ON DECK FOR MONDAY, MARCH 25

Country	Date	Time	Indicator	Period	BNS	Consensus	Latest
US	03/25	10:30	Dallas Fed. Manufacturing Activity	Mar	--	9.6	13.1
US	03/25	01:00	Fed's Evans Gives Speech in Hong Kong				
US	03/25	06:00	Fed's Harker Speaks in London on Economic Outlook				
US	03/25	20:30	Fed's Rosengren Speaks at Finance Conference in Hong Kong				

KEY POINTS:

- **Global stocks cheaper, sovereign yields little changed**
- **US 90s-10s slope is perfectly flat…**
- **…and for reasons other than recession signals**
- **German business confidence improves**
- **Canada quiet**

INTERNATIONAL

Global markets continue to play defence this morning, but with a twist being that stocks are a little cheaper while sovereign bonds are little changed to slightly cheaper. This stands in contrast to Friday's equity sell-off and *falling* Treasury yields partly in the wake of the weak Eurozone PMIs. **Please see views expressed below on the drivers of the US Treasury curve**; in short, I don't see the curve as flashing recession warnings**. Incremental information is very light to start the week. German business confidence beat expectations.** The Mueller report leaves many questions wide open even if the Trump administration is portraying it as proof that they've been angels; issues of campaign finance and exactly why the Mueller report says the investigation did not exonerate Trump remain among the open issues in what will remain a heated political conflict for months if not years ahead. Canada's calendar is quiet today. The US only faces minor regional Fed manufacturing gauges.

- Sovereign bond yields are under upward pressure across Europe and North America. The US Treasuries curve is slightly bear steepening with the 10 year yield up 1-2bps to 2.45% while the front-end is little changed. **The 90s–10s Treasury slope is perfectly flat this morning.** Canada's curve is little changed with the 10 year at 1.60%. **Canada's 90s–10s curve is inverted at -7bps**. Gilts are cheaper across the curve with a mostly parallel upward shift of about 2bps across maturities. Bunds and French bonds are slightly outperforming by cheapening less. Japan's 10 year yield sits at -9bps which is slightly below the 'around' 0% BoJ target and was last at about 0% on March 5th.

- The USD is slightly weaker on a DXY basis. CAD and the Mexican peso are flat, while pound sterling and the Euro are slightly appreciating. Some Scandies are leading appreciating crosses along with the A$ while the yen and won are depreciating.

- Oil prices are down by around 20 cents across the main global benchmarks. WTI is just shy of US$59 and Brent is just under US$67.

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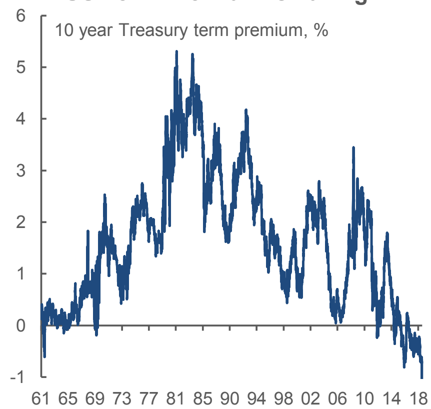
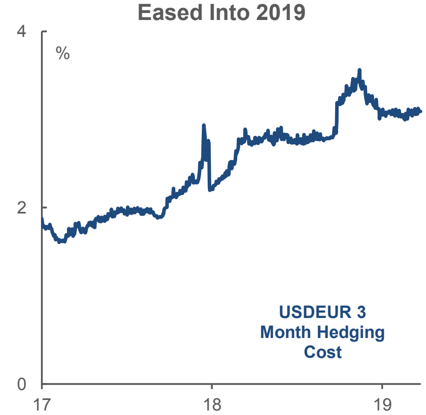
US Term Premium is Falling



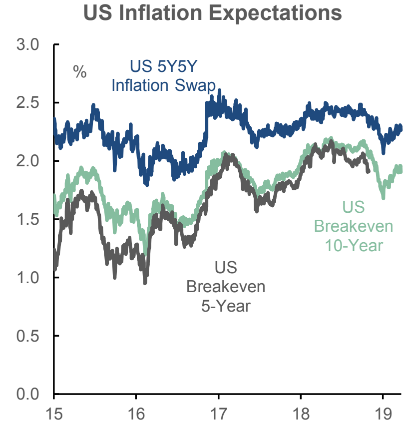
Sources: Scotiabank Economics, New York Federal Reserve.

USDEUR Hedging Costs Eased Into 2019



Sources: Scotiabank Economics, Bloomberg.

US Inflation Expectations



Source: Scotiabank Economics, Bloomberg.

- US equity futures are slightly in the red on balance with TSX futures flat. European cash markets range from a drop of just over ½% in London to a 0.1% rise in Milan. Asian equities were a sea of red as they caught up to Friday's US market close.

German business confidence unexpectedly improved in the March reading of the IFO gauge and it did so mostly in terms of forward-looking expectations. The headline measure rose by almost two full points to 99.6 (98.5 consensus, 98.7 prior revised up from 98.5). The forward-looking expectations component increase by 1.6 points to 95.6 after a small upward revision to February. The currency expectations component increased by just two-tenths to 103.8 after a two-tenths upward revision to the prior month.

UNITED STATES

Why is the US Treasury curve inverting? While there remains a solid safe haven argument particularly given stumbling US-China trade talks and ongoing Brexit uncertainty, I don't view the curve as a recession signal. Instead, **the curve needs to be interpreted with great care given several distortions and influencing factors beyond just expectations for the economy's performance.** Some of those factors are highlighted below.

- **Scarcity:** The US public debt ceiling became binding at about US$22.03 trillion at the start of the month. While eventually the Treasury market may get concerned about debt ceiling politics if it raises risks to honouring US debt obligations and debt ratings, that risk is likely pushed at least well into summer given Treasury's flexibility to manage within the debt ceiling for a time. In the interim period, while US debt is hardly scarce per se, the flat-lined stock of public debt may be adding a premium to Treasury prices.

- **Fed demand:** The Federal Reserve is acting as a bigger source of demand for Treasuries than markets previously anticipated. The surprise in last Wednesday's balance sheet decisions was to taper the rolloff caps to US$15 billion per month from twice that amount and to do so starting in May. I had otherwise expected the balance sheet to be flat-lined from September onward, but the combined effects of tapering starting in May and ending roll-off in September means the Treasuries component of the Fed's SOMA portfolio will be considerably larger than markets anticipated. Indeed, against the notion that the Fed's shrinking portfolio of Treasury securities could reverse the term premium higher, it has continued to decline with the decline intensifying this month (see chart).

- **Fed policy expectations:** While I think markets are underpricing Fed funds and a rate hike is unlikely, the Fed's dot plot that removed hikes this year and showed only one hike in 2020 amidst an unchanged neutral policy rate further tamped down the curve particularly across nearer term yields.

- **Fed signalling:** Fed communications have been anything but impressive since last Fall. Recall that just a few months ago Chair Powell was stating that the Fed was "a long way" from a neutral policy rate and the Fed's balance sheet policy as on "auto-pilot" with no tinkering expected. Now it says no hikes this year, maybe one next year and the balance sheet unwinding will be halted. Markets are debating whether this sudden shift on both policy levers indicates a) whether the Fed knows something about the outlook that no one else does, b) whether the Fed has simply decided to adopt a full-on risk management approach by padding policy rates and the balance sheet until it has more clarity, or c) whether the Fed fouled up including the possibility of becoming more deeply politicized. The nomination of Stephen Moore to the Board of Governors might fail to achieve Senate confirmation, but in the interim period is a debasement of the office. Forget Mankiw's criticism. Moore's own admission is disconcerting enough: "I'm kind of new to this game, frankly, so I'm going to be on a steep learning curve myself about how the Fed operates, how the Federal Reserve makes its decisions. It's hard for me to say even what my role will be there, assuming I get confirmed."

- **Carry:** The ECB's fresh round of Targeted Longer-Term Refinancing Operations (TLTROs III) that was announced on March 7th and that will be started in September 2019 and end in March 2021 with two year maturities may be influencing carry arguments. An anticipatory effect upon liquidity combined with pushed out guidance for an ECB rate hike "at least through the end of 2019" has been followed by rallying bunds with the 10 year German yield falling by about 12bps since the ECB announcements. The knock-on effects probably flattened the US Treasury curve by making Treasury yields relatively more attractive to bunds.

- **FX Hedging costs:** What reinforces the prior point is that FX hedging costs have diminished somewhat this year and partly as a repeat of the common rise in Q4 and then decline each Q1 perhaps as year-end dollar demand subsides within a different regulatory environment that constrains arbitrage activity against seasonal demands. See chart.

- **Inflation expectations:** The decline in longer-term bond yields has not been driven by declining market-based measures of inflation expectations. It remains the case that the undershooting of such expectations in December through early January has significantly reversed higher (see chart). In itself, this weighs against the theory that the curve is signalling deepened recession worries.

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.	2.30	2.32	2.45	2.23	2.24	2.41	2.44	2.44	2.61	2.88	2.87	3.02
CANADA	1.52	1.53	1.63	1.47	1.48	1.60	1.59	1.60	1.71	1.88	1.89	2.01
GERMANY	-0.57	-0.57	-0.53	-0.39	-0.40	-0.33	-0.01	-0.02	0.08	0.60	0.60	0.74
JAPAN	-0.18	-0.17	-0.15	-0.19	-0.19	-0.16	-0.08	-0.07	-0.04	0.50	0.53	0.58
U.K.	0.67	0.66	0.76	0.79	0.78	0.93	1.02	1.01	1.20	1.50	1.49	1.70
	Spreads vs. U.S. (bps):											
CANADA	-78	-79	-83	-76	-76	-82	-85	-85	-89	-100	-98	-100
GERMANY	-286	-288	-298	-262	-264	-275	-245	-246	-252	-228	-227	-228
JAPAN	-248	-249	-261	-242	-243	-257	-252	-251	-264	-238	-235	-244
U.K.	-163	-166	-170	-144	-146	-148	-142	-143	-141	-139	-139	-131

Equities	Level		% change:			
	Last	Change	1 Day	1-wk	1-mo	1-yr
S&P/TSX	16089	-155.3	-1.0	-0.3	0.2	5.7
Dow 30	25502	-460.2	-1.8	-1.3	-2.3	8.4
S&P 500	2801	-54.2	-1.9	-0.8	0.2	8.2
Nasdaq	7643	-196.3	-2.5	-0.6	1.2	9.3
DAX	11350	-14.2	-0.1	-2.6	-1.4	-4.5
FTSE	7159	-48.1	-0.7	-1.9	-0.3	3.4
Nikkei	20977	-650.2	-3.0	-2.2	-2.6	1.7
Hang Seng	28523	-590.0	-2.0	-3.0	-1.5	-5.9
CAC	5259	-10.6	-0.2	-2.8	0.5	3.2
Commodities	Level		% change:			
WTI Crude	58.79	-0.25	-0.4	-0.5	6.0	-10.8
Natural Gas	2.72	-0.04	-1.3	-4.7	-4.2	4.9
Gold	1319.91	6.21	0.5	1.2	-0.6	-2.0
Silver	15.46	-0.08	-0.5	0.7	-2.6	-6.4
CRB Index	183.75	-0.41	-0.2	-0.6	1.1	-6.4
Currencies	Level		% change:			
USDCAD	1.3430	0.0001	0.0	0.7	1.8	4.6
EURUSD	1.1323	0.0021	0.2	-0.1	-0.3	-9.0
USDJPY	110.03	0.1100	0.1	-1.3	-0.9	4.4
AUDUSD	0.7107	0.0024	0.3	0.0	-0.8	-8.3
GBPUSD	1.3232	0.0023	0.2	-0.2	1.0	-7.0
USDCHF	0.9926	-0.0010	-0.1	-0.9	-0.8	5.0

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	**Apr 24, 2019**
US - Fed	**May 01, 2019**
England - BoE	**May 02, 2019**
Euro zone - ECB	**Apr 10, 2019**
Japan - BoJ	**Apr 25, 2019**
Mexico - Banxico	**Mar 28, 2019**
Australia - RBA	**Apr 01, 2019**
New Zealand - RBNZ	**Mar 26, 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.

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