Talking Points

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The latest view on the economy May 24, 2019

That Synching Feeling

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The dawning realization that U.S./China trade tensions are not going to be resolved anytime soon continues to rattle markets. Major developments this week included U.S. restrictions on Chinese telecom companies (and then a small step back), and a hardening of rhetoric on both sides. Amid some back-and-forth, equities receded for the third week in a row, with the S&P 500 now down a little less than 4% over that period. While stocks are grappling for clear direction, bond yields aren't—they have been headed due south through the three weeks of open hostilities. Ten-year Treasury yields fell to 20-month lows of below 2.30%—gathering fuel from a deep slide in oil prices—before nudging up slightly on Friday. Since the trade war flickered back to life, Treasury yields have dropped roughly 20 bps across the curve, slicing all but the very longest bond to below the midpoint of the Fed's overnight target range (2.375%).

Effectively, **investors are still in the process of readjusting expectations on the trade war, shifting its probabilities from outside risk to base case in a matter of weeks**. And, given the tone from both sides—including Xi harkening back to The Long March—this seems to be a **prudent step**. We take a closer look at the impact on Canada of a full-blown trade war in this week's Focus Feature, but it's difficult to put decimal points on this developing battle. Much depends on how markets, businesses, and even consumers respond to events. A variety of Fed speakers have noted recently that the uncertainty alone could chill business investment, which already had been a notable laggard for much of this cycle globally.

While most markets were busily pricing in deeper damage from the trade conflict, the **foreign exchange market was a notable bystander** this week. Most of the majors managed to hold their own against the U.S. dollar, if not even firm a tad, albeit reflecting a swathe of specific factors. A surprise election victory by the ruling coalition gave some mild support to the **Australian dollar**. The **U.K. pound** sagged early in the week, but revived a bit on Friday's announcement of Theresa May's resignation—presumably on the faint hope that her replacement may be able to reset Brexit proceedings (and good luck with that). And, **China's yuan** stabilized after it was allowed to weaken more than 3% over the past month.

The **Canadian dollar** also pulled a counter trend, rising marginally this week even as oil prices fell heavily. Notably, while WTI dropped 7% to $58, WCS was crushed by 11% to just over $42, with the differential moving back into the normally wide range. There were a few supportive factors for the loonie this week, even amid the deteriorating global trade backdrop and sagging crude. **First**, the currency was still basking in the warm glow of last Friday's sudden deal with the U.S. to remove the metals tariffs, and related prospects of the USMCA proceeding with some pace (well, at least until Donald met Nancy). **Second**, the wave of upbeat Canadian domestic data kept rolling, with both retail (+1.1%) and wholesale trade (+1.4%) coming in above expectations for March. Pretty much **since the day the Bank of Canada delivered a downbeat economic forecast at its April MPR, we have been fed a**

steady diet of strong Canadian data. While we still believe Q1 GDP was quite sluggish, we did slightly revise up our call for next week's report (to 0.5% a.r.) on the latest strong indicators, and look for a significant improvement in Q2 (at just over 2% growth).

Finally, the loonie also was supported by **some surprisingly upbeat remarks by Governor Poloz** after the markets had packed it in last Friday. He both indicated that the underlying tendency is for rates to go higher, and that the recent massive job gains may, in fact, be a true indication of how the economy is faring. We have no significant quarrel with the view that job growth is robust—even this week's Economist magazine trumpets *'The Great Jobs Boom'* on its latest cover (and, no, they are not focusing on Canada…pity). However, it is highly debatable whether the gaudy headline job gains will translate into a meaningful pickup in broader activity, given that wage growth remains modest and the biggest increases are in part-time positions. Note that, even with the solid March advance, real retail sales were up a modest 1.2% y/y, not even matching Canada's (torrid 1.4%) population growth trends.

What do these many moving parts mean for the Bank of Canada's policy outlook? There's not much debate that the Bank is locked firmly on the sidelines for the time being. Poloz's recent comments seem to lean to the side that the run of robust domestic data carry more weight than the flare-up in U.S./China trade tensions. And, the Governor has often noted the potential upside risks if and when said tensions recede. Suffice it to say that we take a more jaundiced view of the trade outlook and instead, believe that the better domestic news will in fact soon be overshadowed by a more problematic external backdrop. The fact that even two-year GoC yields have cascaded 65 bps lower in the past six months to below 1.60% suggests that markets are very much of that view as well.

One of the most common questions we field these days is whether Canada's mortgage stress tests may be relaxed in the semi-near future. The short answer now seems to be "highly unlikely", after two key voices—Governor Poloz and the head of the CMHC—offered full support to the tests in the past week. Both suggested that the tests were part of a broader goal of averting a wider problem on the household debt front. And just since the latest round of tests came into effect at the start of last year, growth in overall household debt has cooled notably from more than 5% to just under 3%—taking it a bit below underlying personal income growth.

What's fascinating about this whole episode is how it has now become almost conventional wisdom that the housing market had indeed been in bubble-like conditions in 2016 and early 2017. Oh, and that, yes, non-resident investors were indeed a significant factor fuelling those unsustainable trends—the BoC has released a paper that gives some academic heft to something that was evident to anyone who cared to look at that issue. We would *never* stoop so low as to say "we told you so", but there are always times for exceptions…