



2019 Global Economic Outlook: What to Expect

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By mid-2019, the current economic expansion will turn out to be the longest ever. There's little doubt that we're in a late-cycle environment. The yield curve (that's the gap between long- and short-term interest rates) is almost flat. History tells us that a recession is likely to follow when that curve becomes inverted—when short-term rates are higher than long-term rates. So, should we start talking about the R word?

What's in a rate hike?

Every economic recession was caused or helped by a monetary policy error. Central banks were chasing inflation, only to overshoot by raising interest rates too rapidly and, in turn, materially damaged the economy. Are we starting to overshoot now? Will central bankers repeat past mistakes? Clearly, rates in both the U.S. and Canada have not risen fast enough to reach overshooting territory, but both the U.S. Federal Reserve (Fed) and the Bank of Canada (BoC) are telling us that they're not done yet.

Today's employment and wage numbers clearly support continued rate hikes by the Fed in 2019. The issue will be the real risk of a significant softening in economic activity come 2020, as fiscal stimulus turns into fiscal drag. Will the Fed see what's coming and start softening its position by mid-2019, or will it repeat past mistakes and continue to hike until it's too late?

The same goes for the BoC. Until very recently, it considered taking real rates into positive territory, viewing the neutral rate at around 3%. In order to get to that rate, the BoC will have to hike rates by an additional 1.25%.

We believe that the Fed and the BoC won't repeat past mistakes. By 2019, the Fed will have "2020 vision" and will slow its hiking trajectory. In fact, we won't be surprised if the Fed actually cuts rates in 2020.

The BoC's struggles

The situation is even more complex for the BoC. It's hardly a secret that the Canadian economy is facing significant headwinds. Yes, the United States Mexico Canada Agreement (USMCA) worked to remove some uncertainty from the market and should help lift business investment at the margin, but many hurdles still exist.

Lately, the performance of exports has been disappointing while consumer spending is showing a clear softening trend and oil prices remain soft. The U.S. tax cut is already working to redirect investment from Canada to south of the border. One positive development is the recent move by the federal government to match the U.S. Administration policy and introduce an accelerated depreciation schedule (businesses are allowed to write off investment in the first year). However, it's not a game changer and we expect Canadian GDP growth to average around 1.8% in 2019 and slow notably to 1.3% in 2020.

While the Bank of Canada is expecting wage pressures to rise in the coming quarter, there's no evidence this will actually happen. For this and other reasons, we doubt the BoC will take rates much higher. Consider the slowing housing market, higher interest rates and changes in mortgage qualifications. These have led to a situation where household credit is now rising at the slowest pace in any non-recessionary period over the past 50 years. We expect the BoC to raise interest rates once or twice in 2019.

Additional insights from Ben Tal

Watch these videos for more insights on financial markets and Canadian housing.

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[!\[\]\(5a351309c3b87e4420622c1f0e57efc0_img.jpg\) Canada's Housing Market—Return to "Normal"](#)

What's happening on the world stage?

Global trade is another factor impacting the global economy in general and Canada in particular. NAFTA was replaced by USMCA, but the market didn't react in any significant way. The muted reaction probably reflects the fact that, deep down, investors believed a reasonable agreement would be reached despite all the drama. But what about the China-U.S. dispute? After all, a full-scale trade war with China is unthinkable.

What's happening now is already unthinkable. Following the first wave of tariffs—which were largely aimed at high-value-added Chinese manufacturing exports—the Trump Administration has now implemented phase two. This is a 10% tariff on an additional \$200 billion of Chinese goods,

to be raised to 25% by the end of the year. China retaliated (although not in kind), targeting only \$60 billion worth of shipments from the U.S. with tariffs ranging between 5% and 10%. The U.S. has room for a third phase of tariffs on roughly \$270 billion of Chinese goods. China on the other hand is running out of ammunition when it comes to tariffs—how will Chinese leadership react?

We believe that China will take a long-term view and choose to avoid a full-scale trade war with the U.S., while using its currency as a tool to ease the damage. At this point, we're optimistic that some sort of resolution to the U.S.-China dispute will be found. Along with more muted rate hike trajectories by the Fed and the BoC, this may help equity markets find their footings in 2019.

It's important to consider how economic and market trends can affect your investment portfolio and we can help you with that. If you have any questions about these insights, please give us a call.

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