Weekly Updates Issue # 673

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1. Weekly Markets Changes

[July 20, 2018]

S&P TSX	S&P 500	Dow Jones	NASDAQ	CAD/USD	Gold	WTI Crude
16,435.46 -125.66 -0.76%	2,801.83 +0.52 +0.02%	25,058.12 +38.71 +0.15%	7,820.20 -5.78 -0.07%	$0.7609 -0.22c -0.29%	$1,229.53 -14.79 -1.19%	$68.26 -2.81 -3.96%

2. At 2.5%, inflation in June rises to highest point since 2012

[July 20, 2018] The country's annual inflation rate rose to 2.5% in June as consumer prices grew at their fastest pace in more than six years, Statistics Canada said in a report Friday.

The federal agency's latest inflation number received a boost from higher energy prices, especially gasoline, fuel oil and other fuels. It followed a 2.2% reading for May.

Other big contributors behind last month's stronger inflation figure were pricier airline tickets, restaurants and mortgage interest costs. The downward pressure on prices last month was led by cheaper costs for telephone services, travel tours and digital equipment and devices.

The June pace lifted inflation to its highest point since February 2012 when it was 2.6%. It also moved the number farther away from the 2% mid-point of the Bank of Canada's target range.

The central bank, however, has been expecting inflation to rise.

Last week, the central bank predicted inflation to move as high as 2.5%—due to temporary factors like higher gas prices—before it settles back down to 2% in the second half of 2019.

The Bank of Canada can use interest rate hikes as a tool to help prevent inflation from climbing too high. Governor Stephen Poloz tries to keep inflation within a range of between 1% and 3%.

Poloz raised the trend-setting interest rate to 1.5% last week. It was the bank's fourth hike over the last 12 months.

Friday's Statistics Canada report said the average of Canada's three measures of core inflation, which leave out more-volatile data like pump prices, rose slightly last month to 1.96%, from 1.9%. Underlying inflation is closely watched by the central bank.

While these readings "will boost expectations for a follow-up hike from the Bank of Canada in the near-term, the fact that the core-common measure of inflation remained at 1.9% suggests that central bankers still have the ability to be patient," says Royce Mendes, director and senior economist at CIBC, in a Friday note.

"Indeed, they will likely want to see how much growth tails off after the second quarter rebound. The Canadian dollar is trading stronger, and fixed income has sold off," he adds.

In a separate release, Statistics Canada said retail trade expanded by 2% in May thanks to higher sales at vehicle and auto parts dealers as well as gas stations. Sales growth was just 0.9% in May if these categories are excluded, the agency said.

The May increase follows an April contraction of 0.9%.

"Headline retail sales hit a home run in May," Mendes says in the same CIBC release says. "In real terms, the 2% rise in retail sales will support healthy tracking forecasts for May GDP, already benefitting this week from the solid reading on manufacturing sales."

Provincial breakdown

Here's what happened in the provinces (previous month in brackets).

- Newfoundland and Labrador: 2.3% (1.8%)
- Prince Edward Island: 2.9% (2.4%)
- Nova Scotia: 2.2% (2.3%)
- New Brunswick: 2.2% (2.1%)
- Quebec: 2% (1.7%)
- Ontario: 2.4% (2.3%)
- Manitoba: 2.7% (2.7%)
- Saskatchewan: 2.7% (3%)
- Alberta: 2.8% (2.6%)
- British Columbia: 2.7% (2.7%)

3. Why Trump has little power over the Fed

[July 20, 2018] U.S. President Donald Trump has become increasingly critical of the U.S. Federal Reserve. But there is only "mild cause for concern."

So said Derek Holt, vice-president and head of Capital Markets Economics at Scotiabank in a Thursday report, which outlines several reasons why the U.S. leader currently has little power over the central bank.

Those reasons include the fact that Fed Chair Jerome Powell will have his seat until at least 2022, after the next presidential election. As well, "Trump has no direct influence over regional Fed vacancies" and Fed Board of Governors (BoG) hiring processes.

For those, "[…] there is no need for Presidential or Congressional approval," Holt wrote.

Still, the Trump administration has fulfilled expectations that it would "come to be increasingly concerned about the sterilization of its stimulus efforts by the markets, including through the USD and the Fed," and that will likely continue, Holt said.

His report followed comments made by Trump on Thursday, in which he cast aside concerns about the Federal Reserve's independence, saying he was "not happy" with the Fed's recent interest rate increases.

Trump told CNBC in an interview: "I don't like all of this work that we're putting into the economy and then I see rates going up."

Last month, the Fed raised its benchmark rate for a second time this year and projected two more increases in 2018.

The central bank's rate hikes are meant to prevent the economy from overheating and igniting high inflation. But rate increases also make borrowing costlier for households and companies and can weaken the pace of growth. In particular, the Fed's most recent rate hikes could dilute some of the benefit of the tax cuts Trump signed into law last year.

The president acknowledged that his comments about the Fed would likely raise concerns. The central bank has long been seen as needing to operate free of political pressure from the White House or elsewhere to properly manage interest rate policy.

Trump's comments did have an impact, Holt said, noting that both the greenback and U.S. Dollar Index (DXY) were affected.

However, "The DXY has since recovered a part of this and, in my view, there should be little follow through," he wrote. (That index is still trading about US$0.50 lower than July 19, as of 10 a.m. on July 20, but it remains around three-month, six-month and one-year highs.)

Overall, Holt said in his commentary, "the issue is less about what Trump can 'let' the Fed Chair do and more about how little he can do about it in any practical direct sense, especially within near- to medium-term horizons."
He adds: "On top of volatility that was induced earlier in the year in remarks by the President and his Treasury Secretary Steve Mnuchin, it appears that the administration is still feeling its way on the matter," which could cause "apprehension toward USD-denominated assets […]."
Trump continued to call out the Fed on Friday. He tweeted: "The United States should not be penalized because we are doing so well. Tightening now hurts all that we have done. The U.S. should be allowed to recapture what was lost due to illegal currency manipulation and BAD Trade Deals. Debt coming due & we are raising rates – Really?"
The president's criticism is ironic, Holt noted in his report, given Trump's "pointed criticisms of Yellen in September 2016″ were based on his disapproval of low interest rates and on how, if rates were raised, he thought that would help the stock market.
On a positive note, "Investors can cheerily note that since the Fed first began raising borrowing costs in December 2015, the S&P500 has rallied by about 35%," Holt said.

No rules broken

U.S. administrations don't often comment on Fed actions, but Trump isn't the first president to voice displeasure, says Avery Shenfeld, managing director and chief economist for CIBC, in a Friday report.
"While his recent predecessors maintained their silence on monetary policy matters, both Nixon and Reagan leaned on the Fed during their time in office, while George H.W. Bush griped after his term," he writes.
However, Trump's views likely won't affect the Fed at its next meeting, set for July 31-Aug. 1. "The last time a central bank seemed to have succumbed to pressure for easier monetary policy, we were left with the sharp inflation climb of the Nixon era, hardly a comforting precedent," Shenfeld warns.
Further, he says, "if [Trump's] looking for reasons for a U.S. dollar rally, he should also be looking in the mirror. Markets that worry about trade war damage to Europe, Canada, or Mexico will be tempted to sell those currencies, expecting their trade balances to deteriorate, or their central banks to take a softer line on monetary policy."

4. A transatlantic trade war is brewing. Can it be stopped?

[July 20, 2018] Europe is hoping crunch talks with the United States next week will head off the threat of car tariffs and a transatlantic trade war.

But expectations for the meeting between President Donald Trump and European Commission President Jean-Claude Juncker could hardly be lower.

“Anything short of an outright disaster would be considered a success," Judith Lee, an international trade lawyer at Gibson Dunn, said of the talks scheduled for Wednesday in Washington.

The United States has put tariffs on aluminum and steel imports from the European Union, and the bloc has retaliated with new taxes on American products. Trump is now threatening to hike tariffs on cars and auto parts from the European Union to 20%.

EU trade commissioner Cecilia Malmström, who is also making the trip to the United States, said the purpose of the trip was to lower the temperature.

"The aim of President Juncker's visit is to try to establish a good [relationship], try to see how we can deescalate the situation ... and see if there's a forum where we can discuss these issues," Malmström said on Thursday.

The United States and European Union have the world's largest bilateral trading relationship, worth over $1.1 trillion a year. But some analysts say that Trump will continue to chip away at the vital business link.

"Everybody expects Trump to carry on imposing more tariffs," said David Henig, a trade expert and director at the European Centre for International Political Economy.

Trump has not adopted a conciliatory stance ahead of the meeting, tweeting his reaction this week to an EU antitrust ruling that went against Google.

"I told you so! The European Union just slapped a Five Billion Dollar fine on one of our great companies, Google. They truly have taken advantage of the U.S., but not for long!" he said on Twitter.

On Friday, he accused Europe (and China) of keeping their currencies artificially weak while the dollar strengthened, "taking away our big competitive edge."

'I don't know if it would work'

Top White House economic adviser Larry Kudlow said Wednesday he expects Juncker to bring a "very important free trade offer."

But it's unclear whether the European Union will be able to offer concessions that would satisfy Trump. The bloc would be looking for the United States to make concessions as part of any deal.

The European Union charges a 10% tariff on cars imported from the United States. But 85% of cars assembled in the United States and sold in Europe are exempted because they contain European parts. The United States charges a 2.5% tax on cars imported from Europe.

Malmström said Thursday that the bloc would consider "outside the box" solutions including an effort to coordinate with other major auto-producing nations to lower tariffs on cars produced in the United States.

"It is one idea of many. I don't know if it would work at all," she said.

The United States has already turned down an EU offer to slash its car tariffs during talks over the steel and aluminum tariffs, and analysts have warned that offering further concessions could have negative consequences.

"As soon as we give in ... on cars, he'll smell blood in the water and move on to the next [thing]," said Ross Denton, a trade expert and partner at Baker & McKenzie in London.

'Beyond economic rationalities'

Trump has framed his trade actions as part of an effort to shrink the US trade deficit and boost its exports.

About 35% of the US trade deficit is attributable to auto imports, according to analysts at UBS. The European Union, which is home to Volkswagen), BMW) and Mercedes owner Daimler, exports over €50 billion ($58 billion) in cars and auto parts to the United States each year.

But analysts say that lower tariffs would do little to shift the trade balance.

"Americans love European cars... Do Europeans like American cars, generally? Not so much," said Denton.

Carsten Nickel, a research director at Teneo Intelligence, said that lower car tariffs might please Trump, but they probably wouldn't translate into any real economic benefit.

"The story here goes beyond economic rationalities," he said.

Malmström said that work is already underway on a list of American products that would be hit if Trump moves ahead with the car tariffs.

The bloc warned earlier this month that nearly $300 billion of US exports could be hit by retaliatory tariffs if the Trump administration decides to penalize automobile imports from around the world.

5. 24% of Tesla Model 3 orders have been canceled, analyst says

[July 19, 2018] Tesla is finally making enough Model 3s -- but an analyst says many customers are growing too impatient to wait any longer for them.

Cancellations for Model 3 orders have picked up in recent weeks. Refunds now outpace deposits for Tesla's new mass-market electric car, according to Needham & Co. analyst Rajvindra Gill. Tesla disputes that.

In an analyst note delivered to clients Thursday, Gill cited extended wait times for the car, the expiration of a $7,500 tax credit, and the fact that Tesla has not yet made the $35,000 base model of the car available for purchase yet.

About one in every four Model 3 orders is canceled, Gill said, double the rate from a year ago. Customers have to put down a refundable $1,000 deposit to reserve a Model 3, then pay another $2,500 to choose their specific version. They pay the rest when the car is delivered.

The wait time for a Model 3 is about 4 months to a year, and base model customers could wait until 2020, Gill said.

A Tesla spokesperson denied that Model 3 cancellations exceed new orders. The spokesperson also said the wait times that Gill cites are outdated. Tesla's website currently lists wait times from 1 month to 9 months.

Gill called sales of the Model S and Model X "lackluster," especially with the growing amount of competition from luxury manufacturers. Tesla announced earlier this month that orders and deliveries of those models grew last quarter. The company is also maintaining its delivery target of 100,000 vehicles.

He doubts Tesla will reach its target of 100,000 Model 3 deliveries by the end of the year -- to accomplish that goal would require it would have to ship 27% more cars in the second half of the year than it did in the first half. Gill said that he's also "skeptical of demand" for the sedan.

In another warning, the analyst said Tesla's capital structure is also "unsustainable," as free cash flow continues to evaporate. Gill expects Tesla to burn through $6 billion by 2020. He wrote that the Tesla stock is "still overvalued" despite falling 16% from its June 2017 peak.

He downgraded Tesla stock to "underperform" -- essentially a sell rating.

Tesla has been struggling with the Model 3 for several months. Separately, investors aren't thrilled with founder Elon Musk's antics on Twitter.

Tesla's stock fell nearly 3% Thursday.

6. CMHC changes make it easier for self-employed to get mortgages

[July 19, 2018] CMHC is making policy changes to help self-employed Canadians obtain mortgages.

The self-employed comprise about 15% of Canada’s population, says the crown corporation in a release. But they may have difficulty qualifying for a mortgage because their incomes may vary or be less predictable.

“These policy changes respond to that reality by making it easier for self-employed borrowers to obtain CMHC mortgage loan insurance and benefit

from competitive interest rates," says Romy Bowers, chief commercial officer at CMHC, in a release.
One change will give examples of factors that can be used to support a lender's decision to lend to someone self-employed who has been operating their business for less than 24 months or has been in the same line of work for less than 24 months, says the release. Those factors include purchasing an established business, sufficient cash reserves, predictable earnings and previous training and education.
The other change will provide a wider range of documentation options to meet income and employment requirements, CMHC says. The options can include the Notice of Assessment accompanied by the T1 General, the CRA Proof of Income Statement and the Statement of Business or Professional Activities "to support an 'add back' approach for grossing up income for sole proprietorship and partnerships," says the release.
The changes, which apply to both transactional and portfolio insurance, will come into effect on Oct. 1.

7. Tax burden makes Canada less competitive: survey

[July 17, 2018] Canada's tax burden makes the country less competitive for businesses compared to the U.S., says a quarterly survey by the Chartered Professional Accountants of Canada (CPA Canada).
The "CPA Canada Business Monitor (Q2 2018)" surveyed professional accountants in leadership positions. Compared to a year ago, the survey found 68% of those polled perceive Canada as a less competitive place to invest and do business than the U.S. The finding is unchanged from the last quarter.
The top reason cited for Canada not being competitive was its overall tax burden (29%), followed by the U.S. tax reform passed late last year (14%).
"The survey findings reinforce the need for a comprehensive review of Canada's tax system, led by an independent expert panel, that would strive to reduce complexities, address inefficiencies, improve fairness and ensure economic competitiveness," says Joy Thomas, president and CEO at CPA Canada, in a release.
Several industry groups lobbied the federal government ahead of its February budget to respond to U.S. tax cuts by adding write-offs and other tax measures for business investment.
The survey's findings about the outlook for the Canadian economy and companies include:

- 32% had an optimistic outlook for the economy for the next 12 months—the same as the last quarter but down from 50% in Q2 2017;

- the top two challenges to the Canadian economy were U.S. trade protectionism (39%) and uncertainty (14%);
- 53% are optimistic about the prospects for their own companies for the next 12 months; 68% think their revenues will increase in the next year; and 60% say their profits will increase.

Almost six in 10 of those surveyed (58%) say they have difficulty finding skilled workers and professionals to fill certain jobs. The positions hardest to fill in the last two years were:

- skilled trades (37%);
- skilled/IT positions (22%); and
- middle management (17%).

Threat of personal debt

Four in ten (41%) of those surveyed think the level of Canadian personal debt is a threat to the future demand for their companies' products and services, says the release. The majority (83%) of the business leaders surveyed say the federal government should continue to warn Canadians to reduce their personal debt levels.

Methodology: For the Q2 2018 study, emailed surveys were completed by 466 of 5,922 people identified by CPA Canada as holding senior positions in industry (CFOs, CEOs, COOs and other leadership roles). The response rate was 9.7%, with a margin of error associated with this type of study ±4.4%, with a confidence level of 95%.

8. How Trump's new tax act hurts Americans in Canada

[July 16, 2018] The U.S. tax system has never been kind to U.S. citizens in Canada. Now, with the 2017 Jobs and Tax Cuts Act (JTCA), the U.S. Congress has made life even more challenging for many U.S. citizens in Canada who operate businesses.

U.S. citizens who own Canadian corporations have long been subject to Subpart F of the Internal Revenue Code, which requires certain types of income earned within the corporation to be taxed as U.S. personal income. These rules are known as the Controlled Foreign Corporation (CFC) rules, and they are intended to prevent the U.S. tax deferral that comes with earning investment income through a non-U.S. corporation.

When a CFC earns Subpart F income (mainly comprised of interest, dividends, rents and royalties), that income is added to the personal income of the CFC's U.S. shareholders in the year the income was earned by the CFC—unless taxable dividends have been paid. This is unlike the Canadian regime, where tax is only imposed when funds are distributed from the corporation.

Therefore, deferral of tax within a corporation carries a risk of double taxation: within the corporation as Subpart F income by the U.S. system, and then again by the Canadian system when the funds are distributed.

Up until the JTCA took effect, U.S. citizens in Canada had been able to avoid this accrual taxation in the U.S. for any active business income earned by their corporations. Thus, many owner-operators have been able to retain earnings in their corporate structure to build up a nest egg for their retirements.

Section 965 of the JTCA punishes this type of planning by enacting a deemed repatriation tax.

The stated policy of Section 965 is to provide for a transition to a territorial system of corporate taxation whereby the offshore earnings of foreign subsidiaries of U.S. corporations can be brought back to the U.S. without further taxation. However, in order to level the playing field, Section 965 imposes a one-time tax on the retained earnings of "specified foreign corporations," which are defined as any CFC (whether owned by a U.S. corporation or person).

This one-time tax applies to all post-1986 earnings and profits of a CFC that have not yet been taxed in the U.S. under prior Subpart F rules. For most individual U.S. shareholders of a CFC, this tax applies for the 2017 tax year, and works out to approximately 15.5% of the cash (or cash equivalents) held by the CFC and 8% of the other assets.

Foreign tax credits (FTCs) can generally offset the Section 965 tax, and U.S. citizens that have substantial carry-forwards from prior years may not have much to worry about. As well, FTCs generated by dividends paid in 2018 can be carried back to offset the tax paid in 2017 under Section 965. However, this latter strategy merely avoids the double taxation that would otherwise arise on future dividends, and we expect the IRS will be sluggish in issuing refunds for 2017 based on a carryback of Canadian FTCs.

U.S. owners of Canadian businesses need to evaluate their exposure to the Section 965 tax and implement plans to avoid the double taxation that results from ignoring the problem. Each situation will be different, and some tax will likely need to be paid. However, with proper planning and implementation, that tax can likely be mitigated.

Have a nice and fruitful week!

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