

MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
By Brunello Rosa




Emerging Markets Face Tough Test of Resilience

By the end of the week (most likely on Tuesday 8th May, with a self-imposed deadline on May 12th) the US will decide whether or not to withdraw from the Iran nuclear deal. To force the hand of its historical ally, Israel's PM Benjamin Netanyahu, in a recent press conference, said that [Iran has lied regarding its compliance with the agreement](#), having continued to develop military nuclear capabilities. If Israel decided to launch airstrikes on Iran's nuclear sites at the time the US decides to re-impose (at least part of the) sanctions on the same country, this could represent a quite substantial risk scenario that could cause a spike in oil prices, which have been rising in the last couple of years (and have now reached 70 USD per barrel, for the first time since 2014) thanks to the production cuts agreed between OPEC (and in particular Saudi Arabia), and Russia. In our [recent outlook for oil prices](#) over the 2018-2020 horizon, we discuss in detail this and other (risk and baseline) scenarios.


Geopolitical risks (with perhaps the exception of the Korean situation, which might enter [a period of reduced tensions](#)), increasing oil prices, softening growth, rising U.S. Treasury yields and strengthening US dollar constitute a dangerous mix for emerging markets, whose most fragile components have already started to suffer. Last week, the Argentinian central bank had to increase rates again (outside scheduled meetings, for the third time since April 27th, for a cumulative amount of 12.5% to 40%) to stem ARS depreciation versus the USD. This was due to the decision of [cutting rates in January 2018](#) (at a time inflation wasn't giving signs of moderating from the current 25%) as well as of moving the inflation target upward, from the 8-12% range to 15%, once the objective was missed and appeared unlikely to be reached in the foreseeable future. [In our recent report](#), we discussed the dangers associated to central banks moving the goal posts when they felt they could not reach their inflation targets. Turkey was also at the centre of investors' concerns last week, with the USD/TRY having increased by almost 5% in a week to 4.23, on the back of the S&P's credit rating downgrade and rising inflation, in the context of upcoming general elections, still-large current account deficit and a high and rising stock of external debt.


Market participants are now braced to see whether these cases will remain idiosyncratic episodes or will prove contagious for the entire EM space. Some oil-producing EM economies (e.g. Russia) would certainly benefit from the rise in oil prices. We have [argued in the past](#) that a number of EM currencies were able to better withstand US rates normalization, thanks to improved macroeconomic fundamentals and also [noted how EMs proved quite resilient](#) during the market correction in February. In the next few days and weeks we will see whether or not EMs have in fact sufficient stamina to weather this period of increased investor nervousness.

Our Recent Publications

 [BOE To Remain on Hold in May \(And Even a Hike in August Is Not A Done Deal\)](#) By Brunello Rosa, 4 May 2018

 [US-China Trade Tensions: Skirmishes or Start of a Broader Trade and Technology War?](#)
By Nouriel Roubini, 2 May 2018

 [A Quick Memo on The Koreas: Mutual Advantages of a Possible Re-Unification](#), by Joseph Shupac, 2 May 2018

 [Oil Prices in 2018-20: Unlikely To Hamper Global Growth, Likely To Support Oil-Related Assets](#), by Alessandro Magnoli Bocchi and Francisco Quintana 3 May 2018



The Week Ahead

US - CPI is expected to rise (March, *c*: 2.5% y-o-y; *p*: 2.4%), although core CPI is likely to decrease (*c*: 1.9%; *p*: 2.1%).

UK - The BoE will likely keep its policy rate on hold (*c*: 0.50%; *p*: 0.50%)—even though the GBP is depreciating (GBP/USD at 1.353, -1.8% w-o-w—due to the ongoing slowdown in GDP growth (Q1 2018, *a*: 1.2% y-o-y; *c*: 1.4%; *p*: 1.4%).

Iran - New sanctions are likely on May 12. US President Trump may not renew all the waivers on sanctions on Iran, falling short of a full pull-out from the nuclear deal.

Iraq and Lebanon hold parliamentary elections. In Iraq, the outcome of the May 12 election remains uncertain: a recent poll shows that 60% of voters remain undecided. On May 6, Lebanon held its first parliamentary election since 2009. The turnout was 49 percent. Hezbollah seems to have obtained a large consensus, with more than 20 political parties that define their identity along sectarian lines, the elections are likely to result in a fragmented parliament. PM Saad Hariri is expected to lead the next government.

The Quarter Ahead

US - The Fed will likely increase its policy rate. In the May 2 meeting, the FOMC left rates unchanged but reiterated plans to gradually hike, as inflation is at Fed's target. The likelihood of a 25-bps hike at the June 12-13 FOMC meeting rose to 100% (*pw*: 89%), while the likelihood of "at least three" and "at least four" hikes in 2018 are now at 86% (*pw*: 90%) and 38% (*pw*: 47%), respectively (CME).

The US trade disputes with China, the EU, Canada and Mexico will likely de-escalate. US Treasury secretary Mnuchin is negotiating with China, requesting that China reduces its trade surplus with the US by USD 200bn by 2020 (2017 US trade deficit with China: 337bn). President Trump extended by another 30 days the tariff exemptions on steel and aluminum from the EU, Canada and Mexico.

EMs will likely increase their policy rates to support their currencies. Argentina raised its policy rate twice last week, to 40.00%—a combined hike of 975bps (USD/ARS at 21.74, +16.6% y-t-d). India and Russia will reverse their monetary easing cycles (USD/INR at 66.87, +4.7% y-t-d; USD/RUB at 62.59, +8.5% y-t-d).

Turkey will hold presidential and parliamentary elections on June 24. President Erdogan will remain in office, and his party AKP will get a majority (in coalition with MHP).

Bond issuance in MENA will remain elevated. New MENA bonds amount to USD 49.1bn y-t-d, compared to a total 2017 issuance of USD 86.4bn.

Geopolitical concerns will continue to add a premium to oil prices, already elevated due to stronger-than-expected demand and supply bottlenecks. Sanctions on Iran could eliminate from the market up to 1 mb/d, which Saudi Arabia—in need of higher oil revenues—is unlikely to replace. Brent prices closed at USD/bbl 74.9 (+0.3% w-o-w)—their highest level since November 2014.

Last Week's Review

US - Employment data were slightly disappointing. April's non-farm payrolls (*a*: 164k m-o-m; *c*: 192k; *p*: 135k) and average hourly earnings (*a*: 2.6% y-o-y *c*: 2.7%; *p*: 2.6%) came in below expectations. March's PCE was aligned with consensus (*a*: 2.0%; *c*: 2.0%; *p*: 1.7%) and April's unemployment rate was better than expected (*a*: 3.9%; *c*: 4.0%; *p*: 4.1%).

US Earnings are on track to reach an eight-year record. With data on 81% of the S&P500 firms, 78% have reported a positive EPS surprise, with a blended earnings growth rate of 24.2%, the highest since Q3 2010.

Markets were stable, but the USD continued to appreciate driven by a weakening outlook in the EZ. Stock prices fell moderately (S&P500 -0.3% w-o-w), and volatility decreased to 14.8 (-0.6 points w-o-w). The 10-y UST yield declined by 1bps w-o-w to 2.95%. The USD rose against: *a*) a basket of currencies (DXY up by 1.1% w-o-w); and *b*) the EUR (EUR/USD -1.3% w-o-w to 1.196), supported by a deceleration of EZ GDP growth and inflation, which increased the likelihood of an extension of ECB's QE program.

Eurozone - Preliminary Q1 2018 GDP growth slowed to 2.5% y-o-y (*c*: 2.5%; *p*: 2.7%) and April CPI fell to 1.2% y-o-y (*c*: 1.3%; *p*: 1.3%).

Turkey - The TRY depreciated further against the USD, to USD/TRY 4.231 (+4.7% w-o-w), as: *a*) the government announced a USD 5.7bn fiscal package, triggering concerns on fiscal discipline; *b*) S&P downgraded Turkey's sovereign rating to BB- from BB; and *c*) April CPI increased to 10.9% y-o-y (*c*: 10.4%; *p*: 10.2%).

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

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



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