ECONOMIC MONITOR

October 13, 2016

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Financial Markets Overview

The US election has dominated the newswires in recent weeks and we doubt this will change before November 8. In the wake of some tawdry tape revelations the probability of a Trump victory has plunged to about 15% on betting sites. While this removes some uncertainty regarding the early onset of US protectionism (i.e. Trump's tariffs on Chinese exports to the US, for example), we remind the reader in the article starting on page 3 that a Clinton Administration may also have to consider dollar devaluation, in lieu of protectionism, in order to boost US growth and bring the global economy back into some semblance of balance. (Clinton is also no "friend" of China - going by her speeches!)

The Federal Reserve is forecast to stay out of the political fray by foregoing a hike in November, though several officials have indicated that meeting is "live". We continue to forecast the Fed will hike in December! We have noted often there is no compelling reason for a 25 basis-point hike in November or December (such a small hike has symbolic value only); indeed, the US economy would benefit from more inflationary growth (as would most highly indebted economies). We also assume the Bernard Sanders faction of the Democrat Party, the party now very likely to be in the White House after January 2017, will not be overjoyed with a Fed anxious to raise interest rates in an environment of still very low labor-force participation rates. But the Fed is intent upon a hike, for better or worse!

The charts on the US economy, starting on page 21, also do not make a compelling argument for a hike. The latest Fed of New York "*Nowcast*" of GDP in 2016-Q3 is 2.2% (and 1.3% for Q4), while the Fed of Atlanta's "*GDPNow*" projection is 2.1% for Q3. Growth will not very robust for 2016-H2.

The IMF has downgraded the global economy yet again in its October Economic Outlook, and its outlook for Canada dropped from 1.4% and 2.1% to 1.2% and 1.9% for 2016 and 2017 respectively. The Bank of Canada will no doubt lower its own forecast for 2016 in its October Monetary Policy Report due on October 19. (The July Report's forecast was 1.3% and 2.2% for 2016 and 2017 respectively.)

Despite these downgrades, bond yields have risen significantly in recent weeks. Fear that both the ECB and the BoJ will end QE (quantitative easing) before long, and that the US will turn to fiscal stimulus in 2017 are rampant. Short duration is desirable!

The baseline forecasts this month call for:

1. ► The **FED** to hike in December;
2. ► The **BANK OF CANADA** to stand pat on interest rates this year and probably next;
3. ► **BOND YIELDS** in the US and Canada to rise on the back of more fiscal expansion in the US and uncertainty regarding ECB and BoJ policy going forward;
4. ► The **CANADIAN DOLLAR** to trend sideways;
5. ► The **US DOLLAR** to trend flat/up until after November - a Clinton Administration will have to think about how it can "devalue" the dollar (much preferred over protectionism) thereafter.

Updated Forecast - Base Scenario

	Actual				Projected						
	16-I	16-II	16-III	12-Oct	Nov	Dec	Jan	17-I	17-II	17-III	17-IV
CURRENCIES	***Scenario B: Modest US Growth - Clinton Administration Attemps Dollar Weakening***										
US Dollar Index*	98.69	93.61	93.66	95.80	95.01	95.32	95.17	95.17	94.43	93.45	92.02
Can. Dollar: CDN/US	***1.373***	***1.288***	***1.304***	***1.326***	***1.330***	***1.340***	***1.335***	***1.335***	***1.330***	***1.325***	***1.325***
Can. Dollar: US/CDN	72.82	77.64	76.67	75.41	75.19	74.63	74.91	74.91	75.19	75.47	75.47
Japanese Yen	***115.4***	***108.2***	***102.5***	***104.2***	***100.5***	***100.5***	***100.5***	***100.5***	***100.0***	***99.5***	***98.5***
British Pound	143.1	143.5	131.6	122.2	121.0	121.0	121.0	121.0	122.1	124.2	128.4
Euro	***1.102***	***1.129***	***1.116***	***1.102***	***1.100***	***1.100***	***1.100***	***1.100***	***1.120***	***1.150***	***1.200***
Australian Dollar	72.14	74.60	75.71	75.67	75.19	74.63	74.91	74.91	75.19	75.47	75.47
Chinese Yuan/Rmb	***6.542***	***6.534***	***6.667***	***6.719***	***6.720***	***6.750***	***6.800***	***6.800***	***6.850***	***6.700***	***6.500***
Indian Rupee	67.50	66.89	66.97	66.82	67.00	67.50	68.00	68.00	68.00	67.00	66.00
** Index based on CDN$, Euro, Pound, Yen*											
INTEREST RATES	***Scenario B: Fed Hikes in December - Bank of Canada Stands Pat***										
Canada											
Treasury Bill (91-day)	0.46	0.52	0.53	0.50	0.51	0.50	0.50	0.50	0.50	0.50	0.50
Government Bond (10-yr)	1.20	1.33	1.04	1.21	1.20	1.30	1.25	1.35	1.45	1.50	1.60
Prime	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.70
Target Overnight Rate	***0.50***	***0.50***	***0.50***	***0.50***	***0.50***	***0.50***	***0.50***	***0.50***	***0.50***	***0.50***	***0.50***
Spread: 10-yr - T Bills	0.74	0.81	0.51	0.71	0.69	0.80	0.75	0.85	0.95	1.00	1.10
United States											
Treasury Bill (90-day)	0.29	0.26	0.31	0.36	0.36	0.57	0.60	0.60	0.60	0.60	0.68
Treasury Bond (10-yr)	1.82	1.72	1.58	1.77	1.75	1.85	1.85	1.95	2.10	2.15	2.25
Prime	3.50	3.50	3.50	3.50	3.50	3.75	3.75	3.75	3.75	3.75	3.83
Fed Funds Rate	***0.36***	***0.37***	***0.41***	***0.44***	***0.44***	***0.60***	***0.62***	***0.62***	***0.62***	***0.62***	***0.70***
Spread: 10-yr - T Bills	1.53	1.46	1.27	1.41	1.39	1.28	1.25	1.35	1.50	1.55	1.57
Interest Rate Differential (Canada-US)											
Treasury Bill	0.17	0.26	0.22	0.14	0.15	-0.07	-0.10	-0.10	-0.10	-0.10	-0.18
Bonds-10yr	-0.62	-0.39	-0.54	-0.56	-0.55	-0.55	-0.60	-0.60	-0.65	-0.65	-0.65

Source: Wall Street Journal, Federal Reserve, Dundee Economics

This is our “baseline” scenario for the next four quarters. It is updated monthly. See pages 44-45 for our alternative scenarios.

The US Should Devalue the Dollar ... And here is how!

Martin Murenbeeld

After recent developments on the US political front (including the second debate on October 9 and revelations on Trump's "locker-room" behavior) the probability of Trump being elected President on November 8 has dropped to 15.4%. The likelihood of Clinton being elected has in turn risen to 83.0%*. The issue of unfair trade and dollar overvaluation will not go away however under a Clinton Presidency; her speeches have revealed a number of "Trump-like" views when it comes to US trade with China (and with other countries seen to be taking unfair advantage of the global trading system with taxes, currency manipulation, non-reciprocal legislation, impediments to imports and investment, etc.).

Our reports have frequently suggested that the US should devalue the US dollar. The global economy has serious imbalances; these imbalances affect employment and inflation in the "deficit" regions quite negatively, and create serious policy problems for these regions. (The US is a "deficit" region relative to Asia and Europe, for example, and the southern half of the Eurozone is a "deficit" region relative to the northern half.)

Historically chronic "deficit" countries/ regions eventually adopt protectionist policies, which then risk another global recession or worse; or they decide to unilaterally devalue. The latter is preferable!

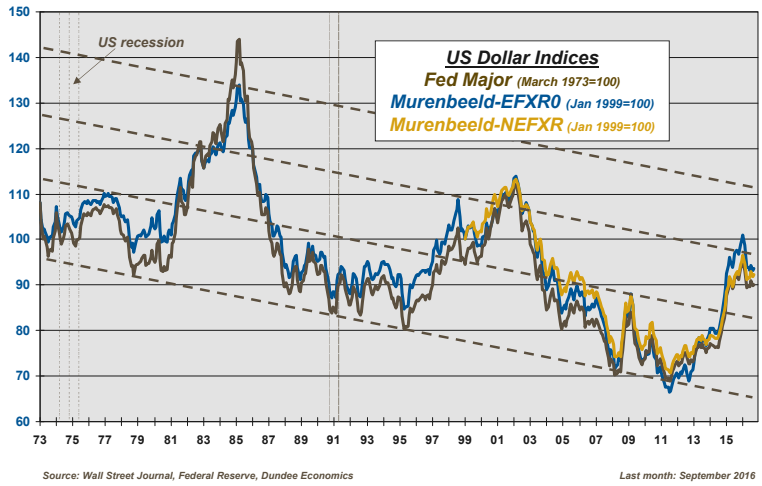
Recently, the IMF and other supra-national bodies have been warning of the perils of protectionism (no doubt the result of Trump's overt protectionism). Unfortunately however, the IMF has been mostly asleep at the switch when it comes to demanding a more appropriate currency alignment globally.

(We remind readers that in the run-up to the Bretton Woods agreement in 1944 Keynes argued – unsuccessfully – in favor of financial penalties for countries that run persistent surpluses. His thinking was that surplus countries

*(https://www.electionbettingodds.com/,10/11/16)

(1) The Dollar is Overvalued …

The dollar should be devalued … !



(2) The Overvalued Dollar …

… is a major headwind for the US economy …

A headwind for GDP:

- ***The US foreign balance (X-M) is contributing to US GDP – US imports (M) are contributing to foreign GDP however …***
- ***(I) Investment (notably non-residential) will remain weak because of an overvalued dollar - which doesn't help US GDP either …***

A headwind for inflation:

- ***The US imports deflation - frustrating Fed efforts to boost inflation***

The Dollar is a Political Issue …

Trump wants "fair" trade … and a lower dollar …?

1. I'm going to direct the Secretary of Commerce to **identify every violation** of trade agreements a foreign country is currently using to harm our workers. I will then direct all appropriate agencies to use every tool under American and international law to end these abuses

2. I am going to instruct my Treasury Secretary **to label China a currency manipulator**. Any country that devalues their currency in order to take advantage of the United States will be met with sharply, and that includes tariffs and taxes

3. If China does not stop its illegal activities, including its theft of American trade secrets, I will use every lawful presidential power to remedy trade disputes, including the application of **tariffs**

"Declaring America's Economic Independence" *- June 28, 2016*

… For Both Republicans and Democrats

Clinton angry with current trade practises too …!

1. "I will prevent countries like China from **abusing global trade rules** and reject trade agreements that don't meet our high standards of raising wages, creating good paying jobs, and enhancing our national security" (https://www.hillaryclinton.com/issues/manufacturing/)

2. "China is, by far, the **worst rule breaker** in the world … China dumps cheap products in our markets, subsidizes state-owned enterprises who undersell in the global market to hurt our companies, and it **discriminates against American companies** … We all know we are losing jobs. … China wants to keep people employed while they try to figure out what to do about their economy … **They're trying to solve their domestic economic problems on the backs of American workers** ...

3. "We have to prevent China/other countries from manipulating their currencies to gain an unfair price advantage" (https://www.hillaryclinton.com/speeches/)

needed to be "disciplined" along with deficit countries. (Hey, you can't have a "deficit" region without a "surplus" region!) Persistent imbalances should eventually also necessitate currency revaluation!)

We believe that the US dollar is grossly overvalued today. This commentary discusses how the US has engineered a devaluation in the past, and how it could do so again.

I. August 15, 1971

On August 15, 1971 President Nixon levied a 10% tariff on all foreign goods entering the US (and took the dollar off the "*gold-exchange standard*"); these tariffs were not removed until other currencies, and specifically the yen and the deutschemark, were revalued upwards against the dollar.

The *Smithsonian Agreement* later that year formalized the results of this action: the dollar was devalued against gold (from $35 to $38 an ounce) and other currencies were revalued against the dollar. The net effect was an approximate 10% devaluation of the dollar against a basket of the world's major currencies.

Background: throughout the 1960's global irritation with US balance of payments (BoP) deficits increased; these deficits bled dollars into the international economy and, inevitably, into the foreign exchange reserves of a number of "surplus" countries – including Germany and Japan. (It was pointed out that in the event all global "reserve" dollars were presented at the US Treasury in exchange for gold, the US would not have sufficient gold reserves to satisfy the conversion – at least not with gold valued at $35/ounce.)

Overseas officials argued that the US needed to do something about its BoP "problem". The US responded with the argument that a number of foreign currencies, notably those from economies healing from the devastation of WWII, should be revalued against the dollar instead. This

argument fell on deaf ears however, for similar reasons China and others do not like their currencies to rise against the dollar today. To be sure, the US took a number of steps during the 1960's to curb capital outflows (capital outflows were the essence of US BoP deficits at that time – not trade deficits), including the imposition of regulations to limit the outward-flow of foreign direct investment (FDI) and interest equalization taxes to stop foreign entities from borrowing dollars in the US.

In 1971 however the US trade balance began slipping into deficit, and the US Administration concluded enough was enough. It levied a 10% tariff on foreign goods coming into the US!

Lesson 1: The US can force dollar devaluation by limiting access to its domestic market with tariffs and other trade barriers.

II. The 1985 Plaza Accord

The G-5 concluded the Plaza Accord in September 1985; it was an accord to devalue the dollar against the other G-5 currencies. (The G-5 included Japan, Germany, France and the UK, along with the US.)

Wikipedia notes the following: "*Between 1980 and 1985 the dollar had appreciated by about 50% against the Japanese yen, Deutsche Mark, French Franc and British pound, the currencies of the next four biggest economies at the time. This caused considerable difficulties for American industry but at first their lobbying was largely ignored by government.*"

I remember it well; I personally lost a fair bit of money betting against the dollar prior to the Plaza Accord (whereupon I learned that "*the market can stay irrational for longer than I can stay solvent*").

Background: the election of Ronald Reagan in 1980 together with Fed Chair Volcker's record high interest rate policy led to a surge of capital flowing into the US. (the FF rate hit 19% in 1981 and 10-year Treasuries yielded nearly 16%!) By 1985 corporate America was fed up, the current account deficit of the US hit a record 3.4% of GDP, and Congress was ready to pass protectionist laws.

The Plaza Accord proved so successful in devaluing the dollar that the Louvre Accord of February 1987 was required to stop the dollar from further declines. It had given back all of its 50% rise!

Lesson 2: The US can engineer dollar devaluation through direct agreement with its key trading partners.

III. What's Next?

Currently, US trade deficits are near record highs, though the US current account deficit is "only" 2.8% of GDP – having benefited from a major reduction in oil imports since 2006 when the CA deficit was over 6% of GDP. The US economy has posted some of its lowest post-recession growth rates since WWII, inflation is below target and the percentage of the population at work is near levels last seen in the late 1970's. Academic studies (as well as The Economist's Big Mac Index) suggest the US dollar is seriously overvalued, and some studies are starting to question whether trade with China (specifically) has been as beneficial for the US as theory suggests it should have been.

Calls for countervailing duties abound as both presidential candidates have sworn to correct the massive US trade imbalance with China (if not also with Japan and Europe).

Based on present trends, a Trump Administration will likely employ the lessons of August 15, 1971 (***Lesson 1***) and limit imports from China and elsewhere with the imposition of tariffs. Presumably, once the dollar is more appropriately priced (i.e. 40% lower against the RMB, for example) these tariffs will be lifted.

If this happens there will be a period of extreme turmoil in global financial and currency markets – there was in 1971! With the US no longer the same global economic hegemon it

was in 1971 however, a global trade war cannot be ruled out; China and other countries can, and likely will, retaliate against US exports.

A Clinton Administration is more likely to have learned from ***Lesson 2***, and call for a *Plaza Accord II*. I doubt this will be successful however, because China is not as pliable as the G-5 was in 1985. Furthermore, under both Bush and Obama Administrations the US Treasury has made numerous appeals to China and other countries to stop "predatory" currency and trade practices, often threatening to name these countries currency manipulators (which then opens the legal door to countervailing duties). To no avail!

Without China's agreement to let the dollar decline, I doubt other Asian currencies (and the euro) will rise significantly against the dollar. A Clinton Administration may therefore eventually also have to decide whether unilateral tariffs and countervailing duties indeed promise the best hope for dollar devaluation.

There is another route to currency devaluation however; the US can devalue the dollar by direct currency market intervention. This is after all how other countries keep their currencies undervalued, and it is legal (although not generally done by the reserve currency country)!

Global currency reserves total about $11 trillion dollars; these reserves expand primarily because of currency intervention – i.e. when central bank sell domestic currency for dollars and other convertible currencies global reserves rise. The $11 trillion therefore indicates that currency manipulation is/ has been a very common practice.

Fred Bergsten, the then Director of the Peterson Institute of International Economics, gave the following testimony before Congress in 2010:

"*There is one, directly monetary, measure that the United States should contemplate taking against China: direct purchases of renminbi to counter China's direct purchases of dollars. It is absurd, especially from a US national perspective but also from the standpoint of global financial stability, that other countries set the exchange rate of the dollar …*

In principle there could be little objection to such 'countervailing currency intervention' [CCI] against manipulation by another country that was keeping its exchange rate substantially undervalued as a result. In practice, the United States could easily adopt such a policy against any currency that is generally convertible, such as the euro if it too became substantially undervalued …

… Countervailing currency intervention [CCI] would be decidedly superior to countervailing duties to deal with the problem of manipulated exchange rates. Undervalued currencies subsidize all of the exports of the country in question and pose a barrier of equivalent magnitude to all of its imports. Countervailing duties [tariffs, etc.] address only exports of individual products from such a country on a case-by-case basis and do not apply to its imports at all…"

A Proposed Strategy to Correct the Chinese Exchange Rate, C. Fred Bergsten - Director, Peterson Institute for International Economics – in testimony before the Treasury Department's Committee on Banking, Housing and Urban Affairs - United States Senate, September 16, 2010

The idea of countervailing currency intervention (CCI) never took; yes, the US has intervened in foreign exchange markets from time to time, but always in cooperation with other countries. A reserve-currency country does not normally intervene in FX markets for the purposes of devaluing its own currency; other countries generally retain the prerogative of setting the price of their own currencies in terms of the reserve currency!

(This is why Fred Bergsten and some other observers have questioned whether the dollar's reserve currency role is really still in the national interest of the US. A reserve currency invariably becomes overvalued when other countries are

free to set their own exchange rates against the reserve currency.)

Lesson 3: the US can devalue the dollar with direct currency market intervention.

So how would the US go about it? The US Treasury will have to instruct its agent in international financial matters, the Federal Reserve Bank of NY, to employ the assets of the Exchange Stabilization Fund (ESF) and sell dollars in FX markets.

"*Whenever necessary, the [ESF] trading desk buys or sells foreign currencies on behalf of the Treasury … for intervention purposes. Treasury and Federal Reserve foreign exchange operations are closely coordinated and typically are conducted jointly. … The ESF does not provide financing to the Federal Reserve System for foreign exchange operations. Rather, the Federal Reserve participates* ***with its own funds…***" (see Fed Point, FRBNY: Exchange Stabilization Fund, May 2007 – bolding added).

CCI requires money, and the FRBNY will have to come up with $billions to commence the program! Fortunately, the Federal Reserve has unlimited funds. It follows that US CCI is dollar devaluation with a QE4 component! Indeed, intervention funded by a central bank is (always) an extremely stimulative monetary policy, as we have seen in China and elsewhere. US CCI would be no different; the Fed might well need to supply, or at least be ready to supply, hundreds of billions of dollars for FX intervention.

(The old-fashioned way of devaluing had a government/central bank announce over a weekend that its currency would commence trading Monday morning at new, lower cross-rates. Imagine the US Treasury announcing one of these weekends that in conjunction with the FRBNY it is prepared "*to do whatever it takes*" to see the dollar trade at $1.50 euro and 5.00 RMB the following Monday!)

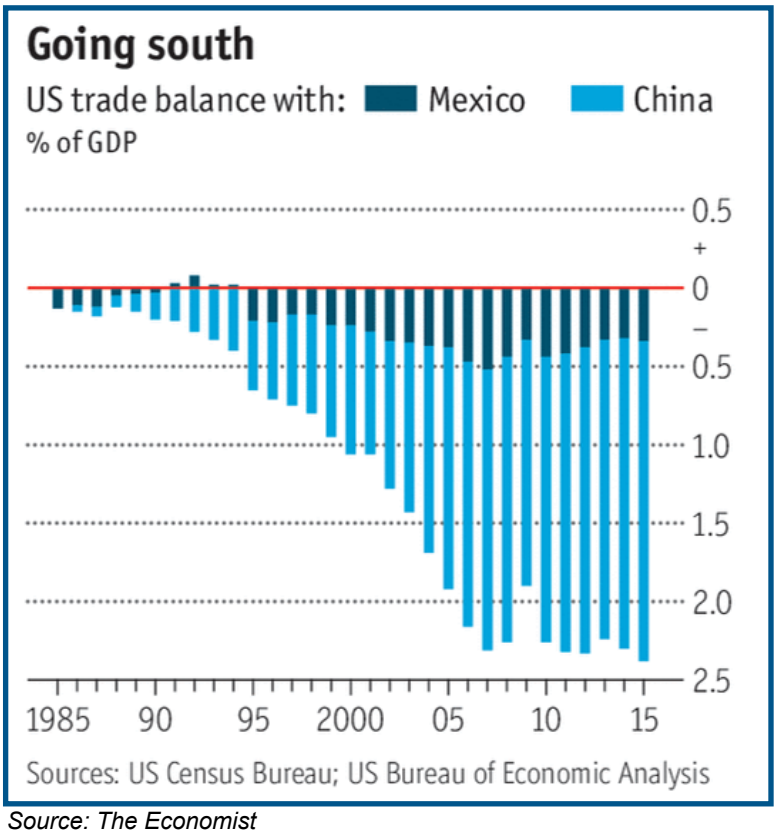
IV Conclusion

Dollar devaluation can be engineered with tariffs, by agreement with trading partners, or through direct currency market intervention. One should not pretend dollar devaluation will go smoothly or be immediately appreciated overseas. There will be blood, as they say. But my point is that it can be done, and it has been done in recent history.

Addendum

We have read several arguments that dollar overvaluation is now "*last year's problem*". China is busy selling dollars of late, and buying RMB in order to stop the RMB from declining.

This is true, but somewhat irrelevant in my view. China has made a bit of a mess of it; it has allowed capital to flow into the country these last 15 years or so without letting the RMB rise sufficiently to choke off "fluff" investment. China welcomed the employment gains domestically



Source: The Economist

from all this capital, and was largely unconcerned with the employment losses abroad.

"*The shock of trade with China was different than the shock of U.S. trade with other countries such as Mexico, Japan and Asian "tiger" economies such as Taiwan and Hong Kong, research shows. The* ***scale of import competition*** *from China was immense, dislocating millions of U.S. manufacturing workers, who had trouble adjusting and finding new work*", (WSJ, 08/11 – bolding added).

The fact that some "fluff" investment is now leaving China, along with the $ billions amassed by those Chinese families who have profited from the massive capital flows into China, is not an argument against restoring global balance. There is a serious, continuing, global demand shortage; Asia still needs to consume much more of its own output. It's not clear that a new Administration in the US will condone picking up slack in global demand by the US economy consuming more foreign output at the cost of domestic output. Indeed, while there is never a good time to restore global balance the US would appear to have come to the end of its tether on this.

The Economist noted in an article entitled "*Free Trade – Coming and Going*"! (October 1, 2016) "*… China's accession to the WTO [in 2001] caused a big shock.* ***The country's size,*** *and the speed at which it conquered rich-world markets for low-cost manufacturing, makes it unique. By 2013 it had captured one-fifth of all manufacturing exports worldwide, compared with a share of only 2% in 1991 …*

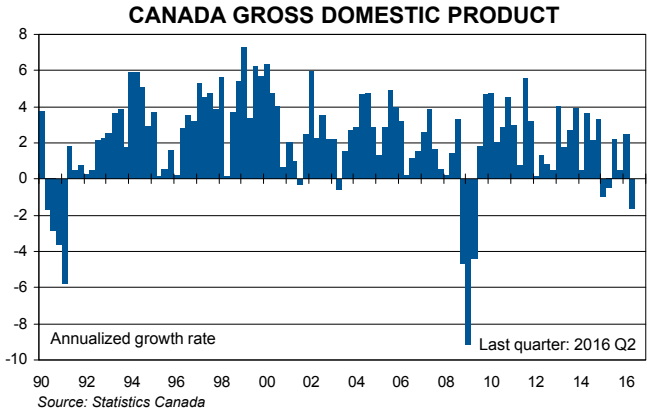
David Autor of the Massachusetts Institute of Technology (MIT), David Dorn of the University of Zurich and Gordon Hanson of the University of California, San Diego, looked into [US] job losses more closely, [and] they found something worrying. At least one-fifth of the drop in factory jobs during [1999-2011] was the direct result of competition from China …

In other rich countries, regions or industries with heavy exposure to Chinese imports also suffered material losses in factory jobs. A study of Spain's jobs market by Vicente Donoso, of the Complutense University of Madrid, and others found that provinces with the greatest exposure to Chinese imports saw the largest falls in the share of manufacturing employment between 1999 and 2007 …" (bolding added).

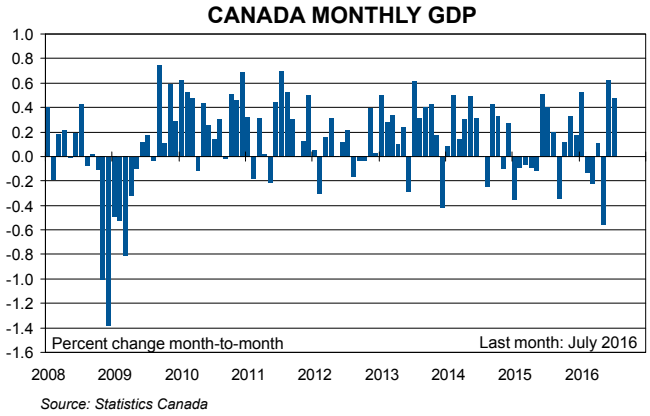
We have noted many times that if China was the size of Jamaica no one would care what policies it followed or how cheap its currency was. But China and the rest of SE Asia encompass more than two billion hardworking, entrepreneurial people. If the currencies of that region are significantly undervalued global problems will inevitably follow ... and they now have!

MONTHLY REVIEW ►
CANADA – ECONOMIC GROWTH

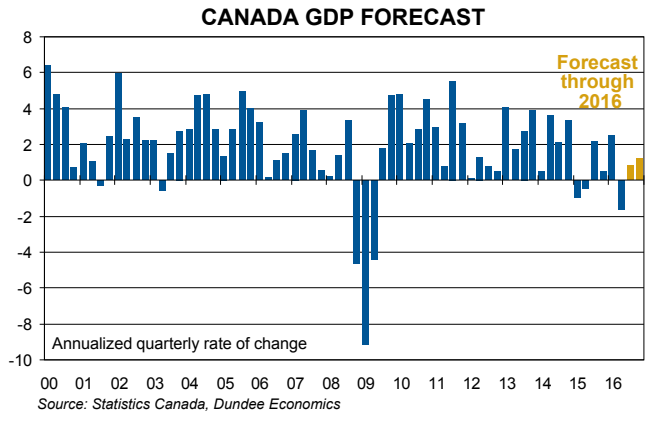
The Canadian economy declined -1.6% (annualized) in 2016-Q2; the decline was due to a sharp decline in exports as a result of the massive wildfires.



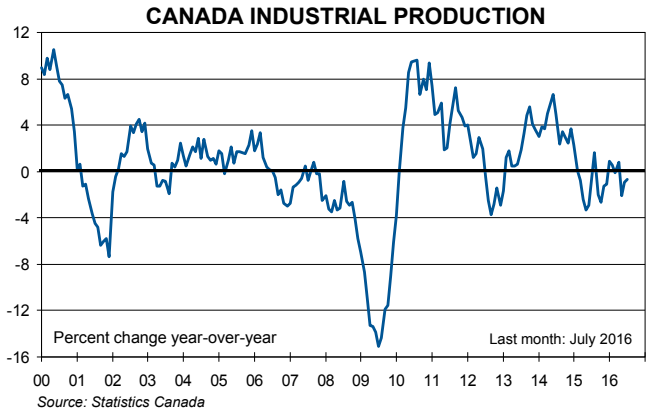
Monthly GDP increased 0.5% in July.



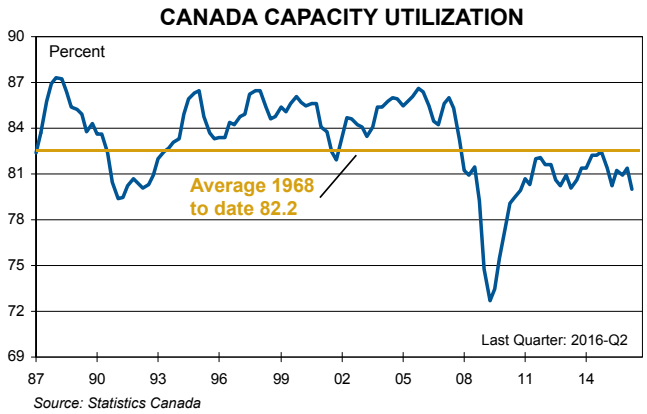
Growth for all of 2016 is shaping up to be less than 1.0%.



Industrial production remains negative ...



... and capacity utilization is trending sideways/down.



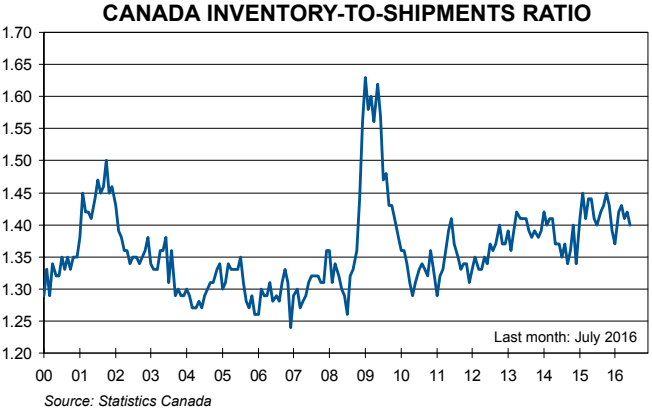
Retail sales growth has declined again in recent months.

MONTHLY REVIEW ►
CANADA – ECONOMIC GROWTH

Manufacturing shipments continue to disappoint ...

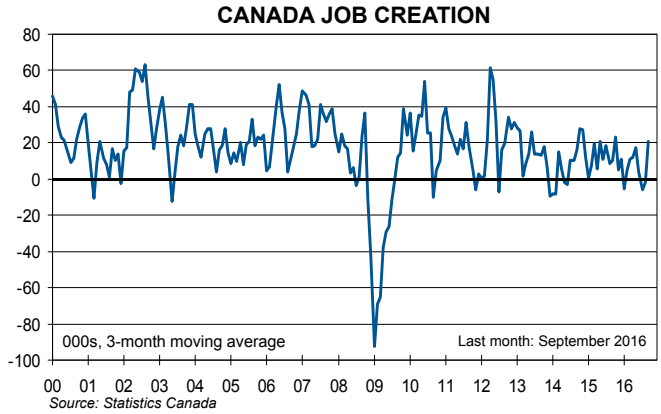
... new orders are down ...

... and the inventory ratio continues to trend sideways.

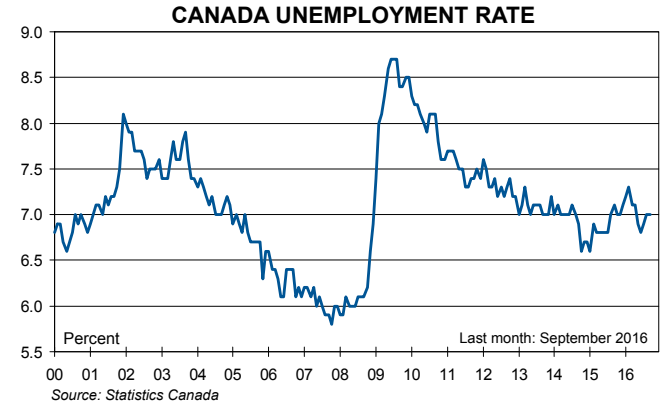


MONTHLY REVIEW ►
CANADA – LABOUR MARKET

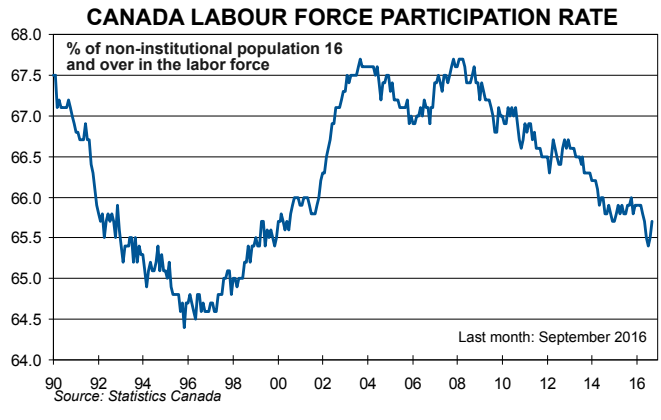
Labour market data were stronger than expected for September ...



... but the unemployment rate remained at 7.0% ...



... the labour force participation rate increased however.



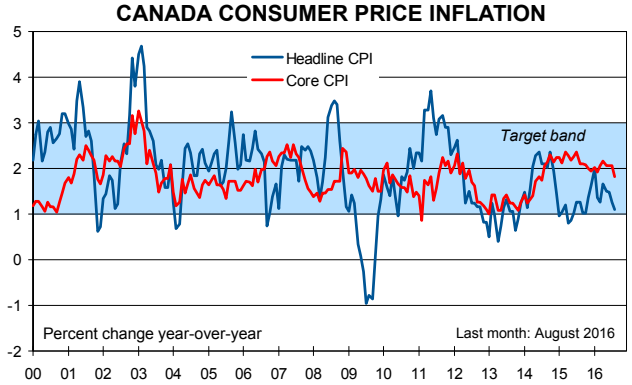
MONTHLY REVIEW ►
CANADA – INFLATION

Headline CPI declined to 1.1% in August from 1.3% in July and core CPI declined from 2.1% to 1.8% .

Industrial product price inflation has been negative for the last seven months, wages have declined and inflation expectations are stable.

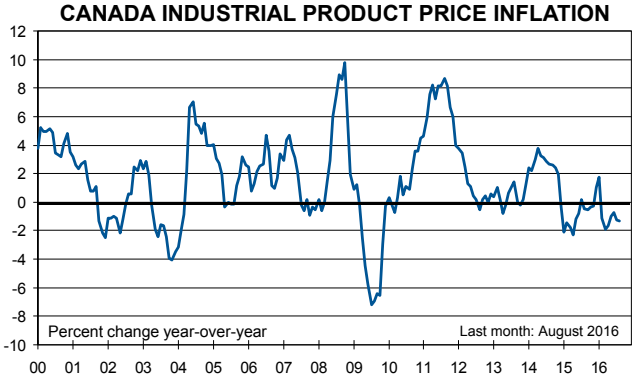
We do not expect inflation to be an issue for the Bank of Canada in 2016/2017.

CANADA CONSUMER PRICE INFLATION



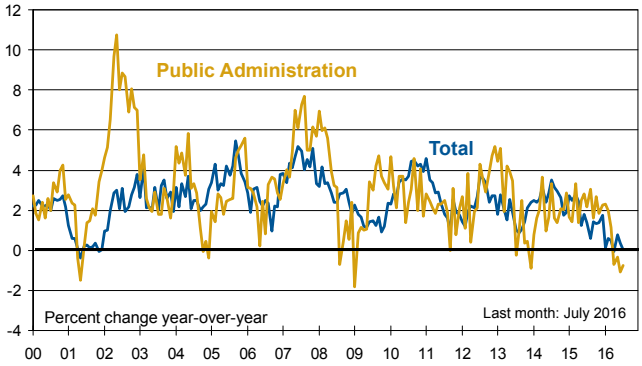
Source: Statistics Canada

CANADA INDUSTRIAL PRODUCT PRICE INFLATION



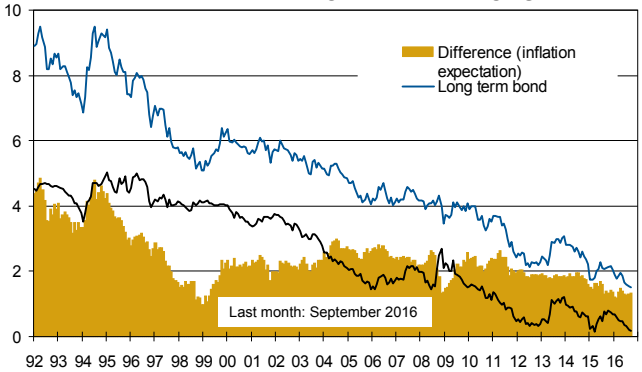
Source: Statistics Canada

CANADA AVERAGE WEEKLY EARNINGS



Source: Statistics Canada

CANADA INFLATION EXPECTATIONS

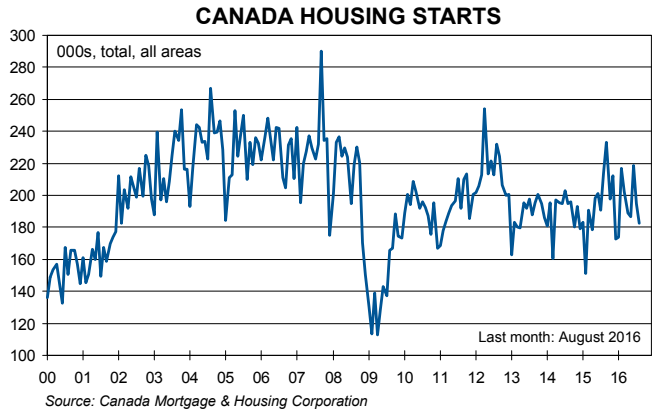


Source: Bank of Canada, Dundee Economics

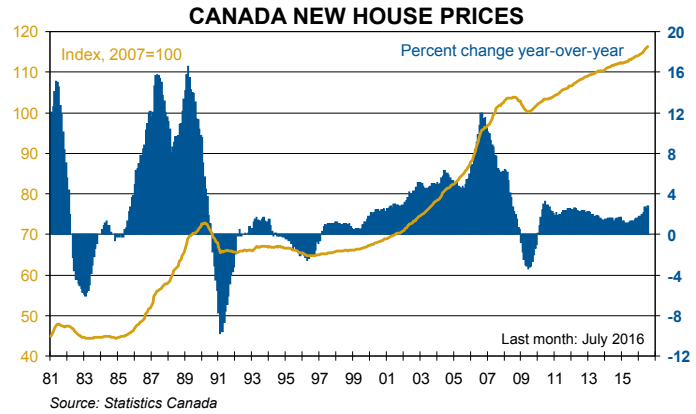
MONTHLY REVIEW ►
CANADA – HOUSING MARKET

Housing market data remain mixed from region to region, but official concern over rapid increases in Vancouver and Toronto house prices has been rising (with Vancouver now levying a property transfer tax on foreign purchases).

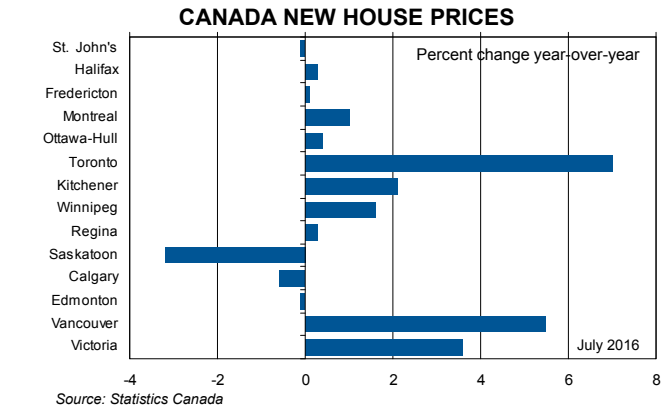
Housing starts are trending sideways.



New house prices continue to increase at a steady rate ...

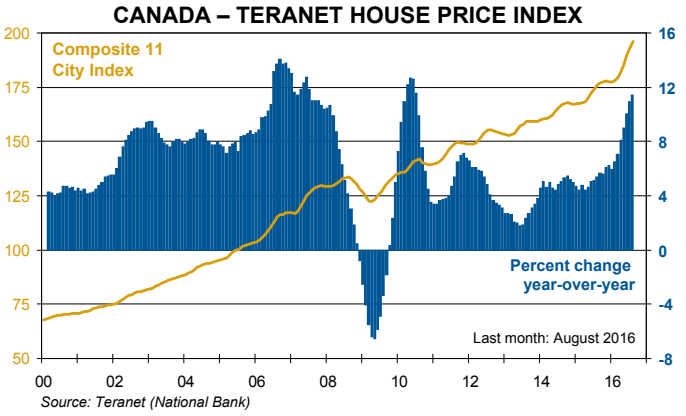


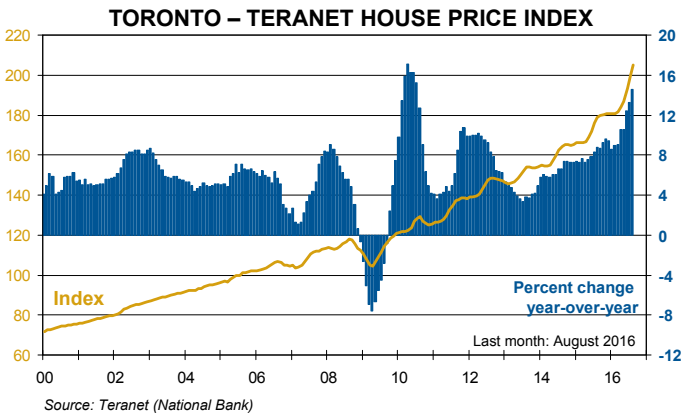
... led by higher prices in Toronto and Vancouver. (This may change in coming months!)

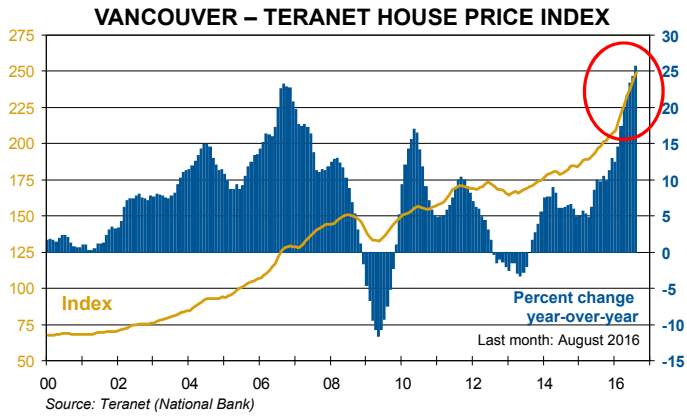


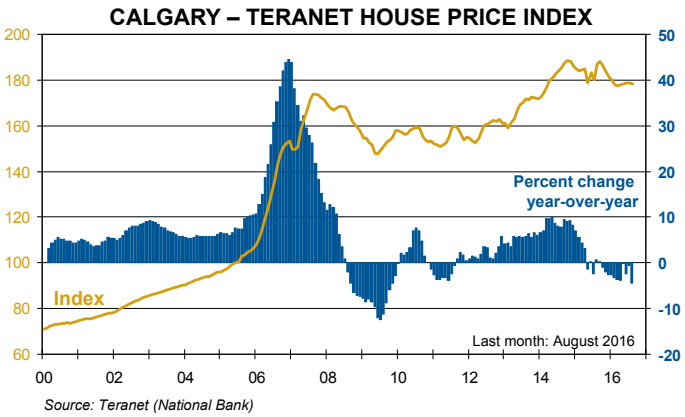
MONTHLY REVIEW ►
CANADA – HOUSING MARKET

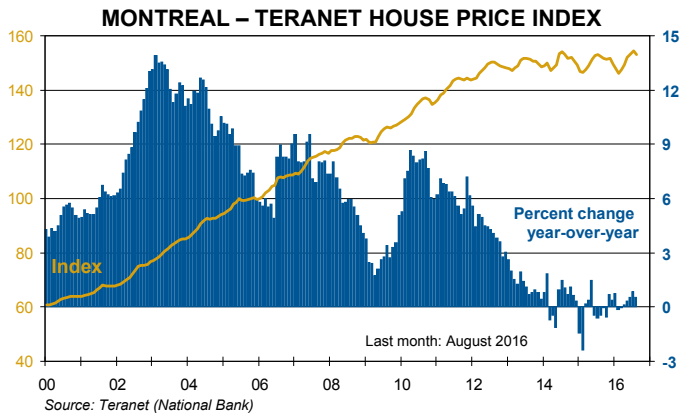
According to Teranet house price indices, existing house prices (11-city composite) increased 11.4% (year-over-year) in August. Existing house prices increased 25.8% in Vancouver and 14.6% in Toronto; elsewhere prices were more subdued or declined.

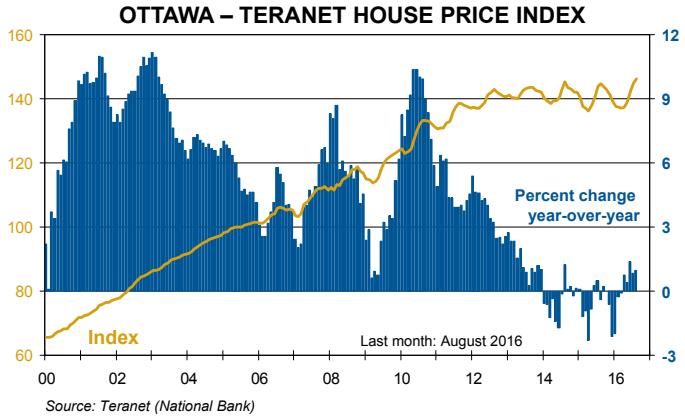












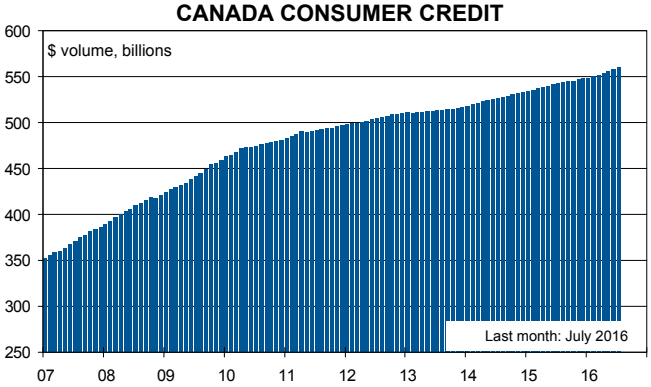
MONTHLY REVIEW ►
CANADA – CREDIT AND DEBT

Consumer credit growth has picked up somewhat; mortgage credit growth is expanding at about 6% year-over-year.

CANADA CONSUMER CREDIT GROWTH

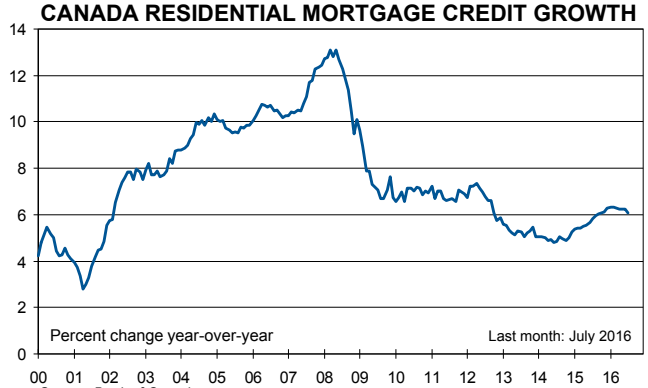
Source: Bank of Canada

CANADA CONSUMER CREDIT



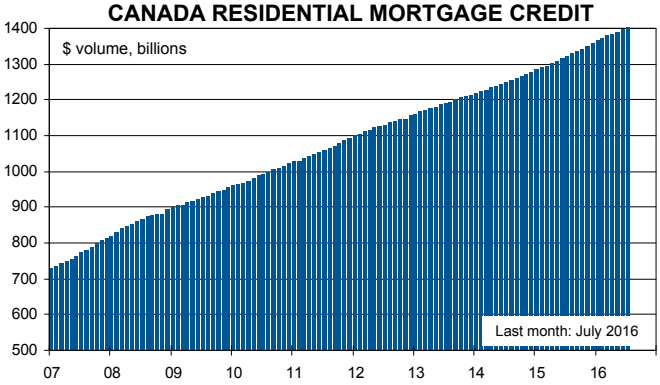
Source: Bank of Canada

CANADA RESIDENTIAL MORTGAGE CREDIT GROWTH



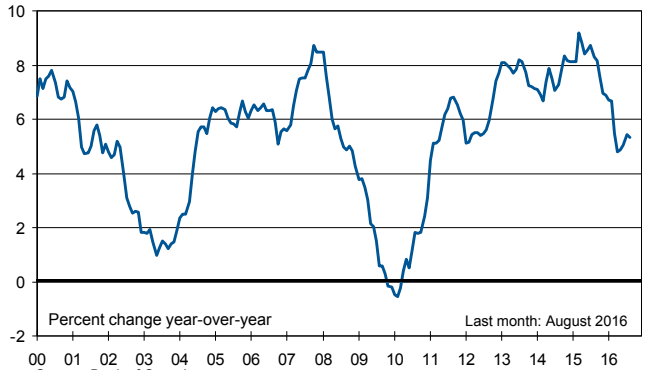
Source: Bank of Canada

CANADA RESIDENTIAL MORTGAGE CREDIT



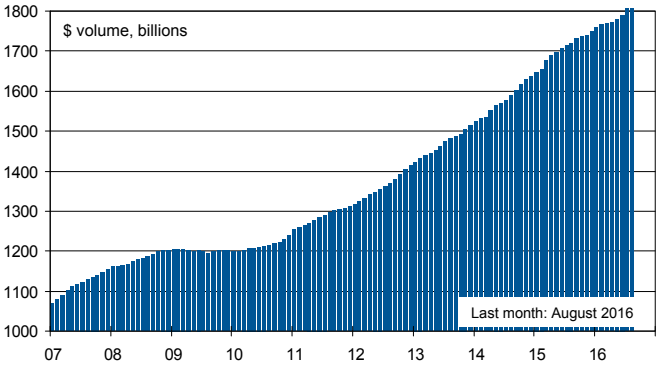
Source: Bank of Canada

CANADA TOTAL BUSINESS CREDIT GROWTH



Source: Bank of Canada

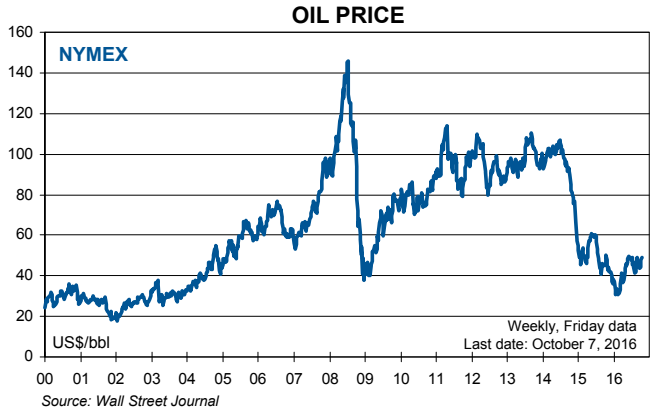
CANADA TOTAL BUSINESS CREDIT



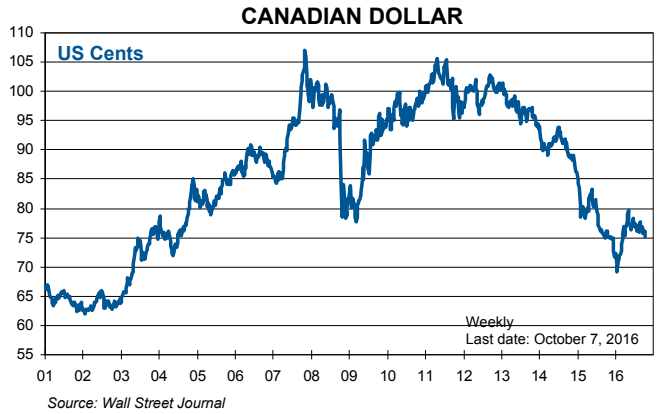
Source: Bank of Canada

MONTHLY REVIEW ►
CANADA – ASSET PRICES

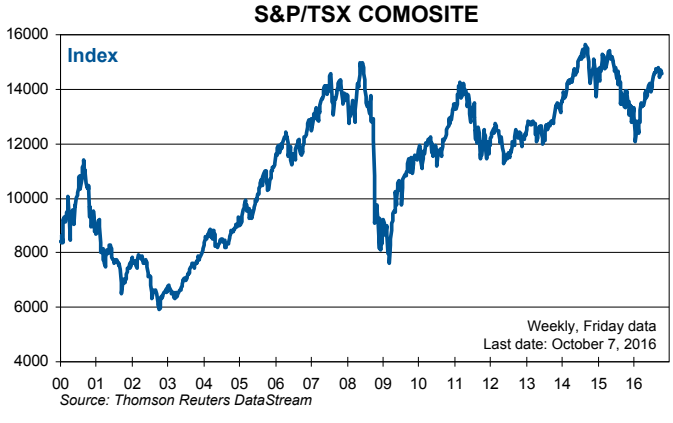
Oil prices increased to around $50 after the latest OPEC get-together.



The Canadian dollar has trended sideways in recent weeks (as forecast) ...

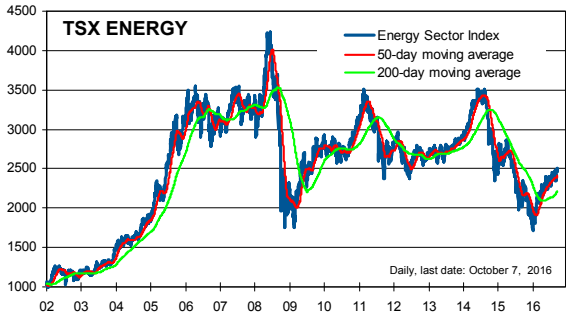


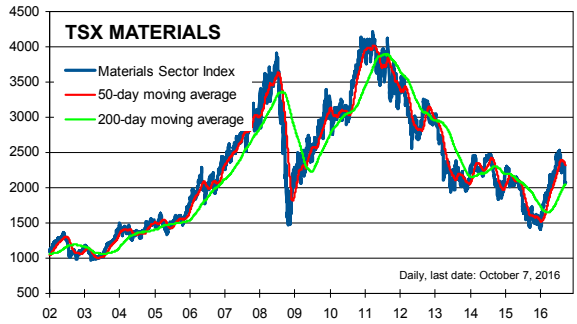
... along with the TSX Composite Index.

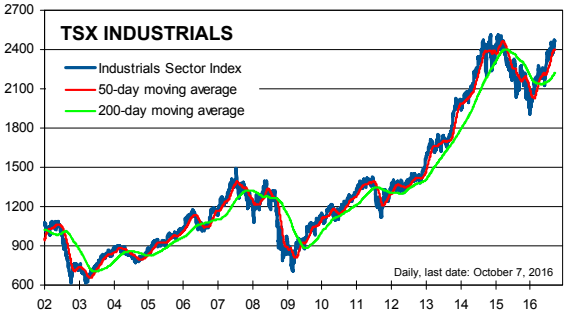


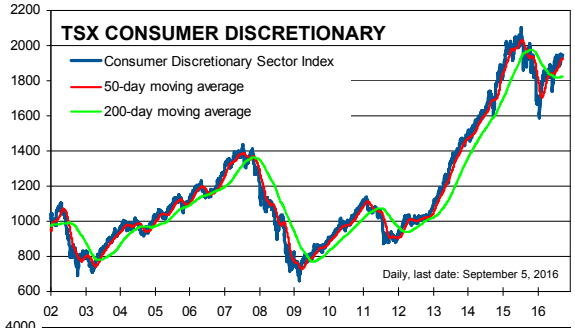
CANADA – TSX GICS SECTORS

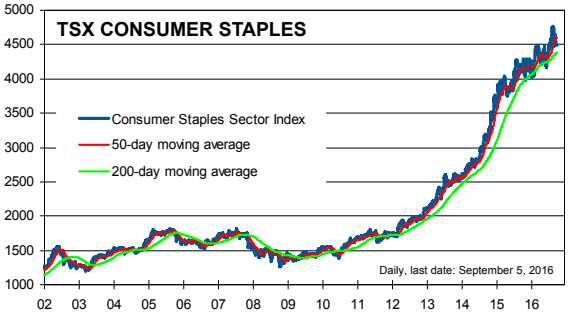
The Consumer Staples, Telecommunications and Utilities sectors have all retreated from the highs set at the beginning of September.

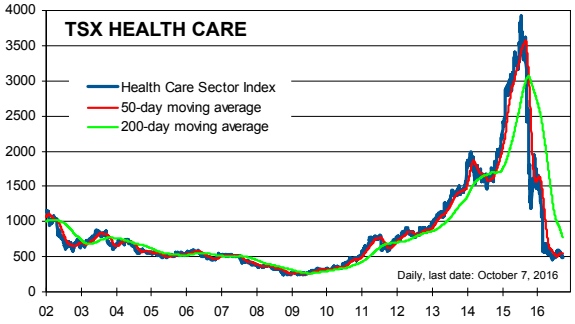


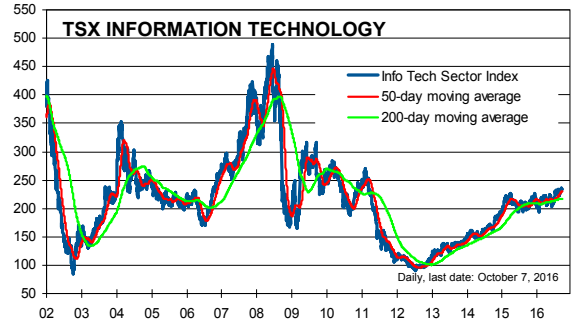


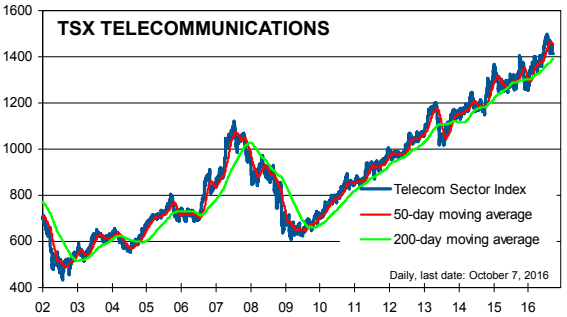


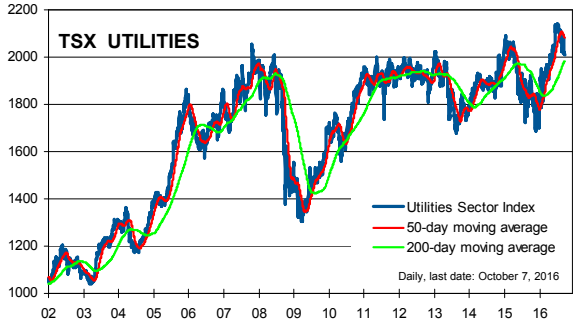








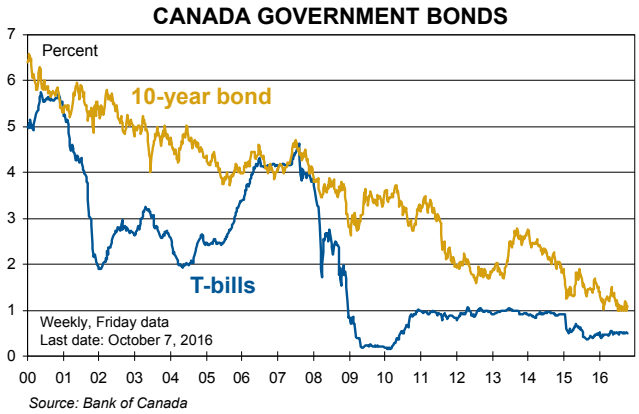




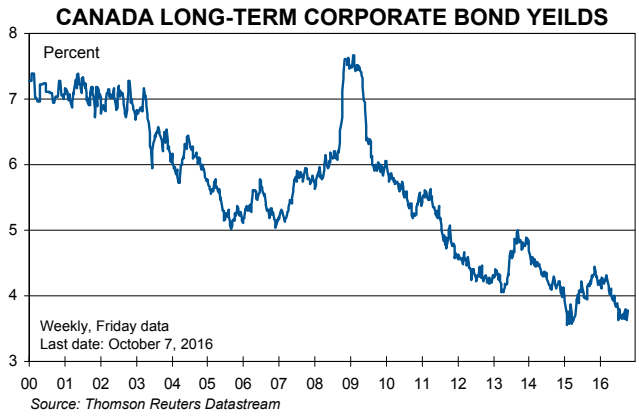
Source: Thomson Reuters Datastream

MONTHLY REVIEW ►
CANADA – INTEREST RATES

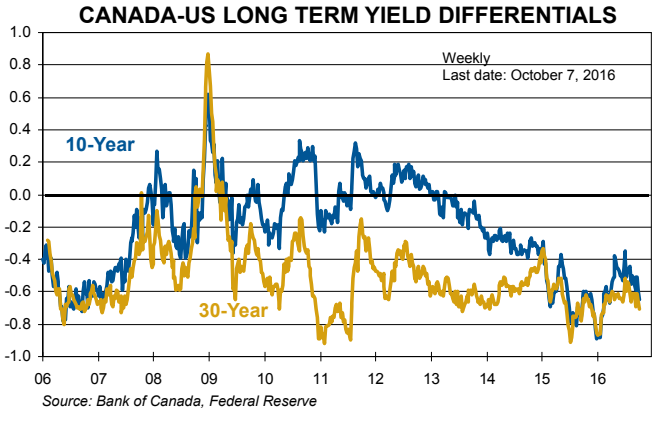
The Canadian 10-year bond yield has hovered around 1.0% in recent weeks ...



... long-term corporate bond yields have hovered around 3.7% ...

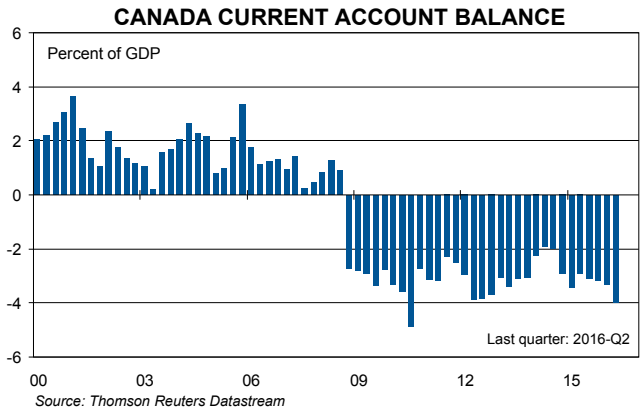


... and Canada-US long term differentials have widened in recent weeks.

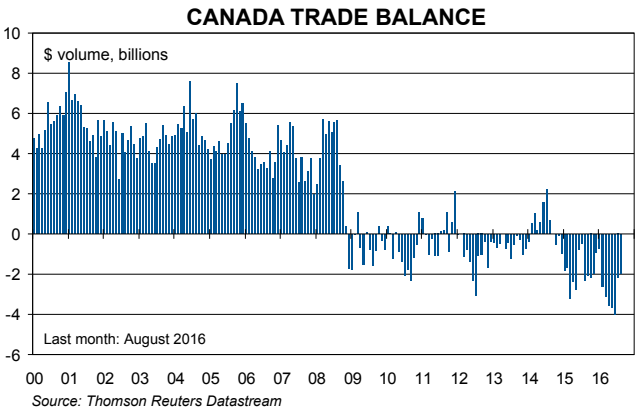


MONTHLY REVIEW ►
CANADA – CURRENT ACCOUNT AND TRADE BALANCE

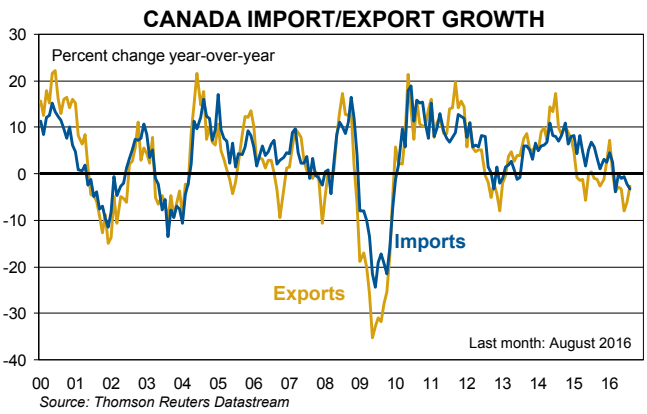
The current account deficit increased to 4.0.% of GDP in 2016-Q2 ...



... Canada's trade deficit declined in August but remains elevated ...

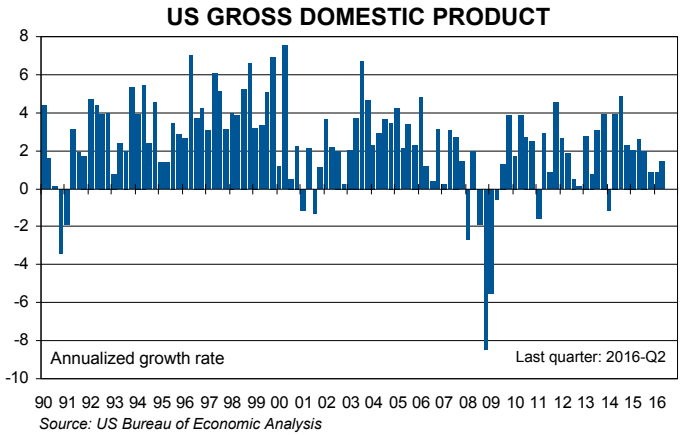


... and both export and import growth have been negative for the last six months!

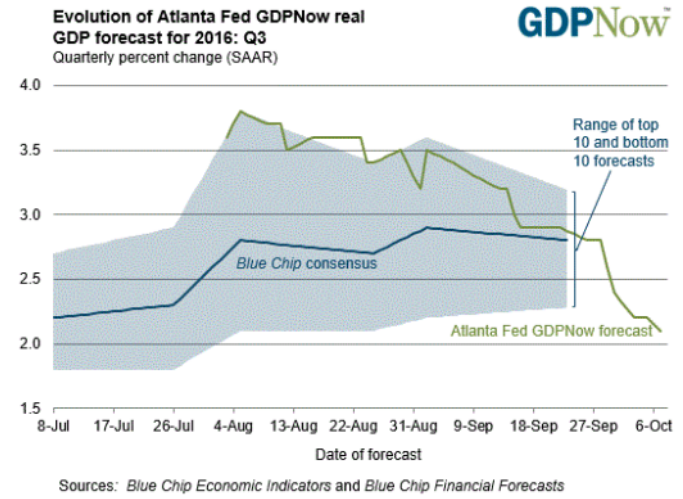


MONTHLY REVIEW ►
UNITED STATES – ECONOMIC GROWTH

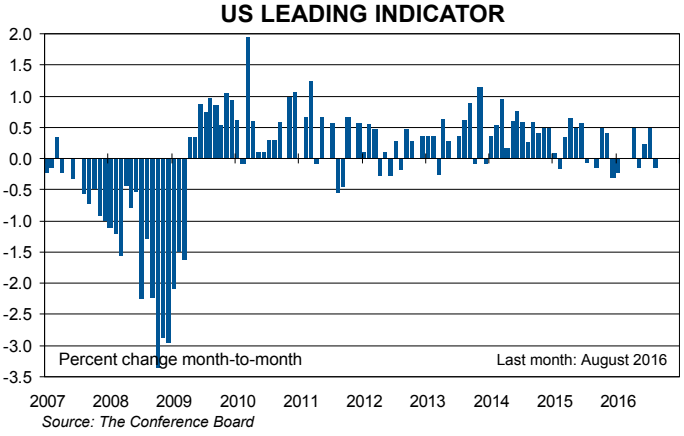
The third estimate of US GDP growth in 2016-Q2 was revised up to 1.4% from 1.1% (s.a.a.r) ...



... Atlanta Fed's *GDPNow* estimate for 2016-Q3 is 2.1%. (Our forecast for all of 2016 is 1.5%-2.0%.)

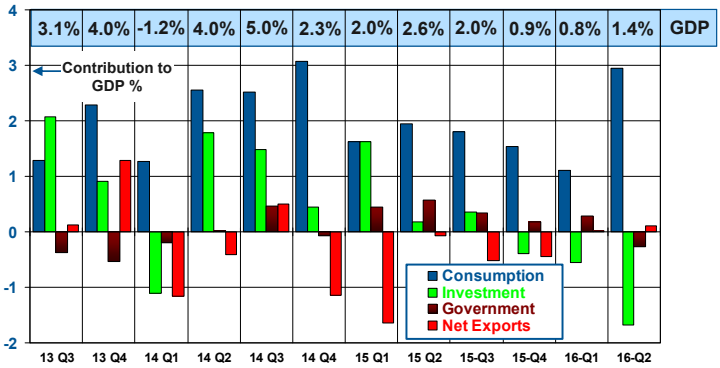


The leading indicator continues to point to only moderate growth.



The largest contribution to US growth in 2016-Q2 came from Household Consumption (services). Investment was the biggest drag on GDP growth and Government Expenditures also subtracted from GDP growth in the second quarter.

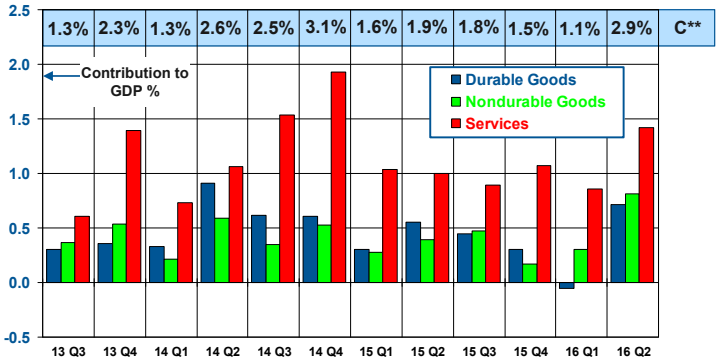
CONTRUBTION TO GDP IN RECENTQUARTERS



Source: US Bureau of Economic Analysis

*** Average of last 12 quarters: 2.2%*

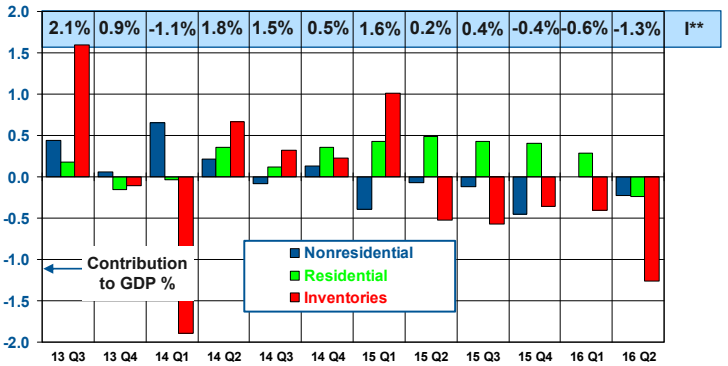
C: HOUSEHOLD CONSUMPTION



Source: US Bureau of Economic Analysis

*** Average of last 12 quarters: 2.0%*

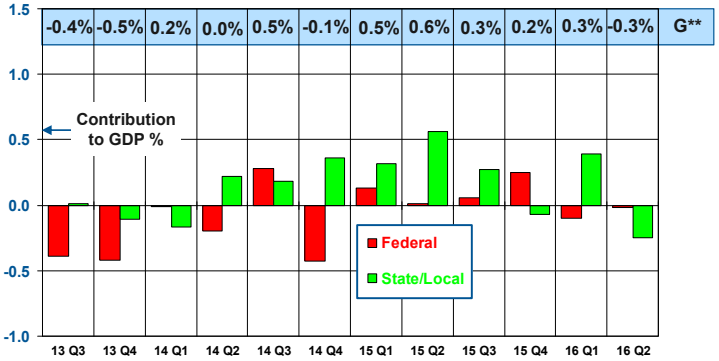
I: INVESTMENT



Source: US Bureau of Economic Analysis

*** Average of last 12 quarters: 0.4%*

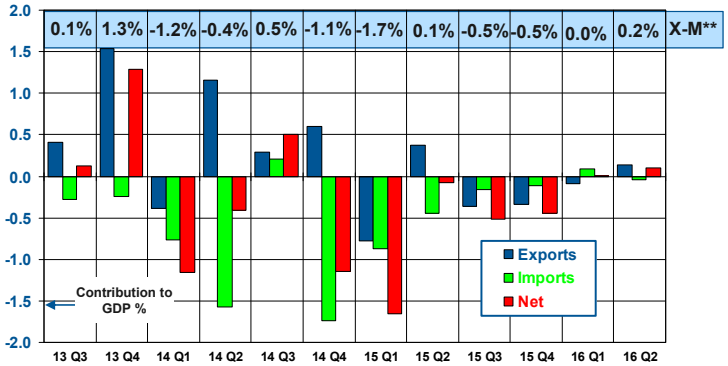
G:GOVERNMENT



Source: US Bureau of Economic Analysis

*** Average of last 12 quarters: 0.1%*

X-M: FOREIGN BALANCE

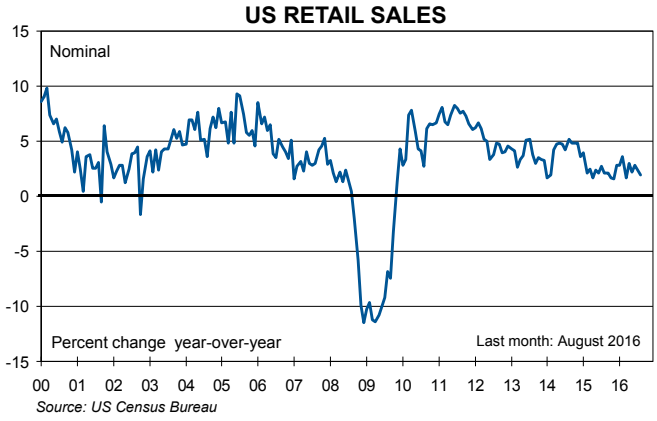


Source: US Bureau of Economic Analysis

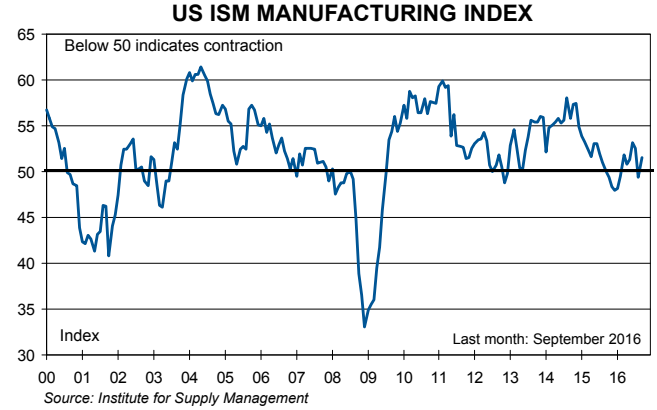
*** Average of last 12 quarters: -0.3%*

MONTHLY REVIEW ►
UNITED STATES – ECONOMIC GROWTH

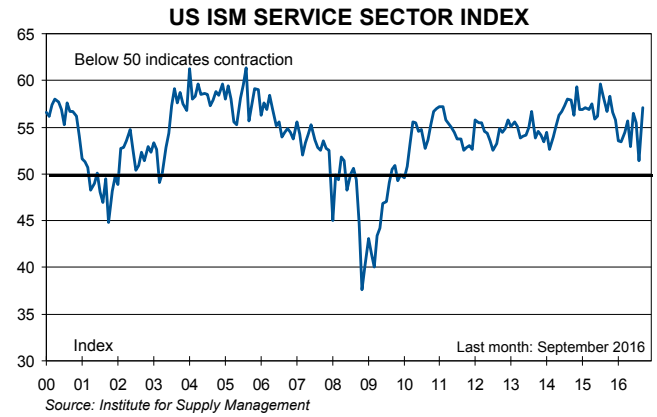
Retail sales growth is trending sideways ...



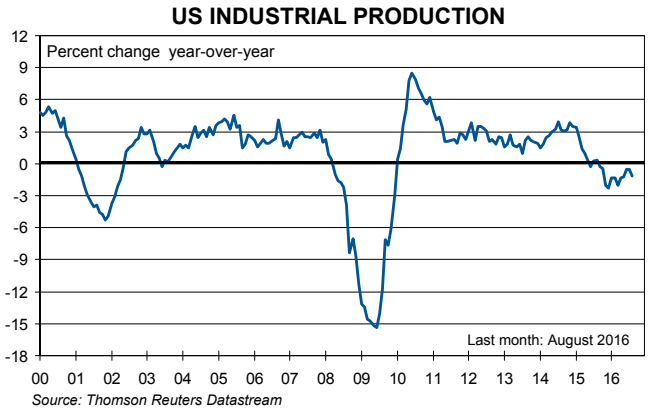
... as is the ISM manufacturing index ...



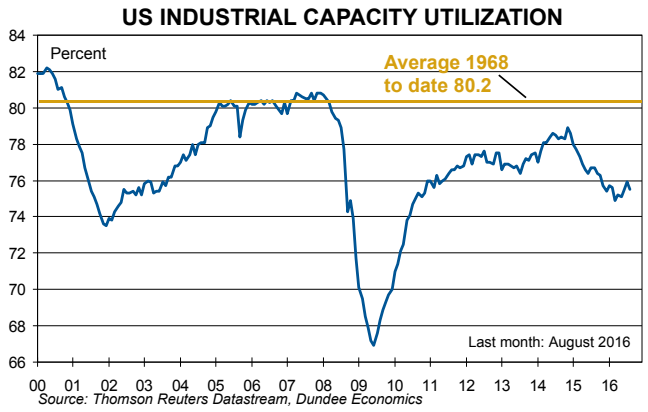
... but the ISM service index increased sharply in September!



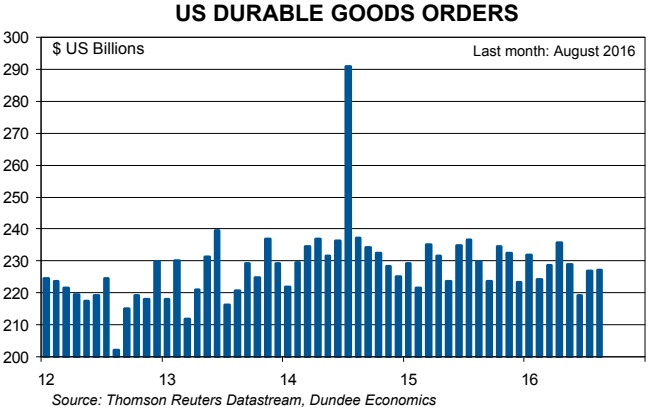
Industrial production has been negative year-over-year for the ninth month through August ...



... industrial capacity utilization, although up from recent lows, remains depressed ...



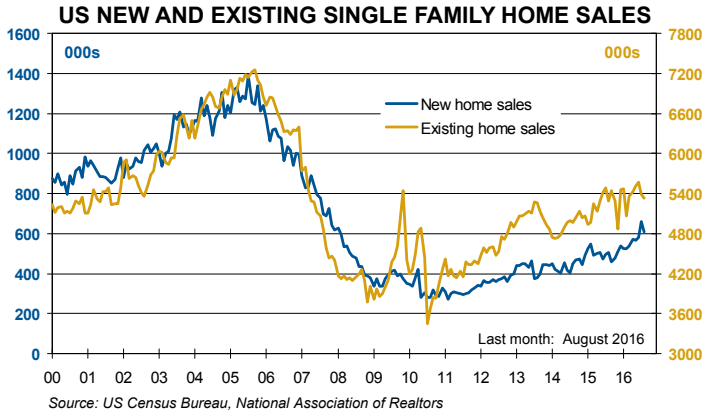
... and durable goods orders are trending sideways.



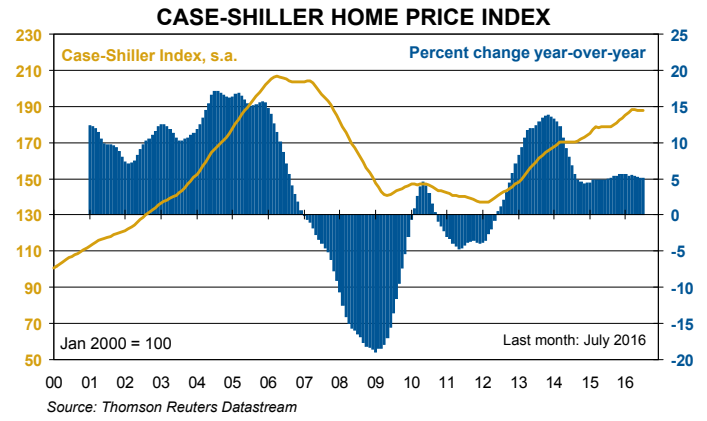
MONTHLY REVIEW ►
UNITED STATES – HOUSING MARKET

Housing starts have leveled off at just over 1.1 million units ...

... new home prices are trending modestly higher, while existing home sales appear to be leveling ...



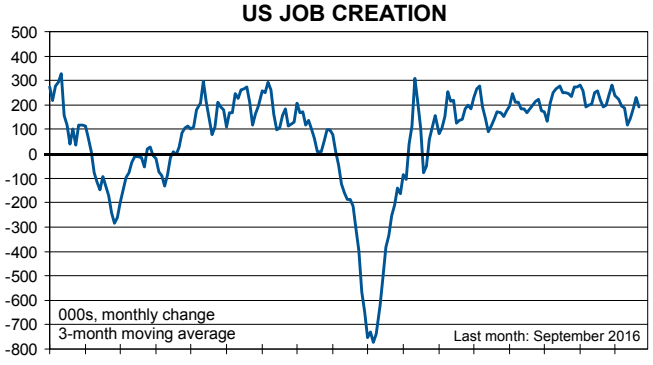
... and the Case-Shiller Home Price Index continues to advance around 5% year-over-year.



MONTHLY REVIEW ►
UNITED STATES – LABOUR MARKET

US labour market data remains mixed; 156 thousand jobs were created in September, and the 3-month moving average now stands at 192 thousand. The unemployment rate ticked up to 5.0%, due to an increase in labour force participation rate (which remains low). Meanwhile, the underemployed and those losing jobs remains elevated.

US JOB CREATION

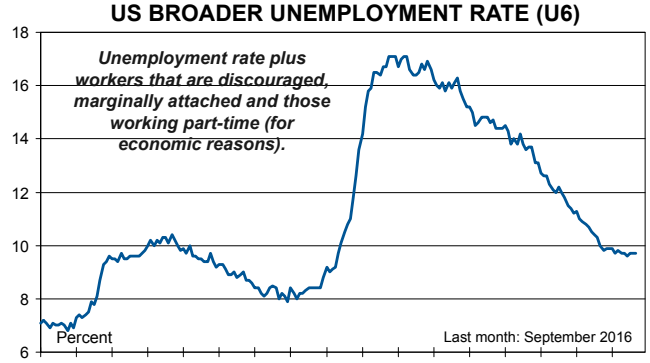


Source: US Bureau of Labor Statistics

US UNEMPLOYMENT RATE

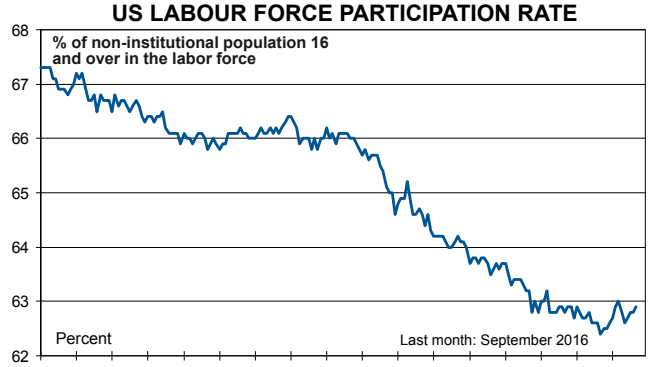
Source: US Bureau of Labor Statistics

US BROADER UNEMPLOYMENT RATE (U6)



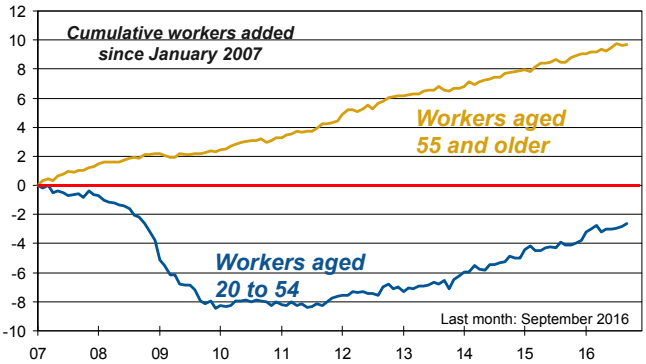
Source: US Bureau of Labor Statistics

US LABOUR FORCE PARTICIPATION RATE



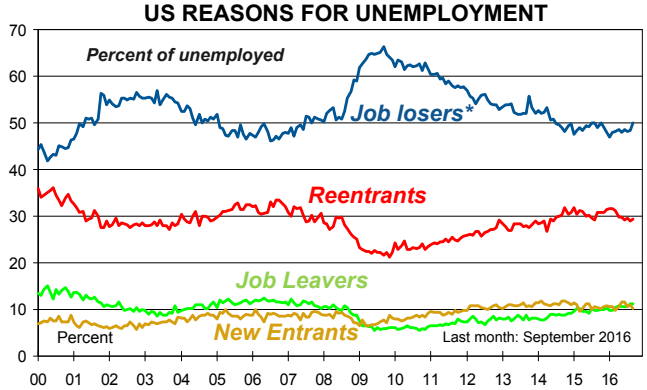
Source: US Bureau of Labor Statistics

CUMULATIVE WORKERS ADDED BY AGE



**Source: US Bureau of Labor Statistics, Dundee Economics*

US REASONS FOR UNEMPLOYMENT



**Includes persons who completed temporary jobs*
Source: US Bureau of Labor Statistics

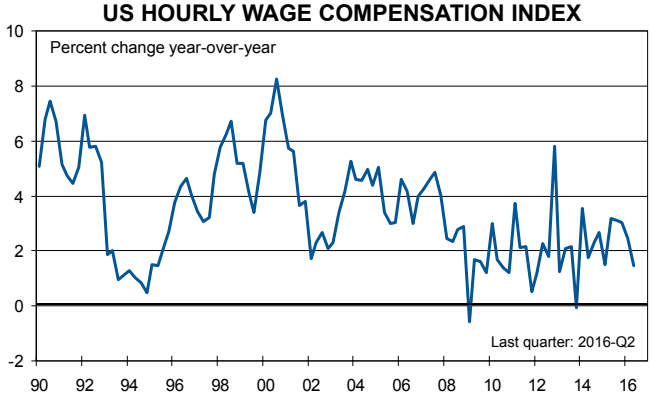
MONTHLY REVIEW ►
UNITED STATES – WAGE INFLATION

US wage inflation is trending sideways. Although hourly earnings have increased, overall labour cost declined in 2016-Q2 for all businesses and for manufacturing more specifically.

US HOURLY EARNINGS

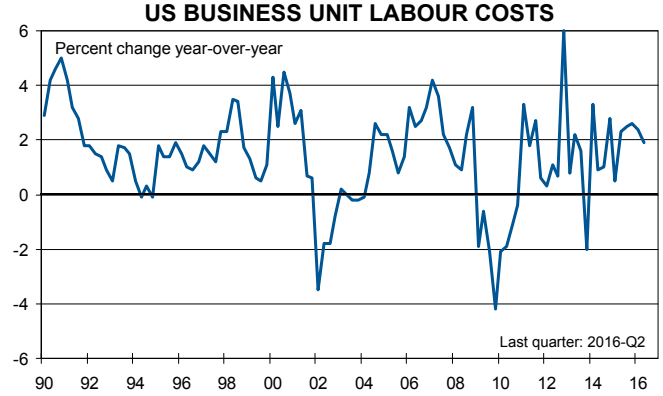
Source: US Bureau of Labor Statistics

US HOURLY WAGE COMPENSATION INDEX



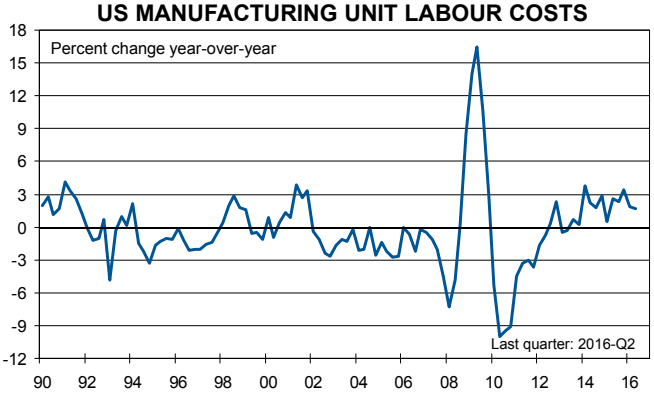
Source: US Bureau of Labor Statistics

US BUSINESS UNIT LABOUR COSTS



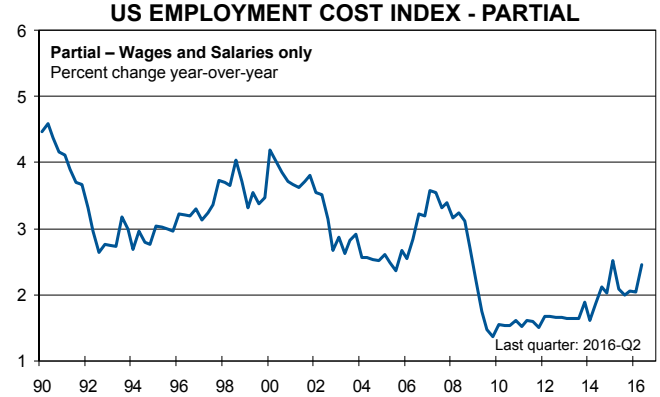
Source: US Bureau of Labor Statistics

US MANUFACTURING UNIT LABOUR COSTS



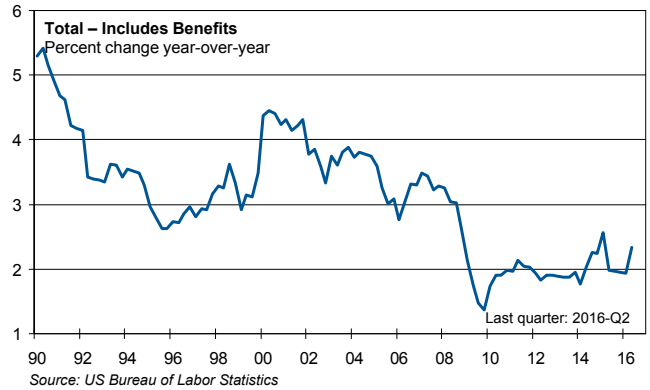
Source: US Bureau of Labor Statistics

US EMPLOYMENT COST INDEX - PARTIAL



Source: US Bureau of Labor Statistics

US EMPLOYMENT COST INDEX - TOTAL



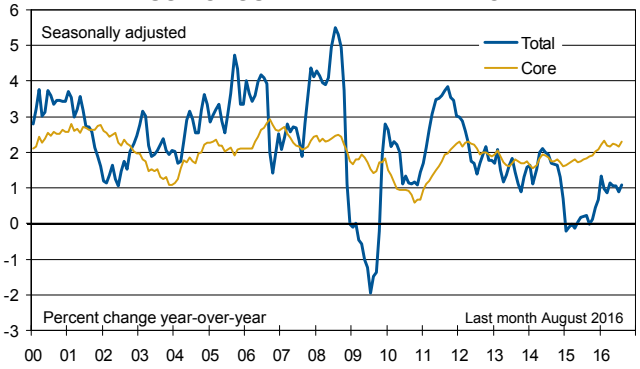
Source: US Bureau of Labor Statistics

Both headline and core inflation rates are trending sideways and likely to remain low ...

... PCE inflation remains well below the Fed's target ...

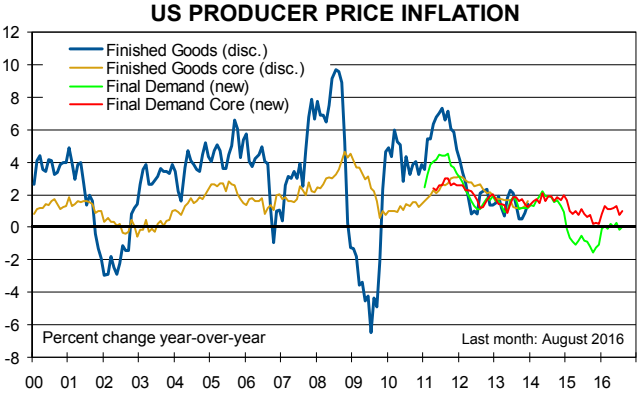
... and inflation expectations are also stable/low.

US CONSUMER PRICE INFLATION



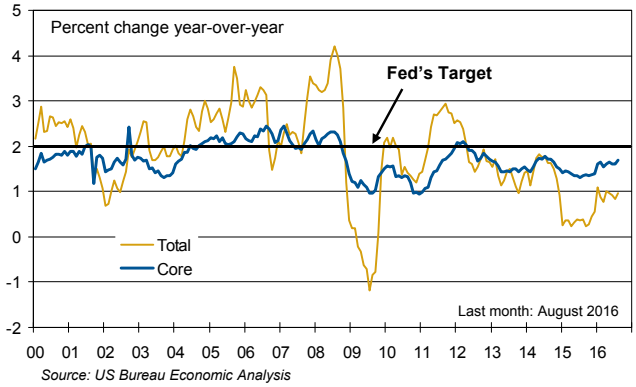
Source: US Bureau of Labor Statistics

US PRODUCER PRICE INFLATION



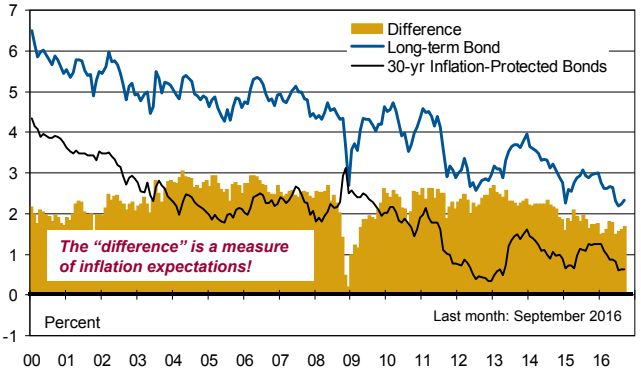
Source: US Bureau of Labor Statistics

US PERSONAL CONSUMPTION EXPENDITURE INFLATION



Source: US Bureau Economic Analysis

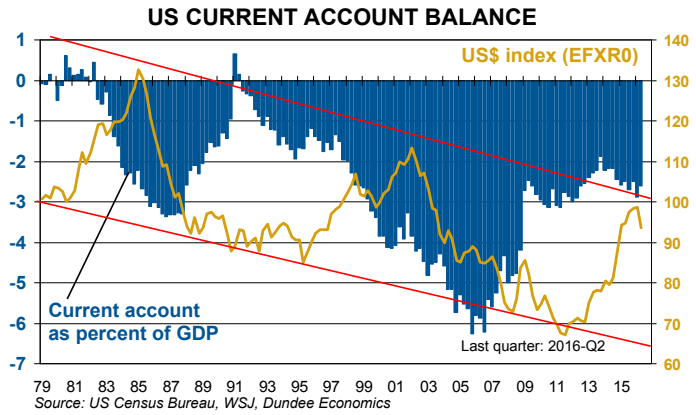
US INFLATION EXPECTATIONS



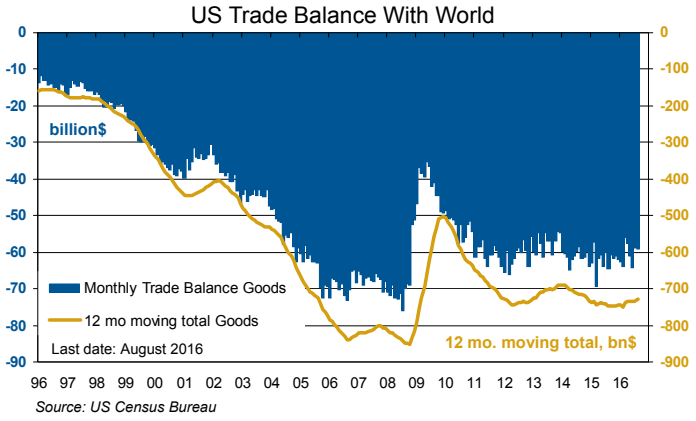
Source: Federal Reserve, Dundee Economics

MONTHLY REVIEW ►
UNITED STATES – CURRENT ACCOUNT AND TRADE BALANCE

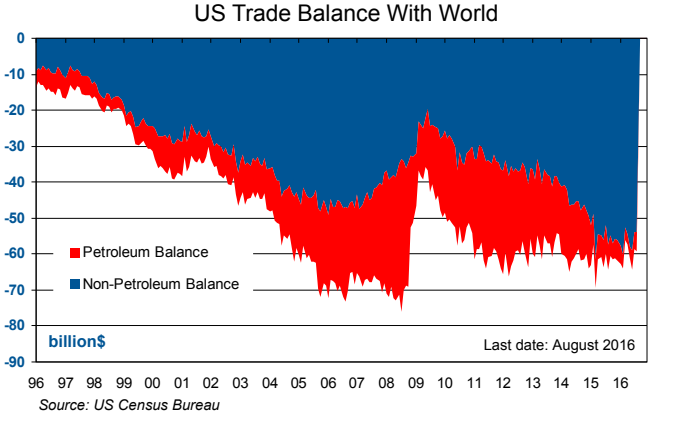
The US current account deficit is rising again, which is one reason we expected the US dollar to decline in 2017-2018.



The US trade deficit has been flat in recent months on the back of weaker domestic growth ...

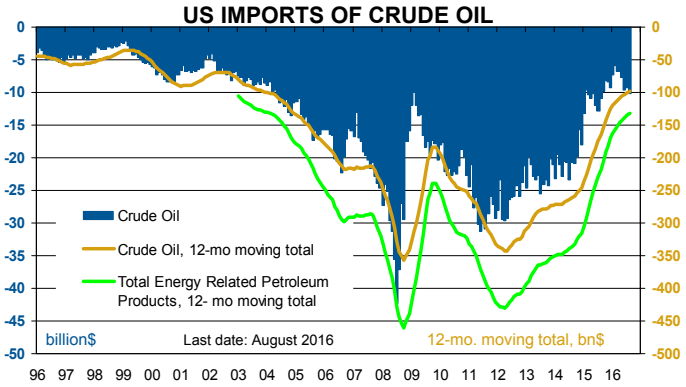


... and the sharp contraction in the petroleum deficit!

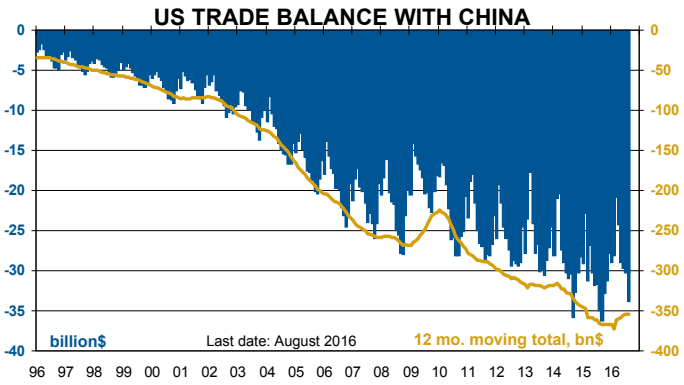


UNITED STATES – TRADE BALANCE

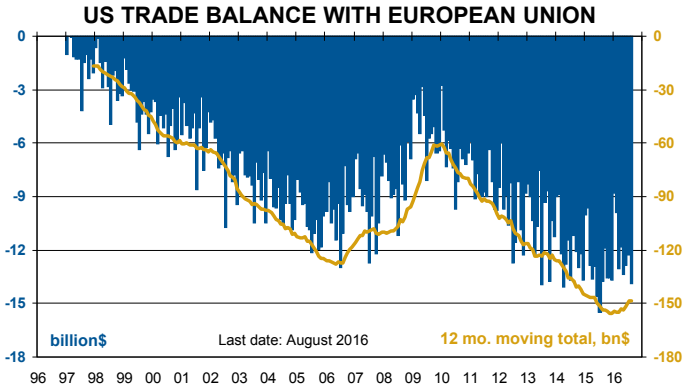
The US continues to post very large trade deficits with China, the EU, and Japan.



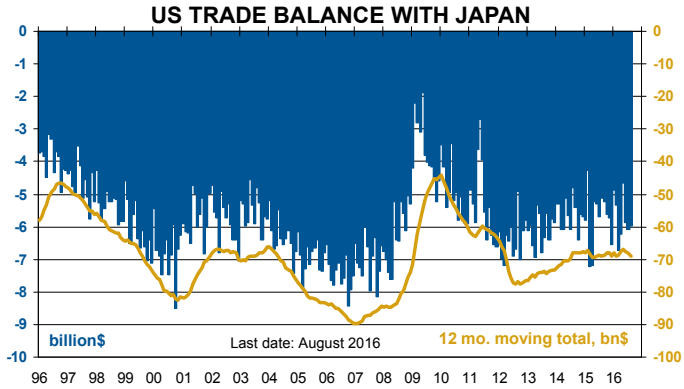
Source: US Census Bureau



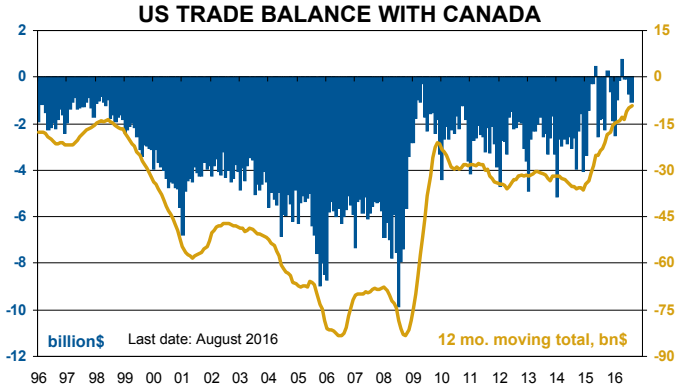
Source: US Census Bureau



Source: US Census Bureau



Source: US Census Bureau

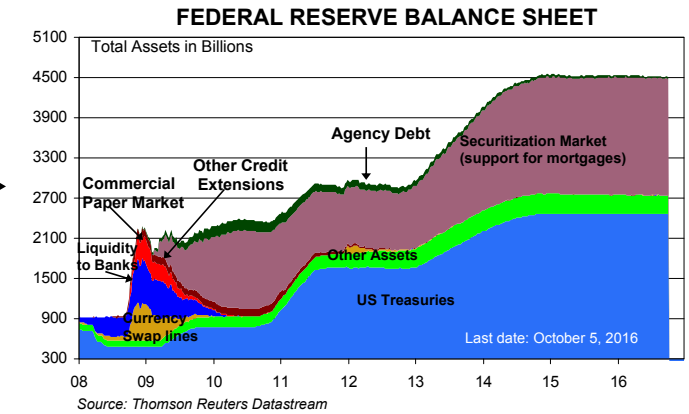


Source: US Census Bureau

MONTHLY REVIEW ►
UNITED STATES – MONETARY POLICY

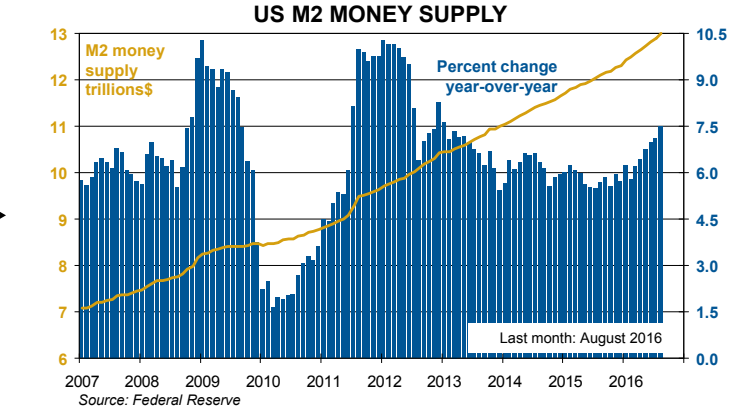
Since QE3 ended in 2014, the Fed's balance sheet has stabilized at just over $4.5 trillion.

Even as the Fed slowly increases short-term interest rates the balance sheet will remain elevated for the foreseeable future.



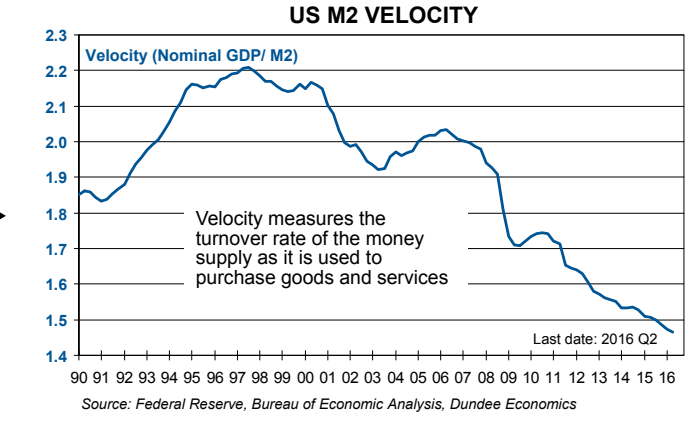
Source: Thomson Reuters Datastream

The M2 money supply increased at 7.5% year-over-year in August ...



Source: Federal Reserve

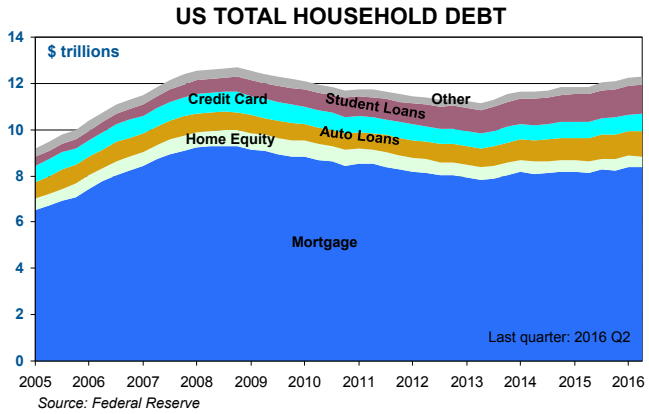
... but M2-velocity continues to plunge!

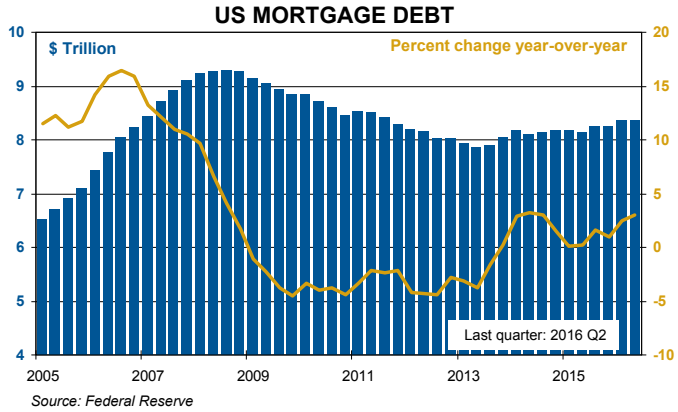


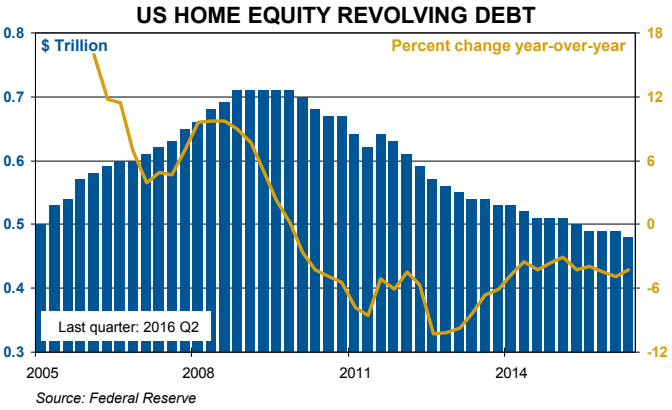
Source: Federal Reserve, Bureau of Economic Analysis, Dundee Economics

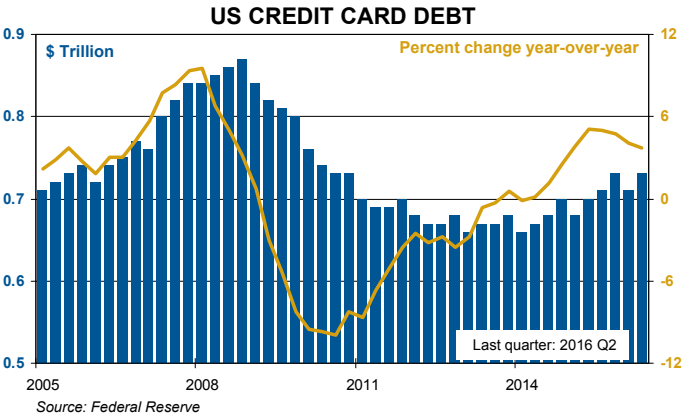
MONTHLY REVIEW ►
UNITED STATES – HOUSEHOLD DEBT

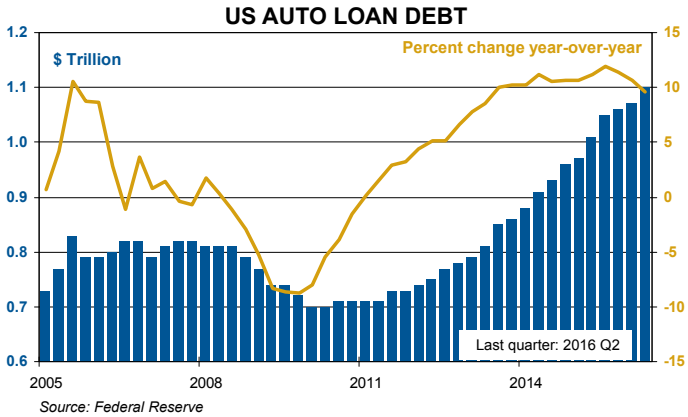
Total US household debt, at $12.3 trillion, increased only slightly in 2016-Q2. Mortgage debt, the largest component of household debt, is not increasing significantly, but auto and student debt are. Home equity revolving debt continues to decline.

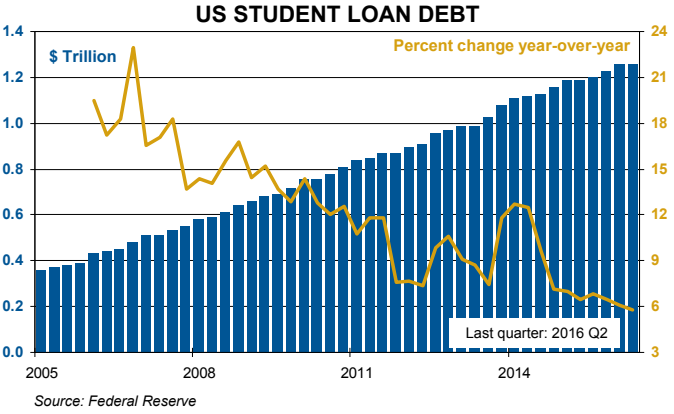






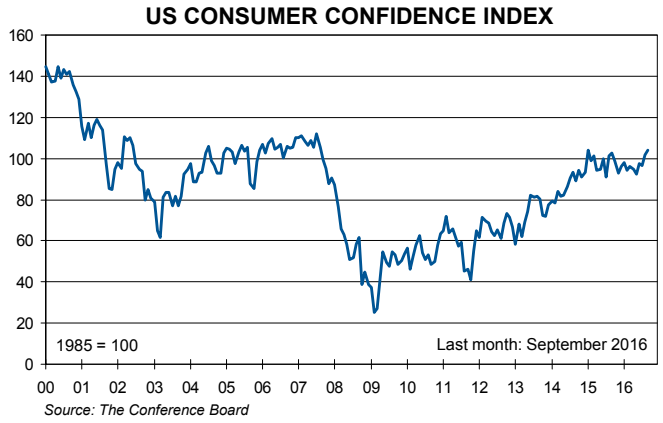




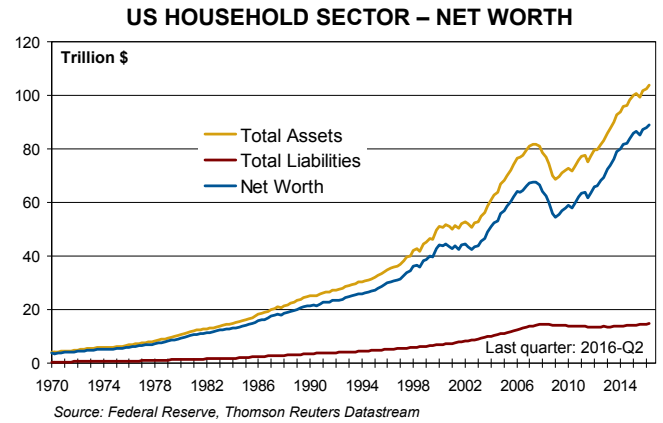


MONTHLY REVIEW ►
UNITED STATES – WEALTH CREATION

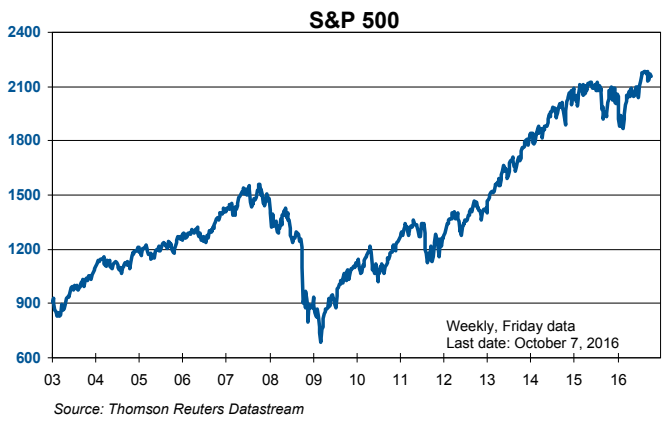
Consumer confidence is on the rise ...



... total household assets (and net-worth) set new highs in 2016-Q2 ...

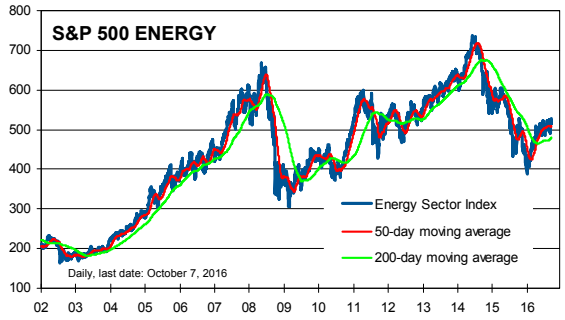


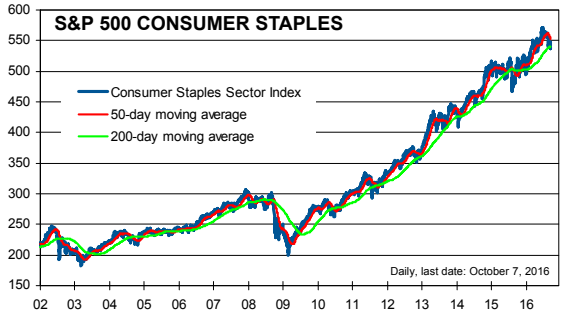
... but US equity markets have come off all-time highs set at the beginning of September.

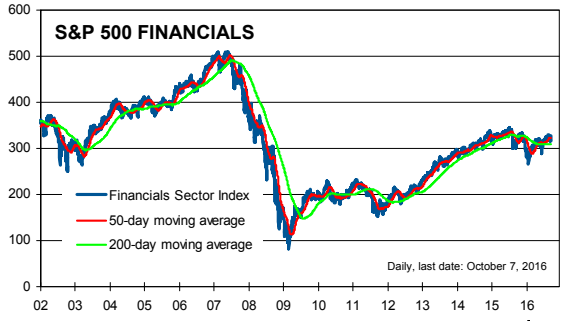


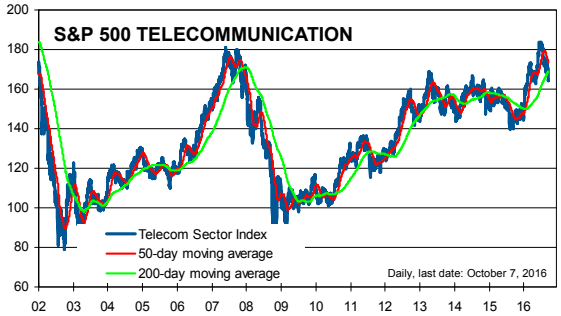
MONTHLY REVIEW ►
UNITED STATES – S&P500 GICS SECTORS

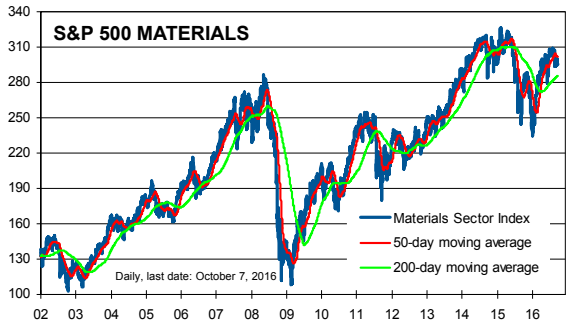
The Energy, Financials, and (to a lesser extent Materials) sectors have lagged the S&P500 index.

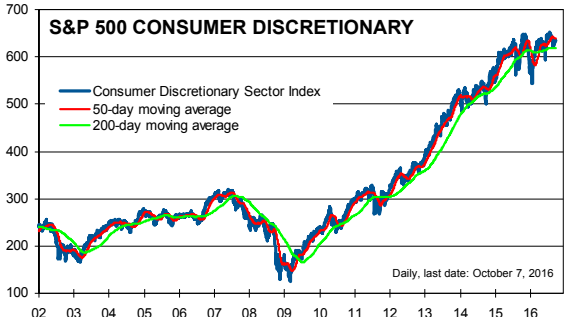


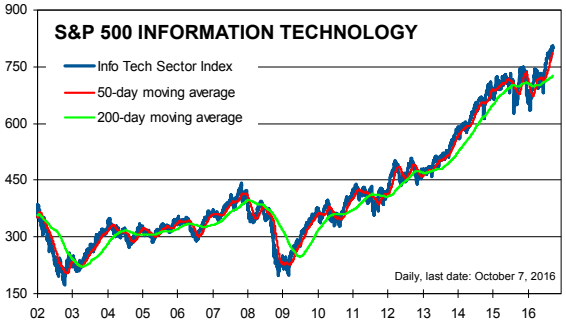


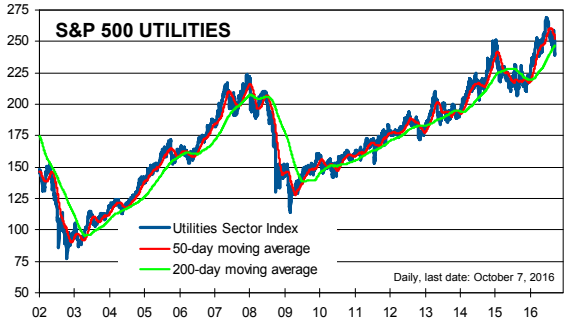








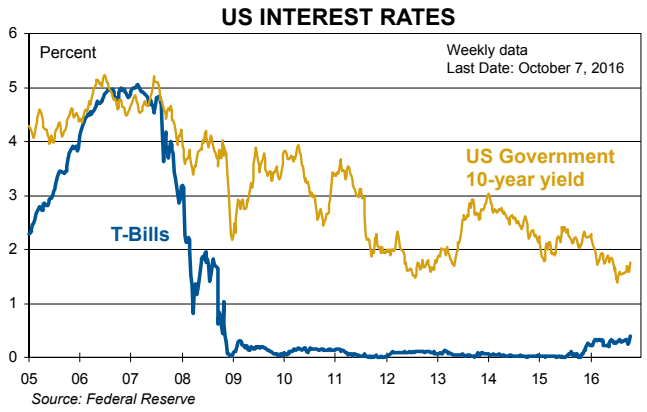




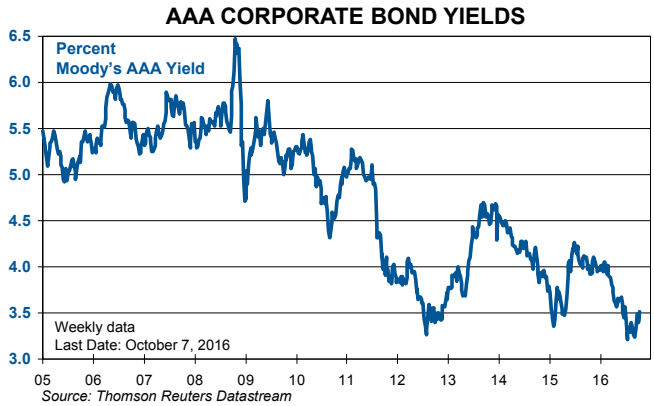
Source: Thomson Reuters Datastream

MONTHLY REVIEW ►
UNITED STATES – INTEREST RATES

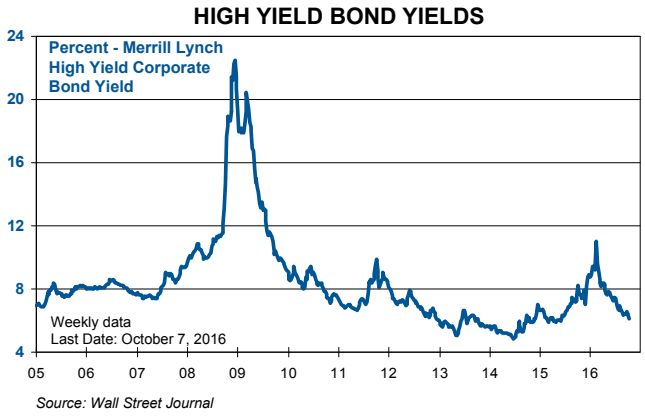
The yield on 10-year Treasuries has increased slightly from recent lows.



The yield on AAA corporate bonds has risen in recent weeks but remains very low ...



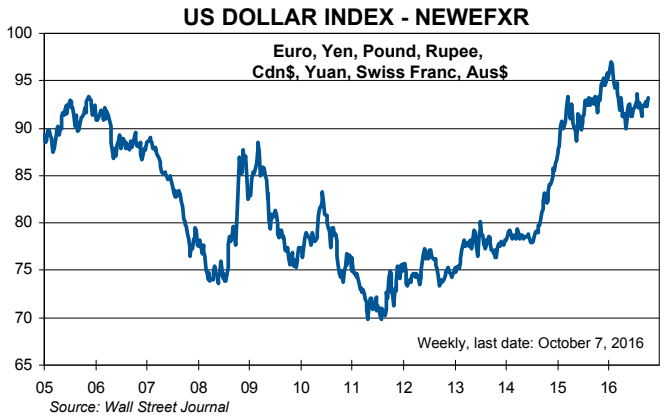
... but the yield on high-yield bonds have declined.

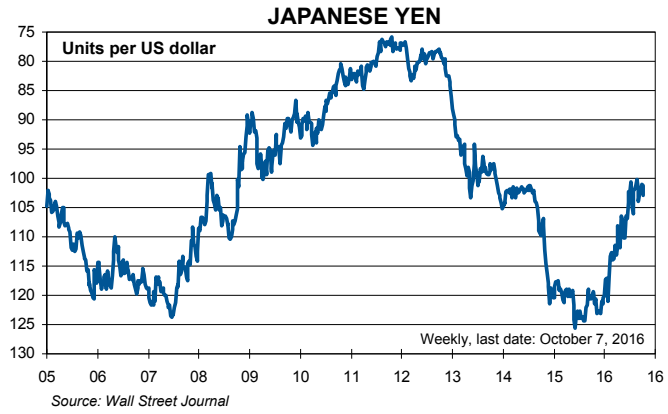


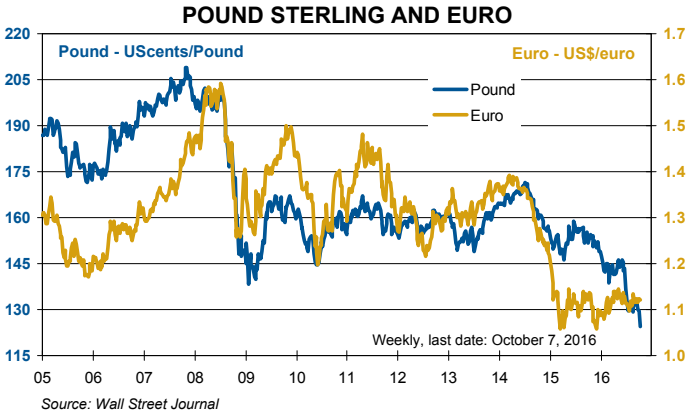
The US dollar has trended sideways in recent months.

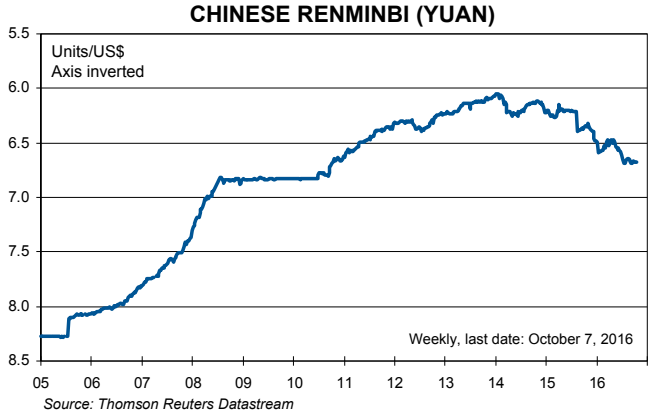
We think the dollar has peaked for this cycle ...

... but its decline will be slow and hesitant. (The UK pound has declined significantly since the BREXIT vote for example, which affects the US dollar index.)





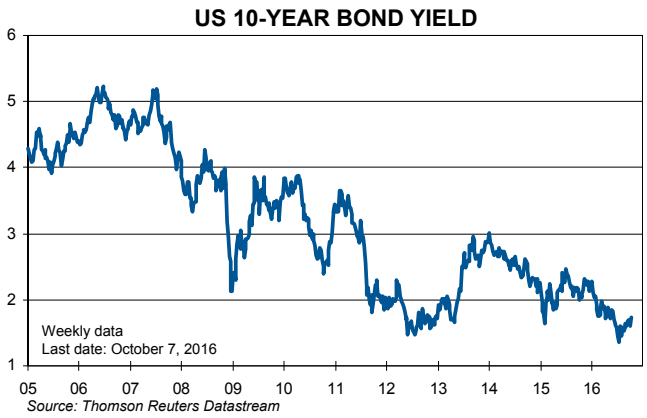


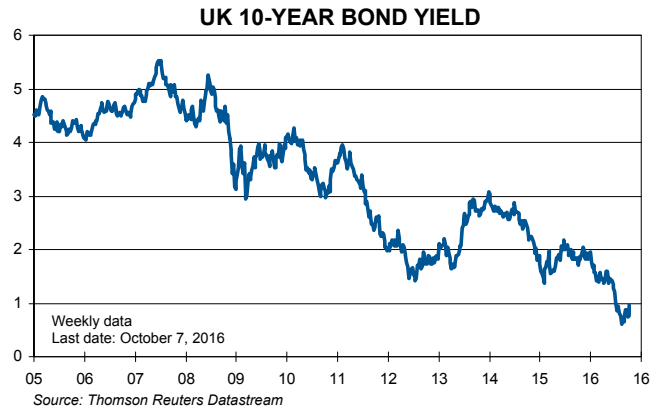


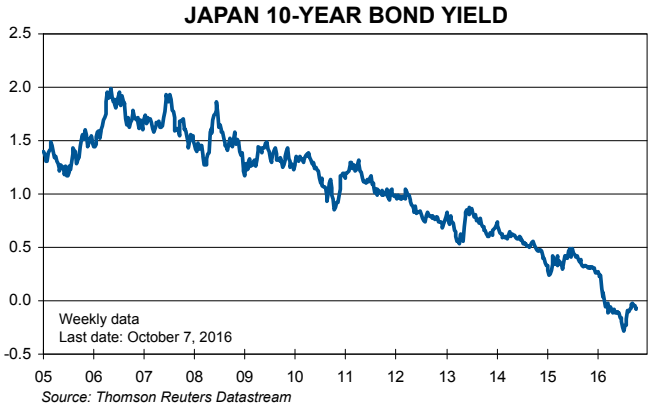
MONTHLY REVIEW ►
INTERNATIONAL – BOND YIELDS

Government bond yields are off recent lows, and may well have bottomed, finally, for the cycle.

Ironically, US Treasuries are "high yield" government bonds these days ... !

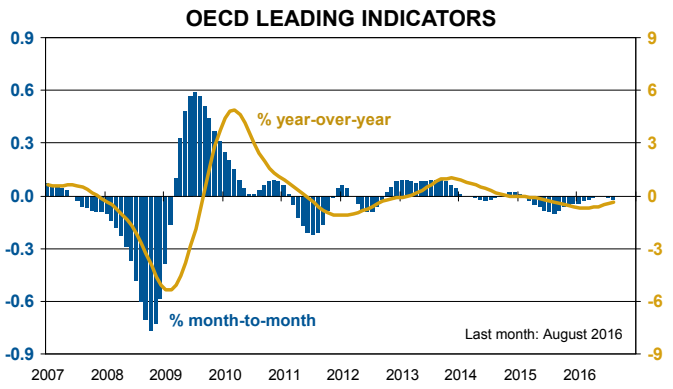


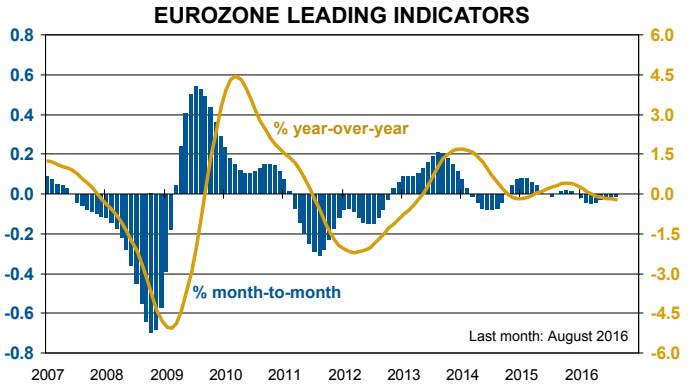


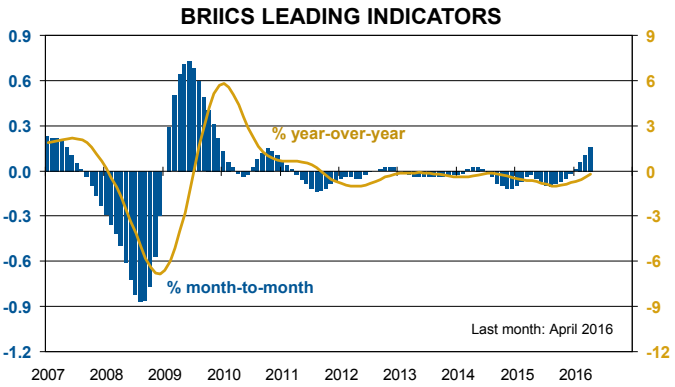


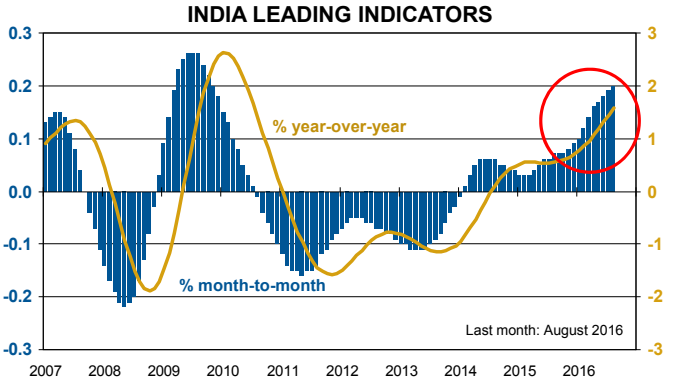
MONTHLY REVIEW ►
INTERNATIONAL – LEADING INDICATORS

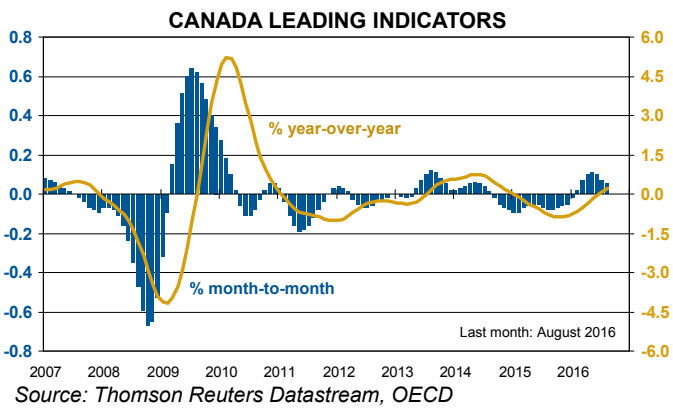
The OECD's leading indicators point to subdued growth, with the exception of India's LI.

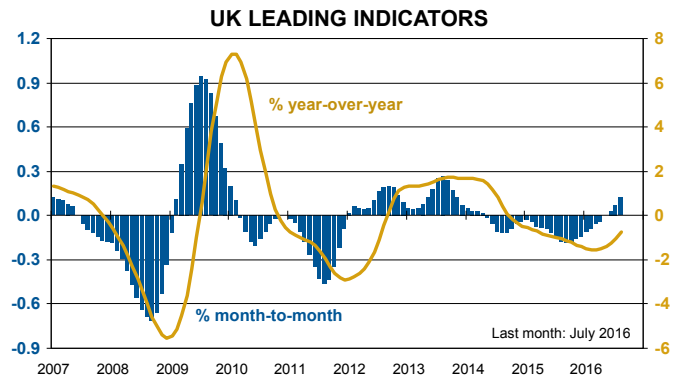










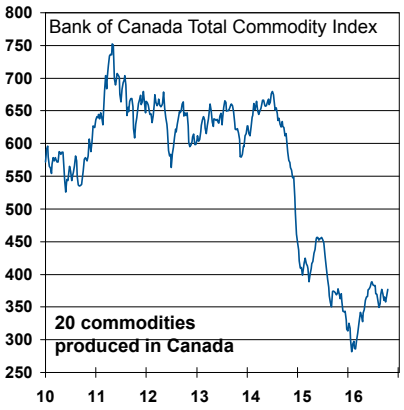


Source: Thomson Reuters Datastream, OECD

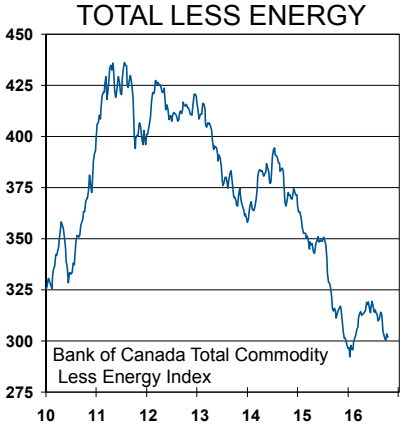
COMMODITY PRICES

1. Bank of Canada Commodity Price Indices (Weekly data to October 7, 2016)

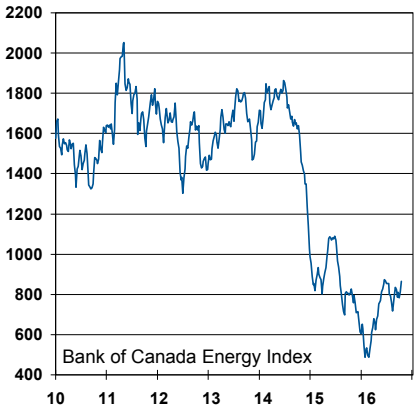
TOTAL COMMODITY



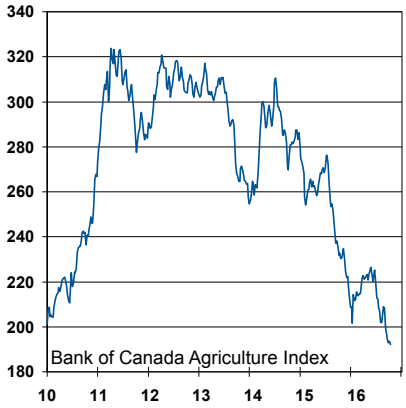
TOTAL LESS ENERGY



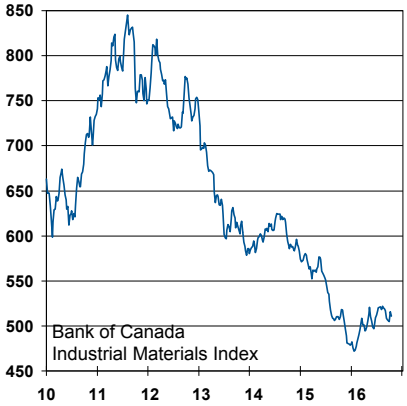
ENERGY



AGRICULTURE



METALS AND MINERALS

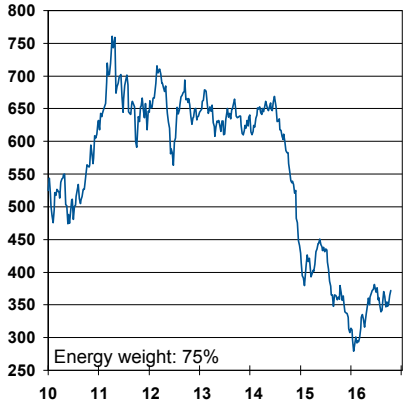


The recent uptrend in commodity prices has stalled ...

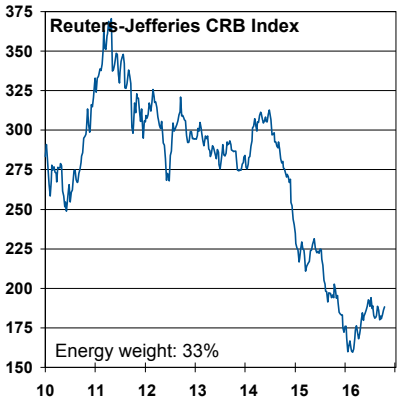
... but if we are right on the US dollar rolling over, we'd expect some improvement in commodity prices in 2017.

2. Other Indices (Weekly data to October 7, 2016)

S&P GSCI COMMODITY



REUTERS/JEFFERIES CRB



ECONOMIST COMMODITY PRICE

Sources: Bank of Canada, Thomson Reuters Datastream, The Economist

COMMODITY PRICES

3. Metals (Weekly data to October 7, 2016)

NICKEL

COPPER

ZINC

ALUMINUM

LEAD

GOLD

PLATINUM

SILVER

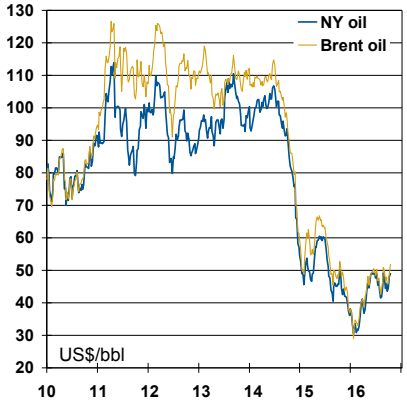
The price of metals dependent upon global growth (i.e. copper) remain subdued. Gold and silver have declined slightly on concern that central banks are going to end QE programs.

Sources: LME, LBMA, Wall Street Journal

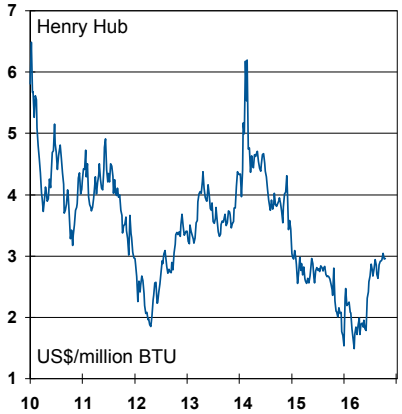
COMMODITY PRICES

4. Energy (Weekly data to October 7, 2016)

SPOT OIL PRICES



NATURAL GAS



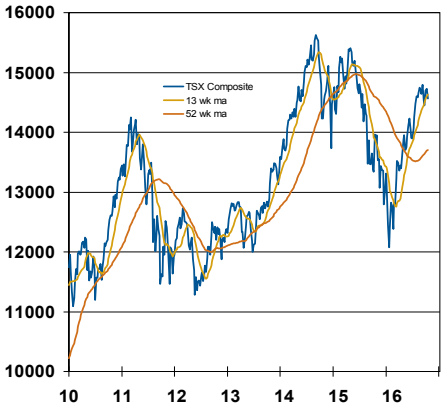
Oil prices increased to just over $50 per barrel after OPEC agreed to limit production.

However, nothing is certain when it comes to OPEC, so we'll have to wait and see. Low oil prices are hurting OPEC revenues however ... !?

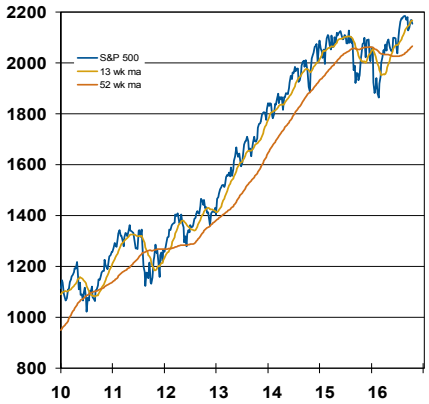
EQUITY MARKETS

5. North America (Weekly data to October 7, 2016)

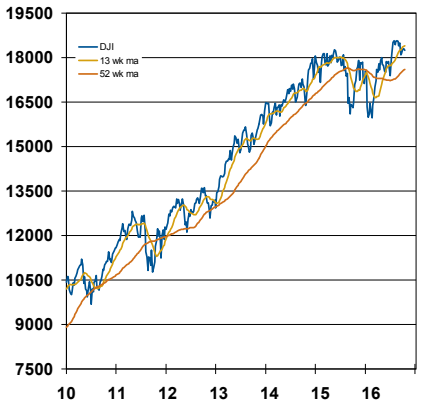
S&P/TSX INDEX



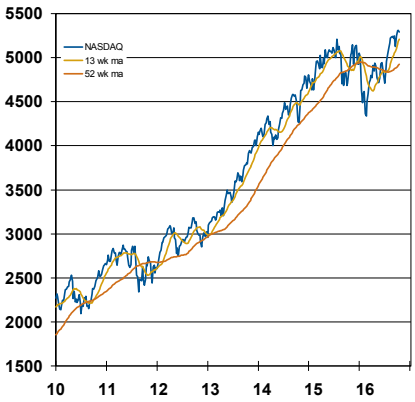
S&P500 INDEX



DOW JONES INDUSTRIALS



NASDAQ INDEX



North American equity markets have retreated from recent highs. We remain constructive on the S&P 500 and S&P/TSX , but we cannot rule out significant volatility this fall. The US political environment is still very uncertain and US growth remains subdued.

Source: Thomson Reuters Datastream

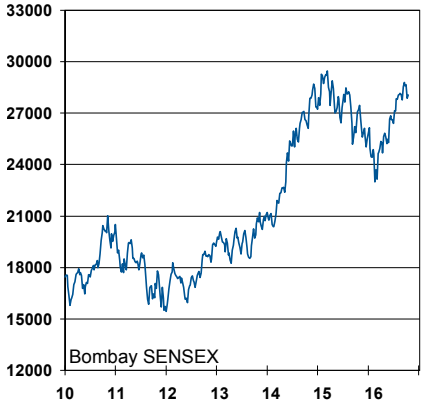
EQUITY MARKETS

6. Around the world (Weekly data through October 7, 2016)

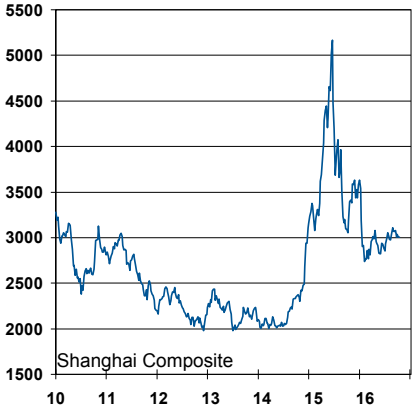
JAPAN

GERMANY

INDIA



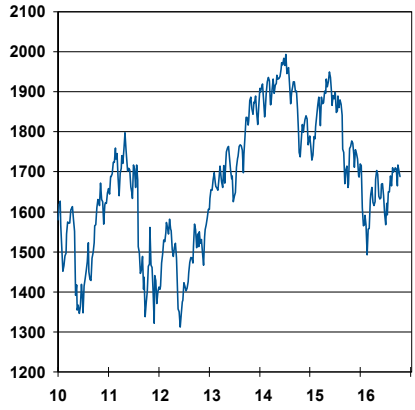
CHINA



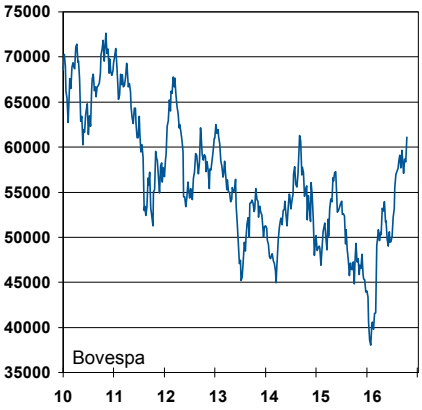
RUSSIA

MEXICO

MSCI EAFE INDEX



BRAZIL



MSCI WORLD INDEX

Source: Thomson Reuters Datastream

Exchange Rates - Comparison of Scenarios*

	Actual				Projected						
	16-I	16-II	16-III	12-Oct	Nov	Dec	Jan	17-I	17-II	17-III	17-IV
US Dollar incl Cdn$											
Scenario A					99.32	101.5	103.6	105.2	108.0	108.6	109.1
Scenario B	***98.69***	***93.61***	***93.66***	***95.80***	***95.01***	***95.32***	***95.17***	***95.17***	***94.43***	***93.45***	***92.02***
Scenario C					92.49	91.44	90.41	89.21	85.89	84.25	83.16
Probability-Weighted					***95.51***	***95.98***	***96.18***	***96.31***	***95.82***	***95.09***	***94.22***
Canadian Dollar											
Scenario A					1.385	1.400	1.420	1.440	1.465	1.470	1.475
Scenario B	***1.373***	***1.288***	***1.304***	***1.326***	***1.330***	***1.340***	***1.335***	***1.335***	***1.330***	***1.325***	***1.325***
Scenario C					1.300	1.295	1.290	1.280	1.255	1.250	1.245
Probability-Weighted					***1.336***	***1.344***	***1.345***	***1.348***	***1.345***	***1.343***	***1.343***
Japanese Yen											
Scenario A					106.0	109.0	111.0	112.5	115.0	116.0	116.0
Scenario B	***115.4***	***108.2***	***102.5***	***104.2***	***100.5***	***100.5***	***100.5***	***100.5***	***100.0***	***99.5***	***98.5***
Scenario C					99.0	98.0	97.0	96.0	93.0	91.00	90.00
Probability-Weighted					***101.5***	***102.0***	***102.3***	***102.4***	***102.0***	***101.5***	***100.8***
British Pound											
Scenario A					116.6	112.3	108.0	104.9	98.7	97.2	95.3
Scenario B	***143.1***	***143.5***	***131.6***	***122.2***	***121.0***	***121.0***	***121.0***	***121.0***	***122.1***	***124.2***	***128.4***
Scenario C					126.5	129.9	133.3	136.8	146.2	152.2	157.2
Probability-Weighted					***120.8***	***120.2***	***119.6***	***119.3***	***119.9***	***121.7***	***124.2***
Euro											
Scenario A					1.060	1.030	1.000	0.980	0.940	0.935	0.925
Scenario B	***1.102***	***1.129***	***1.116***	***1.102***	***1.100***	***1.100***	***1.100***	***1.100***	***1.120***	***1.150***	***1.200***
Scenario C					1.140	1.160	1.180	1.200	1.260	1.290	1.310
Probability-Weighted					***1.100***	***1.098***	***1.095***	***1.095***	***1.110***	***1.131***	***1.159***
Australian Dollar											
Scenario A					70.76	69.64	68.31	67.36	65.87	65.65	65.42
Scenario B	***72.14***	***74.60***	***75.71***	***75.67***	***75.19***	***74.63***	***74.91***	***74.91***	***75.19***	***75.47***	***75.47***
Scenario C					77.69	77.99	78.29	78.91	80.48	80.80	81.12
Probability-Weighted					***74.71***	***74.22***	***74.10***	***74.02***	***74.18***	***74.35***	***74.37***
Chinese Yuan/Rmb											
Scenario A					6.800	6.850	6.950	7.050	7.300	7.500	7.600
Scenario B	***6.542***	***6.534***	***6.667***	***6.719***	***6.720***	***6.750***	***6.800***	***6.800***	***6.850***	***6.700***	***6.500***
Scenario C					6.720	6.720	6.710	6.700	6.500	6.350	6.200
Probability-Weighted					***6.740***	***6.768***	***6.815***	***6.838***	***6.875***	***6.813***	***6.700***
Indian Rupee											
Scenario A					68.50	69.75	71.00	72.00	73.50	74.00	75.00
Scenario B	***67.50***	***66.89***	***66.97***	***66.82***	***67.00***	***67.50***	***68.00***	***68.00***	***68.00***	***67.00***	***66.00***
Scenario C					66.25	65.75	65.25	64.75	64.00	63.50	63.00
Probability-Weighted					***67.19***	***67.63***	***68.06***	***68.19***	***68.38***	***67.88***	***67.50***

* Scenario A: Pound/Euro/RMB Weak - US Dollar Very Strong - Non-US Growth Weakens
Scenario B: Modest US Growth - Clinton Administration Attemps Dollar Weakening
Scenario C: Fed Does Not Hike - Brexit Delayed - ECB/BoJ End QE

Source: WSJ, Thomson Reuters Datastream, Dundee Economics

Interest Rates - Comparison of Scenarios

	Actual				Projected						
	16-I	16-II	16-III	12-Oct	Nov	Dec	Jan	17-I	17-II	17-III	17-IV
Canadian Interest Rates											
T-Bills (91-day)											
Scenario A					0.53	0.54	0.55	0.65	0.90	1.15	1.30
Scenario B	***0.46***	***0.52***	***0.53***	***0.50***	***0.51***	***0.50***	***0.50***	***0.50***	***0.50***	***0.50***	***0.50***
Scenario C					0.50	0.25	0.25	0.20	0.20	0.20	0.20
Probability-Weighted					***0.52***	***0.48***	***0.48***	***0.51***	***0.60***	***0.68***	***0.74***
10-year Bonds											
Scenario A					1.40	1.55	1.70	1.90	2.15	2.35	2.50
Scenario B	***1.20***	***1.33***	***1.04***	***1.21***	***1.20***	***1.30***	***1.25***	***1.35***	***1.45***	***1.50***	***1.60***
Scenario C					0.90	0.80	0.75	0.65	0.60	0.55	0.50
Probability-Weighted					***1.23***	***1.31***	***1.33***	***1.44***	***1.57***	***1.66***	***1.75***
Target Overnight Rate											
Scenario A					0.50	0.50	0.50	0.58	0.83	1.08	1.25
Scenario B	***0.50***	***0.50***	***0.50***	***0.50***	***0.50***	***0.50***	***0.50***	***0.50***	***0.50***	***0.50***	***0.50***
Scenario C					0.50	0.25	0.25	0.25	0.25	0.25	0.25
Probability-Weighted					***0.50***	***0.46***	***0.46***	***0.49***	***0.58***	***0.67***	***0.73***
US Interest Rates											
T-Bills (90-day)											
Scenario A					0.44	0.46	0.58	0.75	0.92	1.08	1.25
Scenario B	***0.29***	***0.26***	***0.31***	***0.36***	***0.36***	***0.57***	***0.60***	***0.60***	***0.60***	***0.60***	***0.68***
Scenario C					0.35	0.32	0.32	0.20	0.10	0.08	0.05
Probability-Weighted					***0.39***	***0.49***	***0.55***	***0.59***	***0.64***	***0.69***	***0.79***
10-year Bonds											
Scenario A					1.95	2.10	2.25	2.45	2.70	2.95	3.10
Scenario B	***1.82***	***1.72***	***1.58***	***1.77***	***1.75***	***1.85***	***1.85***	***1.95***	***2.10***	***2.15***	***2.25***
Bonds - Scenario C					1.50	1.40	1.30	1.15	1.05	1.00	0.95
Probability-Weighted					***1.78***	***1.87***	***1.91***	***2.01***	***2.15***	***2.26***	***2.35***
Fed Funds Rate											
Scenario A					0.60	0.62	0.63	0.77	0.93	1.10	1.27
Scenario B	***0.36***	***0.37***	***0.41***	***0.44***	***0.44***	***0.60***	***0.62***	***0.62***	***0.62***	***0.62***	***0.70***
Scenario C					0.41	0.39	0.37	0.25	0.12	0.10	0.10
Probability-Weighted					***0.49***	***0.58***	***0.59***	***0.62***	***0.65***	***0.71***	***0.81***

*Scenario A: Growth/Inflation Accelerate - Four Fed hikes
Scenario B: Fed Hikes in December - Bank of Canada Stands Pat
Scenario C: US Growth Stalls - Fed and Bank of Canada Cut Rates

Source: WSJ, Thomson Reuters Datastream, Dundee Economics

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