January 2017

Economic Outlook: What to expect in 2017

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As we settle into what promises to be a year of transformation, we sat down with CIBC Deputy Chief Economist Ben Tal to gather his thoughts on what 2017 has in store for key economies, currencies and asset classes:

ECONOMIC GROWTH

At this point, it appears that the U.S. will outperform Canada in 2017. This wouldn't really be a result of Trump's policies, where the main impact will be felt in 2018. It's really due to the weakness of the Canadian economy. While energy prices are likely to rise a bit (see below), the main benefit will be to energy company profits as opposed to real production and investment activity. The oil sector needs higher and stable oil prices to start drilling again.

In addition, the rotation from energy to non-energy export activity in Canada will take longer than expected. This is due to capacity constraints as well as reduced demand from the U.S. manufacturing sector as it adjusts to the ongoing strength of the American dollar. At the same time, it's reasonable to expect another solid year from American consumers, given still elevated pent-up demand and higher wage growth as labour market activity remains strong. We expect GDP growth in Canada to average 1.7% in 2017 versus an average of 2.2% in the US. In Canada, we expect B.C. and Ontario to lead the way.

INTEREST RATES

We believe the correction in the long-end of the bond market that took place in the last two months of 2016 is sustainable. At least for 2017, inflation expectations will remain elevated and the prospects of growing debt levels will maintain the pressure. Accordingly, we see the yield on the U.S. 10-year Treasury bond ending 2017 at roughly the same level it is now, give or take 10 basis points. The same thinking applies to Canadian rates.

As for the short-end of the curve, our guess is that the U.S. Federal Reserve (Fed) will hike rates three times in 2017. The Fed will likely choose to react to the clear elevation in inflation expectations and the current thinking that the economy is operating very close to full capacity. For the Bank of Canada (BoC), while the likelihood of another cut is less than 25%, it's very reasonable to expect the BoC to be on hold in 2017.

OIL PRICES

There has been a clear change in Saudi Arabia's oil agenda, with the country more likely to accept reduced production and higher prices. Add to that some modest improvement in global oil demand and we see reason to believe that oil prices can reach $60 in 2017. However, at that price level, U.S. production is likely to shift gear and the U.S. will act as a de-facto swing producer in the market. In fact, this is already happening. Accordingly, with increased U.S. production, it's difficult to see oil prices rising above the $60 mark.

THE LOONIE

We strongly believe the loonie will face some offsetting forces in 2017. Higher oil prices will act as a positive while diverging U.S.-Canadian monetary policy will act as a negative. It's reasonable to assume that the impact of changes in interest rates will outweigh the impact of energy prices, suggesting that the loonie might lose modest ground during the year.

> *"Higher oil prices will act as a positive while diverging U.S.-Canadian monetary policy will act as a negative…the impact of changes in interest rates will probably outweigh the impact of energy prices, suggesting that the loonie might lose modest ground during the year."*

THE EURO

Despite better economic performance in 2017, the euro is likely to be fragile, at least in the early part of 2017. This is not just because of the impact of Trump on the U.S. currency or even the European Central Bank's (ECB) policy—the main factor here is politics. We have the elections in Netherlands on March 15, the first round of the French election in the spring and the big event is the German election in the fall. The refugee crisis in Germany is clearly a major issue facing Chancellor Merkel. This is not to say that Merkel will lose the election, but with so much uncertainty, the euro will pay the price. We expect the euro to lose some ground in the first half of the year.

EQUITIES

This is a tough one. It's reasonable to assume that 2017 will not be as good as 2016. But are recent gains sustainable? We believe they are.

In the U.S., if we are right and the bond market doesn't reverse its course in 2017, we will not see much inflow into the fixed income market at the expense of equities. The U.S. corporate tax cut will act as a significant boost to corporate profitability, which is starting from a relatively low base given the performance of the past few years. As well, repatriation of corporate cash back to the U.S. should lead to a notable improvement in mergers and acquisitions (M&A) and stock buy-back activity. It's not unreasonable to suggest that recent gains are sustainable, at least in 2017. The energy sector as well as industrials might see further gains due to Trump's energy policies, increased global spending on infrastructure and probably better-than-expected growth coming from China.

In Canada, it's reasonable to assume that the TSX performance in 2016 will not be repeated in 2017. But we still see some opportunities. With oil prices rising, the loonie losing some ground and improved prospects regarding pipelines, the energy sector is well positioned for further gains. The steepening yield curve should be beneficial for financials.

Given the high level of uncertainty regarding what Trump will actually do, these are our best guesses at this point. The main assumption here is that the real impact of the Trump polices will be felt in 2018, and that's also when frictions with Congress might start as we see more evidence of rising debt. But until then, the market might continue to benefit from early days of Trump euphoria in 2017.

It's important to consider how economic and market trends can affect your investment portfolio and we can help you with that. If you have any questions about these insights, please give us a call.