

Working with Fire/Fury and Steel

Douglas Porter, CFA, Chief Economist • douglas.porter@bmo.com • 416-359-4887

Markets generally strengthened on a mixed bag of important events this week, with the U.S. dollar, bond yields, and—especially—stocks making their way higher. Before delving into the grimy details of the economic data, we must first allow that **news out of Washington was again the big driver**, as has so often been the case in the past year. First, we had the week-long sideshow of the steel & aluminum tariffs, which prompted Gary Cohn's resignation and pretty much went along with what the President threatened last week (25% on steel and 10% on aluminum), with the exception of exemptions for Canada and Mexico. The twist here was that the exemptions will only hold so long as NAFTA negotiations are ongoing, which is not exactly a big positive for Canada. It's a bit like the schoolyard bully saying he won't beat you up today, so long as you agree to a deal to hand over your lunch money tomorrow. Note that while the Canadian dollar improved from its worst level this week (of just under \$1.30/US\$, or 77 cents), it was barely better than a week ago by Friday noon at 77.9 cents.

While the steel tariff issue mostly went down as expected, sadly so, the big surprise later in the week was the very sudden thaw in U.S. "relations" with North Korea. President Trump threw another rule book out the window by promptly agreeing to the offer of direct bilateral talks with Kim Jong-un. True, pretty much the entire U.S. intelligence community appears to be highly sceptical that these proposed talks (tentatively expected by May) will produce any lasting improvement, but this is a long way from the pledge of fire and fury just a few short months ago. With tensions having already temporarily eased recently, the latest news didn't make a huge impression on markets, but kept the mostly positive trend going. For example, the S&P 500 was headed for a weekly gain of 3% by mid-Friday, more than reversing last week's dip. And, despite Canada's steel exemption—stop me if you've heard this before—the TSX was lagging at +1.1%.

The economic news played its part in supporting the markets, capped by a **nearly ideal February U.S. payroll report**. Not only did job growth post its strongest month in nearly two years at +313,000 (with upward revisions to boot), holding the jobless rate steady yet again at 4.1%, but wages calmed after the scare they threw into markets last month. Average hourly earnings cooled to 2.6% y/y (from a downwardly-revised 2.8% clip in January), which is only a snick above last year's average pace (of 2.5%). In a sense, that's **almost a perfect outcome**—workers are seeing better gains, but not nearly so quickly as to seriously threaten inflation. That theme was echoed earlier in the week in the Q4 productivity revisions, which showed a 2.9% y/y rise in compensation, but a more modest 1.7% rise in unit labour costs (with productivity gains explaining the gap).

The story in **Canada's job market was a tad less market friendly**, as job growth was tamer (at a so-so +15,400) in February, but wages a bit firmer (at 3.1% y/y). This is quite the relative turnaround from last year, when Canada consistently reported stronger job growth, but milder wage gains than the U.S. was churning out (Canadian



job growth is now 1.5% y/y versus 1.6% stateside). Given the ongoing volatility in the Labour Force Survey and its wage measure, policymakers are now focusing on a blend of four measures of compensation—the ‘wage-common’. But all four measures now seem to be pointing higher, with Canada’s productivity report also showing a notable pick-up in hourly compensation (to 3.3% in Q4). At the same time, manufacturing capacity utilization has popped to its highest level since 2000. The main point is that **while the BoC has moved to the sidelines for now amid the deepening uncertainty on trade and the housing market, the tightening bias remains very much in place with the economy operating close to capacity.**

BAT out of hell? Lest one thought that trade issues and concerns could now move to the sidelines, U.S. Treasury Secretary Mnuchin suggested on Friday that **the Administration is in preliminary talks with Congress on a “reciprocal tax”**. This is essentially a new and reformed version of the earlier so-called Border Adjustment Tax (BAT), although presumably a bit more focussed on particular countries and/or products. There can be little doubt that the main target for any such serious trade action would be China. This week’s widening U.S. trade deficit report once again highlighted the deep and growing imbalance in U.S.-China trade: The deficit with China hit a record \$380 billion over the past 12 months (more than four times the gap with the NAFTA partners combined), and alone accounts for almost half the entire U.S. shortfall.

The nakedly protectionist Administration has so far treated China with relative kid gloves on trade, likely owing to the geopolitical realities of concerns over North Korea. But with tensions receding on that front, at least for now, and the trade deficit steadily widening, the U.S. may feel emboldened to take a more serious and strident approach on trade.

General Disclosure

"BMO Capital Markets" is a trade name used by the BMO Financial Group for the wholesale banking businesses of Bank of Montreal and its subsidiaries BMO Nesbitt Burns Inc., BMO Capital Markets Limited in the U.K. and BMO Capital Markets Corp. in the U.S. BMO Nesbitt Burns Inc., BMO Capital Markets Limited and BMO Capital Markets Corp are affiliates. This document is issued and distributed in Hong Kong by Bank of Montreal ("BMO"). BMO is an authorized institution under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) and a registered institution with the Securities and Futures Commission (CE No. AAK809) under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong). BMO does not represent that this document may be lawfully distributed, or that any financial products may be lawfully offered or dealt with, in compliance with any regulatory requirements in other jurisdictions, or pursuant to an exemption available thereunder. This document is directed only at entities or persons in jurisdictions or countries where access to and use of the information is not contrary to local laws or regulations. Their contents have not been reviewed by any regulatory authority. Bank of Montreal or its subsidiaries ("BMO Financial Group") has lending arrangements with, or provide other remunerated services to, many issuers covered by BMO Capital Markets. The opinions, estimates and projections contained in this report are those of BMO Capital Markets as of the date of this report and are subject to change without notice. BMO Capital Markets endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Capital Markets makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Capital Markets or its affiliates that is not reflected in this report. The information in this report is not intended to be used as the primary basis of investment decisions, and because of individual client objectives, should not be construed as advice designed to meet the particular investment needs of any investor. This document is not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such information be considered as investment advice or as a recommendation to enter into any transaction. Each investor should consider obtaining independent advice before making any financial decisions. This document is provided for general information only and does not take into account any investor's particular needs, financial status or investment objectives. BMO Capital Markets or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Capital Markets or its affiliates, officers, directors or employees have a long or short position in many of the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should assume that BMO Capital Markets or its affiliates may have a conflict of interest and should not rely solely on this report in evaluating whether or not to buy or sell securities of issuers discussed herein.

Dissemination of Research

Our publications are disseminated via email and may also be available via our web site <http://economics.bmocapitalmarkets.com>. Please contact your BMO Financial Group Representative for more information.

Conflict Statement

A general description of how BMO Financial Group identifies and manages conflicts of interest is contained in our public facing policy for managing conflicts of interest in connection with investment research which is available at http://researchglobal.bmocapitalmarkets.com/Public/Conflict_Statement_Public.aspx.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

BMO Financial Group (NYSE, TSX: BMO) is an integrated financial services provider offering a range of retail banking, wealth management, and investment and corporate banking products. BMO serves Canadian retail clients through BMO Bank of Montreal and BMO Nesbitt Burns. In the United States, personal and commercial banking clients are served by BMO Harris Bank N.A., Member FDIC. Investment and corporate banking services are provided in Canada and the US through BMO Capital Markets. BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A, BMO Ireland Plc, and Bank of Montreal (China) Co. Ltd. and the institutional broker dealer businesses of BMO Capital Markets Corp. (Member SIPC), BMO Nesbitt Burns Securities Limited (Member SIPC) in the U.S., BMO Nesbitt Burns Inc. (Member Canadian Investor Protection Fund) in Canada, Europe and Asia, BMO Capital Markets Limited in Europe, Asia and Australia and BMO Advisors Private Limited in India.

"Nesbitt Burns" is a registered trademark of BMO Nesbitt Burns Inc., used under license. "BMO Capital Markets" is a trademark of Bank of Montreal, used under license. "BMO (M-Bar roundel symbol)" is a registered trademark of Bank of Montreal, used under license.

© Registered trademark of Bank of Montreal in the United States, Canada and elsewhere.

™ Trademark Bank of Montreal in the United States and Canada.

© COPYRIGHT 2018 BMO CAPITAL MARKETS CORP.

A member of BMO Financial Group