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MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
By Brunello Rosa

Central Banks in Focus

While the independence of central banks starts to be questioned or, in some cases, openly challenged (as we discussed in last week's column), central banks continue to do their job of trying to deliver price and wider macro-economic stability. Last week, the European Central Bank left its policy stance unchanged and did not provide further details of its future re-investment policy, which probably still needs to be agreed upon within the bank's Governing Council. We will probably need to wait until after the summer break to know more about this crucial aspect of the ECB's policy stance. In Turkey, the CBT unexpectedly kept its policy rate, the one-week repo rate, on hold at 17.75%. This decision surprised analysts and market participants, who had been looking for a 100bps increase in the repo rate. It therefore triggered currency outflows that weakened the TRY, with the USD/TRY rising by 1.2% over the week, to 4.852. The bank's decision might be the first instance of Erdogan using his influence over the CBT's policymaking now that his mandate has been renewed and reinforced as a result of the June 24th elections. On the other hand, press reports suggest the PBoC further eased its policy stance, reducing a specific capital requirement for local financial institutions in order to help them meet their credit demands more effectively. The PBoC easing is part of a wider strategy by the Chinese authorities to implement an expansionary monetary and fiscal stance to cushion the Chinese economy from the potential effects of the trade tensions deriving from commercial wars initiated by US President Trump.

This week, three of the world's major central banks will also hold policy meetings. On Tuesday, the Bank of Japan will conclude its two-day policy meeting and release the new bank's forecasts. Press reports have been suggesting for days that the BoJ will change its policy stance, for example by dropping its Yield Curve Control policy. We don't expect the BoJ to do so, as the inflation target is still too far from present rates for the central bank to tighten its stance (core-core inflation is still close to zero). On Wednesday, the Federal Reserve will hold its Federal Open Market Committee (FOMC) meeting, which is likely to be concluded with the Fed funds target range being left unchanged at 1.75%-2%. The bank's formal statement following the meeting will be watched closely, as the FOMC will most likely prepare the ground for the further 25-bps increase in the policy rate to be implemented at the end of September. On Thursday, the Bank of England will hold its August MPC meeting and is expected to increase its Bank Rate by 25bps to 0.75%, in effect the first tightening of policy rates in a decade (the 25bps increase to 0.5% in November 2017 was merely a return to the effective lower bound, as estimated in 2008). The BoE has probably found a window in which to slot in a rate increase before the Brexit debate becomes even more heated this autumn. Central banks continue working to ensure that the transition of the real economy to levels consistent with its supply-side structure remains as smooth as possible. Hopefully they will be able to continue to do so in an independent and non-conditioned manner in the years to come.

Our Recent Publications

- *BOE Finds A Window To Slot In a Rate Hike*, *by Brunello Rosa, 27 July 2018*
- *Preview: BOJ Unlikely to Change Its Policy Regime Apart From Minor Tweaks*, *by Nouriel Roubini, 27 July 2018*
- *ECB Review: Details On Reinvestment Policy to Come After the Summer Break*, *by Brunello Rosa, 26 July 2018*
- *Emerging Markets Outlook: Rising Risks, Fragility Ahead*, *by Alessandro Magnoli Bocchi and Francisco Quintana, 24 July 2018*
- **The Geopolitical Corner** - *Putin's Game:* *by John Hulsman, 24 July 2018*

The Week Ahead

In the US, the FOMC will likey keep rates on hold (*c:* 2.00%; *p:* 2.00%). July employment data will support further tightening: changes in average hourly earnings (*c:* 2.7% y-o-y; *p:* 2.7%), non-farm payrolls (*c:* 195k m-o-m; *p:* 213k), and the unemployment rate (*c:* 3.9%; *p:* 4.0%). The likelihood of "*at least two additional hikes in 2018*" rose to 67.7% (*pw:* 62.5%).

***In the US and the EZ, inflation data will be broadly in line with the Fed and ECB's 2% target*:** US PCE (July *c:* 2.2% y-o-y; *p:* 2.3%) will be softened by structural factors (Core PCE July, *c:* 1.9% y-o-y; *p:* 2.0%). EZ CPI (July*:* 2.0% y-o-y; *p:* 2.0%) will be supported by energy prices (Core CPI July, *c:* 0.9% y-o-y; *p:* 0.9%).

In the UK, the BoE will likely hike rates (*c:* 0.75%; *p:* 0.50%). In Japan, the BoJ will likely keep policy rates on hold (*c:* -0.10%; *p:* -010%).

The Quarter Ahead

Global growth and inflation will decelerate. In the EZ, Q2-2018 growth will show signs of deceleration (*c:* 2.4% y-o-y; *p:* 2.5%).

Trade tensions will remain, but will likely not lead to a trade-war. The US-EU deal could provide a template for a US-China agreement before August 30, when the USTR is scheduled to complete its review process for additional tariffs on USD 200bn of Chinese imports.

The EU will struggle to counter US sanctions on Iran. As the August 6 deadline for 'new US sanctions' approaches, firms will face a difficult decision on whether to comply with European or American rules.

In the UK, the likelihood of a "hard" Brexit will increase. EU negotiators intend to preserve the integrity of the single market and rejected the UK's latest proposal. UK's PM May sought the support of Austria's Chancellor Kurz and Czech Republic's PM Babiš, but both endorsed EU's position. The likelihood of the UK falling back on WTO rules for trade with the EU is increasing.

***China will support its slowing economy with expansive fiscal policy and monetary easing*.** As fiscal spending started to accelerate, the authorities have pledged to "*make it even more proactive*". After several cuts to commercial banks' RRRs, the PBoC unexpectedly injected - via its medium-term lending facility, which makes loans available to banks – the record amount of 502bn yuan (USD74bn) into the financial system.

The rotation from stocks into bonds will accelerate: *a)* in June, nearly USD 20bn were pulled from large-cap stocks long-term mutual funds and exchange-traded funds—the biggest month of outflows in over a decade; *b)* in H1-2018, more than USD 130bn went into taxable and municipal-bond funds.

EMs will remain vulnerable to outflows due to: *a)* declining USD liquidity; *b)* rising US interest rates; *c)* a stronger USD; and *d)* trade war fears. EM currencies will depreciate further (MSCI EM currency index: -3.0% y-t-d).

***Brent oil prices will remain above 70 USD/b*.** Brent prices rose by 1.6% w-o-w, to 74.3 USD/b, due to: *a)* KSA's suspension of oil shipments through the Red Sea Bab al-Mandab strait, after Yemeni Houthi rebels attacked two oil tankers; *b)* US crude stockpiles falling beyond expectations (week ending July 20, *a:* -6.1mb w-o-w; *c:* -2.6mb; *p:* +5.8mb); and *c)* the easing of US-EU trade tensions.

Last Week's Review

***In the US, stocks were supported by a growth acceleration and lower "US-EU trade risks*".** The S&P500 rose by 0.5% w-o-w, helped by: *a)* faster GDP growth, which reached in Q2-2018 a four-year high: 4.1% q-o-q ann. (*c:* 4.1%; *p:* 2.2%); *b)* a declining risk of a US-EU trade war, after the two sides agreed to: *i)* put on hold any new tariffs; and *ii)* start talks to reduce trade barriers related to all industrial goods other than cars; and *c)* positive earnings data: with Q2 data published for 53% of the S&P500 firms, 83% reported a positive EPS surprise, with a blended earnings rate of 21.3%. The VIX remained at 13, below its long-term trend of 22. The strength of US data also impacted: *a)* the 10y UST, with yields rising 7bps w-o-w to 2.96%; and *b)* the USD, which appreciated against a basket of currencies (DXY +0.2% w-o-w) and the EUR (EUR/USD 1.166, -0.5% w-o-w).

In the EZ, the ECB left its policy rate unchanged (*c:* 0.0%; *p:* 0.0%) and confirmed: *a)* the end of QE in December; and *b)* its expectation of a rate hike at the end of the summer of 2019.

In Turkey, the CBT kept its policy rate on hold at 17.75% (one-week repo rate). The decision surprised analysts *(c:* 18.75%; *p:* 17.75%), triggering outflows that weakened the TRY (USD/TRY 4.852, +1.2% w-o-w).

Pablo Gallego Cuervo *and* ***Josiane C. Zhang*** *contributed to this Viewsletter.*

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Abbreviations, Acronyms and Definitions

a	Actual	*k*	thousand
AKP	Justice and Development Party, Turkey	*KSA*	Kingdom of Saudi Arabia
ann.	annualized	*LN*	Northern League, Italy
ARS	Argentinian Peso	*M5S*	Five Star Movement, Italy
bn	Billion	*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	*MHP*	Nationalist Movement Party, Turkey
bps	Basis points	*mn*	Million
BS	Balance sheet	*NAFTA*	North-American Free Trade Agreement
c	Consensus	*NATO*	North Atlantic Treaty Organization
C/A	Current account	*OECD*	Organization for Economic Cooperation and Development
CB	Central bank	*Opec*	Organization of Petroleum Exporting Countries
CBK	Central Bank of Kuwait	*p*	Previous
CBR	Central Bank of Russia	*PBoC*	People's Bank of China
CBT	Central Bank of the Republic of Turkey	*PCE*	Personal Consumption Expenditures
CDU	Christian Democratic Union, Germany	*PE*	Price to earnings ratio
CNY	Chinese Yuan	*PM*	Prime minister
CPI	Consumer Price Index	*PMI*	Purchasing managers' index
DJIA	Dow Jones Industrial Average Index	*pps*	Percentage points
d-o-d	Day-on-day	*pw*	Previous week
DXY	US Dollar Index	*QCB*	Qatar Central Bank
EC	European Council	*QAR*	Qatari Riyal
ECB	European Central Bank	*QE*	Quantitative easing
ECJ	European Court of Justice	*q-o-q*	Quarter-on-quarter
EIA	US Energy Information Agency	*RBA*	Reserve Bank of Australia
EM	Emerging Markets	*RRR*	Reserve Requirement Ratio
EP	European Parliament	*RUB*	Russian Rouble
EPS	Earnings per share	*SHCOMP*	Shanghai Stock Exchange Composite Index
EU	European Union	*tb/d*	Thousand barrels per day
EUR	Euro	*tn*	Trillion
EZ	Eurozone	*TPP*	Trans Pacific Partnership
Fed	US Federal Reserve	*TRY*	Turkish Lira
FM	Future Movement	*UAE*	United Arab Emirates
FOMC	US Federal Open Market Committee	*UK*	United Kingdom
FRB	US Federal Reserve Board	*US*	United States
FX	Foreign exchange	*USD*	United States Dollar
FY	Fiscal Year	*USD/b*	USD per barrel
GCC	Gulf Cooperation Council	*UST*	US Treasury bills/bonds
GBP	British pound	*VAT*	Value added tax
GDP	Gross domestic product	*VIX*	Chicago Board Options Exchange Volatility Index
GOP	Grand Old Party (US Republican Party)	*WTI*	West Texas Intermediate
IMF	International Monetary Fund	*w-o-w*	Week-on-week
INR	Indian Rupee	*y-o-y*	Year-on-year
IPO	Initial public offering	*y-t-d*	Year-to-date
IS	Islamic State	*2y; 10y*	2-year; 10-year
JPY	Japanese yen		