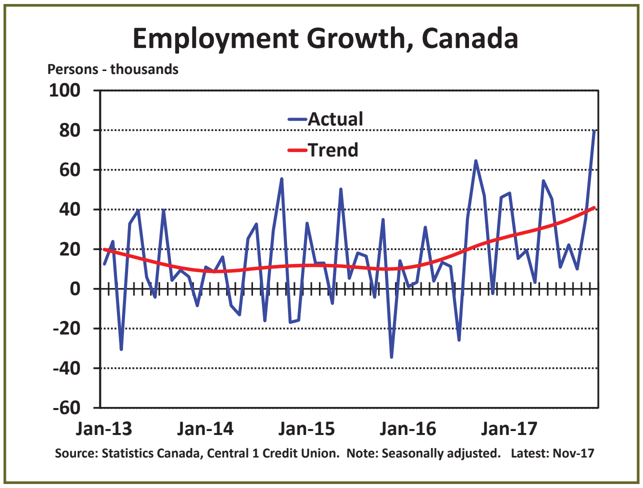
Highlights

- Positive economic data flow on global and domestic economies
- Upside risk to inflation
- Policy uncertainties remain but Bank of Canada to raise soon

With yearend approaching it is fitting to look back at 2017 before looking ahead. The global economy began to resynchronize and there were a few signs of monetary conditions beginning to normalize. Canada's economy also synchronized across most regions prompting the Bank of Canada to reverse its insurance rate cuts. However, trade policy risks increased and geopolitical developments deteriorated.

The global economic scene remains positive into December with most indicators flashing green. The latest PMIs are in positive territory, and in the Eurozone and Japan, at post-recession highs. Leading economic indicators are far from signaling recession. Economic growth in 2018 and 2019 looks to improve but remain in the moderate range though there is some upside potential based on recent momentum and stimulative tax policy changes in the U.S.

Downside risks to global economic growth are considerable if trade policy and geopolitical rhetoric materializes into actions. North American Free Trade Agreement (NAFTA) negotiations conclude in March and a new deal is far from certain, raising the possibility of a U.S. withdrawl. The main concern is whether such a move would spark a trade war, and if not, the economic consequences for Canada would be mild because there could be reversion to the low WTO tariffs or possibly to the original Canada-US Free Trade Agreement. The withdrawl timeline would extend into 2019 with the financial, currency, and investment impacts more immediate. It is difficult to accurately anticipate how geopolitical events may unfold.



With U.S. tax policy changes in the offing, real GDP growth forecasts have been upgraded to 2.5 per cent in 2018 and 2019. Latest economic projections by the FOMC include an upgrade to 2.5 per cent in 2018 from 2.1 per cent due to the anticipated fiscal stimulus. The Fed's projection of the federal funds rate indicates three 25bps increases in 2018 and two to three hikes in 2019.

Interestingly, the futures market for the fed funds rate is far more cautious and restrained than the FOMC. It is pricing in one 25bps increase around mid-2018 and another in early 2019. This forecast leans to the FOMC scenario.

With the U.S. economy in the mid-to-latter stages in this economic expansion phase, applying fiscal stimulus now may result in more inflation pressure than otherwise and a need to raise rates sooner and faster. The U.S. economy is operating at close to full potential by most estimates. Fiscal stimulus is better applied when the economy is in recession or in a slow growth mode, but the current effort is driven by political motivations rather than economic realities. There is a growing potential for inflation and rates to rise faster than expected.

Canada's economy slowed in the third quarter, as widely expected, with real GDP advancing 1.7 per cent annualized, from a 4.0 per cent average in the first half. The output gap closed further, according to the Bank's estimate of potential

Key Canada economic data releases		
Indicator	Prior month	Latest month
Industry GDP	-0.10%	0.20%
Employment	35.3k	79.5k
Unemployment rate	6.3	5.9
Real international goods exports	-0.40%	1.10%
Real international goods trade balance	-$531.5b	$1,225.9b
Real manufacturing sales	0.60%	-1.50%
Real retail sales	-0.50%	1.40%
Real wholesale sales	-1.00%	1.20%
Building permits	4.90%	3.50%
Housing starts	222.7k	252.2k
MLS residential sales	41.9k	43.6k
Total CPI	1.40%	2.10%
Core CPI1.	1.60%	1.70%

Source: Statistics Canada, CREA. 1. Average of three measures.

growth. Using the Bank's growth forecast, the output gap closes no later than the second quarter 2018, and by one measure, has already closed. In other words, inflation pressures should intensify when actual growth remains above potential growth.

Recent data flow was positive. Weakness emerged in manufacturing but all other key indicators posted gains in the latest month. Employment surged pulling the unemployment rate to below six per cent. International trade received a big boost and housing sales and starts rose. Retail and wholesale trade posted large gains. On balance, fourth quarter real GDP looks to advance around 2.5 per cent annualized, with upside potential.

The Consumer Price Index (CPI) jumped to 2.1 per cent year-over-year in November compared to 1.4 per cent in October on a large jump in gasoline prices and off a low November 2016 base caused by a large drop in gasoline prices. More importantly, core CPI measures only edged up to 1.7 per cent from 1.6 per cent in October.

Some of next month's releases will likely come off their strong performances in the latest month given inherent volatility but not enough to downshift underlying positive trends.

The Bank edged up its potential growth estimate for 2018 to 1.5 per cent in its last *Monetary Policy Report* with new estimates arriving in April. More robust than expected business investment was the main reason for the slight upgrade. The April reassessment will likely raise potential growth to 1.6 per cent in 2018, 1.7 per cent in 2019, and 1.8 per cent in 2020. Actual growth will also be upgraded but leave the economy operating above potential, providing a rationale for raising rates, though at a slower pace than previously indicated by prior output gap estimates.

However, the Bank does not conduct rate-setting on a mechanical basis using the output gap or a Taylor Rule. If it did, rates would be higher with another rate increase this past October or December. Other factors such as future prospects and risks are considered.

Why did the Bank hold off? Perhaps the Bank is waiting to assess the impact of the new mortgage stress test on uninsured mortgages to take effect Jan. 1, 2018. Another reason could be to wait for the conclusion of the NAFTA negotiations. Indeed, the Bank cited trade protectionism as the first, and presumably most important, risk to their outlook in the last MPR. Or, following two successive rate increases, the Bank could be waiting to gauge their impact on the economy and the currency.

Recent data and the outlook for the economy and inflation point to a rate increase soon. While growth will slow from 2017's oil recession rebound aided high of 3.0 per cent, 2018 growth will remain above potential thereby absorbing remaining capacity, pulling down the unemployment rate and placing upward pressure

Economic Forecast – Canada								
	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2016	2017	2018	2019
Real GDP, % annualized	4.3	1.7	2.5	2.0	1.5	3.0	2.2	2.0
Unemployment Rate, %	6.5	6.2	6.1	6.1	7.0	6.4	5.8	5.5
Total CPI, % y/y	1.3	1.4	1.6	1.6	1.4	1.6	1.9	2.1

Source: Statistics Canada, Central 1 Credit Union. Shaded cells are forecasts.

on inflation and wages. The Bank needs to be forward-looking and implement rate actions before inflation becomes a problem.

Accordingly, a rate increase is placed at the upcoming March meeting, which will come shortly after release of fourth quarter 2017 real GDP by Statistics Canada. A 25bps increase to 1.25 per cent in the overnight target rate followed by a long pause until late 2018. There is a fair chance the Bank could move sooner in January.

The futures market for three-month Bankers Acceptances is pricing in a 25bps rate increase in March 2018 and almost 75bps by Dec. 2018. The consensus forecast sees the target rate about 60bps higher.

A steepening of the yield curve is expected before flattening later in the cycle. Administered rates will drift higher as the yield curve upshifts with a higher central bank rate and bond yields.

While risks are tilted to the negative due to uncertain trade policy and to the geopolitical situation, upside risks also exist with firmer U.S. growth in the wake of tax reform, synchronized global growth, and momentum in the domestic economy. The balance has shifted in favour of higher interest rates sooner rather than later.

Target Overnight Rate Forecast	
Meeting Date	**(Per cent)**
Dec. 6 (a)	1.00
Jan. 17, 2018	1.00
Mar. 7	1.25
Apr. 18	1.25
May 30	1.25
July 11	1.25
Sep. 5	1.25
Oct. 24	1.50
Dec. 5	1.50
Jan. 2019	1.50
Mar.	1.50
Apr.	1.75
June	1.75
Jul.	1.75
Sep.	1.75

Source: Bank of Canada, Central 1 Credit Union. (a) actual

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Interest Rate Forecast									
	2017 Q3a	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3
Target Overnight Rate	0.79	1.00	1.10	1.25	1.25	1.45	1.50	1.70	1.75
Prime Rate	3.00	3.20	3.30	3.35	3.35	3.65	3.70	3.90	3.95
1-mo. T-Bill	0.73	0.85	0.95	1.15	1.15	1.40	1.45	1.65	1.70
3-mo. T-Bill	0.81	0.90	1.05	1.25	1.25	1.45	1.50	1.70	1.75
6-mo. T-Bill	0.98	1.10	1.15	1.35	1.35	1.55	1.60	1.80	1.85
1-year T-Bill	1.20	1.35	1.45	1.55	1.55	1.80	1.80	2.00	2.10
2-year GoC Bond	1.33	1.50	1.70	1.75	1.75	2.00	2.05	2.20	2.35
3-year GoC Bond	1.39	1.55	1.75	1.80	1.85	2.05	2.10	2.25	2.40
5-year GoC Bond	1.59	1.70	1.90	2.00	2.05	2.25	2.35	2.45	2.60
10-year GoC Bond	1.95	1.95	2.15	2.25	2.35	2.55	2.70	2.75	2.95

Source: Bank of Canada, Central 1 Credit Union. Note: Quarterly average based on daily data. a = actual, all others forecast.

Deposit Rate Forecast									
	2017 Q3a	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3
1-year GIC	0.72	0.75	0.75	0.85	0.85	0.95	1.05	1.10	1.10
3-year GIC	1.27	1.35	1.35	1.45	1.45	1.55	1.65	1.65	1.75
5-year GIC	1.49	1.60	1.60	1.75	1.75	1.85	2.00	2.00	2.05

Source: Bank of Canada, Central 1 Credit Union. Note: Quarterly average based on weekly data. a = actual, all others forecast. Non-redeemable semi-annual rates from Bank of Canada based on typical rate (mode) at six major banks.

Mortgage Rate Forecast									
	2017 Q3a	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3
1-year Mortgage	3.14	3.25	3.25	3.50	3.55	3.80	4.00	4.10	4.25
3-year Mortgage	3.42	3.75	3.75	4.00	4.05	4.25	4.40	4.45	4.50
5-year Mortgage	4.81	4.95	5.00	5.15	5.20	5.25	5.35	5.35	5.45

Source: Bank of Canada, Central 1 Credit Union. Note: Quarterly average based on weekly data. a = actual, all others forecast. Posted fixed term rates from Bank of Canada rates based on typical rate (mode) at six major banks.