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MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
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A Bumper Start of the Year Still Requires Some Cautiousness

The year has started with a continuation, if not an acceleration, of the trends and dynamics observed in 2017, especially in the second half. Global growth remains in a cyclical upswing, with some of the leading indicators (such as PMIs) suggesting a continued and reinforcing expansion. Inflation has not yet raised its ugly head, and – as long as it remains in check – will not derail the upturn. As a result, monetary policy can remain accommodative at global level, even if and when central banks start withdrawing some of the extraordinary accommodation provided in the last few years. For example, in our latest paper, we discuss the central bank of Canada's likely next move, and its possible tightening cycle in 2018. Fiscal policy is adding fuel to a maturing business cycle, especially in the U.S. where the tax cuts have further boosted sentiment and animal spirits (even if the eventual impact on growth will likely be more modest than initially anticipated). Some of the uncertainties that were restraining market sentiment, such as that around the formation of the German government, are now starting to be resolved, even if it will still take a number of months for the new "grand coalition" to emerge. In Europe, Italian elections are still a risk factor, but unlikely to cause an immediate resurgence of the re-denomination risk, and Catalonia-related issues don't seem to bother investors excessively.

Given this background, risk is "on" context and equities have had the best start of the year since 2003, with the U.S. leading the race. The modest rise in short and long-term yields observed in the last few weeks, with the 2y U.S. Treasury yield having reached the psychological barrier of 2% and the 5y and 10y yields having broken 25-year trend lines, seems more in line with this generalised optimism, than an indication of a new "tantrum," even when big players call for the end of the secular bond bull market begun in the 1970-'80s.

Is this all "hanky dory" then? As discussed in our Global Economic Outlook, 2018 would likely see a continuation of the smooth sailing observed in 2017, with a potential for upward surprises in coming weeks, while cautioning that the risk of headwinds was rising (the way we put it is that "we are in the 5th inning of the credit re-leveraging cycle, not in the 8th as we were in 2006-07"). In our scenario analysis, we identify the risks to confidence, economic activity and market prices deriving from an abrupt tightening of global financial conditions (for example led by the closing of the output gaps in several developed and even developing economies), escalating trade restrictions and rising geopolitical tensions. In its latest Global Economic Prospects the World Bank, while acknowledging the ongoing growth momentum, identifies similar short-term risks to the economic outlook.

Our Recent Publications

- *Canada: Strong Cyclical Growth, But Structural Challenges Lie Ahead*
  By Joseph Schupac and Brunello Rosa, 11 January 2018
- *Western Balkans: Still Many Obstacles to EU Accession*
  By Arlind Rama and Brunello Rosa, 9 January 2018

The Week Ahead

North America - BOC Meeting and US Budget. On Weds 17 January, the Bank of Canada will hold its policy meeting and is expected to increase its policy rate by 25bps to 1.25%. In the US, Congress is likely to approve another "budget deal" to avert a government shutdown before January 19, when the current funding runs out. If not approved, the US Treasury could use extraordinary measures to extend funding through late-March or early-April.

Europe – German "grand coalition" and inflation data. Inflation data will be released in the EZ - CPI (c: 1.4% y-o-y; p: 1.4%) and in the UK - CPI (c: 3.2% y-o-y; p: 3.1%). Chancellor Angela Merkel will lead the CDU-SPD negotiation to form a coalition government. As both parties agreed on entering talks to renew their alliance - which needs to be approved on January 21 by the SPD congress - the EUR/USD rose to a three-year high at 1.22 (+1.6% w-o-w).

Turkey **-** On January 18 the MPC of the CBT is expected to hold the key policy rates stable, despite a higher-than-expected December inflation (11.9%; p: 13.0%).

Tunisia **-** Protests over rising prices and tax increases are likely to continue. So far, over 800 demonstrators have been arrested and the army has been deployed. In the next days, protests could also erupt

Algeria **-** On Tuesday 9, the government temporarily banned the import of more than 900 items, in order to reduce imports to USD 30bn in 2018 (from around USD 45bn in 2016 and 2017), in an attempt to narrow the trade deficit.

The Quarter Ahead

US - the growth outlook will remain positive, providing support for further interest rate hikes**.** In December, core CPI rose by 1.8% (*c:* 1.7%; *p:* 1.7%), closer to the Fed inflation target of 2.0.

EZ's economic recovery will likely last**.** Macron's proposal to reform the EU and strengthen the EZ may gain momentum if: *a)* a "grand coalition" government in Germany is agreed; and *b)* Italian general election does not result in complete stalemate. The EZ November unemployment rate slightly declined to 8.7% (*c*: 8.7%; *p*: 8.8%).

UK **-** Brexit negotiations uncertainty will continue to weigh on growth.

China - Inflation is likely to pick up (December CPI: 1.8% y-o-y; *p:* 1.7%) supported by: *a)* rising liquidity, as December M2 grew at 9.2% y-o-y (*p:* 9.1%) and *b)* a still rising PPI (at 4.9% y-o-y in December; *p:* 5.8%).

GCC - Saudi Arabia and Iran's foreign policy will continue to weigh on political stability in the region, but military conflict is unlikely**.** Further GCC rating downgrades may hit the region. In particular, Oman faces the risk to be downgraded to junk as it is raising USD 6.5bn (10% of its GDP) in three tranches of bonds, in order to finance its USD 7.8bn budget deficit.

Commodities - Oil prices are likely to decline from current highs to the USD/bbl. 55-60 range.

Last Week's Review

Sovereign bond yields rose in the US and Europe, triggered by concerns that major CBs may withdraw liquidity faster-than-expected, as: a) on January 9, the BoJ slightly decreased its monthly bond purchases by JPY 10bn (USD 88.8mn); b) on January 10, media reported that China was considering reducing or ceasing purchases of US sovereign debt; and c) on January 11, the minutes of the ECB December meeting hinted at the possibility of QE ending in September 2018. As a result, yield rose: a) the US 10Y bond by 7 bps w-o-w (to 2.55%); b) the German 10Y bund by 7 bps (to 0.51%); and c) the Japan 10Y bond by 1.5 bps (to 0.075%).

Europe **-** On Saturday 13 the Second Payment Services Directive (PSD2) became effective; as a result, European banks will offer third-party financial-service-providers (including fin-techs) access to their customers' accounts.

China **-** In 2017 its trade surplus, at USD 422.5bn, was 17.0% smaller than in 2016, due to a 7.9% y-o-y increase in exports and a 15.9% rise in imports in USD terms. The trade surplus with the US reached an all-time high of USD 275.8bn.

Turkey - The government issued its first USD-denominated bond of 2018: USD 2bn of 10Y bonds, with a 5.20% yield (UST+267bps).

Commodities - Oil prices posted gains for a fourth week in a row. Supported by robust global demand, OPEC output cuts and geopolitical tensions, Brent closed the week at USD/bbl. 69.9 (+3.0% w-o-w).

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

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Abbreviations, Acronyms and Definitions

bn	*Billion*	*GDP*	*Gross domestic product*
BoE	*Bank of England*	*GOP*	Grand Old Party (US Republican Party)
BoJ	*Bank of Japan*	*IMF*	International Monetary Fund
bps	*Basis points*	*IPO*	Initial public offering
c	*Consensus*	*JPY*	Japanese yen
CB	*Central bank*	*k*	thousand
CBK	*Central Bank of Kuwait*	*m-o-m*	Month-on-month
CBO	*US Congressional Budget Office*	*M5S*	Five Star Movement
CBR	*Central Bank of the Russian Federation*	*OECD*	Organization for Economic Co-operation and Development
CBT	*Central Bank of the Republic of Turkey*	*Opec*	Organization of Petroleum Exporting Countries
CDU	*Christian Democratic Union of Germany*	*p*	Previous
CNY	*Chinese Yuan*	*PM*	Prime minister
CPI	*Consumer Price Index*	*PMI*	Purchasing managers' index
DFMGI	*Dubai Financial Market General Index*	*pps*	Percentage points
DJIA	*Dow Jones Industrial Average Index*	*QE*	Quantitative easing
d-o-d	*Day-on-day*	*q-o-q*	Quarter on quarter
DXY	*US Dollar Index*	*tn*	Trillion
EC	*European Council*	*TRY*	Turkish Lira
ECB	*European Central Bank*	*UAE*	United Arab Emirates
EM	*Emerging Markets*	*UK*	United Kingdom
EP	*European Parliament*	*US*	United States
EUR	*Euro*	*USD*	United States Dollar
EZ	*Eurozone*	*USD/bbl.*	USD per barrel
Fed	*US Federal Reserve*	*VAT*	Value added tax
FOMC	*US Federal Open Market Committee*	*w-o-w*	Week-on-week
FRB	*US Federal Reserve Board*	*y-o-y*	Year-on-year
FX	*Foreign exchange*	*y-t-d*	Year-to-date
GCC	*Gulf Cooperation Council*		