

MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
By Brunello Rosa



Europe Between Germany's Renewed Stability and Italy's Political Shift

As we wrote [last week](#), the 4th of March proved a crucial day in European politics. Germany found some temporary stability with the result of the referendum among SPD party members, who approved with a relatively large majority of 66% the Grand Coalition between the SPD and CDU/CSU. This opens the door to Angela Merkel's fourth term in power, which might not last the entire four years of parliament (6 months of which have already passed in negotiating the new coalition contract), but should last at least two years, perhaps before Merkel's accession to a top European job in 2019. On the other hand, following its general election, Italy observes a massive political shift, whose extent will become clearer in coming days. As it takes time to translate votes into seats, thanks to the complications of the new electoral system, some facts are starting to emerge:

- 1) The Five Stars Movement (M5S) emerges as the first party in Italy, with around 30% of votes;
- 2) The centre-right emerges as the first coalition, with around 35-37% of votes;
- 3) Within the centre-right coalition, the League (with around 18%) has more votes (and perhaps seats) than Forza Italia;
- 4) The PD collapses to around 20% of votes, if not below, and its coalition is unlikely to reach 25%.

We have discussed at length in our [in-depth analysis](#) what would be the options emerging from such a scenario. At this stage (but again, scenarios might change in coming days, when the distribution of seats will be clearer and the positions of parties more definite), we could envisage three main options:

- a) A centre-right government led by Salvini, with seats missing to reach a majority found in parliament among other parties;
- b) A M5S-led government, with the potential support of Lega;
- c) Less likely, a sort of "coalition of losers" between PD and Forza Italia, plus centrist parties.

All these options, as mentioned above, represent a massive political shift from the current political equilibrium, whose pillar was represented by the pro-European policies of the PD. Italy will now likely have a government whose attitude towards Europe, in terms of fiscal stance and other sensitive themes such as migration, much more confrontational than before. The market might not initially like this new approach, even if – in case it proved stable – might get used to it. In our analysis, we highlighted this risk that has now materialised: a massive shift towards Euro-sceptical forces. So, the future of the European integration process is now much less certain: as long as Germany was mired in its own political mess, all other countries had some time for a bit of "respite." But once a new, fully legitimised, government will be in place, it is likely that Germany will join France in its effort to reform Europe, perhaps with a slightly less austere fiscal stance. What will be Italy's position in this process is yet to be determined. The government is now much more likely to be led by Euro-sceptical forces, so Italy's position might be much less pro-European than before, putting any further integration at risk.

Our Recent Publications

 [ECB's Dilemma: Euro Strength vs Removing the Easing Bias](#)
by Brunello Rosa and Nouriel Roubini, 2 March 2018



The Week Ahead

US – Non-farm payroll in focus on Friday. Market expectations are for a 200k increase in NFP in February (unchanged from January), but the key indicator to watch will be the average hourly earnings growth, considering the massive impact that the 2.9% y/y increase registered in January [had on the market at the beginning of February](#). Consensus expectations are for a slight deceleration to 2.8% y/y, but clearly an unexpected acceleration to 3% or above would likely trigger another negative market reaction.

China – PMI expected to decelerate. The Caixin Services PMI will be released on Monday and is expected to fall from 54.7 in January to 54.3 in February. The Composite PMI will also be released on the same day.

ECB – Will keep its policy stance unchanged. The ECB will adopt a [cautious stance in this week's meeting](#), following February's weak inflation data.

Turkey - Inflation is expected to decline (c: 10.0% y-o-y; p: 10.4%) and the CTB will keep rates unchanged.

Other Central Banks - In Japan, Canada and Australia, central banks are also likely to keep their respective policy stances (rates and asset purchases) unchanged.

The Quarter Ahead

US - Likely to face retaliatory measures from trade partners following the adoption of tariffs on metals. The EU, China and Brazil already suggested that they might adopt measures against US products. Canada—the largest source of metals imports for the US—and Mexico will refrain from adopting similar measures only if granted tariffs exemptions. A global trade war would likely hamper the global growth acceleration expected in 2018.

UK - The Brexit process will require important decisions: i) a final agreement on the “divorce terms”; ii) a transition deal beyond March 2019; and iii) a proposal for future ties are still pending. In a divided Conservative Party, the position of PM May looks increasingly fragile. Currently, the most likely scenario is [a Canada-style trade deal](#).

EM - Appetite for assets will remain strong. Last week, Indonesia, Kenya and Belarus issued USD 5.6bn in bonds. EM fixed income and equity inflows rebounded (USD 1.4bn and USD 5.4bn respectively, from USD -3.2bn and USD -512mn the week before).

Saudi Arabia will issue new bonds in March or April. The kingdom successfully issued USD 30bn in 2016/17. Going forward, Saudi Arabia's inflation will decelerate moderately from the highs reached in January, when prices surged (a: 3.0% y-o-y; p: 0.4%) on the back of fuel subsidy cuts and the introduction of a 5% VAT rate. Inflation will average around 2.5% in 2018.

In Iraq, the central government and Kurdish authorities will reach an agreement to resume oil exports. Negotiations to resume oil exports are moving forward. The deal should have no impact on global oil exports: Iraq is bound by the Opec agreement and is already exporting at its maximum quota (4.35 mb/d).

China - President Xi Jinping will strengthen his control over the government, the military and the CPC. On February 25, the CPC announced revisions to the constitution in order to “remove the two-terms limit for the offices of the state presidency”.

Asia - In 2018, India will overtake China as the fastest-growing EM. In Q4 2017, India became the world's fastest-growing large economy (a: 7.2% y-o-y ann.; c: 6.9%; p: 6.5%). Momentum will continue into 2018: real GDP growth in India will accelerate to 7.1%, while China will decelerate to 6.5%.

Last Week's Review

US - An Upbeat Assessment Of The Economy By The Fed Chair Increased The Expectation Of Hikes In 2018. Fed chair Jerome Powell said the “outlook for the economy has strengthened since the December meeting, bolstered by strong data and the approval of the tax reform bill”. Compared to the previous week, the likelihood of “at least four hikes in 2018” rose from 21% to 24% (CME Group). At the next Fed meeting (March 21), the likelihood of a 25bps hike remains unchanged at 83%. **President Trump announced tariffs on steel and aluminium imports** (25% and 10%, respectively). Stock markets reacted negatively: the S&P500 declined by 2.0% w-o-w, closing February with its first monthly loss since March 2017 (-4.0% m-o-m). Europe (Eurostoxx 600: -6.0% m-o-m) and Japan (Nikkei 225: -7.5% m-o-m) also lost grounds in February. US 10-year bond yields declined 1 bps w-o-w, to 2.86%. The USD strengthened marginally against a basket of currencies (the DXY rose by 0.1% w-o-w) and weakened against the EUR by 0.2% w-o-w, to EUR/USD 1.233.

In Europe, inflation remains weak. EZ February inflation fell to its lowest level in more than a year (a: 1.2% y-o-y; c: 1.2%; p: 1.3%; ECB target: 2.0%)

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The picture in the front page comes from [this website](#)



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Abbreviations, Acronyms and Definitions

A	Actual	IMF	International Monetary Fund
Bn	Billion	IPO	Initial public offering
BCB	Central Bank of Brazil	JPY	Japanese yen
BoE	Bank of England	k	thousand
BoJ	Bank of Japan	KRG	Kurdistan Regional Government
bpd	Barrels per day	mb/d	Million barrels per day
bps	Basis points	m-o-m	Month-on-month
c	Consensus	mn	Million
CB	Central bank	MPM	Monetary Policy Meeting
CBK	Central Bank of Kuwait	M5S	Five Star Movement
CBO	US Congressional Budget Office	OECD	The Organization for Economic Cooperation and Development
CBR	Central Bank of the Russian Federation	Opec	Organization of Petroleum Exporting Countries
CBT	Central Bank of the Republic of Turkey	p	Previous
CDU	Christian Democratic Union of Germany	PCE	Personal Consumption Expenditures
CNY	Chinese Yuan	PM	Prime minister
CPI	Consumer Price Index	PMI	Purchasing managers' index
CPC	Communist Party of China	pps	Percentage points
CSU	Christian Social Union in Bavaria	QE	Quantitative easing
DFMGI	Dubai Financial Market General Index	q-o-q	Quarter-on-quarter
DJIA	Dow Jones Industrial Average Index	SAAR	Seasonally Adjusted Annual Rate
d-o-d	Day-on-day	SHCOMP	Shanghai Stock Exchange Composite Index
DXY	US Dollar Index	SPD	Social Democratic Party of Germany
EC	European Council	tb/d	Thousand barrels per day
ECB	European Central Bank	tn	Trillion
EIA	US Energy Information Agency	TRY	Turkish Lira
EM	Emerging Markets	UAE	United Arab Emirates
EP	European Parliament	UK	United Kingdom
EUR	Euro	US	United States
EZ	Eurozone	USD	United States Dollar
Fed	US Federal Reserve	USD/bbl.	USD per barrel
FOMC	US Federal Open Market Committee	UST	US Treasury bills/bonds
FRB	US Federal Reserve Board	VAT	Value added tax
FX	Foreign exchange	VIX	Chicago Board Options Exchange Volatility Index
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
GOP	Grand Old Party (US Republican Party)	ZAR	South African Rand