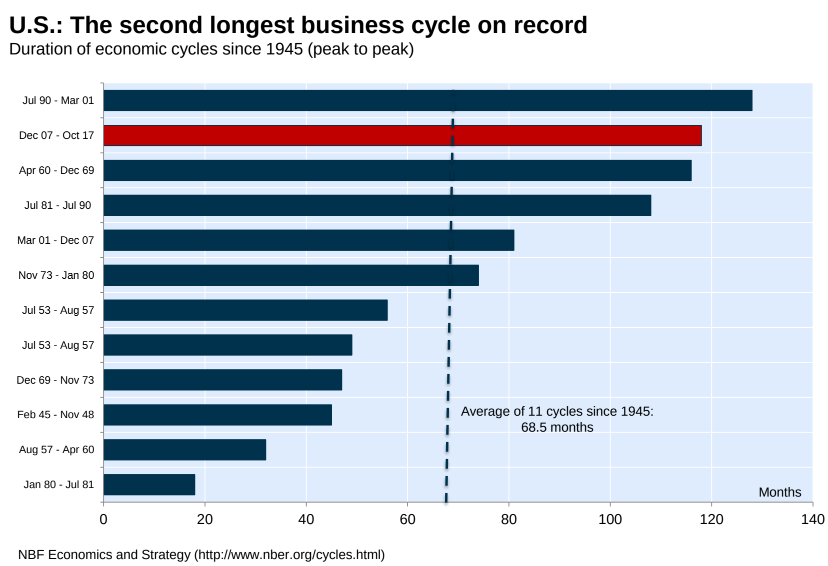
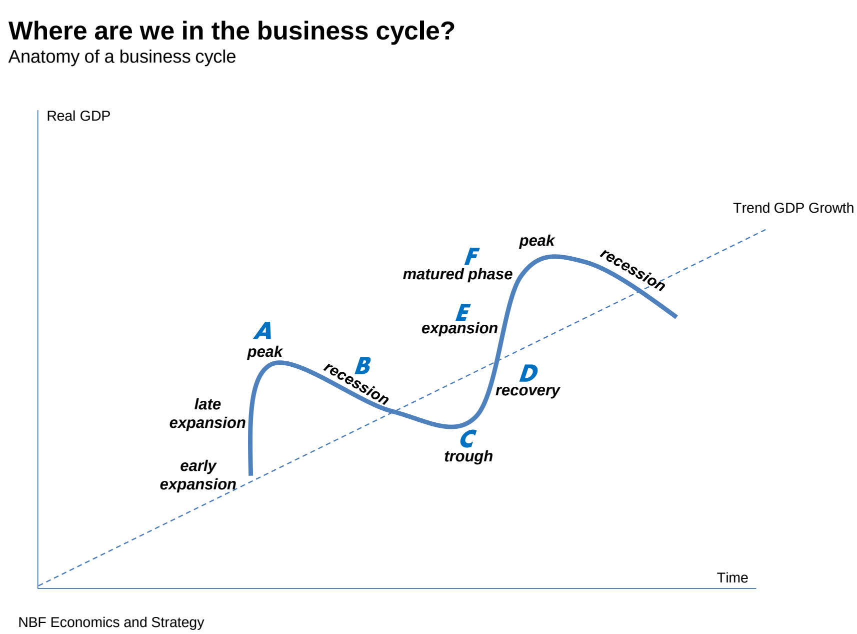
October 30, 2017

U.S.: The second longest cycle on record

U.S. GDP expanded at a robust clip of 3% in Q3 2017. **It's now been 118 months since the previous recession and some market pundits are wary that the next downturn could be just around the corner**. After all, the current business cycle became the second longest ever observed in U.S. history in Q3, exceeded only by that of the 1990s which lasted 128 months (July 1990 to March 2001). According to the NBER, the average length of a business cycle since 1945 is 68.5 months (peak to peak) - chart. So yes, this cycle is getting long in the tooth.

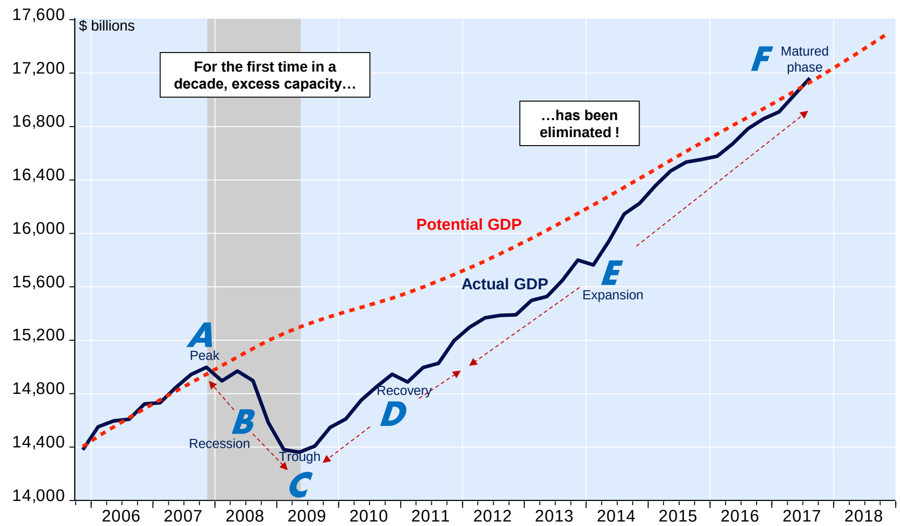


Sill, making a recession call based on duration alone is way too simplistic and prone to error. As the chart below shows, the anatomy of a business cycle is best illustrated as follows: A: The economic peak → B: The recession → C: The economic through → D: The recovery → E: The expansion phase → F: The matured phase of the expansion.



What's critical to keep in mind is that the duration of the different phases can vary widely from one business cycle to another. Even if we acknowledge that the U.S. economy has entered the matured phase of cycle (letter F), we would argue that it has only recently done so. Case in point, the latest U.S. NIPA report revealed that for the first time in a decade, the level of real GDP in Q3 finally surpassed its potential – a development normally associated with the beginning of the matured phase of the cycle. **As shown on the chart below, the current business cycle is characterized by an unusually long recovery (letter D) and a protracted expansion (letter E). The matured phase has only recently begun.** We have shown previously that the average duration of the matured phase of an economic cycle in the U.S. since the early 1960s is 36 months (estimated using the deviation of the unemployment rate from NAIRU).

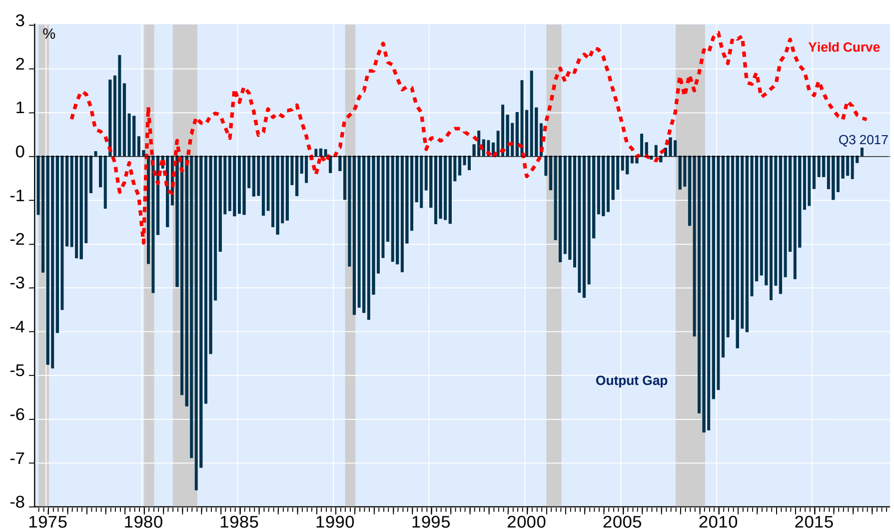
U.S.: GDP exceeds potential for the first time in a decade
Actual vs. potential* real GDP



* As calculated by the Congressional Budget Office (CBO)
NBF Economics and Strategy (data via Datastream)

At this juncture, we take comfort from the fact that the yield curve remains steep despite a positive output gap (chart). We are nowhere near inversion, a powerful signal of an incoming downturn. This bodes well for growth over the coming year. **So unless a policy mistake happens soon, the current business cycle is on track to become the longest on record.**

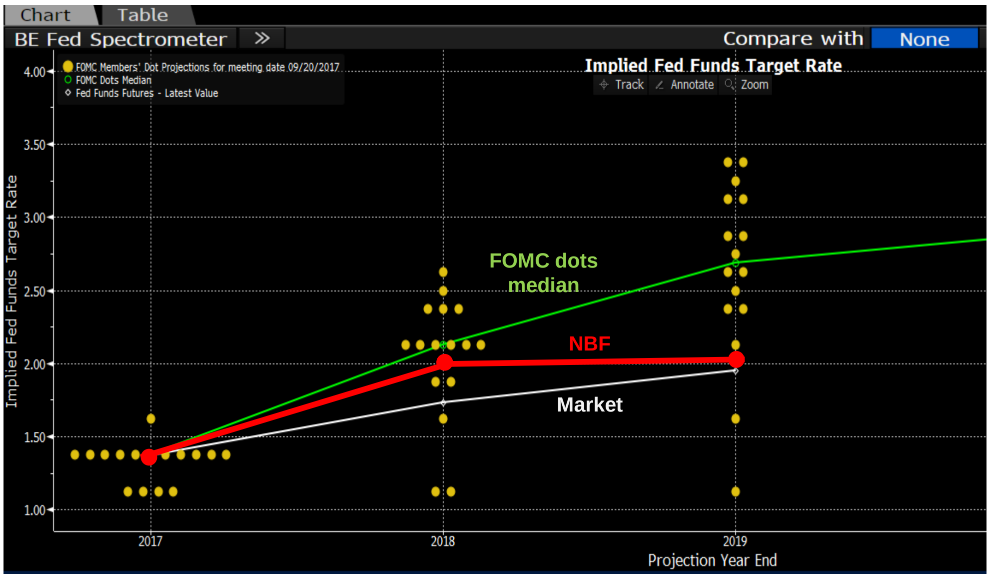
U.S.: Yield curve unusually steep at this point in the cycle
Output gap* vs. yield curve (10-year Treasury yield less 2-year rate)



* Using potential GDP calculated by the Congressional Budget Office (CBO)
NBF Economics and Strategy (data via Datastream)

Of course, the relatively steep curve reflects market expectations that differ from current FOMC guidance when it comes to the amplitude of upcoming rate hikes. At this writing, the market sees the overnight rate being raised about 50 bps between now and next year. That compares Fed guidance of 100 bps when using the median of the FOMC dots and the 75 bps expected by NBF Economics & Strategy (chart).

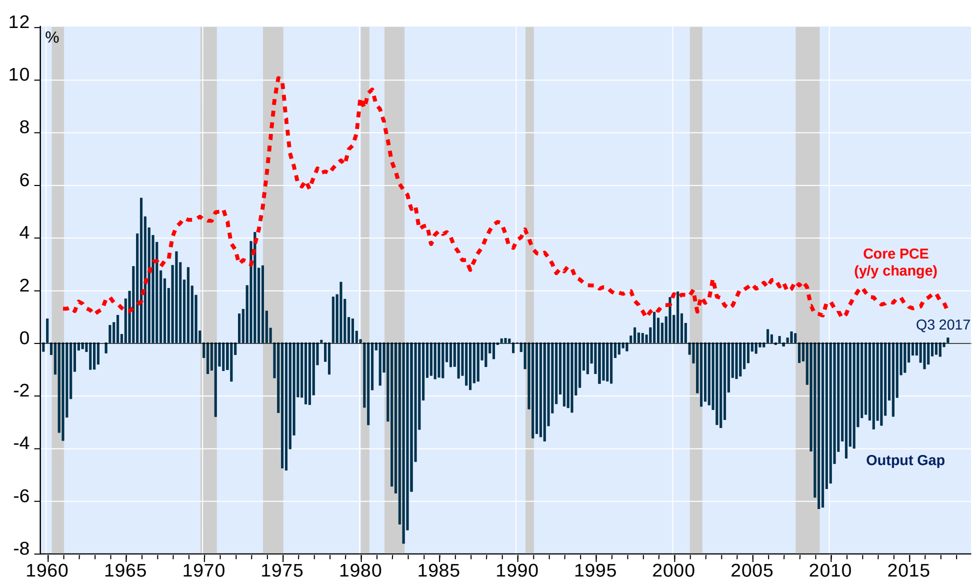
U.S.: Markets and Fed don't see eye-to-eye
Expectations for level of the fed funds rate



NBF Economics and Strategy (data via Bloomberg)

The actual outcome for interest rates will at the end of the day be dictated by inflationary pressures. Though inflation as measured by the core PCE deflator has been extremely tame so far in this business cycle, recall that we have only recently entered the matured phase of the economic cycle, a period normally conducive to higher inflation (chart).

U.S.: Core inflation tends to move higher at this point in the cycle
Core PCE deflator vs. output gap*



* Using potential GDP calculated by the Congressional Budget Office (CBO)
NBF Economics and Strategy (data via Datastream)

Q3 earnings is still very good

We are now more than halfway into the Q3 earnings season and the results continue to come in on the strong side. 74% of companies are beating on the earnings front and 67% are reporting stronger-than expected sales. Earnings so far in Q3 are averaging 8.4% growth vs. 6.3% for sales (table). Recall that at the start of the reporting season, the bottom-up consensus was calling for earnings growth of 4.2% vs. 4.4% for revenues according to Thomson Reuters.

U.S.: Q3 earnings season remains better than expected

Q3 earnings season for the S&P 500 (as of October 27)

95) Actions | 96) Table | 97) Settings | Earnings Analysis

Source Equity Index | Name SPX | Range Current Season | Periodicity Quarter

S&P 500 INDEX | Range CQ3 Ending: 8/16/2017 - 11/15/2017

1) Surprise | 2) Growth

Industry (ICB)	Reported	Sales Growth	Earnings Growth
11) All Securities	273 / 499	6.30%	8.44%
12) > Oil & Gas	16 / 31	16.41%	98.38%
13) > Basic Materials	11 / 18	9.30%	10.54%
14) > Industrials	48 / 81	7.45%	3.23%
15) > Consumer Goods	33 / 59	-3.98%	-0.43%
16) > Health Care	33 / 54	6.04%	7.23%
17) > Consumer Services	29 / 70	9.09%	0.99%
18) > Telecommunications	2 / 3	-0.62%	-1.43%
19) > Utilities	9 / 29	-1.93%	-2.92%
20) > Financials	68 / 103	3.91%	1.40%
21) > Technology	24 / 51	11.33%	28.80%

NBF Economics and Strategy (data via Bloomberg)

Looking ahead, the bottom-up consensus of equity analysts sees earnings growing 11.5% over the next 12-months with positive growth in all sectors but real estate (table).

S&P 500 composite index: EPS Performance

	2016	2017	2018	2019	12 months forward
S&P 500	1.7	10.1	11.8	10.0	11.5
ENERGY	-80.0	336.0	35.8	24.4	49.1
MATERIALS	-7.4	12.3	18.5	10.2	22.2
INDUSTRIALS	2.2	5.8	10.7	10.8	10.0
CONS. DISC.	12.4	5.9	10.3	11.4	9.5
CONS. STAP.	4.2	5.3	7.8	8.0	7.4
HEALTH CARE	8.9	6.7	8.3	9.5	8.0
FINANCIALS	0.9	8.8	14.9	9.8	14.1
IT	5.8	14.0	13.4	9.2	12.9
TELECOM	0.2	-1.1	1.4	0.2	1.0
UTILITIES	5.9	1.3	4.7	5.7	4.1
REAL ESTATE	23.4	-22.7	-1.8	9.6	-6.1

10/27/2017

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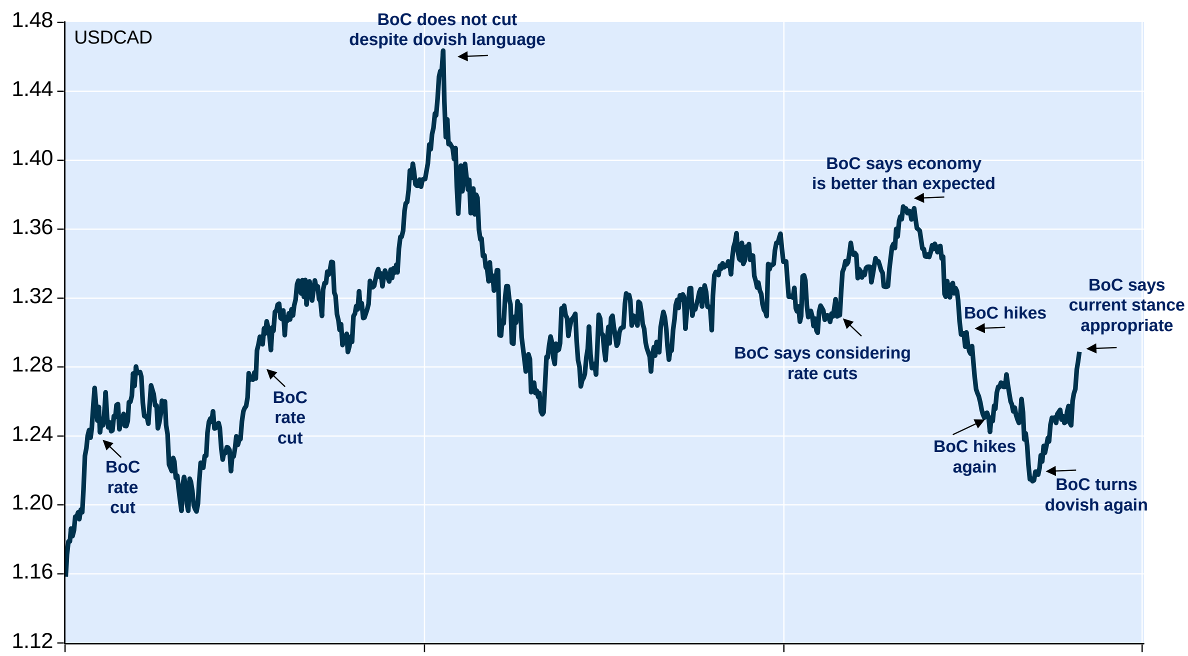
Canada: The BoC opts for dovish tone (again)

The Bank of Canada left its overnight rate at 1.00% last week. **In its updated Monetary Policy Report, the central bank raised its growth forecasts from 2.8% to 3.1% for 2017 and from 2.0% to 2.1% for 2018**. However, uncertainties about geopolitical developments as well as fiscal and trade policies (read NAFTA) remained sources of concern for the Bank**. In its press release, the BoC acknowledged that inflation "has picked up in recent month" and envisaged a return to the 2.0% target in the second half of 2018**. Nevertheless, **Governor Poloz said that, with inflation running below target, "we [the Governing Council] continue to be more preoccupied with the downside risks to inflation".** In doing so, he clearly indicated a bias to delay further rate hikes. **In light of that dovish tone, we have pushed the timing of the next rate hike to January (60% odds), but we still see the overnight rate ending 2018 at 2%.** If we are correctly gauging upcoming fiscal momentum and the impact of the biggest minimum wage increase in 50 years in Ontario, growth and inflation will be stronger than what is currently acknowledged by the Bank of Canada. **So expect another about face from Mr. Poloz in 2018.** The BoC's language had a material impact on the currency again last week but we still see our current trading range of 1.20-1.30 holding for CADUSD.

Canada: BoC induces currency volatility
Canada-U.S. exchange rate



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Stéfane Marion

Morning Comment

NATIONAL BANK OF CANADA FINANCIAL MARKETS

Economics and Strategy

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Marc Pinsonneault
Senior Economist
marc.pinsonneault@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Paul-André Pinsonnault
Senior Fixed Income Economist
paulandre.pinsonnault@nbc.ca

Matthieu Arseneau
Senior Economist
matthieu.arseneau@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Krishen Rangasamy
Senior Economist
krishen.rangasamy@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
MD, Public Sector Research and Strategy
warren.lovely@nbc.ca