FORECASTS

U.S. Political Uncertainty is Paired with Solid Economic Fundamentals

Institute of Fiscal Studies and Democracy *Canadian Economic Forecasts* series

January 2017

IFSDEN17A

About this Document

The Institute of Fiscal Studies and Democracy (IFSD) is a Canadian think-tank sitting at the nexus of public finance and state institutions. Fiscal ecosystems include governments, legislatures, the public administration and other key actors and institutions in our political and economic life. This ecosystem, rooted in hundreds of years of political history and economic development, is composed of an intertwined set of incentives, public and private information and a complex and sometimes opaque set of rules and processes based on constitutional law, legislative law, conventions and struggles for power. The actors within this system depend on one another as well as the robustness and transparency of information and processes, all underpinned by a society's standards of accountability. It is at this dynamic intersection of money and politics that the Institute of Fiscal Studies and Democracy @uOttawa aims to research, advise, engage and teach. The IFSD has been funded by the Province of Ontario to undertake applied research and student engagement in public finance and its intersection with public administration, politics and public policy. The IFSD undertakes its work in Canada at all levels of government as well as abroad, leveraging partnerships and key relationships with organizations such as the World Bank, OECD, IMF and US National Governors Association.

This report was prepared on the initiative of Randall Bartlett, Chief Economist of the IFSD, under the direction of Kevin Page. The report was edited and designed by Jessica Rached. An external reviewer reviewed this report. The assistance of the external reviewer implies no responsibility for the final product, which rests solely with the IFSD.

IFSD
IFPD

1 Stewart Street, Suite 231
Ottawa, ON K1N 6N5
613-562-5800 x 5628
ifsd.ca | info@ifsd.ca | @IFSD_IFPD

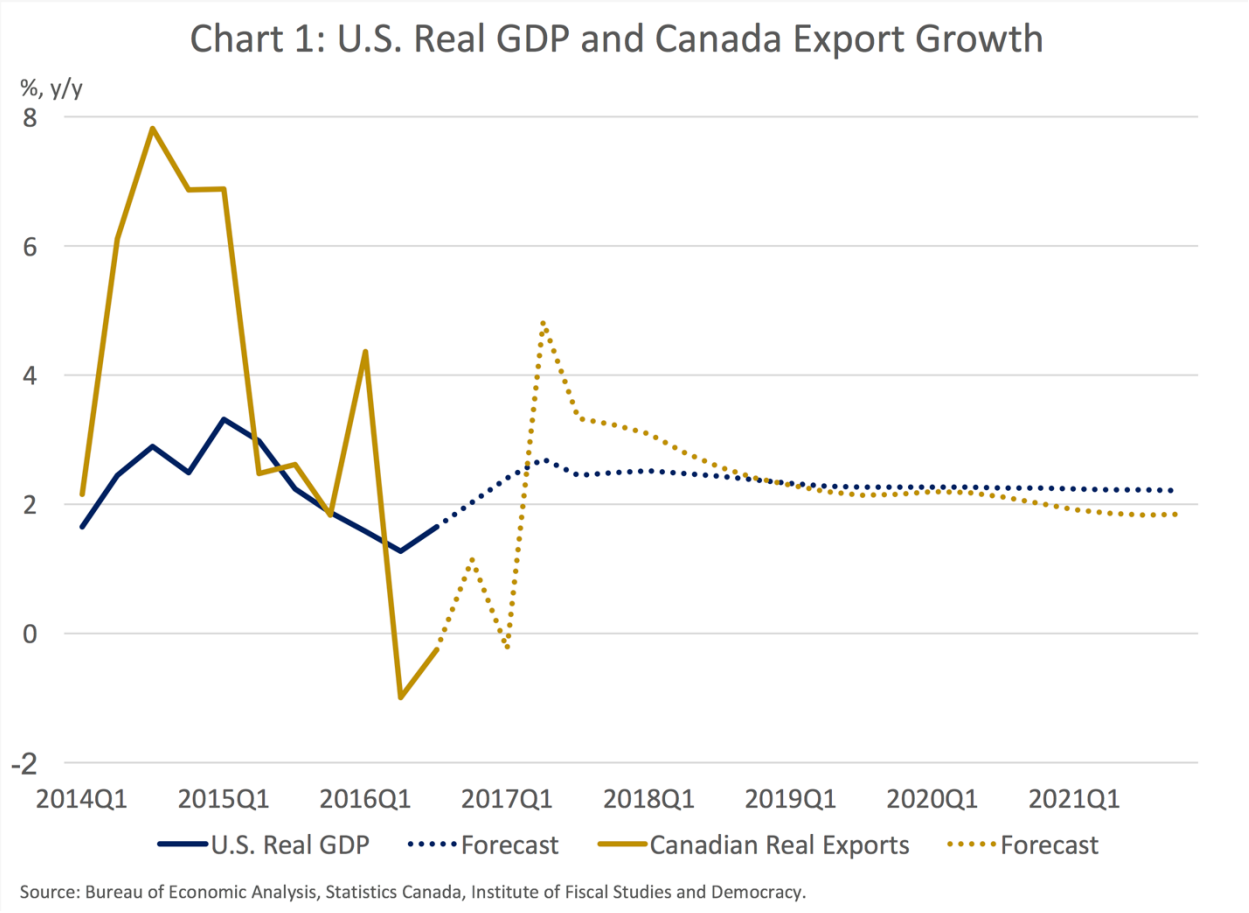
Introduction

It's been a tough couple of years for the Canadian economy. First, the falling price of oil and other commodities caused growth to go into reverse in the first half of 2015. Then, fingers were pointed at the energy sector again for growth dipping into negative territory in the second quarter of 2016, as wildfires in the West caused energy production and exports to temporarily plummet. But even abstracting from the observed weakness in the Canadian oil industry, growth in the rest of the economy couldn't be considered much better than lackluster. And now, with the Canadian housing market in a more vulnerable spot than it has possibly ever been, 2017 looks as though it too could be starting the year on shaky ground.

Thankfully, Canada's 150th birthday year has a few things going for it. First, the US economy is ending 2016 on a strong note as it continues to recover from its post-recession malaise nearly a decade on. With this momentum expected to persist into 2017, demand for Canadian exports from south of the border should continue to improve, which may finally satisfy the aspirations of the Bank of Canada (see Chart 1). Second, the planned infrastructure investment by the federal government should begin to make its way into the Canadian economy. This fiscal impulse comes a year after the Government of Canada and the Bank of Canada expected it, but that is of little surprise when compared with the roll out of the last major round of infrastructure investment, which began in 2009. Third, oil prices look to have stabilized at almost double the lows reached in the first quarter of 2016. And while forward-looking market prices don't suggest they are going to rise much more over the next couple of years, the worst seems to be in the rear view. This should ensure some profitability for energy companies in Canada, although oil prices aren't expected to rise to levels sufficient to spur much in the way of new investment.

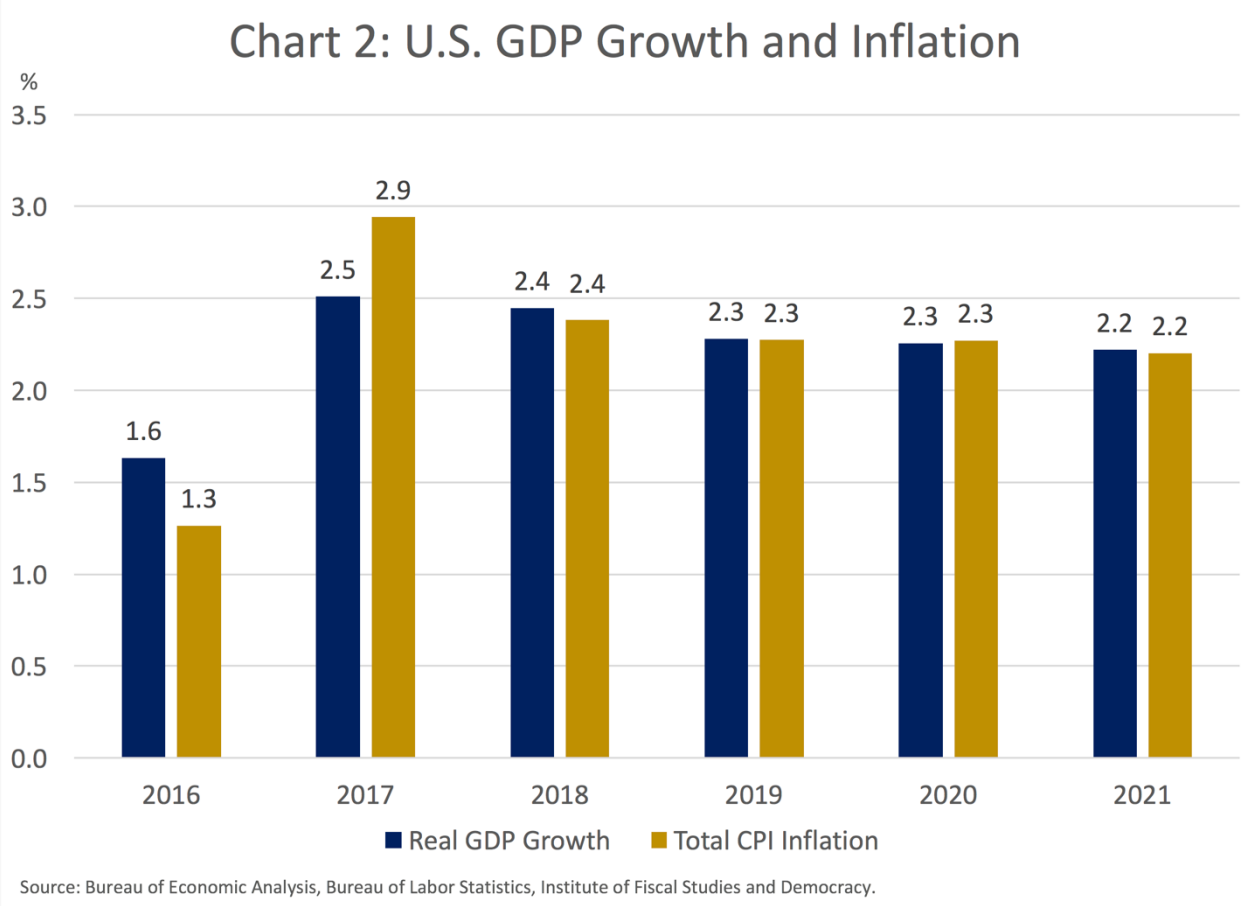
But, of course, political uncertainty reigns supreme in all economic forecasts today. Calling President-elect Donald Trump's economic policies a 'wildcard' is an understatement in the extreme. Indeed, while equity markets have priced in a positive shock to output and inflation from Trump's policies—a reflationary scenario—a sharp increase in trade barriers and decline in immigration could drag on growth while boosting inflation even further—a stagflationary

scenario. Either way, 'The Donald' is likely to keep the world in suspense until he announces otherwise over Twitter. And while there is less uncertainty around infrastructure investment and oil prices, the risks are tilted more to the downside than to the upside in these areas as well.

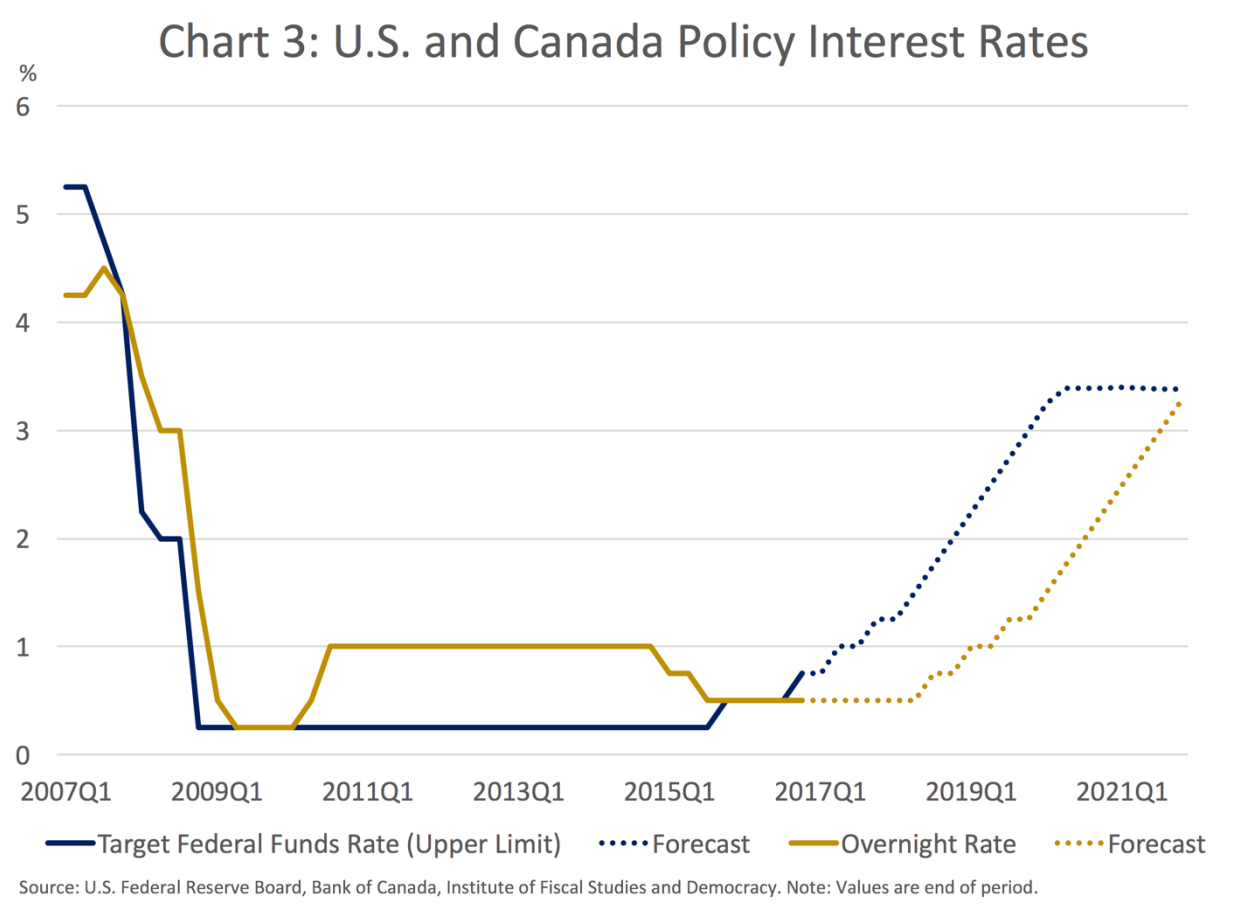


The state of play in the Good Ole US of A

President-elect Donald Trump has the good fortune of taking the helm of the world's largest economy at a time when it is performing better than it has in over a decade and is outperforming all other major advanced economies. Indeed, real GDP growth is expected to hit 2.5% in 2017, besting the moribund pace of 1.6% likely to be posted in the prior year (see Chart 2). And while growth should slow thereafter, it will continue to be supported by fiscal stimulus and highly accommodative monetary policy.



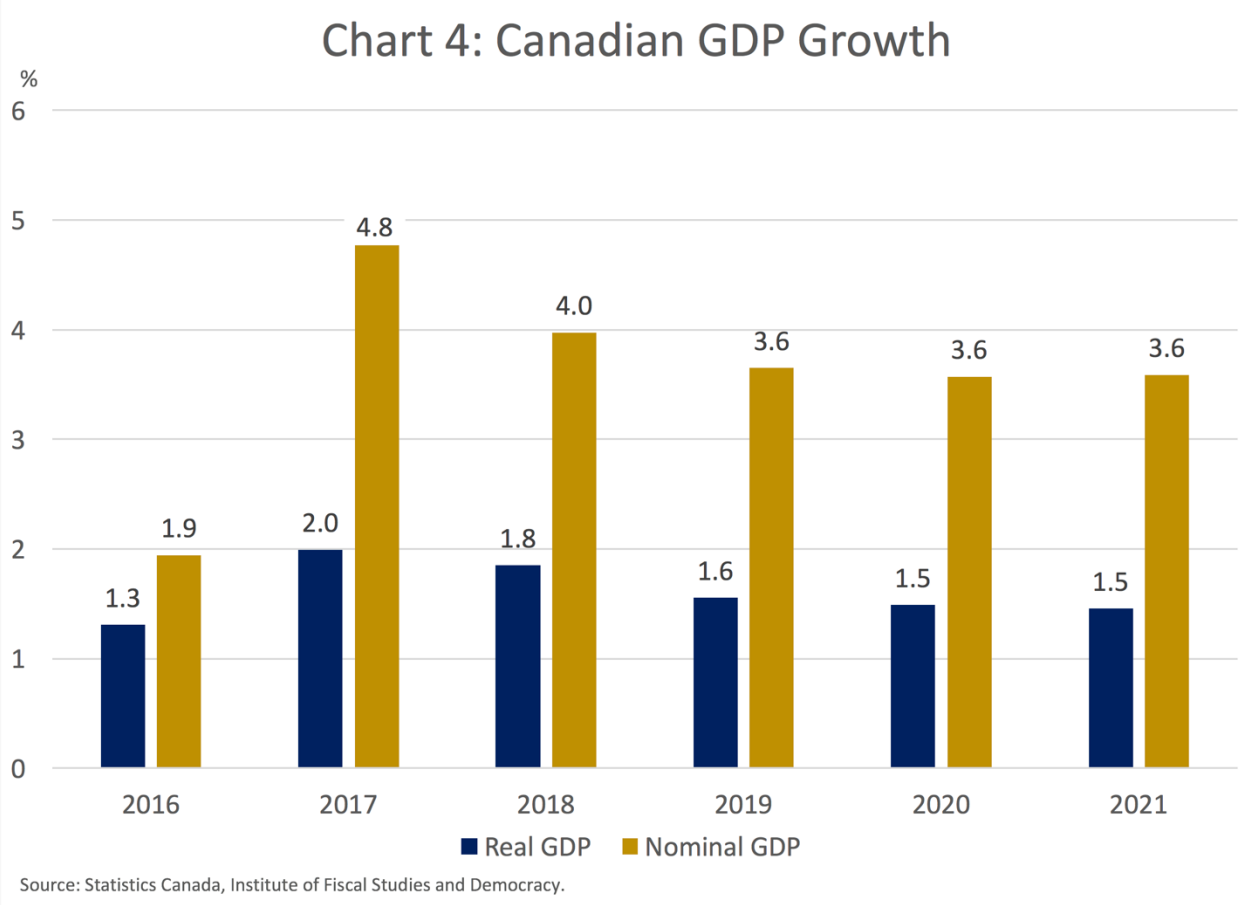
Indeed, in a view that is conservative relative to that of markets, the U.S. Federal Reserve is expected to only very gradually raise interest rates over the next couple of years (see Chart 3). This is because uncertainty around Trump's policies means the Fed is likely to keep some of its powder dry until it knows what fiscal plans are actually in the pipe. Of course, it is important to keep in mind that Trump's advisors have said that the President-elect will not reappoint Fed Chair Janet Yellen when she finishes her term in 2018. As such, it's difficult to know how the next Fed Chair will behave. However, the dual mandate of the Fed is clear—maintain price stability and full employment. And with core inflation forecast to rise above its 2% target and the unemployment rate likely to stay below 5% - the Fed's notional trend level – for the foreseeable future, the likelihood is very much tilted toward more rate hikes as opposed to less.



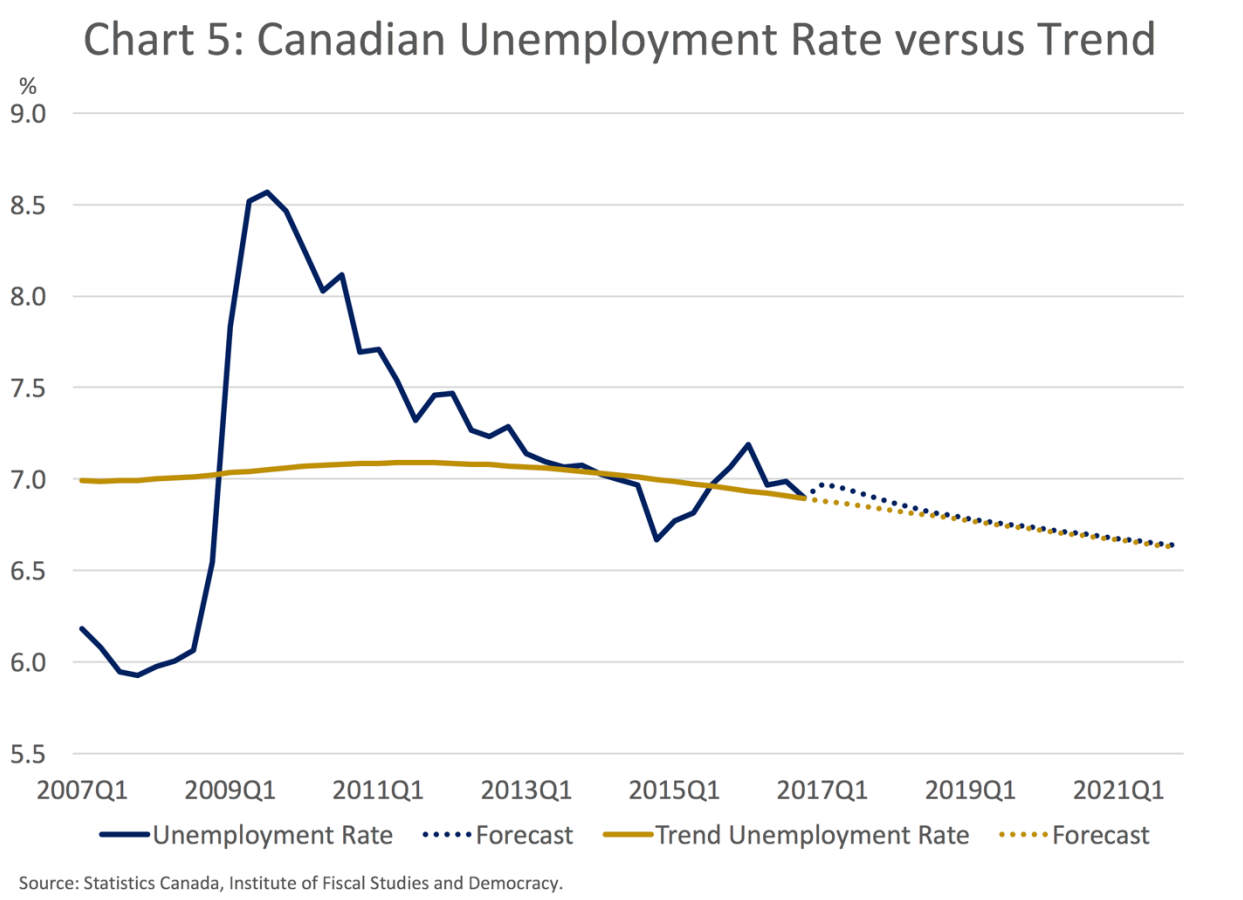
Regardless of the policy mix rolled out by the Trump administration, higher inflation is certainly in the cards stateside (see Chart 2). Given the U.S. economy has nearly returned to trend, any fiscal impulse that boosts economic growth and employment will undoubtedly feed into higher wages, which will elevate core inflation. Tighter immigration will also boost wages by reducing the supply of labour. Tariffs on imports from Mexico and China will push inflation higher as well, although they will apply a drag on growth that could outweigh the benefits of Trump's expansionary fiscal policies. Due to the uncertainty surrounding Trump's policy mix and its economic impact—reflationary versus stagflationary—the forecast presented here assumes a middle-of-the-road outcome.

Have a great year Canada! You only turn 150 once!

So, with the prospects for the U.S. economy looking pretty solid over the next few years, not to mention other major economies around the globe (less the UK), Canada should also fair relatively well in the coming years. Real GDP growth is expected to hit 2.0% in 2017 (see Chart 4)—the best performance since 2014—before gradually decelerating toward its long-run trend growth of around 1.5% by the end of the forecast (see *Demographics Is Destiny: The Impact of Aging On Potential GDP Growth and Neutral Interest Rates* for more information on the IFSD's long-term economic forecast). Notably, nominal GDP growth should be high relative to recent history, particularly in 2017, as the GDP deflator is pushed northward on a rise in CPI inflation and energy prices.

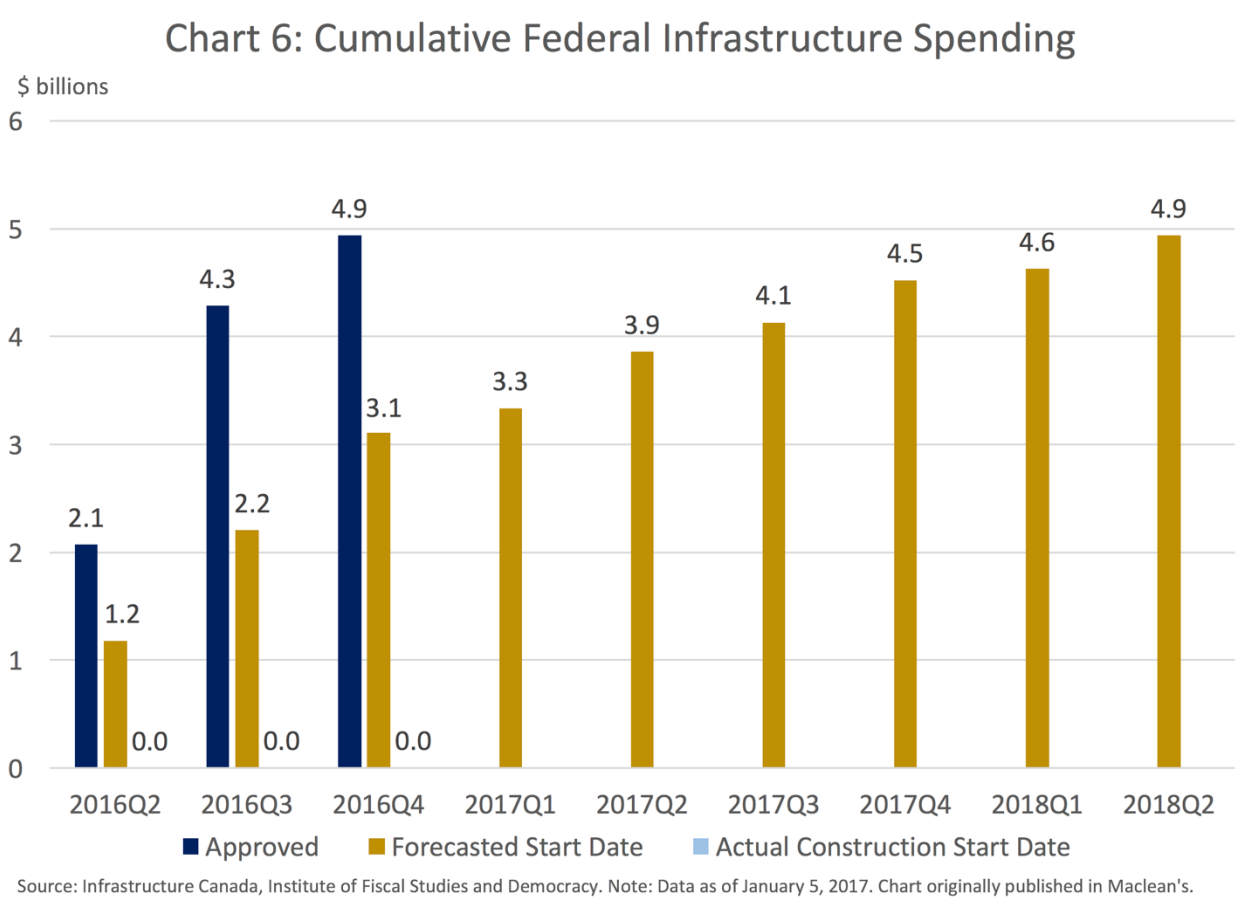


Increased economic activity also bodes well for the labour market in Canada, with the unemployment rate expected to slowly come down from its recent peak of over 7% to 6.6% by the end of 2021 (see Chart 5). That said, employment growth is expected to be very modest in 2017 relative to real and nominal GDP growth. This in part reflects the lagged relationship between output and the labour market, the persistent downdraft from demographics, and the movement from part-time to full-time employment that tends to occur as the economy strengthens.



Much like in the US, this growth will be supported by expansionary fiscal policy and highly accommodative monetary policy. On the former, much hay was made about the infrastructure investments announced in Budget 2016, although it has thus far turned out to be much ado about nothing (see Chart 6). Ground has barely broken on the projects for which federal funds

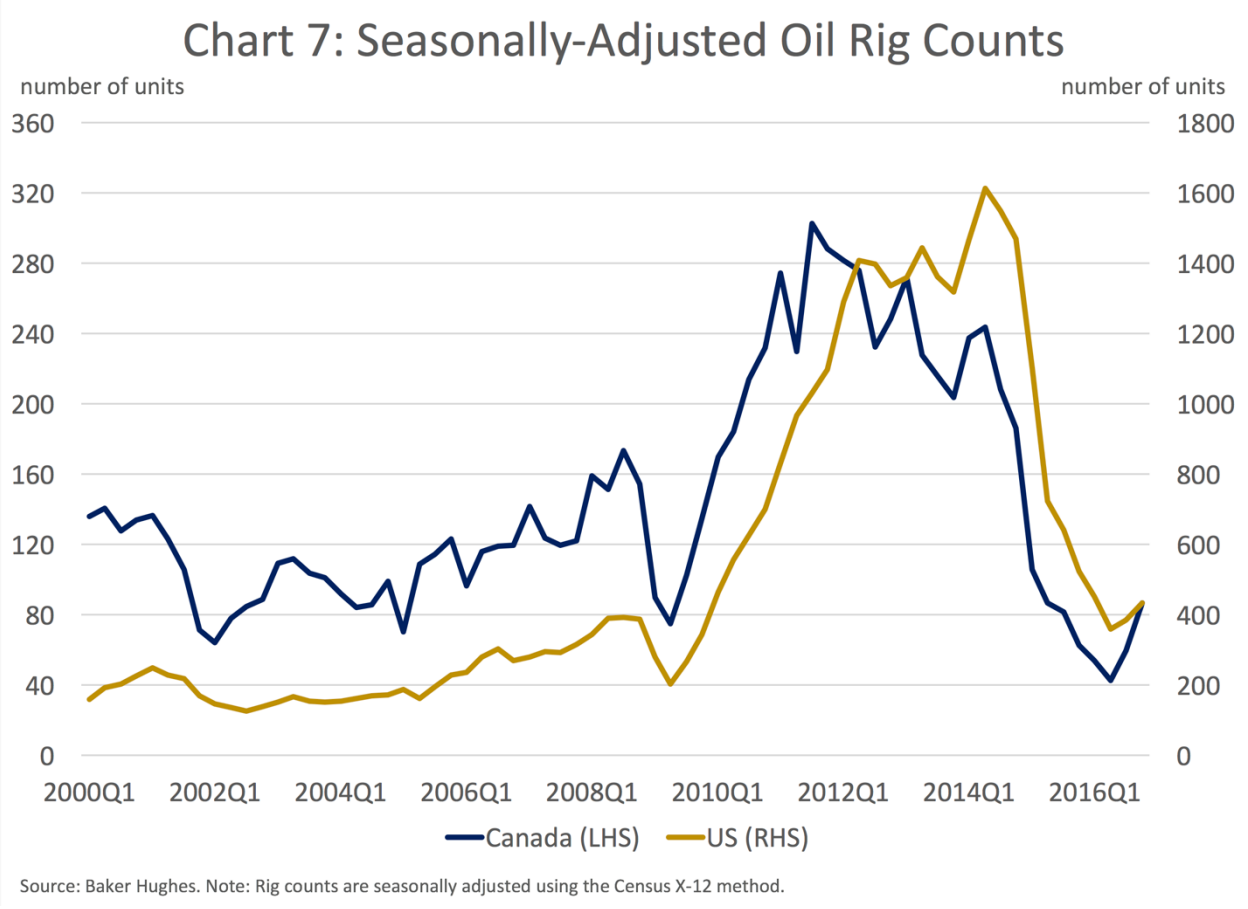
have been approved, although students of history would point out that this should come as no surprise given the pace of infrastructure investment that followed Budget 2009. And while the fiscal impact assumptions baked into Budget 2009 proved far too optimistic, it's tough to blame the current government for adopting similar assumptions. Budgets are political documents after all, and it's always useful to point to the opposition benches for assumptions gone wrong.



However, the political nature of budget documents is a consideration the Bank of Canada should have taken into account before incorporating the fiscal impacts whole hog into their economic forecasts. This lapse in judgment has meant that the Bank of Canada's communications department has had to work overtime to explain the shortfall in growth resulting from a dearth of government investment and what this means for monetary policy. Thankfully, if history proves a useful guide, the federal government and Bank of Canada should

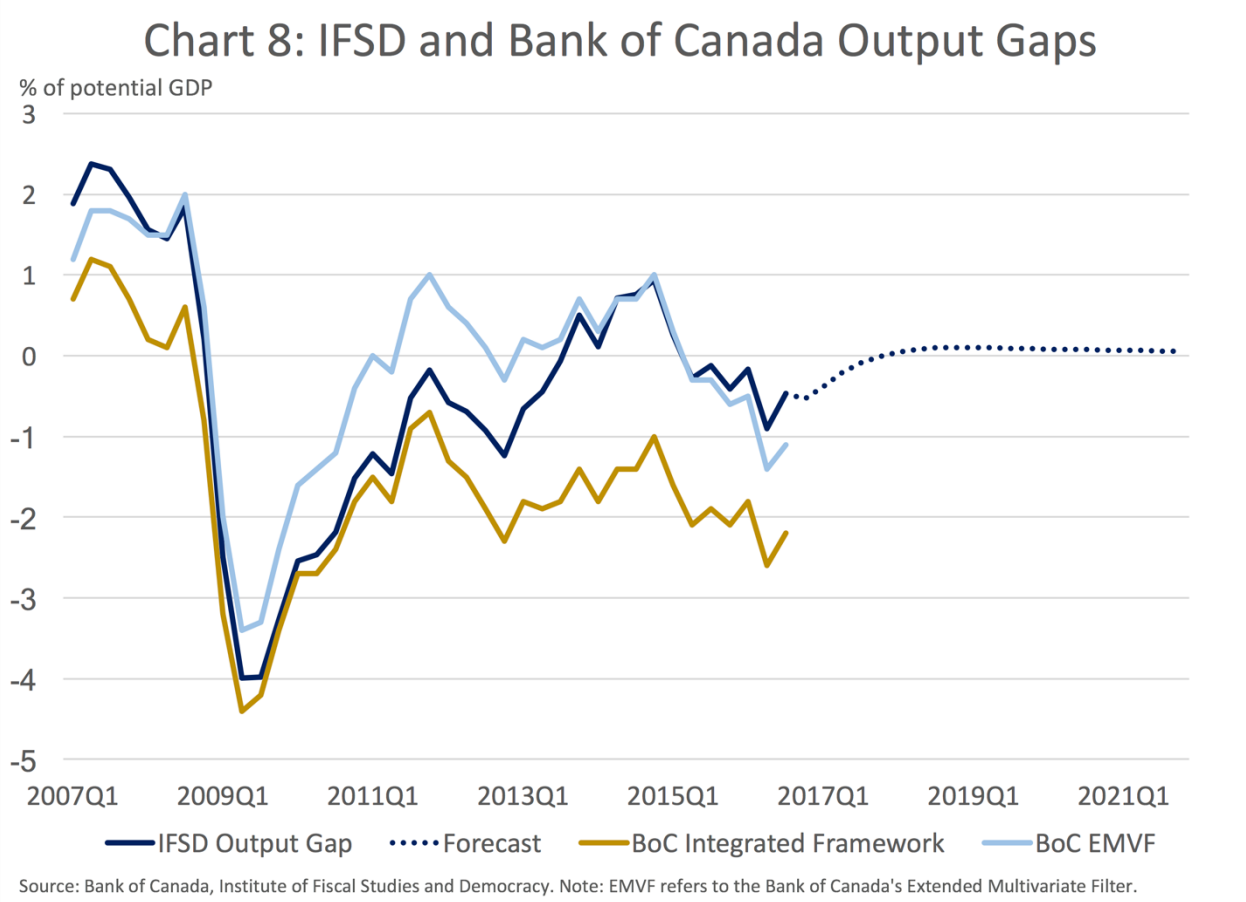
get their wish in the 2017, as the rubber finally begins to meet the road on infrastructure investment.

Another tailwind to the Canadian economy in 2017 is likely to be oil prices. To many, an average price of about US$56 per barrel of West Texas Intermediate (WTI)—the North American light sweet crude benchmark—in 2017 may not seem like much to write home about. However, at more than double the nearly US$26 per barrel daily low reached in the first quarter of 2016, energy companies are generally able to cover their marginal cost of production. Hence the stabilization in rig counts observed on both sides of the border to end 2016 (see Chart 7).



But this price still falls short of the roughly US$65 per barrel thought to be needed to spur meaningful investment in Alberta's oil patch. At the same time, it is more than enough to get shale oil producers excited south of the border. Thus, investment in non-residential structures in Canada should see the bleeding stop in 2017, although any optimism for a rebound in oil sands investment would best remain very guarded.

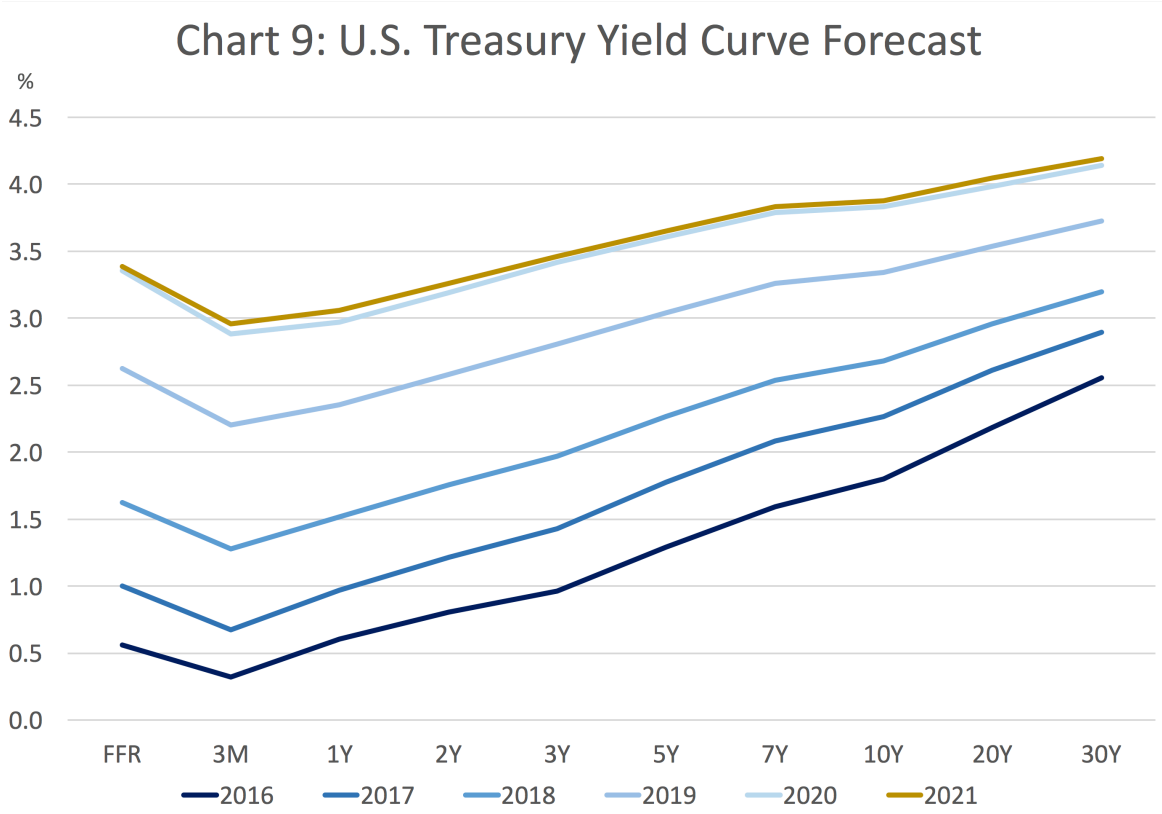
What does this mean for Canadian monetary policy in 2017? Likely very little. Solid GDP growth will help to close the gap between Canadian real output and its potential – known as the output gap (see Chart 8). This will help to support employment growth and, ultimately, wage growth, which will feed into core inflation. But these relationships take time to materialize, and so will allow the Bank to stay on the sidelines for some time, likely until the second half of 2018 (see Chart 3).



And with the Fed expected to continue hiking interest rates over this same period, the Canadian dollar isn't anticipated to retake much more in the way of lost ground over the next couple of years. This should help to further the rotation away from the energy sector and toward non-commodity exports – an aspiration the Bank of Canada all but abandoned in 2016. Of course, once again, the 'Trump factor' adds a great deal of uncertainty to this outlook.

Bond yields are no longer bound to hit record lows

But while higher growth and inflation generally spells good news through higher wages, incomes, corporate profits, and equity prices, bonds have found themselves on the losing end of this updraft. This is because expectations for increased growth and inflation, as well as more elevated borrowing to fund deficits, push up bond yields. And higher bond yields mean lower bond prices.

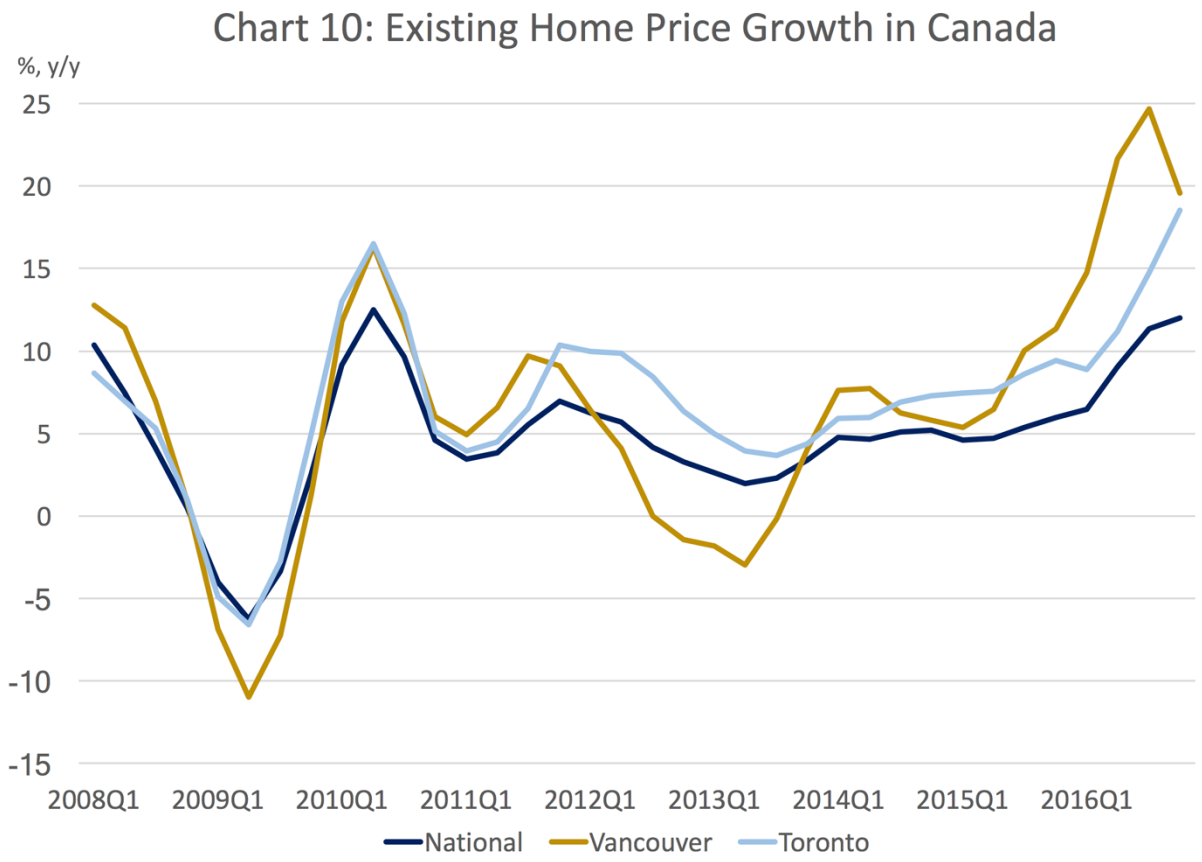


Source: Haver Analytics, Institute of Fiscal Studies and Democracy. Note: Bond yields are in annual average terms.

Rising bond yields have recently been on display most dramatically in the US. There, bonds suffered major losses following Trump's election victory, as the yield curve steepened sharply due to markets pricing in increased borrowing and a reflationary economic scenario. And while the uncertainty surrounding the U.S. outlook remains high, this new higher-yield paradigm appears to be here to stay. Consequently, as the Fed continues to move forward in its hiking cycle over the next few years, the U.S. Treasury yield curve is expected to move higher, broadly in parallel with where it is today (see Chart 9). In contrast, the Canadian yield curve is likely to continue to steepen through mid-2018, as the Bank of Canada stays on hold and the Fed raises rates. However, once the Bank begins to hike the overnight rate, the yield curve is then projected to flatten toward the end of the 5-year forecast, before steepening again as it approaches equilibrium thereafter.

In both countries, consumers and homeowners will be the collateral damage of the increase in borrowing rates, although it will affect each country differently. In the US, the severity of the housing crash and financial crisis left many households deeply credit constrained. The pace of the recovery in the U.S. housing market has therefore been glacial, and the recent increase in yields is likely to be good for lender margins but bad for borrowers, and so be at best a wash.

North of the 49th Parallel, post-recession housing market activity could not have been more different. Until recently, Canadian households were on a mortgage credit binge, particularly in Vancouver and Toronto. Then, in October, the federal government tightened mortgage rules in the hope of cooling the generally pricier end of the market. This policy change was bookended in British Columbia, specifically, by the introduction of 15% foreign buyer's tax in August 2016 and the announcement of Home Owner Mortgage and Equity Partnership Program in December 2016. While the former policy was intended to constrain home price growth in B.C., which it appears to have done very effectively (see Chart 10), the impact of the latter policy is likely to be quite the opposite. On net, taking all of these policies and higher yields into account, the Canadian house market is expected to cool in 2017 and beyond, thereby contributing little to overall GDP growth. However, these measures should have the added benefit of reducing the risks to, and vulnerabilities in, the Canadian economy and financial sector stemming from the hot housing market, as outlined by the Bank of Canada in its December 2016 Financial System Review.



Source: Teranet/National Bank of Canada Composite Home Price Index. Note: The national home price index used is the Composite 11.

The Take Away

While political uncertainty will reign supreme in 2017, particularly in the US, this comes against the backdrop of solid economic fundamentals on both sides of the Canada-U.S. border (see Tables A and B for forecast details). Indeed, under reasonable assumptions, both countries can be expected to perform well on increased infrastructure investment and highly accommodative monetary policy, while inflation is likely to move higher over the outlook. The stabilization in oil prices should also put the brakes on falling energy-sector investment and boost headline inflation. This outlook will support further rate hikes by the U.S. Federal Reserve and set the stage for the Bank of Canada to begin raising interest rates in mid-2018, with sovereign yield curves moving higher as a result.

While useful, keep in mind that the forecast presented here tells only part of the Canadian economic story. A detailed analysis of what to expect in terms of government consumption and investment is also important. As such, the Institute of Fiscal Studies and Democracy will be publishing its federal fiscal forecast in the coming weeks, in order to help inform policymakers as they enter the 2017 budget season. Provincial and territorial economic and fiscal forecasts will soon follow.

Table A. U.S. Economic Outlook, 2016 to 2021	2016	2017	2018	2019	2020	2021
	per cent, unless otherwise indicated					
Nominal GDP level (billions of dollars)	18,570	19,431	20,307	21,169	22,060	22,974
Nominal GDP growth	3.0	4.6	4.5	4.2	4.2	4.1
Real GDP growth	1.6	2.5	2.4	2.3	2.3	2.2
GDP inflation	1.3	2.1	2.0	1.9	1.9	1.9
Total CPI inflation	1.3	2.9	2.4	2.3	2.3	2.2
Core CPI inflation	2.2	2.2	2.4	2.5	2.5	2.4
Unemployment rate	4.9	4.7	4.6	4.5	4.4	4.3
Employment growth	1.7	0.6	0.5	0.4	0.4	0.4
Federal funds rate	0.6	1.0	1.6	2.6	3.4	3.4
Yield on:						
3-month Treasury bill	0.3	0.7	1.3	2.2	2.9	3.0
1-Year Treasury bond	0.6	1.0	1.5	2.4	3.0	3.1
2-Year Treasury bond	0.8	1.2	1.8	2.6	3.2	3.3
3-Year Treasury bond	1.0	1.4	2.0	2.8	3.4	3.5
5-Year Treasury bond	1.3	1.8	2.3	3.0	3.6	3.7
7-Year Treasury bond	1.6	2.1	2.5	3.3	3.8	3.8
10-Year Treasury bond	1.8	2.3	2.7	3.3	3.8	3.9
20-Year Treasury bond	2.2	2.6	3.0	3.5	4.0	4.0
30-Year Treasury bond	2.6	2.9	3.2	3.7	4.1	4.2
WTI crude oil price ($US per barrel)	44.2	55.8	56.0	56.9	58.0	59.2
HH natural gas price ($US per mmbtu)	2.5	3.7	3.8	3.9	3.9	4.0

Source: Bureau of Economic Analysis, Bureau of Labor Statistics, U.S. Census Bureau, U.S. Federal Reserve, Haver Analytics, Institute of Fiscal Studies and Democracy.

Table B. Canada Economic Outlook, 2016 to 2021	2016	2017	2018	2019	2020	2021
	per cent, unless otherwise indicated					
Nominal GDP level (billions of dollars)	2,025	2,122	2,206	2,287	2,368	2,453
Nominal GDP growth	1.9	4.8	4.0	3.6	3.6	3.6
Real GDP growth	1.3	2.0	1.8	1.6	1.5	1.5
GDP inflation	0.6	2.7	2.1	2.1	2.1	2.1
Total CPI inflation	1.5	2.3	2.0	2.0	2.0	2.0
Average of core inflation measures	1.8	1.7	1.8	1.9	1.9	2.0
CPI-trim	1.9	1.8	1.8	1.9	2.0	2.0
CPI-median	2.1	2.0	2.0	2.0	2.0	2.0
CPI-common	1.5	1.5	1.6	1.8	1.9	1.9
Unemployment rate	7.0	6.9	6.8	6.8	6.7	6.7
Employment growth	0.6	0.3	0.5	0.4	0.4	0.3
BOC overnight rate	0.5	0.5	0.6	1.1	1.9	2.9
Yield on:						
3-month Treasury bill	0.5	0.5	0.6	1.1	1.8	2.8
1-Year GOC bond	0.5	0.7	1.0	1.6	2.3	3.0
2-Year GOC bond	0.6	0.8	1.2	1.8	2.4	3.1
3-Year GOC bond	0.6	0.9	1.2	1.9	2.5	3.2
5-Year GOC bond	0.8	1.0	1.3	1.9	2.5	3.2
7-Year GOC bond	1.0	1.2	1.4	1.9	2.6	3.3
10-Year GOC bond	1.3	1.4	1.6	2.0	2.6	3.3
30-Year GOC bond	1.9	2.0	2.0	2.4	2.9	3.5
WTI crude oil price ($US per barrel)	44.2	55.8	56.0	56.9	58.0	59.2
HH natural gas price ($US per mmbtu)	2.5	3.7	3.8	3.9	3.9	4.0
Exchange rate ($US/$CN)	75.5	76.5	77.0	77.6	78.2	79.7

Source: Statistics Canada, Bank of Canada, Haver Analytics, Institute of Fiscal Studies and Democracy.