

ON DECK FOR FRIDAY, SEPTEMBER 13

Country	Date	Time	Indicator	Period	BNS	Consensus	Latest
US	09/13	08:30	Export Prices (m/m)	Aug	--	-0.5	0.2
US	09/13	08:30	Import Prices (m/m)	Aug	--	-0.5	0.2
US	09/13	08:30	Retail Sales (m/m)	Aug	0.1	0.2	0.7
US	09/13	08:30	Retail Sales ex. Autos (m/m)	Aug	0.1	0.1	1.0
US	09/13	10:00	Business Inventories (m/m)	Jul	--	0.3	0.0
US	09/13	10:00	U. of Michigan Consumer Sentiment	Sep P	89.0	90.4	89.8

KEY POINTS:

- Risk-on aided by trade headlines
- Sovereign bonds continue to cheapen post US CPI and ECB
- Why did markets react the way they did to the ECB?
- Don't hold your breath for US capital gains tax cuts
- US retail sales growth probably cooled

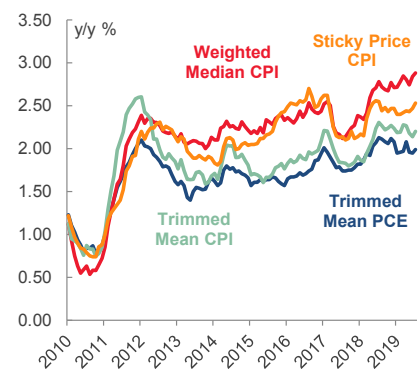
INTERNATIONAL

Spillover effects from yesterday's developments (ECB, US inflation, trade headlines) will likely continue. Incremental information will be focused upon US retail sales for the month of August and an updated measure of US consumer confidence. Markets are displaying some optimism toward the US and China building on momentum toward some sort of truce if not partial agreement on the back of evidence that Chinese buyers are moving back into US pork and soybeans, the US decision to delay the 5% tariff hike by two weeks to mid-October and volatile headlines about whether the US might pursue an interim agreement with China presumably to buy some peace into the US election! Please see below for reasons behind why markets may have reacted the way they did to the ECB and other developments.

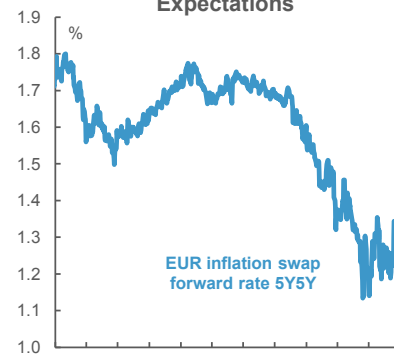
- The USD is a little stronger this morning, but not by much. The euro and euro-related crosses (CHF, DKK, SEK, NOK) are rallying against the dollar along with sterling.
- Oil prices are flat after yesterday's decline.
- US equity futures are up by around ¼% with TSX futures up ½%. European cash markets range from flat (London) to up by about ½% elsewhere. Asian equities rallied across the board with gains up to about 1%.
- Sovereign bonds continue to cheapen after yesterday's violent moves. The US 10 year is up to about 1.8% now, or about 35bps off the low point that was set just last week. Canada's curve is little changed but a touch on the cheaper side. Gilts are cheaper by around 4bps toward longer maturities. EGB 10 year yields are up by about 2bps except in Italy where they are a touch lower.

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A Comparison of Alternative Federal Reserve Inflation Measures


Sources: Scotiabank Economics, FRB Dallas, FRB Cleveland, FRB Atlanta.

Eurozone Inflation Expectations


Sources: Scotiabank Economics, Bloomberg.

Why did markets react the way they did to the ECB announcements? Like a driver doing a U-turn when a black cat crosses the road ahead especially around Friday the 13th, markets did a total about face as the initial euphoria quickly faded. The yield on the 10 year German bond, for instance, initially dropped by about 8bps but within about two hours had reversed this rally and went on to post a cumulative 10bps rise into this morning. The reaction in the 2 year Germany government bond was even more violent as the initial minor 2bps decline has subsequently given rise to about a 14bps rise into this morning to mildly bear flatten the curve. Some of the reasons were explained in the recap of the ECB and US inflation and how conditions affecting both major central banks shifted yesterday ([here](#)). David Letterman wouldn't exactly weep at this 'top ten' list that would have put his audience to slip, but here we go.

- The 10bps deposit rate cut was less than markets had priced and less than some forecasters anticipated.
- Tiering of reserves that exempts some from negative rates sparked portfolio substitution away from shorter dated securities back toward reserves with a significant portion of reserves now insulated against negative rates. While this effect may have been known beforehand, whether tiering would be pursued now was uncertain.
- Asset purchase volumes equal to €20 billion per month were less than expected. The open-ended nature of the purchase program potentially leads to a larger overall pool, but the immediate discounted flow of purchases will be lower than expected.
- Dissenting voices. President Draghi seriously misrepresented the degree of buy-in to the resumption of quantitative easing during his press conference. That became clear afterward. It appears that Germany, France, Netherlands, Austria, Estonia and a pair of Board members disagreed with Draghi.
- The reason the dissenting voices matter is that they put the emphasis upon the lower than expected flow of purchases and away from the open-ended duration of the program. Markets are left wondering if the purchase program will remain open-ended and for how long. That causes one to discount the potential size of the purchase program.
- Covering. A reason why markets may have had a lagged response to the ECB communications is that after seeing the market effects, markets might have swooped in and crystalized the gains by reversing positioning and swinging to neutral or short positions. Buy the rumour, sell the fact.
- US inflation hit at the start of Draghi's press conference. Global bond markets may have reduced cumulative Fed rate cut expectations on the back of the CPI figures and in anticipation that some of the effect would flow through to the Fed's preferred PCE gauges. See chart 1 in addition to the recap noted above as it breaks apart the updated regional Fed CPI metrics that are generally elevated.
- There were seriously conflicting trade headlines out of the US that continued late in the day. One headline indicated scope for an interim peace deal with China, the next headline from the White House poured cold water on the idea, and then Trump indicated last evening that it might be possible "I guess." This administration remains in turmoil.
- Eurozone market-based inflation expectations increased (chart 2). The 5y5y inflation swap has risen by about 12bps since before the ECB communications. In a sense, this is a policy success and desirable goal.
- Well into his press conference, Draghi began to sound exasperated toward prospects for fiscal policy to carry the torch. He indicated monetary policy was getting at its limit of what can be done and that member countries across the Eurozone needed to step up and use fiscal capacity to stimulate their economies. Markets might not have liked a) the message from Draghi that the ECB is at its limits, and b) that dysfunctional Eurozone fiscal policy must get its act together.

UNITED STATES

The main focus will be upon US retail sales last month (8:30amET). It should be a softer reading than the prior month. Autos sales were up by less than 1% m/m (20% weight) and gas prices fell by 5% m/m (8% weight). Therefore, to stay in the black, nominal headline sales will need some help from core sales. The problem on that count is that the prior month was pretty strong and thus poses a high jumping off point. In fact, the retail sales control group that serves as input into measuring total

consumption in the GDP accounts was up by a hefty 1% in July. Moderation with downside risk would not be surprising. Yesterday's CPI figures are not likely to put material upside to the dollar value of core retail sales because the price gains were particularly concentrated outside of retail categories, like medical care through health insurance, recreation, OER etc. Some categories like building materials and generators might get a blip due to hurricane preparations in the southeast, but I doubt that will be material.

A little after retail sales will come the September reading for the UofM consumer sentiment gauge (10amET). It fell significantly in August to the lowest reading since October 2016. The Conference Board's measure did not decline materially for the same month.

What are the prospects for relief in terms of a capital gains tax cut in the US? The bottom line to the points below is to contain the enthusiasm.

1. Trump has previously said he could issue an executive order that would require capital gains to be indexed to inflation. Then on August 21st, Trump rejected the idea, saying it would be "elitist" and just benefit the wealthy and "I don't want to do that." With this President, a flip is always possible, but he'd presumably have to explain why his mind changed and the Dems would have a field day. Mind you, the economist's dream is 0 taxation on capital gains, tax consumption instead, but that's a total pipe dream. The status of the US debate is toward either cutting some income and capital gains taxes (Trump) or raising them (the Dems).
2. How would such a proposal work? Specifically, the cost basis used to determine the capital gain would itself be indexed to inflation. Only incomes are indexed in determining the rate of capital gains taxation. That would amount to a cut to the real rate of cap gains taxation. Trump may not need Congress to do that, but this is uncertain and has been one reason why this proposal has been around for ages but never gone anywhere.
3. Cutting the cap gains rates themselves would require Congress. Trump likely wouldn't get it given the Dems control the House and they want to go in the other direction. At present, the Tax Cuts and Jobs Act applies a 0% rate on cap gains for single incomes below US\$38.6k and joint incomes below US\$77.2k, a 15% rate up to \$425.8k/\$479k (single/joint), a 20% rate above US\$425.8k/\$479k and a 3.8% net investment income tax rate on adjusted gross income above US\$200k/\$250k. This also gets complicated in terms of debate over revising thresholds.
4. Anything Trump does therefore risks being unwound if not entirely reversed. One issue is that some think bypassing Congress to do this would be legally challenged and thus a proposed reduction would be held in limbo. Another issue is that it might not survive after November 2020. A summary of where the Dems stand is as follows:
 - a. Increase the rate: Biden would hike it for those earning incomes over US\$1 million. Sanders would drop the lowest rates for those with incomes over US\$250k. Lower profile candidates would raise the cap gains tax rate to the same as the rate on labour income.
 - b. Wealth tax: Warren would introduce a 2–3% tax on the stock of wealth per year for those over some wealth threshold, such as perhaps US\$50 million. All sorts of scope for gaming this!

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		
	1.73	1.72	1.54	1.65	1.64	1.43	1.79	1.77	1.56	2.27	2.26	2.03		
U.S.	1.61	1.60	1.49	1.47	1.46	1.32	1.45	1.45	1.28	1.67	1.67	1.50	Canada - BoC	1.75
CANADA	-0.71	-0.72	-0.87	-0.73	-0.74	-0.88	-0.49	-0.52	-0.64	0.08	0.04	-0.08	US - Fed	2.25
GERMANY	-0.24	-0.28	-0.29	-0.25	-0.30	-0.33	-0.15	-0.21	-0.24	0.34	0.29	0.22	England - BoE	0.75
JAPAN	0.55	0.55	0.39	0.53	0.50	0.34	0.72	0.67	0.51	1.17	1.14	1.02		
U.K.	Spreads vs. U.S. (bps):													
CANADA	-12	-12	-6	-18	-18	-11	-34	-32	-28	-60	-59	-53	Euro zone - ECB	0.00
GERMANY	-244	-244	-241	-238	-238	-231	-229	-229	-220	-220	-222	-211	Japan - BoJ	-0.10
JAPAN	-197	-200	-184	-190	-194	-177	-195	-198	-180	-193	-196	-181		
U.K.	-118	-118	-115	-112	-114	-109	-107	-110	-106	-110	-112	-101	Mexico - Banxico	8.00
Equities	Level			Change			% change:							
	Last						1 Day	1-wk	1-mo	1-yr				
S&P/TSX	16643			32.1			0.2	0.4	1.8	4.0			Australia - RBA	1.00
Dow 30	27182			45.4			0.2	1.7	3.4	4.0				
S&P 500	3010			8.6			0.3	1.1	2.8	3.6			New Zealand - RBNZ	1.00
Nasdaq	8194			24.8			0.3	1.0	2.2	2.3				
DAX	12488			77.8			0.6	2.4	6.3	3.6				
FTSE	7344			-0.4			-0.0	0.9	1.3	0.9				
Nikkei	21988			228.7			1.1	3.7	7.5	-3.7			Canada - BoC	Oct 30, 2019
Hang Seng	27353			265.1			1.0	2.5	8.2	1.3			US - Fed	Sep 18, 2019
CAC	5665			21.9			0.4	1.1	5.6	6.3			England - BoE	Sep 19, 2019
Commodities	Level			Change			% change:							
WTI Crude	55.07			-0.02			-0.0	-2.6	-3.6	-19.7			Euro zone - ECB	Oct 24, 2019
Natural Gas	2.58			0.00			0.0	3.2	19.9	-8.6			Japan - BoJ	Sep 19, 2019
Gold	1507.21			7.94			0.5	0.0	0.4	25.4				
Silver	18.19			0.03			0.1	-5.4	7.3	28.5			Mexico - Banxico	Sep 26, 2019
CRB Index	174.85			0.39			0.2	1.3	1.0	-8.6			Australia - RBA	Oct 01, 2019
Currencies	Level			Change			% change:							
USDCAD	1.3222			0.0012			0.1	0.4	-0.0	1.7			New Zealand - RBNZ	Sep 24, 2019
EURUSD	1.1103			0.0038			0.3	0.7	-0.6	-5.0				
USDJPY	107.97			-0.1300			-0.1	1.0	1.2	-3.5				
AUDUSD	0.6877			0.0011			0.2	0.5	1.1	-4.4				
GBPUSD	1.2451			0.0116			0.9	1.4	3.2	-5.0				
USDCHE	0.9858			-0.0046			-0.5	-0.2	0.9	2.1				

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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