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Not All Full Employment Equilibria are the Same

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Canadians are a humble lot, less likely to wave the flag as prominently as our American neighbours, more likely to find fault in their country than celebrate its successes. Indeed, polls show that incumbent governments across Canada are generally rated poorly on economic performance. That's despite the fact that you have to go all the way back to when Olivia Newton John topped the charts, in 1974, to find a lower jobless rate than Canada enjoys today.

We're starting to see at least some evidence from wages that Canada is closing in on full employment. But while full employment is a mark of success, not all full employment equilibria are the same. In this case, the mix of spending that has taken us to this point, and how it's been financed, leaves much to be desired, as does the nature of the jobs being created.

As we discuss in this issue (see pages 3-5), Canada has attained full employment with not much to show for it on the export front. That lacklustre pace for real exports and related capital spending extends back to the previous expansion as well. In the face of a steady erosion in our share of foreign markets, the policy mix had to propel government activity during the recession and after the oil shock, as well as a boom in debt-financed consumption and housing.

Had Canada achieved more success abroad, and attracted more business capital spending on new capacity in export sectors, interest rate settings could have been higher and fiscal policy less stimulative. That would have meant less upward pressure on housing prices and household debt, and more progress on reducing what are still some problematic provincial debt burdens.

Capacity expansions in export industries would also tend to be associated with higher productivity, and therefore, more jobs at better pay scales. In short, a different path to full employment, and one with less risk to future financial stability.

But shifting from the current full employment equilibrium, to that more desirable one, is no easy feat, and one that would take many years to unfold. It would require a fresh look across a broad range of tax and regulatory files that impact our attractiveness to trade-oriented business. If that's not politically feasible, a weaker Canadian dollar over the next decade will also have to be part of the policy mix.

Engineering a softer exchange rate in the coming decade will tend to require a lighter hand in raising interest rates, relative to what happens in the US and overseas. That will leave the task of holding back household's debt appetite to macro-prudential measures, which do seem to be starting to bite in the case of the mortgage market. And we'll also have to fight to keep borders open for our exports in a world where protectionism is a growing threat.

MARKET CALL

- We left our rate forecasts virtually unchanged, as both the US and Canadian curves now sit very close to our June-end targets. Other than an upward creep ahead in 30-year yields as the market moves past some term-extension demand and feels the impact of the Fed's QE unwind, our call now implies that we see bond yields essentially range-bound until 2019.
- The Fed minutes pointed to a rate hike in June. But the Fed's tolerance for a bit of an overshoot on CPI also suggests that it wouldn't take much of a disappointment on the growth or employment front to let them pause for a quarter at some point. The central bankers might simply decide that after toping 2%, rates can be kept on hold for a quarter to see how the economy is coping before resuming hikes in 2019.
- If, as we expect, the Bank of Canada hikes in July but goes on another extended pause, that will diverge enough from both market expectations and the Fed's track to send the loonie marginally weaker against the greenback, with greater underperformance versus other majors. Longer term, unless Canada takes steps on the policy front to improve our export competitiveness, we could have a further slide in the C$'s value beyond our 2019 forecast horizon (see pages 3-5).

INTEREST & FOREIGN EXCHANGE RATES

		2018				2019			
END OF PERIOD:		**25-May**	**Jun**	**Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**
CDA	Overnight target rate	1.25	1.25	1.50	1.50	1.75	1.75	2.00	2.00
	98-Day Treasury Bills	1.27	1.25	1.45	1.45	1.75	1.70	1.95	2.00
	2-Year Gov't Bond	1.96	1.90	2.05	2.05	2.10	2.10	2.20	2.25
	10-Year Gov't Bond	2.35	2.50	2.50	2.50	2.60	2.65	2.65	2.60
	30-Year Gov't Bond	2.38	2.50	2.65	2.75	2.85	2.85	2.90	3.05
U.S.	Federal Funds Rate	1.625	1.875	2.125	2.125	2.375	2.625	2.625	2.875
	91-Day Treasury Bills	1.88	1.80	1.90	2.05	2.25	2.55	2.65	2.80
	2-Year Gov't Note	2.48	2.40	2.45	2.50	2.60	2.70	2.70	2.80
	10-Year Gov't Note	2.93	3.00	2.95	3.05	3.20	3.30	3.25	3.15
	30-Year Gov't Bond	3.09	3.25	3.35	3.45	3.50	3.50	3.55	3.60
Canada - US T-Bill Spread		-0.62	-0.55	-0.45	-0.60	-0.50	-0.85	-0.70	-0.80
Canada - US 10-Year Bond Spread		-0.58	-0.50	-0.45	-0.55	-0.60	-0.65	-0.60	-0.55
Canada Yield Curve (10-Year — 2-Year)		0.39	0.60	0.45	0.45	0.50	0.55	0.45	0.35
US Yield Curve (10-Year — 2-Year)		0.46	0.60	0.50	0.55	0.60	0.60	0.55	0.35
EXCHANGE RATES	CADUSD	0.77	0.77	0.76	0.76	0.78	0.78	0.76	0.77
	USDCAD	1.30	1.30	1.32	1.31	1.28	1.29	1.31	1.30
	USDJPY	109	108	106	104	102	102	101	100
	EURUSD	1.17	1.20	1.22	1.25	1.27	1.29	1.30	1.32
	GBPUSD	1.33	1.34	1.34	1.39	1.43	1.47	1.48	1.52
	AUDUSD	0.76	0.75	0.77	0.80	0.81	0.82	0.84	0.85
	USDCHF	0.99	0.98	0.97	0.95	0.94	0.93	0.93	0.92
	USDBRL	3.66	3.60	3.70	3.55	3.50	3.45	3.50	3.55
	USDMXN	19.5	20.1	19.4	18.9	18.5	18.1	18.4	18.0

Can Canada Compete, And at What Exchange Rate?

by Avery Shenfeld and Royce Mendes

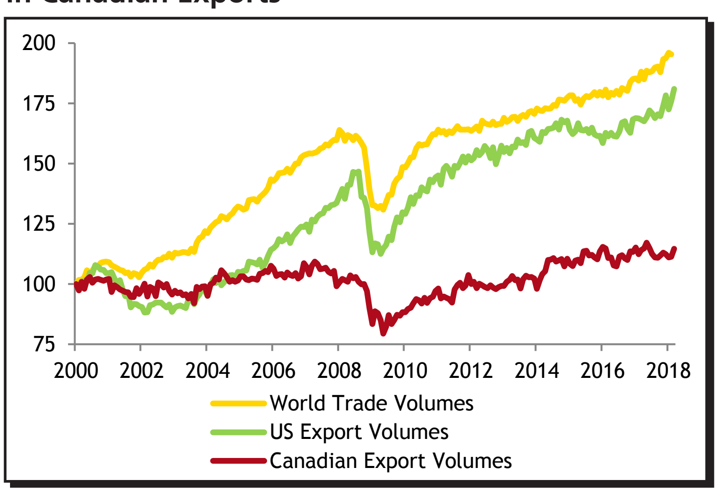
We've had a couple of better months for Canadian exports and manufacturing output, but don't break out the champagne. Let's face it, since the turn of the millennium, other than in the initial post-recession bounce-back, Canada has been an also-ran in the race for global and US markets.

Sure, some of the growth in global trade has centred on the emergence of China and other developing economies. But even relative to the US, Canadian export volumes have lost a lot of ground (Chart 1). Indeed, a listless trend in export growth has been one factor behind Canada's persistent goods trade deficit which hit a record in March. Odd then that trade balances were a hot election issue in the US in 2016, but not here.

Facing lackluster exports, Canada leaned on consumption and housing for the last decade's growth. But easy money and fiscal stimulus were a cocktail of elevated household debt levels, government deficits, foreign borrowing, and pulled-forward consumption and housing. For financial stability reasons, we now want to at least tap the brakes on debt-financed consumption, housing and government spending. If that raises savings, we'll need exports and related capital spending to fill in part of the gap. Such a shift to a more balanced economy would also tend to raise productivity, leaving more scope for higher real wages.

Chart 1

New Millennium Has Seen Listless Trend in Canadian Exports



Source: CPB, Haver Analytics, CIBC

What's been lacking are ribbon-cutting ceremonies at the new facilities—factories, labs and office towers—needed to expand export capacity. When exports were in high gear in the late-1990s, they were accompanied by healthy gains in industrial capacity, growth that has gone missing since then (Chart 2), other than in energy production and a few isolated sectors. The question is, can Canada compete as a location for such facilities?

Slip Slidin' Away

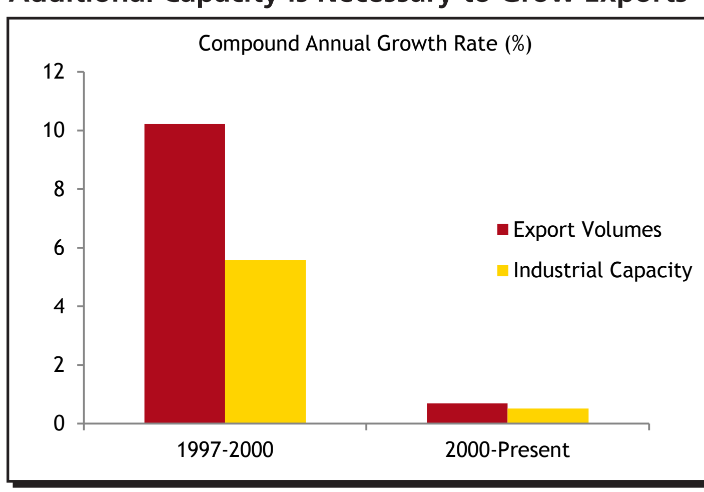
Of late, a lot of the concern has been about energy sector competitiveness. In natural gas, we relied on demand from a US market that has too many of its own sources of production, and are only now seeing some flickers of hope for an LNG facility that would open overseas markets. The oil sector has also been squeezed by a similar lack of transport capacity.

Even so, among major exports, crude oil has still been among the better performers in volume gains since 2012 (Chart 3). Given its heavy weight, crude oil has been the single largest contributor to the growth in export volumes over that period.

We can't, therefore, blame our export woes only on the lack of pipelines. Instead, the weaker elements have been a hodge-podge of manufacturing sectors which have in many cases seen Canadian activity supplanted in the US market by Mexico or other low-cost competitors.

Chart 2

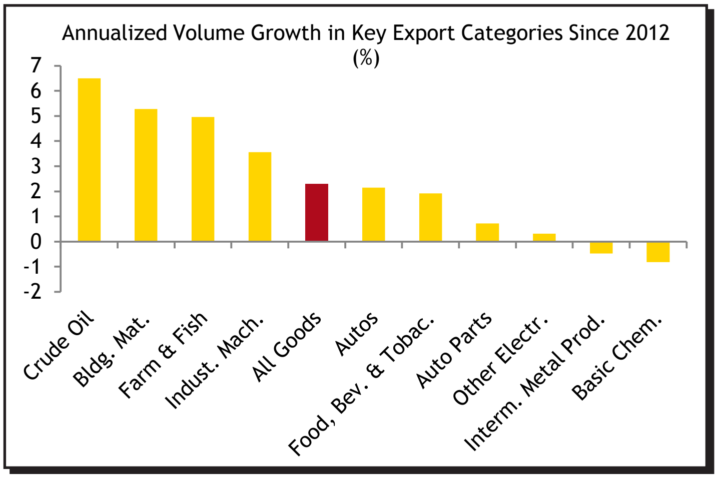
Additional Capacity is Necessary to Grow Exports



Source: Haver Analytics, CIBC

Chart 3

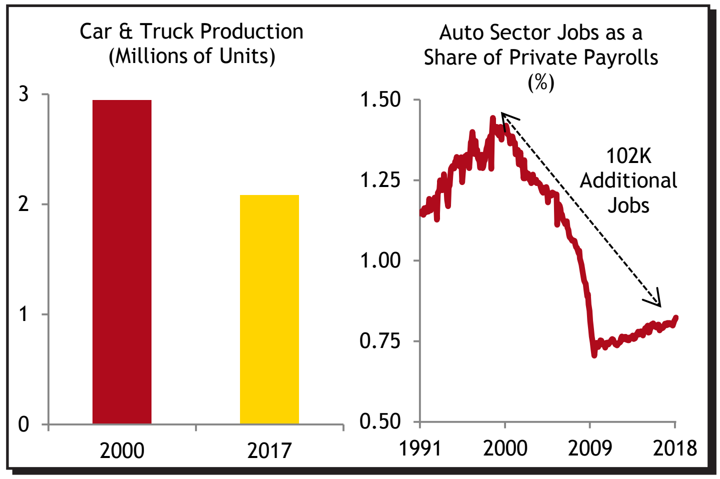
Despite Transport Constraints, Crude Oil Still Export Leader Since 2012



Source: Haver Analytics, CIBC

Chart 5

Waning Auto Production (L) Has Seen Fewer Well-paid Manufacturing Jobs in Canada (R)



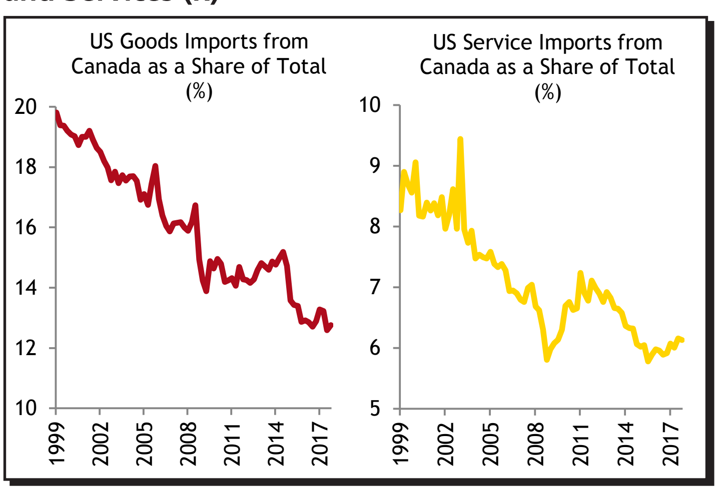
Source: Haver Analytics, CIBC

Simply put, export volumes have grown at a snail's pace as plants shut their doors in Canada and opened elsewhere. As a result, Canada's share of US goods imports has dropped from nearly 20% at the turn of the millennium to only 13% today (Chart 4, left).

The Trump administration has targeted autos in the ongoing NAFTA discussions. But it's not surprising that Canadian negotiators are also trying to put the squeeze on Mexico by joining in with Americans in a plan to limit the share of NAFTA-qualifying vehicles that can be produced in low-wage plants. Despite climbing North American demand, Canadian assemblies are down by almost a million units since 2000, a trend that has seen the equivalent of about 100 thousand manufacturing jobs go missing (Chart 5). We'll need to tread carefully in these talks, lest the lack of lower-cost content in vehicles assembled in Canada make them uncompetitive against vehicles from overseas.

Chart 4

Canada Losing US Market Share in Both Goods (L) and Services (R)



Source: Haver Analytics, CIBC

Not at Your Service

Is it that we're shifting from brawn to brain, from the factory floor to the office tower? We've been doing a lot of back-patting in Canada over the country's wins in attracting some of America's largest tech giants to open offices on this side of the border, tapping into Canada's brain power and our easier immigration policies that let foreign talent work here.

So it's a shocker that the data show that in services, Canada's share of US imports has also fallen by nearly one-third since 2000 (Chart 4, right). Some of the same emerging market countries that are challenging us in goods are also banging down the doors in services, and Canada's market share erosion has even been deeper than all other developed economies (Chart 6).

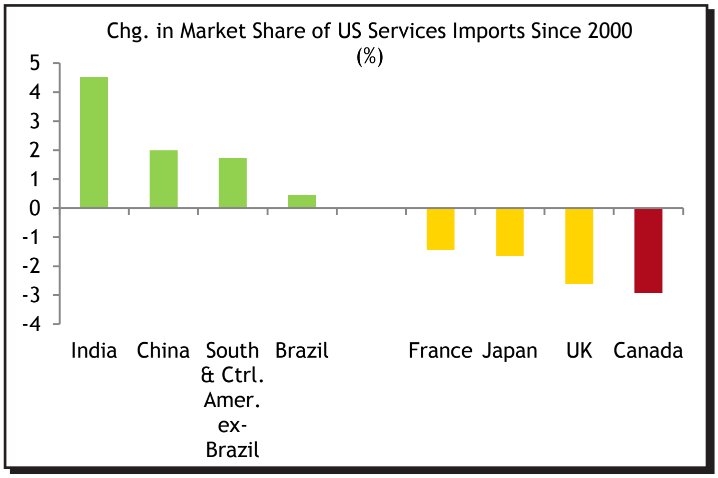
What is to be Done?

If we've diagnosed the problem—too few companies choosing Canada for the next new facility or expansion—what's the remedy? Targeted support for training and education can improve our human resources, particularly in tech-related services.

A thinning of the regulatory books, faster government project approvals, lower corporate taxes, improved business infrastructure and other incentives would also

Chart 6

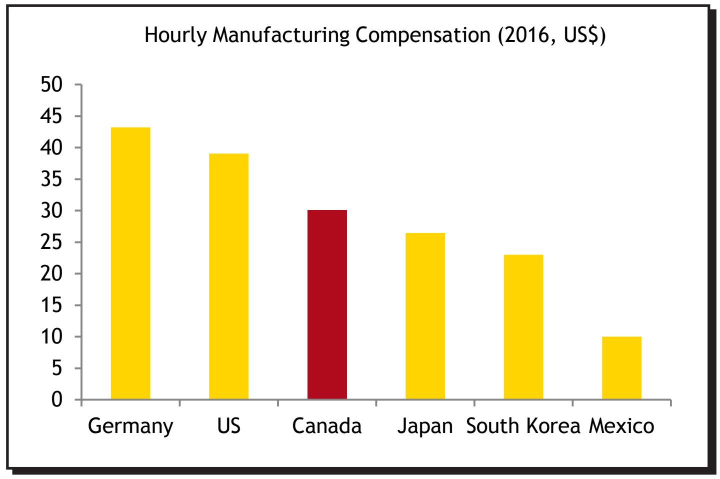
Developed Economies Losing Share of US Services Imports



Source: Haver Analytics, CIBC

Chart 7

Canadian Wages in Line with Other Developed Economies



Source: Conference Board

be helpful. But will we go toe-to-toe with the US? Canada's voting public seems less eager to trade off environmental protection for employment gains, less prone to pare back social programs to open up room for lighter taxation, less willing to rewrite labour laws to undermine unionization. We did cut corporate taxes during recent decades only to see the US match those moves under Trump.

It's not that Canadian wage rates are out of line with those south of the border. According to the Conference Board, average hourly compensation levels in manufacturing stood at 77% of levels stateside as of 2016 (in US dollars), roughly the same ratio as in 1997. But once a business is sufficiently mobile to consider non-US locations, it can look at larger labour savings in Mexico (10% of US costs), Taiwan (25%), or even South Korea (59%). And it's not all about wage costs, since German workers come with a price tag of 111% of those in the US (Chart 7).

If we don't make progress in tilting the playing field back to Canada, there is always the market's invisible hand to do the work for us. A poor current account balance will, over time, tend to push the C$ weaker against other majors. That will particularly be true if, given an elevated household debt level, the central bank has to proceed more cautiously on rate hikes than the US.

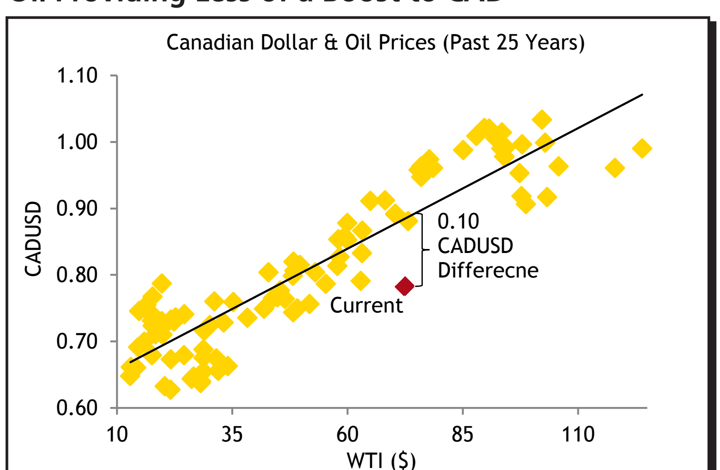
This could be a slow process. Both the current account balance's currency impacts, and the associated trade and investment responses, operate with long lags. But perhaps we're seeing the first signs of the loonie's shift, if you look hard enough. Dollar-Canada's recent levels look on the weak side given where oil has traded and its historic linkage to the exchange rate (Chart 8).

Our current forecast, which extends through 2019, only takes the Canadian dollar a few cents weaker. But look for an extension of that move in the subsequent decade as a necessary condition to lever export gains, while allowing macro prudential rules to wean the economy off of a further household debt binge.

It would be better if Canada had other advantages to support export growth, rather than rely on a weak loonie that makes us less able to spend abroad. But if that's not forthcoming, the C$ will bear the burden of adjustment, spurred by a weak current account, and a 1.40 dollar-Canada in the 2020s is on its way.

Chart 8

Oil Providing Less of a Boost to CAD



Source: Bloomberg, CIBC

US Wage Growth: Trying to Get a Straight Answer

by Andrew Grantham

Ask three economists a question and, as the joke goes, you'll get at least three different answers. The same apparently goes for measures of US wage growth, with the Atlanta Fed suggesting a deceleration, average hourly earnings moving sideways, yet the Employment Cost Index (ECI) pointing to an acceleration (Chart 1 left).

One thing that all of the measures agree on is that wage inflation remains well below levels reached just prior to the financial crisis (Chart 1, right). However, for monetary policymakers trying to judge how quickly to hike interest rates, whether wage inflation is accelerating or decelerating at the moment is also vitally important.

In the Mix

In contrast to the ECI, which uses fixed weights to control for changes in the composition of employment over time, other wage measures can be impacted by shifts in demographic and industrial composition.

We've shown previously (see "Time to Retire The Phillips Curve? Maybe Not") that demographic factors could be subtracting around ½% from headline earnings growth. Over the past year, that impact appears to have gotten worse rather than better. Not only has wage growth of workers aged 55+ remained furthest below pre-recession averages (Chart 2, left), it has actually decelerated further (Chart 2, right).

Of course, the Atlanta Fed measure, where the age breakdown comes from, has shown an aggregate deceleration over the previous twelve months. Moreover, all of the more detailed breakdowns they produce are on an unweighted basis, so can be impacted by differences in their sample and the population.

The Atlanta Fed does produce a headline wage indicator that has the components re-weighted to match their share of the population. At the moment there is a larger than normal gap between that series and the unweighted one. The weighted series shows a deceleration that isn't anywhere near as noticeable (Chart 3).

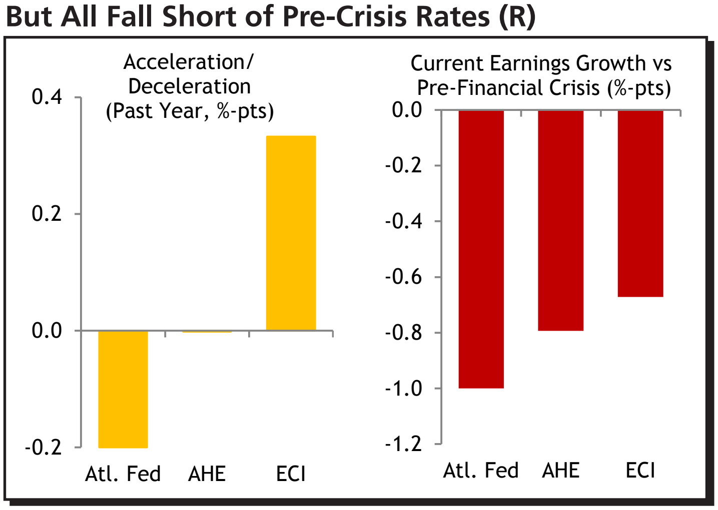
Analysis of average weekly earnings highlights another facet of job gains recently that could be detracting from headline earnings. Where higher wage inflation has been seen is in generally lower-paid occupations. Indeed, in the past year, the first decile and quartile of income earners have actually been seeing stronger wage increases than was the average before the financial crisis (Chart 4). However, in terms of the average earnings figures, this positive is outweighed by slower wage growth elsewhere.

Call the Supervisor

For average hourly earnings, another source of softness recently, has come from the volatile "supervisory" segment. Until just over a decade ago, the headline

Chart 1

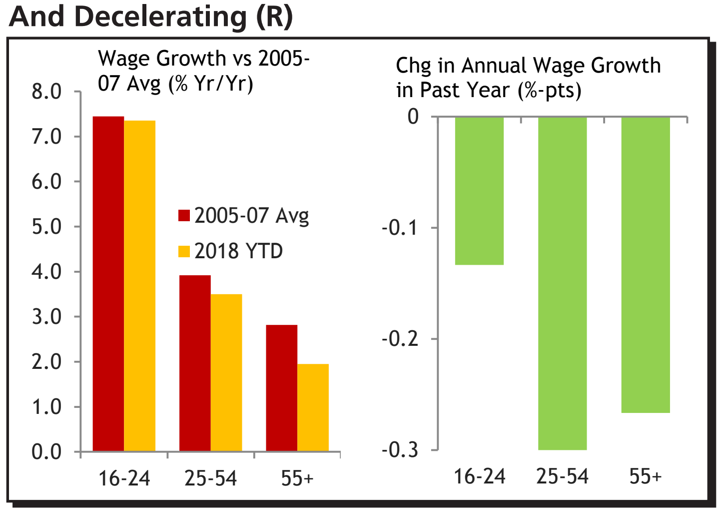
Mixed Recent News on Wages (L); But All Fall Short of Pre-Crisis Rates (R)



Source: Atlanta Fed, BLS, CIBC

Chart 2

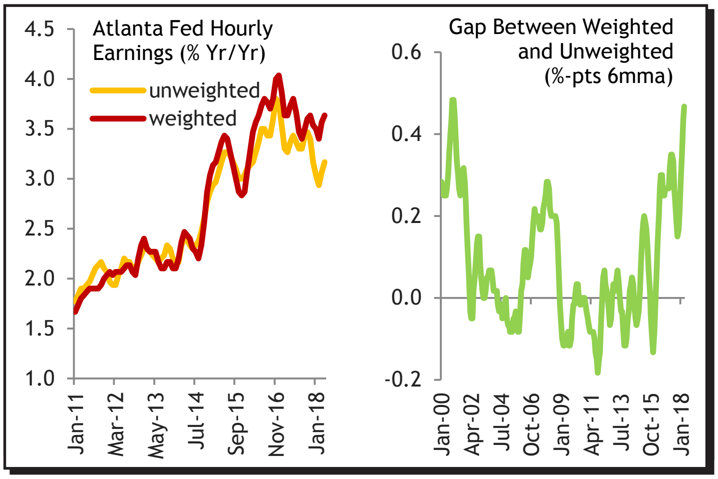
Older Workers Seeing Weaker Wage Gains (L), And Decelerating (R)



Source: Atlanta Fed, CIBC

Chart 3

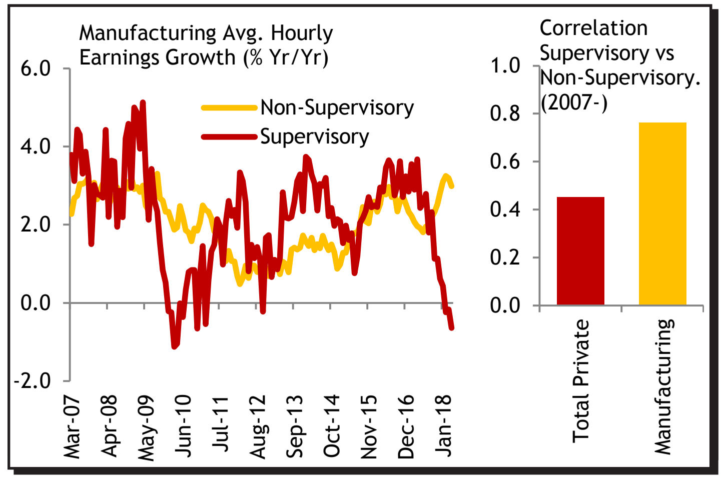
Atlanta Fed Wages Stronger When Weighted (L); Historically High Gap With Unweighted Series (R)



Source: Atlanta Fed, CIBC

Chart 5

Manufacturing Supervisory Wages Slump (L), Against Usual High Correlation (R)



Source: BLS, CIBC

wage figure in the US was for "production and non-supervisory" employees only. At the moment, they account for 83% of the workforce, with the "supervisory" workers accounting for the other 17%.

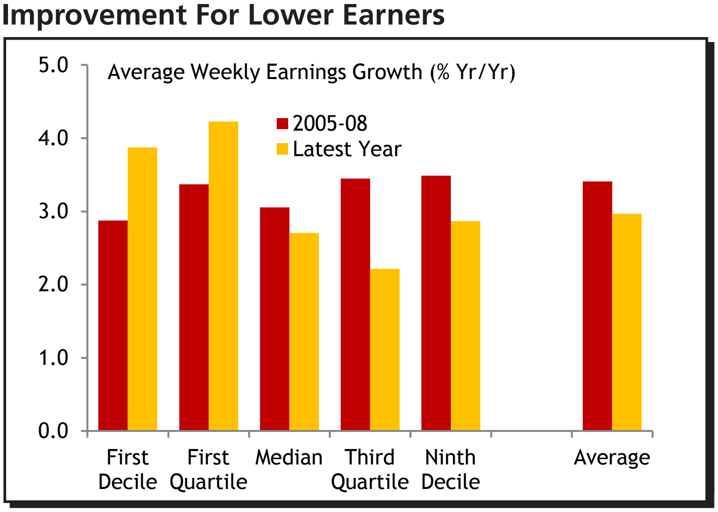
However, the volatile nature of the supervisory element means that segment can have a big impact on the overall direction. Recently that's been highlighted by the apparent slump in wage growth for manufacturing supervisors (Chart 5, left). As a result, this segment, accounting for only 3% of the workforce, has subtracted 0.15%-pts from aggregate wage inflation compared with a year ago. That's even stranger considering that the manufacturing sector generally exhibits a greater correlation between earnings growth of its supervisory and non-supervisory employees (Chart 5, right).

With the unweighted Atlanta Fed wage tracker and the supervisory element of average hourly earnings yielding some strange results, it may be best to concentrate on their alternatives. Looking at the weighted Atlanta Fed series and non-supervisory AHE, and averaging them with the ECI, suggests that underlying wage growth has accelerated slightly in the past year (Chart 6).

The extent of the acceleration is small, implying that the Fed isn't behind the curve on rate hikes. But the fact that underlying wage growth may be a little firmer than the headline suggests that US policymakers are well justified in continuing to edge rates higher.

Chart 4

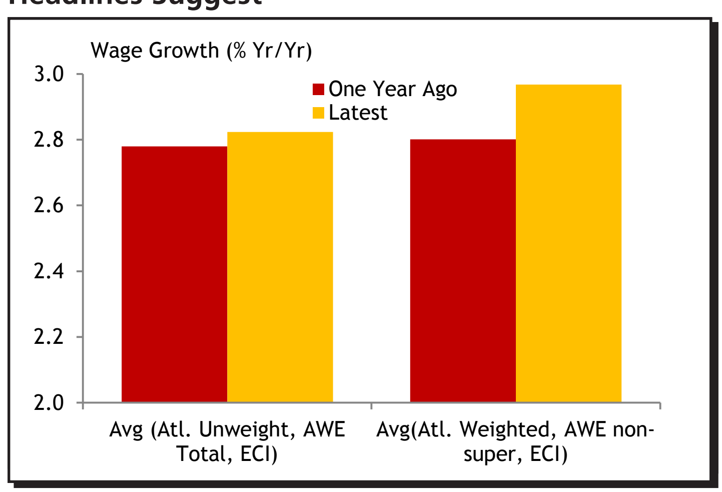
Slow Wages For Higher Paid Outweigh Improvement For Lower Earners



Source: BLS, CIBC

Chart 6

Wage Growth May Be a Little Firmer Than Headlines Suggest



Source: BLS, Atlanta Fed, CIBC

Pipelines: Easing the Bottleneck

by Benjamin Tal, Andrew Grantham, Katherine Judge

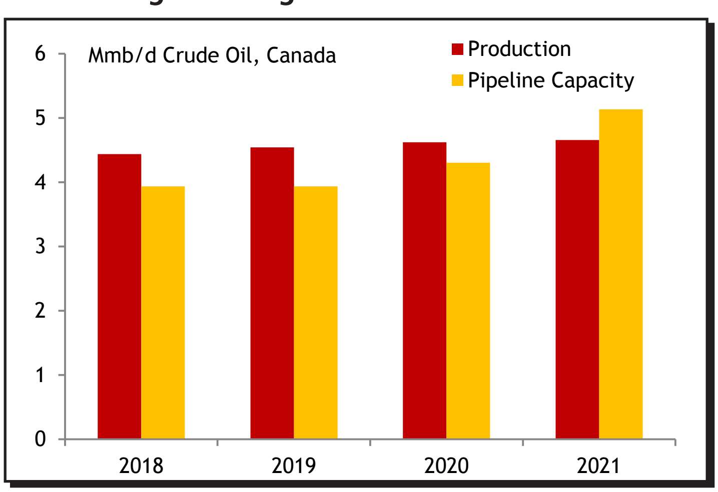
The current pipeline infrastructure in Canada is designed to meet the needs of the past, less so the present, and clearly not the future. The mismatch in the energy market is becoming more evident by the day. The twin factors of the fracking revolution and rising oil sands production are leading to greater access to crude supply in the interior while coastal regions are increasingly facing reduced access to oil and higher feedstock prices. At the margin, demand for oil in North America is falling—reducing intra-continental export opportunities, while Asian markets are expected to dominate demand growth in the coming decades. Simply put, the current pipeline system is ill-equipped to deliver products to where they are needed the most.

The cost is evident. We are already in a situation where production has surpassed takeaway capacity, with the WCS-WTI spread spending more time at wider levels. We estimate that a widening WCS discount has cost the energy sector north of C$12bn in forgone revenues over the past five years—on top of the actual cost of increased reliance on expensive rail transportation and reduced investment.

That cost will rise as pipeline capacity remains constant until 2020 while production rises. By 2020 spreads should narrow again as capacity will be enhanced by the activation of Line 3, to be followed by the Keystone XL line in 2021. However, that extra capacity will not shield the industry or the country from the high cost of disruptions akin to the one we witnessed last November.

Chart 1

Production vs Takeaway Capacity —It's Going to be Tight for a While



Source: CAPP, CIBC

There is a clear and urgent need to find a way to ship Canada's oil in a sustainable way to Asian markets, the Gulf coast, eastern Canada and the US eastern seaboard, while looking for opportunities to add refining and upgrading capacity in the west. Inaction is not an option.

A Tight Couple of Years

Pipeline capacity, or lack thereof, is already impacting companies' ability to get product to market, and the situation will only get worse before it gets better. Production is expected to increase to 4.6 mmb/d by 2020, but pipeline capacity will remain below that at 3.9-4.3 mmb/d in 2020 even as the Line 3 replacement reaches completion.

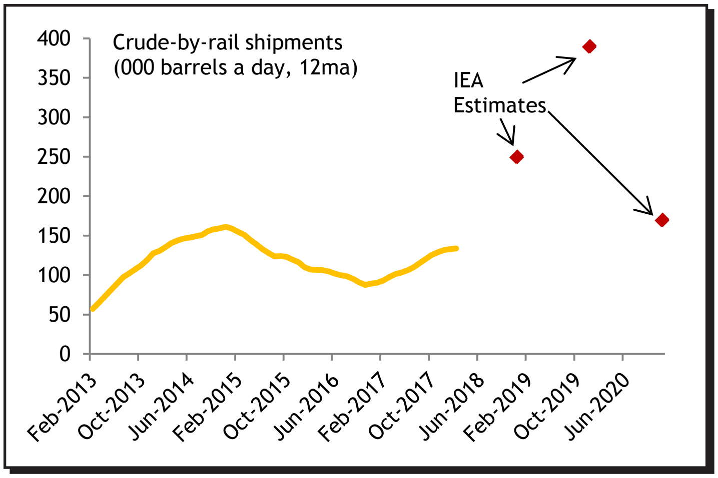
However, even that added capacity will leave the total below expected production. Not until 2021, when Keystone XL and potentially the Trans Mountain expansion are slated for completion, could pipeline capacity once again be greater than expected production (Chart 1).

In the interim, the energy sector will become more reliant on rail transportation. However, there are issues with that. While loading capacity is more than adequate, with the National Energy Board (NEB) estimating it at slightly more than 1 mn bbl/d, rail companies are concerned about making additional investments and/or disrupting existing clients to service what could be a fairly short-lived spike in demand for their mode of transport.

Earlier in the year, the International Energy Agency (IEA) projected that crude shipments by rail could hit 250K barrels per day this year and almost 400K next year, before additional pipeline capacity restrains demand again in 2020 and beyond (Chart 2). However, while rail shipments have risen, they aren't increasing quite as quickly as those projections suggested.

Chart 2

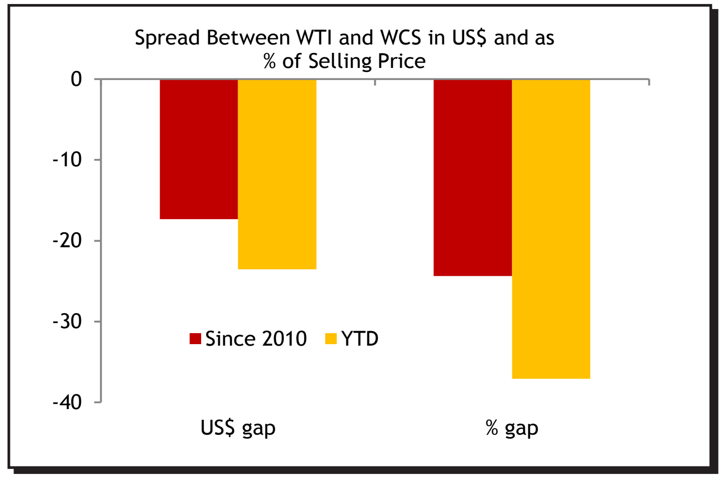
Crude by Rail Capacity—Rising



Source: IEA, NEB, CIBC

Chart 3

WCS-WTI Spread Under Greater Pressure



Source: Bloomberg, NEB, Statistics Canada, CIBC

Moreover, the cost is going up. Having reached a low of around US$12/bbl last year, a recent industry conference placed the cost of transporting oil to the gulf by rail at between US$15 and US$18/bbl. At the previous peak in rail shipments in late 2014, the cost was pegged at close to US$20/bbl. That compares to an average cost of US$6/bbl using pipelines, and could place an additional cost of up to C$2bn if the IEA's forecast for rail use proves correct.

The Opportunity Cost

The opportunity cost of restricted pipeline capacity, not just for the energy sector but also for the wider economy, also seems to be rising.

At any point in time there is a natural price discount between the US benchmark West Texas Intermediate (WTI) crude oil price and the Canadian benchmark Western Canada Select (WCS). That gap reflects the lower quality of WCS relative to WTI and the cost associated with pipeline tolls to transport this oil from Alberta to US refining hubs.

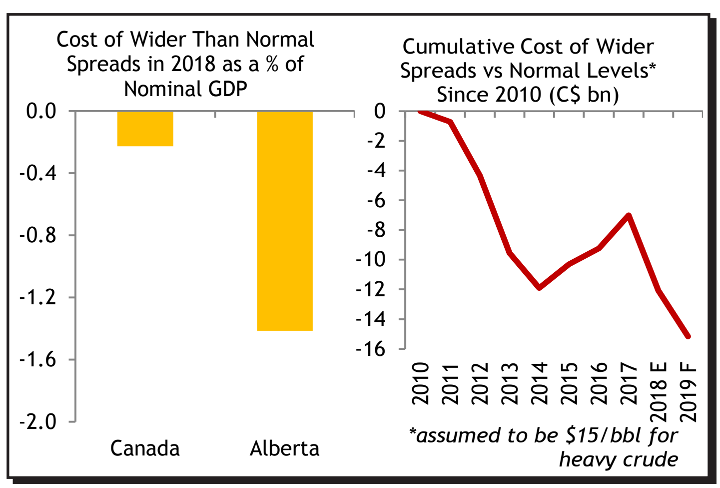
Based on discussions with industry players and the long-term average of the spread between Louisiana Sweet (a light crude similar to WTI) and Maya (a Mexican seaborne heavy crude, similar to WCS), we estimate the quality portion of a neutral WTI-WCS spread to be around US$9. As for the transportation component, based on estimates by the Canadian Association of Petroleum Producers, on average it costs around US$6 per barrel to ship heavy oil from Hardisty to Cushing. Accordingly, we estimate that a neutral discount for WCS is around US$15.

However, the WCS-WTI differential recently reached close to US$30/bbl before narrowing to US$14 recently. The year-to-date average difference is more than US$5/bbl greater than the average since 2010 and nearly US$10/bbl greater than the US$15/bbl neutral spread. Given the lower selling prices for oil compared to pre-2014 levels, the differential is even greater in percentage terms (Chart 3).

Given current production, our forecasts for the C$, and assuming that the WCS-WTI differential averages $20/bbl for the year as a whole due to the narrower gap recently, industry revenues would be around C$5bn lower than if the spread was only C$15/bbl throughout. That equates to almost 0.2% of Canadian nominal GDP, and around 1½% of Alberta's GDP this year (Chart 4, left).

Chart 4

Wider Spreads Have Eroded Benefits of Oil Production



Source: NEB, Bloomberg, CIBC

The cumulative "lost" revenue due to wider spreads since 2010 will almost double this year to C$12bn (Chart 4, right). As for 2019, we expect forgone revenues to rise by a further C$3bn to reach C$15bn.

Unblocking Investment

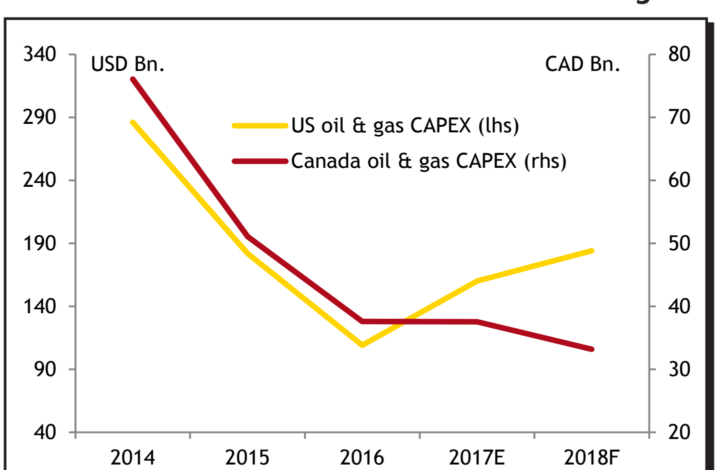
There's also evidence that wider spreads and transportation uncertainty have been holding back investment in the energy sector recently, and by extension real economic activity. As some of these uncertainties dissipate over the coming years, new investments could come back and act as a support to the Canadian and particularly Alberta economies.

Comparing the recent trend in actual and intended oil & gas investment in the US and Canada tells the story, with higher oil prices supporting increased spending stateside but intentions actually for a slight reduction here (Chart 5). For context, the investment intentions survey for Canada was conducted during a time when the WCS-WTI gap was at its widest and Canadian oil prices as a result were little improved from the average of the previous three years (Chart 6, left). Therefore, the survey results could have been overly pessimistic.

There's still evidence that investment and wider economic growth should strengthen as some of the uncertainties surrounding market access dissipate. Earlier this year, the Government of Alberta estimated that additional pipeline capacity would lift capital investment by about US$10bn and provincial GDP by between 1.5-2% by 2023. While a quick resolution may do little for 2018 growth, this implies a ½% upside potential for our 2019 Alberta GDP forecast (Chart 6, right). These also seem to

Chart 5

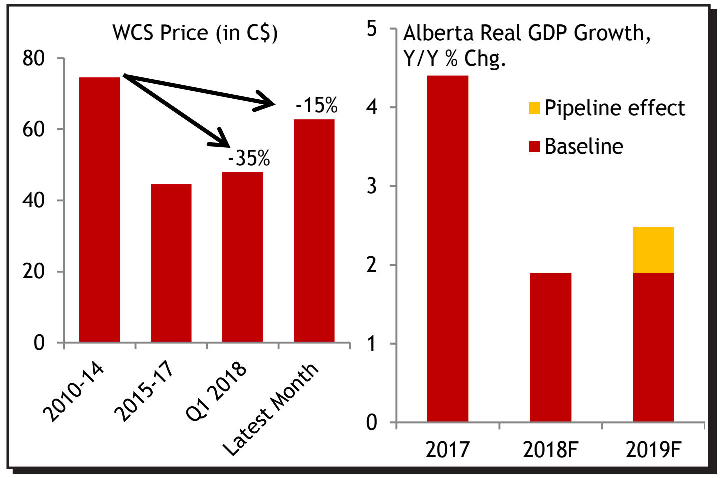
Canadian Investment in Oil on the Downswing



Source: Statistics Canada, Oil & Gas Journal, CIBC

Chart 6

Oil Prices Have Risen Notably Recently, Bolstering the Case for Investment in Additional Pipeline Capacity



Source: Bloomberg, NEB, Statistics Canada, CIBC

be fairly conservative projections, particularly for 2020 and beyond.

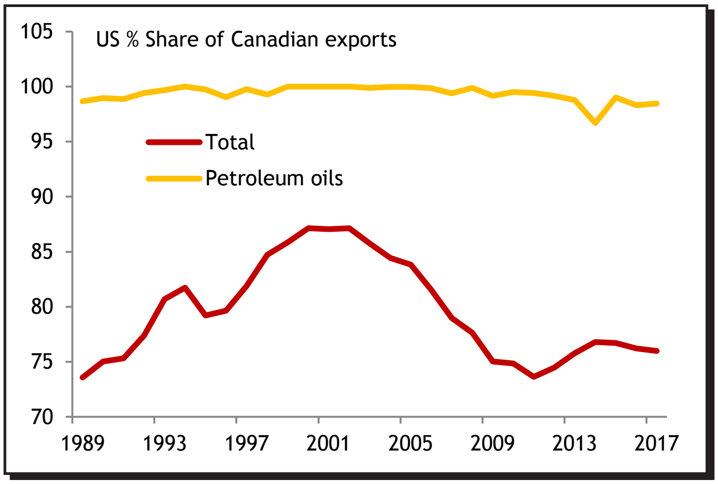
There's also the unmeasurable impact that delays in major investments such as pipelines could have on Canada's perception globally as a place for businesses to invest. Thanks to fairly stable growth and politics (in contrast to the populist wave in other countries), Canada has been perceived as a good place to invest recently. That reputation could, however, be dented by further delays in major projects and impact business investment, not just within the energy sector, but within the wider economy as well.

Diversifying Market Access

New pipeline capacity can also help Canadian oil reach new and faster growing markets. Almost since inception, Canadian oil producers have relied on the American market for an outsized portion of demand. Virtually all Canadian petroleum oils are sent to the US, whereas other industries have become less reliant on the US market (Chart 7). And, until recently, that would have been used to satiate consumption stateside. However, American energy production has increased rapidly since the recession, almost eliminating the need for imported energy altogether.

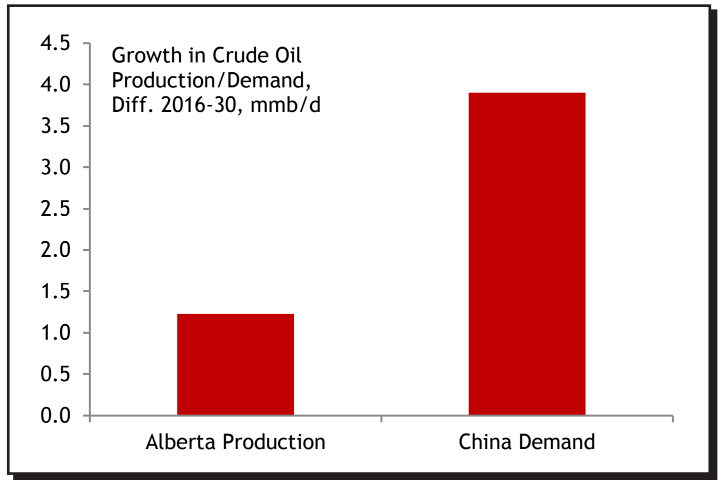
Despite this, US imports of Canadian oil remain steadfast while the American energy trade deficit has shrunk simultaneously. That indicates that American energy products have gained market share abroad, while

Chart 7
Oil Exports Overly Reliant on US Market



Source: UN Comtrade, CIBC

Chart 8
Chinese Demand Set to Outpace Production Gains in Alberta



Source: CAPP, OPEC, CIBC

Canadian producers remain almost solely reliant on markets south of the border.

Indeed, that disparity between market share abroad may widen in the future in the absence of better overseas access for Canadian producers. Asian countries are slated to lead the pack in growth of energy consumption, with growth in China dwarfing production projections for Alberta oil (Chart 8). That provides ample opportunity for Canada to diversify its export base while securing an end-use source of demand.

The obvious question of course is why not add refining and upgrading capacity in Western Canada and avoid the headache associated with pipelines? The North West Redwater Sturgeon refinery with its 50,000 bbl/d capacity will come online soon and we also might see the second phase expansion of that project in the future. But that's where it will end. While on the surface, self sufficiency in upgrading and refining makes sense, the economic reality is different. There is already a surplus of refining capacity in North America, the long-term refined petroleum demand in the continent is not promising and most importantly, most nations have domestic refining capacity that matches their domestic demand. China for example has a stated policy of self-sufficiency in refined petroleum with a clear aim at minimizing any potential hit of importing pure refined products at global prices.

Given that reality, and with the realization that rail cannot be the ultimate and permanent solution, pipelines remain the only reasonable option for shipping Canada's oil to world markets. The debate about the Trans Mountain Expansion pipeline is not, however, about the here and now, it is about the future. Even with added capacity over the next few years, Canada's oil patch will once again face significant pipeline bottlenecks with mounting associated costs. The Trans Mountain expansion line will work to add enough capacity to ease that pain. More importantly, that line represents the only option for Canadian oil to reduce its dependency on the saturated US market and find its way into much faster growing markets.

All told, the future of Canada's economy looks brighter when the energy sector is thriving in a sustainable manner, of which pipeline capacity is a crucial component. Given the evolution of demand and increased competition stateside, investment in more efficient modes of transportation is necessary to attract future investment in the oil industry and maintain the competitiveness of Canada's position as a major oil player. Beyond the energy sector, the successful implementation of pipelines would also demonstrate the attractiveness of Canada to international corporations that may be looking to expand.

ECONOMIC UPDATE

CANADA	17Q4A	18Q1F	18Q2F	18Q3F	18Q4F	19Q1F	19Q2F	2017F	2018F	2019F
Real GDP Growth (AR)	1.7	2.0	2.2	1.6	2.0	1.6	1.4	3.0	2.0	1.6
Real Final Domestic Demand (AR)	3.9	2.5	2.6	1.3	2.0	1.7	1.2	3.0	2.8	1.5
Household Consumption (AR)	2.1	1.8	3.1	1.5	2.3	1.9	1.3	3.5	2.5	1.8
All Items CPI Inflation (Y/Y)	1.8	2.1	2.6	2.7	2.5	2.1	1.8	1.6	2.5	2.0
Unemployment Rate (%)	6.0	5.8	5.8	5.8	5.7	5.7	5.7	6.3	5.8	5.7

U.S.	17Q4A	18Q1A	18Q2F	18Q3F	18Q4F	19Q1F	19Q2F	2017A	2018F	2019F
Real GDP Growth (AR)	2.9	2.3	3.1	2.6	2.2	1.3	1.7	2.3	2.7	1.9
Real Final Sales (AR)	3.4	1.9	3.2	2.9	2.1	1.3	1.7	2.4	2.7	1.9
All Items CPI Inflation (Y/Y)	2.1	2.2	2.7	2.8	2.8	2.6	2.5	2.1	2.6	2.4
Core CPI Inflation (Y/Y)	1.8	1.9	2.3	2.5	2.6	2.4	2.4	1.8	2.3	2.4
Unemployment Rate (%)	4.1	4.1	3.9	3.8	3.8	3.7	3.7	4.4	3.9	3.7

CANADA

A rough start will leave Q1 GDP barely showing a 2% advance, but its weakest month was back in January. Second quarter growth should eclipse 2%, enough to see the BoC pull the trigger on another rate hike in July. Headline inflation will average around 2½% in 2018, slightly above the BoC's target. But that's hardly something to worry about, given that it's mainly due to the temporary effects of higher gasoline prices and minimum wages.

UNITED STATES

Data so far in the second quarter support our view of a pickup in activity over the remainder of the year, and we have left our annual 2018 GDP forecast unchanged as a result. Q2 looks to be particularly brisk, and a more moderate pace later in the year could allow the Fed to skip one quarter on its rate hike path. A higher oil price assumption led us to upgrade our 2018 headline CPI forecast by one tick as gas prices receive a lift.