PERSPECTIVE

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A QUICK LOOK AHEAD FOR 2017

There is no shortage of possible market-altering events on deck for 2017 – from upcoming elections in Europe to Brexit negotiations to China's ongoing reform of its economy…and lest we forget the new kid on the block, U.S. policy under a new administration. The band of uncertainty around possible economic and financial outcomes has widened, but the world has not changed fundamentally. Here are five key macro themes to keep top of mind when the New Year kicks off:

1. *Searching for growth* – The post-crisis cyclical slowdown has been supplanted by a structural slowdown reflective of an aging population, slowing labour supply and disappointing productivity trends around the world. In other words, don't expect it to lift anytime soon. Canada has compounded the growth-challenge with overheated housing markets and high household debt. Recent regulatory measures and an uptick in mortgage rates should help moderate the housing market. But, this will leave the economy hard-pressed to reach outside of a 1.5-2.0% growth range in real terms on a sustainable basis, for the foreseeable future. These influences anchor the view that the Bank of Canada will be in no rush to raise rates, irrespective of the tactic taken by the U.S. Federal Reserve.

2. *The pivot from monetary to fiscal policy* – Central banks were the first line of attack to prop up growth and financial markets around the world, but that baton is increasingly being passed to government authorities. Structural rigidities in an economy require economic reforms to provide a longer term productivity bump. For the most part, this pivot will continue to occur gradually and highly accommodative monetary policy will remain in place within most countries, including Canada. But, there are exceptions to every rule. The U.S. was already on a path to tighten monetary policy in response to improving economic fundamentals, and there is a risk that the anticipated fiscal boost from the new administration may accelerate this pace. We think this is more likely to be a 2018 story, than 2017. There's no doubt that the incoming President will immediately work with Congress to implement an agenda of tax reform, infrastructure spending and deregulation. However, nothing is a slam dunk and some of this stimulus will necessarily require an offset in order to avoid an explosion in government expenditures. In addition, the pass-through of fiscal policy into economic impacts embeds lags. The implication being that U.S. interest rates will continue to rise at a measured pace. We are skeptical that fiscal policy will be a catalyst for dramatic moves by the Federal Reserve in 2017, particularly when benchmarked against the persistent potential for global event risk.

3. *Higher yields, but not high yields* – The Republican sweep of the U.S. chambers of government saw the 10-year Treasury yield jump from roughly 1.85% to 2.35% in the span of 7 trading days. Entrenched market expectations for significant fiscal stimulus and the risk of higher government debt levels galvanize an upward trend that actually took root over the summer months. Investors

around the globe were already stepping back from the notion that central banks would pursue additional aggressive monetary policy decisions. A higher global yield environment should persist in 2017, and the Canadian bond market will take its cue from U.S. movements. But, we are cautious in building too much upside to yields in the near-term, as this would risk undermining the still-fragile state of the global economy, and Canada is certainly no exception.

4. *U.S. dollar to dominate* – Everything is relative, and with the U.S. likely to maintain a comparative advantage with higher yields and stronger economic growth, investor appetite for U.S. assets should remain strong. Even if U.S. 10-year yields stay comfortably below the 3% level recorded during the peak of the taper tantrum in 2013, those yields still offer a hefty premium against similar investments in Europe and Japan. The attractive fundamentals will keep the greenback supported at 13-year highs in 2017. Downside risks remain significant for the Canadian dollar. The loonie could fall to 72 US cents or lower if Canada is hit by the crossfire of a U.S. administration erecting trade barriers or intensifying threats that discourage trade flows. However, it's important to bear in mind that the loonie will also reflect dynamics occurring in the oil market, which offers a counterweight to any downside that materializes on the former. Hopes of supply reduction under the recent OPEC agreement should support oil prices in a $50-$60 range.

5. *Volatility remains the name of the game:* It is a good bet that it will not be smooth sailing throughout 2017. Political event risk will remain at the forefront, particularly if negative U.S. rhetoric on immigration and trade turns into action. Meanwhile, a number of key elections (Germany, France, Norway, Netherlands) will be taking place, and now Italy is back on the table. Outcomes will further test the recent groundswell of populism that could heighten worries around the sustainability of the euro. Outside the political sphere, there are plenty of economic and financial triggers that can occur, including ongoing concern around Italy's banking sector. China's restructuring challenge and elevated debt in emerging markets both have the capacity to trigger volatility through a disorderly unwinding and sharp capital outflows.

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