ON DECK FOR WEDNESDAY, JUNE 5

Country	Date	Time	Indicator	Period	BNS	Consensus	Latest
US	06/05	07:00	MBA Mortgage Applications (w/w)	MAY 31	--	--	1.5
US	06/05	08:15	ADP Employment Report (000s m/m)	May	200	185	275
CA	06/05	08:30	Productivity (q/q a.r.)	1Q	--	0.4	-0.4
US	06/05	10:00	ISM Non-Manufacturing Composite	May	55.4	55.4	55.5

KEY POINTS:

- **Fed cut pricing intensifies after ADP disappointment**
- **US ADP payrolls post weakest gain in nine years**
- **Why the Fed is more likely to cut…**
- **…and what it risks in so doing**
- **A round-up of recent comments by FOMC officials**
- **EC commences disciplinary action against Italy**
- **Negotiations to avert US tariffs on Mexico in focus…**
- **…as negotiators meet while Trump digs in**
- **More Fed-speak on tap today**
- **Australia's economy slightly disappoints**
- **Philippines central bank guides rate cuts**
- **Soft China, European data**

INTERNATIONAL

It's all eyes on Mexico's negotiating prowess and the Fed as markets are continuing a mild risk-on bias. Navarro remarked this morning that the tariffs may not have to go into effect, but we'll see pending more information today and it's unclear if he checked with his boss. Mexico's negotiations to avert a 5% US tariff come Monday are swinging into higher gear today with the risk of comments on the outcome from one or both sides. Pay very close attention to the connections from this back to the Fed, but Fed signals on inflation suggest the cut case is based not only on trade concerns. See below for a fuller explanation of why I'm leaning much more heavily toward the Fed easing and perhaps sooner than markets anticipate. Also provided is a rundown of recent comments by top Fed officials. Italy is the only notable bond market not benefitting as its cavalier policy ways drew a rebuke from the EC that began fiscal disciplinary actions against the credit this morning. US ADP payrolls cratered with more Fed-speak and ISM-services on tap.

- US equity futures are up by another ¼% to ½% this morning. This follows yesterday's 2%+ rally in the cash market. TSX futures are up by just under ¼%. European equity markets are mixed with London and Paris up a touch but the rest flat to down. Italy's stock market is down by almost 1% on the ECB headlines.

- The US two year Treasury yield sank by 10bps after ADP's disappointment. The Treasury curve is bull steepening. Canada's curve is shifting down by

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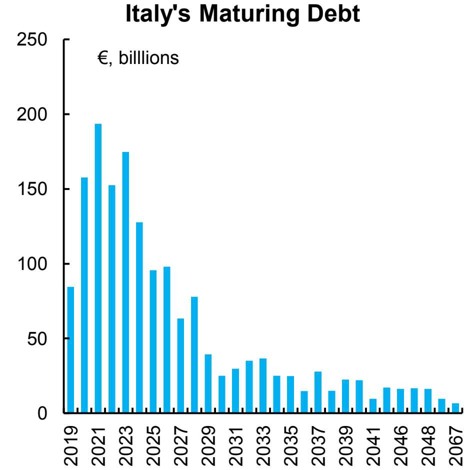
Italy's Maturing Debt



Source: Scotiabank Economics, Bloomberg.

6bps across maturities. Italy's 10 year spread over bunds is up by about 6bps. The rest of the EGBs complex is rallying along with the gilts curve that is down by 4–5bps across maturities.

- Oil prices are down by 40–80 cents with WTI softer than Brent following yesterday's private oil inventory increase ahead of the government report today (10:30amET). Gold is up by US$15 on the real rate expectations argument.

- The USD is broadly weaker against all crosses this morning except for the Mexican peso (trade headlines) and rand. CAD and the A$ are holding their own but an ECB-Fed synchronous bout of easing puts those other central banks at risk.

Mexico's negotiating team—led by Foreign Minister Marcelo Ebrard—meets again with Secretary of State Pompeo, Vice President Pence and Commerce Secretary Ross today after meeting with Lighthizer yesterday. Trump says he's going ahead with tariffs on Monday at a 5% rate and tweeted last evening that it is "no bluff" while putting the twit in twitter by taking a cheap shot at Chuck Schumer. Mexico, however, is saying they are 80% confidence they will negotiate a way around this and after presenting facts on migration. Best of luck, as markets may hang in the balance. Watch for either side to remark on the outcome or Trump to comment or tweet afterward.

The European Commission commenced fiscal disciplinary action against Italy this morning. The announcement effect prompted further cheapening of Italian bonds on an already bad morning for them. Italy's 10 year debt spread is 9bps wider over the 10 year bund. Here is an effort to piece together the main sentences that explain its concerns:

> "Newly adopted measures and adverse demographic trends partly reverse the positive effects of past pensions reforms and weaken Italy's long-term fiscal sustainability. Fiscal sustainability was also hampered by the level shift in interest rates on government bonds observed in 2018 and through early 2019. Italy is exposed to sudden increases in financial market risk aversion due to still large rollover needs (around 17% of GDP in 2019) related to its large public debt. Such increases can lead to high volatility in sovereign bond markets and substantially higher debt servicing costs, with the subsequent risk of negative spillovers to the banking sector and to financing conditions for firms and households."

I've again included the accompanying chart showing Italy's heavy rollover requirements in funding markets in the relatively near-term. **Escalating tensions with Italy are an added downside risk to global developments.**

Australian's economy marginally disappointed expectations by posting growth of 0.4% q/q in seasonally adjusted but non-annualized terms in Q1 (0.5% consensus, 0.2% prior). That's an acceleration toward the fastest growth since Q2 of last year. Regardless, treat the reading as stale in the context of the RBA cut that was predicated upon more current and forward-looking trade concerns.

China's private versions of purchasing managers' indices weakened last night. The Caixin services PMI fell by nearly two points to 52.7 in May which is still above the 50 dividing line in expansion territory. That pulled the composite PMI down 1.2 points to 51.5 given the previously known soft but unchanged manufacturing PMI reading of 50.2.

The Philippines took another step closer to rate cuts overnight. That was despite an acceleration to 3.2% y/y in May's CPI inflation report (2.9% consensus). Bankgko Sentral ng Pilipinas Governor Diokno remarked that "it is irrational to think that high policy rate will remain" and that "The correct assumption is that policy rates cut is inevitable, though the exact timing will be data-dependent and evidence-based." Diokno rejected the first up-tick in inflation since last September "doesn't constitute a trend." On a morning of fairly broad-based USD weakness, the peso slightly underperformed overnight.

Despite earlier disappointments in the UK manufacturing and construction PMIs, the overall composite PMI reading held steady at 50.9 in May. That's because the service PMI increased a bit to 51 (50.4 prior). Overall this is still weak data, but less weak than it might have been if services had not come to the rescue.

Eurozone macro reports were soft but not worse than expected. Retail sales fell 0.4% m/m in April after a flat prior month. Factoring in soft Spanish and Italian PMIs, the overall revised Eurozone composite PMI ticked up to 51.8 (51.6 prior and consensus). This is obviously inconsequential to tomorrow's ECB communications; see the Global Week Ahead for a six pointer on ECB expectations.

UNITED STATES

US ADP private payrolls disappointed expectations with a rise of only 27k last month. That's the weakest reading since March 2010 and it was way under consensus expectations for a 185k print following the 271k prior gain. Ouch. The usual

ISM-services is expected to hold steady around 55 ½ in May (10amET).

Fed-speak is also resurfacing with more dovish comments by Brainard and Evans and guarded remarks by Kaplan this morning. Yesterday's CNBC interview by Vice Chair Clarida and Chair Powell's one paragraph teaser probably said most of what we'll hear from them before the Fed blacks out in a little under a week. Clarida delivers opening remarks at the ongoing Chicago Fed conference (9:45amET), Governor-nominee Bowman faces her nomination hearing at 10amET before the Senate Banking panel. Atlanta Fed President Bostic speaks at 11amET. The Fed's Beige Book is due out at 2pmET.

The Federal Reserve may very well cut interest rates perhaps as soon as the July meeting as we monitor risks to inform our forecasts. There is significant pending information to further inform a formal call including Monday's Mexican tariff decision, the ECB decision tomorrow, the G20 meetings later in the month and OPEC's meeting early next month. We'll evaluate this information very closely just as markets will be doing so and it may well be prudent for the Fed to wait to evaluate such developments before firming up guidance. **Personally I like a cut story much more now than previously and there is a very strong base case argument.** Before now, the cut camp has been more driven by a pretty simplistic view that the US expansion was long in the tooth and it must end in recession. Some of that story's proponents have that view coming into every year. I don't buy that logic, but new information to the forecasts over recent weeks is increasingly pointed in the direction of easing.

The June 19th FOMC statement, forecasts and press conference may incorporate only some of this fresh information. The outcome is very likely to spark a significant downward shift in the dot plot. Recall that the March dot plot showed eleven FOMC officials with a hold at the present 2.25–2.5% fed funds target range, four with one hike and two with two hikes in 2019. A rundown of recent remarks from FOMC officials leans toward a) at least some of those dots showing a cut (e.g. such as Evans, Bullard, maybe Clarida etc), and some of the hawks striking down hikes in favour of holds (like probably Mester, maybe George). Whether that is enough to tilt the median dot toward at least one cut is in question. The voter-weighted outcome may be more likely to indicate a cut given it is more weighted toward doves like Bullard and Evans while somewhat more neutral/hawkish FOMC members like George and Mester who don't vote this year.

The case for cuts is predicated upon the following points:

- Markets have four Fed rate cuts priced in over '19–20 albeit using fed funds futures that are an imperfect guide to market expectations for policy rate adjustments. **The Fed is increasingly saying they are listening to markets**, regardless of the merit to doing so. They'd disappoint markets heavily if nothing out of 100bps was delivered. That includes equity markets that have been factoring in the assumption of policy easing which explains why they've been relatively resilient of late.

- **Don't fight the Fed.** A round-up of recent policy remarks suggest that the reaction function is shifting rapidly toward contemplating easing.

- **A fundamental reassessment of our trade narrative is likely necessary as it is not performing well.** The prior assumption that Trump would strike trade peace into the primaries leading up to the election has to be downplayed in favour of heightened unease and volatility throughout the horizon. That narrative worked through agreements like KORUS and NAFTA, but it's difficult to see the US and China mending fences toward any near-term agreement while US-Mexico tensions have obviously risen in a way that threatens NAFTA 2.0 ratification pending very near-term developments. The overall effect is to damage confidence and markets compensate by seeking safety that the Fed needs to deliver. At a minimum, businesses cannot have confidence in the rules of the game when the protectionist US administration keeps moving the targets.

- **As much as I see it differently, Fed officials seem to be viewing the inflation target more symmetrically than previously**. Throughout the hiking cycle they had the option of holding off because of underperforming inflation relative to the target but they chose not to. Why they are suddenly so fussed about a few debatable tenths here and there to motivate a sudden quest to prime the pump is contentious but also correlated with two things: Trump's attacks on trade and Trump's attacks on the Fed.

- **Again I see it differently as I've written previously including in yesterday morning's note, but several FOMC officials appear to be more concerned about evidence of soft inflation expectations across some readings, albeit usually cherry-picked measures**. These last two points combined indicate they want to catch up for lost underperformance and ensure that inflation hits if not surpasses their target. I don't see modest rate cuts doing that (ask Japan that has tried for decades…) but several like Clarida and Bullard seem to think otherwise.

- **The Fed is worried about slowing growth**. This faces debatable merits since slowing from unsustainable rates over 2018 into early 2019 toward something closer to potential isn't a disaster by any means. **Nevertheless, this is a reflationary shift in Fed thinking that wants to pump up growth while—perhaps dangerously—thinking inflation won't be an issue.**

- **The broad dollar is stronger than we had anticipated by now**. **That's incrementally more cautious for diminished disinflationary pressures.** It's back up to the highest since 2002 now which dampens the inflation picture.

- **A synchronous degree of policy easing may be underway and to be informed by tomorrow's ECB meeting**. See the Global Week Ahead for a preview of that meeting, but if the ECB eases perhaps by more than what is priced then it could very well push additional dollar strength onto the Fed and motivate a counter punch.

- **Clarida's interview yesterday emphasized that he views tariffs as transitory influences upon inflation they can look through versus longer lasting negatives for growth stemming from trade policy irritants.** That's debatable but it's their reaction function. Key in this regard is whether we're just dealing with temporary tariffs or a longer lived negative supply shock that reverses decades of trade liberalization effects that motivated disinflationary pressures. In short, seek inflation protection if the Fed cuts into something more

Easing in the face of all of this is not without its major risks. I personally maintain that if the Fed eases, it will only embolden Trump to do nuttier things on trade. While the Fed may be focused upon its nearer term dual mandate risks, easing and motivating potentially further deteriorations in global trade policy if Trump has the sense the Fed will always rescue him could amplify longer-run downside risk, not mitigate them. It's like a pusher doing all the wrong things for an addict that can't help himself. Further, the Fed has limited bullets at 2.5% and needs to be careful toward how cavalierly it gives them away. Financial market stability considerations are an added consideration.

Please also see the following recap of recent comments by FOMC officials. The general takeaway ranges from fairly strong hints toward easing toward flightless hawks.

Clarida June 4th (permanent voter)

- Says that if policy makers get the sense that "growth is slower than we expect, and if we get the sense that underlying inflation is below where we want it to be, then as Chair Powell and I and others have indicated, we're going to put in place appropriate policy to achieve those goals"

- "Whether or not that means acting preemptively or when the data comes in is just going to depend on the context at the time"

- "If the yield curve inverts as it has...and if it persists for some time, that's obviously something I would definitely take seriously"

Clarida May 30 (permanent voter)

- "Let me be very clear, that we're attuned to potential risks to the outlook."

- "If we saw a downside risk to the outlook, then that would be a factor that could call for a more accommodative policy."

Brainard June 5th (permanent voter)

- Sounded more dovish in a Yahoo Finance interview (transcript not yet available) when she emphasized a need to avoid slippage in inflation expectations, missed inflation targets, how she's watching Friday's nonfarm payrolls report very closely, and how the Fed will be prepared to adjust policy to sustain growth.

Evans June 5th (voting 2019)

- ``It would be prudent to take a look at our setting for monetary policy, as we do each and every time. Before we even talk about more trade uncertainty I'm a little more inclined to think we might wonder if we've got the appropriately accommodative setting to generate inflation at 2, 2.25%." and inflation ``by itself could be a reason for a little more accommodation''

Evans June 4th (voting 2019)

- "With inflation being a little bit on the light side, there's the capacity to adjust policy if that's necessary, but the fundamentals for the economy continue to be solid. The consumer is solid. I think we have to think through what this really means."
- When asked about futures pricing showing a half percentage point cut, "On its face, it suggests the market sees something that I haven't yet seen in the national data."
- "I'm pretty comfortable with where we are at the moment, but there is uncertainty for sure."
- "The fundamentals for the economy continue to be solid"

Bullard June 3rd (voting 2019)

- "A downward policy rate adjustment may be warranted soon to help re-center inflation and inflation expectations at target and also to provide some insurance in case of a sharper-than-expected slowdown." On economic risks from a trade war, he said "The direct effects of trade restrictions on the U.S. economy are relatively small, but the effects through global financial markets may be larger."
- "Financial markets appear to expect less growth and less inflation going forward than the FOMC does, a signal that the policy-rate setting may be too restrictive for the current environment. Even if the sharper-than-expected slowdown does not materialize, a rate cut would only mean that inflation and inflation expectations return to target more rapidly."
- "In addition, both inflation and inflation expectations remain below target, and signals from the Treasury yield curve seem to suggest that the current policy rate setting is inappropriately high."
- "The direct effects of trade restrictions on the U.S. economy are relatively small, but the effects through global financial markets may be larger"
- "An environment of elevated uncertainty surrounding the global trade regime may be a negative factor for global growth that could feed back to U.S. macroeconomic performance"

George May 14 (voting 2019)

- "Lower interest rates might fuel asset price bubbles, create financial imbalances, and ultimately a recession. In current circumstances, with an unemployment rate well below its projected longer-run level, I see little reason to be concerned about inflation running a bit below its longer-run objective."
- "I am not convinced that a slight undershoot of inflation below objective requires an offsetting overshoot of the objective. The current level of inflation may perplex central bankers and financial market participants, but in the context of a growing economy and job gains, it doesn't demand a Fed policy response.''

- “This wait-and-see approach is appropriate because we have not seen upward pressures building on inflation, even though we have experienced above trend growth and a further tightening of labor markets. I see the biggest risks coming from trade policy uncertainty and slower growth abroad, particularly in China, the euro area, and the United Kingdom’’

Rosengren May 22 (voting 2019)

- “There is a lot of uncertainty about what the actual outcome will be” of the U.S.-China trade war
- “My own assumption is that both countries do have an agreement, that over time they will come together. I don’t know when exactly that will be, but my expectation is that it doesn’t have a large impact on my forecast for the economy. But that could be wrong, and if it is wrong, then we’ll have to think differently about monetary policy.”
- “There’s a lot of uncertainty and uncertainty is bad for the U.S. economy as well, so we have to be concerned that the longer this goes on without some resolution, there are some costs just to having this period of waiting where we’re not sure what the outcome will be.”
- “Tariffs are a tax on imported goods and so that will increase the price of those imported goods.”
- “One of the last tools that I would be thinking about is negative interest rates. I don’t think it’s nearly as stimulus as some other central banks do"
- On increased business borrowing, says “I do worry not so much that the leverage could trigger a bad outcome but that it will exacerbate a bad outcome”
- “I think there is pricing pressure for many firms, particularly those with international competition”

Kaplan June 5 (nonvoting 2019)

- On cutting, “It’s early to make a judgment on that. We’re going to be very vigilant in understanding these heightened trade tensions. See if they feed through to the economy. Most importantly, see if they persist.”

Kaplan June 4 (nonvoting 2019)

- Trade tensions have been elevated in the last five to six weeks “and in the next five, six weeks, a number of them could be alleviated.”
- “We’re very cognizant of these downside risks, and very cognizant of the change in the shape of the yield curve.”
- “The only reason I’m not suggesting a specific action yet is it’s very recent.”

Kashkari May 16 (nonvoting 2019)

- “We need to understand what led to these results when we evaluate strategies for conducting monetary policy going forward.”
- “Even though the headline unemployment rate is low, given the continued strong job gains with only modest wage growth, it seems clear to me that we are not yet at maximum employment”
- Fed officials “went on to raise rates a total of nine times through December 2018, during which time inflation was always at or below target. In my view, these rate increases were not called for by our symmetric framework.”
- “Raising rates while inflation was low is an example of a shortcoming of how we implemented our framework rather than a shortcoming of the framework itself. We must consider how our existing framework could have performed if we had utilized its full potential to support the economy”

- "By raising rates more quickly than called for by our symmetric framework, we ran the risk of overtightening and causing a recession. Markets signaled this risk with the steep drop in bond yields and equity prices late last year"
- "FOMC's quick adjustment to pause further rate hikes was appropriate and, thankfully, seems to have mitigated this risk for now"
- "Markets have watched the FOMC treat our inflation target as a ceiling, never to be crossed. In my view, we have not implemented our current framework as it was designed to be implemented"
- "For our current framework to be effective and credible, we must walk the walk and actually allow inflation to climb modestly above 2% in order to demonstrate that we are serious about symmetry"

Harker May 20 (nonvoting 2019)

- In response to question about asset bubbles, Harker said: "That is a real concern, that is why I am not yet sold on any changes to our policy." …"That is one of the issues I am worried about," adding "that is clearly a risk."

Harker May 17 (nonvoting 2019)

- Says "that is one of the issues I am worried about," adding "that is clearly a risk"
- "If inflation expectations become unanchored, they can start to drift down to a point that I believe would be dangerous"
- "We sort of do know that if goes down below 2 for a long time, and keeps drifting down, most likely expectations are going to drift down too"
- "I don't think we are yet at neutral, pretty close, but we will let this play out, I am not in any rush. So at most one" rate hike this year is what he favors

Harker May 6 (nonvoting 2019)

- Harker says "some" of recent weakness in inflation is "transitory"
- Harker sees inflation "running slightly above our 2 percent target for the medium term, but that projection is nowhere near written in stone"
- Fed uncertain about bank demand for reserves, Harker says
- "That uncertainty calls for a cautious approach. It may be that 'ample' is more than we thought, and reserve levels can't really drop much further without inflicting interest rate volatility and creating liquidity-management issues for financial institutions"
- Harker says shorter duration Fed portfolio creates policy flexibility
- "The shorter the duration of the portfolio, the larger the flow of maturing proceeds at any given time. That flow can be redirected, allowing for a swift change in the composition without expanding the balance sheet or having to sell assets outright"

Mester May 23 (nonvoting 2019)

- If you really wanted to get inflation expectations moving up you'd have to take really aggressive action—if that was your only goal." Mester said. "But that would be bad policy because we have another goal and the risk you'd be running on the other goal would be excessive," she added, referring to Fed's employment mandate

- "Since we're not far from our goal, I'd rather do something that is more prudent, which is be willing to keep interest rates low," said Mester, who's viewed as modestly hawkish on inflation
- "Let's hold rates where they are and be more willing to do that even though we have a very low unemployment rate," she said.
- Mester made clear she'd be equally unconcerned by an overshoot of the target if that was not expected to persist. "Suppose we get some readings on inflation that are above 2%," she said. "I'd feel the same way. We really don't have to respond to that."

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.	1.80	1.89	2.11	1.84	1.90	2.07	2.10	2.13	2.26	2.62	2.61	2.69
CANADA	1.34	1.39	1.53	1.30	1.34	1.47	1.44	1.47	1.58	1.74	1.74	1.83
GERMANY	-0.67	-0.65	-0.65	-0.60	-0.57	-0.56	-0.22	-0.21	-0.18	0.41	0.41	0.46
JAPAN	-0.22	-0.19	-0.17	-0.24	-0.21	-0.19	-0.12	-0.10	-0.09	0.42	0.45	0.47
U.K.	0.57	0.60	0.60	0.62	0.65	0.65	0.86	0.90	0.89	1.45	1.49	1.49
	Spreads vs. U.S. (bps):											
CANADA	-46	-50	-58	-54	-56	-60	-66	-66	-69	-89	-87	-87
GERMANY	-247	-253	-275	-244	-247	-263	-232	-234	-244	-222	-220	-223
JAPAN	-202	-207	-228	-208	-210	-226	-223	-223	-235	-221	-217	-223
U.K.	-123	-128	-151	-122	-125	-142	-124	-123	-137	-117	-112	-120

Equities	Level		% change:			
	Last	Change	1 Day	1-wk	1-mo	1-yr
S&P/TSX	16166	150.4	0.9	0.2	-2.0	0.3
Dow 30	25481	149.2	0.6	1.4	-3.9	2.7
S&P 500	2803	58.8	2.1	0.7	-4.8	2.0
Nasdaq	7589	61.8	0.8	0.6	-7.0	-0.6
DAX	11979	7.4	0.1	1.2	-3.5	-6.3
FTSE	7231	16.9	0.2	0.6	-2.0	-5.9
Nikkei	20776	367.6	1.8	-1.1	-6.7	-7.8
Hang Seng	26895	133.9	0.5	-1.2	-10.6	-13.5
CAC	5288	19.9	0.4	1.3	-4.7	-3.2
Commodities	Level		% change:			
WTI Crude	52.88	-0.60	-1.1	-10.1	-14.6	-19.3
Natural Gas	2.39	-0.02	-0.9	-9.1	-6.7	-17.2
Gold	1337.70	12.19	0.9	4.5	4.6	3.2
Silver	14.72	0.02	0.1	1.7	0.4	-10.5
CRB Index	174.52	-0.97	-0.6	-3.2	-4.0	-12.4
Currencies	Level		% change:			
USDCAD	1.3372	-0.0022	-0.2	-1.1	-0.6	3.1
EURUSD	1.1278	0.0026	0.2	1.3	0.7	-3.8
USDJPY	108.12	-0.0300	-0.0	-1.3	-2.4	-1.5
AUDUSD	0.6996	0.0005	0.1	1.1	0.1	-8.1
GBPUSD	1.2725	0.0027	0.2	0.8	-2.8	-5.0
USDCHF	0.9893	-0.0029	-0.3	-1.8	-2.8	0.5

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	1.25
New Zealand - RBNZ	1.50
Next Meeting Date	
Canada - BoC	Jul 10, 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	Jul 02, 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.