CM&E

CANADIAN
MANUFACTURERS
& EXPORTERS

2018 YEAR IN REVIEW
2019 ECONOMIC OUTLOOK

MIKE HOLDEN
Chief Economist

WHO WE ARE

ABOUT OUR CHIEF ECONOMIST

MIKE HOLDEN
Chief Economist
Canadian Manufacturers & Exporters

Mike Holden leads the organization's economic analysis and forecasting functions, and directs CME's major research projects. He has written on a wide range of issues important to manufacturers, including tax competitiveness, market access, and capital investment. He also directs CME's biannual Management Issues Survey, and was a key architect of CME's Industrie 2030 initiative.

Mike has a BA in honours economics from the University of Alberta and an MA in economics from Queen's University.

ABOUT CANADIAN MANUFACTURERS & EXPORTERS

Since 1871, we have made a difference for Canada's manufacturing and exporting communities. Fighting for their future. Saving them money. Helping manufacturers grow.

The association directly represents more than 2,500 leading companies nationwide. More than 85 per cent of CME's members are small and medium-sized enterprises. As Canada's leading business network, CME, through various initiatives including the establishment of the Canadian Manufacturing Coalition, touches more than 100,000 companies from coast to coast, engaged in manufacturing, global business, and service-related industries.

CME's membership network accounts for an estimated 82 per cent of total manufacturing production and 90 per cent of Canada's exports.

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HIGHLIGHTS

AT A GLANCE 2018 | 2019

2018 YEAR IN REVIEW

- Economic news dominated headlines in 2018, but at the end of the day, the Canadian economy performed about exactly as expected. GDP growth across the country slowed from 3.0 per cent in 2017 to an estimated 2.0 per cent last year.
- Consumer and housing market activity slowed in 2018 as higher interest rates and the new mortgage stress test put a dent in purchases of homes and other big-ticket items.
- Government spending and exports picked up some of the slack in 2018. Higher crude oil prices drove export gains for the year as a whole, but exports dropped off towards the end of the year when energy price declined.
- Business investment also picked up in the first half of the year, but is still a long ways from returning to 2015 levels.
- Job growth slowed in 2018, but labour markets remain extremely tight. The unemployment rate fell to an all-time low of 5.6 per cent and a growing number of businesses are reporting labour shortages.
- Thanks to a strong first six months, 2018 was another good year for Canadian manufacturing. Sales grew by an estimated 6.2 per cent and reached a new all-time high of about $690 billion.
- Manufacturing gains were widespread, led by a price-driven increase in the value of petroleum output; motor vehicles and parts production was the one weak spot in Canadian manufacturing last year.

2019 ECONOMIC OUTLOOK

- The Canadian economy will continue to decelerate in 2019. Lower oil prices, slower growth in the US and global economies, softer housing markets and weaker household spending will all be a drag on GDP growth. Expectations are for economic growth in the range of 1.6 per cent in 2019.
- Higher borrowing costs, equity market volatility, geopolitical uncertainty and ongoing trade tensions will all dampen global economic growth this year. This is contributing to softer commodity markets and could impact exports.
- Tax cuts boosted consumer spending and business investment in the US last year. Those impacts will fade as 2019 wears on, contributing to slower growth south of the border. However, the US economy will still out pace Canada this year.
- Tight labour markets in Canada should drive wages higher in 2019. Job vacancies are up and as competition for available talent intensifies, the cost of hiring is likely to rise. However, higher wages will help counter increased borrowing costs and prevent consumer spending from dropping too far.
- Low oil prices and production cuts in Alberta will be a significant drag on the Canadian economy in early 2019. These will negatively impact business investment and exports, and will keep the Canadian dollar from rising.
- Most economists expect the Bank of Canada to raise interest rates 2-3 times in 2019. Our view is that economic conditions do not warrant such action. We expect, at most, 1-2 rate increases this year.

SUMMARY

FIVE THINGS TO WATCH IN 2019

Economic projections are based on historic patterns, emerging trends and an understanding of a deep and complex series of cause-and-effect relationships. However, those aren't the only things that affect how an economy performs. Government policy announcements, large-scale business investment decisions, geopolitical instability and a host of other factors are inherently unpredictable and can have a major impact on an economy's performance.

With that in mind, CME's economics team gazes into its crystal ball every year to highlight five things to watch out for in the coming year. These are some of our "known unknowns" – factors that we know will impact the economy, whether for good or for ill, but whose effect is far from clear.

1. WHAT IMPACT WILL THE CANNABIS INDUSTRY HAVE ON THE CANADIAN ECONOMY?

Businesses are pouring billions of dollars into Canada's burgeoning cannabis industry. But the industry is still in its infancy. There will be mergers and acquisitions as it matures and consolidates. There will be gut-wrenching stock volatility. But cannabis production is creating new economic activity and boosting demand for manufactured goods. If this plays out right, Canadian businesses could leverage their first-mover advantage and become world leaders in the industry.

2. CAN ANYTHING BE BUILT IN CANADA?

The Trans Mountain pipeline is the poster child for Canada's growing reputation as a place where nothing can ever be built – especially in the energy sector. Capital spending in energy has fallen off a cliff; investors are abandoning projects; new federal project approval rules could further chill development; and no one knows for sure what the term "meaningful consultation" means. With several key investment and approval decisions coming this year, 2019 will be an important test for the future of the country's resources sector.

3. IS A RECESSION LURKING AROUND THE CORNER?

Economists have a well-deserved reputation for too-enthusiastically predicting when the next recession will hit. However, the current economic expansion in the US is decidedly long in the tooth and whatever goes up must come down – eventually. There are early warning signs – equity market volatility, a declining yield curve, and growing business pessimism – that could signal an economic downturn in the US within the next 12-24 months. If that happens, Canada is sure to follow suit.

4. WILL GOVERNMENT ACTIONS SUPPORT OR IMPEDE BUSINESS INVESTMENT?

New federal tax changes that allow businesses to immediately expense machinery, equipment and technology purchases should provide a shot in the arm for capital investment in Canada. The problem is that for every step forward, it seems like there's at least one step back. New carbon pricing rules, higher CPP payments and a host of other cost increases will diminish the effectiveness of this government incentive program – to say nothing of the dim outlook for resource investment. How will these influences net out?

5. WHAT WILL THE US PRESIDENT DO?

The glib answer to that question is that no one knows for sure – possibly not even the man himself. However, the US President has the power and influence to singlehandedly shape the future of the global economy and he has not proved shy in his willingness to act as he sees fit. This has prompted Ottawa to try to diversify the country's export markets. But this is not an overnight process. In the meantime, we're all along for the ride; and we have no idea where it's going.

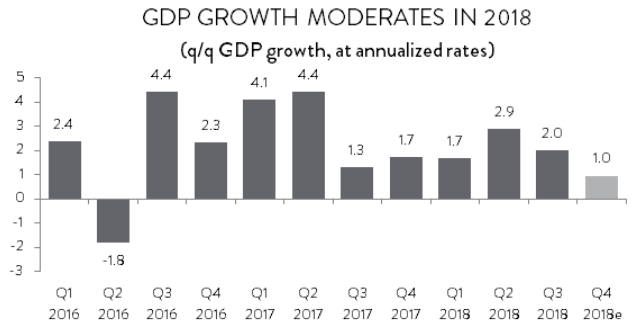
2018 YEAR IN REVIEW

Canadian Economy

OVERVIEW

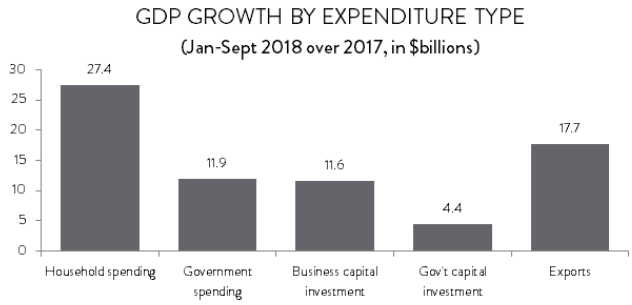
Despite several bouts of high drama, 2018 was actually a pretty ho-hum year for the Canadian economy. There was certainly no shortage of headline-generating excitement across the country. Whether it was Canada-US trade disputes and the new CUSMA, a deepening crisis over the future of the country's energy sector and the apparent inability to build a pipeline that crosses provincial borders, a high-profile auto plant closure, or growing provincial resistance to the federal government's proposed carbon-pricing backstop – economic stories filled the news in 2018.

But at the end of the day, this drama had little impact on overall growth. Going into 2018, the general consensus amongst economists was that GDP growth would moderate from a strong 3.0 per cent in 2017 to somewhere in the range of 2.0 per cent. Twelve months later, it looks as if economists were right on the money – a phrase people in our profession don't get to write very often.

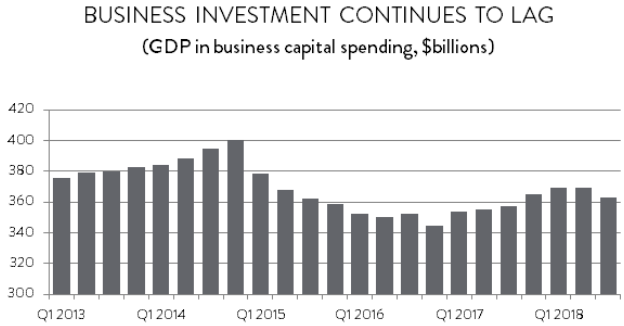


While the economy slowed in 2018, the good news is that growth was more balanced. For several years now, the Canadian economy has relied on household spending to drive growth – a trend that is unsustainable given rising debt levels, a flattening housing market and, now, higher interest rates. Indeed, those factors all contributed to a moderation in consumer activity last year. Household spending was still the largest dollar-value contributor to GDP gains in 2018, but growth slowed considerably – from 3.6 per cent in 2017 to an estimated 2.2 per cent last year.

> "Despite the drama and uncertainty of 2018, the Canadian economy met expectations, growing by about 2.0 per cent."



Picking up the slack were a long-awaited recovery in exports, and government spending. Although exports weakened considerably late in the year, a crude-oil-fuelled surge in the first six months will push exports GDP up by around 2.0 per cent in 2018, compared to about 1.1 per cent in 2017. Meanwhile, deficit financing federally and in most provinces meant that government expenditures had a positive impact on economic growth in 2018. While persistent deficits reduce government spending capacity in the long term, they do have a short-term stimulative effect on the economy.

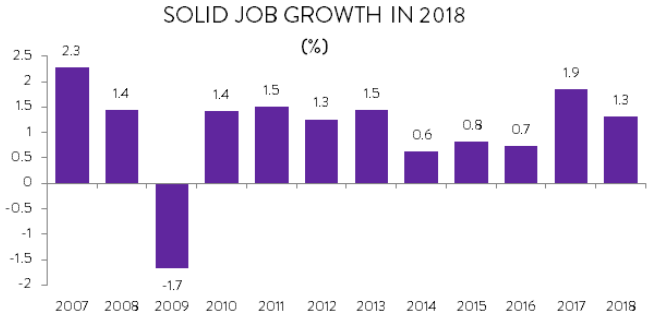


The biggest dark cloud hanging over the economy last year was continued weakness in business investment. Private-sector capital spending was higher in the first half of the year compared to 2017 but fell sharply in the third quarter and remains well below its 2014 peak. In response, the federal

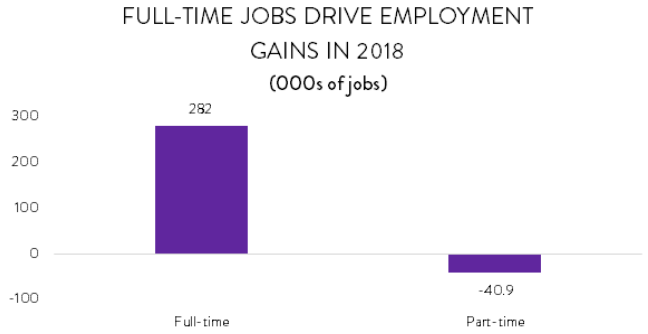
government implemented tax changes late in the year that will allow businesses to immediately expense the value of qualifying investments in machinery, equipment and other capital goods. While this is an excellent step in the right direction, it remains to be seen if it will be enough to counter other policy developments that are raising the cost of doing business in Canada.

LABOUR AND CONSUMER MARKETS

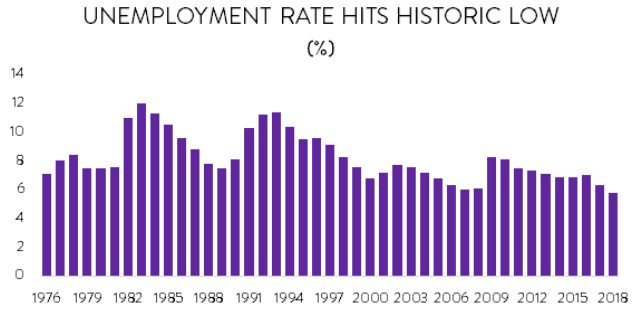
Although economic growth slowed in 2018, it was still a pretty good year to be looking for a job. Employers hired about 241,000 new workers last year – an increase of 1.3 per cent over 2017 levels. While slower than last year's 1.9 per cent growth rate, that increase is still well above rates seen in each of the previous three years. On top of that, literally all those jobs were in full-time positions. In fact, Canada created 282,000 full-time jobs in 2018, while about 41,000 part-time jobs were eliminated.



> "Job growth slowed in 2018, but labour markets remain tight and skills shortages are a growing problem."

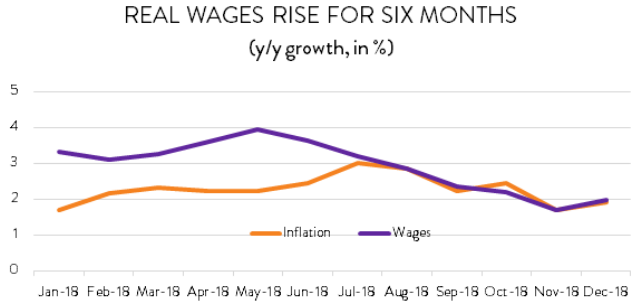


The downside is that two consecutive years of solid job creation, combined with an ageing population and very little growth in the labour pool, have created significant labour shortages across the country. The national jobless rate fell to 5.8 per cent last year – its lowest level dating back more than 40 years – and stood at 5.6 per cent in December. Meanwhile, the number of unfilled jobs was up 37 per cent and the job vacancy rate is nearly double what it was in early 2016.



Tight labour markets finally translated into some meaningful wage gains for Canadian workers in 2018. Despite of strong employment growth and low joblessness, average hourly wages only increased by 1.7 per cent in 2017 – barely above the inflation rate that year. In 2018, the picture improved a little, thanks to strong wage growth early in the year. Average wages increased by 2.9 per cent in 2018, their fastest growth in almost a decade.

The issue, however, is that there were only meaningful wage gains in the first half of the year. Year-over-year wage growth peaked at 3.9 per cent in May and then quickly slowed back down to match the national inflation rate. In other words, Canadian workers only saw real (inflation-adjusted) wage gains in the first half of the year. Since then, all wage increases have been eaten away by inflation.

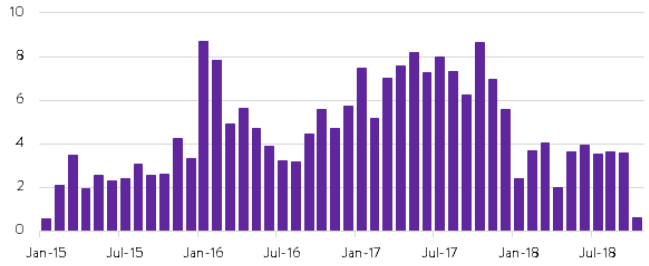


Higher borrowing costs and flat real wages in the second half of the year took the wind out of the sails of Canada's retail markets in 2018. Through October, retail sales are on track to grow by 3.1 per cent for the year. That's a sharp decline from the 7.1 per cent growth last year and the 5.2 per cent increase in 2016.

Consumers tended to spend their extra money in 2018 on electronics, as well as absorbing the cost of higher gasoline prices through most of the year. Meanwhile, purchases of big-ticket items like cars and furniture were relatively flat.

RETAIL SALES DIAL BACK IN 2018

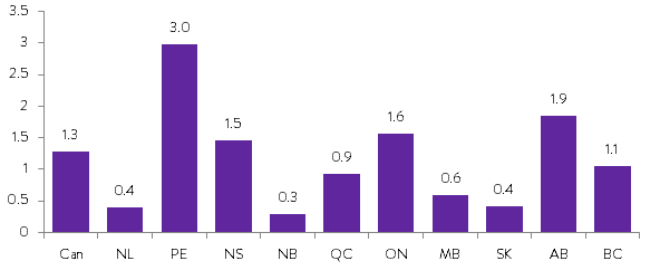
(y/y growth, in %)



Looking at the sub-national picture, all ten provinces saw employment rise in 2018. However, growth rates varied considerably from one to the next. PEI, Alberta and Ontario posted the fastest job growth, while for the second year in a row, Saskatchewan and Newfoundland and Labrador brought up the rear.

PEI AND ALBERTA LEAD JOB GROWTH IN 2018

(%)

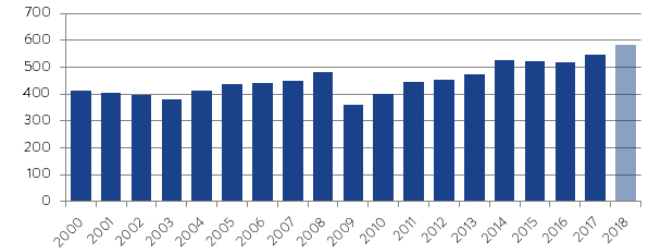


INTERNATIONAL TRADE

For Canadian exporters, 2018 looked a lot like 2017. Overall exports were up significantly – by an estimated 6.8 per cent compared to 2017 – and, when final numbers come in, should easily reach a new all-time high in the range of about $584 billion.

ANOTHER RECORD YEAR FOR EXPORTS

($billions)

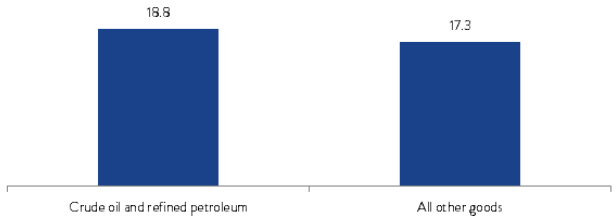


> "Momentum from rising oil prices early in the year helped exports reach a new record high in 2018."

Also like last year, the energy sector did the heavy lifting. Recovering oil prices were the main driver behind the 5.7 per cent growth in exports in 2017, and the story was no different in 2018. Crude oil exports were up by 28 per cent through November and refined petroleum deliveries were 10 per cent higher. Final numbers will be lower as falling oil prices late in the year dampened export values but when all is said and done, fossil fuels once again drove export growth in 2018.

ENERGY PRODUCTS ACCOUNT FOR HALF OF CANADA'S EXPORT GROWTH IN 2018

(Jan-Nov 2018 over last year, in $billions)

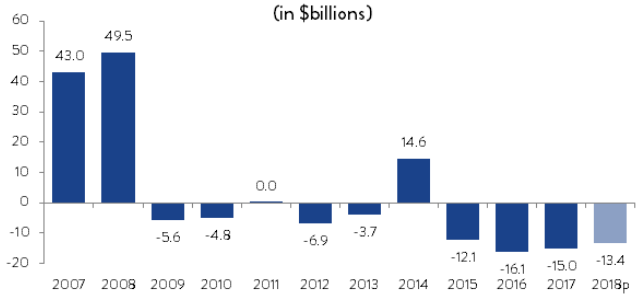


However, exporters of non-petroleum products did have a better year last year. In 2017, total exports not including crude oil and refined petroleum only grew bout about 1.6 per cent. In 2018, those exports are on track to increase by about 4.1 per cent.

Better export success, combined with a modest deceleration in import growth, resulted in a modest improvement in Canada's international trade balance last year. In 2017, Canada posted a trade deficit of $15.0 billion – owing in large part to the country's deteriorating trade imbalance in non-energy exports. That situation improved somewhat last year. Canada's trade deficit in 2018 should come in somewhere in the range of $11.4 billion.

TRADE DEFICIT NARROWS SLIGHTLY IN 2018

(in $billions)

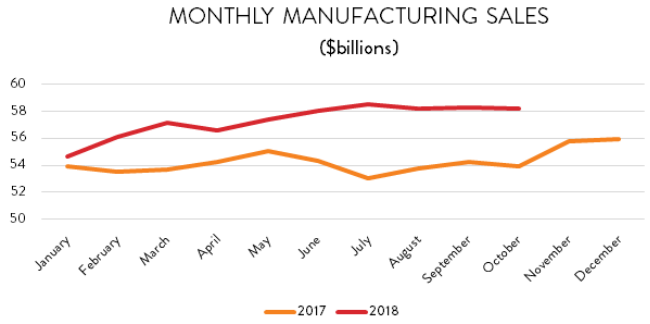


Manufacturing Sector

OVERVIEW

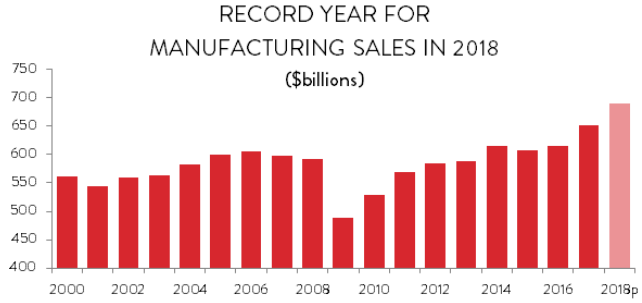
Thanks to a strong first six months, 2018 was, on the whole, a good year for Canadian manufacturing. Strong consumer demand and a robust US economy fuelled new orders for manufactured goods and output rose strongly through to about July.

From that point on, however, sales plateaued and remained more or less steady through October. Usually, such trends are the result of notable declines in certain industries offsetting gains elsewhere. That was not the case in the second half of 2018. With only a few exceptions, output growth slowed to a crawl or began to decline in most of the country's major manufacturing sub-sectors.



However, even though sales were flat in the second half of 2018, they were still a lot better than they were the previous year. The summer and fall of 2017 was an especially weak stretch for manufacturing activity across the country. As a result, even though output growth ground to a halt this past July, sales figures still continued to look good compared to the same period last year.

> "A strong start to the year helped manufacturing sales grow by about 6.2 per cent in 2018."



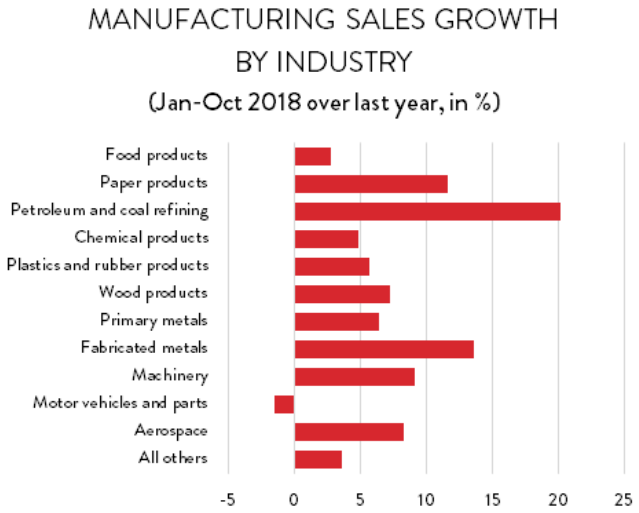
All that said, manufacturing sales reached a new nominal-dollar record last year. While final numbers are yet to come in, our estimates suggest that manufacturing sales will be about $690 billion in 2018, an increase of about 6.2 per cent compared to last year.

The only caveat is that these numbers are all unadjusted for inflation. In real-dollar terms, manufacturing growth was still solid in 2018 (projected to be in the range of 2.6 per cent), and total output will be the best in more than a decade. However, inflation-adjusted sales are still well below levels seen in the mid-2000s.

BY INDUSTRY

Manufacturing gains in 2018 were remarkably widespread across the country's major industries. Of Canada's eleven largest manufacturing sub-sectors, only one saw output fall. Unfortunately, that single decline was the auto sector – Canada's second most important manufacturing industry behind only food processing.

On the positive side, the largest gains were once again in petroleum refining, where strengthening prices throughout most of the year helped boost the value of production. The value of refinery output rose by about 20 per cent in 2018, although growth tailed off towards the end of the year as world oil prices fell and the Alberta crude oil price differential widened. Fabricated metals industries also enjoyed double-digit growth in 2018, while a healthy price environment helped paper manufacturers realize similar gains.



For its part, the auto and parts sector continued to struggle. For the second year in a row, output of motor vehicles and parts was down – falling by an estimated 1.5 per cent in 2018 after declining by 3.4 per cent in 2017. The current outlook is not strong either, with the planned closure of GM's plant in Oshawa later this year.

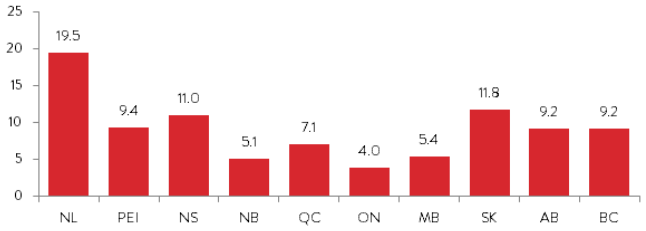
The other industry-specific story in 2018 was the US imposition of tariffs on imports of Canadian aluminum and steel on June 1st, with retaliatory tariffs imposed a month later. Tariffs caused significant disruptions for both producers and consumers of those products, but the impacts were complex and varied depending on the business. In general, however, Canadian steel and aluminum production jumped in the months leading up to June 1st, partly because tariffs were imposed on other countries earlier, giving Canadian producers a brief advantage, and partly because of a run up in production before tariffs were imposed.

In the months that followed, Canadian steel production remained strong on the whole as supply chains adjusted. For aluminum producers, however, output peaked in May and has been steadily declining since. Even so, aluminum production remained well above 2017 levels.

BY PROVINCE

All ten provinces shared in the healthy growth in manufacturing output in 2018. For the second year in a row, Newfoundland and Labrador led the way by a wide margin, posting an increase in the range of 20 per cent, building on the 26 per cent increase in 2017. Nova Scotia and Saskatchewan also saw double-digit growth last year. Alberta's gradual recovery from the oil price crash continued and BC manufacturing output soared in the first half of the year before tapering off in the summer and fall.

MANUFACTURING SALES GROWTH BY PROVINCE
(Jan-Oct 2018 over 2017, in %)



For its part, Quebec enjoyed another solid year of manufacturing output growth. Strength in aerospace and in primary and fabricated metals production helped drive an expansion in the range of 7.0 per cent last year. While that growth rate lagged some of Canada's smaller provinces, it builds on a solid 8.2 per cent expansion last year and demonstrates ongoing strength in Canada's second largest manufacturing province.

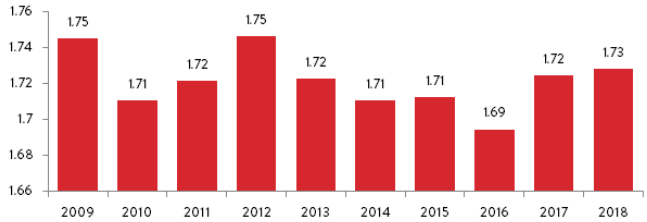
> "Every province saw healthy manufacturing sales growth in 2018. However, Ontario continues to be the weakest performer."

Meanwhile, for the second year in a row, Canada's manufacturing powerhouse Ontario brought up the rear provincially – in no small part because of the weakness in the auto sector described above. In 2017, Ontario manufacturing sales grew by just 1.9 per cent. That picked up to an estimated 4.0 per cent last year. While this sounds like a solid improvement, there are still lingering concerns in the province. One of the reasons why growth is as high as 4.0 per cent is because of temporary auto plant shutdowns in the summer of 2017. That meant that when the summer of 2018 rolled around, output levels were much higher, inflating overall growth totals.

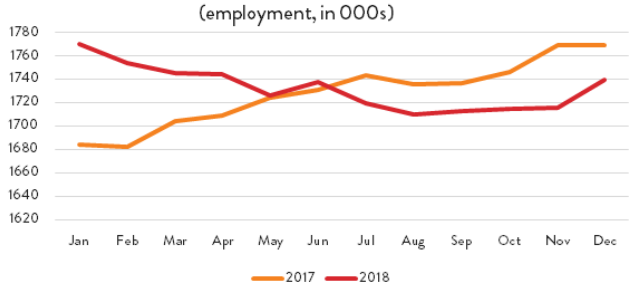
MANUFACTURING LABOUR MARKETS

After a strong showing last year, the job market in manufacturing softened in 2018. For the year as a whole, manufacturing employment managed to rise slightly, adding 4,600 net new jobs compared to 2017. However, that overall modest increase is somewhat misleading given the trends that took place over the course of the year. A late surge in 2017 caused manufacturing employment to peak at 1.78 million people in January – well above the 1.68 million 12 months earlier. From that peak, employment fell steadily through to about July before levelling off at about 1.71 million people. A year-end surge brought the total back up to 1.74 million in December, but that was still less than the 1.77 million people working in manufacturing twelve months earlier. So the end result was a small increase in annual manufacturing employment, but with a downward trend throughout the year.

MANUFACTURING EMPLOYMENT HELD STEADY IN 2018...
(number of jobs, in millions)



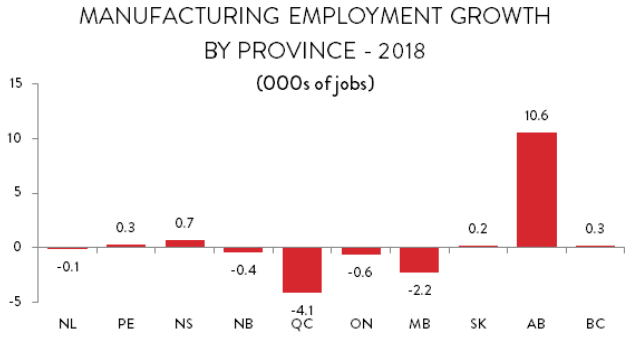
...BUT FELL AS THE YEAR WORE ON.
(employment, in 000s)



Provincially, the story in 2018 was a solid recovery in manufacturing jobs in Alberta but weakness elsewhere. Manufacturers in Alberta added 10,600 new jobs in

2018, causing employment in the sector to jump by 8.8 per cent. Even so, the province is still climbing out of the hole created by the 2014 oil price crash; there are about 14,000 fewer manufacturing jobs in Alberta today than there were four years ago.

> "Job gains in Alberta offset losses elsewhere, keeping manufacturing employment flat in 2018."



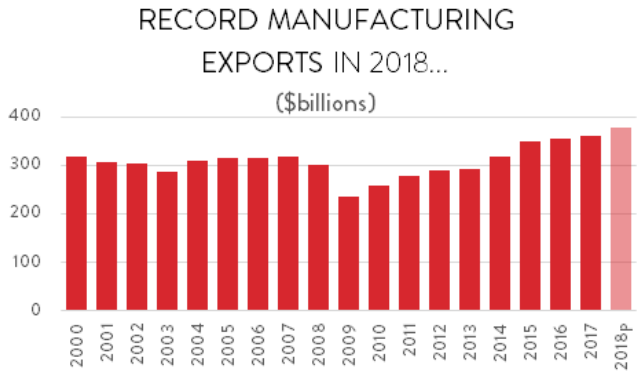
PEI and Nova Scotia also posted healthy jobs gains, but manufacturing employment was flat or down in most other provinces. The largest decline was in Quebec which lost 4,100 net jobs (a 0.8 per cent decline), followed by Manitoba at 2,200 (a 3.5 per cent decrease). For its part, manufacturing employment in Ontario was effectively unchanged, with a loss of 600 jobs (less than 0.1 per cent).

Even though manufacturing employment fell through much of 2018, it did little to ease the chronic labour and skills shortages plaguing the sector. The manufacturing unemployment rate held steady at 3.6 per cent last year – a level which poses a major barrier to future growth in the industry.

MANUFACTURING TRADE

After two years of sub-par growth, manufacturers made some notable progress in penetrating foreign markets. Manufactured goods exports increased by an estimated 4.8 per cent in 2018 – significantly better than the 1.6 per cent growth in each of the two previous years. As a result, manufacturers easily hit a new record in export values – estimated to be in the range of $378 billion.

> "After two years of sub-par growth, manufactured goods exports increased by about 4.8 per cent in 2018."



As was the case last year, petroleum refining was one of the biggest contributors to this growth, as higher prices boosted the value of gasoline and other refined crude oil products. Pharmaceuticals, pulp and primary metal industries also made solid export gains in 2018.

On a dollar-value basis, most of that export growth was in shipments to the United States. However, Canadian manufacturers made some progress in diversifying away from the US market in 2018. In particular, exports made double-digit gains in sales to China, Japan, Germany and the Netherlands, and near-double-digit growth in exports to Mexico.

Even though manufacturers enjoyed reasonable success exporting in 2018, they were unable to match the growth in imports of manufactured goods into Canada. As with exports, it was refined petroleum and pharmaceuticals that drove import growth in 2018, with additional strength in aerospace deliveries, as well as iron and steel. All told, manufactured goods imports into Canada rose by an estimated 7.5 per cent in 2018.

As a result, Canada's large trade deficit in manufactured goods continued to expand in 2018. In 2017, the manufactured goods trade balance came in at about $136 billion. Once final numbers come in, that imbalance will rise to somewhere in the range of $152 billion.

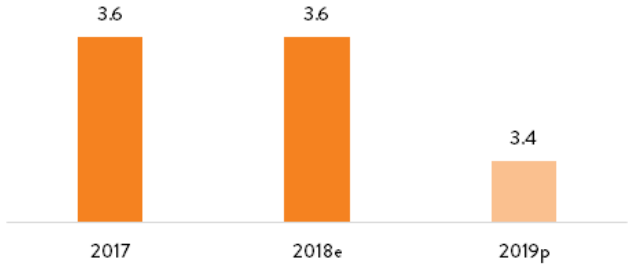
OUTLOOK FOR 2019

Canada's economic growth prospects for 2019 are dimmer than they were last year. Lower oil prices, slower growth in the US and global economies, softer housing markets and weaker household spending will all be a drag on GDP growth in 2019. These negative pressures will be offset to some degree by improving business investment (outside the energy sector), healthy employment levels and the potential for rising wages. Non-energy exports could get a boost from a competitive exchange rate. All told, we expect the Canadian economy to grow by about 1.6 per cent in 2019.

GLOBAL ECONOMY

Overall global economic growth met expectations in 2018, with GDP increasing by an estimated 3.6 per cent. However, after a strong start, growth slowed as the year wore on and economists are moderating their expectations for what 2019 has in store.

GLOBAL ECONOMY TO SLOW IN 2019
(real GDP growth, in %)



Source: IMF, Bank of Canada, CME

Several factors are contributing to this weaker outlook. For one, recent growth had been driven by stronger-than-average expansions in many advanced economies. But higher borrowing costs, equity market volatility, geopolitical uncertainty and ongoing trade tensions will dampen growth this year.

In the Euro area, recent poor numbers coming out of Germany have raised alarms about economic growth in that country, while Italy has been cutting its own growth forecasts as it struggles to cope with runaway public debt. Social unrest has also dented GDP growth in France, although those effects are mostly temporary. The bigger issue is whether or not the French government will be able to implement its much-needed economic reforms.

> "Global economic growth is projected to slow in 2019 as uncertainty begins to weigh on expectations."

The biggest wildcard in Europe, of course, is the ongoing Brexit drama and the impact that will have not only on the UK economy, but the continent as well. Uncertainty is weighing on business investment and economic growth and although a no-deal scenario would have the biggest negative impact, there is no real good-news outcome that is realistically on the table at this point.

GLOBAL ECONOMIC OUTLOOK
(% growth in real GDP)

	2018e	2019p	2019 risks
World	3.6	3.4	↓
China	6.6	6.2	↔
Euro area	1.9	1.5	↓
Japan	0.8	0.9	↑
India	7.3	7.4	↔
Latin America and Caribbean	1.2	2.2	↓

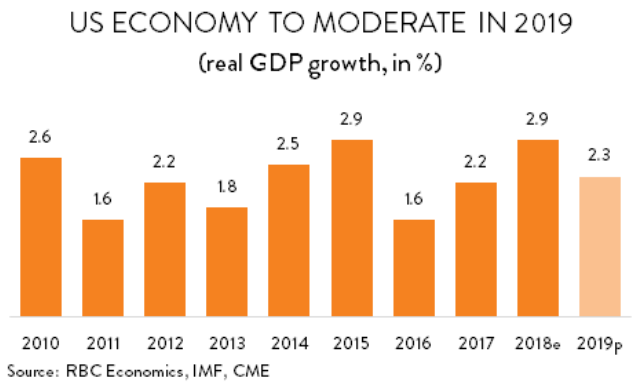
Source: IMF, Bank of Canada, CME

Meanwhile, the trade tensions between the US and China will put a dent in both economies in 2019. China is still expected to grow by more than 6.0 per cent this year, as policy-makers look for ways to counter the impact of higher tariffs by boosting domestic consumption and investment.

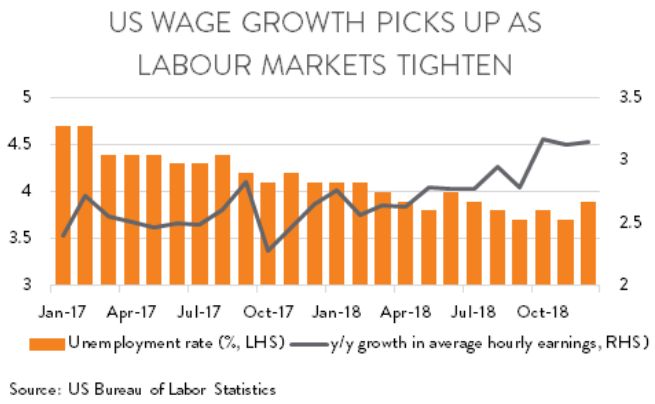
With slower growth in advanced economies, emerging markets will pick up some of the slack in 2019. However, falling commodity prices and imbalances between crude oil supply and demand could dampen growth in commodity-exporting countries. India is expected to see strong growth once again in 2019, while there are notable trouble spots in Turkey and Argentina.

UNITED STATES

Growth in the United States is expected to moderate in 2019. The impact of US tax cuts on consumer spending and business investment – which fuelled last year's strong growth – will fade, although maybe not before one last surge early in the year when tax rebates come in.



Consumer activity in the US should remain relatively solid this year. Strong labour demand has begun to put upward pressure on wages, helping to offset the impact of higher borrowing costs. However, those higher interest rates, combined with rising real estate prices are likely to contribute to some softening of the housing market south of the border.



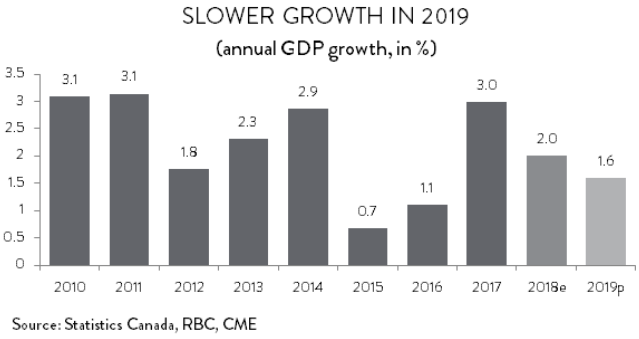
There are several factors driving slower growth expectations in the US. These include spillover effects from a moderating global economy, and the impact of higher interest rates on consumer and business borrowing. On top of that, trade wars – most notably with China – are undercutting US exports and creating significant business uncertainty. A stronger US dollar will offset some of the resulting higher prices on imports, but it will also magnify the impact of retaliatory tariffs imposed by other countries.

> "With tax stimulus running its course, the US economy should moderate as the year wears on."

Finally, there are growing concerns about whether or not there is a recession lurking around the corner. The US economy is in the midst of its second longest period of sustained expansion in its history. But what goes up must come down, and some of the traditional recession bellwethers – equity markets and the yield curve on bonds – are making noise. According to a recent Duke University/CFO Global Business Outlook survey, almost half of US chief financial officers believe the US will be in recession within the next 24 months. If that happens, Canada is almost sure to follow suit. This issue is discussed in more detail further below.

CANADA

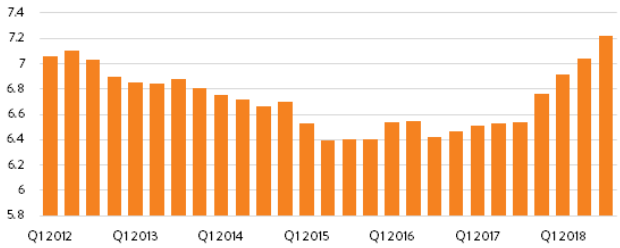
With slower growth expected in the global and US economies, there's no surprise that expectations for Canada in 2019 are dialed back as well. After a rather ordinary expansion of about 2.0 per cent last year, our expectations are for GDP growth to moderate even further in 2019 – to somewhere in the range of 1.6 per cent.



Household spending has made an outsized contribution to economic growth in recent years. That began to change in 2018 as higher interest rates raised borrowing costs for the heavily-indebted consumer. That impact will continue to filter through the Canadian economy in 2019, dampening sales of big-ticket items like cars and raising debt-servicing costs on mortgages and credit cards.

DEBT-SERVICING COSTS TAKE A BITE OUT OF CONSUMER ACTIVITY

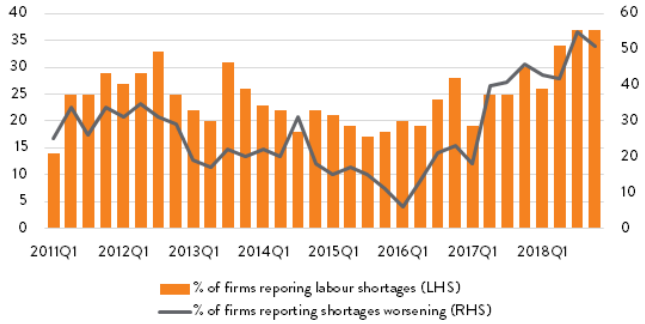
(interest payments on debt, as a % of disposable income)



Speaking of mortgages, the new stress test introduced last year, combined with higher borrowing costs, caused real estate markets to soften. While home sales and prices are not expected to shoot back up in 2019, we are far from a buyer's market in housing; any improvements in prices are being swallowed up by higher mortgage payments. Look for these effects to slow residential construction activity in 2019.

Short-term hiring intentions remain solid going into 2019, but labour markets are already tight and room for job growth could be limited. The unemployment rate is plumbing new depths and businesses across the country (except on the prairies) are having a hard time finding the workers they need. However, these shortages have not yet translated into any meaningful wage gains for workers. Look for that to change in 2019. Higher wages will help boost consumer spending, but will also raise production costs for businesses.

LABOUR SHORTAGES A GROWING CONCERN FOR 2019



Source: Bank of Canada

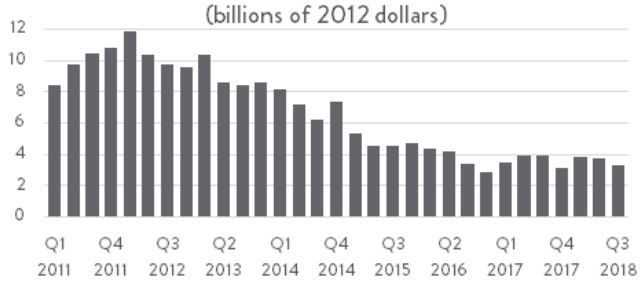
It will be a mixed year for non-residential business investment in 2019. On the positive side, federal tax changes that allow businesses to immediately expense qualifying capital goods purchases should provide a shot in the arm. However, tighter financial conditions and a low Canadian dollar will make it more expensive to import machinery and equipment.

> "The Canadian economy will slow in 2019, with growth in the range of 1.6 per cent."

At the same time, any growth in business investment will have to come outside the energy sector. Energy sector investment – which is normally the biggest driver of business spending in Canada – is expected to decline again in 2019 as a combination of lower oil prices, transportation bottlenecks, mandated production cuts in Alberta, and a profoundly uncertain regulatory/approval process for major energy projects take their toll on the sector.

BUSINESS INVESTMENT IN MINERAL EXPLORATION & EVALUATION

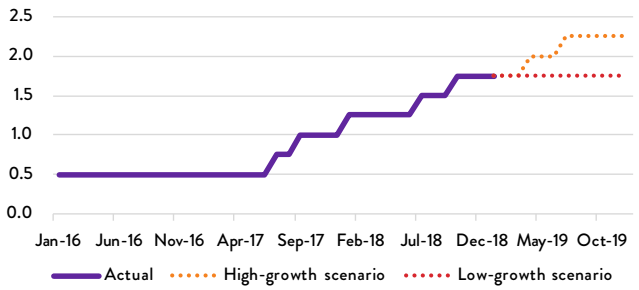
(billions of 2012 dollars)



With growth prospects dimming, the Bank of Canada is in an interesting position going into 2019. The Bank clearly has a bias towards raising lending rates, and most economists have factored 2-3 rate increases into their baseline expectations for the year. However, it's hard to make the case that the economy needs to be reined in, given the deteriorating outlook for the energy sector, stable inflation, tepid housing markets, high consumer debt levels, and recent declines in exports. Our expectations are for a more wait-and-see approach – resulting in no more than 1-2 small rate increases in 2019, likely in the first half of the year.

A combination of factors will keep the Canadian dollar from rising in 2019. Diverging economic growth rates between Canada and the US, potentially widening interest rate differentials and lower crude oil prices will all weigh on the loonie in the first half of this year. Barring dramatic unforeseen circumstances, the Canada-US exchange rate likely average somewhere in the 73-to-75-cent range for the year. This should help keep non-energy export growth solid in 2019.

INTEREST RATE OUTLOOK



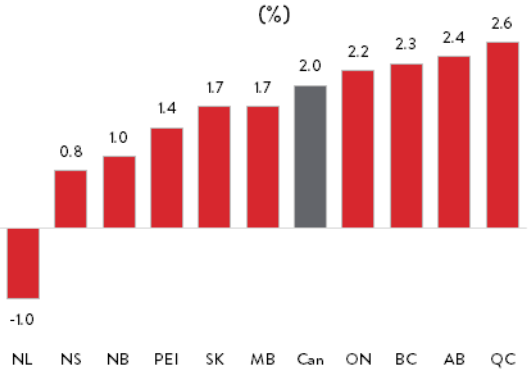
Source: Bank of Canada, CME

Provincially, expect BC to lead the country in economic growth in 2019 as construction on the $40 billion LNG Canada project gets underway. Capital projects will also boost GDP in Newfoundland and Labrador this year. Elsewhere growth will moderate, with the biggest year-over-year drop expected in Alberta where lower oil prices and mandated production cuts will put a dent in the provincial economy early in the year.

PROVINCIAL GDP GROWTH

2018 ESTIMATES

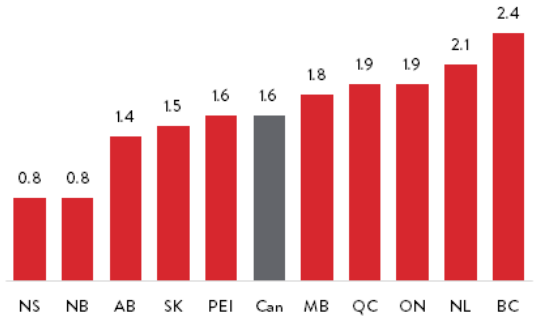
(%)



Source: RBC Economics

2019 FORECAST

(%)



Source: CME

FIVE THINGS TO WATCH IN 2019

Economic forecasting is like driving a car looking only through the rearview mirror. Projections are based on historic patterns, emerging trends and an understanding of a deep and complex series of cause-and-effect relationships.

However, those aren't the only things that affect how an economy performs. Government policies have an impact, albeit moreso in the long term than the short term – never trust government statements that take credit for creating jobs when monthly employment numbers come out. On top of that, surprise announcements, large-scale business investment decisions, geopolitical instability and a host of other factors are inherently unpredictable and can have a major impact on an economy's performance.

With that in mind, CME's economics team gazes into its crystal ball every year to highlight five things to watch out for in the coming year. These are our "known unknowns" – factors that we know will impact the economy, whether for good or for ill, but whose effect is far from clear.

1. WHAT IMPACT WILL THE CANNABIS INDUSTRY HAVE ON THE CANADIAN ECONOMY?

It's not every day that a new industry is born before our eyes. To be sure, businesses and products come and go and evolve over time. However, the legalization of cannabis is different. An established, but illegal, product has become unburdened and Canadian businesses are investing billions of dollars in new greenhouses, research and development, and value-added product development, including oils, edibles and beverages. They are employing thousands of Canadians in the process.

Canada is just the second country in the world to legalize the use of marijuana. If, and when, other countries follow suit, Canadian businesses will have a significant first-mover advantage and have the opportunity to establish themselves as world leaders in production and innovation.

However, there is much we don't know. First of all, the industry is in its infancy. Stock valuations are volatile. There will be mergers, acquisitions and consolidations as the industry matures. On a related note, no one knows yet just how big this industry is. Value-added cannabis products clearly qualify as manufactured goods. How much of a boost will cannabis be to Canada's manufacturing output? Similarly, how much will capital investment in cannabis production increase demand for manufactured goods from other industries?

And finally, there's the issue of government control and regulation. Provincial government policies on cannabis use vary considerably. Will policy differences converge or diverge? On top of that, governments are keen to collect tax revenue from this new source, but they are fighting against an established black market that has operated for generations. Will they strike an appropriate balance?

At the end of the day, however, this is a positive uncertainty for the Canadian economy. We know that billions of dollars are being invested in this industry, creating spinoff effects throughout the manufacturing sector and beyond. What we don't know is how large this effect will be in 2019 or what its growth potential is down the road.

2. CAN ANYTHING BE BUILT IN CANADA?

Canada has an identity crisis when it comes to natural resources development. Our fossil fuel industries are a major contributor to the national economy and support a wide range of government services, but resistance to development and eroding confidence in the project approval process have had a dramatic effect on investment and resulted in billions of dollars of foregone economic growth.

The poster child for this issue is the Trans Mountain pipeline. The last of three major pipeline projects still on the table, the Trans Mountain expansion project was nationalized last year to keep it from being abandoned. Federal attempts to find a buyer have failed and the project remains in legal/regulatory limbo.

Trans Mountain is symptomatic of a broader problem. Energy sector development has become a wedge issue, dividing the country and setting provinces against one another. Many believe that Bill C-69 – a proposed federal law to reform the regulatory approval process – will only further chill development; companies are being asked to spend billions of dollars over several years on an approval process with an uncertain timeline and no assurance that their project will be allowed to go ahead at the end of the day.

The impacts of this uncertainty and social resistance are widespread and unambiguously negative. At its peak, the crude oil price differential was costing the Canadian economy an estimated $80 million per day, although that differential – and the associated impact – has since narrowed. To get around their transportation bottlenecks, companies are increasingly shipping oil by rail, which is crowding out existing rail capacity for traditional heavy users in agriculture, mining and primary manufacturing. Meanwhile, new capital spending in the oil sands has dried up and tens of billions of dollars in resource-related investments are leaving the country.

One notable exception to this is the $40 billion LNG Canada project set to go ahead in BC. However, not only are protests against that project ramping up, but there are billions of dollars in additional LNG investments whose fates are still undecided. Decisions on several of these projects will be made in 2019. They will be a telling sign for the future of resource development in Canada.

However, this issue of major project construction is not limited to the resource sector. Public infrastructure projects across the country are plagued with delays and cost overruns, whether they be subway and LRT lines, or even the renovation of Canada's dilapidated federal government buildings. The Centre Block in Ottawa is closed for an estimated 10 years, but no one takes that timeline seriously; there isn't even a design or plan in place yet. It is also worth noting that when the Centre Block was destroyed by fire in 1916, it took just four years to build a new, larger edifice in its place.

All this to say, Canada has a growing reputation in the global business community as a place where major projects cannot be built. This coming year will be an important test for the future of the country's resources sector and economic activity generally.

3. IS A RECESSION LURKING AROUND THE CORNER?

The economic cycle is a fact of life. Extended periods of expansion are inevitably followed by recessions; the economy overheats, creating imbalances which are corrected though a period of contraction. The United States is currently 10 years into an economic recovery/expansion phase, dating back to the 2008-2009 global economic and financial crisis – that's the second longest sustained expansion phase in US history.

In Canada the story is a bit different because of the importance of oil production to the economy. High oil prices insulated Canada from a downturn in the early 2000s, but low prices triggered a small recession in 2015.

No one knows exactly when an economic slowdown will happen, but there are several warning signs over and above the fact that the current expansion phase in the US is long in the tooth. For starters, one of the most reliable indicators of an imminent recession is the gap between short-term and long-term interest rates. Usually, rates are higher on long-

term bonds because of the implicit risk of holding those securities. However, if investors are pessimistic about short-term economic prospects, they flock to longer-term securities, driving up short-term rates. When short-term rates exceed long-term rates, this results in an "inverted yield curve" – a phenomenon that has successfully predicted nearly every recession since World War II.

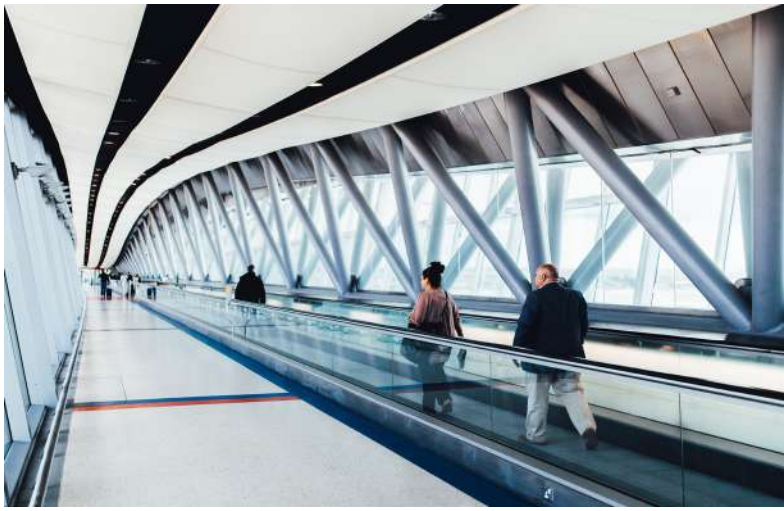
The yield curves in Canada and the US are still positive, but they're narrowing. On top of that, equity markets – another potential recession bellwether – in both countries have been both volatile and dropping.

A potential recession brings all sorts of challenges to the Canadian economy. Besides the obvious negative impact on manufacturers and other businesses, there's the issue of fiscal sustainability. Canada has been running persistent fiscal deficits federally and in most provinces even as the economy has been relatively strong. A recession would dramatically slow revenue growth, increase demand for additional fiscal stimulus and drive the deficit significantly higher. In short, Canada is not in a good fiscal position to weather an economic downturn.

That said, no one can predict the timing, severity or duration of a recession. However, there are warning signs that one could appear within the next 18 months.

4. WILL GOVERNMENT ACTIONS SUPPORT OR IMPEDE BUSINESS INVESTMENT?

Lagging business investment in machinery, equipment and technology is a large dark cloud hanging over Canada's economic future. Although there was a modest recovery in business investment intentions in 2018, planned investments last year were still 12.3 per cent below 2014 levels. In the manufacturing sector, they were 11.1 per cent lower than in 2014. These figures do not account for the effects of inflation; if they did, the decline would be even greater.



Investment in machinery, equipment and technology is critical to productivity growth and long-term global competitiveness. To its credit, the federal government recognized the importance of encouraging capital spending when, in late 2018, it announced that it would match US provisions that allowed businesses to immediately write off all qualifying capital expenditures in the year in which they were made. This improvement to the Accelerated Capital Cost Allowance (ACCA) is a significant step forward for the business community.

The problem is that every step forward seems to be on a moving sidewalk that's heading in the wrong direction. While there are some positive tax developments coming in 2019 (lower EI premiums and a decrease in the federal small business tax rate), these will be offset by higher Canada Pension Plan (CPP) payments and the new carbon taxes that kicked in on January 1st. These will impact the cost of hiring and retaining staff, as well as the cost of production, transportation and inputs for most manufacturers. Meanwhile businesses in several provinces are coping with dramatic increases in other costs as well – electricity prices, workers' compensation benefits, minimum wages, health care taxes and property taxes are all rising in various parts of the country. On top of that, as mentioned above, there are concerns looming about the potential for an economic downturn within the next 12-24 months.

How will these influences net out? This matters not just because of the need to improve capital investment in Canada, but also for the future of beneficial policy development in this country. Businesses see programs like the ACCA as necessary not because they spark new investment, but because they help compensate for other policies that undermine their competitiveness. In that sense, the impact of programs like an enhanced ACCA may be limited because they do not improve the business climate as much as prevent it from getting worse.

At some point down the road, the federal government will review the effectiveness of the enhanced ACCA. But if economic conditions deteriorate and other costs rise to offset that benefit, then businesses may not have the ability or inclination to invest regardless of the tax incentives. This could lead governments to conclude that programs like the ACCA are not effective and should be discontinued.

That would only magnify the existing problem. The solution is broad tax and regulatory reform that makes it easier and cheaper to do business in Canada, while also incentivizing investment and growth.

5. WHAT WILL THE US PRESIDENT DO?

The final wild card for the Canadian economy in 2019 is the most unpredictable of all. The Trump presidency has been a never-ending source of drama, entertainment or frustration depending on your point of view, political affiliation, or how much skin you have in the game. No one knows for sure what he will do next, possibly not even himself.

What we do know is that as the leader of the most powerful democracy in the world, Donald Trump has the power to singlehandedly shape the future of the global economy. Geopolitics aside, the most obvious example of this is the US triggering a series of tariff wars against countries it believes to be engaged in unfair trading practices – most notably China and the EU.

For Canada, uncertainty also comes from the fact that steel and aluminum tariffs remain in place into early 2019 – likely awaiting a "managed trade" solution – while the replacement NAFTA agreement is signed but still faces an uphill battle getting Congressional approval in the US. Finally, the President's liberal use of "national security" provisions to justify trade actions adds an additional element of uncertainty to the mix.

This uncertainty has prompted Ottawa to place growing policy emphasis on diversifying Canadian exports away from the US market. However, diversification is a long and slow process – especially given the interconnected nature of the North American economic space. Existing supply chains and business relationships are not easily or quickly unravelled.

Domestically in the US, there's also the issue of the ongoing investigations into the President's conduct. Two criminal investigations are underway. The now-Democratic-controlled Congress has introduced articles of impeachment against Mr. Trump, and the Judiciary Committee has brought forward legislation to protect Special Counsel Robert Mueller from being fired as he pursues his investigation of potential collusion with Russia during the 2016 Presidential campaign. On top of all that, at the time of writing, the US government was partially shut down over a dispute with Congress about funding Trump's plan to build a wall along the US-Mexico border.

The list goes on, but the point is clear: Donald Trump is a wild card for Canada's economic outlook in 2019.