

MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
By Brunello Rosa





U.S. Stock Market Record Is Welcome, But Still Suggests Caution

The S&P500 index rose by 0.9% last week, reaching an all-time high of 2,874.7 points. The VIX index declined by 0.6 points, to 12; it is now well below its 52-week average of 13.6 and its 10-year average of 19.5. A high level of economic activity is underpinning this strong performance in U.S. equity markets. A 4% annualised rate of GDP growth in Q2 of 4% is expected to be confirmed this week. The US unemployment rate is near its historic lows, at 3.9%. Inflation also remains well behaved: this week core PCE is expected to be confirmed to have remained at the Fed's target level of 2%. Developments in other financial markets are helping too. The long end of the US yield curve remains low despite strong growth and rising inflation; the 10y yield is still below the crucial 3% threshold level. This confirms what we discussed at length [in a recent report](#) on US fixed income; namely, that the flattening US yield curve (the 2y10y yield spread recently reached 21bps, the lowest level in more than a decade) does not necessarily indicate that of a recession is imminent. In FX markets, the USD depreciated against a basket of currencies last week. The dollar index DXY fell by 0.7%. This fall also helped US equity valuations. Some commentators have attributed this (temporary?) interruption to the USD rally to President Trump's criticism of the Fed's policy tightening. There might be an element of truth to this view; that said, Fed chairman Jay Powell, in [his inaugural speech at Jackson Hole's annual symposium](#) of central bankers last week, reaffirmed the current Fed's policy of gradually tightening policy rates. The Fed continues to [foresee two more rate hikes in 2018 and three in 2019](#).

US financial markets are being buffeted but not shaken by the political and geopolitical risks the US is facing (or, in some cases, has actively been working to create). Investigation into "Russia-gate" are increasingly focusing on the President's inner circle, but they do not necessarily seem to be leading towards impeachment. Indeed, the probability of impeachment will decline if the Democrats do not manage to win at least one of the two houses of Congress in November. Meanwhile, negotiations on NAFTA had seemed destined to fail until a recent [breakthrough with Mexico](#) re-opened the possibility of a positive conclusion being reached. [Trade tensions with China](#), though they are still escalating, do not necessarily seem to be leading to a full-blown trade war. Even Trump's [recent spat with Turkey's President Erdogan](#) seems to be only a small political skirmish in the grand scheme of things. The US performance is broadly in line with our [strategic asset allocation](#) (which will be updated in September), which still foresees a skew towards equities and some cautious risk taking. The US performance also remains in line with our analysis following the [stock market fall in early February](#), when we warned that volatility and inflation fears would likely continue to weigh on markets. Indeed, it took a full seven months to recover the equity valuation highs that had been reached on January 26th. At this point, we continue to suggest caution. The factors that could lead to further stock market rises in the US might be countered by increasing fragilities in the world economy, particularly in emerging markets, which have started feeling the pain of the Fed's tightening and USD strength. Politics and geopolitics may also affect financial markets in unexpected ways, even if a U.S. equity bear market is not on our radar screen just yet.

Our Recent Publications

 [Unconventional Policy Options Undertaken by Turkey Are Unlikely to Succeed](#), by N. Roubini, 23 August 2018

 [BOJ Policy Tweaks Fail To Impress Markets](#), by Brunello Rosa and Nouriel Roubini, 21 August 2018

 [Turkey: Exports Are At Risk](#), by Ousmène Jacques Mandeng, 22 August 2018

 [The Geopolitical Corner – How the world really works \(Part 2\)](#), by John C. Hulsman, 20 August 2018



The Week Ahead

In the US, the second reading of Q2-2018 GDP growth is expected to confirm the first print (c: 4.0% ann.; p: 4.1%).

In the US and the EZ, inflation data are expected to be in line with the Fed and ECB's 2% target: In the US, core prices (Core PCE July, c: 2.0% y-o-y; p: 1.9%) will likely maintain inflation around current levels (US PCE July c: 2.2% y-o-y; p: 2.2%). In the EZ, CPI is expected to remain flat (August: 2.1% y-o-y; p: 2.1%) supported by energy prices (Core CPI August, c: 1.1% y-o-y; p: 1.1%).

In the EZ, Fitch might downgrade Italy's credit rating in its August 31 review. In June, net holdings of Italian sovereign debt by foreign investors declined by EUR 38bn (p: EUR -34bn), the highest monthly decline on record. The 10y Italian bond yield rose by 2bps w-o-w (to 3.15%).

The Quarter Ahead

In the US, the Fed will continue to tighten, but EM volatility could reduce the frequency of hikes in 2019. In Jackson Hole, the Fed kept to its view that gradual rate hikes sustain and not imperil medium-term growth in the US. The August FOMC minutes set the stage for another hike in September. However, as the FOMC's outlook of the US economy was less optimistic, the likelihood of "at least 2 additional hikes in 2018" declined to 63.7% (pw: 65.4%), while the likelihood of "at least 4 additional hikes by September 2019" fell to 21.8% (pw: 25.8%). The Fed's balance sheet is likely to: 1) remain overextended; and 2) exert downward pressures on UST yields, preventing full normalisation.

EZ growth is expected to slow. Government spending, consumption, investment, and trade are set to decline.

China will keep supporting its slowing economy with expansive fiscal policy and monetary easing. Last week, China injected USD 22bn into the banking system, via loans to commercial banks.

Turkey will continue trying to avoid an IMF bailout. Last week, CBT signed a USD 3bn currency swap deal with the QCB to: a) ease bilateral trade in local currencies; b) support financial stability; and c) enhance reserves in both CBs. The deal comes as part of Qatar's USD 15bn investment pledge to stabilize the TRY (USD/TRY 6.005, -0.1% w-o-w). On its Sep 13 meeting, the CBT is unlikely to hike rates.

Tariff escalation is unlikely to lead to a full-blown trade war. Last week, the US enforced a 25% tariff on USD 16bn of Chinese imports. As last week's US-China trade talks ended with little progress, China will retaliate proportionately.

Iran and China will cooperate, pushed by US sanctions and tariffs. China has cut oil imports from the US since trade tensions started, and has started to use Iranian vessels to transport oil, in order to avoid obtaining shipping insurance in international markets. China is also expected to take over the Iranian operations of France's Total. The US has asked buyers of Iranian oil to cut imports to zero starting in November.

Saudi Arabia will struggle to win back investor's confidence. KSA has reportedly called off the domestic and international stock listing of Saudi Aramco. KSA's sovereign wealth fund will try to obtain USD 11bn in loans from international banks, as it needs to pay for the government's economic reforms.

Brent oil price will likely remain above 70 USD/b. Price rose w-o-w (+5.6%, to 75.8 USD/b), supported by: a) a larger-than-expected drop in US crude stockpiles (a: -5.8mb w-o-w; c: -1.5mb; p: +6.8mb); and b) Iran sanction worries.

Last Week's Review

US stocks hit record highs. The S&P500 rose (0.9% w-o-w) to an all-time high of 2,874.7, supported by rising optimism on trade talks and the US economy outlook. The VIX declined by 0.6 points to 12.0 (52w avg.: 13.6; 10y avg.: 19.5). Following dovish remarks by the Fed's chairman, US 10y bond yields declined by 4bps w-o-w to 2.83%, and the UST yield curve flattened further (2y/10y spread: 21bps, the lowest level in more than a decade). The USD depreciated w-o-w against: a) a currency basket (DXY -0.7%); and b) the EUR (EUR/USD 1.162, +1.6%), weakened by President Trump's criticism of the Fed's policy tightening.

Europe and EMs stocks registered gains. Declining concerns about Turkey helped stocks in the EZ (Eurostoxx 50 +1.6% w-o-w) and EMs (MSCI EMs +2.7% w-o-w).

In the UK, the GBP appreciated, as the UK government unveiled plans for a "no-deal" Brexit (GBP/USD 1.284, +0.7% w-o-w).

In Japan, inflation surprised on the upside but remained below 1% (CPI July, a: 0.9%; c: 0.4% y-o-y; p: 0.7%), far from its 2% inflation target.

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Abbreviations, Acronyms and Definitions

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