rise consistently. As we discussed in our *Brazil Country Briefing (May 3, 2019)*, there is a lot of room for micro reforms in the country, which could boost investment, and with it potential growth. For now, those micro-reforms remain plans.

Chart 5



Sources: Scotiabank Economics, IMF.

Chart 6



Sources: Scotiabank Economics, IMF.

Colombia

SHORT RUN IMPROVED, LONGER RUN STILL BLURRY

- **Economic recovery is underway although at a slower pace than anticipated. Domestic demand remains strong, but we are reducing our GDP growth forecast to 3.2% y/y owing to a greater drag from trade.**
- **BanRep will hold the lending rate steady as it balances the need to boost growth against short term upward pressures on inflation. We expect stability for the rest of 2019.**
- **Short term fiscal prudence is positive, but decreasing revenues over the medium term remain a challenge.**
- **Recent news on lower fiscal indebtedness this year was good, but structural challenges remain since fiscal revenues are expected to fall in the medium term.**

Expected easing by the Federal Reserve and the accompanying developments in international financial markets are creating a more benign environment for Colombia to pursue its reform agenda. The economic recovery continues but at a slower pace while the government's fiscal objectives should be attainable this year. Monetary policy should be on hold for the foreseeable future. Relative to other emerging markets Colombia is in solid shape for the moment, but medium-term challenges remain in the fiscal and external accounts.

ECONOMIC RECOVERY IS UNDERWAY WITH INFLATION UNDER CONTROL

Colombia's 1Q GDP disappointed relative to market consensus and authorities' projections even though domestic demand growth was robust. A larger than expected deterioration in the trade balance led to Q1 growth, at 2.8% y/y, falling just short of our expectation of 3%. The larger drag from trade in part reflected the strength of the domestic economy, as imports of capital goods rose by 11% y/y. On the supply side, the negative surprise in 1Q19 came from construction activities that declined by 5.6% y/y; other sectors like mining (+5.3% y/y), retail (+4.0% y/y) and financial activities (5.5% y/y) showed further improvement, while public sector services are slowing down.

The weaker result in Q1 is dragging down our forecast for 2019 from 3.4% to 3.2%. Domestic demand remains relatively strong but the drag from net exports is expected to persist. Government spending might surprise upwards in 2H19 due to October elections and our forecast also includes a strong investment recovery on the back of a very strong civil works programs that depends on the effective execution of the 4G program. Therefore, our balance of risks is rather neutral. On the supply side GDP will be supported by a recovery in mining, a gradual recovery in industrial activity, and still-strong retail and financial activities. The construction sector will continue subtracting from GDP growth due to high inventories or at most showing nil expansion. For 2020 we expect gradual recovery to continue and GDP growth to accelerate a bit to 3.6%.

Inflation accelerated to 3.4% y/y due to rising food and house prices, though core inflation (excluding food and regulated prices) remains below 3%. A base effect in

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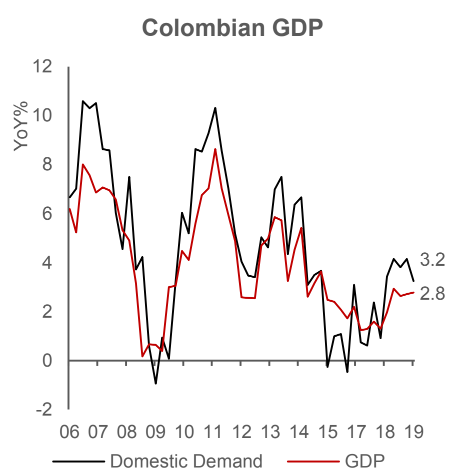
Colombia	2017	2018	2019f	2020f
Real GDP (annual % change)	1.4	2.6	3.2	3.6
CPI (y/y %, eop)	4.1	3.2	3.2	3.1
Central bank policy rate (%, eop)	4.75	4.25	4.25	4.50
Colombian peso (USDCOP, eop)	2,986	3,254	3,120	3,167

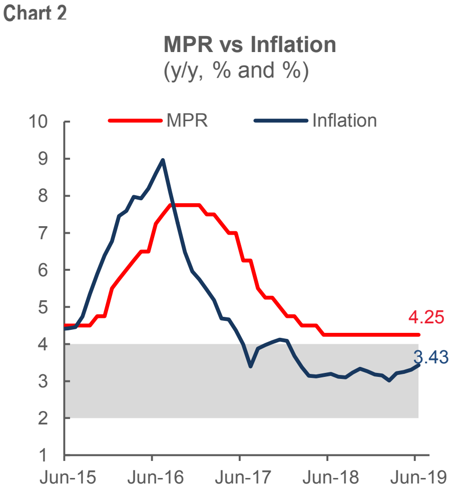
Source: Scotiabank Economics.

Chart 1



Sources: DANE, Scotiabank Economics.

Chart 2



Sources: Banco de la República, DANE, Scotiabank Economics.

foodstuffs should lift yearly inflation in the coming months, but those effects are going to be diluted later in 2019. FX pass-through has been rather moderate, and we do not see a big issue on this front as we believe the COP depreciation observed during the past few months will be temporary. The negative output gap will continue to put downward pressure on prices. We expect inflation to close 2019 at 3.2% y/y. For 2020 we do not see relevant changes in price dynamics; therefore, we project year-end headline at 3.1% y/y.

The Colombian central bank (BanRep) has to balance between temporary inflation pressures that can affect inflation expectations and an economy that is still running below potential, which supports continued monetary stimulus. Recent communication from BanRep points to a central bank more concerned by the slack in the economy that, in line with developed countries' central bank dovishness, make us look for policy rate stability at 4.25% for longer. Policy rate settings in real terms are slightly expansionary. Additionally, recent COP appreciation will help keep inflation expectations anchored. Therefore, we removed the 25 bps hike that we had for 3Q19. We still believe that in 2020 the next move is going to be a rate hike due to the domestic demand recovery expected next year.

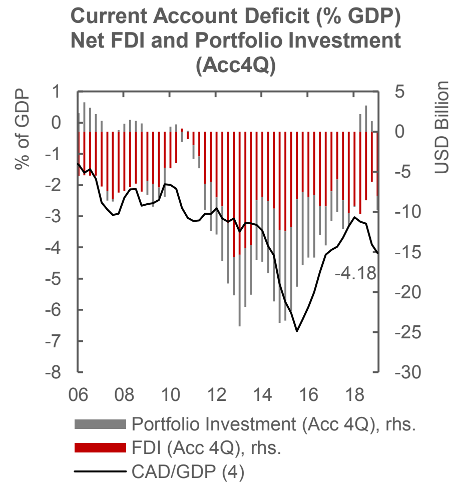
WIDENING CURRENT ACCOUNT DEFICIT IS STILL A CONCERN AND FISCAL CONSOLIDATION FAR FROM BEING STRUCTURAL

The current account deficit remains a major concern. It stood at 4.6% of GDP in 1Q 2019, 1.1 ppts higher than the same period of 2018, although financing is still healthy via FDI. As indicated in previous reports, domestic demand recovery requires a deterioration in the current account as higher investment comes with higher capital and raw material imports. For 2019 we expect an external deficit of nearly USD 13 billion (4.1% of GDP), much higher than peers in Latam; thus, vulnerability in case of an external shock is very high. The international reserves accumulation program, that was suspended in May but can be renewed, could help to face an eventual external shock, but it would be just a band-aid. The structural external deficit can only be corrected by increasing productivity and measures to increase export competitiveness or increase national savings.

Doubts about the fiscal outlook are all gone in the short term. The Government committed to reducing the fiscal deficit from 3.1% in 2018 to 2.4% of GDP in 2019 despite the 2.7% of GDP recommended by the fiscal committee. Announcements of deficit reduction beyond the fiscal rule sent a fiscal responsibility message which was positive for markets and helped to keep Colombia's international rating two notches above investment grade. However, it is worth clarifying that attaining the 2.4% target was partly due to accounting changes. Therefore, structural questions are far from being solved. In fact, deficit targets beyond 2021 are higher than fiscal rule permits. That's why there was a mixed signal in Colombian sovereign ratings—while Moody's removed a negative outlook and affirmed Baa2 rating, Fitch changed its outlook to negative reflecting structural concerns.

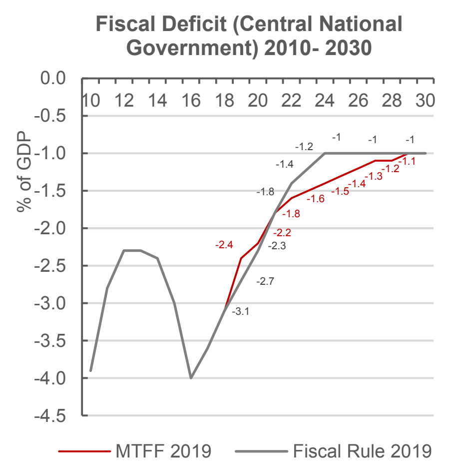
Medium-term fiscal challenges are far from being resolved, according to recent Government projections. Although there is a commitment to reduce expenditures from 19% of GDP in 2019 to 16.7% of GDP ten years ahead, revenues continue to fall as a percentage of GDP (from 16.6% to 15.7% in the same period) and could be even worse if GDP doesn't meet government expectations. As we said earlier, short-term fiscal prudence is positive, but structural reform policy is needed. Colombian assets recently have been supported by the short-term good news, and also were helped by a renewed era of accommodative monetary policy, but again, relative advantage could be short-lived—Colombia needs deeper actions.

Chart 3



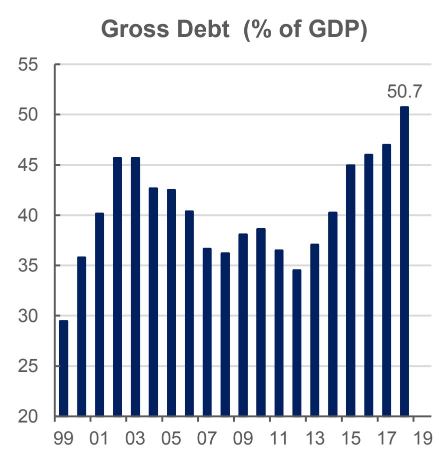
Sources: Banco de la República, Scotiabank Colpatria.

Chart 4



Sources: MTFF 2019, Comité de la Regla Fiscal 2019, Scotiabank Economics.

Chart 5



Sources: Ministerio de Hacienda y Crédito Público, Scotiabank Economics.

Peru

GROWING IN AN ENVIRONMENT OF CONTINUOUS GLOBAL AND POLITICAL UNCERTAINTY

- **We ratify our GDP growth forecasts of 3.1% for 2019 and 3.7% for 2020.**
- **Macro balances are strong, but are not feeding into growth.**
- **Private investment is a significant concern. Non-mining investment is declining.**
- **Consumption is performing well, but employment growth is slowing.**
- **The Central Bank is under increasing pressure to reduce its Reference Rate, but has yet to give guidance in that direction.**

We recently reduced our GDP growth forecast from 4.0% to 3.1% for 2019, and from 4.0% to 3.7% for 2020. Three significant aspects have changed, affecting our outlook for 2019-2020. These include:

1. A more complex and uncertain global environment.
2. A renewed round of domestic political uncertainty and early concern over 2021 elections.
3. The reality of a weak first semester for GDP and private investment growth.

Growth in the first half of 2019 is likely to be a relatively soft 2.4%–2.5% (2.3% in 1Q). These weak results have been mainly due to resource sectors, as declining mining and fishing GDP shaved off 0.7pp from growth in 1Q alone (fishing GDP fell by 34%; mining by -1.7%, in the year-to-May). The next fishing season—starting in November—should be better, and some of the temporary factors that beleaguered mining (refinery maintenance, environmental compliance, and social conflict) should also dissipate going forward.

However, it is also true, and this is much more important, that non-mining private investment is comatose, down 0.5% in 1Q, with no reason to believe that 2Q would have been much better. This is really our greatest concern. Even with mining investment up strongly (37% growth in 1Q), we have lowered our aggregate private investment growth forecasts from 6.5% to 3.5% for 2019, and 5.4% to 4.0% for 2020, with non-mining private investment contribution to growth nearly insignificant. The additional risk is that such low private investment will eventually affect jobs growth—if it isn't doing so already—and, therefore, consumption growth. This is key, as consumption, up 3.5%–3.8% in the past two years or so, is the only domestic demand component consistently sustaining the economy.

The fragility of domestic demand growth puts into perspective the need for greater fiscal spending. However, this may not happen soon. Public sector investment declined in the first half of the year, as expected given new regional and local government authorities. It should improve going forward, in line with the authorities' learning curve, but the going will be slow.

GDP should perform better in 2H19, as public investment picks up and resources sectors growth normalizes. However, as long as private investment is weak, the sustainability of over 3% GDP growth will be shaky.

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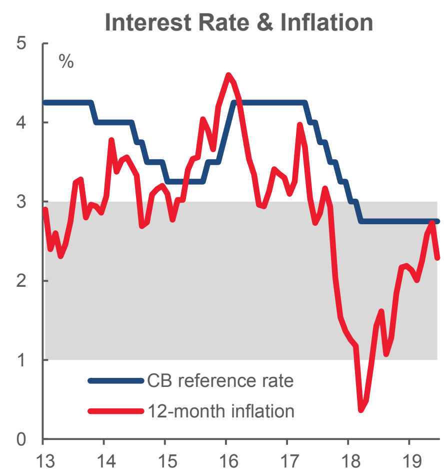
Peru	2017	2018	2019f	2020f
Real GDP (annual % change)	2.5	3.9	3.1	3.7
CPI (y/y %, eop)	1.4	2.2	2.2	2.3
Central bank policy rate (%, eop)	3.25	2.75	2.75	2.50
Peruvian sol (USDPEN, eop)	3.24	3.37	3.35	3.30

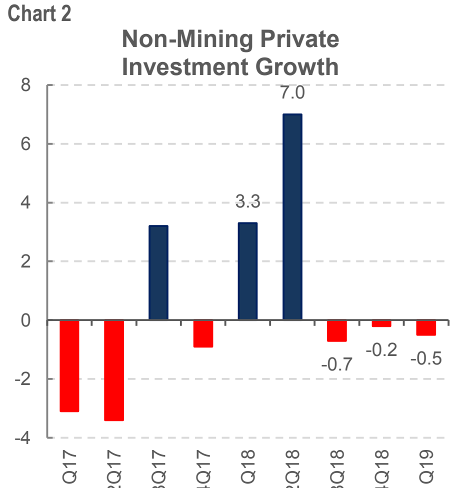
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, BCR, INEI.

Chart 2



Source: BCR.
Prepared by: Scotiabank Economics.

The political environment is not helping. The weight of concern of the business community is shifting, however, from the ongoing tension between the government and opposition in Congress, to the 2021 elections. Corruption issues have affected nearly all major parties, as well as many past candidates, and this has opened up the playing field to a plethora of potential outsiders. Concern regarding the 2021 elections has come much earlier than in previous political cycles.

At the same time, macro balances are very strong. The 12-month fiscal deficit to May is a mild 1.5% of GDP, which compares well with our forecast of 2.0% for full-year 2019. If anything, the deficit may be too low. The government's 2019 budget calls for a 2.5% deficit, and to be so far below this target largely reflects underspending. This is in line with the decline in public sector investment, and means that the government is not contributing adequately to domestic demand.

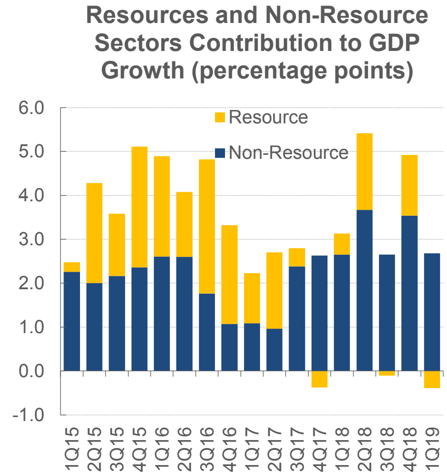
WILL IT OR WON'T IT?

We are lowering our inflation forecasts for 2019 to 2.2% from 2.4% and from 2020 to 2.3% from 2.5%. With inflation moderating, GDP growth underperforming and a somewhat more apprehensive Central Bank (CB), we no longer hold that the CB will maintain its reference rate at 2.75%, and now expect one 25bp reduction to take place no sooner than 4Q19 and no later than 1Q20. We do this with trepidation, however, as the CB has not been clear in its guidance. The CB, in its July quarterly Inflation Report, painted a less rosy picture than in the past, with forecasts for lower global and domestic growth, weaker terms of trade, and less robust confidence levels. Although CB spokespersons recognized in the Report that the balance of risks had deteriorated since the past two reports, they seemed to suggest that a decision to lower its reference rate would hinge on whether an expected increase in fiscal spending materialized, and whether the government will take greater action in ensuring progress in large-scale infrastructure and mining projects. Overall, we sense that the CB is, indeed, giving greater consideration to lowering its reference rate, but also believe that the CB will exercise patience for perhaps one or two more quarters before making a decision. The CB also seems keen on managing expectations, especially consumer and business confidence levels, which also suggests that it would try to hold off lowering its reference rate for as long as possible in order to avoid signaling concern prematurely.

The PEN has fluctuated between 3.28 and 3.39 in the year to date. Strong capital inflows this year have taken the PEN below 3.30 recently, with the drop only stemmed by Central Bank intervention. This year's 3.28 and 3.39 range limits are not fortuitous but, rather, represent levels at which the CB has intervened, and we expect this range to hold for the remainder of the year, barring strong global FX movements. Our 3.35 year-end forecast falls within this range. Short-term movements will depend on fluctuations in metal prices, the USD globally and capital inflows, within the limits set by the Central Bank. For the time being, capital flows into sovereign bonds show no signs of abating, and are the dominating force in a PEN market which is ignoring lower metal prices and risk-off events.

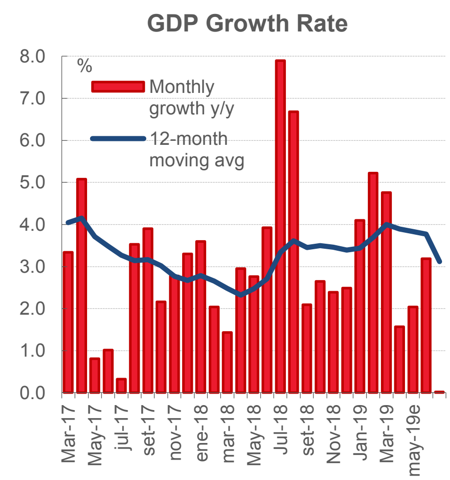
To end on a positive note, the likelihood of a major negative political event, such as the closing of Congress or impeachment of the President, while not totally out of the question, has faded significantly, and the far most likely scenario is that both the President and Congress will last through their mandates. Corruption issues and the prosecution of major politicians continue to generate noise, but the initial thunder and lightning has turned more into a (rather continual) rumbling. There is hope of good news on infrastructure investment, as well. We've seen real progress, albeit in baby-steps, in infrastructure projects, and Finance Minister Carlos Oliva has promised to present a broad program of projects in late July. This merits cautious optimism going forward.

Chart 3



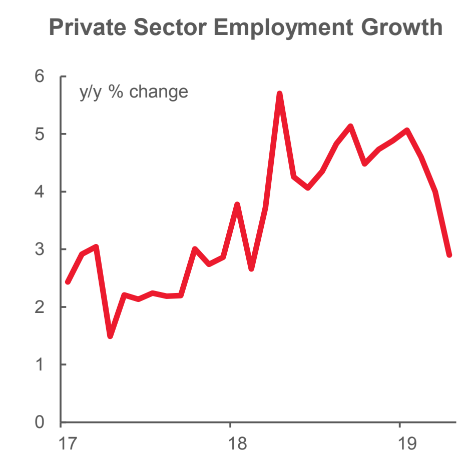
Source: BCR.
Prepared by: Scotiabank Economics.

Chart 4



Sources: Scotiabank Economics, INEI.

Chart 5



Sources: Sunat, BCR.
Prepared by: Scotiabank Economics.

Chile

ECONOMIC RECOVERY IS REAL BUT FRAGILE

- **We continue to forecast GDP growth of 3.2% this year. Domestic demand will be led by investment during the second half of the year. Our forecast has a slight downward bias due to slower-than-expected activity in the first quarter, explained by an escalation in the trade war and negative supply shocks coming from agriculture, fishing and mining.**
- **The deterioration of the labor market seems to have concluded. Job creation and wages have started to pick up and we should see an increase in private consumption in the following months.**
- **We keep our inflation forecast at 2.8% for year end. After the surprising cut of 50 bps in the benchmark rate by the Central Bank, we do not anticipate additional downward adjustment unless the external tensions increase and/or domestic demand disappoints our baseline scenario.**

MACRO UPDATE

During 1Q19, GDP growth was lower than expected, mainly as a result of negative surprises coming from mining, agriculture and fishing sectors. Accordingly, Q1 GDP growth printed at 1.6% y/y, below the preliminary reading of 1.8% y/y. Despite the negative surprise, core-activity remained solid and is still consistent with GDP growth around 3.2% for 2019. We anticipate a relevant acceleration during the second half of the year, with domestic demand led by investment, with the velocity of the latter highly conditioned, as usual, by the approval of political reforms and stable terms of trade. At the margin, GDP expanded 2.1% y/y in April, with a solid dynamism in non-mining activity (0.3% m/m sa). Services activity continues to lead the way, but mining, and activity in general is showing stronger signs of life (chart 1).

With respect to investment, even though we had a lower-than-expected expansion of 2.9% y/y in 1Q19, the outlook for the rest of the year remains favorable. Within its categories, Machinery and equipment grew below expectations in 1Q19, but Construction showed stable growth. In addition, we expect a more robust pipeline of investment projects to materialize during the second half of 2019. Moreover, the Government has announced new fiscal stimulus to accelerate public investment, totalling more than USD 2,400 million in expenditures for 2019 and 2020.

Private consumption has not shown significant negative surprises. The deceleration in durable goods has materialized, as we expected, but we have seen a strong resilience and even acceleration in consumption of services. In that context, private consumption expanded 3.2% y/y during the 1Q19, slightly lower than previous quarters, with an annual contribution of 2pp to GDP growth. Durable goods have had a negative impact on growth, influenced by the drop in car sales, after reaching records in 2018. In contrast, non-durable goods are growing at a stable pace and at the margin they are showing acceleration. In the labor market, the deterioration seems to have ended (chart 2). The unemployment rate reached

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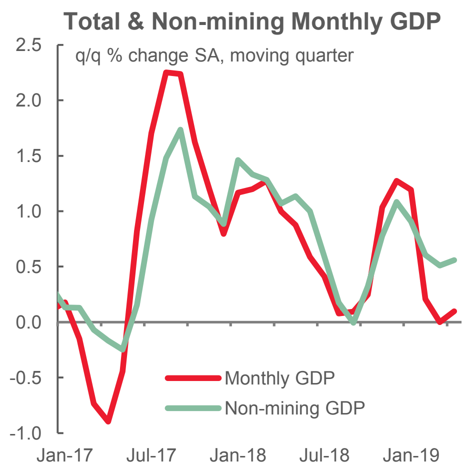
Chile	2017	2018	2019f	2020f
Real GDP (annual % change)	1.5	4.0	3.2	3.2
CPI (y/y %, eop)	2.3	2.6	2.8	3.0
Central bank policy rate (%, eop)	2.50	2.75	2.50	3.25
Chilean peso (USDCLP, eop)	615	694	645	640

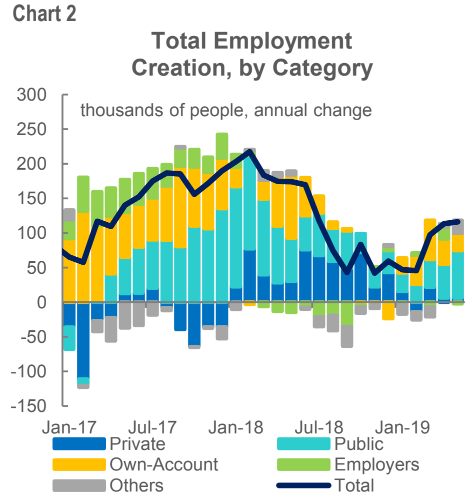
Source: Scotiabank Economics.

Chart 1



Source: Central Bank of Chile.

Chart 2

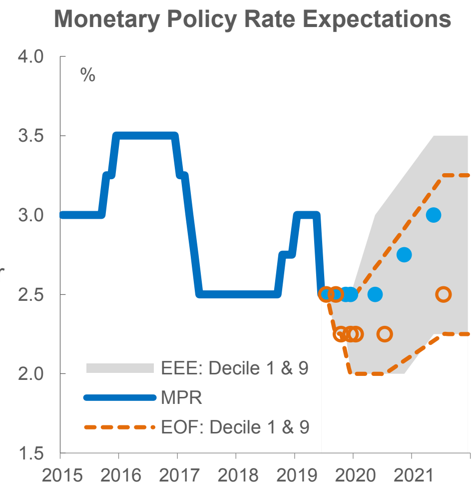


Source: National Bureau of Statistics (INE).

7.1%, and the latest data available for May confirms a recovery in job creation, mainly in self-employment and public jobs, associated with an acceleration of countercyclical public spending. These, along with the recovery in wages and a surge in labor income, are the main drivers of the stabilization in private consumption for the rest of the year.

Taken together, the recovery in wages and the stabilization of the Chilean peso (CLP) pass-through (which was low in the first part of the year), should trigger inflation prints toward historical averages from July on, both in services and goods, reversing the sluggish start of the year. As a reference, in 1H19 annual core inflation (which excludes food and energy) has been closer to 2% than to 3% (the central bank's inflation target for the next two years). Nevertheless, we keep our inflation forecast of 2.8% for the end of the current year, as we expect some upward effect coming from services, seasonal factors and recent CLP depreciation. This, along with higher oil prices due to rising external risks, should sustain 2.8% inflation for 2019 and 3.0% for 2020.

Chart 3



EEE: Survey of Economic Expectations.
EOF: Survey of Financial Traders.
Source: Central Bank of Chile.

In early June, the Central Bank surprised the market by cutting the policy rate 50 bps, from 3.0% to 2.5%. The decision was driven by a new estimate of potential GDP (+25 bps, reaching 3.4%) due in part to higher immigration that should increase the output gap, the lower neutral monetary policy rate, and the reduction in its GDP growth range estimate for 2019 (from 3.0-4.0% to 2.75-3.50%). This led the Board to recalibrate the necessary monetary stimulus, erasing the 50 bps increase in the MPR delivered between October 2018 and January 2019. Contrary to market expectations, we do not forecast new cuts in the MPR unless the performance of the economy disappoints us. Additionally, if the risks emerging from the external scenario become a reality, a significant fall in copper prices and/or relevant correction in world GDP might influence the CB to cut the rate again. We do not see that as our baseline scenario so we anticipate the normalization process will be resumed during the third quarter 2020, as we have been anticipating in our previous reports, with the benchmark rate at 3.25% in December 2020 (chart 3).

After reaching $710 in May, as global uncertainty escalated, the CLP has strengthened. In the last weeks, the Chilean peso appreciated to levels close to 680 CLP/USD, as copper stabilized around 2.7 USD/lb and the USD has weakened across the board. Current levels are aligned with short-term fundamentals, but we expect the exchange rate to continue appreciating by the end of the year. Waning external risks, a rebound in the copper price to levels around 2.9 USD/lb and a higher depreciation of the USD globally, along with better domestic figures, allow us to forecast the CLP around 645 CLP/USD by December.

The main risks to activity come from the external sector, presenting a threat to Chilean exports and terms of trade. Copper prices have been stable in the last three months, but the risk of a correction due to an escalation in the trade war or a renewed weakness in China are the most important sources of concern. Domestically, the main risk is political: the ability to reach agreements to approve critical reforms to enhance potential growth. In this sense, Piñera's administration changed six ministers of his Cabinet in June, showing signs of flexibility and a major concern for consolidating growth above 3%.

United Kingdom

- **GDP growth in the UK will remain weak through 2019 and 2020 as rising Brexit and global trade risks continue to depress business investment in Britain against moderate support to growth from household consumption gains.**

- **We anticipate that the Bank of England will maintain its policy rate unchanged at 0.75% through 2019 and 2020. While continued wage pressures in the UK are on track to push inflation to target late next year, the Bank will likely remain on the sidelines amid prolonged Brexit uncertainty and as most major central banks take a more accommodative stance in light of reduced global growth prospects.**

As the Brexit process lingers and trade risks pile on, the UK economy remains on a weak footing with little upside. There has been virtually no progress on the Brexit front since the EU agreed on April 12 to extend the UK's departure from the bloc until as late as October 31. In the meantime, the US's relatively short-lived threat of tariffs on Mexican goods and Washington's as-of-yet unresolved trade dispute with China continue to highlight the severe downside risks to global economic growth. We nevertheless continue to believe that US-China tensions will not escalate into a full-blown trade war.

We forecast that the UK economy will expand in 2019 by its slowest pace in a decade before picking up slightly but remaining sluggish in 2020. Our forecast for growth of 1.1% and 1.2% in 2019 and 2020, respectively, assumes that Britain will exit the EU in an orderly fashion as late as the October 31 deadline, although there is a growing chance that the withdrawal target date is pushed once again to the first half of next year. Yet, the likelihood that the UK stumbles out of the EU without a proper arrangement has risen in recent months with Boris Johnson handsomely leading the race to replace Theresa May as Prime Minister on July 24th. Mr. Johnson has both claimed that the UK will leave the EU "do or die, come what may" by the October cut-off, but has also claimed that the odds of a 'no-deal' Brexit are "a million-to-one against". We remain optimistic that Mr. Johnson will ultimately push for an exit arrangement with the EU given the sharp economic disruption that would be brought on by a 'hard' Brexit. Support to block a no-deal Brexit is also on the rise in the House of Commons as the deadline draws near.

Business investment in the UK is set to contract for a second straight year in 2019 as firms hold back spending plans owing to the multitude of risks on the horizon as well as a broader decelerating trajectory for global growth. Business surveys point to continued weakness in investment due to trade and Brexit uncertainty (chart 1), while capacity utilisation pressures have eased off. Export orders have also deteriorated amid weakening growth abroad, namely in continental Europe (chart 1, again).

Household consumption remains the only bright spot in Britain's economy thanks to steady job gains and strong wage increases. Despite the prevailing economic uncertainty in the UK, real retail sales growth has accelerated rapidly since mid-

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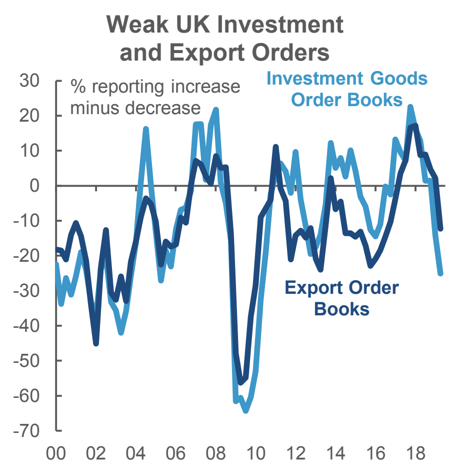
United Kingdom	2017	2018	2019f	2020f
Real GDP (annual % change)	1.8	1.4	1.1	1.2
CPI (y/y %, eop)	3.0	2.1	1.8	2.0
Central bank policy rate (%, eop)	0.25	0.75	0.75	0.75
UK pound (GBPUSD, eop)	1.20	1.28	1.25	1.40

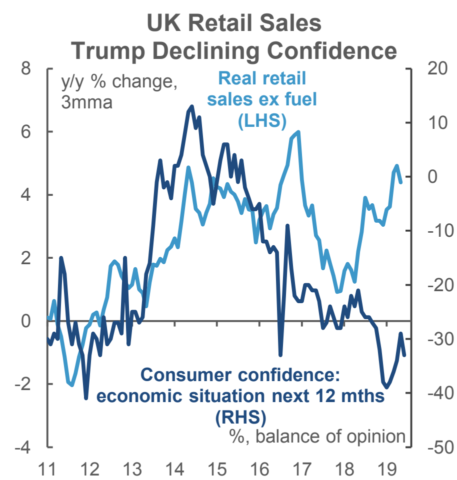
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, European Commission.

Chart 2

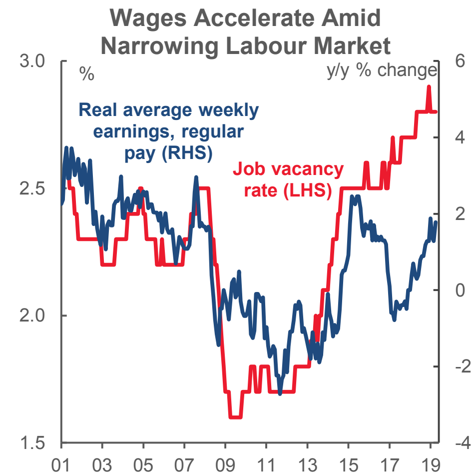


Sources: Scotiabank Economics, Gfk, ONS.

2018 (chart 2). Job vacancy rates have hit their highest level since the collection of data began as firms continue to tap labour markets to increase their productive capacity, lifting real weekly earnings growth to its fastest pace since early-2016 (chart 3).

We now expect that the Bank of England will leave its policy rate unchanged at 0.75% through 2019–20. Our previous forecast called for a 25 bps increase in the second quarter of 2020. We anticipate that UK inflation will remain on a decelerating path through 2019 and undershoot the BoE's target until as early as late-2020 alongside falling energy prices and the fading impact of past GBP depreciation on domestic prices. While inflation is set to rebound late next year owing to continued wage pressures, the BoE is unlikely to move ahead with policy tightening in light of global trade risks, especially as other major central banks take a more accommodative stance. Brexit may also remain unresolved past year-end.

Chart 3



Sources: Scotiabank Economics, ONS.

Eurozone

- **In 2019, the Eurozone will post its slowest economic expansion in five years amid decelerating global growth and heightened trade risks owing to the White House's protectionist policies.**
- **With weakening growth and inflation well below target, we anticipate that the ECB will lower its deposit facility rate by 10 bps at its September meeting, to -0.50%, and, at a later date, disclose details of a new asset purchase program to be launched in early-2020.**

The Eurozone economy is set to decelerate its slowest pace of expansion in five years as prospects for the global and domestic economies weaken in the face of mounting US protectionism and Brexit-related risks. We forecast that real GDP growth in the Eurozone will slow from last year's rate of 1.9% to 1.1% and 1.3% in 2019 and 2020, respectively.

While the US and China have agreed to a détente over the imposition of additional import tariffs, the two parties have made little progress on a concrete deal that would put an end to the trade dispute. At home, EU auto exports to the US remain at risk of facing tariffs; President Trump recently accused the ECB of manipulating the euro, "making it unfairly easier for them to compete against the USA". Meanwhile, the odds of a no-deal Brexit have risen with Boris Johnson in pole position to succeed Theresa May as Prime Minister.

The outlook for the Eurozone economy is characterized by a clear dichotomy between continued weakness in the manufacturing sector in contrast to stabilizing growth in services (chart 1). Manufacturing output growth remains in negative territory, having sharply decelerated since early-2018 when the US first imposed tariffs on steel and aluminum products, but also owing to production issues in the auto sector amid new vehicle emission standards in the EU. On the other hand, the services industry has regained an upward trajectory over the last two quarters on the back of resilient household spending, following a slowdown in the latter part of 2018 partly as a consequence of the 'yellow vests' protests in France and heightened political uncertainty in Italy.

With no clear end in sight to the US-China trade war and its concomitant hit to global business confidence and trade volumes, as well as prevailing Brexit uncertainty, the Eurozone manufacturing sector may contract in 2019 for the first time since the 2011–13 recession. Germany, where the manufacturing sector represents over a fifth of GDP (chart 2), is on track to lose the most from declining global trade; German manufacturing new orders have contracted in annual terms for ten consecutive months.

Capacity utilization rates remain above their post-financial crisis average and should motivate increased capital outlays across the Eurozone (chart 3) in spite of global trade concerns. Uncertainty around Brexit and the global economy will nevertheless limit what could have otherwise been a very solid year for business investment in the manufacturing sector. In 2019, capital expenditures should still grow at a strong clip in Spain and the Netherlands, where operating rates remain significantly elevated after having rapidly risen in recent years. In France and

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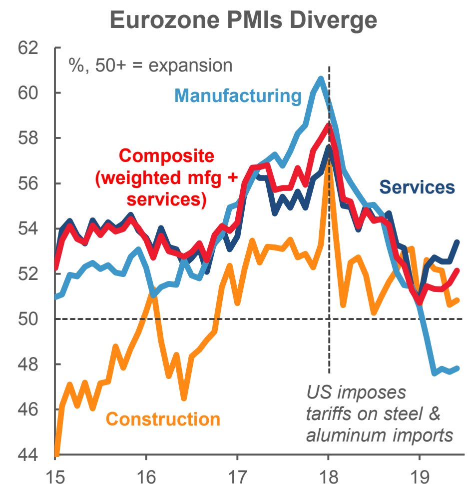
Eurozone	2017	2018	2019f	2020f
Real GDP (annual % change)	2.4	1.9	1.1	1.3
CPI (y/y %, eop)	1.3	1.5	1.3	1.4
Central bank MRO rate (%, eop)	0.00	0.00	0.00	0.00
Central bank deposit rate (%, eop)	-0.40	-0.40	-0.50	-0.50
Euro (EURUSD, eop)	1.18	1.15	1.15	1.24

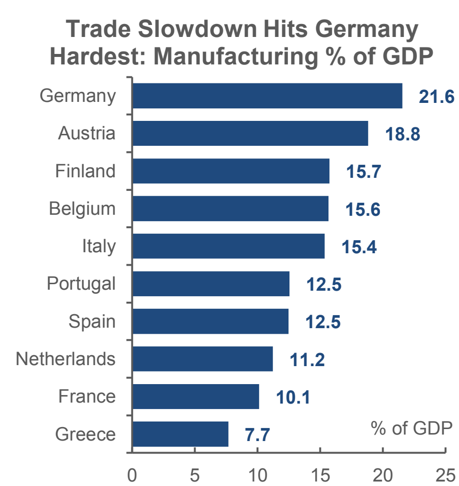
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, IHS Markit.

Chart 2



Sources: Scotiabank Economics, Eurostat.

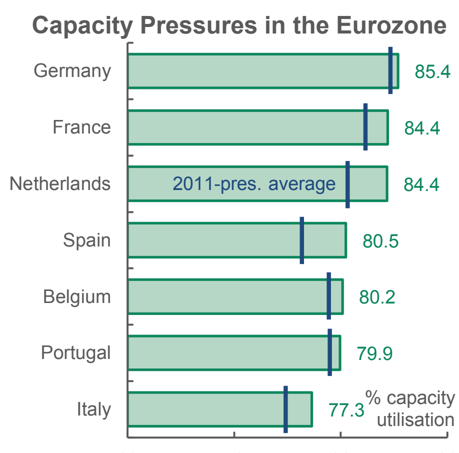
Germany, however, the recent easing of capacity pressures owing to declines in output and the plethora of risks on the horizon will dampen investment growth.

GDP growth in the Eurozone will be kept afloat by sturdy household demand on the back of steady job gains and accelerating wage increases, which should provide an offset to a decline in consumer confidence alongside a worsening economic outlook. The unemployment rate in the Eurozone is on track to reach its pre-financial crisis low in the coming months; jobs growth in the bloc has averaged 1.4% y/y since Q1-2018 (chart 4), or a full percentage point above the 0.4% y/y average expansion in the labour force during the same period. Amid record-high vacancy rates and labour shortages, wages growth in the Eurozone has sharply accelerated to its highest pace in a decade (chart 5). While prices should get a boost from rising wages (chart 6), headline inflation in the Eurozone will likely remain far from the ECB's target of close to, but below, 2% with energy costs set to decline over the forecast horizon. Real employee earnings—alongside softening inflation and strong wage gains—should provide support to services sector output against falling industrial production (chart 7).

We anticipate that the ECB will lower its deposit facility rate from -0.40% currently to -0.50% at its September meeting due to continued weakness in inflation and in light of the growing risks to the bloc's economy. At its July meeting, the Bank's forward guidance will likely hint at the likelihood of lower rates—teeing itself up for a September cut—the possible deployment of a new quantitative easing program, and the implementation of a tier-based system for banks' excess reserves at the central bank. The latter measure would be put in place amid concerns that negative rates on central bank deposits are hurting bank profitability. We expect that the ECB will announce the details of its next phase of asset purchases later in the year (November or December meetings) for an early-2020 launch date.

Current IMF chief Christine Lagarde looks set to replace Mario Draghi at the helm of the ECB on November 1 and will likely maintain the current dovish stance of the Bank. The ECB's forward guidance may be slightly clouded in the coming months, however, as it would effectively tie Lagarde's hands during the beginning of her eight-year term.

Chart 3



Sources: Scotiabank Economics, national statistics agencies.

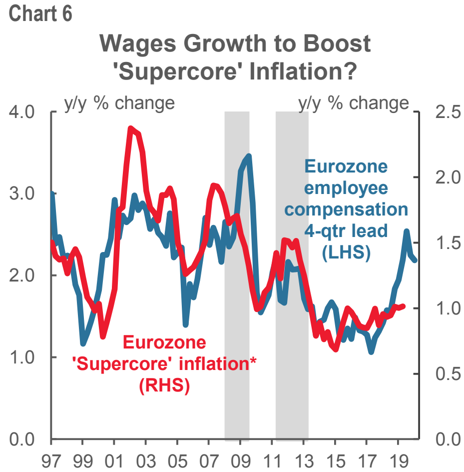
Chart 4

Sources: Scotiabank Economics, Eurostat.

Chart 5

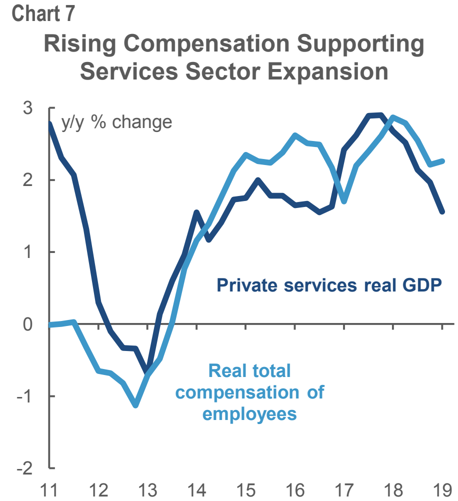
Sources: Scotiabank Economics, Eurostat, ECB.

Chart 6



Sources: Scotiabank Economics, Eurostat, ECB, Haver Analytics.
*consumer prices excluding energy, food, alcohol, tobacco, air transportation, and packaged holidays (~2/3rds of headline basket).

Chart 7



Sources: Scotiabank Economics, Eurostat.

China

- **China's economic growth will continue to slow gradually as both domestic and external demand dynamics soften.**
- **Policymakers' fiscal and monetary stimulus measures will prevent China's real GDP growth from dropping below the official target.**

ECONOMIC GROWTH OUTLOOK

The Chinese economy is facing a challenging combination of forces that is causing its output growth to slow: external sector headwinds due to the US-China trade dispute and weaker global economic momentum combined with softer domestic demand dynamics. Nevertheless—in order to promote social stability—we expect the Chinese administration to remain committed to the official 2019 economic growth target of 6–6½% y/y, prompting policymakers to respond to decelerating economic activity with additional fiscal and monetary stimuli. Accordingly, we maintain our 2019 and 2020 real GDP growth forecasts for China at 6.2% and 6.0%, respectively (chart 1).

The persistent trade dispute between the US and China has caused a collapse of Chinese exports to the US (chart 2). Meanwhile, however, Chinese shipments to the rest of the world have weathered global demand weakness relatively well, likely assisted by recent depreciation of the Chinese yuan. While the trade truce agreed between US President Donald Trump and Chinese President Xi Jinping on the sidelines of the G20 Leaders' Summit in Osaka at the end of June is a welcome development, we expect impending trade negotiations to be challenging given the complexity of issues—technology, cyber security, intellectual property protection, market access, etc.—to be discussed. Regardless, both sides would benefit from a concrete improvement in relations, with private sector players increasingly emphasizing the importance of reaching a mutually satisfactory trade agreement. As the talks will likely drag on over the coming months, the existing 25% import tariffs on around USD 250 bn of Chinese shipments to the US will continue to weigh on Chinese exporters and business sentiment. This, combined with weaker global demand dynamics as well as the downturn in the electronics cycle, will continue to be reflected in China's manufacturing industry. Indeed, industrial output and manufacturing sector confidence have softened substantially in recent months, despite the Chinese government's support measures—such as cuts to the manufacturing sector value added taxes.

Weaker confidence and the lagged impact of the government's deleveraging efforts in 2017–2018 are reflected in softer domestic demand. Despite rapid income gains—real disposable incomes rose by 6.8% y/y in the first quarter—and recovering house prices (chart 3), the Chinese consumer has tightened her purse strings, as witnessed by weak retail and auto sales (chart 4). However, we expect household spending to pick up somewhat through the rest of the year—early signs of recovery are already evident in auto sales—as the administration is likely to focus on stimulus that assists the economy's transition toward a consumer-led growth model, complementing the already-announced support measures, such as higher individual income tax thresholds and higher deduction limits.

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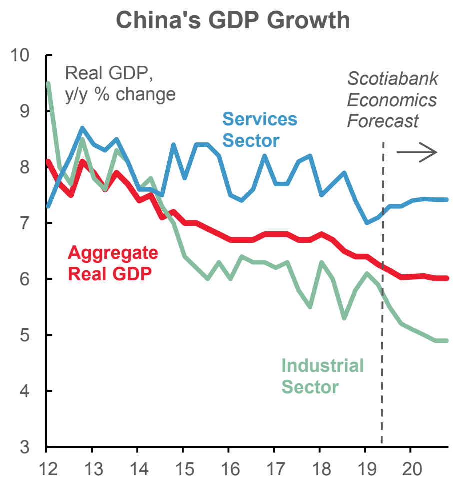
China	2017	2018	2019f	2020f
Real GDP (annual % change)	6.8	6.6	6.2	6.0
CPI (y/y %, eop)	1.8	1.8	2.6	2.3
Central bank policy rate (%, eop)	4.35	4.35	4.35	4.35
Chinese yuan (USDCNY, eop)	6.51	6.88	6.70	6.50

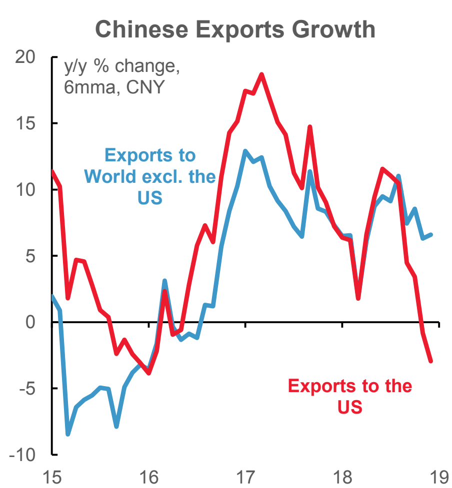
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

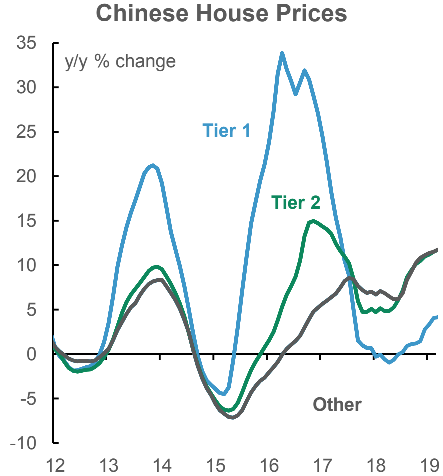
Chart 2



Sources: Scotiabank Economics, Bloomberg.

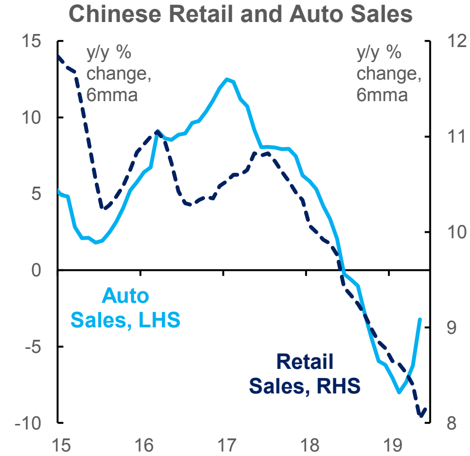
Fixed investment growth in China continues to decelerate on the back of softer business confidence and the delayed impact of more rigorous lending standards following the administration clamp-down on shadow banking activities over the past couple of years. Indeed, annual fixed investment growth in the industrial sector has been in negative territory so far this year, while the services sector has fared slightly better. A nascent pickup is underway, driven by public outlays (chart 5) and reviving real estate investment. The Chinese administration is encouraging local governments to issue special purpose bonds for infrastructure projects, such as highways, high-speed rail, power grids, and gas facilities. Meanwhile, looser property purchase rules in certain cities and lower mortgage rates have supported house prices, prompting a recovery in housing starts.

Chart 3



Sources: Scotiabank Economics, Bloomberg.

Chart 4

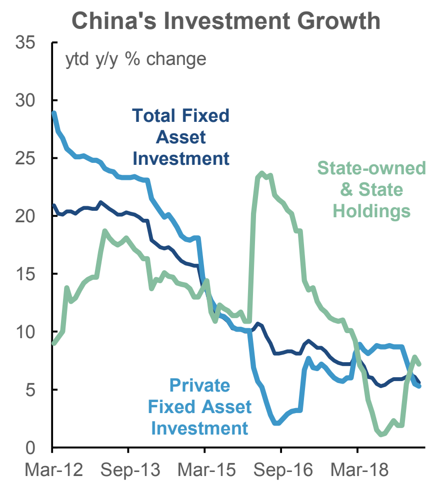


Sources: Scotiabank Economics, National Bureau of Statistics of China.

INFLATION AND MONETARY POLICY OUTLOOK

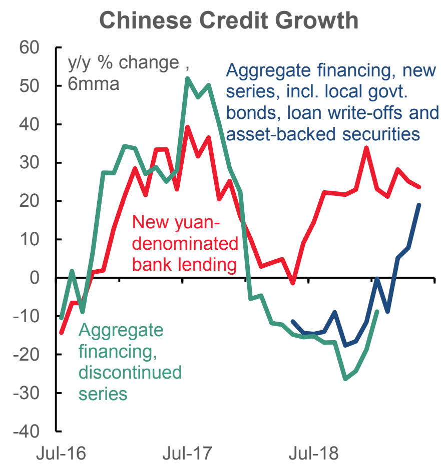
Headline inflation in China has picked up in recent months on the back of higher pork prices, approaching the government's target of around 3% y/y. We expect consumer price inflation to close the year at 2⅔% y/y before easing slightly over the course of 2020. Nevertheless, price pressures further up the distribution chain are much weaker, with annual producer prices currently rising by less than 1% y/y. Manageable inflationary pressures should allow the People's Bank of China (PBoC) to maintain an accommodative monetary policy stance through 2020.

Chart 5



Sources: Scotiabank Economics, Bloomberg.

Chart 6



Sources: Scotiabank Economics, Bloomberg, The People's Bank of China.

We expect the PBoC to roll out some additional monetary stimulus in the near term in order to support the slowing economy. The central bank will continue to provide the financial system with ample liquidity through open market operations, reserve requirements, and standing and medium-term lending facilities. We expect the PBoC to lower banks' reserve requirement ratios further (from the current level of 13.5% for major banks) in the coming months. Moreover, the PBoC may follow the US Fed's expected rate cut and tweak the 7-day reverse repo rate—which has stayed at 2.55% since March 2018—slightly lower in the third quarter of 2019. We do not expect the central bank to use significant devaluation of the Chinese yuan as a way to support the economy. While the value of the CNY increasingly reflects market forces—and has depreciated on the back of trade-related concerns—the PBoC will remain aware of the yuan's value being a sensitive issue in the trade discussions with the US.

Chinese authorities' deleveraging efforts have eased along with the intensification of the US-China trade dispute, resulting in a pickup in credit growth (chart 6). A key policy goal is to ensure that small/micro and private companies have improved access to funding. Such lending will increasingly rely on state-owned banks as opposed to shadow banking entities. Overall, we anticipate that monetary conditions in China will stay prudent yet growth-supportive through 2020. The PBoC is aware of the potential systemic risks that might follow from flooding the economy with excessive liquidity, in line with developments after the global financial crisis.

Japan

- **International trade dynamics and a planned consumption tax rate hike dominate the Japanese economic growth outlook.**
- **Ultra-accommodative monetary policy to remain in place amidst below-target inflation.**

ECONOMIC GROWTH OUTLOOK

The Japanese economy will likely sustain its modest pace of growth through 2020, with real GDP gains roughly in line with the economy's estimated potential growth of 0.7% y/y. The country's output grew by 0.9% y/y in the first quarter of 2019 following a 0.8% advance in 2018 as a whole (chart 1); we expect slightly weaker momentum going forward with economic growth likely to average 0.8% y/y and 0.6% in 2019 and 2020, respectively. As global uncertainties remain elevated, the Japanese economy will continue to be driven by domestic demand. The country's tight labour market should provide some support to household spending even though sentiment has weakened notably over the past year (chart 2) and real wage gains remain muted. Moreover, momentum will be sustained by growth-oriented fiscal policies, accommodative financial conditions, and companies' healthy balance sheets that should underpin business investment prospects. The approaching 2020 summer Olympics in Tokyo will further bolster investment activity over the next year. Meanwhile, there are two dominant factors that create uncertainties for the economy's outlook: global trade dynamics and the scheduled increase in Japan's consumption tax rate in October 2019.

Prospects for Japanese exporters and the industrial sector remain dim on the back of softer global activity and international trade dynamics. Japanese export volumes have contracted by 6% y/y so far this year (chart 3), driven by demand weakness in Asia and the European Union. Japan is also indirectly exposed to the US–China tensions, given that the country is deeply integrated into Asian supply chains with more than half of its exports consisting of intermediate goods. Moreover, the US administration's threat to impose import tariffs on automobiles and auto parts poses a downside risk to Japan's economic outlook. This reflects the fact that 40% of Japanese exports to the US—which is Japan's second largest export market after China, purchasing 18% of total shipments abroad—consist of vehicles and their parts. To prevent the adverse tariff scenario from materializing, Japan is in the midst of trade negotiations with the US. The two countries aim to reach a mutually satisfactory trade agreement by the mid-November deadline imposed by the US administration.

The increase in the consumption tax rate from 8% to 10% in October will impact Japan's near-term growth dynamics. We expect the tax rate hike to move forward as planned—assuming no major adverse global economic shocks between now and October—as it is critical in putting Japanese government finances on a more sustainable path. We anticipate that consumers and businesses will bring spending forward in anticipation of the tax hike, which will likely be followed by a contraction in expenditure (and q/q real GDP growth) in the final quarter of the year. Nevertheless, the Japanese administration is better prepared for the

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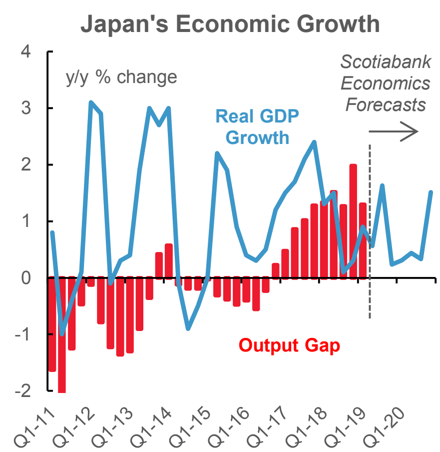
Japan	2017	2018	2019f	2020f
Real GDP (annual % change)	1.9	0.8	0.8	0.6
CPI (y/y %, eop)	1.1	0.3	1.8	0.8
Central bank policy rate (%, eop)	-0.10	-0.10	-0.10	-0.10
Japanese yen (USDJPY, eop)	113	110	108	105

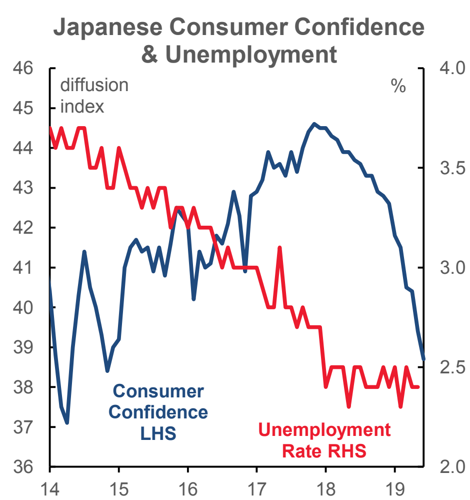
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bank of Japan, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

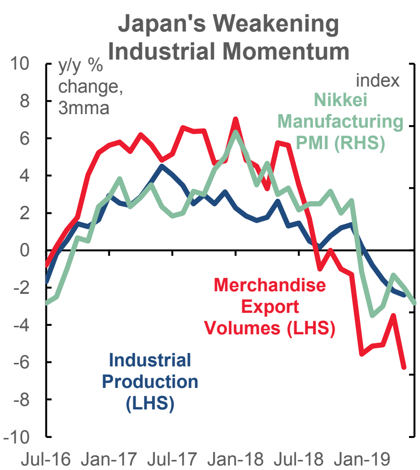
occasion now than in 2014 when the tax rate was raised from 5% to 8%. It has planned various offsetting measures, such as rebates and support for low-income households, while food and drinks will be exempted from the higher tax rate. Moreover, half of the revenue generated by the tax rate hike will be allocated to increased spending on education.

INFLATION AND MONETARY POLICY OUTLOOK

Inflationary pressures are set to remain low in the foreseeable future, yet the headline metric will register a temporary pickup following the consumption tax rate increase (chart 4). The CPI excl. fresh food—the Bank of Japan's (BoJ) preferred inflation measure—currently hovers below 1% y/y. We do not expect it to reach the BoJ's 2% inflation target anytime soon as demand-driven price pressures remain absent on the back of muted wage gains. Moreover, a potential pickup in global risk aversion, safe-haven flows into Japanese assets, and an associated strengthening bias of the Japanese yen (chart 5) complicate the inflation outlook. Should the yen appreciate further against the US dollar below the USDJPY 105 mark, the BoJ's policymakers would likely start feeling increasingly uncomfortable about the currency's strength and its disinflationary consequences.

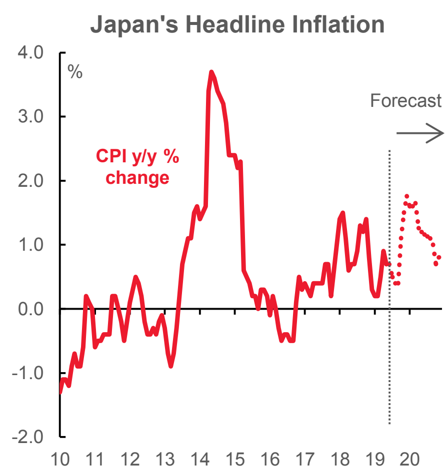
We expect the BoJ to maintain highly accommodative monetary conditions through 2020 and beyond, continuing the policy outline of "Quantitative and Qualitative Monetary Easing with Yield Curve Control". We expect the BoJ to keep the short-term policy rate and the 10-year bond yield target unchanged at -0.1% and around 0%, respectively, for the time being. Against the background of elevated global uncertainties and late-cycle dynamics, we note that the BoJ's monetary policy room is fairly limited. Should the BoJ need to stimulate the economy further over the coming quarters, it could potentially provide funds to banks through its Loan Support Program with a negative interest rate; such a subsidy would prompt banks to lower their lending rates. Alternatively, it could take the negative interest rate even lower—e.g. to -0.2%—and strengthen its forward guidance, and/or coordinate a stronger combined fiscal and monetary stimulus program.

Chart 3



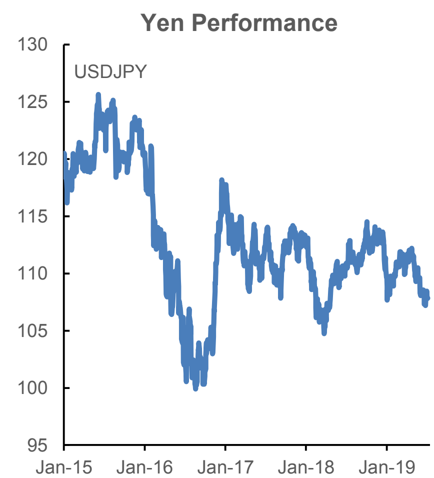
Sources: Scotiabank Economics, Bloomberg.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

Chart 5



Source: Bloomberg, Scotiabank Economics.

India

- **The Indian economy is going through a broad-based soft patch.**
- **Low inflation allows for additional monetary stimulus before year-end.**
- **The new Modi government maintains a growth-supportive fiscal policy stance while remaining committed to prudent public finances.**

ECONOMIC GROWTH OUTLOOK

The Indian economy is showing signs of softness. Output grew by only 5.8% y/y in the first quarter of 2019, compared with an average expansion of 7.4% y/y in 2018 (chart 1). We forecast India's real GDP to advance by 6.5% y/y in 2019 as a whole. In 2020, real GDP growth is expected to pick up slightly, reaching the lower end of the economy's estimated potential growth of 7–7½% y/y.

The current soft patch is fairly broadly based. Investment activity and private consumption growth are moderating on the back of weaker consumer and business confidence, higher inventories, and lower hiring intentions. Meanwhile, net exports remain a drag on the economy as import gains are outpacing those of exports. The recent decision by the US administration to terminate India's designation as a beneficiary developing country that granted it preferential trade treatment will adversely impact India's external sector outlook. Nevertheless, we expect the impact to be rather limited for the economy as a whole as India is less export-oriented than its regional peers and its shipments to the US only account for 2% of GDP. Weaker global and domestic demand conditions continue to be reflected in India's manufacturing sector and its eight core industries—electricity, steel, refinery products, crude oil, coal, cement, natural gas and fertilizers (chart 2).

We expect that stimulative monetary and fiscal policies will provide support to the Indian economy over the coming quarters. Continued infrastructure outlays, lower interest rates, and expected political stability in the period ahead should underpin investment prospects, while favourable demographics and the government's fiscal measures—such as lower GST rates on certain goods and cash transfers to small-scale farmers—are set to underpin consumer spending. Accordingly, we believe that India will be able to take back its position as the fastest-growing major economy before the end of the year.

INFLATION AND MONETARY POLICY OUTLOOK

Price pressures in India remain manageable with headline inflation currently hovering at slightly over 3% y/y, comfortably within the Reserve Bank of India's (RBI) annual inflation target of 4% ±2%. Inflation will likely creep gradually higher over the coming months, extending the trend that has been in place since the recent low point of 2% y/y in January (chart 3). Nevertheless, we expect price pressures to stay within the central bank's target band through 2020. While core inflation—currently at slightly above 4% y/y—remains above the headline metric, it continues to show signs of moderation.

We maintain our careful observation of the following risks to inflation: 1) financial market volatility and potential depreciation pressure on the Indian rupee; 2)

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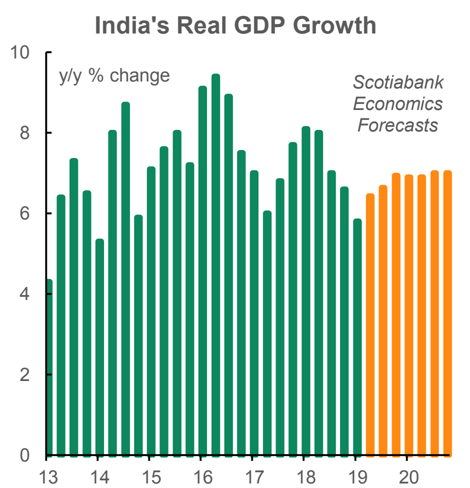
India	2017	2018	2019f	2020f
Real GDP (annual % change)	6.9	7.4	6.5	7.0
CPI (y/y %, eop)	5.2	2.1	4.1	4.8
Central bank policy rate (%, eop)	6.00	6.50	5.25	5.25
Indian rupee (USDINR, eop)	63.9	69.8	68.0	66.0

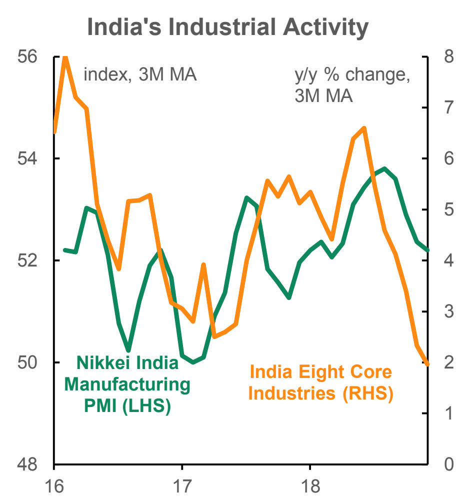
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

volatile food prices; 3) international crude oil price developments; 4) the ongoing slowdown in global activity that may translate to softer commodity prices and weaker demand-driven price pressures; and 5) the southwest monsoon (June–September) rainfall, which remains well below normal at the time of writing. The monsoon's impact on prices is two-fold; draught conditions will likely raise food prices while adversely impacted rural incomes may result in weaker demand-driven inflation.

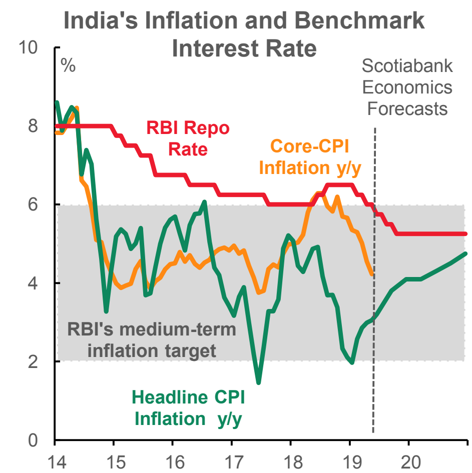
The RBI continues to make further efforts to stimulate the Indian economy. Following the Monetary Policy Committee's bimonthly meeting on June 4–6, the benchmark repo rate was cut by 25 basis points to 5.75%, marking a third consecutive interest rate reduction (chart 3). The RBI also shifted its monetary policy stance to accommodative from neutral, signaling possible further rate cuts ahead. Given the current soft inflation dynamics and weaker economic growth momentum, we expect the RBI to deliver another 25 basis point cut at the August 7 policy meeting, followed by one more cut in in the final months of 2019.

POLITICAL AND POLICY OUTLOOK

India concluded its seven-stage general elections in May. Prime Minister Narendra Modi's Bharatiya Janata Party (BJP) won a single-party majority, securing 303 seats in the 545-seat parliament. The BJP-led National Democratic Alliance now holds 353 seats. The outcome points to political stability and policy continuity over the coming quarters, underpinning investor confidence toward Indian assets. Moreover, the result should allow the BJP to focus on implementing structural reforms. If the administration were able to move labour and land reforms successfully forward, business sentiment and investment in India would likely improve notably, underpinning the economy's longer-term growth prospects. Nevertheless, we note that the likelihood of substantial progress on that front in the near term remains limited.

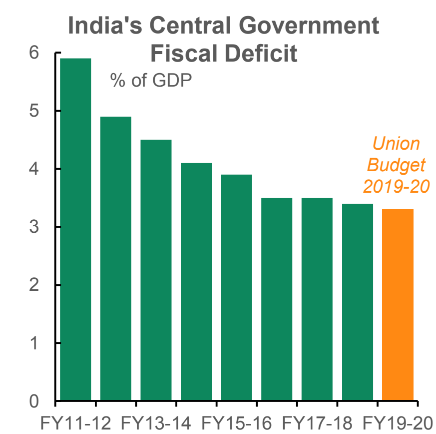
The government's fiscal policy stance is prudent, yet growth-supportive. The Union Budget for fiscal year 2019–20 (April–March) was unveiled on July 5; it is a balancing act between promoting investor confidence on India's fiscal sustainability and stimulating domestic demand by reviving investment and supporting the rural economy. The central government budget deficit in FY2019–2020 is expected to narrow to 3.3% of GDP from 3.4% of GDP in the previous fiscal year (chart 4). The Interim Budget, which was unveiled in February ahead of the general elections, had amended the FY2019–20 shortfall forecast from 3.1% of GDP to 3.4% as the government wanted to boost its popularity by increased spending. Given India's softer economic growth momentum and associated downward pressure on tax revenue, we assess that the government's deficit target may be at risk. Nevertheless, a portion of higher public outlays may be financed by a transfer of the RBI's sizable excess reserves to the government, yet a final decision on such a maneuver has not yet been made. Accordingly, uncertainty regarding the trajectory of India's public finances remains high, keeping the Indian rupee vulnerable to changing investor sentiment and risk appetite.

Chart 3



Sources: Scotiabank Economics, Bloomberg.

Chart 4



Sources: Scotiabank Economics, IMF, India Ministry of Finance.

South Korea

- **South Korea's export-oriented economy is losing growth momentum.**
- **Fiscal and monetary policies are likely to become more growth-supportive while inflationary pressures remain low.**

ECONOMIC GROWTH OUTLOOK

The South Korean economy is showing signs of weakness with output declining in the first quarter of 2019 (-0.4% q/q, +1.6% y/y). While we do not expect the economy to dip into a recession, i.e. to record a second consecutive quarterly drop in real GDP, the softness has prompted us to revise our South Korean growth forecasts downward. We now expect the nation's real GDP to advance by 2.0% y/y in 2019 (vs. 2.4% previously) and 2.7% in 2020 (vs. 2.8%).

The export-oriented South Korean economy is feeling the impact of weaker global demand (chart 1), trade tensions between the US and China, and the ongoing downturn in the global semiconductor sector, which reflects lower Chinese demand and smartphones' longer replacement cycle. Moreover, should the US administration decide to move ahead with tariffs on automobile imports—without giving South Korea an exemption—by its self-imposed mid-November deadline, the South Korean outlook would be adversely impacted as 30% of the nation's exports to the US consist of vehicles and their parts.

Domestic demand will play a key role in the South Korean economic outlook. While the labour market has weakened somewhat in recent months, consumer spending will be underpinned by recent minimum wage hikes (of 16.4% in 2018 and 10.9% in 2019). Construction and facilities investment is set to remain muted on the back of concerns regarding domestic and global economic developments, yet the Bank of Korea's (BoK) accommodative monetary policy stance should provide needed support for private sector investment. Moreover, the government's expansionary fiscal policy stance will likely take on a key role in keeping the economy on a decent growth trajectory.

INFLATION AND MONETARY POLICY OUTLOOK

Inflationary pressures are expected to remain contained in the foreseeable future. Price gains at the headline level continue to hover slightly below 1% y/y, with only a modest pickup to 1.2% y/y expected by year-end (chart 2). With the current tax cut on new car purchases set to expire at the end of the year, headline inflation will likely rise next year. Nevertheless, we do not expect inflation to meet the BoK's 2% y/y target by end-2020.

In line with a regional trend, the BoK has become somewhat more dovish recently. While the central bank continues to monitor risks related to financial stability and high household debt, we assess that it will loosen monetary conditions in the near future. We expect the BoK to cut the Base Rate by 25 basis points to 1.50%—thereby reversing the November 2018 hike—soon after the US Federal Reserve cuts its benchmark interest rate. Nevertheless, we do not expect the BoK to adopt an aggressive monetary easing stance as maintaining financial stability remains a priority for its policymakers.

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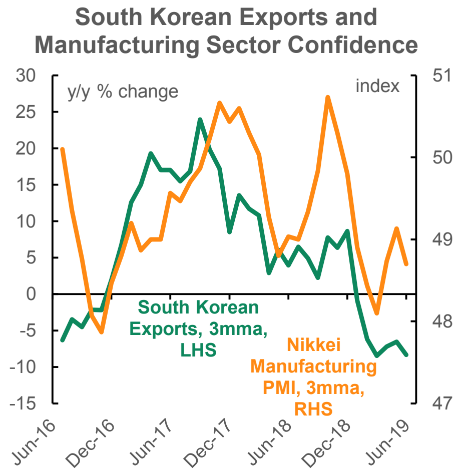
South Korea	2017	2018	2019f	2020f
Real GDP (annual % change)	3.2	2.7	2.0	2.7
CPI (y/y %, eop)	1.4	1.3	1.2	1.6
Central bank policy rate (%, eop)	1.50	1.75	1.50	1.50
South Korean won (USDKRW, eop)	1,067	1,116	1,140	1,100

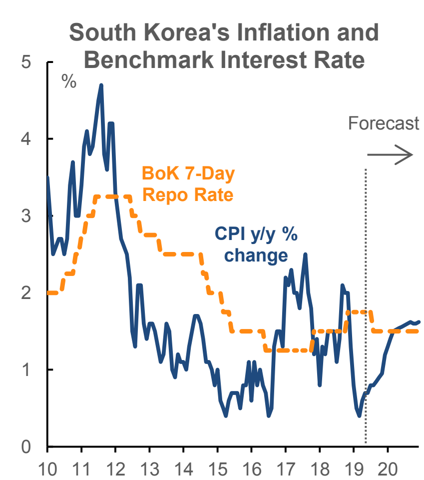
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Australia

- **Australia's economic growth is expected to slip below potential, yet recession remains unlikely.**
- **Policymakers will likely deploy additional stimulative measures to revive the economy.**

ECONOMIC GROWTH OUTLOOK

The Australian economy is shifting to a slightly lower economic growth trajectory on the back of global growth concerns, weaker international trade dynamics, and softer domestic demand momentum. Compared to the 2.8% real GDP gain recorded in 2018 we expect output growth to average 2.4% y/y in 2019–20 (chart 1), falling below the economy's potential of 2¾% y/y. Given Australia's solid economic fundamentals and adequate policy levers to address even a significant shock, we assess that the likelihood of the Australian economy skidding into a recession in the foreseeable future remains very low.

The Australian export sector will be adversely impacted by slower economic growth momentum globally, yet China—Australia's most important market—continues to play the dominant role in determining the external sector outlook. Indeed, China purchases almost 40% of Australia's total exports and over 80% of the shipments of the main export, iron ore. A weaker Australian dollar, improved terms of trade (the ratio of export prices to import prices), and the Chinese administration's plans to boost infrastructure spending—and hence the country's commodity demand—will partially be able to offset the adverse dynamics stemming from weaker global demand.

Australia's domestic demand will continue to be driven by consumer spending, supported by solid labour market dynamics (charts 2 and 3), recently passed income tax cuts, and strong population growth. Nevertheless, we expect the labour market to cool slightly over the coming quarters. Moreover, high household debt, weak real income growth in recent years, and continued cooling in the residential real estate market will likely keep the consumer rather cautious. We maintain our view that downside risks stemming from the housing market developments are diminished by Australia's low interest rates, a still-strong labour market, robust loan quality, and continued net immigration. We expect the residential property market to stabilize over the second half of 2019, reflecting the fact that monthly price declines continue to diminish (chart 4).

Australian investment activity will likely be shaped by international developments; business confidence and private sector investment intentions are set to stay moderate as worries regarding the global economy remain elevated. We expect that lower residential real estate prices will keep dwelling investment activity soft over the coming quarters, while continued infrastructure outlays and resumed resource sector investment—following years of contraction—are anticipated to provide some support to economic growth.

Australia has ample fiscal room to provide further support to the economy if needed. The centre-right Liberal-National government led by Prime Minister Scott

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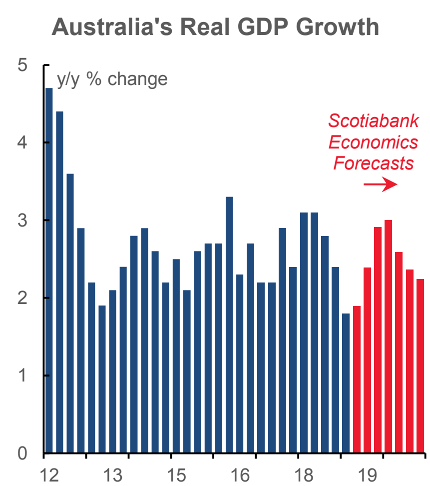
Australia	2017	2018	2019f	2020f
Real GDP (annual % change)	2.4	2.8	2.3	2.6
CPI (y/y %, eop)	1.9	1.8	1.6	1.9
Central bank policy rate (%, eop)	1.50	1.50	0.75	0.75
Australian dollar (AUDUSD, eop)	0.78	0.70	0.75	0.78

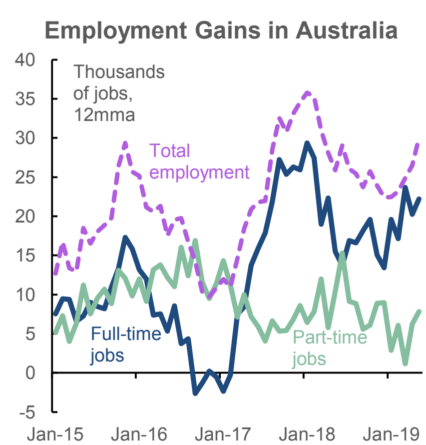
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Australian Bureau of Statistics.

Morrison—which won a third term in power following the May 2019 federal elections—maintains its commitment to bringing the budget to a surplus position in fiscal year 2019–20 (July–June). Nevertheless we point out that, should downward pressure on the economy intensify, the government's fiscal stance would likely be loosened—e.g. by bringing tax cuts and infrastructure spending forward—to complement the Reserve Bank of Australia's (RBA) monetary stimulus efforts.

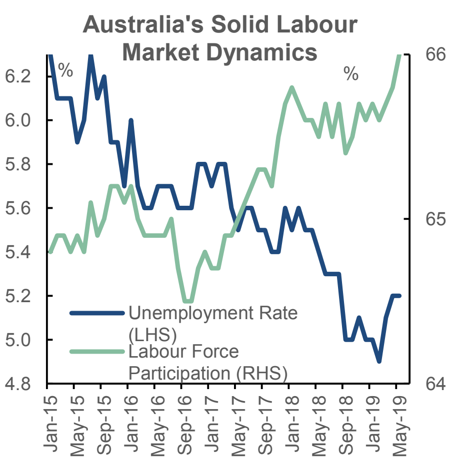
INFLATION AND MONETARY POLICY OUTLOOK

The RBA is taking decisive steps to support the economy. The central bank lowered the benchmark interest rate by 25 basis points in June and July, taking the rate from 1.50% to 1.0%—a new record low (chart 5). A decision to ease monetary conditions in two consecutive meetings highlights monetary authorities' concerns regarding Australia's economic outlook. RBA Governor Philip Lowe noted that the decision to lower the benchmark interest rate was justified by the need to support employment growth and to boost confidence that inflation will return to the RBA's 2–3% annual inflation target over the medium term.

Australia's monetary authorities have underscored risks related to both the global and domestic economy. They have noted that uncertainty stemming from trade and technology disputes is undermining investment prospects, with global risks tilted to the downside. Australia's economy is showing signs of moderation with an opening of the output gap; employment gains are expected to slow in the coming quarters, albeit from above average levels; and inflation is persistently low. Headline inflation hovers below the RBA's target with prices rising by only 1.3% y/y in the first quarter of 2019 on the back of lower fuel prices, muted housing-related price gains, and soft wage gains. We expect demand-driven price pressures to remain largely absent through our forecast horizon, yet base effects will likely take headline inflation back toward the 2% mark in early 2020 (chart 5).

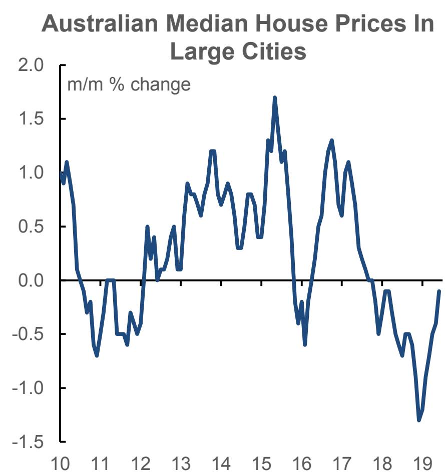
The RBA has indicated that it stands ready to adjust monetary policy further if needed. Governor Lowe has pointed out that labour market developments would play a key role in directing future decisions. We expect the RBA to monitor developments for a few months. Assuming that the labour market will fail to strengthen in the near term, another 25 basis point cut will likely follow in the final months of 2019. Nevertheless, we highlight that the impact of looser monetary conditions will be mostly limited to boosting confidence. The policy actions' transmission to the real economy is set to be fairly small on the back of already low interest rates in the economy, high household debt, and the ongoing residential housing price correction.

Chart 3



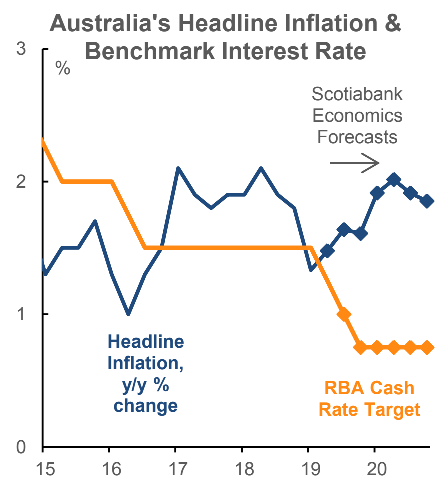
Sources: Scotiabank Economics, Australian Bureau of Statistics.

Chart 4



Sources: Scotiabank Economics, Bloomberg, CoreLogic.

Chart 5



Sources: Scotiabank Economics, Bloomberg.

Commodities

DOUR SENTIMENT BUT FUNDAMENTALS POINT TO STEADY CONDITIONS

- **The global economy remains fundamentally strong but trade war-induced uncertainty continues to weigh on investment activity and on market sentiment towards risk assets like commodities.**
- **We believe economic sentiment will improve in the second half of 2019 and a rationalization of overly bearish sentiment is expected to support the prices of industrial commodities like copper back toward levels justified by tightening fundamentals (chart 1).**
- **Oil prices are forecast to remain range-bound and anchored around $55/bbl (WTI) through the end of 2020 on the back of mildly slower demand growth due to investment stifled by trade uncertainty, still-strong US shale growth, and continued OPEC+ production discipline.**
- **Most industrial metals are feeling the brunt of downside pressure from sour macro sentiment and prices are expected to rise toward levels more reflective of physical tightness through 2020, while iron ore markets are digesting material supply disruptions in Brazil and Australia and prices are expected to moderate over the next 18 months.**
- **Gold prices are forecast to remain elevated in 2H19 and trend back toward $1300/oz by end-2020 as interest rate expectations normalize, leaving annual average prices at roughly $1350/oz through 2019–20.**

The global economy remains fundamentally strong yet uncertainty related to the now year-long trade war between the United States and China continues to weigh on investment activity and market sentiment. The mildly slower global economy has taken the wind out of demand expectations for industrial commodities while cuts from the US Federal Reserve are now forecast to provide a temporary boost to gold prices. The global economy is expected to gradually improve exiting 2020 and the prices of industrial metals like copper are forecast to grind higher on tightening balances and a reversal of bearish sentiment. Oil prices are expected to remain in the mid-$50s through the end of 2020 as markets balance between shale growth and OPEC+ discipline before rising toward $60/bbl.

OIL STEADY DESPITE VOLATILITY ON BOTH SIDES OF GLOBAL LEDGER

Oil has spent 2019 range bound between $50–65/bbl (WTI) as markets bounced between macro concerns and acute supply disruptions. Bearish sentiment can be credited with keeping prices relatively steady despite historically acute sanctions-driven supply losses in Iran and Venezuela, not to mention ever-hotter tensions between the US and Iran most recently punctuated by the downing of a $130 million US Airforce drone that would have in any other period dramatically spiked risk premiums. **Mildly slower demand growth due to investment stifled by trade uncertainty, still-strong US shale growth, and continued OPEC+ discipline are expected to keep balances in mild deficit (chart 2) and prices steady around current levels averaging roughly $55/bbl through the end of 2020.**

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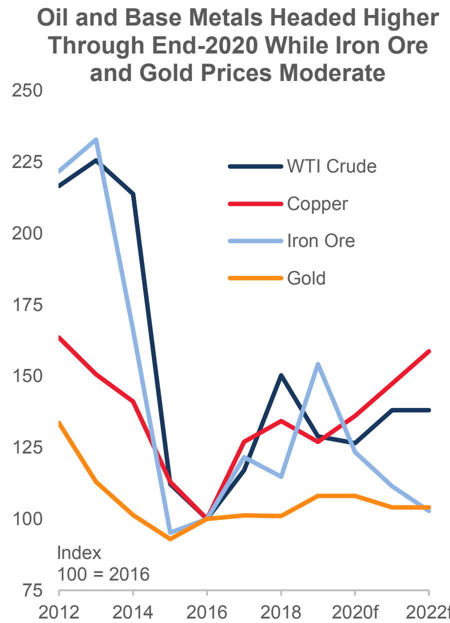
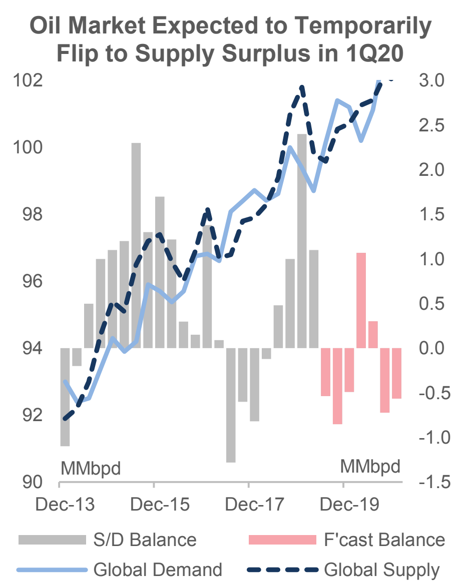
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Scotiabank GBM, IEA, EIA, JODI, OPEC.

Global oil demand continues to advance but remains heavily dependent on India, where growth is returning, and China, where fuel demand—particularly diesel—has been slipping amidst a trade war-induced slowdown in investment and manufacturing and weighed heavily on overall demand growth in the first quarter of 2019. We expect that global demand growth will reaccelerate to 1.7 MMbpd y/y in 2H19 before moderating, keeping annual demand growth flat at 1.3 MMbpd in 2019–2020.

Global supply is expected to remain more-or-less flat on an annual basis through 2019, with strong US gains (+1.5 MMbpd) balanced by significant losses in OPEC supply due to both voluntary cuts (-0.9 MMbpd) and involuntary sanctions impacts (-1 MMbpd). Further OPEC+ discipline and sanctions-related hardship are expected to balance strong but decelerating US production growth through 2020, though shale supplies are likely to tip markets into mild surplus in early-2020. The US shale patch has marked the fastest pace of growth of any major oil basin in history at more than 2 MMbpd in 2018, though we expect that pace to begin easing in 2020 (+1.3 MMbpd) and continue slowing to less than 0.5 MMbpd by the early 2020s as rig counts and productivity plateau (chart 3). Other non-OPEC regions including Brazil are also expected to contribute additional output to 2020 balances, while Canada will add back heavy crude supplies as curtailment is lifted, differentials expand to support oil-by-rail investment, and Line 3 enters service in late-2020.

OPEC+ agreed to roll over its current output agreement to keep 1.2 MMbpd of oil off the market, now through the first quarter of 2020. The group mildly beat expectations of a 6-month extension, but a continuation of the group's status quo was well-telegraphed and baked into market pricing. While the outcome of the meeting was unremarkable, the road taken to get there over the past month has been both interesting and revealing. Planning got off to a rocky start when members couldn't agree on a date for the joint meetings, finally settling on a compromise of July 1st and 2nd. Yet the first official word of an agreement came before July's meetings even began as Russian President Putin broke the news following bilateral talks with Saudi Arabia at the G20 meetings in Japan. So while OPEC remains an organization driven by consensus, most members are simply following the lead of OPEC+'s two dominant producers. And while some like Iran may not like it, they are exempt from the deal and have a common interest in maintaining some degree of oil price stability. OPEC production is expected to remain around current post-2014 low levels (chart 4).

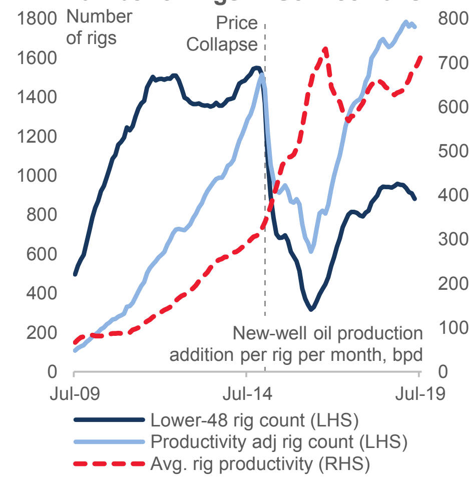
METALS PRICES EXPECTED TO RISE AS MACRO SENTIMENT NORMALIZES

Metals like Dr. Copper have felt the brunt of the macro headwinds despite firming fundamentals, given base metals' strong demand linkage to global economy activity and investment. Meanwhile, supply-side disruptions have roiled the otherwise-staid iron ore market and prices are back above five-year highs. We expect that base metals' fortunes will reverse through 2020 and prices will rise back to levels more reflective of tight physical balances, while iron ore prices are expected to moderate.

The Chinese economy is reaccelerating as the Beijing's stimulus efforts feed through and provide a boost to global materials demand. Chinese real estate prices are rising, the recent stimulus boost to housing starts is expected to revive weak building completions (chart 5) and maintain the current strengthening in appliance production, and the first-half collapse in Chinese auto sales looks to be finally turning the corner.

Chart 3

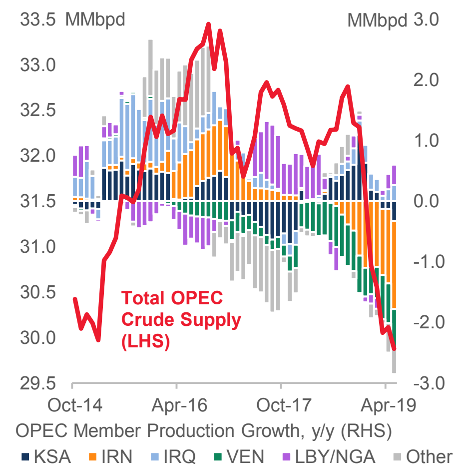
Rig Productivity Rising Again As Number of Rigs in Service Falls



Sources: Scotiabank Economics, EIA, Baker Hughes.

Chart 4

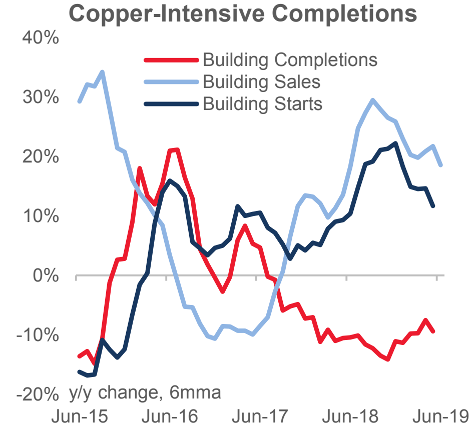
OPEC Production At Post-2014 Low



Sources: Scotiabank Economics, OPEC.

Chart 5

Chinese Stimulus Boosts Steel-Intensive Starts, Expected To Boost Copper-Intensive Completions



Sources: Scotiabank Economics, NBS.

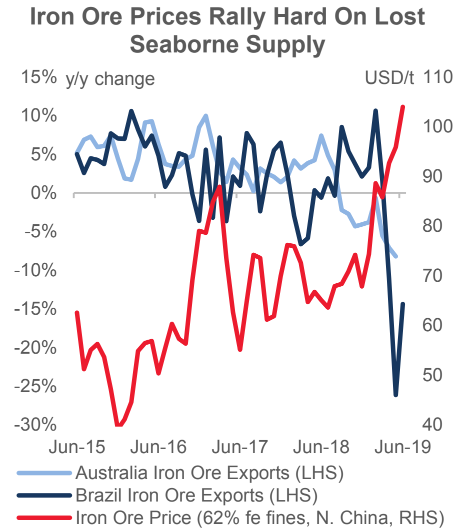
Iron ore prices (62% fines, N. China) reached a five-year high of more than $125/t in early July on a combination of stronger-than-anticipated Chinese steel demand, supply losses stemming from a crackdown on Brazilian tailings dams, and terrible weather in both Brazil's north and along Australia's northwest coast that crimped exports (chart 6). Current global production losses are running at nearly 90 million tonnes against a total seaborne market of roughly 1.7 billion tonnes and ore inventories held at major Chinese ports are down more than 25% y/y to a three-year low. We believe there may be a few more months of upside for iron ore prices before demand begins to moderate on contracting Chinese steel mill margins—currently at their lowest level since 2016—and currently-idled iron ore mines are incentivized back onto the market to satisfy the gap, pushing prices back toward our long-term iron ore price target of $60–70/t.

GOLD GAINS TO MODERATE AS MARKET TRIMS FED CUT EXPECTATIONS

Gold prices reached a six-year high of roughly $1,420/oz in late-June on the back of increasing market confidence that the US Federal Reserve will cut interest rates later this year (chart 7). For the last six years gold has failed to sustainably breach the $1,350/oz level, held back by tightening monetary conditions, a rising US dollar, and the apparent numbing of investor risk perception amidst a firehose of White House-related news flow. Conditions have recently shifted in gold's favour and bullion has skyrocketed, pushing past the $1,350/oz six-year resistance level and then continuing as high as $1,420/oz. While still far off the all-time highs of nearly $2,000/oz reached in 2011 amidst the Eurozone crisis, the price of bullion expressed in Canadian dollar is flirting with a fresh record and is currently sitting just below C$1,900/oz.

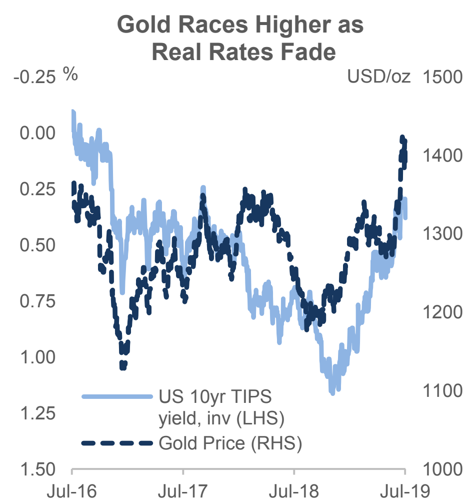
The price of bullion will continue to be driven by interest rates and the trajectory of the US dollar through the end of 2020. We believe that gold prices are artificially high due to exaggerated market pricing of aggressive cuts by the US Federal Reserve relative to our more modest expectations for only 75 basis points of cuts through end-2020. As rate expectations normalize, gold should falter slightly though remain higher than before the Fed paused and reversed its tightening path. Meanwhile, a secular decline in the value of the US dollar should provide steady tailwinds for pricing. We expect that gold prices will average roughly $1400/oz in the second half of 2019 and begin gradually falling back toward $1300/oz by end-2020, leaving annual average prices at roughly $1350/oz in 2019–20.

Chart 6



Sources: Scotiabank Economics, Bloomberg.

Chart 7



Sources: Scotiabank Economics, Bloomberg.

Table 1

Commodities	2000–2017			Annual Average			
	Low	Avg.	High	2017	2018	2019f	2020f
WTI Oil (USD/bbl)	17	62	145	51	65	56	55
Brent Oil (USD/bbl)	18	65	146	55	72	65	62
WCS - WTI Discount* (USD/bbl)	-43	-16	-6	-13	-26	-14	-21
Nymex Natural Gas (USD/mmbtu)	1.64	4.83	15.38	3.02	3.07	2.71	2.75
Copper (USD/lb)	0.60	2.38	4.60	2.80	2.96	2.80	3.00
Zinc (USD/lb)	0.33	0.84	2.10	1.31	1.33	1.22	1.20
Nickel (USD/lb)	2.00	7.12	24.58	4.72	5.95	5.70	6.00
Aluminium (USD/lb)	0.56	0.87	1.49	0.89	0.96	0.90	0.90
Iron Ore (USD/tonne)	17	67	187	72	70	90	72
Metallurgical Coal (USD/tonne)	39	131	330	187	206	195	170
Gold, London PM Fix (USD/oz)	256	890	1,895	1,257	1,268	1,350	1,350
Silver, London PM Fix (USD/oz)	4.07	14.80	48.70	17.05	15.71	15.37	15.00

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

Foreign Exchange

- **USD liable to soften as US yields decline and domestic growth slows.**
- **CAD outperforms in H1 on growth rebound, stable policy outlook.**

The **US dollar (USD)** declined in June in what was its first monthly loss since the start of the year. The drop in the USD follows two months of more or less flat trading as investors pondered the broader direction of the major currencies amid swirling geo-political risks and global trade uncertainties. The drop in the USD is hardly decisive at this stage but we do think the decline represents the first real challenge to the rebound that got underway in early 2018 and might well figure as a sign that the secular decline in the USD (which we believe started in 2017) is resuming, in line with our longer-run forecast.

We have adjusted our policy outlook for the Federal Reserve and now expect 75bps of easing through the end of this year. Fed communications have evolved from neutral to more obviously dovish in recent weeks, with policy makers moving from indicating that they can be patient to signaling they are "closely monitoring" (central bank speak for "poised to respond to") economic developments amid persistently low inflation.

Markets have quickly priced in a rather aggressive series of Fed rate cuts in the next few months. Expectations have been egged on by comments from President Trump that have not only disparaged the Fed's previous tightening decisions but also its chairman. President Trump has also taken to commenting more readily on exchange rates and thinks the USD is too strong while the euro (EUR) and yuan (CNY) are undervalued. The President has taken a variety of views on USD since entering the White House but now seems more clearly focused on a weaker exchange rate. Investors will also need to closely monitor how this issue evolves in the coming months and whether a lower USD becomes a more or less formal policy objective.

The expected deceleration in US GDP growth to more sustainable levels in the second half of the year may compound the market-led declines in US yields and might strengthen the President's criticisms as the White House considers re-election. Slower growth plus intensifying focus on the exchange rate by President Trump suggests to us that the USD is unlikely to strengthen significantly now and is more likely to spend the second half of the year trading more defensively in general. We think softer growth trends and lower domestic bond yields leave the USD more exposed to longer-run concerns regarding structural imbalances in the US economy, such as the rapid deterioration in the US's fiscal position.

The **Canadian dollar (CAD)** remains the top-performer amongst the G-10 currencies in year-to-date terms. This trend reflects the CAD's recovery from an extremely soft end to 2018 to some extent but it has built on a solid rebound in Q1 with additional gains in Q2, reflecting signs that the domestic economy is also stabilizing and moving back towards trend. Strong employment gains, rising wages and on-target inflation suggest that the Bank of Canada (BoC) can take its time to assess monetary policy requirements in the next few months and would be under no pressure to follow any easing in Fed policy.

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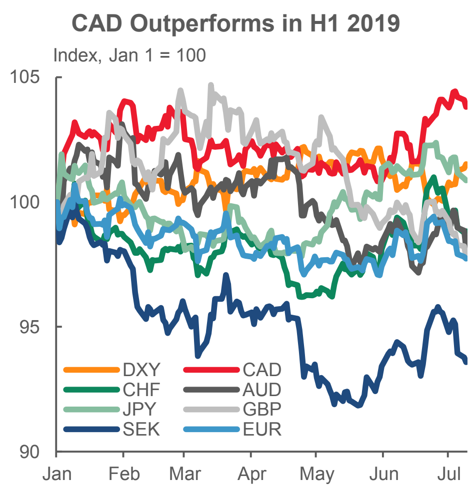
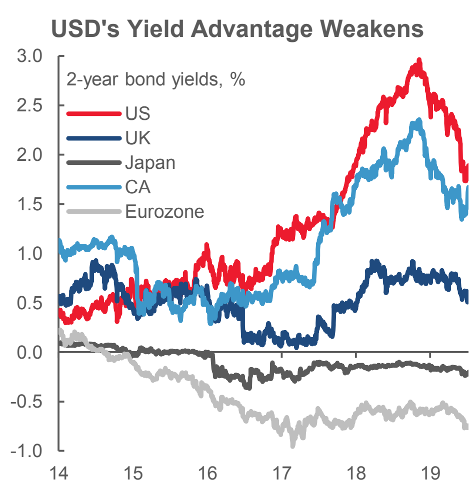
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Canadian short-term yields have drifted lower, in line with the global trend which has reflected rate cuts in Australia and New Zealand as well as a tilt towards dovish language from the Fed and European Central Bank (ECB). But declines have come at a slower pace than much of the rest of the developed market space, and the US especially. This has had the effect of compressing US/Canada interest rate differentials significantly. Since March, the US/Canada 2-year cash bond spread has narrowed around 60 basis points, undercutting the USD and underpinning the CAD.

We expect the CAD to strengthen in the second half of the year and target a year-end rate for USDCAD of 1.28. The risk of a more precipitous, general USD decline in the next few months cannot be ignored, however. We note that the year-to-date trend in USDCAD is closely tracking the pattern of trade seen in 2017 when US/Canada yield spreads also narrowed dramatically—back then because the BoC tightened monetary policy sooner than markets had expected—driving a significant decline in the USD. We also highlight the fact that the USD does not yet appear to have fully reflected the narrowing in yield spreads that has already occurred and might have some catching up to do. Our fair value model for USDCAD suggests an estimated "equilibrium" exchange rate, based on spot regressions with 2-year bond spreads, 5-year bond spreads, and crude oil, for USDCAD of nearer 1.25.

In **Europe**, persistently low inflation and lagging economic growth is tilting the policy outlook more obviously towards the ECB providing more accommodation even as the central bank transitions from the leadership of President Draghi, whose term expires in October, to his presumptive replacement, Christine Lagarde. Despite disappointing underlying economic trends, Eurozone data suggest that foreign investment inflows are slowly returning as investors diversify away from US markets and back to the Eurozone. Strengthening net investment inflows will help underpin the EUR even as core yields remain near, or below zero. We expect EURUSD to appreciate towards 1.15 later this year.

In the **United Kingdom**, Brexit remains the all-consuming issue for markets and has helped drive the pound (GBP) broadly lower through Q2. The Brexit process has been put on hold, however, while the Conservative Party selects a new leader to replace PM Theresa May who announced she would step down following the failure to advance her Brexit strategy. The new party leader will assume the Prime Minister's position in late July. Whether this leads to any more success remains to be seen, however. The European Union has made clear that the Withdrawal Agreement is not up for renegotiation and there is still a significant portion of the UK parliament that is opposed to a hard or "no-deal" Brexit. We continue to assume a negotiated Brexit as our base case, but the October 31 deadline is fast approaching and, realistically, another delay (to H1 2020) may be required to achieve a smooth departure. The ongoing uncertainty will dampen housing demand and business investment and keep UK growth in a low gear and the Bank of England sidelined. Prolonged uncertainty also suggests downside risks to our GBP forecast.

Latam FX has been volatile over the past month, with the Colombian peso the best regional performer, benefitting from relatively muted political uncertainty. For the Mexican peso (MXN), June was a roller-coaster month, triggered by President Trump's immigration-related tariff threats and their subsequent postponement. However, we anticipate MXN volatility will remain high, as the country is likely to take center stage on the US presidential election process—either via USMCA becoming part of the debate or by tariff and immigration frictions popping up sporadically. In addition, the MXN faces uncertainty over both Pemex and sovereign ratings pressures—alongside a weakening economy, which many believe will eventually trigger Banxico rate cuts (although we have a less dovish read of Banxico than many).

In Brazil, reform momentum seems to be getting stronger, meaning the pension reform and the central bank independence bill look likely to be less watered down than it seemed just a month ago. Their approval should boost the real, although surveys suggest that reform expectations may already be partially priced in to local markets. The positive trend in policy is supportive in a region of fairly broad-based slippage but the question is, will it be enough? Brazil's troubled fiscal situation will not be solved just by pension reform and more work will have to be done.

Chile and Peru are the relative regional stability stories but US-China trade tensions and weaker-than-expected growth trends represent major uncertainties for both. The Chilean peso and the Peruvian sol also face headwinds from low domestic interest rates in a world where DM yields are falling and carry trades have been the flavor of the past few weeks.

The US-China trade ceasefire will spur risk appetite amid global reflation policies. **EM Asian currencies** are expected to advance in general ahead of the July 31 FOMC meeting. Meanwhile, risk aversion could resurface from time to time as the world's two largest economies will face a long road before they can reach a deal.

The Chinese yuan (CNY & CNH) will likely trade in a range of 6.7-6.9 during the trade renegotiation period. USDCNY could reach the 6.4 level seen last June should the US and China finalize a trade deal. We allocate a 70% probability for this scenario. On the other hand, USDCNY could surge to the 7.0 mark under the acquiescence of the PBoC, if the renewed trade talks fall apart. We assess a 30% chance of this.

Easing US-China trade tensions will likely buoy export-driven currencies such as the South Korean won (KRW), Taiwanese dollar (TWD) and Thai baht (THB). The US and North Korea restarting nuclear talks is supportive of the KRW. Meanwhile, dividend-related repatriation outflows could contain the TWD appreciation in July-September. The Bank of Thailand's Monetary Policy Committee has been concerned that the THB strength may not correlate with economic fundamentals. The increase in negative-yielding debt globally will continue to draw investors to high-yielding assets denominated in Indian rupee (INR) and Indonesian rupiah (IDR).

While the Hong Kong dollar (HKD) is likely to keep its recent gains due to the narrowing yield advantage of the USD, the Singapore dollar (SGD) is approaching overbought levels. The Monetary Authority of Singapore (MAS) could reduce the slope of its S$NEER policy band in October if the city-state's 2019 GDP growth estimate is officially lowered. The Malaysian ringgit (MYR) is likely to benefit from firm oil prices, with the OPEC+ extending their output cut deal.

APPENDIX 1

International	2000–17	2017	2018	2019f	2020f	2000–17	2017	2018	2019f	2020f
	Real GDP (annual % change)					Consumer Prices (y/y % change, year-end)				
World (based on purchasing power parity)	3.9	3.8	3.7	3.1	3.2					
Canada	2.1	3.0	1.9	1.4	2.0	1.9	1.8	2.0	1.9	1.9
United States	2.0	2.2	2.9	2.5	1.6	2.2	2.1	2.2	1.7	2.1
Mexico	2.2	2.1	2.0	0.9	1.1	4.4	6.8	4.8	4.1	4.1
United Kingdom	1.9	1.8	1.4	1.1	1.2	2.1	3.0	2.1	1.8	2.0
Eurozone	1.4	2.4	1.9	1.1	1.3	1.8	1.3	1.5	1.3	1.4
Germany	1.4	2.2	1.4	0.7	1.2	1.5	1.4	1.6	1.5	1.6
France	1.4	2.3	1.7	1.3	1.3	1.4	1.2	1.6	1.3	1.4
China	9.3	6.8	6.6	6.2	6.0	2.3	1.8	1.8	2.6	2.3
India	7.1	6.9	7.4	6.5	7.0	6.8	5.2	2.1	4.1	4.8
Japan	0.9	1.9	0.8	0.8	0.6	0.1	1.1	0.3	1.8	0.8
South Korea	4.9	3.2	2.7	2.0	2.7	2.5	1.4	1.3	1.2	1.6
Australia	2.9	2.4	2.8	2.3	2.6	2.7	1.9	1.8	1.6	1.9
Thailand	4.1	4.0	4.1	3.2	3.4	1.9	0.8	0.4	1.2	1.6
Brazil	2.5	1.1	1.1	0.9	1.8	6.5	3.0	3.8	4.3	4.6
Colombia	3.9	1.4	2.6	3.2	3.6	5.1	4.1	3.2	3.2	3.1
Peru	5.0	2.5	3.9	3.1	3.7	2.7	1.4	2.2	2.2	2.3
Chile	3.9	1.5	4.0	3.2	3.2	3.3	2.3	2.6	2.8	3.0
Commodities										
	(annual average)									
WTI Oil (USD/bbl)	62	51	65	56	55					
Brent Oil (USD/bbl)	65	55	72	65	62					
WCS - WTI Discount* (USD/bbl)	-16	-13	-26	-14	-21					
Nymex Natural Gas (USD/mmbtu)	4.83	3.02	3.07	2.71	2.75					
Copper (USD/lb)	2.38	2.80	2.96	2.80	3.00					
Zinc (USD/lb)	0.84	1.31	1.33	1.22	1.20					
Nickel (USD/lb)	7.12	4.72	5.95	5.70	6.00					
Aluminium (USD/lb)	0.87	0.89	0.96	0.90	0.90					
Iron Ore (USD/tonne)	67	72	70	90	72					
Metallurgical Coal (USD/tonne)	131	187	206	195	170					
Gold, London PM Fix (USD/oz)	890	1,257	1,268	1,350	1,350					
Silver, London PM Fix (USD/oz)	14.80	17.05	15.71	15.37	15.00					

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

APPENDIX 2

North America	2000–17	2017	2018	2019f	2020f	2000–17	2017	2018	2019f	2020f
	Canada (annual % change, unless noted)					United States (annual % change, unless noted)				
Real GDP	2.1	3.0	1.9	1.4	2.0	2.0	2.2	2.9	2.5	1.6
Consumer spending	2.9	3.5	2.1	2.0	1.9	2.4	2.5	2.6	2.2	1.9
Residential investment	3.6	2.4	-1.5	-3.6	1.3	-0.3	3.3	-0.3	-1.9	0.8
Business investment*	2.2	2.2	2.2	0.2	5.5	3.0	5.3	6.9	4.0	2.3
Government	2.2	2.7	3.0	1.6	1.7	1.0	-0.1	1.5	2.0	1.6
Exports	1.3	1.1	3.2	1.7	2.4	3.7	3.0	4.0	2.0	1.8
Imports	3.0	4.2	2.9	1.5	2.8	3.7	4.6	4.5	1.8	2.9
Nominal GDP	4.3	5.6	3.6	2.7	4.2	4.0	4.2	5.2	4.2	3.3
GDP deflator	2.1	2.6	1.7	1.3	2.1	1.9	1.9	2.3	1.6	1.6
Consumer price index (CPI)	1.9	1.6	2.3	1.8	2.0	2.2	2.1	2.4	1.7	2.0
CPI ex. food & energy	1.6	1.6	1.9	1.9	2.0	2.0	1.8	2.1	2.0	2.2
Pre-tax corporate profits	0.0	20.1	0.5	-4.1	2.1	5.3	3.2	7.8	0.2	1.9
Employment	1.4	1.9	1.3	2.1	1.0	0.7	1.6	1.7	1.5	1.0
Unemployment rate (%)	7.1	6.3	5.8	5.7	5.9	6.1	4.4	3.9	3.8	3.9
Current account balance (CAD, USD bn)	-18.7	-59.4	-58.5	-57.6	-55.9	-500	-440	-491	-543	-606
Merchandise trade balance (CAD, USD bn)	22.9	-23.9	-22.0	-26.1	-28.0	-680	-805	-887	-894	-971
Federal budget balance (FY, CAD, USD bn)	-3.6	-17.8	-19.0	-11.8	-19.8	-540	-665	-779	-896	-892
percent of GDP	-0.2	-0.9	-0.9	-0.5	-0.8	-3.7	-3.4	-3.8	-4.2	-4.0
Housing starts (000s, mn)	200	220	213	202	199	1.26	1.20	1.25	1.24	1.26
Motor vehicle sales (000s, mn)	1,678	2,036	1,983	1,935	1,915	15.6	17.1	17.2	16.8	16.7
Industrial production	0.0	4.9	2.9	0.4	1.9	0.7	2.3	4.0	1.9	1.7
	Mexico (annual % change)									
Real GDP	2.2	2.1	2.0	0.9	1.1					
Consumer price index (year-end)	4.4	6.8	4.8	4.1	4.1					
Current account balance (USD bn)	-15.0	-19.6	-21.6	-22.1	-20.8					
Merchandise trade balance (USD bn)	-7.2	-11.0	-13.6	-5.8	-13.1					

Sources: Scotiabank Economics, Statistics Canada, CMHC, BEA, BLS, Bloomberg. *For Canada it includes capital expenditures by businesses and non-profit institutions.

Quarterly Forecasts	2018	2019				2020			
Canada	Q4	Q1	Q2e	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Real GDP (q/q ann. % change)	0.3	0.4	2.5	1.5	2.3	2.4	2.0	1.5	1.7
Real GDP (y/y % change)	1.6	1.3	1.3	1.2	1.7	2.2	2.0	2.0	1.9
Consumer prices (y/y % change)	2.0	1.6	2.1	1.8	1.9	2.1	2.1	2.0	1.9
Avg. of new core CPIs (y/y % change)	1.9	1.9	2.1	2.0	2.0	2.0	2.0	2.0	2.0
United States									
Real GDP (q/q ann. % change)	2.2	3.1	1.8	1.9	1.4	1.5	1.5	1.9	2.1
Real GDP (y/y % change)	3.0	3.2	2.6	2.2	2.1	1.6	1.6	1.6	1.7
Consumer prices (y/y % change)	2.2	1.6	1.6	1.6	1.7	2.0	2.0	2.0	2.1
CPI ex. food & energy (y/y % change)	2.2	2.1	2.0	2.0	2.0	2.1	2.2	2.2	2.2
Core PCE deflator (y/y % change)	1.9	1.7	1.6	1.6	1.7	1.8	1.9	1.9	1.9

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

APPENDIX 3

	2018	2019				2020			
Central Bank Rates	Q4	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Americas				(%, end of period)					
Bank of Canada	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
US Federal Reserve (upper bound)	2.50	2.50	2.50	2.00	1.75	1.75	1.75	1.75	1.75
Bank of Mexico	8.25	8.25	8.25	8.25	8.25	8.25	8.00	7.75	7.50
Central Bank of Brazil	6.50	6.50	6.50	6.50	7.00	7.75	8.25	8.50	8.50
Bank of the Republic of Colombia	4.25	4.25	4.25	4.25	4.25	4.25	4.50	4.50	4.50
Central Reserve Bank of Peru	2.75	2.75	2.75	2.75	2.75	2.50	2.50	2.50	2.50
Central Bank of Chile	2.75	3.00	2.50	2.50	2.50	2.50	2.50	2.75	3.25
Europe									
European Central Bank MRO Rate	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
European Central Bank Deposit Rate	-0.40	-0.40	-0.40	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
Bank of England	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	1.00	0.75	0.75	0.75	0.75	0.75
Bank of Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
People's Bank of China	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
Reserve Bank of India	6.50	6.25	5.75	5.50	5.25	5.25	5.25	5.25	5.25
Bank of Korea	1.75	1.75	1.75	1.50	1.50	1.50	1.50	1.50	1.50
Bank of Thailand	1.75	1.75	1.75	1.75	1.75	1.50	1.50	1.50	1.50
Currencies and Interest Rates									
Americas				(end of period)					
Canadian dollar (USDCAD)	1.36	1.33	1.31	1.31	1.28	1.28	1.28	1.25	1.25
Canadian dollar (CADUSD)	0.73	0.75	0.76	0.76	0.78	0.78	0.78	0.80	0.80
Mexican peso (USDMXN)	19.65	19.43	19.22	20.24	20.87	21.12	20.99	21.10	21.44
Brazilian real (USDBRL)	3.88	3.92	3.85	3.97	4.18	4.08	4.11	4.07	4.18
Colombian peso (USDCOP)	3,254	3,189	3,211	3,150	3,120	3,050	3,100	3,182	3,167
Peruvian sol (USDPEN)	3.37	3.32	3.29	3.34	3.35	3.36	3.32	3.33	3.30
Chilean peso (USDCLP)	694	680	679	660	645	645	645	640	640
Europe									
Euro (EURUSD)	1.15	1.12	1.14	1.13	1.15	1.19	1.22	1.24	1.24
UK pound (GBPUSD)	1.28	1.30	1.27	1.25	1.25	1.28	1.30	1.32	1.40
Asia/Oceania									
Japanese yen (USDJPY)	110	111	108	108	108	107	107	105	105
Australian dollar (AUDUSD)	0.70	0.71	0.70	0.75	0.75	0.77	0.77	0.78	0.78
Chinese yuan (USDCNY)	6.88	6.71	6.87	6.70	6.70	6.60	6.60	6.50	6.50
Indian rupee (USDINR)	69.8	69.1	69.0	68.0	68.0	67.0	67.0	66.0	66.0
South Korean won (USDKRW)	1,116	1,135	1,155	1,140	1,140	1,120	1,120	1,100	1,100
Thai baht (USDTHB)	32.5	31.7	30.7	31.0	31.0	30.5	30.5	30.0	30.0
Canada (Yields, %)									
3-month T-bill	1.65	1.67	1.65	1.65	1.65	1.65	1.65	1.65	1.65
2-year Canada	1.86	1.55	1.47	1.50	1.40	1.35	1.35	1.35	1.35
5-year Canada	1.89	1.52	1.39	1.45	1.40	1.40	1.40	1.40	1.40
10-year Canada	1.97	1.62	1.46	1.50	1.55	1.60	1.65	1.65	1.70
30-year Canada	2.18	1.89	1.68	1.70	1.80	1.90	2.00	2.05	2.10
United States (Yields, %)									
3-month T-bill	2.36	2.39	2.09	1.85	1.60	1.60	1.60	1.60	1.60
2-year Treasury	2.49	2.26	1.76	1.70	1.70	1.80	1.80	1.80	1.80
5-year Treasury	2.51	2.23	1.77	1.75	1.80	1.90	1.90	1.90	1.90
10-year Treasury	2.68	2.41	2.00	2.10	2.20	2.35	2.40	2.45	2.45
30-year Treasury	3.01	2.82	2.53	2.65	2.70	2.85	2.85	2.90	2.90

Sources: Scotiabank Economics, Bloomberg.

APPENDIX 4

The Provinces	(annual % change except where noted)										
Real GDP	**CA**	**NL**	**PE**	**NS**	**NB**	**QC**	**ON**	**MB**	**SK**	**AB**	**BC**
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	1.9	-2.7	2.6	1.2	0.1	2.5	2.2	1.3	1.6	2.3	2.4
2019f	1.4	2.0	2.1	1.3	0.6	2.1	1.4	1.5	1.4	0.5	2.2
2020f	2.0	0.8	2.0	1.3	0.8	1.8	1.8	1.5	1.6	2.5	3.0
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	0.5	4.6	3.2	1.9	4.2	3.4	3.1	3.8	4.5	4.4
2019f	2.8	3.0	4.1	3.0	2.2	3.2	2.5	3.3	3.3	1.3	4.2
2020f	4.1	3.8	3.9	3.3	2.5	3.7	3.7	3.3	4.0	4.6	5.7
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	2.1	1.9	1.4	2.3	0.5	1.5	2.5	1.2	1.6	1.0	3.0
2020f	1.0	0.2	0.8	0.3	0.2	0.8	1.2	0.6	0.7	1.0	1.5
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	11.8	9.0	6.8	8.0	5.2	5.6	5.5	5.5	6.7	4.6
2020f	5.9	11.6	9.0	6.8	8.0	5.4	5.8	5.5	5.5	6.8	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	1.0	0.9	3.9	2.1	46	69	6.8	3.2	26	44
2020f	199	1.3	0.8	3.8	2.0	41	72	6.0	4.8	30	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	1,935	30	9	51	39	447	813	60	49	220	217
2020f	1,915	30	9	50	37	440	800	56	48	217	228
Budget Balances, Fiscal Year Ending March 31 (CAD mn)											
2017	-18,957	-1,148	-1	151	-117	2,361	-2,435	-789	-1,218	-10,784	2,727
2018	-18,961	-911	1	230	67	2,622	-3,672	-695	-303	-8,023	301
2019e	-11,815	-522	14	28	5	2,500	-11,700	-470	-380	-6,711	374

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

Foreign Exchange Strategy