A Most Uncertain World

- **The slowdown in global growth is largely the result of elevated levels of trade-related uncertainty. Growth is a victim of the China-US trade war.**
- **A recession should be avoided if uncertainty remains at current levels, but a sharp rise in concerns could lead to a significantly weaker outlook.**
- **Central banks are acting and will continue to do so. Limited fiscal responses are expected in Europe, but policymakers in countries with an ability to use discretionary fiscal policy should be on standby in case the outlook worsens.**

Uncertainty is taking its toll on the global economy. There are now clear signs that Trump's trade policies along with a raft of other Trump-related developments are leading to a pull-back in global business spending. Moreover, risks of a hard Brexit also weigh on sentiment. Nowhere is this more evident than in manufacturing industries, where global manufacturing PMIs are in contractionary territory, mirroring the global slowdown in trade and industrial production. In many countries, including the United States, the growth slowdown appears manageable to date, while in others, Germany in particular, economies are teetering on the edge of technical recessions.

Our outlook assumes that policy uncertainty remains elevated through 2020 before gradually abating in 2021. This view assumes that President Trump will seek some degree of stability in the lead-up to the 2020 Presidential election. We have formally included measures of uncertainty in our macro models for the US and Canada and find clear evidence that the rise in uncertainty under President Trump has reduced US and Canadian output by 0.75 and 0.5 percentage points through 2019, with that impact expected to increase through 2020. As much as President Trump is publicly blaming the Federal Reserve for the slowing in US economic activity, we think he and his advisors understand the damage being caused by his actions, and will work to limit the harm going forward.

Accordingly, **we do not believe the US or Canada will trip into a recession**. Growth will slow in both countries given the weight of uncertainty to date, as can be seen in PMIs, but there are no imbalances large enough in either economy that could lead to a recession. The peak weakness in growth rates is likely to be seen late this year and early next year. The risk of a more serious slowdown, or recession, is almost entirely a function of President Trump's future actions. A further significant increase in uncertainty, particularly one that originates from actions or threats on the trade side, could see business activity retrench enough to trigger a recession. Recent statements and actions from the President are clear reminders that uncertainty could well increase from current levels.

Policy stimulus is clearly required at the global level to deal with the current slowdown and the potential for greater weakness. To date, central banks have been the only game in town. If we are correct in our assessment that uncertainty will not increase from current levels, then we believe only modest

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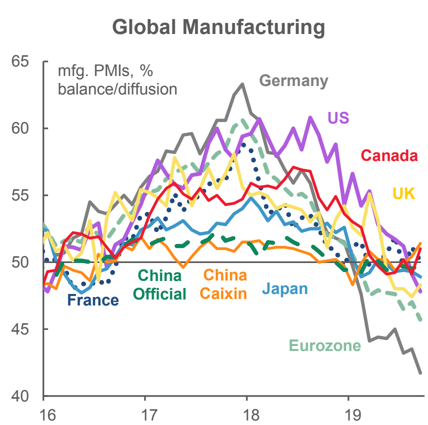
Chart 1



Sources: Scotiabank Economics, Markit, ISM.

policy stimulus is required in Canada and the US. In the US, 50 bps of additional easing may be required in addition to the 50 bps of cuts that have already been executed. In Canada, though there is no clear reason to cut based on domestic developments, we believe the Bank of Canada will lower interest rates by 50 bps as insurance against the possibility of weaker outcomes. Globally, some central banks have acted in response to signs of weakness and others to guard against clear and present risks to the outlook. We think the Bank of Canada will be in this latter camp.

In Europe, it is high time for politicians to rely less on the European Central Bank and consider using active fiscal policy to manage the downturn. It is clear more stimulus is required to raise growth and inflation. With legitimate questions about the effectiveness of negative interest rates already being asked, Europe will need to set aside the dogmatic pursuit of fiscal objectives and get serious about economic management. Nowhere is this more pressing than in Germany, arguably the weakest major economy in Europe at the moment, where policymakers refuse to undertake expansionary fiscal policies while complaining about the ECB's interest rate policy.

Table 1

Global Real GDP	2000–18	2018	2019f	2020f	2021f
		(annual % change)			
World (PPP)	3.9	3.7	2.9	3.1	3.3
Canada	2.1	1.9	1.6	1.8	1.9
United States	2.1	2.9	2.2	1.4	1.8
Mexico	2.2	2.0	0.2	1.0	2.0
United Kingdom	1.9	1.4	1.1	1.2	1.6
Eurozone	1.4	1.9	1.0	1.1	1.3
Germany	1.4	1.5	0.5	0.8	1.2
France	1.4	1.7	1.3	1.3	1.4
China	9.1	6.6	6.1	6.0	5.8
India	7.1	7.4	5.8	6.7	7.4
Japan	0.9	0.8	0.8	0.5	1.2
South Korea	3.9	2.7	1.9	2.3	2.5
Australia	2.9	2.7	1.8	2.4	2.5
Thailand	4.1	4.1	2.4	2.1	2.7
Brazil	2.4	1.1	1.0	1.8	2.1
Colombia	3.8	2.6	3.2	3.6	3.6
Peru	4.9	4.0	2.3	3.0	3.5
Chile	3.9	4.0	2.7	3.2	3.0

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

If we are wrong in our assessment and uncertainty increases further through next year, there may be a need for more activist fiscal policies. A substantial increase in uncertainty could lead to a much weaker global outlook, potentially leading to technical recessions in the US, Canada, and other countries. If that were to happen, other central banks may need to consider cutting rates aggressively, while Finance Ministers would need to implement fiscal stimulus measures. Negative interest rates may be possible, though we would expect aggressive fiscal action might keep short-term interest rates at or above zero.

The good news in all of this is that we still think it is relatively easy for President Trump to reverse some of the damage he has so far caused. A deal with China and less aggressive posturing on trade would have immediate positive impacts on sentiment and markets. It could even lead to upward revisions to forecasts for 2020 and 2021. We're crossing our fingers and hoping that President Trump, in his "great and unmatched wisdom", sees things our way.

Canada

JOB GROWTH TRUMPING UNCERTAINTY

- **The hiring boom rolls on as firms continue to face labour shortages.**
- **Growth should accelerate modestly next year if there is no further increase in trade-related uncertainty. Though risks of a recession exist, we do not think we are headed for a period of protracted weakness. That view could change if uncertainty rises significantly.**
- **Strong population growth will continue to provide human stimulus in Canada, a major differentiator relative to other advanced economies, where population growth is slowing.**

Without question, the most surprising Canadian economic development over the last year has been the resounding strength of the Canadian labour market. More jobs have been created as of August than in all of 2018. Some measures of wages are rising strongly, the unemployment rate is hovering near 45-year lows, there are nearly 600k job vacancies, and Canadian firms continue to report that labour shortages are by far the most important factor limiting production or sales increases. This is set against a global environment tainted by elevated uncertainty, which has led to a retrenchment in global industrial production and trade volumes, along with significant impacts in financial markets.

An immediate consequence of the strength in labour outcomes has been to keep Canadian consumer confidence elevated despite the barrage of worrisome global news (chart 1). This is important in a number of ways. Our recession probability model, which uses information from the yield curve and consumer confidence (in contrast to most yield-curve-based recession probability models), is only pointing to 20% chance or so of a recession in the next 18 months (chart 2). The strength in confidence, which is itself a reflection of underlying dynamism in the labour market, is keeping a lid on recession risks—thus far. Moreover, the resilience of consumer confidence, combined with a fall in mortgage rates and strong employment and wage gains, has contributed to a dramatic turnaround in the Canadian housing market, with sales rebounding sharply through the summer months.

Uncertainty is nevertheless exacting a heavy toll on the Canadian economy. Our macroeconomic model for Canada and the US has been updated to formally include an uncertainty channel. The rise in trade-related concerns and the follow-on impact on financial markets has led to a marked reduction in the level of activity relative to what would have been the case if uncertainty had not increased as much as observed. In the US, the source of the shock, the level of economic activity is expected to be 0.75 percentage points lower at the end of 2019 than would have occurred with less uncertainty (see the US section of this report for details on the approach we have taken). In Canada, the impact is estimated at 0.5 percentage points of output (chart 3) by the end of this year. This is a sizeable economic impact, which of course is being addressed through monetary policy. In Canada's case, absent this uncertainty, we might still be focused on the need for additional interest rate increases, rather than our current call for 50 bps of cuts.

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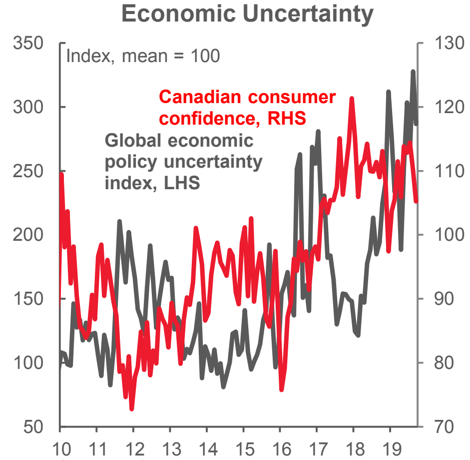
Canada	2018	2019f	2020f	2021f
Real GDP (annual % change)	1.9	1.6	1.8	1.9
CPI (y/y %, eop)	2.0	2.0	1.9	2.5
Central bank policy rate (%, eop)	1.75	1.50	1.25	1.25
Canadian dollar (CADUSD, eop)	0.73	0.77	0.80	0.80

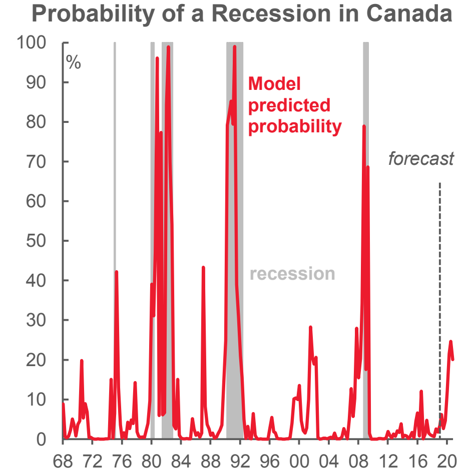
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, PolicyUncertainty.com, Conference Board.

Chart 2



Sources: Scotiabank Economics, Haver Analytics.

Despite this uncertainty, we expect Canadian growth will accelerate modestly, rising from 1.6% this year to 1.8% in 2020. This is in contrast to the US outlook, which may see a sharp reduction in growth rates from this year to next. Several factors account for this:

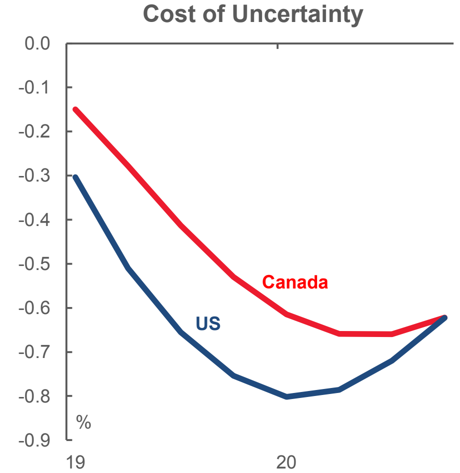
- Canada is experiencing an immigration-led population boom, with population rising at its fastest rate in 20 years. This is in sharp contrast to other advanced economies, including the US, where population growth has slowed. This is giving Canada a dose of human stimulus that other countries aren't benefitting from, while also increasing the pool of available labour for firms in need of workers. Immigrants to Canada have been buying goods and services, and have undoubtedly been supporting housing markets.

- Fiscal policy will likely be slightly more stimulative next year. Announcements to date from the leading parties reflect a mixture of tax cuts, transfers, and spending measures. In all likelihood, the announced measures by the Liberals or the Conservative Party of Canada will add around 0.1 percentage points to growth next year. The exact impact will of course depend on which party wins, what measures they implement and when they take effect. That will be determined in time. For the moment, we are penciling in a boost of 0.1% to growth next year, as the deficit is set to expand under either party.

- Construction of the CAD 40 billion LNG Canada terminal in Kitimat will be in full swing next year, providing a substantial amount of investment, which will meaningfully increase growth prospects in British Columbia and the rest of the country.

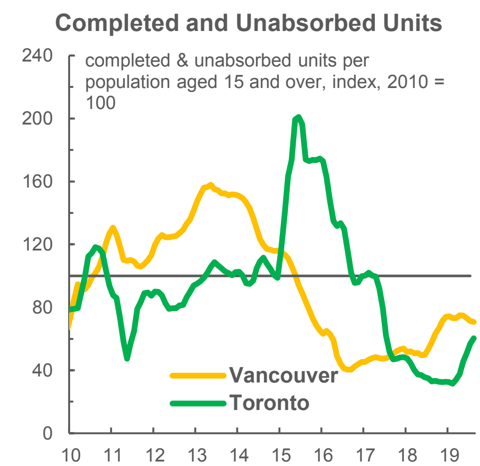
A key area of attention in coming months will be the evolution of the housing markets. The rise in employment, fall in interest rates, and sustained population growth are providing a solid backdrop to national housing markets. Sales activity has picked up dramatically over the summer following a period of generalized weakness that began late last year. We attribute this weakness to the impact of various regulatory changes designed to calm markets and increase the financial resiliency of

Chart 3



Sources: Scotiabank Economics.

Chart 4



Sources: Scotiabank Economics, Statistics Canada.

Table 1

Quarterly Canadian Forecasts	2019		2020				2021			
	Q3e	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic										
Real GDP (q/q ann. % change)	1.5	1.2	2.0	2.0	1.4	1.6	2.0	2.1	2.0	1.9
Real GDP (y/y % change)	1.5	1.7	2.1	1.7	1.6	1.7	1.8	1.8	2.0	2.0
Consumer prices (y/y % change)	1.9	2.0	2.1	1.9	1.9	1.9	2.0	2.1	2.2	2.5
Avg. of new core CPIs (y/y % change)	2.0	2.0	2.0	2.0	2.0	2.1	2.1	2.1	2.2	2.2
Financial										
Canadian Dollar (USDCAD)	1.32	1.30	1.28	1.28	1.25	1.25	1.25	1.25	1.25	1.25
Canadian Dollar (CADUSD)	0.76	0.77	0.78	0.78	0.80	0.80	0.80	0.80	0.80	0.80
Bank of Canada Overnight Rate (%)	1.75	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
3-month T-bill (%)	1.65	1.40	1.20	1.20	1.25	1.25	1.25	1.25	1.25	1.30
2-year Canada (%)	1.58	1.30	1.20	1.25	1.30	1.30	1.35	1.40	1.45	1.50
5-year Canada (%)	1.40	1.25	1.25	1.30	1.35	1.40	1.45	1.50	1.55	1.60
10-year Canada (%)	1.36	1.30	1.40	1.50	1.55	1.60	1.65	1.70	1.75	1.80
30-year Canada (%)	1.53	1.45	1.55	1.65	1.75	1.80	1.85	1.90	1.95	2.00

Sources: Scotiabank Economics, Statistics Canada, Bloomberg.

households. Those adjustments, while necessary, are clearly in the rear view mirror as the laws of economics assert themselves. Demand remains greater than supply in most markets and inventories are generally low (chart 4). This suggests that housing markets have some momentum going forward, and that affordability will remain a challenge for Canadians in a range of communities. It also suggests that consumer spending will accelerate in coming quarters as these newly purchased homes are furnished or improved.

Moreover, **the pick-up in sales activity is leading to a sharp rise in credit growth, which might give pause to the Bank of Canada if, as we believe, it were to seek to provide a cushion to the rise in uncertainty**. For much of the last three years, Governor Poloz has warned of the perils of high household indebtedness. Those concerns are likely to re-emerge, even though household balance sheets generally seem to be in good shape. The most recent data on delinquency rates on credit cards shows a decline in delinquencies relative to last year. Arrears rates on mortgages remain near the lows seen in the last 25 years or so (chart 5). This could all change quickly if the unemployment rate were to increase, but with the pent-up demand for labour currently plaguing Canadian industry, that appears unlikely to occur.

There are nevertheless reasons for concern. Business activity remains solid but inventory levels are at their highest in 10 years (chart 6). This is to some degree understandable given the increase in unfilled orders observed over the last two years, but it does represent a vulnerability if sales were to slow significantly.

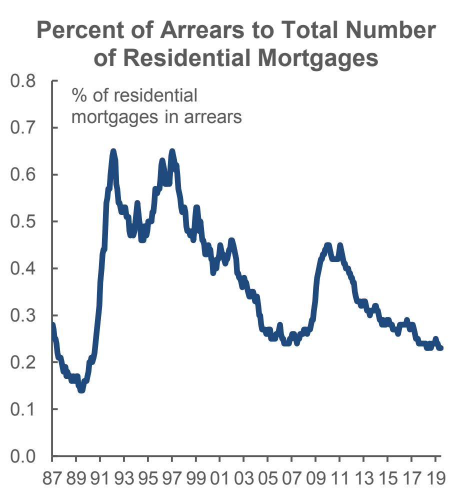
Canada is not immune to the vagaries of US trade policy. Some uniquely Canadian factors give us a better cushion to deal with elevated uncertainty than other countries, but the simple fact is that an amplification of policy volatility has the potential to drag Canada down with the US. If uncertainty is kept in check, as we expect, there is a solid case to believe that Canadian growth will increase modestly in 2020 relative to this year.

Table 2

Canada	2000–18	2018	2019f	2020f	2021f
	(annual % change, unless noted)				
Real GDP	2.1	1.9	1.6	1.8	1.9
Consumer spending	2.9	2.1	1.7	1.8	1.9
Residential investment	3.4	-1.5	-1.7	3.1	2.5
Business investment	2.2	2.2	-2.3	3.0	2.3
Government	2.2	3.0	1.6	1.7	1.6
Exports	1.4	3.2	2.7	2.4	2.3
Imports	3.0	2.9	0.9	2.4	2.4
Nominal GDP	4.2	3.6	3.2	3.8	4.3
GDP Deflator	2.1	1.7	1.6	1.9	2.4
Consumer price index (CPI)	1.9	2.3	1.9	2.0	2.2
CPI ex. food & energy	1.6	1.9	2.2	2.1	2.0
Pre-tax corporate profits	0.0	0.5	1.7	3.4	2.0
Employment	1.4	1.3	2.1	1.0	1.0
Unemployment rate (%)	7.0	5.8	5.7	5.9	5.9
Current account balance (CAD bn)	-20.8	-58.5	-35.9	-28.6	-24.5
Merchandise trade balance (CAD bn)	20.6	-22.0	-10.6	-8.5	-8.2
Federal budget balance* (FY, CAD bn)	-4.4	-19.0	-14.0	-19.8	-14.1
percent of GDP	-0.3	-0.9	-0.6	-0.8	-0.6
Housing starts (000s)	201	213	210	206	202
Motor vehicle sales (000s)	1,694	1,983	1,940	1,915	1,915
Industrial production	1.0	3.1	0.9	2.1	1.8
WTI oil (USD/bbl)	62	65	57	55	62
Nymex natural gas (USD/mmbtu)	4.74	3.07	2.61	2.64	2.75

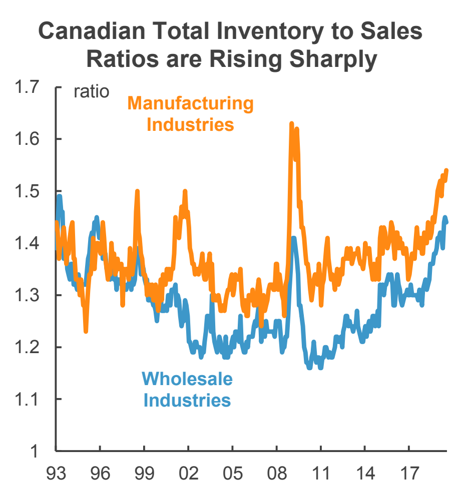
Sources: Scotiabank Economics, Statistics Canada, CMHC, Bloomberg.

Chart 5



Sources: Scotiabank Economics, CBA.

Chart 6



Sources: Scotiabank Economics, Statistics Canada.

United States

MULTIPLE FORKS IN THE ROAD AHEAD

- **US growth is moderating as the damage from erratic and misguided policymaking sets in, but neither secular stagnation nor stagflation is looming on the horizon. Medium-term prospects for the US economy depend critically on the still-buoyant US consumer.**
- **The evolution of trade policy uncertainty and general turmoil in Washington, slowing growth outside of the US, and the inflation path multiply uncertainties around macroeconomic outlook and Fed policy.**

NEITHER SECULAR STAGNATION NOR STAGFLATION

Since late-2017 we have projected that US growth would be boosted by fiscal stimulus in 2018 and slow back toward underlying potential just below 2% in subsequent years. This outlook remains on track: we still do not project a recession in our forecast horizon, but our projections are subject to some major uncertainties. If anything, 2018 saw faster growth than we initially forecast and the ensuing slowdown has been more gradual than our models implied and slightly more resilient to Trump's trade wars than expected.

The Trump Administration's erratic policies have hit supply chains and kept the US dollar strong, pushing forward-looking surveys of business sentiment into territory that is sometimes suggestive of a forthcoming recession. Although US manufacturing and services purchasing managers' indices (PMIs) have softened, these indices have been only partially reliable indicators of looming recessions. The US manufacturing PMI has previously dipped below 50 (i.e., contraction) twice since the global financial crisis (GFC), and has registered five other false recession signals since 1980 (chart 1). It's notable that industrials account for only about 9.4% of the S&P500 and around 11.6% of US economic output. The signal may be better when we look at manufacturing and services together—and at present they don't jointly point toward a recession (chart 1 again).

US financial conditions remain accommodative, surprise indices have trended upward in recent months, and Fed Nowcasts still point to decent growth in Q3 (chart 2) in line with our expectations. Against past history, current US financial conditions are consistent with continued growth; they are likely fuelling some of the recent over-performance against, admittedly, diminished expectations. US corporate profits and core capital goods orders remain at elevated levels (chart 3), but uncertainty could dampen investment decisions going forward. And with inventory-sales ratios near GFC highs, running down these stockpiles could add a further drag on growth.

The US growth outlook depends critically on the still-buoyant US consumer—and there are good reasons to think Americans remain in spending mode. Household balance sheets are in good shape, with the debt-

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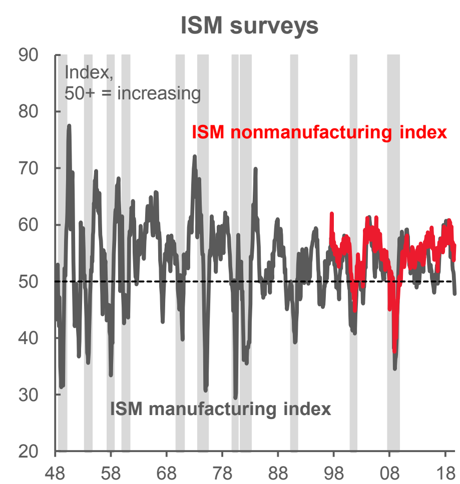
United States	2018	2019f	2020f	2021f
Real GDP (annual % change)	2.9	2.2	1.4	1.8
CPI (y/y %, eop)	2.2	1.9	2.2	2.2
Central bank policy rate (%, eop)	2.50	1.75	1.50	1.50
Canadian dollar (USDCAD, eop)	1.36	1.30	1.25	1.25

Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, ISM, NBER.

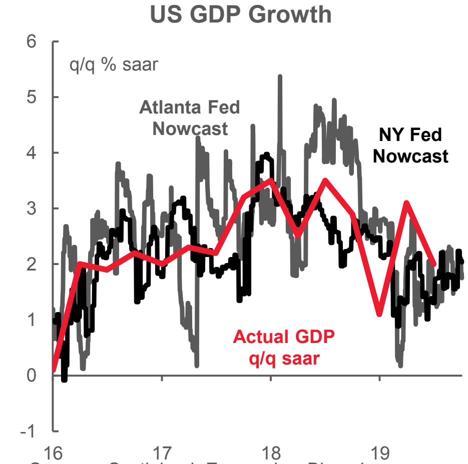
service ratios at their lowest levels in 40 years and the ratio of household net worth to GDP at a record high. New housing starts are just off their post-GFC high, pushed up by lower mortgage rates, which should sustain growth in consumer durables sales (chart 4). Wage growth continues on a sustained upward trend, although it has slowed recently. **Still, consumers and labour markets are often lagging indicators of incipient downturns, and, at the margin, consumer sentiment is now softening, hiring is slowing, and saving rates are rising.**

Nevertheless, even after the recent turmoil in the Middle East, we see little chance that moderate growth is going to be transformed into stagflation. In contrast with the 1970s, underlying US inflation remains soft and higher oil prices aren't likely to strengthen it meaningfully. Headline inflation has been below the Fed's 2% target since late-2018 and is expected to rise back toward the target during 2020. Similarly, as the *Commodities section* lays out, oil prices are expected to remain flat as global growth slows and Saudi capacity comes back online. In any event, the US economy has become steadily less oil intensive over time and oil is now a less important driver of US inflation than in the 1970s (chart 5).

Consequently, we expect PCE inflation to return to the Fed's 2% target only in 2021, on the back of rising labour costs, the lagged impact from fiscally-induced excess demand, and the eventual US dollar depreciation. US dollar depreciation, as well as the pick-up in GDP growth in late-2020 on the back of stronger domestic demand, is driven by our expectation of a decline in trade policy uncertainty following the 2020 US presidential election and by the lagged effect of monetary policy stimulus introduced by the Federal Reserve in 2019.

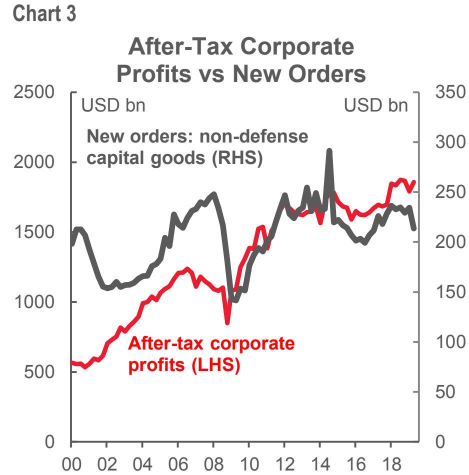
The US outlook has rarely been subject to the degree of uncertainty that currently provides a persistent backdrop to financial markets and policy makers. Three sources of uncertainty dominate the outlook, as summarized by the Federal Reserve's communications over the last few months: escalating trade policy uncertainty, accumulating risks to global growth and unexpected weakness in inflation. Each type of uncertainty can affect the US economy to a greater or lesser extent and shape the stance of monetary policy over 2019–21.

Chart 2



Sources: Scotiabank Economics, Bloomberg, Atlanta + NY Federal Reserve Banks.

Chart 3



Source: Scotiabank Economics, BEA, Census Bureau.

Table 1

Quarterly US Forecasts	2019		2020				2021			
	Q3e	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic										
Real GDP (q/q ann. % change)	1.8	1.1	1.3	1.3	1.5	1.8	1.9	1.9	2.0	2.0
Real GDP (y/y % change)	2.0	2.0	1.6	1.4	1.3	1.5	1.6	1.7	1.9	1.9
Consumer prices (y/y % change)	1.8	1.9	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
CPI ex. food & energy (y/y % change)	2.1	2.1	2.1	2.2	2.2	2.2	2.1	2.1	2.1	2.1
Core PCE deflator (y/y % change)	1.6	1.8	1.8	1.9	1.9	1.9	1.9	1.9	2.0	2.0
Financial										
Euro (EURUSD)	1.09	1.10	1.12	1.15	1.19	1.20	1.20	1.20	1.22	1.22
U.K. Pound (GBPUSD)	1.23	1.22	1.25	1.30	1.32	1.36	1.38	1.38	1.40	1.40
Japanese Yen (USDJPY)	108	108	107	107	105	105	103	103	102	102
Fed Funds Rate (upper bound, %)	2.00	1.75	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
3-month T-bill (%)	1.85	1.60	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.40
2-year Treasury (%)	1.62	1.40	1.45	1.50	1.50	1.60	1.65	1.70	1.70	1.75
5-year Treasury (%)	1.55	1.35	1.45	1.60	1.70	1.80	1.80	1.85	1.85	1.90
10-year Treasury (%)	1.67	1.50	1.60	1.70	1.85	2.00	2.05	2.10	2.10	2.15
30-year Treasury (%)	2.11	2.05	2.10	2.20	2.35	2.50	2.60	2.70	2.75	2.80

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

THE FED'S THREE DIFFICULT QUESTIONS

The outlook we present is contingent on three key assumptions:

- a reduction in trade policy uncertainty in 2021, following the 2020 US presidential election;
- a gradual slowing of growth outside the US during 2019–20; and
- persistently weak inflation.

Where is the trade war going? (charts 6–8)

Our baseline assumption is that trade uncertainty remains high through 2020, given that US-China trade negotiations are proceeding sporadically: tariff measures are announced and postponed; at times, rumours of an escalation in tensions shake financial markets (e.g., a potential de-listing of China-based companies is one recent case), while at other times exuberant optimism takes hold. Overall uncertainty is expected to wane over the course of 2021 as the impetus for further trade disruptions is likely to be diminished after the US elections, regardless of the winner (chart 6).

Table 2

United States	2000–18	2018	2019f	2020f	2021f
	(annual % change, unless noted)				
Real GDP	2.1	2.9	2.2	1.4	1.8
Consumer spending	2.4	3.0	2.5	2.0	2.0
Residential investment	-0.3	-1.5	-2.6	0.1	1.6
Business investment	3.2	6.4	2.6	1.1	2.3
Government	1.1	1.7	2.3	1.7	1.6
Exports	3.7	3.0	0.0	1.2	2.1
Imports	3.8	4.4	2.0	2.9	2.8
Nominal GDP	4.1	5.4	4.0	3.1	3.7
GDP Deflator	2.0	2.4	1.7	1.6	1.9
Consumer price index (CPI)	2.2	2.4	1.8	2.2	2.2
CPI ex. food & energy	2.0	2.1	2.1	2.2	2.1
Core PCE deflator	1.7	1.9	1.6	1.9	1.9
Pre-tax corporate profits	4.9	3.4	-0.2	2.7	1.8
Employment	0.8	1.7	1.5	1.0	1.0
Unemployment rate (%)	6.0	3.9	3.8	4.0	4.2
Current account balance (USD bn)	-500	-491	-582	-661	-723
Merchandise trade balance (USD bn)	-691	-887	-901	-987	-1064
Federal budget balance (USD bn)	-552	-779	-1,008	-1,034	-1,097
percent of GDP	-3.7	-3.8	-4.7	-4.7	-4.8
Housing starts (mn)	1.26	1.25	1.24	1.26	1.26
Motor vehicle sales (mn)	15.7	17.2	17.0	17.0	17.1
Industrial production	0.9	4.0	1.0	1.5	1.9
WTI oil (USD/bbl)	62	65	57	55	55
Nymex natural gas (USD/mmbtu)	4.74	3.07	2.61	2.64	2.64

Sources: Scotiabank Economics, BEA, BLS, Bloomberg.

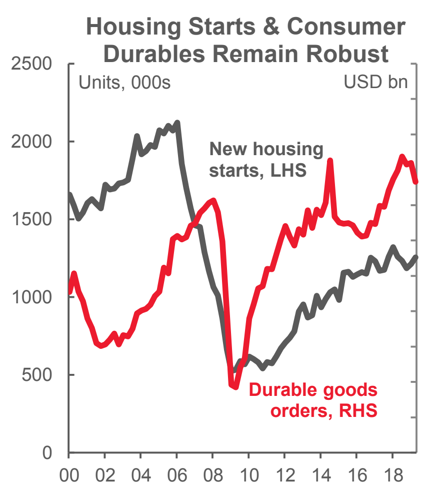
A more optimistic scenario is one in which the lack of certainty about the direction of trade policy declines during 2020, possibly on the heels of the conclusion of a deal between the US and China. Our simulations using the Scotiabank Global Macroeconomic Model (SGMM), which has now been re-estimated to include an explicit measure of trade-policy uncertainty, imply that US GDP growth would rise by 0.2 ppts in 2020 (chart 7) as US-China tensions abate. In the model, lower uncertainty would lead to stronger stock markets and a lower VIX, which supports consumption and investment; a weaker exchange rate owing to a reversal of the flight to the safety of the USD, which would boost exports; and stronger demand through higher investment spending and an acceleration of growth in international trade. All of these effects imply that the Fed would raise the fed funds target rate to 1.75% in Q2-2020 (chart 8) and keep it at that level for the rest of the forecast horizon.

On the other hand, we can also easily envision a scenario where uncertainty remains high through the end-2021. In this case, the results of our simulations show that US GDP growth is 0.2 ppts weaker in 2020 and 0.1 ppts weaker in 2021 than in our base case, leading the Federal Reserve to cut the fed funds target rate by an additional 25bps in Q2-2020. In this scenario, the policy rate is likely to be at 1.25% at the end of 2021.

What if global growth is weaker? (charts 9–10)

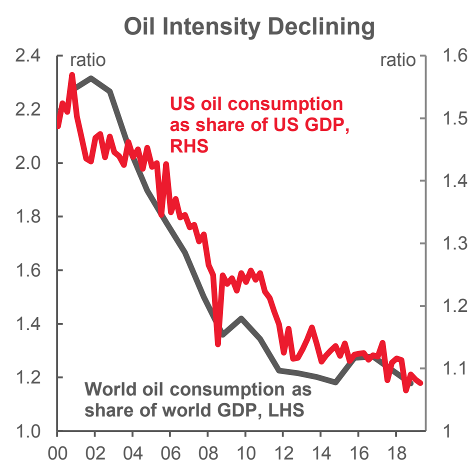
In addition to the effects of trade policy, there is evidence of a global growth slowdown that may or may not be related to it. Even though

Chart 4



Sources: Scotiabank Economics, Census.

Chart 5



Sources: Scotiabank Economics, Bloomberg, IMF, BEA.

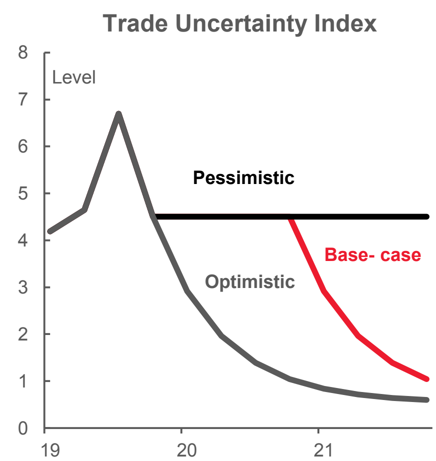
the US is relatively closed to international trade, the global economic cycle matters for the US growth outlook. Not only are US exports dependent on foreign demand, but any slowing in demand for US products is likely to be amplified by resulting weakness in financial markets and tighter borrowing conditions.

As an alternative scenario we assume that global growth is 0.5 ppts weaker over the full projection horizon compared to our baseline, 0.5 ppts being the difference between the median and the 20th percentile forecast for global growth amongst Bloomberg contributors. In this case, US GDP growth is expected to be 0.1 ppts weaker and the Federal Reserve is expected to provide further monetary policy accommodation relative to the base case, with rates falling to 1.25% in 2020 (charts 9 and 10).

Could inflation pick up faster?

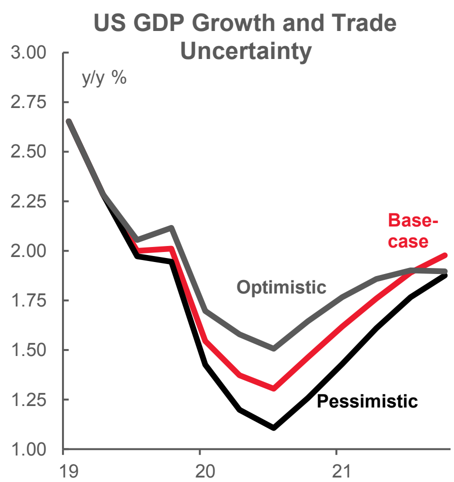
While downside risks to growth are significant, inflation behaviour can complicate the Federal Reserve's calculus. Our outlook assumes that the existing weakness in core inflation remains persistent. If, however, it is more transient, or the recent increases in tariffs produce a larger pass-through than we have assumed, the Fed will have fewer factors to point to when justifying easy monetary policy. For example, if core PCE inflation returns to 2.0% in Q1-2020, compared to 1.8% in the baseline, the rate cut in Q1-2020 may be postponed to later in the year and the case for it might be less robust.

Chart 6



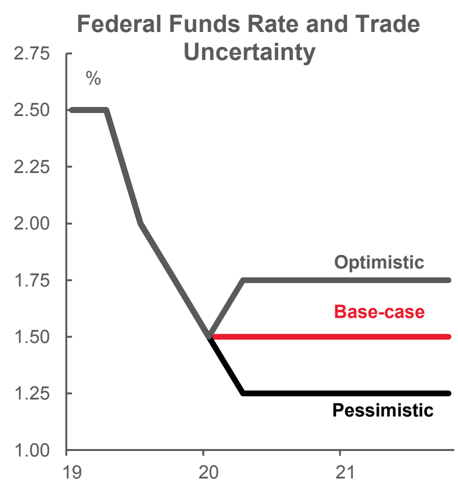
Sources: Scotiabank Economics, Trade Policy Uncertainty, PolicyUncertainty.com.

Chart 7



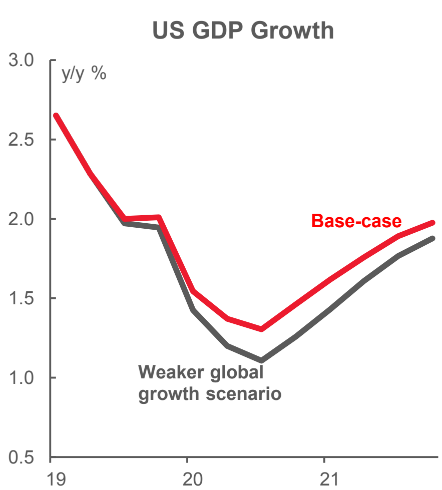
Sources: Scotiabank Economics.

Chart 8



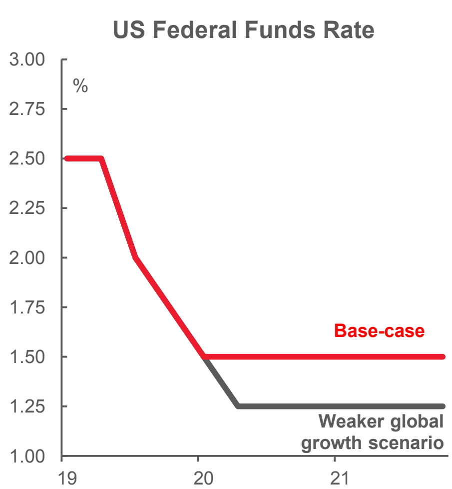
Sources: Scotiabank Economics.

Chart 9



Sources: Scotiabank Economics.

Chart 10



Sources: Scotiabank Economics.

US & Canadian Monetary Policy & Capital Markets

- **The Federal Reserve is forecast to cut twice more and then hold at 1.5%. Additional tools to address market liquidity are expected.**
- **The Bank of Canada is forecast to cut its policy rate twice and then hold at 1.25%.**
- **The US and Canadian yield curves are forecast to bear steepen over 2020–21 (charts 1, 2, table on page 14).**

FEDERAL RESERVE—MORE TO COME

We have added one more forecast rate cut since the last round. The Federal Reserve is now expected to cut twice more and take its fed funds target rate down to 1.5% for a cumulative full percentage point of easing. With fed funds futures markets pricing the rate at 1% by the end of 2020, the balance of risks must still turn out more favourably than markets are assuming in order to avoid tightening financial conditions. October is expected to bring multiple forms of easing including a rate cut. Thereafter, we're split on the odds of an additional cut in December or the first quarter of next year and will assess as material risks are evaluated. Following these reductions, our forecast is for the Fed to remain sidelined over the duration of 2020 and throughout 2021. This forecast change is informed by explanations below in terms of rising risks to the global and domestic outlook, a heavy line-up of major event risks and challenges to funding markets.

RISING GLOBAL DOWNSIDE RISKS

Risks to world growth have increased since our last forecast round. World trade volumes are shrinking with the pain being felt across Asia and Europe. Global industrial output has stalled. Global purchasing managers' indices foretell further weakening (chart 3). The effects of the US-led trade war—particularly, but not exclusively toward China—are causing rising spillover effects across many countries with significant dependence upon exports to China. Fixed investment in China has sharply diminished. Developments such as these reinforce the illustrations provided in Federal Reserve Vice Chair Clarida's speech in March

Chart 4

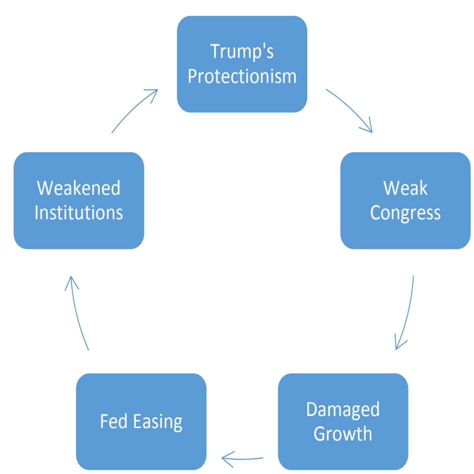


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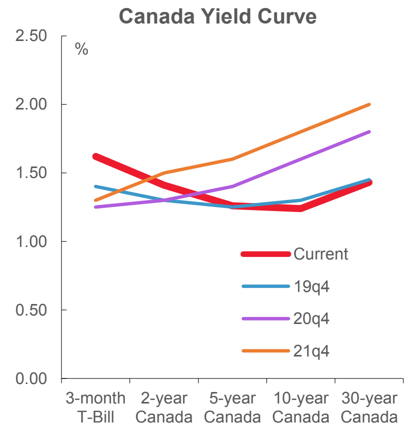
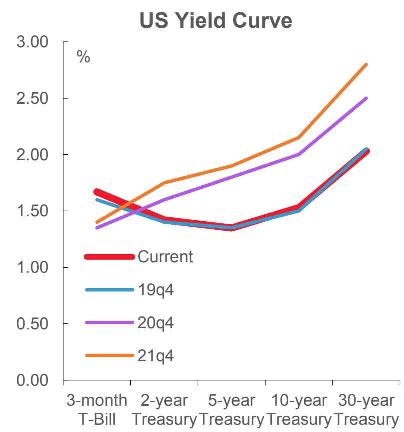
Chart 1



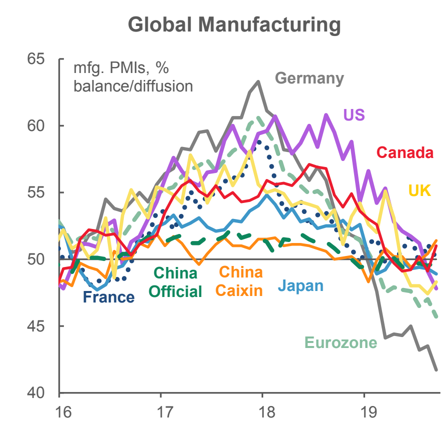
Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Chart 3



Sources: Scotiabank Economics, Markit, ISM.

regarding past episodes of Fed easing in response to external risks (here). We have not lost sight of the conundrum faced by the Fed in that it is emboldening Trump in a vicious feedback loop between falling rates and more protectionism (chart 4).

MAGNIFIED EVENT RISK

Since our last forecast round, the list of event risks over coming weeks has become even longer. We lack conviction to predict their outcomes but have tilted toward increased downside risks surrounding several of the examples illustrated below. Broad dollar strength that continues to point to ever-widening trade deficits may continue to translate into a persistently protectionist US administration (chart 5).

1. **October 10th:** US-China trade negotiators meeting in Washington.
2. **October 14th:** US-EU meeting on the Airbus-Boeing tariff dispute.
3. **October 15th:** US 5% tariff hike to 30% on US$250 billion of Chinese imports goes into effect.
4. **October 18th:** US tariffs on EU imports go into effect failing agreement.
5. **October 19th**: Benn Act Brexit deadline to request extension.
6. **October 31st:** possible UK withdrawal from the EU.
7. **November 17th:** US decision on auto tariffs is due.
8. **Late November:** The hoped-for timeline for passing the USMCA in Congress.
9. **December 15th:** US to impose 15% tariff on US$160 billion of Chinese imports.

RISING US RISKS

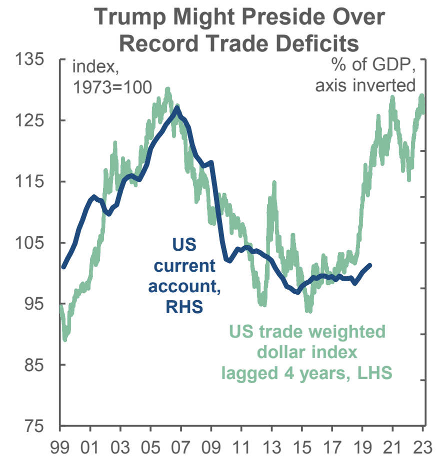
The argument that the trade wars impair prospects abroad but that the US economy will remain immune to the consequences has been clearly invalidated by a dispassionate reading of the macroeconomic and market signals. It is among the economic myths propagated by the US administration, along with the view that the tax cuts have paid for themselves. Bond markets are passing judgement with a roughly four-in-ten chance of recession being signalled which is on par with several other past downturns. ISM gauges have taken a turn for the worse and point to falling manufacturing output. The pace of hiring activity has noticeably slowed this year and wage growth may have crested and begun to moderate. Job growth may be further imperilled by production cuts to address relatively bloated inventories (chart 6). Fiscal policy is on the verge of transitioning toward being contractionary as the effects of the Tax Cuts and Jobs Act and the February 2018 spending bill drop out (chart 7).

At the same time that activity measures have soured somewhat, inflation has been gently on the mend (chart 8). This is unlikely to hold the Fed back from further easing because a) inflation remains below 2%, b) the prospect of overshooting 2% and proving symmetry to the Fed's goal is low, and c) Fed commentary has put emphasis upon using all available tools to keep the economy in a strong place and at full employment. In other words, just as one of the dual mandate variables—inflation—has begun to register some improvement, a bigger question mark has been placed upon activity measures.

CHALLENGES TO FUNDING MARKETS

Despite the brave face the Fed presents regarding the matter, it's highly likely that the deterioration in short-term funding markets over September into October caught the

Chart 5

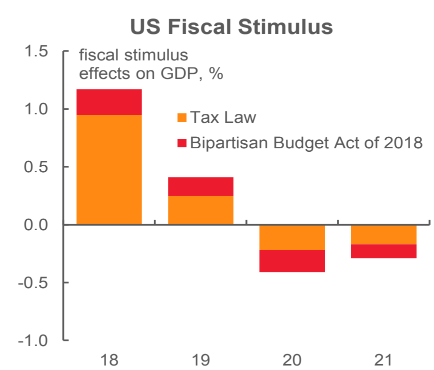


Source: Scotiabank Economics, Federal Reserve, Bloomberg.

Chart 6

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

Chart 7



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

central bank flat-footed. Inadequate market liquidity struggled to deal with demand for cash in order to meet corporate tax payments and large Treasury auction settlements, given rising deficits and Treasury issuance after the debt ceiling was lifted following a half-year binding freeze on net issuance. The result was that the Fed was losing control over rising short-term market rates that were rippling through other markets and impacting confidence.

At the heart of the matter is whether Fed policy underestimated the amount of reserves required in the system to be held at the Fed. Since reserves peaked in 2014, they have fallen by about US$1.5 trillion and nearly $1 trillion of that amount has occurred since the start of 2018 (chart 9). This is not a question of Fed competence. It has always been highly uncertain what amount of reserves may be required in the context of changing regulations such as requiring banks to hold more liquidity and higher quality liquid assets.

To make up for this decline in market liquidity, the New York Federal Reserve has embraced aggressive use of repo operations that are scheduled to continue through the October 30th FOMC meeting. The Fed enters into agreements to purchase Treasuries in exchange for a cash loan that can be redeployed in the interim period of the short-term agreement. To date, the volumes being taken down in recent one day repos and 10 day term repos have been very substantial (chart 10). Clearly there is demand for liquidity, but more permanent solutions are expected to be unveiled.

Thus, at the October 29th–30th FOMC meeting, we expect an announcement about a permanent Standing Fixed-Rate Repo Facility that was last broached in the minutes to the June FOMC meeting. The facility would offer funds slightly above the interest rate on excess reserves. Such a facility could improve market transparency and improve certainty regarding the adequacy and timeliness of liquidity backstops compared to traditional open-market operations by the New York Fed. **Chair Powell has also indicated that the Fed will restart purchases of Treasury bills to inflate reserves and it is likely that the Fed will return to the pre-crisis era of growing Treasury security holdings in keeping with GDP.** It may well be that the Fed needs to target between US$1½–1¾ trillion of reserves (from US$1.34 trillion now) and thus inject US$250 billion or more. This will involve experimentation to discover the optimal level of excess reserves in the system.

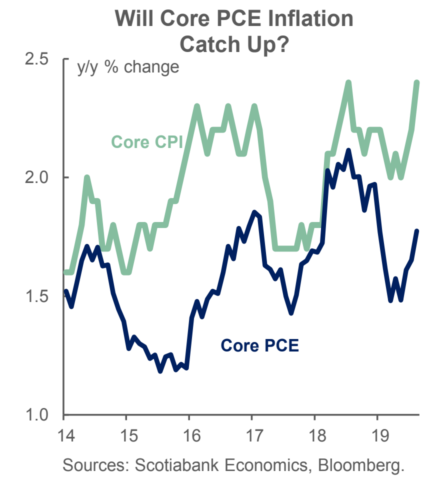
Simultaneous to such actions, a further potential option is to simultaneously reduce the fed funds target rate and IOER rate by another quarter percentage point and maybe slightly widen the IOER-Fed funds spread again.

Thus, addressing market dysfunction as well as managing risks to the fundamentals-based drivers of monetary policy are complementary reasons for easing policy somewhat more than previously forecast. At the heart of the matter, however, Trump's trade wars are directly responsible for forecast changes and by corollary support a bias toward more easing than forecast rather than less.

BANK OF CANADA—MORE POTENTIAL THAN THE FED TO SHOCK MARKETS

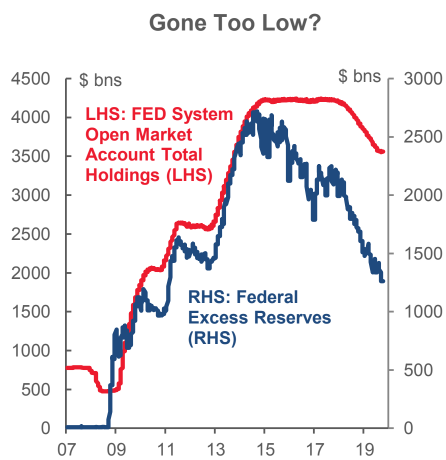
Our forecast at this point continues to be for the Bank of Canada to cut its overnight lending rate twice starting in each of 2019Q4 and 2020Q1 with even odds that a first reduction is delivered either in October or December. The next Business Outlook Survey, additional domestic data and key trade-related deadlines over coming weeks as highlighted on the previous page are among the considerations we will be monitoring closely. Thereafter, we expect the rate to remain on hold over the duration of 2020–21. In contrast to our Fed view, our forecast for the BoC is somewhat more aggressive than a) consensus and b) market pricing in OIS contracts.

Chart 8



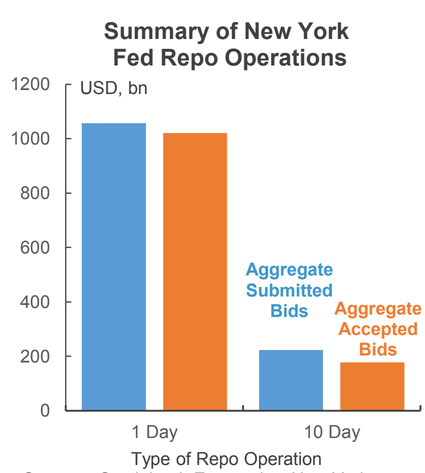
Sources: Scotiabank Economics, Bloomberg.

Chart 9



Sources: Scotiabank Economics, Bloomberg.

Chart 10



Sources: Scotiabank Economics, New York Federal Reserve.

The international arguments—including those that apply to the US—won't be repeated here, but they compound the uncertainties facing the Canadian economy and the Bank of Canada. If downside risks to the global and US outlook continue to build, then Canada has never been fully immune to such developments in the past.

Several of the more domestic arguments in favour of policy easing have strengthened or at least been maintained since our last forecast round.

1. Narrowing BoC-Fed Rate Differential

When the Fed eases materially, the BoC almost always follows suit (chart 11). When it has materially parted company with the Fed, like into the early 2000s after previously following the Fed in the late 1990s, the BoC has had to quickly change course thereafter. This makes perfect sense for a modestly sized open economy with open capital markets that are highly integrated with the US economy and financial system.

The point of joining the Fed is drawing nearer. The BoC has lost most of its relative rate advantage to the Federal Reserve such that the policy rate spread now sits at just -0.25% and may disappear entirely at the end of October and go positive soon thereafter if the BoC sits out Fed easing. While the C$ has not performed in sync with tightening Canada-US rate differentials, this may say more about persistent US dollar strength against a variety of currencies since the Fed began easing, and partly due to safe-haven demand. CAD, however, may be more vulnerable the longer the policy rate narrows and the more it narrows if the BoC were to do nothing. We don't find it plausible that the BoC would tolerate material C$ appreciation that would further erode export competitiveness amidst global trade tensions.

2. Increased market risk of recession

The risk of recession derived from bond markets has increased (chart 12). It is not as useful a measure as in US and both are distorted, but, like the Fed, there is little for the BoC to gain by challenging thousands of agents clearing information in markets each day.

3. Weak trend growth

The second quarter was strong with Canadian GDP growth of 3.7%. That, however, is an anomaly by comparison to no growth over the prior two quarters and a material slowdown in the third quarter that is still being monitored. If, by later this year, the Bank of Canada can look back and see only one stand-out quarter for growth in the past four quarters while the rest average out to well below potential growth, then even backward-looking data independent of forward-looking risks might suggest the economy is in need of some stimulus. Just as there were transitory drivers of prior softness, there were transitory drivers of Q2 strength and the trend remains soft.

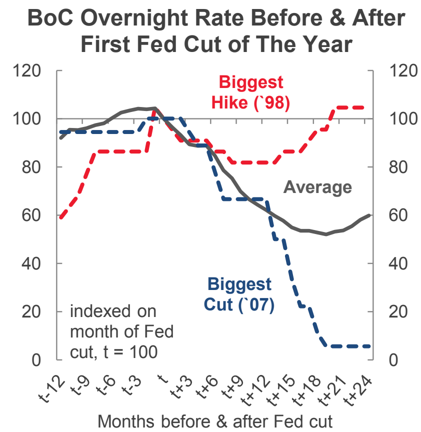
4. Slack

There continues to be excess capacity in the Canadian economy (chart 13). The BoC's two gap measures roughly ranged from -½% to -1% at the end of Q2. This lies in contrast to the US where the output gap is materially in excess demand territory. The persistence of slack and risks to growth don't guarantee that the BoC stays on its 2% inflation target and it may opt to take out insurance via easing. In any event, it is a target range of 1–3% that connotes some flexibility to address uncertainties. Further, while they are not the greatest measures, market-based inflation expectations are very low (chart 14).

5. Rising Inventory Imbalances

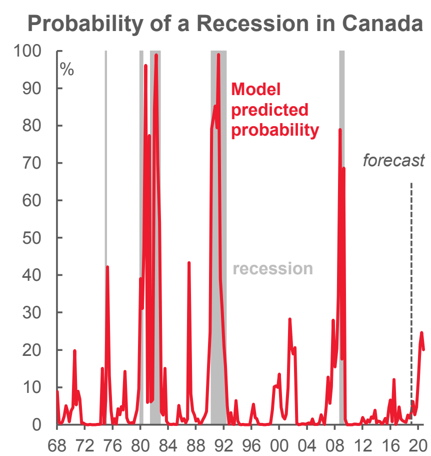
Whether output and hiring are sustainable may lie in doubt in the face of evidence regarding high inventory imbalances (chart 15). Costly to finance and store, the imbalance across manufacturers and wholesalers is at its worst since 2009.

Chart 11



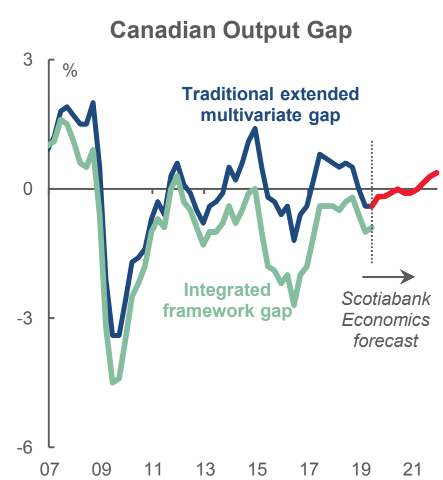
Sources: Scotiabank Economics, Federal Reserve, Bank of Canada.

Chart 12



Sources: Scotiabank Economics, Haver Analytics.

Chart 13



Sources: Scotiabank Economics, Bank of Canada.

6. Strained households

While housing markets are generally stabilizing in the wake of adjustments to B20 mortgage guidelines introduced at the start of 2018, cyclical pressures upon household finances are evident. Job gains and lower fixed rate borrowing costs have helped, but debt payments are taking about a percentage point more out of incomes than they were 2–3 years ago. Further, saving off disposable income has been running around just over 1% since mid-2018 and in stark contrast to the much higher US rate of saving.

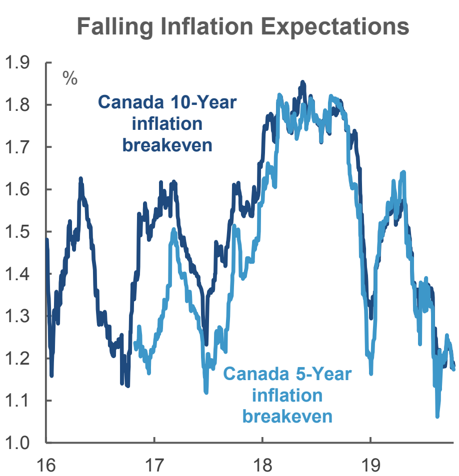
7. Investment is not Reacting to Stimulus

Tax incentives to invest that were introduced in the October 2018 mini-budget are thus far not having the intended effect of boosting trend investment. This is largely a global phenomenon in the age of trade wars. Maybe investment would be weaker without the incentives, but its weakness calls into question future complementary job gains and export growth.

8. Don't Count on Fiscal Policy

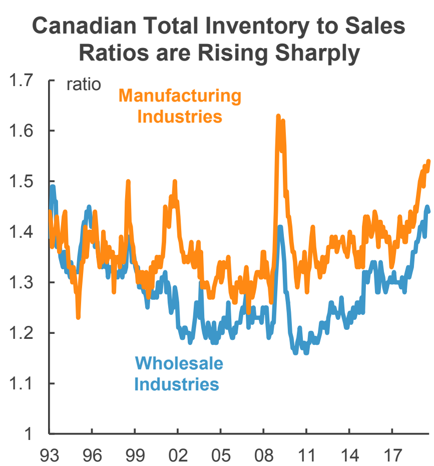
Can the BoC count upon post-election fiscal policy easing? That's doubtful. By the time the election is over and some probably fractured parliament sits, a budget would then have to be presented and passed. Implementation and impact lags would likely push out small fiscal stimulus to next summer as a transitory one-off to growth (chart 16).

Chart 14



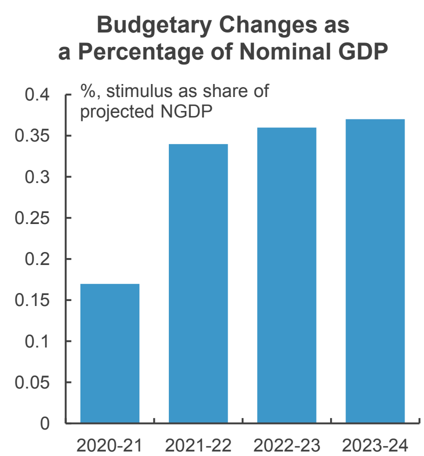
Sources: Scotiabank Economics, Bloomberg.

Chart 15



Sources: Scotiabank Economics, Statistics Canada.

Chart 16



Sources: Scotiabank Economics, Liberal Party Election Platform.

Table 1

Scotiabank Economics' Canada-US Yield Curve Forecast

	2019		2020				2021			
	(end of quarter, %)									
Canada	**Q3**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
BoC Overnight Target Rate	1.75	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
Prime Rate	3.95	3.70	3.45	3.45	3.45	3.45	3.45	3.45	3.45	3.45
3-month T-bill	1.65	1.40	1.20	1.20	1.25	1.25	1.25	1.25	1.25	1.30
2-year Canada	1.58	1.30	1.20	1.25	1.30	1.30	1.35	1.40	1.45	1.50
5-year Canada	1.40	1.25	1.25	1.30	1.35	1.40	1.45	1.50	1.55	1.60
10-year Canada	1.36	1.30	1.40	1.50	1.55	1.60	1.65	1.70	1.75	1.80
30-year Canada	1.53	1.45	1.55	1.65	1.75	1.80	1.85	1.90	1.95	2.00
United States	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Fed Funds Target Rate	2.00	1.75	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
Prime Rate	5.00	4.75	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
3-month T-bill	1.85	1.60	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.40
2-year Treasury	1.62	1.40	1.45	1.50	1.50	1.60	1.65	1.70	1.70	1.75
5-year Treasury	1.55	1.35	1.45	1.60	1.70	1.80	1.80	1.85	1.85	1.90
10-year Treasury	1.67	1.50	1.60	1.70	1.85	2.00	2.05	2.10	2.10	2.15
30-year Treasury	2.11	2.05	2.10	2.20	2.35	2.50	2.60	2.70	2.75	2.80

Sources: Scotiabank Economics, Bloomberg.

Mexico

GONE WITH THE WIND OF UNCERTAINTY

- **The Mexican economy is on the brink of recession in 2019 while the outlook for 2020 remains bleak and a downward bias for the economic activity persists.**
- **Investment is plummeting, job creation is slowing rapidly, construction activity is falling, and private consumption runs at the weakest pace in a decade.**
- **A loss of confidence from firms and households appears to be the main factor explaining recent economic performance, even though formal indicators of confidence are not that bad.**
- **Fiscal policy is being discussed in Congress and should be finalized by November 15th at the latest. Fiscal discipline is reaffirmed but there are optimistic assumptions in the macroeconomic framework that imply a "stressed" budget that will likely require additional spending cuts to reach the fiscal targets.**
- **Some proposed changes on the public revenues side are highly controversial, generating additional uncertainty for businesses and households.**
- **On the positive side, inflation has been declining and has hit the official target of 3%, and even though core inflation remains stubbornly stable around 3.8%, this has been enough for Banco de Mexico to cut its reference interest rate twice, and more cuts are expected.**
- **In a highly uncertain environment where many risk factors remain present, we have reduced our GDP forecast for 2019 even further, now standing at 0.2%. We expect sluggish economic activity to carry into 2020 with growth subdued at around 1.0%.**

WIDESPREAD SIGNS OF WEAKNESS

Recent data on economic activity have been unexpectedly weak: Gross fixed investment fell 3.2% real annual in the first semester, the weakest reading in the decade for a similar period. Industrial production fell 1.7% real y/y in July—marking nine consecutive months of contraction—mainly driven by a dramatic 8.4% real y/y drop in Construction and a 10.0% real y/y reduction in the oil industry. Job creation on a yearly basis kept slowing down in August, growing only 1.8%, the slowest since 2009. Internal private consumption unusually stalled in April–June, barely growing 0.1%. Lastly, capital goods imports nose-dived in August, falling 17.2% annual in June–August and signaling more acute weakness in investment in coming months.

Instead of receding, uncertainty on the business environment continues to rise, and the outlook for the economy has complicated even further. One of the key elements to define the Government's 2020 forecasts was the so-called "Economic

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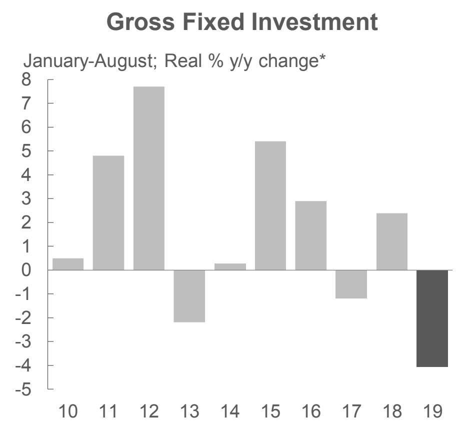
Mexico	2018	2019f	2020f	2021f
Real GDP (annual % change)	2.0	0.2	1.0	2.0
CPI (y/y %, eop)	4.8	3.4	3.8	3.7
Central bank policy rate (%, eop)	8.25	7.50	7.00	7.00
Mexican peso (USDMXN, eop)	19.65	20.83	21.36	21.65

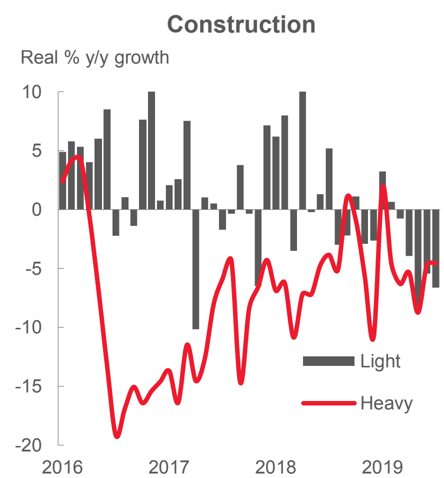
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, INEGI.
* Corresponds to the average growth for the first 8 months of each year.

Chart 2



Sources: Scotiabank Economics, INEGI.

Package", which contains the macroeconomic framework used to determine the fiscal policy, public revenues and spending. The Economic Package, now being discussed in the lower house of Congress, was considered to be "responsible" by many analysts, because it targets to achieve a primary surplus of 0.7% of GDP.

The macroeconomic framework in the Economic Package is unusually optimistic in a couple of key variables: GDP growth (expected at 2.0%, above the forecast of the most optimistic private analyst) and oil production (forecast at 1,951 thousand barrels per day, +13% vs estimated 2019). If the economy grows less, as the markets are expecting, public revenues would likely be lower and more spending cuts would be needed to achieve the fiscal goals which would, in turn, hurt economic growth. If oil production does not grow as forecast, Pemex finances would be in trouble and more financial support from the Federal Government would likely be needed, thus putting pressure on sovereign ratings.

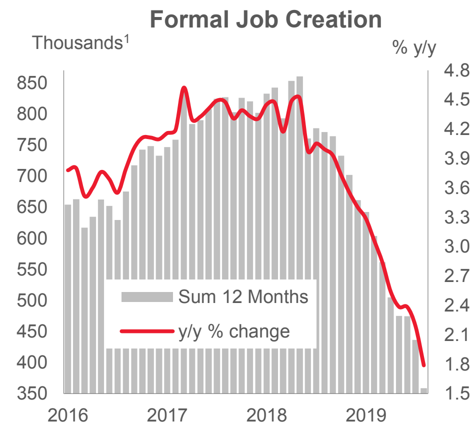
Some proposed changes in the tax framework are generating not only anxiety among the business community, but even open criticism from the Mexican Banks Association. Among these changes are: increasing the rate on interest income retention to 1.45% from 1.04% (which taxes savings), limiting deduction of net interest payments to 30% for businesses, and changing different laws to prevent fiscal fraud but actually hurting the rule of law, since "suspicions" from the authority could be enough to arbitrarily confiscate property and freeze banking accounts. If these measures are implemented, investment and economic growth prospects would be negatively affected.

One of the key assumptions to justify the more optimist economic growth in the Government's plan was that the new trade agreement with the USA and Canada (TMEC) would be ratified in the near future. After impeachment discussions started in the US Congress, chances for the TMEC to be ratified in the short term practically vanished.

On the positive side, inflation has been surprisingly well behaved, hitting the official target of 3% which, coupled with the evident weakness in the economy and some political pressures on Banco de Mexico, gave the central bank room to cut its reference interest rates at each of the last two decision meetings. Under these new conditions, it is likely that Banco de Mexico will cut its reference interest rate more than previously expected. We are changing our forecast for the reference interest rate, now expecting at least one more cut in the coming November meeting and two more cuts at the beginning of 2020, reaching a level of 7.00% and then remaining at that level for the remainder of 2020–21. Worth noting is that weakness in economic activity and the political pressure it presents is pushing market participants to anticipate even more interest rate cuts. However, cutting interest rates in an adverse global environment will add sensitivity to the Mexican Peso, so Banco de Mexico will need to be very careful with its monetary policy.

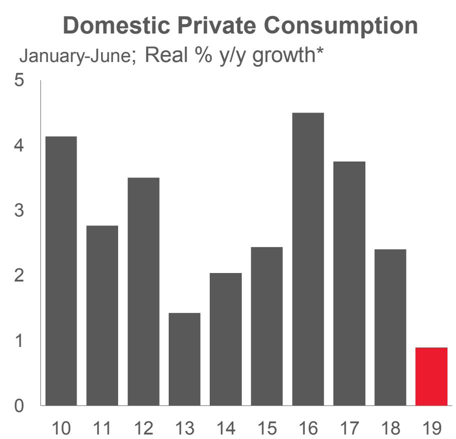
Finally, there are many risks still lurking on the horizon. A more adverse external environment is quite relevant, and could happen if protectionism keeps rising in the global scene, the US economy stalls, there is a hard Brexit that produces shockwaves over global financial markets, or some new geo-political tension erupts. On the internal front, a failure to restore confidence among investors or a new downgrade of Pemex and sovereign ratings are among the most relevant risks. If oil production does not start to increase promptly, to reach Pemex's business plan projections, or should tax revenues keep weakening as the economy slows down, then a downgrade on sovereign debt will likely take place.

Chart 3



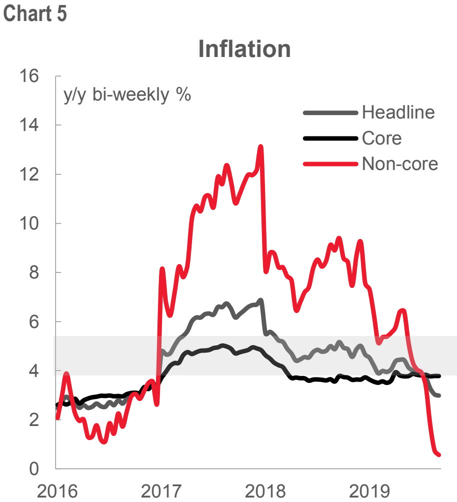
Sources: Scotiabank Economics, Social Security Ministry database.
* Data up to August 2019.
1/ New insured workers

Chart 4



Sources: Scotiabank Economics, INEGI.
* Corresponds to the average growth for the first 6 months of each year.

Chart 5



Sources: Scotiabank Economics, INEGI.

Brazil

BRAZIL'S CURRENCY HOLDS THE KEY FOR INFLATION & GROWTH

- **At this point, still very weak growth and a benign inflation backdrop have allowed the Central Bank (BCB) to ease more than we had expected. At this stage, the possibility of rates remaining at current very loose settings will depend on: 1) the BRL remaining anchored to avoid FX-inflation pass-through, 2) whether the government can deliver on pension and fiscal reform.**

- **On the growth and inflation front, we think the BRL holds the key. Consumers are getting a windfall from low rates, but if the BRL continues falling, we could see inflation force rates higher—thus putting the brakes on consumers' current happy spending.**

INVESTOR APPETITE WILL BE KEY TO DETERMINE IF THE BCB WILL BE FORCED TO BACKPEDAL ON RATE CUTS

The sharp drop in the Brazilian real (BRL) over the past couple of months (-10.5% since July 18, 2019) has only had a marginal impact on BCB easing expectations. Our take is that current very loose monetary policy (and low yields), as well as mounting uncertainty in Argentina have combined to erode support for the real. We believe Brazil's "neutral real rate" lies somewhere around 4.5%, after the TJLP helps cut it by about 100bps (one of the causes for Brazil's high rates used to be lending market segmentation, with "premium borrowers" taken off market by BNDES subsidized lending).

Interestingly, in the presentation of the just-released BCB Inflation Report, Campos Neto didn't sound terribly worried about FX-inflation pass-through risk. The message basically was that the combination of low inflation and stronger fiscal accounts was enough to maintain strong investment appetite for Brazil—and he said the BCB doesn't make or present FX-inflation pass-through estimates. The relatively dovish stance maintained by the BCB seemingly validates the DI curve's pricing of an additional 60bps (about 80% of a 50bps cut in the next meeting, and an 80% probability of a subsequent 25bps cut) in the SELIC rate. If the BRL doesn't rebound, our estimates suggest about 200–250bps of latent FX-related inflation would hit the Brazilian economy but, to some degree, that will depend on global market conditions.

On October 1st, the pension reform bill passed the Committee level, and is expected to be submitted to the Senate Floor for a vote in the second half of October. The key question is whether potential changes to water it down (reducing savings by up to BRL100 bn) can be avoided. As we have long argued, Brazil's fiscal woes run deeper than pensions. The pension reform—unaltered—would result in fiscal savings equivalent to about 10 percentage points of GDP over 10 years. The problem is the country has gross-debt-to-GDP of 90%, a fiscal deficit which has remained stubbornly above 7% of GDP, and we'd argue that the country's steady state interest rates are closer to 8–9% than

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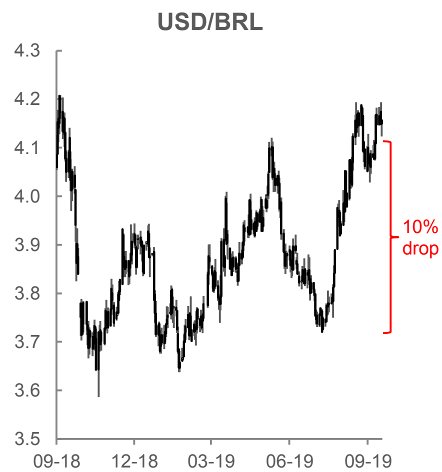
Brazil	2018	2019f	2020f	2021f
Real GDP (annual % change)	1.1	1.0	1.8	2.1
CPI (y/y %, eop)	3.8	3.9	4.6	4.1
Central bank policy rate (%, eop)	6.50	5.50	6.50	6.75
Brazilian real (USDBRL, eop)	3.88	4.18	4.18	4.30

Source: Scotiabank Economics.

Chart 1



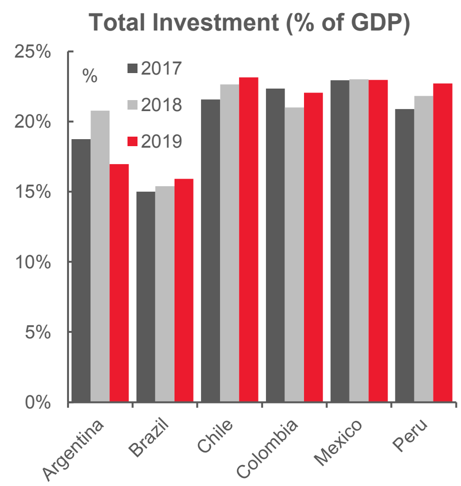
Sources: Scotiabank Economics, Bloomberg.

to 6%. All that means that—after pensions—a fiscal reform will be necessary. The higher-than-expected resistance to pension reform suggests that fiscal reform will not be a walk in the park. Based on the comments on September 26th by Fitch Ratings' Shelly Shetty at the EMTA conference in NY, at least one of the three major agencies seems to agree with the view that, while pension reform is positive, it is just one of several necessary steps. Shetty said: "For us to become more positive on Brazil, we definitely want to gain more confidence that there will be fiscal consolidation and that there is a credible strategy for Brazil to cut its fiscal deficit and reduce its debt burden", and added that even with pension reform, the country's fiscal situation is shakier than that of its peers.

GROWTH AND INFLATION—FOR NOW, MUCH ADO ABOUT NOTHING

Although some growth indicators are starting to show signs of life—notably both services and manufacturing PMIs are posting positive numbers—total growth for 2019 year-to-date remains sub 1.5%. July's monthly economic activity index printed at a stronger-than-expected +1.3% y/y (vs consensus +1.0% y/y), while retail sales posted a much stronger-than-expected +4.3% y/y (consensus +2.2% y/y). Our sense is that low rates are helping boost consumer demand, but until we see investment pick up from levels that are low, even within a region of low investment, it is difficult to see a material improvement in the country's low potential growth rate. We think the country's growth potential lies around 2.0%, meaning there is still some slack. This slack is what we see as having allowed the BCB to lower rates to unprecedented low levels, but we remain somewhat concerned that poor fiscal performance may be among the factors that force the central bank to backpedal on rates, reducing the demand from what remain very highly leveraged households. We expect growth of 1.0% in 2019, and an acceleration to just south of 2.0% in 2020 and slightly over 2.0% in 2021, but see a de-anchoring of inflation as the biggest risk.

Chart 2



Sources: Scotiabank Economics, IMF.

With regard to inflation, the key lies in BRL in our opinion. Brazil has among the higher rates of FX-inflation pass-through in the region, and so far, it has lost about 10% vs the greenback since mid-July. The drivers of the drop are debatable, with Argentina's turmoil likely playing a role. However, we think the BCB's aggressive easing also played a part. At the end of the day, we could argue that MXN's resilience is basically attributable to high carry—which has in turn made the total turnover of the MXN decline dramatically, as it loses its proxy-hedge status. Conversely, as BRL's yields have dropped, the real has become more vulnerable. The key risk we see is that appetite for the country fades if pension reform is not followed closely by fiscal reform, meaning the macro-improvement story loses steam. We're forecasting a still fairly stable inflation backdrop, where we only see IPCA rise to 4.6% in 2020—but that's based on our assumption of a BCB that starts gradually tightening rates in 2020 Q3. Without higher yields, the BCB could yet again fall behind the curve on the inflation front.

Colombia

RESILIENT ECONOMIC ACTIVITY DESPITE HIGH EXTERNAL RISK

- **Economic activity is consolidating. With strong domestic demand, the trade deficit continues to widen—which suggests balance of payments issues will remain a concern. Our GDP growth forecast remains at 3.2% y/y this year and 3.6% in 2020–21, although with a downward bias due to the external environment.**
- **Headline inflation has picked up recently due to temporary supply shocks in foodstuffs. Although we expect a fairly quick reversal of the shocks, the CPI bias is to the upside due to a still-muted (but latent) exchange rate pass-through risk.**
- **BanRep will likely hold the lending rate steady at 4.25% as it balances the better domestic demand and short-term upward pressures on inflation with a lower neutral rate due to lower international interest rates. We expect stability for the rest of 2019 and one hike in 1H20 to 4.5%.**
- **The sustainability of long-run twin deficits continues to be the main concern for the Colombian economy. We believe the current account deficit will continue above 4% and fiscal targets will be met, although due to one-off revenues.**

Colombian economic activity continues its gradual recovery, decoupling from the weakness of Latam peers and deceleration in developed countries, as it is a relatively closed economy, the political situation is stable, and it is benefitting from the impact of tax reform and the construction of 4G infrastructure. Domestic demand and GDP showed solid growth in 1H19. Hard data for July continue to point to higher 3Q19 growth and investment recovery. Domestic demand strength has implied a higher current account deficit due to higher capital imports that have helped investment this year. Additionally, although the government has slowed expenditures this year and has a slightly higher tax collection, budget inflexibility and extremely high tax evasion make fiscal accounts a structural concern for the Colombian economy. Monetary policy should be on hold for the near future, while the temporary pick-up in headline inflation will likely vanish during 1H20.

ECONOMIC RECOVERY HAS CONSOLIDATED AND INFLATION HAS INCREASED RECENTLY

Colombia's 1H GDP—although a bit below government expectations—showed that domestic demand growth continues to be robust. In fact domestic demand grew at 4.3% y/y in 1H19, while GDP growth was 3% y/y. The trade deficit is mainly due to stagnant exports and strong imports of capital goods. Robust capital imports imply an investment recovery and explain why domestic demand outpaced GDP growth—it could also support potential growth down the line. Capital imports goods expanded by 12.6% y/y, and investment has recovered (+4.3% y/y 1H19). Having said that, the economy is still running below potential output (~3.3%). On the supply side, it is worth noting that only the construction sector (6% of total GDP) declined in 1H19, while services sectors led growth in the first half of the year.

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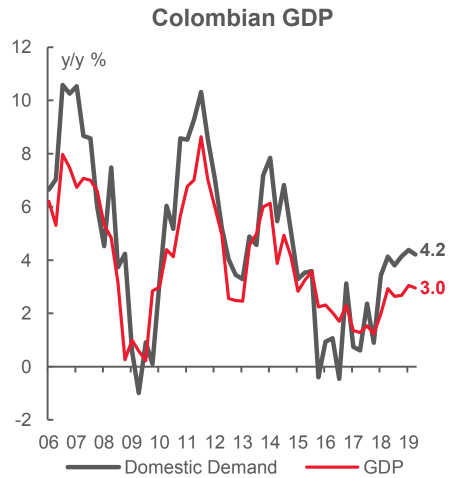
Colombia	2018	2019f	2020f	2021f
Real GDP (annual % change)	2.6	3.2	3.6	3.6
CPI (y/y %, eop)	3.2	3.7	3.2	3.1
Central bank policy rate (%, eop)	4.25	4.25	4.50	4.50
Colombian peso (USDCOP, eop)	3,254	3,310	3,250	3,180

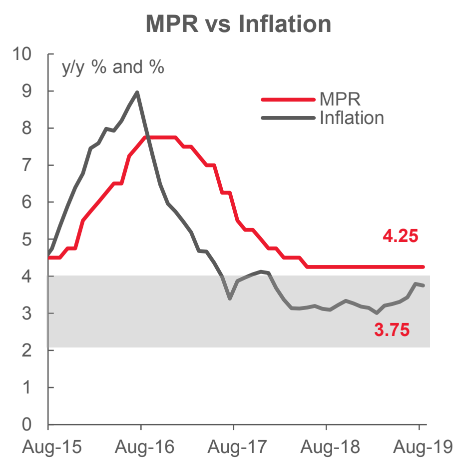
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, DANE.

Chart 2



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

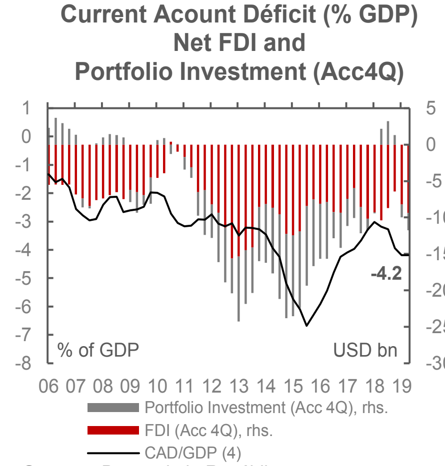
Financial services, Commerce and Telecom services grew above 4%. July coincident indicators, such as retail sales, manufacturing, energy demand, and oil production, among others, point to a still-strong domestic demand. Therefore, we kept our forecast of 3.2% for 2019 GDP growth and 3.6% for 2020 and 2021. Having said that, weaker global demand puts a downward bias on our economic activity projections, especially for 2020–21.

Inflation accelerated to ~3.8% y/y due to a temporary supply shock in food prices. Core inflation (excluding food and regulated prices) remains close to 3%, although with a slightly positive trend. A base effect in foodstuffs should keep yearly inflation around the current level but those effects are going to be diluted early in 2020. FX pass-through has been rather moderate. Although we do not see a big issue on this front, the 12.2% year-to-date average depreciation is reflected in an upward bias to our forecast for headline inflation to end 2019 at 3.7% and at 3.2% for 2020. Beyond 2020 we do not anticipate shocks; therefore under a closing output gap, inflation in 2021 should continue close to 3%.

The Colombian Central Bank (BanRep) is balancing between temporary inflation pressures that can affect inflation expectations, stronger GDP growth and domestic demand, and external downward risks that can affect gradual economic activity recovery in the coming months. According to BanRep's staff, policy rate at 4.25% is in a slightly expansionary territory, and lower external rates push down the neutral rate in Colombia. Recent communication from BanRep points to a central bank on the sidelines—keeping policy rate at 4.25% for longer, despite developed countries' central bank dovishness. In fact Governor Echavarría and Minister Carrasquilla explicitly have said that with current information they rule out policy rate cuts in the near future. Our forecasts of a stronger economy next year and headline inflation a bit higher than 3% are in line with a stable policy rate this year at 4.25% and one hike in the 1H20 to 4.5% to approximately what we think is the neutral rate. For 2021 we anticipate stability in the policy rate.

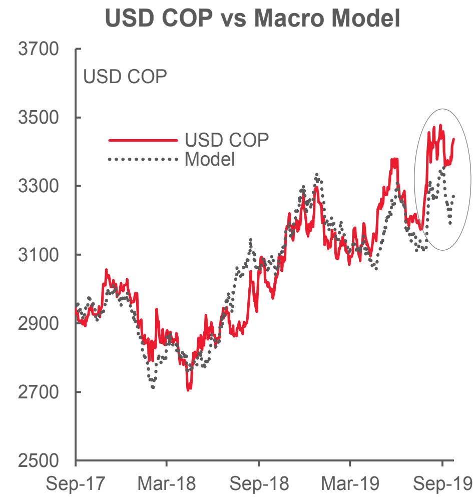
2019 COP weakness, although in line with peers, is not in line with domestic fundamentals. In fact, several models indicate that dynamics of both structural and idiosyncratic variables point to stronger COP. For instance, terms of trade improvement (higher oil prices); stronger economy; healthy current account deficit financing (FDI); lower country risk perception (CDS 5Y at ~90, while December 2018 was at ~150); short-run fiscal consolidation; and higher domestic market interest rates all suggest an appreciation of around 9% from current levels.

Chart 3



Sources: Banco de la República, Scotiabank Economics.

Chart 4



Sources: Bloomberg, Scotiabank Economics.

Uncertainty regarding trade tensions and the global economy should continue, which allows us to think that short-term financial pressure will also continue, although on a smaller scale. Therefore, we revised up our COP forecast to $3310 for the end of the year, which implies an appreciation of 4% from current levels. We do not expect external pressure to escalate further next year, therefore we expect the COP to end 2020 at $3250, which is still above what models forecast, but somewhat stronger than 2019.

TWIN DEFICITS TO CONTINUE

Colombia's current account deficit remains a major concern. It stood at 4.4% of GDP in 1H 2019, 0.7 pp higher than the same period of 2018, although financing is still healthy via FDI. As indicated previously, 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.

Fiscal accounts this year, so far, have been able to manage the initial shortfall in revenues projected at the beginning of the year. Minister Carrasquilla froze COP$10tr of the initial budget, and tax collection has been higher than expected. Although, in the short run it looks as though fiscal accounts are in better shape, next year's fiscal budget (which is currently in Congress for approval) needs an additional COP$8.5tr (~US$2.5b or 0.8pp of GDP) that will come from privatizations to comply with the 2.4% of fiscal deficit goal. In other words, Band-Aids and one-offs continue to be the most recurrent way to finance short-term fiscal accounts, but there is no real policy to solve long-run fiscal sustainability once and for all. Therefore, we expect Fitch to deliver a downgrade to BBB- (still investment grade) for Colombia in 1Q20.

Peru

ECONOMIC RESILIENCE, BUT WEAKISH GROWTH, IN AN UNCERTAIN WORLD

- **We're lowering our GDP growth forecasts to 2.3% for 2019 (from 3.1%) and 3.0% for 2020 (from 3.7%), and initiating forecast for 2021 at 3.5%.**
- **With legitimacy concerns regarding the government and Congress and the call for new elections, the political environment will be a risk for some time to come.**
- **Private investment (non-mining) growth is suffering the most.**
- **Although growth is slowing, markets are focusing on macro strengths.**
- **Inflation is subdued, and fiscal and external accounts are robust.**
- **The Central Bank is likely to reduce its reference rate, but not aggressively.**

There seems to be no end to political uncertainty in Peru. President Vizcarra dissolved Congress and called for new Congressional elections to be held on January 26. After initial resistance from opposition groups in Congress, things are starting to settle around this new status quo in which President Vizcarra maintains a hold on power with the allegiance of most State institutions and popular support. However, the Constitutional Tribunal might still have a say in the matter of whether President Vizcarra acted legally, and until matters are more clearly defined, political and governability risks will continue to be high. Double elections, in 2020 for Congress and again in 2021 for Congress and the President, add to uncertainty.

Greater political and global uncertainty have led us to lower our GDP growth forecasts to 2.3% from 3.1% in 2019, and to 3.0% from 3.7% in 2020. We're providing a round number for 2020, as there is too much uncertainty for precision. This also means that both upside and downside risks are great and the margin of error wide. We're initiating a growth forecast for 2021 at 3.5%. Hopefully, by 2021, with new elections, political turbulence will be behind us, and the new government can focus more on economic management.

One special ongoing concern for us is economic management, which appears to be a secondary issue for a Vizcarra regime that is more focused on politics. The installation of a new cabinet may hamper economic management over the short time in which the cabinet—basically, a lame duck one—will operate. Although, economic policy is not likely to vary from the overall pro-market stance that has dominated for the past two decades, it will not be easy for the new cabinet head, Vicente Zeballos, and his team to implement quality economic management.

Meanwhile, economic institutions such as the Central Bank continue to be reliable, and as long as continuity in pro-market economic policy is not at risk, many businesses will continue with a business-as-usual attitude, with the caveat that business as usual today means being very conservative in terms of investing.

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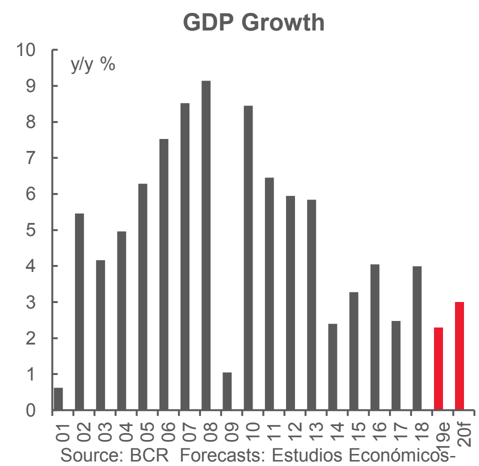
Peru	2018	2019f	2020f	2021f
Real GDP (annual % change)	4.0	2.3	3.0	3.5
CPI (y/y %, eop)	2.2	2.0	2.0	2.3
Central bank policy rate (%, eop)	2.75	2.25	2.25	2.50
Peruvian sol (USDPEN, eop)	3.37	3.35	3.42	3.35

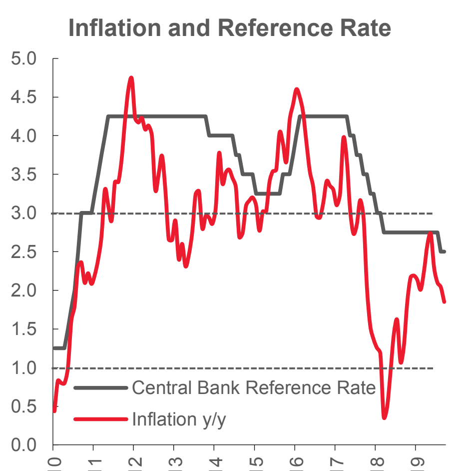
Source: Scotiabank Economics.

Chart 1



Source: BCR Forecasts: Estudios Económicos-Scotiabank Peru

Chart 2

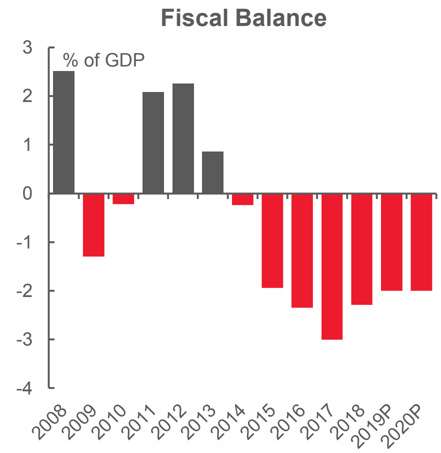


Sources: BCR, INEI, Scotiabank Peru.

Our forecasts seem to suggest that 2020 (GDP growth of 3.0%) will be somewhat better than 2019 (2.3%). This is not really the case, as the main difference between the two years will be resource sectors. We expect 2020 to be a more normal year for resource sectors, with 2.7% growth (barring an El Niño), after a poor 2019 in which aggregate resource GDP fell 1.1%.

Our main concern is private investment. Political uncertainty and global tension are affecting business confidence and investment plans. We have lowered our forecast for 2019 private investment growth from 4.0% to 1.1%. Given moderate growth in mining investment, this actually means that non-mining private investment will be close to nil. Although excess capacity has fallen in a number of sectors, we have yet to see greater corporate loans demand, and domestic demand growth is mild enough to allow businesses to wait for the political dust to settle before committing to investment in greater capacity. Where we are seeing investment is in technology, which is helping productivity (and curtailing inflation), and providing some support to growth.

Chart 3



Sources: BCR Forecasts: Estudios Económicos-Scotiabank Peru.

Politics is also, we believe, distracting the government from focusing on public sector investment and executing infrastructure investment. Given the political risks, we are lowering our public sector forecast for 2020 from 6.5% to 4.5%. However, 2019 has surprised to the upside, and we've raised our forecast from -1.5% to 0.5%, as regional and local government investment has performed less dismally than expected. Regional and local government investment should improve, as newly elected authorities gain a firmer rein on spending, but the improvement in public sector investment would have been that much greater in an environment of greater political calm.

Consumption growth is robust, but slowing, and we've lowered our private consumption growth forecast from 3.5% to 3.0%. Consumption has been a leading driver of growth in the past year, as employment has held up, although restricted to a few, albeit labor-intensive, sectors, including agroindustry, mining investment, residential construction, tourism, and new business formats based on apps.

The impact of political risk is largely restricted to growth. Price stability and non-growth macroeconomic indicators are performing much better, and we see little need for major changes.

We continue to expect the trade balance to be in surplus, close to US$6 bn for both 2019 and 2020, which is non-materially lower than before. Financial capital inflows were very strong in early 2019, taken net international reserves to a record US$68 bn, currently. The pace of inflow is not sustainable, but, given that Peru's macro picture bears up so well compared to peers, there seems to be little reason to fear a strong outflow of capital.

We maintain our expectation that the PEN will close 2019 at 3.35. As financial inflows subside, and given high political uncertainty and elections in 2020, we expect the PEN to weaken mildly to 3.42 by year-end 2020.

We've made no material change to our fiscal deficit forecast, which remains at 2% of GDP for 2019. We've raised our forecast for 2020 from 1.8% of GDP to 2.0% to account for the impact of slower growth.

We see no evidence of inflationary pressures, and expect inflation to hover around the 2% mid-point of the Central Bank's target range. It would take a supply shock to take inflation outside of the CB's comfort zone. The CB has recently signaled that it might lower rates, and, given political uncertainty and lower growth outlook, we see motivation for them to do so. We continue to expect the CB to follow up on the September decision to lower its policy rate from 2.75% to 2.50% with one more cut, to 2.25%, by year end.

Chile

RECOVERY IN INVESTMENT SUSTAINS GDP GROWTH IN 2019

- **We revised downward our GDP growth forecast from 3.2% to 2.7% for 2019, and keep 2020 at 3.2%. A negative supply shock in the first half of the year and a more challenging external scenario are the main drivers for this revision. We expect a significant rebound of public and private investment—mainly in the mining sector—in the second half of the year.**
- **Local financial markets followed external developments, as the peso depreciated against the dollar and stock prices and long-term interest rates fell. The latter, combined with the prospects of a more expansionary monetary policy, has resulted in low borrowing costs for all categories of credits and maturities giving strong support to the construction sector.**
- **Our inflation forecast has been raised from 2.8% to 3.1% for end-2019. The depreciation of the peso and increases in some regulated tariffs are the main drivers for this adjustment. Following the cut of 50 bps in the benchmark rate by the Central Bank in September, we expect an additional cut of 25 bps in our baseline scenario.**

MACRO UPDATE

Economic activity and domestic demand grew below expectations in 19Q2. Negative supply shocks in specific sectors were the main factors responsible for this deceleration. Personal Services, a sector that constantly shows stability, plunged in June and this shock showed persistence in July, due to the public school teachers' strike (that lasted 8 weeks). Personal Services account for 12% of GDP. Manufacturing was also sluggish, as the trade war amplified and volatility in global markets have risen. Despite our downward correction in GDP growth, due to negative shocks in June and July, we are still on the optimistic side of expectations, as we expect a rebound of investment and stabilization of private consumption during the second half of the year.

Investment increased a surprising 4.8% YoY in 19Q2, with strength in construction spending offsetting more subdued growth in machinery and equipment outlays. We are optimistic about investment in the second half of year, as projects in development continue to increase and others start to materialize. In addition, the government has announced a set of initiatives that aim to boost investment this year and in 2020. We forecast a 7.0% expansion in investment during the second half of the year (5.5% y/y in 2019).

With respect to domestic demand, private consumption has increased slower than expected. We believe this deceleration is related to higher precautionary savings. However, disposable income is still growing at a stable pace. The services sector continues to perform well, while the good sector is slowing. A number of measures confirm a rebound in labor income, as the recent slowdown in consumption coincides with a move of monetary aggregates toward less-liquid assets. Toward the end of 2019, the recovery in job creation and wages should trigger an

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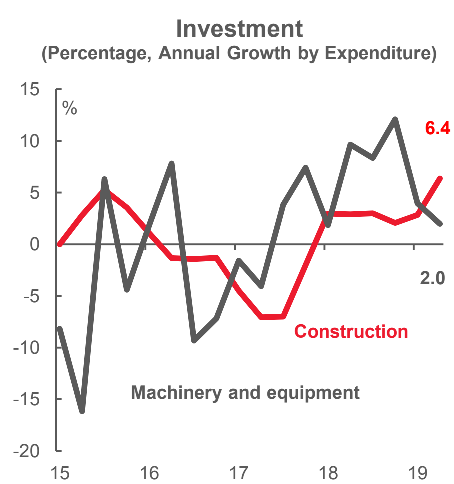
Chile	2018	2019f	2020f	2021f
Real GDP (annual % change)	4.0	2.7	3.2	3.0
CPI (y/y %, eop)	2.6	3.1	2.6	3.0
Central bank policy rate (%, eop)	2.75	1.75	2.00	3.00
Chilean peso (USDCLP, eop)	694	690	640	635

Source: Scotiabank Economics.

Chart 1



Sources: INE, Transbank, Scotiabank Economics.

improvement in consumer confidence, leading to stronger consumption and retail sales.

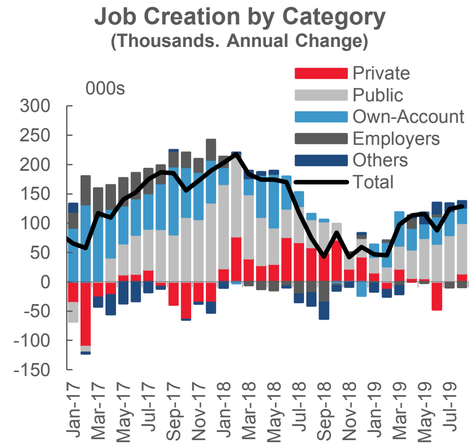
The unemployment rate reached 7.2% in August, suggesting the weakness seen in 2018 is well behind us. Total employment is recovering, driven by public sector jobs (education, health and public administration) and greater expansion of self-employment in the trade sector. Manufacturing employment continues to decline as external demand impacts some subsectors, such as forestry and paper.

Inflation normalization is still in progress. After coming in significantly below the 3.0% target during the first semester, total inflation is expected to pick up, ending at around 3.1% in December. The recent depreciation of the CLP—around 8.5% since March 2019—will have a significant effect on the CPI. According to our estimates, the accumulated inflation between October 2019 and February 2020 would be no less than 1.4%, which is above market estimates. In addition to the exchange rate pass-through to imported goods, the drought in the central zone of the country and strengthening domestic demand should boost core inflation in coming quarters.

This context of higher exchange rate and an internal demand will add a note of caution when the Central Bank is evaluating additional cuts in the reference rate, beyond the cut we expect to occur in October, which would leave the MPR at 1.75%. The Central Bank is likely to strongly weigh external headwinds in its consideration of rate cuts.

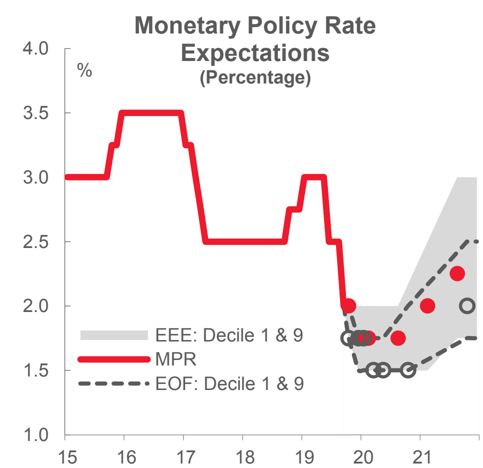
The CLP is in the upper bound of its historical relation with copper price. In the past few weeks, it reached $728, its highest level since early 2016. The recent depreciation is explained by a stronger dollar and lower copper price, along with persistent external headwinds. We forecast an appreciation toward $690 at the end of 2019. Better domestic activity figures, and more stability on the global trade front should lead to some appreciation.

Chart 2



Sources: ANAC, Scotiabank Economics.

Chart 3



Sources: Central Bank of Chile, Scotiabank Economics.

United Kingdom

LURCHING ONWARD

- **Under our baseline assumptions, Brexit is likely to be further delayed into the first half of 2020. The economy is forecast to move sideways until Brexit is resolved, with a shallow pick-up taking hold in late-2020 and into 2021.**
- **The Bank of England is expected to remain on hold over the forecast horizon unless we see a disruptive, no-deal Brexit, which is not our baseline projection.**

BREXIT DRAMA ABOUT TO PEAK AND CONTINUE INTO 2020

Our UK forecasts obviously hinge critically on the path ahead for Brexit and the next few weeks will see related tensions peak. The "Benn" law forces a first milestone on October 19. The statute compels the government at Westminster to seek an extension to January 31, 2020 to its invocation of the EU's Article 50 on withdrawal if no deal on the UK's future relationship with the EU has been struck by October 19.

Every day that passes after October 19 without a deal or a request for an extension on Art. 50 increases the pressure for a confidence motion from the Opposition benches since the Government would be in contempt of Parliament. Our baseline projections assume that a deal is reached this month or that the Government seeks an extension—or that the Opposition parties pass a motion of no confidence, form a temporary caretaker government, and apply for an extension to Art. 50, probably beyond end-January, before triggering an election.

We expect Brexit to be pushed into the first half of 2020 and proceed under an eventual deal that prevents the restoration of a hard border between the Republic and Northern Ireland. The extra time could give an opportunity to flesh out further existing proposals or prepare the way for a return to some version of Theresa May's backstops. Under a no-deal Brexit, the Bank of England (BoE) estimates a hit to the UK economy of between three and five ppts of GDP.

SAUCER-SHAPED ECONOMIC OUTLOOK

Under our baseline scenario, we forecast growth to remain muted through 2020 before picking up mildly into 2021 as the dampening effects of uncertainty around the UK's relationship with Europe begin to wane. Forecast at 1.1%, growth in 2019 (table) is set to come in at its slowest pace since the global financial crisis (GFC). The UK economy contracted in Q2 as companies unwound inventories amassed ahead of an earlier Brexit deadline at end-March and auto factories brought forward their annual summer shutdowns. While we expect a modest improvement in the remainder of 2019, with growth continuing at roughly the same pace into 2020, Brexit uncertainty continues to weigh on the real economy: the UK's manufacturing and services PMIs have both tipped into

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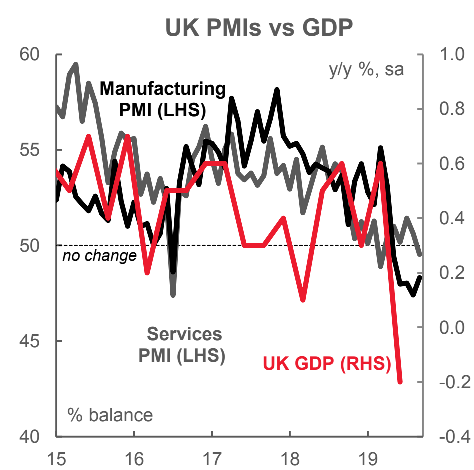
United Kingdom	2018	2019f	2020f	2021f
Real GDP (annual % change)	1.4	1.1	1.2	1.6
CPI (y/y %, eop)	2.1	1.8	2.0	2.1
Central bank policy rate (%, eop)	0.75	0.75	0.75	0.75
UK pound (GBPUSD, eop)	1.28	1.22	1.36	1.40

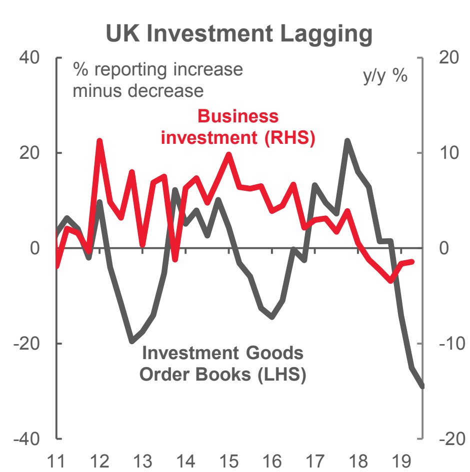
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Haver Analytics, Markit, Office for National Statistics.

Chart 2



Sources: Scotiabank Economics, European Commission, ONS.

contractionary territory (chart 1), with the services index at the lowest level of any major economy in Europe. Business investment, already on track to record its second annual contraction in 2019 after falling in every quarter of 2018, looks set to be deferred further (chart 2).

Consumption continues to provide the main lift to the UK economy as job markets and earnings sustain gains. Firms appear to be substituting labour for capital to deal with capacity constraints in an uncertain environment. This has taken job vacancy rates to their highest-ever levels and unemployment rates to post-GFC lows, which has resulted in strong earnings growth as firms compete for labour (chart 3). Households have pushed their savings rates down sharply to sustain purchasing plans in the face of rising prices, but more recently, savings rates and intentions have edged up again in response to the ongoing Brexit saga (chart 4). Although retail sales growth has accelerated rapidly since mid-2018, higher savings rates could put a drag on this one pocket of strength in the UK economy.

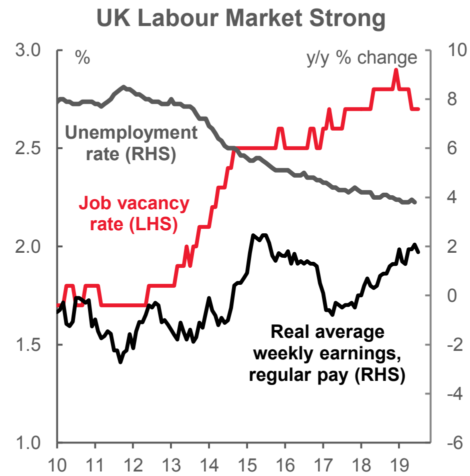
Sterling depreciation has done little to improve the UK's balance of payments and exports are unlikely to boost growth in the near-term. The current account deficit grew markedly at the start of 2019 as the trade balance worsened; export order books are now in contractionary territory (chart 5) and unlikely to provide a lift to production.

The eventual upturn on the far side of what BoE Deputy Governor Ramsden has called a 'saucer-shaped' outlook depends entirely on the resolution of Brexit, the lifting of uncertainty, and the domestic policies that will follow. Assuming that Brexit is, indeed, resolved in 2020, we expect to see a pick-up in investment and demand more broadly into 2021 that should raise economy-wide growth toward 1.6% (table). Regardless of who is in power at Westminster, we would expect to see this upturn supported by concerted fiscal stimulus in an attempt to make up for potential lost during the years of Brexit drift. Given the relative price insensitivity of the UK's imports and exports, a recovery in sterling isn't likely to provide a substantial new drag on growth, but would slow inflation.

We expect the Bank of England to remain on hold throughout the forecast horizon unless a disruptive no-deal Brexit goes forward. While the MPC sounded a marginally more cautious note in its September 19 decision, and MPC External Member Michael Saunders' September 27 speech shifted him out of the BoE's small camp of hawks by hinting at a possible rate cut, we expect the BoE to remain in 'wait and see' mode. The price effects of the GBP's earlier depreciations have largely been absorbed. Both headline and core inflation are set to end 2019 below 2%, but still-strong wage growth accompanied by an eventual resolution of the Brexit situation, should take inflation marginally above 2% in 2021 (table). The BoE is unlikely to react pre-emptively to contain price pressures after avoiding a Brexit-induced recession.

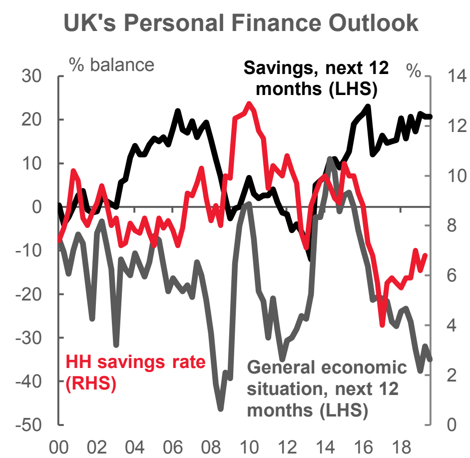
While the BoE's September decision was agnostic on the direction of monetary policy under a no-deal scenario, we would expect the MPC to cut rates if the UK crashes out of the EU. The Bank would prioritize stimulus to cushion the shock to domestic demand rather than raising rates to offset any inflationary pressures created by a sell-off in sterling.

Chart 3



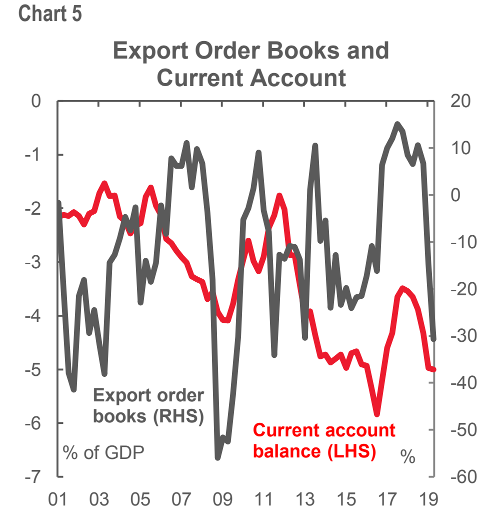
Sources: Scotiabank Economics, ONS.

Chart 4



Sources: Scotiabank Economics, GfK NOP, EC, ONS .

Chart 5



Sources: Scotiabank Economics, Bloomberg.

Eurozone

AS LONG AS IT TAKES

- **Inflation is expected to remain below the ECB's nearly 2% target into 2021. Eurozone growth is forecast to remain middling over this period, with risks to the downside stemming from a re-opening of Europe's trade tensions with the US.**
- **As a result, we expect the ECB's 'as long as it takes' to last at least until end-2021 and likely into 2022. Although advocacy for fiscal stimulus is likely to step up, we do not anticipate any immediate actions in the Eurozone countries that have the policy space to undertake them.**

WEAKER INFLATION, GROWTH, & TRADE

Euro-area inflation continues to slow from its recent high of 2.3% y/y in October 2018, but we expect price pressures to bottom in 2019 and firm up slightly going into 2020 and 2021 (table). Headline inflation has been brought down by low energy prices and non-core services, which include education fees and airfares (chart 1). Non-energy industrial goods and core-services price pressures have gradually risen over the last 18 months, and Eurozone compensation growth has accelerated to its fastest pace in a decade, but, together, this hasn't been enough to offset other sources of demand and price weakness. Amidst ongoing global trade tensions and slowing demand in the world's major economies, Eurozone market-based inflation expectations have fallen well below the ECB's 2% target (chart 2).

At the same time, the Eurozone real economy continues to stumble and we have marked growth down to 1.0% in 2019—the slowest expansion in over five years—and expect it to remain muted at 1.1% in 2020 and 1.3% in 2021 (table). This is somewhat softer than the ECB's outlook, which forecasts 1.1% growth in 2019 and 1.4% growth in 2020. Germany remains the centre of the Eurozone's anaemic growth, with a 0.1% contraction in Q2. Composite Eurozone PMIs have trended downward since the beginning of 2018 (chart 3). These economy-wide indices have been driven by deteriorating conditions in manufacturing as tariff battles with the US intensify, Brexit uncertainty remains rampant, and demand from China remains soft; conditions in the services sector, in contrast, have firmed up a bit. Weak export order books across the Eurozone imply that any rebound in manufacturing isn't going to be led by trade.

The EU-US trade 'truce' negotiated between European Commission President Jean-Claude Juncker and US President Trump in July, 2018 appears to be crumbling. Following the recent WTO ruling on European subsidies to Airbus, the US moved on October 3 to impose tariffs from October 18 on USD 7.5 bn worth of imports from Europe, with 10% taxes on aircraft and 25% taxes on traditional wine, spirits, and foodstuffs. Europe intends to respond in kind and may not wait for a WTO ruling on its own case against US subsidies to Boeing. Retaliation could be led by the rescission of prior trade settlements with the US, which would quickly lead to a further unravelling of trade relations across the Atlantic and bring forward US tariffs on European automobiles.

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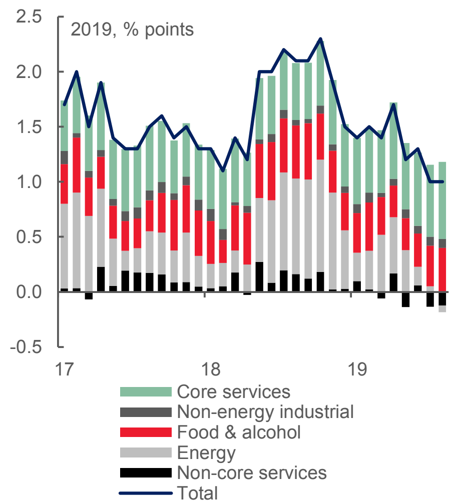
Eurozone	2018	2019f	2020f	2021f
Real GDP (annual % change)	1.9	1.0	1.1	1.3
CPI (y/y %, eop)	1.5	1.2	1.3	1.5
Central bank MRO rate (%, eop)	0.00	0.00	0.00	0.00
Central bank deposit rate (%, eop)	-0.40	-0.50	-0.50	-0.50
Euro (EURUSD, eop)	1.15	1.10	1.20	1.22

Source: Scotiabank Economics.

Chart 1

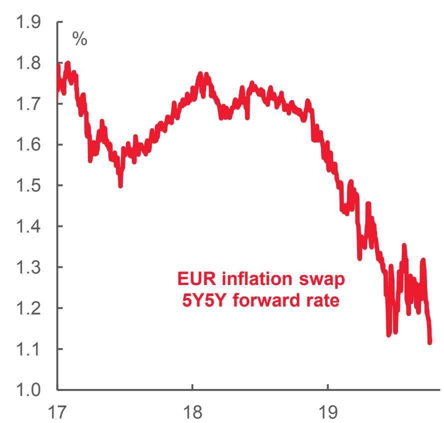
Contributions to Eurozone Inflation



Sources: Scotiabank Economics, Eurostat.

Chart 2

Eurozone Inflation Expectations



Sources: Scotiabank Economics, Bloomberg.

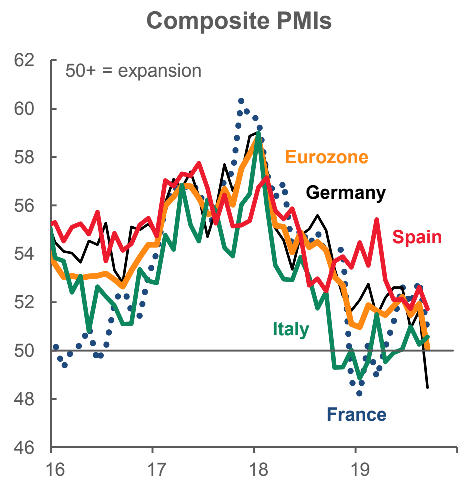
ECB: AS LONG AS IT TAKES

With global trade prospects still complicated and manufacturing continuing to weaken, the European Central Bank's (ECB) September 12 announcement of a new round of monetary policy stimulus measures provides a reasonable compromise between the Governing Council's hawks and doves with its shift from 'whatever it takes' to 'as long as it takes.' The package features:

- A lower deposit rate, down 10 bps from -0.40% to -0.50%;
- More dovish forward guidance that promises to keep key rates low until "the inflation outlook robustly converges to a level sufficiently close to, but below, 2% within its projection horizon," and where "such convergence has been consistently reflected in underlying inflation dynamics."
- Open-ended re-initiation of asset purchases (i.e., QE) of EUR 20 bn per month for as long as necessary, which will likely require public issuer limits to be lifted from 33% to 50%;
- Better-than-expected terms for TLTRO III; and
- A two-tiered system for reserve remuneration that shields a share of banks' excess liquidity from the -0.50% deposit rate.

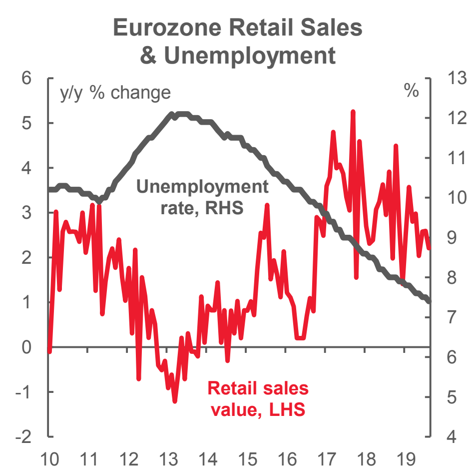
With inflation expectations and outturns continuing to come in well below the ECB's nearly 2% target, there must be more slack outstanding than current capacity-utilization data and the ECB's output gap models imply.

Chart 3



Sources: Scotiabank Economics, IHS Markit.

Chart 4



Sources: Scotiabank Economics, Eurostat.

IMF MEANS 'IT'S MAINLY FISCAL'

Christine Lagarde will bring her repeated calls at the IMF for concerted fiscal stimulus in the major economies to her new role as ECB President from November 1—with a focus on Eurozone countries, principally Germany, that have substantial fiscal space. Public infrastructure and other investment spending that could address the Eurozone's weak productivity growth ought to feature prominently in any fiscal stimulus. At present, investment accounts for only about 21% of GDP, a full percentage point lower than its pre-GFC average. **Nevertheless, sentiment in northern Europe remains tipped against opening the spending taps and we have not incorporated any major new fiscal stimulus into our baseline.**

AS ELSEWHERE, MUCH HINGES ON HOUSEHOLDS

Consumers remain the critical element in our Eurozone outlook and household finances look poised to help keep the Eurozone out of recession. Seasonally-adjusted Euro area unemployment hit 7.4% in August, its lowest reading since May 2008, as jobs growth continues to run faster than the concurrent expansion in the labour force. With high vacancy rates, in part driven by skill mismatches, and the fastest earnings growth in a decade outpacing inflation, households' real spending power is set to keep rising, which should sustain retail sales growth (chart 4). The ECB's new tiering system should also ensure banks are better able to pass on low rates to their customers.

BREXIT PAIN FALLS MAINLY NEAR ALBION

We expect the Brexit process to proceed in the first half of 2020 under a deal agreed between London and Brussels, as discussed in the *United Kingdom section*. In the meantime, Brexit uncertainty will continue to weigh on Eurozone investment and growth: Eurozone manufacturing tied to the UK accounts for about 2.5% of the currency bloc's annual GDP. Ireland, Luxembourg, Malta, Belgium, and the Netherlands are the most exposed to changes in British demand and Brexit uncertainty.

China

- **The US-China trade conflict weighs on the Chinese economy as the adverse impact spreads beyond trade-related activities to the broader economy through weaker confidence.**
- **Any progress in trade talks would be positive for the economy, yet we expect the dispute to drag on for an extended period of time.**
- **Chinese authorities are expected to continue employing additional fiscal and monetary stimulus measures to prevent a more substantial growth deceleration.**

ECONOMIC GROWTH OUTLOOK

The downward pressure on the Chinese economy is intensifying. The trade and technology conflict with the US is adversely impacting the Chinese manufacturing sector and the country's exporters. Moreover, resultant weaker confidence is weighing on household and business spending and investment decisions. In addition to the trade-dispute-related slowdown, China's continuing structural transformation to becoming an economy driven by the consumer and the services sector is leading to lower GDP gains. We have made a small downward revision to our 2019 real GDP growth forecast for China, and expect output gains to average 6.1 y/y in 2019, vs. the earlier forecast of 6.2%. Momentum will likely decelerate further over the coming two years toward 5¾% y/y in 2021—a rather notable slowdown from the 6.6% expansion recorded in 2018.

Broadly based weakness is visible in softer retail, industrial, investment and export data (charts 1 and 2). Moreover, credit growth—particularly bank lending—has failed to accelerate enough to boost growth momentum (chart 3). This implies that the Chinese government will need to unveil additional stimulus in order to maintain economic growth in line with the official 2019 target of 6–6½% y/y and to promote social stability. Indeed, we expect the administration to announce further fiscal support in the near term—specifically targeting the Chinese consumer, private sector enterprises, as well as infrastructure—to complement the already-announced measures, such as cuts to the manufacturing sector value-added taxes, higher individual income tax thresholds and raised deduction limits, and increased issuance quotas for local governments' special purpose bonds for infrastructure projects.

The US-China trade conflict continues, causing fluctuations in global risk sentiment. With every escalation, a resolution to the dispute is becoming increasingly difficult to achieve. An additional set of US import tariffs on Chinese goods became effective on September 1, joined by a round of Chinese retaliatory tariffs. Further levies are set to take effect in mid-October and mid-December. With the two countries' teams back at the negotiation table, any progress in improving the bilateral relationship would be positive for the global economy; we assess that an interim agreement covering some aspects of traditional trade of goods seems more achievable than a comprehensive deal, given that little headway has been achieved in resolving disagreements regarding such issues as technology, cyber security, intellectual property protection, and market access.

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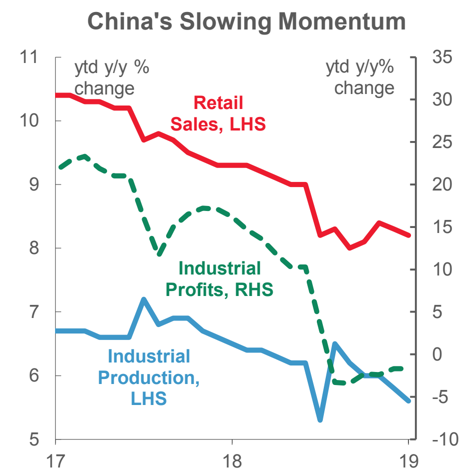
China	2018	2019f	2020f	2021f
Real GDP (annual % change)	6.6	6.1	6.0	5.8
CPI (y/y %, eop)	1.8	3.0	2.3	2.5
Central bank policy rate (%, eop)	4.35	4.10	4.00	4.00
Chinese yuan (USDCNY, eop)	6.88	6.90	6.70	6.50

Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2

Sources: Scotiabank Economics, Bloomberg, Customs General Administration PRC.

We highlight that the US administration may be overestimating its negotiation power and China's willingness to make a comprehensive deal with the US, which would require notable concessions by China. Given persistent unrest in Hong Kong, we point out that the Chinese leadership will likely try to avoid looking weak domestically as it deals with its US counterpart in order to underpin social stability in the mainland. Moreover, with manufacturing in the US—a core element of President Trump's platform—now contracting, China may be more willing to endure some additional economic pain domestically if it leads to a lower likelihood of President Trump getting re-elected. Finally, the unpredictable nature of White House policies may be a disincentive for China to give concessions to the US as any reached agreement could potentially get disregarded at short notice. Against this backdrop, we expect China to remain firm during the trade negotiations, demanding the removal of the tariffs that have been imposed so far. Accordingly, we expect the dispute and the negotiations to drag on for months, most likely through Trump's presidency.

INFLATION AND MONETARY POLICY OUTLOOK

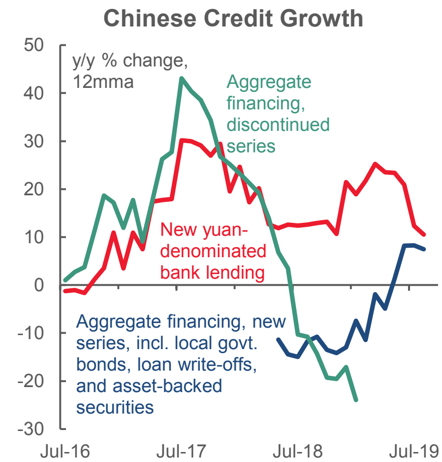
Inflationary pressures have intensified in China on the back of higher food prices. Headline inflation is approaching the government's target of around 3% y/y (chart 4). We expect consumer price inflation to close the year at the 3% y/y mark before stabilizing at around 2½% in 2020–21. Nevertheless, price pressures further up the distribution chain are much weaker, with annual producer price inflation currently residing in negative territory. Manageable inflationary pressures should allow the People's Bank of China (PBoC) to maintain an accommodative monetary policy stance through 2021.

The PBoC has rolled out additional monetary stimulus; the reserve requirement ratios were cut by 50 basis points to 13.0% for major banks in mid-September, bringing the total year-to-date reduction to 150 bps (chart 5). An additional 100 bps cut for qualified city commercial banks was also unveiled, effective in two phases on October 15 and November 15. We expect the PBoC to introduce some additional monetary easing in the near term, in the form of lower interest rates and reserve requirement ratios.

Simultaneously, Chinese monetary authorities continue to take further financial market reform steps, as demonstrated by the August interest rate reform. The new 1-year Loan Prime Rate (LPR)—currently set at 4.20%, 15 bps below the former 1-year benchmark lending rate—is more market-driven as it is updated based on quotations from 18 banks. The LPR will be used as a reference rate for new lending rate and is set to reflect changes in the PBoC's 1-year medium-term lending facility (MLF) rate, which the PBoC uses to inject liquidity into the banking system. The MLF has been kept on hold at 3.30% since April 2018, yet we expect it to be reduced over the coming months, resulting in a lower LPR rate of 4.0% by mid-2020. The new setup is expected to improve monetary policy transmission and lower funding costs in the economy, yet we note that such an outcome would be more pronounced if the PBoC also moved ahead with reforming the benchmark deposit rate.

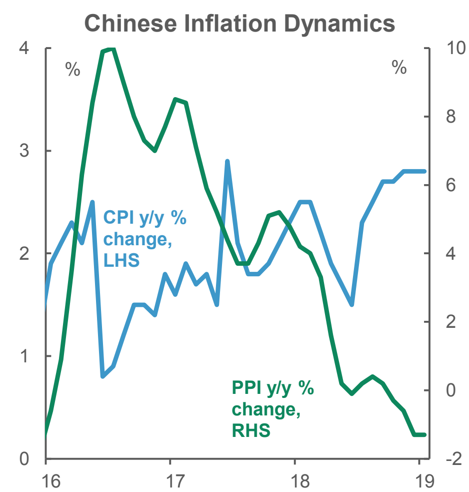
In August, the Chinese yuan broke above USDCNY7.0 for the first time since early 2008. We do not expect the PBoC to use significant devaluation of the Chinese yuan as a way to support the economy as it might trigger capital flight pressures. While the value of the CNY increasingly reflects market forces—and has depreciated on the back of trade-related concerns—we expect the PBoC to keep the CNY relatively stable as it remains aware of the yuan's value being a sensitive issue in the trade discussions with the US.

Chart 3



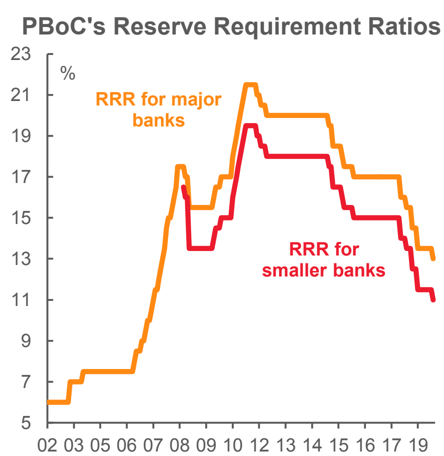
Sources: Scotiabank Economics, Bloomberg, the People's Bank of China.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

Chart 5



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

Japan

- **Global uncertainties and the consumption tax rate hike cloud Japan's economic growth outlook.**
- **Bank of Japan stands ready to provide additional monetary stimulus.**

ECONOMIC GROWTH OUTLOOK

The Japanese economy's near-term outlook is highly uncertain, given that the consumption tax rate rose from 8% to 10% on October 1 and is expected to trigger a dip in consumer spending in the final months of 2019. Nevertheless, the economy's performance has been reasonably sound so far this year as some spending has been brought forward in anticipation of the tax rate hike. In addition to the domestic tax-related challenges, global uncertainties will likely depress sentiment at home, potentially holding up business investment and hiring decisions. While Japan's public finances are strained—necessitating the consumption tax rate hike—growth-oriented fiscal policies will support economic activity, particularly ahead of the 2020 Summer Olympics in Tokyo.

Japanese exporters are adversely affected by weaker global demand (chart 1), with shipments to the European Union and Asia being hit particularly hard. Indeed, the external sector has been a drag on growth since the second half of 2018, and we see no signs of the trend reversing in the near term. However, the fact that the US and Japan reached a trade agreement in September is a bright spot in the uncertain trade environment, yet it remains unclear if the deal will insulate Japan from potential US tariffs on automotive imports. We expect Japan's real GDP gains to average 0.8% y/y in 2019, in line with the economy's potential. Growth momentum will likely weaken to 0.5% in 2020 before rebounding to 1.2% in 2021.

INFLATION AND MONETARY POLICY OUTLOOK

Japan will continue to struggle with low inflation over the foreseeable future as global uncertainties weigh on economic growth prospects, limiting wage growth and demand-driven inflationary pressures. Changes in global risk aversion and associated fluctuations in the Japanese yen complicate the inflation outlook further. The CPI excl. fresh food—the Bank of Japan's (BoJ) preferred inflation measure—currently hovers at 0.3% y/y, far from the central bank's 2% inflation target (chart 2). While the inflation metric is set to pick up temporarily following the implementation of the consumption tax rate hike in October, we forecast that inflation will remain below the target through 2021.

The BoJ will likely maintain highly accommodative monetary conditions through 2021. Following the September monetary policy meeting, BoJ Governor Haruhiko Kuroda underlined the possibility that "the momentum toward achieving the price stability target will be lost" and that he has recently become more open toward additional monetary easing. The BoJ will likely discuss its policy options—e.g. lower short- and/or long-term policy rates, expanded asset purchases, or alternative measures such as provision of funding to banks through the Loan Support Program with a negative interest rate—in great detail over the near future, standing ready to provide further stimulus should the economy weaken.

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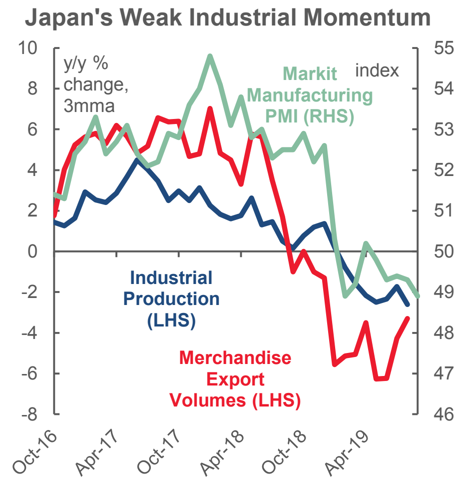
Japan	2018	2019f	2020f	2021f
Real GDP (annual % change)	0.8	0.8	0.5	1.2
CPI (y/y %, eop)	0.3	1.5	0.6	0.8
Central bank policy rate (%, eop)	-0.10	-0.15	-0.15	-0.15
Japanese yen (USDJPY, eop)	110	108	105	102

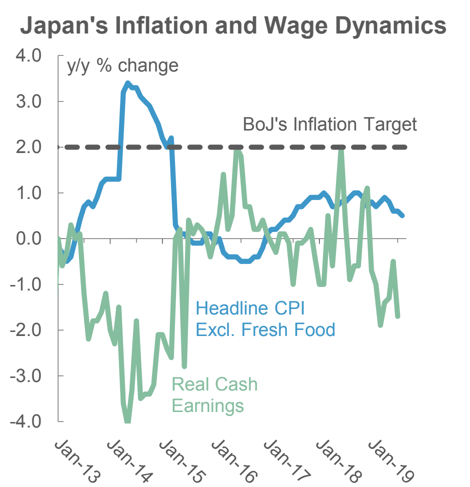
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

India

- **India's growth slowdown has spread across consumer spending, fixed investment, and exports.**
- **Weaker economic activity prompts policy responses from the government and the central bank, underpinning a gradual recovery over the coming months.**
- **Inflation in India is set to remain contained in the foreseeable future.**

ECONOMIC GROWTH OUTLOOK

The Indian economy is showing signs of softness, prompting decisive action by the country's policymakers. Both rural and urban demand indicators suggest lost momentum, with prospects for household spending—the engine of the economy—likely to remain muted in the near term. Lower business confidence (chart 1) due to elevated global uncertainties is filtering through to investment activity, suppressing India's eight core industries—electricity, steel, refinery products, crude oil, coal, cement, natural gas and fertilizers (chart 1). Meanwhile, weaker global demand conditions are weighing on Indian exporters and the manufacturing sector.

The country's real GDP growth slowed notably in the second quarter of 2019 with output expanding by 5.0% y/y, vs. 5.8% in the January–March period and 7.4% in 2018 as a whole (chart 2). We forecast India's output gains to average 5.8% y/y this year, well below the economy's estimated potential growth of 7–7½%. However, we assess that the economy is on the verge of a gradual recovery, thanks to the multitude of measures implemented by both the government and the Reserve Bank of India (RBI). Nevertheless, to complement fiscal and monetary policy initiatives, continued strong political will is required to carry out structural reforms—in such areas as land and labour—in order to materially improve India's longer-term growth prospects. We forecast that India's real GDP growth will average 7.1% y/y in 2020–21.

The Indian government is implementing measures to underpin the flagging economy, yet the nation's room for fiscal stimulus is limited on the back of India's weak public finances. We consider that it is highly unlikely that India will be able to meet the fiscal year 2019–20 (April–March) central government budget deficit target of 3.3% of GDP due to downward pressure on tax revenue. Moreover, we note that the fiscal shortfall remains significantly bigger at the general government level, close to 7% of GDP in FY2019–20. The stress on India's public finances would have been even stronger without the recent sizeable transfer that the government received from the RBI, consisting of dividends and excess capital, equivalent to 0.9% of GDP vs. the budgeted 0.7%.

In order to boost private sector investment over the coming years, the government announced a substantial corporate tax reform in September, which sees the corporate tax rate cut from 30% to 22%, effective from April 1, 2019. Moreover, newly incorporated manufacturing sector companies will face a lower 15% tax rate, aimed at boosting the government's "Make in India" initiative and attracting

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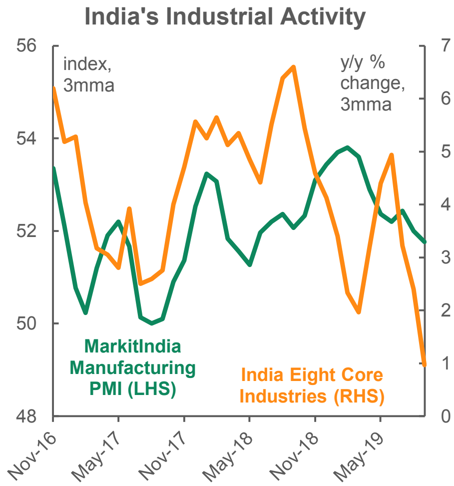
India	2018	2019f	2020f	2021f
Real GDP (annual % change)	7.4	5.8	6.7	7.4
CPI (y/y %, eop)	2.1	3.7	4.5	5.0
Central bank policy rate (%, eop)	6.50	4.90	4.75	5.50
Indian rupee (USDINR, eop)	69.8	68.0	66.0	64.0

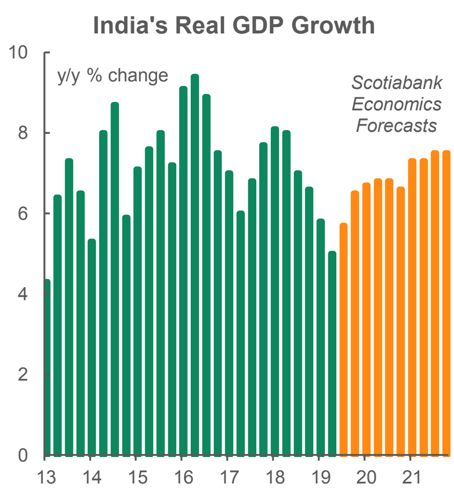
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

higher foreign direct investment inflows. Indeed, with these new tax cuts India is now placed among the lowest corporate tax rate jurisdictions in the emerging market universe (chart 3). In addition, Indian policymakers have recently unveiled various other initiatives to improve the economy's outlook, such as a merger of ten public sector banks into four, a bank recapitalization package, plans for infrastructure spending, support for the automobile sector, as well as other tax measures targeting start-ups and investors.

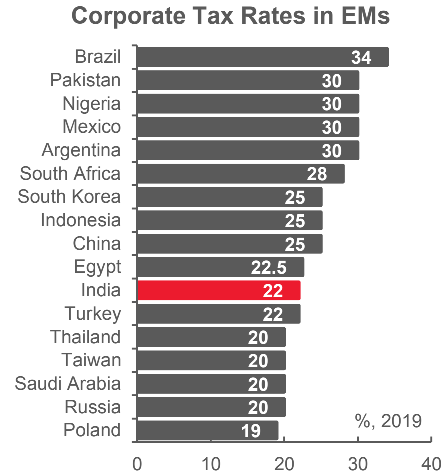
INFLATION AND MONETARY POLICY OUTLOOK

Indian monetary authorities continue to take steps aimed at reversing the current sharp slowdown in economic activity. Given India's restrained public finances, the RBI will be responsible for most of the economic revival efforts. Nevertheless, the central bank continues to struggle with inadequate monetary policy transmission, as its benchmark interest rate cuts have only partially been reflected in lower bank lending rates. The benchmark repo rate has been reduced in five consecutive monetary policy meetings by a total of 135 basis points since the beginning of the easing cycle in February 2019 (chart 4). The most recent rate cut took place in early October when the policy rate was reduced by 25 bps to 5.15%, the lowest level since 2010.

The RBI maintains its "accommodative" monetary policy stance. Furthermore, it has signalled that the stance would remain unchanged "as long as it is necessary to revive growth" and that additional policy space exists to address weak economic activity. Accordingly, we expect some further monetary stimulus over the coming months, taking the repo rate to 4.75% by early 2020 (chart 4). Assuming a recovery in growth momentum and a gradual climb in inflationary pressures over the next year and a half, the RBI will likely return to a cautious monetary tightening bias in 2021.

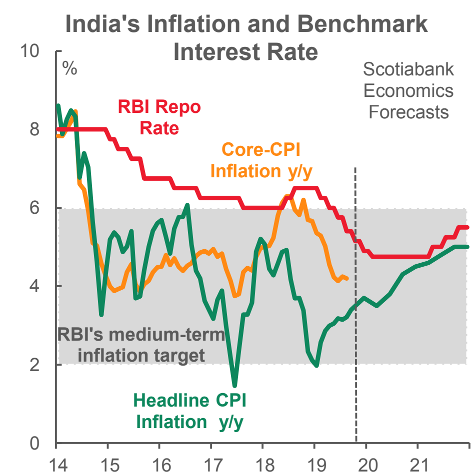
A benign inflation outlook allows the RBI to focus on stimulating domestic demand. Both headline and core inflation—currently hovering at 3⅓% y/y and 4%, respectively—remain comfortably within the RBI's annual inflation target of 4% ±2%. Moreover, a negative output gap, manageable inflation expectations, and above-normal monsoon rainfall that should keep food prices in check point to contained inflationary pressures over the foreseeable future. We expect price pressures to remain within the RBI's target through 2021, yet we will likely witness a gradual rebound toward 5.0% y/y in 2021 on the back of strengthening economic momentum.

Chart 3



Sources: Scotiabank Economics, Bloomberg.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

South Korea

- **Export-sector headwinds continue to weigh on economic activity.**
- **Authorities' fiscal and monetary stimulus efforts underpin the outlook.**

ECONOMIC GROWTH OUTLOOK

The export-oriented South Korean economy is losing momentum (chart 1) as four issues simultaneously weigh on activity: 1) softening global demand dynamics; 2) trade tensions between the US and China and associated supply-chain ripple effects; 3) the ongoing downturn in the global electronics sector, which reflects lower Chinese demand and smartphones' longer replacement cycle; and 4) the Japan-South Korea dispute and subsequent export restrictions set by Japan on materials critical to the South Korean semiconductor sector. The external sector outlook is potentially further jeopardized by the expected decision by the US administration by mid-November on whether it will move ahead with tariffs on automobile imports.

Domestic demand will play a key role in underpinning economic activity in South Korea as the external sector will face persistent challenges. Nevertheless, because of softer consumer and business confidence, South Korean households have become cautious spenders (chart 2) while construction and facilities investment by the private sector is set to remain muted. Meanwhile, public spending will support growth; in early August, the National Assembly passed a supplementary budget of around USD 5 bn (equivalent to 0.3% of GDP). In addition, the budget proposal for 2020, totalling around USD 443 bn, foresees a 9.3% y/y rise in public outlays.

The South Korean economy grew by 1.0% q/q (2.0% y/y) in the second quarter following a contraction in output in the January–March period. We expect the nation's real GDP gains to remain moderate through the second half of 2019 with growth averaging 1.9%% this year. Favourable base effects combined with policymakers' monetary and fiscal stimulus efforts will help the economy rebound gradually in 2020–2021, with real GDP growth expected to average 2.4% y/y.

INFLATION AND MONETARY POLICY OUTLOOK

In line with a broadening global trend, the Bank of Korea (BoK) has become concerned about the economy's outlook, which is weighed down by persistent external sector uncertainties. Meanwhile, inflationary pressures remain absent, allowing for looser monetary conditions. Accordingly, the central bank lowered the Base Rate by 25 basis points to 1.50% following the July monetary policy meeting, thereby reversing the November 2018 interest rate hike. While the BoK left monetary conditions unchanged at the subsequent policy meeting, it signalled that it will consider the need for further policy adjustment. We assess that another 25 bps rate cut to 1.25% will likely take place in the near future.

South Korea's inflationary pressures have virtually disappeared with annual CPI increases hovering near 0%. Given low demand-driven price pressures, inflation will likely remain muted for several quarters. In fact, we do not expect headline inflation to reach the BoK's 2% y/y target before 2021.

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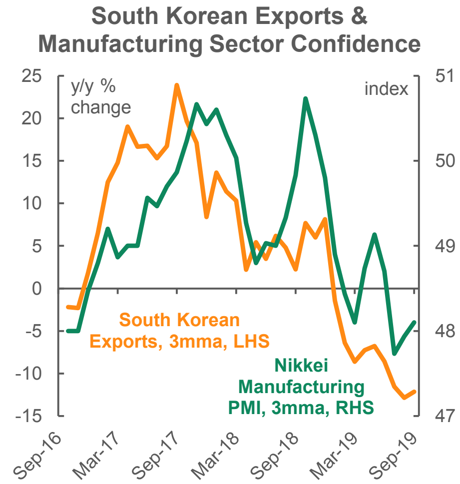
South Korea	2018	2019f	2020f	2021f
Real GDP (annual % change)	2.7	1.9	2.3	2.5
CPI (y/y %, eop)	1.3	0.6	1.6	2.1
Central bank policy rate (%, eop)	1.75	1.25	1.25	1.50
South Korean won (USDKRW, eop)	1,116	1,180	1,140	1,100

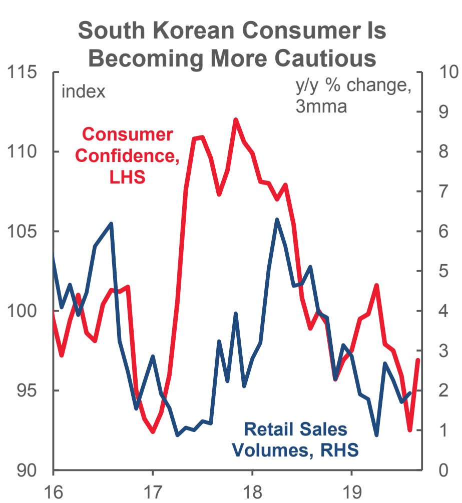
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Australia

- **No recession in sight, though real GDP gains will likely remain below potential through 2021.**
- **Household spending plays a key role in the economy's growth outlook, yet the Australian consumer is set remain cautious.**
- **Muted inflation allows for further monetary easing, with the benchmark interest rate continuing to break new record-lows.**

ECONOMIC GROWTH OUTLOOK

The persistently challenging global economic environment is clouding Australia's economic outlook. We expect Australia's output to expand by 1.8% in 2019, before recovering to 2.4% y/y in 2020–2021. Accordingly, real GDP gains are expected to remain below the economy's potential of 2¾% y/y through our forecast horizon (chart 1). The country's real GDP grew by 1.4% y/y (+0.5% q/q non-annualized) in the second quarter following a 1.7% y/y gain (+0.5 q/q) in the January–March period. Despite muted momentum, we assess that Australia has solid economic fundamentals and adequate policy space to address even significant economic softness. Accordingly, we consider that the likelihood of the Australian economy facing a recession remains low.

Australia's external sector is supporting economic activity as it is benefiting from improved terms of trade (chart 2), thanks to elevated iron ore prices; the momentum is offsetting the impact from global demand weakness. Meanwhile, Australia is less integrated into the regional manufacturing supply chains than its peers in Asia-Pacific and is hence somewhat insulated from the ripple effects stemming from the US-China trade conflict. While the Australian economy will benefit from Beijing's fiscal stimulus efforts, China's continuing economic growth slowdown will be an issue for Australia's longer-term growth prospects.

Fixed investment growth will continue to be influenced by international developments as concerns regarding global economic growth momentum weigh on business confidence (chart 3) and on private sector investment intentions. The downturn in residential real estate prices is set to keep dwelling investment gains muted over the coming quarters. As counterbalance, public infrastructure outlays and the gradual resumption of resource sector investment should underpin economic activity.

Household spending will be an important factor supporting economic growth, yet the outlook is influenced by mixed considerations. Consumer confidence has softened notably over the course of 2019 (chart 3), putting future spending decisions potentially on hold. Moreover, a high household debt burden and muted wage gains weigh on the consumer while the labour market momentum is expected to soften over the coming months. On the positive side, however, tax relief measures that target low- and middle-income earners, low interest rates, and a recovering housing market should underpin spending prospects.

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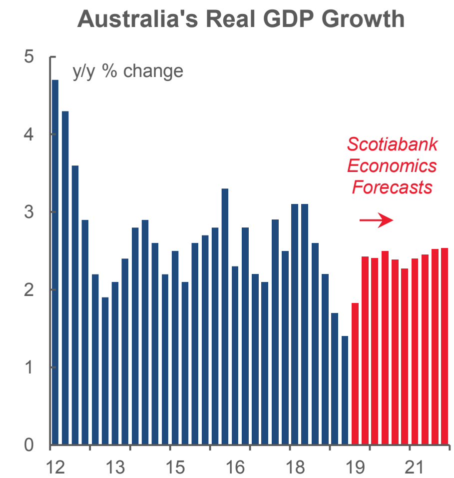
Australia	2018	2019f	2020f	2021f
Real GDP (annual % change)	2.7	1.8	2.4	2.5
CPI (y/y %, eop)	1.8	1.6	1.9	2.1
Central bank policy rate (%, eop)	1.50	0.50	0.50	0.50
Australian dollar (AUDUSD, eop)	0.70	0.68	0.72	0.74

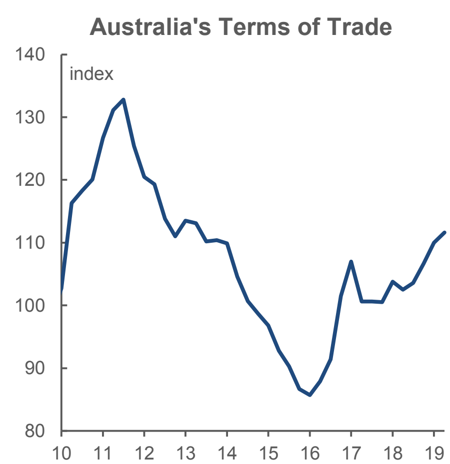
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Australian Bureau of Statistics.

Australia's labour market remains solid for the time being, yet some signs of softening are starting to emerge. Over the past 12 months to August, an average of 26,000 new jobs have been added to the economy every month, representing a high number by historical standards. Furthermore, 60% of those positions have been full-time jobs. Nevertheless, the unemployment rate has crept up to 5.3% from 4.9% earlier this year, reflecting higher labour force participation (chart 4). We expect employment gains to soften over the coming months—toward more-normal levels—as global uncertainties and weaker confidence will likely put some hiring decisions on hold.

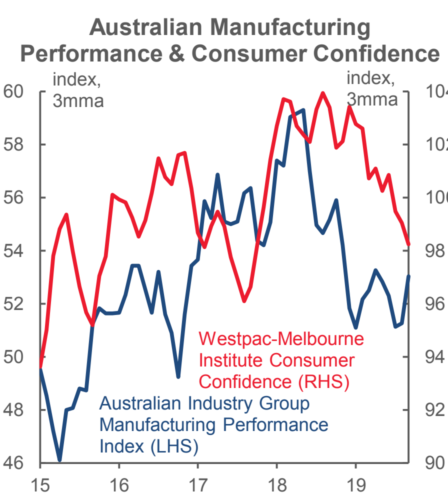
Australia's residential property market is showing signs of stabilization with house prices in large cities rising for three consecutive months since July (chart 5). Nonetheless, we monitor the housing market carefully, as price developments vary widely across the country and housing turnover will likely stay low for the time being due to muted confidence.

INFLATION AND MONETARY POLICY OUTLOOK

Australia's headline inflation continues to hover below the Reserve Bank of Australia's (RBA) 2–3% annual inflation target, with prices rising by 1.6% y/y in Q2 of 2019, yet inflationary pressures intensified slightly from the first quarter reading of 1.3% y/y. We expect demand-driven price pressures to remain largely absent through our forecast horizon; headline inflation will likely climb higher only gradually, reaching the lower end of the RBA's target range in early 2021.

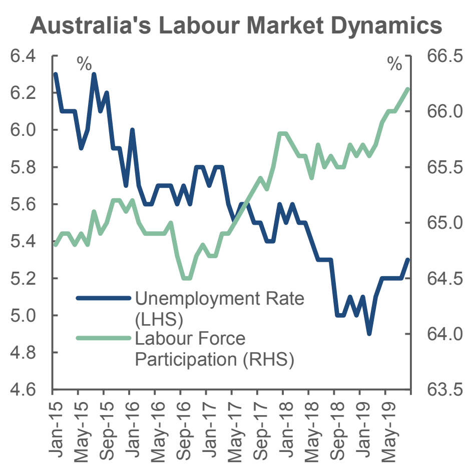
Enabled by low inflationary pressures, the RBA continues to take decisive steps to support the economy. In early October, the benchmark interest rate was lowered by 25 bps to 0.75%—a record low. The policy rate was reduced by the same magnitude at the central bank's meetings in June and July. A total of 75 bps of easing over the past four months highlights the monetary authorities' concerns regarding Australia's economic outlook. RBA Governor Philip Lowe has highlighted that the RBA is prepared to ease monetary policy further if needed. He has pointed out that interest rates are set to remain low for an extended period of time as the central bank aims to reach full employment in the economy and to achieve the inflation target. Given weak inflation projections and our expectation that Australia's labour market will fail to strengthen in the near term, we forecast the RBA to cut the benchmark rate one more time in this easing cycle, to 0.50%. We assess that the RBA would also be prepared to employ unconventional monetary policy tools to complement the interest rate cuts, should the achievement of the employment and inflation targets become subject to notable risks.

Chart 3



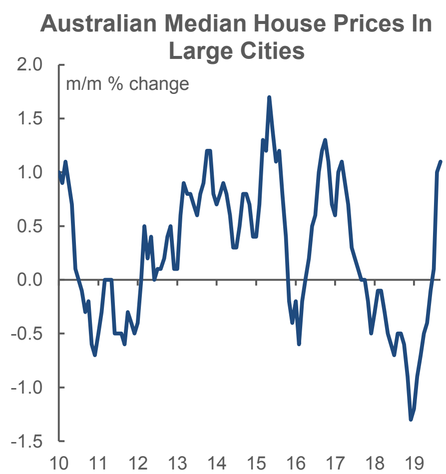
Sources: Scotiabank Economics, Bloomberg.

Chart 4



Sources: Scotiabank Economics, Australian Bureau of Statistics.

Chart 5



Sources: Scotiabank Economics, Bloomberg, CoreLogic.

Commodities

MACRO TAKE THE WHEEL

- **Softer macroeconomic conditions, weak industrial activity, and ever-uncertain-yet-steadily-worsening trade tensions have markets on the defensive and industrial commodity prices have waned amidst lowered demand expectations.**
- **While the outlook for most industrial commodities has been revised lower in this outlook, our forecast for crude prices remains relatively unchanged given supply-side risk offsets and should be considered relatively bullish on the commodity given our broader bearish bias.**
- **Gold has enjoyed a resurgence amidst the weakness in industrial commodities and market fears of a further slowdown. Bullion is expected to reach a near-term annual peak in 2020 as the US enters a presidential election amidst impeachment proceedings and a trade war, and Brexit roils Europe across the Atlantic.**

The commodity market finds itself on the other side of the stimulus-aided and optimistically synchronized global growth that supported industrial commodity prices from late-2016 into mid-2018. The prices of most industrial commodities have fallen in the year-and-change since the US-China trade war began in earnest as businesses throttled back on investment amidst volatile US trade policy and disrupted supply chains (chart 1).

As chart 1 makes clear, industrial misfortune has been a boon for gold as investors flocked to safety and central banks around the world reversed their prior tightening biases and began cutting interest rates to help spur demand. While still-healthy consumer demand is floating modest growth across the OECD, commodities will be driven by contracting activity in the materials-intensive and trade-dependent industrial sector, where PMIs are trending negative alongside industrial production and trade indicators (chart 2). Some of this slowdown makes sense simply as the hangover from the stimulus-fuelled strength through to mid-2018, though we believe that the volatility and ever-worsening state of US trade relations has added considerable additional uncertainty—firms are understandably hesitant to put capital in the ground when previously stable supply chains and relationships can unravel at the flippant pace of a presidential tweet thread.

While the outcome of the US presidential showdown will set the tone for the post-2020 global economy we don't expect a resumption of the pre-2016 election status quo. In a scenario where President Trump is re-elected we anticipate that the White House will continue on its current path of policy volatility though to diminishing effect as firms adapt and supply chains are reoriented. A Democratic victory would likely reduce the volatility of the policy-making process—and thus the current level of investment uncertainty—but is expected to nonetheless weigh on markets directly given fiery primary campaign rhetoric that spooked much of Wall Street and has sowed the seeds of at least some degree of self-fulfilling prophecy selloff; this weakness is also expected to be temporary and fall off steadily through the early 2020s.

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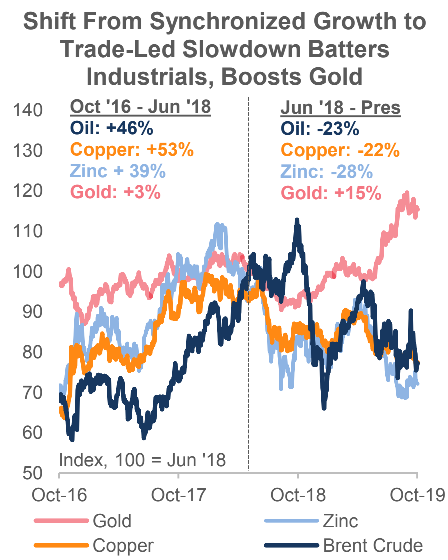
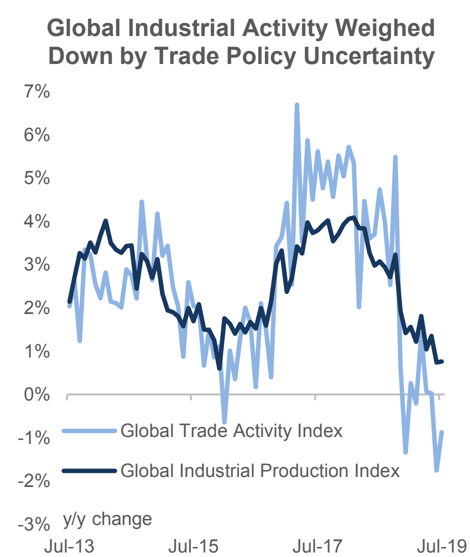
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, CPB.

This weaker macroeconomic backdrop continues to dominate commodity price formation, and currently volatile tides of the global economy are expected to drown out most commodity-specific fundamentals until either 1) those fundamentals become particularly acute and financial markets are forced to contend with cash-settlement supply-demand dynamics, or 2) the macro fog is lifted and markets can once again properly discriminate between various materials on a case-by-case basis.

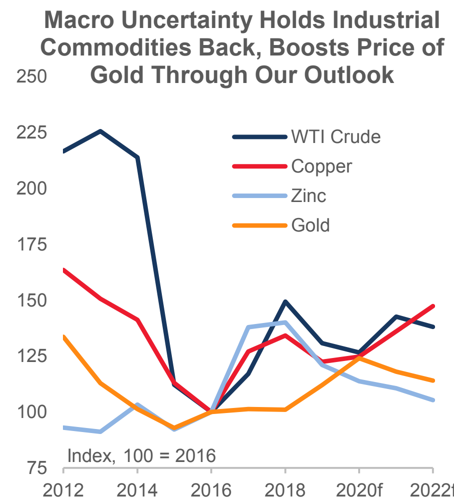
With that backdrop in mind, **we now expect 2020 to be a particularly good year for gold with prices forecast to average $1,550/oz** (up from $1,350/oz in our last outlook) while economic uncertainty will continue to weigh on **copper's prospects and prices are forecast to languish around $2.75/lb** (from $3.00/lb) (chart 3). **Despite an extremely active oil market our WTI crude price forecast has remained more-or-less unchanged at $55/bbl in 2020** as our increasingly bearish macro outlook offsets the political risk boost that oil prices are expected to retain on the back of mid-September attacks against Saudi Arabia's oil industry (see full commentary here).

ENERGY: SUPPLY RISKS HELP CRUDE AVOID MACRO DOWNGRADE

Against a bearish macro backdrop where most industrial commodities are seeing outlooks downgraded, our mostly-unchanged oil price forecast should be seen as fundamentally bullish for the commodity and a reflection of a risk premium embedded in the price following recent attacks in Saudi Arabia—while the market has returned most of the post-attack gains, we would still likely be lower today absent the attacks. We expect WTI crude to average $55/bbl in 2020 and $62/bbl in 2021, with oil balances set to steadily tighten over the coming two years. While our outlook for crude is constructive, the hardest times for oil prices are very nearly upon us as supply-demand balances are expected to tip into acute surplus in the first quarter of 2020. This surplus is more the result of a timing mismatch than a reflection of longer-term weakness, with large non-OPEC fields years in the making coming online together just as demand falls off seasonally (chart 4). Nonetheless, pricing is expected to feel significant pressure as spot markets wane to pay for storage to bridge the demand gap and early weakness will drag on annual average pricing.

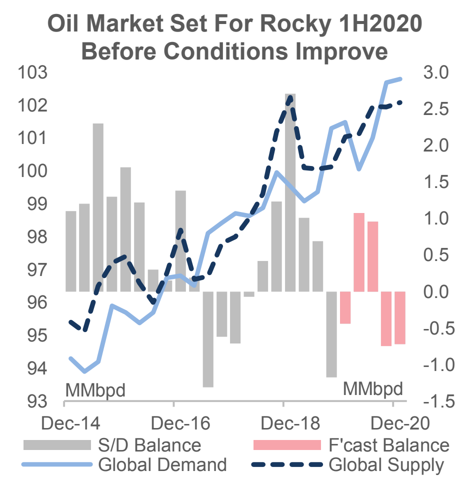
Conditions are set to improve through 2020 as demand growth reaccelerates and US growth—long the sharpest thorn in the side of oil price bulls—finally begins to slow. Oil consumption growth is expected to reaccelerate as business activity picks up following the 2020 US election; while not as investment-driven as metals like copper, oil demand will benefit from faster growth in construction, shipping, and trade. On the supply side, US shale growth continues to slow as expected and now the US Energy Information Administration expects 2020 supply growth to average around 1 MMbpd and exit December at less than 0.6 MMbpd, down from the 1.64 MMbpd high water mark pace averaged in 2018 (chart 5). Oilfield activity across the major US basins has fallen alongside crude prices are there are 151 fewer rigs drilling for oil than this time last year (-18% y/y) and the short-cycle nature of the shale patch means these downturns feed to production far more quickly than in past cycles. While it is clear that the shale patch will be able to accelerate in the event of a prolonged supply shortage, moderate prices around the low $60s (WTI) are expected to now keep shale growing at a modest and decelerating pace while further demand growth provides OPEC+ the space to ease the group's production constraints.

Chart 3



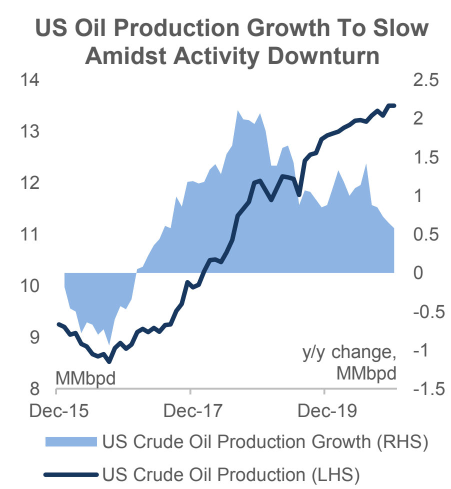
Sources: Scotiabank Economics, Bloomberg.

Chart 4



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

Chart 5



Sources: Scotiabank Economics, EIA STEO.

METALS: COPPER'S PAIN IS GOLD'S GAIN

The prices of major metals diverge strongly in moments of economic weakness and uncertainty such as we're experiencing today. While base metals, most notably copper, have waned amidst weak investment and a sluggish Chinese economy, precious metals like gold have traded at their strongest levels since the eurozone crisis as investors retreat into haven assets and central banks' prior tightening paths give way to renewed interest rate cuts.

Copper is typically best at embodying the narrative facing metals markets and today is no different. Prices are sitting at less than $2.60/lb, down 25% since mid-2018 despite continued global deficits and still-low exchange-listed inventories. We are lowering our base metals price forecasts and copper is now expected to average $2.75/lb in 2020 before finally rising to $3.00/lb in 2021. While the near-term doesn't look particularly strong for copper pricing, the longer-term promise of large supply deficits in the early 2020s remains a constant source of future upward price pressure to front-run those shortages (chart 6).

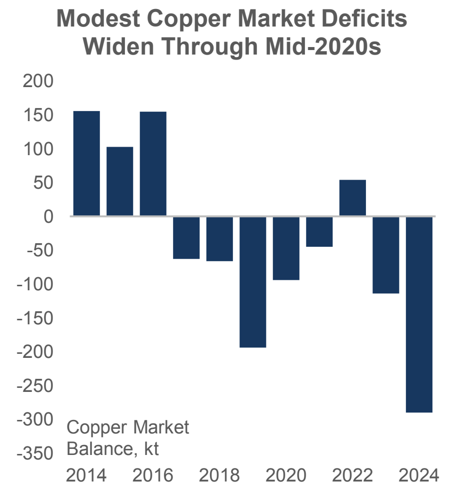
Gold is experiencing its brightest moment since the eurozone crisis and a bar of the stuff was fetching more than $1,500 per ounce this past month. Looser monetary policy has reduced the opportunity cost of holding non-yielding bullion while mounting political risks—from trade wars to Brexit to impeachment—are providing plenty of safe haven demand (chart 7). Silver is an interesting enigma in this market as prices are yanked skyward despite generally sour fundamentals, which are made worse if one is to factor for the manufacturing malaise weighing down the base metals. We believe that silver's current strength is entirely a result of spillover from gold's impressive rally. Given the gold market's considerably larger overall size, even small leakage from that pool can cause pronounced increases in silver prices and this likely accounts for much of silver's current strength.

Table 1

Commodities	2000–2018			Annual Average				
	Low	Avg.	High	2017	2018	2019f	2020f	2021f
WTI Oil (USD/bbl)	17	62	145	51	65	57	55	62
Brent Oil (USD/bbl)	18	65	146	55	72	64	59	65
WCS - WTI Discount* (USD/bbl)	-50	-17	-6	-13	-26	-13	-19	-24
Nymex Natural Gas (USD/mmbtu)	1.64	4.74	15.38	3.02	3.07	2.61	2.64	2.75
Copper (USD/lb)	0.60	2.41	4.60	2.80	2.96	2.70	2.75	3.00
Zinc (USD/lb)	0.33	0.87	2.10	1.31	1.33	1.15	1.08	1.05
Nickel (USD/lb)	2.00	7.06	24.58	4.72	5.95	6.50	7.50	8.00
Aluminium (USD/lb)	0.56	0.87	1.49	0.89	0.96	0.90	0.90	0.90
Iron Ore (USD/tonne)	39	101	194	72	70	90	72	65
Metallurgical Coal (USD/tonne)	39	135	330	187	206	184	150	150
Gold, London PM Fix (USD/oz)	256	910	1,895	1,257	1,268	1,400	1,550	1,475
Silver, London PM Fix (USD/oz)	4.07	14.85	48.70	17.05	15.71	16.50	18.75	17.75

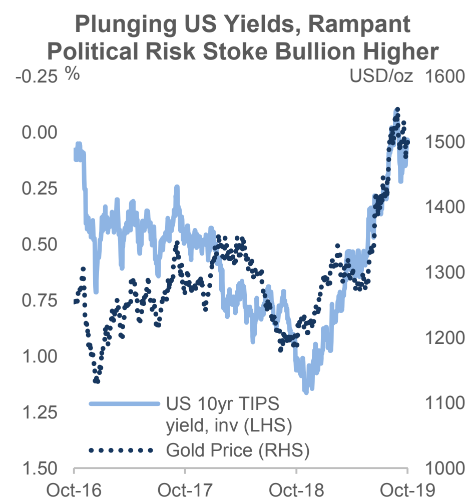
* 2008–18 average.
Sources: Scotiabank Economics, Bloomberg.

Chart 6



Sources: Scotiabank Economics, Wood Mackenzie.

Chart 7



Sources: Scotiabank Economics, Bloomberg.

Foreign Exchange

- **USD benefits from safe-haven demand amid trade, Brexit and political uncertainties.**
- **CAD is a top G-10 performer in YTD terms but is struggling to respond to positives.**

Persistent **US dollar (USD)** strength, trade frictions, slowing global growth trends and a possible dénouement (or not) to Brexit will likely shape FX trading in the major currencies in the final quarter of the year (and possibly beyond). The USD has fared better than we had expected at the start of the year and remains resilient amid softer US yields and signs that the US economy is losing momentum. A good part of the reason for the USD's strong performance stems from the fact that trade wars, Brexit and other geo-political uncertainties have embellished the USD's safe-haven status and lifted investor demand for the currency.

Analysis by Scotiabank Economics estimates that uncertainty has boosted the broad effective value of the USD by some 11% relative to its pre-election level. And, with US political risk starting to rise amid the clamour over an impeachment inquiry and the slow-burn start to the US presidential cycle, it is possible, if not likely, that uncertainty will continue to affect the exchange rate for some time to come and prevent or slow the downturn in the USD that we expect to unfold from a fundamental perspective.

Even in the shorter term, we can note some upside risks for the USD, which often experiences stronger demand late in the year (especially through October and November). The USD's typical, "seasonal" uplift in Q4, reflecting demand for USD liquidity running into year end, may be amplified this year by signs of tightness in USD funding markets that have emerged recently, prompting the Federal Reserve to restart short-term repo operations in a bid to ease liquidity tensions.

Fundamentally, we continue to feel that the long-term secular trend in the USD is geared towards softness amid rising US structural imbalances and slowing growth. Moreover, there are evident concerns—on both sides of the US political aisle—that a strengthening USD is perhaps less desirable. The caveat here is that global uncertainties need to ease in order for investors to feel comfortable enough to redeploy capital elsewhere and reduce the USD's risk premium.

In the UK, some clarity over the Brexit situation should emerge in the next few weeks, with the UK due to exit the EU on October 31st. However, at this late stage, there remains a fair degree of uncertainty on how (or even if) the departure will unfold. We continue to assume a negotiated departure as our base case but, realistically, time is getting very short for an agreement to be reached. An extension request—mandated by UK law—should be made if no progress emerges at the EU summit meeting on October 17–18th. But UK Prime Minister Johnson has insisted that the UK will leave the EU on the 31st and made it clear that he is opposed to an extension demand. This is raising concerns that the government might bypass the extension law via contingency measures and exit without a deal.

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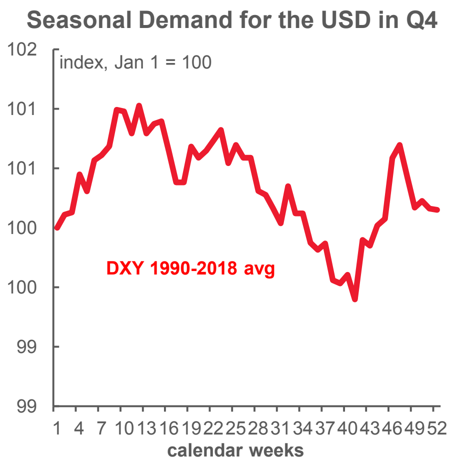
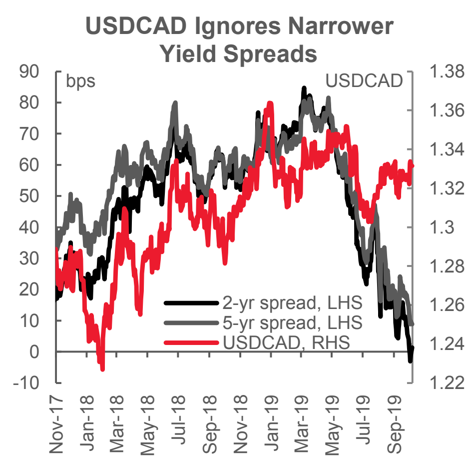
Chart 1



Sources: Scotiabank Economics, Scotiabank FICC Strategy, Macrobond.

Chart 2



Sources: Scotiabank Economics, Macrobond, Scotiabank FICC Strategy.

The pound (GBP) is liable to vacillate in line with the evolving narrative on Brexit in the next few weeks; a no-deal exit will see the GBP retest the recent low just under 1.20 (at least) versus the USD while a delay will trigger a minor relief rally to the 1.25 area. We think that even in the event of a Brexit deal that sees the UK depart on schedule, the potential for immediate gains in what we consider to be a quite under-valued pound may be somewhat limited. Brexit—negotiated or not—may further dampen UK GDP growth and tilt the Bank of England towards more policy accommodation. We also think that Prime Minister Johnson is likely to go to the country at the earliest opportunity after Brexit is achieved in order to try and bolster the Conservatives' position in parliament. Deeper gains in the GBP will require more sustainable signs of economic and political stability in the UK.

In Europe, growth trends have been depressed by Brexit and global trade tensions, undercutting activity in the German export machine. In the context of weak activity and persistently low inflation, the European Central Bank decision to cut rates deeper into negative territory and restart asset purchases was no surprise. Although Eurozone-US short term rate differentials continue to narrow gradually, the USD's higher nominal and real yields leave it at a clear advantage in the competition to attract global capital. The euro (EUR) also remains subject to Brexit-related volatility, with a no-deal Brexit adding to EUR-negative forces and a delay or negotiated departure likely to lift the EUR somewhat.

The Canadian dollar (CAD) remains one of the top-performing currencies in the G-10 space year to date. But USDCAD held in a tight range through the latter part of Q3 and may remain better supported into year end, given the USD's tendency to appreciate in Q4. The CAD has failed to gain support from firm oil prices or sharply narrower US-Canada interest rate differentials in the past few months, leaving it looking a little "under-valued" versus the USD from our perspective. We expect the CAD to gain modestly over the course of 2020, given that domestic growth should match, or slightly better US growth, notwithstanding a modest relaxation in Bank of Canada (BoC) monetary policy settings. Relatively tighter monetary conditions in Canada versus our G-10 peers suggest that the CAD will remain firm on the crosses. This is especially the case against the Australian and New Zealand dollars where benchmark interest rates are at a record low and—unusually—well below the BoC's benchmark rate.

Despite persistently low inflation and growth prospects that have been trimmed back by global trade frictions, we expect **the yen (JPY)** to appreciate slightly against the USD in the coming year. Bank of Japan policy makers remain under pressure to boost inflation but may hold off on implementing additional stimulus measures until the impact of the October 1st consumption tax increase becomes clear. Scope for additional, large-scale asset purchases may be limited in any case. We expect narrower US/Japan interest rate differentials to support modest JPY appreciation in the longer run and expect Japan's large and persistent current account surpluses (well above 3% of GDP) to cushion the exchange rate in periods of heightened market volatility or uncertainty.

Latam currencies have followed broad-based greenback strength in recent months as concerns over the global economy and better-than-expected data out of the US temporarily erased Fed policy easing odds— although US data has disappointed more recently. In the short term, we anticipate that Latam FX will continue to depreciate as the region's central banks embark on an easing agenda while subdued commodity prices will provide little support for the currencies. Domestic and international political risks are also set to dampen regional currency strength for the remainder of 2019 and into 2020, although an easing of trade tensions in the coming year could breathe some life back into the Latam crosses.

As the country battles heavily subdued business and investor confidence, the Mexican economy has narrowly avoided a recession while it expands at its slowest pace in a decade with scarce signs of an incoming pick-up in activity. Alongside a worsening economic outlook, concerns over the fiscal sustainability of Pemex—the state-controlled oil company—loom negatively over the creditworthiness of the Mexican government and will continue to limit any MXN upside. While the risk of US tariffs on Mexican imports appears to have abated, and US-China trade talks are set to resume, investor sentiment toward Mexican assets—and EM more generally—remains weak amid sluggish growth and a less-than-market-friendly administration. We anticipate that Banxico will cut its policy rate by an additional 50 bps to 7.00%—where we expect it will remain through our forecast horizon—in the first quarter of 2020 as the Mexican central bank tracks the Fed.

The Brazilian real (BRL) has stabilised around the 4.15–4.20 mark after losing around 11% of its value against USD since a recent high in mid-July alongside a cumulative reduction of 100 bps in the Banco Central do Brasil's policy rate and concerns over the country's fiscal position. The BRL will prove sensitive to developments on the fiscal reform front, while positive news out of trade discussions between Brazil's two main trading partners, the US and China, could provide a boost for BRL in the near term. While we anticipate that the BCB will resume a tightening path over our forecast horizon, monetary policy will remain relatively accommodative as the central bank's real rate will continue below its neutral level for the foreseeable future. For the moment, pension reform—on track for enactment in late-October—has eased immediate concerns over the public deficit. However, further progress on the fiscal front will be required to ease investor concerns with government debt totaling around 90% of GDP alongside a budget deficit of around 7% of GDP. We expect that BRL will remain on a depreciating trend alongside precarious public finances.

The Colombian economy remains a relative outperformer within Latin America with real GDP expected to grow by 3.2% this year—significantly above Mexico and Brazil (0.2% and 1.0%, respectively) while edging ahead of Chile and Peru (2.7% and 2.3%, respectively)—and average 3.6% in 2020–21. Owing to improving economic growth and around-target inflation, BanRep is part of a small club of central banks around the globe set to hold monetary conditions steady—and possibly even tighten—over this year and next. The Colombian peso (COP) is expected to edge higher from all-time lows at present as USD is expected to give back some of its recent gains and as Colombian rate differentials with the US and with its regional peers widen.

The Peruvian sol (PEN) and Chilean peso (CLP) will be at the mercy of commodity prices and developments on the US-China trade negotiations front through our forecast horizon. The CLP is nearing a four-year low alongside declining copper prices amid weaker global demand, particularly from China. We see some upside room for CLP into year-end as the domestic economy gathers steam on the back of fiscal stimulus and relatively accommodative monetary policy. Although the slump in copper has also put some downward pressure on PEN, it has traded within an especially narrow range of between 3.20 and 3.40 soles per USD since early 2016; we forecast it will remain around the upper bound of this range through the forecast horizon alongside only a slight improvement in copper prices.

The outcome of US-China trade talks and the October FOMC monetary policy decision will drive EM Asian currencies in 4Q2019. Both the US and China have made conciliatory gestures, raising expectations that the 13th round of the high-level trade negotiations could deliver a minor breakthrough. The Chinese yuan (CNY & CNH) will likely trade towards 7.0 and 6.9 if the US and China agree to a trade deal. An agreement would also buoy export-driven currencies such as the South Korean won (KRW) and Taiwanese dollar (TWD). The Thai baht (THB) could advance as well but to a lesser extent given its year-to-date outperformance and the Thai regulator's concern that THB strength is eroding the nation's export competitiveness. Rising amounts of negative-yielding debt will prompt investors to chase the high-yielding regional currencies should the US-China trade tensions de-escalate. Alternatively, a breakdown in the upcoming trade talks will drive USDCNY towards 7.20 with the PBoC's acquiescence, and undermine other regional currencies amid intensifying risk aversion.

Continued civil unrest in Hong Kong is expected to keep weighing on the Hong Kong dollar (HKD). Meanwhile, the Singapore dollar (SGD) will likely stay soft amid expectations that the Monetary Authority of Singapore will ease policy via the exchange rate, its main monetary policy tool, in response to sluggish growth.

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APPENDIX 1

International	2000–18	2018	2019f	2020f	2021f	2000–18	2018	2019f	2020f	2021f
	Real GDP (annual % change)					Consumer Prices (y/y % change, year-end)				
World (based on purchasing power parity)	3.9	3.7	2.9	3.1	3.3					
Canada	2.1	1.9	1.6	1.8	1.9	1.9	2.0	2.0	1.9	2.5
United States	2.1	2.9	2.2	1.4	1.8	2.2	2.2	1.9	2.2	2.2
Mexico	2.2	2.0	0.2	1.0	2.0	4.5	4.8	3.4	3.8	3.7
United Kingdom	1.9	1.4	1.1	1.2	1.6	2.1	2.1	1.8	2.0	2.1
Eurozone	1.4	1.9	1.0	1.1	1.3	1.7	1.5	1.2	1.3	1.5
Germany	1.4	1.5	0.5	0.8	1.2	1.5	1.6	1.3	1.4	1.6
France	1.4	1.7	1.3	1.3	1.4	1.4	1.6	1.3	1.4	1.5
China	9.1	6.6	6.1	6.0	5.8	2.3	1.8	3.0	2.3	2.5
India	7.1	7.4	5.8	6.7	7.4	6.5	2.1	3.7	4.5	5.0
Japan	0.9	0.8	0.8	0.5	1.2	0.1	0.3	1.5	0.6	0.8
South Korea	3.9	2.7	1.9	2.3	2.5	2.5	1.3	0.6	1.6	2.1
Australia	2.9	2.8	1.8	2.4	2.5	2.7	1.8	1.6	1.9	2.1
Thailand	4.1	4.1	2.4	2.1	2.7	1.7	0.4	0.7	1.3	1.8
Brazil	2.4	1.1	1.0	1.8	2.1	6.4	3.8	3.9	4.6	4.1
Colombia	3.8	2.6	3.2	3.6	3.6	5.0	3.2	3.7	3.2	3.1
Peru	4.9	4.0	2.3	3.0	3.5	2.7	2.2	2.0	2.0	2.3
Chile	3.9	4.0	2.7	3.2	3.0	3.2	2.6	3.1	2.6	3.0
Commodities										
	(annual average)									
WTI Oil (USD/bbl)	62	65	57	55	62					
Brent Oil (USD/bbl)	65	72	64	59	65					
WCS - WTI Discount* (USD/bbl)	-17	-26	-13	-19	-24					
Nymex Natural Gas (USD/mmbtu)	4.74	3.07	2.61	2.64	2.75					
Copper (USD/lb)	2.41	2.96	2.70	2.75	3.00					
Zinc (USD/lb)	0.87	1.33	1.15	1.08	1.05					
Nickel (USD/lb)	7.06	5.95	6.50	7.50	8.00					
Aluminium (USD/lb)	0.87	0.96	0.90	0.90	0.90					
Iron Ore (USD/tonne)	101	70	90	72	65					
Metallurgical Coal (USD/tonne)	135	206	184	150	150					
Gold, London PM Fix (USD/oz)	910	1,268	1,400	1,550	1,475					
Silver, London PM Fix (USD/oz)	14.85	15.71	16.50	18.75	17.75					

* 2008-18 average.

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

APPENDIX 2

North America	2000–18	2018	2019f	2020f	2021f	2000–18	2018	2019f	2020f	2021f
	Canada (annual % change, unless noted)					United States (annual % change, unless noted)				
Real GDP	2.1	1.9	1.6	1.8	1.9	2.1	2.9	2.2	1.4	1.8
Consumer spending	2.9	2.1	1.7	1.8	1.9	2.4	3.0	2.5	2.0	2.0
Residential investment	3.4	-1.5	-1.7	3.1	2.5	-0.3	-1.5	-2.6	0.1	1.6
Business investment*	2.2	2.2	-2.3	3.0	2.3	3.2	6.4	2.6	1.1	2.3
Government	2.2	3.0	1.6	1.7	1.6	1.1	1.7	2.3	1.7	1.6
Exports	1.4	3.2	2.7	2.4	2.3	3.7	3.0	0.0	1.2	2.1
Imports	3.0	2.9	0.9	2.4	2.4	3.8	4.4	2.0	2.9	2.8
Nominal GDP	4.2	3.6	3.2	3.8	4.3	4.1	5.4	4.0	3.1	3.7
GDP deflator	2.1	1.7	1.6	1.9	2.4	2.0	2.4	1.7	1.6	1.9
Consumer price index (CPI)	1.9	2.3	1.9	2.0	2.2	2.2	2.4	1.8	2.2	2.2
CPI ex. food & energy	1.6	1.9	2.2	2.1	2.0	2.0	2.1	2.1	2.2	2.1
Pre-tax corporate profits	0.0	0.5	1.7	3.4	2.0	4.9	3.4	-0.2	2.7	1.8
Employment	1.4	1.3	2.1	1.0	1.0	0.8	1.7	1.5	1.0	1.0
Unemployment rate (%)	7.0	5.8	5.7	5.9	5.9	6.0	3.9	3.8	4.0	4.2
Current account balance (CAD, USD bn)	-20.8	-58.5	-35.9	-28.6	-24.5	-500	-491	-582	-661	-723
Merchandise trade balance (CAD, USD bn)	20.6	-22.0	-10.6	-8.5	-8.2	-691	-887	-901	-987	-1064
Federal budget balance (FY, CAD, USD bn)	-4.4	-19.0	-14.0	-19.8	-14.1	-552	-779	-1,008	-1,034	-1,097
percent of GDP	-0.3	-0.9	-0.6	-0.8	-0.6	-3.7	-3.8	-4.7	-4.7	-4.8
Housing starts (000s, mn)	201	213	210	206	202	1.26	1.25	1.24	1.26	1.26
Motor vehicle sales (000s, mn)	1,694	1,983	1,940	1,915	1,915	15.7	17.2	17.0	17.0	17.1
Industrial production	1.0	3.1	0.9	2.1	1.8	0.9	4.0	1.0	1.5	1.9
	Mexico (annual % change)									
Real GDP	2.2	2.0	0.2	1.0	2.0					
Consumer price index (year-end)	4.5	4.8	3.4	3.8	3.7					
Current account balance (USD bn)	-14.6	-22.0	-16.3	-20.0	-25.6					
Merchandise trade balance (USD bn)	-7.7	-13.6	-7.0	-15.1	-17.3					

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

Quarterly Forecasts	2019		2020				2021			
Canada	Q3e	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Real GDP (q/q ann. % change)	1.5	1.2	2.0	2.0	1.4	1.6	2.0	2.1	2.0	1.9
Real GDP (y/y % change)	1.5	1.7	2.1	1.7	1.6	1.7	1.8	1.8	2.0	2.0
Consumer prices (y/y % change)	1.9	2.0	2.1	1.9	1.9	1.9	2.0	2.1	2.2	2.5
Avg. of new core CPIs (y/y % change)	2.0	2.0	2.0	2.0	2.0	2.1	2.1	2.1	2.2	2.2
United States										
Real GDP (q/q ann. % change)	1.8	1.1	1.3	1.3	1.5	1.8	1.9	1.9	2.0	2.0
Real GDP (y/y % change)	2.0	2.0	1.6	1.4	1.3	1.5	1.6	1.7	1.9	1.9
Consumer prices (y/y % change)	1.8	1.9	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
CPI ex. food & energy (y/y % change)	2.1	2.1	2.1	2.2	2.2	2.2	2.1	2.1	2.1	2.1
Core PCE deflator (y/y % change)	1.6	1.8	1.8	1.9	1.9	1.9	1.9	1.9	2.0	2.0

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

APPENDIX 3

	2019		2020				2021			
Central Bank Rates	**Q3**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Americas				(%, end of period)						
Bank of Canada	1.75	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
US Federal Reserve (upper bound)	2.00	1.75	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
Bank of Mexico	7.75	7.50	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00
Central Bank of Brazil	5.50	5.50	5.50	5.50	6.00	6.50	6.75	6.75	6.75	6.75
Bank of the Republic of Colombia	4.25	4.25	4.25	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Central Reserve Bank of Peru	2.50	2.25	2.25	2.25	2.25	2.25	2.50	2.50	2.50	2.50
Central Bank of Chile	2.00	1.75	1.75	1.75	1.75	2.00	2.25	2.50	2.75	3.00
Europe										
European Central Bank MRO Rate	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
European Central Bank Deposit Rate	-0.50	-0.50	-0.50	-0.50	-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	0.75
Asia/Oceania										
Reserve Bank of Australia	1.00	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Bank of Japan	-0.10	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15
People's Bank of China*	4.35	4.10	4.05	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Reserve Bank of India	5.40	4.90	4.75	4.75	4.75	4.75	4.75	5.00	5.25	5.50
Bank of Korea	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.50	1.50
Bank of Thailand	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.50	1.50
Currencies and Interest Rates										
Americas				(%, end of period)						
Canadian dollar (USDCAD)	1.32	1.30	1.28	1.28	1.25	1.25	1.25	1.25	1.25	1.25
Canadian dollar (CADUSD)	0.76	0.77	0.78	0.78	0.80	0.80	0.80	0.80	0.80	0.80
Mexican peso (USDMXN)	19.73	20.83	21.08	20.93	21.04	21.36	21.47	21.28	21.34	21.65
Brazilian real (USDBRL)	4.16	4.18	4.08	4.11	4.07	4.18	4.21	4.24	4.27	4.30
Colombian peso (USDCOP)	3,478	3,310	3,295	3,280	3,265	3,250	3,233	3,215	3,198	3,180
Peruvian sol (USDPEN)	3.37	3.35	3.40	3.38	3.43	3.42	3.37	3.38	3.34	3.35
Chilean peso (USDCLP)	729	690	670	660	650	640	635	635	635	635
Europe										
Euro (EURUSD)	1.09	1.10	1.12	1.15	1.19	1.20	1.20	1.20	1.22	1.22
UK pound (GBPUSD)	1.23	1.22	1.25	1.30	1.32	1.36	1.38	1.38	1.40	1.40
Asia/Oceania										
Japanese yen (USDJPY)	108	108	107	107	105	105	103	103	102	102
Australian dollar (AUDUSD)	0.68	0.68	0.69	0.70	0.71	0.72	0.72	0.72	0.74	0.74
Chinese yuan (USDCNY)	7.15	6.90	6.80	6.80	6.70	6.70	6.60	6.60	6.50	6.50
Indian rupee (USDINR)	70.9	68.0	67.0	67.0	66.0	66.0	65.0	65.0	64.0	64.0
South Korean won (USDKRW)	1,196	1,180	1,160	1,160	1,140	1,140	1,120	1,120	1,100	1,100
Thai baht (USDTHB)	30.6	31.0	30.5	30.5	30.0	30.0	29.5	29.5	29.0	29.0
Canada (Yields, %)										
3-month T-bill	1.65	1.40	1.20	1.20	1.25	1.25	1.25	1.25	1.25	1.30
2-year Canada	1.58	1.30	1.20	1.25	1.30	1.30	1.35	1.40	1.45	1.50
5-year Canada	1.40	1.25	1.25	1.30	1.35	1.40	1.45	1.50	1.55	1.60
10-year Canada	1.36	1.30	1.40	1.50	1.55	1.60	1.65	1.70	1.75	1.80
30-year Canada	1.53	1.45	1.55	1.65	1.75	1.80	1.85	1.90	1.95	2.00
United States (Yields, %)										
3-month T-bill	1.85	1.60	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.40
2-year Treasury	1.62	1.40	1.45	1.50	1.50	1.60	1.65	1.70	1.70	1.75
5-year Treasury	1.55	1.35	1.45	1.60	1.70	1.80	1.80	1.85	1.85	1.90
10-year Treasury	1.67	1.50	1.60	1.70	1.85	2.00	2.05	2.10	2.10	2.15
30-year Treasury	2.11	2.05	2.10	2.20	2.35	2.50	2.60	2.70	2.75	2.80

Sources: Scotiabank Economics, Bloomberg.
* 1-year Benchmark Lending Rate will be replaced by the 1-year Loan Prime Rate from Q1 2020

APPENDIX 4

The Provinces					(annual % change except where noted)						
Real GDP	**CA**	**NL**	**PE**	**NS**	**NB**	**QC**	**ON**	**MB**	**SK**	**AB**	**BC**
2000–18	2.1	2.4	1.8	1.3	1.2	1.8	2.0	2.3	2.0	2.8	2.7
2018e	1.9	-2.7	2.6	1.2	0.1	2.5	2.3	1.3	1.6	2.3	2.4
2019f	1.6	2.0	2.1	1.3	0.6	2.4	1.7	1.4	1.3	0.5	2.2
2020f	1.8	0.6	1.9	1.3	0.8	1.6	1.7	1.5	1.5	2.4	2.8
2021f	1.9	0.8	1.8	1.1	0.7	1.6	1.6	1.5	1.7	2.7	2.4
Nominal GDP											
2000–18	4.3	5.6	4.2	3.3	3.4	3.7	3.9	4.4	5.4	5.9	4.7
2018e	3.6	0.5	4.6	3.2	1.9	4.2	3.5	3.1	3.8	4.5	4.4
2019f	3.2	3.5	4.1	3.0	2.2	3.7	3.3	3.4	3.4	1.9	4.4
2020f	3.8	2.9	3.9	3.2	2.4	3.3	3.4	3.3	3.8	4.5	5.4
2021f	4.3	3.7	3.8	2.8	2.1	3.6	3.9	3.3	4.5	5.7	5.1
Employment											
2000–18	1.4	0.6	1.1	0.6	0.4	1.3	1.3	1.0	1.1	2.2	1.5
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	1.1	1.8	2.2	0.6	1.6	2.6	1.2	1.7	0.8	3.0
2020f	1.0	0.0	0.8	0.3	0.2	0.8	1.2	0.6	0.7	1.0	1.5
2021f	1.0	-0.1	0.6	0.1	0.2	0.8	1.0	0.6	0.6	1.2	1.3
Unemployment Rate (%)											
2000–18	7.1	14.3	11.1	8.8	9.5	7.9	7.0	5.1	5.0	5.3	6.5
2018	5.8	13.8	9.4	7.6	8.0	5.5	5.6	6.0	6.1	6.6	4.7
2019f	5.7	12.1	8.9	6.8	8.1	5.2	5.6	5.4	5.4	6.8	4.6
2020f	5.9	12.1	9.0	6.8	8.1	5.4	5.8	5.5	5.5	6.9	4.8
2021f	5.9	12.0	9.1	6.9	8.0	5.5	5.8	5.6	5.4	6.8	4.9
Housing Starts (units, 000s)											
2000–18	200	2.5	0.8	4.3	3.4	44	72	5.2	5.2	34	29
2018	213	1.1	1.1	4.8	2.3	47	79	7.4	3.6	26	41
2019f	210	0.9	1.1	4.6	2.8	49	71	6.8	2.5	27	44
2020f	206	1.3	1.1	4.2	2.4	46	76	6.0	3.3	30	37
2021f	202	1.1	1.0	4.2	2.4	44	78	6.0	3.7	31	32
Motor Vehicle Sales (units, 000s)											
2000–18	1,674	29	6	48	38	415	646	48	45	217	182
2018	1,984	28	8	51	38	449	853	67	47	226	217
2019f	1,935	31	9	51	39	448	810	60	49	223	215
2020f	1,915	26	7	50	38	435	805	58	50	227	219
2021f	1,915	26	7	47	36	435	805	58	51	231	219
Budget Balances, Fiscal Year Ending March 31 (CAD mn)											
2018	-18,961	-911	1	230	67	2,622	-3,672	-695	-303	-8,023	301
2019e	-14,000	-522	14	120	5	2,500	-7,435	-470	-268	-6,711	1,535
2020f*	-19,800	-575	2	31	38	0	-10,252	-360	26	-7,912	179

* NL budget balance in 2020 is net of one-time revenue boost via Atlantic Accord. Sources: Scotiabank Economics, Statistics Canada, CMHC, Budget documents; Quebec budget balance figures are after Generations Fund transfers.

Foreign Exchange Strategy