Talking Points

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The latest view on the economy August 31, 2018

Not A Friendly Turn, Actually

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There's nothing like some high drama on the last day of summer. We may, or may not, have a North American trade deal by later today, at least in principle. **The main sticking point appears to be the independent dispute settlement mechanism** (Chapter 19), which Canada wants to maintain and the U.S. wants to scrap. This very issue also proved to be the most contentious in the original FTA negotiations three decades ago, in a classic case of history repeating. There is the slight chance that Friday is not a cement-hard deadline for Canada to join—assuming there is progress in the talks—a point even President Trump hinted at in a Thursday interview: *"Canada's going to make a deal at some point. It may be by Friday or it may be within a period of time, but ultimately they have no choice."* Suffice it to say, that markets have doubts on that last point, as both the Canadian dollar and—tellingly—the Mexican peso were sagging Friday morning, and both were down for the week. Adding intrigue, The Toronto Star reported Friday that Trump told Bloomberg off the record that any deal would be *"totally on our terms"*, leaving all negotiators in a difficult position.

Looking beyond NAFTA, this week reinforced the summer's market theme—**the stark dichotomy between a robust U.S. domestic economy and thriving equities on the one side, and a fractious trade backdrop and deteriorating conditions elsewhere**. And this dichotomy may be emboldening the President to become even more aggressive on the trade front, which in turn is widening the chasm. A quick sampling on the U.S. backdrop, from just this week:

- Consumer confidence soared in August, hitting a new cycle high, and topped only by the heady days of the year 2000.
- Second quarter GDP was revised even higher to 4.2%, lifting the year-over-year pace to 2.9%. Early returns for Q3 suggest it will stay close to 3%.
- Capital spending remains robust, with business forging ahead even in the face of tariffs. Real business investment rose at a 10% annual rate in the first half of the year.
- Core inflation edged up to precisely hit the Fed's goal at 2.0%.
- The S&P 500 and the Nasdaq hit record highs on Wednesday, respectively moving above 2900 and 8000 this week.

The buoyant equity market ran into some late-week turbulence, as trade concerns re-emerged yet again. The initial feel-good lift from Monday's announcement of a preliminary bilateral deal with Mexico soon gave way, as Trump unleashed harsh rhetoric at just about everywhere else. The main targets were:

- **China:** Trump indicated that he could proceed with tariffs on $200 billion of Chinese imports as soon as next week. This would be a massive ramping up of the trade battle, and would affect many consumer products. China, no doubt, would retaliate.

- **Europe:** Trump brushed aside the EU offer to cut auto tariffs to zero as insufficient, and added for good measure that *"Europe's as bad as China, just smaller"*. If the threat wasn't so serious, that line would provide some comic relief.
- **The WTO:** The Administration has clearly had its issues with the WTO since Day 1, but Trump is now openly threatening to pull out of the trade body.
- **Canada:** Trump continually wielded the cudgel of "Carmageddon" over Canada this week, stating that *"the easiest thing we can do is tariff their cars"*. It's unclear what's more obnoxious about that statement—the casual economic threat against a long-time friend and neighbour, or using 'tariff' as a verb.

The mounting trade tensions come at a time when there are **increasing signs that growth outside the U.S. is taking a step back**. The Euro Area saw GDP growth average just 1.5% in the first half of the year, down almost a full point from last year's solid 2.4% advance. Brexit uncertainty has clubbed U.K. growth to a slightly slower pace than that (although there was a morsel of optimism on the Brexit front this week). Japan is also headed for much milder growth this year of roughly 1%. While China's headline statistics are flagging only a slight moderation, pronounced weakness in the equity market, industrial metals prices, and timely indicators point to a more meaningful slowing. Keep an eye on next week's round of PMIs for August for a better bead on current conditions.

Whatever slowing the rest of the major economies are dealing with is **mild compared to widening trauma in some emerging markets**. After a brief reprieve, the Turkish lira slid again this week, even as borrowing costs have moved substantially higher. Much the same can be said about Argentina, raised to the power of three. The peso was crushed almost 20% this week despite a 15 ppt hike in interest rates, and an IMF program, as investors fled. August has been a brutal month for both of these battered emerging markets (with Venezuela in an entirely separate category of pain), with the lira now down 26% this month and the peso off 28%. So far, their travails have not morphed into full-blown contagion, but Brazil and South Africa have been the next most wobbly (both the rand and the real fell roughly 9% in August), and are the two we are watching most closely for signs of trouble.

The darkening global backdrop would normally be **about all the Bank of Canada would need to convince them to move to the sidelines at next week's interest rate decision**. Yet, there was a flicker of doubt on the meeting, driven by the Bank's own history (visions of last year's September surprise still dance in some heads), by 3% headline inflation, and by NAFTA hopes. But a good-but-not-great Q2 GDP result of 2.9% growth, which almost precisely met the BoC's estimate, and cooling household borrowing argue for no rush on rates. As we assert in today's Focus, markets have all but ruled out a move next week, but are still leaning heavily to a rate hike in October—assuming no NAFTA shocks ahead. Even the strength in oil prices (WTI pushed above $70 this week) is not much of a driver, as Canada's own crude prices were hit this week by the Federal Court of Appeal's decision to **rule against the Trans Mountain pipeline**, which at the very least will delay that project. WCS was trading below $43 on Friday, or almost 40% below WTI.

Bringing it all back to NAFTA, the preliminary US/Mexico deal does carry some potential positives for Canada, especially with Mexico willing to make some serious concessions on the auto front. There were also some parts that Canada likely isn't thrilled about handing over without some give in return from the U.S., including extended patent protection on drugs, longer copyrights, and the ramped-up de minimis limits. Moreover, **the incredibly tight four-day negotiating window foisted on Canada by the bilateral deal between the Two Amigos all but ensures a tough deal**, with heavy costs needed to ensure a modicum of trade certainty.

We'll end with a lesson that all good hockey players learn. Sometimes, even the wiliest player will get pounded by a hit they just didn't see coming, and sometimes the hit will be a cheap shot. But immediate retaliation just isn't an option, since it will only bring a one-sided penalty. It's best just to take the offender's number, lock it away, skate on, and await a more suitable opportunity for a proper response.

Almost lost in a very busy week of economic news was the little gem on Monday that **Ottawa's income tax revenue from high-income earners actually fell by $4.6 billion in 2016**. For a refresher, after the 2015 October election, the new government promptly cranked the top income tax rate by 4 percentage points, to ostensibly pay for a mild 1.5 ppt rate reduction in the middle bracket. At the time, they expected revenues to rise $3 billion from the high-bracket measure, an estimate that was later clipped to $2 billion. Finance is now saying that temporary factors drove the 2016 weakness, and that revenues will bounce back—well, they will need a towering bounce-back of at least $13 billion, just to bring revenues for the two years back in line with even the revised forecast.

The main point here, and we and others made it at the time of the tax hike, is that the higher marginal tax rates go, the more individuals will aggressively adjust their affairs to avoid these taxes. Currently, no fewer than seven of the 10 provinces have top-end marginal rates above 50%, and four are above 53%, **among the highest marginal rates in the world**.

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