Rosa & Roubini
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MAKING SENSE OF *THIS* WORLD — *25 June 2018*

R&R Weekly Column
By Brunello Rosa

Q2 Ends With Some Hopes and Many Warning Signals

This week the second quarter of 2018 will end, with some hopes and a few warning signals on the economic, financial and geopolitical front. From a macroeconomic perspective, Q2 saw a re-acceleration of growth in US economic activity, partly boosted by the tax cuts approved in January, while the soft patch that affected economic growth in the Eurozone, UK and Japan seems now to be a more persistent phenomenon than initially anticipated, in spite of recent better PMI data. As a result, while US inflation is now above target in both headline and core terms, core inflation remains subdued in the Eurozone and Japan, and is falling fast in the UK and is now just above the BOE target. China's economy has performed decently in both Q1 and Q2, although recent data have been mixed and regulatory tightening in credit this year is likely to slow down economic growth.

Central banks have reacted accordingly. The Federal Reserve has signaled that, unless something goes wrong, it will carry on with its policy normalization at the pace of one 25-bps increase in the Fed funds target range per quarter in 2018, with two additional hikes expected during the remainder of the year. The Bank of Japan has remained on hold this year and will likely wait much longer to review its policy stance, especially after the unexpected economic contraction in Q1. The European Central Bank, while announcing the tapering of its asset purchases, has signalled that the first rate hikes might not occur until Q3 2019. The Bank of England has postponed to at least August (if not later), the rate hike that most market participants (but not us) expected to occur in May. The PBoC cut the reserve requirement ratios for many banks after soft economic data and just announced a new round of cuts to deal with the expected growth slowdown from trade frictions.

The most vulnerable emerging markets have suffered from the combined effects of USD strength (in turn deriving from US rate policy normalisation, Fed's balance sheet reduction and US Treasury's increased issuance to finance the greater budget deficit created by the tax cuts), oil price increases (due to past cuts to production, partly eased at the latest OPEC meeting), policy mishaps and still-large current account deficits: top of the list were Argentina and Turkey. A number of EM central banks (in Argentina and Turkey, but also in Brazil, India, Indonesia, Mexico) have been forced to increase their policy rates or intervene in the FX market to defend their currencies against the USD appreciation. Oil exporting countries, such as Russia and Saudi Arabia, have done better, thanks to higher oil prices.

From a geopolitical standpoint, most developments don't seem particularly reassuring. Slightly easier tensions on the Korean peninsula, to the full advantage of Kim Jong-Un, have been more than offset by the beginning of a full-fledged trade war between the US and the rest of the world, starting from China, and including Canada and Mexico (with NAFTA being put on hold) and the European Union. In Europe, a new severe crisis seems inevitable, whether due to the lack of agreement on migrants, on fiscal policy or on Brexit. The new "populist" government in Italy is likely to be only modestly confrontational initially, but the truce with the EU and the markets might only last until the autumn.

Markets have reflected those economic and geopolitical developments. As we expected, US equity prices have not returned to their January 2018 peak yet, and we don't expect them to do so for the rest of the year. The 10y US Treasury yield finds it hard to go beyond 3% on a sustained basis, especially as long as the ECB and the BOJ continue with the asset purchases, depressing bund and JGB yields. This week, we will publish our asset allocation update, which will suggest how to position in this difficult environment.

Our Recent Publications

- *BOE: After June MPC and Mansion House Speech*, *by Brunello Rosa, 22 June 2018*
- *Italy: New Government to Be Initially Only Modestly Confrontational with Europe, by Brunello Rosa and Nouriel Roubini, 20 June 2018*

The Week Ahead

Turkey - President Erdogan is expected to win a simple majority in the presidential elections. Polls anticipate the re-election of President Erdogan, who is likely to need a second round (July 8) to secure a victory. In the simultaneous parliamentary elections, an alliance led by his party AKP is likely to get majority in parliament. However, a victory of the opposition bloc is within the margin error, resulting in heightened uncertainty. The TRY strengthened by 1.1% w-o-w to USD/TRY 4.68.

US and EZ - Headline inflation is expected in line with CBs targets. Inflation is expected exactly on the 2% target set by the Fed and the ECB: (US PCE May y-o-y c: 2.0%; p: 2.0%); and (EZ CPI Jun, y-o-y, c: 2.0%; p: 2.0%). While in the case of the US, core inflation will show that the rise in inflation is structural (Core PCE May y-o-y, c: 1.8%; p: 1.8%) in the EZ, the price rise has been so far driven by external factors such as energy prices (Core CPI Jun y-o-y, c: 1.0%; p: 1.1%).

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, probably in September and December, to close the year with a Fed funds rate of 2.25 to 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 are vulnerable to outflows: EM currencies depreciated by 0.5% w-o-w, according to the MSCI EM currency index, -4.5% in the last two months. Over the next quarter, EMs CBs will continue to increase interest rates to slow down currency depreciation.

Europe - Low growth and political uncertainty will increase volatility. Germany's central bank cut its GDP growth forecast from 2.5% to 2%, as the "external environment" is increasing uncertainty. In Italy, political concerns will linger: this week, Italian 10y bonds rose by 11bps to 2.73% following the appointment of two staunch Eurosceptics to lead key parliamentary finance committees. By contrast, the German 10-year Bund yield fell by 7bps to its lowest for three weeks, 0.34%.

In the near term, trade tensions will continue to rise but are unlikely to lead to a full-fledged trade-war. Over the last week, China, the EU and Turkey set retaliatory tariffs against US products, but tensions should subside after the US mid-term elections in November.

MENAT - Social instability constitutes a rising risk. Protests could erupt as a result of inflation related to USD strength or to reforms: in Jordan, Prime Minister Hani Mulki was forced to resign as a result of the austerity measures imposed as a part of the IMF reform package.

GCC - MSCI confirmed the inclusion of 32 securities from Saudi Arabia in its EM index, with a weight of ~2.6%. The first batch will be added in May 2019, and the second on August 2019.

Brent oil prices - To remain above 70 USD/b in spite of Opec output expansion. Opec's agreed production extension was below market expectations, resulting in a rise in Brent prices by 3.3% w-o-w, to 75.8 USD/b.

Last Week's Review

Global stock markets declined on rising concerns of a trade war. The S&P500 lost 0.4% w-o-w, and the VIX index rose 2 points to 14—below the long-term trend of 22—on simmering concerns over global trade tensions, particularly after President Donald Trump threatened to slap a 20 per cent tariff on all cars imported from the EU. The 10-y UST yield declined by 3bps w-o-w, to 2.89%. The USD depreciated against a basket of currencies (DXY down by 0.3% w-o-w), and against the EUR (by 0.3% w-o-w to EUR/USD 1.165). The EUR was lifted by encouraging survey data (EZ PMI Comp. Jun, *a:* 54.8%; *c:* 53.9%; *p:* 54.1%) and by news that Greece's creditors had finally brokered a long-awaited debt relief deal. Opec agreed to extend production to partially offset expected declines in Venezuela, Iran and, probably, Libya, where domestic conflict is threatening oil exports. However, the rise—1mb/d in theory, around 700k in practice—was below market expectations, resulting in a rise in Brent prices by 3.3% w-o-w, to 75.8 USD/b.

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*
AKP	*Justice and Development Party*
ann.	*annualized*
ARS	*Argentinian Peso*
bn	*Billion*
BCB	*Central Bank of Brazil*
BoC	*Bank of Canada*
BoE	*Bank of England*
BoJ	*Bank of Japan*
bpd	*Barrels per day*
bps	*Basis points*
BS	*Balance sheet*
c	*Consensus*
C/A	*Current account*
CB	*Central bank*
CBK	*Central Bank of Kuwait*
CBO	*US Congressional Budget Office*
CBR	*Central Bank of Russia*
CBT	*Central Bank of the Republic of Turkey*
CDU	*Christian Democratic Union of Germany*
CNY	*Chinese Yuan*
CBT	*Central Bank of the Republic of Turkey*
CPI	*Consumer Price Index*
DJIA	*Dow Jones Industrial Average Index*
d-o-d	*Day-on-day*
DXY	*US Dollar Index*
EC	*European Council*
ECB	*European Central Bank*
EIA	*US Energy Information Agency*
EM	*Emerging Markets*
EP	*European Parliament*
EPS	*Earnings per share*
EU	*European Union*
EUR	*Euro*
EZ	*Eurozone*
Fed	*US Federal Reserve*
FM	*Future Movement*
FOMC	*US Federal Open Market Committee*
FRB	*US Federal Reserve Board*
FX	*Foreign exchange*
FY	*Fiscal Year*
GCC	*Gulf Cooperation Council*
GBP	*British pound*
GDP	*Gross domestic product*
GOP	*Grand Old Party (US Republican Party)*
IMF	*International Monetary Fund*
INR	*Indian Rupee*
IPO	*Initial public offering*
IS	*Islamic State*
JPY	*Japanese yen*
k	*thousand*
KSA	*Kingdom of Saudi Arabia*
LN	*Northern League*
M5S	*Five Star Movement*
m-o-m	*Month-on-month*
mb	*Million barrels*
mb/d	*Million barrels per day*
MENA	*Middle East and North Africa*
mn	*Million*
NAFTA	*North-American Free Trade Agreement*
OECD	*The Organization for Economic Cooperation and Development*
Opec	*Organization of Petroleum Exporting Countries*
p	*Previous*
pw	*Previous week*
PCE	*Personal Consumption Expenditures*
PE	*Price to earnings ratio*
PM	*Prime minister*
PMI	*Purchasing managers' index*
pps	*Percentage points*
QCB	*Qatar Central Bank*
QAR	*Qatari Riyal*
QE	*Quantitative easing*
q-o-q	*Quarter-on-quarter*
RBA	*Reserve Bank of Australia*
REER	*Real Effective Exchange Rate*
RUB	*Russian Rouble*
tb/d	*Thousand barrels per day*
tn	*Trillion*
TPP	*Trans Pacific Partnership*
TRY	*Turkish Lira*
UAE	*United Arab Emirates*
UK	*United Kingdom*
US	*United States*
USD	*United States Dollar*
USD/bbl.	*USD per barrel*
UST	*US Treasury bills/bonds*
VAT	*Value added tax*
VIX	*Chicago Board Options Exchange Volatility Index*
WTI	*West Texas Intermediate*
w-o-w	*Week-on-week*
y-o-y	*Year-on-year*
y-t-d	*Year-to-date*
ZAR	*South African Rand*
10-y	*10 year*
ZEW	*Centre for European Economic Research*

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