IstanBears

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If you can keep your head when all about you
Are losing theirs and blaming it on you,
If you can trust yourself when all men doubt you,
But make allowance for their doubting too;

Yada, yada, yada…
Yours is the Earth and everything that's in it, yada, yada.

Full disclosure: The plan for this piece was to riff off Rudyard Kipling's famous poem, pointing to the S&P 500 as remarkably managing to keep its head while the rest of the world seemed to be "losing theirs". With the benchmark index finally moving to within a hair of its late-January record high on Thursday, even as a variety of global markets were struggling amid widespread trade tensions and various sanctions, the plan was falling into place—until Friday. After rumbling away in the background for weeks, **a full-blown plunge in the Turkish lira sent shockwaves across global markets**, slicing stocks and pulling bond yields broadly lower.

Details of Turkey's trauma can be found in our Focus publication (see Art Woo's Thought), but the skinny is that markets there have been clobbered by **a nasty combination of ill-judged domestic economic policies** (President Erdogan's disdain for higher interest rates for one), **vulnerable fundamentals** (low savings, large current account deficits, high inflation), **and U.S. sanctions** (made worse by Trump's doubling of steel and aluminum tariffs on Turkey). Erdogan's response on Friday was far from helpful, choosing a combative stance and imploring Turks to convert the dollars under their pillows for lira. In response, the lira went into a veritable free-fall, (and whatever figure we quote here will likely need to be cranked up by the time you read this) dropping by more than 15% on Friday alone. In this fast-moving situation, the currency is now down more than 40% in 2018—with the cost of a US$ leaping above 6.5 liras versus 3.8 at the start of the year.

For the rest of the world, Turkey is certainly a significant player, but with economic output of less than US$900 billion (and falling) **it's not big enough to shake global markets alone for long**. The concern is that there are other weak spots out there, and the relentless trade battles risk exacerbating underlying fault lines, as so vividly displayed by Turkey. To point to just a few examples: 1) the Russian rouble has slid 7% in the past two weeks, after the U.S. hit it with new sanctions, 2) Argentina's peso has also been walloped this year, falling by more than 30%, partly on concerns over its own domestic political scandal, 3) the U.K. pound has dropped 11% in four months as fears of a no-deal-Brexit mount; and, 4) China's currency and equities continue to reel from the deepening trade skirmish with America.

As suggested at the outset, these slowly building stress lines in the rest of the world were being largely ignored by U.S. markets, in part because the U.S. economy and earnings just kept thundering ahead. In stark contrast to notably cooler growth elsewhere, U.S. GDP is on course to accelerate this year to almost 3% growth,

factories have added more jobs in the past year than at any time in the past 30 years, and Q2 earnings for the S&P 500 are up more than 20% y/y. On the flip side, each of the Eurozone, Britain and Japan reported Q2 GDP growth of less than 2% (Japan was actually best at 1.9%). But the world worries finally caught up with U.S. markets, with only the Nasdaq managing to stay in the green this week, and 10-year Treasuries pulling back below 2.9% after briefly piercing 3% last week.

Looking ahead, we recall the old adage *"never change your fundamental forecast in August"*, a reminder that summer markets are thinner and prone to dramatic moves that may mean little later on. **But we wouldn't dismiss the unfortunate lurch to protectionism and trade battles as a passing phase, nor the very real difficulties that some major emerging markets face in this more hostile backdrop**—and amid a tightening Fed. At a minimum, we believe that global growth is past its peak, and that activity will slow more broadly in 2019. Still, with inflation slowly grinding higher and job markets tight almost everywhere, the Fed and the Bank of Canada will continue to gradually tighten in coming quarters. But, as we have seen so many times in the past, the rate hike timetable can be delayed if emerging market turmoil intensifies—a prime example can be found in events 20 years ago to this month in August 1998, when the Asian crisis morphed into a broader emerging market crisis and the Fed ultimately cut rates by 75 bps that fall.

Given that cautionary note, we would suggest that you ignore this less-quoted passage in Kipling's "If"; let's call it his anti-Volcker Rule:

If you can make one heap of all your winnings
And risk it on one turn of pitch-and-toss,
And lose, and start again at your beginnings
And never breathe a word about your loss;

Until late in the week, it seemed that **Saudi Arabia** was going to make the biggest market news emanating from the Middle East. Its abrupt decision to halt all new trade and investment with Canada was reportedly accompanied by an edict to sell all holdings of Canadian stocks and bonds, *"no matter the cost"*. While Canadian markets did stumble slightly for about 24 hours, traders quickly reversed the small losses and returned to the bigger picture. Before Friday's broader global weakness, the TSX was essentially unchanged for the week, bond spreads had moved by about 1 bp versus their U.S. counterparts, and the Canadian dollar was down less than 0.5%. After all, given **the relatively modest nature of Canada's exposure to Saudi Arabia**, and that nothing had fundamentally changed for the Canadian economic outlook, what self-respecting hedge fund wouldn't step in on the other side of the Saudi sell order?

That's not to say Canadian markets escaped the late-week turmoil, with the TSX headed for a moderate loss of 0.5% and the Canadian dollar off about 1% amid broad U.S. dollar strength. Notably, the currency sagged on the Turkey trauma despite an ostensibly snappy job gain in July. Canada's employment report was up to its old tricks last month, surprising with a hearty 54,000 jobs jump and a 2-tick slide the jobless rate to match the cycle-low of 5.8%. The problem was that the gains relied heavily on a 36,500 surge in education jobs—*in July!*—and a reported 5% m/m spike

in total hours worked in the sector. Now we know that back-to-school sales start earlier every year, but this is getting ridiculous.

Bigger picture is that the Canadian job market remains tight, and—provided the EM turmoil subsides—the BoC will continue raising rates. Here's one classic example of just how tight the labour market is, courtesy of my one-time employer The London Free Press: Chapman's Ice Cream is struggling to find workers in their Markdale plant (about 100 km North-West of Toronto), and is now **offering $500 signing bonuses** for basic production workers.

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