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GLOBAL ECONOMIC HIGHLIGHTS

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MEXICAN RATE HIKE CYCLE LOOKS OVER; WEAK CANADIAN INFLATION DAMPENS RATE HIKE EXPECTATIONS

MEXICO: As expected, the Bank of Mexico on June 22 raised its policy rate 0.25 percentage points to 7.00 percent, and seems likely to leave interest rates on hold going forward. The Bank's monetary policy announcement described the balance of risks to inflation as neutral, and emphasized that "monetary policy measures affect the behavior of inflation with a considerable lag." Considering this statement, as well as the dissent of one monetary policy committee member who preferred to leave interest rates unchanged in June, further Mexican rate hikes seem unlikely unless the peso depreciates significantly. Mexican economic indicators are softening in the second quarter, a sign that the shocks to the economy which made a recession seem possible in early 2017 – interest rate hikes, higher consumer energy prices, uncertainty about US trade policy, and pass-through of a weak currency to higher import prices – are in fact restraining domestic demand and activity. Real wholesale sales edged down 0.1 percent in April, a third consecutive month of decline. Real retail sales rose 1.2 percent on the month but fell by the same amount a month earlier. Wholesale sales have trended lower since January, while retail sales are essentially flat since November 2016. Real (inflation-adjusted) sales of nonfinancial service sector businesses rose 0.2 percent on the month in April after falling 0.4 percent in March. Economic growth in the first half of 2017 was better than our pessimistic call for significant weakness or even recession, but headwinds still seem likely to keep Mexican real GDP growth well below its 3.5-4.5 percent potential in 2017. The recent decline in global benchmark oil prices (WTI crude last week fell briefly to near $42 per barrel, its lowest since August 2016) could also act as a headwind to Mexican growth by reducing public oil revenues, passing through to reduced public investment and spending later in 2017 and in 2018.

CANADA: Strong retail sales and employment insurance data confirm solid growth at the opening of the second quarter, but May's weaker inflation is a body blow to the case for a Canadian interest rate hike. Retail sales rose 0.8 percent by value and 0.3 percent in real terms in April from March, and were up 7.0 percent and 5.6 percent, respectively, from a year earlier in nominal and real terms. Motor vehicle and parts sales fell 1.0 percent on the month but were up 8.7 percent on the year, and sales excluding motor vehicles and parts rose 1.5 percent on the month and 6.4 percent on the year. Initial claims for employment insurance fell 3.2 percent on the year in April to 142,440. This was the best April claims data since 2011 -- Statistics Canada does not provide a seasonally-adjusted series so April 2017 is most clearly interpreted relative to other years' April data. More important to the Bank of Canada's July monetary decision, headline and core inflation weakened in May. CPI fell 0.2 percent in May from April on an 1.1 percent decline in transportation costs, partially offset by a 0.3 percent increase in food prices. CPI excluding food and energy rose a modest 0.1 percent on the month, unchanged from April. From a year earlier, the seasonally-adjusted CPI index rose 1.3 percent in May, down from April's 1.7 percent. Food prices fell 0.2 percent in year-over-year terms, transportation costs rose 2.3 percent, and CPI excluding food and energy slowed to 1.5 percent from 1.6 percent in April and 1.7 percent in March. Two of the Bank of Canada's three measures of core inflation slowed in May: CPI-median slowed to 1.5 percent from 1.6 percent, and CPI-trim to 1.2 percent from 1.3 percent. CPI-median was the weakest since June 2015, and CPI-trim the weakest since October 2014. CPI-common was unchanged at 1.3 percent, where it has sat since January, well below the Bank of Canada's 2.0 percent inflation target. In addition, the recent leg down in global benchmark oil prices (WTI crude is near $45 per barrel today after touching its lowest since August 2016 last week) is a headwind to a recovery of

Canada's energy sector. The Bank of Canada's two 0.25 percentage point policy interest rate cuts in January and July 2015 were in large part reactions to the global plunge in oil prices which began in late 2014, and which passed through to weaken Canadian investment, manufacturing, hiring, and wage growth. For the Bank of Canada to be ready to raise its overnight rate target, core inflation will have to pick up, and the quantity of jobs added in the first half of 2017 will need to be complemented by an increase in job quality in the second half—that is, more full-time employment in higher wage sectors. Until then, Canadian interest rates are unlikely to increase. We continue to expect the next change in Canada's overnight rate target to be a 0.25 percentage point rate hike to 0.75 percent in January 2018, and if oil prices fall below $40 per barrel, that hike could be pushed further into the future. Since the Bank of Canada would like to be able to raise interest rates in part to cool the housing market, more Canadian regulatory measures to slow the flow of mortgage credit are possible in the next few quarters.

EUROZONE: ECB President Mario Draghi argued for a gradual taper of the ECB's asset purchase program in a June 27 speech centered on two key arguments. The first is that inflation's current undershoot of the ECB's target is temporary. The headwind to Eurozone inflation from low global energy prices should drop out of the year-ago comparison in the HICP consumer price index as energy prices stabilize. In addition, the Eurozone's above-trend growth is absorbing the overhang of underemployed and discouraged workers, who are not included in the official unemployment rate, and whose underemployment holds down inflationary pressures – the ECB expects labor market slack to be absorbed "within the next two years." President Draghi's other main argument was that the ECB's withdrawal of stimulus should be slow. Even if the temporary factors holding down Eurozone inflation abate, other longer-term changes in the Eurozone's economy will slow the process by which a strengthening economy feeds through to labor market pressures, faster wage growth, and higher inflation. Eurozone economies liberalized job and product markets during the sovereign debt crisis and its aftermath in ways that reduce inflationary pressures, echoing how the reduction in US workers' bargaining power over wages since the 1980s coincided with a trend slowdown in US inflation. European demographic changes – an aging workforce and faster immigration – increase labor supply, also preventing the increase in demand from creating inflation. Draghi also mentioned the argument that globalization could dampen inflation by bringing cheap imports into the Eurozone, although he sounded less persuaded by the argument than others he mentioned. If some of these long-term changes to the Eurozone economy limit inflation pressures, the ECB should normalize monetary policy much more slowly in 2018 and 2019 than in prior Eurozone recoveries. The euro appreciated about 0.75 percent against the dollar to $1.13 per euro following Draghi's speech as markets focused on Draghi's first argument. Over time, his second argument (persistent factors will hold down inflation persistently) will likely make the ECB's withdrawal of monetary stimulus molasses-slow in 2018 and beyond. In the base case, we expect a €5-10 billion euro per month taper of asset purchases in 2018, which would not complete a taper of the ECB's QE program until sometime in the second half of 2018 or even later; the taper is more likely to be slower than this than faster. Relative to our forecast for the Federal Reserve to make one more 0.25 percentage point federal funds target hike in December 2017, to begin shrinking its balance sheet before year-end, and then to raise the federal funds target a cumulative 0.75 percentage points in 2018, the ECB looks unlikely to gain ground on the Federal Reserve in normalizing interest rates in the next 12 months. The euro's appreciation in the first half of 2017, reflection diminished expectations for US fiscal stimulus, was probably a short-term deviation from a trend strengthening of the dollar.

UNITED KINGDOM: The Bank of England's Financial Policy Committee raised the countercyclical capital buffer from 0 percent to 0.5 percent at the June 27 Financial Stability Report release, reversing the 0.5 percentage point cut to the buffer made after the June 2016 Brexit vote; the FPC stated in the Financial Stability Report that it expects to raise the buffer to 1.0 percent in November. This tightening is the first reversal of the monetary and financial stimulus policies enacted by the BoE after the Brexit referendum, and signals that an interest rate hike is possible (though we think not likely) in the second half of 2017. Governor Carney favors holding the bank rate unchanged, and will probably get his way since central bank governors usually do. But the monetary policy committee's June 2017 decision against a hike was a narrow 5-3 split vote, and BoE chief economist Andy Haldane said subsequently that he expects to support a rate hike going forward. If British wage growth accelerates and the post-Brexit economic relations between the UK and European Union become clearer, a bank rate hike would become likely.

UNITED STATES: The IHS Markit services PMI dipped to a 3-month low of 53.0 in the flash June release from 53.6 in May, and the manufacturing PMI dipped to a 9-month low of 52.9 from 53.7. The divergence between strong survey data and soft activity indicators in the first months of 2017 seems to be closing with sentiment surveys returning to earth, rather than with activity indicators taking off. The US economy is on pace for another year of trend-like moderate growth in 2017.

AUSTRALIA: The Australian Federal Government's Major Bank Levy takes effect on July 1. The legislation passed last week will charge Australia's largest five banks 0.06 percent of certain liabilities over A$100 billion, or 6 cents for every A$100 of liabilities. The Australian Treasury estimates the levy will raise A$6.2 billion over the next four years and that it will give smaller banks a leg up competitively. The affected banks have estimated that the levy will cost them about 3 percent of their combined 2016 profits. These estimates do not include an identical levy the state government of South Australia will also implement on July 1. Separately, Moody's Investor Services' downgraded 12 Australian banks' credit rating last week, including the big four, on concerns that high levels of household debt and rapid home price appreciation are increasing credit risk. We do not expect this double-hit to derail Australia's expansion. Australia's financial sector is profitable, and the bank levy is not unusually large compared with similar levies enacted in Europe after the financial crisis. However, these pressures could portend an era of slower growth for the industry relative to Australia's economy and perhaps increased costs passed on to borrowers.

CHINA: Recovering mining output and higher commodity prices are supporting revenues and profits in Chinese heavy industry in 2017. Profits of industrial firms rose 22.7 percent in year-ago terms in the first five months of 2017, a moderation from the 24.4 percent year-ago increase in the year through April. In the year through May, operating revenues rose 13.5 percent.