

Canada

TEMPORARY WEAKNESS

- **Growth is on a much more solid footing than assumed by markets. Growth will remain around potential through 2020. The risk of a recession is very low.**
- **The very sharp rebound in the price of Canadian oil since late Fall, coupled with global oil prices quickly rising off their Christmas Eve lows, suggest the impact of lower oil prices may not be as large as feared.**
- **With underlying measures of inflation at roughly 2%, the Bank of Canada will remain on its path to normalize policy as interest rate increases so far have not had the feared outsized impacts.**

The Canadian economy remains on solid footing, and is far from being on the edge of a precipice, as could be inferred from developments in financial markets over the last few weeks. While true that the global decline in equity prices and the concomitant decline in oil prices is cause for concern, economic indicators here (and in the US) remain generally positive. Fundamentals remain sound, with growth expected to hover slightly below 2% this year, roughly in line with the economy's potential. Underlying measures of inflation will remain around the 2% targeted by the Bank of Canada. To keep inflation around this target, Governor Poloz will need to gradually remove the remaining monetary stimulus by bringing rates to their neutral level of 2.75% by 2020Q1.

A TALE OF TWO PERSPECTIVES

The generalized decline in markets and increases in volatility since the Fall, the tumble in oil prices, developments on the Brexit front and Trump-related developments have captured the headlines in recent weeks. These are naturally weighing on consumer and business sentiment, and are causing some to question how much longer the global expansion will last. Are we on the cusp of a major slowdown in growth, as can be inferred from some financial indicators, or simply entering a period of slowing, but still good growth? We believe the latter, and think markets have over-reacted to reasonably minor changes to the outlook. The reversal in equity markets seen in the last couple of week is consistent with that view, as are the results of our recession probability model for Canada which uses economic and financial information to quantify the risk.

From a Canadian perspective, much is being made of the rapid drop in oil prices and the widening of the differential of the price received for Canadian oil late last year. As the Bank of Canada notes, the USD20–30 drop in international oil prices represents a serious terms of trade shock to Canada given how much oil we produce. What's more, lack of egress capacity and a shutdown of refineries in the US forced the price paid for Western Canada Select to fall to nearly \$15 in November, while the price of bitumen was briefly negative. Since then, these refineries have re-opened, international oil prices have rebounded sharply (chart 1), and the Alberta government has forced oil companies to cut their

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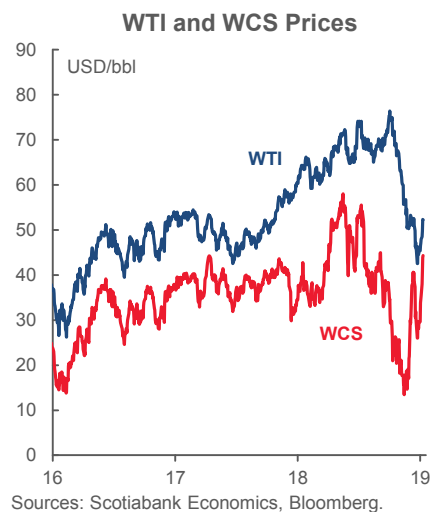
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Canada	2017	2018e	2019f	2020f
Real GDP (annual % change)	3.0	2.1	1.8	2.0
CPI (y/y %, eop)	1.8	2.0	1.7	2.2
Central bank policy rate (% eop)	1.00	1.75	2.50	2.75
Canadian dollar (CADUSD, eop)	0.80	0.73	0.79	0.81

Source: Scotiabank Economics.

Chart 1



production by 9% to reflect the limited egress capacity and to drain inventories. While a government-mandated cut in production will unquestionably reduce output in the oil patch and real GDP, the price of Western Canada Select has more than made up for lost ground and is now generally above levels seen in 2016–17. **This suggests that the impact of the decline in oil prices may not be as sharp for Canada as the Bank of Canada believes.** That being said, the fall in oil prices since last summer and the production cutbacks in the oil patch will have a depressing impact on growth in 18Q4 and 19Q1, when production cutbacks peak. As the cutbacks are temporary and will be scaled back as rail capacity rises, we see much of the impact of oil market developments as having a temporary impact on growth.

A second concern is the impact of the decline in equity markets on Canadian confidence and spending. The 10% or so decline in the S&P TSX Composite index is a shock that reduces Canadian wealth, which in turn will reduce consumer spending. The extent of this impact is a function of two factors: the size of the decline in wealth and its persistence. Since we think markets have over-reacted to economic data and political developments, we assume financial wealth will gradually rise to levels that are more consistent with underlying economic fundamentals. The pickup in equity indices over the last two weeks is a sign that this is already underway. This suggests the impact of the decline may not be as large as feared by some. Further, the impact of financial wealth on spending is much smaller in Canada than in the US. Chart 3, derived from our macro-econometric model, demonstrates this clearly.

While these factors are causing us to shave our forecast down to 1.8% in 2019 and to boost it to 2.0% in 2020, it is important to note that these growth rates are roughly in line with potential growth rates. The modest decline in growth from the 2.1% observed in 2018 is not a material deterioration in the outlook, and speaks to the still generally positive fundamentals:

- **Monetary policy remains highly accommodative, with the real policy rate still negative,** and nominal rates well below the Bank of Canada’s estimated neutral rate range of 2.5–3.5%
- **Human stimulus, more commonly known as population growth, is rising at its most rapid pace in almost 10 years on the back of rising immigration (chart 4).**
- **Employment growth remains strong, with an acceleration in job growth through 2018.** This has provided a boost to wages and salaries which rose by almost 3% in 18Q3, the most recent period for which we have data. This will help reduce the impact of the fall in wealth on consumer activity, though retail sales fell sharply in October, the most recent month for which we have data. Car sales are also falling, though they have come off extremely high levels.
- **Canadian household balance sheet remains relatively healthy.** The debt to net-worth ratio is at roughly where it was in 2007 (chart 5). While debt service is going up in line with the rise in interest rates, it is moving gradually and there is as yet very little evidence this is causing widespread challenges for households. The proportion of mortgages in arrears is near historical lows and is well below the levels seen before rate increases began.
- In manufacturing, real unfilled orders are up 8% y/y (chart 6), while unfilled orders as a proportion of shipments are at their highest level in 2 years.

Chart 2

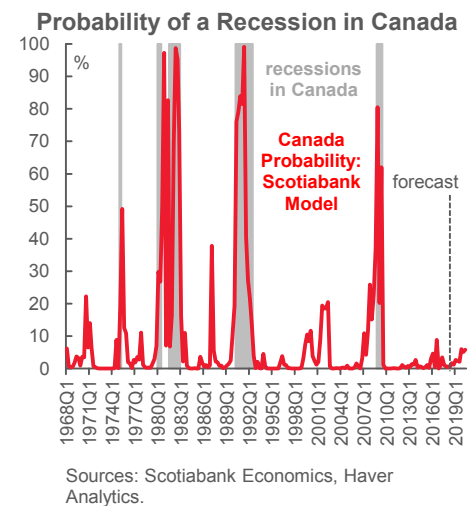


Chart 3

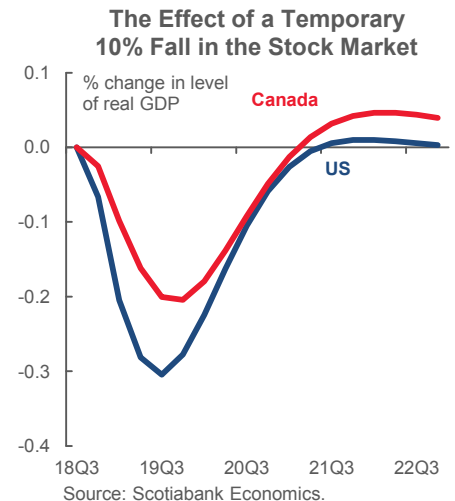
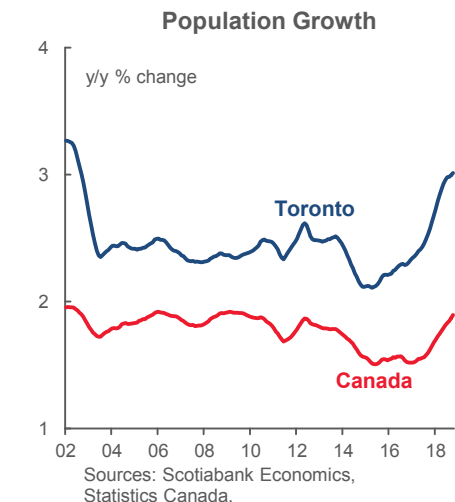


Chart 4



There are notable areas of weakness however:

- As noted, developments in the oil industry are currently acting as a drag on growth.** This will affect export growth, where non-oil export growth has disappointed in the latter half of the year. Capacity constraints in exporting industries are a likely factor underlying that, although there has been a broad-based slowdown in global trade this year.
- The housing sector has cooled relative to last year, with sales and starts falling relative to 2017.** However, residential construction remains healthy across much of Canada. The pace of sales and price gains has largely stabilized since a modest recovery during the summer months, which coincided with accelerating economic growth and still-low interest rates and followed a strong initial response to the stricter mortgage qualification tests that came into effect on January 1st. We continue to expect that the Canadian housing market will experience a period of relative price stability into 2019, albeit with some regional variation. National housing starts are projected to ease from 213,000 units in 2018 and average just north of 200,000 units in 2019–20, roughly 10% below the peak build rate of 2017. This will lead to a decline in residential investment relative to 2018.
- Likewise, it is clear that business investment is moderating following the rapid pace set in early 2018.** The second half of 2018 was characterized by extreme levels of uncertainty. Was NAFTA going to be renegotiated? Would the US trade war with China get out of hand? Were markets signaling a risk of recession? These factors likely depressed business investment late last year and we believe they will continue to suppress investment in the first months of 2019 as uncertainty remains elevated. Capacity constraints are important however, and unfilled orders are piling up. Firms will either need to increase the pace of hiring in an extremely tight labour market, or increase their capital stock to meet this demand.

Canadian capacity pressures remain significant, even though traditional measures of capacity such as the output gap suggest it is hovering around zero. These pressures are most evident in the labour market, where job vacancies are at a historical

Chart 5
Debt to Net Worth Ratio


Sources: Scotiabank Economics, Statistics Canada.

Chart 6
Real Unfilled Manufacturing Orders


Sources: Scotiabank Economics, Statistics Canada.

Table 1

Quarterly Canadian Forecasts	2018		2019				2020			
	Q3	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic										
Real GDP (q/q ann. % change)	2.0	1.7	0.9	2.4	2.2	1.9	2.2	2.0	1.5	1.5
Real GDP (y/y % change)	2.1	2.1	1.9	1.8	1.8	1.9	2.2	2.0	1.9	1.8
Consumer prices (y/y % change)	2.7	2.0	1.8	1.5	1.6	1.7	1.9	2.1	2.2	2.2
Avg. of new core CPIs (y/y % change)	2.0	1.9	1.9	1.9	2.0	2.0	2.0	2.0	2.0	2.0
Financial										
Canadian Dollar (USDCAD)	1.29	1.36	1.32	1.30	1.27	1.27	1.25	1.25	1.23	1.23
Canadian Dollar (CADUSD)	0.77	0.73	0.76	0.77	0.79	0.79	0.80	0.80	0.81	0.81
Bank of Canada Overnight Rate (%)	1.50	1.75	1.75	2.00	2.25	2.50	2.75	2.75	2.75	2.75
3-month T-bill (%)	1.58	1.65	1.80	2.05	2.30	2.55	2.80	2.80	2.80	2.80
2-year Canada (%)	2.21	1.86	2.00	2.20	2.45	2.65	2.85	2.85	2.85	2.85
5-year Canada (%)	2.34	1.89	2.10	2.30	2.55	2.75	2.95	2.95	2.95	2.95
10-year Canada (%)	2.43	1.97	2.20	2.35	2.60	2.80	3.00	3.00	3.00	3.00
30-year Canada (%)	2.42	2.18	2.35	2.50	2.75	2.90	3.10	3.10	3.10	3.10

Sources: Scotiabank Economics, Statistics Canada, Bloomberg.

high of 550,000 job vacancies, a rise of nearly 40% over the last two years. **Labour shortages are an acute constraint to business activity**, and while this is a brake on growth, it reflects the high rate of Canadian economic activity. The puzzle continues to be on the wage side, where wage pressure remains somewhat muted. It is still unclear why this is the case, though there is evidence that workers paid an hourly wage, and thus likely less attached to their employer, are reaping the benefits of the strength in labour demand, as their wages have been growing even once the increase in minimum wages last year is taken into account. On the industrial side, capacity utilization rates are well above the post-recession average though they remain below historical averages.

Inflation remains well behaved in Canada. Its evolution continues to be in line with the predictions of our macro-econometric model. Underlying measures of inflation are, for all intents and purposes, at the BoC's 2% target (the actual reading is 1.9%) and are expected to remain there through our forecast horizon as the BoC gradually tightens rates to keep inflation at its target. There is of course a risk that inflationary pressures diminish over time if wage pressures attenuate or growth disappoints, but we currently expect neither of these outcomes.

There are plenty of risks to the outlook. **Given how late we are in the economic cycle, these risks are naturally more tilted to the downside than the upside.** The dominant negative risk continues to be an escalation of the US-China trade war. Current signs point to our long assumed détente on this front, but as with all things related to President Trump, there are always risks that things get out of hand. We also see lots of volatility coming out of the Trump administration, as the President reacts to his re-election prospects and investigations by the House of Representatives into his personal and business affairs. The President's response to these developments could create uncertainty and financial market volatility, with potential feedback on the US and the rest of the world. **Risks aren't uniquely tilted to the downside.** It may well be that the estimated impact of oil prices on our economy is overstated, or even that oil prices continue the impressive bull run they have been on for the last two weeks. We may also be underestimating the rate at which population is rising and the economic consequences of that. Finally, it's possible that business investment picks up more sharply than we assume as the range of factors causing uncertainty wane in the first few months of this year.

Table 2

Canada	2000–17	2017	2018e	2019f	2020f
	(annual % change, unless noted)				
Real GDP	2.1	3.0	2.1	1.8	2.0
Consumer spending	2.9	3.5	2.2	1.9	1.8
Residential investment	3.6	2.4	-1.1	-0.4	0.9
Business investment	2.2	2.2	4.8	1.1	6.2
Government	2.2	2.7	3.0	1.5	1.6
Exports	1.3	1.1	3.1	2.5	2.4
Imports	3.0	4.2	3.2	1.0	3.1
Nominal GDP	4.3	5.6	4.1	3.4	4.3
GDP Deflator	2.1	2.6	2.0	1.6	2.3
Consumer price index (CPI)	1.9	1.6	2.3	1.7	2.1
CPI ex. food & energy	1.6	1.6	1.9	1.9	2.0
Pre-tax corporate profits	0.0	20.1	5.0	6.1	2.1
Employment	1.4	1.9	1.3	1.1	0.7
Unemployment rate (%)	7.1	6.3	5.8	5.7	5.9
Current account balance (CAD bn)	-19.4	-60.1	-58.6	-55.8	-56.5
Merchandise trade balance (CAD bn)	22.3	-24.6	-22.0	-24.3	-28.5
Federal budget balance* (FY, CAD bn)	-3.6	-17.8	-19.0	-18.1	-19.6
percent of GDP	-0.2	-0.9	-0.9	-0.8	-0.8
Housing starts (000s)	200	220	213	202	200
Motor vehicle sales (000s)	1,678	2,034	1,984	1,930	1,900
Industrial production	0.0	4.9	2.4	-0.7	2.3
WTI oil (USD/bbl)	62	51	65	58	62
Nymex natural gas (USD/mmbtu)	4.83	3.02	3.07	3.25	3.25

Sources: Scotiabank Economics, Statistics Canada, CMHC, Bloomberg.

The Provinces

- We still forecast moderating expansions in most provinces during 2019–20, with BC maintaining the top spot due to major project activity and a weaker 2019 Alberta outlook representing the most significant revision.
- Several Provinces foresee improved FY19 budget balances at mid-year and are embracing more stimulative fiscal policy, but softer oil prices and the ongoing carbon tax skirmish complicate deficit reduction plans.

OIL PRODUCTION CUTS TO WEIGH ON EXPANSION

Alberta output restrictions on large oil producers, enacted by the provincial government to alleviate a record light-heavy oil price differential, constitute the most significant change since our October *Global Outlook*. Higher heavy oil prices relative to the WTI benchmark should allay the backlog of shipments built up amid a yawning discount, but cuts will weigh on oil & gas sector output. Accordingly, we have lowered our 2019 Alberta growth forecast by 1 ppt, to 1.5%. The province is expected to add just 0.2 pts to national growth in 2019, far less than the 0.7 ppt boost last year and the 0.9 ppt average during 2010–14 (chart 1).

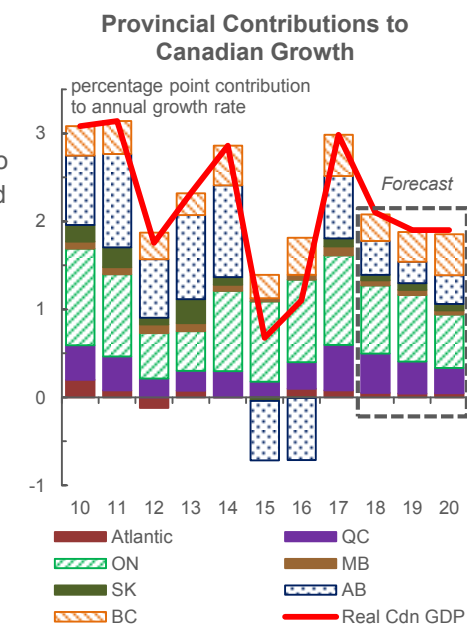
Most elsewhere, our provincial outlook remains characterized by a broad-based easing of economic growth through 2020, with the key drivers largely intact. We still expect softer household spending in most regions, anchored by greater consumer caution brought about by slower employment gains and rising interest rates. We also continue to foresee more modest export gains as the US expansion returns to a more sustainable pace. Central Canada should bear the brunt of this effect given its elevated share of shipments bound for the American market, especially in 2020 as US growth slows more substantially.

A handful of provinces will likely buck the trend of softer growth. BC should be aided by the CAD 40 bn LNG Canada venture. Stronger job creation plus stable major project activity underlie Saskatchewan's higher forecast growth profile for 2019–20. Newfoundland and Labrador should benefit from stepped-up oil production and work on an offshore drilling platform extension.

The surge in machinery and equipment (M&E) outlays that contributed to early-year advances in multiple provinces is cooling as expected. Real M&E investment fell back in Quebec in Q3-2018 and in Ontario and across the rest of Canada in Q2-2018 (chart 2), mirroring falling national capacity utilization rates. Pressures to expand plants and upgrade equipment remain in place across much of the country, but we look for a further moderation of M&E spending this year with many firms appearing to have already addressed their capacity limits.

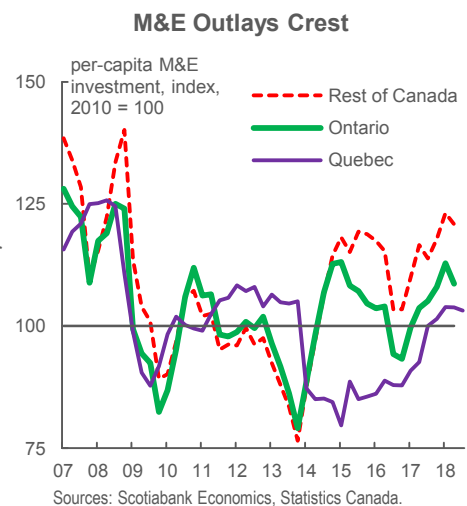
Labour shortages are spreading and intensifying. Job vacancy rates trended higher early this year in Central Canada, BC and Alberta to a lesser extent, but Statistics Canada's *Job Vacancy and Wage Survey* has since reported substantial climbs across Atlantic Canada and the Prairies (chart 3, p.2). Labour market tightness tends to put upward pressure on wages, but skills mismatches also limit firms' ability to grow. National immigration target increases through 2021 should help to alleviate these pressures alongside a robust newcomer selection process and tailored regional programs. We continue to monitor the situation in Quebec, but question the wisdom of

Chart 1



Sources: Scotiabank Economics, Statistics Canada.

Chart 2



Sources: Scotiabank Economics, Statistics Canada.

cutting 2019 newcomer admissions by more than 20% versus last year in light of slowing population growth and an extremely tight labour market.

Another key threat to provincial economic prospects comes via heightened global protectionist vitriol. The possibility of a Sino-US trade war could hamstring export gains across Canada—from jurisdictions in Atlantic and Central with strong ties to the American market to BC where a significant share of shipments are bound for Asia. Moreover, US tariffs remain in place on steel and aluminum imports. Yet we remain optimistic that cooler heads will prevail on both fronts. The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) also takes effect this year, and provides new market access in South America and the Pacific Rim, regions generally not well served by Canadian exporters (chart 4).

REVENUE BUMP, OIL PRICES, CARBON TAX ALTER FISCAL LANDSCAPE

Economic conditions and accounting revisions underlie improved fiscal year 2018–19 (FY19) balance projections in a number of Provinces (chart 5). Prior years’ adjustments following updated tax return data, stronger growth forecasts, or both, are expected to lift revenues higher than expectations in several regions. Quebec foresees a further padding of its coffers through FY21 via updated financial forecasting methods. Nova Scotia and Saskatchewan are exceptions, with softer taxable income profiles through FY19. Though impermanent, these are positive developments with revenue generation likely to become more challenging as the economic cycle matures.

Buoyed by better fiscal results, some Provinces are moving to spur business investment and offer pocketbook relief. Quebec, mirroring federal measures and responding to US tax reform, is allowing full depreciation expensing for select outlays until 2024, with further tax support for seniors and families. Ontario will also parallel federal policy vis-a-vis expensing of new depreciable assets and introduced a tax credit for low-income individuals. Prince Edward Island will hike its Basic Personal Amount (BPA) beyond the boost already outlined and reduce taxes on small business and new capital investment in 2019. New Brunswick plans to phase out its small business tax and levies on secondary properties. As well, we believe the next BC budget will devote further attention to costs and fees given the government’s focus on improving affordability.

Oil price movements present a risk to debt and deficit reduction plans in Alberta. Light crude prices—the rise of which is responsible for upward revisions to non-renewable resource royalty forecasts—have been trending downward. Diminished economic activity stemming from oil production cuts could dampen hiring and corporate profits, and, by extension, tax receipts. Add to this costly rail cars purchased to further alleviate the light-heavy discount and expenditure restraint planned from FY20 onward and there is little room to manoeuvre in the event of a revenue slump.

Other net oil-producing provinces are more insulated from the current Western Canadian oil price predicament. Saskatchewan’s economic base is less tilted towards heavy oil production and it has the advantage of diversification across several resource sectors. Newfoundland and Labrador’s fiscal blueprint relies on even greater spending control, but its oil has the benefit of tidewater access.

Opposition to the federal carbon tax—set to take effect this year—has also led to some revised fiscal blueprints. Ontario forfeits CAD 1.5 bn in FY19 revenues after aborting its cap-and-trade system, with the fiscal hit mitigated as related spending is cancelled; it will instead incent private-sector investment in clean technology. Manitoba

Chart 3

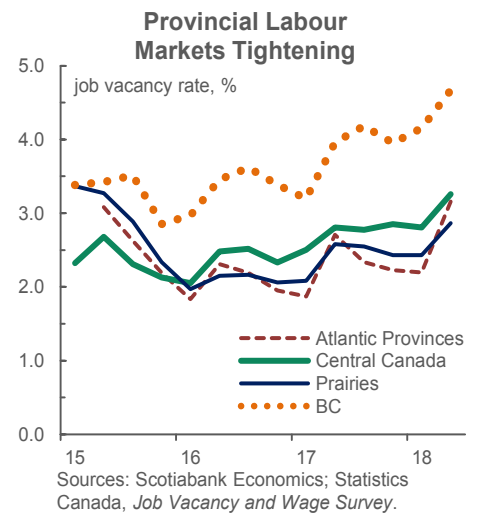


Chart 4

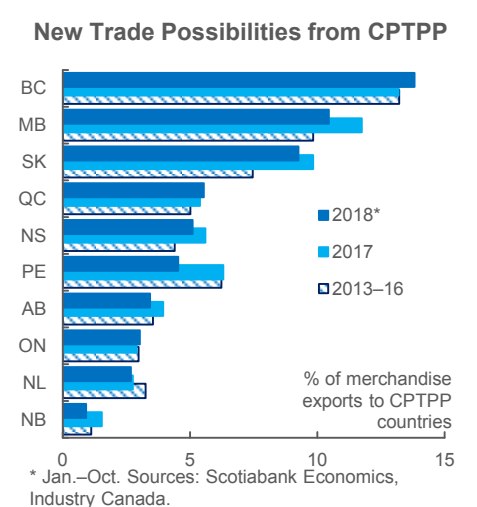
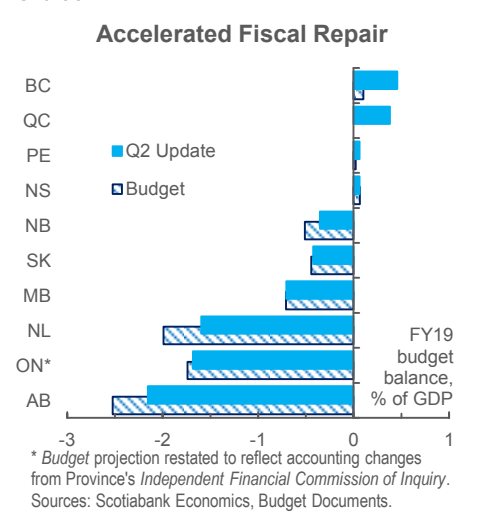


Chart 5



axed its proposed carbon tax but scrapped a Basic Personal Amount hike planned for the 2019 tax year to offset foregone proceeds. New Brunswick's rejection of the federal plan is part and parcel of its efforts to lower the cost of living and will be balanced with scaled-back infrastructure outlays to achieve fiscal balance by 2020. Saskatchewan continues to resist a price on carbon on the grounds that it will hinder the adoption of lower-carbon technologies, and has set sector-specific emissions targets.

The federal government is offering new supports for business competitiveness alongside its headline move to accelerate the pace at which firms can depreciate capital investments. It will allocate CAD 800 mn more than that previously allotted over the next five fiscal years to the *Strategic Innovation Fund* to spur research and development and attract new investment. A new *Export Diversification Strategy*—investing CAD 1.1 bn during FY19–24—has the objective of boosting Canadian overseas exports by 50% by 2025. These measures may provide some assistance for tech sector development in tandem with initiatives already underway in some provinces. They will be further complemented with federal funding of CAD 230 mn for the AI and Manufacturing Superclusters and CAD 153 mn each for the Protein, Ocean and Digital Technologies Superclusters over the next 10 years.

Table 1

The Provinces		(annual % change except where noted)										
	CA	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	
Real GDP												
2000–17	2.1	2.4	1.8	1.3	1.2	1.8	2.0	2.3	2.0	2.8	2.7	
2017	3.0	0.9	3.5	1.5	1.8	2.8	2.8	3.2	2.2	4.4	3.8	
2018e	2.1	-0.5	2.0	1.2	1.1	2.3	2.1	1.8	1.5	2.3	2.4	
2019f	1.8	1.5	1.6	1.0	0.9	1.8	1.9	1.8	1.8	1.5	2.6	
2020f	2.0	0.7	1.1	0.9	0.9	1.6	1.6	1.5	1.8	2.4	3.5	
Nominal GDP												
2000–17	4.3	5.6	4.2	3.3	3.4	3.7	3.9	4.4	5.4	5.9	4.7	
2017	5.6	4.3	4.8	2.9	4.3	5.0	4.1	5.4	4.8	10.0	6.9	
2018e	4.1	2.9	3.9	3.1	2.8	4.4	3.5	3.6	3.9	5.0	4.8	
2019f	3.5	3.8	3.6	2.8	2.6	3.4	3.4	3.7	3.8	2.9	4.8	
2020f	4.2	3.9	3.0	2.8	2.5	3.7	3.7	3.5	4.4	5.2	6.0	
Employment												
2000–17	1.4	0.6	1.1	0.6	0.4	1.3	1.3	1.0	1.1	2.2	1.5	
2017	1.9	-3.7	3.1	0.6	0.4	2.2	1.8	1.7	-0.2	1.0	3.7	
2018	1.3	0.5	3.0	1.5	0.3	0.9	1.6	0.6	0.4	1.9	1.1	
2019f	1.1	0.1	1.1	0.3	0.2	0.9	1.3	0.6	0.8	1.0	1.2	
2020f	0.7	0.0	0.7	0.2	0.2	0.6	0.7	0.6	0.6	1.0	1.0	
Unemployment Rate (%)												
2000–17	7.1	14.3	11.1	8.8	9.5	7.9	7.0	5.1	5.0	5.3	6.5	
2017	6.3	14.8	9.8	8.4	8.1	6.1	6.0	5.4	6.3	7.8	5.1	
2018	5.8	13.8	9.4	7.6	8.0	5.5	5.6	6.0	6.1	6.6	4.7	
2019f	5.7	13.5	9.4	7.6	7.9	5.4	5.4	5.9	6.0	6.6	4.7	
2020f	5.9	13.4	9.5	7.6	7.9	5.6	5.5	5.9	6.0	6.7	4.7	
Housing Starts (units, 000s)												
2000–17	200	2.5	0.8	4.3	3.4	44	72	5.2	5.2	34	29	
2017	220	1.4	0.9	4.0	2.3	46	79	7.5	4.9	29	44	
2018	213	1.1	1.1	4.8	2.3	47	79	7.4	3.6	26	41	
2019f	202	1.4	0.8	3.9	2.0	42	74	6.1	4.6	30	38	
2020f	200	1.4	0.8	3.8	2.0	41	72	6.1	5.0	31	37	
Motor Vehicle Sales (units, 000s)												
2000–17	1,657	29	6	48	38	413	635	47	45	216	180	
2017	2,041	33	9	59	42	453	847	62	56	245	235	
2018	1,984	28	8	51	38	449	853	67	47	226	217	
2019f	1,930	30	8	48	35	430	826	60	48	220	225	
2020f	1,900	30	8	47	34	420	810	55	48	215	233	
Budget Balances, Fiscal Year Ending March 31 (CAD mn)												
2017	-19,000	-1,148	-1	151	-117	2,361	-991	-764	-1,218	-10,784	2,737	
2018	-19,000	-911	75	230	67	2,622	-3,700	-695	-303	-8,023	301	
2019f	-18,100	-547	4	27	-131	1,650	-14,544	-518	-348	-7,512	1,350	

Sources: Scotiabank Economics, Statistics Canada, CMHC, Budget documents; Quebec budget balance figures are after Generations Fund transfers.

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