(Trump × Trade) + Trudeau = Trouble?

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Just last week, we posed the question: Is the honeymoon over? In retrospect, the timing could have been better, as stocks proceeded to reel off their best day of the year and then hit fresh all-time highs today. And who asks that question anyway, with Valentine's Day right around the corner? Still, while stocks continue to rumble, most other financial markets are displaying clear signs of waning enthusiasm for the reflation trade. Treasury yields are chopping about in a relatively narrow range, but they continue to mostly drift lower in the New Year, slipping a bit further on net this week despite a tough 10-year auction. The dollar rebounded slightly this week, but remains well below its peak hit in early January. In a nutshell, while markets are still tantalized by the prospect of new policy measures—witness Thursday's pop in stocks on the promise of "*something phenomenal*" and "*big league*" on taxes—it will require action to generate lasting moves at this stage.

It's no surprise that the dollar is the most reluctant participant in the reflation trade, as Administration officials have expressed concerns about the currency's strength. Notably, the US$ is actually down almost 2% against the Canadian dollar since the election, partly on firming oil prices and partly on a surprising run of upbeat Canadian economic data. That trend was extended today with a sixth consecutive healthy jobs report, replete with 48,300 new jobs and a dip in the unemployment rate to 6.8%. Over the past six months, the economy has added 239,000 new jobs, the best such span since 2002 (a blowout year for job growth). In addition, home building activity remains quite perky, with housing starts holding well north of 200,000 units in the past two months—making a bit of a mockery of those who say supply shortages are the problem behind soaring home prices, but I digress. Finally, merchandise trade reported another surplus of roughly $1 billion in December, ending a long run of deficits.

Normally a return to a trade surplus would be warmly greeted by Ottawa's policymakers, but this is an awkward time to be running surpluses, with the U.S. Administration's laser-like focus on trade imbalances. The good news is that U.S. data this week showed that Canada's surplus with the U.S. was a moderate US$11 billion for all of 2016, and a deficit on services trade would no doubt offset that figure. That rough balance in trade between the two nations will likely figure quite prominently in Prime Minister Trudeau's speaking points in his much-anticipated meeting with President Trump on Monday. While it won't come up, he could also point out that Canada is not exactly "stealing" many manufacturing jobs these days, as factory payrolls are bumping along at record lows and down 20% from just a decade ago in Canada.

There are many that want the PM to talk tough on trade, perhaps amping it up from comments made by Foreign Affairs Minister Freeland this week. But, the cruel reality is that while total trade with Canada accounts for roughly 3% of U.S. GDP, trade with the U.S. accounts for a honking 37% of Canadian GDP; and that's just goods. **The bilateral trade relationship is very important for the U.S., but it's beyond critical for Canada**.

Heading into the **Federal Budget** in the weeks ahead (date to be determined), we are fielding plenty of questions on the possibility of a change in the 50% inclusion rate on capital gains taxes. Certainly not wanting to fuel unnecessary speculation on that front, but it is a popular question/concern this year, as it was in 2016. We have no specific indication or information that Ottawa is seriously considering such a change (i.e. an increase), other than to note that Finance is casting about for revenues, they are taking a long look at all so-called tax expenditures, and this government seems to have few qualms about taxing the "rich". (As an aside, it's interesting that current policymakers are suddenly concerned about raising revenues when at first they had little apparent concern about letting the deficit fly from almost nothing to more than $25 billion in the space of a year. Apparently, deficits do matter after all, but that's a discussion for another day.)

Our few words of advice to Finance on this item would be as follows: Don't do it.

There are at least **three reasons why capital gains rates should be relatively low**. One is the practical matter that a lower rate reflects the fact that many capital gains over time simply reflect an inflation component, which shouldn't be taxed. Second, and much more importantly is the fact that capital gains are taxed on a one-way street; that is, investors can't claim capital losses (aside from offsetting future capital gains), and are thus taking all the risk. That's a sweet deal for governments, as heads (the investment goes up) they win, tails (the investment goes down) you lose. Thus the tax collector becomes like the New England Patriots of investors—they never seem to lose. Third, and perhaps most important, a less unfavourable tax rate on capital gains is meant to encourage investment, which then hopefully spawns innovation and growth. We cannot simultaneously crank personal marginal tax rates to some of the highest levels in the world and look to crank up investment taxes as well on the one side, and then wring our hands in anguish and wonder why we suffer from a lack of entrepreneurialism and innovation on the other side.