Talking Points

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The latest view on the economy January 18, 2019

We Gotta Get Out of This Place

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Despite some policymakers' best efforts to seemingly thwart confidence, markets have managed to repair much of the late-2018 damage in the opening weeks of this year. To pick just one example, the S&P 500 has fired back up by more than 13% from its closing low on December 24, thereby recouping more than half of its Q4 losses in less than four weeks. Bond yields have largely followed suit, albeit somewhat more belatedly, with 10-year Treasuries rising 25 bps from the extremes reached in early January. Oil, too, has bounced from December lows, grinding back above $53. But, in all cases, even with impressive recoveries of late, there has still been a notable reset lower from where we stood just three short months ago.

We would make the case that the reset is largely appropriate given the milder outlook for global growth in the coming year. After peaking roughly a year ago, we look for GDP trends to simmer down to around 3¼% in 2019, below long-run norms (of closer to 3.5%)—but far from a heavy-duty braking. But, of course, larded on top of that duller global growth backdrop are at least three—policy-inflicted—weights of massive uncertainty. **In no particular order from the Hall of Shame**, we are dealing with the **U.S. government shutdown**, **Brexit**, and the **U.S./China trade battle**. Only on the latter has there been any sense of optimism, and that likely involves a temporary patch. China has reportedly offered to go on a "*six-year buying spree*" to eliminate the trade imbalance, but that would not in any way address U.S. concerns on structural issues. Still, any cooling of the harsh rhetoric on the trade file is a welcome respite, especially since it is probably the most important of the three issues from an economic and market standpoint.

Meantime, on both the **shutdown** and **Brexit**, the quagmire simply seemed to deepen this week, with the word **"deadlock"** quite appropriate for both. We, along with almost all others, initially brushed off the economic impact of the U.S. government shutdown, having seen this Kabuki play many times before. However, now stretching into a record four weeks, with no off-ramp in clear sight, the costs are beginning to build. The early guesstimates that the shutdown could shave perhaps 1 tenth from Q1 GDP—maybe 2 at worst—are running into the stark reality that the end is not nigh. And, crucially, the economic data blind spots will widen as releases are heavily delayed. So, ironically, we may not officially know the true economic costs until it is long over. **Even Canadian policymaking will get drawn into the squabble**, with the **December trade data now delayed**, unleashing some fog on the broader GDP figures as well.

Brexit has completely different contours, and implications, but offers even more uncertainty. (At least with the shutdown, there are some very straightforward routes out of the morass.) The drama-meter was turned up to 11 this week. Between the Brexit bill's inglorious defeat, a failed no-confidence push, and now a quick window on Plan B (to be voted on on January 29th), there was plenty of grist for the mill. Yet, notably, markets remained remarkably calm through the storm, perhaps inured to the noise over the past three years. The pound actually finished the week slightly higher

(even rising 1.3% against the euro), while the FTSE managed to follow the leaders higher (albeit in a more modest fashion than most major indexes). The economic impact of the relentless uncertainty is subtle, but U.K. GDP has lagged the Eurozone for the past two years, and business frustration all but boiled over following this week's impasse.

Circling back to the **U.S./China trade talks**, markets rallied late in the week on a couple sparks of optimism. First, there was a report that the U.S. was floating the idea of relaxing the tariffs to move the talks forward. While that was swiftly denied by Treasury, even the idea seemed to offer faint hope. Next came the report of China's plan to aggressively ramp up imports, and markets found a second wind late in the week. Given that the bilateral trade friction was arguably the single-biggest weight on markets late last year, and perhaps the single-biggest tail risk to the global outlook, the outsized market response to even glimmers of good news is understandable. While we remain beyond sceptical that a "full meal deal" can be reached by March—it took North America more than a year to basically tweak an existing deal with NAFTA—it is indeed encouraging that both sides seem to be finding a way to de-escalate tensions.

Another round of sour Canadian home sales figures, and a further cooling on household borrowing, seems to have awoken some of the big bears on Canadian housing. But before everyone goes all "sell Canada on the coming melt in housing", we would just point to a variety of countering facts. **First**, the reported 11% drop in home sales last year, as well as the 4% drop in average transaction prices, can be seen as Mission Accomplished by policymakers. The triumvirate of tighter mortgage rules, five rate hikes, and foreign-buyer taxes (in B.C. and Ontario) were all aimed at cooling a previously piping hot market. With no further big policy changes in the works, it looks like sales will largely stabilize in 2019, with prices likely to follow suit.

Meantime, there are two factors that could lend some serious support to the housing outlook in the year ahead. As we have pointed out at every available occasion, do not forget that **Canada is currently experiencing the strongest population growth in a generation** (up more than 1.4% y/y). **Second**, even with the rebound in yields in the past two weeks, long-term borrowing costs are still down from the modest levels of a year ago. And that retreat in yields over the past few months is now being reflected in some lower mortgage rates.

No doubt that **Canada's economy still needs** (arguably, desperately) **to rotate away from a massive dependency on consumer spending and housing**, and **toward business investment and exports**. But that **doesn't mean that housing "needs" or will go into the tank, especially when underlying demand remains so sturdy**.

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