October 2018

Canada Outlook

Attractive fundamentals in the face of ongoing market volatility

HSBC outlook

Our growth outlook is tempered by concerns about politics, trade tensions and some emerging markets

The risk of recession remains low in Canada and the US

Overall, we think the economic environment continues to look positive

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What's behind the divergent performance of emerging markets?

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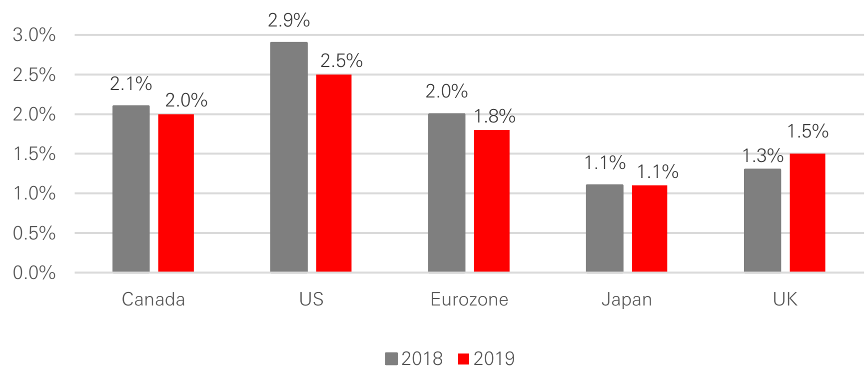
HSBC

Q4 Outlook: Trade concerns moderate, but market volatility may trouble investors even as fundamentals remain solid

Our overall positive growth outlook remains coloured by concerns about politics, trade tensions between the US and China, and instability in some key emerging markets, such as Turkey. However, strong fundamentals suggest that looking past short-term noise in the markets is the best course of action.

We still maintain that the risk of recession remains low over the next 12 months in Canada and the US. The apparent resolution of the NAFTA talks, with the announcement of the United States-Mexico-Canada Agreement (USMCA), should provide more certainty for investors and businesses. Overall, we think the positive economic environment will continue, but with periods of volatility, as we move toward the close of 2018.

Real GDP consensus forecasts



Source: Bloomberg as at October 9, 2018

HSBC investment strategy highlights: Equities remain favoured over bonds

Currently, the equity return potential continues to look attractive relative to fixed income. Within fixed income, we are overweight in corporate and provincial bonds. Corporate bonds offer higher yields than government bonds and are well supported by strong balance sheets and earnings growth. Within the government sector, we still prefer provincial bonds over Government of Canada bonds because of their higher return potential.

We are also positive on the energy sector. Oil prices are moving higher in the wake of Saudi Arabia and Russia ruling out any near-term increases in supply despite President Trump's demands for more production. We forecast more oil supply pressures in the fourth quarter, which bodes well for Canadian producers and the wider Canadian economy.

Q3 in review

Canada's economic performance and growth outlook continue to put it near top-performing countries like the US

Due to uncertainty surrounding NAFTA, the Bank of Canada elected to keep the overnight rate at 1.5%

The Fed raised interest rates for the third time this year, pushing the federal funds target range to 2.00-2.25%

Markets continue to ignore good fundamentals and instead trade on lacklustre sentiment

Economic growth, corporate earnings and tight credit spreads on corporate bonds (the interest rate premium charged to attract investors to invest in corporates instead of safer government bonds) all point to a rosier outlook than what would be predicted based on activity on most equity markets outside the US. Indeed, markets are fixated on trade tensions and geopolitical news. While these factors are important, they should be kept in perspective.

Canada's economic performance and growth outlook put it near top-performing countries like the US. The Bank of Canada's core measures of inflation remain anchored around 2%, which indicates the economy is still operating near capacity. We expect the Bank to raise rates two or three times between now and the end of 2019. Largely because of the economic uncertainty surrounding NAFTA negotiations, the Bank held the overnight rate steady at 1.5% at its September 5 announcement. GDP rebounded by 2.9% in the second quarter, in line with the Bank's forecast. The Bank expects GDP growth to have slowed temporarily in the third quarter as a result of more fluctuations in energy production and exports.

Canadian equities continue to offer solid returns and good valuations supported by positive earnings growth, but many investors are understandably disappointed by the disparity with higher US returns. For 2019, we forecast attractive earnings growth for Canada and expect US earnings growth will be tempered as the stimulus from tax cuts moderates. Another positive sign for Canadian companies is that the corporate fixed-income market appears strong, based on credit metrics like balance sheet strength and default rates.

On September 26, as expected, the US Federal Reserve (Fed) raised interest rates for the third time this year, pushing the federal funds rate to a range of 2.00% to 2.25%. We see this as a sign of increased confidence in the US economy, where economic and jobs growth is strong against a backdrop of stable inflation.

Key central bank interest rates

Central Bank	Current Rate	Next Meeting	Last Change
Bank of Canada	1.50%	Oct 24, 2018	Jul 11, 2018 (+25 bps)
US Federal Reserve	2.25%	Nov 08, 2018	Sep 26, 2018 (+25 bps)
Bank of England	0.75%	Nov 01, 2018	Aug 02, 2018 (+25 bps)
European Central Bank	0.00%	Oct 25, 2018	Mar 10, 2016 (-5 bps)
Reserve Bank of Australia	1.50%	Nov 06, 2018	Aug 02, 2016 (-25 bps)
Bank of Japan	-0.10%	Oct 31, 2018	Jan 29, 2016 (-20 bps)
Central Bank of the Russian Federation	7.50%	Oct 26, 2018	Sep 14, 2018 (+25 bps)
People's Bank of China	4.35%	n/a	Oct 23, 2015 (-25 bps)

Sources: Central banks of listed countries as at October 9, 2018. One basis point (bp) is equal to 1/100th of 1% or 0.01%.

Canadian market and economic highlights

Canada's economy expanded faster than analysts expected in July — posting a 0.2% month-over-month seasonally adjusted gain

Performance was buoyed by the manufacturing sector, wholesale trade and stronger utilities

July's GDP result appears to put the economy on pace for close to 2% annualized growth in the third quarter

Canadian market sectors deliver mixed performance

Five of the 11 sectors of the S&P/TSX Composite Index posted a positive return in the third quarter. The other six sectors finished the quarter in negative territory. The top-performing sector was healthcare, which finished 31.2% higher. The worst-performing sector was materials, which finished 12.8% lower.

The Canadian economy expanded faster than expected

The Canadian economy expanded faster than analysts expected in July — posting a 0.2% month-over-month seasonally adjusted gain. Consensus forecasts called for a 0.1% gain after a flat performance in June. The biggest factor was a 1.2% gain in the manufacturing sector, its strongest showing since late 2017. Performance was also buoyed by rebounding wholesale trade and stronger utilities, which spiked in response to weather-related demand for electricity to run air conditioning. Declines were seen in key segments such as retail and construction.

Analysts had made cautious growth forecasts for July, in the wake of an outage at the Syncrude oil sands plant in Alberta that caused a significant portion of the country's oil production to be side-lined for a month. The Syncrude facility started coming back online in late July and returned to full capacity in September, which may boost future GDP data.

The July GDP result appears to put the economy on pace for close to 2% annualized growth in the third quarter. This would be sharply lower than the second quarter's 2.9% growth, but it would be significantly higher than the 1.5% growth forecast from the Bank of Canada in mid-July. If the economy continues to strengthen faster than expected, it will only add to the case for the Bank of Canada to hike rates again at its next meeting on October 24.

Canada's economy at a glance

Economic indicators	Latest period		Year ago
Real GDP	July	0.2% m-o-m	2.4% y-o-y
Unemployment rate*	September	5.9%	6.2%
Housing starts (000s)*	September	188.7 units	217.1
New motor vehicle sales	July	179,587 vehicles	-2.8% y-o-y
Retail sales	July	0.3% m-o-m	3.7% y-o-y
Current account balance*	Q2	-$15.9 billion	-$16.3 billion
Consumer Price Index	August	-0.1 m-o-m	2.8 y-o-y

m-o-m = month-over-month change; y-o-y = year-over-year change
*Levels are shown for the latest period and the same period a year earlier
Sources: Statistics Canada and Bloomberg at October 9, 2018

Spotlight on emerging markets

Emerging markets suffered significant volatility during the summer, but pressures were not uniform across countries

Fed policy tightening and concerns about global growth have provided a common shock to emerging markets

But the impact on individual markets has reflected fundamental vulnerabilities or idiosyncratic factors

What's behind the divergent performance of emerging markets?

While most major emerging market currencies have depreciated against the US dollar in recent weeks, the scale of the sell-off has not been uniform. The Argentinian peso, for example, has fallen by almost 30% against the dollar since the end of July but the Thai baht has risen slightly, and a number of other emerging market currencies have declined by around 2% or less.

Higher US rates are a key driver

Our analysis suggests that investors are favouring the US dollar over emerging-market currencies in large part because of higher US interest rates and stronger economic growth. These factors have encouraged a sell-off in emerging market currencies as investors move back into US dollars. There is also a perception that downside risks to global growth increased earlier in the year, based on factors such as China-US trade tensions. Economies that are more fragile in terms of structural and economic indicators, or that face idiosyncratic risks, such as repressive politics, have suffered greater losses.

Argentina has multiple challenges

Consider Argentina: a number of factors help explain why it has suffered more than most in the current environment. It has one of the largest current account deficits among emerging market economies, meaning Argentina is heavily dependent on foreign borrowing. It also has a large government budget deficit. In addition, Argentina has a large stock of foreign-currency-denominated debt worth around 55% of GDP. Argentina has also been hurt by its high inflation rate, which started the year at 25% and has since risen to over 30%.

Many emerging markets are much less vulnerable

While few economies have the mix of vulnerabilities that Argentina faces, some have come under pressure. Those that have underperformed have tended to display at least one of the following characteristics: a larger-than-average current account deficit; an above-average level of foreign-denominated borrowing; higher-than-average inflation; or a large exposure to the commodity cycle. This holds true for South Africa, Brazil, Chile and Colombia. There are, however, many emerging-market economies that do not suffer from these vulnerabilities. Asian economies have limited current account deficits or large surpluses, relatively low levels of foreign-currency denominated debt and comfortable inflation rates.

Valuations suggest a more positive outlook

From a long-term valuation perspective, and looking at emerging markets in aggregate, both equities and bonds appear attractive. Local currency debt, in particular, stands out. In the current environment, we need to be cognisant of the risks, but valuations suggest that investors are now being rewarded for taking on those risks.

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Expiry Date: January 31, 2019

HD181017; DK1800390A; H20181018; P1810019