Talking Points

BMO Capital Markets
We're here to help.™

The latest view on the economy May 31, 2019

Brave New Yield

Douglas Porter, CFA, Chief Economist • douglas.porter@bmo.com • 416-359-4887

The market's wall of worry just turned into Mount Everest, amid climbing trade tensions. Mixing metaphors, President Trump flung **gasoline onto the protectionism inferno** with a Thursday threat to impose a 5% tariff on all Mexican imports on June 10, rising to 25% by October. Seemingly unafraid to further inflame markets, or to trample every conventional diplomatic norm, or to threaten the fragile path for USMCA approval, the President's tariff threat was aimed at border security—far removed from any trade issue. Having well learned not to dismiss the Administration's threats on trade—no matter how outlandish the bluster—markets are selling first, and will ask questions later. The peso has responded most forcefully, dropping 2.6% today, a move which would alone counter much of the first round of potential U.S. tariffs.

Equities were already under some serious pressure from the deepening U.S./China tussle, even before the latest threat aimed at Mexico. After reaching record highs just one short month ago, broad U.S. averages had already dropped nearly 6% from the apex, prior to Friday's tariff trauma (down roughly 1% as we speak). The Mexican melee sealed a tough month for stocks globally, with the MSCI headed for a 6% setback. That would mark the first drop of the year, and in the same league as 7%+ declines last October and December. While the TSX held up somewhat better, even it was on track for nearly a 4% pullback in May, weighed as well by a downbeat response to the run of Q2 bank earnings. A late-month retreat in crude oil prices also hurt, with WTI dropping almost 14% in May to end below $55.

Bonds, of course, are feasting on the equity markets' struggles, as well as the related sag in oil. For weeks, many commentators, including us, were highlighting the seeming disconnect between plunging bond yields and robust stocks. Well, it appears that the conundrum has been resolved, with the bond rally fuelled even further by the sag in stocks. After already falling 20 bps since the start of the month, 10-year Treasury yields almost doubled that with another 16 bp drop this week alone (to 2.16%). The 2-5 year portion of the curve gripped a 1-handle late in the week, a long, long way from the fed funds target of 2.25%-to-2.50%. Almost the entire Treasury curve has now seen yields drop by 100 bps or more from their peaks of little more than six months ago. It's almost redundant to note that the market is now priced for two Fed rate cuts by the end of this year. The fact that the Fed's Vice Chair, Richard Clarida, is now openly discussing the possibility of rate reductions is the potential smoke behind a very real fire.

The Bank of Canada has certainly taken note. Thursday's speech by Senior Deputy Governor Wilkins, while upbeat on business investment, also warned about the inverted yield curve. The BoC had earlier called it an "innocent inversion"—because it was due more to bonds rallying rather than short rates rising. But Wilkins' remarks betray a growing unease among central bankers surrounding the relentless drop in long-term yields. Canada is on the cusp of an extreme inversion, as the 30-year bond is now just 2 meagre basis points above the overnight target rate of 1.75%. We have long contended that the persistence of sub-2% yields at the very long end of the GoC curve is a strong signal from financial markets that "neutral" short-term interest rates in Canada are still much lower than the Bank's revised estimate of 2.25%-to-3.25%.

If the Fed was to succumb to mounting trade tensions and still-mild inflation with rate trims, **would the Bank follow? Only reluctantly.** This week's Statement after the rate decision carried a whiff of optimism on the economic outlook, with the Bank affirming that growth was picking up after a two-quarter struggle. Today's GDP release chimed in, as March powered up with a 0.5% m/m jump on broad-based gains, largely countering the measly 0.4% annualized growth for all of Q1 (after a revised 0.3% "advance" in Q4). Moreover, the starting point for the Bank is much lower, with the overnight rate below both inflation and neutral, neither of which is the case for the Fed. And, contrary to the U.S., the primary measure of Canadian core inflation is not obviously below target (at 1.9% in April, and 2.0% in March). Accordingly, the odds of a BoC rate cut this year are lower, although markets are currently pricing in about a 65% chance of one move by year-end.

Meanwhile, **back at the U.S. economy**… This week's releases actually suggested that **domestic growth is holding up well**. Consumer confidence snapped higher in May, with job prospects seen as the strongest of the cycle. Gains in April incomes and spending point to some consumer-related support for Q2 GDP growth. We are sticking to our call of 1.3% for the quarter, a big step down from the surprise 3.1% Q1 gain, but see a touch of upside for the spring period. However, given the swirling trade uncertainties, and the very clear risk of a big downward lurch in growth, there won't be any upward forecast revisions anytime soon.

Next week will bring a raft of early indications of how the North American economy fared in May, amid the escalating trade tensions and the de-escalating equity markets. Employment reports for both countries on Friday will grab the headlines, although even solid gains may be viewed by many as a lagging indicator. Perhaps more telling will be earlier reads from U.S. factories (Monday's ISM), consumers (auto sales for both countries), and Canadian home buyers (preliminary sales figures for the big cities will roll in throughout the week). We suspect that, aside from the ISM, the tone will remain solid, for now—but **the big issue** is how **much damage will be inflicted** on growth in the second half of the year from **trade conflict** and its **market casualties**.

Never one to jump on a crowded bandwagon, but it's Raptor time. We were asked at the start of the week if there would be an impact on Canada's economy from the deep Dino run in the playoffs. Beyond the direct impact of attendance at home games, there are also sales of jerseys and Drake paraphernalia, visitors, and the throngs watching at bars and restaurants. But our initial take was that, while there could indeed be a small impact, it's tough to see more than a 0.1 ppt bump to GDP, which would then be reversed the following month. Note that Q1 nominal GDP sported a $2.25 trillion annualized read. That translates into $188 billion of goods and services produced every single month, meaning it would take almost $200 million of net new activity to boost GDP even by one tick. I realize ticket prices are high for the finals… but not that high!

As for a forecast, I will simply note that of the 14 NBA playoff series so far this year, 12 have been won by the higher seed (i.e., the team with home-court advantage, in this case the Raptors, of course). In staggering contrast, only 7 of the 14 NHL series have gone that way, and the Blues may keep it there.