Rosa & Roubini
ASSOCIATES

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R&R Weekly Column
By Brunello Rosa

The Final Quarter of 2018 Begins, With Plenty of Risks (and Some Opportunities)

This week, the final quarter of 2018 begins. During the previous quarter, Q3, the global economy continued to grow, but the cyclical acceleration that began in 2017 had already ended in most developed markets (DMs), with the exception of in the US. In emerging markets (EMs), declining global liquidity and domestic fragilities triggered periphery-to-core flows, with Argentina and Turkey being the most highly impacted countries. The Fed and Bank of England continued their policy normalisation plans (though their plans differ widely in the pace at which they will raise rates), while the ECB and BOJ both remained extremely accommodative. A number of EM central banks had to embark upon "defensive" policy rate hikes in order to prevent further depreciations of their currencies. As discussed in the latest edition of our strategic asset allocation and market update, global equities rose by around 2.5% during Q3, led by US stocks, while market volatility remained subdued. In contrast, EM equities lost more than 4% on a quarterly basis and 20% since their highs of January 2018, with a number of stock indices having entered "bear market" territory. In the fixed-income space, 10-year bond yields remained broadly stable during Q3, as strong demand compensated for an increasing supply and rising inflation. Bond indices in DMs and EMs fell marginally, however. In commodity markets, oil prices remained around USD 75 per barrel, supported by supply constraints (e.g. output declines in Venezuela and sanctions on Iranian exports), while copper prices fell more than 10% as a result of concerns about the potential impact a US-China "trade war" on global growth.

In Q4, growth in global economic activity will continue but will be even more asynchronous, as a deceleration continues in Europe, Japan and most emerging markets. The Fed will continue to tighten its policy stance, no longer "accommodative", while the ECB will end its QE program in December. The BOJ might also continue to tweak its policy to continue exiting its extraordinarily accommodative stance of the last few years. As a result, during this final quarter of 2018 (and continuing in 2019), the risk of a correction in European and EM equity prices will increase due to liquidity withdrawal and political tensions. Analysts' expectations of stock markets for the next 12 months - expectations of a more than 10% rise in DMs, and around a 20% rise in EMs - seem overoptimistic. US 10-year bond yield will likely remain above 3% in Q4 because of declining liquidity and rising issuance, but steady demand is likely to keep it capped. In EMs, bond yields are also likely to increase. We expect oil prices to remain above USD 70/b, supported by strong demand and supply constraints in OPEC and the US. Given diminishing USD liquidity and rising risks in Europe and EMs, investors' portfolios are likely to gradually de-risk. A number of "special situations" will attract investor attention, meanwhile. In DMs, US mid-term elections in November, Brexit negotiations, Italy's budget fist-fight with the EU will all attract attention; in EMs, elections in Brazil at the end of this week will do so, as will US-China trade wars and the ongoing situation in Argentina and in Turkey. Further ahead, in 2019, growth is likely to soften at the global level, with both DM (including the US) and EM economies decelerating. At this stage, we believe that a generalised EM crisis is unlikely because global liquidity remains elevated (even if it is contracting) and fundamentals remain solid in most emerging economies. In 2020, however, the risk of a global recession is higher than most analysts currently foresee. On a multi-year horizon, then, investors' portfolios are likely to be re-adjusted to ensure capital preservation.

Our Recent Publications

- *DEF Update: Italy's 'Populist' Budget Defies the EU, Markets and Rating Agencies, by Brunello Rosa, 28 September 2018*
- *REVIEW: Fed Hikes Rates and Drops "Accomodative" Stance, by Brunello Rosa, 27 September 2018*
- *PREVIEW: Fed Continues to Normalize at a Steady Pace, by Brunello Rosa and Nouriel Roubini, 24 September 2018*
- *MARKET UPDATE: The Divergence Between the U.S. And Other Countries Is Still Increasing, by Alessandro Magnoli Bocchi and Francisco Quintana, 27 September 2018*
- **The Geopolitical Corner** – *The problem with Brexit is that absolutely no one is listening, by John C. Hulsman, 25 September 2018*

The Week Ahead

In the US, wage growth is expected to accelerate (average hourly earnings September, c: 3.0% y-o-y; p: 2.9%) and the unemployment rate will decline (September, c: 3.8%; p: 3.9%), while the number of new jobs will decelerate modestly (non-farm payrolls September, c: +185k m-o-m; p: 201k).

In Turkey, inflation will likely rise (September CPI y-o-y, c: 21.2%; p: 17.9%).

The Quarter Ahead

In December, the US Federal Reserve will likely hike its policy rate to 2.25-2.50%. Last week, the FOMC projected four more hikes by end-2019 (December 2018 and three in 2019). Market expectations about a hike in December 2018 currently stand at 79.2% (pw: 81.1%), while the likelihood of "at least 3 additional hikes by September 2019" decreased to 45.4% (pw: 46.5%).

In the EZ, economic growth will likely keep decelerating. Last week France and Spain dragged down economic sentiment across the EZ (Economic Sentiment indicator, a: 110.9; c: 111.2; p: 111.6).

In Italy, political risk will rise, as the government approved a sharp fiscal deficit increase. The "Document of Economy and Finance" revealed that the country aims for a 2019 budget deficit at 2.4% of GDP—above the 1.6% recently announced by the economy minister and the 0.8% targeted by the previous government—which could: a) trigger EC demands and warnings; and b) increase the likelihood of downgrades by credit rating agencies. Italian assets suffered the announcement: 10y bond yields, +30bps w-o-w, to 3.14%; FTSEMIB, -3.8% w-o-w.

Trade negotiations between US and China will continue until year-end. China called off scheduled talks after US President Trump ordered new tariffs on Chinese goods. However, trade negotiations will likely resume after the US mid-term elections in November and a trade war will be avoided. The CNY weakened by 0.2% w-o-w against the USD (at USD/CNY 6.868, -5.3% y-t-d).

In China, bond issuance will continue to finance the stimulus program. In August-September, the issuance of local bonds averaged USD 48bn/month (up from a 3.5bn/month in H1-2018. To fund infrastructure programs, the central government allowed local governments to issue USD 200bn worth of bonds, until year-end.

EM weakness is likely to continue. The IMF announced a USD 7bn increase in its bailout package for Argentina (to USD 57.1bn) given that ARS volatility remained high (USD/ARS 41.280, -10.0% w-o-w).

In Turkey, the economy is likely to stabilize. The TRY rose 3.8% against the USD (to USD/TRY 6.056) on: a) speculation that US pastor Brunson might be released soon; and b) the announcement that Akbank, Turkey's second-largest bank by market value, signed a new USD 980m syndicated loan agreement, a crucial sign of confidence by investors.

In 2019, the inclusion of GCC bonds in a key benchmark bond index could attract USD 60bn. From January 31, JP Morgan will include KSA, UAE, Bahrain, Kuwait and Qatar sovereign bonds into its "EM bond index global diversified" with a joint weight of 11.2% (Kuwait: 0.8%).

Brent oil price will remain close to 80 USD/b, as OPEC decided not to increase output. Last week, the price of Brent oil rose to 82.7 USD/b (+5.0% w-o-w) as OPECs decided to maintain its current quotas, in spite of recent output increases in KSA (+0.5mb/d q-o-q) and Russia (+0.2mb/d q-o-q).

Last Week's Review

US and European stocks fell on rising concerns about a possible trade war and Italy's debt sustainability. Global stocks fell w-o-w (MSCI AWCI, -0.4%), as: 1) US stocks (S&P500, -0.5%) were hampered by renewed concerns about a "US-China trade war"; and 2) EZ stocks (Eurostoxx 50, -0.9%) were hit by: a) the increase of Italy's 2019 budget deficit target; and b) softer-than-expected EZ inflation (Core CPI, September prel., a: 0.9% y-o-y; c: 1.1%; p: 1.1%). Despite the weekly loss, the S&P 500 rose by 7.2% q-o-q, its best quarterly performance since Q4-2013. Volatility in US stocks remained low (VIX, +0.4 points to 12.1; 52w avg.: 13.6; 10y avg.: 19.5).

The USD strengthened against: 1) a currency basket (DXY, +1.0%); and 2) the EUR (EUR/USD 1.161, -1.2%). EMs currencies (MSCI EM Currency index) strengthened by 0.2%. US bonds were unaffected (UST 10y yield -1bps to 3.06%) by: a) last week's policy rate hike by the Fed (a: 2.00-2.25%; c: 2.00-2.25%; p: 1.75-2.00%); and b) inflation data, which remained at a level consistent with further hikes (US PCE August, a: 2.2% y-o-y; c: 2.2%; p: 2.3%).

__Pablo Gallego Cuervo__ contributed to this Viewsletter.

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@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*	*LN*	*Northern League, Italy*
AKP	*Justice and Development Party, Turkey*	*M5S*	*Five Star Movement, Italy*
ann.	*annualized*	*m-o-m*	*Month-on-month*
ARS	*Argentinian Peso*	*mb*	*Million barrels*
avg.	*Average*	*mb/d*	*Million barrels per day*
bn	*Billion*	*MENA*	*Middle East and North Africa*
BoC	*Bank of Canada*	*MHP*	*Nationalist Movement Party, Turkey*
BoE	*Bank of England*	*mn*	*Million*
BoJ	*Bank of Japan*	*NAFTA*	*North-American Free Trade Agr.*
bpd	*Barrels per day*	*NATO*	*North Atlantic Treaty Organizat.*
bps	*Basis points*	*OECD*	*Organization for Economic Cooperation and Development*
BS	*Balance sheet*	*Opec*	*Organization of Petroleum Exporting Countries*
c	*Consensus*	*p*	*Previous*
C/A	*Current account*	*P2P*	*Peer-to-peer*
CB	*Central bank*	*PBoC*	*People's Bank of China*
CBB	*Central Bank of Bahrain*	*PCE*	*Personal Consumption Expenditures*
CBK	*Central Bank of Kuwait*	*PE*	*Price to earnings ratio*
CBT	*Central Bank of Turkey*	*PM*	*Prime minister*
CDU	*Christian Democratic Union, Germany*	*PMI*	*Purchasing managers' index*
CNY	*Chinese Yuan*	*pps*	*Percentage points*
CPI	*Consumer Price Index*	*prel*	*Preliminary*
DJIA	*Dow Jones Industrial Average Index*	*pw*	*Previous week*
DJEM	*Dow Jones Emerging Markets Index*	*QCB*	*Qatar Central Bank*
d-o-d	*Day-on-day*	*QAR*	*Qatari Riyal*
DXY	*US Dollar Index*	*QE*	*Quantitative easing*
EC	*European Commission*	*q-o-q*	*Quarter-on-quarter*
ECB	*European Central Bank*	*RE*	*Real estate*
ECJ	*European Court of Justice*	*RBA*	*Reserve Bank of Australia*
EIA	*US Energy Information Agency*	*RRR*	*Reserve Requirement Ratio*
EM	*Emerging Markets*	*RUB*	*Russian Rouble*
EP	*European Parliament*	*SWF*	*Sovereign Wealth Fund*
EPS	*Earnings per share*	*tn*	*Trillion*
EU	*European Union*	*TRY*	*Turkish Lira*
EUR	*Euro*	*UAE*	*United Arab Emirates*
EZ	*Eurozone*	*UK*	*United Kingdom*
Fed	*US Federal Reserve*	*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*	*WTO*	*World Trade Organisation*
IMF	*International Monetary Fund*	*w*	*Week*
INR	*Indian Rupee*	*w-o-w*	*Week-on-week*
IPO	*Initial public offering*	*y*	*Year*
IRR	*Iranian Rial*	*y-o-y*	*Year-on-year*
JPY	*Japanese yen*	*y-t-d*	*Year-to-date*
k	*Thousand*	*ZAR*	*South African Rand*
KSA	*Kingdom of Saudi Arabia*	*2y; 10y*	*2-year; 10-year*