

ON DECK FOR THURSDAY, JANUARY 16

Country	Date	Time	Indicator	Period	BNS	Consensus	Latest
US	01/16	08:30	Export Prices (m/m)	Dec	--	0.3	0.2
US	01/16	08:30	Import Prices (m/m)	Dec	--	0.3	0.2
US	01/16	08:30	Initial Jobless Claims (000s)	Jan 11	215	218	222
US	01/16	08:30	Continuing Claims (000s)	Jan 4	1800	1750	1728
US	01/16	08:30	Philadelphia Fed Index	Jan	2.00	3.7	0.3
US	01/16	08:30	Retail Sales (m/m)	Dec	0.2	0.3	0.2
US	01/16	08:30	Retail Sales ex. Autos (m/m)	Dec	0.4	0.5	0.1
US	01/16	10:00	Business Inventories (m/m)	Nov	--	-0.2	0.2
US	01/16	10:00	NAHB Housing Market Index	Jan	--	74.0	76.0
US	01/16	16:00	Total Net TIC Flows (US\$ bn)	Nov	--	--	-48.3
US	01/16	16:00	Net Long-term TIC Flows (US\$ bn)	Nov	--	--	32.5

KEY POINTS:

- Little trade deal reaction other than a sell-off in agricultural commodities
- The US & China will need to roll over Phase 1...
- ...as part of any Phase 2 trade deal
- How China could manipulate demand to hit purchase targets...
- ...and how the US could manipulate supply
- China's financing pick-up wasn't driven by businesses or consumers
- US retail sales to wrap up the holiday season
- US Philly Fed to inform ISM expectations
- Euro gains on ECB minutes ahead of Lagarde

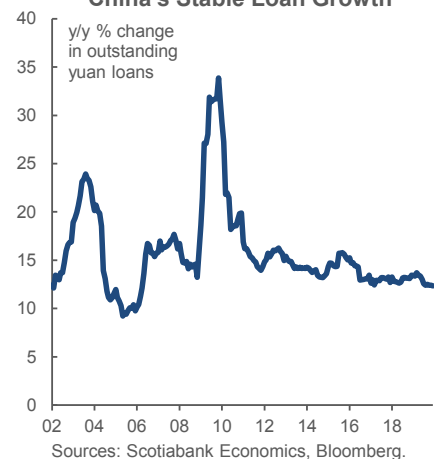
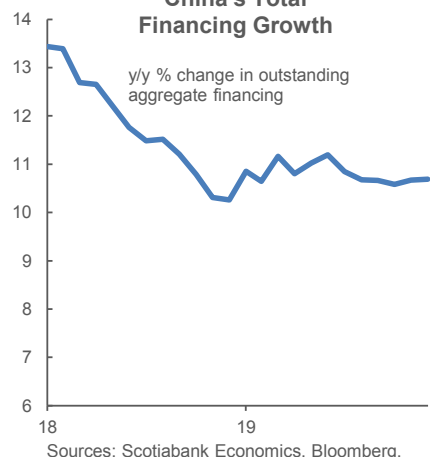
INTERNATIONAL

Mixed developments across global asset classes will be informed by a return to US fundamentals this morning. There is very little follow through on the theatrics that dominated yesterday's press conference and the signing of the US-China trade deal except that agricultural commodities are retreating. China's financing figures were weaker than the headline suggested. The US releases retail sales for December and the Philly Fed's regional business gauge that informs ISM expectations, as well as jobless claims and import prices. More US bank earnings beats rolled in. I review ways in which China could game the system to meet US purchase targets and ways in which US businesses might deliver on the needed supply. Key is that the finite two-year nature of the US-China trade deal could not only be manipulated in ways that don't help US or global growth, it could also set up a source of downside risk into 2022.

- US equity futures are up by about ¼% with TSX futures performing similarly. European cash markets have a slight negative bias led by London's ½% decline.
- US and Canadian bond yields are flat across the curves. Gilts are dearer in a mild bull flattening. The yields on EGB 10s are lower by 1–2 bps.
- Commodities are mildly on the defensive. Oil is little changed and so is gold. Agricultural commodities continue to retreat because of concern over the

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China's Stable Loan Growth

China's Total Financing Growth


language in the US-China trade agreement that stipulates purchase targets will be made if the need is there which is less ironclad than had been hoped for. Maybe there is also recognition of points made below including that China's total demand for world agricultural commodities might not be increased as opposed to diverted a bit more to the US on a temporary basis.

- Currencies are mixed with CAD, the yen and Mexican peso little changed to the USD while the A\$/NZ\$, real, sterling and euro appreciate somewhat. The euro gained somewhat after publication of minutes to the December ECB meeting that emphasized a need for 'vigilance' in the monitoring of unintended side effects to stimulus efforts. ECB President Lagarde speaks at 1pmET.

China released figures for aggregate financing and new yuan loans during December overnight. Financing activity picked up by more than expected but primarily only due to a pick-up in local government special bonds issuance as opposed to business and consumer financing. Local currency loan growth disappointed expectations and decelerated. Charts 1 and 2 show the trends in year-ago growth rates for yuan denominated loans and total financing activity that bolts on FX loans, shadow financing products, bonds and equity issuance. Charts 3 and 4 provide the annual tallies for both measures in terms of the outstanding amounts.

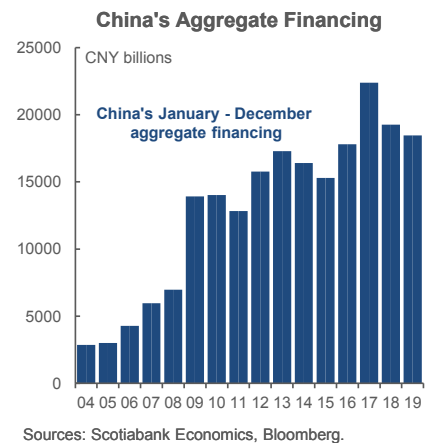
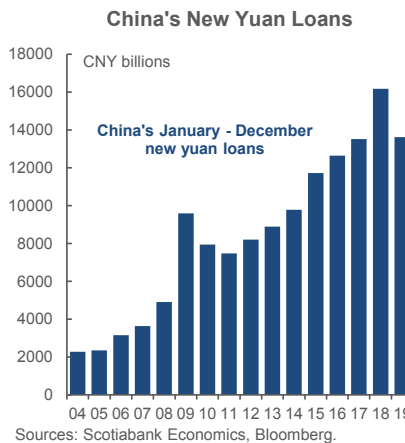
UNITED STATES

US macro data risk jumps higher this morning.

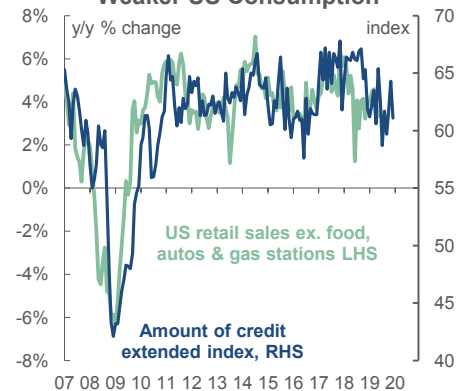
Retail sales (8:30amET) will inform how the holiday season concluded after sales were flat in November ex-autos and gas. Consensus expects 0.3% m/m for total sales, 0.5% ex-autos and 0.4% for ex-autos and gasoline. I think there is some downside risk to this because a) auto sales volumes fell, b) auto prices were up only 0.1% m/m for new cars and trucks and used vehicle prices fell by 0.8% m/m, and c) gasoline was a roughly neutral m/m contributor while broader core CPI prices were up only 0.1% m/m. Retailers' earnings guidance on the holiday season also appeared to be on the cautious side. To save the headline sales tally, we'd need a strong core ex-autos and gas component on volumes and/or prices, or a solid gain in gasoline volumes.

What's going on with the US consumer? For one thing, credit extended is slowing and that's not a good thing for consumption growth (chart 5). For another, real wage growth is cooling as nominal wage growth decelerates at the same time that headline price inflation has picked up somewhat (chart 6). The result is that what's left over to drive consumption growth out of net cash flows and what is being tapped into by way of credit growth has turned toward a cooler consumption profile. You need more than strong balance sheets with a high saving rate and low debt service payments as a share of incomes to drive consumption growth. Cash remains king in driving the US consumer.

The Philly Fed measure will be the next step in informing ISM-mfrg expectations (8:30amET). It's wickedly volatile with little go by so I don't even usually submit an estimate. Compared to, say, nonfarm, the Philly Fed consensus is just over half the size and it's a massive random number generator.



Credit Slowdown Points Toward Weaker US Consumption



US Real Wage Growth is Cooling



A pair of beats from Morgan Stanley (EPS US\$1.20, consensus US\$1.02) and BoNYM are adding to evidence that most US banks enjoyed a stronger than expected Q4 earnings season so far.

An integral part of any 'phase 2' US-China trade agreement will be the necessity of rolling over 'phase 1' provisions with respect to purchase targets for Chinese imports of American goods and services. Yesterday's morning note showed how rapidly and unrealistically the total purchase and agricultural purchase requirements must increase under the agreement, and chart 7 shows a breakdown of the purchases.

Rolling over into a series of two-year 'phase 1' purchase targets is necessary because of the finite two-year period that is covered. Failure to do so would trigger a demand vacuum in 2022. Rolling over the purchase targets could prove to be at least as difficult as moving the necessary mountains to address 'phase 2' issues. What follows is a summary of a) how China could increase demand for US imports in keeping with the purchase targets, and b) how the US could feed the necessary supply. Overall, the effects on US GDP growth are likely to be a wash.

1. How China Could Game the Purchase Targets

China could easily game the system to make the extra previously announced US\$200B of purchases of US goods and services above the 2017 baseline by the end of 2021. Here's the playbook.

a. Stockpile

China could stockpile some of the purchases for future purposes and then enter a demand vacuum after the two year agreement expires. More market-driven economies couldn't do this under the pressure of shareholders, but China's more command-driven SOE-dominated economy could. Obviously stockpiling can't occur for some services or some perishables, but all of the US\$78B in manufactured goods could be treated like this. So could all of the US\$52B of energy quotas. Manufacturing and energy quotas are two-thirds of the US\$200B overall two year target. Then US exporters are back at square one after the current phase 1 deal expires and demand enters a vacuum as inventory depletion becomes the focus for China's economy.

b. Re-Export

There is nothing I can see in the agreement that says China has to be an end-use destination for such purchases. China could buy what trading partners need from the US and re-export it to them. If so, the US bilateral balances with other countries might artificially deteriorate as an offset to any improvement with China.

c. Trade Diversion

China could flat out import less from other countries. China could buy fewer soybeans from Brazil, less agricultural commodities from Canada, less oil from the middle east, etc. Again, this would be a transitory diversion absent a second phase 1 deal.

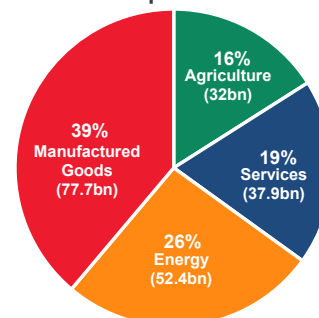
d. Overpay

The purchase targets are set in nominal dollar terms. China could still pay inflated prices for some of the quotas notwithstanding the requirement to buy at market prices. For some parts of the quotas, there are market prices that can be observed, but China can say they have to pay much more for market prices to meet the quotas. Market prices go up when demand rises absent supply! For other categories, there are no transparent prices or high product differentiation so who's to say what's a fair price for a lot of the services?

e. Two-Systems Booking Points

China could manipulate its two-systems by diverting trade from HK to mainland Chinese ports.

Breakdown of Additional US Exports to China on Top of 2017 Baseline



Note: Based on an agreed upon 200 Billion USD Export increase to China over the next two years.
Sources: Scotiabank Economics, USTR.

2. How the US Could Supply the Amounts

The other key question concerns whether US businesses will produce more to meet Chinese demand. If so, then that's a GDP addition even if it's transitory. Alternatively, will US businesses deplete inventories? If so, that's a subtraction from US GDP growth.

What might inform this issue is that the starting point is not one of depleted inventories (chart 8). Inventories to sales are toward cycle highs in manufacturing and at wholesalers. They could sell down in some of these categories without producing more such that any minor improvement in the US trade balance contribution to GDP growth is offset by inventory disinvestment. Again, it depends critically on the sector we're looking at as this is more feasible for some goods than others.

Second, if the market price attached to rising Chinese demand is more attractive than the market price of selling to others, then US businesses could divert supply away from other export destinations.

And you're not going to get investments in longer lived production for a two year deal. Businesses need longer horizons than that.



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.	1.56	1.55	1.58	1.60	1.60	1.65	1.78	1.78	1.86	2.23	2.24	2.33	Canada - BoC	1.75
CANADA	1.64	1.63	1.63	1.55	1.55	1.60	1.54	1.53	1.61	1.66	1.66	1.72	US - Fed	1.75
GERMANY	-0.59	-0.59	-0.60	-0.52	-0.50	-0.49	-0.22	-0.20	-0.18	0.29	0.31	0.33	England - BoE	0.75
JAPAN	-0.12	-0.12	-0.13	-0.09	-0.09	-0.11	0.02	0.01	0.01	0.46	0.46	0.44		
U.K.	0.45	0.47	0.59	0.42	0.44	0.62	0.63	0.65	0.82	1.15	1.18	1.30		
Equities	Spreads vs. U.S. (bps):												Next Meeting Date	
	8	8	5	-4	-5	-5	-24	-25	-25	-57	-58	-61		
	8	8	5	-4	-5	-5	-24	-25	-25	-57	-58	-61		
	8	8	5	-4	-5	-5	-24	-25	-25	-57	-58	-61		
	8	8	5	-4	-5	-5	-24	-25	-25	-57	-58	-61		
Commodities	Level						% change:							
	Last	1-day	1-wk	Last	1-day	1-wk	1 Day	1-wk	1-mo	1-yr				
S&P/TSX	17415			62.3			0.4	1.4	2.1	15.2			Australia - RBA	0.75
Dow 30	29030			90.6			0.3	1.0	2.8	19.9			New Zealand - RBNZ	1.00
S&P 500	3289			6.1			0.2	1.1	3.1	25.7				
Nasdaq	9259			7.4			0.1	1.4	5.0	31.6				
DAX	13413			-19.2			-0.1	-0.6	0.0	22.7				
FTSE	7605			-38.0			-0.5	0.1	1.1	10.8				
Nikkei	23933			16.5			0.1	3.1	-0.1	17.1				
Hang Seng	28883			109.5			0.4	1.1	5.0	7.4				
CAC	6027			-5.2			-0.1	-0.3	0.6	25.3				
Currencies	Level						% change:							
	Last	1-day	1-wk	Last	1-day	1-wk	1 Day	1-wk	1-mo	1-yr				
USDCAD	1.3038			-0.0004			-0.0	-0.1	-0.9	-1.6			Canada - BoC	Jan 22, 2020
EURUSD	1.1164			0.0014			0.1	0.5	0.2	-2.0			US - Fed	Jan 29, 2020
USDJPY	109.97			0.0700			0.1	0.4	0.4	0.8			England - BoE	Jan 30, 2020
AUDUSD	0.6926			0.0024			0.3	1.0	0.6	-3.4			Euro zone - ECB	Jan 23, 2020
GBPUSD	1.3062			0.0024			0.2	-0.0	-2.0	1.4			Japan - BoJ	Jan 21, 2020
USDCHF	0.9623			-0.0018			-0.2	-1.1	-2.0	-2.8			Mexico - Banxico	Feb 13, 2020
													Australia - RBA	Feb 03, 2020
													New Zealand - RBNZ	Feb 11, 2020

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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