Rosa & Roubini
ASSOCIATES

MAKING SENSE OF *THIS* WORLD — *18 June 2018*

R&R Weekly Column
By Brunello Rosa

London *Caput Mundi* (for This Week)

This week, the UK will stage a series of high-profile events. First of all, the House of Commons will continue to vote on the EU Withdrawal Bill, on the series of amendments that have been approved by the Lords and that the lower chamber has started to reject last week, including on the continued participation of the UK in the EU customs union or even in the single market. The most relevant front that is still open, on which there will likely be a vote on Wednesday, is the possibility for the UK parliament to have a "meaningful vote" on what the government should do in case of "no deal" between the UK and the EU.

Last week, the Commons rejected the original amendment by the Lords by 324 votes to 298, i.e. with a majority of 26. This means that when the bill returns to Commons on Wednesday, only 14 Tory MPs would have to change their vote to defeat the government. It is estimated that there are currently around 15 pro-Remain Tory MPs that could vote against their own government. If that occurred, Theresa May's negotiating strategy might need to change completely, as it would be enough for the EU to reject any deal (however advantageous for both sides) to create turmoil in the UK and de-facto postpone Brexit indefinitely.

As discussed in our recent analysis, the post-Brexit customs arrangements are far from being simple technical commercial options and mask instead deep political choices that the country needs to make, also to preserve its territorial integrity. The risk is of course that the country makes no clear choices, goes un-prepared to meetings (including the June 28-28 EU Summit) and will undergo a few more rounds of political turmoil, before entering a permanent limbo or – worse – falling down a cliff-edge.

All this would have serious implications for the UK economy, which will be discussed at the Mansion House dinner on Thursday, when both BOE Governor Carney and Chancellor Hammond will speak and provide their views. Carney will speak just a few hours after having concluded its Monetary Policy Committee meeting, which we – in line with the market – expect to be concluded with an unchanged policy stance. However, this meeting will be important for two reasons.

First, it will conclude the summer round of G4 central bank meetings that started last week (with the Fed, the ECB and the BOJ) and will help us taking stock of how global central banks are currently seeing the world and their domestic economies. Secondly, it will be the last meeting before August, when the BOE might be carry on with its stated plans, and increase its policy rate by 25bps to 0.75%. Hopefully the language of the statement will shed some light on the BOE's current inclination in favour of further tightening, given the recent fall in headline inflation (to 2.4%, from the 3.1% recorded as recently as in November 2017). Even if the BOE rightly keeps its decision-making process separate from the day-to-day Brexit developments, it is clear that, if something goes horribly wrong between June 2018 and March 2019, BOE's policy actions will be the first line of defense (including for the GBP), as it was the case in the aftermath of the June 2016 referendum.

Our Recent Publications

- *ECB REVIEW: ECB Indicates End of QE and Beginning of Rates Guidance, by Brunello Rosa, 14 June 2018*
- *WP North Korea – US Summit: A Vague Agreement That Mostly Benefits Kim Jong-Un, by Alessandro Magnoli Bocchi, Pablo Gallego Cuervo, Francisco Quintana, 14 June 2018*
- *FED REVIEW: Fed Delivers A Hawkish Hike, by Brunello Rosa, 13 June 2018*
- *Working Paper: Bullet Points on Italy - New Government to Be Initially Only Modestly Confrontational with Europe, by Brunello Rosa and Nouriel Roubini, 11 June 2018*
- *Fed Preview: Hike in June Done Deal, Four Hikes in 2018 Not Yet, by Nouriel Roubini and Brunello Rosa, 11 June 2018*

The Week Ahead

Opec - Likely to expand output, oil prices to remain above 70 USD a barrel. In the June 22 meeting, Opec is expected to announce an expansion of output of around 1.0 mb/d. As a result, Brent prices declined by 3.9% w-o-w, to 73.4 $/barrel. The additional production will temporarily offset the expected decline in exports from Venezuela and Iran—estimated by IEA at 1.5 mb/d by year-end.

UK and Switzerland – BOE and SNB are expected to leave rates unchanged, at 0.5% and -0.75% respectively. In the UK, inflation came below expectations (CPI May, *a:* 2.4% y-o-y; *c:* 2.5%; *p:* 2.4%), reducing the likelihood of a hike this year.

Turkey -The electoral campaign will come to an end. Polls anticipate the re-election of President Erdogan, but the alliance led by AKP could be unable to win the majority in the parliament.

The Quarter Ahead

US - The Fed will continue to hike rates and reduce USD global liquidity… In the US: *a)* the Fed will accelerate the pace of reduction of its BS (USD 30bn per month in Q2 2018; 40bn in Q3; 50bn in Q4); *b)* the government will increase bond issuance; while *c)* as a result of the strength of the economy, the Fed will keep hiking rates: on June 12 it increased the funds rate from 1.75 to 2.00%—the 7th increase in the ongoing cycle, the 2nd this year—and updated its forecast for hikes in 2018 from three to four (with three more in 2019). The Fed—encouraged by rising inflation (CPI May y-o-y, *a:* 2.8%; *c:* 2.7%; *p:* 2.5%)—dropped all assurances that it will keep rates below their longer-run norms.

US and North Korea will initiate negotiations for denuclearization. Contents of the agreement signed on June 12 are to be discussed over the next quarter. The negotiation process is likely to fail after a few months, due to the lack of trust between the parts.

In the near term, trade tensions will continue, unlikely to lead to a trade-war. China quickly retaliated to the new US tariffs, but a fully-fledged trade war is unlikely to erupt over the next quarter.

Europe - QE will come to an end by December 2018. Last week, the ECB announced that it will halve the size of its monthly asset purchases to EUR15bn after September, and phase them out entirely after December. It left interest rates at record lows (*a:* 0.00%), and postponed hikes to H2-2019.

The increasingly hawkish stance of the Fed and the ECB increases the risk of an EM crisis in late 2018. In a context of declining USD liquidity, rising US interest rates and a stronger USD, EMs are vulnerable to outflows—EM currencies depreciated by 0.7% w-o-w, according to the MSCI EM currency index)—particularly in the fixed income space. Over the next quarter, EM CBs will continue to increase interest rates to prevent currency depreciation.

GCC - Bahrain stands out as the most vulnerable country. With limited energy and financial resources, its debt is currently classified as junk by all main rating agencies. According to S&P, the country has a 23% probability of default over the next five years. The price of the 2028 government bond has declined by 16% y-t-d, and the cost of insuring Bahraini debt against default is close to 400bps, a two-year high.

Bond issuance in MENA remains active. In spite of rising interest rates—last week Saudi Arabia and Bahrain rose rates to match the Fed's hike—issuance in the GCC remains high. Last week, Qatar National Bank issued a widely-demanded 3-y CNY 1,250mn bond (~USD 195mn), with a coupon of 5.25%.

Last Week's Review

Global stock markets suffered rising concerns of a trade war. The S&P500 lost 0.4% w-o-w —with unchanged volatility—after President Trump announced new tariffs on USD 50bn of Chinese imports. The 10-y UST yield declined by 3bps w-o-w, to 2.92%. The USD appreciated against a basket of currencies (DXY up by 1.3% w-o-w), supported by expectations of faster rate hikes by the Fed. The EUR depreciated by 1.4% w-o-w against the USD (to EUR/USD 1.161), as investors focused on the dovish tone of the ECB statement (i.e: no interest rates hikes before the end of the summer of 2019). Hindered by a stronger USD, gold declined by 1.3% to 1,279 USD/oz—its lowest point in 2018. The BoJ left rates unchanged at -0.1%.

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*	*IS*	*Islamic State*
AKP	*Justice and Development Party*	*JPY*	*Japanese yen*
ann.	*annualized*	*k*	*thousand*
ARS	*Argentinian Peso*	*KSA*	*Kingdom of Saudi Arabia*
bn	*Billion*	*LN*	*Northern League*
BCB	*Central Bank of Brazil*	*M5S*	*Five Star Movement*
BoC	*Bank of Canada*	*m-o-m*	*Month-on-month*
BoE	*Bank of England*	*mb*	*Million barrels*
BoJ	*Bank of Japan*	*mb/d*	*Million barrels per day*
bpd	*Barrels per day*	*MENA*	*Middle East and North Africa*
bps	*Basis points*	*mn*	*Million*
BS	*Balance sheet*	*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*
EPS	*Earnings per share*	*TRY*	*Turkish Lira*
EU	*European Union*	*UAE*	*United Arab Emirates*
EUR	*Euro*	*UK*	*United Kingdom*
EZ	*Eurozone*	*US*	*United States*
Fed	*US Federal Reserve*	*USD*	*United States Dollar*
FM	*Future Movement*	*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*	*WTI*	*West Texas Intermediate*
GCC	*Gulf Cooperation Council*	*w-o-w*	*Week-on-week*
GBP	*British pound*	*y-o-y*	*Year-on-year*
GDP	*Gross domestic product*	*y-t-d*	*Year-to-date*
GOP	*Grand Old Party (US Republican Party)*	*ZAR*	*South African Rand*
IMF	*International Monetary Fund*	*10-y*	*10 year*
INR	*Indian Rupee*	*ZEW*	*Centre for European Economic Researc*
IPO	*Initial public offering*		