Here’s What We’re Thinking  

6/13/2019

**Investment Strategy**

Softening economic data in the U.S. bolsters case for U.S. Federal Reserve rate cut. Calls for the U.S. Federal Reserve (Fed) to cut interest rates are ringing loudly these days amid persistently soft inflation data, modestly deteriorating labour market statistics, and an economy embroiled in a trade feud with China. The market-implied odds of a July cut increased after this week’s inflation reading. Fed funds target rate futures now indicate almost 25bps of easing in the next two months. The effects of the prolonged trade spat with China are starting to affect the United States. Corporate investment outlooks are less certain, economists are less confident in their growth expectations, and consumers face increased prices for core goods.

However, we do not expect a recession in 2019. Higher prices can depress consumption and may lead to lower corporate investment as companies grow concerned about future demand. Reassuringly, U.S. consumers have maintained spending levels amid rising wages and tight labour markets. Because of this, we do not expect a recession in 2019, but we do expect growth to decelerate and financial markets to remain volatile. In the very near-term, growth concerns should be placated by fiscal and monetary stimulus efforts in other parts of the world. A Fed rate cut would likely extend the current economic cycle and help reset market expectations for growth and inflation, though we believe the bar for a rate cut has been set quite high. In particular, we think economic fundamentals would need to deteriorate significantly in order for the Fed to act.

**Equities**

Tariffs could depress U.S. corporate earnings by 5%-10% in a worst-case scenario. The scenario analysis in Figure 1 depicts how tariffs on U.S. imports of Chinese goods may affect corporate margins and earnings. We used imports from China as a percentage of U.S. GDP to approximate the percentage of U.S. corporate costs tied to Chinese goods. We then assumed a 50%/50% fixed/variable cost structure to estimate the effect of tariffs on profitability. Further, we adjusted sales growth (consensus for 2019 is ~4%) to show how a positive, or negative, sales surprise could lessen, or deepen, the effect of tariffs.

**Figure 1: Scenario analysis shows tariffs could depress S&P500 earnings and margins**

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<th>Deviation from Sales Growth Expectation</th>
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Sources: Scotia Wealth Management, Bloomberg

**G20 in Japan next way station for potential U.S.-China trade agreement.** By his own admission, U.S. President Donald J. Trump is holding up trade negotiations until the G20 summit in Osaka, Japan at the end of June. Mr. Trump continues to threaten new and higher tariffs, while demanding that the U.S. and China return to the tentative agreement they reached in April. Recall, it was at that point the Chinese reportedly reneged on some parts of the agreement and negotiations fell apart. New and existing tariffs distort firms’ investment outlooks and force them to re-engineer their supply chains. Such initiatives are already underway at a number of major, multinational companies. Despite heightened rhetoric and renewed...
tensions, we continue to expect the U.S. and China will reach an agreement because doing so is in the best interest of both parties.

**Fixed Income**

The European Central Bank (ECB) expects rates to remain at their current levels through 1H20. The ECB pushed out its forward guidance for a potential rate hike last week, stating it expects rates to remain at their present level until “at least the summer of 2020”, in contrast with prior guidance of “through the end of 2019”. The Governing Council also made changes to its expectations for GDP growth and inflation in 2019 and 2020. Importantly, the ECB clearly conveyed its willingness to “act in case of adverse contingencies”. That phrase, which was included in both the ECB’s meeting statement and President Mario Draghi’s press conference, underscores the ECB’s commitment to supporting GDP growth and achieving its 2% symmetric inflation target.

**TLTRO-III to be used as a backstop.** Details of the third iteration of the ECB’s Targeted Long-Term Refinancing Operations (TLTRO-III) were announced concurrently with last week’s press conference. TLTRO-III is slightly less attractive than its predecessors. The new rate on loans will be 10 basis points higher than it was under TLTRO-II, incenting banks to fund themselves in traditional money markets. President Draghi asserted the new program was designed as a backstop to avoid an increase in funding costs that could choke off consumer loan growth in Europe. Further, the ECB indicated it would be willing to inject liquidity in markets if necessary and to use all of the tools at its disposal should any additional downside risks materialize.

**Economics**

The European Commission (E.C.) launches excessive deficit procedures for Italy. At the core of the disagreement between the European Commission (E.C.) and the Italian government are dissenting views regarding the path to recovery. As shown in Figure 2, the E.C. sees Italy’s deficit-to-GDP ratio widening to 3.6% in 2020 from 2.4% in 2019, whereas the Italian Treasury forecasts it will narrow to 1.4% from 1.5%. Further, the E.C. estimates that the size of the output gap, the difference between current economic output and an economy’s long-term potential output, is smaller than the prediction of the Italian Treasury. The two sides disagree on Italy’s future growth potential and the likelihood that the country’s economy overheats as its recovery unfolds.

**Figure 2: Italy’s economic prospects depend on who you ask**

![Graph showing deficit-to-GDP ratio for Italy](image)

Sources: Scotia Wealth Management, Bloomberg

**Credibility issues are at the heart of divergent views.** The primary reason Italy’s forecast differs from the E.C.’s is that Italian officials assume an increase in the country’s value-added-tax (VAT) while the E.C. does not. A VAT is a consumption tax placed on a product at each value-added stage in the supply chain, from production to point of sale. The E.C. has excluded an increase in its estimates, believing Italian officials’ plans for an increase are insufficiently detailed and therefore not credible. The E.C. is most concerned with whether a country’s fiscal position is improving or deteriorating, rather than whether the country strictly adheres to the E.U.’s rules. Accordingly, we do not believe the impasse between Italy and the commission will be resolved anytime soon.

**Geopolitics**

Mexico takes action to stem flow of South American migrants. Late last Friday, President Trump announced he would not impose tariffs on U.S. imports of Mexican goods. The Mexican government committed to deploying National Guard troops to curb illegal immigration but did not confirm President Trump’s
claim that Mexico would also buy “large quantities” of U.S. agricultural products. Additionally, the claim was not included in the two countries’ joint statement.

**United States-Mexico-Canada Agreement (USMCA) back on the table.** With the U.S. and Mexico having reached an agreement to avoid new tariffs over the weekend, the path forward for the USMCA is slightly less murky. Both Canada and Mexico had conditioned a final agreement on complete removal of trade restrictions among the three countries. The path to approval in both Canada and Mexico is less complex than it is in the United States. The détente secured over the weekend puts the three countries in a better position to make the USMCA a reality.
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