ON DECK FOR WEDNESDAY, JANUARY 10

Country	Date	Time	Indicator	Period	BNS	Consensus	Latest
US	01/10	07:00	MBA Mortgage Applications (w/w)	JAN 5	--	--	0.7
CA	01/10	08:30	Building Permits (m/m)	Nov	--	-1.0	3.5
US	01/10	08:30	Export Prices (m/m)	Dec	--	0.4	0.7
US	01/10	08:30	Import Prices (m/m)	Dec	--	0.4	0.7
US	01/10	09:00	**Fed's Evans Discusses Economy and Policy Outlook**				
US	01/10	09:10	**Fed's Kaplan Speaks in in moderated Q&A in Dallas**				
US	01/10	10:00	Wholesale Inventories (m/m)	Nov F	--	0.7	0.7
US	01/10	13:30	**Fed's Bullard Speaks on U.S. Economic Outlook in St. Louis**				

KEY POINTS:

- China's warning hits multiple asset classes
- China educates Trump with a Balance of Payments 101 lesson…
- …by warning that it could buy fewer Treasuries....
- …in response to trade tensions and US fiscal deficits…
- …but could it all boomerang on China as well?
- EGBs, gilts and oil could also be vulnerable to China headlines
- Chinese CPI rises, but core inflation remains stable
- Higher inflation supports Norges Bank hikes
- European data updates are inconsequential this morning
- Watch US import prices for inflation signals
- Brazilian CPI rises by more than expected…
- …but rate hikes are still a long way off

INTERNATIONAL

A deliberate warning from China to the US administration is hitting equities, North American sovereign bonds and the USD. Relative immunity in European debt markets and higher commodity prices may be trades worth re-evaluating. Other developments are relatively minor and focused upon a handful of regional markets. If one thought 2018 would be smooth sailing, then the tensions raised by the Trump administration with China risk showcasing more of what lies ahead.

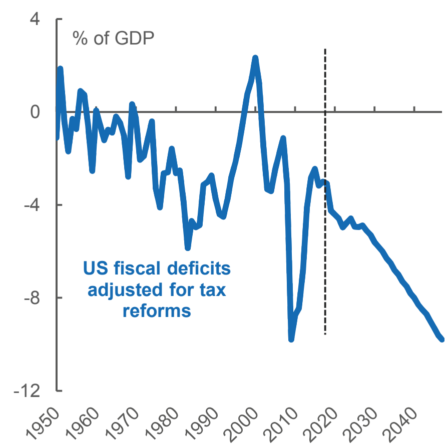
- Yesterday's bond sell off is carrying into today but with a more credible catalyst (see below). Immediately after China's headlines hit, the US 10 year Treasury yield spiked and is underperforming all other sovereign markets this morning with a 3-4bps rise. The mechanism by which China says it could buy fewer Treasuries (lower current account, less capital account outflows) could also by corollary be used to explain less buying of EGBs and gilts so the sanguine response in European debt markets so far seems somewhat unusual in my opinion. Canadian sovereign yields are also cheapening up across the curve but slightly outperforming the US long-end.

- The USD also sold-off the nanosecond that the headlines out of China hit the wires. The USD is down versus most other crosses especially the yen but also the euro and euro-related currencies. CAD is appreciating but underperforming except against pound sterling and the Mexican peso.

- Oil prices are adding to momentum. WTI is up to about US$63½ this morning and Brent is setting its sights on US$70. Gold is also up by about $10 to US$1323 on heightened concerns about the US Treasury market and USD. I'm fine with gold, but it's unclear that oil should be rallying on escalating trade and capital market tensions between the US and China that are at risk of getting much worse pretty quickly in my opinion.

CONTACTS

Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com



Sources: Scotiabank Economics, CBO.

- Equities are taking the China headlines hard. US equity futures tanked at the same time that the warning from China on buying fewer Treasuries hit and futures are down by up to ½% across the benchmarks led by Nasdaq selling. TSX futures are also lower by ¼%. European cash markets are down by about ½% on average across the Eurozone while London is flat partly aided by a softer pound sterling cross against the euro. Asia will have some catching up to do tonight but equities there were little changed on average overnight.

Yesterday's rise in yields was driven by a misinterpretation of less tactical bond buying by the BoJ that in my opinion is nowhere close to policy exits regardless of what markets think. **Today's sell off is motivated by a warning from China that hit the wires shortly before 6amET. Anonymous Chinese officials told newswires they are considering reducing or stopping Treasury buying partly due to trade tensions.** This isn't just petty tit-for-tat stuff like keep our washing machines out and we'll sell your debt accompanied by a big raspberry. The logic behind trade tensions with the US and souring Chinese demand for Treasuries is that if measures are taken by the Trump administration that damage China's current account position (that, by the way, is only slightly in surplus at about 1% of GDP and falling from a 10% peak a decade ago when Mitt Romney was all over it), then by corollary that weakens the incremental supply of net foreign currency receipts available to invest abroad through capital account outflows to do things like buy Treasuries. It's a warning shot by the state to the US administration that trade tensions would cost American borrowers. Ergo why the title to this week's Global Week Ahead was "Why The US Shouldn't Rock The Boat With China" available here. **Make no mistake about it, this is a very deliberate action on behalf of the Chinese administration ahead of expected developments over the remainder of this month that include potential US action on trade disputes governing issues like steel imports and washing machines and ahead of President Trump's State of the Union address at the end of this month that is expected to carry protectionist messages and guide the policy bias.** Thus, headline risk to markets through this protectionist risk and its impact upon markets could well escalate very rapidly over the duration of this month and beyond. In my opinion, this US administration and the minority of economist(s) it chooses to listen to have a disturbingly poor understanding of the interconnectedness of the world's trade and capital flows. Partly as a consequence, this US administration overstates its ability to put 'America first' by dictating the terms of business to China without understanding the pain that such an approach risks exposing everyone to. Because of that, all asset classes are vulnerable including the stable genius's beloved Dow that's off by over one hundred points so far this morning.

The Chinese officials also flagged supply worries related to deficit funded stimulus and concomitant bond issuance which reinforces our view that markets (and the Fed) would sterilize much of anything positive to come out of regressive tax 'reforms'. They are right to be worried about the US fiscal picture in my opinion (see chart). At the margin, the US is borrowing money it doesn't have to fund questionable tax policy changes and guess who it has to borrow from. In that sense, China's reaction to US fiscal and trade policy holds the key to the success or failure of the poster child of US economic reforms. Of course, at some point, there is a limit to Chinese actions against the US Treasury market and the impairing effects upon its own holdings while others may eventually come to see value if yields spike too far. China owns about US$1.2 trillion worth of Treasuries and bought about US$140 billion more of them over the past year after selling them on misplaced reflation bets over the back half of 2016. Further, driving the USD too low risks unhinging China's own currency from its relatively stable range of 6.5-6.7 versus the dollar over recent months and by corollary running the risk of importing more inflation into China's economy. Thus, at some point, there is a moderation of the tensions as both sides begin to realize they potentially have a lot to lose on the interconnectedness of trade policies and financial market developments.

On that note, Chinese CPI rose a little less than expected to 1.8% y/y (1.7% prior, 1.9% consensus). Inflation has risen from a low point of 0.8% y/y last February. Food prices are falling at a decelerating rate of -0.4% y/y in December but they are still dragging on headline inflation. Excluding food and energy, Chinese inflation is running at 2.2% y/y and has been at about that rate throughout that past year.

Norges Bank got a little ammunition in support of guidance from Governor Oystein Olsen to expect rate hikes sooner than previously anticipated. That's because CPI inflation climbed a half point to 1.6% y/y with underlying or core CPI responsible for much of the headline rise as underlying CPI climbed from 1.0% y/y to 1.4% (1.2% consensus). The Norwegian Krone is among the strongest performing currencies this morning as it appreciated right on the back of the inflation figures.

European data was pretty light and uneventful compared to grander developments in this morning's markets. Updates were focused upon the industrial sector. UK industrial output climbed in line with expectations (+0.4% m/m in November) but the prior month was revised up a little to make for a slightly better overall tone offset by soft details. Utilities drove the biggest gain with a 3.2% jump in output as manufacturing gained a little and resource sector output fell. French industrial output fell 0.5% m/m which was in line with expectations and followed a large gain of 1.7% the prior month.

Brazil's inflation rate continues to move away from its low point in August and did so by more than expected in the latest update. December's IPCA inflation climbed to a shade south of 3% y/y and is up by about a half percentage point from

August's reading. That's still low and below the central bank's wide inflation target range of 3-6%. Brazil's inflation rate is expected to rise to the 4% mark by the back half of this year which would bring it back within the target range but still toward the lower end and motivating no central bank policy moves this year.

UNITED STATES

An empty US calendar will keep the focus upon bond market developments and their global influences. Import prices (8:30amET) may be worth a quick peek given the USD connections and pass-through into CPI and PCE inflation. US import prices were falling by 11.6% y/y at the weakest point in September 2015 when commodities were dragging them lower and the net effect of movements in commodities and the USD since then has lifted import prices by over 3% y/y by late last year. A 10% trade weighted depreciation in the broad dollar index adds about ½% to core inflation within six months with the effect ebbing to a 0.3% lift a year after the dollar movement. That's in line with the currency moves that have been experienced since peak dollar strength at the end of 2016 and so higher US inflation is coming. Indeed, core PCE is showing a little of this already and it's the Fed's preferred inflation gauge.

Fixed Income	Government Yield Curves (%):											
	2-YEAR			5-YEAR			10-YEAR			30-YEAR		
	Last	1-day	1-wk	Last	1-day	1-wk	Last	1-day	1-wk	Last	1-day	1-wk
U.S.	1.96	1.97	1.93	2.34	2.33	2.25	2.58	2.55	2.45	2.93	2.90	2.79
CANADA	1.79	1.79	1.68	2.02	2.01	1.86	2.22	2.20	2.05	2.44	2.41	2.29
GERMANY	-0.62	-0.61	-0.62	-0.20	-0.20	-0.21	0.54	0.47	0.44	1.32	1.32	1.27
JAPAN	-0.12	-0.13	-0.13	-0.07	-0.09	-0.10	0.09	0.07	0.05	0.85	0.84	0.81
U.K.	0.53	0.54	0.47	0.80	0.80	0.74	1.29	1.28	1.21	1.83	1.82	1.77
	Spreads vs. U.S. (bps):											
CANADA	-18	-18	-25	-32	-32	-38	-36	-35	-40	-49	-49	-49
GERMANY	-258	-258	-255	-254	-253	-245	-204	-209	-201	-161	-158	-152
JAPAN	-209	-210	-207	-241	-242	-235	-249	-248	-240	-208	-206	-197
U.K.	-143	-143	-147	-155	-153	-151	-130	-127	-123	-111	-108	-102

Equities	Level		% change:			
	Last	Change	1 Day	1-wk	1-mo	1-yr
S&P/TSX	16319	1.6	0.0	0.1	1.4	5.8
Dow 30	25386	102.8	0.4	2.3	4.3	27.9
S&P 500	2751	3.6	0.1	2.1	3.8	21.3
Nasdaq	7164	6.2	0.1	2.2	4.7	29.0
DAX	13261	-125.1	-0.9	2.2	0.8	14.5
FTSE	7739	7.9	0.1	0.9	4.7	6.4
Nikkei	23788	-61.8	-0.3	4.4	4.3	23.2
Hang Seng	31074	62.3	0.2	1.7	8.5	36.6
CAC	5502	-21.9	-0.4	3.2	1.9	12.6
Commodities	Level		% change:			
WTI Crude	63.56	0.60	1.0	3.1	10.8	25.1
Natural Gas	2.94	0.01	0.5	-2.4	6.0	-10.4
Gold	1322.14	9.36	0.7	0.7	5.9	11.3
Silver	17.14	0.08	0.5	0.1	8.3	2.8
CRB Index	195.25	1.10	0.6	-0.0	5.5	2.2
Currencies	Level		% change:			
USDCAD	1.2451	-0.0013	-0.1	-0.7	-3.2	-5.9
EURUSD	1.1991	0.0054	0.5	-0.2	1.9	13.6
USDJPY	111.43	-1.2200	-1.1	-1.0	-1.9	-3.7
AUDUSD	0.7845	0.0021	0.3	0.1	4.2	6.5
GBPUSD	1.3523	-0.0017	-0.1	0.1	1.4	11.1
USDCHF	0.9777	-0.0053	-0.5	0.1	-1.4	-3.9

Central Banks	
Current Rate	
Canada - BoC	1.00
US - Fed	1.50
England - BoE	0.50
Euro zone - ECB	0.00
Japan - BoJ	-0.10
Mexico - Banxico	7.25
Australia - RBA	1.50
New Zealand - RBNZ	1.75
Next Meeting Date	
Canada - BoC	Jan 17, 2018
US - Fed	Jan 31, 2018
England - BoE	Feb 08, 2018
Euro zone - ECB	Jan 25, 2018
Japan - BoJ	Jan 23, 2018
Mexico - Banxico	Feb 08, 2018
Australia - RBA	Feb 05, 2018
New Zealand - RBNZ	Feb 07, 2018

Source: Bloomberg. All quotes reflect Bloomberg data as at the time of publishing.
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