MAKING SENSE OF *THIS* WORLD — *2 July 2018*

R&R Weekly Column
By Brunello Rosa

EU Summit Yields Little Results, As European Crisis Intensifies

The results of the EU summit on June 28th-29th have been disappointing, as we predicted in our recent travel notes from Berlin. A lot of the media attention was focused on the discussion over migration, and the agreement reached seems insufficient for all sides. Merkel made bilateral agreements with Spain and Greece to allow a re-patriation of the migrants caught in Germany and first registered in those countries. Similar agreements have been discussed with other governments, but not from the Visegrad group. Additionally, Italy has not ratified any similar bilateral agreement (given the opposition of Interior Minister Salvini, also leader of the League), and this was the most important for Merkel to sign. More importantly, Germany's Interior Minister, and leader of the CSU Horst Seehofer said that even if those agreements had been signed, they would not be as effective as his proposal of rejecting migrants engaging in "secondary movements" within the EU at the German border. This was a proposal that Merkel refused to accept, fearing a domino effect that would lead all European countries to close their borders, thus marking the end of Schengen but also of one of the four freedoms of Europe – that of free circulation. As a result, Seehofer has offered his resignations, which means that Germany's government crisis is far from over and might actually intensify in coming days.

On the Eurozone reform, vague language on the "beginning [of] political negotiations on the European Deposit Insurance Scheme" accompany the only tangible result, the agreement on the fact that the "ESM will provide the common backstop to the Single Resolution Fund (SRF)." All other elements supposed to be discussed, (Euro budget, macroeconomic stabilisation mechanism, European unemployment insurance scheme – presented in a letter by Eurogroup president Mario Centeno to Donald Tusk) have been postponed until December 2018. On a side note, Greece eventually got the long-waited measures of debt relief that would allow a clean-ish exit from its third program of international financial assistance. Finally, on Brexit, as we anticipated, the Europeans could only welcome the "further progress made on parts of the legal text of the Withdrawal Agreement," while expressing "concern that no substantial progress has yet been achieved on agreeing a backstop solution for Ireland/Northern Ireland," and reiterating that "work must also be accelerated with a view to preparing a political declaration on the framework for the future relationship, [which] requires further clarity as well as realistic and workable proposals from the UK as regards its position on the future relationship." Effectively the Europeans told the Brits to put their act together and make a decision on what kind of Brexit they want, at the same time warning all member states to be ready for any possible outcome (read: no-deal).

On the back of the considerations above, it is hard not to see an intensification of the European crisis (discussed in a previous column), which will eventually crystallise in one or more of the following ways: a German government collapse; a collision course between Italy and the market, possibly leading to a renewed Euro- or banking crisis; a political crisis in the UK following failed negotiations for an acceptable deal in October; an outbreak of populist parties in the many countries of Europe in which they are gaining power, and most likely in the European elections in 2019. These events are likely to induce increased volatility in FX rates (especially EUR/USD and GBP/EUR), in bond yields (in particular bunds and gilts) and eurozone peripheral spreads (chiefly the 10y BTP/bund yield spread).

Our Recent Publications

- *Mismanagement and International Tensions Stifle a Great Potential, by Rémi Bourgeot, 29 June 2018*
- *Rising Risks in Emerging Markets From Decline in Global Liquidity, by Alessandro Magnoli Bocchi and Francisco Quintana, 26 June 2018*

The Week Ahead

In the US, June data are likely to continue to support rate hikes. Changes in average hourly earnings (*c:* 2.7% y-o-y; *p:* 2.7%), non-farm payrolls (*c:* 190k; *p:* 223k), and the unemployment rate (*c:* 3.8%; *p:* 3.8%) are expected to remain in line with May data. The June 12-13 FOMC minutes will provide further insights into the Fed's view on monetary policy.

Mexico is holding general elections. The opposition leader Lopez Obrador has likely become the new president, with his party—the left-wing NRM—likely to also win a simple majority in both chambers of parliament.

In Turkey, inflation is expected to accelerate (June CPI, *c:* 14.0%; *p:* 12.2%).

The Quarter Ahead

In the 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)* the Fed will keep hiking rates, probably in September and December, to close the year with a Fed funds target range of 2.25-2.50%.

… putting pressure on EM currencies to weaken further. In a context of declining USD liquidity, rising US interest rates and a stronger USD, EMs will remain vulnerable to outflows: EM currencies depreciated (MSCI EM currency index: -1.1% w-o-w), with significant moves in ARS (USD/ARS 28.88, +7.0% w-o-w), CNY (USD/CNY 6.62, +1.7% w-o-w), and INR (USD/INR 68.45, +0.9% w-o-w. Over the next quarter, most EM CBs are likely to continue to increase interest rates to pre-empt currency depreciation.

In Europe, low growth and political uncertainty will increase volatility. France and Germany still need to reach an agreement on key EZ reforms, and the implementation of the migration agreement is likely to be contested in national parliaments.

In the near term, trade tensions will remain high, but may not lead to a trade war. In July, Trump' visit to the UK and his participation in the NATO summit could potentially alleviate tensions with US' Western partners.

***China is likely to shift its policy towards growth support*.** Last week, the PBoC announced a 50bps cut in the RRR of its main banks. The cut will release USD 108bn of liquidity, which will support both bank lending and Chinese stocks (CSI300 fell by 3.2% w-o-w, hitting a one-year low).

***In Russia, relations with the west will stay frosty*.** However, further sanctions on Russia are unlikely. On July 16, Trump and Russian President Putin will meet.

***In the GCC, Kuwait, Saudi Arabia and the UAE will provide financial support to Bahrain*.** Bahrain will need circa USD 10bn over the next two years for debt servicing and repayment.

***MENA countries will continue to issue bonds*.** In the first half of 2018, MENA issued USD 50.0bn worth of bonds, equivalent to 58% of 2017's total issuance of 86.4bn.

***Brent oil prices will remain above 70 USD/b, in spite of Opec output expansion*.** Brent prices rose by 4.5% w-o-w, to 79.4 USD/b, helped by a 9.9mb drop on US crude inventories, according to the EIA.

Last Week's Review

US stocks declined on ongoing concerns of a trade war. The S&P500 lost 1.3% w-o-w, and the VIX index rose by 2 points—to 16, still below its long-term trend of 22—after the Trump administration announced plans, later abandoned, to restrict Chinese investment in US technology. The 10-y UST yield declined by 4bps w-o-w, to 2.85%. The USD depreciated against a basket of currencies (DXY down by 0.1% w-o-w), and against the EUR (by 0.3% w-o-w, to EUR/USD 1.168).

In the US and the EZ, inflation came out in line with the Fed and ECB's 2% target (US PCE May, *a:* 2.0% y-o-y; *c:* 1.9%; *p:* 1.8%; EZ CPI Jun, *a:* 2.0% y-o-y; *c:* 2.0%; *p:* 1.9%). While in the US the increase is due to structural factors (Core PCE May, *a:* 2.3% y-o-y; *c:* 2.2%; *p:* 2.0%), in the EZ inflation is driven mostly by energy prices (Core CPI Jun y-o-y, *a:* 1.0%; *c:* 1.0%; *p:* 1.1%).

In Turkey, President Erdogan was re-elected. The AKP-led alliance won a majority in parliament. Expectations of policy normalization (including the removal of the state of emergency) helped the TRY appreciate by 1.9% w-o-w (to USD/TRY 4.59).

__Pablo Gallego Cuervo__ 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	*k*	thousand
AKP	Justice and Development Party	*KRG*	Kurdistan Regional Government
ann.	annualized	*KSA*	Kingdom of Saudi Arabia
ARS	Argentinian Peso	*LN*	Northern League
bn	Billion	*M5S*	Five Star Movement
BCB	Central Bank of Brazil	*m-o-m*	Month-on-month
BoC	Bank of Canada	*mb*	Million barrels
BoE	Bank of England	*mb/d*	Million barrels per day
BoJ	Bank of Japan	*MENA*	Middle East and North Africa
bpd	Barrels per day	*mn*	Million
bps	Basis points	*MPM*	Monetary Policy Meeting
BS	Balance sheet	*NAFTA*	North-American Free Trade Agreement
c	Consensus	*NATO*	North Atlantic Treaty Organization
C/A	Current account	*NRM*	National Regeneration Movement
CB	Central bank	*OECD*	The Organization for Economic Cooperation and Development
CBK	Central Bank of Kuwait	*Opec*	Organization of Petroleum Exporting Countries
CBO	US Congressional Budget Office	*p*	Previous
CBR	Central Bank of Russia	*pw*	Previous week
CBT	Central Bank of the Republic of Turkey	*PCE*	Personal Consumption Expenditures
CDU	Christian Democratic Union of Germany	*PE*	Price to earnings ratio
CNY	Chinese Yuan	*PM*	Prime minister
CBT	Central Bank of the Republic of Turkey	*PMI*	Purchasing managers' index
CPI	Consumer Price Index	*pps*	Percentage points
DJIA	Dow Jones Industrial Average Index	*QCB*	Qatar Central Bank
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	*RRR*	Reserve Requirement Ratio
EM	Emerging Markets	*RUB*	Russian Rouble
EP	European Parliament	*SHCOMP*	Shanghai Stock Exchange Composite Index
EPS	Earnings per share	*tb/d*	Thousand barrels per day
EU	European Union	*tn*	Trillion
EUR	Euro	*TRY*	Turkish Lira
EZ	Eurozone	*UAE*	United Arab Emirates
Fed	US Federal Reserve	*UK*	United Kingdom
FM	Future Movement	*US*	United States
FOMC	US Federal Open Market Committee	*USD*	United States Dollar
FRB	US Federal Reserve Board	*USD/b*	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
JPY	Japanese yen	10-y	10-year

Rosa & Roubini Associates Ltd is a private limited company registered in England and Wales (Registration number: 10975116) with registered office at 118 Pall Mall, St. James's, London SW1Y 5ED, United Kingdom. VAT registration number GB 278 7297 39.