

Navigating 2019

9 big insights for the year ahead



2019 will put Canada's economy to the test

Not since the financial crisis have markets ended the year with such uncertainty as they did in 2018.

Last year's final trading days, and weeks, signalled a worrisome divergence in views about the economy, global trade and policy predictability that will likely continue into 2019.

For years, consumers have been our undisputed economic heroes. As each crisis or shock unfolded, households could be depended on to pull out their credit cards and add to their mortgages. The aftershocks of the Great Recession would have been far worse without household spending to mask slow business investment and exports.

We can thank low interest rates for that. Since the mid-2000s, central bank policy rates have gone down much more than up, and now that's changing. After keeping rates at ultra-low levels for most of the past decade, the Bank of Canada has hiked them five times since July 2017 – and is expected to do so twice more in 2019.

But if this year shapes up to be one of greater uncertainty, both in Canada and abroad, it won't be solely because of the overextended consumer. Globalization is being challenged, with the U.S. administration engaging in a trade war with China, and the UK's exit from the EU proving to be far from graceful or predictable.

Is it too much to expect the economic boom to continue? This year will mark the 10th anniversary of expansion for the U.S. economy, which remains the world's largest single engine of growth. That would set a record if it continues past mid-year, and would put the economy, without much doubt, closer to the end of the boom than the beginning.

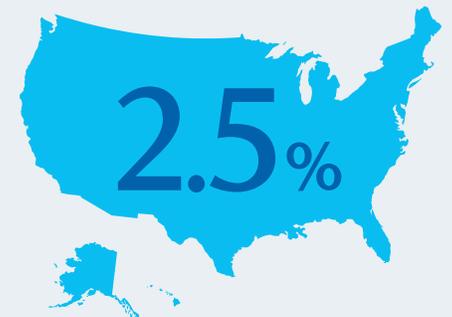
Against this backdrop, we set out here to examine some of the trends that will unfold in the year ahead – the risks to watch for and the opportunities to be had.

Coming into 2019, the U.S. economy was on firm ground, with growth projected to slow mildly, to 2½%. Canada enjoys several advantages, including strong population growth, an increasingly dynamic economy and our continued embrace of free trade, though we also face pressure from lower-than-expected oil prices and tightening financial conditions.

Add all this together, and we still believe it's premature to say this year will mark the end of the expansion. So what will keep growth going? After years of ultra-low interest rates, it will have to be more than the consumer.

In 2019, the economy may finally have to stand on its own.

Projected economic growth for 2019



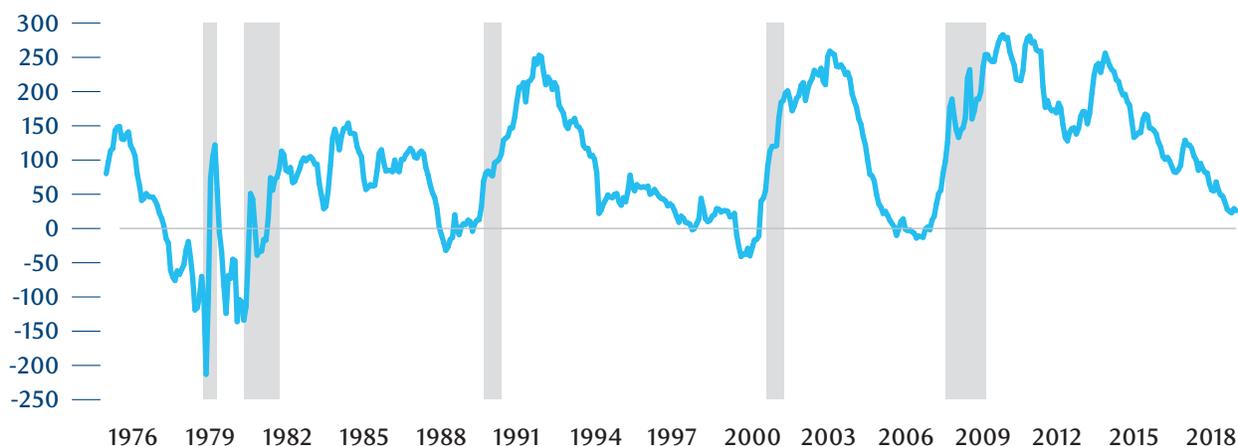
A fabled recession indicator worth watching

The shape of the yield curve – that is, the spread between long- and short-term interest rates – is a hot topic these days. When long-term rates are below short-term rates, the yield curve is said to be “inverted,” and a potential signal that a recession is not far off, with the typical lag around 18 months. While the spread between two- and five-year U.S. Treasuries inverted in early December, a more accurate gauge, the spread between two- and 10-year Treasuries,

remained slightly positive. These moves were seen in Canada too. It pays to watch movements in the yield curve, because if it inverts, this compresses interest rate margins and makes lenders less willing to extend credit. That would have a knock-on effect for business activity. Business loan growth in Canada accelerated in 2018, so we’ll be watching to see if that trend continues this year.

When the U.S. yield-curve turns negative, a recession has followed

Spread between 10-year and 2-year yield, in basis points



Source: US Treasury, NBER, RBC Economics Research

“It pays to watch movements in the yield curve, because if it inverts, this compresses interest rate margins and makes lenders less willing to extend credit.”



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A golden decade of household wealth creation is losing its lustre

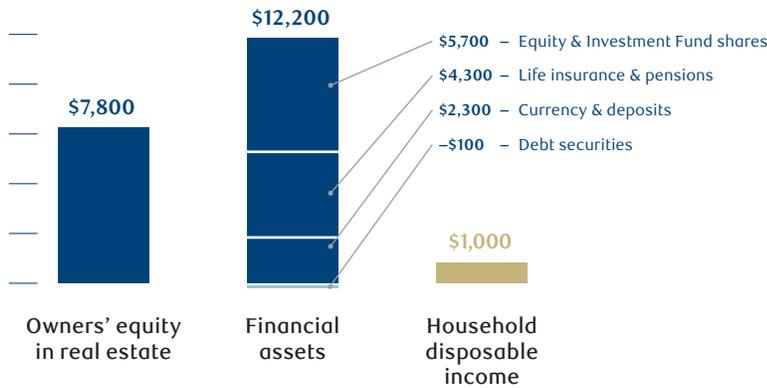
Declining interest rates over the past decade didn't just make the cost of borrowing cheaper for households. They also had a hand in pumping up asset values and household wealth in Canada. While it wasn't shared by everybody – far from it – net worth per household soared by 56% over that period, which represented an average gain of a little more than \$20,000 per year per household in today's dollars. A booming housing market was a big factor, with homeowners' equity in real estate (the value of households' real estate assets less mortgage debt) rising by an average of \$7,800 annually. Still, it was significant growth in financial assets that contributed most by adding \$12,200 per year on average to households' balance sheets. A strong economy certainly helped fuel assets such as equities and investment funds but so did low interest rates, especially for the valuation of future pension plan benefits.

\$20,000
average annual gain
in net worth over the
past decade



Canadian households have gotten wealthier over the last decade

Average increase in assets, per household per year, since 2008 in constant 2018 dollars



Source: Statistics Canada, RBC Economics Research

With interest rates now climbing, expect dynamics to change for both sides of households' balance sheets, not just liabilities. On the asset side, we see more limited growth prospects in real estate holdings. Our view is that housing prices will be largely flat in the near term (in part due to rising rates) and the ownership rate will decline in Canada, due to affordability issues. Some downward pressure is also likely to build on the value of households' future pension plan benefits.

So after a strong decade-long run of aggregate household wealth growth in Canada, we may be facing a slower rate of appreciation over the next little while. If this is the case, much will rest on (so-far meagre) income gains to ease the impact.

RBC housing forecast for 2019

(% change from 2018)

	Sales	Prices
Vancouver	0.0%	-2.5% ↓
Calgary	1.0% ↑	0.5% ↑
Toronto	5.6% ↑	0.5% ↑
Montreal	2.6% ↑	4.0% ↑

“ Our view is that housing prices will be largely flat in the near term (in part due to rising rates) and the ownership rate will decline in Canada, due to affordability issues. ”

Bar to home ownership

Projected share of income, 2019



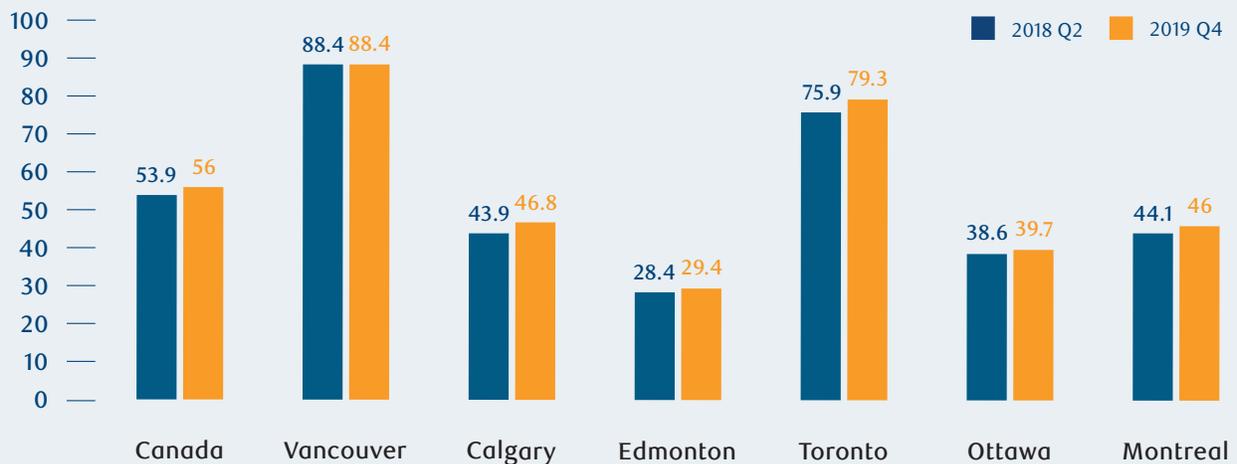
Housing affordability to worsen

Policy makers likely give themselves high marks for guiding Canada’s housing market to a soft landing in 2018, yet there has been no improvement in affordability. The bar to home ownership is higher than ever in Vancouver and Toronto, where a typical household would need to spend a record 88% and 76% of its income, respectively, to pay the mortgage, property taxes and utilities for a home purchased today. The bar will get even higher in 2019, as the Bank of Canada continues to hike rates. Add in tougher mortgage stress-test rules and some first-time buyers will be looking at a very high hurdle.



Home ownership costs relative to incomes will rise

Home ownership cost at market value as a % of median household income



* Based on RBC’s forecasted interest rates and household income, keeping home prices unchanged.
Source: RPS, Statistics Canada, Bank of Canada, RBC Economics Research



The average household faces a \$1,000 hit from rate hikes

Eighteen months in, Canadian households have yet to feel the full brunt of the Bank of Canada's interest-rate hiking cycle, from the increases that have already happened and those yet to come. The amount of interest households pay is poised to rise in the year ahead – adding to increases households were forced to absorb in 2018.

In this age of elevated household-debt levels, even small upticks in interest rates can produce large increases in interest payments. We estimate an average household will pay about \$1,000 more in 2019 to service its principal and interest obligations. That would represent a 7.6% jump from 2018 – a tough pill to swallow for many. Rising incomes, however, will provide a buffer. We expect average disposable income per household before debt-service obligations will grow by \$2,300 in 2019. This means that after servicing its debt, the average Canadian household will end up with \$1,300 more in its pocket.

A nice cushion like this will keep a majority of households out of trouble. The question, though, is whether it will be enough to cover the rise in the cost of other goods and services. For many Canadians, it probably won't. Expect some belt-tightening in the year ahead.

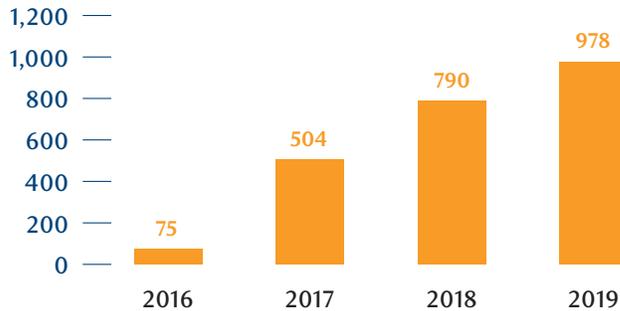
Average household principal and interest payment

7.6% Increase in 2019



Household debt payments will rise in 2019

Annual increase in debt service obligations per household in Canada, in dollars



* Including debt-free households. | Source: Statistics Canada, RBC Economics Research

“ The average household will end up with \$1,300 more in its pocket ”



Consumers will pay fewer visits to the car lot

Even before being pinched by rising interest rates, fewer Canadians were buying autos, in part reflecting a potent combination of technology and demographics. For those living in urban areas there's been an explosion in ride-sharing and car-sharing services, like Uber and ZipCar, while research has found the number of young people with driver's licenses has been waning. Another way to look at this is auto sales adjusted for Canada's

population aged 16 and over. Auto sales in Canada peaked in 2017. That was a year after peak-vehicle sales in the U.S., but the decline in Canada has been sharper. Now, add in the impact of higher interest rates, which will eat into household discretionary income and force some consumers to decide just what they can live without. Will a new set of wheels be near the top of that list?

Peak auto sales in Canada and the U.S. is behind us

Unit auto sales per 1000 population age 16+

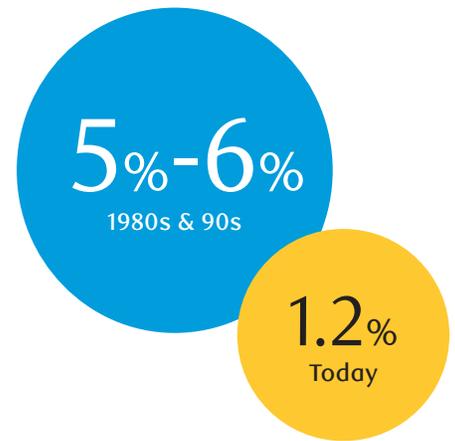


Source: BEA, Statistics Canada, RBC Economics Research

Rising interest rates will squeeze government spending...

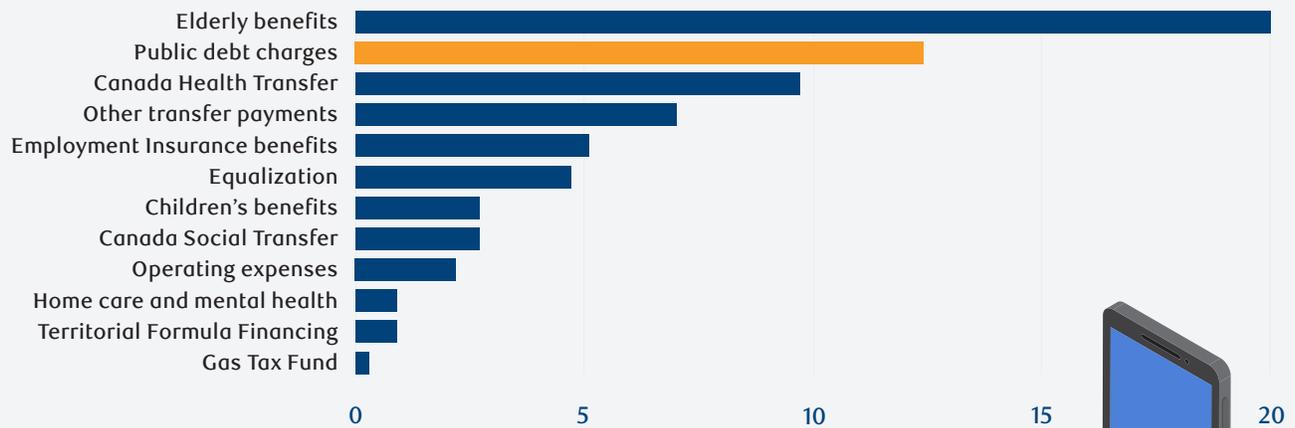
Households won't be alone in feeling pressured by rising interest rates. Governments will also see their spending options limited as they have to earmark more money for debt charges. Consider the federal government's fiscal outlook. Relative to other expenditure items, federal debt-servicing costs will account for the second-largest increase in federal spending from fiscal 2017-2018 to fiscal 2023-2024. Only one other item will increase faster: benefits for the elderly. To be sure, as a share of GDP, federal public debt charges – at 1.2% – are small compared to the 5%-6% witnessed in the late 1980s and into the 1990s. At that time interest rates were in the double digits. Nothing like that is going to happen during this round of tightening by the Bank of Canada. However, with growing demands on the public purse from an aging population, higher debt charges will account for an increasing part of the equation limiting funds available for other priorities.

Federal public debt charges as a share of GDP

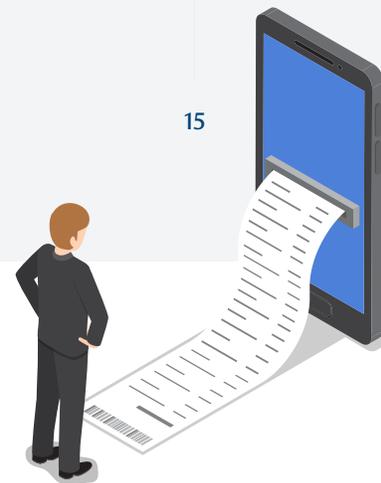


Ottawa will spend more on debt payments than almost any program

Federal government spending growth, FY 2017-18 to 2023-24, billions of dollars

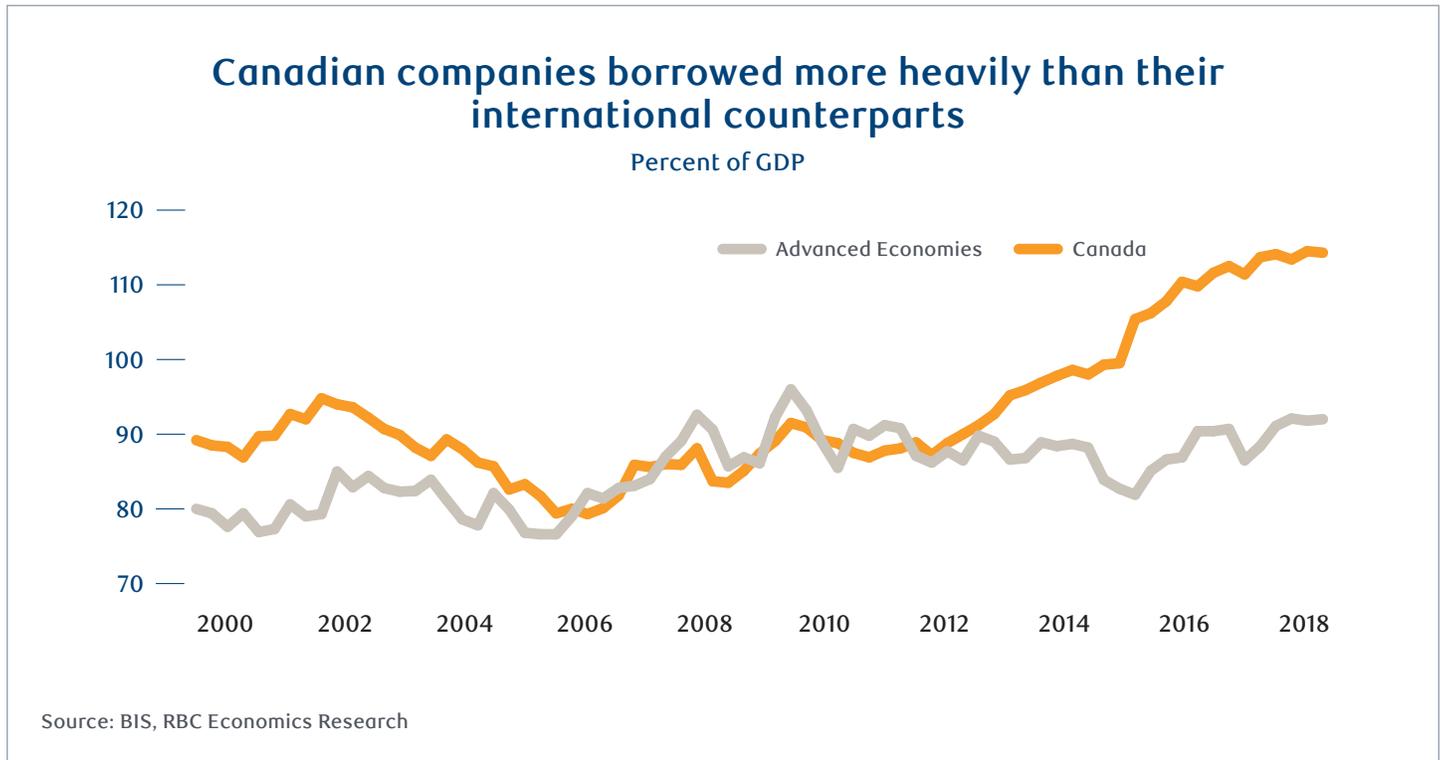


Source: Department of Finance, RBC Economics Research



...And impact corporate balance sheets

Canadian companies also ran up debt balances as low interest rates spurred spending on residential structures and capital goods. Slower growth and softer housing construction in 2019 will likely weigh on credit demand.



Two big new revenue streams for governments in 2019

\$6 billion

The amount of money Ottawa and the provinces will collect from various carbon pricing schemes in fiscal 2019-2020. Governments aren't keeping it all. In several provinces, much of carbon revenue will be returned to households in the form of rebate cheques.

\$400 million

The total amount the federal and provincial governments expect to collect from cannabis duties this year. Ottawa alone anticipates it will bring in \$100 million, the federal government's maximum take in the first two years of legalization under a revenue-splitting deal with provinces.





Labour shortages could finally lead to wage growth

With the Canadian economy running close to full capacity in 2018, the bigger story was labour shortages. The national jobless rate hit a 44-year low in November, and the latest data showed more than half a million unfilled jobs, up nearly 100,000 from the same point in 2017. Businesses surveyed by the Bank of Canada and other groups consistently said they were having an increasingly tough time finding and hiring workers.

There's little relief in sight. Overall, employment rates remain two percentage points below pre-recession heights, a situation unlikely to change due to the steady aging of the Canadian workforce. Retirement rates are steadily increasing, participation rates of youth (especially young men) remain flat or are declining, and women of prime working age continue to participate in fewer numbers than their male counterparts. Immigration has historically provided a significant source of new workers to Canada, but increases contemplated in the near term will likely be insufficient to satisfy the increase in demand for workers. Policies to bring more people into the labour force – expanded childcare programs or increased investments in work-integrated learning – could help address labour shortages.

547,300

number of job openings in Canada

* As of June 2018



Historically, worker shortages have spurred increases in wages. The fact that significant wage growth hasn't materialized this time around remains a puzzle for economists and policy makers. Our take is that, while labour markets continue to look like those at the beginning of the last expansion in 2004, changes in demographics and behavior are affecting the wage response. A decrease in labour turnover – Canadians' reluctance to leave their jobs for greener pastures – is one factor that appears to have limited wage growth. However, in the past year, more Canadians have been leaving their current jobs – a factor that suggests stronger wages ahead.

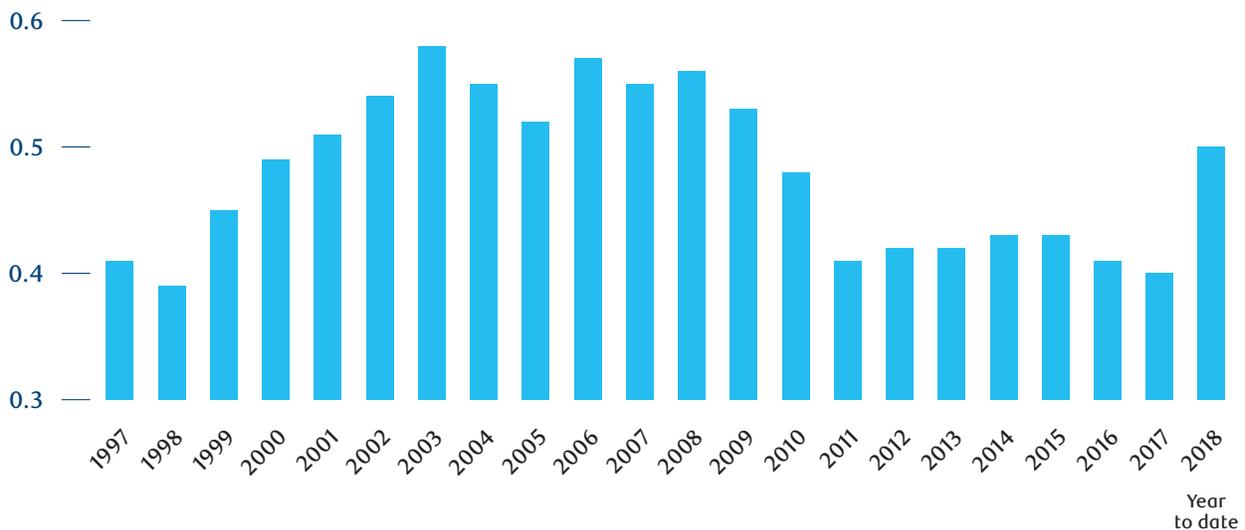
“ More Canadians have been leaving their current jobs – a factor that suggests stronger wages ahead. ”

270,000 

Throughout the 2020s more than 270,000 people will retire from the Canadian labour market every year. That means that 2019 is the year businesses have to get serious about attracting and keeping younger workers.

More Canadians are leaving jobs because they're unhappy

% of labour force



Unemployed people who left their jobs because they were 'dissatisfied' as % of labour force
 Source: Statistics Canada, RBC Economics Research

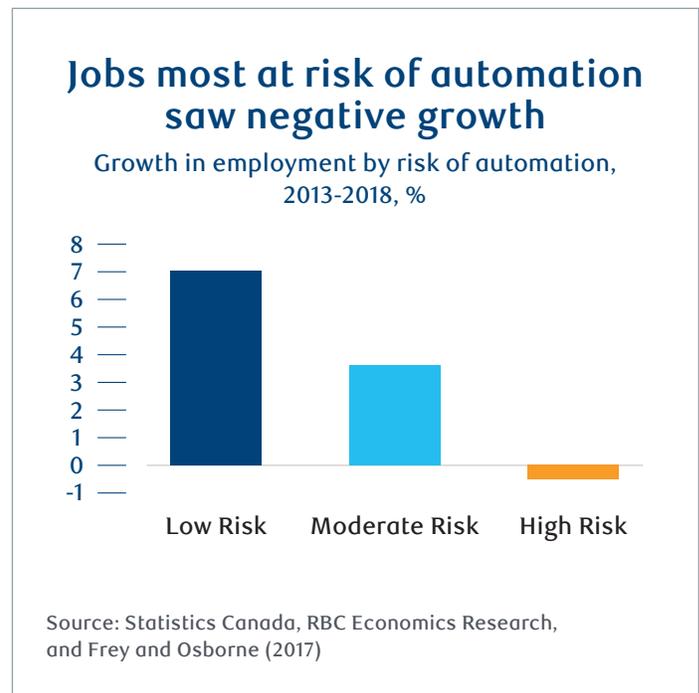


Jobs at risk of automation see losses

Over the years countless headlines have warned of the threat robots pose to jobs, and yet employment has continued to rise. We are now, however, starting to see the automation of certain jobs being reflected in labour statistics.

We can see that by looking at the employment growth of jobs most “at risk” of being made obsolete through technological advances, compared to growth in jobs that face a “moderate” or “low risk” of automation. Over the last five-year period, jobs in the “at risk” category actually experienced declining employment, while employment in “low risk” occupations soared. Not all “at risk” jobs saw declines – food service workers, administrative assistants and bookkeepers all enjoyed strong employment growth. Still, we see no reason to expect this broader transformation of the job market to reverse.

The thing to remember is that automation of jobs doesn’t mean jobs are going away. While new technologies can disrupt employment by replacing workers directly, it can also reduce costs and drive expansions such that overall employment grows. What’s needed is for policy makers to play a greater role in helping workers through this adjustment, with more resources put towards education and training to help mitigate the disruptive effects of automation.





Canada's not-so-secret growth weapon: immigration

When it comes to population growth, Canada leads the G7. Indeed, no other country in the group comes close. In 2018, Canada's population was on track to increase 1.4%, the strongest pace in 18 years and double the 0.7% rate for the U.S., the G7 country with the next-highest population growth rate.

Strong (net) immigration accounted for almost half (45%) of Canada's population increase last year. That contribution will only grow, since Ottawa has committed to boost its annual immigration target from 310,000 new permanent residents in 2018 to 350,000 by 2021, with a big jump of 6.7% to 331,000 scheduled for 2019. About two-thirds of 2019's increase will come from the economic programs that target highly skilled workers and are aimed at addressing labour shortage issues across Canada.

350,000

Canada's target number for immigrants by 2021

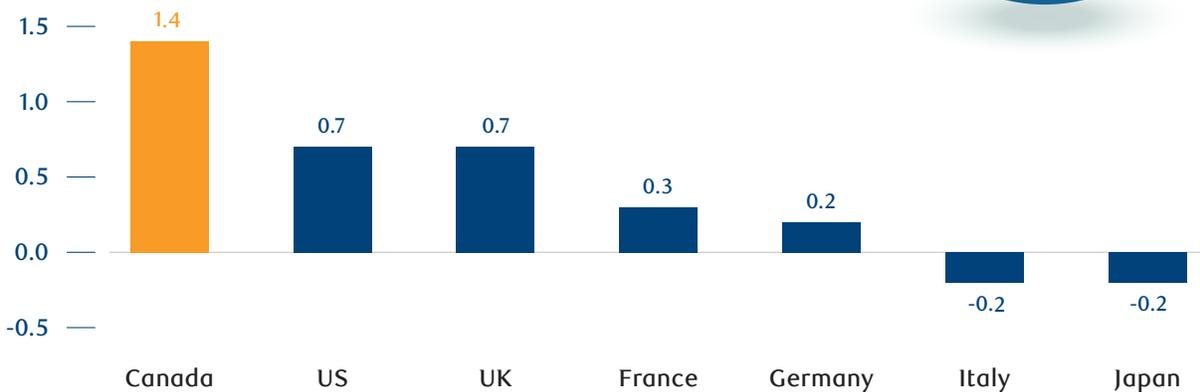


Growth in non-permanent residents was the other noteworthy development in 2018. The number of foreign nationals admitted to live in Canada on a temporary basis reached an all-time high of 166,000 (net of returning individuals), which represented about one-third of the total rise in population. That's up from less than 10% two years ago. This group includes temporary foreign workers, international students and asylum seekers. All three categories soared, reflecting strong demand for skilled labour, Canada's growing reputation as a desirable place to obtain post-secondary education, and increases in cross-border refugee claimants. We see little in the short term that would reverse these trends.

Share of population growth from non-permanent residents: **1/3**

Canada's population grew faster than all other G7 countries

Annual % change in resident population, 2018



Source: Statistics Canada, US Bureau of the Census, Eurostat, INSEE, Germany's Federal Statistical Office, ISTAT, Japan's Statistics Bureau, RBC Economics Research

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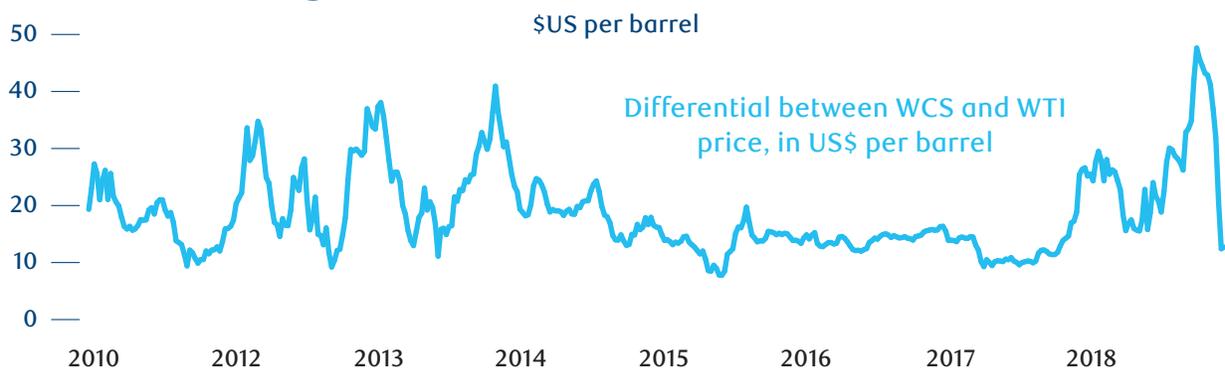
Canadian oil won't plumb 2018 lows

The Alberta government's remarkable intervention in the oil sector at the end of 2018 will carry over into the next 12 months and beyond.

Having first agreed to buy 7,000 railcars, the province then announced production cuts to clear bloated inventories and help the price of Canadian oil move closer to global benchmarks. But these actions won't have any impact on global prices as that responsibility lies in large part with OPEC, which on December 7 announced plans to cut production by 1.2 million barrels per day to boost oil prices. Lower global supply means the market will get closer to balance in 2019. This is good news for Canadian producers as well, given that the spread between WTI and Western Canadian Select is also moving in a positive direction.

1.2 million barrels/day: OPEC's production cut, which should help oil prices

The price gap between Canadian and international oil



Source: Bloomberg, RBC Economics Research



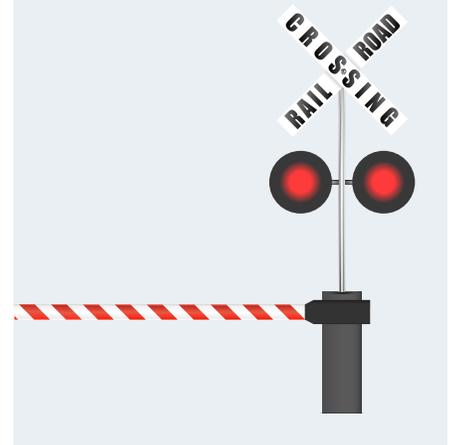
Oil elbows out other sectors in rail transport

Canadian oil producers shipped more than 200,000 barrels a day of oil by rail last summer – a record high, and nearly double the amount they shipped in the summer of 2017. But what has been a saving grace in dealing with transportation bottlenecks caused by a lack of pipeline capacity has turned into a problem for shippers of other commodities.

Rising crude-by-rail shipments have served to elbow out grain and metals in particular. In 2018, grain farmers were particularly vocal in their complaint that rail companies were prioritizing oil shipments over grain, keeping them from getting their product to market in a timely manner.

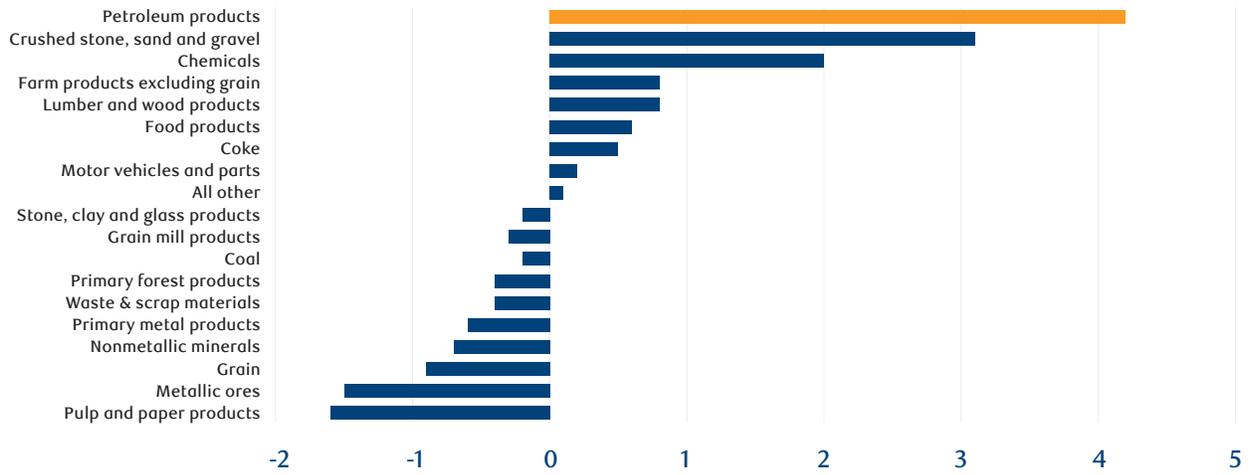
There might be some relief this year. In addition to Alberta's railcar purchase and production costs, replacement of Enbridge's Line 3 is expected to add 370,000 barrels a day of pipeline capacity in the second half of 2019. At the same time, oil sands producer Cenovus signed three-year deals with Canada's two big rail companies to move 100,000 barrels a day of heavy crude by rail, suggesting crude-by-rail will continue to play a role in 2019.

“Crude-by-rail is causing problems for other commodities.”

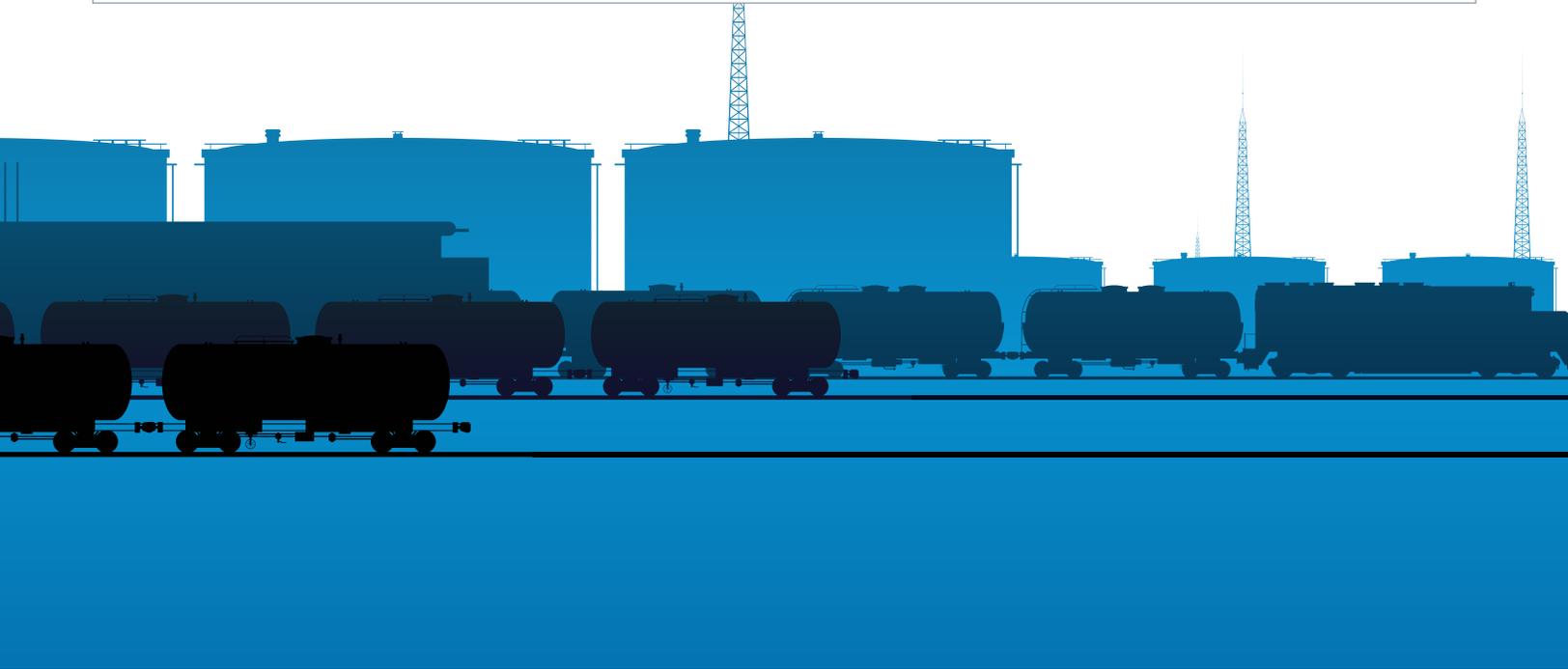


Oil shipments by rail compared to other commodities

Change in average daily carloads from 2008 to 2018, in thousands



Source: Association of American Railroads, RBC Economics Research





Competitiveness measures will look beyond taxes

After more than a year of mounting anxiety in Canada about the competitive threat from U.S. corporate tax cuts, the federal government’s Fall Economic Statement won praise from business leaders for the suite of tax measures it contained, such as accelerated capital expensing. That, coupled with the fact Canada’s corporate tax rates remain the third-lowest in the G7, should help Canada’s competitive landscape in 2019.

But competitiveness is not all about taxation, and improvements don’t always have to cut drastically into government revenues. Inefficient government bureaucracy ranks above tax rates as a “problematic factor for doing business” in Canada, according to the World Economic Forum. Consider the average time it takes to deal with construction permits: at 250 days, according to World Bank data, the process takes longer than in any other G7 country, and almost three times as long as in the U.S. The seemingly endless process to get new oil pipelines built to alleviate Canada’s oil transportation bottlenecks is another example.

“Businesses say red tape is a bigger problem than taxes for competitiveness”



On this front we see progress in 2019, too. The federal budget update included several new deregulation initiatives, including a top-down review of Canada's red tape regimes, more emphasis put on the economic impact of government rule books, an agency focused on regulatory innovation, and the introduction of a "regulatory modernization bill" to be reviewed annually in search of "outdated or duplicative" rules.

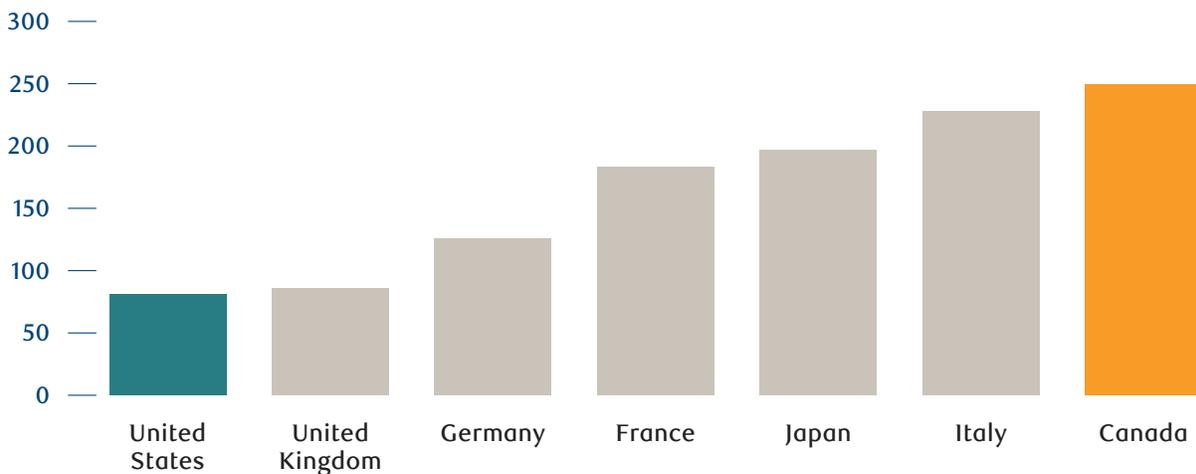
Notably, Canada's competitiveness challenges haven't prevented a pickup in business investment. Foreign direct investment in Canada during the first three quarters of 2018 is already ahead of the total inflow of investment in all of 2017, albeit still at historically low levels. At the same time, a new generation of businesses is being created, which is vital to job growth.

The existence of competitiveness constraints doesn't mean there will be no investment growth. The thornier question is how much more growth there would have been if they hadn't been there.

“ Foreign direct investment in Canada is finally picking up. ”



Dealing with Construction Permits - Time (days)



Source: World Bank (doingbusiness.org), RBC Economics Research

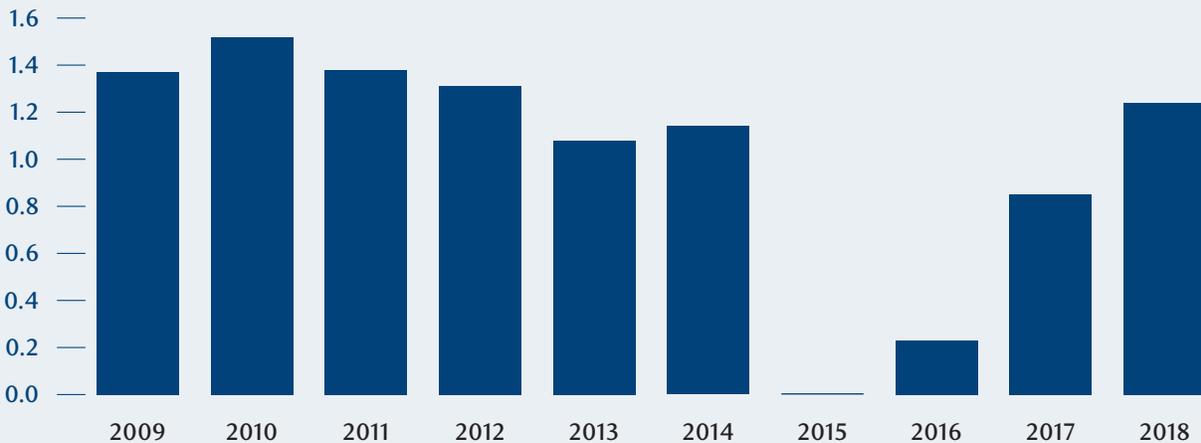
More firms, more jobs

For an economy to thrive it needs entrepreneurs to take risks, launch new ventures and, importantly, create jobs. For too long, Canada's net firm creation – a measure of the number of business in the country that reflects new enterprises opening and failed businesses closing – was on a downward trajectory. By 2015 it flat-lined amid a pullback in the oil and gas industry. We've seen a recovery since then, with net firm creation over the first half

of 2018 running at its fastest pace since 2012. Growth was led by the transportation and warehousing sector, one of the strongest economic performers in recent years. And for an economy looking forward, the information and communications technology sector emerged as a growth star in 2018. Need another reminder why net firm creation matters? In 2017, it resulted in 100,000 new jobs being created, and was on track for a similar gain in 2018.

More new businesses are being created than at any time since 2012

Net firm creation (entry rate less exit rate), percent



Source: Statistics Canada, RBC Economics Research

“ In 2017, net firm creation resulted in **100,000** new jobs being created, and was on track for a similar gain in 2018. ”



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Canada would be caught in the crossfire of a U.S.-China trade war

Concerns about Canada's most important trade relationship eased when the USMCA deal was struck in late September. It's true that bilateral irritants remain and the USMCA has yet to be ratified. Nonetheless, the focus in Canada has shifted to possible repercussions from the escalating trade spat between the U.S. and China.

The good news, if it can be called that, is that the U.S. administration is developing a reputation for ramping up rhetoric in disputes before ultimately agreeing to a "new" deal with relatively minor tweaks. We saw that with the talks to update NAFTA. As it stands, the administration and China have agreed to a trade war truce to start the year. And while the US\$360-billion of U.S.-China bilateral trade that has already been targeted with tariffs is an eye-catching number, it pales in the global context. U.S. exports and imports totaled about US\$5.3 trillion in 2017; for China, it was US\$4.6 trillion.

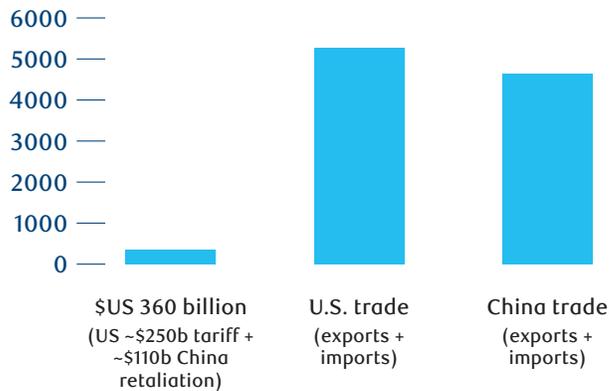
Yet a meaningful escalation in the U.S.-China trade dispute can't be ruled out. The impact on Canada would be mixed, but tilted to the downside. Model simulations from the IMF's latest World Economic Outlook have even shown some potential near-term benefits to Canada and Mexico, as Chinese and U.S. businesses and households shift trade to other partners. That would please Canadian exporters looking to develop more significant trading relationships with China.

2017 Global Exports and Imports



Products subject to U.S. and China tariffs relative to total trade

\$US billions



Source: World Bank (doingbusiness.org), RBC Economics Research

“ A full-blown trade conflict would have negative impacts on Canada. ”



But we doubt the impact on Canada would be that benign. Taking full advantage of trade opportunities emerging from a U.S.-China trade war would probably require expensive investments to reorient supply chains which currently keep demand for Canadian products inextricably tied to demand for U.S. products. Efforts are underway to change that, but in the short run those expenditures could be hard to justify given the potentially temporary nature of the U.S.-China trade disruption.

On the other hand, a full-blown U.S.-China trade conflict would have immediate and negative impacts on Canada, through stock market volatility that could affect business and consumer confidence, as well as the potential for higher prices from tariffs making their way into broader supply chains and onto the backs of households.

The best Canada and the world can hope for is that the current trade truce not only holds, but leads to existing tariffs being scaled back.

Free trade deals will pay off for Canada, but we need more action

While too many countries are devoting energy and resources to erecting walls along their borders – both of the physical and tariff variety – Canada remains a steadfast believer that a freer flow of goods, services and people between nations is key to unlocking economic potential. In addition to Canada’s Comprehensive Economic and Trade Agreement with Europe, which came into force in 2017, the Comprehensive and Progressive Trans-Pacific Partnership will deliver its first round of

tariff reductions in January 2019. The CETA and CPTPP together are estimated to add about one-half of a percentage point to Canadian growth over the long term. Of course, having trade deals doesn’t automatically translate into more trade. Canadian companies must do more to take advantage of their access to global markets. While our country will continue to be tied closely to our southern neighbour, these trade agreements give Canada a crucial head start at a time when the U.S. is turning inwards.



“The CETA and CPTPP together are estimated to add about one-half of a percentage point to Canadian growth over the long term.”

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