Rosa & Roubini ASSOCIATES

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R&R Weekly Column
By Brunello Rosa

R&R 2018 Outlook: Smooth Sailing for Now, With Headwind Risks Rising

Global Economic Outlook We are in the last few days of 2017, and so it is natural to have a look at the year about to begin and how we see it. As we have recently discussed in our 2018 Global Economic Outlook, we believe that the growth momentum that has characterised 2017 (as a moderate, global expansion), will likely continue in 2018. In fact, the global economy and financial markets currently appear in a sort of *Goldilocks* period of growth and inflation being not too cold and not too hot. Since the summer of 2016, the global economy has been in an expansion stage, positive growth that is accelerating in most key countries and regions. In most developed markets and emerging economies, there is an expansion as opposed to the slowdown – positive but slowing growth - that was observed in the two risk-off episodes of Q3 2015 and Q1 2016.

One might wonder whether such a prolonged period of expansion would eventually end, being already quite mature. But economic expansions don't die out of old age or natural death, as recessions are caused either by domestic or external shocks. In our global economic outlook, we consider a number of headwind risks: China hard landing, geopolitical risks, US/Trump, surge in long-term yields, a shock widening credit spreads, Eurozone risks resurfacing, not enough capex in energy-consuming economies. In our view, none of them is likely enough to trigger a sharp risk-off episode, although even a milder combination of some of them may trigger volatility and market correction of risky assets from elevated levels. In our outlook, we also discuss two alternative scenarios (upside and downside) compared to the baseline of a continued moderated expansion.

Market implications When the economy is in global expansion, inflation remains well-behaved, central banks are either normalising slowly or providing continued accommodation, fiscal policy is neutral at worst, regulation is set to become looser, naturally risk is "on" and risky asset prices are on their way up. At the same time, valuations are stretched, credit spreads low and private and public debt piling up. So, the risk of a "Minsky moment" is increasing significantly and may materialize in 2019-2020 if the current asset and credit cycle turns into a full-blown bubble. Also, we consider a big macro shock a necessary condition for a significant market correction (a 10% US and global equities correction), and this is a likely risk scenario, rather than our baseline for 2018.

In our 2018 Strategic Asset Allocation paper, we discuss the implications for asset allocation of such an environment, which remains challenging, as expected returns are likely to remain lower than during the pre-crisis period. In our view, in the context described above, a moderate risk-taking within a defensive positioning is justified. Achieving the goal of wealth preservation would require adopting conservative investment strategies, with a greater exposure to alternatives to provide some incremental return.

Our Recent Publications

- *Strategic Asset Allocation 2018: Moderate Risk-Taking Within A Defensive Positioning*
  by Alessandro Magnoli Bocchi, 22 December 2017
- *2018 Global Economic Outlook: Smooth Sailing for Now, With Headwind Risks Rising*
  by Nouriel Roubini and Brunello Rosa, 21 December 2017
- *December 2017 Review: Riksbank Brings Forward Reinvestment Plans*
  by Brunello Rosa, 20 December 2017

The Week Ahead

Global - The year will close with an all-time high in global bond issuance: In 2017, the total value of global bond issuance y-t-d reached USD 6.8tn, mostly driven by low interest rates. Blue-chip corporate borrowers accounted for more than 55% of the issuances, with EMs capitalizing on the appetite for higher yields.

Europe – Preliminary German CPI: On 29 December, Germany will publish its preliminary December CPI (c: 1.5% y-o-y; p: 1.8%).

The Quarter Ahead

US – Fiscal Reform and Fed Tightening: in the US, the fiscal reform will start being implemented and its effects on GDP, budget deficit and inflation felt. As the Fed is likely to hike interest rates more rapidly than other CBs (the FOMC's "dot plot" suggests three hikes in 2018), the USD is likely to strengthen somewhat in 2018 (we expect EUR/USD at 1.14 at yearend).

Europe - EZ's economic recovery to continue, but EU centrifugal forces likely to resume: The EZ's economic recovery will likely last, as political uncertainty in Germany is unlikely to impact the economy. However, centrifugal forces will continue to gain strength (on 21 December, in Catalonia's regional elections pro-independence parties secured a renewed majority in the parliament), as well as the nationalistic drive of some Central and Eastern European countries (on December 20, the EC started the process for issuing a formal warning to Poland, over reforms that would allegedly curtail the independence of the judiciary system). In the UK, Brexit-led uncertainty will likely weigh on growth.

EMs – Russian rate cuts ahead of elections, Brazilian Pensions, and China's reforms: In Russia, interest rates are likely to be cut further, ahead of the March 2018 presidential election. In China, President Xi will start implementing reforms and growth will likely slow. In Brazil, as growth picks up and the October 2018 general elections approach, the chances of pension reforms will fade.

Middle East - In the GCC, OPEC-led oil production cuts will likely continue to take a toll on GDP growth: Saudi Arabia's political and economic challenges will put further pressure on the region. Tensions with Iran will reach the level of "cold war", but military conflict will be avoided. The economic and military partnership of Saudi Arabia and the UAE will further weaken the GCC and add pressure on Qatar. GCC financial markets will experience volatility and a pick-up in bond yields, but will eventually stabilize. Currency pegs will hold, as oil prices will stay at around USD 55-60 per barrel.

Last Week's Review

US – The House of Representatives and the Senate approved the final version of the GOP tax plan: The final bill—already signed by President Trump—will cut taxes by USD 1.5tn over the next ten years, as it includes: a) lower individual tax rates, e.g. the top rate was lowered from 39.6 to 37%; b) a reduction of the corporate tax, from 35 to 21%; and c) an up-to-20% tax-free deduction of the income for pass-through businesses—partnerships and sole proprietorships. In order to comply with the Senate's budget-balancing rules, the individual tax cuts will expire after 2025. The Congress also averted a US government shutdown by passing a temporary spending bill, which funds the government through January 19.

GCC – Saudi Arabia's expansionary budget: Saudi Arabia announced the first expansionary budget in three years. In 2018, overall public spending will reach SAR 978bn (USD 291bn), a 5.6% y-o-y increase. As a result, the government expects GDP to grow at 2.7% in 2018 (from an estimated -0.5% in 2017).

Emerging Markets: In *South Africa*, Cyril Ramaphosa was elected leader of the ANC: his promise to fight corruption—which could lead to the ANC sacking President Jacob Zuma over graft allegations—is likely to raise the electoral support to his party. The markets reacted positively to the news: a) the JALSH stock market index rose by 1.7% w-o-w; b) the ZAR appreciated 3.7% w-o-w against the USD (to USD/ZAR 12.609). In *Turkey*, a) the TRY appreciated against the USD (1.3% w-o-w, to USD/TRY 3.810); and b) yields on local currency bonds slightly retreated (3bps w-o-w in the 2yr bond—to 13.07% - and 38bps w-o-w in the 10yr bond—to 11.71%), due to improved EM sentiment and the lack of further negative news on the "Zarrab case."

Pablo Gallego Cuervo contributed to this Viewsletter. *The picture in the front page comes from this website.*

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Abbreviations, Acronyms and Definitions

ANC	*African National Congress*	*GDP*	*Gross domestic product*
bn	*Billion*	*GOP*	*Grand Old Party (US Republican Party)*
BoE	*Bank of England*	*IEA*	*International Energy Agency*
BoJ	*Bank of Japan*	*IMF*	*International Monetary Fund*
bps	*Basis points*	*IPO*	*Initial public offering*
c	*Consensus*	*JALSH*	*Johannesburg Stock Exchange FTSE All Shares Index*
CB	*Central bank*	*m-o-m*	*Month-on-month*
CBK	*Central Bank of Kuwait*	*Nafta*	*North American Free Trade Agreement*
CBR	*Central Bank of the Russian Federation*	*OECD*	*The Organization for Economic Co-operation and Development*
CBT	*Central Bank of the Republic of Turkey*	*Opec*	*Organization of Petroleum Exporting Countries*
CPI	*Consumer Price Index*	*p*	*Previous*
DFMGI	*Dubai Financial Market General Index*	*PM*	*Prime minister*
DJIA	*Dow Jones Industrial Average Index*	*PMI*	*Purchasing managers' index*
d-o-d	*Day-on-day*	*QE*	*Quantitative easing*
EC	*European Commission*	*q-o-q*	*Quarter on quarter*
ECB	*European Central Bank*	*RUB*	*Russian Ruble*
EFSF	*European Financial Stability Facility*	*SOE*	*State-owned enterprise*
EM	*Emerging Markets*	*tn*	*Trillion*
EP	*European Parliament*	*TRY*	*Turkish Lira*
EUR	*Euro*	*UAE*	*United Arab Emirates*
EZ	*Eurozone*	*UK*	*United Kingdom*
Fed	*US Federal Reserve*	*US*	*United States*
FOMC	*US Federal Open Market Committee*	*USD*	*United States Dollar*
FRB	*US Federal Reserve Board*	*USD/bbl.*	*USD per barrel*
FX	*Foreign exchange*	*y-o-y*	*Year-on-year*
GCC	*Gulf Cooperation Council*	*y-t-d*	*Year-to-date*
GBP	*British Pound*	*w-o-w*	*Week-on-week*

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