SUMMARY

- We believe active investors’ success in adding value in Canada's markets in 2017 will hinge on their ability to navigate an increased probability of extreme economic outcomes – both good and bad.
- Left-tail outcomes could result from protectionist U.S. trade policy, including Donald Trump's promised renegotiation of NAFTA, and the potential for higher interest rates that would affect Canada's debt-laden consumers and detract from GDP growth by lowering consumption and residential investment.
- Right-tail opportunities could develop if pro-growth policies in the U.S. drive economic growth north of the border by spurring exports and business fixed investment.

At the risk of entering the realm of cliché, we couldn't help but draw parallels with Dickens’ classic novel, “A Tale of Two Cities,” when forecasting the Canadian economy in 2017. As he wrote, “It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity.”

The key theme of income inequality running through the heart of the novel rings as true now as it did a century-and-a-half ago, manifesting itself globally in 2016 with the U.K.'s Brexit vote, Italy’s constitutional referendum and the election of Donald Trump as president of the U.S. And we face the spectre of more political volatility in 2017 with the upcoming elections in France and Germany.

It is within this global environment that Canada's small and open economy must navigate, and we believe 2017 will be a tale of two “tails.” More specifically, we believe the tails of the distribution of economic outcomes have become fatter – that is, the probability of more extreme outcomes (both good and bad) is higher than in a normal distribution (see Figure 1).
There is nothing particularly earth-shaking about our baseline forecasts of 1.5%-2.0% real GDP growth and core inflation of 1.5%-2.0% for Canada, or our view that the Bank of Canada will hold the overnight rate at 0.5%. What is worth noting is that with fatter tails comes less certainty about our baseline view. And we believe active investors’ success in adding value in 2017 will hinge on how well they navigate the potential risks and opportunities we see for Canada.

Left-tail risks: “The worst of times”

Protectionist U.S. trade policy

During his campaign, Donald Trump railed against “terrible” U.S. trade agreements and promised to renegotiate NAFTA. But will he follow through with this campaign promise? There are congressional proposals to impose a destination tax on goods crossing the U.S. border that could be devastating to Canadian exports. Renegotiating NAFTA will be a lengthy and complicated process; it is unclear whether it can be successfully completed. We may see the Trump administration looking for immediate results by targeting specific companies and industries within the World Trade Organization framework.

Mexico and China have been the main targets of Trump’s trade concerns, while Canada has been relatively under the radar (except for the revival of the Keystone XL pipeline, which former President Barack Obama had rejected in 2015). Canadian Prime Minister Justin Trudeau has elevated a former PIMCO Secular Forum speaker, Chrystia Freeland, to foreign minister with the explicit task of ensuring that Canada does not become collateral damage in new trade deals. We will continue to monitor this fluid situation, which remains a major left-tail risk to our baseline forecast.

Debt-laden consumers and a housing correction
Canadian consumers could face a very difficult 2017, with the potential for higher interest rates when net debt-to-income ratios are at an all-time high of 167%. Most housing markets in Canada have never been more expensive, and governments are implementing policies to reduce (or reverse) house price inflation. Vancouver has put a 15% tax on foreigners buying homes, and the Canada Mortgage and Housing Corporation (CMHC) and Office of the Superintendent of Financial Institutions (OSFI) are implementing policies to slow mortgage credit growth. While our base case is that housing price inflation will slow in 2017, there is a risk that prices could contract. Higher interest rates and lower house prices could detract from GDP growth by lowering consumption and residential investment.

An oil price collapse

Oil prices have been highly volatile of late, with Canada’s Western Canadian Select trading as low as $13.80 per barrel before closing the year at $37.60. This oil price shock damaged the Canadian economy and was a main reason the Bank of Canada cut the overnight rate to 0.5% from 1% in 2016. Looking ahead, we think OPEC’s decision in November to cut oil production has probably truncated the downside risk to oil prices for 2017. This means the energy sector will likely be a contributor to GDP growth this year (given the low base effects). That said, if oil prices were to move substantially lower, Canadian GDP growth would likely suffer.

Right-tail opportunities: “The best of times”

Robust U.S. economic growth fuels Canadian exports

Canadian policymakers have been holding their breath waiting for robust exports to propel the country’s economic expansion. The Bank of Canada recently released its Winter 2016-17 Business Outlook Survey, which, compared with the previous quarter, showed that more Canadian firms expected the November election to lead to strong U.S. economic growth.

While considerable uncertainty remains about U.S. fiscal policy, with Republicans controlling both houses of Congress and the presidency, we expect a positive fiscal impulse over the next couple of years. Moreover, financial and energy markets have interpreted Trump’s preference for less regulation positively. We see a clear possibility that a pro-growth agenda from Washington could lead to increased consumer and business confidence and in turn spur more investment and consumption. Historically, a strong U.S. economy has translated into strong Canadian exports – and this could be a meaningful positive upside to our baseline forecast for 2017.

An increase in business fixed investment

One of the hallmarks of the global economic recovery since the financial crisis has been the absence of robust growth in business fixed investment. Faced with high degrees of uncertainty about everything from government policy to Asia and Europe, businesses’ fixed investment has lagged levels seen in past cycles. If a pro-growth U.S. agenda leads to a rise in what John Maynard Keynes called “animal spirits,” then we could see investment-led growth in both the U.S. and Canada. A virtuous cycle of export growth and investment could in turn enable Canada to outperform PIMCO’s 2017 real GDP forecast of 1.5%-2%.
Investment implications

We forecast that both the U.S. Federal Reserve and the Bank of Canada will continue to pursue accommodative monetary policies. While the Fed may raise the fed funds rate multiple times in 2017, it will likely be cautious to avoid making a “hawkish mistake.” As U.S. rates rise, we would expect Canadian rates to rise and for the yield curve to steepen. However, the Bank of Canada’s more accommodative stance would likely translate to a slower pace of increases than in the U.S.

Such accommodative monetary policies should continue to support the credit cycle and credit spreads. We think a number of geopolitical, economic and policy events will contribute to continued volatility in the markets. This could lead to bouts of spread widening in the credit markets, and we would look to buy high quality income-generating bonds during those periods. Finally, as the U.S. economy recovers and Fed policy normalizes, we expect the U.S. dollar to strengthen against a basket of currencies (including the Canadian dollar).

Here’s to a happy ending to this tale of two tails.

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