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What We Think…

Growth

The consensus forecast for global growth in 2018 is 3.6% according to Bloomberg*. The IMF says it will be slightly higher at 3.7%, while the economists at Goldman Sachs forecast an even higher 4%. So why all the optimism? It is the first time in many years that most advanced and emerging economies are expected to grow synchronously, thus bettering expectations a year ago when there were suspect regions – notably Europe and OPEC countries (and even Canada). Global Growth is expected to end 2017 on a positive note, somewhere around 3.6% – higher than the consensus forecast at the end of 2016 of 3.3%. There is positive sentiment surrounding growth for most regions in 2018: advanced economies and emerging markets expected to grow at 2.3% and 4.9% respectively, lead by China at 6.5%.

The US economy is expected to show some of the best gains amongst advanced economies in 2018 (2.6%) versus 2017 (2.3%), despite already being demonstrably stronger than 2016 (1.5%). There are a variety of factors that should support US growth in 2018 including:

- Wage gains due to declining unemployment and minimum wage increases.
- Tax reform that will see corporate tax rates drop meaningfully as well as induce repatriation of US corporate profits held in foreign subsidiaries (amongst other changes), which will benefit consumption through higher dividends to shareholders and wages increases.
- Deregulation in financial services, the energy industry and the FDA.
- Relatively healthy consumer balance sheets that will support spending.
- Infrastructure spending – can 2018 be worse than 2017?
- Capital investment driven by the need to increase productivity and offset the dearth of qualified workers.
- Stock market strength, although vulnerable to correction.
- Improved global growth that should increase US exports.

The Canadian economy has historically benefitted from strong US growth and 2018 would be no different, were it not for the little issue of a NAFTA rewrite or tear-up. However, there is no evidence from legislative manoeuvrings of the Trump administration up to now, that it will be able to bulldoze trade policy changes through Congress. There are many states that support large parts of NAFTA, at least those relating to Canadian-US trade, and we expect this sentiment to prevail over any outcome to negotiations.

NAFTA isn't the whole story for Canadian growth anyways – GDP growth was surprisingly strong and reasonably broad-based in 2017, at 3.0% yoy as of Q3 (consumer 2.3%, government 0.7%, business 0.3%, inventories 0.6% & trade -0.9%). Job growth has been terrific and been the major sponsor of consumer spending. Like the US, Canadian wage growth has been moderate, but is trending upwards nonetheless; and like the US, Canadian minimum wages are also on the increase. Income growth, which has benefitted the increase in jobs, should again support the consumer in 2018, but is unlikely to generate close to the 3% growth experienced in 2017, when the Bank of Canada's near-ZIRP and a weak Canadian dollar fuelled consumption. The housing market has also slowed, most notably in the largest markets of Toronto and Vancouver – a direct response to the respective macroprudential housing policies enacted in those jurisdictions. We expect Canadian growth to be between 2-2.5% this year.

There are risks to the Canadian and US growth forecasts – the unintended consequence of higher interest rates certainly being one of them. Politics and geo-politics are also a concern, especially in the US, but could have knock-on effects in Canada. While American consumers have spent the last decade repairing their balance sheets, the same cannot be said of Canadian consumers with debt to income at 171.1%, which is of particular concern going forward, especially considering the 79%

* All consensus forecasts numbers are from Bloomberg Economic Forecasts as of January.

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contribution to Canadian GDP from consumption. And then of course, there is NAFTA.

The Eurozone is expected to deliver growth of 2.1% in 2018 with positive numbers across the board. 2017 Growth was surprisingly good for the zone, averaging 2.3% with big pickups over the previous year from the major economies of Germany, France and Italy; Spanish growth was also high but lower than in 2016. In general, growth was healthy across the zone, which should be repeated this year. Low rates and aggressive QE from the ECB have ultimately fuelled the recovery and will not be withdrawn quickly.

Japan was perhaps the most surprising growth story last year, delivering around 1.7% driven by domestic consumption, investment and exports. We should see more follow through in 2018, given years of pent-up demand from consumers and expectations for a relatively strong global economy.

Inflation

Will this be the year? We have been on the side of traditionalists (although not necessarily strong "*Phillips Curvists"*) – those who believe that low unemployment will lead to higher wages and ultimately higher inflation. But we concede that it has been difficult to define low unemployment because there have been secular shifts in the workforce: demographic changes related to the boomer cohort moving into retirement; the peak and subsequent decline of women's participation; and the delayed entry of graduates who are pursuing further education or just loafing in their parent's basements. Some also point to the secular shift to low paying service jobs from higher paying manufacturing jobs – a pattern that has been at work for some time. However, we believe that ultimately the large number of unfilled positions, due mainly to the shortage of qualified workers, is more important than the secular factors. No doubt, companies are making capital investments to address the supply shortage, but wages are creeping upwards, albeit, thus far at a very controlled pace. But, all expectations are for the US unemployment rate to decline further in 2018 – it only takes 108K new jobs per month to keep it at steady state and last year's average monthly payroll increase was 171K. We anticipate that wage growth will move to the desired 3%.

Canada's unemployment rate sank to a 40-year low of 5.7% in December's labour force survey. (Although Canadian payrolls are notoriously volatile, this is not true for the unemployment rate.) Historically, Canadian unemployment is, on average, a couple of percentage points higher than the US's, due, in part, to definitional differences. In a report released last April by the Bank of Canada that analysed US and Canadian employment data, Bank economists suggested that, as of February, some slack remained in the labour market in Canada, whereas none was present in the US – unemployment rates were 6.7% and 4.5% respectively at that time. However, today's Canadian rate is significantly lower, suggesting little slack remains in its labour market. We expect that the secular shifts affecting the US are similar in Canada. Similarly, our outlook for higher US wages, generally holds true for Canadian wages.

The secular deflationists argue that the world is overrun with too much materials and labour, aided and abetted by technology and globalisation. In terms of products and some services, it is hard to argue with this premise, absent any real wage pressures, hence the low level of core inflation. Weaker commodity prices, particularly energy, are also a contributor. But we contend, that trade deficits (as % of GDP), which have been deflationary for developed countries, have likely peaked (2011 was the US peak) and are unlikely to get worse. The backlash against trade in the US supports this view. In addition, productivity gains are far reduced from levels seen pre-recession, which suggests that there are limitations to the benefits of capex. We recognize the argument made by some analysts that businesses have been reluctant to make capital investment due to uncertainty over economic prospects, despite extremely business-friendly monetary policy. Still, we expect that

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the pressure on domestic wages is likely to be a more significant driver of inflation going forward.

Monetary Policy

With global growth firing on most cylinders and deflation pressures having peaked, that this is a golden opportunity for the world's major central banks to hasten a retreat from stimulus policy should seem obvious. But there are still many who feel that the Fed is on the precipice of a policy mistake. We feel that a lesson of the last few years is that there will never be the *ideal* opportunity to normalise, so long as there are risks of a slowdown or market corrections. Nevertheless, we are confident that the Fed will remain on course, having raised Fed Funds 125 bps from the trough and having mapped out a plan for the reduction of its balance sheet. The Fed has regained some lost credibility over the last year and we expect this to continue with the transition of Fed chair to Jerome Powell. Most observers, expect continuation of the "Yellen" strategy, but that may necessarily be the case, especially noting the plethora of open spots on the FOMC and that the current voters on the committee will likely lean more "hawkish" this year.

We expect the Bank of Canada to also raise rates this year, albeit reluctantly, responding to tighter labour markets and following the lead of the Fed. However, we expect the Bank to be responsive to the vulnerabilities of trade, the consumer and housing. The Bank will also be keenly aware that the Canadian dollar appreciated by about a dime since last May, although it will also be aware that the currency will not help it on its way to normalising overnight rates. Unlike the Fed, the BoC has not outlined a clear direction over the short-term, preferring to be data dependent and somewhat spontaneous. We do not feel their modus operandi will change substantially in 2018.

Bond investors will also be watching the actions of the ECB and BoJ closely, for signs of changes to their respective QE policies. The ECB has been difficult to pin down, at times sending mixed signals as to the timing of an eventual taper of its QE program. We expect the ECB to be cautious in reversing policy, after all, 2017 was only the second time since 2010 that we have seen growth above 2% from the Eurozone, the other being in 2015 when growth was very uneven across members. Like the ECB, we expect the BoJ to also be cautious in reversing policy, and would not be surprised to see a quick reversal of any tapering, should circumstances dictate. We note that the BoJ has just recently trimmed its bond purchases, which some investors have concluded is the beginning of a broader initiative to taper its QE program.

Yield Curves

It is common for government yields curves to flatten during central bank tightening cycles and this time appears to be no different. Over the last forty years, the Fed has had 6 tightening cycles, lasting an average of 41 months, where it has raised overnight rates by an average of 523 bps, and resulted in a flattening of the Treasury curve by an average of 154 bps. It is also common for both short and long-term Treasury yields to rise during tightening cycles, by an average of 251 and 97 bps for 2 and 30-year bonds respectively. So far, this cycle we have seen the Treasury curve flatten by 114 bps and 2-year yields rise by 91 bps, but 30-year yields have fallen by 23 bps. Furthermore, the slope of the Treasury curve (2-30's) has typically bottomed-out at 25 bps – it is already 85 bps. This suggests to us, a greater likelihood of a rise of long yields going forward.

Unfortunately, we don't have experience with yield curves that have been distorted by not just one, but several, substantial central bank QE programs, interconnected in a world of borderless (high grade) sovereign bond markets. Our thesis has been that we would see more like a parallel shift of the Treasury curve, as the Fed raises rates and the long end responds to increasing real yields, term premiums and inflation expectations. Our contention was and still is that the QE programs of the Fed, ECB and BoJ have lowered real yields and distorted term premiums, but that unwinding

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extremely low rates and QE would inevitably reverse this. However, while the Fed is already retreating from QE, the ECB and BoJ haven't started.

Although 30-year bund yields have risen by 92 bps from their trough, they are still at a meagre 1.26%, while barely investment grade 30-year Portuguese yields are 3.15%, just slightly higher than AAA 30-year Treasuries at 2.74%. You may not like Trump, but it would be hard to argue that owning long US dollar Treasuries is a riskier proposition than long OT's (Obrigações do Tesouro) denominated in Euros. Mario Draghi's has made good on his pledge, made 5½ years ago, to do "Whatever it takes" (to preserve the Eurozone), which has effectively turned the ECB into the ultimate *Hoover*, or should we say *Electrolux*, of bond duration. The Bank of Japan is not far behind the ECB in terms of central bank holdings on a dollar basis, despite operating with a much smaller vacuum. However, on a GDP basis, the BoJ's balance sheet is far bigger, with holdings equal to 93% of GDP compared with the ECB at 38% and the Fed at 23% (relatively stable for the past 3½ years).

The only other central bank with a vacuum capable of having a substantial influence on the Treasury curve is the People's Bank of China, although their vacuum operates quietly – more like a *Dyson* than a *Hoover*. Currently the PBoC has a balance sheet of about $US 5.5 trillion. There have been rumblings that the Bank is nervous about its Treasury holdings, but we don't see any alternative to Treasuries at this point. However, it is entirely possible that the Bank will decrease the risk of its holdings by shortening the average duration.

An expected increased supply of Treasuries in 2018 should be another factor contributing to a steeper Treasury curve. Although the Treasury has indicated that it will issue more short-term bonds next year, the CBO estimates overall financing needs to be about $US1 Trillion per year for 2018-20, which means a substantial amount of issuance is bound to come in the long-end.

In 2017, the Government of Canada yield curve was only slightly correlated with the US Treasury yield curve (15%) – aggressive actions from the BoC ensured that the front-end of the yield curve was far more volatile in Canada than in the US. It was reasonable for the Bank to reverse its near-ZIRP (although less reasonable how it went about it), but no such requirement exists this year. Of course, the Bank may be required to respond to a shock, but barring such action, we see the Bank following the Fed in direction, if not in magnitude. Consequently, we expect relative steepening between the Canada and US yield curves.

Credit

Twenty-seventeen was a good year for corporates, as economies outperformed early predictions and central bank actions were widely supportive. Yield spreads narrowed across the board, with performance increasing with risk. Economic fundamentals will continue to support corporate bonds in 2018, but reduced break-evens and tapering of QE programs could put pressure on yields spreads. Shorter duration, higher rated issues will be less vulnerable to poor performance, offering better protection against rising underlying government yields and "risk-off" sentiment. High yield issues are particularly vulnerable, given the extremely low absolute yields and extremely narrow yield spreads.

Provincial bonds had a good year in 2018, benefitting from the general "risk-on" trade. In addition, provincial issuers were adept at controlling domestic supply through diversification of issuance globally. Of the $CAD 78 Billion issued last year –23% went to the US and 8% went to Europe, the second highest level of international issuance on record. Euro supply increased by $CAD 4 Billion year-over-year – a threefold increase, the direct consequence of low European yields and the "ECB Electrolux". Provincial treasures are likely to want to repeat their global issuance strategy this year, but a reduction of the ECB's QE program could get in the way.