



*R&R Weekly Column*  
*By Brunello Rosa*




## Q1 Proved to Be a Challenging Quarter - Q2 Won't Be Much Easier

Year 2018 witnessed one of the best starts in the last couple of decades, with the stock market rallying on the back of the fiscal reform (aka “tax cuts”) approved by the US administration at the end of last year, which was followed in short order by the approval of additional fiscal spending, partly devoted to infrastructure plans. This fiscal expansion by the largest economy in the world at the time the global economy is already experiencing a synchronised expansion, on the one hand further boosted investor confidence, on the other hand fuelled inflation fears that crystallised at the beginning of February, when US average hourly earnings for January came out at 2.9% y/y. Those fears, and the related fears of a faster tightening by the Fed, conjured to create the correction in the equity market experienced in February. At that point, we were of the view that a full-fledged bear market would be unlikely, but also that [stock indices would be unlikely to return to January peaks](#), as four factors would continue weighing on valuations: (1) inflation scares (as opposed to outturns); (2) rising protectionism; (3) volatility and (4) (geo)political issues.

At the end of the quarter, most equity markets (especially in DM) closed Q1 in the red, with the S&P500 experiencing the first quarterly loss since 2015, as those factors are all still at play. Inflation fears remain, in our opinion, over-hyped, as the structural factors that keep global inflation in check (technological advancement, globalisation, flatter Phillips curve) are still very much at work, but investors remain concerned that those central banks normalising their policy stance (and chiefly, the Fed), would react to rising inflation by raising rates faster and higher. The imposition of tariffs on steel, aluminium and IP by the US, which is generating some retaliatory action by the affected countries, are weighing on investor sentiment, although the policy uncertainty related to the actual implementation of those protectionist measures is creating volatility in the market, as testified by last week's equity rally, prompted by reduced fears of an imminent trade war. Finally, geopolitical events remain on the back of investor's minds, as they have not been able so far to dent their sentiment, but have the potential of causing massive cumulative effects if they materialise. Between trade wars and geopolitical events sits Brexit, which could prove very costly for the UK if the country will end up leaving the EU with no deal, [thus falling into WTO rules](#) (or “below”) for international trading, at the time of rising protectionism.

All these issues will remain in place also in Q2, when a new set of challenges will come to the fore, and chiefly: will the Fed continue its policy normalisation at the currently [forecast pace of three hikes in 2018](#), or will increase its pace? Will the [ECB signal further tapering of QE in June](#)? Will Italy be able to form a [government that will remain compliant with EU fiscal discipline](#), or will it start adopting a much more confrontational stance with the EU? The good news is that an expanding global economy allows reforms to be made and provides resilience in the face of materialising risks. On the other hand, it's the accumulation of risks that eventually dents investor confidence and prompt a re-thinking of perspective returns on investment. Given this background, our [updated strategic asset allocation](#) continues to favour a moderate risk taking (i.e. skew towards equities) within a defensive positioning, with a slight increase in exposure to sovereign bonds and lower exposure to commodities.

### Our Recent Publications

 [Asset Allocation Update: Cautious Risk Exposure With Defensive Positioning](#), by Francisco Quintana and Alessandro Magnoli Bocchi, 29 March 2018

 [Transition Deal, Trade Agreements and Risks of a Cliff-Edge into WTO](#), by Brunello Rosa, Pablo Gallego Cuervo and Renata Bossini, 28 March 2018



The Week Ahead

**US - March employment data will be published**, the most relevant being: 1) change in non-farm payrolls (c: 185k m-o-m; p: 313k); and 2) unemployment rate (c: 4.0%; p: 4.1%). Also, the US ISM manufacturing for March is expected to decline (c: 60.0; p: 60.8).

**Europe – In the Eurozone, March CPI is expected to rise** (c: 1.4% y-o-y; p: 1.2%).

**Egypt - President Sisi will be officially re-elected for a second term.** The preliminary results of the March 26-28 presidential election show he secured approximately 92% of the votes (2014 election: 96.9%). Turnout is expected to have declined to 42.5% (2014 election: 47%).

**Australia** - The RBA will likely keep its policy rate on hold (c: 1.50%; p: 1.50%).

The Quarter Ahead

**East Asia - Security concerns will ease.** On March 25-28, North Korean leader Kim Jong-un visited China to discuss with President Xi Jinping the denuclearization of the Korean peninsula. Going forward, Kim Jong-un will meet: 1) South Korea's President Moon Jae-in (April 27); and 2) US President Trump (May). Japan has also requested a bilateral meeting.

**Russia - Western diplomatic relations will stay frosty.** Russia will expel 60 US diplomats and close a US consulate in retaliation for analogous US actions, triggered by the attack in the UK on a former Russian intelligence agent. Russia's retaliatory measures are also expected against the European and North American countries that adopted similar moves.

**Key EMs will continue to lower policy rates.** Last week: 1) South Africa cut rates by 25 bps, to 6.50%; 2) Egypt cut by 100 bps, to 16.75%. Russia and Brazil are likely to announce further cuts this year.

**GCC - The Saudi Arabia and Kuwait stock market indices are likely to rise.** 1) The Kuwait's stock market will enter FTSE Russell's EM index in two stages in September and December 2018, to reach a 0.4% weighting in the index. Kuwait stocks are up 4.8% y-t-d; 2) The Saudi Arabia's Tadawul will enter the same index, starting in March 2019, with a weight of 2.7%. For the first time, the KSA is classified as an EM by a major index compiler, joining China, Russia and India. If MSCI follows up in June, the Tadawul could see foreign fund inflows exceeding USD 40bn. Saudi stocks are up 8.9% y-t-d.

**Oil prices are likely to decline.** Brent prices fell by 1.6% w-o-w to USD/bbl. 69.3, as the weekly change in US inventories showed an unexpected increase of 1.6mn barrels (c: -0.3; p: -2.6). Prices are likely to decline further in Q2, on rising US shale oil output, as current oil prices are significantly above production costs: a new Fed's survey shows WTI breakeven prices of USD/bbl. 47-55 (a: 64.9; WTI prices have been above USD/bbl. 55 since October 2017). We expect Brent oil prices to be in the USD/bbl 55-65 range by year-end, despite Saudi Arabia and Russia efforts to make the Opec oil production cuts agreement permanent.

Last Week's Review

**The USD strengthened against a basket of currencies** (DXY rose by 0.7% w-o-w) and against the EUR (EUR/USD declined by 0.3% to 1.232). Demand for US Treasuries has increased as investors remain concerned about the long-term impact of: a) a global trade war; and b) a potential increase in regulation for the tech sector. As a result, the 10-y UST yield went below 2.8% for the first time since early February, closing the week at 2.74% (-7bps w-o-w).

**US – GDP and Inflation.** The revision of Q4 2017 GDP came above expectations (a: 2.9% ann. q-o-q; c: 2.7%; p: 2.5). US February PCE came out in line with consensus (a: 1.6% y-o-y; c: 1.6%; p: 1.5%; Fed target: 2.0%).

**Inflation increased less than expected in Germany.** Germany's February CPI fell short of expectations (a: 1.5% y-o-y; c: 1.6%; p: 1.2%; ECB target: 2.0%).

**Stocks resumed gains following a de-escalation of tension between the US and China.** As both countries signalled their willingness to engage into negotiations, stocks reacted with gains—the S&P500 rose by 2.0% w-o-w—and volatility fell to 20, below its long-term average of 22 points.

**Stock markets closed Q1 2018 in red.** All DM markets suffered losses in Q1: the US (S&P500 -1.2% y-t-d, its first quarterly loss since 2015), the UK (FTSE 100: -8%), Germany (Dax: -6.5%) and Japan (Nikkei 225: -7%).

**Turkey – 2017 GDP grew above expectations** (a: 7.4% y-o-y; IMF forecast: 7.0%; 2016: 3.2%).

**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

<i>a</i>	<i>Actual</i>	<i>ISM</i>	<i>Institute for Supply Management</i>
<i>ann.</i>	<i>annualized</i>	<i>JPY</i>	<i>Japanese yen</i>
<i>bn</i>	<i>Billion</i>	<i>k</i>	<i>thousand</i>
<i>BCB</i>	<i>Central Bank of Brazil</i>	<i>KRG</i>	<i>Kurdistan Regional Government</i>
<i>BoC</i>	<i>Bank of Canada</i>	<i>KSA</i>	<i>Kingdom of Saudi Arabia</i>
<i>BoE</i>	<i>Bank of England</i>	<i>LN</i>	<i>Northern League</i>
<i>BoJ</i>	<i>Bank of Japan</i>	<i>MSS</i>	<i>Five Star Movement</i>
<i>bpd</i>	<i>Barrels per day</i>	<i>m-o-m</i>	<i>Month-on-month</i>
<i>bps</i>	<i>Basis points</i>	<i>mb/d</i>	<i>Million barrels per day</i>
<i>c</i>	<i>Consensus</i>	<i>MENA</i>	<i>Middle East and North Africa</i>
<i>C/A</i>	<i>Current account</i>	<i>mn</i>	<i>Million</i>
<i>CB</i>	<i>Central bank</i>	<i>MPM</i>	<i>Monetary Policy Meeting</i>
<i>CBK</i>	<i>Central Bank of Kuwait</i>	<i>MSS</i>	<i>Five Star Movement</i>
<i>CBO</i>	<i>US Congressional Budget Office</i>	<i>OECD</i>	<i>The Organization for Economic Cooperation and Development</i>
<i>CBR</i>	<i>Central Bank of the Russian Federation</i>	<i>Opec</i>	<i>Organization of Petroleum Exporting Countries</i>
<i>CBT</i>	<i>Central Bank of the Republic of Turkey</i>	<i>p</i>	<i>Previous</i>
<i>CDU</i>	<i>Christian Democratic Union of Germany</i>	<i>pw</i>	<i>Previous week</i>
<i>CNY</i>	<i>Chinese Yuan</i>	<i>PCE</i>	<i>Personal Consumption Expenditures</i>
<i>CPI</i>	<i>Consumer Price Index</i>	<i>PM</i>	<i>Prime minister</i>
<i>CPC</i>	<i>Communist Party of China</i>	<i>PMI</i>	<i>Purchasing managers' index</i>
<i>CSU</i>	<i>Christian Social Union in Bavaria</i>	<i>pps</i>	<i>Percentage points</i>
<i>DFMGI</i>	<i>Dubai Financial Market General Index</i>	<i>QCB</i>	<i>Qatar Central Bank</i>
<i>DJIA</i>	<i>Dow Jones Industrial Average Index</i>	<i>QE</i>	<i>Quantitative easing</i>
<i>d-o-d</i>	<i>Day-on-day</i>	<i>q-o-q</i>	<i>Quarter-on-quarter</i>
<i>DXY</i>	<i>US Dollar Index</i>	<i>RBA</i>	<i>Reserve Bank of Australia</i>
<i>EC</i>	<i>European Council</i>	<i>SAMA</i>	<i>Saudi Arabian Monetary Authority</i>
<i>ECB</i>	<i>European Central Bank</i>	<i>SHCOMP</i>	<i>Shanghai Stock Exchange Composite Index</i>
<i>EIA</i>	<i>US Energy Information Agency</i>	<i>tb/d</i>	<i>Thousand barrels per day</i>
<i>EM</i>	<i>Emerging Markets</i>	<i>tn</i>	<i>Trillion</i>
<i>EP</i>	<i>European Parliament</i>	<i>TRY</i>	<i>Turkish Lira</i>
<i>EU</i>	<i>European Union</i>	<i>UAE</i>	<i>United Arab Emirates</i>
<i>EU27</i>	<i>EU members (except the UK)</i>	<i>UK</i>	<i>United Kingdom</i>
<i>EUR</i>	<i>Euro</i>	<i>US</i>	<i>United States</i>
<i>EZ</i>	<i>Eurozone</i>	<i>USD</i>	<i>United States Dollar</i>
<i>Fed</i>	<i>US Federal Reserve</i>	<i>USD/bbl.</i>	<i>USD per barrel</i>
<i>FOMC</i>	<i>US Federal Open Market Committee</i>	<i>UST</i>	<i>US Treasury bills/bonds</i>
<i>FRB</i>	<i>US Federal Reserve Board</i>	<i>VAT</i>	<i>Value added tax</i>
<i>FX</i>	<i>Foreign exchange</i>	<i>VIX</i>	<i>Chicago Board Options Exchange Volatility Index</i>
<i>FY</i>	<i>Fiscal Year</i>	<i>WTI</i>	<i>West Texas Intermediate</i>
<i>GCC</i>	<i>Gulf Cooperation Council</i>	<i>w-o-w</i>	<i>Week-on-week</i>
<i>GBP</i>	<i>British pound</i>	<i>y-o-y</i>	<i>Year-on-year</i>
<i>GDP</i>	<i>Gross domestic product</i>	<i>y-t-d</i>	<i>Year-to-date</i>
<i>GOP</i>	<i>Grand Old Party (US Republican Party)</i>	<i>YPG</i>	<i>People's Protection Units (Kurdish militia in Syria)</i>
<i>IMF</i>	<i>International Monetary Fund</i>	<i>ZAR</i>	<i>South African Rand</i>
<i>IPO</i>	<i>Initial public offering</i>	<i>10-y</i>	<i>10 year</i>



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