Valeurs mobilières Banque Laurentienne
Laurentian Bank Securities

# 2018 Economic and Financial Outlook

## A Slowly Maturing Business Cycle?

During the first half of 2017, the US$ gave up much of the strong gains it had made in late 2014 and 2015, especially after it became clear that it was the central banks of other developed economies that were thinking about tightening their own monetary policies. Since last January — earlier than many observers had expected — the ECB has been reducing its QE interventions as its economic outlook is improving. The Bank of Canada, somewhat unexpectedly, raised rates twice this summer on the acceleration in economic momentum observed in 2017H1; and the Bank of England, starting to confront rising inflation, has recently increased its policy rate for the first time since the summer of 2007, more than 10 years ago.

However, the tide appears to have turned once again. On the one hand, the ECB remains timid in its intentions to scale down bond purchases (it is buying less assets but has extended the buying period further into the future), the Bank of Canada recently announced that it will remain prudent given the low inflation outlook and the numerous risks ahead (NAFTA being the elephant in the room) and the BOE, while inflation is creeping up, is stuck dealing with the risk that Brexit will slow down the UK economy. On the other hand, the Fed, as expected, raised short term rates in December and has started to shrink its balance sheet in the context of strong growth, tightening labour markets and very likely tax cuts as soon as 2018, which could further boost growth.

This asymmetry could lead to another bout of appreciation of the U.S. dollar as the relatively faster removal of monetary accommodation in the U.S will continue to favour the greenback. However, higher short term and long term interest rates, as well as appreciating currency could lead to tightening financial conditions in the U.S. beyond what is currently desired by the Fed. This, in turn, could have significant negative impacts on U.S. growth and on the American trade deficit. It could also potentially create financial instability in countries heavily indebted in the U.S. dollar as well as incite the Trump administration to increasingly favour protectionist policies.

For these reasons, we believe that the Fed will tamper its expectations. We expect two more hikes in 2018 (the dots point to three more rate increases in 2018) and that the Fed's QE reversal targets will be revised lower, early in the New Year, to avoid provoking financial tightening, another disproportionate US$ appreciation, global economic uncertainty and political backlash against free-trade.

Domestically, the Bank of Canada is likely to keep short term rates low. Given the elevated 100% household debt-to-NGDP ratio, the back-to-back 25 basis points hikes of July and September have already prompted a retrenchment in retail sales; yet they rebounded strongly in October. Moreover, the Canadian economy is even less likely than the U.S. economy to see inflationary pressures, preventing the BoC from raising its policy rates multiple times.

Even though we perceive the risks of an economic slowdown to be increasing, unless very unfavorable developments regarding NAFTA negotiations fail to be compensated by a lower CAD we don't expect a recession next year. We now see, at best, the Bank of Canada raising its policy rate once by 25 basis points in 2018, later during the year. However, Canadian long term rates will continue to face some upward pressures because of increasing long term interest rates on the U.S. bond market. As we mentioned last year in our 2017 Outlook, the Bank of Canada may control the very short end of the Canadian yield curve but the country remains largely a "price-taker" on the long term bond market, where prices are determined globally.

In March 2017 we turned our overweight equity position into a neutral one and advised investors to remain cautious. U.S. earnings growth beat our expectations but recently it has been U.S. tax cuts enacted by Republicans that recently fuelled equity prices. Any significant correction of U.S. equity prices at this point would provide an attractive entry point to position one's portfolio with an overweight in US equity. Meanwhile, we remain globally neutral with an underweight on U.S. equity and overweight positions in Canada, other developed markets and emerging markets.

Finally, stocks still appear cheap relative to bonds as the S&P 500 earnings yield remains historically high relative to the effective yield of U.S. corporate high-yield issuers. In addition, the odds of a recession remain relatively low at the moment as credit conditions remain very accommodative. Yet, corporate spreads, in tightening mode for the entirety of 2017, could see some reversal and we recommend remaining underweight.

For the most part, we believe that, in spite of heightened uncertainty, global growth has picked up significant momentum in 2017 and we expect it to remain robust in 2018 and beyond. The latest IMF economic outlook pencils in real GDP growth at 3.7% in 2018, a low estimate in our opinion. This should benefit global equities even in a rising interest rate environment.

- **We expect the commodity rally to continue in 2018, especially in the oil sector. We forecast WTI to reach $US67 per barrel by year-end.** Our positive oil outlook for 2018 is, of course, conditional on OPEC members extending their agreement to cut production until December 2018 as well as participating non-OPEC countries sticking to the agreement. So far, the one-year agreement has helped reduce excess inventories by 50%. Extending the agreement until the end of next year would be enough to swiftly eliminate the remaining excess oil inventories by next Fall. This should be supportive of higher oil prices throughout the year.
- In turn, this should contribute to the outperformance of Canadian equities and the Canadian dollar. The **Canadian dollar**, which regained some ground since last summer due to higher oil prices and the

Bank of Canada's surprised rates hikes, remains weak compared to where it stood less than two years ago. It traded within a wide range of 1.20 to 1.37 during 2017. **We expect volatility to persist but the trading range to move towards a lower band of 1.15 to 1.30 next year.** Obviously, the complete derailment of NAFTA negotiations would push the CA$ out of this range, towards 1.35-1.40.

- **We are neutral on gold.** We had expected gold prices to fall in 2017 but had cautioned investors that if the Fed remained behind the curve and inflation expectations started to increase, gold prices could be supported. And, indeed, the hesitation of the Fed in raising rates during the last two years supported the price of gold. **This lukewarm situation for gold should persist in 2018. Again, gold prices should be inversely correlated to the mood at the Fed: tightening bias early in the year followed by capitulation in the second-half.**
- After another bad year (the 3rd in a row), **forestry and agriculture stocks** (e.g. fertilizers) should **recover in the U.S. and Canada amid the strong demand growth** for such products in emerging countries, now that the global economy is growing at a faster clip than during the previous 10 years.
- While we caution investors against the sector due to the monetary policy tightening environment, REITs are excellent hedges against inflation and their yield is expected to remain higher than that of long term government bonds. **We recommend establishing positions in the REITS sector on weakness and as a diversifying strategy. Last summer provided an excellent opportunity to do so. We expect that the situation will present itself again this year.**
- **The U.S. Financials sector figures among our top overweight sectors as relative valuation appears attractive and 2018 expected earnings growth is elevated relative to other sectors.** Financials stocks should also outperform in a rising rate scenario and a steepening yield curve environment; this should help sector deliver strong dividend growth. Moreover, part of the Republican deregulation agenda, which is aimed specifically at reducing the regulatory burden on U.S. financial institutions, represents another source of upside for banks. Finally, lowering the U.S. corporate tax rate from 35% to 20%, as currently proposed by Republicans, should be particularly beneficial to U.S. banks.
- The **Canadian Financials sector should also outperform in 2018** as relative valuation appears attractive and the sector should benefit from a rising rate scenario, a steepening yield curve and a growing global economy which should encourage business investment. The sector also provides dividend growth opportunities.
- **The global economic recovery and rising technology capex spending should benefit both the U.S. and Canadian information technology sector.** In the U.S., the sector will be the largest contributor to overall EPS in 2018. In Canada, the pick-up in relative upward earnings revisions should also prove to be a tailwind to the sector's performance.
- As we are of the view that a **lower corporate tax rate should lead to higher investment and capital expenditures, the Industrials sector should benefit in 2018**
- **We also expect defensive sectors, such as Consumer Staples in the U.S. and Canada and Pharma in the U.S., to outperform next year.**

The bottom line is that, in spite of strong global growth, the risks are such that the Canadian economic environment and the Canadian dollar should remain volatile next year. Because we expect the price of oil to increase and NAFTA to be renewed, but U.S. tax cuts to favour U.S. competitiveness, the Canadian dollar should end the year only marginally stronger than it currently is. This should nevertheless continue to benefit large **Canadian exporters at the expense of domestically oriented businesses, more dependent on highly leveraged domestic consumers.**

Finally, as in previous years, we caution readers there are risks to the above economic perspectives and market forecasts. First, global growth could falter if the U.S. enters trade wars with its principle trading partners, namely Canada, Mexico and China. These could cause real havoc on the markets if the domestic value of U.S. denominated debt held outside the U.S. swells to unstainable levels as the US$ appreciates. Second, political risks in the Middle-East and Asia are numerous and tensions have reached new highs recently. These would cause flights to quality which would favour U.S. assets and the U.S. dollar.

## Financial Forecasts

| | 15Q4 | 16Q1 | 16Q2 | 16Q3 | 16Q4 | 17Q1 | 17Q2 | 17Q3 | 17Q4 | 18Q1 | 18Q2 | 18Q3 | 18Q4 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Canada | | | | | | | | | | | | | |
| **Overnight Rate Target** | **0.50** | **0.50** | **0.50** | **0.50** | **0.50** | **0.50** | **0.50** | **1.00** | **1.00** | **1.25** | **1.25** | **1.25** | **1.25** |
| 3-Month Treasury Bills | 0.51 | 0.45 | 0.50 | 0.52 | 0.48 | 0.54 | 0.71 | 1.00 | 0.95 | 1.20 | 1.25 | 1.25 | 1.25 |
| 2-Year Bond | 0.48 | 0.54 | 0.52 | 0.54 | 0.74 | 0.75 | 1.09 | 1.52 | 1.55 | 1.75 | 1.80 | 1.85 | 1.90 |
| 5-Year Bond | 0.73 | 0.68 | 0.57 | 0.61 | 1.11 | 1.11 | 1.38 | 1.75 | 1.75 | 2.00 | 2.05 | 2.10 | 2.15 |
| 10-Year Bond | 1.39 | 1.23 | 1.06 | 1.19 | 1.72 | 1.62 | 1.75 | 2.10 | 1.92 | 2.05 | 2.15 | 2.30 | 2.40 |
| 30-Year Bond | 2.15 | 2.00 | 1.71 | 1.85 | 2.31 | 2.30 | 2.14 | 2.47 | 2.20 | 2.40 | 2.55 | 2.65 | 2.80 |
| United States | | | | | | | | | | | | | |
| **Federal Funds Rate Target*** | **0.375** | **0.375** | **0.375** | **0.375** | **0.625** | **0.875** | **1.125** | **1.125** | **1.375** | **1.375** | **1.625** | **1.625** | **1.875** |
| 3-Month Treasury Bills | 0.16 | 0.21 | 0.22 | 0.33 | 0.61 | 0.74 | 1.01 | 1.10 | 1.30 | 1.35 | 1.55 | 1.60 | 1.85 |
| 2-Year Bond | 1.06 | 0.76 | 0.59 | 0.76 | 1.18 | 1.25 | 1.38 | 1.48 | 1.80 | 1.80 | 1.90 | 1.95 | 2.05 |
| 5-Year Bond | 1.76 | 1.21 | 1.00 | 1.24 | 1.93 | 1.93 | 1.89 | 1.93 | 2.15 | 2.20 | 2.30 | 2.40 | 2.50 |
| 10-Year Bond | 2.27 | 1.78 | 1.46 | 1.59 | 2.44 | 2.39 | 2.30 | 2.38 | 2.40 | 2.50 | 2.65 | 2.80 | 3.00 |
| 30-Year Bond | 3.01 | 2.61 | 2.28 | 2.31 | 3.07 | 3.01 | 2.83 | 2.86 | 2.75 | 2.90 | 3.10 | 3.20 | 3.40 |
| **Canadian Dollar (US$/C$)** | **0.72** | **0.77** | **0.76** | **0.76** | **0.75** | **0.75** | **0.77** | **0.80** | **0.79** | **0.80** | **0.81** | **0.81** | **0.82** |
| **S&P 500 Index** | 2044 | 2060 | 2099 | 2168 | 2239 | 2366 | 2423 | 2519 | 2650 | 2700 | 2735 | 2780 | 2800 |
| **TSX Index** | 13010 | 13494 | 14064 | 14726 | 15288 | 15548 | 15350 | 15635 | 16500 | 16900 | 17300 | 17600 | 18000 |
| **Oil WTI (US$/barrel)** | 37.0 | 38.3 | 48.3 | 48.2 | 53.7 | 50.7 | 46 | 52 | 60 | 62 | 64 | 66 | 67 |

Quarter-end data and annual averages

Updated: December 2017 *midpoint of the target range for the Fed funds

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