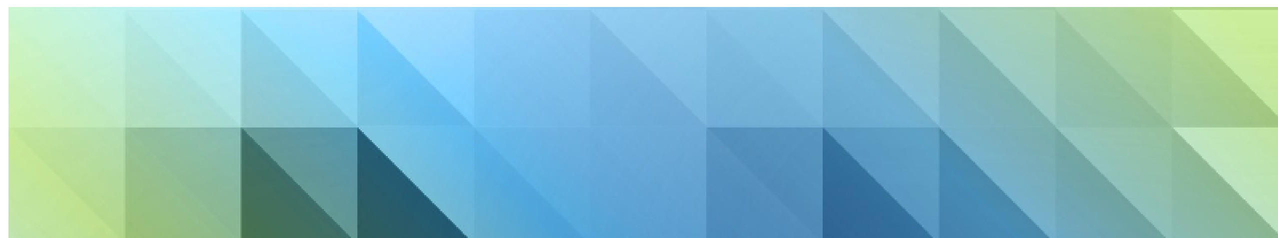

# Market Update

27 October 2017

**In America, the house of representatives narrowly approved a Senate approved 2018 federal budget clearing the way for the GOP controlled senate to pass a massive set of tax cuts later this year.** The entire approval of tax cuts should have been a slam dunk not a grinding narrow victory. Finally, the world's largest economy is shifting away from monetary stimulus to fiscal stimulus. However, monetary tightening may not be as linear as forecasted, due to a lack of sustained inflationary pressure that failed to materialize in developing countries which will put central bankers on hold as they look to further raise interest rates. President Trump must now put his money where his mouth is, as the opportunity to replace Fed Chairwoman Janet Yellen has materialized. The two mentioned front runners for the job are Fed Governor Jerome Powell and Stanford Economist John Taylor. By replacing Fed Chair Yellen, Trump risks disrupting and spooking equity markets. Fed Chairwoman Yellen has been systematic in telegraphing change without creating market upheaval. America's economy grew at a solid annual rate of 3% in the third quarter. It marks the first time in three years that growth has hit at least 3% for two consecutive quarters.

The Commerce Department reported Friday that the July thru September advance in the Gross Domestic Product (GDP) followed a 3% rise in the second quarter. It was the strongest two quarter showing since back to back gains of 4.6% and 5.2% in the second and third quarters of 2014.

The economy accelerated this summer despite the impact of

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hurricanes Harvey and Irma, which many private economists believe shaved at least 50 basis points off GDP. Even with two major hurricanes making landfall in the America, the economy made significant progress. Outside of the areas directly impacted by the hurricanes, there are few signs of weakness.

The third quarter performance was certain to be cited by President Trump, who pledged during last year's campaign that his economic program would boost growth from the anemic 2.2% averages seen since the country emerged from the Great Recession during 2009. Private economists believe even 3% annual gains will be hard to achieve for an economy facing a slowdown in productivity and an aging workforce.

Hurricane Harvey made initial landfall in Texas on August 25th, and Irma hit Florida on September 10th. Government reports made clear various sectors ranging from oil and gas refineries in Texas to farming in Florida were all affected. However, it could not break out estimates of how much the hurricanes had decreased economic growth. Private economists have estimated that the storms sapped anywhere from 50 basis points to 1% from GDP. Analysts believe much of the lost output will recover as rebuilding begins. The 3% growth rate for third quarter GDP and the 3.1% increase in the second quarter followed a much weaker 1.2% increase in the first quarter. Many analysts believe growth in the current quarter will come in around 2.7%. The House of representatives this Thursday gave approval to a Republican budget that would provide for $1.5 trillion in tax cuts over the next decade. Administration officials have said the tax cuts will spur faster growth and the faster growth will erase much of the cost of the tax cuts. Democrats and many private economists have challenged that forecast.

The European economy is humming again except for Britain, where fears about the effect of the country’s exit from the European Union are taking an increasingly heavy toll on business and consumer confidence. Manufactures in the Eurozone rounded off the first half of 2017 by ramping up at the fastest rate for over six years, according to closely watched purchasing manager indexes (PMI) released Monday by the research firm IHS Markit. June’s manufacturing PMI for the Eurozone rose to 57.4, its highest since April 2011 and up from May’s 57.0. Suggesting EU

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momentum will continue into the second half, new orders rose at the fastest rate since early 2011, backlogs of work increased at the fastest pace in over 13 years, raw materials were depleted and factories increased headcount at a near record pace. The upturn was particularly strong in France and Italy, with German business confidence hit an all time high in June.Prime Minister Theresa May is pleading with EU leader to allow the United Kingdom a two year window to transition out of the EU while continuing to make transfer payments to the EU in order maintain trade agreements. Another optical hot spot erupted in Europe as Catalonia looks for independence from Spain putting an already struggling economy in deeper hardship.

Oil prices on the Brent crude side moved to their highest by comments made by Saudi Arabia's Crown Prince Mohammed bin Salman at $59.30 a barrel. It is important to note that Saudia Arabia is famous for such rhetoric. West Texas Intermediate (WTI) was more impervious to the comments, but it also gained a few cents, to close at $52.64 a barrel, the highest in six months.

The comments themselves include reassurance that the Aramco initial public offering is still on track for its scheduled takeoff in the second half of 2018, a vague pledge to do whatever it takes to support oil prices; and lastly, a vow to quit its oil dependency and move beyond fossil fuels at some point. Regardless these assurances have all been made many times before. The comments from Crown Prince Mohammed bin Salman add to the already growing optimism about OPEC's production cut deal, which will almost certainly be extended until the end of next year, after Russia and now Saudia Arabia have backed an extension.

China's leadership is full of support and talk of continued globalization and full integration of world markets. However, digging a bit deeper beyond the party slogans's we find President Xi Jinping looking to extend his grip beyond China and be a dominate force in global trade thus putting China as the defect super power. Military dominance by China is not possible, however economic dominance they believe is within sight. Government funding to lead the world from robotics to electric cars is gargantuan. The scope of such ambitious programs is called "Made in China 2025". The fallout of such policies is North America

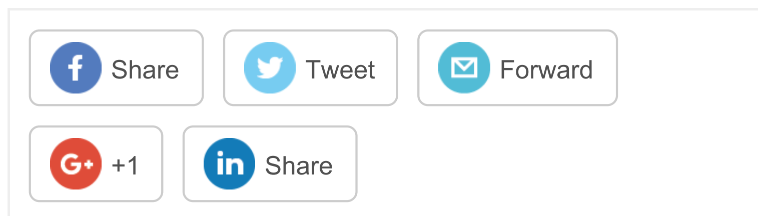
and the EU coming together and forming one trading block, while China focuses on Asia and Africa. Realistically speaking, for any economic engine it is all about momentum and sustainability of such traction. Chinese leadership faces 4 major hurdles: An aging population, unchecked environmental concerns, the transition of state run enterprises into private hands and the shift out of manufacturing and into consumer services. Leadership cannot do much about aging demographics outside easing the one child policy. Regarding environmental concerns it intends to have combustion engines replaced by electric vehicles. As per the last two major hurdles, there are about 100 state owned super corporations in China with an average return on assets of 2.9%. To put this in perspective privately held Chinese firms of the same size are retiring 10.2%. State owned firms serve to fulfill the social agenda's of the Party by keeping employment high and investment inflows strong with little regard to corporate profitability. China will continue to reject privatization as it wishes to retain not just political but economic control in China as it has done in the past 40 years. Lastly, regarding the transition from a manufacturing world to a consumer services world, China would need to make all their citizens wealthier in order to afford such a transition. Wealthy economies transition to a service economy with some pain, while economies that rely on simple and elementary manufacturing to provide jobs require decades to do so.

The Bank of Canada decided to maintain interest rates. Governor Poloz estimates that the economy is operating close to its potential. However, wages and other data indicate that there is still slack in the labour market. This suggests that there could be room for more economic growth than the Bank is projecting without inflation rising materially above target. Additionally, housing and consumption are forecast to slow in light of policy changes affecting housing markets and higher interest rates. Due to high debt levels, household spending is likely more sensitive to interest rates than in the past. So the BoC put on hold another interest rate hike with the next announcement coming December 6th, 2017.

Finance Minister Bill Morneau announced this week that Canada's economic success in 2017 is driven by government policy. Let's dig a little deeper. Of the 3.1% growth expected this year nearly 40%

came from the second quarter which was directly driven by the resurgence of the energy sector. Also, unrelated to government policy, exports boosted first quarter GDP, specifically fuelled by the auto sector. The child benefit payments were intended to spur consumer spending, but it only had a one time boost elect rather than the promised long term driver of economic growth. Rampant spending coupled with tax hikes to pay off the spending will damage and not drive long term economic growth. How does the government plan to pay off all this newly accumulated debt? Simple — slowly but surly raise taxes first on corporations and next on citizens. So brace yourselves.

On a more positive note, the IMF has reported that Canada will lead the G7 nation in economic growth for 2017, 2018 and into the early part of 2019. As small silver lining in a large dark cloud formation.

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