Talking Points

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Goodbye Yellow Brick (Belt and) Road

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A further escalation of the U.S./China trade hostilities was the dominant item this week and has leapt back to the top of the list of single-biggest threats to the global economic outlook. Financial markets are clearly struggling with how to play this new, dangerous turn; uncertain both of the odds of an eventual agreement, and just how deep the damage will be in the absence of a deal. Rapidly ping-ponging between fear and relief over the past two weeks, markets swung back into near-neutral mode by week's end on China's lack of interest in further talks until the U.S. shows "substantial sincerity". In honour of the upcoming biopic "Rocket Man", we turn to Sir Elton John for some words of wisdom in this murky environment:

Don't Go Breakin' My Deal: We have long been sceptical that the U.S./China tussle was headed anywhere positive, and had been pleasantly surprised/amazed that the talks seemed to be going reasonably well—until two weeks ago. At this point, we would counsel caution, especially given the fact that there is **no clear route for both sides to de-escalate in a face-saving manner**. We would simply repeat, yet again, that it took 14 months of extremely hard bargaining to pound out the USMCA, and that was between three friendly nations, with a perfectly good existing deal in place. The U.S./China talks are, frankly, between two adversaries, with no existing deal, and where one side is asking the other to fundamentally change the way it conducts business. That can't happen overnight, and the only surprise was how smoothly things seemed to be progressing… until they weren't.

I'm Still Standing: Despite the mounting risks around a deepening trade war, equities have held up reasonably well. Prior to Friday, and the latest volley from China, the S&P 500 was down little more than 2% from its all-time high—hit less than three weeks ago. (The TSX is off just 1.5% from its record.) Some of that resilience reflects hope springing eternal that a deal can ultimately be reached, some on the decision by the Trump Administration to delay auto tariffs for six months, and some on hopes for stimulus from China (and possibly, the Fed itself).

Someone Saved My Loon Tonight: The renewed trade war has not been kind to currencies. With China letting the yuan slide nearly 3% (to 6.92/US$) in the past two weeks, the U.S. dollar has risen against almost all major currencies (save the super-safe yen and Swiss franc). Emerging market currencies have been caught in the crossfire, with Brazil's real notably weak (down 4% in May). The Australian dollar has also been walloped, dropping below 69 cents(US), with tomorrow's election an added source of uncertainty. The Canadian dollar has softened to a three-week low; but, at just above 74 cents (or $1.346/US$) it has actually held up better than most, with some support from firm oil prices and recent robust domestic economic data. As well, the currency got a boost from movement on the steel & aluminum tariff front; a deal is reportedly at hand, and that is a necessary step on the long road to getting the USMCA approved. (Okay, the title to this section is a stretch, but I had to reference that great song—which may be the only pop song ever to mention *"stocks and bonds"*.)

Don't Let the Yield Go Down On Me: While most markets are struggling with the trade war, bonds are absolutely thriving. Yields have plunged anew since hostilities renewed, with 5-year Treasuries leading at down 17 bps in just two weeks. This has been like pushing on a rock that was already rolling downhill on sagging core inflation trends, taking almost all Treasury yields to their lowest ebb in a year. And, everything from the 2-year space out to 10s is now at, or below, the Fed's mid-point target rate (i.e., inverted curve, again). The rally in Canadian bonds has been a little less forceful, again partly on a wave of decent domestic data, but also on the simple fact that GoCs were already scraping along at incredibly low levels to begin with. Ten-years have still managed to drop nearly 10 bps in the past two weeks; and, at less than 1.7%, they are tucked neatly below core inflation.

Saturday Night's Alright For Fighting: In fact, no night is good for fighting on this front. But with no official talks currently planned—and even that's a point of dispute at this stage—the next big event looks to be the G20 summit in Japan, ending on Saturday June 29.

Rocket Man: While the U.S./China tussle dominated headlines this week, not to be overlooked are many other swirling geopolitical risks. North Korea has been making mischief again, while the U.S. and Iran have been openly hurling threats at each other. President Trump suggested that he *"hoped"* the two wouldn't go to war, which passes for good news these days. The recent bellicosity, as well as attacks on Saudi tankers and oil facilities, has kept oil prices fired up even in the face of fading global growth. WTI rose almost 3% this week to $63/barrel. Notably, gold prices have benefitted little on net from the mounting geopolitical tensions, still holding close to $1280 on a firm U.S. dollar and mild global inflation trends.

Tiny Dancer: As it is so wont to do, the Canadian economy is doing its own thing amid the global turmoil. Almost since the day that the Bank of Canada's MPR came out three weeks ago with a surprisingly downbeat economic forecast, growth has suddenly been on wheels. To wit, April alone saw the biggest monthly jobs gain on record (largely confirmed by this week's ADP release), a snap-back in housing starts, and clear signs that home sales are recovering (outside of British Columbia). We also know that inflation is now remarkably close to "home", with headline CPI bang on the 2% target, and core just one tick below. And, of course, oil prices have fully rebounded from last year's nastiness, especially so for Canadian prices (WCS is back above $50), while the loonie is lagging. The economy will also get a moderate lift from the impending removal of the metals tariffs. Under normal circumstances, this backdrop would augur for eventual rate hikes by the Bank… but these are not normal times. Instead, markets are still priced for a reasonable chance of a rate cut over the next year (which could be interpreted as a small chance of something going seriously awry).

Stephen and the Frets: As if to reinforce the market's view, the Bank's latest Financial System Review—now produced annually—opined that the risk of a severe recession is *"elevated and rising"*, citing *"uncertainty and tensions around global trade arrangements"*. The Bank also raised climate change as a potential risk to the financial system for the first time, albeit with few details. Yet, despite the warnings, the Bank's core view is that a recession is not on the horizon. In a recent interview with Maclean's magazine, Mr. Poloz concluded that the Bank is expecting smooth sailing until the end of his mandate in June 2020. Oh, and that a fortune cookie told him that he is "independent politically", and he keeps that message in his wallet. (All true.)