Short Soft Patch, or Game Set Match?

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The gusher of weak global indicators remained in full force this week, with particular softness in manufacturing and trade reports. **It's increasingly apparent that the global economy stumbled heavily around the turn of the year, and the critical question at this point—as alluded to in the title—is whether this is "just" a short stretch of weakness, or the beginning of something much more ominous?** The rollicking recovery in global equity markets, which rolled on this week, suggests that Mr. Market thinks it's the former. Given our forecast of roughly 2% growth in North America, and the chance of one more rate hike by both central banks, clearly we, too, lean in that direction. Yet, we are keeping an open mind amid the consistency, breadth, and depth of the weakness, as well as the studious failure of bond yields to follow stocks higher.

Making no bones about it, a number of indicators have been shockingly soft of late. To briefly recap this week's tale of woe, **China auto sales were down 18% y/y in January**, and recall the largest market in the world by far had regularly posted double-digit annual gains until last year. Stateside, **the Philly Fed fell heavily** in February, existing home sales continued their year-long descent, and leading indicators dipped at the start of the year. In the rest of the G7, both **the Euro Area and Japan saw their PMI for manufacturing** drop below the key 50 line in February, while German business confidence fell for a sixth consecutive month to a four-year low. Just to reiterate, the economies that have seen the sharpest deceleration in GDP growth over the past year have been Japan and Germany, both of which are extremely dependent on auto exports.

Frustratingly, the raft of weak global reports arrives at a time of a paucity of official U.S. economic releases, leaving us with second-tier, dated, and even dubious data. But, there can be little doubt that activity at the very least took a deep pause for breath at the start of the year. We would ascribe the deeper-than-expected cooling in global growth to **three main factors**:

1. The intensifying **trade war** prompted an inventory/production swing, where output ramped up in the Fall to avoid even higher tariffs, only to sag heavily late last year and into early 2019. Korean exports provide a classic example—they soared 10% in the three months to October, only to then plunge 20% by February.
2. The **financial market volatility and stock slide** late last year crushed almost every measure of sentiment and confidence available; and, given the lack of hard U.S. data, private sector surveys have been especially prominent.
3. The **U.S. government shutdown** likely had at least a passing impact, as well, on sentiment and spending. We suspect it clipped Q1 GDP by 0.3 ppts. It may well have contributed to the deep drop seen in U.S. December retail sales; note that Canadian sales for the same month barely budged (-0.1%, as expected).

If these are the three factors that truly drove the early-year weakness, then it is indeed reasonable to believe that this is just a soft patch, and not the beginning of the end of the cycle. Tackling the three factors in reverse order, and thus going from the least to the most important:

With the shutdown done, and the direct impact over, we will not only soon get caught up on the official statistics, but the small direct weight on growth will be lifted. Of course, the political drama remains seemingly cranked up to 11 permanently, but markets long ago learned to tune that out.

Second, sentiment may begin to turn, and possibly quickly, with the snap-back in stocks. The S&P 500 is now up an astonishing 18.6% from its December lows, and there are signs that some of the surveys are now mounting a comeback as well. Early examples of modest turns include the NAHB, ISM for manufacturing (unlike in the Euro Area), and consumer confidence (U of M).

Finally, **we and the market have been pleasantly surprised at how the U.S./China talks appear to be progressing**—President Trump is set to meet with Vice Premier Liu after our publication deadline. While it's been obvious from the start that they couldn't reach a full deal on structural issues in such a short time frame, news this week that there could be MOUs on six areas has to be viewed as significant progress. **The structural issues will be a marathon**, not the three-month sprint, but this looks to be an encouraging start. While a better tone on U.S./China trade won't turn back the clock on global weakness in factory activity, it could halt the losses. Now, we'll have to see if there is enough progress for the U.S. to not just delay further tariff increases, but possibly even seek a path back from the 10% tariffs they have imposed. The fate of steel & aluminum tariffs on Mexico and Canada, which are still very much with us despite a signed USMCA, are an excellent test case.

Looking ahead to next week, Friday's March 1 deadline for U.S./China trade talks may be a non-issue as early as this afternoon, but markets will grapple with many other hurdles as well. Chair Powell will testify to Congress on Tuesday and Wednesday morning, with a chance to further explain the Fed's abrupt 90 degree turn to neutral, and to provide some light on plans for the balance sheet. The U.S. data mill will be playing catch-up, with the first estimate of Q4 GDP on Thursday perhaps the most anticipated release. We are at 2.6%, but some are much weaker (the Atlanta Fed's model is now at just 1.4%). Much more timely data arrive Friday, with the manufacturing ISM and vehicle sales for February both offering a good sense of whether the lull is ending or extending. The key issue for all indicators is simply if they can pull out of the air pocket as quickly as the financial markets did in the past eight weeks. We highly suspect the workout period will be quite a bit longer for the real economy to rebound.

Canada is no island amid the global cooldown, as it has seen its share of weak data recently—as well as one of the most spirited rebounds in stocks. However, this week's key December releases were uneventful, as **both wholesale and retail trade nudged up in volume terms**. True, a 0.2% rise in retail volumes won't get too many pulses racing, but that qualifies as a big win in a world of sagging statistics.

The economic calendar cranks up next week as well in Canada, with important news on each of CPI, trade, and GDP for Q4. Governor Poloz was loud and clear in this week's speech that, while he still thinks rates need to eventually get a tad higher, the path to getting there is *"highly uncertain"*. We suspect that a mild CPI result (the headline could droop below 1.5% for January), and a soft end to Q4 for growth (close to 1% for the quarter and at best flat for December GDP) **will keep BoC policy in the deep freeze** for an extended period… just like most of Canada. On a sidebar to the weather: Memo to Wiarton Willie and Punxsutawney Phil, and your call for an early spring this year—you pampered rodents should leave the forecasting to the experts.