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GLOBAL ECONOMIC HIGHLIGHTS

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# CRUDE OIL PRICES FALL AS US OUTPUT RISES, BUT NO SPILL OVER TO EXCHANGE RATES – AT LEAST SO FAR

**UNITED STATES:** WTI crude fell to near $42 per barrel June 21, the lowest price for crude oil since August 2016, on the continuing increase in US unconventional oil production and near-record inventories. The Baker Hughes count of petroleum well-drilling rigs rose 120 percent on the year in the most recent data for the week of June 16, while US crude production rose 8 percent in the same terms and crude and refined petroleum stocks stood within 2 percent of record highs. Surprisingly, the drop in oil prices has not caused a corresponding appreciation in the dollar against the peso or Canadian dollar, currencies which often weaken when crude prices fall. The disconnect seems unlikely to persist: Either oil prices will rise, stabilizing the economic prospects of Canada and Mexico, or the dollar is likely to appreciate against these trading partners' currencies as markets recognize the growth headwinds to exporters of cheaper crude.

**CANADA:** Canadian manufacturing sales rose 1.1 percent in value terms to a new record high of $54.4 billion in April, and rose 0.5 percent in volume or real terms. From a year earlier, manufacturing sales rose 7.6 percent by value and 1.9 percent by volume. Inventories rose 0.9 percent on the month in April. Canadian inventories were very low in early 2017, and businesses added to them rapidly in the first quarter, fueling strong manufacturing output, GDP growth, and hiring (like the roughly 25,000 manufacturing jobs added in May). Inventories reached a more normal level by April relative to the pace of manufacturing sales, and so manufacturing production and hiring were set to moderate slightly in the second quarter. However, the decline in oil prices that accelerated June 21 creates new downside risks to the Canadian economic outlook. The Bank of Canada signaled the approach of a rate hike a week ago Monday when Deputy Governor Carolyn Wilkins emphasized the need for Canadian monetary policy to be forward looking and to normalize interest rates before the output gap has closed. Recent data support a rate hike in the near term: Job growth was on a tear in the first half of 2017, and if sustained, would likely pass through to better average weekly hours, wage growth, and inflation prospects. But low oil prices do not support a rate hike, and in fact, the Bank of Canada has a track record of cutting interest rates in response to falling oil prices. They have given no reason to believe they are less sensitive to the pass through of energy prices today than in recent years. Expectations for a Canadian policy interest rate hike – whether they be recent market chatter of a rate hike before year-end 2017, or PNC Economics' more conservative expectation for a hike in January 2018 – could be rolled back if oil prices stay low or even move lower.

**MEXICO:** Financial markets price in a 0.25 percentage point policy rate hike to 7.0 percent from the Bank of Mexico on Thursday, June 22, which would mirror the Federal Reserve's hike a week earlier. A 0.50 percentage point hike would not be out of the question, since the Bank of Mexico has raised rates more aggressively than the Federal Reserve earlier in 2017 to bolster the peso's exchange rate and limit inflation pressures from Mexican energy prices, which the government liberalized on January 1. On the other hand, lower oil prices add to downside risks to the Mexican growth outlook. While the Bank of Mexico has prioritized defending the exchange rate over supporting growth so far this year, a plunge in energy prices could change their assessment of the tradeoffs between a near-term risk of high inflation from a weaker currency and a medium-term risk of low inflation from a weak economy.

**EUROZONE:** The European Union won concessions from the UK this week when it insisted in the opening round of Brexit negotiations that the EU and UK first resolve political issues around Brexit, including the status of EU citizens resident in the UK and of UK citizens living in other EU states, the Northern Irish border, and the UK's divorce bill, and only discuss trade arrangements after progress had been made on the political side. The EU's approach to the UK echoes their extraction last week of concessions from the Greek government last week, when the EU insisted on economic and political reforms before refinancing Greek debts owed to the EU's financial rescue funds. In both cases, the EU is using its economic leverage to extract political cooperation – and probably can continue to do so.

**UNITED KINGDOM:** The Bank of England's Monetary Policy Committee held the bank rate unchanged at its decision last Thursday June 15, but the vote in favor of unchanged rates was a narrow 5-3 split. BoE Governor Mark Carney made a forceful defense of the BoE's dovish policy stance in a speech on Monday, followed by a more hawkish speech by BoE chief economist Andy Haldane Wednesday. The BoE looks likely to keep interest rates on hold during the rest of 2017 (it is very unusual for a monetary policy committee to overrule its governor), but rate hikes could become possible if the June 8 election results in a more conciliatory British approach to Brexit negotiations (seeking a "soft Brexit") which secures continued market access for exports of British services to other EU states.

**JAPAN:** As expected, the Bank of Japan held its monetary stance unchanged at its June 21 decision, and looks set to maintain a highly expansionary policy in the second half of 2017. The BoJ's forward guidance (a.k.a. "qualitative easing") pledges that they will not complete a taper of their quantitative easing program until inflation "exceeds 2 percent and stays above the target in a stable manner," suggesting both headline and core inflation must rise above target before the BoJ raises its short-term or long-term policy interest rates.

**AUSTRALIA:** Employment rose 42,000 between April and May, much higher than the 10,000 consensus expectation. April's growth figures were revised up by 8,700 for a gain of 46,100 jobs. The composition of job growth was good too in May: Full-time jobs increased 52,100 while part-time employment fell 10,100. The unemployment rate fell to 5.5 percent in May from 5.7 percent in April, reaching the lowest since July 2013. Meanwhile, the participation rate ticked up slightly to 64.9 percent in May from 64.8 percent in April. Labor market data have been much better in 2017 than in 2016. Job growth has averaged 30,700 per month so far this year compared with an average gain of just 8,900 per month in 2016. Moreover, employment gains in 2017 have been mostly in full-time positions, good news for wage prospects. The distinction between full-time and part-time employment has become less important to the Reserve Bank of Australia in its assessment of the labor market. Still, they will be heartened by the steady improvement in overall job growth and will be inclined to keep monetary policy unchanged in the rest of 2017 and in 2018.

**CHINA:** MSCI announced that it will add a 5 percent allocation to 222 domestically-traded large-cap Chinese stocks ("A-shares") in its emerging markets index and a 0.71 percent weight in its global stock market index going forward, the first inclusion of domestic Chinese stocks in these benchmarks which are closely followed by many global investors. MSCI's decision is likely to fuel tens of billions of dollars of capital inflows into the Chinese economy over the next few years, a meaningful one-time increase. But relative to the nearly trillion dollar decline in Chinese foreign reserves between mid-2014 and 2017, MSCI's decision does not materially change the balance of risks to China's foreign reserves or exchange rate. If US interest rates rise significantly, Chinese foreign reserve outflows are likely to resume, reviving downside risks to the yuan.

**BRAZIL:** The central bank's monthly proxy for real GDP growth, the IBC-Br index, provided further confirmation of Brazil's emergence from economic depression. The index rose 0.3 percent in April from March and 0.5 percent from a year earlier. However, Brazil continues to face downside risks from the political turmoil which resumed in May after the release of an audio recording of President Michel Temer apparently authorizing a bribe.