ON DECK FOR TUESDAY, JULY 9

Country	Date	Time	Indicator	Period	BNS	Consensus	Latest
CA	07/09	08:15	Housing Starts (000s a.r.)	Jun	215	209	246
CA	07/09	08:30	Building Permits (m/m)	May	--	-10.0	14.7
US	07/09	10:00	JOLTS Job Openings (000s)	May	--	7473	7449

KEY POINTS:

- **Risk-off sentiment driven by tomorrow's Powell testimony**
- **Limited Fed-speak should just tease markets today**
- **CDN housing starts soar on both singles and multis**
- **Mexican CPI barely returns to inside Banxico's target range**
- **Bank Negara holds as expected**
- **Japan's real wages still going nowhere**
- **Fed cuts to address the shape of the yield curve…**
- **...would risk compounding policy distortions…**
- **...that could inflame future stability risks...**
- **...as the curve's shape was engineered by policy measures…**
- **...and should not be literally interpreted as a recession gauge**

INTERNATIONAL

Markets will lie in wait ahead of tomorrow's testimony by Fed Chair Powell and the BoC's communications that will both unfold within the same rough 10am-12pmET interval. Relative rate and USDCAD influences will be subject to several potential scenarios, with markets largely priced for a neutral sounding BoC and dovish Fed and hence vulnerable to surprises on both counts. There is nothing of real consequence to markets by way of fresh developments overnight and little expected today. Light Fed–speak, Mexican CPI, an expected hold by Bank Negara and Canadian housing starts are about as exciting as things get today. I'll go over why I still think perennial bears are too focused upon the inverted US yield curve below.

- The USD is a touch stronger this morning while other safe havens like the yen and Swiss franc are holding their own. The A$ and pound sterling are leading decliners with CAD not far behind after a stellar run of late. Concern that Fed Chair Powell's testimony tomorrow may not sound as dovish as markets would like is perhaps influencing positioning today.

- US Treasury yields are slightly higher while gilts and bunds are mostly flat and Italian spreads are about 6bps narrower over bunds in the 10 year section of the curve.

- Oil prices are up by about half a buck in terms of both WTI and Brent.

- US equity futures are driving the same risk-off trade again with exchanges down by just under ½%. TSX futures are slightly lower. European equity markets range from being flat in London to off by up to 1% (Frankfurt). Asian equities were mixed but generally lower overnight, with the Nikkei 225 up a

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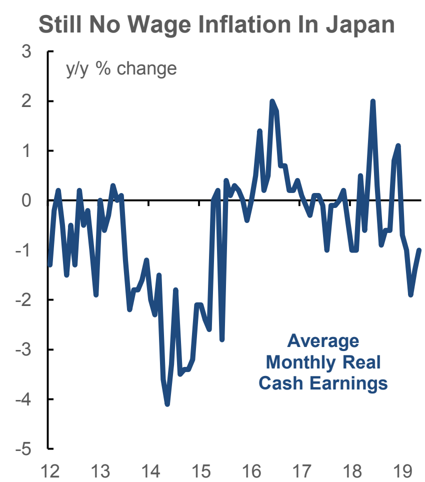
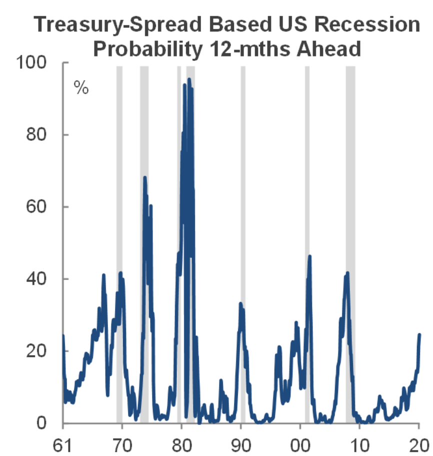


Source: Scotiabank Economics, Bloomberg.



Sources: Scotiabank Economics, FRBNY.
Shaded areas represent recession periods.

tick or two along with Shenzhen but Seoul, HK and Shanghai all down by round ¼% to ¾%.

Malaysia's central bank met expectations for a policy hold at an overnight rate of 3% and a cautious bias as it assesses risks to the outlook. There was no surprise to warning about downside risks to unchanged growth forecasts. The ringgit was unchanged following the communications.

Japan's inflation adjusted wages are still going nowhere (see chart 1). At -1.0% y/y, wages are not keeping pace with very low inflation, and they generally haven't for many years.

Canadian housing starts exceeded consensus expectations at 245.7k in June and the details were solid. Around 210k was the consensus expectation with the range from 195–220k. The release rarely affects markets. Singles were up 8% and multiple housing units increased by 31%. Ontario (+35%) was the stand-out, followed by Quebec (+12%) and BC (+12%).

Mexican inflation was bang on consensus expectations at 3.95% y/y (4.3% prior) partly because bi-weekly CPI was already pointed in that direction. Core inflation was steady at 3.85% y/y unless we're counting hundredths of basis point moves that most other markets round off. **The main takeaway is that core inflation is just barely inside the upper limit of Banxico's 2–4% inflation target range and the central bank is likely to wait to evaluate more inflation evidence before potentially altering policy.**

UNITED STATES

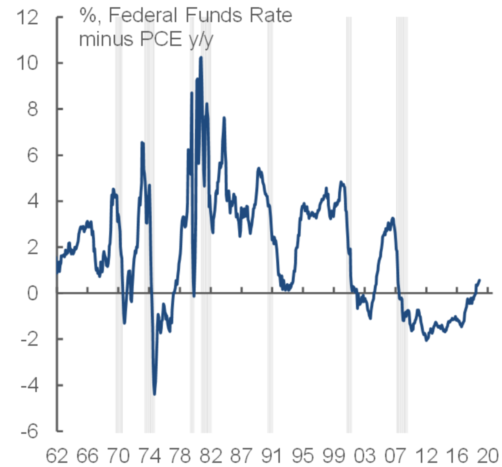
Fed-speak will likely just tease today ahead of the big show tomorrow when Fed Chair Powell delivers his semi-annual testimony to Congress at 10amET. Today, Chair Powell provides introductory remarks on stress tests at a Boston Fed conference (8:45amET) and Vice Chair Quarles speaks on stress tests at 2pmET. St. Louis President Bullard provides welcoming remarks at an event at 10:10amET. Atlanta Fed President Bostic will deliver a moderated chat at 2:20pmET.

There are no US releases of any consequence this morning with just the JOLTS job vacancies measure for May due at 10amET.

Now, if I'm a perma-bear looking to overstate my recession case, I start by showing you chart 2 that depicts the NY Fed's recession probability model that is based solely on the 90s10s yield curve slope, but I truncate the sample to recent times to make it look as bad as possible. Instead, the full sample shows that the recession probability derived from the current reading is still among the lowest prior to any past recession. If I were such a perma-bear, I might also ignore evidence that a recession would be historically unusual with a real policy rate that is close to zero (chart 3).

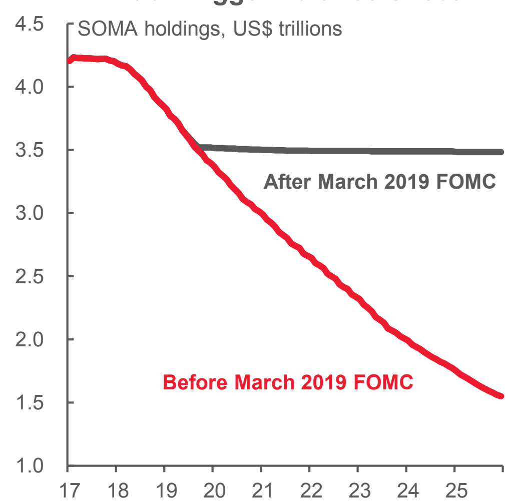
But the bigger problems with relying upon the slope of the yield curve as the only real evidence of how the US might be headed into recession—with a very small minority saying we're already there—remain the points about how policy has distorted the curve. I still think the flattened and inverted curve was driven by the following measures that are mostly policy distortions that make today's curve incomparable to the past and that should be treated with care as recession gauges.

United States Real Policy Rate



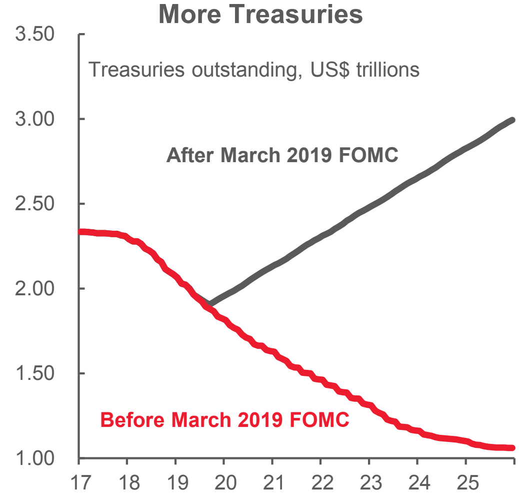
Sources: Scotiabank Economics, Federal Reserve, Bureau of Economic Analysis.

A Much Bigger Balance Sheet



Sources: Scotiabank Economics, FRB New York.

The Fed Will Buy A Lot More Treasuries



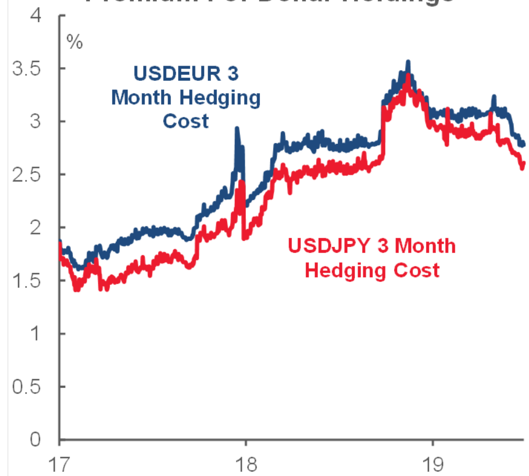
Sources: Scotiabank Economics, FRB New York.

In fact, easing short-term rates to remove curve inversion would risk responding to policy distortions that inverted it in the first place with compounded policy distortions.

1. The Fed's Treasury buying

Charts 4 and 5 remind readers how important the March FOMC meeting was when it completely shifted course on the SOMA portfolio and the Treasury component. If the Fed shifts from winding down Treasury purchases to about US$1 trillion by the end of 2025 under its old normalization plans to ramping them up to US$3 trillion over that same time period, wouldn't one expect this to flatten if not invert the curve? That was a huge shift in favour of more Treasury buying that induced higher prices and lower yields through an effort to pad everything from the SOMA to excess reserves in the system because nobody knows what may be the optimal size of reserves and the balance sheet. Nobody really knows with any precision what the neutral rate is either with brackets around the FOMC's 2.5% guesstimate.

FX Markets Demand A Premium For Dollar Holdings

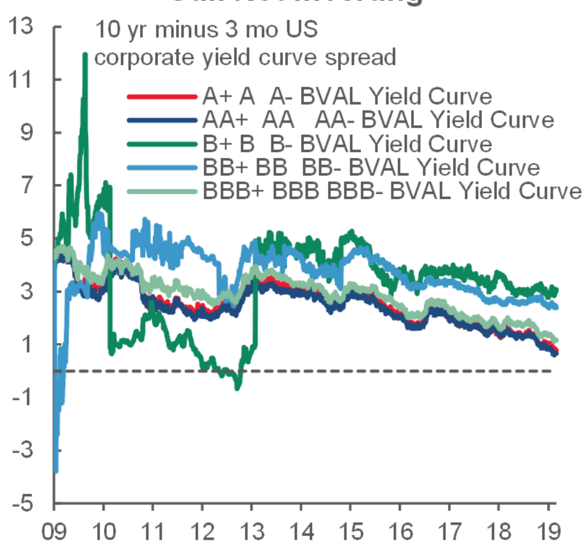


Sources: Scotiabank Economics, Bloomberg.

2. ECB TLTROs

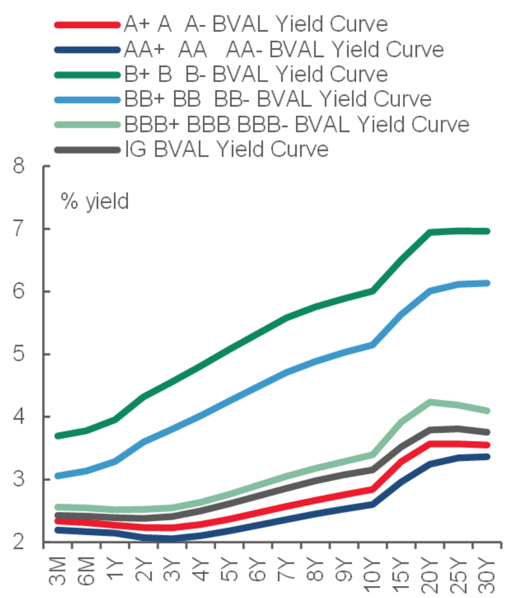
If anticipation ahead of the ECB's latest round of TLTROs had banks licking their chops over all the extra bonds they could buy with subsidized funding either directly or indirectly through portfolio shifts in response to lending incentives, wouldn't that drag all correlated global bond yields lower?

US Corporate Yield Curves Still Not Inverting



Sources: Scotiabank Economics, Bloomberg.

US Corporate Bond Market Is Not Inverted



Sources: Scotiabank Economics, Bloomberg.

3. Debt Ceiling

If Uncle Sam stopped issuing public debt which has been frozen by the debt ceiling at US$22.02 trillion since March 1st, wouldn't that induce relative scarcity and hence a premium in Treasury prices and lower yields? Demand has built-in sources of upward pressure through buyers such as pensions and life cos and that rising demand is being squeezed into what has been an unchanged pie for the past four months and with no signs as of yet that could inform when the debt ceiling may be suspended or raised.

4. Seasonal Dollar Hedging Costs

And if hedging costs out of the euro and yen into the USD fell since what appears to be evidence of late year seasonal spikes (chart 6), wouldn't that benefit foreign buying of Treasuries and also flatten/invert the curve?

5. Corporate curves

You don't normally get US recessions when consumer finances are in stellar shape. The corporate debt challenge isn't enough to tilt the balance on recession risk. Also consider charts 7–8 that show the corporate bond curves are not inverted as they were in the depths of the GFC and so there remains a reward to term extension in corporate credit. Fiscal stimulus has abated but fiscal policy is not contractionary. Tariff wars are a downside risk, but have so far affected a trivial share of US consumption within a huge domestic economy.

So go ahead and cut? It won't do anything at all for inflation (pick up Japan on the other line…) and it would only follow up one set of policy distortions with another in a classic case of fool me twice. The outcome—in mid-2000s form—would fan stability issues as if we didn't learn one single thing over the past decade. The Fed may well ease—in fact, is likely to—but it shouldn't go as far as markets have priced with the information we have at this point and if it does then history is about to repeat itself.

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.	1.90	1.89	1.76	1.87	1.86	1.74	2.06	2.05	1.97	2.54	2.53	2.50
CANADA	1.67	1.67	1.48	1.57	1.57	1.40	1.58	1.58	1.47	1.73	1.73	1.68
GERMANY	-0.73	-0.74	-0.76	-0.62	-0.63	-0.69	-0.36	-0.37	-0.37	0.24	0.24	0.25
JAPAN	-0.19	-0.20	-0.21	-0.22	-0.23	-0.24	-0.14	-0.15	-0.15	0.35	0.36	0.38
U.K.	0.55	0.55	0.53	0.53	0.53	0.53	0.72	0.72	0.72	1.35	1.35	1.36
	Spreads vs. U.S. (bps):											
CANADA	-22	-22	-28	-29	-29	-35	-48	-47	-51	-81	-80	-83
GERMANY	-263	-263	-252	-249	-248	-244	-242	-241	-234	-230	-229	-225
JAPAN	-209	-209	-198	-209	-209	-198	-220	-219	-212	-218	-217	-212
U.K.	-135	-134	-124	-134	-133	-122	-134	-133	-125	-119	-118	-115

Equities	Level		% change:			
	Last	Change	1 Day	1-wk	1-mo	1-yr
S&P/TSX	16463	-79.0	-0.5	0.5	1.4	0.1
Dow 30	26806	-116.0	-0.4	0.8	3.2	8.2
S&P 500	2976	-14.5	-0.5	1.2	3.6	6.9
Nasdaq	8098	-63.4	-0.8	1.2	4.6	4.4
DAX	12410	-133.7	-1.1	-0.9	3.0	-1.1
FTSE	7543	-6.2	-0.1	-0.2	2.9	-1.9
Nikkei	21565	30.8	0.1	-0.9	3.3	-2.2
Hang Seng	28116	-215.4	-0.8	-2.6	4.3	-2.0
CAC	5564	-25.4	-0.5	-0.2	3.7	3.1
Commodities	Level		% change:			
WTI Crude	57.97	0.31	0.5	-1.9	7.4	-21.5
Natural Gas	2.38	-0.03	-1.1	4.8	1.7	-16.0
Gold	1392.77	-2.78	-0.2	-1.8	3.9	10.7
Silver	15.07	-0.14	-0.9	-1.2	1.1	-5.8
CRB Index	180.19	-0.49	-0.3	-0.5	3.3	-9.1
Currencies	Level		% change:			
USDCAD	1.3127	0.0031	0.2	0.1	-1.1	0.2
EURUSD	1.1203	-0.0011	-0.1	-0.7	-1.0	-4.7
USDJPY	108.82	0.1000	0.1	0.9	0.3	-1.8
AUDUSD	0.6930	-0.0042	-0.6	-0.9	-0.4	-7.2
GBPUSD	1.2453	-0.0062	-0.5	-1.1	-1.8	-6.1
USDCHF	0.9940	0.0001	0.0	0.8	0.4	0.3

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	1.00
New Zealand - RBNZ	1.50
Next Meeting Date	
Canada - BoC	Jul 10, 2019
US - Fed	Jul 31, 2019
England - BoE	Aug 01, 2019
Euro zone - ECB	Jul 25, 2019
Japan - BoJ	Jul 30, 2019
Mexico - Banxico	Aug 15, 2019
Australia - RBA	Aug 06, 2019
New Zealand - RBNZ	Aug 06, 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.