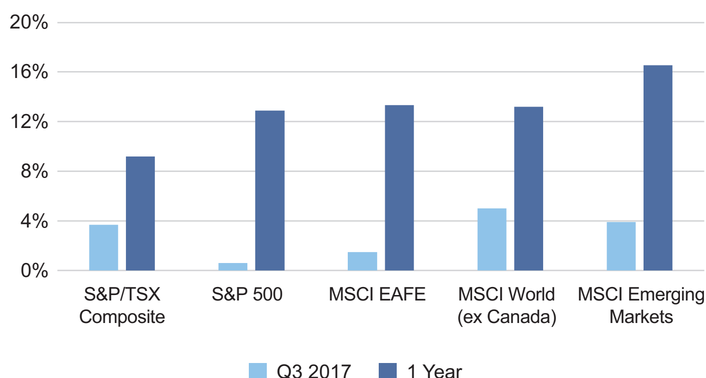
World economic growth became even more broad-based in the quarter as many lagging non-G7 countries experienced some growth spurts. Despite monetary tightening in Canada and the U.S., other major central banks continued to run loose monetary policies which encouraged further growth. Purchasing manager indices in the G7 are at six-year highs, promising continued near-term growth. However, some countries outside Europe, such as the U.S., are most likely in the later portion of the economic expansion cycle.



Source: TD Securities, MSCI

Canada

According to the Bank of Canada's (BoC's) measure of the output gap, there is little to no slack left in the domestic economy. After an exceptionally strong first half of 2017 that saw real GDP growth average 4% annualized, the capacity utilization rate jumped to 85% in the second quarter, the highest in 10 years. This reduced slack bodes well for further investment spending even with the risks surrounding North American Free Trade Agreement (NAFTA) renegotiations.

Another positive has been the continued strength of the labour market. About 375,000 jobs have been created in the last 12 months, and more than half of these jobs are full-time, private-sector jobs. Income gains from a solid labour market coupled with persistent low interest rates have continued to support home prices in spite of tighter borrowing conditions imposed by both the federal and provincial governments. All of this led the BoC to increase the overnight rate twice in the quarter by a total of 50 basis points. While intended to slow credit growth and home prices, these moves helped the Canadian dollar appreciate by over 10% since May, thereby hurting non-energy exporters. With core inflation trending higher, although still below the BoC's target, and the economic outlook still strong, we expect the BoC to raise the overnight rate further in the near future.

The U.S.

The U.S. economy remains healthy, although gains will probably moderate as the expansion matures. Recent leading economic indicators support near-term real GDP growth in the 2% to 2.5% range despite the devastating hurricanes of the last few months. After three interest rate increases in the last year, the U.S. Federal Reserve (the Fed) is maintaining a data-dependent stance on further hikes as inflation still remains below its 2% target. Volatility in the markets remains low even with the political ineffectiveness of the Trump administration, and it is surprising to see the triumph of hope over experience when it comes to the positive market reaction to President Donald Trump's proposed tax cuts.

Europe

The economies of the major European countries continue to expand. The European Central Bank's (ECB's) monthly 60 billion euro bond buying program is reinforcing growth in a zero inflation environment. This monetary stimulation may be tapered somewhat in the coming year depending on the growth and inflation outlook. Politics keep shifting back and forth as evidenced by the coalition upset in the German election, protests over President Emmanuel Macron's policies in France, and the threat of separation from Spain by the Catalonians.

The U.K.

In comparison with other G7 countries, some analysts are calling the U.K. the "sick man" of the economic world due to slowing growth, above-target inflation, a fracturing real estate market, and a less than stable coalition government. Additionally the Bank of England's (BoE's) inflation-fighting efforts are hamstrung by Brexit and a slowing economy. Any monetary tightening could severely damage the economy.

Japan

In Japan, growth increased in the first half of the year, supported by an upturn in public investment and stronger export growth to Asian markets, according to the OECD. Rising corporate profits should help strengthen business investment through 2018, the OECD added. However, overall real GDP is forecast to be 1.6% for 2017 and 1.2% for 2018. The Bank of Japan continues to monetize its enormous debt load via continued quantitative easing, especially targeting the 10-year government bond yield at 0%, yet inflation remains stubbornly low. In addition, the forthcoming election may not be a shoo-in for Prime Minister Shinzo Abe, adding political risk to the outlook.

Emerging Markets

Many emerging market equity markets continued to improve in the third quarter in response to continued economic activity, relative stability in China, a weaker U.S. dollar, and an improvement in commodity prices. This has occurred in spite of several inherent threats. S&P Global lowered the rating of China's debt, which remains investment grade. South Korea is still faced with North Korea's escalating nuclear bomb threats instigated by more U.S. economic sanctions. Among the underperforming emerging market equity indices so far this year, Pakistan stood out as its prime minister resigned in July following allegations of corruption and Donald Trump warned that the U.S. would no longer be silent about safe havens for terrorism. Saudi Arabia and other neighbours blockaded Qatar, accusing the oil-rich nation of supporting terrorism. In South America, Brazil faces a severe recession.

Overall, many emerging market consumers are not showing the same optimism as equity markets, a signal that caution should be the watchword.

Bonds

In a change from last quarter, it was the BoC – not the the Fed – that tightened monetary policy. Globally, however, central banks toned down the more hawkish rhetoric they communicated to financial markets earlier this year, although expectations for action may only be delayed. Though it most likely will be more muted than originally thought, the Fed, the ECB, and the BoE, are all expected to follow through on some form of tighter policy in the near future. Given this outlook, the sustainability of a flattening yield curve may be pressured as central banks, still dealing with mediocre growth and below target inflation rates, could be limited in meaningfully increasing rates further.

Canadian Bond Market Performance

	Third Quarter	1 Year
FTSE TMX Universe Bond Index	-1.84%	-2.97%
FTSE TMX Short Term Bond Index	-0.45%	-0.70%
FTSE TMX Long Term Bond Index	-4.09%	-5.95%
Canadian Federal Bonds	-1.57%	-3.98%
Provincials	-2.52%	-3.97%
Investment Grade Corporate	-1.34%	-0.36%
High Yield Corporate	2.30%	11.30%

Source: FTSE TMX