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Market Update

03 March 2017

President Trump's first address to congress that surpassed critics expectations, is having a major uplifting of markets. The well composed and executed address to congress did lack substance and detail which markets will be looking for in the days to come. Since the President Tump election, markets have focused on the potential for fiscal policy stimulus such as tax cuts and spending increases, all designed to boost the American economy. But over the last few days, there has been a reminder that monetary policy, which for much of the period 2008, still has the potential to have a big impact. The possibility of a rise in rates from the Federal Reserve this month overshadowed President Donald Trump's speech to Congress.

The headline inflation rate is expected to be 2%, although the core rate is forecast to be stable at 1.7%. The unemployment rate is 4.8% and wage growth has edged higher to 3.2%, well below pre 2007 rates of increase. Ironically the post-election euphoria of the markets may have convinced the Fed that this would be a good time to act.

Whether it is low financial stress, ultra low market volatility, solid American economic data flow, firmer inflation, the American dollar has given up half of its post election gains, stocks at the all time highs and treasury yields are well off the recent highs add to the fact that the global economic backdrop is improving makes a March

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interest rate hike extremely digestible. Consensus is quickly building in this very direction. As we enter March, 53% of the earnings reports by corporations have been stated which will bring greater light to the Fed as to the health of corporate America.

A third interest rate increase by the Fed during the current tightening cycle will be less momentous than the first. Longer term, the big issue is when the Fed starts to unwind the asset purchases made during the crisis and shrink their balance sheet. This may take a while. Fed Chair Yellen has suggested that ending the reinvestment process would be equivalent to 0.50% hikes in the interest rates. A big rise in bond yields would be very dangerous for an economy which still has lots of debt, particularly if mortgage rates rise sharply. President Trump tends to steal the headlines, however investors still need to watch chair Janet Yellen closely. Let's not forget the days of Alan Greenspan past Fed Chairman. Interest rates would rise and fall as needed to modulate economic growth and avoid a runaway economy.

The current administration will be shackled by a Federal Reserve that wishes to tighten monetary policy making the prospects of euphoric growth limiting. A planned massive fiscal policy by government needs an accommodative monetary policy. Interest rate hikes achieve the exact opposite. The Federal Reserve and government policy are at odds. Interest rate hikes protect the economy from over heating which acts as a slowing effect to economic growth. Think of it this way, if this was a formula one race, Trump "the driver" wants to break the top speed record, have the best lap times and come in first. A resounding hat trick of the President. However, the Fed wants to avoid wrecking the ultra high performance formula one car and finish first. Unfortunately, Trump set a combative tone with Janet Yellen and the board of governors. The greatest monetary event America embarked on avoided a total collapse of capital markets was the massive tarp bailout of 2008. While the rest of the world resisted such actions and made a grand statement how their economic systems were sound. Since then, the truth has surfaced with most other central

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banks reeling from non action by embarking on dangerous negative interest policies and extreme bouts of deflation.

The realities of Brexit just shook Britain as EU citizens living in the UK express panic as the Home Office (government regulation) will be introduced shortly to remove individuals who do not have proper health insurance and long term residence.

EU members seem to be holding pat as the economic waters are forecast to get even choppier. There are early signs that recovery is crystallizing as employment numbers improve and wage inflation is on the incline. However, private consumption is still the engine of recovery fuelled by better wages. GDP growth is still moderate at 1.6% for 2017 and 1.8% for 2018. Investment growth remains subdued to geopolitical uncertainties. Major headwinds remain for Europe overall with upcoming elections in France, Holland and Germany. Brexit and Grexit represent a long term headwind which will continually erode confidence both in fiscal and monetary policy.

The oil market got a stark reminder Tuesday that rising oil production in America could upend efforts by major producers to bring global supply and demand for crude back in to balance. The Energy Information Administrative reported drilling productivity rose by 41,000 barrels a day in February from January. Oil output from the Permian basin and New Mexico is expected to rise by 53,000 a day. Looking at oil rig counts in America we see a 4th straight week to 591 operating rigs as reported by Hughes Baker. Total rig count is at its highest since October 23rd, 2015. May 2016 represents the lowest rig count. From the bottom to present, rig counts have risen more than 80% and robust production of shale oil in America will threaten OPEC's efforts. By far, America remains the single largest use of hydro carbons. Trump has made it clear that he favours the expansion of an energy self reliant and North America integrated supply chain which is just a continuation of past president George W. Bush.

The People's Bank of China is in the throws of an interest rate tightening cycle which caused a liquidity issue pushing the

demand for Yuan higher which in turn hurt export numbers due to an inflated Yuan.

Our neighbours to the South have an everlasting effect on our nation. The Bank of Canada held its benchmark interest rate steady on Wednesday and warned that it is keeping a watchful eye on significant uncertainties weighing on the outlook for the economy. The scheduled rate announcement arrived as the Central Bank tries to assess the direction of American economic policy under President Donald Trump and the potential fallout from any policy changes.

The BoC has said American proposals, which include a border tax and protectionist policies, would have noted consequences for Canadian investment and exports.

As widely expected, the trend setting target for the overnight interest rate stayed at the same level since July 2015 at 0.5%.

In explaining the decision by Governor Stephen Poloz, the BoC stated improvements seen in recent economic data releases have been consistent with its projections. The BoC expects growth in the fourth quarter of 2016 might come in slightly stronger than predicted due to recent consumption and housing data releases. The Canadian economy outperformed expectations in the final three months of 2016 by growing at an annual rate of 2.6% as reported by Statistics Canada. Latest report on real GDP shows the biggest contribution to the Q4 increase came from household consumption, which rose at an annual rate of 2.6%. Down drafts on economic growth were led by an 8.2 % decline in business investment, which was the ninth consecutive quarterly contraction. Economic consensus had predicted economic growth in the Q4 would expand by 2%, according to Thomson Reuters.

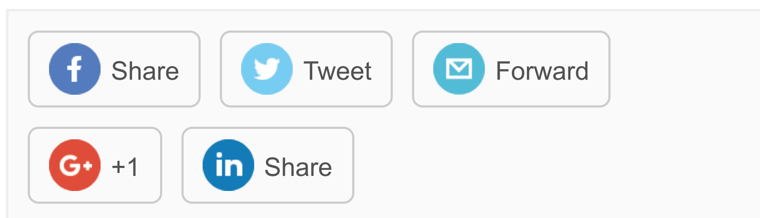
Overall, the economy expanded by 1.4% in 2016 compared to 0.9% growth in 2015.

The real GDP figures were released as the Bank of Canada and the federal government try to gauge the direction of American

economic policy under President Donald Trump. Concern has spread through corporate Canada and Ottawa over the impact of potential changes to taxation and trade policies by Trump's administration.

The Q4 real GDP followed growth in the third quarter at a revised annual rate of 3.8%. Third quarter reading was driven by a strong rebound in energy exports after the devastating spring wildfires in the Alberta oil patch.

As discussed in many recent articles, Canada housing market in Vancouver, GTA and surrounding areas has entered the perfect storm of ultra low interest rates. Lack of supply of single family homes, speculation and climbing foreign money inflows. Once real estate prices exceed annual appreciation of 20%, the entire market becomes unsustainable. Canada did not follow the Reserve Bank of Australia's lead by first decreasing interest rates and then increasing interest rates to 1. Stop the Aussie dollar from appreciating and 2. Temper sizzling hot real estate prices as they soared due to an influx of foreign buyers. A variable fixed 5 year mortgage ranges from a low of 3.74% to a high of 5.25%. Canada has many similarities economically and politically which is why I view Australia as a barometer on how their interest rates fare. For some reason, the BoC always reacts slower to economic changes than the Aussie's. Not since the Bank of Canada Governor Dodge, have we seen an active hand. The BoC plays the wait and see game with America first.



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