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R&R Weekly Column
By Brunello Rosa

March 4th, 2018: The Day of Reckoning for European Politics

At the end of this week, we'll know something more about the future of the European integration process, as the results of the referendum among the SPD party members on the proposed Grosse Koalition (GroKo) with the CDU/CSU and of the Italian general elections will be known.

The conventional narrative says that the SPD will eventually give green light to the GroKo, and that Italy will manage to find a parliamentary majority for a new government to emerge, even if this means that political forces that fought on opposite sides during the electoral campaign (in particular Forza Italia and PD), will have to find a compromise and form what would look like the Italian version of the German GroKo. The result of these expected outcomes is that the European integration process will re-start, with some progress made between the EU Council meetings in March and June. We don't disagree that this could in fact be the eventual outcome, although we have already warned that any further integration step will be minimal at best, at this stage. We have also identified an upside scenario in which this process is accelerated by Merkel's accession to a top EU job (head of the Commission or head of the EU Council) in 2019, while Macron continues to pushed on its pro-European platform at a national level.

At the same time, we have also highlighted the risks surrounding this conventional narrative. Regarding Germany, as we wrote in the inaugural column for this Viewsletter (on 4 December 2018), the risk is that of finding a short-term solution while creating a long-term problem, meaning a further collapse of the SPD (as junior party in the GroKo) and a further fragmentation of the German political system, with continued growth of Die Linke, the AfD and FDP, making Germany virtually ungovernable three-four years from now. The polls have recently shown that the voting intentions in favour of the SPD have already collapsed, to 15-16%, i.e. below that of the AfD, which in the meanwhile have increased. It is true that the SPD, having won the places for both the Finance and the Foreign Ministers will have greater chance to influence the policies of the GroKo, in particular its fiscal stance. But while the SPD in the Finance Ministry can at the margin make Germany's fiscal stance less rigid and more investment prone, it's unlikely to be able to make the final push for the EU/EZ to become the full-fledged transfer union it needs to become in order to survive in the long run.

Regarding Italy, we have written that there is still too much complacency in the market, given the level of uncertainty on the eventual outcome. Even the EU Commission President Jean Claude Juncker has expressed similar concerns last week, before moderately backtracking when accused of interfering in domestic political matters. But the uncertainty of the outcome is a fact. An untested electoral law, a record-high level of expected abstention and undecided voters, the fragmentation of the political system means that nobody can say with any level of credibility what the eventual distribution of seats will be, and therefore what parliamentary majority will eventually emerge to support a government. It is well possible that a protracted period of political uncertainty following the election will keep markets nervous about Italy, penalising its sovereign debt and bank equity prices.

March 4th will be an important day for Europe: If events unfold broadly as expected, the European integration process could re-start and progress in its usual bumpy way, muddling through economic and political difficulties. If instead events unfold differently, the process will likely suffer a sudden and protracted stop, which will take time to reverse.

Our Recent Publications: *Monetary Policy in the Medium-Term: Tighter Stance, Expanded Toolkit,* *By Alessandro Magnoli Bocchi and Francisco Quintana, 23 Feburary 2018*

The Week Ahead

US - Next round of NAFTA negotiations will start. Were President Trump to act on the US Department of Commerce recommendation to "*implement tariffs on all steel and aluminium products (at least 24.0% and 7.7% respectively) from all countries*", the negotiations could suffer a setback. The US is the world's largest importer of steel, and 25% of its steel imports comes from Canada and Mexico.

EU - Italy's electoral campaign will come to an end and German inflation. The March 4th elections are unlikely to result in a stable coalition government, possibly leading to a new vote. On Tuesday 27, Germany's February CPI will be published (*p:* 1.6% y-o-y).

The Quarter Ahead

***US - The adoption of protectionist measures could damage foreign relations, particularly with China*.** In the near term, the US seems poised to impose new trade tariffs and barriers, in particular to China - which is the origin of 21.3% of total US imports of goods (USD 505bn in 2017, almost four times of what the US exports to China). The relationship with Mexico and Canada would also suffer, as the US imports about 75-80 percent of their total exports.

EU - During the second quarter of the year Germany and France will have a window of opportunity to push for reforms. In Germany, the formation of "grand coalition" government is expected to be approved by SPD party members on March 4. In France, Macron's approval ratings are likely to increase, following recent positive data (2017 GDP growth, at 1.9%, is at a six-year-high; Q4-2017 unemployment, at 8.9%, is the lowest since 2009).

Japan - The BoJ will maintain its dovish monetary policy. The reappointment of Governor Kuroda for a second 5-year term suggest policy continuity. In the UK, above-target inflation (*c:* 3.0% y-o-y; *BoE target:* 2.0%) is likely to result in an interest rate hike in May.

China - Imports from Japan—China's largest trading partner—increased by 30.8% y-o-y, suggesting strengthening growth prospects for the Chinese economy.

EMs - Investor's appetite for EM debt will remain strong. Kenya's USD 2bn bond issuance of 10- and 30-year bonds attracted order books of USD 14bn, despite the country's recent downgrade by Moody's. Bonds were priced at 7.25 and 8.25 percent respectively, marginally below the issuer's initial guidance.

GCC - In 2018 Saudi Arabia will continue to issue debt. The government intends to finance half of its USD 64bn budget with debt, but y-t-d has only raised USD 3.5bn in domestic debt. Bahrain will start preparations to introduce a 5% VAT in late 2018. In the **oil** sector, in order to avoid major market shocks, Opec and non-Opec producers—including Russia—will discuss extending their production agreement beyond the end of 2018.

Last Week's Review

***US - The FOMC January meeting minutes increased expectations of a hike in March*.** According to the minutes, *"a majority of participants noted that a stronger outlook for economic growth raised the likelihood that further gradual policy firming would be appropriate"*. The likelihood for a 25-bps interest rate hike in the March 21 FOMC meeting stands at 83.1% *(CME)*. The US markets had a modest reaction, with the S&P500 rising by 0.8% w-o-w, while US 10-year bond yields remained unchanged w-o-w at 2.87%. The USD strengthened, with the DXY up 0.8% w-o-w.

***EU- The ECB January meeting minutes showed concerns about the weakness of the USD*.** In the minutes, the ECB highlighted that the actions of the Trump administration might be creating the conditions for a currency war. The officials also stated that EZ inflation is still too low to tighten policy. The EUR depreciated 0.8% w-o-w against the USD, to EUR/USD 1.230.

***Turkey - Non-resident investors have significantly reduced their positions in Turkish assets over the past two weeks*.** According to CBT data, foreign investors' holdings in Turkey declined by USD 1.3bn (*2017:* +10.5bn; *January 2018:* +1.2bn).

Japan - January trade data showed exports increasing by 12.2% y-o-y, showing firm global demand.

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*	*GOP*	*Grand Old Party (US Republican Party)*
bn	*Billion*	*IMF*	*International Monetary Fund*
BCB	*Central Bank of Brazil*	*IPO*	*Initial public offering*
BoE	*Bank of England*	*JPY*	*Japanese yen*
BoJ	*Bank of Japan*	*k*	*thousand*
bpd	*Barrels per day*	*m-o-m*	*Month-on-month*
bps	*Basis points*	*mn*	*Million*
c	*Consensus*	*MPM*	*Monetary Policy Meeting*
CB	*Central bank*	*M5S*	*Five Star Movement*
CBK	*Central Bank of Kuwait*	*OECD*	*The Organization for Economic Cooperation and Development*
CBO	*US Congressional Budget Office*	*Opec*	*Organization of Petroleum Exporting Countries*
CBR	*Central Bank of the Russian Federation*	*p*	*Previous*
CBT	*Central Bank of the Republic of Turkey*	*PCE*	*Personal Consumption Expenditures*
CDU	*Christian Democratic Union of Germany*	*PM*	*Prime minister*
CNY	*Chinese Yuan*	*PMI*	*Purchasing managers' index*
CPI	*Consumer Price Index*	*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*	*SHCOMP*	*Shanghai Stock Exchange Composite Index*
d-o-d	*Day-on-day*	*SPD*	*Social Democratic Party of Germany*
DXY	*US Dollar Index*	*tb/d*	*Thousand barrels per day*
EC	*European Council*	*tn*	*Trillion*
ECB	*European Central Bank*	*TRY*	*Turkish Lira*
EIA	*US Energy Information Agency*	*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*	*UST*	*US Treasury bills/bonds*
FOMC	*US Federal Open Market Committee*	*VAT*	*Value added tax*
FRB	*US Federal Reserve Board*	*VIX*	*Chicago Board Options Exchange Volatility Index*
FX	*Foreign exchange*	*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*

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