



NOVEMBER 22, 2018

**REASSESSING THE ECONOMIC OUTLOOK:
STAYING CALM IN TURBULENT SEAS**

PRESENTED TO

ASSOCIATION OF WOMEN IN FINANCE

Jock Finlayson, Executive Vice President and Chief Policy Officer

OVERALL STORYLINE...

- The global economy is **losing momentum** after a few decent years
- North America is at a **cycle peak**
- **Rising interest rate environment** in both US & Canada
- Threat of accelerating **US-China trade war**...with spillover effects
- **Canada benefits from NAFTA resolution**...but will the US actually implement?
- **Canada also faces risks** around household debt, housing markets, and loss of competitiveness vis-à-vis the US
- **B.C. is expected to outpace Canada** in the 2018-20 period
- Fundamental shift in the **job market** – a mix of population aging, weaker labour force growth, and the onward march of the digital economy

GLOBAL ECONOMY HAS PEAKED AMID ESCALATING RISKS



f=forecast.

Source: IMF (2008-2014); Capital Economics (2015-2020). Note that the global numbers and forecasts reflect "official" Chinese government data, which some analysts believe overstate China's growth rate.

GLOBAL EXPANSION HITS SOME SPEED BUMPS (LATE 2018 AND INTO 2019)

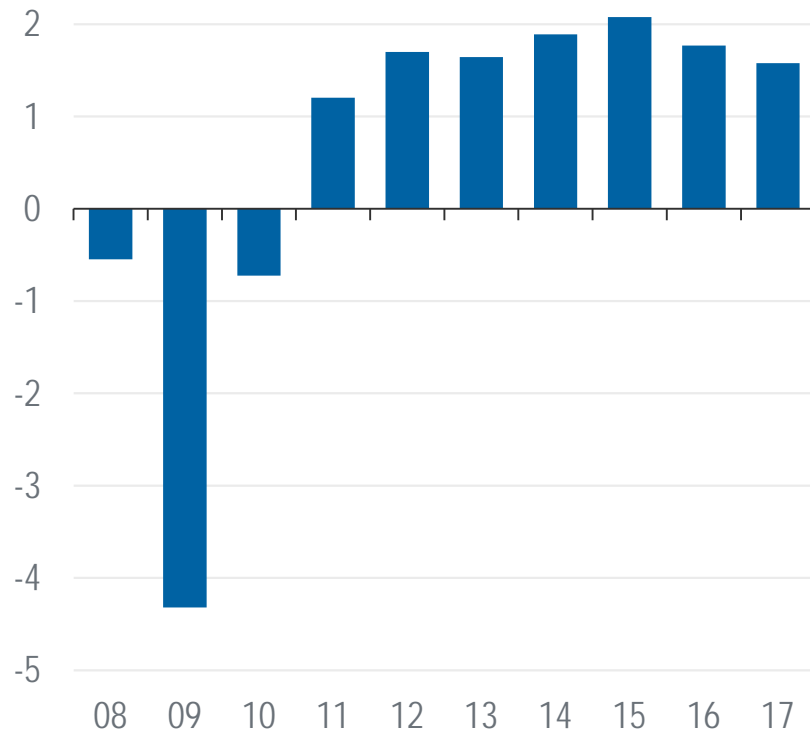
- The **OECD** leading indicator recently dipped to the lowest level since 2012
- **Global commodity prices down 12% since September 2018**
- **US:** growth remains solid overall; but higher interest rates are crimping housing demand; Trump's trade war is starting to hurt the economy; and the 'sugar high' from 2018 tax cuts and spending stimulus is set to fade
- Severe weakness in some **key emerging markets** (Turkey, Brazil, Argentina, S. Africa, etc.) amid rising US interest rates and a stronger US dollar
- **China:** sharp fall in stock market; currency down 10% y-t-d; trade war with U.S. is shifting some manufacturing production to other EMs in Asia; record levels of private sector debt
- **UK:** BREXIT turmoil
- **Canada:** the economy is now being pressured by lower oil global prices and a record price discount vis-à-vis WTI crude

DESPITE POLITICAL NOISE, US EXPANSION CONTINUES

- GDP growth reached 3.5% (annualized) in Q3, following 4.2% in Q2
 - current expansion is 2nd longest on record
 - economy is benefitting from a 'sugar high' provided by tax cuts and increased gov't spending
 - inflation pressures are building, driven in part by Trump's tariff-mania
- Employment continues to climb... as 'full employment' approaches
 - unemployment rate near a 30 year low – heading for 3.5% in 2019
- Housing starts have been choppy, amid higher prices and escalating building costs; likely to peak at ~1.3 million in 2019
- Business investment is rising, but gains are modest
- Economy is forecast to expand by ~3% in 2018, but then slow in 2019-20
- Federal Reserve is expected to hike its policy rate 3-5 times in next 15 months

US HAS PASSED THE PEAK OF THE EMPLOYMENT CYCLE

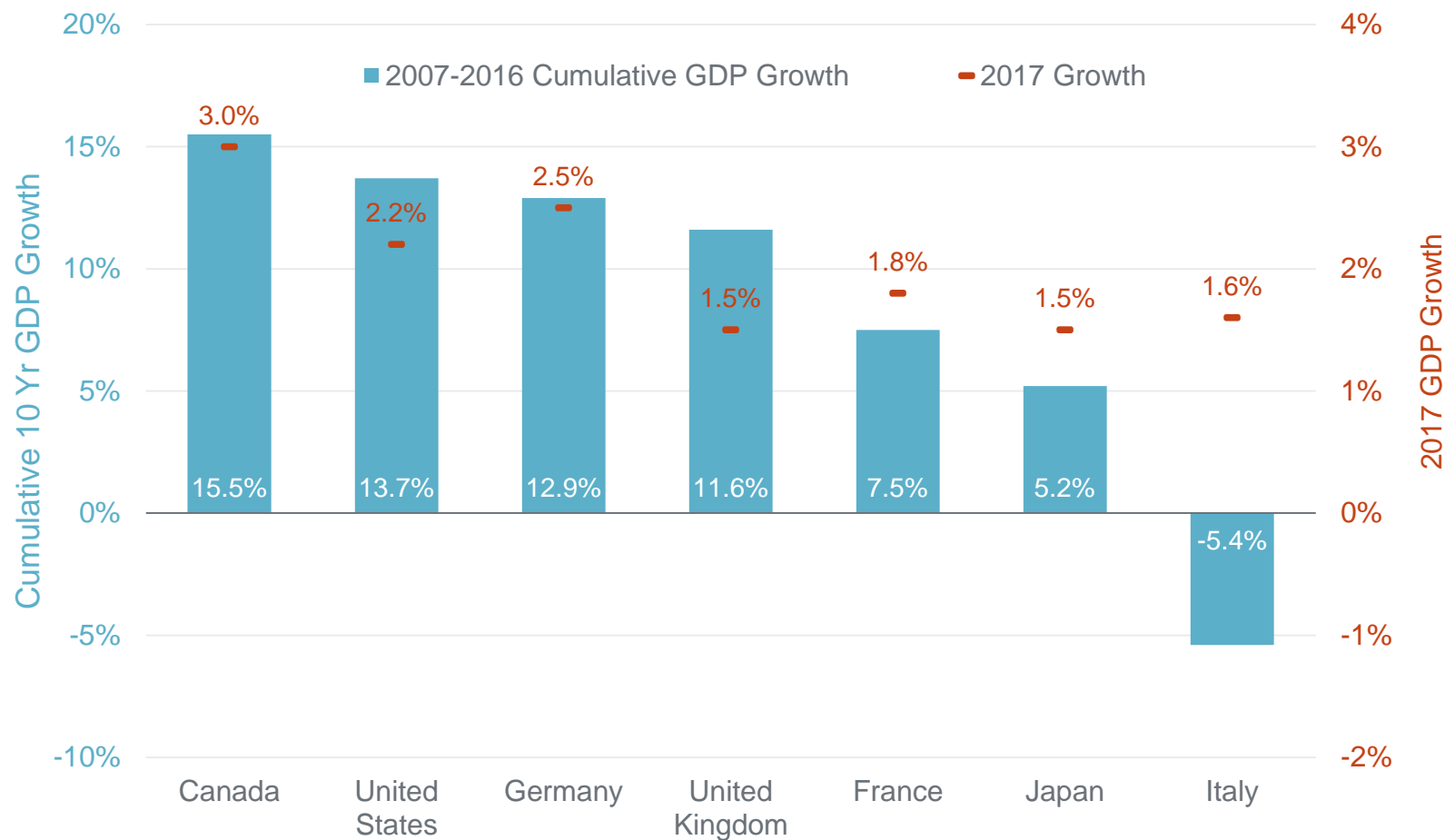
US non-farm payroll growth, %



US non-farm payroll growth, y/y %



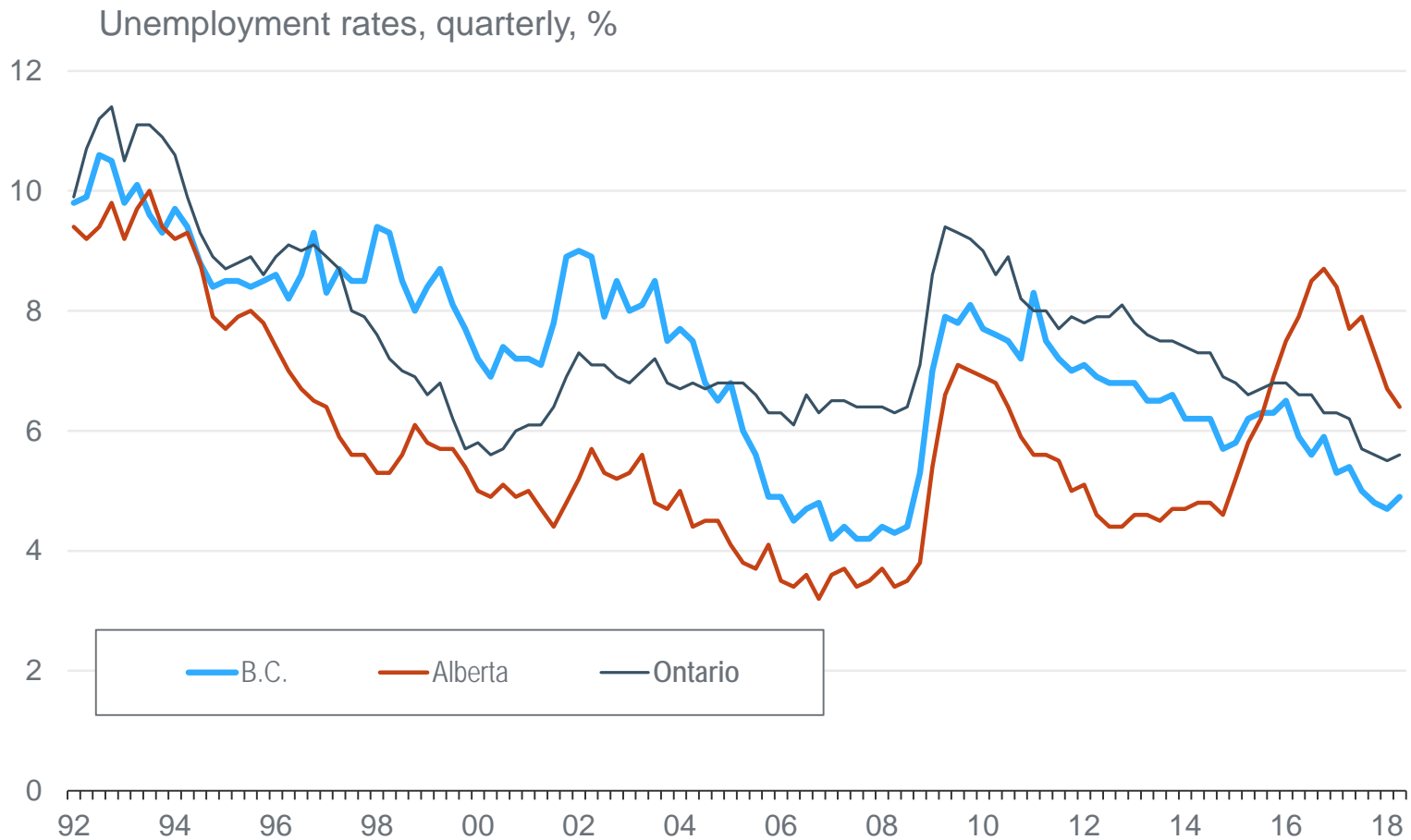
SURPRISE! CANADA LED THE G7 IN ECONOMIC GROWTH IN THE DECADE TO 2016... AND ALSO IN 2017



CANADA'S ECONOMY IN LATE 2018

- Despite trade tensions, waning competitiveness, the difficulty of advancing large projects, and high levels of household debt...**the economy has held up quite well**
- Some **deceleration of job creation**, following a surge in 2017.
- Most measures of **inflation** have increased
- Solid **household consumption** has supported aggregate demand but is expected to soften in 2019
- The **strong US economy** is helping (76% of Canada's exports)
- **Slumping oil prices** -- a worrisome development, especially if it persists
- Don't overlook **population growth**: Canada leads the G7, largely fueled by international immigration into urban areas

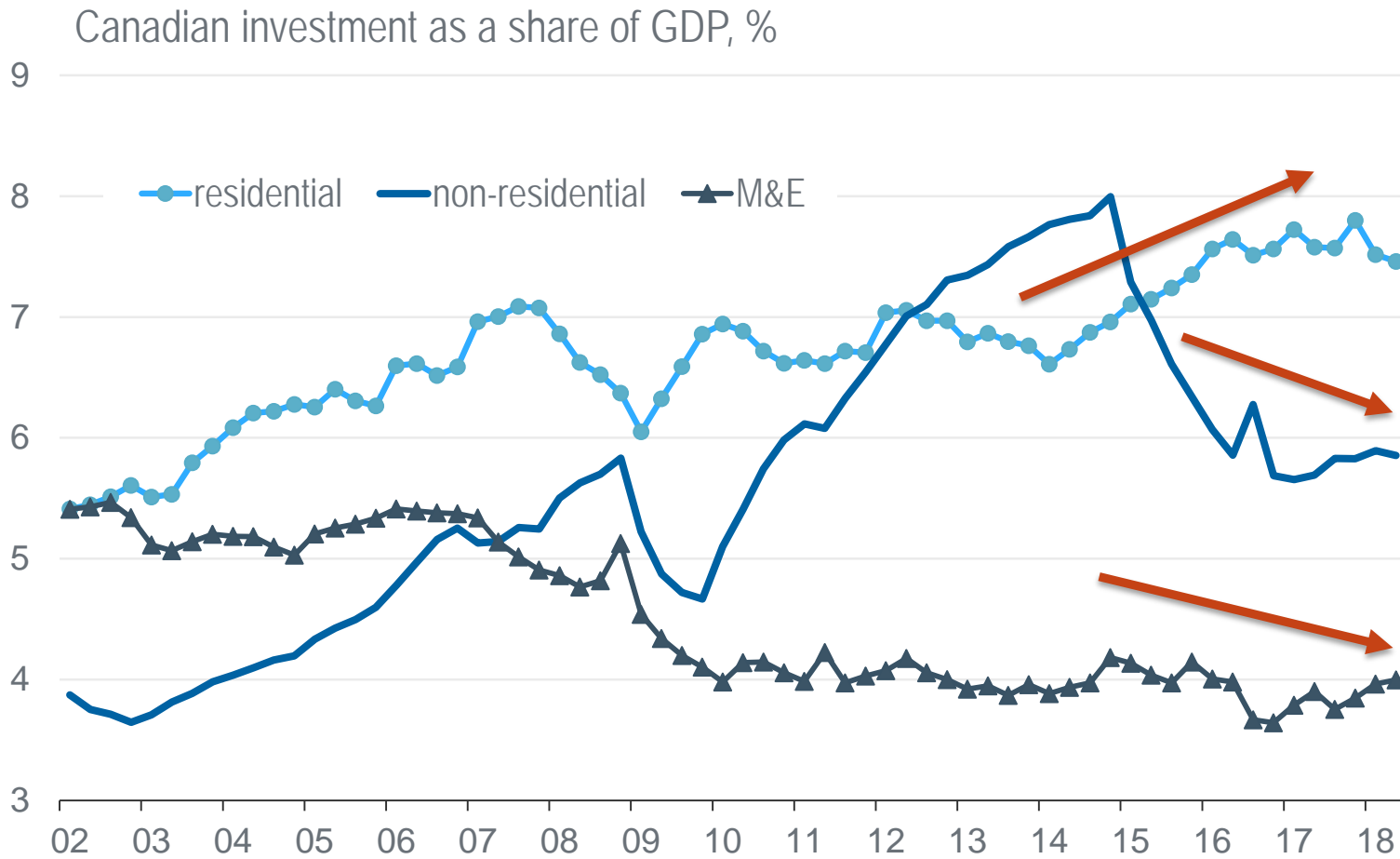
LABOUR MARKETS IN CANADA ARE TIGHTENING



Source: Statistics Canada, Labour Force Survey.

LOTS OF RESIDENTIAL INVESTMENT...BUT NOT ENOUGH 'PRODUCTIVE' BUSINESS CAPITAL SPENDING

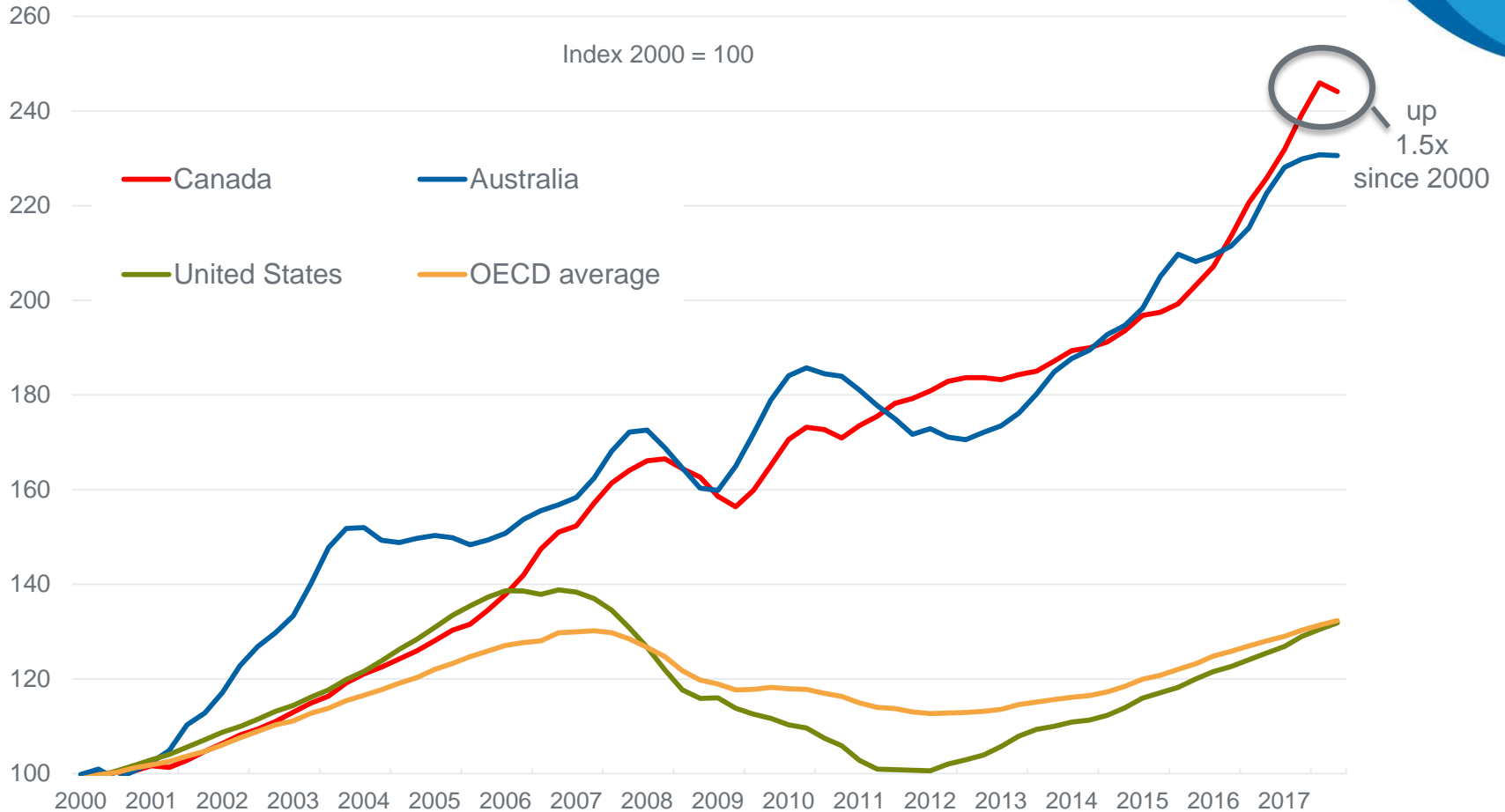
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RECORD HOUSEHOLD DEBT = VULNERABILITY TO RISING INTEREST RATES



EVOLUTION OF REAL HOUSE PRICES



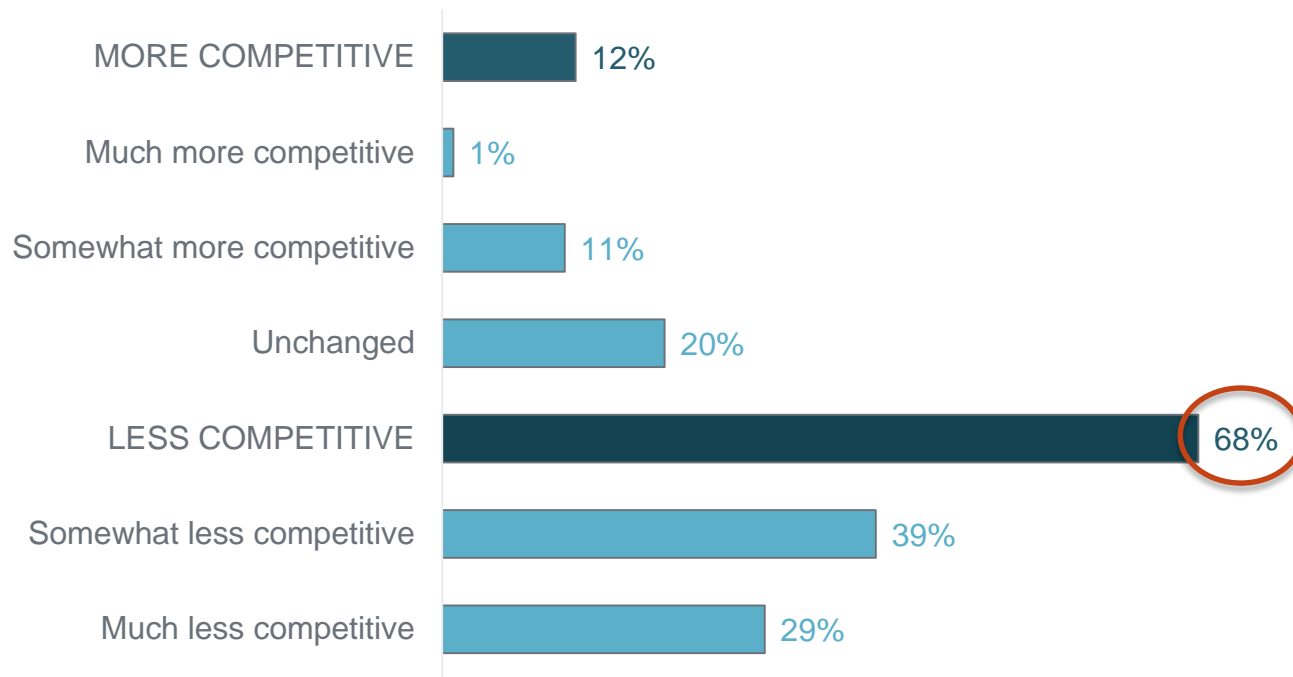
CANADIAN ECONOMIC FORECAST*

(ANNUAL % CHANGE UNLESS OTHERWISE NOTED)

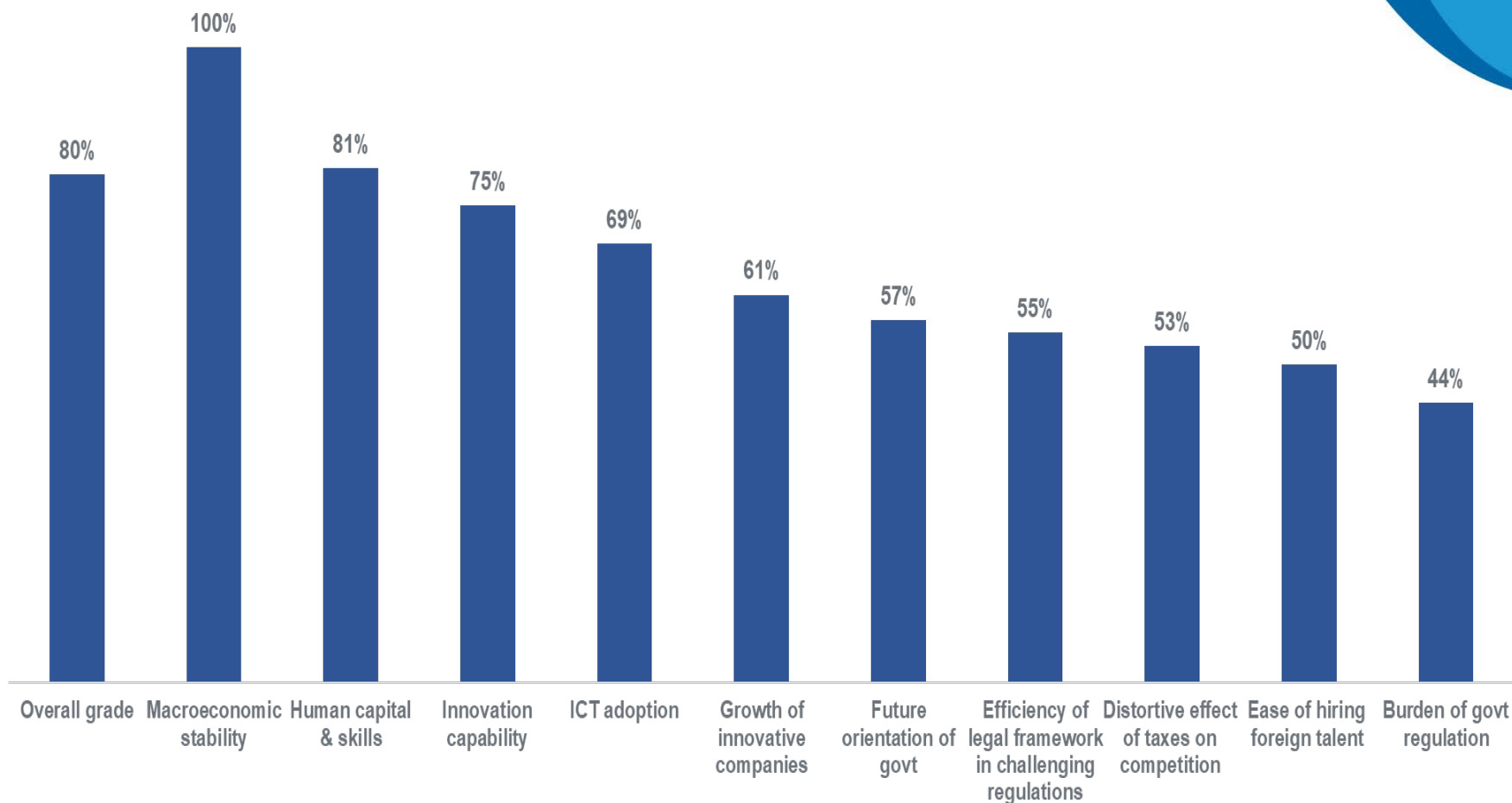
	2017	2018	2019	2020
Real GDP	3.0%	2.1%	1.9%	1.7%
Real consumption	3.5%	2.2%	1.8%	1.4%
Employment	1.9%	1.2%	1.0%	0.7%
Housing starts (000 units)	220	207	200	190
Bank of Canada policy rate (Q4)	1.25%	1.75%	2.50%	2.75%
10 year Gov't bond yield (Q4)	2.20%	2.45%	2.85%	3.00%
US cents/Cdn\$ (Q4)	79.0	76.3	77.0	77.0

HOW COMPETITIVE IS CANADA COMPARED TO THE US?

Q: Compared to one year ago, how competitive do you believe Canada is, compared to the United States, as a place to invest and do business? (Canadian CPAs)



CANADA'S PERFORMANCE IN THE 2018 WORLD ECONOMIC FORUM "GLOBAL COMPETITIVENESS REPORT"



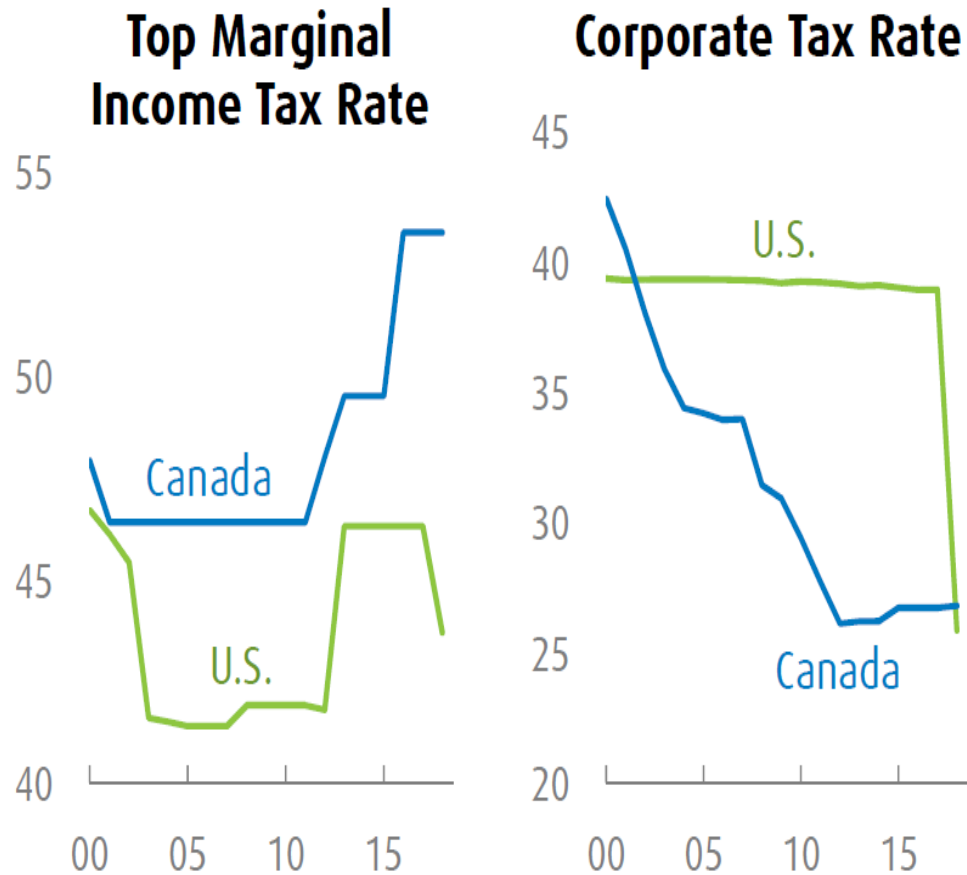
World Ranking



Source: World Economic Forum, *The Global Competitiveness Report 2018*.

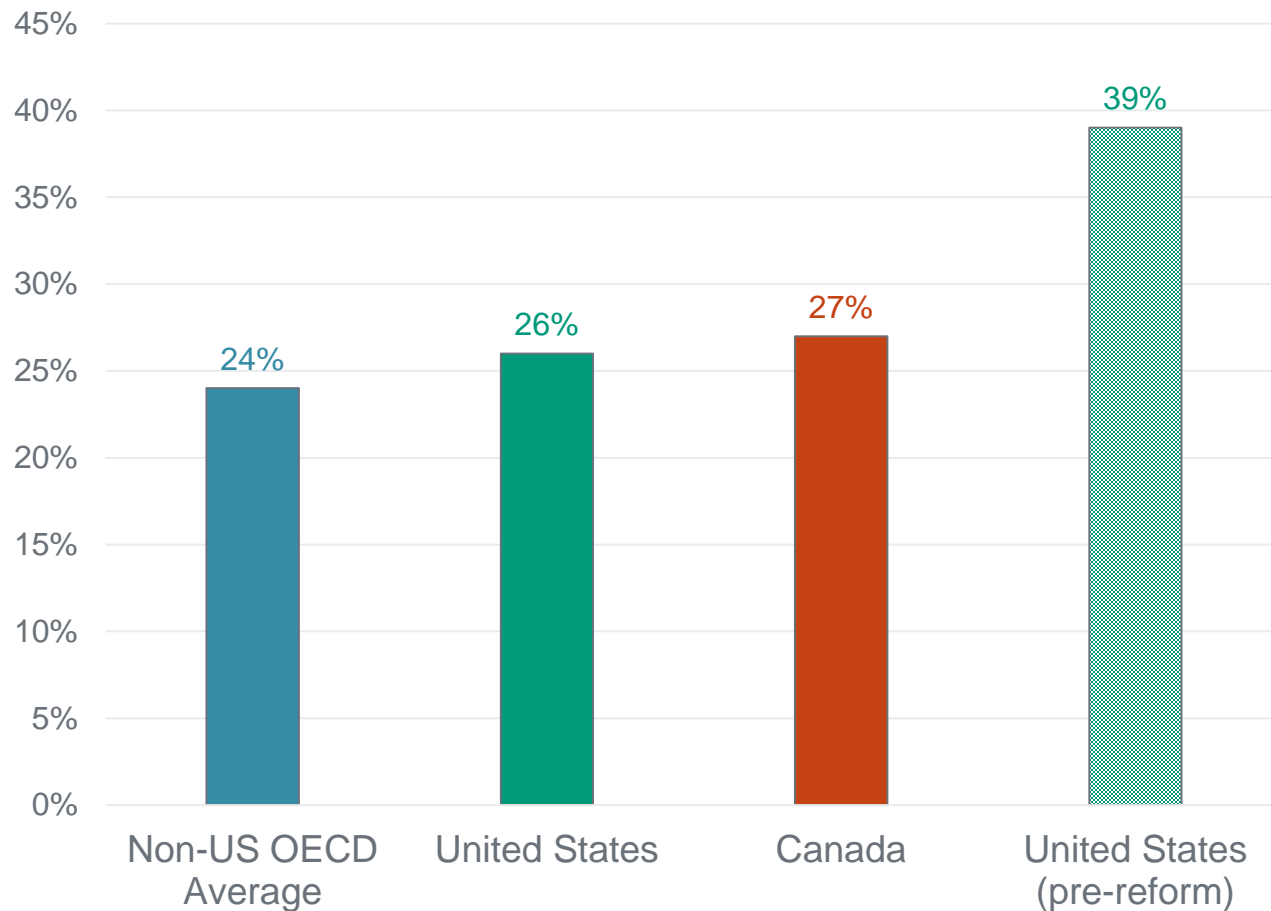
CANADIAN COMPETITIVENESS IS UNDER THREAT

(percent)



CANADA HAS LOST ITS PREVIOUS BUSINESS TAX ADVANTAGE OVER THE UNITED STATES

Statutory Corporate Income Tax Rate, Combined, 2018



THE ARITHMETIC OF LIVING STANDARDS

$$GDP/Population = GDP/Hours\ Worked \times Hours\ Worked/Population$$



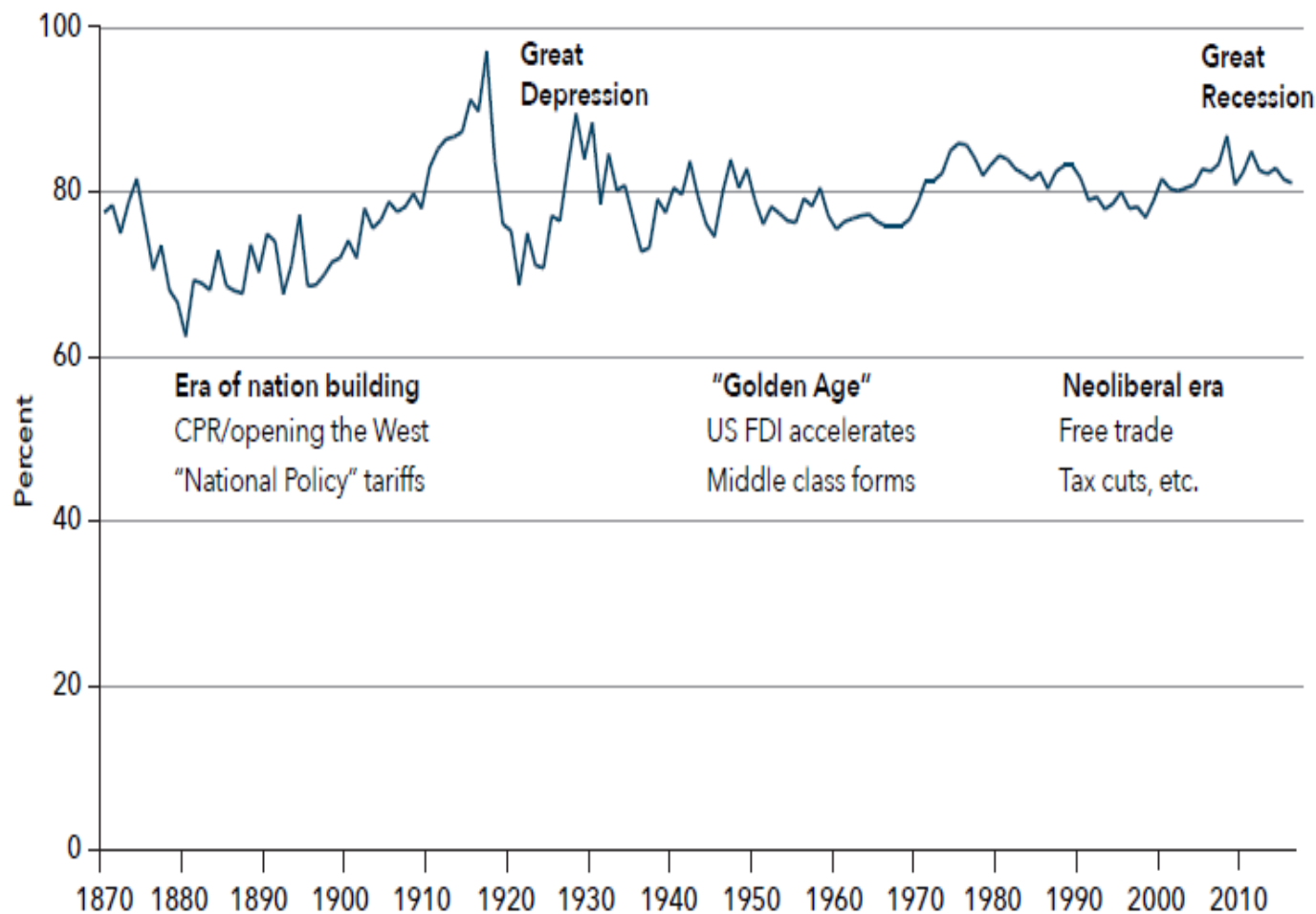
$$GDP\ per\ person = Labour\ productivity \times Labour\ Intensity$$

“Working better”

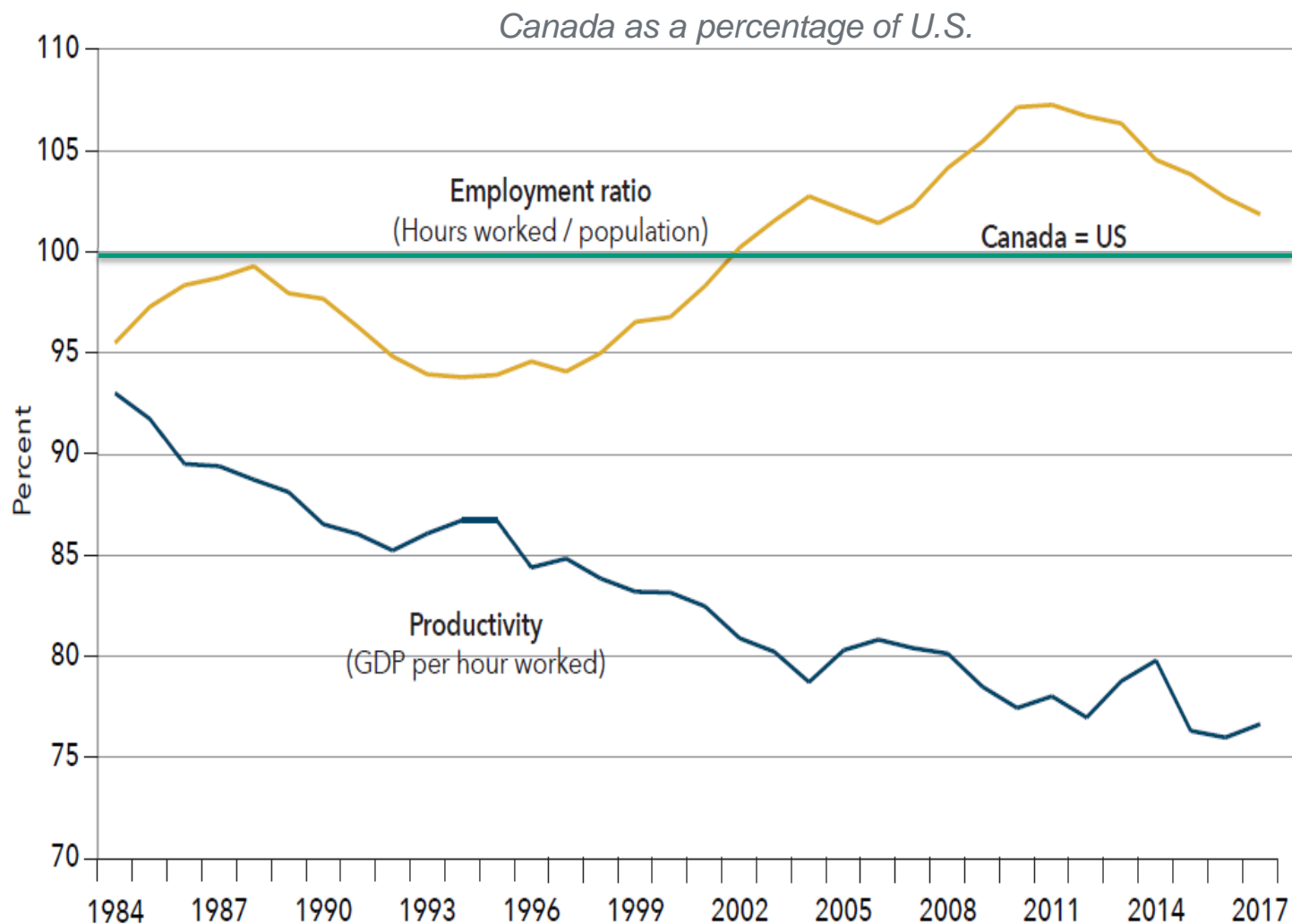
“Working more”

CANADA'S GDP PER PERSON HAS STAYED AROUND ~80% OF U.S. LEVELS SINCE 1870!

Real GDP per person, Canada as a percentage of U.S. levels



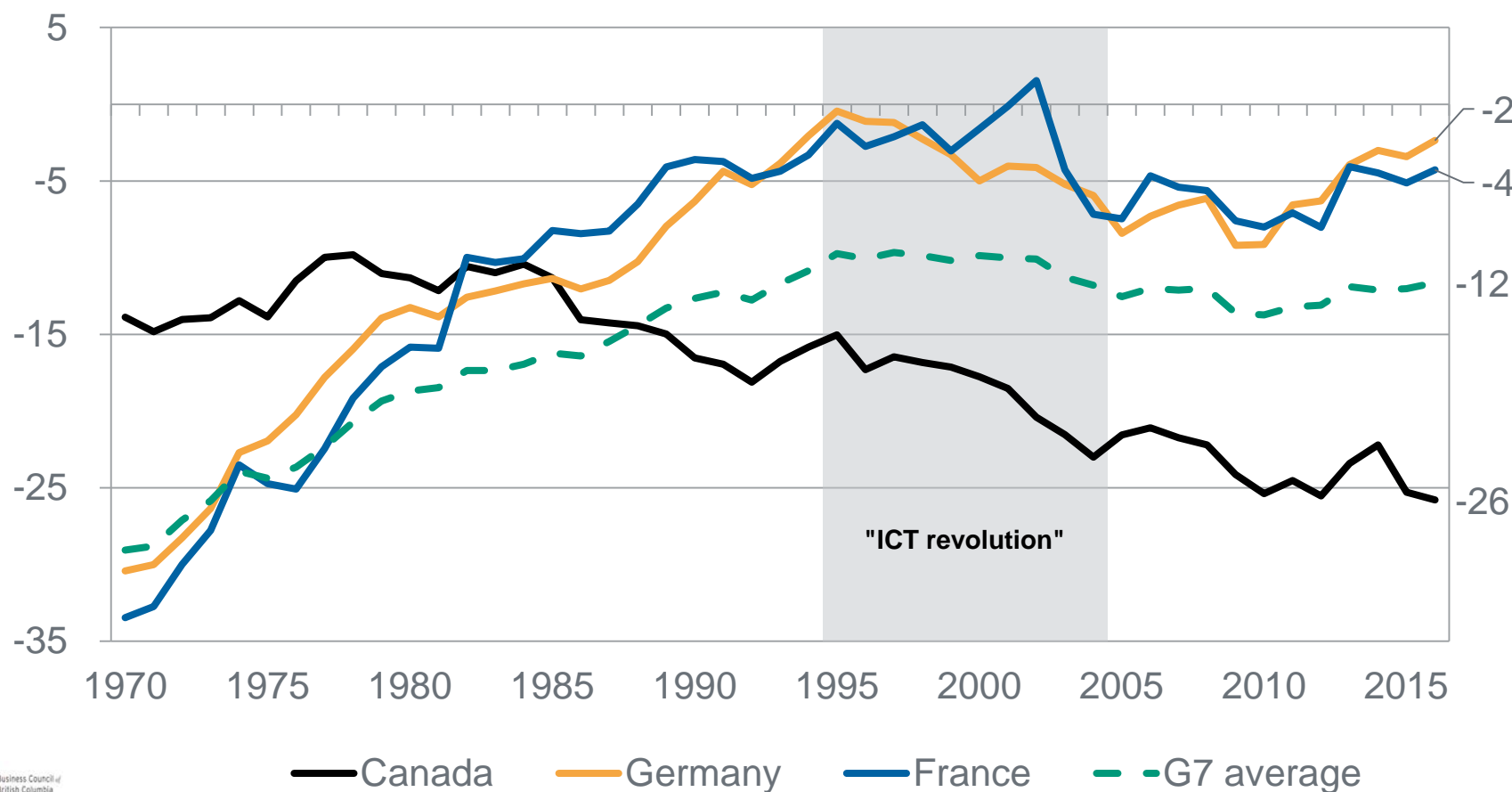
CANADA HAS KEPT PACE WITH U.S. ON GDP PER PERSON BY “WORKING MORE” NOT “WORKING SMARTER”



CANADA'S *RELATIVE* LABOUR PRODUCTIVITY HAS STEADILY DETERIORATED SINCE LATE-1970S

21

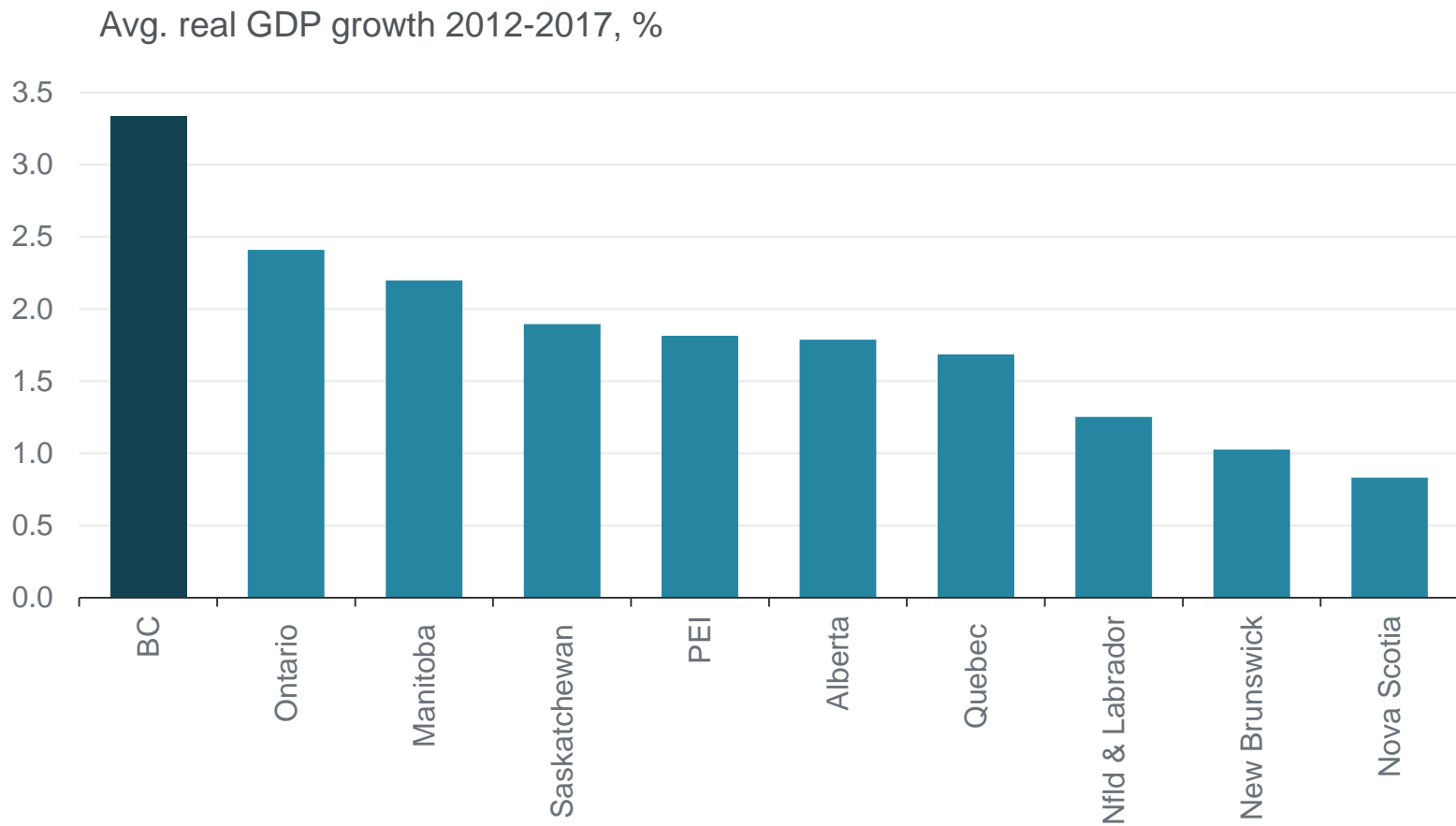
Labour productivity gap with U.S. in percentage points, GDP per hour worked (total economy)
Gap in % points



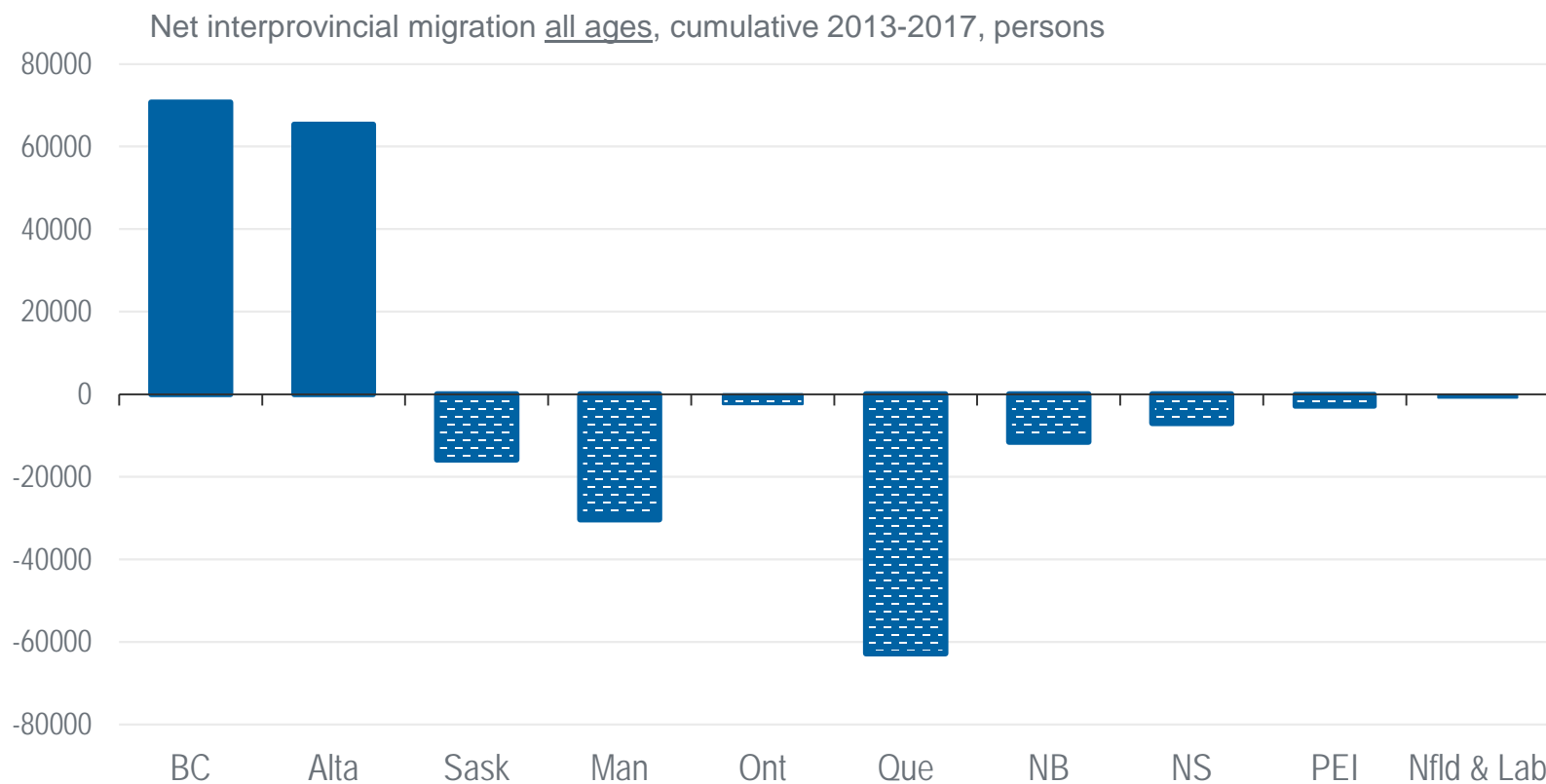
B.C. ECONOMIC PICTURE

- B.C. has led Canada over the past 5 years on most key performance metrics
- Growth has been running above long-run potential...but is expected to downshift going forward
- Rising consumer outlays, a growing population, and housing-related activity have been key factors underpinning the economic expansion since 2014
- Business investment/capital formation remains a weak spot
- Higher interest rates, tighter mortgage lending regulations, and new housing-related policy measures are dampening home sales
- Downside and upside risks:
 - LNG – significant upside for 2019-20 and beyond – adds 0.3 to 0.5 percentage points to real GDP growth rate in the next two years
 - Extended housing market downturn -- a notable downside risk

B.C. #1 IN CANADA, 2012-17



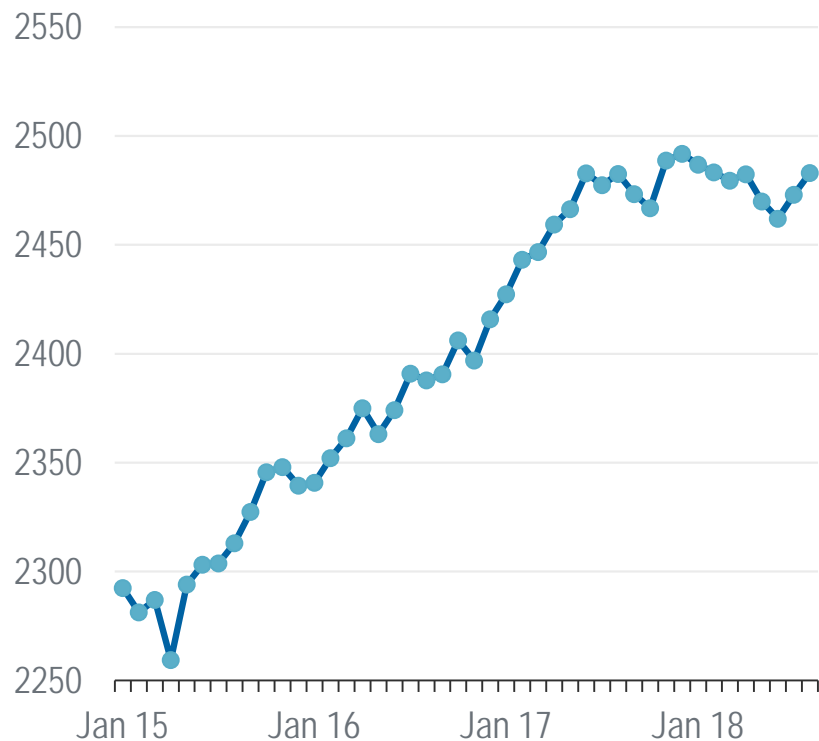
INTERPROVINCIAL MIGRANTS SETTLE (ONLY) IN B.C. AND ALBERTA



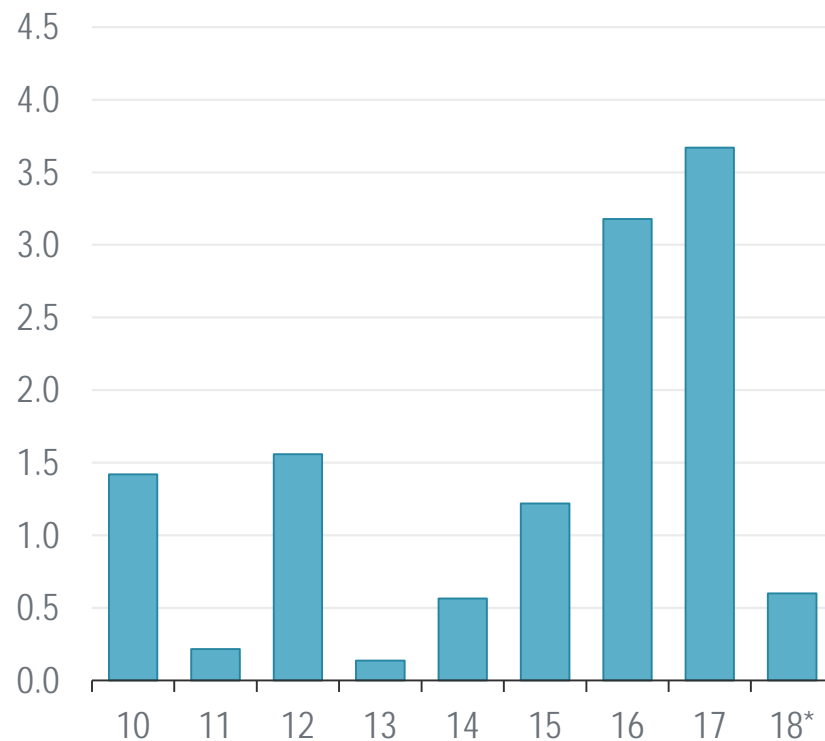
Source: Statistics Canada.

IMPRESSIVE JOB GAINS IN 2016/17 ...BUT LESS SO THIS YEAR

B.C. employment, SA, 000s



B.C. employment growth, %



B.C. ECONOMIC OUTLOOK (BCBC FORECAST)

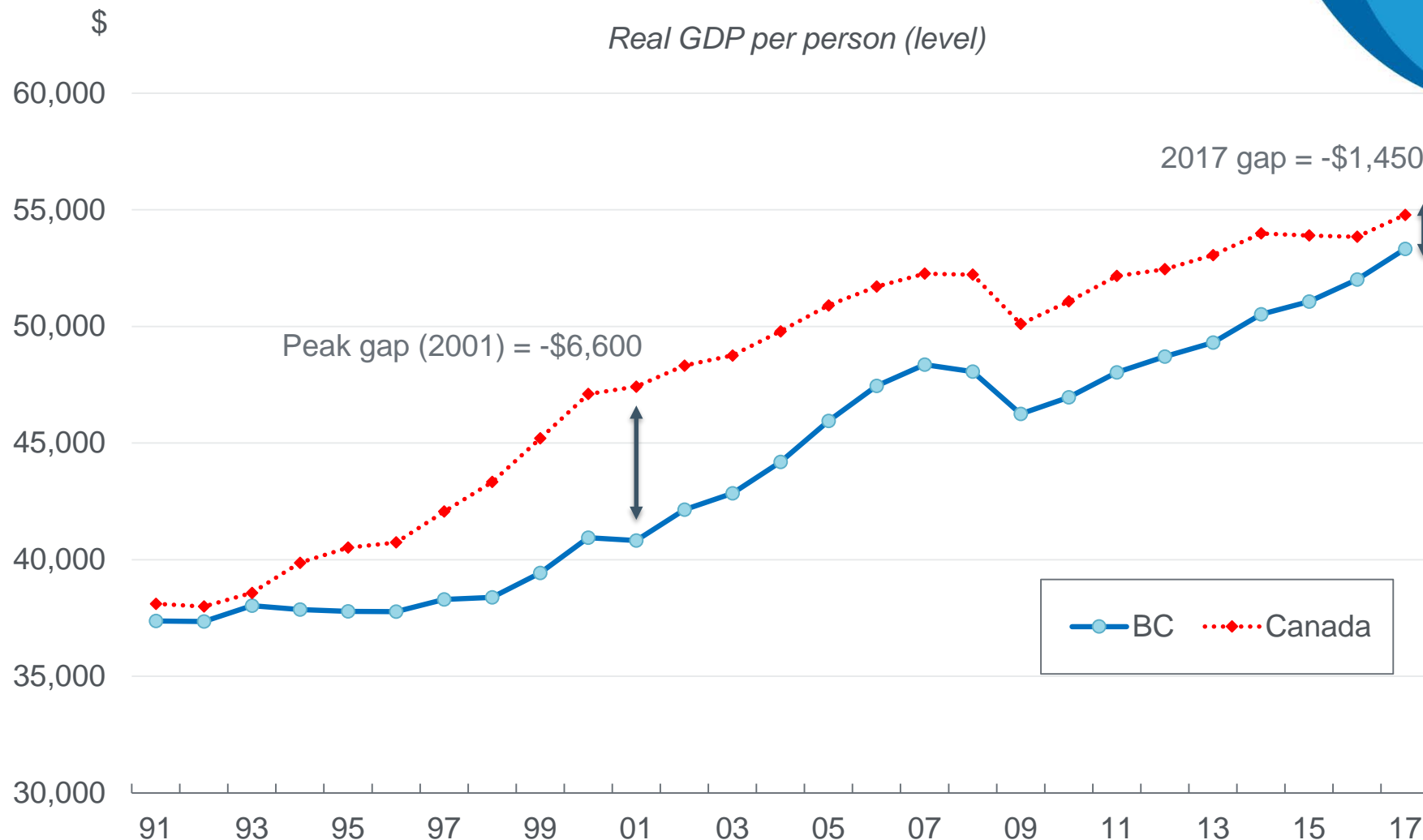
(ANNUAL % CHANGE UNLESS OTHERWISE INDICATED)

	2016	2017	2018f	2019f
Real GDP	3.7	3.9	2.3	2.5
Employment	3.2	3.7	1.0	1.2
Unemployment rate (%)	6.0	5.1	4.6	4.4
Housing starts (000 units)	41.8	40.1	40.0	38.0
Retail sales	7.4	9.0	4.5	5.0
B.C. CPI	1.8	1.7	2.7	2.3

f – forecast

Source: Statistics Canada and BC Stats; Business Council for forecasts.

B.C. IS (SLOWLY) CLOSING THE GAP IN LIVING STANDARDS



Source: Statistics Canada, Table: 36-10-0222-01 and 17-10-0005-01 (for population). Note: 2012 chained \$

LEGALIZING CANNABIS...PRELIMINARY THOUGHTS

- Economic impact will hinge on how much non-licensed ‘black market’ consumption migrates to the legal market....and how many current non-users indulge.
- Statistics Canada estimates a majority of “illegal” users will migrate to legal channels, while 6-9% of non-users “may try” cannabis following legalization. Post-legalization, the domestic market could approach 7 million (versus 4.8 million in 2017); many are ‘occasional’ users
- PBO pegs annual domestic spending via legal and non-legal channels at under \$10 billion. Some of this results in reduced consumer spending on *other* goods/services. Some is already captured in the economic accounts
- Distinguish one-time upward adjustment to the level of GDP vs. an ongoing ‘new contribution’ to overall GDP growth from cannabis production/consumption
- Net effect on Canada’s real GDP growth rate is unlikely to exceed 0.1% p.a. Recall that GDP is a ‘value-added’ measure, not a measure of gross spending



Don't Wait for Fear to Do the Work of Reason

November 2018 | Mikhial Pasic, CFA



RBC Wealth Management

There's Wealth in Our Approach.™

Outcomes

- **Signs that we're at a Later Stage of the Economic Cycle**
 - **Macro Trends:** Labour markets remain tight, above potential growth
 - **Financial Markets:** Leverage/interest coverage/issuance trends, valuation

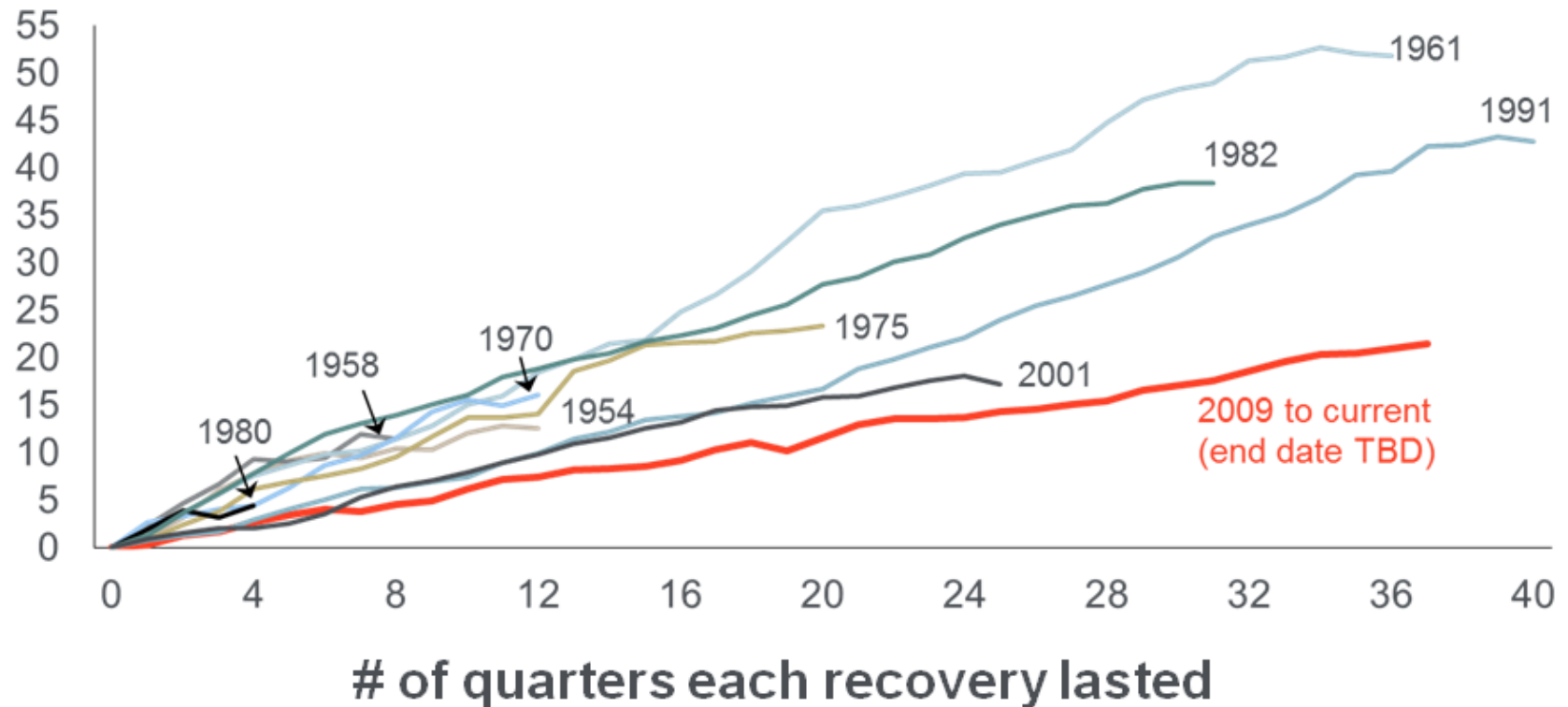
- **A Framework for the Progression from Late Cycle to End of Cycle**
 - **Higher Shorter-Term Yields:** CB tightening pushes up short-term yields
 - **Parallel Shift Higher in Yields:** A flat curve drifts higher while eco is firm
 - **Higher Funding Costs Hit Corps/Consumers:** Impact is eventually felt
 - **Lower Stock Prices:** Impact of weaker economy and higher funding costs

- **What we are worried about on the transition from 2nd to 3rd phase**
 - **US Corporate Issuers:** Many issuers have added leverage this cycle
 - **The Canadian Consumer:** No deleveraging here (unlike the US)

Low and Slow has been the Story of this Cycle

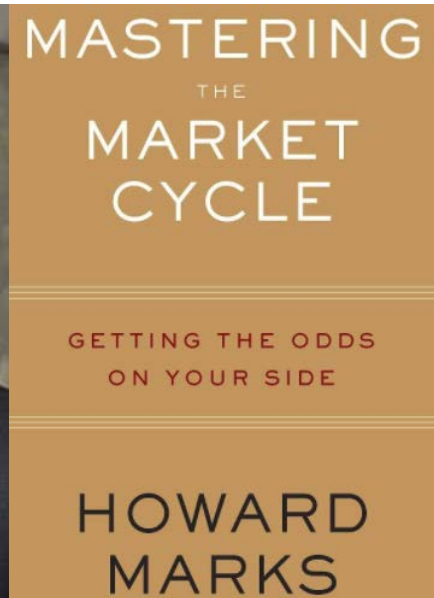
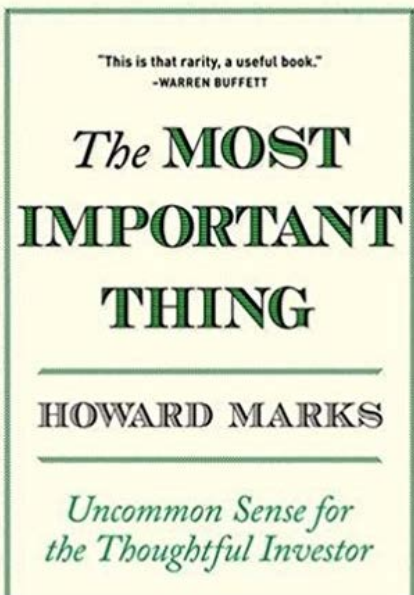


Comparing Cumulative Real GDP Growth in Economic Expansions



Part One: Thinking about the Cycle

Wisdom from Oaktree's Howard Marks



Rule #1:

Most things will prove to be cyclical.

Rule #2:

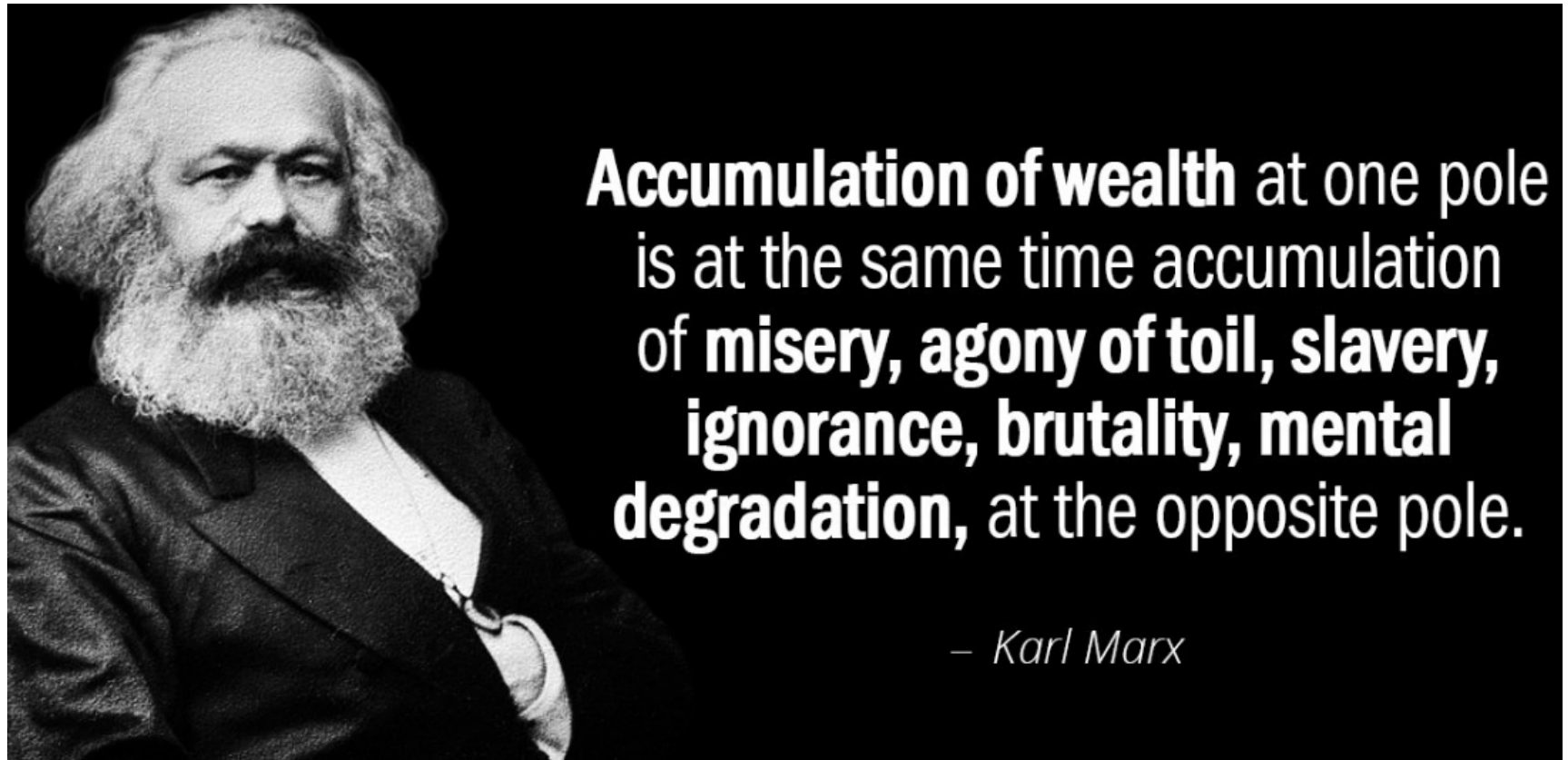
Some of the greatest opportunities for gain and loss come when other people forget rule number one

'If one is approached with a deal predicated on cycles having ceased to occur, remember that invariably that's a losing bet'

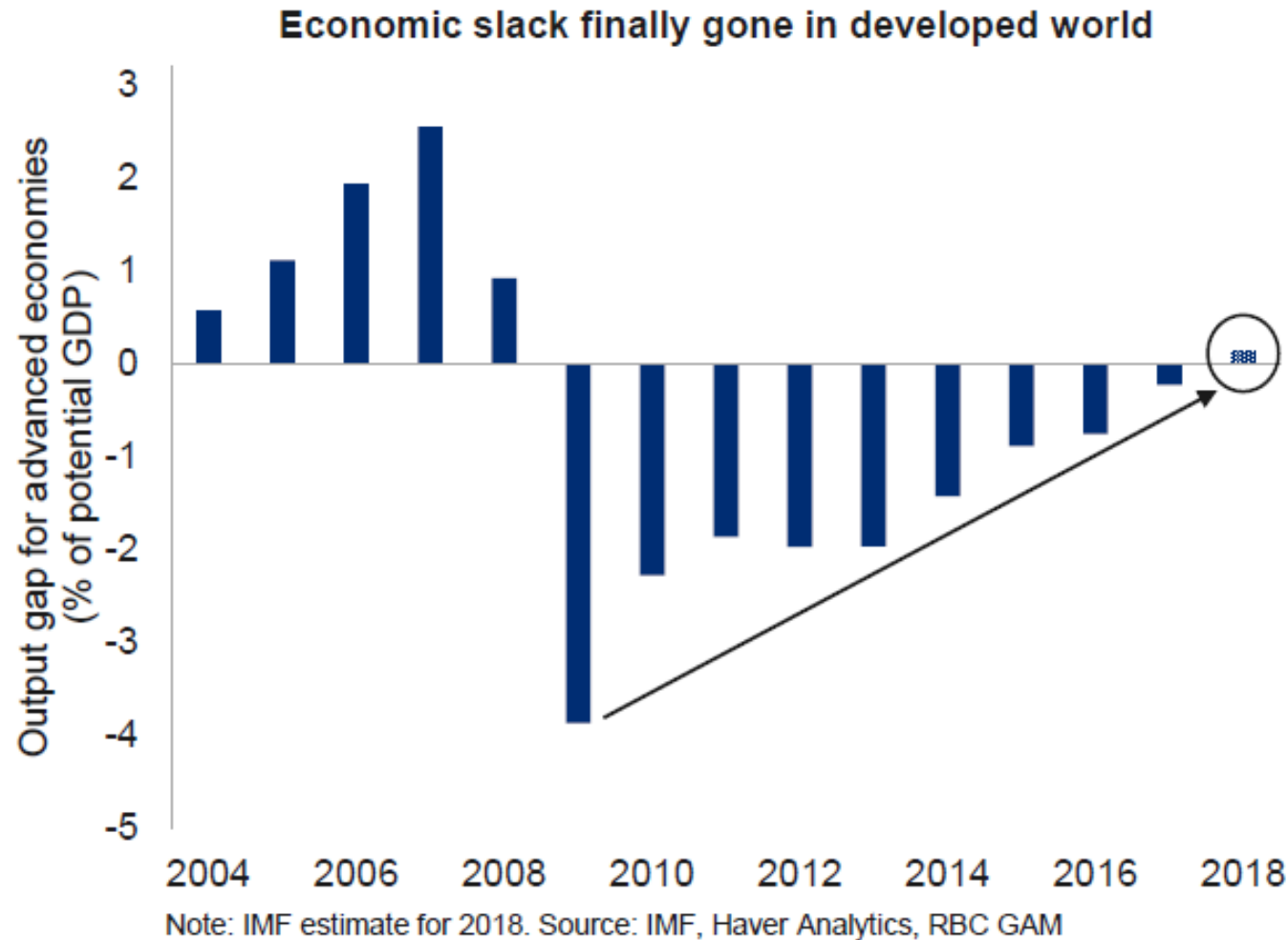
That's Howard Marks ... Not to be Confused with Karl Marx



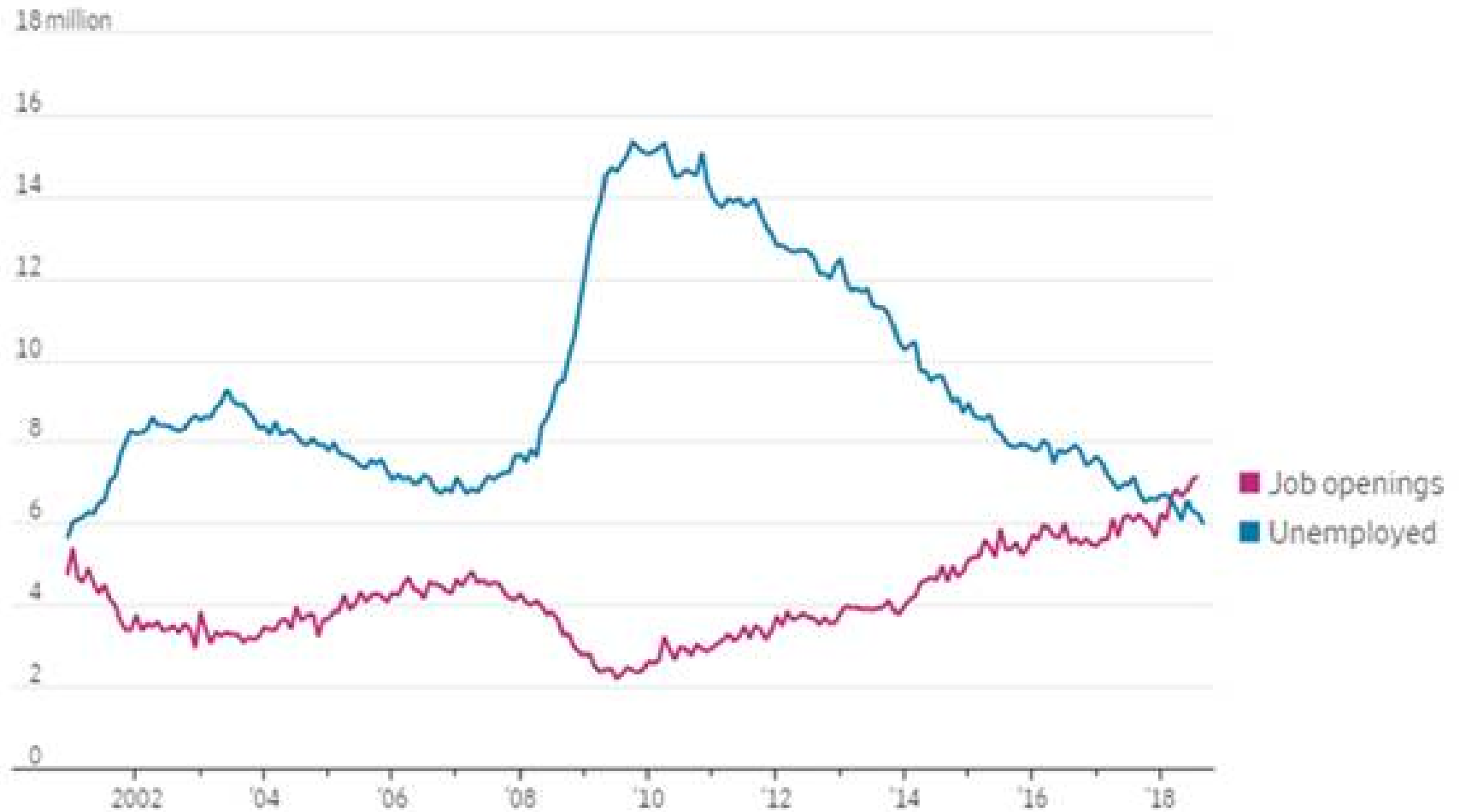
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A Sign that it's Later in the Cycle: Global Economic Growth is Back Above Potential

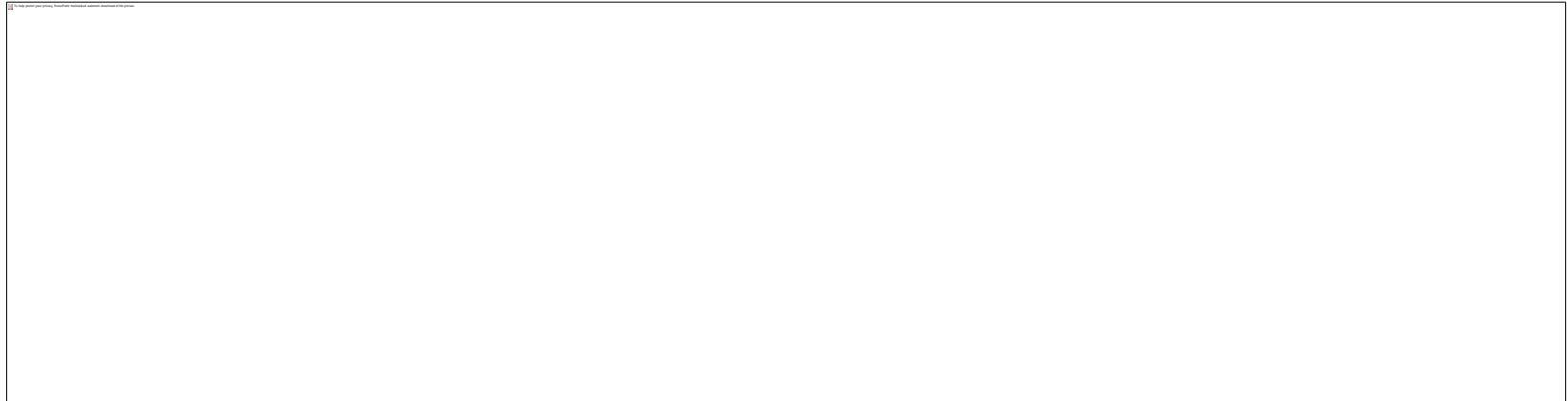


Another Late Cycle Sign: More Job Openings than Unemployed People

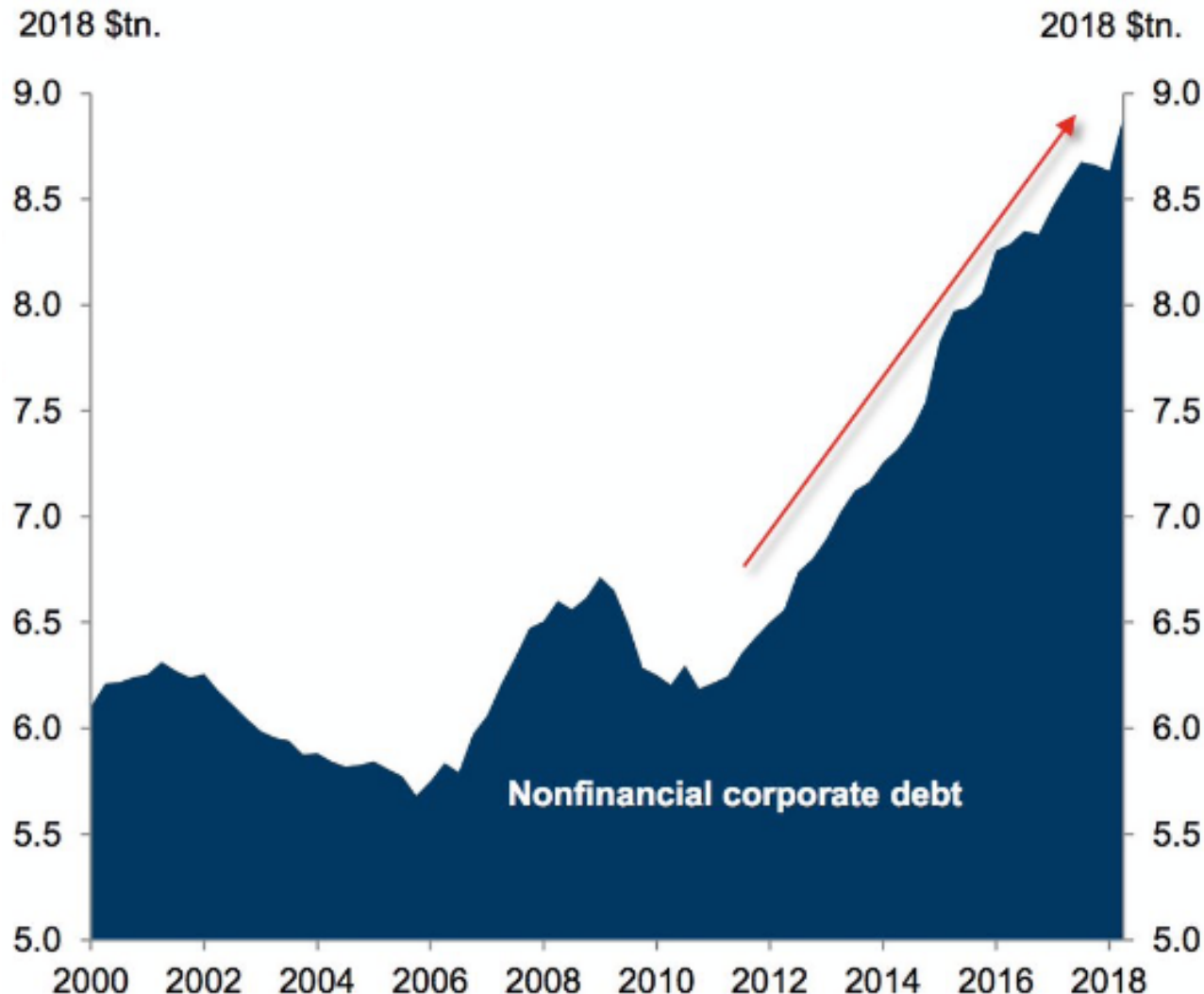


Note: Seasonally Adjusted

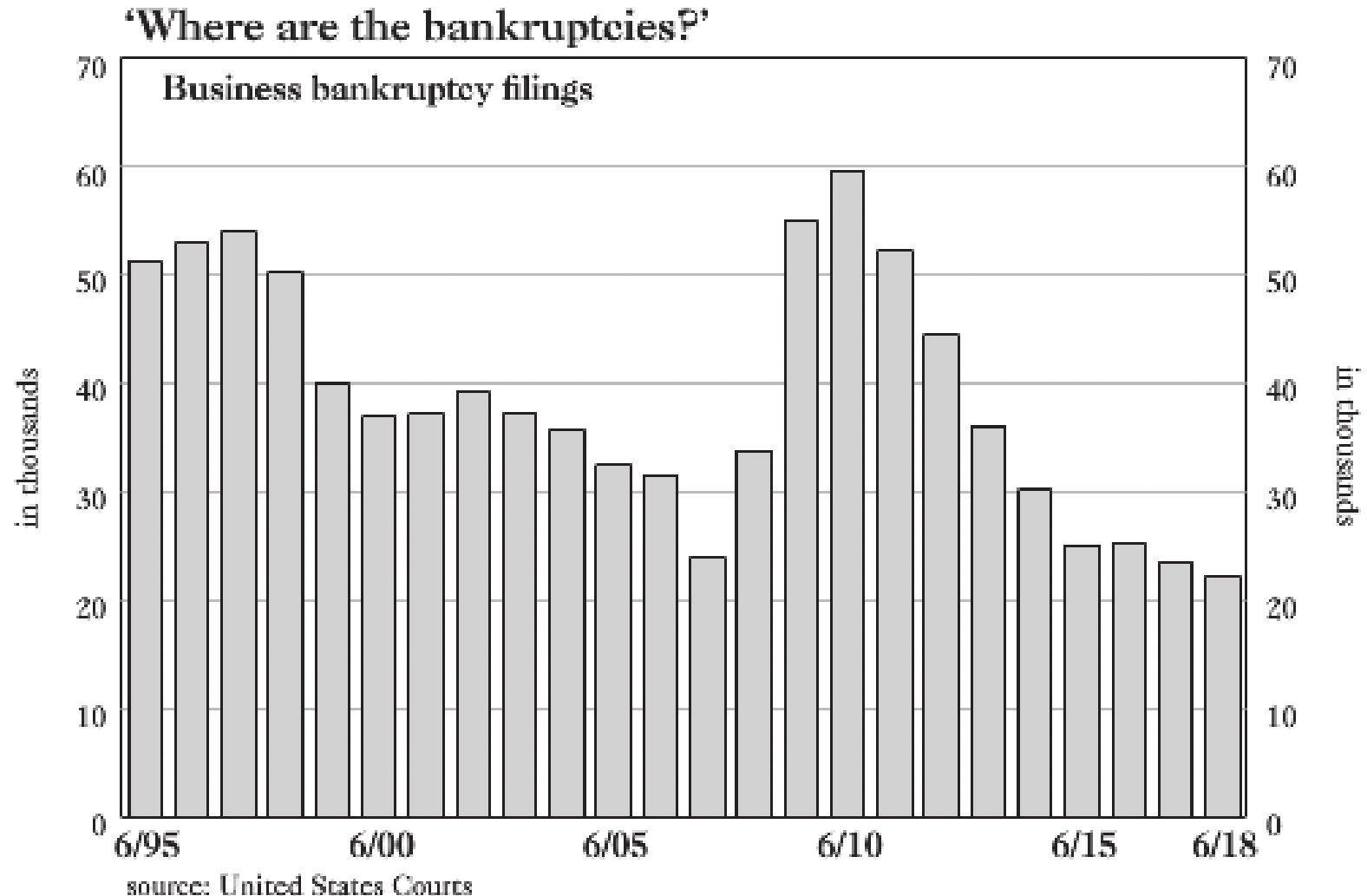
When Labour is in Short Supply, Expanding the Pool becomes Critical



Business Confidence is High, Forget Survey Data, they are Borrowing with Confidence



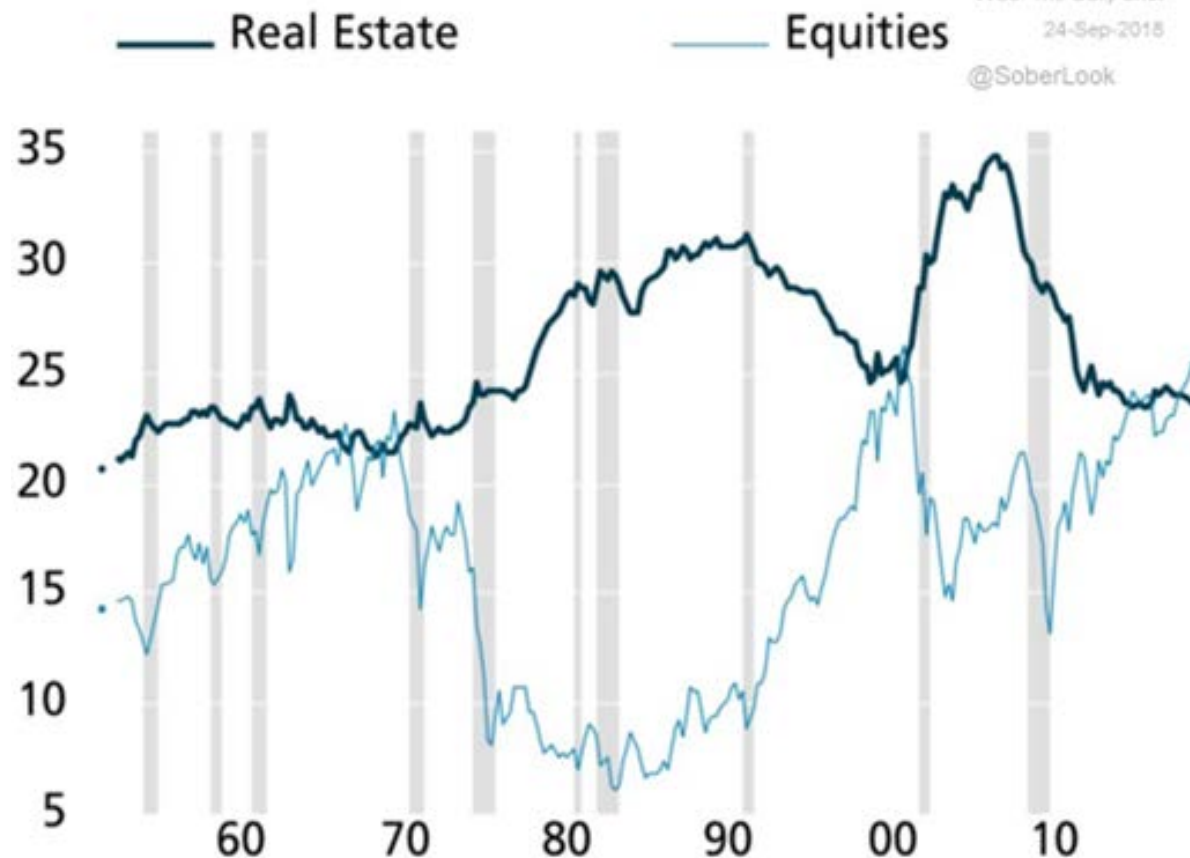
Apparently a Sustained Below-Trend Run of Bankruptcies will Embolden People...



Another Sign of Confidence: Stocks Represent a Meaningful Share of Net Worth



Households: Select Assets % Net Worth

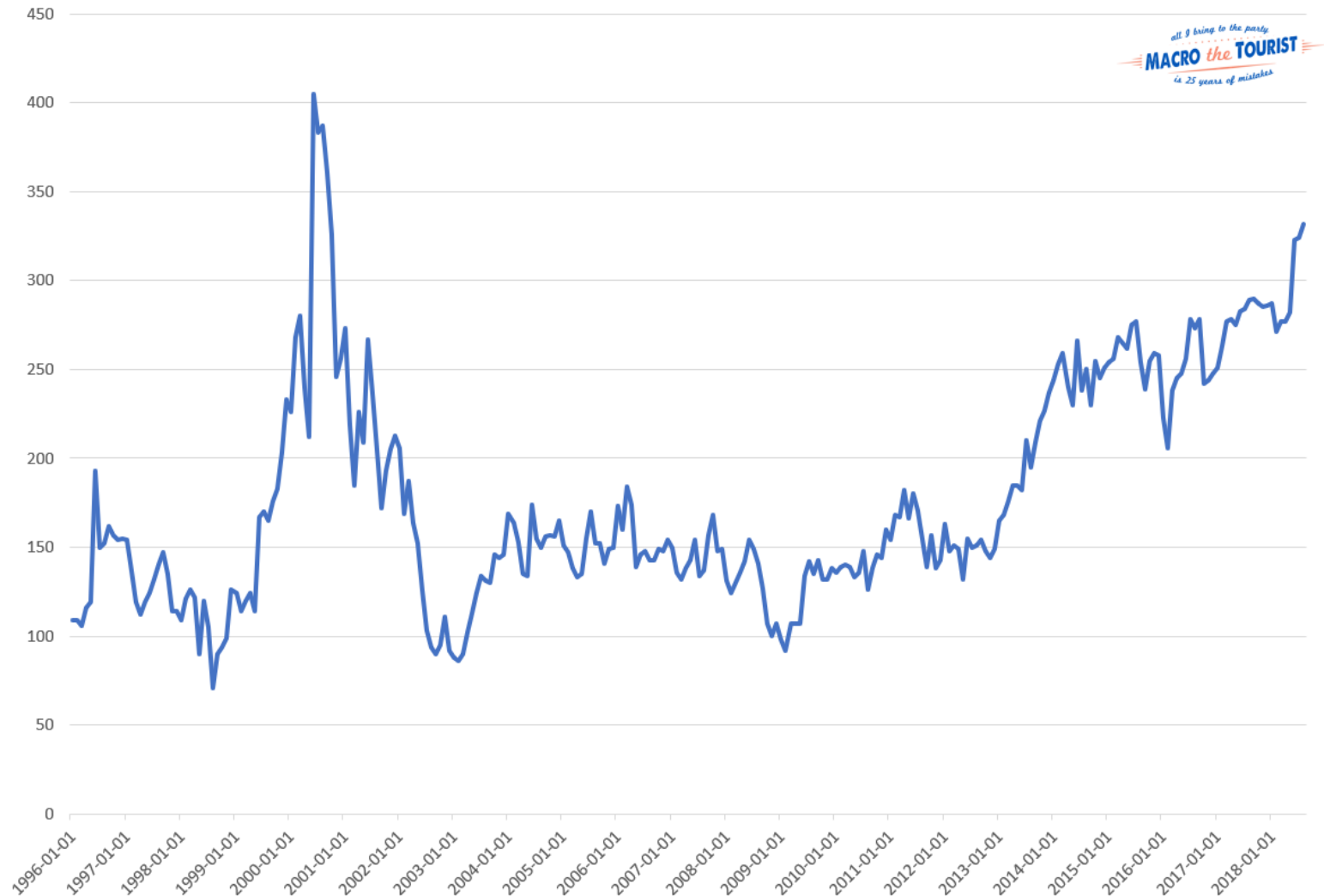


Source: Thomson Reuters Datastream, TS Lombard

There is a Point at which Confidence turns into Cockiness



Number of Russell 3000 Companies Trading for more than 10-times Revenues



The Biggest Sign it's Later in the Cycle: New ways to PRETEND your Getting Rich!



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99% of Instagram private Jet photos are fake

Home / Images / 99% Of Instagram Private Jet Photos Are Fake



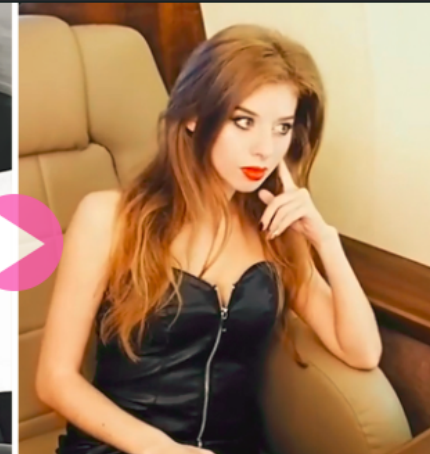
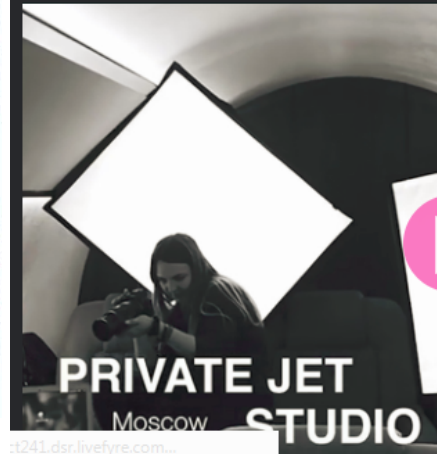
RICH KIDS OF INSTA-SHAM Inside the Private Jet Studio wannabe rich kids use to PRETEND they're flying in style... which can be rented for as little as £185

You can now fake the life of the rich and famous on Instagram by renting a grounded private jet... and there's on-board hair and make-up too

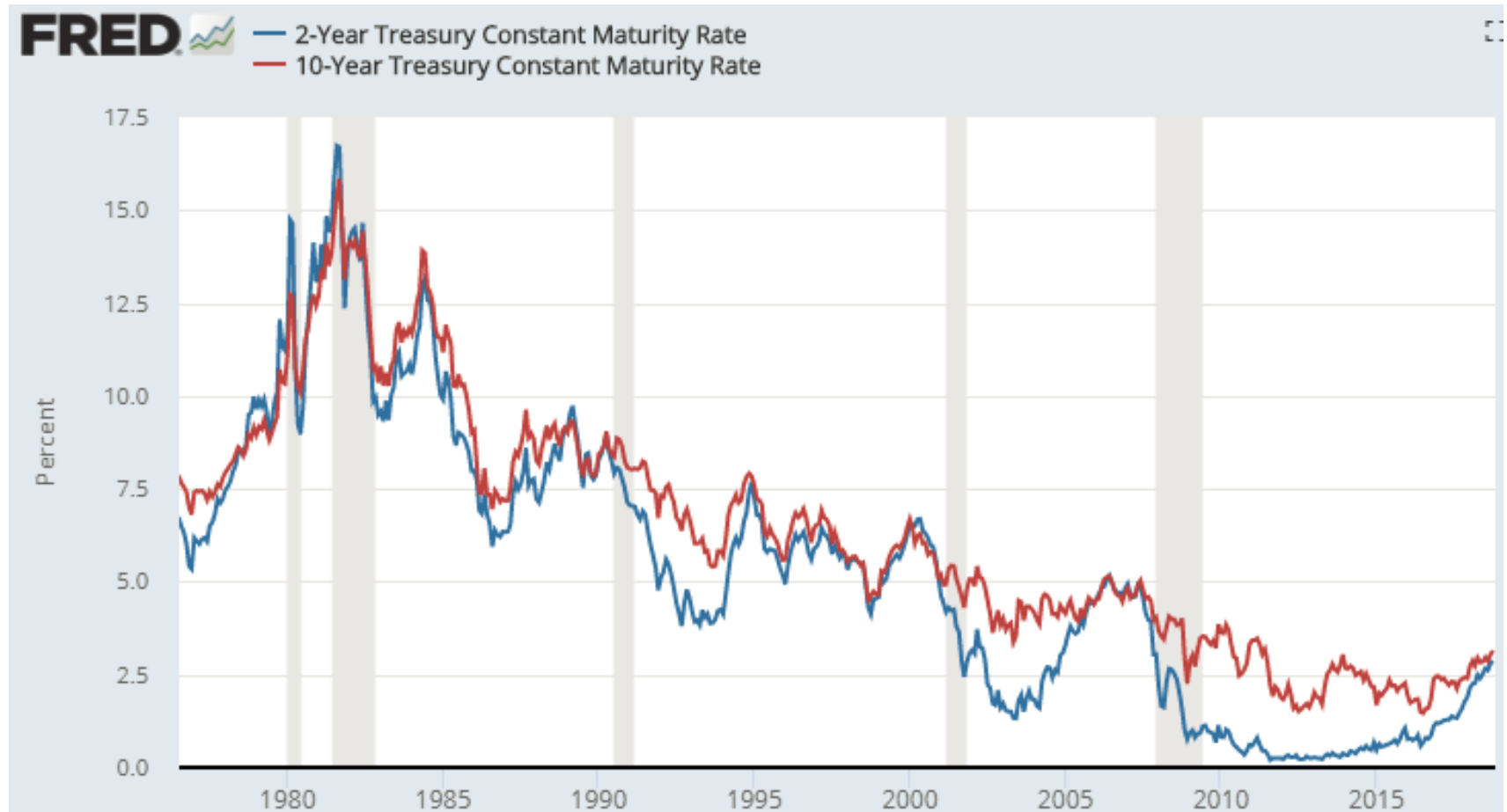
REVEALED

By Josie Griffiths

20th October 2017, 9:52 am | Updated: 20th October 2017, 4:50 pm



Bond Yields Usually Rise into a Recession, so we Obsess about trying to Forecast them



You may Remember Jim Allworth's Favourite Indicator: The Yield Curve



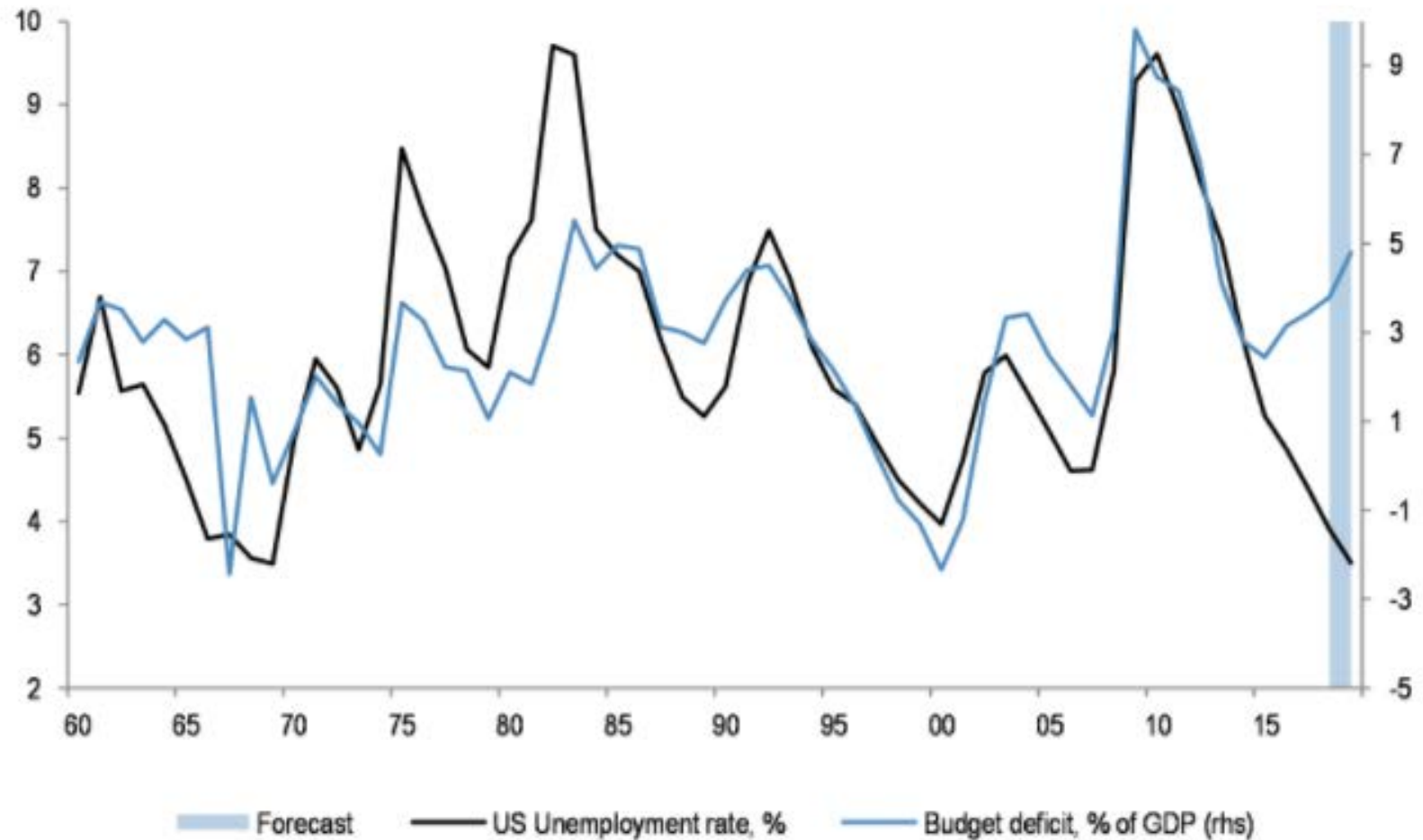
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Why We Expect to See Yields Drift Higher: Widening US Budget Deficit



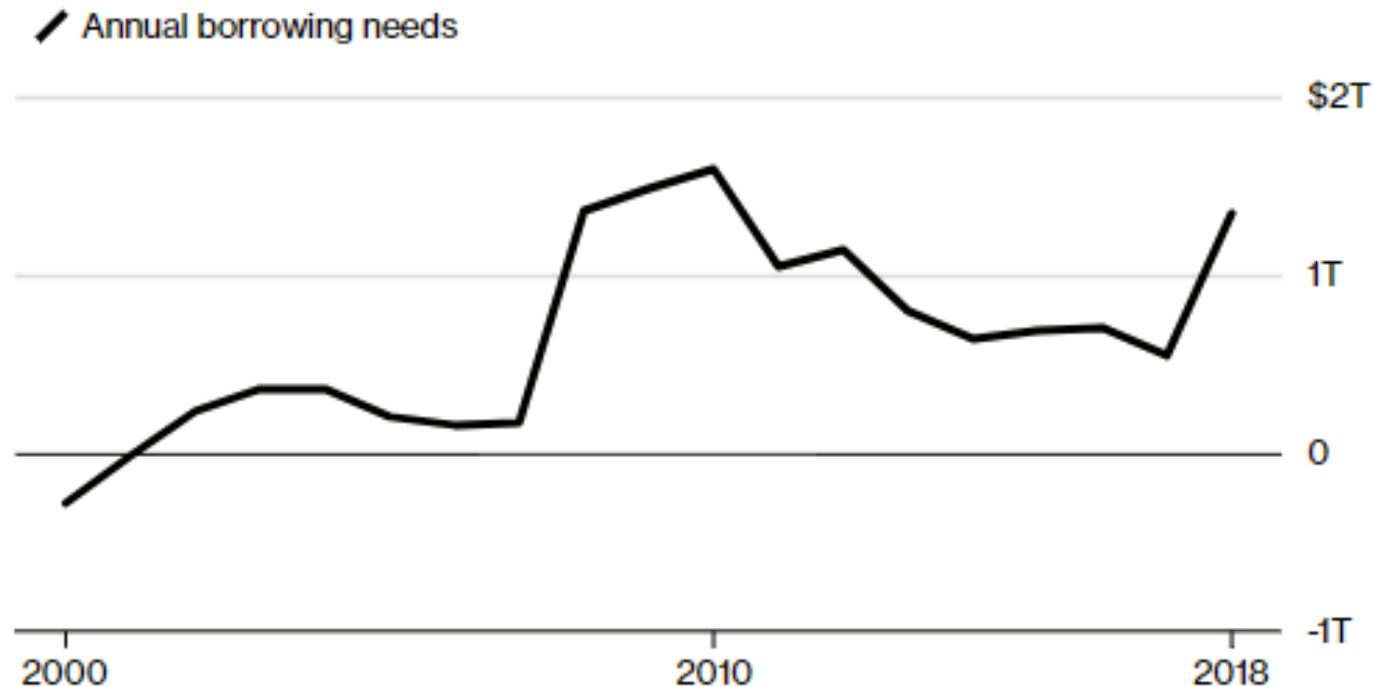
Figure 6: US unemployment rate and budget deficit



This Means the US has a Lot of Government Bonds to Issue (and the Fed is Done Buying)



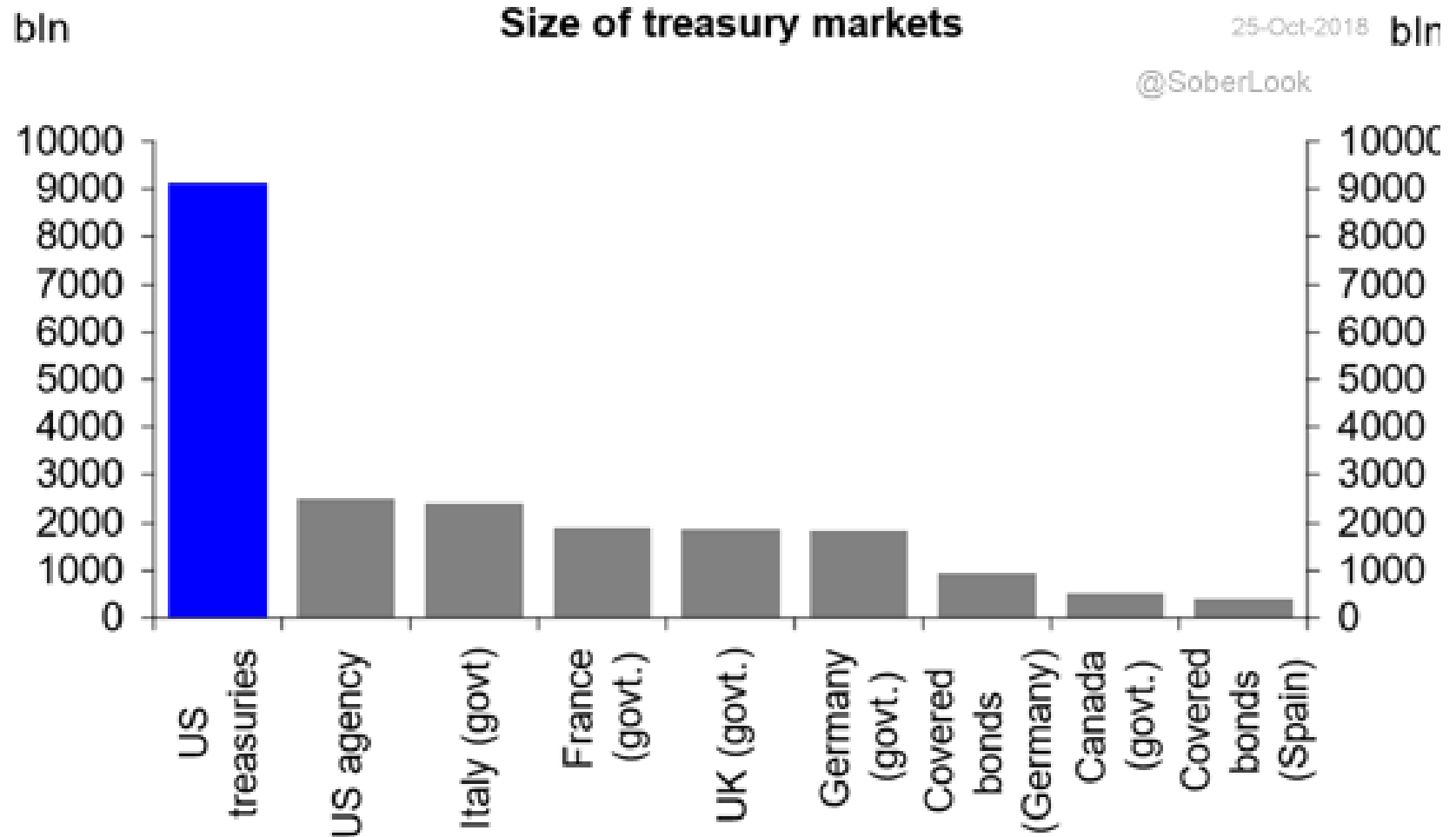
U.S. government borrowing will more than double this year from 2017



Source: Treasury Department data compiled by Bloomberg

Note: 2018 figure includes forecast for fourth quarter

The US Treasury Market Sets the Tone for Global Government Funding Markets



Source: Fitch Ratings, US Treasury, SIFMA, US debt management office, Agency France Tresor, Bundesrepublik Deutschland, European Covered Bond Council, DB Global Research

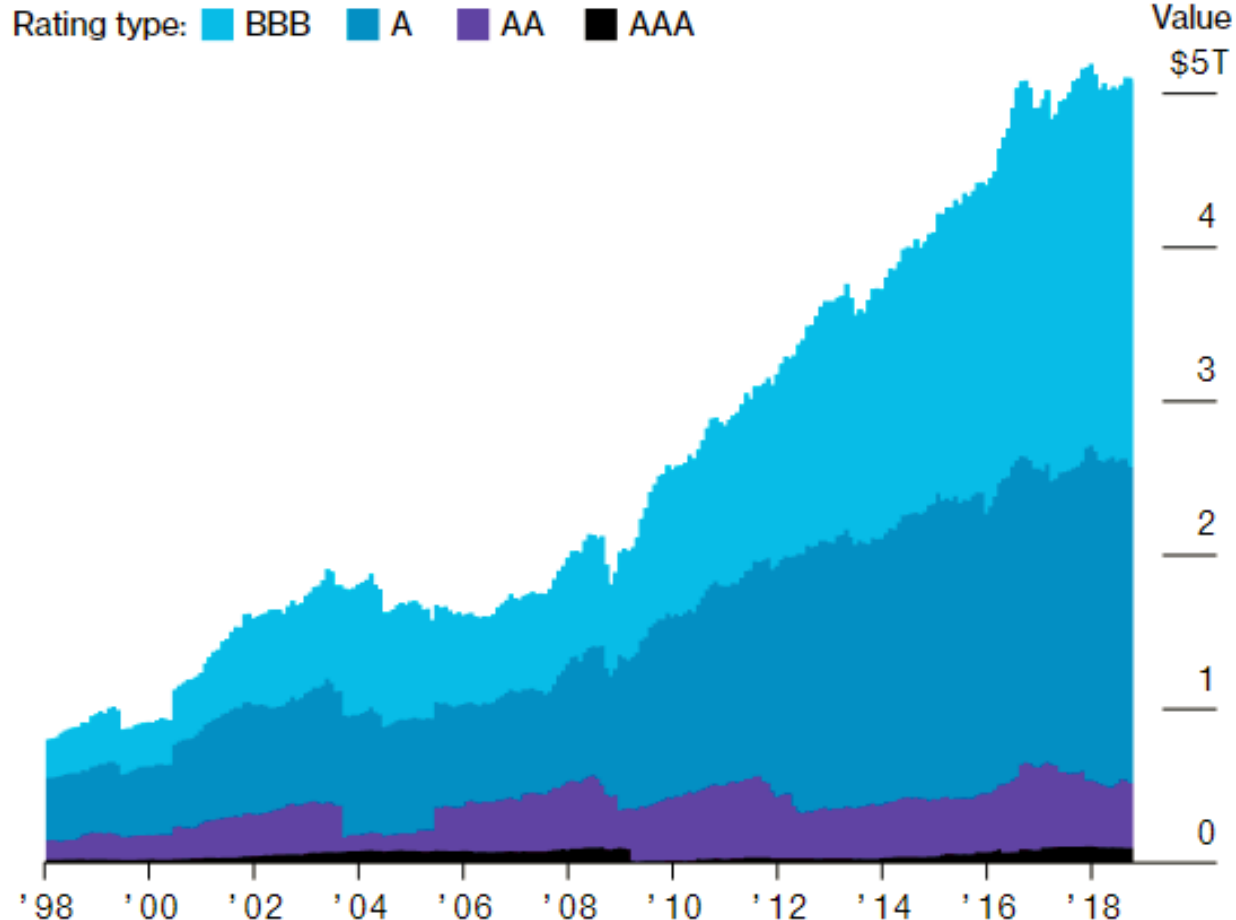
The Move from Phase 2 to Phase 3: Higher Government Bond Yields Impact Corporates



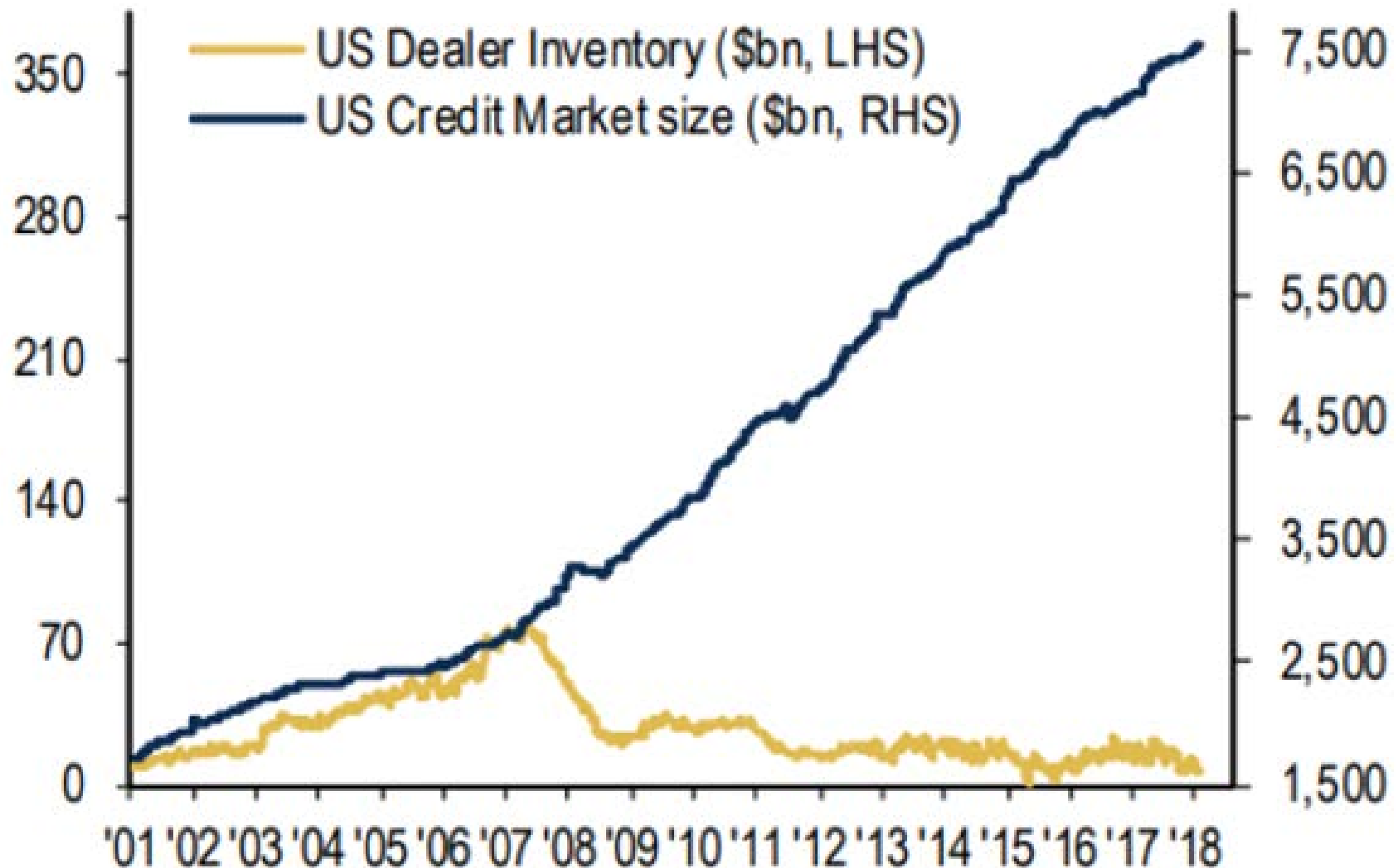
The Pile of Corporate Debt has Grown Considerably in Recent Years



More than half of the U.S. investment-grade index now sits in the lowest ratings tier



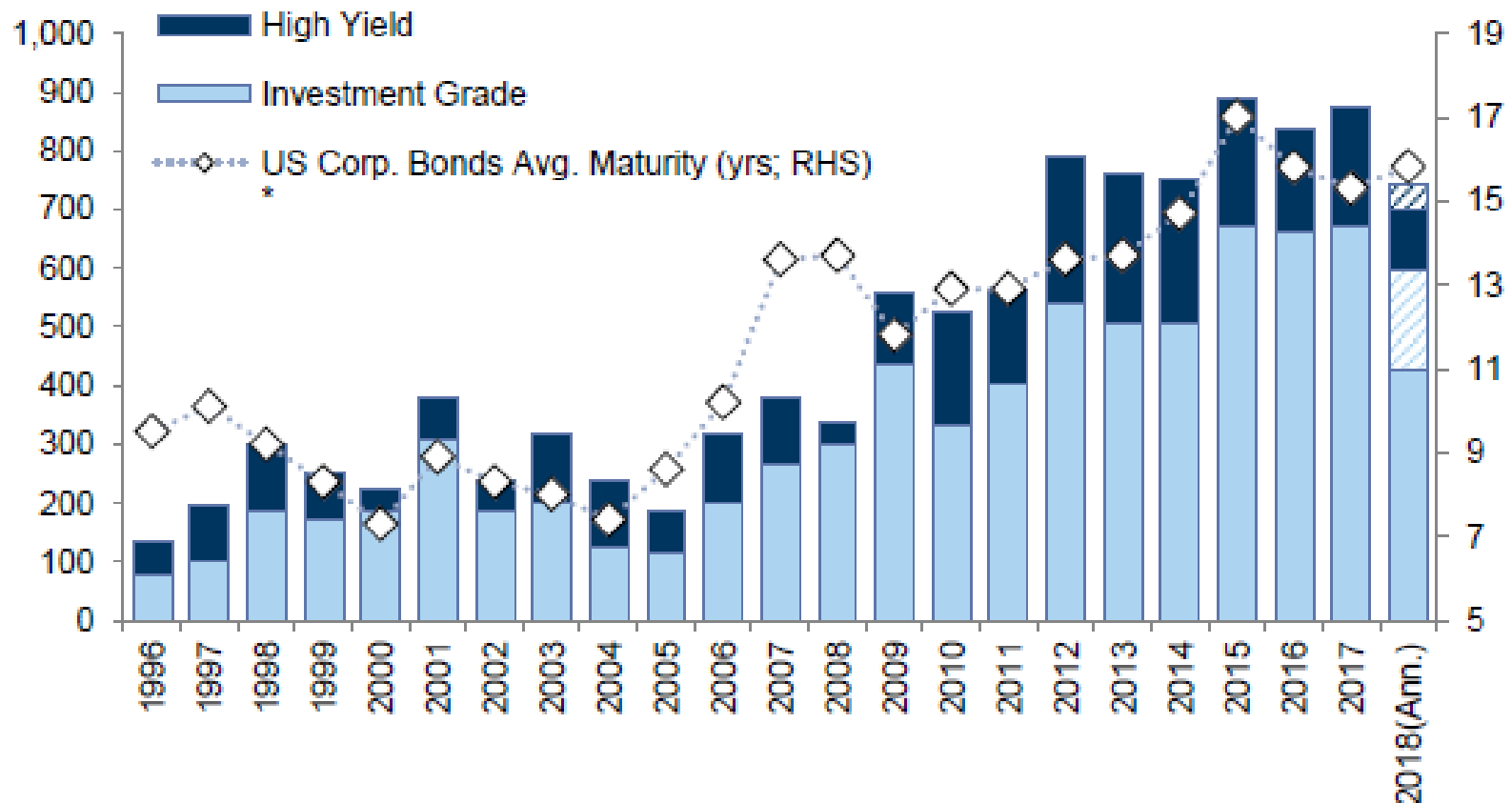
Investors Should be Aware of this because they Hold a Greater Share of the Risk



Companies have Transferred Risk to Investors by Extending Term on New Issues



US Non-Financial Corp. Debt Issuance (\$,bn); Avg. Maturity of Issuance

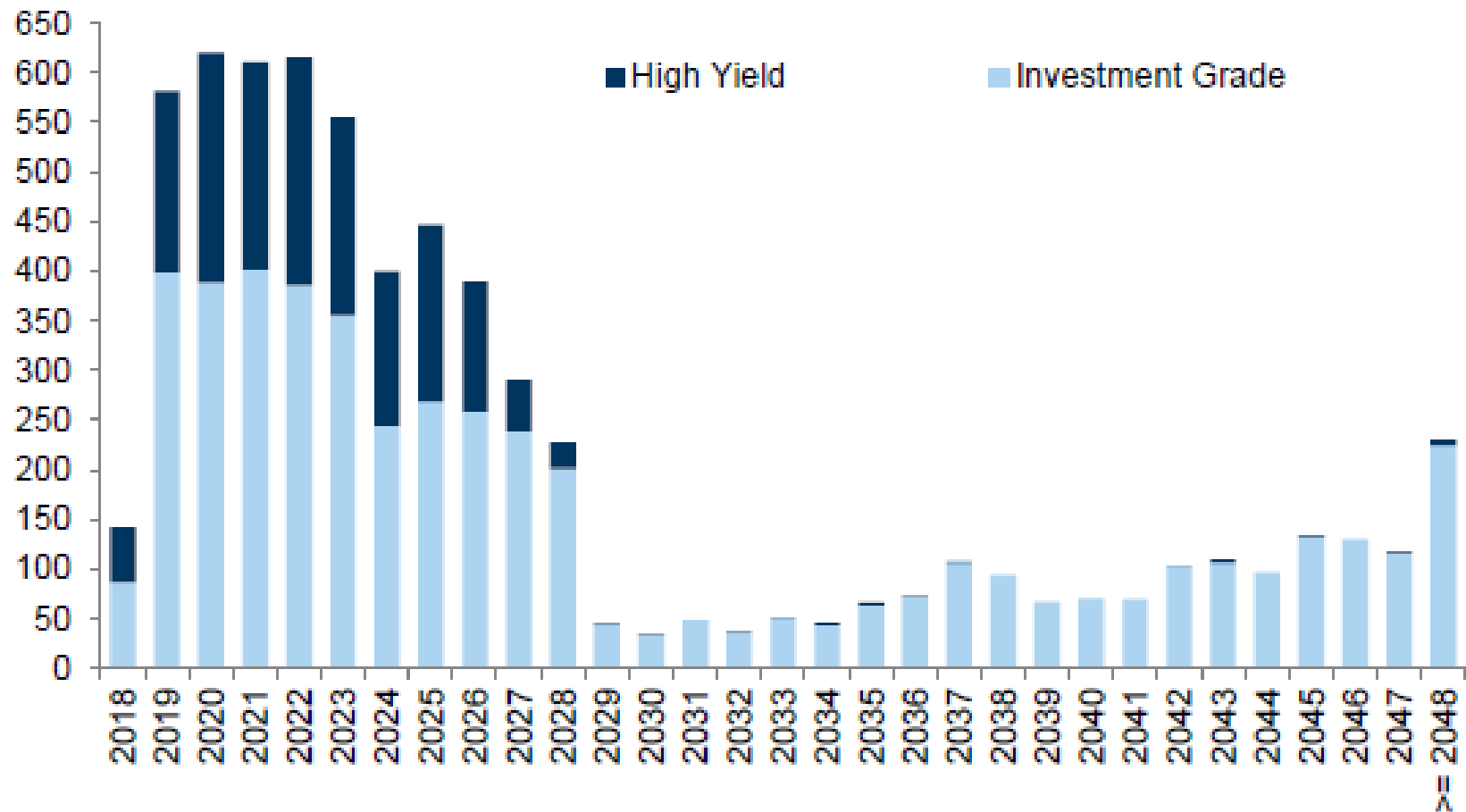


* Avg maturity includes all non-convertible corporate debt, MTNs and Yankee bonds, but excludes all issues with maturities of one year or less and CDOs

...but they are Not Immune to Refinancing Risk



Face Value of US Non-Financial Corp. Debt by Year of Maturity (\$, bn)



We are Watching CCC Bonds for a Sign that Refinancing Risk is Increasing



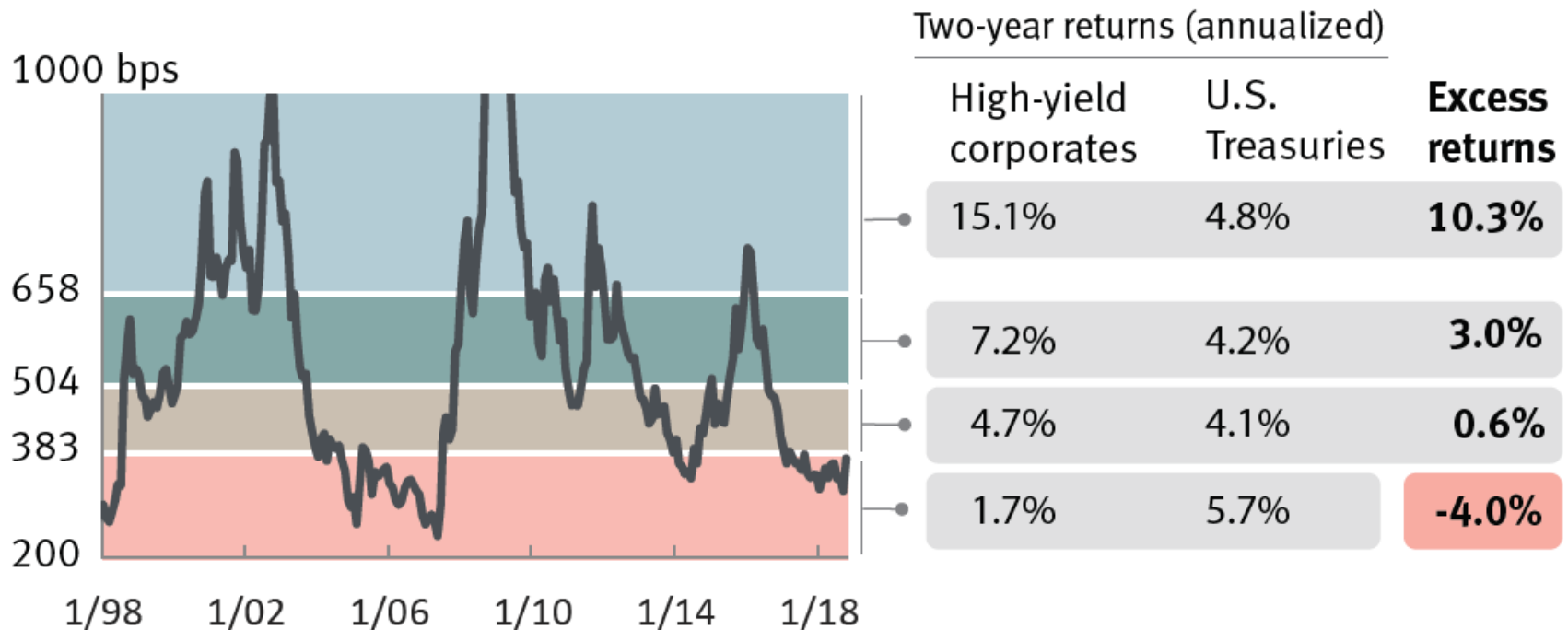
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No Signs of Stress Yet ... but it Doesn't Pay to Wait!



Range of high-yield credit spreads since 1998 divided into quartiles and historical performance



Source - Bloomberg, FactSet; Data calculated using Average Bloomberg Barclays US Aggregate High Yield Index and Bloomberg Barclays US Aggregate Treasury Index 2-yr total return data

No Need for FOMO on Bonds if You Maintain an Allocation to Stocks



S&P 500 outperforms HY bonds when credit spreads are narrow

Data for when spreads fall under 425 bps until the move back above 425

Time frame	S&P 500 return	High-yield bond return	Outperformance of S&P 500
Jan. 1994 – Aug. 1998	120%	44%	76%
Dec. 2003 – Aug. 2007	49%	31%	18%
Nov. 2013 – Dec. 2014	20%	5%	15%
Jan. 2017 – Sep. 2018	35%	10%	25%
Average	56%	23%	34%

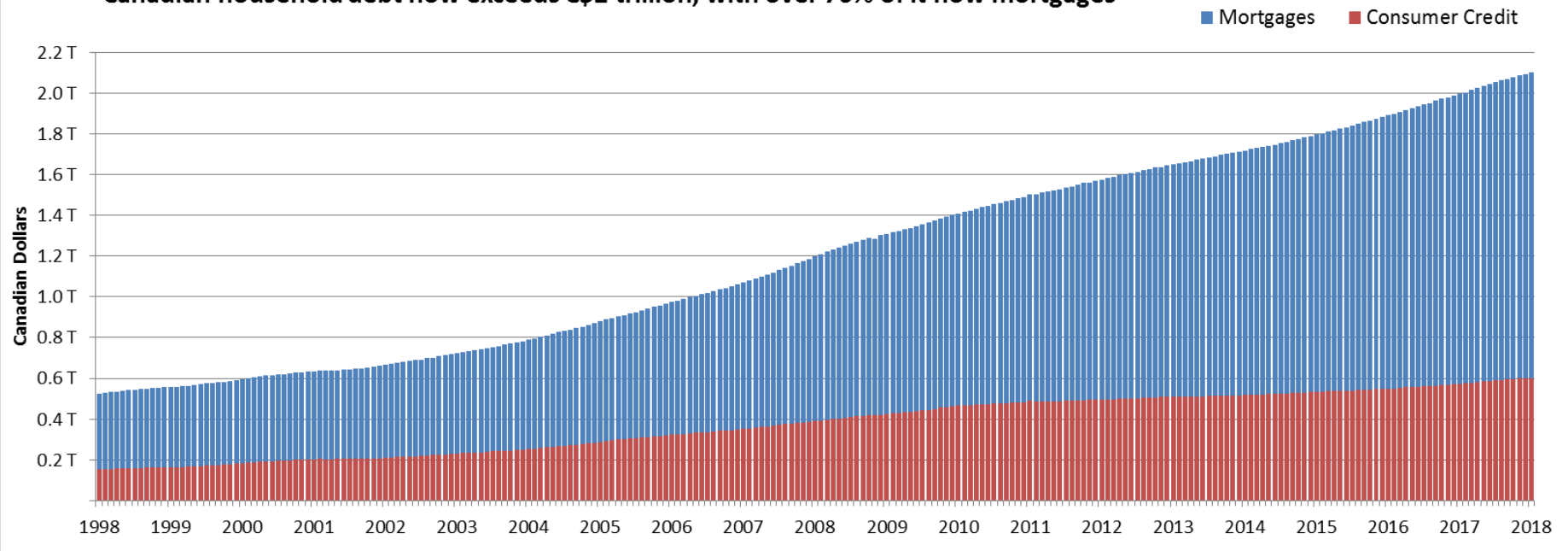
Source - Bloomberg, FactSet; data calculated using Bloomberg Barclays US Aggregate High Yield Index total return

The Other Place Debt has Piled Up: The Canadian Consumer



Debt Piles Up

Canadian household debt now exceeds C\$2 trillion, with over 70% of it now mortgages

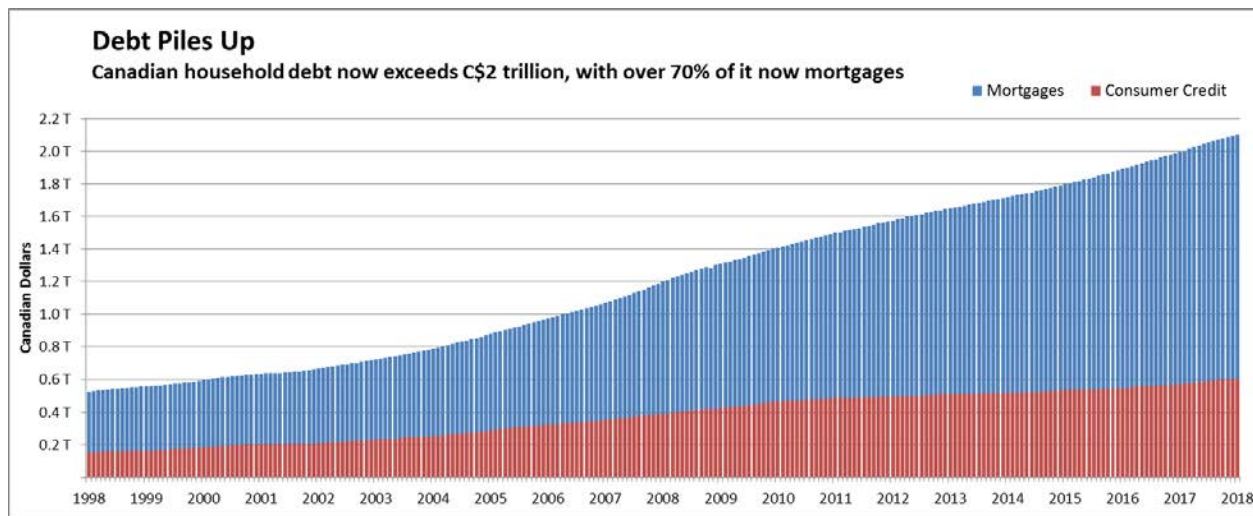


Remember when the American Consumer was the Irresponsible One?

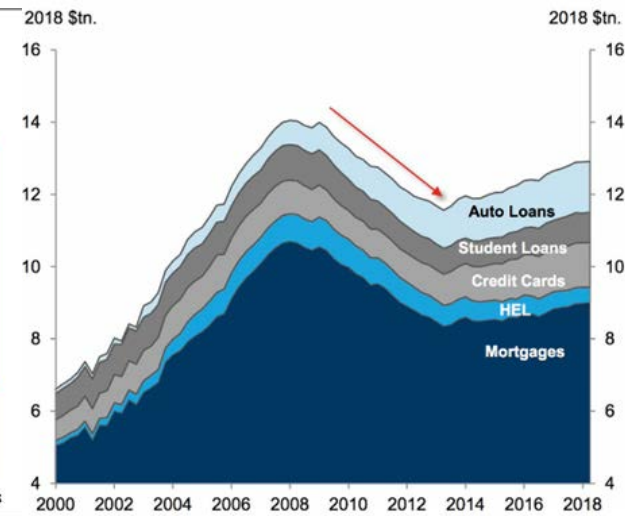


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The Canadian Consumer



The US Consumer



The Government is Concerned about what this Means as Interest Rates have Increased



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Government
of Canada

Gouvernement
du Canada

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Consumer Alert: Managing debt when interest rates rise

From: [Financial Consumer Agency of Canada](#)

News Release

Ottawa, Canada

At a time when Canadians are carrying record amounts of debt, the Financial Consumer Agency of Canada (FCAC) is advising consumers to take steps to manage a rise in interest rates.

An interest rate increase requires consumers to make higher monthly payments on credit products and loans such as variable interest rate mortgages, personal loans and lines of credit. Interest rate increases could also impact loans that are coming up for renewal such as fixed rate mortgages. For some consumers, higher debt payments means having less money to put toward other expenses.

Consumers may be more vulnerable if a larger share of their disposable income is applied to servicing their debt, since they may lack flexibility in their monthly budget to cope with higher borrowing costs.

A rate increase is a good time for consumers to review their finances. FCAC recommends consumers review their budget to see how higher interest rates will impact their payments and take steps to manage an increase, such as:

- paying down larger debts, especially those with the highest interest rates
- making prepayments on their mortgage or accelerating mortgage payments
- cutting expenses and putting more money toward paying down debt
- avoiding taking on more debt
- setting aside savings to deal with unplanned expenses
- consolidating debts with high interest rates into a loan with a lower interest rate

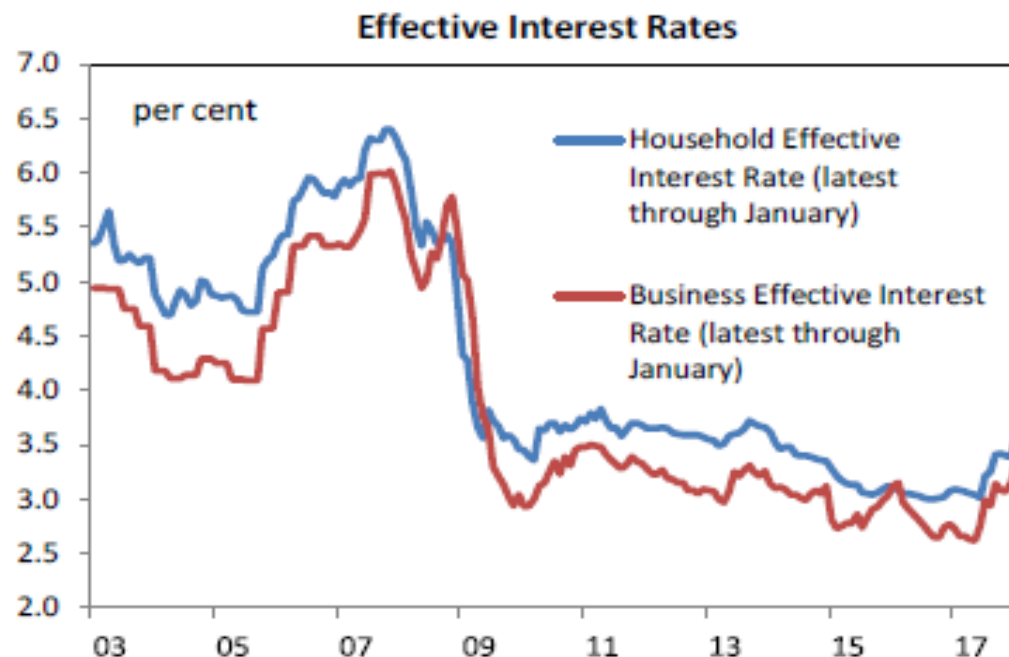
Why? After a Decade of Borrowing More and Paying Less, the Math is Changing



More Debt, Less Interest Payments

Year	Household Debt	Interest Paid on Outstanding Credit Balances	Effective Rate
2007	\$1,230	\$82.41	6.70%
2017	\$2,040	\$77.52	3.80%
Change	\$810	-\$4.89	-2.90%

...but Interest Payments are Going Up

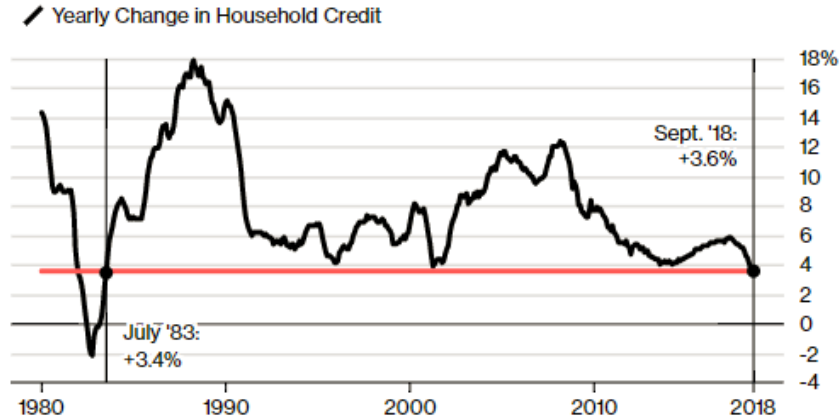


Zooming in on the Significance of the Recent Shift



Canadians are Borrowing Less...

Canadian household credit hasn't grown this slowly since 1983



Source: Bank of Canada, Bloomberg Calculations

...as Interest Rates have Increased

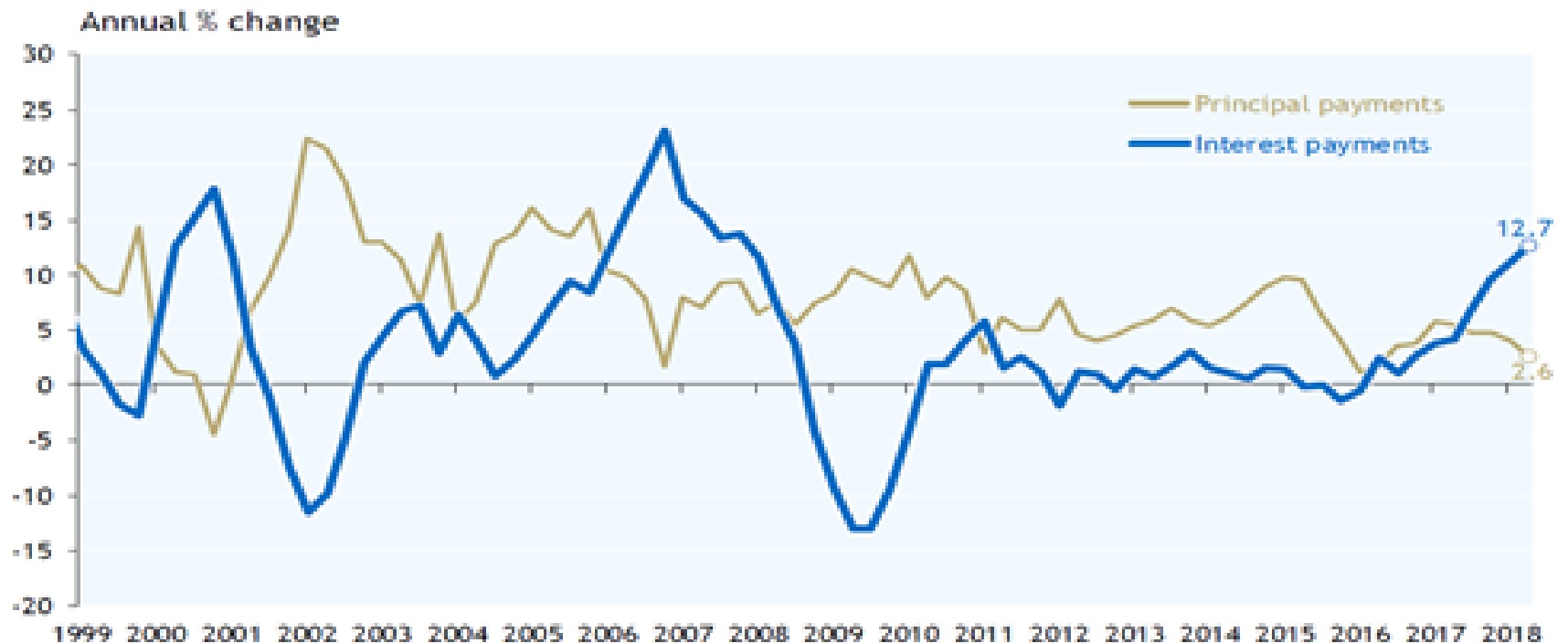
Borrowing Rates on the Rise



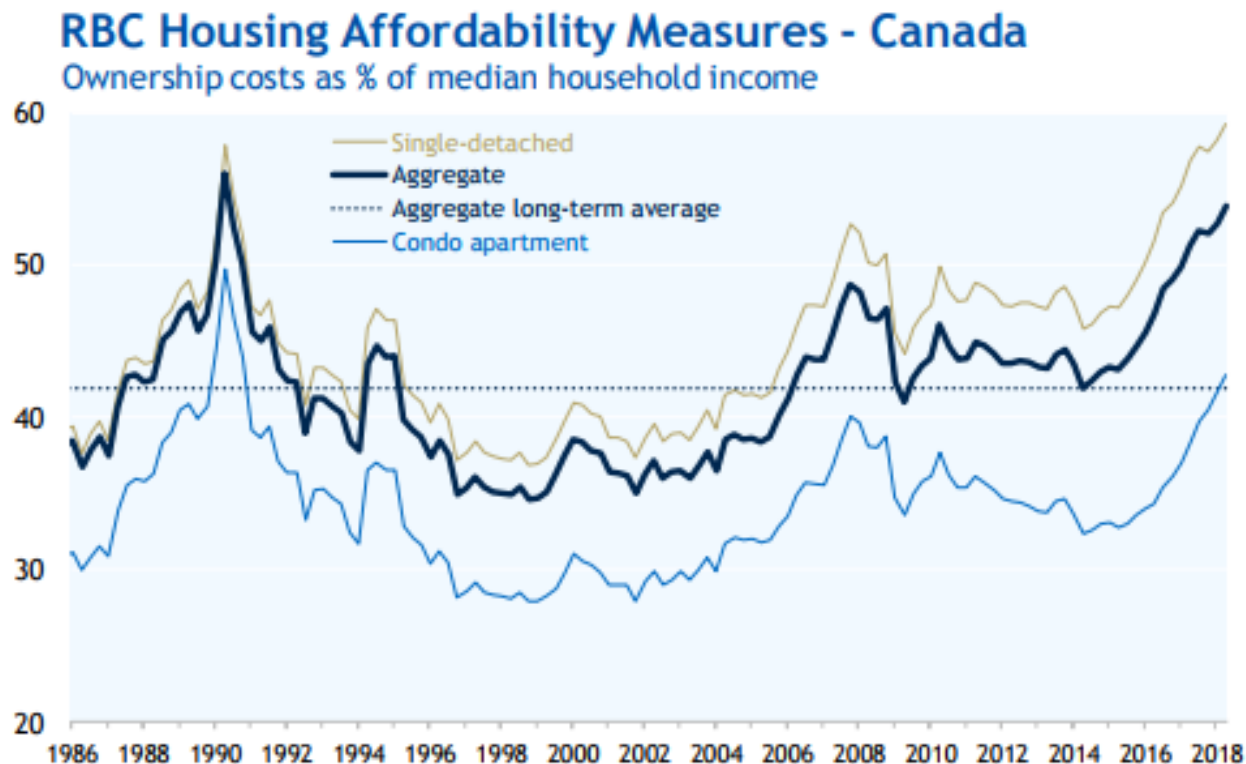
Canadians are Spending More on Debt Service ... but not Reducing their Balances



Breakdown of Growth in Principal and Interest Payments



Higher Interest Rates are the Latest Source of Housing Affordability Challenges



The share of income a household would need to cover ownership costs (in %)

Canada	Vancouver	Calgary	Edmonton	Toronto	Ottawa	Montreal
53.9	88.4	43.9	28.4	75.9	38.6	44.1

Second quarter 2018

The Takeaway: A Slower Pace of Rate Hikes from the BoC



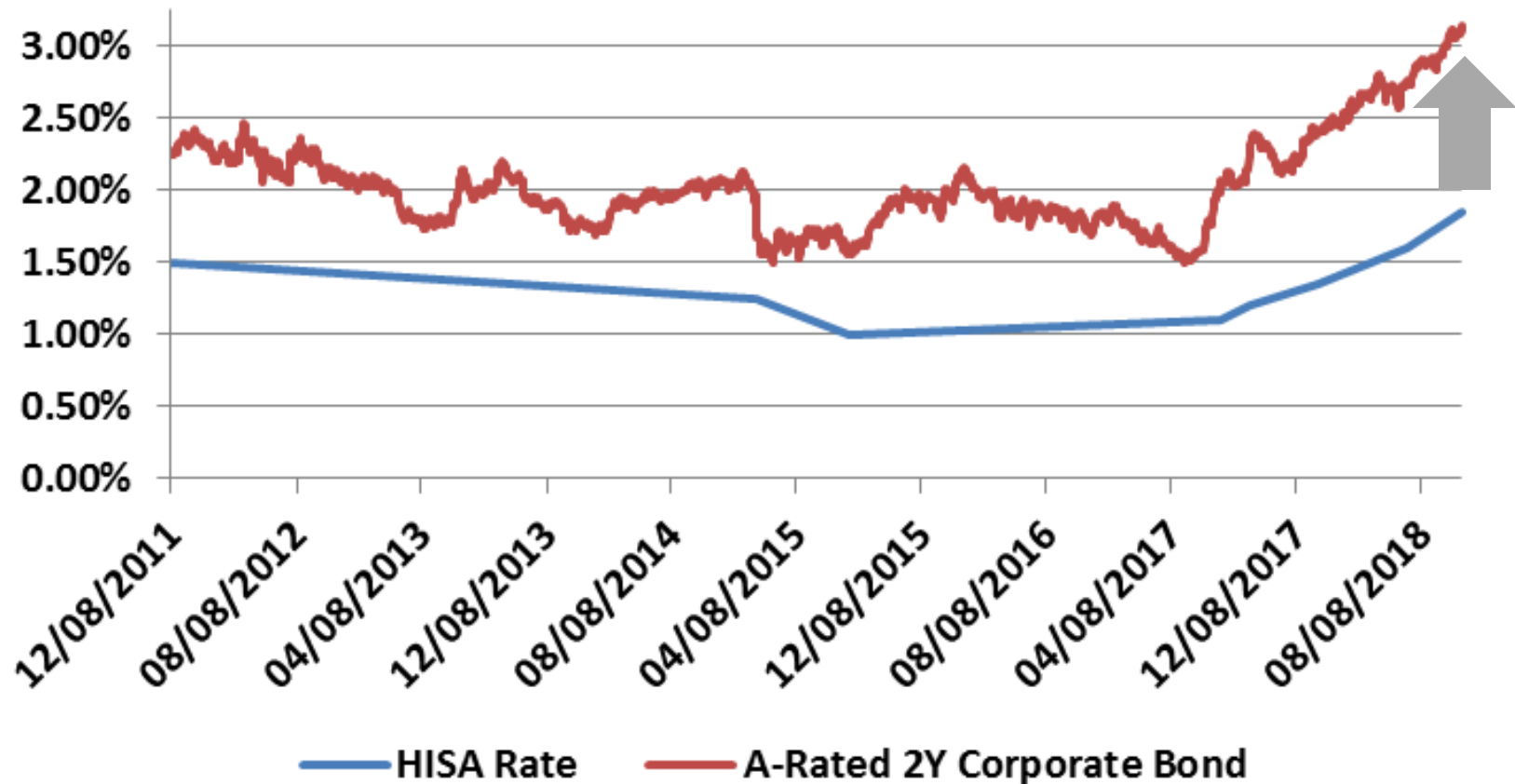
RBC Economics thinks the BoC is Closer to Stopping in 2019 than the Market

Canada Overnight Rate Projections												
	Actuals				Forecast							
	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4
RBC Eco	1.25	1.25	1.50	1.75	2.00	2.25	2.25	2.25	2.50	2.75	2.75	2.75
Swap Curve	1.25	1.25	1.50	1.87	2.08	2.24	2.37	2.39	2.48	2.57	2.66	2.42

Don't Just to Nothing! Short-term, high quality bonds Look Attractive versus Cash



Opportunity Cost to Sit in Cash has Increased





Thank you
