The global expansion remains caught in a tug-of-war between geopolitical drags and macroeconomic policy supports. Although the single largest geopolitical drag thus far can be linked to trade conflicts, almost all recessions over the past fifty years have been led by a spike in oil prices. The September 14th drone attack on a Saudi Arabian oil facility temporarily took 5% of the world's supply of oil offline and caused an overnight price surge of almost 15% - the biggest jump in more than 20 years. While impressive, as the quarter ended most of that spike had been reversed on hopes that production would return to normal in a matter of weeks. This event, however, is a reminder that an already sluggish global economy is vulnerable to the threats from multiple geopolitical flashpoints. Working to offset these potentially negative effects has been the significant monetary policy response from several central banks. The European Central Bank (ECB) introduced a broad-based easing package and the U.S. Federal Reserve (the Fed) cut its lending rate by 25 basis points on two occasions. Even though the Bank of Japan and the Bank of Canada (BoC) remained on hold, almost 20 central banks from around the world eased policy this quarter.

Central bank easing to trump the trade war?

This tug-of-war between the drags and the policy responses help to explain the divergent economic paths experienced so far in 2019. Geopolitics have weighed heavily on business sentiment and have caused a pronounced deceleration in global capital expenditures and manufacturing output – impacting Europe especially hard. On the other hand, this slowdown has remained mostly contained as monetary policy has led to lower borrowing rates along with rising equity markets. These developments have continued to support consumer spending and service sector activity. On balance, these divergences have mostly netted each other out to produce the stable, trend-like economic growth that investors have become accustomed to during this extended economic expansion.

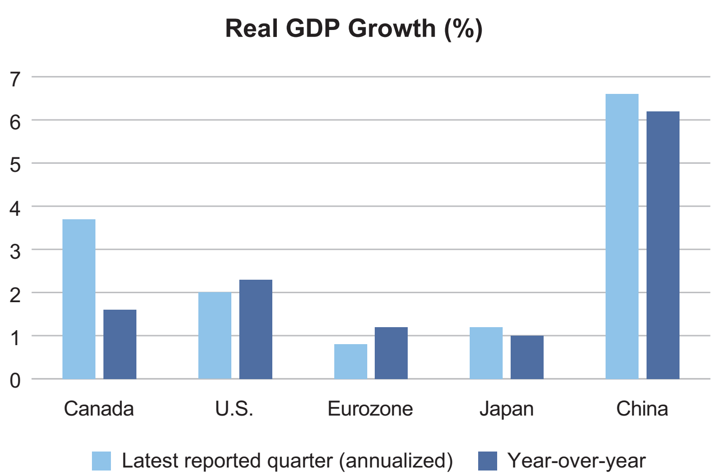
Geopolitical concerns remain high, global business sentiment remains low

Forecasting how these dynamics will develop is difficult as recent employment surveys show a broad slowing in employment growth while, at the same time, manufacturing surveys suggest that the intensity of the drags may be fading. Indeed, global manufacturing is expected to have increased at a 1% annualized growth rate this quarter – not impressive but still the strongest rate this year. This increase, alongside a rebound in Asian exports this quarter, has added to the view that drags on the manufacturing sector might be fading. A resolution in the U.S./China trade negotiations would most certainly provide a boost. In the meantime, however, geopolitical concerns remain high, global business sentiment remains low, thus expectations for a near term rebound in capital expenditures should also remain low. As well, there has been some cooling of consumer spending – most notably in China and Japan – throughout the summer and the recent moderation in job growth will dampen income growth.

To end the trend of subpar global growth, a stabilization in business sentiment along with an upturn in final demand growth will be needed. The global economy should be able to weather the current storm, but it will take time and require more policy easing by the Fed and the Bank of China in particular to ensure that a rebound takes hold next year.

U.S. economic data surprises to the upside

Taking a closer look at North America, the situation improves somewhat. Indeed, given that the U.S. economy ended the third quarter with a string of upside surprises, it is somewhat odd that the Fed has been cutting rates. Strength in housing markets and an upturn in manufacturing suggest that the economy, though down, is hardly out. Improved housing affordability has enticed buyers which has spurred home builders into action – starts surged 12% in August to their highest level in a decade – and strong building permit activity suggests that there is further room to run. Record-low debt service costs combined with healthy balance sheets give households the opportunity to take advantage of low borrowing rates, and with employment strong, consumers are benefitting from rising incomes. Strong equity market returns also help. Manufacturing has advanced in three of the last four months, led by consumer goods and construction supplies. Most surprising has been the modest bounce in the production of business equipment despite trade uncertainty. The sustainability of this upturn in capital expenditures will heavily influence the direction of the economy in the months to come. This helps to explain the recent actions of the Fed: despite the two rate cuts that have been characterized by Fed Chairman Jay Powell as a form of insurance against weaker global conditions, the Fed has continued to weigh against market expectations for even more cuts. As the quarter ended, a further reduction of just 50 basis points is expected by the end of 2020.



Source: Bloomberg

Canadian economy remains resilient

The Canadian economy has, thus far, weathered the trade war storm reasonably well. With many global economies reporting weak second quarter activity – especially in manufacturing and trade – Canadian GDP advanced by a healthy 3.7% led by gains in industrial production and net exports. Housing has made a comeback too, supported by lower borrowing rates. The third quarter, however, won't look as positive because the reality of slowing global growth will continue to have a negative impact. Combined with flat retail sales growth and continued high levels of consumer indebtedness, it is easy to conclude that growth will indeed slow.

The BoC appears to be content being patient with monetary policy – not wanting to re-inflate the housing market by lowering interest rates at a time when headline and core inflation rates are either at or above target. Also, the Fed's seeming reluctance for further easing removes pressure on the BoC to act if, for example, the Canadian dollar were to appreciate in an undesired manner as a result of a Fed ease. The market has priced in only a 25 basis point rate reduction through 2020. It would take a serious downturn in the economic data or the global economic backdrop for the BoC to reconsider its position.