MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
By Brunello Rosa

Holidays Are Over: Resumption of Full Activity Brings Major Risks to the Fore

This week, following US Labor Day on Monday September 3rd, the holiday season will be over. The return to work will be accompanied by several events that indicate the possibility of a high and imminent level of risk existing in a number of developed economies (DMs) and emerging markets (DMs). Starting with DMs, Brexit negotiations will enter their final stage in the coming days for a deal that needs to be struck by the end of September in order to be brought to the EU Council for approval on October 10th. This will occur just after the annual Tory party conference, which will be held in Birmingham between September 30th and October 3rd. This will be the last chance for the Conservatives to find a common position and present a united front in final rush to conclude the Brexit negotiations. The risk of a no-deal Brexit outcome is increasing, but at the same time, the chief EU negotiator said that the Commission might be prepared to offer an arrangement that has never been given to other countries before, rather than continue to stick to the dichotomy of the Canada/Norway models that has dominated the negotiations thus far. The GBP has been quite sensitive to this news, and has recovered somewhat of late versus the EUR and the USD. Further south, Italy is about to enter its month of passion, with the Document of Economic and Finance (DEF) Update set to be approved by Parliament by September 27th. The market is eagerly awaiting the number that Finance Minister Giovanni Tria will designate for Italy's budget deficit in 2019, which will be compared with the 0.9% level previously agreed upon with the EU. The new level will certainly be higher than 0.9%, but will it be also higher than Italy's current budget deficit level of 1.8%? If it is set higher than 1.8%, that would likely signal the interruption of Italy's convergence towards the Medium-Term Objective of a balanced structural budget. Indeed, market participants are widely expected to start a speculative attack against Italy's public debt and banking system, with rating agencies getting ready to downgrade the country's creditworthiness, potentially leading to the collapse of the newly formed populist government. This could, in the medium-term, lead to a Eurozone break-up. In a recent report, we discuss how to hedge against that risk.

Moving to the EM space, the Turkish crisis that has dominated August has subsided since the TRY has stabilised thanks to the central bank "stealth" increase in interest rates. The underlying issue has not been resolved, however. More decisive actions will need to be taken by Erdogan to end the crisis and avoid a collapse of the newly formed presidential regime. The government will try to continue avoiding asking for IMF assistance, which is considered politically toxic in Ankara given the relationship between Trump and Erdogan. In contrast, Argentina has been desperately asking the IMF to speed up its intervention; Argentina's central bank was forced to increase its interest rates by further 15% to 60% last week to stem the peso's depreciation. USD/ARS reached the record high of 38.7 (with intraday beyond 42) as investors continue to steer away from Argentina's bonds and currency. The actively risky situations in Argentina and Turkey are at risk of involving other emerging markets as well, as we have discussed in previous reports and will analyse further in an upcoming paper. The presidential elections on October 7th in Brazil might offer further scope for such EM contagion. In conclusion, market participants have hopefully gotten plenty of rest during the summer, as the autumn will probably prove to be extremely bumpy, and is likely to bring a number of sleepless nights.

Our Recent Publications

- *Hedging Against A Euro Break-Up, by Alessandro Magnoli Bocchi, Brunello Rosa and Pablo Gallego Cuervo, Damiano Terziotti, 30 August 2018*
- **The Geopolitical Corner** – *How the world really works (Part 3), by John C. Hulsman, 28 August 2018*

The Week Ahead

In the US, August employment data will likely support the Fed's tightening cycle: Released this week on Friday, changes in average hourly earnings (*c:* 2.8% y-o-y; *p:* 2.7%), non-farm payrolls (*c:* 187k m-o-m; *p:* 157k), and the unemployment rate (*c:* 3.9%; *p:* 3.9%) will likely support additional Fed hikes. Last week, the likelihood of "*at least two additional hikes in 2018*" rose to 71.2% (*pw:* 67.0%), while the likelihood of "*at least 4 additional hikes by September 2019*" increased to 29.0% (*pw:* 22.9%).

In the EZ, Q2-2018 GDP growth will likely remain flat (*c:* 2.2% y-o-y; *p:* 2.2%).

The Quarter Ahead

The US will likely continue to diverge from other DMs. After the cyclical acceleration of 2017-Q12018, the global economy is decelerating and risks are rising. The divergence between stable DMs and volatile EMs will persist. In the US, the economic cycle is likely to: *a)* remain strong in Q3 (consumer confidence, August: *a:* 133.4—the highest reading since October 2000; *c:* 126.5; *p:* 127.4); and *b)* weaken in early 2019.

Italian assets will continue to suffer. The 10y Italian bond yield rose by 9bps w-o-w (to 3.24%), as concerns mount over: *a)* a larger budget deficit; and *b)* an October credit rating downgrade by Moody's and S&P. Q2-2018 GDP growth remained stable (*a:* 1.2%; *c:* 1.1%; *p:* 1.2%).

China will maintain an expansive fiscal policy and monetary easing, in order to counter headwinds coming from: *a)* fears of a trade war; and *b)* domestic deleveraging. So far, the adopted policy measures are sustaining the economy (NBS manufacturing PMI: August, 51.3; *p:* 51.2) but tensions are rising in the financial system: to avoid negative spill-overs, the Chinese government is likely to intervene in P2P lending—as 167 platforms are currently in "*financial trouble*" (outstanding P2P loans: July, CNY 1.0tn; *p:* 1.3tn). The CNY depreciated against the USD (USD/CNY 6.830, +0.4% w-o-w).

EMs will likely suffer additional outflows. Last week, Argentina: *a)* hiked interest rates by 1,500bps (to 60%); and *b)* asked the IMF for an early release of standby funds. The ARS depreciated further against the USD (to USD/ARS 36.800, +19.4% w-o-w).

Turkey is trying to avoid an IMF bailout. Last week: a) Moody's downgraded 20 Turkish financial institutions; b) the economic confidence index reached its lowest level since March 2009 (August, 83.9: p: 92.2); c) the EU and Turkey showed signals of rapprochement. The TRY continued to weaken against the USD (USD/TRY 6.518, +8.5% w-o-w). On its September 13 meeting, the CBT will not hike rates but will adopt other tightening measures (e.g.: last week, the CBT rose taxes on FX deposits). In the next 12 months, Turkish banks must refinance around USD 77bn of wholesale bonds and FX-denominated syndicated loans.

Brent oil price will likely remain above 70 USD/b. Brent price rose w-o-w (+2.1%, to 77.4 USD/b), supported by: *a)* a larger-than-expected drop in US crude stockpiles (*a:* -2.6mb w-o-w; *c:* -0.7mb; *p:* -5.8mb); and *b)* looming US sanctions on Iranian oil exports.

Last Week's Review

US stocks kept rising. The S&P500 was lifted (0.9% w-o-w) by the: *a)* US-Mexico trade deal—and hopes of a US-Canada deal; and *b)* upward revision of US GDP growth (Q2-2018, *a:* 4.2% ann.; *c:* 4.0%; *p:* 4.1%). US 10y bond yields rose by 2bps w-o-w to 2.85%. The USD remained flat w-o-w against: *a)* a currency basket (DXY +0.0%); and *b)* the EUR (EUR/USD 1.160, -0.2%). EM stocks stabilized (MSCI EMs +0.5% w-o-w). Volatility increased marginally (VIX, +0.9 points to 12.9; *52w avg.:* 13.6; *10y avg.:* 19.5), driven by concerns about: *a)* trade wars; and *b)* EM currencies' weakness.

European stocks registered losses**:** concerns about Italy—Fitch lowered its credit outlook to "*negative*" from "*stable*"—and Turkey hit EZ stocks (Eurostoxx 50 -1.0% w-o-w). In the UK, the GBP appreciated further, on hopes of a Brexit deal, as the EU chief negotiator Barnier announced that "*Brussels is willing to offer Britain a partnership such as there never has been with any other third country"* (GBP/USD 1.296, +0.9% w-o-w).

In the US and the EZ, inflation data remained in line with the Fed and ECB's 2% target**:** *a)* in the US, inflation (US PCE July *a:* 2.3% y-o-y; *c:* 2.2% y-o-y; *p:* 2.2%) ticked up, driven by core prices (Core PCE July, *a:* 2.0% y-o-y; *c:* 2.0% y-o-y; *p:* 1.9%); *b)* in the EZ, CPI declined slightly (August*: a:* 2.0% y-o-y; *c:* 2.1% y-o-y; *p:* 2.1%), dragged by a weaker core inflation (Core CPI August, *a:* 1.0% y-o-y; *c:* 1.1%; *p:* 1.1%).

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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		