

### ON DECK FOR WEDNESDAY, SEPTEMBER 18

Country	Date	Time	Indicator	Period	BNS	Consensus	Latest
US	09/18	07:00	MBA Mortgage Applications (w/w)	Sep 13	--	--	-3.1
CA	09/18	08:30	Core CPI - Common (y/y)	Aug	--	1.9	1.9
CA	09/18	08:30	Core CPI - Median (y/y)	Aug	--	2.1	2.1
CA	09/18	08:30	Core CPI - Trim (y/y)	Aug	--	2.1	2.1
CA	09/18	08:30	CPI, All items (m/m)	Aug	-0.4	-0.2	0.5
CA	09/18	08:30	CPI, All items (y/y)	Aug	1.7	1.9	2.0
CA	09/18	08:30	CPI, All items (index)	Aug	--	136.7	137.0
US	09/18	08:30	Building Permits (000s a.r.)	Aug	--	1300	1317
US	09/18	08:30	Housing Starts (000s a.r.)	Aug	1240	1250	1191
US	09/18	08:30	Housing Starts (m/m)	Aug	4.0	5.0	-4.0
US	09/18	14:00	FOMC Interest Rate Meeting (%)	Sep 18	2.00	2.00	2.25
US	09/18	14:30	Powell Holds Press Conference				

### KEY POINTS:

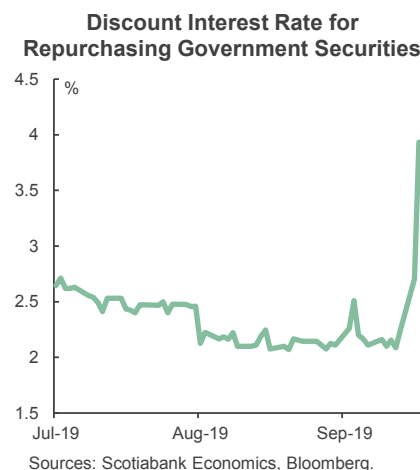
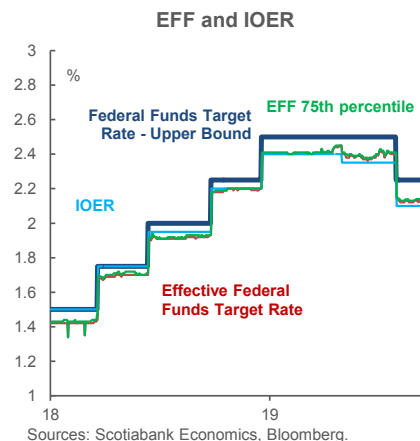
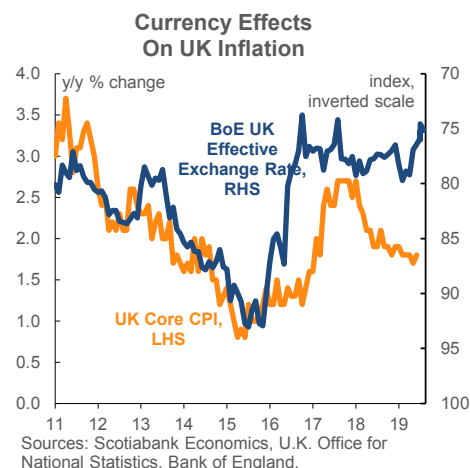
- Short-term money markets have all eyes on the Fed
- The Fed needs to address the plumbing in short-term rates markets
- Is this week's short-term rate spike just a warm up into year-end?
- Fed to cut, but 'as appropriate' and 'mid-cycle' could carry the day
- CDN CPI: mean reversion of prior jump?
- Oil markets will watch US inventories, Saudi presentation
- UK CPI: Two reasons the BoE could look through the drop
- Brazil's CB expected to cut
- Canada's rising inventory imbalances

### INTERNATIONAL

A jam-packed day lies ahead and sudden movements in short-term rates make this morning's expected NY Fed actions and this afternoon's Fed communications of even greater interest to markets. While most of [this](#) preview of the Fed meeting that I sent out last Friday remains intact, I'm changing my prior view on inaction toward functioning of short-term rates markets obviously in light of the abrupt moves in short-term rates since Monday (see below). Price discovery has revealed a more sudden and deeper issue in the plumbing behind short term rates. I don't think the Fed should over-react to what may be somewhat but not fully transitory pressures, but expect deeper guidance toward this issue in light of very recent market moves and the possibility that they are just a warm-up for later in the year in a repeat of what happened toward the end of last year. Canadian CPI inflation is also on tap (see below). UK core inflation fell by more than expected (see below). Saudi Arabia will deliver a presentation sometime this afternoon (eastern time, 7 hours behind Riyadh) that they say will provide proof that Iran was behind the drone attack and so oil markets will pay keen attention. If that's not enough, Brazil is widely expected to cut rates this afternoon (see below).

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- Sovereign yields are dropping across major markets. US Treasury yields are down by 2–3bps across maturities. Canada's curve is little changed ahead of CPI. European 10s are rallying by 2–4bps and their curves are generally bull flattening somewhat.
- US equity futures are down by up to ¼% across exchanges. TSX futures are slightly lower. European cash markets are slightly higher on balance, but little changed.
- Oil prices are lower following private US oil inventories and ahead of the US government report (see below) and ahead of the Saudi presentation.
- Currency markets are divided. Crosses like the yen and CAD are little changed to the USD, the Mexican peso and rand are slightly firmer, and the European and A\$/NZ\$ crosses are all generally depreciating.

**UK core CPI inflation fell to 1.5%** (1.9% prior, 1.8% consensus). That's the lowest rate since November 2016 and puts the 2% inflation target at greater risk. The deceleration was driven by clothing and footwear prices (-0.8% y/y, -0.4% prior), health spending (2.4% y/y, 2.7% prior), recreation prices including toys (1.2%, 2.4% prior), restaurants and hotels (2.8%, 3.1% prior) and household services (0.8%, 1% prior). There are two reasons for the Bank of England to have a cautious approach. One is shown in chart 1 in that sterling's recent depreciation might yet drive somewhat higher core inflation. The other is that the BoE remains state contingent upon Brexit/Brexit developments and the high uncertainty that remains.

**Brazil's central bank is expected to cut its Selic rate by 50bps this afternoon** (5pmET). Falling inflation relative to the target range has opened up flexibility to focus upon growth.

## UNITED STATES

I think the detailed preview that I sent out last Friday ([here](#)) still generally stands but there have been two fresh developments that merit consideration. One of those developments has led me to change my mind on a part of the expected communications.

**a) First, Powell won't call this much of an oil shock if at all.** He'll be cautious toward the course of future events. So far, however, WTI is up by only about US\$4 on net since the Monday open following the weekend attacks with the initial US\$8½ spike being cut in half. That's not terribly material to anything the Fed looks at. If the Saudis are fully up and running again by month-end then it's a wash, contingent upon escalation risk which can only be monitored at this point especially for a central banker. There is a minimal influence so far upon inflation from higher gasoline prices and a slight real wage shock that is disinflationary on core PCE through second round effects—if any—and usually only on much bigger moves.

**b) The second issue concerns repo and short-term funding market challenges that surfaced over the last day or so.** This has driven measures of the effective fed funds rate to overshoot the upper bound of the present 2¼% to 2½% target range that is expected to be cut by ¼ point today (chart 2). It has also driven repo rates sharply higher (chart 3). Theories abound (see for example Roger Quick's note last evening) and appear to primarily focus upon combined influences such as settlement of US Treasury purchases following auctions in the context of deficit funded fiscal stimulus and rising public debt outstanding plus corporate demand for liquidity to meet the September 15<sup>th</sup> tax deadline. The issues may run much deeper, however, in that balance sheets are less capable of handling such spikes in demand for liquidity and so higher rates reflect the imbalance. Perhaps this is price discovery in action that is revealing where the optimal amount of reserves sits and maybe they've gone too low and too fast especially when combined with tighter liquidity management regulations following the crisis.

So what is the Fed to do about it? For one, I don't think they'll over react to a single day's pressures, but they need to do something and at least jawbone options. The Fed could cut the spread between IOER and the upper end of the fed funds target range again and this time to -20bps as a way of anchoring market rates at a lower level by paying less for reserves in the system. We could hear more about a standing repo facility that staff presented as an option over the summer. We could hear more reference to going back to expanding the balance sheet in pre-crisis fashion that isn't likely to be presented as QE all over again versus a necessity to preserve market functioning. And this morning's NY Fed market operations that are expected to inject another US\$75 billion into repo markets could be relied upon more heavily and also in a return to standard operations that were the norm in markets before the crisis.

Also note that lost in the coverage over the past couple of days is that hedging costs into dollars have also risen somewhat this week. The EURUSD three month hedging cost increased by over 10bps since Monday and the USDJPY measure climbed by about 13bps. Watch these measures into year-end for a possible replay of a seasonal surge like the one that happened toward the end of last year. In fact, with some regularity, there is a rise in hedging costs into dollars partly driven by seasonal year-end demand for dollar funding. The repeated existence of this seasonal surge is perhaps not something that weak form market efficiency should allow to persist but it does. More constrained balance sheets with tighter regulations especially around liquidity and capital management restrain the ability to arbitrage away price distortions when they surface and do so in violation of models such as covered interest parity before adjusting for basis. All of this suggests that short-term dollar funding markets are in need of longer lived solutions.

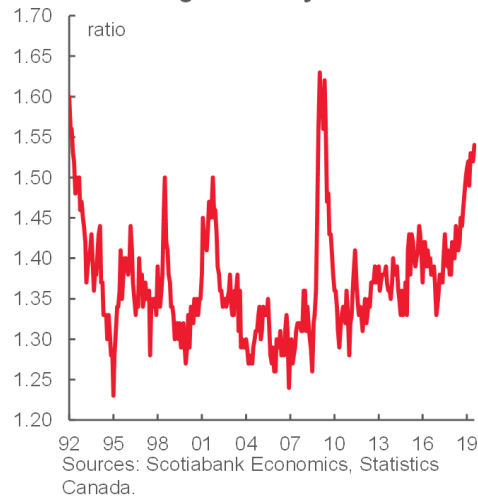
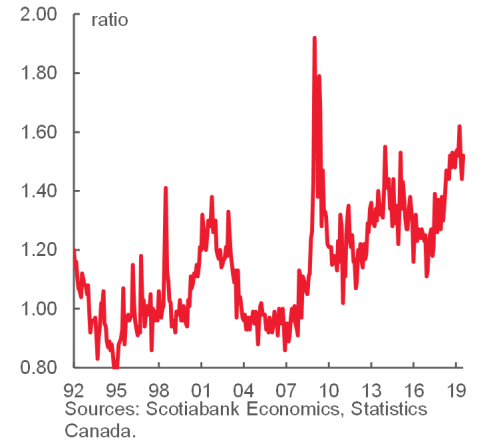
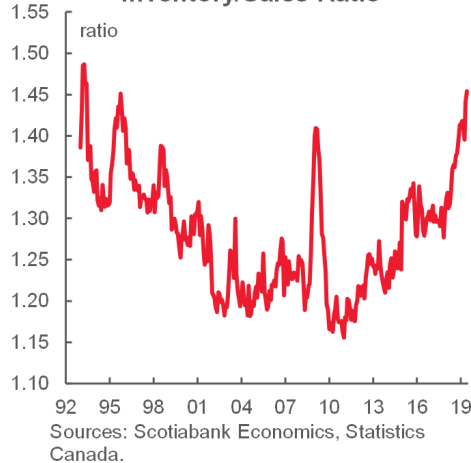
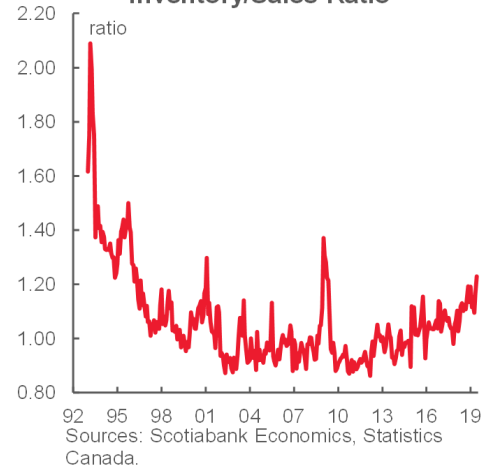
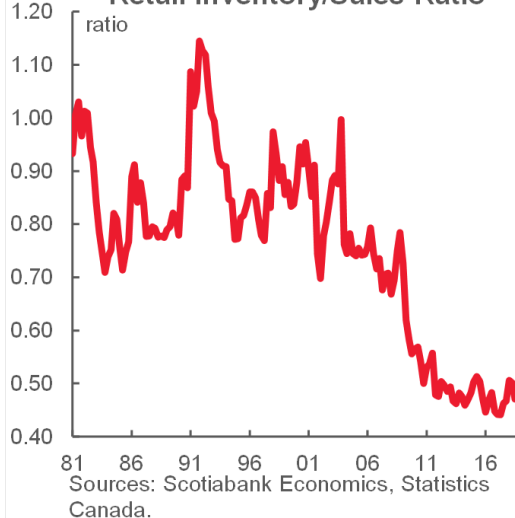
**US housing starts are also due out today (8:30amET).** A rebound from the prior month's drop is expected. Also watch weekly crude oil inventories (10:30amET) through the government report that was expected to show another draw down before yesterday afternoon's private industry figures unexpectedly showed a build of over half a million barrels last week.

## CANADA

**Canada updates inflation figures for August this morning (8:30amET).** It will likely have transitory influences upon markets given the greater focus upon this morning's expected NY Fed market operations and this afternoon's Fed communications. I'm forecasting headline inflation to decelerate to 1.7% y/y (2.0% prior) alongside a 0.4% m/m drop in seasonally unadjusted prices. Consensus is at 1.9%. Base effects, seasonality and gas prices get me to my estimate. What I'm primarily betting upon is that the 0.5% m/m jump in NSA prices during July—with much of that in old core—poses a high jumping off effect given how unusual it was as the ten year average change for July is close to nil. With Q3 growth tumbling, especially keep an eye on the average of the three 'new' core measures for pressure on the 2% target.

I've also provided charts 4-10 as a depiction of Canada's inventory to sales ratios by sector and in aggregate. Aggregate inventories are at their highest relative to sales since the early 1990s. This is being led higher by manufacturers and wholesalers with little evidence of imbalances at retailers. This is a home grown risk to the economy in terms of production and employment going forward given inventories are costly to finance and store. Manufacturers and wholesalers are pushing into the highest inventory imbalance since the depths of the 2009 recession (manufacturers) or before that (wholesalers).

**Economy-Wide Inventories**

**Canada Mfg Inventory/Sales Ratio**

**Canada Transportation Mfg Inventory/Sales Ratio**

**Canada Wholesale Inventory/Sales Ratio**

**Canada Wholesale Auto & Parts Inventory/Sales Ratio**

**Canada Motor Vehicles Retail Inventory/Sales Ratio**

**Canada Retail Inventory/Sales Ratio**


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	Canada - BoC	1.75
	1.70	1.73	1.68	1.63	1.66	1.59	1.78	1.80	1.74	2.24	2.27	2.22		
	1.61	1.61	1.58	1.47	1.47	1.44	1.45	1.45	1.42	1.61	1.62	1.63	US - Fed	2.25
	-0.73	-0.71	-0.84	-0.72	-0.71	-0.83	-0.50	-0.47	-0.56	0.04	0.08	0.02	England - BoE	0.75
	-0.27	-0.25	-0.27	-0.29	-0.26	-0.28	-0.18	-0.15	-0.20	0.33	0.36	0.29	Euro zone - ECB	0.00
	0.52	0.54	0.49	0.47	0.50	0.45	0.66	0.70	0.64	1.09	1.14	1.12		
	Spreads vs. U.S. (bps):													
	-9	-12	-9	-16	-19	-15	-32	-36	-32	-63	-65	-59		
	-243	-244	-252	-235	-237	-243	-227	-228	-230	-220	-219	-220	Japan - BoJ	-0.10
-197	-197	-194	-192	-191	-188	-196	-196	-194	-191	-191	-193	Mexico - Banxico	8.00	
-118	-119	-119	-116	-116	-115	-112	-111	-110	-116	-113	-110			
Equities	Level						% change:							
	Last	Change			1 Day	1-wk	1-mo	1-yr						
S&P/TSX	16835	83.4			0.5	1.8	4.2	3.9					Australia - RBA	1.00
Dow 30	27111	34.0			0.1	0.7	4.7	3.3					New Zealand - RBNZ	1.00
S&P 500	3006	7.7			0.3	0.9	4.1	3.5						
Nasdaq	8186	32.5			0.4	1.3	3.7	2.9						
DAX	12388	15.1			0.1	0.2	7.1	1.9						
FTSE	7327	6.8			0.1	-0.1	3.0	0.4						
Nikkei	21961	-40.6			-0.2	2.7	7.6	-6.2					Canada - BoC	Oct 30, 2019
Hang Seng	26754	-36.1			-0.1	-1.5	4.0	-1.2					US - Fed	Sep 18, 2019
CAC	5626	10.6			0.2	0.1	6.1	4.9					England - BoE	Sep 19, 2019
Commodities	Level						% change:							
WTI Crude	58.88	-0.46			-0.8	5.6	7.3	-15.7					Euro zone - ECB	Oct 24, 2019
Natural Gas	2.69	0.02			0.7	5.3	22.2	-8.4					Japan - BoJ	Sep 19, 2019
Gold	1501.61	0.23			0.0	0.3	-0.8	25.3					Mexico - Banxico	Sep 26, 2019
Silver	17.84	0.01			0.0	-0.8	4.0	25.9					Australia - RBA	Oct 01, 2019
CRB Index	178.27	-0.53			-0.3	2.6	4.6	-6.5					New Zealand - RBNZ	Sep 24, 2019
Currencies	Level						% change:							
USDCAD	1.3251	0.0007			0.1	0.4	-0.5	2.1					Canada - BoC	1.75
EURUSD	1.1054	-0.0019			-0.2	0.4	-0.2	-5.3						
USDJPY	108.16	0.0300			0.0	0.3	1.4	-3.7					US - Fed	2.25
AUDUSD	0.6843	-0.0023			-0.3	-0.3	1.2	-5.2					England - BoE	0.75
GBPUSD	1.2458	-0.0042			-0.3	1.1	2.7	-5.2					Euro zone - ECB	0.00
USDCHF	0.9950	0.0019			0.2	0.2	1.4	3.2					Japan - BoJ	-0.10

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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