Talking Points

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The latest view on the economy

January 4, 2019

Snappy New Fear

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If you had been fortunate enough to have packed it in after the Fed hiked on December 19 and just returned to your desk today (and somehow managed to avoid all forms of communication, whilst luxuriating in Antarctica), it would superficially appear that not much happened. After all, the S&P 500 is up a tad from that day's close, oil is slightly lower at around $48, the euro and Canadian dollar are modestly firmer and even the 30-year Treasury yield is flat at just below 3%. Then, however, you might suddenly realize that the yen has mysteriously popped almost 4% in barely two weeks, that gold is up over 3%, and that two-year Treasury yields have dropped a hefty 16 bps—all despite some big reversals today. Of course, lurking below the mostly calm net moves in many markets has been **unusually high volatility in thin trading conditions**. To cite just one example, the Dow has seen moves of more than 400 points in fully 6 of the past 10 trading days, with some wild intraday shifts to boot.

Effectively, we are witnessing in real time markets grappling with the question of just how deep the slowdown in global growth will be in 2019. That growth will be slower this year is not really a question, not with tighter central bank liquidity, not with less U.S. fiscal policy juice, and not with the ongoing China/U.S. trade tussle. The broad slide in equities in Q4 of 2018, along with a deep dive in cyclically-sensitive commodities (notably copper), has even got some whispering the "R-word". Not helping matters was the widespread drop in purchasing managers indexes in December, with global measures falling back to 2016 levels, and thus erasing the so-called Trump Bump. This pullback was highlighted by the swoon in the U.S. ISM, which saw its largest month-to-month slide in a decade, with particular weakness in new orders. Coming on the heels of a big downward revision in Apple's sales forecasts, this simply ramped up the slowdown chatter another notch. Conditions suddenly looked so soft that **not only were markets discounting any further rate hikes by the Fed, but even rate *cut* speculation was in the air, at least at some point later in 2019**.

And then, just as the outlook appeared very bleak indeed, the cavalry came riding over the hill. First, it was announced that China/U.S. trade talks would resume in earnest next week, and China cut its reserve requirements for banks. As well, oil prices continued to forcefully recover on supply restraint from OPEC, rebounding 15% from last week's depths. Next, **the always important U.S. jobs report calmed growth concerns with an emphatic show of strength in December**, replete with a 312,000 payroll gain and a cycle-high 3.2% y/y wage gain. Finally, Fed Chair Powell suggested on Friday that the Fed is indeed sensitive to the market's message, that rate hikes are not pre-set, and that they could adjust the balance sheet unwind if it truly is causing the market stress. This well-timed combination acted as just the tonic to counter the sour start to the year, and leaves markets now broadly unchanged early in 2019.

Looking past the recent market volatility and some of the more extreme views on the outlook, we remain comfortable with the broad strokes of our forecast. To wit, that U.S. growth will simmer down from last year's 3.1% surge to roughly 2% in 2019 (on a Q4-to-Q4 basis), that this will be enough to clip the jobless rate a bit further and put slightly more upward pressure on wages and core prices, and that the Fed will eventually raise rates a bit further. But, the unusual political backdrop does offer some serious event risk to this forecast—between the uncertain outlook for trade (even on the unresolved USMCA file, let alone on the U.S./China front), as well as for government funding, and fiscal policy more generally. Along with the fragility in financial markets, the Fed thus will certainly be patient before taking any further steps, and a mild inflation backdrop offers it plenty of leeway to be flexible. Tellingly, Powell indicated on Friday that the Fed will be prepared to possibly adjust policy as it did in 2016, when it paused until the very end of the year.

Canada has been a bit of a bystander amid the wild swings in sentiment on the global outlook in recent weeks, with the TSX seeing more muted moves than the S&P 500. However, the Canadian dollar had been hammered by the combination of lower commodity prices and global growth fears, ending 2018 at barely above 73 cents ($1.365/US$) and down 7.8% for the year. The loonie has started this year on a better footing, supported by the comeback in oil and a broader retreat in the U.S. dollar. **Even with a lacklustre domestic jobs report (employment up 9,300 in December and a flat jobless rate at 5.6%), the currency still managed to snap back 1.8% this week to 74.7 cents ($1.339), after a tough Q4.**

While Chair Powell had to toe a very fine line in his remarks on Friday, so too will Governor Poloz in his full meal rate decision next Wednesday (i.e., including the MPR and a press conference). The Bank will most likely cut its GDP forecast for 2019 (it was last at 2.1%, while consensus is probably now more in line with our call of 1.8%), but do so in a way that doesn't further ding confidence. Somewhat overshadowed amid the big-time rally in Treasuries recently, and the flat yield curve, has been an even flatter curve in Canada and sub-2% yields right out to the 10-year area in GoCs. **Remarkably, 10-year yields dipped 8 bps for all of 2018, even with 75 bps of BoC tightening, and are down another 4 bps so far this year to little more than 1.9%.** Not only does that offer nothing above current core inflation, it's also far below the Bank's official view on neutral overnight rates (somewhere between 2.5% and 3.5%). If, like his Fed counterpart, Governor Poloz is sensitive to the market's message, he would be hearing loud and clear that it's time to again hit the snooze button.

Adding to the sense that the Bank can now take its sweet time before hiking rates further is mounting evidence that past rate increases are already having an outsized impact. This week brought a blizzard of indicators showing that interest-sensitive sectors are struggling in Canada. After years of knocking down much bigger gains in vehicle sales than stateside, the opposite was the case in 2018. **Canadian auto sales ended last year with a dull thud**, falling 8% y/y in December and down 2.6% for the full year, the first annual decline since 2009. **Meantime, home sales were downright weak in December**, even accounting for a tough year-on-year comparison. Vancouver sales plunged 47% y/y, while each of Toronto, Edmonton and Calgary saw sales slide by roughly 20%, with prices showing little move in any

of the four cities. With the two big engines of housing and consumer spending cooling before our eyes, the economy is now heavily dependent on exports, business investment and infrastructure spending for growth in 2019. With those thin supports, we look for a further cooling in GDP this year to just 1.8%, with risks leaning to the downside of that modest call.

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