Talking Points

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The latest view on the economy July 6, 2018

# No Tariff Tantrum for Treasuries

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U.S. inflation is rising, the job market is tight, Q2 GDP may have approached 5%, the Fed is hiking remorselessly, the budget deficit is fattening fast, and long bond yields are… falling? Benchmark 10-year Treasury yields dipped for the second week in a row, and are now probing the lower limits of the tight 2.8%-to-3.0% range that they have been stuck in for most of the past five months. The handy excuse for the latest move is "trade war fears", what with the U.S. and China making good on their threats to hit $34 billion of products with tariffs and counter-tariffs today. Yet, U.S. equities managed to grind out decent gains this week (albeit after a bit of a pummelling the prior two weeks), and the U.S. dollar took a small step back, so other markets were not especially rattled by trade concerns.

While yields are no doubt being held back more broadly by **gnawing trade fears**, there are clearly other factors keeping a lid on long-term rates. We would point to: 1) fading non-energy commodity prices; and, 2) benign wage pressures. On the first point, while much of the attention has been focused this year on the blistering gains in oil—the President griped again this week about them—**non-oil prices have been going in reverse**. Copper, and its PhD in Economics, dropped heavily in the past month (-14%) and is now barely above a year ago, after posting gains of more than 20% y/y just this spring. Ag prices are also in full retreat again, with both livestock and crop futures down from a year ago. Arguably, some of this widespread commodity weakness can be traced directly back to the trade trauma—a) some specific commodities are being hit with tariffs (e.g., soybeans), b) the U.S. dollar is firming, dampening the US$ price of goods, and c) the trade cloud on global growth is weighing on cyclical commodities (e.g., copper).

Besides commodities, a **lack of serious wage pressure** in much of the developed world is also keeping broader inflation concerns at bay. While there are plenty of signs that wages are gradually responding to tight job markets across the OECD, the emphasis is on *gradual*. Today's U.S. employment report is Exhibit A, with average hourly earnings rising a mild 0.2% in June and holding fast at a 2.7% y/y clip. True, that is slightly above last year's average gain of 2.5%, but hardly the stuff to cause anyone serious inflation angst. It's a broadly similar story for some of the other compensation measures, with wages & salaries from the ECI also up 2.7% y/y in the latest reading.

The moderate wage result, combined with a surprising 2-tick back-up in the jobless rate to 4.0%, was easily enough to offset yet another impressive gain in payrolls (+213,000 after the hefty 244,000 revised May gain). Earlier this year, we asked where would the workers come from to fuel the expansion? Well, a stabilization in the participation rate has helped drive a 1.2% y/y rise in the labour force, which works out to just over 160,000 per month, or just slightly below the recent underlying trend in job gains. Bigger picture, the fact is that **the job market will continue to tighten** with this kind of job growth and, yes, **wages will erratically grind higher**. So, even with the modest rally in Treasuries lately, **we are still looking for yields to push above 3% later this year**—presumably as trade tensions ease post mid-term elections.

**Canada's bond rally** has been even more emphatic in recent months, with the trade concerns a much bigger deal for the domestic economy. But, Canada was not the star of the tariff show this week, and the Canadian dollar managed to strengthen slightly on net after a comeback last week. **The local jobs report was almost the mirror image of the U.S. version**, replete with a 2-tick rise in the unemployment rate (to another round number of 6.0%), an above-expected headline jobs gain (+31,800), and somewhat milder-than-expected wages (but still strong at +3.6% y/y). In essence, it was a mixed bag and simply not enough to move the needle on the Bank of Canada outlook—even with all the trade noise, we and the market expect a 25 bp rate hike next Wednesday, which will take the overnight rate up to 1.50%.

**We made two small tweaks to our Canadian forecast last week that are worth mentioning**: First, we **trimmed this year's GDP outlook** by a tick to 1.9%, mostly on intensifying trade tensions but also due to the outage at Syncrude. A one-tick cut may not sound like a big deal, but it's firmly below consensus and it's the direction of the revisions that's important here. Along the same lines, **we have also taken out one of the expected BoC rate hikes over the next 18 months**, and now look for the overnight rate to finish next year at 2.25%, or still below what the Bank considers neutral. Again, while not a huge change, it's the direction of the revision that matters.

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Perhaps not realizing that South Park was being ironic with their ***"Blame Canada"***, the Administration has taken up the cause with great gusto. White House Press Secretary Sanders said this week that *"We've been very nice to Canada for many years, and they've taken advantage of that",* echoing President Trump's comments from earlier this year: *"We lose a lot with Canada. People don't know it. Canada is very smooth."* Proving Canadians are smooth is far too daunting a task, so instead we will show just how they are indeed 'taking advantage' of the U.S., with ***"A Day in the Life of Joe/Janet Canadian"***:

I saw a Hollywood film today, oh boy
The New England Patriots had just won the Bowl
A crowd of Teslas/F150s turned away
But I just had to go on Amazon and look
Having already at Walmart read the book
I'd love to turn CNBC on

Woke up, fell out of my Sealy/Serta bed,
Dragged a Dell mouse across Facebook/Instagram/Google's head
Found my way downstairs and drank a cup of Starbucks/Coke/Pepsi/Bud Light
And looking up at my Apple Watch I noticed I was late
Found my Abercrombie coat and grabbed my Nike hat
Made the Uber/Lyft in seconds flat
Made my way upstairs with Mickey Dees and had a Marlboro smoke
And Siri/Alexa spoke and I went into a Disney dream

I read the news in U.S. Today, oh boy
Four thousand folks in Blackberry's Waterloo
And though the folks were rather few
They wanted to boycott U.S. goods at the mall
Upon reading the list above, those folks decided after all
Nevermind, they'd still love to turn Netflix on