BMO CAPITAL MARKETS ECONOMICS

Focus

A weekly financial digest

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January 11, 2019

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BoC on Hold amid Slower Growth

Fed Chair Powell Signals Patience

China/U.S. Trade Tensions Ease

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Forecast changes:

- **Two rate hikes in 2019 delayed for both Fed (May-Sep to Jun-Dec) and Bank of Canada (Apr-Oct to Jul-Dec)**
- **No rate hikes in 2020 (one for both before)**

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Passive Prices Prod Powell Pause

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In light of more dovish talk from policymakers and the Minutes of the December FOMC meeting, **we have both delayed and reduced the amount of expected rate hikes by the Federal Reserve. We now see increases in June and December**—one to three months later than previously thought—and no longer expect a final move next year (the market is currently pricing in only a fraction of one hike in 2019). Policy rates should merely approach, rather than exceed, the neutral rate, which the majority of the FOMC judges is within a quarter-point range of 2.75%. This implies somewhat less recession risk. The 10-year Treasury rate will likely drift only modestly higher to 3.0% by year-end from 2.7% recently.

It is because inflation is *"low and under control"* that Chair Powell can state, *"we're in a place where we can be patient and flexible"*, despite a *"very strong"* labour market (payrolls ballooned 2.6 million in 2018, the third best year this cycle). Recall, in an earlier speech, he said inflation is coming in a little below target and expectations (core PCE inflation was 1.9% in November). The patience mantra was echoed by virtually every other Fed speaker this week, even those with more hawkish leanings.

True to form, **the December CPI report capped a year of fairly benign inflation**. The headline rate ended the year at 1.9%, two-tenths below where it started and just a snick above the eight-year mean. While higher gasoline prices initially pushed the rate to a six-year high of 2.9% by mid-year, the late-year correction yanked it lower. Excluding fuel costs, and a modest 1.6% increase in food prices, the core rate ended the year at 2.2%, four-tenths above where it started and three-tenths above the eight-year norm. So, the underlying inflation trend did pick up in the face of tighter labour markets and higher wages, with some lift from tariffs (though the effect was largely neutered by the dollar's appreciation). Still, it rose only modestly and with little momentum as the shorter-term core metrics (3- and 6 months) held close to 2.0%.

Inflation is being held down by three long-run forces: anchored expectations (which Powell says is a *"key"* influence), **e-commerce** and **automation**. Five-year forward inflation rates (implied from TIPS) have hovered near 2% in the past two years, suggesting investors believe the Fed will do what it takes to keep inflation close to target. Indeed, core CPI inflation has averaged 1.9% in the past six years with a symmetrical 1.6% to 2.4% range around the target. Meantime, the holiday shopping season highlighted another year of fierce online competition (to the chagrin of Macy's investors). One-in-ten retail dollars are now spent online, double the share six years ago. The use of robots and AI systems is also rising, promising to deliver goods at even lower cost (and faster), while dissuading many workers from seeking salary increases.

Whether these three forces can continue to contain wage pressures will determine the inflation outlook. Provided the economy slows toward potential in the next year, core CPI inflation should average just 2.3% this year, before returning to target by late next year (we also assume some convergence between the core CPI and core PCE). This is the stuff of Fed patience rather than aggression, allowing it to carefully fine-tune its policy settings without tipping the economy into recession.

Sal

Poloz Preaching Patience

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The Bank of Canada did what was expected this week, keeping policy rates steady and sounding more cautious while maintaining a desire to get to neutral, even if at a slower pace. The **outlook for this year was heavily downgraded**, with real GDP slashed 0.4 ppts to 1.7%, more or less in line with our call for 1.8%. The oil production cuts hit growth hard, with 2018Q4 and 2019Q1 to average about 1%, modestly below our forecast. Expectations for much weaker growth through the early part of this year set the Bank up nicely for a pause of at least a few months.

While oil was a major theme in the policy statement, housing and household debt were more prominent during Governor Poloz's press conference. It looks as though the **persistent softness in the housing market has increased concern at the BoC**. Indeed, debt service ratios have risen close to their prior peak (hit in 2007Q4), suggesting that households are under increasing pressure from rising interest rates. Fortunately, the huge rally in Government of Canada bonds over the past couple of months should limit any further increases in mortgage rates (and perhaps even bring term mortgage rates down if current levels are sustained). Meantime, we'll get the final home sales figures for 2018 next week and they aren't likely to be pretty (see Key for Next Week). The question for the BoC is whether the market stabilizes, which we've seen some signs of in select markets. It's clear that policymakers are watching housing closely.

The sharp downgrade in the BoC's outlook and generally more cautious tone have prompted a modest change to our rate forecast. **We continue to see two rate hikes this year, but have pushed back the timing to July and December** (from April and October previously), as the Bank likely won't have sufficient information to have confidence that the rest of the economy has weathered the oil shock until closer to mid-year. And, with Governor Poloz highlighting uncertainty around neutral and the inability of long-term rates to push higher, we've taken the 2020 hike out of the forecast, leaving the peak in policy rates at 2.25%, a bit below the BoC's neutral range.

Key Takeaway: Canada is dealing with slowing global growth, lower oil prices and production cuts, a slowing housing market, and downside risks from the U.S.-China trade war. That's more than enough reason for the BoC to be more cautious through the first half of the year, and to further delay the next rate hike. *B.A.A.R.*

Brexit Vote... Yea or Nay?

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Yes, **the U.K. Parliament will hold its vote on PM May's Brexit deal on January 15**, for real this time. The vote was postponed last month to buy the PM some time to convince lawmakers to back the deal she made with the EU, but I don't think the result will be any different. The majority won't pass the deal as is, but it will be interesting to see how wide the margin will be. Perhaps the fear of the unknown ("Operation Brock" didn't help) will push more members of parliament to support her. A couple of major Brexit supporters seemed to throw in the towel on Friday, saying that they now believe that Brexit will not actually happen. The billion dollar question is: **What happens next?** There are many, many possibilities. But

Mrs. May will have exactly three days to return to Parliament with her Plan B, as she is legally unable to wash her hands of the situation if/when she loses the vote. To make things more interesting, Labour Leader Jeremy Corbyn has said that, when the time is right, he will call for a no confidence vote against the government. Moreover, when he wins, he will return to negotiate a better deal with Brussels, but will need to extend Article 50 in the process. Did he ask the EU if they were agreeable to that? Last I heard, PM May's deal was the deal. We've had 2½ years of this. No more changes. (I'm paraphrasing.) Also bear in mind that, even if there was a deal, a 21-month transition period would begin, but there's still no guarantee that both sides could agree to a future trade arrangement over that time period. Then, we would return to the present-day uncertainty.

Don't expect this issue to be over next week. There will be more to'ing and fro'ing, and we will likely see PM May return to Brussels to make some tweaks, then return to London to share it with her colleagues, then go back to Brussels, and so on. But that will require a new exit date, beyond March 29th. Even Austria's Kurz is on board with that, saying that a hard Brexit was in no one's best interest. That is true. But everyone has their own idea of what their 'best interests' are. JLee

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Region	Good News	Bad News
Canada ▪ BoC on hold as temporary factors expected to slow growth ▪ WTI-WCS spread narrows ▪ C$ firms as oil prices gain	**Building Permits** +2.6% (Nov.) **Ivey PMI** +2.5 pts to 59.7 (Dec.)	**Merchandise Trade Deficit** widened sharply to $2.1 bln (Nov.) **Housing Starts** -4.9% to 213,419 a.r. (Dec.) —but solid 2018 **New Housing Price Index** unch (Nov.) **Conference Board Consumer Confidence Index** -11.2 pts to 103.0 (Dec.)—two-year low
United States ▪ First round of talks with China makes progress ▪ Fed Chair Powell signals no rush to hike rates ▪ Day 21 of partial government shutdown ties the longest on record	**Consumer Prices** +1.9% y/y (Dec.) **Consumer Credit** +$22.1 bln (Nov.) **Initial Claims** -17k to 216k (week of Jan. 5)	**Non-manufacturing ISM** -3.1 pts to 57.6 (Dec.) **NFIB Small Business Optimism Index** -0.4 pts to 104.4 (Dec.)—lowest since Oct. '17 **Job Openings** fell to 6,888k (Nov.)
Japan ▪ BoJ Gov. Kuroda maintains *"economy is expanding moderately"*	**Bank Lending Ex-Trusts** +2.5% y/y (Dec.)	**Household Spending** -0.6% y/y (Nov.) **Current Account Surplus** narrowed to ¥757.2 bln (Nov. P) **Services PMI** -1.3 pts to 51.0; **Composite PMI** -0.4 pts to 52.0 (Dec.) **Consumer Confidence** -0.2 pts to 42.7 (Dec.)
Europe ▪ Temporary factors likely to shrink Germany's Q4 GDP ▪ PM May looks for a "Plan B" ahead of key Brexit vote… ▪ …as chatter of no-confidence motion resurfaces	**Euro Area—Retail Sales** +0.6% (Nov.) **Euro Area—Jobless Rate** -0.1 ppts to 7.9% (Nov.) **Germany—Retail Sales** +1.4% (Nov.) **Germany—Trade Surplus** widened to €19.0 bln (Nov.) **France—Jobless Rate** steady at 8.9% (Nov. P) **Italy—Retail Sales** +0.7% (Nov.) **Italy—Jobless Rate** -0.1 ppts to 10.5% (Nov. P) **U.K.—Index of Services** +0.3% (3 mths to Nov.)	**Euro Area—Economic Confidence** -2.2 pts to 107.3 (Dec.) **Germany—Industrial Production** -1.9% (Nov.) **Germany—Factory Orders** -1.0% (Nov.) **France—Industrial Production** -1.3% (Nov.) **France—Trade Deficit** widened to €5.1 bln (Nov.) **France—Consumer Confidence** -4 pts to 87 (Dec.) —one-year low **Italy—Industrial Production** -1.6% (Nov.) **U.K.—Real GDP** eased to +0.3% (3 mths to Nov.) **U.K.—Industrial Production** -0.4% (Nov.) **U.K.—Trade Deficit** widened to £12.0 bln (Nov.)
Other ▪ China agrees to import a *"substantial amount"* of U.S. goods and… ▪ …Vice Premier Liu He to continue talks in the U.S. at month-end	**China—Foreign Reserves** edged up to $3.07 trln (Dec.)—but down in 2018 **Australia—Retail Sales** +0.4% (Nov.)	**China—Consumer Prices** +1.9% y/y; **Producer Prices** +0.9% y/y (Dec.)—eased sharply **Australia—Building Approvals** -9.1% (Nov.) **Australia—Trade Surplus** narrowed to A$1.9 bln (Nov.)

Indications of stronger growth and a move toward price stability are good news for the economy.

Recession Obsession

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Google searches on "recession" surged in December to their loftiest level since 2011 (amid the European debt crisis). This was not surprising. The 9.2% plummet in the S&P 500 was the worst for any December since 1931. Meanwhile, the yield curve continued flattening. The spread between the 10- and 2-year nodes averaged just 15 bps for the month, the smallest since 2007 (ahead of the Great Recession), which was the last time the yield curve inverted. Historically, large stock price declines and yield curve inversions have corresponded with recessions, hence the surge in searches. Below, we take a look at how well these two market signals have done in predicting recessions.

Stock Prices

During the recent market rout, the S&P 500 at one point fell 19.8% from its September high, precariously close to what most consider "official" bear market territory (but the 20% mark is somewhat arbitrary). Since the 1950s, there have been nine bear markets, and seven were associated with recessions (*Table 1*). If we lower the bar a notch to at least a 19% decline, there have been 14 such occurrences including 2018's, and eight were associated with recessions… to paraphrase Nobel Laureate Paul Samuelson's famous quip, "the stock market has predicted 13 of the past eight recessions". Since the mid-1950s, all nine recessions aside from 1960, have corresponded with at least a 17% drop in the stock market; but, again, there have been six false positives (stock market drop, but no recession) including, most recently, during 2011 and 1998.

The S&P 500 has peaked ahead of recessions in almost every instance (1980's peak was more contemporaneous). The average lead time was 6-to-7 months, stretching out as far as 12-to-14 months. The latter reflects the stronger technology-inspired bull markets of the 1960s and 1990s (the cycles that most closely resemble the current one). While peak-to-trough declines have averaged about 30%, stocks have typically only fallen about 10% by the time the economic downturn actually started. At any rate, the action in the stock market since September seems at least negative enough to signal a risk of recession, but doesn't alone provide sufficient evidence.

Table 1

Stock Market Selloffs and Recessions

Recession Start (expansion end)	S&P 500 Peak Lead Time (months)	Peak-to-Recession (%)	Peak-to-Trough (%)
07/1953	6.9	-7.3	-14.9
08/1957	1.6	-8.0	-20.7
04/1960	9.0	-10.4	-13.9
12/1969	13.2	-15.1	-36.1
11/1973	10.8	-20.2	-48.2
01/1980	-0.4	-3.6	-17.1
07/1981	8.2	-6.8	-27.1
07/1990	0.5	-3.5	-21.7
03/2001	12.4	-24.0	-49.1
12/2007	2.8	-5.6	-56.5
Mean	**6.5**	**-10.5**	**-30.5**
Median	**7.5**	**-7.6**	**-24.4**
High	**13.2**	**-24.0**	**-56.5**
Low	**-0.4**	**-3.5**	**-13.9**

Assumes expansion ends on last day of last non-recession month
Sources: BMO Economics, Haver Analytics

Consider how the market got here. Equity valuations were clearly stretched by almost any measure heading into 2018, with the market giddy on the prospect of corporate-tax-cut-led fiscal stimulus at a time of zero real policy rates. At the same time, earnings growth was accelerating, and speculative activity (think Bitcoin) was picking up. As the prospect of 2019 conditions came into view, including more trend-like growth in GDP and earnings, and near-neutral policy rates, equities were at clear risk of correction. Although the recent correction was large, it is likely to be a false signal concerning recession. As mentioned above, stocks fell 19.4% in 2011 and 19.3% in 1998. Both turned out to be false positive signals, and were followed by subsequent rallies to new highs. The 1998 case is especially fitting given that it was late in the cycle, the

market had just come off a big tech-inspired run, and external factors led the Fed to pause its tightening campaign (actually cut rates three times).

As an aside, the relentless strength in corporate profits has been one of the factors bucking typical late-cycle behaviour seen across the equity spectrum, but the picture isn't as strong below the surface. In Q3, headline corporate profits were up a hefty 19.6% y/y (after tax and with CCA adjustment). But, that picks up tax relief and accelerated depreciation allowances. Before tax and ex-CCA, profit growth was flat in the quarter, and is actually down from the 2014Q3 high. From another perspective, headline profits as a share of GDP have turned higher (counter to what you'd see late in the cycle), but that's not the case after stripping out stimulus effects. In fact, the latter looks very consistent with what you'd expect at this late-cycle stage (*Chart 1*). All factors considered, the equity market backdrop seems to have fulfilled the necessary conditions for recession starting sometime later this year (or early next year at the latest), but is it sufficient? Given the spotty track record, we look to the other indicators for confirmation.

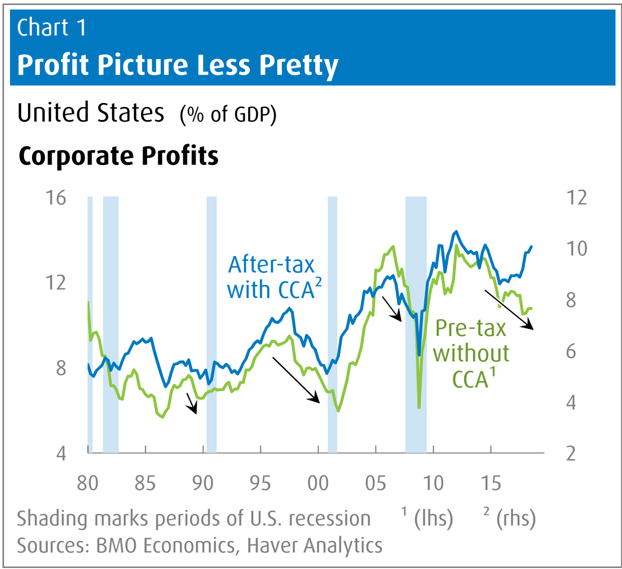
Yield Curve

The yield curve has a better track record than stock prices in predicting recessions (*Chart 2*). For example, the spread between 10- and 2-year Treasury yields (the market's most-followed slope metric) has turned—persistently—negative before each of the past five recessions (persistent meaning negative on a monthly average basis). On average, the inversion begins some 17-to-18 months before a recession begins (*Table 2*). Apart from the briefest and near-smallest possible inversion (just one month averaging -2 bps in June 1998), there has never been a false positive in the past 40 years… i.e., an inversion but no recession within 1-to-2 years.

However, 2-year notes only started being issued in 1976, so either the 3-month T-bill rate or the fed funds (overnight) rate is typically paired with the 10-year note yield. For example, the NY and Cleveland Fed's recession probability models include the 3-month rate whereas the Conference Board's Leading Index includes the fed funds rate.[1] The yield curve (employing bond-equivalent 3-month rates) did not invert ahead of the 1957-58 and 1960-61 recessions (false negatives). Interestingly, it also didn't invert in 1998 (it did for five scattered days during September and October, but not enough to turn the monthly or even weekly averages negative). However, it did invert in 1966 without an ensuing recession (false

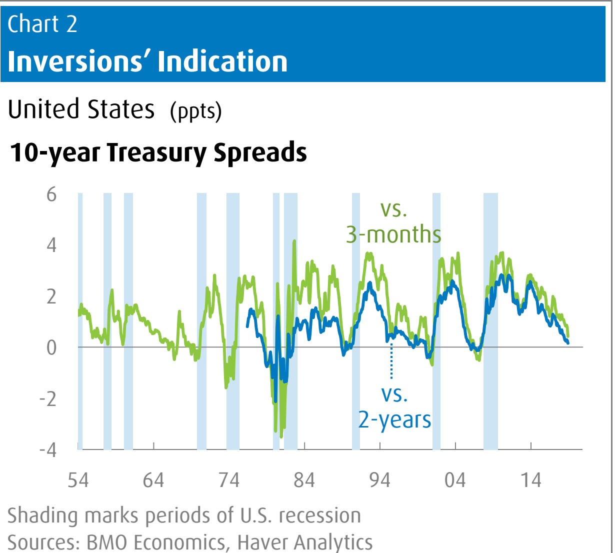
[1] The New York Fed model, based on monthly averages, pegged the one-year odds of recession at 21% in December. The Cleveland Fed model, based on the mid-month weekly average, pegged the one-year odds of recession at 24% as at December 14. Both odds should be marked a bit higher in January.

Chart 1
Profit Picture Less Pretty



Shading marks periods of U.S. recession ¹ (lhs) ² (rhs)
Sources: BMO Economics, Haver Analytics

Chart 2
Inversions' Indication



Shading marks periods of U.S. recession
Sources: BMO Economics, Haver Analytics

Table 2
Yield Curve Inversions and Recessions

	10-yr less 2-yr		10-yr less 3-mo	
Recession Start (expansion end)	Inversion?	Months to recession	Inversion?	Months to recession
08/1957			No	
04/1960			No	
12/1969			Yes	14
11/1973			Yes	7
01/1980	Yes	18	Yes	16
07/1981	Yes	12	Yes	11
07/1990	Yes	20	Yes	15
03/2001	Yes	15	Yes	10
12/2007	Yes	24	Yes	18
Mean		**17.8**		**13.0**
Median		**18.0**		**14.0**
High		**24**		**18**
Low		**15**		**7**

Sources: BMO Economics, Haver Analytics

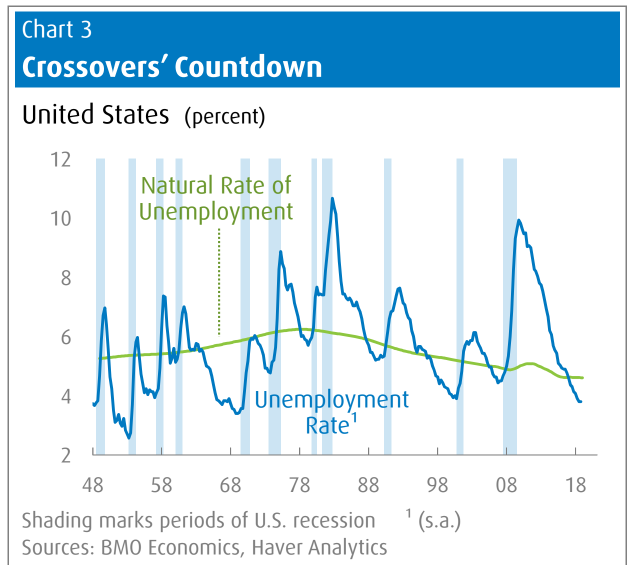
positive). With three sets of false signals recorded, the yield curve's recession-forecasting ability is clearly not fool-proof. But, to its credit, the full curve has correctly flagged the past seven recessions since the 1969-70 contraction with no false signals, and an average lead time of 13 months.

Note that since the Great Recession, the yield curve has become inherently flatter than in past cycles, potentially making it prone to more false positives (inversions without recessions) and weakening its recession-signalling power. There are three key reasons why the curve has become flatter.

First, the neutral policy rate has fallen sharply in recent years, mostly due to demographics (we're getting older and retiring) and productivity (it's gotten slower). When the FOMC first began publishing its longer-run projections for the neutral rate in late 2012, the median was 4.25% (in line with historic norms). The latest projection was 2.75%, down 150 bps. Second, smaller inflation risk premiums are embedded in longer-run inflation expectations today. This reflects the Fed's adoption of a formal 2% inflation target in January 2012 and the fact that core PCE inflation has not been north of 1.9% since April 2012. Third, the Fed has purposely flattened the yield curve. Through three rounds of quantitative easing (QE) as well as "Operation Twist", it amassed $2.5 trillion of Treasuries with a skew to longer-term maturities. While the Fed began paring its Treasury portfolio in October 2017 (by $243 billion so far), the remaining holdings should still exert some flattening influence (augmented by other central banks' QE and massive portfolios).

Chart 3

Crossovers' Countdown



Shading marks periods of U.S. recession [1] (s.a.)
Sources: BMO Economics, Haver Analytics

Table 3

Natural Rate Crossovers and Recessions

Recession Start (expansion end)	Crossover?	Quarters ahead
07/1953	Yes	12
08/1957	Yes	11
04/1960	Yes	5
12/1969	Yes	26
11/1973	Yes	9
01/1980	Yes	14
07/1981	Yes	8
07/1990	Yes	12
03/2001	Yes	19
12/2007	Yes	8
Mean		**12.4**
Median		**11.5**
High		**26**
Low		**5**

Sources: BMO Economics, Haver Analytics

Natural Rate Crossover

We also take a look at a third economic omen. The juncture at which the unemployment rate falls below the natural rate (what we call the "natural rate crossover") is a compelling recession predictor (*Chart 3*). Looking at the past 10 recessions, the crossover occurs an average of 12-to-13 quarters before the onset of recession (*Table 3*). The relatively long lead time (compared to stock prices or the yield curve) reflects the time it takes for ebbing labour market and broader economic slack (a diminishing output gap) and, eventually, a mounting positive output gap, to stoke the inflation process. And, also, the time it takes for Fed policy tightening to reach a point that causes recession. (Note that the difference between the current and natural unemployment rates tracks the output gap quite closely.)

For the current cycle, the natural rate crossover occurred in 2017Q1, pointing to a potential recession in 2020H1 if the average lead time holds. Interestingly, although the yield curve is not yet inverted (persistently), if it were to happen in the immediate months ahead, and the average lead time here holds, this, too, would point to a potential recession in 2020H1. For the stock market's signal to make this a trifecta, September's peak would have to be surpassed this year. The Fed's action this year might again determine the expansion's fate.

Economic Forecast Summary for January 11, 2019

BMO Capital Markets Economic Research

	2018				2019				Annual		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2017	2018	2019
CANADA											
Real GDP (q/q % chng : a.r.)	1.7	2.9	2.0	1.5	1.0	2.5	2.2	1.9	3.0	2.1	1.8
Consumer Price Index (y/y % chng)	2.1	2.3	2.7	1.9	1.4	1.7	1.6	2.0	1.6	2.2	1.7
Unemployment Rate (percent)	5.8	5.9	5.9	5.7	5.6	5.7	5.7	5.7	6.3	5.8	5.7
Housing Starts (000s : a.r.)	224	218	197	217	210	207	204	200	220	214	205
Current Account Balance ($blns : a.r.)	-69.3	-66.7	-41.4	-55.7 ↑	-55.3 ↑	-55.7 ↑	-57.0 ↑	-57.9 ↑	-60.1	-58.3 ↑	-56.5 ↑
Interest Rates	(average for the quarter : %)										
Overnight Rate	1.25	1.25	1.50	1.75	1.75	1.75 ↓	2.00	2.08 ↓	0.71	1.44	1.90 ↓
3-month Treasury Bill	1.14	1.21	1.47	1.66	1.65 ↓	1.70 ↓	1.90 ↓	2.05 ↓	0.69	1.37	1.85 ↓
10-year Bond	2.24	2.28	2.28	2.32	2.00 ↑	2.05	2.15 ↓	2.20 ↓	1.78	2.28	2.10
Canada-U.S. Interest Rate Spreads	(average for the quarter : bps)										
90-day	-44	-66	-61	-70	-81 ↓	-91 ↓	-83 ↑	-83 ↑	-26	-60	-85 ↓
10-year	-52	-64	-65	-72	-75 ↓	-74 ↓	-74 ↓	-73 ↓	-55	-63	-74 ↓
UNITED STATES											
Real GDP (q/q % chng : a.r.)	2.2	4.2	3.4	2.6	1.9	2.4	2.0	1.9	2.2	2.9	2.4
Consumer Price Index (y/y % chng)	2.3	2.6	2.6	2.2	1.8	2.0	2.0	2.1	2.1	2.4	2.0
Unemployment Rate (percent)	4.1	3.9	3.8	3.8	3.7	3.6	3.5	3.5	4.4	3.9	3.6
Housing Starts (mlns : a.r.)	1.32	1.26	1.23	1.24	1.26	1.24	1.23	1.21	1.21	1.26	1.24
Current Account Balance ($blns : a.r.)	-487	-405	-499	-509	-535	-547	-563	-573	-449	-475	-555
Interest Rates	(average for the quarter : %)										
Fed Funds Target Rate	1.46	1.71	1.96	2.21	2.38	2.46 ↓	2.63 ↓	2.71 ↓	1.00	1.83	2.54 ↓
3-month Treasury Bill	1.58	1.87	2.08	2.36	2.45	2.65	2.70 ↓	2.90 ↓	0.95	1.97	2.65 ↓
10-year Note	2.76	2.92	2.93	3.03	2.75 ↑	2.80	2.90	2.95 ↓	2.33	2.91	2.85
EXCHANGE RATES	(average for the quarter)										
US¢/C$	79.1	77.5	76.5	75.7	75.1 ↑	75.2 ↑	75.3 ↑	75.4 ↑	77.1	77.2	75.2 ↑
C$/US$	1.27	1.29	1.31	1.32	1.33 ↓	1.33 ↓	1.33 ↓	1.33 ↓	1.30	1.30	1.33 ↓
¥/US$	108	109	112	113	109 ↓	109 ↓	110 ↓	110	112	110	110 ↓
US$/Euro	1.23	1.19	1.16	1.14	1.14	1.15 ↑	1.16 ↑	1.17 ↑	1.13	1.18	1.15 ↑
US$/£	1.39	1.36	1.30	1.29	1.24	1.23	1.26	1.29	1.29	1.34	1.26

Blocked areas represent BMO Capital Markets forecasts

Up and down arrows indicate changes to the forecast ↑↓ Spreads may differ due to rounding

Canada

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Existing Home Sales, MLS Home Price Index

Tuesday, 9:00 am (expected)

	Existing Home Sales	Average Prices
Dec. (e)	**-16.0% y/y**	**-4.0% y/y**
Nov.	-12.6% y/y	-2.9% y/y
	MLS Home Price Index	
Dec. (e)	**+2.0% y/y**	
Nov.	+2.0% y/y	

December home sales are going to look ugly compared to a year ago, as buyers rushed to beat new mortgage rules in the late stages of 2017. We're looking for sales to be down 16% y/y in the month, which would conclude a very challenging year for housing. For all of 2018, our call would leave sales down about 11%, the weakest since 2008. Unfortunately, 2019 isn't likely to see much of a bounce, though sales should be generally steady instead of the sharp pullback seen last year. Indeed, the big declines in the year-over-year pace of sales should largely reverse by the end of 2019Q1. Despite the expected chunky year-over-year decline in December, sales still look to be up decently on a seasonally-adjusted basis from the prior month. Regionally, Vancouver and the surrounding regions continue to be the softest markets in the country. The Prairies remain under pressure as well, with lower oil prices a renewed weight on confidence. And, Toronto sales slumped over 20% y/y, but that market showed signs of stabilizing in the back half of the year. Accompanying the drop in sales, average prices look to fall 4% y/y. However, the quality-adjusted MLS HPI is expected to be steady at up 2.0% y/y.

Consumer Price Index

Friday, 8:30 am

Dec. (e)	**-0.3% (+0.1% sa)**	**+1.8% y/y**
Consensus	*-0.3%*	*+1.7% y/y*
Nov.	-0.4%	+1.7% y/y

Core CPI Measures (% y/y)

	Trimmed Mean	Weighted Median	Common Comp.
Dec.			
Nov.	+1.9%	+1.9%	+1.9%

Consumer prices likely dropped for the fourth time in five months, with headline prices pulling back 0.3%. Gasoline prices were down heavily again, alone carving a couple of ticks from the headline. December is seasonally the weakest month of the year, with prices falling 0.4% on average over the past five years. However, changes in the airfare category in March 2018 prompted a drastic shift in seasonal patterns to what seems more consistent with anecdotal evidence (e.g., prices are significantly higher at Christmas time and March break). Note that the prior seasonal pattern had very subdued moves over the course of the year, and the larger moves have been a meaningful swing factor for overall CPI. Accordingly, the seasonally adjusted CPI looks to be up 0.1%. Other notable factors include mortgage interest costs, which should be strong again but might have limited further upside if mortgage rates start to pull back in line with the recent rally in bonds. Our call for the CPI would lift annual inflation a tick to 1.8% y/y (though just barely).

The Bank of Canada's core CPI measures have hovered around 2% since February, consistent with the target. We're looking for them to hold steady in December, with the risks tilted to the downside as core prices have been trending a bit soft in recent months.

United States

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Retail Sales

Wednesday, 8:30 am
(This report will likely be delayed by the government shutdown)

		Ex. Autos
Dec. (e)	**unch**	**unch**
Consensus	*+0.2%*	*+0.1%*
Nov.	+0.2%	+0.2%
	Ex. Autos/Gas	
Dec. (e)	**+0.4%**	
Consensus	*+0.4%*	
Nov.	+0.5%	

Sliding gas station receipts will gouge retail sales in December, masking an otherwise merry holiday shopping season, according to chain-store receipts and credit-card data. New auto sales also held to the fast lane, cruising above the full-year tally of 17.2 million. While total retail sales were likely unchanged in December, sales excluding autos and gas stations likely rose a solid 0.4% following an even larger gain in November. With investment and exports downshifting, households are now in the driver's seat of the expansion. Consumer spending growth likely topped 3% (annualized) for a third straight quarter in Q4. Lower gas prices and firmer wages are providing fuel amid fading support from tax cuts and equity wealth.

Beige Book
Wednesday, 2:00 pm

Prepared for the January 29-30 FOMC meeting, the Fed's regional report should reflect some moderation in economic activity, while underscoring concerns about trade protectionism and labour shortages. Recent reports indicate businesses are trying to pass cost increases to consumers, though prices largely remain in check. This should reinforce the Fed's patience.

Housing Starts
Thursday, 8:30 am
(This report will likely be delayed by the government shutdown)

Dec. (e)	**1.250 mln a.r. (-0.5%)**
Consensus	*1.253 mln a.r. (-0.2%)*
Nov.	1.256 mln a.r. (+3.2%)

The second largest two-month drop in homebuilder confidence on record and fewer new home sales suggest housing starts retreated in December after a hurricane-related bounce in November. An expected 0.5% decline to 1.25 million units (annualized) would put starts below last year's average, though the latter (1.264 million) would still be the best annual rate since the housing bust. Residential construction likely slowed GDP for a fourth straight quarter in Q4, though lower mortgage rates (30-year down 50 bps since mid-November) should stem the losing streak in Q1.

Industrial Production
Friday, 9:15 am

	Industrial Production	Capacity Utilization
Dec. (e)	**+0.1%**	**78.4%**
Consensus	*+0.3%*	*78.6%*
Nov.	+0.6%	78.5%

After jumping the prior month, industrial production likely rose slightly in December. The ISM manufacturing index's nasty spill (the worst since the recession) indicates lingering recent softness in the sector. Meantime, oil production retreated from record highs amid tumbling prices, while heating demand nosedived in response to unseasonably warm temperatures. An expected 0.1% advance in total output should trim the capacity utilization rate to 78.4%. This is near a 3½-year high, though below levels (of over 80%) that presaged firmer inflation in the last cycle.

United Kingdom

Brexit Vote
Tuesday, following debate concluding at 11:30 am GMT

See Jennifer Lee's Thought on page 3.

Financial Markets Update

		Jan 11 [1]	Jan 4	Week Ago	4 Weeks Ago	Dec. 31, 2018
					(basis point change)	
Canadian Money Market	Call Money	1.75	1.75	0	0	0
	Prime Rate	3.95	3.95	0	0	0
U.S. Money Market	Fed Funds (effective)	2.50	2.50	0	25	0
	Prime Rate	5.50	5.50	0	25	0
3-Month Rates	Canada	1.62	1.62	0	-2	-2
	United States	2.42	2.41	1	1	6
	Japan	-0.17	-0.19	2	8	-2
	Eurozone	-0.31	-0.31	0	0	0
	United Kingdom	0.92	0.91	1	2	1
	Australia	2.06	2.06	0	4	-3
2-Year Bonds	Canada	1.88	1.85	3	-14	2
	United States	2.54	2.50	5	-19	5
10-Year Bonds	Canada	1.95	1.93	2	-15	-2
	United States	2.71	2.67	4	-18	2
	Japan	0.01	-0.05	6	-2	2
	Germany	0.18	0.21	-3	-7	-6
	United Kingdom	1.28	1.28	1	4	1
	Australia	2.31	2.23	7	-16	-1
Risk Indicators	VIX	19.7	21.4	-1.7 pts	-2.0 pts	-5.8 pts
	TED Spread	37	40	-3	-2	-8
	Inv. Grade CDS Spread [2]	79	85	-6	0	-9
	High Yield CDS Spread [2]	406	434	-27	-8	-44
					(percent change)	
Currencies	US¢/C$	75.37	74.77	0.8	0.9	2.8
	C$/US$	1.327	1.337	—	—	—
	¥/US$	108.40	108.51	-0.1	-4.4	-1.2
	US$/€	1.1476	1.1395	0.7	1.5	0.1
	US$/£	1.281	1.272	0.7	1.8	0.4
	US¢/A$	71.91	71.13	1.1	0.3	2.0
Commodities	CRB Futures Index	178.39	173.35	2.9	-1.1	5.1
	Oil (generic contract)	52.02	47.96	8.5	1.6	14.6
	Natural Gas (generic contract)	3.03	3.04	-0.3	-20.7	3.2
	Gold (spot price)	1,289.99	1,285.15	0.4	4.2	0.6
Equities	S&P/TSX Composite	14,898	14,427	3.3	2.1	4.0
	S&P 500	2,583	2,532	2.0	-0.7	3.0
	Nasdaq	6,947	6,739	3.1	0.5	4.7
	Dow Jones Industrial	23,848	23,433	1.8	-1.0	2.2
	Nikkei	20,360	19,562	4.1	-4.7	1.7
	Frankfurt DAX	10,883	10,768	1.1	0.2	3.1
	London FT100	6,920	6,837	1.2	1.1	2.9
	France CAC40	4,778	4,737	0.9	-1.6	1.0
	S&P ASX 200	5,775	5,619	2.8	3.1	2.3

[1] = as of 10:30 am [2] = One day delay

Global Calendar
January 14 – January 18

Japan

Monday January 14

Markets Closed

Tuesday January 15

Machine Tool Orders

Dec. P		
Nov.	-17.0% y/y	

Wednesday January 16

Core Machine Orders

Nov. (e)	**+3.0%**	**+0.1% y/y**
Oct.	+7.6%	+4.5% y/y

Producer Price Index

Dec. (e)	**-0.3%**	**+1.8% y/y**
Nov.	-0.3%	+2.3% y/y

Tertiary Industry Index

Nov. (e)	**-0.5%**	
Oct.	+1.9%	

Friday January 18

	CPI	Core CPI
Dec. (e)	**+0.3% y/y**	**+0.8% y/y**
Nov.	+0.8% y/y	+0.9% y/y

CPI ex. Food & Energy

Dec. (e)	**+0.3% y/y**	
Nov.	+0.3% y/y	

Industrial Production

Nov. F (e)	**-1.1%**	**+1.4% y/y**
Oct.	+2.9%	+4.2% y/y

Euro Area

Monday January 14

EURO AREA

Industrial Production

Nov. (e)	**-1.3%**	**-1.9% y/y**
Oct.	+0.2%	+1.2% y/y

Tuesday January 15

EURO AREA

Trade Surplus

Nov. (e)	**€12.6 bln**
Oct.	€12.5 bln

ECB Pres. Draghi delivers annual report to European Parliament

FRANCE

Consumer Price Index

Dec. F (e)	**+0.1%**	**+1.9% y/y**
Nov.	-0.2%	+2.2% y/y

Wednesday January 16

GERMANY

Consumer Price Index

Dec. F (e)	**+0.3%**	**+1.7% y/y**
Nov.	+0.1%	+2.2% y/y

ITALY

Industrial Orders

Nov.		
Oct.	-0.3%	+2.0% y/y

Consumer Price Index

Dec. F (e)	**-0.1%**	**+1.2% y/y**
Nov.	-0.3%	+1.6% y/y

Thursday January 17

EURO AREA

Consumer Price Index

Dec. F (e)	**unch**	**+1.6% y/y**
Nov.	-0.2%	+1.9% y/y

Core CPI

Dec. F (e)	**+1.0% y/y**
Nov.	+1.0% y/y

U.K.

Tuesday January 15

Parliamentary debate on Brexit concludes at 11:30 am GMT; vote to follow

Wednesday January 16

Consumer Price Index

Dec. (e)	**+0.2%**	**+2.1% y/y**
Nov.	+0.2%	+2.3% y/y

Core CPI

Dec. (e)	**+1.8% y/y**
Nov.	+1.8% y/y

Producer Price Index—Output

Dec. (e)	**+0.1%**	**+2.9% y/y**
Nov.	+0.2%	+3.1% y/y

BoE Gov. Carney delivers Financial Stability Report to U.K. Parliament

Thursday January 17

RICS House Price Balance

Dec. (e)	**-13%**
Nov.	-11%

Friday January 18

Retail Sales (incl. Fuel)

Dec. (e)	**-0.8%**	**+3.6% y/y**
Nov.	+1.4%	+3.6% y/y

Other

Monday January 14

CHINA

Aggregate Yuan Financing D

Dec. (e)	**1.30 trln**
Nov.	1.52 trln

New Yuan Loans D

Dec. (e)	**0.85 trln**
Nov.	1.25 trln

M2 Money Supply D

Dec. (e)	**+8.1% y/y**
Nov.	+8.0% y/y

Foreign Direct Investment D

Dec.	
Nov.	-26.3% y/y

Trade Surplus D

	in USD	in CNY
Dec. (e)	**$51.6 bln**	**345.0 bln**
Nov.	$44.7 bln	306.0 bln

Wednesday January 16

AUSTRALIA

Westpac Consumer Confidence

Jan.	
Dec.	+0.1%

D = date approximate

Upcoming Policy Meetings | BoE: Feb. 7, Mar. 21, May 2 | ECB: Jan. 24, Mar. 7, Apr. 10

North American Calendar
January 14 – January 18

Canada

Monday January 14

(no releases)

Tuesday January 15

- 8:30 am — **New Motor Vehicle Sales** [D]
  - Nov. (e): **-9.0% y/y**
  - Oct.: -1.4% y/y
- 9:00 am — **Existing Home Sales** [D] / **Average Prices**
  - Dec. (e): **-16.0% y/y** / **-4.0% y/y**
  - Nov.: -12.6% y/y / -2.9% y/y
- 9:00 am — **MLS Home Price Index** [D]
  - Dec. (e): **+2.0% y/y**
  - Nov.: +2.0% y/y

Wednesday January 16

- Noon — 5-year bond auction $3.0 bln

Thursday January 17

- 8:30 am — **ADP Employment Report**
  - Dec.
  - Nov.: +39,067
- 10-year bond auction announcement

Friday January 18

- 8:30 am — **Consumer Price Index**
  - Dec. (e): **-0.3%** (**+0.1% sa**) / **+1.8% y/y**
  - *Consensus*: *-0.3%* / *+1.7% y/y*
  - Nov.: -0.4% / +1.7% y/y
- 8:30 am — **Trimmed Mean Core CPI**
  - Dec.
  - Nov.: +1.9% y/y
- 8:30 am — **Weighted Median Core CPI**
  - Dec.
  - Nov.: +1.9% y/y
- 8:30 am — **Common Component Core CPI**
  - Dec.
  - Nov.: +1.9% y/y
- 8:30 am — **Int'l Securities Transactions** — **Inflows** / **Outflows**
  - Nov.
  - Oct.: $4.0 bln / $14.9 bln

United States

Monday January 14

- 11:30 am — 13- & 26-week bill auction $75 bln

Releases marked by * will be delayed by the U.S. government shutdown

Previous Data Delayed by Shutdown
(release dates TBA unless noted)

- **New Home Sales—Nov.** **(e) 556k (+2.2%)** / Oct. 554k (-8.9%)
- **Factory Orders—Nov.** **(e) +0.4%** / Oct. -2.1%
- **Goods & Services Trade Deficit—Nov.** **(e) $54.0** / Oct. $55.5 bln
- **Wholesale Inventories—Nov. F** **(e) +0.2%** / Oct. +0.8%
- **Budget Balance—Dec.** Dec. '17 -$23.2 bln

Tuesday January 15

- 8:30 am — **PPI Final Demand**
  - Dec. (e): **-0.1%** / **+2.4% y/y**
  - *Consensus*: *-0.1%* / *+2.5% y/y*
  - Nov.: +0.1% / +2.5% y/y
- 8:30 am — **PPI Final Demand ex. F&E**
  - Dec. (e): **+0.1%** / **+2.9% y/y**
  - *Consensus*: *+0.2%* / *+3.0% y/y*
  - Nov.: +0.3% / +2.7% y/y
- 8:30 am — **Empire State Manufacturing Survey**
  - Jan. (e): **12.0**
  - *Consensus*: *12.0*
  - Dec.: 10.9
- Fed Speakers: Minneapolis' Kashkari (11:30 am); Kansas City's George (1:00 pm); Dallas' Kaplan (1:00 pm)
- 11:00 am — 4- & 8-week bill auction announcements

Wednesday January 16

- 7:00 am — **MBA Mortgage Apps**
  - Jan. 11
  - Jan. 4: +23.5%
- 8:30 am — **Retail Sales*** / **Ex. Autos***
  - Dec. (e): **unch** / **unch**
  - *Consensus*: *+0.2%* / *+0.1%*
  - Nov.: +0.2% / +0.2%
- 8:30 am — **Retail Sales ex. Autos/Gas***
  - Dec. (e): **+0.4%**
  - *Consensus*: *+0.4%*
  - Nov.: +0.5%
- 8:30 am — **Import Prices**
  - Dec. (e): **-1.5%**
  - *Consensus*: *-1.3%*
  - Nov.: -1.6%
- 10:00 am — **NAHB Housing Market Index**
  - Jan. (e): **56**
  - *Consensus*: *56*
  - Dec.: 56
- 10:00 am — **Business Inventories***
  - Nov. (e): **+0.2%**
  - *Consensus*: *+0.3%*
  - Oct.: +0.6%
- **2:00 pm — Beige Book**
- 4:00 pm — **Net TIC Flows** — **Total** / **Long Term**
  - Nov.
  - Oct.: $42.0 bln / $31.3 bln
- Fed Speaker: Minneapolis' Kashkari (6:30 pm)

Thursday January 17

- 8:30 am — **Initial Claims**
  - Jan. 12 (e): **223k (+7k)** [C]
  - Jan. 5: 216k (-17k)
- 8:30 am — **Continuing Claims**
  - Jan. 5
  - Dec. 29: 1,722k (-28k)
- 8:30 am — **Housing Starts***
  - Dec. (e): **1.250 mln a.r. (-0.5%)**
  - *Consensus*: *1.253 mln a.r. (-0.2%)*
  - Nov.: 1.256 mln a.r. (+3.2%)
- 8:30 am — **Building Permits***
  - Dec. (e): **1.300 mln a.r. (-2.1%)**
  - *Consensus*: *1.288 mln a.r. (-3.0%)*
  - Nov.: 1.328 mln a.r. (+5.0%)
- 8:30 am — **Philadelphia Fed Index**
  - Jan. (e): **10.0**
  - *Consensus*: *10.0*
  - Dec.: 9.1
- Fed Speaker: Vice Chair for Supervision Quarles (10:45 am)
- 11:00 am — 13- & 26-week bill auction announcements
- 11:30 am — 4- & 8-week bill auction
- 1:00 pm — 10-year TIPS auction $13 bln

Friday January 18

- 9:15 am — **Industrial Production** / **Capacity Utilization**
  - Dec. (e): **+0.1%** / **78.4%**
  - *Consensus*: *+0.3%* / *78.6%*
  - Nov.: +0.6% / 78.5%
- 10:00 am — **University of Michigan Consumer Sentiment**
  - Jan. P (e): **98.5**
  - *Consensus*: *96.0*
  - Dec.: 98.3
- Fed Speakers: New York's Williams (9:05 am); Philadelphia's Harker (11:00 am)

[C] = consensus [D] = date approximate

Upcoming Policy Meetings | Bank of Canada: Mar. 6, Apr. 24, May 29 | FOMC: Jan. 29-30, Mar. 19-20, Apr. 30-May 1

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