Rosa & Roubini
ASSOCIATES

MAKING SENSE OF *THIS* WORLD — *5 February 2018*

R&R Weekly Column
By Brunello Rosa

Higher Yields and Lower Equity Prices: Be Aware, Not Scared

Last week staged the contemporaneous rise in long-term yields in US and other developed markets and a correction in equity markets, with the S&P500 losing 3.9% w-o-w, the worst weekly performance in two years. This market reaction was triggered by central bank communication and data releases. On Wednesday, the FOMC statement highlighted that "inflation on a 12-month basis is expected to move up this year," opening the door to a further 25-bps increase in March, in line with our preview. On Friday, the January 2018 employment report showed a solid 200k increase in non-farm payrolls, beating expectations for a 180k rise, with the unemployment rate remaining at the record low of 4.1%. More importantly, labour compensation showed signs of vitality with wages growing by 2.9% y/y, increasing concerns about rising inflation.

Better economic data and central bank communication triggered a bond sell-off. During the week, 10Y UST yields rose from 2.66% to 2.84%—a four-year high. In the EU, the German 10Y bond rose from 0.63% to 0.76%. This rise in yields has been driven by an increase in the nominal (rather than the real) component of long-term rates, and in particular by the normalisation of the inflation risk premium, rather than an increase in inflation expectations. In spite of higher US Treasury yields and expectation of potentially higher policy rates, the USD kept depreciating, with EUR/USD rising above 1.25 for the first time since December 2014.

The event of the past week confirmed what we suggested in our Viewsletter of 15 January 2018 ("*A Bumper Start of the Year Still Requires Some Cautiousness*") and are in line with our 2018 Global Economic Outlook ("*Smooth Sailing for Now, With Headwind Risks Rising*") and 2018 Strategic Asset Allocation ("*Moderate Risk-Taking Within A Defensive Positioning*"). With equities having staged the best start of the year for the last 20 years (with S&P500 still having returned 5% year-to-date), it would be premature to consider this episode as the beginning of a protracted correction, in particular considering that the rise in yields is underpinned by improving economic fundamentals. At the same time, investors should be wary of short-term market reversals, and therefore of increased volatility, in this environment.

As we discussed in our Outlook, one of the greatest macroeconomic risks for 2018, underpinning what we labelled as a "malign upside scenario", is an unexpected rise in inflation, which forces global central banks, and primarily the Fed, to increase rates faster than initially anticipated (or signal a faster pace of policy normalisation), thus worsening the initial market reversal deriving by rising yields. At the same time, investors should hold their nerves, as global inflation remains largely under control, as we discussed in our Viewsletter of 8 January ("*Neither Permanent, Nor Temporary, But "Persistently" Low Inflation"*). In many large areas of the global economy (including Europe and Japan), there's still plenty of work to do to bring inflation on a sustainable path in line with central bank targets, and the powerful forces of globalisation and technological innovation, with their impact on income distribution and inequality, are still at play. As a result, investors should not be scared of moderate rises in wage growth and inflation, and therefore in yields, in line with an improved economic outlook. Still-low German and Japanese long-term yields will continue to constitute an anchor also for US Treasury rates.

Our Recent Publications

- *China In a Slow Transition, No Hard-landing But a Bumpy Road Ahead by Francisco Quintana, 30 January 2018*
- *BOE Preview February 2018: On Hold, But Alert by Brunello Rosa, 2 February 2018*

The Week Ahead

US - The Congress needs to reach a "budget deal" to avert a second government shutdown before February 8, when current funding runs out. The new funding bill is likely to be temporary, until late March.

UK – BOE and "EU Withdrawal Bill": On February 8, the BoE will be holding its first monetary policy meeting of 2018; no policy changes are expected. The "EU Withdrawal Bill," which intends to replicate existing EU regulations to prevent a legal vacuum following Brexit, will continue to be discussed at the House of Lords. Any disruption could delay the exit date from the EU.

The Quarter Ahead

US - The outlook for GDP growth remains positive, supported by tax-cuts and domestic investment. The Fed will continue to normalize monetary policy, with the probability of a hike in March—the first meeting with Jerome Powell at the helm—now at 77.5%, according to Fedwatch. Other issues that will shape the outlook are: a) the debt ceiling, which needs to be raised before early-April; b) the USD 1.5tn infrastructure plan, which President Trump promised to push through Congress in last week's State of the Union speech; and c) Nafta negotiations, where some progress has been achieved last week.

Global financial markets - The probability of a correction in late 2018 is rising, as central banks reduce net QE. In the shorter run, bonds selloff is likely to continue, with higher yields being justified by improving fundamentals: higher global growth and the re-pricing in of inflation risks. The size of the sell-off in government bonds is unlikely to replicate the taper tantrum of 2013. Going forward, speculation of the eventual removal/reduction of monetary stimuli will bring EZ and Japanese yields higher.

EZ - The economic recovery will last, although the EUR's unexpected strength may lead to a tightening in monetary conditions.

UK - Brexit process will be further complicated by strong divisions inside the Conservative party and the weak leadership of PM May.

Turkey - The military operation in Syria will not disrupt foreign inflows, which amounted to USD 1.2bn in January. Inflation will come down from last year's 11.9%: consensus expects 9.5% and the CBT 7.9%. The financing of the deficit will become more diversified, as the Treasury announced its plans to issue the equivalent of USD 0.5bn in CNY-denominated bonds.

Russia - The outlook remains positive thanks to higher oil prices, and in spite of recent US sanctions against Russian individuals: last week, Moody's changed the outlook from "stable" to "positive".

China - President Xi will start implementing reforms and growth will slow moderately: the decline in January's PMI for the manufacturing sector suggests a mild deceleration ahead.

GCC - Higher oil prices will reduce budget deficits. In particular, the ***Kuwait*** deficit is expected to narrow to 9.0% of GDP in FY 2017/18 (p: 17.0%).

Last Week's Review

US - Fed, NFP, wages. The Fed's FOMC decided to keep policy unchanged, but a more positive language was used to describe the economy, suggesting a rate increase in March. Labour market data showed signs of vitality: wages grew 2.9% (c: 2.6%; p: 2.5%) and non-farm jobs increased by 200k (c: 180k; p: 160k), increasing concerns about rising inflation.

Markets - Sell-off in equities and bonds. Markets reacted negatively to better economic data. An improving outlook, requiring less policy support, implies liquidity withdrawal. During the week, 10Y UST yields rose from 2.66% to 2.84%—a four-year high. Mirroring the move in UST yields, the German 10Y bond rose from 0.63% to 0.76%. The S&P500 lost 3.9% w-o-w. In spite of the expectation of higher rates, the USD kept depreciating, rising above EUR/USD 1.25 for the first time since December 2014, to close the week at EUR/USD 1.248, a 0.9% w-o-w depreciation.

China - Manufacturing PMI declines: January's PMI for the manufacturing sector showed a decline to 51.3 (p: 51.6), suggesting a mild deceleration ahead.

Pablo Gallego Cuervo and Renata Bossini contributed to this Viewsletter.

The picture in the front page comes from this website.

@RosaRoubini Rosa & Roubini Rosa&Roubini Associates

For more information, please call us on +44 (0)207 1010 718 or send us an email to info@rosa-roubini-associates.com

www.rosa-roubini-associates.com

118 Pall Mall, London SW1Y 5ED

Abbreviations, Acronyms and Definitions

10Y	*10-year*	*GOP*	*Grand Old Party (US Republican Party)*
bn	*Billion*	*IMF*	*International Monetary Fund*
BoE	*Bank of England*	*IPO*	*Initial public offering*
BoJ	*Bank of Japan*	*ISM*	*Institute for Supply Management*
Bpd	*Barrels per day*	*JPY*	*Japanese yen*
bps	*Basis points*	*k*	*thousand*
c	*Consensus*	*m-o-m*	*Month-on-month*
CB	*Central bank*	*mn*	*Million*
CBK	*Central Bank of Kuwait*	*MPM*	*Monetary Policy Meeting*
CBO	*US Congressional Budget Office*	*M5S*	*Five Star Movement*
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*
CDU	*Christian Democratic Union of Germany*	*p*	*Previous*
CNY	*Chinese Yuan*	*PCE*	*Personal Consumption Expenditures*
CPI	*Consumer Price Index*	*PM .*	*Prime minister*
CSU	*Christian Social Union in Bavaria*	*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*	*SHCOMP*	*Shanghai Stock Exchange Composite Index*
EC	*European Council*	*SPD*	*Social Democratic Party of Germany*
ECB	*European Central Bank*	*tb/d*	*Thousand barrels per day*
EM	*Emerging Markets*	*tn*	*Trillion*
EP	*European Parliament*	*TRY*	*Turkish Lira*
EU	*European Union*	*UAE*	*United Arab Emirates*
EUR	*Euro*	*UK*	*United Kingdom*
EZ	*Eurozone*	*US*	*United States*
Fed	*US Federal Reserve*	*USD*	*United States Dollar*
FOMC	*US Federal Open Market Committee*	*USD/bbl*	*USD per barrel*
FRB	*US Federal Reserve Board*	*UST*	*US Treasury bills/bonds*
FX	*Foreign exchange*	*VAT*	*Value added tax*
FY	*Fiscal year*	*w-o-w*	*Week-on-week*
GCC	*Gulf Cooperation Council*	*y-o-y*	*Year-on-year*
GBP	*British pound*	*y-t-d*	*Year-to-date*
GDP	*Gross domestic product*	*YPG*	*People's Protection Units*