ON DECK FOR FRIDAY, JANUARY 11

Country	Date	Time	Indicator	Period	BNS	Consensus	Latest
US	01/11	08:30	CPI (m/m)	Dec	-0.2	-0.1	0.0
US	01/11	08:30	CPI (y/y)	Dec	1.9	1.9	2.2
US	01/11	08:30	CPI (index)	Dec	--	251.1	252.0
US	01/11	08:30	CPI ex. Food & Energy (m/m)	Dec	0.2	0.2	0.2
US	01/11	08:30	CPI ex. Food & Energy (y/y)	Dec	2.1	2.2	2.2
US	01/11	14:00	Treasury Budget (US$ bn)	Dec	--	-4.0	-204.9

KEY POINTS:

- **Mixed global markets ahead of CPI, post Fed speech**
- **Fed's Clarida turns incrementally dovish…**
- **…willing to 'offset' crosswinds if they persist…**
- **…which reinforces 'watching,' 'waiting,' 'patient' and 'flexible' guidance for now**
- **Our sunnier assumptions cautiously assume better days ahead…**
- **…and temporarily interrupted hikes**
- **US CPI: softer headline, but focus upon core**
- **The Fed is finally waking up to broad dollar strength's influences upon inflation**
- **The many varied influences upon inflation**
- **Brexit headlines continue to induce volatility**
- **Mixed UK macro data**
- **The US government shutdown is the longest ever**
- **Scotiabank Economics will release its Global Outlook today**

INTERNATIONAL

Mixed global markets are marked by USD weakness and a slight gain in oil prices versus slight softness in equities and rallying sovereign debt—outside of the UK. Brexit headlines are driving more volatility (see below). Fed Vice Chair Clarida's speech last evening is motivating dollar softness and rallying Treasuries (see below) ahead of US CPI (see below). All of this is on the day that the US government shutdown becomes a record long governmental failure. A discussion of the Fed and inflation dynamics is provided below. Also note yuan weakening this morning on speculation the PBoC is concerned about recent strength; I still think further monpol easing may well be in the cards on the path to the Lunar New Year shutdowns. We will issue our full Global Outlook report today including an in-depth look at the Fed and Bank of Canada forecasts.

- The USD is broadly softer against almost all major and semi-major currencies this morning on the back of Clarida's speech last evening. Pound sterling is outperforming on Brexit headlines. The Mexican peso is underperforming but still up a touch while CAD is roughly in the middle of the fray.

- The US Treasury curve is rallying by 2–3bps across maturities. Canada is slightly underperforming through the front-end and belly. Gilts are cheaper across the curve with yields up 2–3bps on the back of Brexit headlines. Bunds are little changed.

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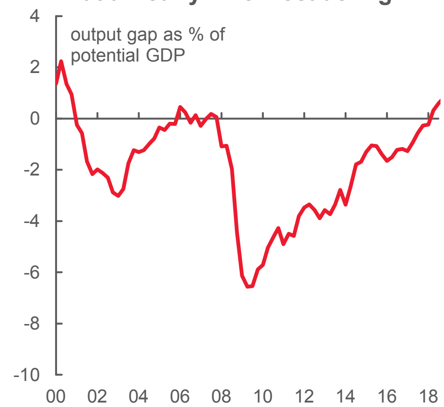
US Excess Demand is Running at a Nearly Two-Decade High



Sources: Scotiabank Economics, Congressional Budget Office.

- Oil prices are gently higher with WTI running just under US$53 and Brent just under US$62. Western Canada Select gained a little again yesterday pending today's moves. It stands at US$44.74—the highest since early September before the swoon. That's a 232% rise since the low point in mid-November.

- US equity futures are slightly lower by up to ¼% across exchanges. TSX futures are similar. European cash markets are down by between ¼% and ½%. Asian equities were generally higher except for a mild dip in the Sensex, as the Nikkei 225 was up 1%, HK gained ½%, mainland China rallied ¾% and the Kospi was up by just under ¾%.

This piece hit the wires this morning and flagged the possibility of extending the Article 50 Brexit deadline beyond March 29th. PM May's office denied the report while UK-EU negotiations toward the backstop arrangements are ongoin. Sterling – predictably – has been volatile this morning.

UK data was mixed this morning. It included dips in industrial production (-0.4%), a slightly wider than expected trade deficit, a 0.2% m/m rise in GDP in November and a 0.3% gain in the monthly services index with the latter two reports slightly exceeding expectations. All is not lost yet for the UK economy!

UNITED STATES

Fed Vice Chair Clarida's speech last evening (here) was incrementally dovish in nature—for now. He basically expressed optionality to react or "offset" if 'crosswinds' to the US economy arising from external risks and financial market tightening persist. He implied they will react to inflation rather than pre-empt due to his low faith in inflation models. It's a huge stretch to go to the dark place of requiring cuts as some headlines immediately suggested in my opinion. Overall, I think his speech just reinforced Powell's 'watching,' 'waiting,' 'patient,' and 'flexible' messages. The way we express such guidance in our base case assumptions is through a near-term pause before coming back with a Q2 hike. Obviously we too are watching, waiting and flexible in the face of risks that could go very well or very badly so there is substantial conditionality to our central bank forecasts. But on topics like Brexit, US-China trade negotiations and the US debt ceiling we are walking on the sunnier side of the street for now, but mindful toward the risks that could alter the story.

But it all comes down to what Clarida said about inflation ahead of today's CPI report that I'll wind together in terms of near-term and future expectations.

Most of today's global market focus will be upon US CPI for December (8:30amET). I'm expecting headline to pull back to 1.9% y/y (2.2% prior) and core to slightly slip to 2.1% y/y (2.2% prior, 2.2% consensus). For headline CPI, base effects counsel an unchanged reading of 2.2% y/y but falling gasoline prices and typically soft seasonal month-ago price changes could bring the reading down to 1.9% y/y. For core CPI, shifting base effects will also carry minimal influence but seasonally soft prices could put slight downward pressure to around 2.1% y/y from 2.2% the prior month.

At issue is the interplay between several influences upon inflation. Gasoline is a prime culprit for headline CPI and PCE softening, but monetary policy looks beyond such influences to underlying momentum. **Second round effects of lower gas prices and their positive influences upon household budgets could—all else equal—gently boost core inflation.**

Broad dollar strength is one effect that is disinflationary at the margin. I'm a bit surprised to see the Fed waiting this long to acknowledge the influence through its references to tightened financial conditions. They waited so long to do so that they created the impression they were looking through it! **The danger is the Fed keeps chasing the dollar's volatility in lagging fashion and getting whipsawed in the process through its transitory influences upon inflation swings.** Fed research shows that a 10% broad dollar appreciation knocks back core PCE inflation by about ½% within six months and 0.3% within one year as the effects dissipate. Former Vice Chair Stanley Fischer's speech on the effects remains a valid portrayal of the Fed's work on the topic (here). Some of the core inflation upswing until recently was due to the lagging influences of the 10% broad dollar depreciation from early 2017 until early 2018. Some of the softening in core inflation of late is capturing the influences of the broad dollar's 12% appreciation from the start of last year until the end of 2018.

The broad dollar has slightly weakened so far this year. It's early to assess whether this has legs to it, but it is reasonable to forecast a weakening dollar over the year. This is a one part fundamentals view and one part hopeful that major risks like US-China trade policy, Brexit and US government funding on the path to the debt ceiling ultimately settle down and motivate less safe haven seeking. If the dollar is peaking and if it weakens, then as the lagging effects of broad dollar appreciation shake out of the disinflationary pattern, the Fed may swing around the other way again.

In the meantime, inflation is not just going to be a dollar story. The output gap is in the greatest degree of excess aggregate demand in about two decades (see chart). It jumped by over one percentage point just in recent quarters. This should carry lagged positive effects upon inflation as capacity constraints become more binding.

Further, nominal wage growth is at post-GFC highs with real wages gaining. This too should be constructive to building wage and price pressures.

Then we have the risks to price stability that are posed by a very erratic US administration that is doing its best to irresponsibly destabilize world trade. Clarida spoke about a potential productivity renaissance. I'm less sure of that. If trade liberalization reverses then the constraints on export growth back into investment. Less confidence in investing over time saps productivity growth. Less productivity growth constrains the supply side in ways that Clarida ignored in his speech. More supply side constraints are—all else equal—inflationary. **Stagflation is the potential outcome, while the Fed is talking of downside risks to inflation.** Implementing and adhering to its dual mandate requires focusing upon two tail risks to inflation and I find the unwillingness of the Fed to lock horns with the administration even if indirectly by flagging the upside risks to the inflation half of its dual mandate due to US protectionism and the isolationist stance of the US government to be curious. Curious, in that it risks the Fed letting the genie out of the bottle again, which it has been prone to do more often than not over the decades.

Fixed Income	Government Yield Curves (%):											
	2-YEAR			5-YEAR			10-YEAR			30-YEAR		
	Last	1-day	1-wk	Last	1-day	1-wk	Last	1-day	1-wk	Last	1-day	1-wk
U.S.	2.54	2.58	2.49	2.53	2.57	2.50	2.71	2.74	2.67	3.04	3.06	2.98
CANADA	1.89	1.91	1.85	1.90	1.92	1.85	1.96	1.99	1.93	2.17	2.19	2.13
GERMANY	-0.59	-0.59	-0.60	-0.35	-0.35	-0.35	0.24	0.26	0.21	0.84	0.85	0.86
JAPAN	-0.15	-0.15	-0.18	-0.15	-0.14	-0.18	0.02	0.02	-0.04	0.70	0.70	0.66
U.K.	0.80	0.78	0.76	0.94	0.92	0.90	1.29	1.27	1.28	1.82	1.80	1.81
	Spreads vs. U.S. (bps):											
CANADA	-66	-67	-64	-64	-65	-65	-75	-76	-74	-88	-87	-85
GERMANY	-313	-317	-309	-289	-292	-285	-247	-249	-246	-220	-221	-213
JAPAN	-269	-273	-267	-268	-271	-269	-269	-272	-271	-234	-237	-232
U.K.	-174	-180	-174	-159	-165	-161	-142	-147	-139	-122	-126	-117

Equities	Level		% change:			
	Last	Change	1 Day	1-wk	1-mo	1-yr
S&P/TSX	14903	98.8	0.7	4.9	1.6	-8.5
Dow 30	24002	122.8	0.5	5.8	-1.5	-6.1
S&P 500	2597	11.7	0.5	6.1	-1.5	-6.2
Nasdaq	6986	29.0	0.4	8.1	-0.7	-3.1
DAX	10867	-54.5	-0.5	0.9	0.8	-17.7
FTSE	6923	-19.5	-0.3	1.3	1.7	-10.8
Nikkei	20360	195.9	1.0	4.1	-3.7	-14.1
Hang Seng	26667	145.8	0.5	4.1	3.5	-14.3
CAC	4775	-30.6	-0.6	0.8	-0.6	-13.0

Commodities	Level		% change:			
WTI Crude	52.25	-0.34	-0.6	8.9	1.2	-18.1
Natural Gas	3.05	0.08	2.7	0.1	-30.8	-1.2
Gold	1292.71	6.08	0.5	0.6	4.0	-2.2
Silver	15.71	0.09	0.5	1.1	8.1	-8.3
CRB Index	178.99	0.39	0.2	3.3	-1.5	-8.3

Currencies	Level		% change:			
USDCAD	1.3221	-0.0015	-0.1	-1.1	-1.3	5.6
EURUSD	1.1532	0.0032	0.3	1.2	1.9	-4.2
USDJPY	108.29	-0.1400	-0.1	-0.2	-4.5	-2.7
AUDUSD	0.7222	0.0037	0.5	1.5	0.2	-8.5
GBPUSD	1.2813	0.0066	0.5	0.7	2.6	-5.4
USDCHF	0.9821	-0.0024	-0.2	-0.6	-1.1	0.6

Central Banks	
Current Rate	
Canada - BoC	**1.75**
US - Fed	**2.50**
England - BoE	**0.75**
Euro zone - ECB	**0.00**
Japan - BoJ	**-0.10**
Mexico - Banxico	**8.25**
Australia - RBA	**1.50**
New Zealand - RBNZ	**1.75**
Next Meeting Date	
Canada - BoC	**Mar 06, 2019**
US - Fed	**Jan 30, 2019**
England - BoE	**Feb 07, 2019**
Euro zone - ECB	**Jan 24, 2019**
Japan - BoJ	**Jan 23, 2019**
Mexico - Banxico	**Feb 07, 2019**
Australia - RBA	**Feb 04, 2019**
New Zealand - RBNZ	**Feb 12, 2019**

Source: Bloomberg. All quotes reflect Bloomberg data as at the time of publishing. While this source is believed to be reliable, Scotiabank cannot guarantee its accuracy.