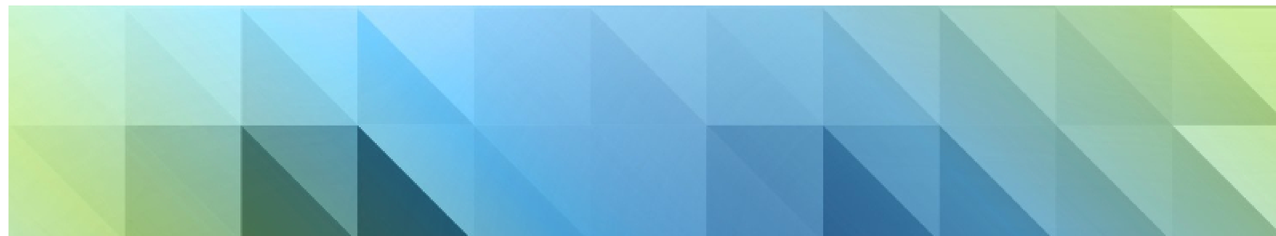

Market Update

10 Feb 2017

America is at full employment. The Federal Reserve is forced to raise rates in order to prevent an economy from overheating because an overheated economy could lead to hyperinflation followed by a depression. Higher rates also enable monetary easing in the future in order to soften the blow when the economy eventually starts contracting.

Regardless of the current administrations attempts to devaluate the green back with rhetoric, the fact is that yields and interest rates are in an upward trend as long as other safe currencies like the Yen, Euro, or the Franc which are at zero or subzero interest rates. The American dollar will appreciate as interest rates and yields increase. A higher dollar makes the economy less competitive and could be the trigger for a reversal in the employment trend.

Rising interest rates bring out higher borrowing costs and higher inflation, which leads to higher wages and eventually shrinking profit margins for corporations. The entire process is best defined as positive feed back. A vicious cycle that leads to an erosion of economic growth. Each and every economy is an intricate machine that is made of millions of parts.

What we all have in common is that we are human and we behave like humans. Human behaviour resists changes and prefers satisfaction now rather than later. Thus, we rush to buy cars, houses, and all other things we think we need as soon as we feel comfortable and positive about the future. Why? The economy is

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growing along with wage inflation leads us to assume that the current trend will replicate into the future. As a result of increased confidence about our financial health we soon start living beyond our means, counting on the next salary increase, bonus or promotion to cover for the difference. As this all progresses another trend starts to take root.

At some point, a small percentage of companies will find it difficult to operate with consistently higher labor and debt servicing costs and will start to trim costs which undoubtedly means job losses.

At the first sign of employment numbers reversing, more tightening occurs as corporations decline to invest in a contracting economy. As we are close to the natural unemployment rate, the big question is where are all the new jobs going to come from. America's economic machine cannot sustain job creation as it has in the last 5 years. A trend reversal is in the cards. It's unnatural for the unemployment rate to stay close to the natural rate for extended periods of time.

As soon as there is less hiring, a negative spiral is triggered. Less employment leads to lower demand for goods. At some point, unfortunately, America enters a recession. The Fed then must lower rates and eventually a new cycle begins. Remember the days of Allen Greenspan.

Let's keep in mind one thing, we are nearing a peak in economic performance. If the current administration cannot bring about solid fiscal policy stimulus such as capital repatriation and infrastructure spending then the Federal Reserve must step in and stimulate through monetary policy. Being at all time lows for interest rates such actions are near impossible.

However, if the current administration does execute on capital repatriation, proposed tax cuts and infrastructure spending then interest rates will tighten quickly and the Fed will dial in further aggressive interest rate hikes. Regarding the current administration, one thing is certain, it has ignited a fire storm within the American political machine and abroad with other friendly and non friendly nations the outcomes of which are not known yet. One thing is clear, bi partisanship in American politics is gone. The

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Democrats will fight and oppose any Trump policy and the media has supercharged its focus on the new administration. Financial markets want the market to push ahead well above the 20,000 mark on the DOW, however administration hick ups are major headwinds.

Economically, the EU is showing promising sign of economic turn around in the northern economy. However as Greece is an indicator that the peripheral states are headed back into deep economic woes. Unlike America and China the EU is not one cohesive country but rather a collective of nations wrapped together for the purpose of a single currency and free movement of trade and people with in the EU. It is still a young union, in present configuration, which has suffered a great blow by the United Kingdom wishing to leave and the full economic fall out. Fiscal reforms will be long, drawn out and hard to come by.

Oil prices have seen steady buoyancy on two fronts: OPEC compliance hits 90% as all the oil cartel countries cut back and the added tension due to potential sanctions on Iran coming together making for ideal conditions for oil to continue rising.

While the government will try to cushion any sharp slowdown, growth will moderate this year on the back of a cooling property market and rising global economic uncertainties. FocusEconomics panelists forecast that the economy will grow 6.4% in 2017, which is unchanged from last month's estimate. In 2018, the panel expects GDP to slow to 6.1%. China PMI index fell again from 51.4%in December to 51.3% in January. The index points to a still contracting China however the index remains above 50% pointing that full economic contraction is not underway.

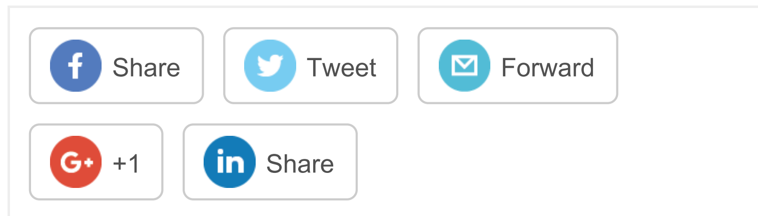
Canada's labour market continues to pump out new jobs, but Canadians are seeing wage increases fade and their work hours shrink. Last month, the job market unexpectedly added 48,300 net new positions, thanks to surges in part-time and private-sector work according to Statistics Canada report. The January employment survey showed an increase of 32,400 part-time positions and a smaller gain of 15,800 jobs in the desirable category of full time employment. Statistics Canada report also found that private sector jobs rose 32,400 between December and

January, compared with an increase of 7,700 public sector positions. An unexpected jump in employment dropped the unemployment rate last month to 6.8% from 6.9%.

December's overall real estate price increases was driven by cities in Ontario that have seen their housing markets boosted by soaring Toronto prices, including Hamilton and Kitchener, where prices climbed 0.3% and 0.8%, respectively.

Tighter mortgage lending rules put in place by federal government last year are anticipated to rein in Canada's housing market, which has been robust since the financial crisis in the midst of low interest rates. Economists do not expect to see the full impact of those changes until later in 2017.

Supply of new houses is down to near lows due to municipalities in Ontario closing off new lands from residential development which has been the major accelerant pushing housing prices sky high. An important note is in order for home prices to stay healthy a key factor is affordability and ongoing wage inflation. In other words, buying power.



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