May 29, 2019 @ *8:45 EST*

ON DECK FOR WEDNESDAY, MAY 29

Country	Date	Time	Indicator	Period	BNS	Consensus	Latest
US	05/29	07:00	MBA Mortgage Applications (w/w)	May	--	--	2.4
CA	05/29	10:00	**BoC Interest Rate Announcement (%)**	**May 29**	**1.75**	**1.75**	**1.75**
US	05/29	10:00	Richmond Fed Manufacturing Index	May	--	6.0	3.0

KEY POINTS:

- **Global markets are in risk-off mode on further escalation of trade tensions**
- **China threatens to cut off rare earths…**
- **...to the detriment of multiple industries…**
- **...which risks backfiring upon China's abuse of market power**
- **BoC statement: more upbeat domestically, reserved toward external risks**
- **US only faces the Richmond Fed gauge**
- **European data likely affected by Easter's timing…**
- **...in terms of French CPI and consumption…**
- **...while a spike in German unemployment should be faded**

INTERNATIONAL

Markets are in a risk-off frame of mind again and the Bank of Canada faces the unfortunate timing of having to weigh in amidst it all. That, in turn, counsels restraining its optimism. Blame promethium, neodymium, ytrrium, scandium and at least seventeen rare earth elements used across multiple industries and products. This isn't a chemistry lesson and I'm sure not the one to give it. The issue, however, is that **China's state-directed press delivered synchronous warnings to the US that punitive steps taken against Chinese technology companies and tariff threats may be met with blocking access to China's near-monopoly production of rare earths.** This is a dangerous game for China (see below), but the takeaway to markets is **an escalation of trade concerns**. **European data was difficult to read.** German unemployment soared but I'd fade it for now (see below). French inflation eased but Easter distortions require more data over future months. French consumption accelerated but Easter might have distorted this reading as well. **Canadian markets will focus upon the BoC statement (see below) that will likely sound more neutral than market pricing by appearing optimistic toward the domestic picture but guarded toward the international environment.** The US faces light data.

- **Sovereign bond yields are falling almost everywhere.** German 10s are now yielding -17bps. US 10s are down 4bps to 2.23% with Canada 10s underperforming at 1.56% and doing so across the curve. The 10 year JGB is down to -10bps and pushing significantly below the BoJ's 'around zero' yield target.

- Oil prices are down by nearly two bucks in terms of Brent and WTI. Gold is slightly higher and over US$1800.

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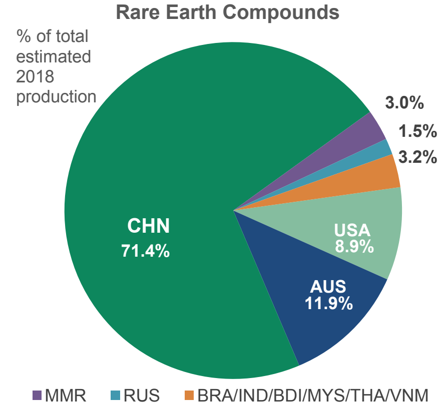
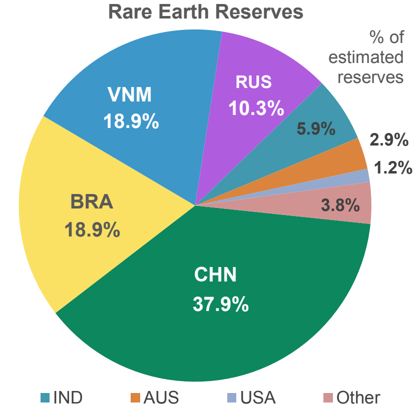
China Dominates Production of Rare Earth Compounds



Sources: Scotiabank Economics, US Geological Survey.

Ownership of World Rare Earth Reserves



Sources: Scotiabank Economics, US Geological Survey.

Canadian Core Inflation

Sources: Scotiabank Economics, Statistics Canada.

- US equity futures are down by about ¾% on average. TSX futures are down by about ½% with bank earnings not helping. European cash markets are down by over 1% across all of the bourses. Tokyo fell by about 1%, Seoul was off by 1 ¼%, the Sensex was down by 0.6% and HK fell by ½%. Mainland China's exchanges were roughly flat as a rally in its dominant producers of rare earths insulated the market effects of increased trade tensions.

- The USD is little changed on a DXY basis. That's because other safe haven currencies like the yen and Swiss franc are appreciating while the euro, pound sterling and CAD are flat. The Mexican peso is depreciating with the won leading the decliners perhaps as an indirect casualty of China's rare earths threat against South Korea's industrial complex. The yuan is little changed.

China's state-directed media issued warnings to the US (and others…) that it thinks it can leverage a near-monopoly of rare earths production to exact pain upon the US economy in order to give it leverage in trade talks. The Communist Party of China's Global Times' editor tweeted: **"Based on what I know, China is seriously considering restricting rare earth exports to the US. China may also take other countermeasures in future."** Xinhua issued this piece and warned "China has plenty of cards to play." The People's Daily wrote this one that included the same implied threat and warned that "The United States completely overestimates its ability to manipulate the global supply chain." Right, we got the message that was delivered in obviously orchestrated fashion.

But do China's threats risk seriously backfiring over the longer run? For one, this puts an exclamation point on the matter of how the rest of the world needs to expedite the strategic development of its own rare earths both at the mining and processing stage. I'm generally not a fan of strategic industry arguments that often rely upon specious infant industry and protectionist arguments. Blame my training. But this case may well be different. The extent to which rare earths are used in everything from auto components to smart phones and medical processes and devices and much else makes the production monopoly guided by non-market forces in China a matter of strategic importance to the world economy. Right now China dominates production (see chart), but not reserves (next chart). Developing reserves elsewhere will take years to accomplish and will be costly, but the world clearly cannot rely upon unfettered access to China's reserves when it repeatedly demonstrates a cavalier attitude toward using access to them as a weapon in political conflicts (e.g. against Japan in 2010). This is exactly the argument used by policy makers who advocate controls on Chinese investment and participation abroad in that the state uses such industries toward political aims in the context of poor corporate governance, opaque decision making processes and too often through the absence of market mechanisms to guide business decisions. Second, driving rare earth prices higher and impeding access affects all of China's trading partners; it's an issue that risks drawing in all of China's trading partners in an escalation of the tensions. The impact upon global industries could see China losing friends at a quickened pace and nobody wins in that scenario.

French inflation decelerated while consumption picked up. Blame the Easter bunny? The French bond curve is slightly outperforming gilts and bunds. Inflation-adjusted consumption grew by 0.8% m/m in April, which was double consensus, but a downward revision to the prior month (-0.3% from -0.1%) explained some of the beat. Breadth was decent as spending on food, household durables and energy increased but spending on autos gave back some of the prior month's surge. Weak consumption in March and a rebound in April could have been influenced by the later timing of the Easter holiday this year.

As for French inflation, the figures kicked off the march toward the Eurozone add-up next Tuesday ahead of the ECB policy announcements two days later. French CPI on an EU-harmonized basis decelerated to 1.1% y/y (1.5% prior, 1.2% consensus). I wouldn't overreact, however, in that the shifting timing of the annual Easter holiday may have been at least partly responsible. Easter was on April 21st this year versus April 1st last year, and holiday related spending including on travel and accommodations picked up later this year than last. Ergo, inflation on a year-ago basis was likely overstated in April and understated in May as seasonal adjustment factors struggle to accurately compensate. This may be repeated in Spain's numbers tomorrow and then in Germany's and Italy's inflation readings on Friday.

Much of the spike in Germany's unemployment rolls this month should be looked through. Unemployment rose by 60,000 m/m in May for the biggest single-month increase since April 2009. Das ist furchtbar! Oh, wait a minute. Germany's Federal Employment Agency noted that two-thirds of the rise was due to a methodological change that altered classification of workers. Even so, the rise in unemployment excluding this change would have been the worst since at least 2012–13. It's unclear what was behind the spike after controlling for the change in methods, but it's theoretically possible that the shifting timing of the Easter holiday was a partial culprit. Curiously, job vacancies fell which indicates the whole labour market didn't fall apart.

US markets only face the **Richmond Fed's manufacturing gauge** for May (10amET). As an input to ISM-manufacturing expectations, the issue is whether the prior month's dip stabilizes.

CANADA

The BoC will be the main event in Canadian markets (also see Monday morning's note). It's a statement-only affair to be followed by SDG Wilkins' economic progress report on Thursday at 2:15pmET and her press conference at 3:50pmET. The pattern may somewhat follow the April script in which the statement was perceived as dovish by markets (e.g. striking out rate increases) but then the press conference turned around much of that initial reaction when Poloz began emphasizing more of the positives and downplayed rate cut risk. This time around the statement is unlikely to be perceived as dovish versus neutral/upbeat and still in wait and watch mode, but more positives could again come from Wilkins' speech and presser. If they truly are data dependent, then everything we've learned about Canada since the April statement has been more positive than anticipated. External risks are evident but remain unclear in terms of where we end up on Brexit, US-China, US-Europe, NAFTA 2.0 implementation across all three countries, US funding and debt ceiling issues, Italy's fiscal drama and how the ECB may position itself next week. In addition to strong activity readings in March and April so far, headline inflation is on target at 2% and core inflation is averaging just a smidge below (see chart). Overall, the BoC may wish to reassert optionality in market pricing for future moves by leaning against cut pricing toward a more balanced scenario but without going too far at this point.

There is a limit to the usefulness in looking back at the April statement, however, in that developments since then have been significant. Recall that **after the April statement, Poloz subsequently sounded more upbeat** in parliamentary testimony on April 30th / May 1st, in his speech on May 6th and in press interviews on May 17th. His pre-recorded interview that aired on the 17th said "The natural tendency is for interest rates to still go up a bit" and he said that before knowing that metals tariffs would be eliminated virtually as his interviews were being aired. By extension, his interview also preceded advancement of the CUSMA deal in parliament. Data ripped over the past month. Oil prices have come off over the past month but a) remain much improved, and b) face the OPEC meeting and potential Trans Mountain progress in the near term.

Being a non-MPR statement, comparing potential wording changes is also made more difficult because the prior MPR statement was written to be more forecast oriented. Overall, I would expect a greater degree of positive conviction toward the rebound from Q4/Q1 weakness, a more positive take on NAFTA and metals tariffs, continued concern toward global developments but little change to the concluding paragraph. The last paragraph had said they are in monitoring mode after having struck out "future rate increases" in the April statement.

There are nevertheless a few specific things to watch for in the statement:

Expect retention of some form of "The Bank expects growth to pick up, starting in the second quarter of this year." We don't get GDP until Friday for March and Q1 but all the higher frequency readings and NAFTA/CUSMA advancement in parliament are lending support to the rebound narrative from idiosyncratic and temporary growth headwinds.

A possibly upgraded near-term inflation reference with CPI at 2% y/y now compared to "returning to about 2 per cent by year end." Unchanged reference to "around 2%" through 2020–2021.

Some generally similar version of: "Governing Council judges that an accommodative policy interest rate continues to be warranted. We will continue to evaluate the appropriate degree of monetary policy accommodation as new data arrive."

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.	2.07	2.13	2.22	2.02	2.07	2.18	2.23	2.27	2.38	2.67	2.71	2.81
CANADA	1.53	1.54	1.66	1.46	1.47	1.61	1.56	1.57	1.71	1.82	1.83	1.95
GERMANY	-0.64	-0.64	-0.63	-0.55	-0.55	-0.50	-0.17	-0.16	-0.09	0.47	0.49	0.57
JAPAN	-0.17	-0.16	-0.15	-0.19	-0.18	-0.16	-0.09	-0.07	-0.06	0.47	0.49	0.52
U.K.	0.60	0.60	0.69	0.66	0.67	0.78	0.91	0.92	1.02	1.51	1.50	1.57
	Spreads vs. U.S. (bps):											
CANADA	-54	-59	-56	-56	-60	-57	-66	-69	-67	-85	-88	-86
GERMANY	-271	-277	-285	-257	-262	-268	-239	-243	-247	-219	-222	-224
JAPAN	-224	-229	-238	-221	-224	-234	-232	-234	-244	-220	-221	-229
U.K.	-147	-153	-153	-136	-140	-141	-132	-135	-137	-116	-120	-123

Equities	Level		% change:			
	Last	Change	1 Day	1-wk	1-mo	1-yr
S&P/TSX	16297	-49.2	-0.3	-0.8	-1.8	2.4
Dow 30	25348	-237.9	-0.9	-1.3	-4.5	4.0
S&P 500	2802	-23.7	-0.8	-1.3	-4.8	4.2
Nasdaq	7607	-29.7	-0.4	-1.2	-6.7	2.8
DAX	11841	-186.4	-1.5	-2.7	-4.0	-6.5
FTSE	7154	-114.6	-1.6	-2.4	-3.8	-6.3
Nikkei	21003	-256.8	-1.2	-1.3	-5.6	-6.1
Hang Seng	27236	-155.1	-0.6	-1.7	-8.9	-10.7
CAC	5206	-106.7	-2.0	-3.2	-6.7	-4.3
Commodities	Level		% change:			
WTI Crude	57.40	-1.74	-2.9	-8.9	-9.6	-14.0
Natural Gas	2.63	0.04	1.7	0.5	1.3	-8.7
Gold	1283.94	4.59	0.4	0.8	0.3	-1.1
Silver	14.48	-0.07	-0.5	0.3	-3.5	-13.1
CRB Index	179.86	-0.40	-0.2	-1.2	-2.3	-10.9
Currencies	Level		% change:			
USDCAD	1.3492	-0.0002	-0.0	0.4	0.3	3.6
EURUSD	1.1153	-0.0007	-0.1	0.0	-0.3	-3.4
USDJPY	109.31	-0.0700	-0.1	-1.0	-2.1	0.5
AUDUSD	0.6927	0.0003	0.0	0.7	-1.8	-7.7
GBPUSD	1.2650	-0.0003	-0.0	-0.1	-2.2	-4.5
USDCHF	1.0061	-0.0016	-0.2	-0.4	-1.3	1.5

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	**1.50**
Next Meeting Date	
Canada - BoC	**May 29, 2019**
US - Fed	**Jun 19, 2019**
England - BoE	**Jun 20, 2019**
Euro zone - ECB	**Jun 06, 2019**
Japan - BoJ	**Jun 20, 2019**
Mexico - Banxico	**Jun 27, 2019**
Australia - RBA	**Jun 04, 2019**
New Zealand - RBNZ	**Jun 25, 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.