Talking Points

The latest view on the economy

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And So It Begins

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On this august occasion, there is only one appropriate path to take, and that is the high road. We, like pretty much everyone else, are awaiting to see precisely what the new Administration brings on the economic file, with a mixture of trepidation and hope. Markets have similarly gone into something approaching a holding pattern for the past month, looking beyond all the campaign bluster and now waiting to see real policies. To wit, from exactly a month ago, the S&P 500 is up 0.1%, 10-year Treasury yields are off 5 bps, and the broad US$ is down 0.2%. For all intents and purposes, prices have come to a standstill after the initial post-election reflation trade rush.

There is little debate that the potential positives and negatives from the new President’s economic proposals break cleanly down the line between: a) stimulus, whether from tax cuts or infrastructure spending, and a lighter regulatory touch (positives), and b) the threat of protectionism (negative). Both angles have been covered and debated ad nauseam since the election, and we would simply reinforce the message that we believe it will take longer for stimulus measures to affect the economy than currently appreciated. As an example, the Bank of Canada took a stab at potential U.S. stimulus measures in their latest forecast this week, and is assuming new steps will add just 0.1 ppts to GDP this year and perhaps 0.4 ppts in 2018. We would not strenuously disagree, and actually now find ourselves right in line with the latest Blue Chip consensus of 2.4% U.S. growth this year and 2.5% next. In fact, any lift to this year’s outlook is likely to come more from the significant and broad-based upswing in sentiment surveys since the election than stimulus measures.

Now, turning the focus to the biggest potential economic negative of protectionism, which has also received mountains of coverage (and we take a deeper look at some of the so-called border tax proposals in this week’s Focus Feature). Thankfully, the key point people on the trade file have talked down the sweeping border-adjustment tax (President Trump himself declared it “too complicated” this week), and have indicated that the focus of any trade actions will likely fall on China and Mexico. While that may well be the case, any ramping up of protectionist pressures could blunt a global economy which is already dealing with exceptionally slow underpinnings. Rather than just rub our economist hands in anguish and wail about the unfairness of it all, we would focus on three potential unintended consequences of a tougher U.S. trade policy, starting from the specific and rising to the broad.

One: The incoming Commerce Secretary Wilbur Ross has indicated that the two main areas of concern for the U.S. in NAFTA negotiations will be rules-of-origin and the dispute settlement mechanism. On the former, effectively the U.S. wants to raise the North American and U.S. content in parts, most notably in the auto sector. But, the auto market is extremely competitive, and presumably automakers are sourcing parts at the lowest cost—a move to increase those costs could/would dent their competitiveness, possibly costing domestic producers more market share.
Two: In addition, any such protectionist measures that tilt the playing field more to the U.S. advantage could be met, rather quickly, by increased upward pressure on the U.S. dollar, essentially negating the impact. President Trump himself noted that the currency was very strong in an interview this week, perhaps a nod in this direction. Meanwhile, Ross almost seemed to crow in testimony this week that the threat of protectionist measures had driven down the peso 35% (technically, down 30% since Mr. Trump declared his candidacy). Tellingly, Ross also noted that the Canadian dollar had also weakened, “which is no accident”. (In fact, the C$ is little-changed since the election.) But, more broadly, the trade-weighted US$ is up nearly 5% since the election, bound to act as at least a modest drag on net trade in the coming year.

Three: Finally, we would simply remind that there are two sides to trade flows. While it is all good and well for the incoming Administration to try to affect imports, their measures can have a major impact on U.S. exports as well. Carrying on the currency theme, how do you think the appetite for U.S. products will be in Mexico in the coming year, amid a massive increase in peso prices for such goods and services? Not good—it’s safe to say that we may well be looking at a double-digit decline in Mexican imports from the U.S. in 2017, based simply on the economic factors at play. And that’s even before considering the potential for any retaliatory trade measures from Mexico and/or the ill-will many ordinary Mexicans will possibly feel about buying American products. And, note that Mexico is the second largest consumer of U.S. goods (behind only Canada), running at 4 times the purchases of an economy like, say, Britain.

Having said all that, we are quietly confident/hopeful that the key players on the new Trump team are fully aware of these potential unintended consequences, and that—as Mr. Ross subtly alluded to this week—much of the trade rhetoric is a negotiating position. From a Canadian perspective, this is clearly the most important unknown at this stage.

Curiously, the biggest threat to the Canadian dollar this week was not U.S. trade threats, but something closer to home. Governor Poloz did a quick number on the loonie during his press conference by simply noting that “yes, a rate cut remains on the table” at this week’s meeting. Why, yes, and the Toronto Maple Leafs may win the Stanley Cup this year—current Vegas odds are 40:1, which actually may not be too far from the chances of a Bank rate cut this year. Even so, markets responded with Pavlovian vigour, and sent the currency skidding 1.7% on Wednesday, with an additional 0.8% drop since then to below 75 cents. It seems that with Canadian core inflation holding at a low ebb (shy of 1.7% in December) and the export outlook challenged by the threat of protectionism, the last thing the BoC wants is for the Canadian dollar to start heading higher, or bond yields to rise meaningfully. So, they will just keep playing that same old song (“we may cut”) to try to keep both under control, even though Mr. Poloz has clearly stated—many, many times—that it will take a big shock to get them off the sidelines.