

MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
By Brunello Rosa



Market Prices Re-Aligning to Economic Fundamentals and Policy Differentials


[Last week's column](#) discussed how uncertainties on the solidity and durability of the ongoing global expansion were keeping central banks more cautious than otherwise they could be, given the stage of the business cycle. We correctly predicted that the [ECB's Governing Council would discuss](#) the soft patch the EZ economy is experiencing (in this respect – watch this week's Eurozone Q1 GDP growth, inflation and unemployment data), that the [BOJ would keep its policy stance unchanged](#), that the [Riksbank would postpone](#) the timing of its first policy rate increase. We also reiterated our view that the [BOE would be more likely to raise rates in August than in May](#), and the preliminary reading of Q1 2018 GDP (which came in at +0.1%, versus 0.3% expected, and declining from the 0.4% recorded in Q4 2017) makes a rate hike on May 10th quite unlikely at this stage.


On the other hand, the US economy last week exhibited data that came in above expectations on March retail and home sales, and in particular Q1 2018 GDP which featured a 2.3% q/q annualised growth (compared to a consensus view of 2% - but decelerating from the 2.9% recorded in Q4 2017). This data came out ahead of this week's FOMC meeting, which we expect (in line with consensus) to result in unchanged policy, ahead of a further increase in Fed Funds target range in June. The statement accompanying the decision is likely to signal the upcoming further incremental tightening in early summer.

On the back of these data and policy divergence, the USD rose against a basket of currencies (DXY was up by 1.3% on a weekly basis, its second largest weekly gain in 2018), EUR/USD declined by 0.8% to 1.213 on a weekly basis and GBPUSD fell significantly below 1.40. The UST 10-y yield remained unchanged on the week (at 2.96%), after having crossed the 3% level for the first time since 2013. Some technical analysts would suggest this could be the beginning of a bear market in bonds. We believe that as long as Bund and JGB long-term yields remain this low, also the long end of the US Treasury curve will remain anchored.

A stronger dollar would help other DM central banks to reach their inflation target, and so last week's moves were likely welcomed across the board. This was probably less true for EM economies, which tend to experience capital outflows when the dollar strengthens. However, as we discussed in [a recent analysis on EM currencies](#), EM countries are now more resilient to US policy normalisation, in spite of the notable rise in private-sector debt, even denominated in USD (the exception could be Argentina, where the central bank last week was forced to increase rates intra-meeting by 300bps to 30.25%, to prevent a slide of the ARS versus the USD). All this to say that when market pricing follows economic fundamentals and policy differentials, the life of policymakers is easier. Unfortunately, this alignment has been the exception rather than the rule recently, with USD weakening in spite of the fiscal stimulus and higher monetary policy rates. The next few weeks will tell whether this re-alignment will continue or not.

Our Recent Publications

 [Riksbank Pushes Back The Timing of First Rate Hike](#)
by Brunello Rosa, 26 April 2018

 [Riksbank: Time To Push Back the Repo Rate Path](#)
by Brunello Rosa, 23 April 2018

 [TRAVEL NOTES FROM ITALY: Short-Term Resilience, Long-Term Fragility](#)
by Brunello Rosa and Nouriel Roubini, 24 April 2018



The Week Ahead

US - Will release inflation and employment data. The markets expect flat inflation (March PCE inflation, c: 1.8% y-o-y; p: 1.8%) and stronger employment (April nonfarm payrolls c: 198k m-o-m; p: 103k; unemployment rate c: 4.0%; p: 4.1%).

Fed and RBA will leave their policy rates unchanged. The Fed is expected to hold until June for the next hike (c: 1.75%; p: 1.75%); the RBA will also hold steady (c: 1.50%; p: 1.50%).

April manufacturing PMIs are expected to soften in the US (ISM April, c: 58.6; p: 59.3) **and China** (c: 50.5; p: 51.5).

EZ - CPI is expected to slightly decline (c: 0.9%; p: 1.0%).

The Quarter Ahead

US - Yields will likely rise, but only moderately. Higher yields are likely due to rising inflation expectations (the 2y/10y spread widened by 10bps w-o-w), and additional bond issuance to finance fiscal deficits. However, rising uncertainty about the stock market, a rotation from stocks to bonds and higher geopolitical risk will keep demand for USTs strong.

US-China trade dispute will likely de-escalate. Next week, US Treasury Secretary Mnuchin and Trade Representative Lighthizer will visit China to negotiate on trade issues. The markets are also optimistic about a Nafta deal being closed in the near term.

UK - BoE is unlikely to hike rates on May 10, after both March CPI inflation (a: 2.5% y-o-y; c: 2.7%; p: 2.7%) and Q1 2018 GDP growth (a: 1.2% y-o-y; c: 1.4%; p: 1.4%) came below expectations, prompting a depreciation of the GBP (GBP/USD at 1.378, -1.6% w-o-w).

Turkey, Iraq and Lebanon will hold elections. Turkey's president Erdogan will remain in office on June 24. In Iraq, the May 12 election will be dominated by the same nine political blocs—five Shia, two Sunni and two Kurdish—that have shared power since 2003. On May 6, Lebanon will hold its first parliamentary election since 2009.

Iran - New sanctions are likely on May 12. The US administration rhetoric has become increasingly aggressive, even after French President Macron and German Chancellor Merkel tried to soften the US position last week.

Potential sanctions on Iran add a geopolitical premium to oil prices, already elevated due strong demand and supply bottlenecks. Sanctions on Iran could eliminate up to 1 mb/d from the market. Brent prices went above 75 USD/bbl past week—for the first time since Nov. 2014—, closing at USD/bbl 74.6 (+0.5% w-o-w).

Tension in Korea will likely decrease. On April 27, the leaders of North and South Korea announced they will work to de-nuclearize the region. North Korean leader Kim Jong-un and US President Trump will meet in June.

Last Week's Review

US - Better-than-expected data strengthened the USD. US data came above expectations: a) March retail sales (a: +0.6% m-o-m; c: +0.4%; p: -0.1%); b) March new home sales (a: +4.0% m-o-m; c: +1.9%; p: +3.6%); and c) Q1 2018 GDP (a: 2.3% q-o-q ann.; c: 2.0%; p: 2.9%). The USD rose against a basket of currencies (DXY up by 1.3% w-o-w), its second largest weekly gain in 2018. Stock prices remained flat (S&P500 -0.1% w-o-w) but volatility decreased to 15.4 (-1.5 points w-o-w). The UST 10-y yield remained unchanged w-o-w (at 2.96%), after having crossed the 3% level for the first time since 2014.

DMs - The ECB and the BoJ kept policy rates unchanged. The ECB acknowledged softer growth ahead, but provided no additional guidance on the end of the QE program, resulting in a EUR/USD decline of 0.8% w-o-w to 1.213. The BoJ maintained its accommodative stance.

Russia - The CBR paused the easing cycle and kept rates steady at 7.25% (c: 7.25%; p: 7.25%). RUB weakness (USD/RUB at 62.12, +8.1% m-o-m) and the threat of further US sanctions have raised inflation concerns; as a result, the easing cycle (-375 bps since March 2016) has been put on hold.

Turkey - The CBT hiked policy rates above expectations (a: 13.50%; c: 13.25%; p: 12.75%), and will keep monetary policy tight until the inflation outlook improves. The TRY appreciated 0.8% w-o-w to USD/TRY 4.04.

Argentina - The central bank hiked rates by 300bps (a: 30.25%; p: 27.25%) to prevent a slide of the ARS.

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

a	Actual	KSA	Kingdom of Saudi Arabia
AKP	Justice and Development Party	LN	Northern League
ann.	annualized	MSS	Five Star Movement
ARS	Argentinian Peso	m-o-m	Month-on-month
bn	Billion	mb	Million barrels
BCB	Central Bank of Brazil	mb/d	Million barrels per day
BoC	Bank of Canada	MENA	Middle East and North Africa
BoE	Bank of England	MHP	Nationalist Movement Party
BoJ	Bank of Japan	mn	Million
bpd	Barrels per day	MPM	Monetary Policy Meeting
bps	Basis points	NAFTA	North-American Free Trade Agreement
c	Consensus	OECD	The Organization for Economic Cooperation and Development
C/A	Current account	Opec	Organization of Petroleum Exporting Countries
CB	Central bank	p	Previous
CBK	Central Bank of Kuwait	pw	Previous week
CBO	US Congressional Budget Office	PCE	Personal Consumption Expenditures
CBR	Central Bank of Russia	PE	Price to earnings ratio
CBT	Central Bank of the Republic of Turkey	PM	Prime minister
CDU	Christian Democratic Union of Germany	PMI	Purchasing managers' index
CNY	Chinese Yuan	pps	Percentage points
CBT	Central Bank of the Republic of Turkey	QCB	Qatar Central Bank
CPI	Consumer Price Index	QAR	Qatari Riyal
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	RBA	Reserve Bank of Australia
EC	European Council	REER	Real Effective Exchange Rate
ECB	European Central Bank	RUB	Russian Rouble
EIA	US Energy Information Agency	tb/d	Thousand barrels per day
EM	Emerging Markets	tn	Trillion
EP	European Parliament	TPP	Trans Pacific Partnership
EU	European Union	TRY	Turkish Lira
EZ	Eurozone	UAE	United Arab Emirates
Fed	US Federal Reserve	UK	United Kingdom
FOMC	US Federal Open Market Committee	US	United States
FRB	US Federal Reserve Board	USD	United States Dollar
FX	Foreign exchange	USD/bbl.	USD per barrel
FY	Fiscal Year	UST	US Treasury bills/bonds
GCC	Gulf Cooperation Council	VAT	Value added tax
GBP	British pound	VIX	Chicago Board Options Exchange Volatility Index
GDP	Gross domestic product	WTI	West Texas Intermediate
GOP	Grand Old Party (US Republican Party)	w-o-w	Week-on-week
IMF	International Monetary Fund	y-o-y	Year-on-year
IPO	Initial public offering	y-t-d	Year-to-date
JPY	Japanese yen	ZAR	South African Rand
k	thousand	10-y	10 year
KRG	Kurdistan Regional Government	ZEW	Centre for European Economic Research

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