

ON DECK FOR WEDNESDAY, JUNE 12

Country	Date	Time	Indicator	Period	BNS	Consensus	Latest
US	06/12	07:00	MBA Mortgage Applications (w/w)	JUN 7	--	--	1.5
US	06/12	08:30	CPI (m/m)	May	0.1	0.1	0.3
US	06/12	08:30	CPI (y/y)	May	1.9	1.9	2.0
US	06/12	08:30	CPI (index)	May	--	256	256
US	06/12	08:30	CPI ex. Food & Energy (m/m)	May	0.2	0.2	0.1
US	06/12	08:30	CPI ex. Food & Energy (y/y)	May	2.0	2.1	2.1
US	06/12	14:00	Treasury Budget (US\$ bn)	May	--	-199.5	160.3

KEY POINTS:

- Risk-off sentiment driven by HK protests, trade concerns
- Market worries imply they wish Hong Kong's protestors well
- US CPI: lower headline and core?
- Why no US CPI reading will please the Fed
- China's core inflation falls again

INTERNATIONAL

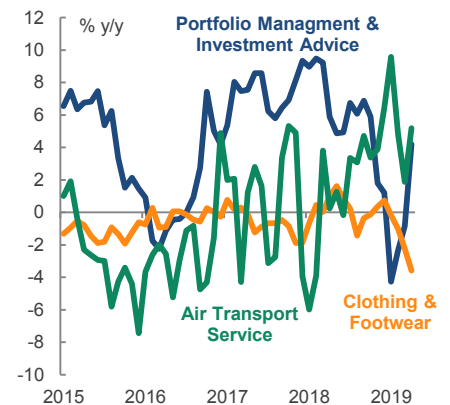
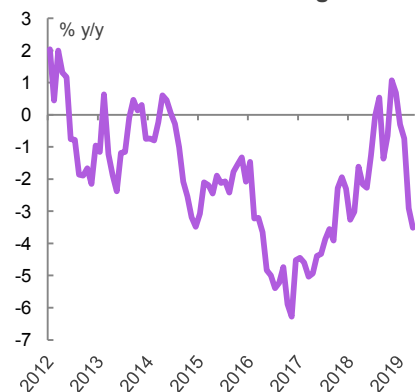
Stocks are not particularly enamoured with images of Hong Kong protestors being beaten back by police batons and tear gas volleys over China's quest to impose an extradition arrangement upon the former British colony. Such an arrangement would open the door to Hong Kong extraditing residents to China or other countries with which it does not presently have an extradition framework. This encroachment upon Hong Kong's independence—and the scope for legitimate concerns regarding mainland China's abuse—could put at risk HK's special status with other world economies as observed in the increased concern within the US Congress for one example. Through a narrower markets lens, the issue is the durability of the "One Country, Two Systems" framework that guides Hong Kong's quasi-independent status that preserves access to world markets. Do global businesses need to fundamentally reassess multi-faceted risks associated with operating in HK?

Cooler Chinese core inflation is positive for PBOC expectations in terms of room to stimulate (see below). The bulk of today's incremental price action may be dominated by US CPI and what markets think it may reveal to the Fed. As explained below, I don't think it matters one iota and the Fed's mind is already made up.

- US equity futures are down by about ¼% to ½% with the Nasdaq leading the decline. TSX futures are down by about ¼%. European cash markets are down by between ½% and ¾%.
- Sovereign bond yields are falling again. US yields are down by 2–3bps across the curve with slightly more at the front-end than further out. Canada is also rallying by slightly less. The gilts curve is a touch cheaper at the front end while EGB yields are slightly lower in core 10s.

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PCE Categories Cited By Powell For Dragging Down US Inflation

Net Purchases of Used Vehicles PCE Inflation Gauge


- Oil prices are falling by about US\$1½ in terms of both Brent and WTI. Private US oil inventory figures showed a build yesterday ahead of today's government report (10:30amET).
- The USD is little changed on balance. The yen and pound sterling are slightly appreciating, while the won, A\$, CAD and peso are among the slightly depreciating crosses and the euro is flat.

China's headline rate has gone to the hogs because of the African swing flu's impact, but core inflation is heading the other direction and that continues to open room for prospective easing. The first accompanying chart demonstrates the outcome as core CPI continues to decline whereas it was pork prices that pumped headline inflation.

UNITED STATES

US CPI (8:30amET) will be the last major inflation reading the Fed digests ahead of next Wednesday's policy decision with just import prices (tomorrow) and UofM inflation expectations (Friday) remaining. Most economists see headline CPI decelerating to 1.9% from 2.0% and core CPI inflation stabilizing at 2.1%. I'm with consensus on headline but with about one fifth of consensus that sees a downtick in core. It's not hard to get the latter outcome on shifting base effects, typical seasonality and weak momentum arguments. On the momentum argument, note that consensus has gone on auto-pilot with +0.2% m/m forecast for each of the past three months of core CPI readings and each time it has instead gotten 0.1% in no small part due to persistent 'transitory' drag effects and methodological arguments.

The transitory influences that Chair Powell has highlighted are shown in the second chart. They've already turned around and yet core PCE inflation remains soft. For example, 'portfolio management and investment advice' fees are rebounding as did 'air transport service' prices in the last PCE report pending another update at month-end. Clothing and footwear prices are still cooling. The third chart separates out the influence of used motor vehicle prices that are still falling in PCE and it is separated because this driver has more to do with methodological shifts that should be at least partly controlled against.

Regardless, whether core comes in flat or lower by a tick here or there arguably doesn't matter to the Fed. Either scenario won't impress the Fed in terms of its preferred inflation gauge as core CPI tends to overestimate core PCE by quite a lot over time. See charts 4 and 5 for depictions of the magnitude by which headline and core PCE gauges are undershooting CPI especially the latter which is the one the Fed pays closer attention to. The same issue of how CPI overestimates PCE inflation plagues the trimmed and weighted median CPI measures shown in chart 6.

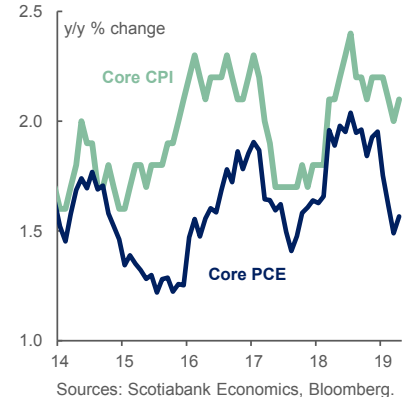
Indeed CPI is not the measure of inflation that the Fed cares about for many reasons. The reconciliation of the PCE inflation gauge with CPI is explained [here](#) and broken down [here](#). The accompanying pie chart shows the relative important of the sources of difference between PCE and CPI. About half of the difference has to do with the different weights that PCE places upon components compared to CPI including weights upon fuels, rent of shelter and "other" categories. Some of the difference also lies in the so-called "out of scope" effects that capture differences in what the two price measures include. For example, PCE includes spending by or on behalf of households (ie: including governments and corporations which matters to health care for example) whereas CPI only captures what is directly spent by households.

Then bolt onto that observation the 'run hot' symmetrical inflation target argument. Despite modelling it to death, the Fed has

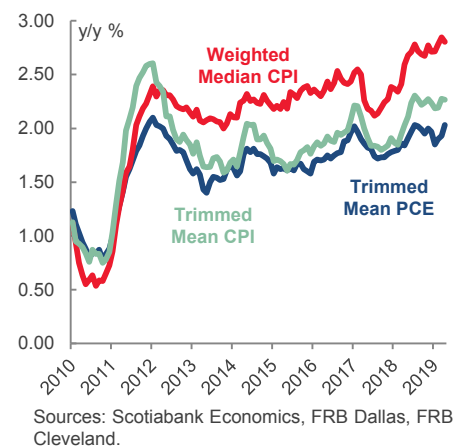
US PCE is Undershooting CPI



Core PCE is Undershooting Core CPI



A Comparison of Alternative Federal Reserve Inflation Measures

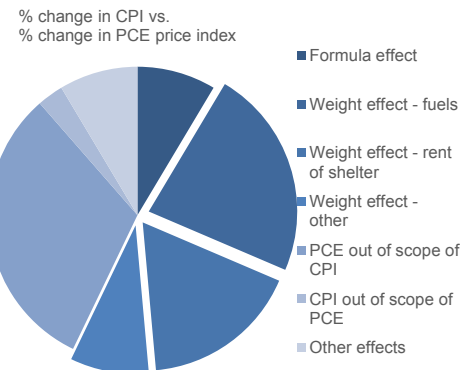


persistently overestimated inflation risk and hasn't hit its 2% objective in all but fleeting cases in early 2012 and for a brief moment last year. That's right, for ten years the Fed has been like the BoJ perhaps not in the magnitude of the misses but in the direction by perennially overestimating inflation. 'Running hot' is a catch up argument to target above-2% inflation for a time in order to prove the seriousness of its symmetrical 2% inflation goal that is supposed to be as open to upsides as it is to downsides as long as it averages around 2%. This is the point being made by folks like Clarida and Bullard in that if its an average target, then prove it through monetary policy actions rather than treating 2% as the ceiling that's never hit.

While in theory, the Fed might not formally shift to some average inflation targeting framework until next year when it makes decisions on an altered framework, but in practice all of the signals from the Fed suggest it is already there. Buy the rumour, sell the fact, don't wait for the Fed to formally announce this shift because markets have already read the Fed's signals and priced it in. Overall, when the core PCE undershoot of core CPI is added to the run-hot overshoot of 2% argument, the cumulative outcome is that the Fed could easily be a half to three quarters of a percentage point away from the implied other side of its symmetrical inflation goal. If so, then don't rule out the scope for the Fed to take a more serious approach than markets may be pricing.

It is this shift in the Fed's reaction function that I think matters more than trade, more than GDP, more than geopolitical factors or anything else. Underweighting this shift in reaction function by not listening to umpteen speeches and conference papers on the topic of late is why consensus is moving slowly relative to markets in forecasting rate cuts.

Differences Between PCE & CPI



Sources: Scotiabank Economics, BEA.

Fixed Income	Government Yield Curves (%):												Central Banks	
	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		
U.S.	1.90	1.93	1.86	1.89	1.92	1.88	2.12	2.14	2.14	2.60	2.62	2.65	Canada - BoC	1.75
CANADA	1.46	1.48	1.34	1.41	1.42	1.30	1.52	1.53	1.45	1.77	1.77	1.74	US - Fed	2.50
GERMANY	-0.68	-0.67	-0.68	-0.59	-0.59	-0.61	-0.24	-0.23	-0.23	0.36	0.39	0.40	England - BoE	0.75
JAPAN	-0.19	-0.19	-0.22	-0.22	-0.22	-0.24	-0.11	-0.11	-0.12	0.34	0.36	0.42	Euro zone - ECB	0.00
U.K.	0.60	0.59	0.57	0.64	0.64	0.62	0.86	0.86	0.86	1.45	1.44	1.45	Japan - BoJ	-0.10
Equities	Spreads vs. U.S. (bps):												Next Meeting Date	
	Last	1-day	1-wk	Last	1-day	1-wk	Last	1-day	1-wk	Last	1-day	1-wk		
	Level	Change		Level	Change		Level	Change		Level	Change			
	1 Day	1-wk	1-mo	1 Day	1-wk	1-mo	1 Day	1-wk	1-mo	1 Day	1-wk	1-mo		
	% change:	% change:		% change:	% change:		% change:	% change:		% change:	% change:			
CANADA	-44	-45	-52	-47	-49	-58	-61	-62	-69	-83	-84	-90	Mexico - Banxico	8.25
GERMANY	-258	-260	-253	-248	-251	-248	-236	-238	-236	-223	-223	-225	Australia - RBA	1.25
JAPAN	-209	-212	-208	-211	-213	-212	-223	-225	-226	-226	-226	-223	New Zealand - RBNZ	1.50
U.K.	-129	-134	-129	-124	-128	-126	-127	-128	-127	-115	-118	-119		
Commodities	Level													
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WTI Crude	51.84			-1.43			-2.7	0.3		-15.9		-21.9		
Natural Gas	2.39			-0.01			-0.3	0.6		-8.6		-18.6		
Gold	1335.09			8.24			0.6	0.4		3.8		3.0		
Silver	14.70			-0.05			-0.3	-0.2		-0.7		-12.3		
CRB Index	173.62			-1.24			-0.7	0.7		-3.0		-13.3		
Currencies	Level													
	Level													
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	Level													
USDCAD	1.3298			0.0014			0.1	-0.9		-1.3		2.2	Mexico - Banxico	Jun 27, 2019
EURUSD	1.1323			-0.0003			-0.0	0.9		0.9		-3.6	Australia - RBA	Jul 02, 2019
USDJPY	108.37			-0.1500			-0.1	-0.1		-0.9		-1.8	New Zealand - RBNZ	Jun 25, 2019
AUDUSD	0.6951			-0.0011			-0.2	-0.3		0.1		-8.2		
GBPUSD	1.2751			0.0026			0.2	0.5		-1.6		-4.6		
USDCHF	0.9935			0.0011			0.1	-0.1		-1.3		0.7		

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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