Shabby Road

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A wise person once advised: *"Never change your fundamental view in August."* Investors appear to be shunning that wisdom, with markets broadly taking down anything levered to global growth. Stocks, commodities and bond yields all took a big bath early this week, with growing questions on China the focal point for general unease on the broader backdrop. And while it's tempting to ascribe some of the volatility to thin summer markets, volumes have been massive in certain areas. The S&P 500 suffered its worst day of the year on Monday, with a further sag Friday, and is now 4% below record levels prevailing just two weeks ago. The darkening outlook for growth is smacking commodity prices, which were already facing rough weather from bloated supplies and a robust U.S. dollar. The deepening sag in resource prices and a slower global growth backdrop are taking a cleaver to yields almost everywhere. U.S. 10-year Treasury yields fell 15 bps on the week, and are within sight of record lows in Canada.

Full disclosure: That opening paragraph was written almost exactly four years ago, by yours truly, shortly after China devalued—with just a few of the figures and dates updated to show how history rhymes. This week started with the second shoe dropping on the trade war, as China let the yuan slide 2% to above 7/US$, halted purchases of U.S. farm products, and the U.S. promptly labelled China a currency manipulator. While none of these steps on their own pose a major threat to growth, investors were rattled by the rapid-fire escalation in the war, and by the blinding flash of the obvious that no deal is on the horizon—especially coming just a week after purportedly "constructive" trade talks.

To help analyze the implications, we will harken back to the Beatles' **Abbey Road**, arguably their finest (and final) work... completed 50 years ago this month. Yes, the cultural references will eventually be from this century.

You never give me your money: The root cause of the trade war is the groaning bilateral trade imbalance, with the U.S. reporting a goods deficit of just over $400 billion in the past 12 months. July trade results from China were mildly encouraging, with exports holding up well at 3.3% y/y—the bad news is that imports from the U.S. tanked 19%, flagging a further widening in the bilateral gap. (Aside: One line of this song goes, *"And in the middle of negotiations, you break down."* Appropriate.)

Because: Because the trade negotiations seemed to be stalling, President Trump last week proposed a 10% tariff on roughly $300 billion of Chinese imports on September 1. This sparked the latest retaliatory measures by China, which then prompted the currency manipulator tag. In turn, this prompted concerns about an outright currency war—although a semblance of stability in the yuan at just over 7/US$ suggests China has no appetite to destabilize the currency. The IIF reports that China's corporate sector now carries $1.5 trillion in US$ debt, half of which is in non-financials. We suspect some

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further modest depreciation if tariffs ratchet higher, but believe the drop will be in the zone of a further 2%-to-3% softening—a near-offset to the tariffs.

Come Together: The two sides are still scheduled to resume talks in Washington in September. However, that may be at risk if (a) if the 10% tariffs are in fact applied; and, (b) if the U.S. does not relent on Huawei.

Something: Something beyond the direct trade/currency wars spooked markets this week. Responding to the mounting threat to global growth, bond yields plunged, inverting curves in many markets. To cite the biggest example, 10-year Treasuries are now a staggering 30 bps below 3-month T-bill yields. Given that this is the curve that the Fed pays closest attention to, the deep inversion set off recession alarm bells globally.

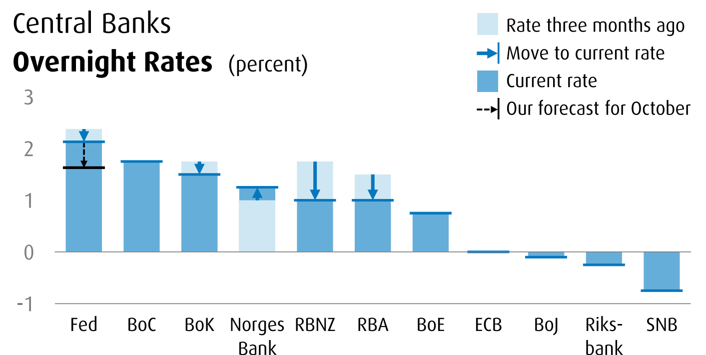
I Want You (She's So Heavy): After last week's broadside, President Trump demanded that the Fed cut again immediately. And, somewhat oddly, he also demanded an immediate end to quantitative tightening—in fact, the FOMC had already decided to halt QT just last week.

Mean Mr. Mustard: The President also chastised the Fed, yet again, for the strong dollar, even though the greenback is actually in the purview of the Treasury.

Powell's Silver Hammer: After last week's Fed move, and the escalation in trade risks, a variety of central banks cut rates this week, and some aggressively so. Perhaps for the first (and last?) time ever, the Reserve Bank of New Zealand moved markets Wednesday with a 50 bp slice, and it was readily followed by a round of cuts across Asia.

Carry That Weight: Canadian bond yields matched, and in some cases exceeded, the rally in Treasuries. Thirty-year GoC yields reached their lowest level on record on Wednesday—flirting with 1.4%, before finishing closer to 1.5%. Expectations for Bank of Canada rate cuts were fired up by the plunge in global yields as well as rate cuts elsewhere. A weak jobs report for July added further fuel, with employment falling for the third time in five months and the unemployment rate rising two ticks to 5.7%. The attached chart shows that the BoC's 1.75% overnight rate could—if it was kept steady—be the highest among the developed world central banks, if the Fed cuts by 50 bps by October, as we now expect.

Chart 1
Tall Poppy



Sources: BMO Economics, Haver Analytics

Here Comes the Sun: While it was a volatile week for equities, including a 3% slide on Monday, somewhat calmer currency conditions helped stabilize stocks. For the week, the S&P 500 was on track to slip roughly 1% after last week's 3.1% drop.

Golden Slumbers: Gold has completely broken out of its lengthy slumber, even as other commodities have suffered. In a classic flight to safety, the yellow metal popped another 4% this week to a six-year high of just above US$1,500. A year ago it was struggling to stay above $1,200.

The End: How will the trade war end? We remain pessimistic, with recent developments indicating that it will be extremely tough for both sides to back down. Perhaps the best we can ask for is a dialing down of the rhetoric, and a ceasefire—which has happened a few times before. Concerning, though, is that the tensions then eventually return, typically a little louder and a little worse. The persistent trade uncertainty will blunt business capital spending, more than offsetting any support from lower borrowing costs and looser fiscal policy, pointing to well-below-potential GDP growth next year. **The clear risk is that a further escalation of the trade war leads to a much worse outcome for the economy—and no amount of Fed easing can fully compensate for that scenario.**

The latest trends in **Canada's housing market** are addressed in this week's Focus Feature. The main point is that **not only does the market seem to be stabilizing, it looks to be regaining some momentum in a number of key cities**. Looking a bit further out, I have long contended that the risk to housing is more on the upside, not the downside—in studied contrast to the legion of bears. And recent activity does nothing to dissuade that view; it now looks like home sales popped in July (national data due Thursday), with double-digit gains from year-ago levels and moderate average price gains.

Many voices were agitating earlier this year for a relaxation of regulatory (or macro-prudential) measures, and others have suggested what we really need right now is a rate cut. But, with long-term borrowing costs already falling fast and feeding into lower mortgage rates, any easing in other ways may be the last thing housing needs at this point. Consider the following:

- The latest plunge in global yields simply pounds home the point that rates will remain low for long—or forever.
- Population growth remains a big driver, and doesn't look to ebb anytime soon, with robust immigration inflows continuing.
- The lack of reasonably valued investment alternatives is fuelling real estate demand.
- The market appears to have absorbed past tightening measures, and the Federal Budget contained steps to support demand.
- Vacancy rates are low in most major cities, powering up rents.
- Demand for second homes, and from short-term rentals (e.g., Airbnb) is strong.
- Supply is tight where it's most needed—larger units in major cities.

Taking these trends together, it seems that the risks are heavily tilted to upward, not downward, pressure on prices over the medium term. In this landscape, **domestic policymakers may need to consider other ways to control speculation**—especially from abroad—**in a world where interest rates stay below inflation, or even below zero**.

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