ON DECK FOR TUESDAY, JULY 23

Country	Date	Time	Indicator	Period	BNS	Consensus	Latest
US	07/23	10:00	Existing Home Sales (mn a.r.)	Jun	5.3	5.3	5.3
US	07/23	10:00	Existing Home Sales (m/m)	Jun	0.0	-0.2	2.5
US	07/23	10:00	Richmond Fed Manufacturing In	Jul	--	5.0	3.0

KEY POINTS:

- **US$ firms, US 2s cheapen on debt deal**
- **US debt ceiling deal lowers risk of confrontation…**
- **…but spending bills must still be enacted…**
- **…and the US has taken a further step toward fiscal profligacy**
- **Gilts, sterling shrug off Johnson's expected victory**
- **Brazilian inflation is compatible with easing next week**
- **Will the US Richmond Fed add to Philly's upside?**
- **US existing home sales on tap**

INTERNATIONAL

A US debt ceiling deal (see below) is driving cheaper short-term US Treasuries this morning ahead of relatively light US data (see below). In the worst kept secret going, the UK Conservative Party announced that Boris Johnson has won the postal leadership ballot is set to become the new UK Prime Minister as Theresa May steps down. Canada will be dead quiet for the remainder of the week except for Wednesday's 10s auction.

- The USD is broadly stronger this morning against all major crosses. This is likely driven in part by the US debt ceiling deal that *might* remove one risk that could require US monetary policy accommodation.

- Consistent with this interpretation is that US Treasury yields are a little higher at the front-end and unchanged further out along the curve. Canada's curve is bull flattening with the 10 year yield down about 2–3bps. In EGBs, bunds and French bonds are little changed while Italian spreads are narrowing. The gilts curve is little changed after the expected vote result.

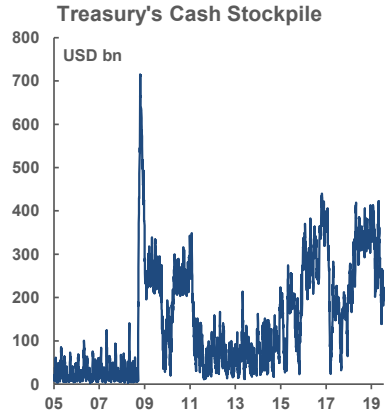
- Oil prices are somewhat lower with both WTI and Brent down about 20 cents. Gold is flat.

- US stocks are rallying with futures up by ¼% – ½%. TSX futures are up by about ½%. European cash markets are up by around 1% or more with the Dax leading the way via a 1 ¾% rise.

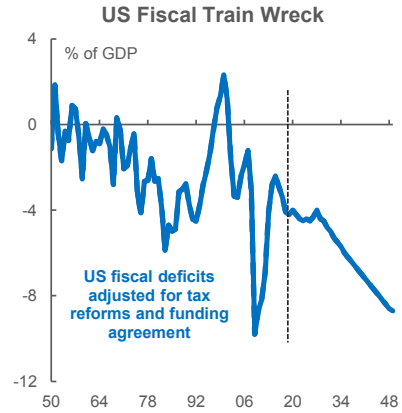
Brazil's mid-month inflation measure for July incrementally supports the case for the central bank to ease monetary policy at its July 31st decision. The IBGE IPCA-15 inflation metric fell to 3.3% y/y (3.8% prior, 3.3% consensus) and is rolling over from nearly 5% in May.

CONTACTS

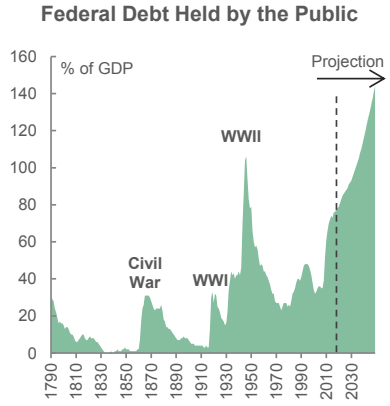
Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com



Sources: Scotiabank Economics, Bloomberg.



Sources: Scotiabank Economics, CBO.



Sources: Scotiabank Economics, Congressional Budget Office.

UNITED STATES

A debt ceiling and funding agreement is the dominant influence over the Treasury curve this morning ahead of relatively light data. The **Richmond Fed manufacturing gauge** (10amET) will be monitored for the risk that it could follow the Philly Fed metric's jump higher and thus set up an improved ISM-manufacturing reading on August 1st. **US existing home sales** are also on tap for a June update (10amET).

The American government has indeed plotted a free-spending path toward ever rising deficits and debt outstanding. Respected center-left economists Furman and Summers say this doesn't matter (here) but it is the bond market that will determine whether they are right over time. The combined actions of the debt ceiling deal that was struck by President Trump and the four Congressional leaders yesterday, as well as the previously set pending expiration of the concept of sequestration, will further magnify the long-term funding pressures facing US Treasury markets. Here are suggested points for consideration.

- The pressure to get a deal done was rising ahead of Congress's summer recess and as extraordinary measures employed by the US Treasury to fund the government were getting strained. For instance, Treasury's cash stockpile had been cut in half since the end of April after the effects of the latest tax season (chart 1). US Treasury Secretary Mnuchin had guided that the US government's back would be against the wall into early September, thus requiring action before recess.

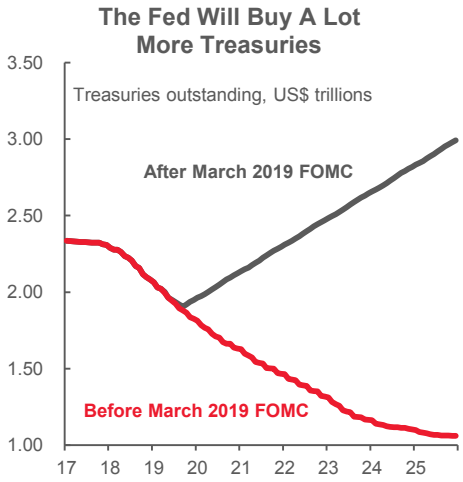
- What the deal entails is a total of US$2.7 trillion in spending over the next two fiscal years. An extra US$320 billion has been applied to spending caps over the next two years minus $80 billion in spending cuts and relative to what would have been mandatory sequestration cuts of about US$126 billion. In absolute terms, spending will be about $50 billion extra each year over current spending levels for a modest fiscal assist to growth.

- According to these folks, the effect of yesterday's agreement might add $2 trillion to debt over the next decade compared to the prior forecast, with Trump increasing spending by 22% over his term in office.

- If passed, the agreement would suspend the debt ceiling again until July 31st 2021. That pushes the next debt ceiling battle into the new Congress that will take place after the November 2020 election and starting in January 2021.

- The deal must be approved by the House this week with a vote perhaps on Thursday before recess commences on Friday July 26th and next week by the Senate before it goes on recess after August 2nd.

- This deal helps, but does not guarantee that a government shutdown on October 1st will be avoided. Twelve spending bills still have to be passed by September 30th in order to action the spending within the newly agreed caps. This may require stopgap funding measures. Recall that Trump shut down the government from December 22nd 2018 to January 25th 2019 as he sought border wall funding. Doing so again may be less likely into a Presidential election year, but the course of action he has pursued thus far largely makes this expectation a function of predicting his mood in September.



Sources: Scotiabank Economics, FRB New York.

- Recall that the Budget Control Act of 2011 had set in motion years of *relative* fiscal restraint to rein in crisis-driven deficits in that failure to reach agreement on fiscal controls would trigger deeper automatic cuts. Sequestration will end in 2021 and with it the threat to trigger deep spending cuts in the absence of future spending deals.

- Recall that the debt ceiling was introduced in 1939 and has been raised 86 times since 1959. The ceiling was fairly routinely raised until the post-GFC era. President Obama's administration introduced the Budget Control Act of 2011 that sought to lower the federal deficit and, barring agreement on how to do so, introduced the concept of sequestration that would mean possibly draconian automatic spending cuts. Sequestration will end in 2021.

- The CBO will need to revise long-run projections for the deficit and debt should this agreement be passed. The prior projections in June 2019 for the long-run deficit-to-gdp ratio and federal debt held by the public as a share of GDP are shown in charts 2 and 3. The US administration and Congress are doing nothing to address long-term pressures of rising US federal government debt ahead of looming increases in social security and health care related spending.

- To prevent deficits from spiraling out of control and interest expense crowding out budgetary program spending (ask Canada, early 1990s…), either future spending cuts, higher taxes or long-term higher interest rates may be needed. Note the irony in that the Republican Party that railed against deficits in the past is yet again driven them much higher.

- By way of implications for the Federal Reserve's policy actions, the agreement may lessen but not eliminate risk of a shutdown in September and that's likely why the US Treasury front-end is underperforming all other major markets this morning. The two year Treasury yield is up 2bps and the curve is mildly bear flattening.

- Perhaps fear-not the nearer term supply pressures in the context of the Fed's ramping up of its Treasury holdings within the SOMA portfolio (chart 4) in light of the altered course of balance sheet policy that was set at the March FOMC. Relative to the prior plan, the five year projection for the Fed's Treasury holdings will be about US$2 trillion higher and that's assuming a steady state world absent recession or future pressure upon nonconventional monetary policy actions. Is this course of action in conformance to the dual mandate set by Congress, or is it the Fed acting to enable deficit spending on top of Trump's protectionist tendencies?

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.	1.83	1.81	1.85	1.80	1.80	1.87	2.05	2.05	2.10	2.58	2.57	2.61
CANADA	1.43	1.44	1.53	1.37	1.39	1.51	1.46	1.48	1.59	1.70	1.72	1.78
GERMANY	-0.78	-0.77	-0.73	-0.68	-0.67	-0.59	-0.35	-0.35	-0.24	0.25	0.25	0.34
JAPAN	-0.20	-0.20	-0.18	-0.23	-0.23	-0.21	-0.14	-0.14	-0.12	0.38	0.38	0.39
U.K.	0.49	0.50	0.59	0.48	0.49	0.59	0.70	0.71	0.82	1.32	1.33	1.43
	Spreads vs. U.S. (bps):											
CANADA	-40	-38	-32	-44	-41	-36	-59	-56	-52	-88	-85	-83
GERMANY	-260	-259	-258	-248	-248	-246	-240	-239	-235	-232	-233	-228
JAPAN	-202	-201	-203	-203	-203	-208	-219	-218	-222	-220	-219	-223
U.K.	-133	-131	-126	-132	-132	-128	-135	-134	-128	-126	-124	-118

Equities	Level		% change:			
	Last	Change	1 Day	1-wk	1-mo	1-yr
S&P/TSX	16519	32.9	0.2	0.0	-0.0	0.6
Dow 30	27172	17.7	0.1	-0.7	1.7	8.5
S&P 500	2985	8.4	0.3	-1.0	1.2	6.3
Nasdaq	8204	57.6	0.7	-0.7	2.1	4.6
DAX	12500	210.7	1.7	0.6	1.3	-0.4
FTSE	7594	79.5	1.1	0.2	2.5	-0.8
Nikkei	21621	204.1	1.0	0.4	1.7	-3.5
Hang Seng	28466	95.2	0.3	-0.5	-0.0	0.7
CAC	5627	60.0	1.1	0.2	1.8	4.6
Commodities	Level		% change:			
WTI Crude	56.06	-0.16	-0.3	-2.7	-2.4	-17.4
Natural Gas	2.31	-0.01	-0.3	-0.0	5.4	-15.3
Gold	1426.50	1.58	0.1	1.4	1.9	16.5
Silver	16.39	0.07	0.4	7.0	7.2	6.6
CRB Index	178.12	-0.43	-0.2	-1.1	-0.2	-7.5
Currencies	Level		% change:			
USDCAD	1.3157	0.0038	0.3	0.5	-0.2	-0.1
EURUSD	1.1171	-0.0038	-0.3	-0.4	-2.0	-4.5
USDJPY	108.15	0.2800	0.3	-0.1	0.8	-2.9
AUDUSD	0.7027	-0.0009	-0.1	0.2	0.9	-4.8
GBPUSD	1.2450	-0.0026	-0.2	0.3	-2.3	-5.0
USDCHF	0.9832	0.0012	0.1	-0.5	1.2	-0.9

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	Sep 04, 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.