

ON DECK FOR TUESDAY, JUNE 11

Country	Date	Time	Indicator	Period	BNS	Consensus	Latest
US	06/11	08:30	PPI (m/m)	May	0.1	0.1	0.1
US	06/11	08:30	PPI ex. Food & Energy (m/m)	May	0.2	0.2	0.2

KEY POINTS:

- Risk-on cross-asset rally is absent fresh catalysts
- US core producer price inflation softens
- UK wage growth surprises higher
- Oil rallies ahead of US inventories
- Trump is dead wrong on quantitative tightening at the Fed
- Federal Reserve cheat sheet: arguments for and against easing
- What the S&P500 does around the first cut of the cycle
- US to auction 3s today
- Canada quiet

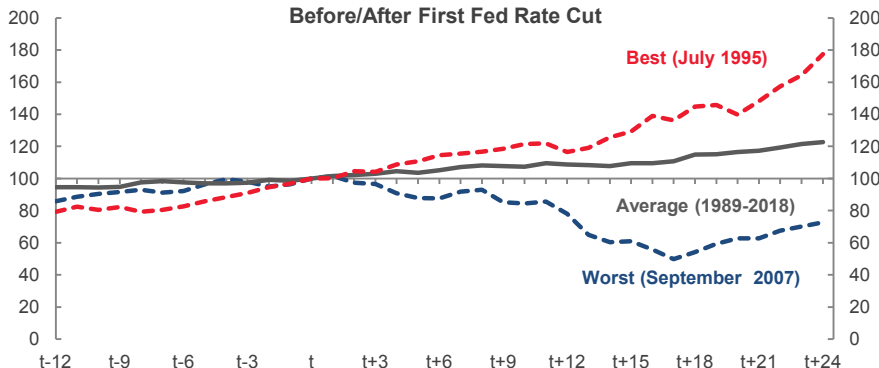
INTERNATIONAL

A risk-on bias is in swing across global markets and in generally synchronous fashion across asset classes. There really isn't any fresh catalyst and developments overnight into today are relatively light. UK wage growth surprised higher, providing a brief diversion from the Brexit train wreck. Another US inflation gauge may soften today. US private oil inventories may inform rallying crude prices.

Oil prices are rallying, led by WTI that is up by over 1%. US private industry oil inventory figures will be released later today ahead of tomorrow's government tally. A draw is expected following a large rise the prior month, but the estimates are very often way off and analysts have generally missed most of the recent rise. Gold has lost about \$25 so far this week following the US-Mexico agreement to avert tariffs.

- US equity futures are up by ½% with TSX futures not far behind. European cash markets are up by between ¼% (Madrid) and 1½% (Dax) while Asian markets were a sea of green led by mainland China's exchanges that rallied by 2.6% (Shanghai) to 3.7% (Shenzhen).

**S&P 500 Normalized Total Return
Before/After First Fed Rate Cut**

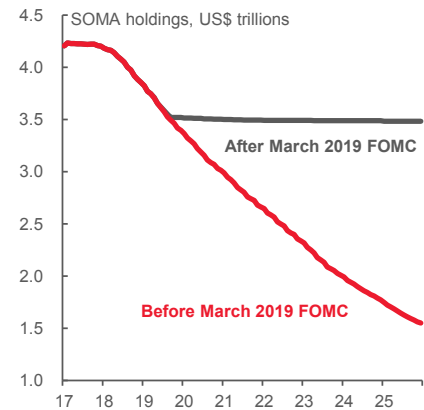


Sources: Scotiabank Economics, Bloomberg.

CONTACTS

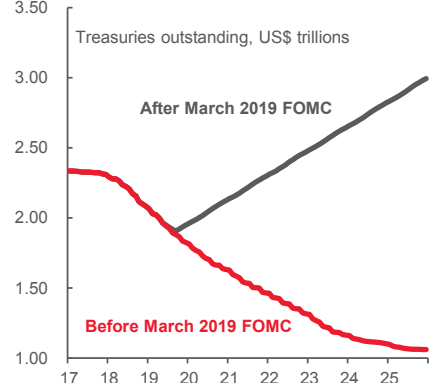
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A Much Bigger Balance Sheet



Sources: Scotiabank Economics, FRB New York.

The Fed Will Buy A Lot More Treasuries



Sources: Scotiabank Economics, FRB New York.

- Sovereign bond yields are mixed with the US, UK and Canada leading mild cheapening. US Treasury yields are up by 1–2bps in a mild 2s10s flattener with Canada performing similarly. Gilt yields are 1–2bps higher in a mild bear flattener. EGB 10s are generally rallying by 1–4bps in 10s. In general, bond prices firmed after Trump started tweeting about euro manipulation likely as an attempt to bully the Fed the way he does...
- Safe haven currencies like the USD, yen and Swiss franc are mildly defensive this morning as the Mexican peso, rand, won, sterling (post wages, see below), Euro and CAD lead the slightly appreciating crosses.

UK wage growth unexpectedly accelerated in April. Weekly earnings excluding bonuses increased by 3.4% y/y (3.2% consensus, 3.3% prior). That reverses some of the two month deceleration from 3.5% y/y in January which had been the fastest wage growth since July 2008. The economy generated 32,000 jobs in the three month change in April given the way they are reported, and the unemployment rate held steady at 3.8%. Pound sterling ignored political uncertainty and Brexit at least for a moment and rallied in the wake of the figures.

UNITED STATES

The US released producer prices for May this morning and they decelerated in line with expectations for core while undershooting on headline prices. Core PPI fell to 2.3% y/y (consensus 2.3%, 2.4% prior) and from a 2.9% peak in December. Headline PPI fell to 1.8% y/y (2.0% consensus, 2.2% prior) and down from a peak of 3.4% last July.

The US also auctions US\$38 billion in 3s today (1pmET).

What do US stock markets usually do when the Fed resumes an easing campaign? The first accompanying chart provides a depiction of what happens to the S&P500 starting twelve months before the first rate cut in an easing cycle and up to two years after the first cut. On average, stocks do tend to rally but it can take a few months to be noticeable and the range of possible outcomes is wide. The worst responses were understandably in the lead up to the GFC when stocks continued to slide in 2007 and then the dot com period in 2001. Take those two episodes out of the sample and the average return two years hence increases to over 30% as the rest of the episodes since 1989 were all favourable responses.

Trump again remarked yesterday that “The Fed interest rate way too high, added to ridiculous quantitative tightening! They don’t have a clue!”. I’ll come back to the debate about his first point in a cheat sheet approach later, but for now **is Trump right when he persistently portrays the Fed as still on a quantitative tightening path? Not one bit which begs the question who has the better clue in all of this.**

As evidence, the next two charts show forecasts for the Federal Reserve’s SOMA portfolio out to 2025 because, well, we have a patented crystal ball that’s sure to be correct! Alternatively, it’s what you get after working through the maturity composition of the Treasuries, FRNs, TIPS, agencies and MBS held in the Fed’s SOMA portfolio that was built up through three rounds of QE and by bolting onto that the altered balance sheet plans from the March FOMC meeting. The punchline is that Trump couldn’t be more wrong in asserting that the Fed remains on a balance sheet tightening path.

The first of the two charts shows the projections for the overall SOMA portfolio before and after plans were revised in March. If nothing had changed, the SOMA portfolio would have continued shrinking from a peak of about US\$4¼ trillion in holdings at the end of 2017 to \$3.6 trillion now and ultimately about US\$1.5 trillion at the end of 2025. The revised plan holds the balance sheet steady at about US\$3½ trillion throughout this whole period. **That’s an extra US\$2 trillion Mr. Trump et al.**

The second of the two charts shows the before and after for Treasury holdings within the SOMA portfolio. As other assets roll off, Treasury holdings will climb. If nothing had changed then Treasury holdings would have fallen down to about US\$1 trillion by the end of 2025 from about US\$2.3 trillion at the end of 2017 and just under US\$2 trillion now. With the changed balance sheet plans, the Fed’s Treasury holdings will vault toward US\$3 trillion by the end of 2025. In short, **Treasury holdings in this steady state world will be three times larger than they would have been if nothing else changed.**

So Trump’s factually wrong on yet another argument, but that won’t change his attacks...

Lastly, in the interests of framing the debate into the June FOMC meeting next week, **please see the accompanying table that lines up arguments for Fed policy easing and arguments against policy easing.** I’m sure it’s incomplete but it probably depicts the main considerations.

Federal Reserve Cheat Sheet

Arguments For Easing	Arguments Against Easing
GDP growth will weaken to a one-handed pace that just isn't good enough	The US economy is strong with low unemployment and continued growth that doesn't need help
There are downside risks to mild projected GDP growth that require accommodation even if no recession lurks	There are also upside risks to growth
Bond markets are signalling recession probabilities in line with actual past recessions	Bond markets are distorted and markets often over react such that policymakers should craft policy independently
Don't disappoint market pricing for cuts that would tighten financial conditions	Markets have gone too far and easing could inflame bubbles
Trade policy risks have been worse than anticipated for longer and will remain elevated. The damage has already been done to trade and investment	Trump will settle down into an election year
Look through potential tariff effects on inflation as transitory and in favour of growth drivers of the dual mandate, or view tariffs as ultimately deflationary like the 1930s. Bernanke vowed to never repeat the Fed's mistake back then.	Tariff effects could be inflationary if presented as a persistent supply shock such that easing would inflame inflation risk
The Fed's 2% inflation goal is symmetrical, meaning that ten years of failed model-based forecasts for higher inflation will now position the Fed to risk an overshoot of 2% as an average goal and not a ceiling to prove it is serious about its target	2% is still the target, trying to overshoot may not work or it could be problematic with unintended consequences to the bond market.
Inflation expectations are falling as a threat to Fed goals	Falling inflation expectations depend upon the measure and they are at best imperfect guides.
Fed-speak sounds more open to easing and don't fight the Fed	Powell hasn't said much of late and wait for the more open June FOMC debate
The Fed will give into Trump's pressure tactics	The Fed is independent, will pursue its Congressional dual mandate and might even exert its independence by defying Trump
The Fed may want to act faster and more pre-emptively in the face of increased risks this time	The Fed remains slow moving and will take its time and monitor further developments like the G20, OPEC meeting etc.
USD strength has many drivers and it has tightened financial conditions while putting downside pressure on inflation pass-through that requires Fed counter-action.	USD strength may be transitory if it is driven by trade policies that could settle down.
Other central banks like the PBOC, ECB, BoJ and BoE are shoving dollar strength onto the Fed which requires relative central bank adjustments	Currency markets face many varied drivers with monetary policy just one of them and duelling central banks yield subpar outcomes compared to global coordination
The Fed has to respect its Congressional dual mandate and do whatever it thinks is necessary.	Easing would bow to Trump and by bailing him out it could embolden him in such fashion as to worsen the outlook for trade policy
Weak payrolls in May were a warning shot as hiring confidence has been drained and don't risk waiting to find out	Volatile jobs could bounce higher next time so wait for a trend
The unemployment rate can go lower without stoking materially faster wage and price pressures that have eluded the Fed to date. Estimates for the natural rate of unemployment keep pushing lower so let's test it further.	Where the natural rate of unemployment rests is uncertain and this may be a dangerous pursuit
The US economic expansion is long in the tooth and the risk of accidents is naturally higher, requiring pre-emptive action	Expansions don't die of old age
The Fed is central banker to the world and easing could benefit multiple regions to the indirect benefit of the US economy and global financial stability	Monetary policy must be conducted strictly in terms of what is necessary for the US while letting the rest of the world adjust and adapt
Monetary policy can still ignite aggregate demand	Monetary policy would be like pushing on a string in the face of confidence-sapping trade wars that push us into a liquidity trap

Fixed Income	Government Yield Curves (%):												Central Banks	
U.S. CANADA GERMANY JAPAN U.K. CANADA GERMANY JAPAN U.K.	2-YEAR			5-YEAR			10-YEAR			30-YEAR			Current Rate	
	Last	1-day	1-wk	Last	1-day	1-wk	Last	1-day	1-wk	Last	1-day	1-wk		
	1.93	1.90	1.89	1.93	1.92	1.90	2.16	2.15	2.13	2.63	2.63	2.61	Canada - BoC	1.75
	1.48	1.46	1.39	1.43	1.41	1.34	1.53	1.52	1.47	1.78	1.77	1.74	US - Fed	2.50
	-0.67	-0.67	-0.65	-0.59	-0.59	-0.57	-0.23	-0.22	-0.21	0.39	0.40	0.41		
	-0.19	-0.19	-0.19	-0.22	-0.23	-0.21	-0.11	-0.12	-0.10	0.36	0.36	0.45	England - BoE	0.75
	0.58	0.56	0.60	0.63	0.61	0.65	0.85	0.84	0.90	1.43	1.42	1.49		
	Spreads vs. U.S. (bps):													
	-45	-45	-50	-50	-51	-56	-62	-63	-66	-85	-86	-87	Euro zone - ECB	0.00
	-260	-257	-253	-252	-251	-247	-238	-237	-234	-224	-223	-220	Japan - BoJ	-0.10
-212	-210	-207	-215	-215	-210	-226	-227	-223	-227	-227	-217			
-135	-135	-128	-130	-131	-125	-130	-131	-123	-120	-121	-112			
Equities	Level						% change:						Mexico - Banxico	8.25
S&P/TSX Dow 30 S&P 500 Nasdaq DAX FTSE Nikkei Hang Seng CAC	Last	Change					1 Day	1-wk	1-mo	1-yr				
	16216	-14.7					-0.1	1.3	-0.5	-0.3				
	26063	78.7					0.3	5.0	0.5	2.9				
	2887	13.4					0.5	5.2	0.2	3.8				
	7823	81.1					1.0	6.7	-1.2	2.1				
	12201	155.2					1.3	3.5	1.2	-4.4				
	7411	35.5					0.5	2.7	2.9	-4.2				
	21204	69.9					0.3	3.9	-0.7	-7.0				
	27789	210.7					0.8	3.3	-2.7	-10.5				
	5422	39.9					0.7	2.9	1.8	-0.9				
Commodities	Level						% change:							
WTI Crude Natural Gas Gold Silver CRB Index	53.95	0.69					1.3	0.9	-12.5	-18.4				
	2.36	0.01					0.3	-2.2	-9.8	-19.9				
	1322.89	-5.06					-0.4	-0.2	2.9	1.7				
	14.75	-0.17					-1.1	0.3	-0.3	-11.8				
	174.81	0.74					0.4	-0.4	-2.3	-12.3				
Currencies	Level						% change:							
USDCAD EURUSD USDJPY AUDUSD GBPUSD USDCHF	1.3262	-0.0007					-0.1	-1.0	-1.6	2.2				
	1.1314	0.0002					0.0	0.6	0.8	-4.0				
	108.73	0.2800					0.3	0.5	-0.5	-1.2				
	0.6957	-0.0004					-0.1	-0.5	0.2	-8.6				
	1.2710	0.0025					0.2	0.1	-1.9	-5.0				
	0.9923	0.0025					0.3	0.0	-1.4	0.7				
Next Meeting Date														
												Canada - BoC	Jul 10, 2019	
												US - Fed	Jun 19, 2019	
												England - BoE	Jun 20, 2019	
												Euro zone - ECB	Jul 25, 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.

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