NATIONAL BANK
FINANCIAL MARKETS
A division of National Bank of Canada

ECONOMIC OUTLOOK

Economics and Strategy

Winter 2017

Contents

Highlights

- Investors will look to 2017 with anticipation, hoping pro-growth fiscal policies are enacted to address the problem of declining potential. Advanced economies as a group are likely to see a pick-up in growth as a stronger U.S. offsets Brexit-related moderation in Europe. Emerging markets should continue to decelerate amidst headwinds brought by China's rebalancing and deteriorating demographics. We're calling for world GDP to expand 3.3% in 2017, while acknowledging downside risks including the rise of trade protectionism and record amount of USD-denominated debt which has become harder to service after the greenback's historic surge.

- Fiscal stimulus is making a comeback in America. Republican control of both houses of Congress puts President-elect Trump in a good position to successfully push his agenda. The combination of tax cuts and spending increases should lift U.S. GDP growth above 2% in both 2017 and 2018. With little slack left in the economy, the fiscal boost will allow inflation to hit the Fed's target for the first time in five years, although the persistence of dollar strength and demographic challenges should prevent runaway prices.

- After two years of underperformance, Canada could return to above-potential growth in 2017. A stronger U.S. economy and the implementation of the Comprehensive Economic and Trade Agreement should have positive repercussions for Canada's non-energy exporters, while government spending will support domestic demand and offset an expected moderation in consumption growth and housing. We expect Canada's economy to grow about 1.9% in 2017, although a stronger performance is possible should oil prices surprise enough on the upside to rekindle investment spending, more so after the federal government's approval of two major pipelines. However, downside risks such as disappointing global growth or restrictive trade policies from the incoming U.S. administration or others should not be underestimated.

- Ontario and B.C. should once again be Canada’s star performers in 2017 boosted by domestic demand, while a more competitive Canadian dollar coupled with a strengthening U.S. economy should give a lift to their exporters. However, those two provinces remain at risk of a housing correction after large price gains earlier. Quebec should again manage above-potential growth as renewed strength of business investment and international exports offset an expected moderation in consumer spending. Alberta and Saskatchewan will come out of recession helped by a stabilization in commodity prices and strong population growth. Manitoba should return to 2% growth buoyed by a diversified economy. Saddled by declining working-age population, economic growth in Atlantic Provinces will remain weak, with Newfoundland and Labrador even seeing a decline in output.

ECONOMIC OUTLOOK

WORLD

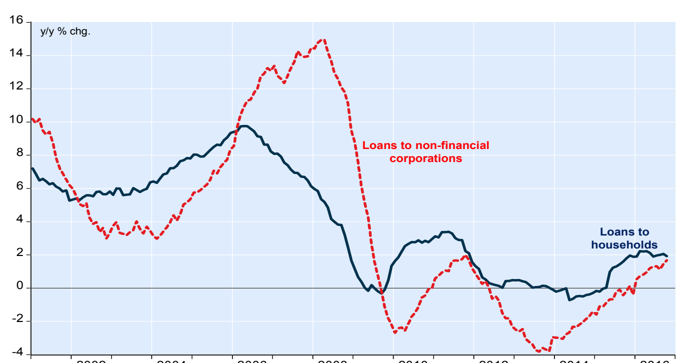
Credit risk

The global economy seems to have picked up steam in the second half of 2016. Industrial production increased in Q3 as advanced economies returned to growth, complementing continued expansion in emerging markets. And based on Markit's manufacturing global Purchasing Managers Index, it seems momentum extended to the last quarter of the year, providing a good handoff to 2017. Advanced economies were boosted by a resurgence in economic activity in the U.S. and continued growth in the Eurozone and Japan.

While Japan's industrial production was flat in October, things seem to have improved later in Q4 based on the Tankan survey which showed manufacturer sentiment rising to a one-year high. Markit confirmed the improvement via its flash manufacturing index which jumped to an 11-month high in December with output, new orders and employment all increasing at a faster pace. GDP growth in 2017 could be around 0.6%, a touch better than the prior year thanks in part to the ¥28.1tn fiscal stimulus that was announced last summer and continued support from the Bank of Japan's ultra-loose monetary policies. A weaker yen should assist exporters. The government's decision to delay to 2019 the sales tax increase from 8% to 10% is also good news. Still, unfavourable demographics will continue to cap growth in the world's third largest economy.

The Eurozone too continued to expand in the final quarter of 2016 with Markit readings above 50 for both services and manufacturing, the latter even hitting a 68-month high in December. The European Central Bank's stimulus is starting to bear fruit as evidenced by improving household credit and business loans. The credit channels are slowly being unblocked and that bodes well for the economy going forward.

Eurozone: Bank lending is improving
MFI loans to households and non-financial corporations

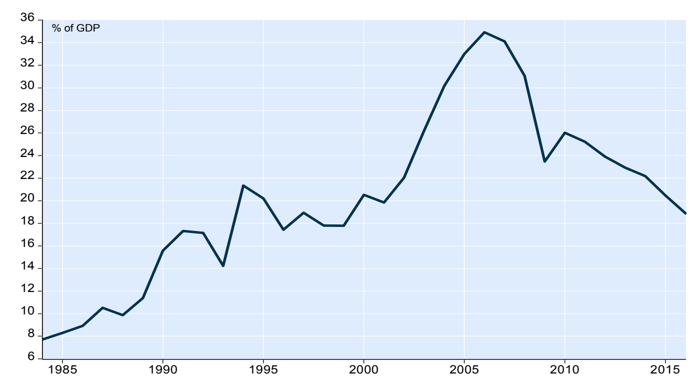


NBF Economics and Strategy (data via Datastream)

The cheaper euro resulting from the ECB's ultra-loose policies — the QE program was extended to at least the end of 2017 — should also support exporters as they face challenges brought by softening demand from emerging markets, the zone's major customers. But uncertainties related to Brexit and upcoming elections may pull back an economy which, like Japan, is already being restrained by a low potential. All in all, we expect the zone to grow about 1.5% in 2017.

In China too, momentum seems to have extended to the final quarter of 2016. Retail sales and industrial production topped consensus expectations by growing 10.8% and 6.2% respectively on a year-on-year basis in November. New bank loans were also stronger than expected during that month, rising by almost 795 billion yuan. Beijing seems to be succeeding in achieving its objective of rebalancing towards domestic demand because the latter's share of the economy continues to grow. As a result, the export sector's share of the economy has fallen to the lowest since 1999. Reduced dependence on trade is good news for China as it braces for a possible ramp up in protectionist measures from the incoming U.S. administration.

China: Export share of economy lowest since 1999
Exports



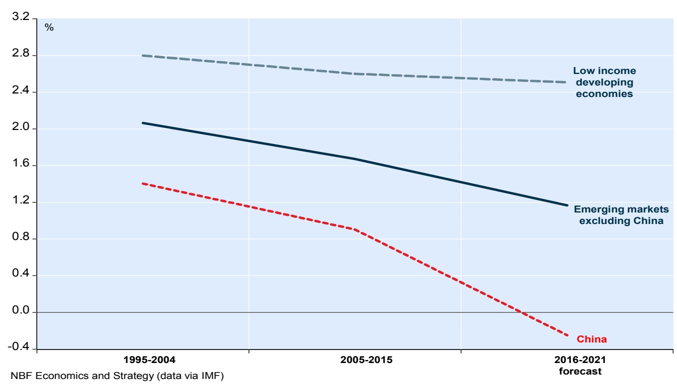
NBF Economics and Strategy (data via Datastream, IMF)

That's not to say China will be able to sustain the 6.5% growth objective set out by Beijing in the last 5-year plan. The economy faces serious challenges including some that are unusual for emerging economies. For instance, China's demographics are turning from tailwind to headwind as the working age population (the number of people aged between 15 and 64) is expected to fall over the next four years. That does not bode well for potential GDP in the world's second largest economy.

ECONOMIC OUTLOOK

WORLD

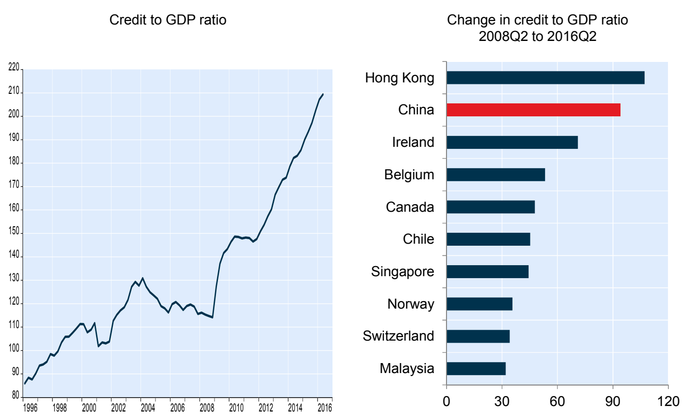
China: Deteriorating demographics
Working age population growth



NBF Economics and Strategy (data via IMF)

Also concerning to Beijing is the debt situation. Credit intensity has roughly doubled since 2009 — it now takes twice as much credit to generate an additional unit of GDP in China. Corporations have borrowed heavily with their debt now accounting for a massive 145% of China's GDP. The corporate debt to earnings ratio has accordingly soared. That's bad news for China's banks because of the increased potential for defaults.

China: Credit intensity has soared since 2009

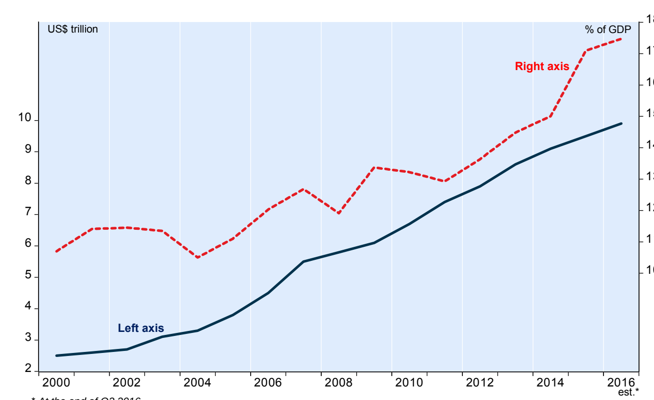


NBF Economics and Strategy (data via Bank of International Settlements)

Credit risks have been enhanced further by the proliferation of shadow banking products. About half of the stock of shadow credit products is reportedly high yield and hence high risk. So, the question is not *if* but *when* defaults are going to hit China's financial system. Banks have been asked to boost their capital levels and they are now tapping markets and even asking the central bank for assistance. The People's Bank of China, via its emergency lending facility, extended more than 700 billion yuan to banks in December alone, a record. So, the threat of a financial crisis in the world's second largest economy should not be underestimated. That would not be without repercussions across the globe, particularly in countries that have deep supply chain linkages with China. According to the IMF, a 1% negative shock to China's final demand growth could have a cumulative impact on global GDP of roughly 0.25% after a year.

The debt problem isn't isolated to just China. According to the Bank of International Settlements' latest Quarterly Review, US dollar-denominated debt outstanding outside of America at the end of 2016Q2 amounted to a record $9.9 trillion, or almost 18% of world GDP excluding the U.S. While USD-denominated debt has increased in emerging markets to $3.3 trillion (about $1 trillion in China), that pales in comparison to advanced economies (ex-U.S.) where such debt jumped to $ 6.6 trillion at the end of Q2 or roughly 25% of GDP of advanced economies excluding the U.S.

World: Record debt denominated in US dollar
USD-denominated debt held outside of the U.S.



* At the end of Q2 2016
NBF Economics and Strategy (data via Bank of International Settlements)

The USD surge is bad news for those borrowers. Rising bond yields will also bring additional headwinds to the global economy. In emerging markets for example, the effective corporate bond yield has jumped almost half a percentage point since the U.S. elections, and that poses problems given the rising credit intensity in those economies.

The combination of rising borrowing costs, a surging US dollar and a potential slowdown in China do not bode well for emerging markets which should see growth soften in 2017. In contrast, advanced economies as a group are likely to see a pick-up in growth as a stronger U.S. offsets Brexit-related moderation in Europe. All in all, the world economy could expand by 3.3% or so in 2017. That's an improvement after the prior year's dismal showing, but an unremarkable performance nonetheless considering continued assistance from monetary and fiscal stimulus.

ECONOMIC OUTLOOK

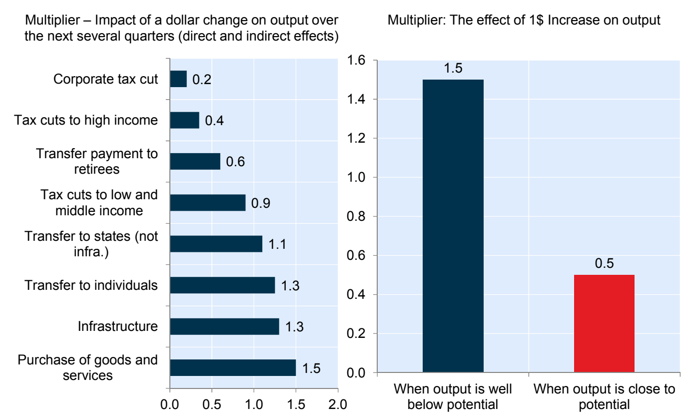
UNITED STATES

Confidence on the rise

The end of Congressional gridlock boosted not just financial markets but also business confidence. The National Federation of Independent Business index jumped to a two-year high right after the elections as small businesses expressed optimism about the outlook for the economy and hence sales. They thought it was a good time to expand and accordingly planned to increase employment. It seems investors and businesses are assuming the incoming President delivers on his election promises to boost the economy via fiscal stimulus and deregulation.

The expected fiscal stimulus should indeed lift U.S. growth, although the extent of the boost will depend on the type of measures implemented. Tax cuts for corporations and wealthy individuals seem to be more appealing to Republican policymakers and hence more likely to be implemented in full. But according to the Congressional Budget Office, those measures provide less bang for the buck compared to government current expenditures, transfers and infrastructure spending. Multipliers are also the smallest when the economy is close to potential, as is currently the case. So, we won't be holding our breath for the 4% GDP growth that was promised during the election campaign. But growth over 2% in both 2017 and 2018 is feasible considering the upcoming tax cuts.

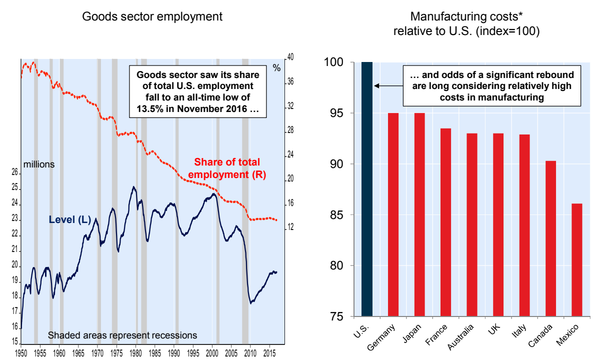
U.S.: Impacts of fiscal stimulus may vary



NBF Economics and Strategy (data via Congressional Budget Office)

Such above-potential growth should make an already-tight labour market even tighter. Recall that the jobless rate fell to 4.6% in November, the lowest since mid-2007. Employment in the services sector should remain buoyant while the goods sector, which just had its worst year since the 2009 recession, could stabilize somewhat in 2017 helped by construction and mining jobs. But we're not expecting miracles. The goods sector's share of total employment is now at a record low of 13.5% and odds of a significant rebound are long considering relatively high costs in the manufacturing sector which accounts for over 60% of goods sector jobs. Wage pressures are expected to pick up in 2017, although the effect could be muted if, as we expect, the participation rate recovers e.g. if a significant portion of the 94 million people who are currently out of the labour force find opportunities thanks to the fiscal boost.

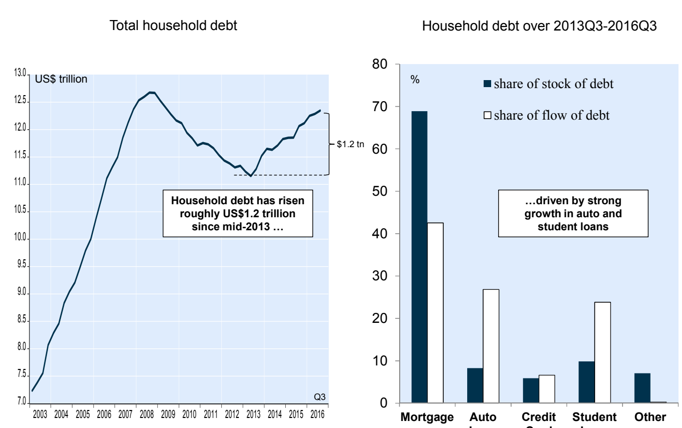
U.S.: Can goods sector employment be great again?



* KPMG calculated manufacturing sector costs in 2016 based on 12 representative industry-specific business operations: aerospace, agri-food, automotive, chemicals, electronics, green energy, medical device, metal components, pharmaceutical, plastics, precision manufacturing, telecommunications
NBF Economics and Strategy (data via Datastream, KPMG)

Continued labour market resilience coupled with cheap credit should sustain consumption growth. Households are making the most of low interest rates and borrowing more as evidenced by latest data from the New York Fed which shows debt rising by $1.2 trillion since mid-2013. About 42% of that amount has gone into mortgages, not particularly impressive considering mortgages account for 69% of total debt. In contrast, student and auto loans accounted for a disproportionately large amount, together taking about half of the US$1.2 trillion despite accounting for just 18% of total debt.

U.S.: Household debt continues to climb



NBF Economics and Strategy (data via New York Fed)

ECONOMIC OUTLOOK

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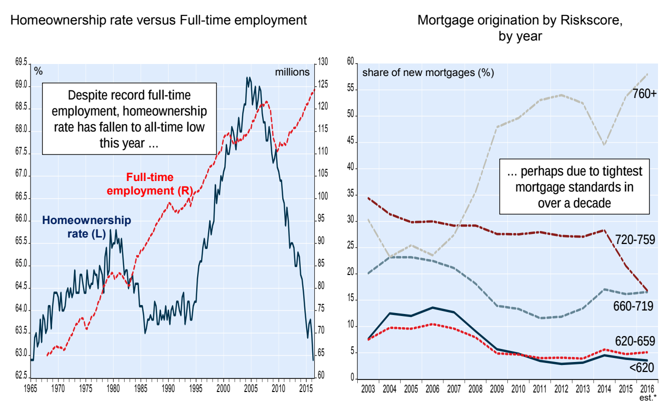
Explaining the relatively low mortgage volumes is the significant increase in bank lending standards. Roughly 58% of new mortgage originations in 2016 went to borrowers with credit scores 760 and above. That explains why America's homeownership rate is at an all-time low despite rising household formation, record full-time employment and low interest rates. So, one should not be surprised the housing market remains in recovery mode as opposed to expansion — recall the Case-Shiller 20-city home price index is still about 8% below the peak reached a decade ago. And with interest rates on the rise, things are about to get a bit tougher for would-be home buyers.

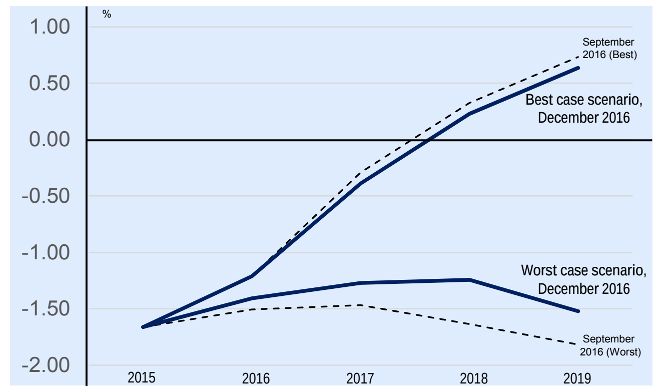
U.S.: Tightest mortgage standards in over a decade



* Average for first three quarters of 2016
NBF Economics and Strategy (data via Datastream, New York Fed)

The Federal Reserve not only raised the fed funds rate to 0.75% in December but also increased the number of hikes it expects for 2017 from two to three. It still expects three hikes each in 2018 and 2019. The long-run level of the nominal fed funds rate was left unchanged at 2.50-3.75%, range which the majority of participants expect to be reached by 2019. The slightly more hawkish stance reflects the less pessimistic view about downside risks. Indeed, the Fed's revised GDP growth forecasts for the worst case scenario now show a smaller output gap at the end of 2019.

U.S.: Fed less pessimistic about downside risks to economy
Output gap calculated using CBO's estimates of potential and Fed's latest GDP projections



NBF Economics and Strategy (data via Federal Reserve, Congressional Budget Office)

Given the progress that has been made already in achieving the Fed's dual mandate (as highlighted by Chair Yellen during December's press conference), three hikes next year cannot be ruled out particularly if upcoming data is consistent with an economy growing above potential. At this point, markets are pricing just two rate hikes for next year, a view we're inclined to share. There are major uncertainties about fiscal policy and a deterioration in financial conditions could throw a wrench in the Fed's outlook. Recall that the trade-weighted US dollar is not far from the peak reached back in February 2002. That's not only curbing U.S. exports but also capping imported prices. Unfavourable demographics are also keeping a lid on inflation as an aging workforce saves more of its income earned in anticipation of retirement. Those forces explain perhaps why the pass-through of wage inflation to the core PCE deflator has significantly diminished in the last few decades. In other words, even if wage growth heats up, don't expect runaway inflation anytime soon.

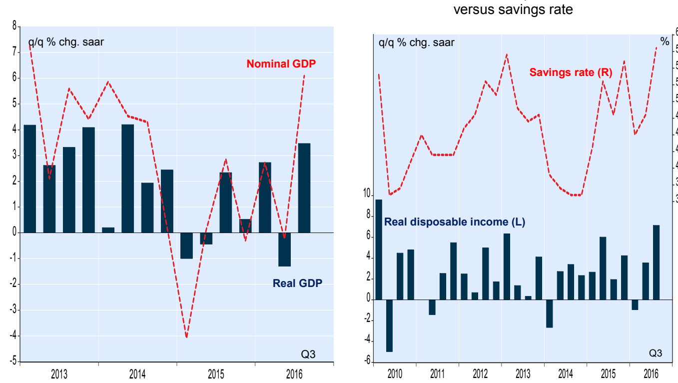
ECONOMIC OUTLOOK

CANADA

Return to above-potential growth in 2017?

Canada's economy output grew 3.5% annualized in Q3 as the oil and gas sector rebounded after the prior quarter's wildfire-related output slump. The federal government also provided an assist through its enhanced Child Benefit program which boosted household incomes, the latter surging 7.1% the biggest quarterly jump since 2010. That allowed Canadians to spend more but also to pad their nest eggs, the savings rate rising to 5.8% in Q3 the highest since 2001. Also encouraging was the 6.1% annualized increase in nominal GDP which would have boosted public finances.

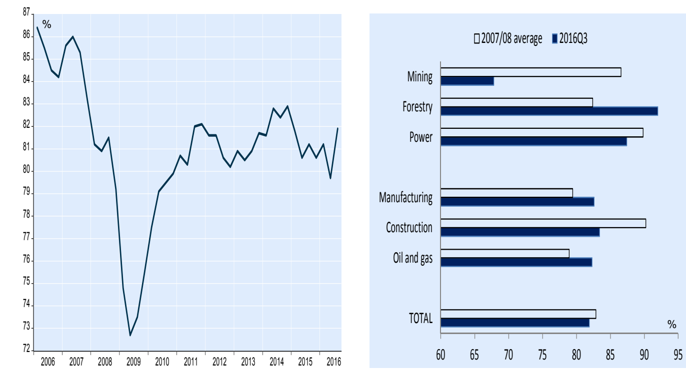
Canada: Economy bounced back sharply in third quarter



NBF Economics and Strategy (data via Statistics Canada)

The output surge allowed for part of the economy's excess slack to be absorbed. The capacity utilization rate rose more than two percentage points to 81.9% in the third quarter. While that remains below levels seen before the Great recession of 2008/09, there are sectors where utilization rates are now either close to or above pre-recession averages, e.g. oil and gas, forestry and the manufacturing sector. So, while investment in mining and energy could remain depressed due to the persistence of soft commodity prices, there are reasons to be optimistic about a rebound in investment elsewhere. In food manufacturing for example, the capacity utilization rate is now at an all-time high.

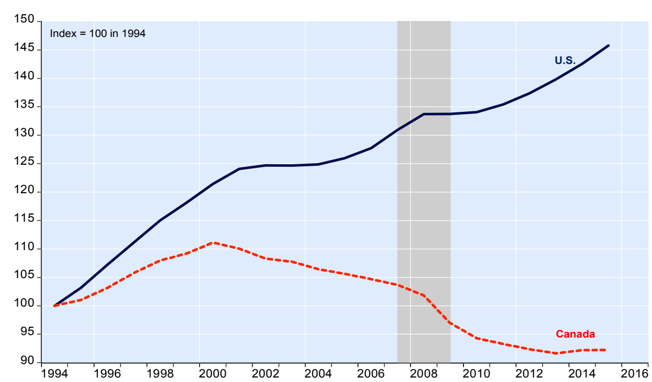
Canada: Capacity usage improves
Capacity utilization rate



NBF Economics and Strategy (data via Datastream)

The manufacturing sector could use some additional investment after seeing its net stock of capital sink to multi-decade lows, contrasting sharply with rising capacity south of the border. However, the timing of such investment is unclear because manufacturers may want to wait for global economic headwinds to abate or for confirmation about the sustainability of foreign demand. Of particular interest to Canadian exporters is U.S. trade policy which could potentially take a turn for the worse after the President-elect vowed to renegotiate the North American Free Trade Agreement.

Canada: Destruction of capital stock in the manufacturing sector
End-year net stock of capital in Manufacturing Canada vs. the U.S.



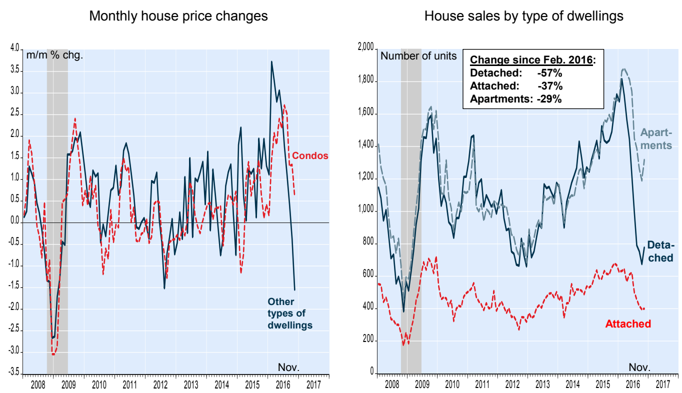
NBF Economics and Strategy (data via Datastream)

Regardless, we expect investment spending to stabilize in 2017 after the slump observed the preceding two years. Domestic demand will also find support from government spending in light of the announced fiscal stimulus by the federal government. But question marks surround the outlook for consumption and housing after their debt-fuelled ascent in earlier years. According to the Teranet-National Bank House Price Index™, resale prices are already falling

CANADA

in several metropolitan areas including Vancouver where sales are in freefall. Measures imposed by government such as the qualification for an insured mortgage and the 15% tax on foreigners' acquisitions in British Columbia are starting to bite. Expect the price correction to extend through 2017 in that city. Toronto's house price decline is likely to be less brutal because of the reported tightness of supply. Even then, the housing wealth effect, which for years supported Canada's consumption spending, is set to fade.

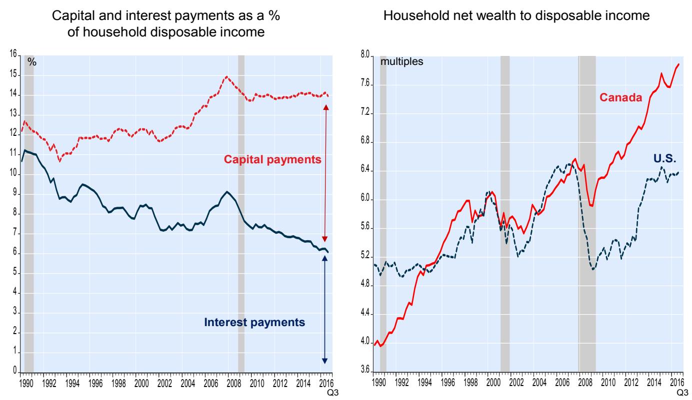
Vancouver: Home sales and prices are falling



NBF Economics and Strategy (Data from Teranet-National Bank House Price Index and REBGV, the latter seasonally adjusted by NBF)

With housing flashing red, should one be concerned about disorderly deleveraging similar to the one that occurred in the U.S. during the Great recession? Chances of that happening are low in our view, assuming of course the labour market does not take a generalized dive from here. In sharp contrast to Vancouver and Toronto, housing remains affordable in cities such as Calgary, Edmonton and Montreal. Moreover, incentives for tactical defaults by mortgage holders (as seen during the U.S. housing crash) are low in Canada considering accumulated home equity. Capital repayments as a share of mortgage payments are at all-time highs partly due to regulations that have lowered the amortization period. Also, thanks to record low interest payments, overall household debt service remains manageable at roughly 14% of disposable income. But even without deleveraging, don't expect consumers to contribute as much to growth.

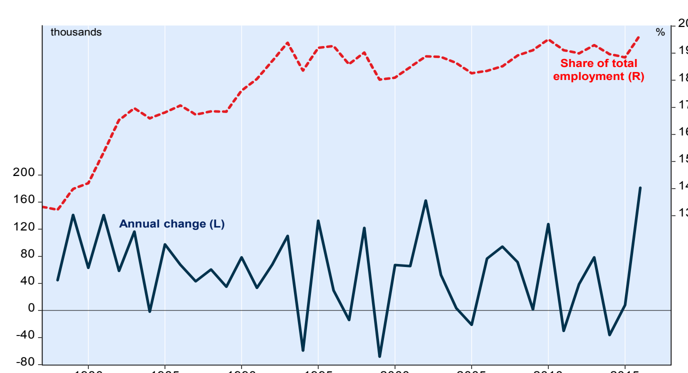
Canada: Wealth rising and debt service is manageable



NBF Economics and Strategy (data from Statistics Canada)

With domestic demand under pressure, the export sector will once again be the major driver of growth in 2017. True, downside risks such as restrictive trade policies from the incoming U.S. administration should not be underestimated. But considering how integrated the two economies have become, and hence the potentially large loss of efficiency resulting from trade barriers, we assume common sense will prevail among policymakers on both sides of the border as to not materially hurt trade flows. If we're right, strengthening U.S. demand coupled with the lagged impacts of a cheaper Canadian dollar should give a boost to exporters, allowing GDP to grow about 1.9% in 2017. That will be the first time in three years Canada sees above-potential growth, meaning the output gap will narrow somewhat. That's not to say the Bank of Canada will quickly abandon its dovish stance on monetary policy. Given its concerns about domestic risks, the central bank will continue to err on the side of caution and delay interest rate hikes to 2018, particularly with inflation remaining mild and an unimpressive labour market seemingly tilting towards part-time employment.

Canada: Biggest ever annual jump in part-time employment
Part-time employment according to Labour Force Survey, by year



NBF Economics and Strategy (data via Statistics Canada)

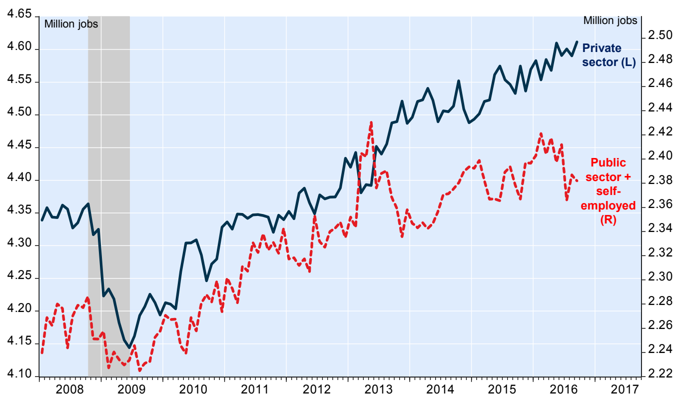
ECONOMIC OUTLOOK

PROVINCIAL ECONOMIES

Ontario

At this writing, Ontario employment was on track to grow about 1% in 2016, the best provincial showing after B.C. Accordingly, the unemployment rate has fallen to an eight-year low. Most of the jobs added have been in the private-sector, as has been the case since the second half of 2013.

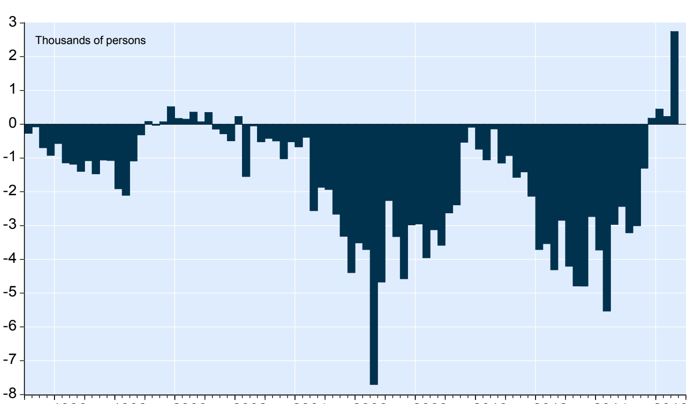
Ontario: Most jobs growth of the last 3 years has been in private sector
Private-sector employment vs. public-sector employment and self-employment



NBF Economics and Strategy (data via Statistics Canada)

For the first time in five years, Ontario's net interprovincial migration turned positive in 2016, mainly because of a net inflow from Alberta for the first time since 2001.

Ontario: Net migration from Alberta
Quarterly number of arrivals from Alberta minus departures to Alberta

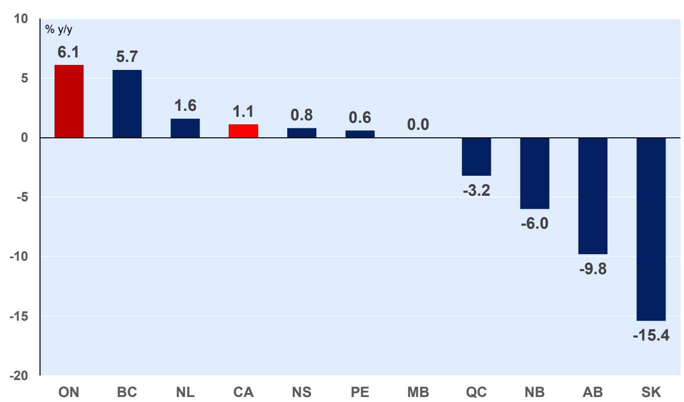


NBF Economics and Strategy (data via Statistics Canada)

This shift should support Ontario's population growth of 1.1% annually between now and 2020, compared to 1.0% over the previous decade. True, growth of the main labour pool – the population aged 15 to 64 – will slow, but in contrast to Quebec and the Atlantic provinces, that labour pool will not contract.

Reflecting the solid employment situation, consumer spending was on track to grow roughly 3% in 2016 while residential construction also advanced strongly for a second consecutive year. Business investment, on the other hand, likely fell after a robust 2015 — data available so far for investment in non-residential building construction and in machinery and equipment were below that of 2015 over the same period. For this reason 2016 growth in final domestic demand may be softer than the prior year. Still, overall GDP growth for 2016 could match the prior year's 2.5% print given strength in external trade which has been offsetting weakness in business investment. In the first 10 months of 2016, the value of non-energy international merchandise exports was up 6.1% year-on-year, the highest among provinces. Not surprisingly, auto industry exports were significant contributors with growth of almost 13%.

Change in value of non-energy goods exports
First 10 months of 2016 compared to same period of 2015, customs basis



NBF Economics and Strategy (data via Statistics Canada)

Since employment can be expected to grow at least 1% annually over the coming years, the aggregate wage bill should continue to grow at a brisk pace. But with households likely to beef up their savings to address the debt situation, consumer spending growth could moderate to about 2.5% in 2017 and 2018. Tighter eligibility rules for insured mortgages and the rise of mortgage rates are likely to cool the housing market. We expect housing starts to decline almost 15% in 2017. Domestic demand should, however, find support from a revival of business investment in response to better corporate profits and capacity constraints in some industries. Exporters will benefit from stronger U.S.

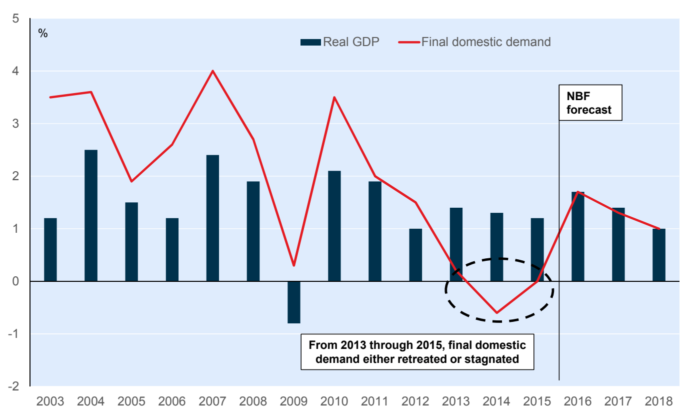
PROVINCIAL ECONOMIES

economic growth and perhaps from the Canadian dollar's depreciation, although a marked depreciation of the Mexican peso will still pose competitive challenges. Regardless, we anticipate economic growth in Canada's largest province will exceed 2% over the forecast horizon.

Quebec

It was a year to remember in Quebec. Final domestic demand, which had stalled in real terms from 2013 through 2015, surged unexpectedly in 2016.

Quebec: Economic growth
Annual change in real GDP and real final domestic demand

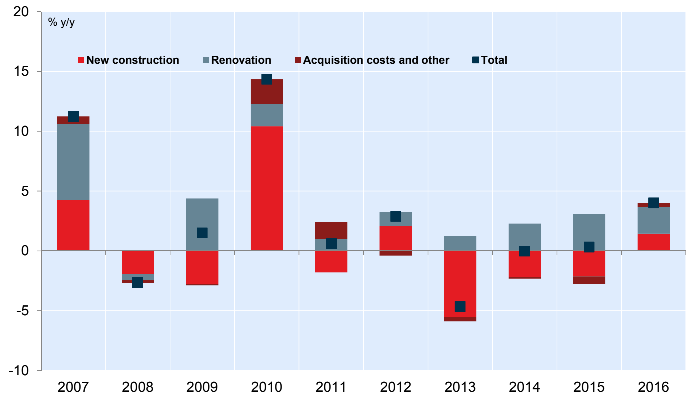


NBF Economics and Strategy (historical data from Statistics Canada, 2016-2018 from NBF forecast)

Employment growth in 2016 may have ended up at around 0.8%. The unemployment rate, slightly above 6% at this writing, is among the lowest of the provinces. More importantly, the gains of the last two years have been in full-time jobs and mostly in the private sector. As a result, real consumer spending could end up growing above 2% in 2016, the best in three years.

Homebuilding also gave a lift to domestic demand. In the first nine months of 2016, nominal residential investment was up 4% from a year earlier, the largest increase since 2010. As in 2014 and 2015, the contribution from home renovation spending was substantial.

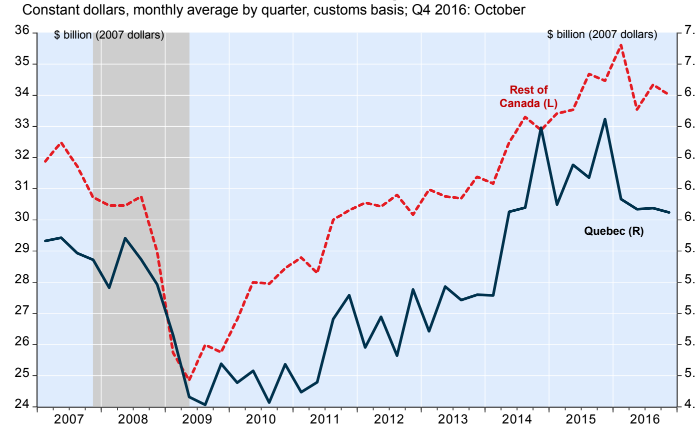
Quebec: Change in residential construction expenditure
Total expenditure and components contributions, first nine months of each year



NBF Economics and Strategy (data via Statistics Canada)

In contrast, business investment remains weak. While there is some evidence of stabilization, it is likely to end 2016 with a fourth consecutive decline from the previous year. Disappointing international exports have capped corporate profits and the desire to invest, especially with the expensive U.S. dollar raising the cost of imported machinery and equipment. Volume international merchandise exports in the first ten months of the year were down 2.6% from a year earlier, with declines in the two main export categories of aerospace products and aluminum.

Quebec: International merchandise exports
Constant dollars, monthly average by quarter, customs basis; Q4 2016: October



NBF Economics and Strategy, Statistics Canada and ISQ data

Even then, GDP growth for 2016 likely ended up around 1.7%, the best in five years. The year-over-year decline of international exports may not have subtracted from GDP growth because imports fell more than exports – 3.4% in the first ten months.

ECONOMIC OUTLOOK

PROVINCIAL ECONOMIES

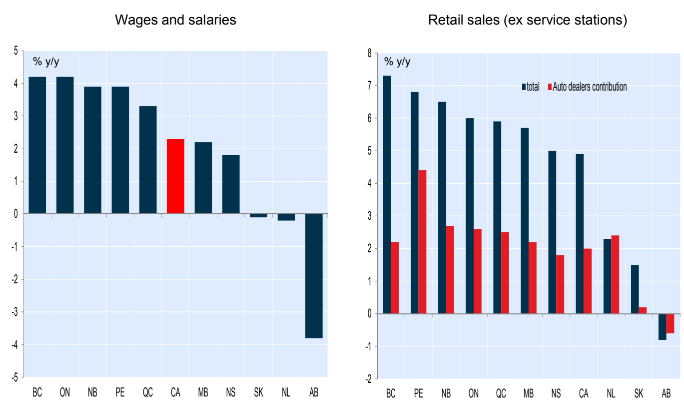
For 2017 we expect economic growth of 1.4%, somewhat down from our estimate for 2016. This forecast assumes renewed growth of business investment and international exports offsetting a cooling of consumer spending.

So, economic growth can be expected to exceed that of potential GDP for a second consecutive year in 2017. Potential GDP growth has been limited by the contraction since mid-2013 of the main labour pool, the population aged 15 to 64. This decline can be expected to continue. Absent changes in other factors, Quebec will need to accommodate an increasingly slower economic growth rate. One way to address this problem would be to reduce obstacles to the integration of immigrants into the labour market.

British Columbia

B.C. was the employment-growth champion of 2016. Its labour force was on track to expand almost 3%, with the private sector accounting for most of the new jobs. The most recent unemployment rate was 6.1%, the lowest of any province. So, it should not be surprising that in the first nine months of 2016, B.C. led the country in growth of aggregate wage bill (along with Ontario) and in growth of retail sales. A record influx of international tourists also helped prop up retail sales.

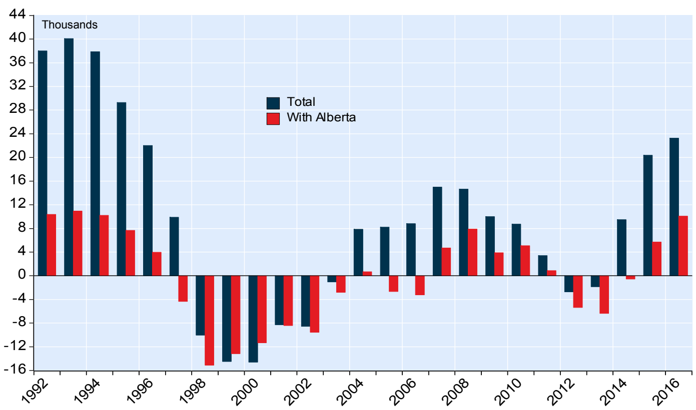
Growth of aggregate wage bill and growth of retail sales, by province
First 9 months of 2016 compared to same period of 2015



NBF Economics and Strategy (data via Statistics Canada)

The strength of the province's labour market allowed it to easily absorb a reversal of net migration between B.C. and Alberta in addition to the usual net inflow from the other provinces.

B.C.: Net interprovincial migration since 1992
Years ending June 30



NBF Economics and Strategy (data via Statistics Canada)

Residential construction was also booming in 2016. Housing starts likely topped 40,000, making 2016 the best year since 1993. Starts in the Vancouver area were headed for an all-time high. With prices of detached homes beyond reach for most people, the share of rental and condo housing in Vancouver starts is higher than ever.

However, the resale market seems to be struggling. Existing-home sales peaked in February 2016. By all appearances, the subsequent retreat was hastened by various measures introduced by local and national governments.[1] First-time Vancouver homebuyers are likely to be especially affected by a more recent measure requiring a homebuyer seeking an insured five-year mortgage to qualify at the posted rate rather than the lower discounted rate.

The Teranet–National Bank House Price Index™ shows home prices now retreating in Vancouver. This should continue over the next months. The total decline should not reach worrying proportions, as the housing market will continue to be supported by fundamentals (employment, immigration). Residential building permits suggest starts will be restrained by these developments but will remain relatively high.

[1] Down payment required for an insured mortgage hiked to 10% from 5% for the portion of a home price exceeding $500,000 (a threshold often exceeded in Vancouver); 3% luxury tax on home purchases exceeding $2 million; 15% tax on home purchases by foreigners; anti-corruption campaign in China.

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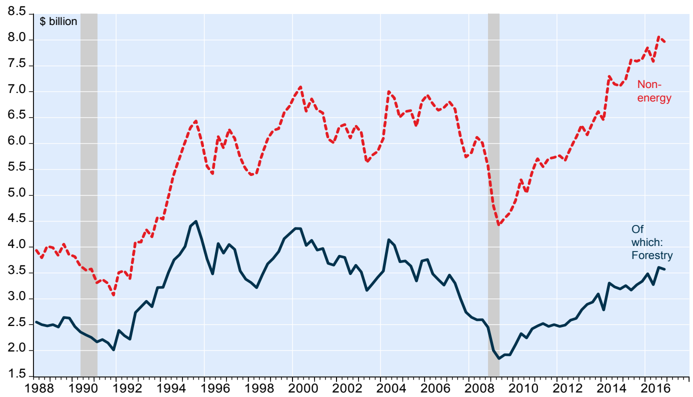
Contrasting with Ontario and Quebec, B.C. does not seem to have problems with business investment. Investment in non-residential building construction in the first nine months of 2016 was up sharply from a year earlier in real terms, more than offsetting a decline of such investment by governments.

B.C.: Value of non-energy merchandise exports at a record
Quarterly, seasonally adjusted, customs basis



NBF Economics and Strategy (data via BCStats)

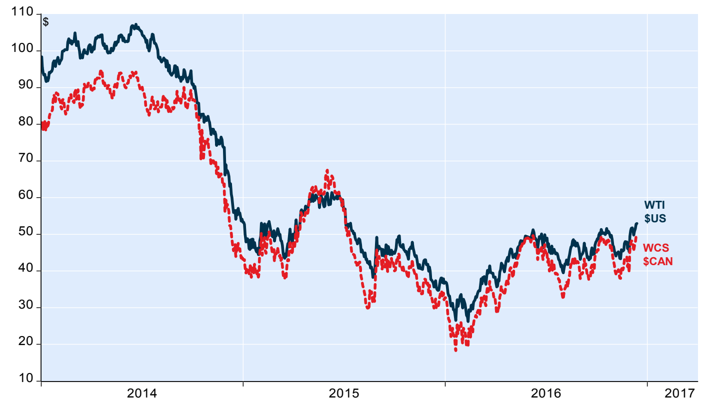
Merchandise exports in the first 10 months of 2016 were up 5.9% in value from a year earlier. Almost half the increase came from forestry exports, whose value has been boosted by an 11% rise of international lumber prices.

After hitting roughly 2.8% in 2016, the strongest of any province, B.C.'s GDP growth should cool over the next two years, to 2.3% in 2017 and 2.1% in 2018 as the housing market decelerates, employment growth moderates to a more sustainable pace and the U.S. government imposes tariffs on Canadian softwood products. The impact of the latter measure on the province's exports will be partly offset by new projects coming online or reaching full capacity in the mining and primary metals sectors.

Alberta

Albertans will soon see some light at the end of that long tunnel. The recession that started in 2015 due to the oil-price slump and the resulting energy-sector investment crunch, extended to 2016 with additional drag from temporary interruption of oil extraction by wildfires. However, the stabilization of oil prices in Q4 2016 (WTI averaging close to US$49) can be expected to brake the decline of investment and of oilfield-equipment production. The downtrend of employment also seems to have faded recently.

Crude oil prices
Price per barrel: WTI ($US) and WCS ($CAN)

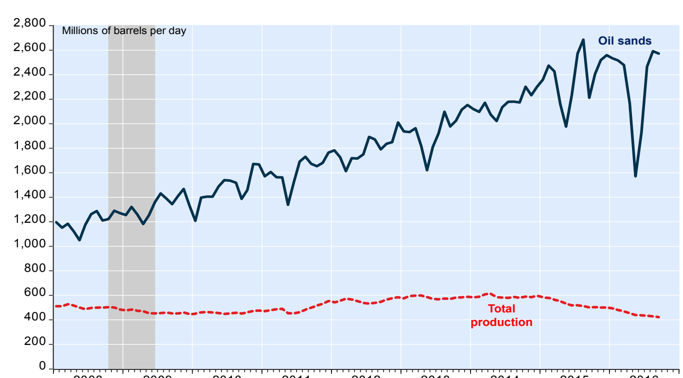


FBN Économie et stratégie (données via Thomson-Reuters Datastream)

Alberta's economy is set to return to growth in the coming years, buoyed by increased government infrastructure spending and, in 2017, by Fort McMurray rebuilding and higher oil production, assuming no interruption as in 2016. Economic growth could reach 2% in 2017, cooling to 1.3% in 2018. This scenario assumes an average WTI price of a little above $US50 in 2017 and close to $US60 in 2018. Employment can be expected to grow, though without returning to the 2015 level over the forecast period. Thus the unemployment rate will remain well above pre-2016 levels.

Apart from the shutdown forced by wildfires, oil production has been stable since the end of 2015 at about 3 million barrels a day. This output is likely to increase over the coming years.

Alberta: Crude oil production
Last observation: September 2016



NBF Economics and Strategy (data via Alberta Resources Conservation Board)

ECONOMIC OUTLOOK

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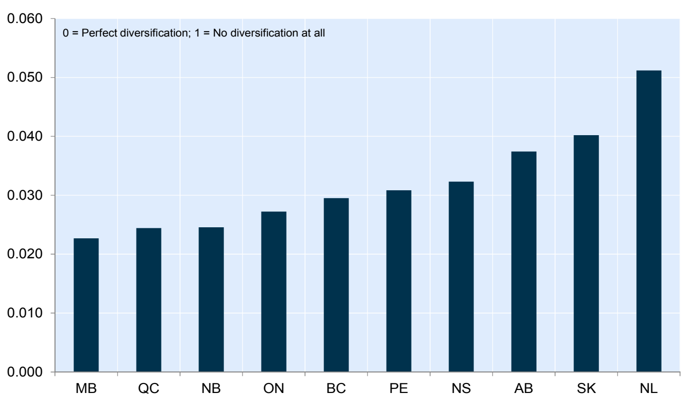
Despite the recent net interprovincial emigration from Alberta, overall population growth is expected to outstrip that of the rest of Canada. That being said, the 2.5%-plus annual population growth of 2013 and 2014 is a thing of the past. Thus housing starts over the forecast period are unlikely to return to the 30,000-plus rates of 2012-2015.

Manitoba

Manitoba's economy is the most diversified among the provinces, a feature that generally gives it a relatively stable growth rate. Despite soft patches in some sectors, it could end 2016 with an expansion of 1.5%. This is slower than usual – in 10 of the last 12 years its growth has topped 2% – but good compared to the rest of the country.

Normalized Herfindahl-Hirschman index of economic diversification
Based on 2015 industry shares of real GDP at basic prices



NBF Economics and Strategy (calculated from Statistics Canada data)

A sharp cutback of oil extraction subtracted from growth in 2016, though oil accounts for only 2% of the economy. Ten months into 2016, the value of merchandise exports, even excluding energy, was flat from a year earlier. Declines in wheat and soy exports offset increases for other oilseeds. Exports of metals, aerospace products, pharmaceuticals and farm machinery also declined. On the other hand, pork exports, especially to China, soared.

Employment was on track to contract 0.5% in 2016, with public-sector losses more than offsetting private-sector growth. This retreat is likely to prove temporary, since the economy goes into 2017 with a number of favorable developments.

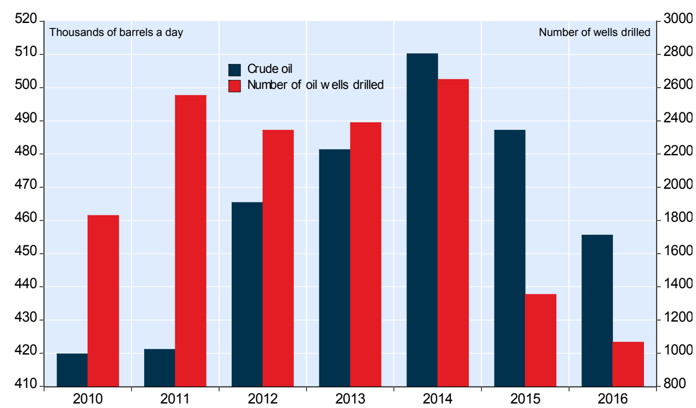
One is a likely revival of manufacturing output. Another is that construction output, which was flat in 2016, will benefit from a ramp-up of Manitoba Hydro investment. A third is that oil production is likely to stabilize.

We expect Manitoba's economy to return to 2% growth in 2017. One factor in this acceleration, which is remarkable in the circumstances, is strong population growth buoyed by a policy of attracting and retaining international immigrants.

Saskatchewan

Oil and gas extraction and related services account for about 16% of the Saskatchewan economy. Like Alberta, the province was sent into recession in 2015 and 2016 by the slump of hydrocarbon prices, especially since conventional crude extraction, dominant in Saskatchewan, reacts faster to price fluctuations than oilsands production.

Saskatchewan: Crude oil production
First 9 months of each year



NBF Economics and Strategy (data from Saskatchewan Ministry of the Economy)

Potash output may also have fallen in 2016. Ten months into 2016, merchandise exports, even excluding energy, were down 15% from a year earlier. The decrease was concentrated in potash, farm products and, to a lesser extent, metal products. Global prices for potash and uranium, of which Saskatchewan is the world's leading producer, fell almost 20% and 30% respectively in 2016. Grain prices were also soft.

Employment was on track to fall 0.9% in 2016. The loss has been concentrated in the construction industry despite strong growth in institutional and government building, since

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investments in new-home construction ended the year down at least 15% in real terms to correct for past overbuilding. In the medium term, housing starts are likely to stabilize, since the province's population growth exceeds the national average.

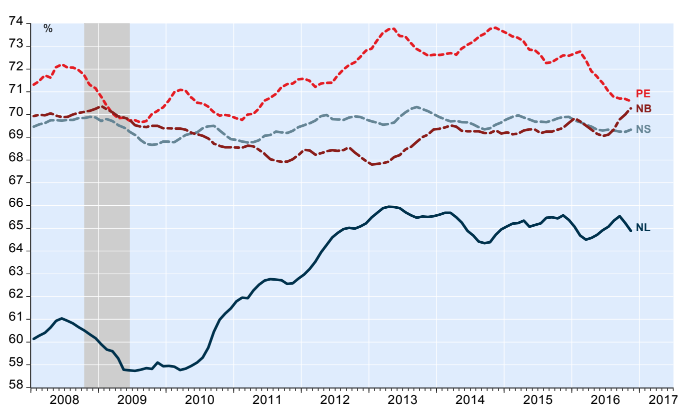
Saskatchewan's economy should return to growth in 2017 as oil output stabilizes and exports improve. Demand for potash and grains will probably bounce back, since bumper wheat harvests in the rest of the world are unlikely to be repeated in 2017. Canola exports can be expected to benefit from the recent Canada-China agreement.

Atlantic Provinces

In each of the Atlantic Provinces the death rate now outstrips the birth rate and each has a net outflow of population to the other provinces. Thanks to net inflows from abroad, their populations have kept growing or, in the case of New Brunswick and Nova Scotia, have resumed growing.

In each province the main labour pool (the population aged 15 to 64) has been shrinking since the beginning of the decade. The continuous contraction of employment in each province since 2014 (except in Nova Scotia where there was a slight increase in 2015) needs to be seen in this context. For instance, no real downtrend of the employment rate has begun in Newfoundland and Labrador, still less in New Brunswick. The rate began falling in P.E.I. in 2015 and, more recently and to a lesser extent, in Nova Scotia.

Atlantic Provinces: Employment rate 15-64 years old
Employment / Civilian population 15 to 64 years old; 6-month moving average



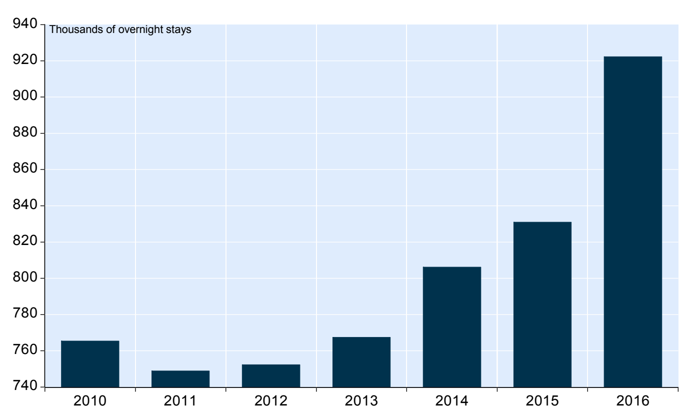
NBF Economics and Strategy (data from Statistics Canada)

In **Newfoundland and Labrador**, crude oil extraction in 2016 was running more than 20% above the prior year – there has been no major production shutdown as there was in 2015. Meanwhile, volume iron ore shipments were up almost 5%. These two factors largely offset retreats in construction, wholesale trade and manufacturing. As a result, real GDP is on track for growth of 1% in 2016 after two consecutive years of decline.

Unfortunately this doesn't look like the beginning of a trend. Construction output will continue to decline in 2017 as large projects are completed. Crude oil extraction will fall with the progressive exhaustion of oilfields. Reduced fishery quotas will hurt seafood exports. In last spring's budget the government announced tax increases including higher marginal income tax rates for individuals and a two-point hike (to 15%) of the provincial portion of the harmonized sales tax.

Taken together these factors point to a 2.7% contraction of real GDP in 2017, to a substantial decline of employment and a return to an unemployment rate on the order of 15%. The gloomy outlook for the labour market could spur migration to other provinces. GDP will recover late in the year as the Hebron oilfield comes on stream.

Prince-Edward-Island: Number of overnight stays sold
Fixed-roof accommodations and campground operations; First 10 months of the year



NBF Economics and Strategy (data from Tourism PEI)

The 2016 decline of employment in **Prince Edward Island** was disappointing. The unemployment rate would have been higher were it not for a decline in the participation rate of people aged 15 to 64. Running counter to these job losses is growth of the aggregate wage bill and of retail

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sales, the latter stimulated perhaps by a record influx of tourists.

Construction of new homes was down and the value of international merchandise exports was up only slightly, with manufacturing exports other than foodstuffs down from a year earlier. But the good showing of most of the other economic indicators suggests P.E.I. real GDP could grow 1.2% in 2016, a decent showing for such a province. There is nothing to indicate that the Island economy cannot maintain a similar pace in the coming years. P.E.I. will remain a choice attraction for Canadians in other provinces and people in the northeastern U.S., the latter enjoying a favourable exchange rate. Exports of seafood and potato products are likely to grow faster.

In **Nova Scotia**, real GDP growth has been limited since 2015 by reduced natural gas production, which will continue to be a factor over the forecast period. On the other hand, some buoyancy is likely in manufacturing and construction.

In September 2015 the Halifax shipbuilding yard began work on a Canadian navy contract. In 2016, the value of international exports was flat for tires and down for paper, plastics and rubber products. But it was up strongly for processed fish products, suggesting the manufacturing sector overall had a decent showing. There is no reason the sector cannot maintain this performance over the forecast period.

Business investment in nonresidential structures was down sharply in 2016. However, the construction industry is likely to gain lift from work on the Maritime Link Transmission Project.

Meanwhile, if the Nova Scotia government meets its budget targets for the current fiscal year, it will be among the provinces not running a deficit. In contrast with its Atlantic neighbours, it has not had to raise the provincial portion of the harmonized sales tax recently.

The **New Brunswick** had anemic growth in 2016. The main culprit was the closing of a large potash mine early in the year. The startup of production at the Caribou zinc mine last July has not fully compensated. The value of the province's international merchandise exports was down sharply even for non-energy exports. In addition to the potash mine closing, exports of chemical byproducts of oil refining has declined. In 2016 these byproducts accounted for almost 40% of the New Brunswick's non-energy exports. Higher exports of sawmill products were offset in part by lower exports of paper, and exports of pulp were flat. Also, at the beginning of the year the project to convert the Canaport LNG import terminal to an export facility was put on hold as a result of deteriorating global prices for natural gas.

The effect on consumer spending of the return of employment growth in 2017 will be lessened by last July's two-point hike in the provincial portion of the harmonized sales tax. The income tax rate for corporations has been raised to 14% from 12%.

The outlook for exports of forest products in 2017 is clouded by the fate of the softwood lumber agreement with the U.S., which expired in October 2016. Economic growth is likely to accelerate in 2017 with no large plant closings on the horizon, but will remain slow at less than 1%.

ECONOMIC OUTLOOK

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World Economic Outlook

	Forecast		
	2016	**2017**	**2018**
Advanced countries	***1.6***	***1.8***	***1.9***
United States	1.6	2.2	2.4
Euroland	1.7	1.5	1.6
Japan	0.5	0.6	0.5
UK	1.8	1.1	1.7
Canada	1.3	1.9	1.7
Australia	2.9	2.7	2.9
New Zealand	2.8	2.7	2.6
Hong Kong	1.4	1.9	2.8
Korea	2.7	3.0	3.1
Taiwan	1.0	1.7	1.9
Singapore	1.7	2.2	2.6
Emerging Asia	***6.4***	***6.1***	***5.9***
China	6.6	6.2	6.0
India	7.6	7.6	7.7
Indonesia	4.9	5.3	5.5
Malaysia	4.3	4.6	4.7
Philippines	6.4	6.7	6.8
Thailand	3.2	3.3	3.1
Latin America	***-0.5***	***1.6***	***2.1***
Mexico	2.1	2.3	2.0
Brazil	-3.3	0.5	1.5
Argentina	-1.8	2.7	2.8
Venezuela	-10.0	-4.5	-3.0
Colombia	2.2	2.7	3.8
Eastern Europe and CIS	***1.0***	***1.7***	***1.8***
Russia	-0.8	1.1	1.2
Czech Rep.	2.5	2.7	2.4
Poland	3.1	3.4	3.3
Turkey	3.3	3.0	3.2
Middle East and N. Africa	***3.2***	***3.2***	***3.3***
Sub-Saharan Africa	***1.5***	***2.9***	***3.6***
Advanced economies	***1.6***	***1.8***	***1.9***
Emerging economies	***4.1***	***4.4***	***4.5***
World	***3.0***	***3.3***	***3.4***

Source: NBF Economics and Strategy

ECONOMIC OUTLOOK

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United States
Economic Forecast

(Annual % change)*	2014	2015	2016	2017	2018	2016	Q4/Q4 2017	2018
Gross domestic product (2009 $)	2.4	2.6	1.6	2.2	2.4	1.9	2.1	2.5
Consumption	2.9	3.2	2.6	2.6	2.6	2.7	2.5	2.5
Residential construction	3.5	11.7	5.2	4.8	1.8	2.5	4.0	1.5
Business investment	6.0	2.1	(0.6)	1.3	1.8	(0.1)	1.6	2.1
Government expenditures	(0.9)	1.8	0.8	1.5	2.7	0.3	2.5	2.2
Exports	4.3	0.1	0.1	(1.5)	(0.3)	0.3	(1.5)	0.5
Imports	4.4	4.6	0.6	1.8	1.6	0.4	2.5	1.0
Change in inventories (bil. $)	57.7	84.0	20.7	42.8	40.8	44.0	42.0	40.0
Domestic demand	2.6	3.1	2.0	2.3	2.5	1.9	2.5	2.4
Real disposable income	3.5	3.5	2.7	2.0	1.7	2.4	1.8	1.7
Household employment	1.6	1.7	1.8	1.1	1.2	1.7	1.1	1.2
Unemployment rate	6.2	5.3	4.9	4.9	4.7	4.8	4.8	4.6
Inflation	1.6	0.1	1.3	2.1	2.2	1.8	1.9	2.3
Before-tax profits	5.9	(3.0)	0.5	7.2	4.6	10.9	4.9	4.5
Federal balance (unified budget, bil. $)	(483.3)	(439.0)	(588.0)	(594.0)	(620.0)	...	...	...
Current account (bil. $)	(392.1)	(463.0)	(488.0)	(500.0)	(540.0)	...	...	...

** or as noted*

Financial Forecast**

	Current 12-20-16	Q1 2017	Q2 2017	Q3 2017	Q4 2017	2016	2017	2018
Fed Fund Target Rate	0.75	0.75	1.00	1.00	1.25	0.75	1.25	2.00
3 month Treasury bills	0.52	0.58	0.80	0.84	1.05	0.55	1.05	1.93
Treasury yield curve								
2-Year	1.25	1.55	1.60	1.75	1.89	1.22	1.89	2.58
5-Year	2.06	2.27	2.34	2.41	2.62	2.00	2.62	2.92
10-Year	2.57	2.70	2.78	2.82	3.03	2.54	3.03	3.24
30-Year	3.15	3.22	3.25	3.27	3.43	3.15	3.43	3.59
Exchange rates								
U.S.$/Euro	1.04	1.03	1.00	1.01	1.03	1.04	1.03	1.07
YEN/U.S.$	118	118	120	117	115	117	115	111

National Bank Financial

*** end of period*

ANNEX

Canada
Economic Forecast

(Annual % change)*	2014	2015	2016	2017	2018	Q4/Q4 2016	Q4/Q4 2017	Q4/Q4 2018
Gross domestic product (2007 $)	2.6	0.9	1.3	1.9	1.7	1.7	1.9	1.6
Consumption	2.8	1.9	2.2	1.6	1.3	2.3	1.1	1.3
Residential construction	2.7	3.8	2.2	(3.0)	(1.5)	(0.2)	(2.0)	(1.5)
Business investment	3.2	(11.5)	(7.0)	0.7	2.6	(2.7)	2.7	1.9
Government expenditures	0.0	1.9	1.8	2.8	0.8	2.2	2.7	0.5
Exports	5.8	3.4	1.1	3.4	4.3	1.5	4.1	3.7
Imports	2.2	0.3	(0.5)	2.2	2.2	2.0	2.5	1.7
Change in inventories (millions $)	9,392	3,861	-47	1,485	1,249	2,511	1,608	1,500
Domestic demand	1.9	0.3	1.0	1.4	1.1	1.5	1.5	1.0
Real disposable income	1.3	3.3	2.8	2.6	1.7	2.8	1.9	1.7
Employment	0.6	0.9	0.7	0.8	0.7	0.8	0.6	0.7
Unemployment rate	6.9	6.9	7.0	7.0	6.9	6.9	6.9	6.8
Inflation	1.9	1.1	1.5	1.8	2.0	1.6	1.9	1.9
Before-tax profits	8.2	(19.5)	(4.8)	15.1	7.5	8.8	11.5	6.0
Current account (bil. $)	(48.2)	(67.6)	(72.0)	(63.4)	(52.2)	....	....	....

** or as noted*

Financial Forecast**

	Current 12-20-16	Q1 2017	Q2 2017	Q3 2017	Q4 2017	2016	2017	2018
Overnight rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	1.25
3 month T-Bills	0.48	0.48	0.48	0.48	0.63	0.48	0.63	1.21
Treasury yield curve								
2-Year	0.82	0.89	0.89	0.94	1.03	0.80	1.03	1.65
5-Year	1.20	1.34	1.36	1.42	1.52	1.18	1.52	2.09
10-Year	1.80	1.96	2.00	2.05	2.14	1.80	2.14	2.62
30-Year	2.40	2.49	2.50	2.50	2.56	2.40	2.56	2.96
CAD per USD	1.34	1.38	1.40	1.39	1.37	1.34	1.37	1.33
Oil price (WTI), U.S.$	52	50	47	52	55	50	55	60

National Bank Financial

*** end of period*

ECONOMIC OUTLOOK

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Provincial economic forecast

	2014	2015	2016e	2017f	2018f	2014	2015	2016e	2017f	2018f
	Real GDP (% growth)					**Nominal GDP** (% growth)				
Newfoundland & Labrador	-1.0	-2.0	1.0	-2.7	2.0	-1.3	-11.5	1.4	1.3	4.1
Prince Edward Island	1.5	1.3	1.3	1.2	1.4	3.5	3.9	3.5	3.5	3.7
Nova Scotia	0.8	1.0	1.1	1.2	1.4	1.7	2.4	2.0	2.8	2.7
New Brunswick	-0.1	2.3	0.5	0.8	0.9	1.0	2.9	2.7	2.6	2.7
Quebec	1.3	1.2	1.7	1.4	1.0	1.9	2.6	2.9	2.5	2.8
Ontario	2.7	2.5	2.5	2.3	2.2	4.7	4.9	3.9	3.9	4.0
Manitoba	1.5	2.2	1.5	2.1	1.5	2.5	3.1	1.5	3.5	3.5
Saskatchewan	2.4	-1.3	-0.5	1.8	1.2	1.3	-5.7	-5.0	4.2	3.2
Alberta	5.0	-3.6	-2.3	2.0	1.3	8.9	-12.5	-3.9	6.0	3.4
British Columbia	3.3	3.3	2.8	2.3	2.1	5.2	3.8	4.3	4.8	4.1
Canada	2.6	0.9	1.3	1.9	1.7	4.5	0.2	1.8	3.6	3.8
	Employment (% growth)					**Unemployment rate** (%)				
Newfoundland & Labrador	-1.9	-1.0	-1.3	-3.0	-3.9	12.0	12.8	13.5	15.3	17.4
Prince Edward Island	-0.4	-1.0	-2.3	0.3	0.3	10.5	10.4	10.8	11.0	10.8
Nova Scotia	-1.1	0.1	-0.5	0.2	0.4	8.9	8.6	8.2	7.8	7.6
New Brunswick	-0.2	-0.4	-0.2	0.4	0.4	9.9	9.7	9.7	9.7	9.4
Quebec	-0.1	1.0	0.8	0.9	0.4	7.8	7.6	7.1	6.6	6.7
Ontario	0.8	0.7	1.1	1.0	1.1	7.3	6.8	6.6	6.5	6.5
Manitoba	0.1	1.5	-0.5	1.1	0.9	5.4	5.6	6.2	5.9	5.4
Saskatchewan	1.0	0.5	-0.9	0.4	0.9	3.8	5.0	6.3	6.4	5.5
Alberta	2.2	1.2	-1.6	0.2	0.7	4.7	6.0	8.1	9.0	8.5
British Columbia	0.6	1.3	2.9	1.2	1.1	6.1	6.1	6.1	6.2	6.1
Canada	0.6	0.9	0.7	0.8	0.7	6.9	6.9	7.0	7.0	6.9
	Housing starts (000)					**Consumer Price Index (% growth)**				
Newfoundland & Labrador	2.1	1.7	1.6	1.5	1.3	1.9	0.4	2.7	2.8	2.0
Prince Edward Island	0.5	0.6	0.6	0.5	0.4	1.6	-0.6	1.3	1.9	2.0
Nova Scotia	3.1	3.8	3.6	3.3	3.1	1.7	0.4	1.2	1.4	1.9
New Brunswick	2.3	2.0	1.8	1.7	1.6	1.5	0.5	2.3	2.2	2.0
Quebec	38.8	37.9	37.7	35.0	35.0	1.4	1.1	0.8	1.4	1.9
Ontario	59.1	70.2	74.5	64.5	60.0	2.3	1.1	1.9	1.8	1.9
Manitoba	6.2	5.5	5.3	5.5	5.3	1.8	1.2	1.4	1.9	2.2
Saskatchewan	8.3	5.1	4.8	5.1	5.0	2.4	1.6	1.3	1.7	2.1
Alberta	40.6	37.3	24.4	24.2	23.7	2.6	1.2	1.3	2.0	2.2
British Columbia	28.4	31.4	42.2	35.0	30.0	1.0	1.1	1.9	2.0	2.0
Canada	189.3	195.5	196.5	176.3	165.4	1.9	1.1	1.5	1.8	2.0

e: estimate f: forecast

Historical data from Statistics Canada and CMHC, National Bank of Canada's forecast.

ECONOMIC OUTLOOK

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