MAKING SENSE OF *THIS* WORLD 2 January 2018

R&R Weekly Column
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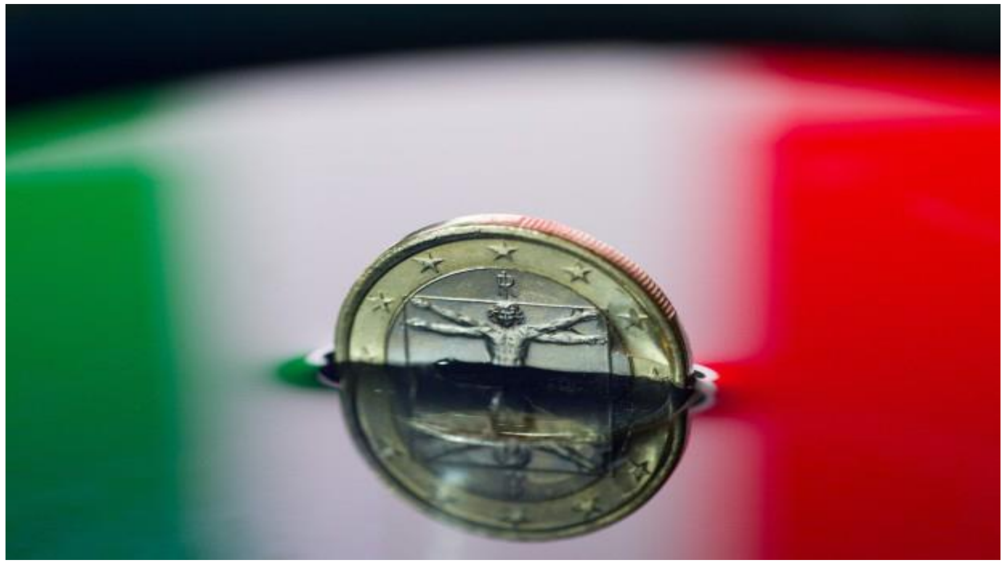

Italy: A Year of Living Dangerously

At the end last year, Italy's President Sergio Mattarella dissolved parliament (a few months ahead of the natural end, in mid-March), to allow general elections to be held on March 4th, 2018. The Italian general election is the most relevant political event of the first quarter of 2018, if we assume that Russian presidential election will end up with the victory of President Putin (with effectively no rivals).

This election will likely mark the beginning of a period of renewed political instability for the country, after a few years of relative calm, in spite of the four Prime ministers since 2011 (Monti, Letta, Renzi and Gentiloni, none of which formally mandated by an electoral result). In fact, since the fall of Berlusconi in November 2011, various forms of "grand coalition" between the PD and Forza Italia and its derivatives (in particular, the New Centre-Right founded by Berlusconi's former dolphin, Angelino Alfano) have warranted a majority in parliament to pass tough legislation on various fronts: pension, labour market, public administration reform, two new electoral laws, and even a constitutional reform that was eventually rejected by the referendum of December 2016.

But the new electoral law is less likely to produce a majority, unless a coalition reaches around 40% of the votes (which, depending on vote distribution) might result in a 50% majority of seats in parliament. At the moment, only the centre-right coalition led by Berlusconi's Forza Italia seems able to reach that result. But even if that happened, the divergence in programs between Forza Italia, Northern League (now only called League) and Brothers of Italy (a radical right-wing party) wouldn't warrant any stability in government.

If no coalition manages to obtain a majority in parliament, then it will be Mattarella's job to try to form a government and find a majority in the Chambers. His predecessor Napolitano succeeded in that, not without raising some eyebrow of constitutional experts. A "President's government" (or a variant of it) would start by ensuring full continuity in Italy's journey towards fiscal consolidation, by appointing a technocrat as Finance Minister, able to reassure the market. In this case, the incumbent Finance Minister Pier Carlo Padoan might remain in charge for a bit longer, to ensure continuity. But the market will remain skeptical of a government without a solid political mandate. A new round of elections might be necessary after only a few months.

In all this, BTPs will continue to enjoy the backstop of ECB's QE, but at a reduced pace, at the time banks are also offloading some of their BTP holdings (to comply with European and BIS requirements) and NPLs will continue to weigh on banks' balance sheets. This cocktail of events seems spicy enough to justify market participants' attention towards Italian elections in early March.

The Week Ahead

Global: PMIs/ISM will be released around the world: China Caixin manufacturing PMI for December will be released between Monday night and Tues morning; the Eurozone manufacturing PMI and the US Markit manufacturing PMI for December will be released on Wednesday. China's Caixin services PMI for December will be out Wednesday night/Thursday morning, the US manufacturing ISM and EZ services PMI for December will be out on Thursday.

US – Focus on NFP and Fed's minutes and speakers: On Weds, the minutes of the December FOMC meeting will be released. Later in the week, Fed speakers include Bullard, Harker, and Mester. On Friday 5 January, the US will publish the December m-o-m change in non-farm payrolls (*c:* 185k, *p:* 228k) and unemployment rate (*c:* 4.1%; *p:* 4.1%): positive data would increase the likelihood of a Fed rate hike at the FOMC meeting on March 21, 2018 (current probability estimated at 56.4%, according to CME Group).

Eurozone – Focus on Inflation: On Friday 5 January, the EZ y-o-y CPI will be published (*c:* 1.4%; *p:* 1.5%).

Middle East – Turkish inflation and protests in Iran. In Turkey, inflation data might prolong the TRY appreciation. On Thursday, December 28, the US and Turkey announced the end of reciprocal visa restrictions in place since October, although the US Embassy still has concerns about its arrested local employees. The TRY appreciated 1.1% d-o-d against the USD on the news (to USD/TRY 3.774). On Wednesday, January 3, the December y-o-y inflation in Turkey will be announced (*p:* 13.0%): a significant drop would further support the TRY. ***In Iran, protests over rising prices and alleged corruption are likely to continue***. There is also growing discontent about the country's involvement in external conflicts.

The Quarter Ahead

The outlook for bonds in 2018 remains mildly negative**.** On the week ending on 20 December 2017, bonds suffered the third largest withdrawal in 2017 (USD 3.3bn), as investors grew concerned by hawkish central banks and strong economic data. As a result, the 10-year US Treasury yield increased 2 bps m-o-m (to 2.41%).

The EZ's economic recovery will likely last, in spite of *a)* the threat posed by the March 4 elections in Italy, where support for the Eurosceptic opposition is on the rise (M5S has led all the December polls): potential outcomes include a hung parliament, a grand coalition or a populist, anti-EUR government; and *b)* rising centrifugal and nationalistic forces (Catalonia and Poland). Inflation will remain below the 2% ECB target, and monetary policy will remain expansionary. In the UK, Brexit-led uncertainty will weigh on growth.
Emerging Markets: *In Brazil*, as growth picks up and the October 2018 general elections approach, the chances of pension reforms will fade. *In Russia*, interest rates are likely to be cut further ahead of the March 18 presidential election. *In China*, President Xi will start implementing reforms and growth will likely slow.

In the GCC, OPEC-led oil production cuts will continue to take a toll on GDP growth. Saudi Arabia's political and economic challenges will put further pressure on the region, weakening the GCC. Tensions with Iran will reach the level of "cold war", but military conflict will be avoided. ***The UAE will lead non-oil growth in 2018*** (expected at 3.7% in 2018), driven by rising investment related to the Dubai Expo 2020. 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

The USD registered in 2017 its largest annual decline since 2007**.** The DXY has dropped 9.9% y-o-y, its first yearly depreciation since 2012. A strong euro—which appreciated 1.2% w-o-w to EUR/USD 1.201, supported by faster-than-expected growth and declining risks— was the main driver, while the recent Fed rate hikes have failed to have a significant impact on the USD.

In Europe, Germany inflation data hit a five-year high and Catalonia results hit Spanish equities. The December harmonized CPI of 1.6% y-o-y brings the yearly average to 1.7%, the highest figure since 2012. In Spain, stocks have been hit by the political uncertainty following the result of the Catalonia regional elections, with the IBEX-35 falling 2.5% w-o-w.

In Japan, unemployment hit a 24-year low. *In* November, the unemployment rate dropped 0.1 pps to 2.7%, its lowest level since end-1994. Y-o-y CPI reached 0.6% (*p:* 0.2%) core CPI hit 0.9% (*p:* 0.8%), still far from BoJ's target inflation of 2%.

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

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	*k*	thousand
CB	Central bank	*m-o-m*	Month-on-month
CBK	Central Bank of Kuwait	*M5S*	Five Star Movement
CBR	Central Bank of the Russian Federation	*Nafta*	North American Free Trade Agreement
CBT	Central Bank of the Republic of Turkey	*OECD*	The Org. for Economic Co-operation & Development
CPI	Consumer Price Index	*Opec*	Organization of Petroleum Exporting Countries
DFMGI	Dubai Financial Market General Index	*p*	Previous
DJIA	Dow Jones Industrial Average Index	*PM*	Prime minister
d-o-d	Day-on-day	*PMI*	Purchasing managers' index
DXY	US Dollar Index	*pps*	Percentage points
EC	European Council	*QE*	Quantitative easing
ECB	European Central Bank	*q-o-q*	Quarter on quarter
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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