RBC ECONOMIC RESEARCH

FINANCIAL MARKETS MONTHLY

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Tariff hikes, rate cuts?

What a difference a month can make. The S&P 500 hit a record high on May 3, fueled by optimism around US-China trade talks and improving economic data. But then a sharp turnaround on trade kicked off four consecutive weeks of equity market declines, leaving the index more than 6% lower by the end of May. Not only did the US hike tariff rates on nearly $200 billion in Chinese imports (and threaten to slap duties on all remaining trade with the country), President Trump unexpectedly took aim at Mexico, threatening escalating rounds of tariffs on all US imports from the country (about $350 billion as of last year) unless it does more to stem illegal immigration. The stunning turn of events took place just as Canada, the US and Mexico are making a push to ratify last year's CUSMA (NAFTA 2.0) trade deal. It sent a chill through markets, signaling both that trade agreements provide little protection against protectionism, and that tariffs might be used as a stick even outside the realm of economic policy.

The impact has been even more significant in fixed income markets. 10-year US Treasury yields are now more than 1 percentage point below last year's highs, and close to 2017's lows. Ditto for Canada. Meanwhile, German Bunds hit new, record low yields and UK Gilts are in territory not seen since the aftermath of the Brexit referendum in 2016. Markets are now discounting multiple rate cuts by the Fed by the end of this year and a 25 basis point cut by the Bank of Canada. At this stage, we don't share that view—our forecast still looks for steady rates from the Fed and BoC through next year. That assumes threats against Mexico remain just that, and that the US-China trade dispute doesn't escalate further. But if trade relations continue to deteriorate and the economic (and equity market impact) deepens, the Fed could move in the direction of easing. All eyes are now on a potential Trump-Xi meeting at the G20 later this month.

Central bank near-term bias

↔ With our forecast assuming no further escalation in trade tensions—and a relatively modest impact on Canada and US growth—we think market pricing for a rate cut this year will ultimately go unrealized. We see the BoC on hold through next year.

↔ Rising trade tensions have increased the odds of the Fed cutting rates this year, though comments from Governor Powell indicate policymakers will want to see some impact from tariffs before making any move.

↔ Ongoing Brexit uncertainty, rising global trade tensions, and an expectation for modest economic growth will keep the BoE on the sidelines into next year.

↔ The ECB pushed back its forward guidance once again in June, now indicating rates will be held at current levels at least through the first half of next year.

↘ The RBA cut its cash rate for the first time since 2016 in June and Governor Lowe signaled further easing is likely. We think the next cut will come in August, though there is risk of a move as soon as July.

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Highlights

▲ US consumer confidence remains high and spending is expected to pick up in Q2…

▲ …but industrial production is slowing and business investment started the quarter on a soft note.

▲ The latest tariff increase on Chinese imports will raise the US effective tariff rate by ~3/4 ppt.

▲ We think the Fed would have to see more of an impact in economic data before lowering rates in response to trade tensions.

Are tariffs starting to take a toll on the US economy?

The US economy started the year with another quarter of above-3% GDP growth—the third such gain in the last four. Details were less than stellar, however, with domestic spending rising just 1.5%, one of the slowest increases in the past five years. We're looking for a better composition of growth in the second quarter. Government spending will provide a boost as shutdown-related declines in the past two quarters are reversed. And while April was a flat month for consumers, solid momentum toward the end of last quarter leaves household spending tracking a firm increase in Q2. Resurgent consumer confidence (May's reading was the best this year and not far from 2018's multi-decade highs) and a solid labour market point to continued strength in the sector, which represents 2/3 of the US economy.

While that key engine of growth still looks to be in high gear, other areas of the economy are showing signs of stalling. US manufacturing output fell by 1/2% or more in three of the first four months of 2019. Activity in the sector is now flat relative to a year ago—a first since 2015-16 when a pullback in the energy industry took its toll. The ISM manufacturing survey showed business sentiment continuing to soften in May. The new export orders index, in particular, has declined in each of the last five quarters, and half of respondents quoted in the report said tariffs were driving up costs or impacting their supply chains. Trade uncertainty might also be negatively impacting capital spending plans. After rebounding to start the year, capex orders unexpectedly fell in April and shipments are down so far in the second quarter. Business investment got a boost from corporate tax cuts and investment incentives last year, but slower growth in Q1 could be a sign of things to come if trade issues are unresolved.

Latest threats could deepen the impact

Optimism that the US and China were close to a trade agreement faded quickly in May when the Trump administration announced an increase in tariff rates from 10% to 25% on nearly $200 billion of Chinese imports. That increase, which had been threatened last year but was put off amid ongoing negotiations, amounts to a significant escalation in the two countries' trade spat. For scale, the average US import tariff increased by 1 percentage point over the last year, largely due to the new levies on China. We think this latest tariff hike will add another 3/4 ppt. And the Trump administration might not be done there, threatening to add tariffs on all remaining Chinese imports that have yet to be targeted. China responded by announcing retaliatory tariff hikes on a list of $60 billion of US imports. All eyes are now on the G20 summit in Japan in late-June when it is hoped that a face-to-face meeting between Presidents Xi and Trump might help ease tensions and allow negotiators to clear the current impasse.

With the Trump administration's trade ire seemingly focused on China, Mexico was caught off-guard by Trump's threat to apply across-the-board tariffs on Mexican imports (starting at 5% and potentially rising to 25% by October) if the country doesn't do more to stem the flow of illegal immigrants. The move was particularly surprising given the current push to ratify CUSMA. US trade relations are clearly in a state of flux—even more so than over the past year. Our working assumption is that threats against Mexico will not lead to sustained action, and that some form of de-escalation between the US and China will be agreed in the coming months. Still, we think the latest tariff hikes and increased uncertainty for businesses will weigh on the US industrial sector and business investment through the middle of the year. As a result, we are looking for growth to slow to just less than 2% in the coming quarters, though that forecast remains subject to considerable uncertainty on the trade outlook.

At this stage, we don't think the moderate slowing in US GDP growth assumed in our forecast is enough for the Fed to reverse course and begin lowering interest rates. But further escalation of trade tensions, or a greater hit from recent actions than we're assuming (particularly if the impact spreads more significantly to the consumer sector) could see policymakers moving in that direction. Rates markets are currently discounting almost 75 basis points of easing from the Fed by next January.

Plenty to like under the surface of Canada's Q1 GDP report

Canadian GDP rose an annualized 0.4% in Q1, not much better than the previous quarter's 0.3% gain. The details were much better, though, with domestic demand rising 3.4% following Q4/18's 1% decline. Surprisingly, consumer spending led the way with households shelling out more on both goods and services. The sharp improvement seemed to defy soft retail sales in the quarter, but is in line with strong job growth and an improving income backdrop. Business investment also shot higher, retracing the previous quarter's decline. A jump in aircraft purchases was a big factor, though the increase in machinery and equipment spending was broadly based. Some of the pickup in M&E investment came from imports, which surged nearly 8% in Q1. Combined with a drop in exports (mostly in the energy sector), net trade shaved almost 4 percentage points from headline growth. Business capex will come back to earth in Q2 (the jump in aircraft purchases won't be repeated) accompanied by a corresponding decline in imports.

In addition to solid expenditure details, the trend in monthly activity is encouraging. GDP jumped 0.5% in March, matching the best monthly pace since 2016. The economy was firing on all cylinders—a decline in utilities output after a cold weather-driven surge in February was the only soft spot. We saw a solid gain in services industries (more than 70% of Canada's economy) where output is up 2.5% from a year earlier. Goods sectors also improved with mining, oil and gas, manufacturing, and construction all posting gains after declining in the previous month. March's increase shows the Canadian economy had solid momentum heading into the current quarter. We continue to expect GDP growth will rebound to a 2.2% annualized pace in Q2.

As trade tensions rise, BoC staying positive—for now

With the Bank of Canada widely expected to hold interest rates steady and maintain a neutral bias in May (they did both), their latest policy statement was all about tone. The two major developments since their April meeting were improving domestic data and rising global trade tensions (they met after the latest tariff hikes on China but before Trump's threats against Mexico). The BoC put more emphasis on improving data, noting "accumulating evidence" that the slowdown over the last two quarters will be transitory. That includes strong job growth (suggesting businesses, too, think recent softness is temporary), early signs of recovery in the energy sector, and stabilization in most housing markets. Consumer spending, exports, and business investment were also noted to be improving in the current quarter.

While Governing Council seemed pleased with the economy's turn for the better, they also said escalating trade conflicts are generating heightened uncertainty. That includes growing US-China tensions and Canada's own trade issues with China (particularly a ban on some canola exports). But even on the trade file the bank wasn't overly pessimistic, noting rising odds of CUSMA ratification (again, prior to Trump's threats against Mexico) and the lifting of US steel and aluminum tariffs. That seemed consistent with their usual refrain that trade risks are both to the upside and the downside.

While trade risks might be two-way, the BoC will have to onboard recent tariff action when they update their forecasts in July. Recall that the previous round of US tariffs and China's retaliation were seen shaving about 0.2 and 0.5 ppts from US and Chinese GDP, respectively, by the end of next year. The latest round of US tariff hikes, if sustained, might see those impacts nearly doubled. And if the Trump administration follows through on threats against Mexico, the hit would be even larger. So while the BoC maintained that global growth has been evolving as expected, they could be marking down their forecast in July. That would have knock-on effects for the domestic growth outlook, given both Canada's exposure to the US industrial sector (which is bearing the brunt of tariff increases) and potential weakness in commodity prices stemming from a softer global outlook (something we're already seeing in recent oil price declines). Markets seem to be more concerned about trade developments than the BoC was in May, and are now pricing in a 25 bp rate cut by the end of this year.

Highlights

▲ Canadian GDP growth came in below 1/2% for a second consecutive quarter, but domestic spending picked up in Q1.

▲ A broadly-based 0.5% increase in March GDP suggests solid momentum heading into the second quarter.

▲ The BoC sounded relatively positive in May, emphasizing recent improvement in economic data…

▲ …but rising trade tensions could see the BoC trimming their global growth forecast in July.

Highlights

▲ We expect UK GDP growth will slow to 0.3% in Q2 after temporary factors gave the economy a boost in Q1.

▲ Odds of a no-deal Brexit have increased but we continue to think that will be avoided.

▲ Euro area PMIs point to ongoing divergence between domestic and externally-oriented industries.

▲ Slow GDP growth and inflation and an increase in unemployment has the RBA back in easing mode.

PM May's resignation keeps Brexit uncertainty rolling

Recent data point to the UK economy returning to a more moderate pace of growth in Q2 after GDP rose 0.5% in Q1. Recall that some temporary factors, including stock-piling ahead of a potential no-deal Brexit at the end of March, helped boost growth early this year. Surveys show that increase unwinding in Q2, with the manufacturing PMI falling below 50 (pointing to stagnating activity) for the first time since the immediate aftermath of the Brexit referendum. Rising global trade tensions and slower industrial production, including in Europe, might have contributed to the softening in sentiment. The construction sector also weakened, though improvement in services provided some offset. The PMI data are pointing to flat or slightly lower Q2 GDP but underestimated the pace of growth early this year. We maintain our forecast for growth to slow to 0.3% in the current quarter, with the services industry (80% of the UK's economy) providing enough support to offset weakness in other sectors.

Political and trade uncertainty is almost certain to persist in the near-term. Prime Minister May has just stepped down as head of the Conservative party but will continue as caretaker PM until a new party leader is chosen. Top candidates generally favour a harder form of Brexit than May negotiated with the EU. That has increased the odds of a no-deal Brexit at the end of October, though it remains the case that a majority in Parliament is against such an outcome. Ongoing uncertainty about Brexit—recall the BoE's assumed rate profile is contingent on a smooth transition to any new trading relationship—and rising global trade tensions are likely to keep the BoE on the sidelines at least through the end of this year. Markets are even pricing in some odds of a cut over the next year.

Major euro area economies back to growth in Q1

Euro area survey data are telling a now-familiar story, with ongoing weakness in the manufacturing sector being offset by a slightly stronger services industry, leaving overall sentiment pointing to a relatively subdued pace of growth. On a country basis, Germany's industrial sector seems to be getting the worst of it. Production was down 2% year-over-year in Q1 and the country's manufacturing PMI points to continued slowing in the current quarter. Unemployment in Germany ticked higher in May for the first time in more than five years—perhaps a lagged impact of the slowdown over the second half of last year. Steadier growth in the more domestically-oriented services sector is expected to keep the German economy expanding. We forecast the same for the euro area as a whole, netting out to a less than impressive 0.3% increase in Q2 GDP. Given the economy's lack of momentum and growing downside risks around the global outlook, the ECB's June meeting came with a dovish message. Most significantly, the central bank extended its forward guidance once again, now saying rates will remain at current levels at least through the first half of next year (its previous guidance was through the end of 2019).

RBA cuts its cash rate, signals more to come

While the Reserve Bank of Australia stopped short of an easing bias in May, minutes of their meeting and subsequent comments from Governor Lowe showed the central bank clearly leaning in the direction of lower rates. Combined with another round of soft domestic data (including an increase in the unemployment rate to an eight-month high) and rising global trade tensions, the shift in tone had analysts unanimously expecting a rate cut in June. The RBA delivered, lowering its cash rate by 25 basis points to a new low of 1.25%. Governor Lowe said, "it is not unreasonable to expect a lower cash rate," and the policy statement hinted that labour market and inflation developments will be key. The latest GDP figures showed sub-trend growth continuing in 2019 with a 0.4% quarterly increase in Q1. Year-over-year growth of 1.8% is the slowest since the global recession. This pace of activity isn't enough to keep the unemployment rate from rising further, nor to put inflation back on track toward the RBA's 2-3% target range (Q1's core readings averaged 1.4%, matching a multi-decade low). As such, we look for a follow-up cut in August, though there is growing risk that the RBA moves again in July. We expect the RBA will stop there, but markets are now leaning toward a sub-1% cash rate. In addition to domestic data, we think any moves from other central banks could influence how far the RBA goes in its own easing cycle.

Interest rate outlook

%, end of period

	Actuals					Forecast						
	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4
Canada												
Overnight	1.25	1.25	1.50	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Three-month	1.10	1.26	1.59	1.64	1.67	1.65	1.65	1.65	1.65	1.65	1.65	1.65
Two-year	1.78	1.91	2.21	1.86	1.55	1.50	1.60	1.70	1.75	1.85	1.85	1.90
Five-year	1.97	2.07	2.34	1.89	1.52	1.50	1.65	1.80	1.85	1.95	1.95	2.00
10-year	2.09	2.17	2.43	1.97	1.62	1.65	1.80	1.90	2.00	2.10	2.15	2.20
30-year	2.23	2.20	2.42	2.18	1.89	1.90	2.05	2.15	2.25	2.30	2.35	2.35
United States												
Fed funds**	1.75	2.00	2.25	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50
Three-month	1.73	1.93	2.19	2.45	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40
Two-year	2.27	2.52	2.81	2.48	2.27	2.00	2.20	2.35	2.45	2.55	2.55	2.55
Five-year	2.56	2.73	2.94	2.51	2.23	2.05	2.25	2.45	2.55	2.65	2.75	2.75
10-year	2.74	2.85	3.05	2.69	2.41	2.25	2.45	2.60	2.70	2.80	2.85	2.85
30-year	2.97	2.98	3.19	3.02	2.81	2.75	2.90	3.00	3.10	3.20	3.20	3.20
United Kingdom												
Bank rate	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00
Two-year	0.82	0.72	0.82	0.75	0.63	0.60	0.65	0.75	0.85	1.00	1.00	1.00
10-year	1.34	1.28	1.57	1.27	0.99	0.95	1.05	1.10	1.15	1.25	1.30	1.30
Euro area												
Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.30	-0.20	-0.10
Two-year	-0.59	-0.69	-0.55	-0.59	-0.60	-0.65	-0.60	-0.55	-0.50	-0.40	-0.30	-0.20
10-year	0.50	0.31	0.47	0.25	-0.07	-0.10	0.00	0.15	0.20	0.25	0.30	0.30
Australia												
Cash target rate	1.50	1.50	1.50	1.50	1.50	1.25	1.00	1.00	1.00	1.00	1.00	1.00
Two-year	2.00	2.00	2.02	1.89	1.47	1.20	1.10	1.10	1.15	1.25	1.35	1.50
10-year	2.60	2.63	2.67	2.32	1.78	1.50	1.65	1.75	1.85	2.00	2.10	2.15
New Zealand												
Cash target rate	1.75	1.75	1.75	1.75	1.75	1.50	1.25	1.25	1.25	1.25	1.25	1.25
Two-year swap	2.21	2.14	2.02	1.96	1.62	1.50	1.40	1.40	1.45	1.55	1.65	1.80
10-year swap	3.06	3.02	2.89	2.64	2.15	2.00	2.00	2.10	2.20	2.35	2.45	2.50
Yield curve*												
Canada	31	26	22	11	7	15	20	20	25	25	30	30
United States	47	33	24	21	14	25	25	25	25	25	30	30
United Kingdom	52	56	75	52	36	35	40	35	30	25	30	30
Eurozone	109	100	102	84	53	55	60	70	70	65	60	50
Australia	60	63	65	43	31	30	55	65	70	75	75	65
New Zealand	85	88	87	68	53	50	60	70	75	80	80	70

* Two-year/10-year spread in basis points, **Top of 25 basis point range

Source: Reuters, RBC Economics Research

Central bank policy rate

%, end of period

		Current	Last				Current	Last	
United States	Fed funds	2.25-2.50	2.00-2.25	December 19, 2018	Eurozone	Deposit rate	-0.40	-0.30	March 10, 2016
Canada	Overnight rate	1.75	1.50	October 24, 2018	Australia	Cash rate	1.50	1.75	August 3, 2016
United Kingdom	Bank rate	0.75	0.50	August 1, 2018	New Zealand	Cash rate	1.50	1.75	May 8, 2019

Source: Bloomberg, Reuters, RBC Economics Research

Economic outlook

Growth outlook

% change, quarter-over-quarter in real GDP

	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4	2017	2018	2019F	2020F
Canada*	1.5	2.5	2.1	0.3	0.4	2.2	2.2	1.8	1.8	1.7	1.7	1.6	3.0	1.9	1.4	1.8
United States*	2.2	4.2	3.4	2.2	3.1	1.6	1.5	1.7	1.8	1.8	1.7	1.5	2.2	2.9	2.4	1.7
United Kingdom	0.1	0.4	0.7	0.2	0.5	0.3	0.3	0.4	0.4	0.4	0.4	0.3	1.8	1.4	1.6	1.5
Euro area	0.4	0.4	0.1	0.2	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.3	2.5	1.8	1.2	1.5
Australia	1.0	0.9	0.3	0.2	0.4	0.6	0.7	0.7	0.6	0.5	0.6	0.7	2.4	2.8	2.1	2.5

*annualized

Inflation outlook

% change, year-over-year

	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4	2017	2018	2019F	2020F
Canada*	2.1	2.3	2.7	2.0	1.6	2.1	1.8	2.2	2.3	2.0	2.1	1.9	1.6	2.3	1.9	2.1
United States*	2.2	2.7	2.6	2.2	1.6	1.8	1.8	2.0	2.2	2.1	2.2	2.1	2.1	2.4	1.8	2.1
United Kingdom	2.7	2.4	2.5	2.3	1.8	2.2	1.9	1.8	2.2	2.1	2.1	2.1	2.7	2.5	1.9	2.1
Euro area	1.3	1.7	2.1	1.9	1.4	1.4	0.8	1.1	1.2	1.4	1.4	1.4	1.5	1.8	1.2	1.3
Australia	1.9	2.1	1.9	1.8	1.3	1.5	1.5	1.4	1.9	1.9	2.0	2.1	1.9	1.9	1.4	2.0

Source: Statistics Canada, Bureau of Economic Analysis, Bureau of Labor Statistics, Office for National Statistics, Statistical Office of the European Communities, Australian Bureau of Statistics, Statistics New Zealand, RBC Economics Research

Inflation tracking

Inflation Watch

	Measure	Current period	Period ago	Year ago	Three-month trend	Six-month trend
Canada	CPI ex food & energy[1]	Apr	0.2	2.0	2.1	2.1
United States	Core PCE[1,2]	Apr	0.2	1.6	0.9	1.5
United Kingdom	All-items CPI	Apr	0.6	2.1	1.3	1.4
Euro area	All-items CPI[1]	May	0.1	1.2	2.1	0.8
Australia	Trimmed mean CPI[1]	Q1	0.3	1.6	N/A	N/A
New Zealand	All-items CPI	Q1	0.1	1.5	N/A	N/A

1 Seasonally adjusted measurement.
2 Personal consumption expenditures less food and energy price indices.

Source: Statistics Canada, Bureau of Labor Statistics, Office for National Statistics, Statistical Office of the European Communities, Australian Bureau of Statistics, Statistics New Zealand, RBC Economics Research

Currency outlook

Level, end of period

	Actuals					Forecast						
	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4
Canadian dollar	1.29	1.31	1.29	1.36	1.33	1.34	1.34	1.35	1.35	1.36	1.36	1.37
Euro	1.23	1.17	1.16	1.15	1.12	1.10	1.12	1.14	1.15	1.17	1.18	1.18
U.K. pound sterling	1.40	1.32	1.30	1.28	1.30	1.26	1.27	1.30	1.31	1.33	1.34	1.34
Chinese Renminbi	6.3	6.6	6.9	6.9	6.7	7.0	7.3	7.4	7.5	7.5	7.6	7.7
Japanese yen	106.3	110.8	113.7	109.7	110.9	113.0	117.0	120.0	119.0	118.0	117.0	116.0
Australian dollar	0.77	0.74	0.72	0.70	0.71	0.69	0.68	0.67	0.67	0.67	0.66	0.66

Canadian dollar cross-rates

	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4
EUR/CAD	1.59	1.53	1.50	1.56	1.50	1.47	1.50	1.54	1.55	1.59	1.60	1.62
GBP/CAD	1.81	1.73	1.68	1.74	1.74	1.69	1.71	1.75	1.76	1.81	1.82	1.84
CAD/CNY	4.86	5.04	5.32	5.04	5.03	5.22	5.41	5.48	5.56	5.51	5.59	5.62
CAD/JPY	82.4	84.3	88.1	80.4	83.0	84.3	87.3	88.9	88.1	86.8	86.0	84.7
AUD/CAD	0.99	0.97	0.93	0.96	0.95	0.92	0.91	0.90	0.90	0.91	0.90	0.90

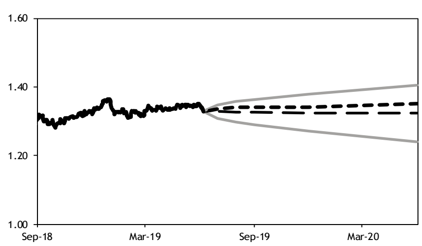
Rates are expressed in currency units per US dollar and currency units per Canadian dollar, except the euro, UK pound, Australian dollar, and New Zealand dollar, which are expressed in US dollars per currency unit and Canadian dollars per currency unit.

Source: Bloomberg, RBC Economics Research

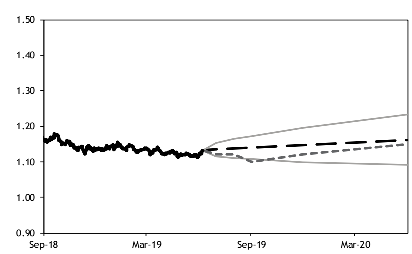
RBC Economics outlook compared to the market

The following charts track historical exchange rates plus the forward rate (dashed line) compared to the RBC Economics forecast (dotted line) out one year. The cone for the forecast period frames the forward rate with confidence bounds using implied option volatilities as of the date of publication.

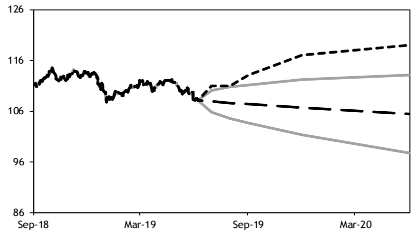
Canadian dollar



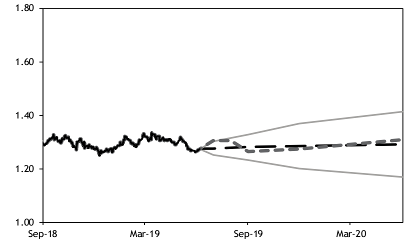
Euro



Japanese yen



U.K. pound

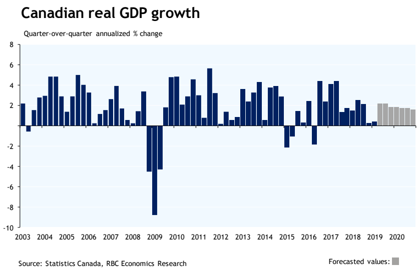


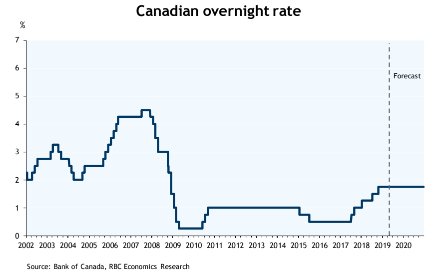
Central bank watch

Bank of Canada

Canada's Q1 GDP report showed soft headline growth but strong domestic spending and decent momentum toward the end of the quarter. We expect growth will rebound to 2.2% in Q2.

The BoC sounds pleased with recent improvement in the domestic data, though rising trade risks are hard to ignore. The Q2 Business Outlook Survey will give some insight into how businesses are coping.

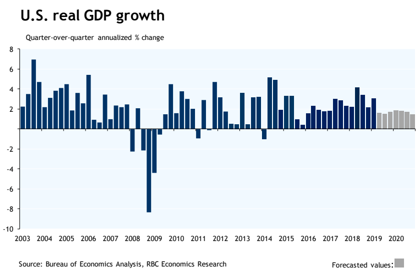


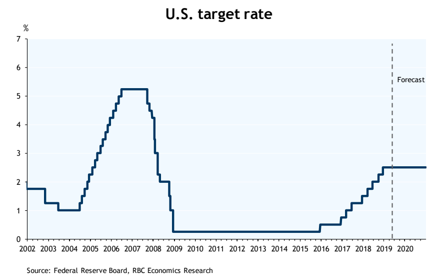


Federal Reserve

US consumer spending growth is expected to pick up in the current quarter, helping to offset any sluggishness in business investment due to rising trade tensions.

Unless we see more notable impact on the US economy from rising trade tensions, we don't see the Fed validating market pricing for multiple rate cuts this year.

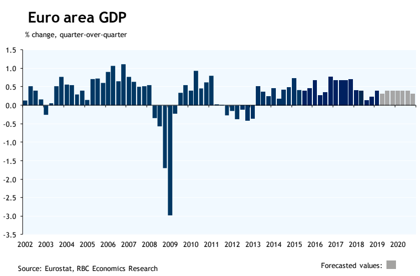


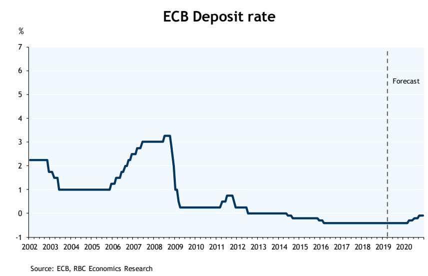


European Central Bank

A sluggish manufacturing sector, particularly in Germany, is expected to limit euro area GDP growth to 0.3% in Q2.

The ECB pushed out its forward guidance by six months in June, now pledging to keep rates on hold through the middle of next year. Draghi also said there were preliminary discussions about measures that could be taken if the outlook deteriorates.

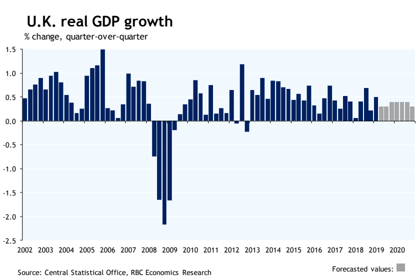


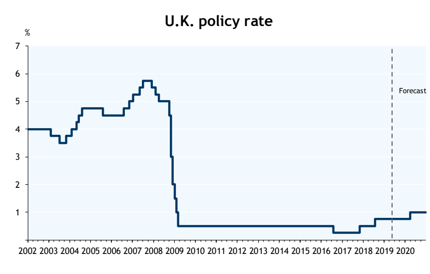


Bank of England

The UK economy is expected to see a more modest increase in Q2 as temporary factors that boosted growth in Q1 (including stock-building ahead of a potential no-deal Brexit) fade.

The longer Brexit uncertainty persists—and keeps UK growth relatively subdued—the longer the BoE will remain sidelined.

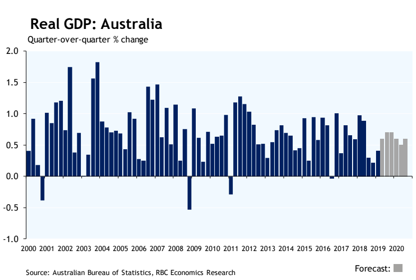


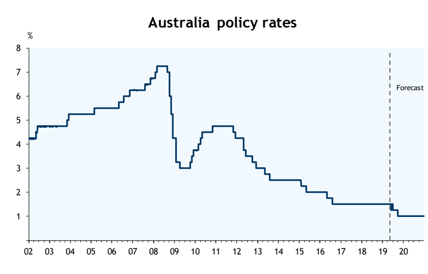


Reserve Bank of Australia

Australia saw another quarter of sub-trend GDP growth in Q2, including soft domestic spending. Activity hasn't been strong enough to keep the unemployment rate from ticking higher.

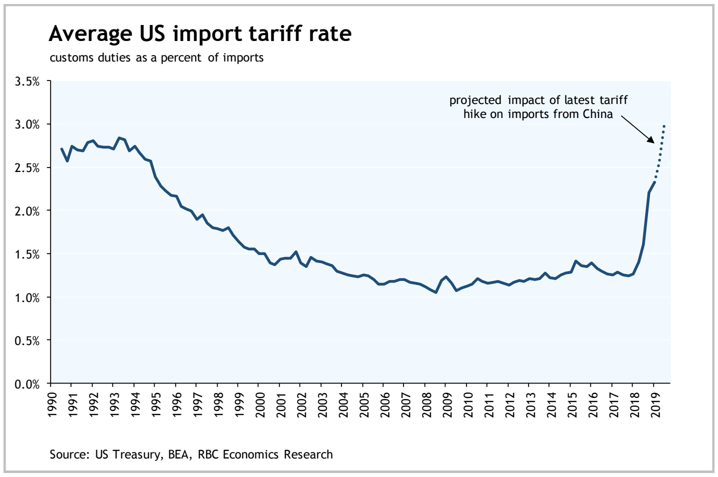
Soft domestic data and rising global trade tensions sealed the deal for an RBA rate cut. We expect another move in August will be the last, though there is some risk of a sub-1% cash rate.



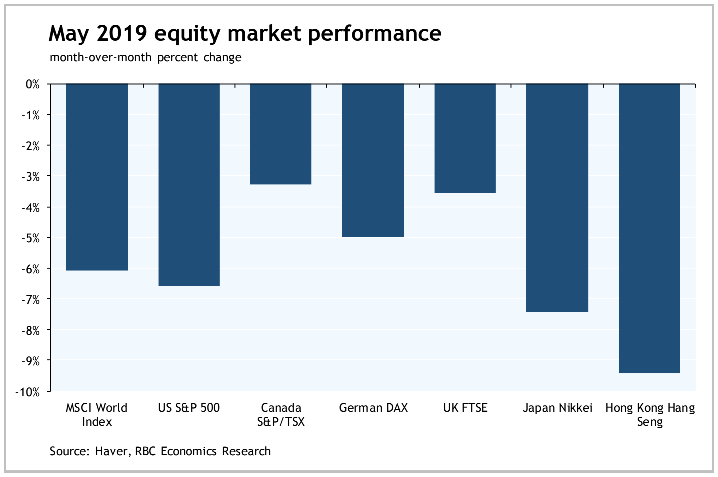


Trade tensions hitting equity and bond markets

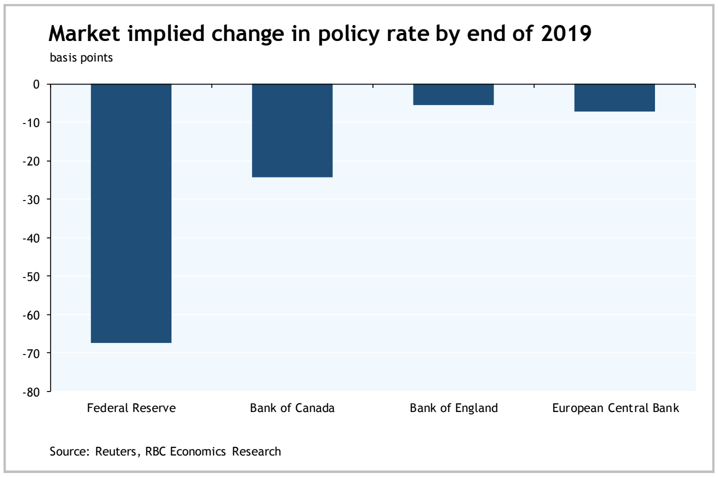
US-China trade talks took a turn for the worse in May when the US raised tariff rates on nearly $200 billion in Chinese imports. The Trump administration has threatened tariffs on all remaining Chinese imports, and recently surprised markets with tariff threats against Mexico.



Rising trade tensions pushed equity markets sharply lower in May. US and Canadian benchmark indices fell from the record highs seen in late-April and early-May. Asian equities underperformed and Germany saw a 5% decline.



Tariff hikes and threats of more action have markets discounting significant easing from the Fed this year. The BoC is also seen cutting rates by the end of 2019. And markets have flipped to imply some odds of *easing* from the BoE and ECB.



Expectations of rate cuts and rising risk aversion have put significant downward pressure on government bond yields. 10-year US Treasuries are close to 2% (they were above 3% as recently as November) while German 10-year Bunds are back into negative territory and at record lows.