KEY POINTS:

- **Stocks stumble ahead of the Fed**
- **The Fed should argue against over-valued asset markets…**
- **...including stocks that may still be cheap…**
- **...while pointing to mounting early evidence of a solid recovery…**
- **...that it is intent upon nurturing with heavy and prolonged stimulus…**
- **...in order to get us back to where we were as fast as possible**
- **US CPI could temporarily stabilize**
- **Cooler Chinese inflation expected**
- **Brazilian inflation could drop to a 21 year low**

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TODAY'S NORTH AMERICAN MARKETS

What drove a mild off-day in the equity market? That's not clear, but apprehension ahead of the Fed may be one consideration, albeit if misplaced. There really wasn't anything calendar-based to motivate the trade by way of incremental evidence today. In my view, the Fed should admit to a broad cross-section of early evidence on solid if not V-shaped readings across the global economy, how it intends to apply as much stimulus as possible to get the economy back to where it was as rapidly as possible, and come out swinging against the camp that says they are causing an asset bubble. I'll return to these points, but first, a recap of the day's market swings.

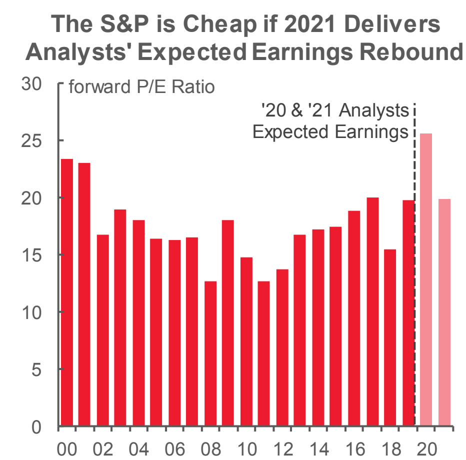
- US and Canadian spreads narrowed over European and Latin American sovereign yields. 10s and 30s rallied by 4–6bps in both the US and Canada and curves flattened with 2s down by about 2bps in both countries.

- Stocks mostly fell. The Nasdaq was an exception as it gained ¼%. The S&P500 fell by ¾% as selling was broadly based except for IT and communications stocks. The TSX fell by about ¾%. European cash markets closed about 1½% to about 2% lower.

- Oil prices edged higher by ½% to 1½%. Gold was up $17 but continues to gyrate around largely unchanged levels since about mid-April.

- The US dollar depreciated a touch and mostly against other safe havens like the yen and Swiss franc. The euro, won and rand also gained. CAD slightly depreciated but the weakest crosses were the Mexican peso, real and A$/NZ$.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2

Sources: Scotiabank Economics, OpenTable.

OVERNIGHT MARKETS

China will update CPI and producer price inflation for May tonight (9:30pmET). Consensus expects producer prices to keep declining by about 3% y/y mainly as a reflection of what we already know about commodities. CPI is expected to decelerate to under 3% y/y (3.3% prior) as the combined effects of weakening Swine Flu influences on pork prices perhaps join with dissipating core inflation that is already running at its lightest since the GFC. Aggregate financing figures may also arrive overnight or any time by early next week.

Brazil will also update its main inflation gauge for May (8amET). We could see the weakest inflation print since early 1999 on soft energy prices and the ongoing COVID-19 shock.

TOMORROW'S NORTH AMERICAN MARKETS

US CPI for May will be released at 8:30amET ahead of the FOMC, while having zero bearing upon the Fed's communications. The year-over-year headline CPI inflation rate may hold steady at 0.3% y/y with my guesstimate a tick lower. Core CPI inflation is expected to hold at 1.4% y/y (my estimate) or slip a tenth. A shift in year-ago base effect comparisons to May instead of April might knock a little off inflation and gas price changes should be a minor influence this time. The main uncertainty focuses upon whether May will continue to be a month for modest seasonal price gains relative to net effects of supply chain disruptions and weak demand.

Then we're onto the Fed with the statement, forecasts and dot plot at 2pmET followed by Chair Powell's press conference at 2:30pmET. As written in the Global Week Ahead (here), don't expect a sudden narrative shift. The emphasis is very likely to remain upon cautious optimism centered upon nurturing the rebound in an all-out effort to over-stimulate and get the economy back to full capacity as quickly as is possible under the circumstances. The speed of the bond market sell-off—except for today—might motivate more emphasis upon yield curve control and maybe that's why bonds rallied today in anticipation of such today.

But there are two main issues I'd like to add to the arguments that were offered in the week ahead.

1. Asset valuations

There is a growing school of thought that the Fed and other central banks are driving an asset bubble when the evidence is wanting. In fact, I'd go further than that and suggest that the Fed can stimulate away and should tolerate richer asset valuations yet.

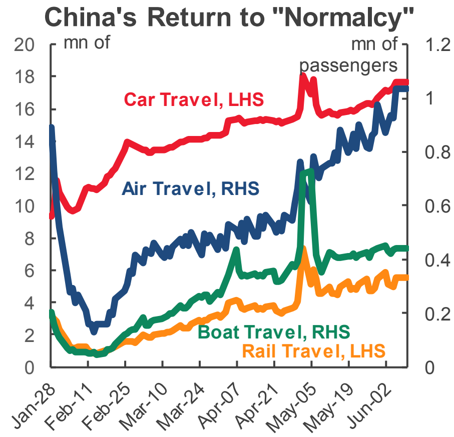
First, on stocks, traditional relative measures that were recapped in yesterday's note showcase how stocks are not cheap but there is nothing particularly out-of-sample going on here. Yet investors are buying on a price relative to forward earnings basis over multiple quarters ahead in anticipation of a rebound. They're not buying stocks to get a claim on earnings this quarter (or lack thereof…) or last quarter or even this full year's earnings that will be depressed by the first half experience. In fact, for the S&P500, price compared to 2021 earnings expectations sits at about 20 times (chart 1). If the earnings rebound turns out to be anything close to analysts' expectations, then maybe….gasp…stocks are cheap and nobody wants to say as much.

If so, then daily gyrations aside, stocks could have considerably more room to run. This runs counter to the common narrative that the Fed's stimulus is driving ridiculous stock valuations rather than viewing such valuations as based upon post-COVID-19 earnings expectations in a recovery (I'll come back to recovery evidence in a moment).

Second, given that the Fed looks at broad asset markets, we also need to do so. When I look at commodity valuations, we've got a long way to go yet before we get to over valuation. Talked to the oil patch lately? Enough said.

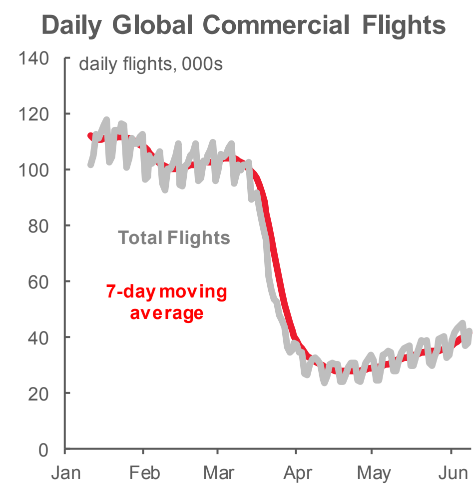
Housing also doesn't seem over-valued. One gauge is homebuyer affordability that before the COVID-19 shock was only slightly more affordable than the two decade average. Another is repeat sales home price indices that were climbing by 4.4% y/y before the shock and well below the recent peak rate of growth in early 2018.

Chart 3



Sources: Scotiabank Economics, Ministry of Transport of the People's Republic of China.

Chart 4



Sources: Scotiabank Economics, Flight Radar.

And then of course we have the Fed's preferred core PCE gauge of inflation that is likely to decelerate sharply over the faces downside risk over the duration of the year. Not only is evidence of asset inflation often overstated, it principally matters when it shows up in broad price signals and that's not likely to happen for some time.

2. Rebound expectations

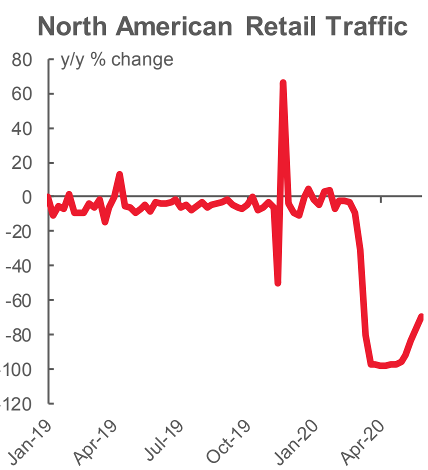
Equity analysts' earnings expectations are based upon underlying expectations for an economic rebound. In my opinion, there are already signs that the global economy is recovering and quite possibly going V-shaped which should inform a cautiously optimistic bias at the Fed. Heck, that's not even entirely a forecast as there is evidence that conditions are already headed there such that by the time GDP growth returns to the black in Q3 we'll already be well into recovery mode.

Look at the evidence. German restaurant bookings are soaring (chart 2). Chinese air travel has already recovered to well above where it was at the start of the year (chart 3). Global air travel is gradually recovering (chart 4). North American retail foot traffic is starting to recover, albeit out of a deep pit (chart 5). US homebuyer foot traffic is slowly inching higher (chart 6) and mortgage purchase applications have not only recovered the COVID-19 shock but are at levels seen well before the US economy shut down in mid-March (chart 7).

Is all of this durable? Some will argue this time is different and that we'll never return to the same activities. I wouldn't be so sure. As sophisticated as humans like to think we are as a species, we are not. We never change, or maybe we just adapt and move on by doing things differently, spending money in different ways or on different things with varying time periods toward a full recovery. History offers abundant evidence. I've been doing this gig in one form or another for about a quarter century which is just barely enough time in the grand sweep of history's humbling lessons to have learned that every time a shock arises, we're told we'll never be the same again and things will never return to some sense of normalcy. We do. Every time that view turns out to be dead wrong. One of my favourite examples was when demographics best sellers told us during the early 1990s recession that an aging population meant fundamentally changed behaviour and we'd never have another housing boom after the 1980s. Oops.

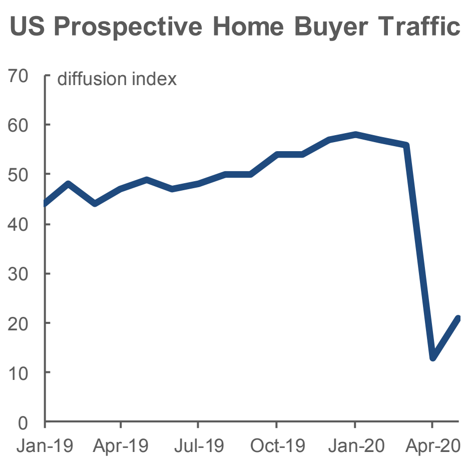
As for second-wave COVID-19 risk, yes it's real, especially as reopening efforts gain speed and social inhibitions toward large gatherings so obviously decline. But will that stop the economy again? Probably not. One reason is that governments can't afford to do that all over again; to take on balance sheet the shut down economy again could risk deficits rapidly soaking up excess world saving and impairing the ability of companies and households to roll over debt from the last cycle. Governments across the world were running procylical fiscal policy with varying shades of abandon before the shock and this limited their flexibility to address this one.

Chart 5



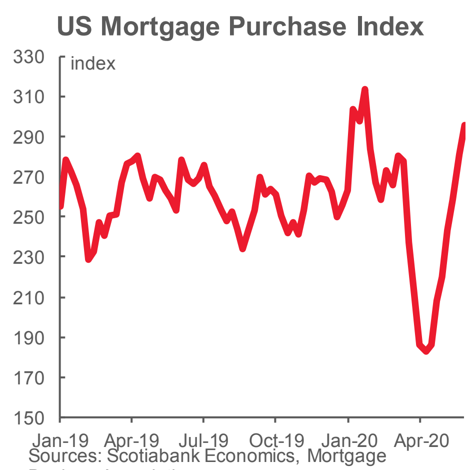
Sources: Scotiabank Economics, PRODCO.

Chart 6



Sources: Scotiabank Economics, National Association of Home Builders.

Chart 7



Sources: Scotiabank Economics, Mortgage Bankers Association.

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.	0.20	0.23	0.16	0.40	0.45	0.32	0.83	0.88	0.69	1.58	1.64	1.49
CANADA	0.30	0.32	0.29	0.45	0.48	0.39	0.63	0.67	0.54	1.19	1.25	1.14
GERMANY	-0.61	-0.62	-0.65	-0.56	-0.58	-0.62	-0.31	-0.32	-0.42	0.20	0.21	0.07
JAPAN	-0.14	-0.13	-0.14	-0.10	-0.08	-0.13	0.02	0.05	0.01	0.55	0.59	0.52
U.K.	0.01	0.00	-0.03	0.08	0.08	0.03	0.34	0.33	0.22	0.73	0.77	0.64
	Spreads vs. U.S. (bps):											
CANADA	10	9	12	5	3	7	-19	-20	-15	-39	-39	-35
GERMANY	-81	-85	-82	-96	-102	-94	-113	-120	-110	-138	-144	-142
JAPAN	-34	-35	-31	-50	-53	-44	-81	-82	-67	-103	-105	-96
U.K.	-19	-23	-19	-32	-37	-29	-49	-54	-46	-84	-87	-85

Equities	Level		% change:			
	Last	Change	1 Day	1-wk	1-mo	1-yr
S&P/TSX	15834	-141.2	-0.9	2.9	5.8	-2.4
Dow 30	27272	-300.1	-1.1	5.9	12.1	4.6
S&P 500	3207	-25.2	-0.8	4.1	9.5	11.1
Nasdaq	9954	29.0	0.3	3.6	9.1	27.2
DAX	12618	-201.6	-1.6	5.0	15.7	4.8
FTSE	6336	-136.9	-2.1	1.9	6.7	-14.1
Nikkei	23091	-87.1	-0.4	3.4	14.4	9.3
Hang Seng	25057	280.5	1.1	4.4	3.4	-9.1
CAC	5095	-80.4	-1.6	4.9	12.0	-5.3
Commodities	Level		% change:			
WTI Crude	38.38	-0.56	-1.4	2.9	55.1	-27.9
Natural Gas	1.77	0.00	0.0	-3.0	-3.1	-25.0
Gold	1716.16	0.83	0.0	1.0	0.8	29.2
Silver	17.63	0.05	0.3	-2.9	17.7	18.2
CRB Index	138.45	0.95	0.7	3.2	11.0	-20.5
Currencies	Level		% change:			
USDCAD	1.3420	0.0003	0.0	-0.6	-4.2	1.1
EURUSD	1.1338	-0.0002	-0.0	0.9	4.9	0.2
USDJPY	107.76	0.0000	0.0	-1.0	0.1	-0.6
AUDUSD	0.6952	-0.0009	-0.1	0.4	7.1	-0.1
GBPUSD	1.2727	-0.0001	-0.0	1.2	3.2	0.3
USDCHF	0.9506	-0.0002	-0.0	-1.1	-2.3	-4.0

Central Banks	
Current Rate	
Canada - BoC	0.25
US - Fed	0.25
England - BoE	0.10
Euro zone - ECB	0.00
Japan - BoJ	-0.10
Mexico - Banxico	5.50
Australia - RBA	0.25
New Zealand - RBNZ	0.25
Next Meeting Date	
Canada - BoC	Jul 15, 2020
US - Fed	Jun 10, 2020
England - BoE	Jun 18, 2020
Euro zone - ECB	Jul 16, 2020
Japan - BoJ	Jun 16, 2020
Mexico - Banxico	Jun 25, 2020
Australia - RBA	Jul 07, 2020
New Zealand - RBNZ	Jun 23, 2020