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R&R Weekly Column
By Brunello Rosa

Volatility Abates But Inflation Fears Will Continue to Weigh on Markets

Last week staged a rebound in equity markets after the sell-off of the previous days: on a weekly basis, the S&P500 rose by 4.2%, and VIX declined by 30% to 19.5. So, for the time being, the market has moved along the lines we highlighted at the beginning of the sell-off (see our weekly column of 5 February 2018), when we thought this would not represent the beginning of a bear market, and we suggested investors should get used to an environment of higher volatility in equity and bonds and higher sovereign yields due to the increase in the inflation risk premium included in the term premium embedded in long-term rates.

At the same time, the market remains particularly susceptible to inflation surprises (which can easily translate in "inflation scares"), as the sell-off in equities showed last week at the time of the publication of US inflation data, when January CPI came in unchanged from December at 2.1% y/y, against expectations of a drop to 1.9%. In particular, the fiscal and investment plans of the US administration, at this stage of the business cycle, risk being mostly inflationary, forcing the Fed to tighten more and faster. So, we expect inflation and higher yields and volatility to continue weighing on the US (and other) equity prices going forward, making it harder for equity indices to rise much beyond previous highs.

Of course, central banks are vigilant on the inflation phenomenon, with the Federal Reserves under Jay Powell, with a slightly more hawkish FOMC composition, likely to increase the Fed funds target range in March. But not all central banks are joining the Fed, Bank of Canada and Bank of England in their policy tightening cycles. The ECB and the BoJ have re-affirmed that they intend to continue providing monetary stimulus until inflation shows signs of sustainable upward trend towards the 2% target. The Swedish Riksbank has recently revised downward its inflation forecasts, likely implying a postponement of the expected time of the lift-off.

Low for longer yields in Europe and Japan will continue to constitute an anchor for US Treasury yields, with the 10y yield unlikely to rise much beyond 3%. The main upside risk is represented by an increase in real yields due to a rise in the US budget deficit and debt for the next few years (with the GOP abandoning their traditional stance of fiscal prudence). More in general, a continued accommodative monetary stance should help the global economy to remain in the ongoing synchronized expansion, unless some unexpected shock, including of geopolitical nature, brings this to a sudden end.

Our Recent Publications

- *Volatility and Inflation Fears Likely to Continue Weighing on Markets*
  By Brunello Rosa and Nouriel Roubini, 14 February 2018
- *Riksbank Review: On Hold, With a Dovish Tilt*
  By Brunello Rosa, 14 February 2018
- *Q&A on FOMC Composition and Fed's Policy Regime*
  by Brunello Rosa and Nouriel Roubini, 13 February 2018
- *Riksbank Preview: On Hold, With A Dovish Bias*
  by Brunello Rosa and Nouriel Roubini, 12 February 2018

The Week Ahead

***US* - The FOMC minutes will likely shed light on March FOMC meeting**. On Wednesday, the minutes will likely confirm that the Fed is ready to hike in March, given that the post-meeting statement in January was upbeat on inflation.

Europe - On Friday, the EZ will publish CPI data, which will remain below the ECB target (c: 1.3% y-o-y; p: 1.3%).

Turkey - The normalization of relations with the US might begin. Past week's visit of US Secretary of State Tillerson ended with a commitment to normalize relations and "work together in northern Syria", although no action has been adopted yet. The TRY appreciated 0.6% d-o-d against the USD (to USD/TRY 3.743) on the news.

The Quarter Ahead

***US - Rising fiscal spending could boost the deficit*.** On February 12, the US President proposed a USD 4.4tn federal budget for FY2019. The proposed budget, unlikely to be approved in its current form by the Congress, doubles the previous deficit projection to USD 984bn for 2019. In a decade, total debt would rise by 50% to nearly USD 30tn.

Europe - The Italian elections on March 4 constitute the most significant risk to the EZ economy in H1 2018. The vote is very uncertain and the eventual distribution of seats might make it hard to form a coalition government, and that could lead new elections after 6 months.

Japan - GDP growth is set to decelerate in 2018. In Q4 2017, GDP growth decelerated (*a:* 0.5% q-o-q SAAR; *c:* 0.9%; *p:* 2.3%). Momentum will continue to weaken into 2018: growth will likely decline to 1.2% y-o-y (*p:* 1.5%), maintaining the need for monetary policy support.

China - Declining shadow lending and a strong CNY suggest that the economic activity could soften in the next quarter.

Russia- The 2017 recovery was weaker than expected (*a*: 1.5% y-o-y; *c*: 1.8%; *p:* -0.2%). High oil prices will support growth in 2018, which is likely to accelerate modestly to 1.7%.

EM Securities outlook remains positive. Strong global growth and a weak USD support EM assets, which y-t-d have received net inflows of USD 11bn into bonds and USD 25bn into equities.

***GCC - Spreads are bound to increase*.** Over the last year, the spreads between US and GCC 3-month interbank rates narrowed significantly (to 6 bps in Saudi Arabia and 8 bps in the UAE, as of past week). In 2018, spreads are expected to widen, driven by the interest rate hike expectations in the US and the rising demand for loans in the GCC (expected to rise from around 0% growth in 2017 to around 5% in 2018, in both in Saudi Arabia and the UAE).

***South Africa - The outlook for 2018 improves following the resignation of President Zuma*.** The new president is Zuma's deputy, Cyril Ramaphosa, who is viewed as reform-oriented, business-friendly, and likely to tackle corruption. Elections are due to be held next year. The ZAR appreciated to a 3-year high of USD/ZAR 11.601.

Last Week's Review

US - Higher-than-expected inflation triggered a bond selloff. January CPI beat expectations (*a:* 2.1% y-o-y; *c:* 1.9%; *p:* 2.1%). As markets saw the data as a confirmation that inflation will continue to rise, bonds were sold and yields rose: the 10-year UST climbed from 2.83% on February 13 to a four-year high of 2.91% on February 15. US equity markets were on the up: the S&P500 rose by 4.2% w-o-w and the VIX declined by 30% w-o-w to 19.5. The USD weakened against the EUR by 1.3% w-o-w to EUR/USD 1.241.

Europe – EZ GDP, Inflation in Germany and the UK. The Eurozone economy expanded by 2.7% y-o-y in Q4 2017, in line with consensus (*a:* 2.7% y-o-y; *c:* 2.7%; *p*: 2.7%). Germany's January 2018 inflation was unchanged, below the 2.0% ECB target (*a:* 1.6% y-o-y; *c:* 1.6%; *p*: 1.6%) while UK's remained above the 2.0% BoE target (*a:* 3.0% y-o-y; *c:* 2.9%; *p*: 3.0%).

***Egypt - Raised USD 4bn in new debt*.** Egypt sold bonds issued in 5, 10 and 30-year tranches, with yields of 5.6%, 6.6% and 7.9% respectively. The sale attracted USD 12bn in orders, showing that appetite for EM debt—which reached record highs in 2017—remains strong despite recent market turmoil.

GCC - Final data confirm that 2017 was an exceptional year for fixed-income issuance. In 2017, the supply amounted to a record-high USD 86.4bn (*2016:* 62.0bn; *2015:* 28.0bn).

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

a	*Actual*
bn	*Billion*
BCB	*Central Bank of Brazil*
BoE	*Bank of England*
BoJ	*Bank of Japan*
bpd	*Barrels per day*
bps	*Basis points*
c	*Consensus*
CB	*Central bank*
CBK	*Central Bank of Kuwait*
CBO	*US Congressional Budget Office*
CBR	*Central Bank of the Russian Federation*
CBT	*Central Bank of the Republic of Turkey*
CDU	*Christian Democratic Union of Germany*
CNY	*Chinese Yuan*
CPI	*Consumer Price Index*
CSU	*Christian Social Union in Bavaria*
DFMGI	*Dubai Financial Market General Index*
DJIA	*Dow Jones Industrial Average Index*
d-o-d	*Day-on-day*
DXY	*US Dollar Index*
EC	*European Council*
ECB	*European Central Bank*
EIA	*US Energy Information Agency*
EM	*Emerging Markets*
EP	*European Parliament*
EUR	*Euro*
EZ	*Eurozone*
Fed	*US Federal Reserve*
FOMC	*US Federal Open Market Committee*
FRB	*US Federal Reserve Board*
FX	*Foreign exchange*
FY	*Fiscal Year*
GCC	*Gulf Cooperation Council*
GBP	*British pound*
GDP	*Gross domestic product*
GOP	*Grand Old Party (US Republican Party)*
IMF	*International Monetary Fund*
IPO	*Initial public offering*
JPY	*Japanese yen*
k	*thousand*
m-o-m	*Month-on-month*
mn	*Million*
MPM	*Monetary Policy Meeting*
M5S	*Five Star Movement*
OECD	*The Organization for Economic Cooperation and Development*
Opec	*Organization of Petroleum Exporting Countries*
p	*Previous*
PCE	*Personal Consumption Expenditures*
PM	*Prime minister*
PMI	*Purchasing managers' index*
pps	*Percentage points*
QE	*Quantitative easing*
q-o-q	*Quarter-on-quarter*
SAAR	*Seasonally Adjusted Annual Rate*
SHCOMP	*Shanghai Stock Exchange Composite Index*
SPD	*Social Democratic Party of Germany*
tb/d	*Thousand barrels per day*
tn	*Trillion*
TRY	*Turkish Lira*
UAE	*United Arab Emirates*
UK	*United Kingdom*
US	*United States*
USD	*United States Dollar*
USD/bbl.	*USD per barrel*
UST	*US Treasury bills/bonds*
VAT	*Value added tax*
VIX	*Chicago Board Options Exchange Volatility Index*
w-o-w	*Week-on-week*
y-o-y	*Year-on-year*
y-t-d	*Year-to-date*
YPG	*People's Protection Units*
ZAR	*South African Rand*