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MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
By Brunello Rosa

Markets Stabilise After A Large Sell-Off, But Risks Remain

After three weeks of equity re-pricing and heightened volatility, markets started to stabilise near the end of last week. As we discussed in an in-depth report, this sell-off episode was both healthy and unsurprising. This is primarily because further increases in equity valuations would have sent prices increasingly far above their historical ranges. US equities were already 40-50% above their average PE ratios, and already three standard deviations above their average CAPE ratios. Indeed, as we discussed in our strategic asset allocation report for 2018, investors this year should have considered moderate risk-taking only within the context of defensively positioning themselves. For now, there remains enough momentum in the economy (supported by global monetary and fiscal stimulus) to offset some of the negative factors affecting risky asset prices. Such negative factors may include rising inflation, global economic deceleration and divergences in growth, rising interest rates (coming from various central banks, including the Bank of Canada this week), trade skirmishes or trade wars impacting Chinese growth, geopolitical tensions, and a number of idiosyncratic instances of risk each of which has the potential to cause widespread damage if badly handled (in DMs chiefly Italy, but also the UK; in EMs, Turkey, Argentina, India, South Africa, and a number of other countries). Eventually, however, perhaps by 2020, these risks are likely to outweigh the factors that have been supporting the economy, and the market will correct. In the meantime, for the first time since the financial crisis (apart from very short periods during 2014-15) the interest rate offered by US 3m T-bills is higher than headline and core inflation, offering a real-return alternative to equities.

This recent sell-off has occurred just before the US mid-term elections, and perhaps partly because of them. As discussed in our recent report, the possibility of a divided Congress makes it less likely that legislation will be passed that would allow the government to avoid the "fiscal cliff" that awaits the US when the effects of tax cuts passed earlier this year fade in late 2019. But there are also a number of other crisis situations that remain unresolved and will weigh on the performance of asset prices. While the situation in Turkey seems to be stabilising (following the release of Pastor Brunson), developments in the Brexit negotiations and in Italy appear increasingly unfavourable. This past Saturday there was a large rally in London to ask for a second referendum; the likelihood of a no-deal scenario is increasing by the day, and the prospect of a special EU Council meeting being held in November has been shelved.

Last Friday, Moody's downgraded Italy's creditworthiness by one notch to Baa3 (with a stable outlook) - i.e. just one notch above "junk" status. This downgrade occurred as a result of the prospective deterioration of Italy's fiscal position following the Italian government's proposed budget for 2019, which foresees an increase in the budget deficit. The EU Commission sent a harsh letter urging the government to reconsider its generous spending plans, asking for a reply to letter to be given by Monday 22 October. During the weekend, an extraordinary Council of Ministers meeting, which was called to resolve the fiscal amnesty dispute that has emerged within the governing coalition, failed to approve an alternative deficit profile, which is what would be needed to prevent an excessive deficit procedure from being opened. This occurred in spite of Finance Minister Giovanni Tria's reported request that the government consider a reduction in the planned deficit for 2019, to 2.1% from the current 2.4% .

Thus, the deficit stand-off is likely to continue until mid-November, when the budget will be either approved or rejected by the Commission. In the meantime, on October 26 S&P might follow Moody's and cut Italy's credit rating. Italy is currently alone in this battle against the rating agencies, the EU, and in particular the market (the 10y BTP-Bund spread having reached 340bps last Friday). Mario Draghi, while striking a conciliatory tone and being confident that a compromise with Italy would be reached, recently said that for idiosyncratic situations as might occur there is still the possibility of OMTs, and any extra call for ECB action is misplaced. This week, the ECB will likely buy more time before announcing any details of its reinvestment plans, which could either help Italy or put additional pressure on it.

Our Recent Publications

- *MONETARY AFFAIRS: ECB Likely to Buy More Time Before Committing, by Brunello Rosa, 22 October 2018*
- *TRAVEL NOTES: American Mid-Term Elections: Verdict on the Trump Revolution, by John C. Hulsman, 17 October 2018*
- *WORKING PAPER SERIER: Poland Remains in Defiance of EU Rules, by Arlind Rama, 18 October 2018*
- *MARKET VIEWS: A Healthy and Expected Market Sell-Off, by Brunello Rosa, 15 October 2018*

The Week Ahead

In the US, GDP growth is expected to decelerate, driven by declining exports (c: 3.3% q-o-q ann.; p: 4.2%), while the manufacturing PMI is expected to remain stable (October, preliminary, c: 55.6; p: 55.6).

In the EZ, the ECB is expected to keep its policy stance unchanged (c: 0.0%; p: 0.0%), given the ongoing deceleration of economic growth and rising political risks.

In Canada, the BoC is expected to hike its policy rate (c: 1.75%; p: 1.50%) to counter rising inflation.

In Turkey, the CBT is likely to keep interest rates on hold (at 24.00%), helped by the recent appreciation of the TRY.

The Quarter Ahead

In the US, the Fed will continue to tighten monetary policy. Last week, the September 25-26 FOMC meeting minutes confirmed the Fed's commitment to further monetary policy tightening, increasing expectations about a hike in December to 83.9% (pw: 79.8%), and the likelihood of "at least 3 additional hikes by September 2019" to 53.0% (pw: 48.5%).

In the EU, political and economic risks will keep rising: i) the EC formally warned the governments of Belgium, France, Italy, Portugal and Spain not to break EU budget rules. As Italy's divided government is unlikely to reformulate its budget, the EC might issue a negative opinion (i.e.: a rejection—an unprecedented move), given that the "size of the budget deviation is significant". Last week, ***Moody's cut Italy's sovereign rating to*** Baa3 (one notch above junk status) on fiscal sustainability concerns. S&P will announce its rating decision by the end of October; ii) for the UK, the EU summit concluded without a Brexit deal. Plans to extend the transition period until end-2021 will find opposition within the UK; and iii) in Germany, October's ZEW economic sentiment index fell (a: -24.7; c: -12.0; p: -10.6), to its lowest level since 2012. Weaker CDU coalition partners (as shown last week in Bavaria's regional elections) increase risks for Angela Merkel's government.

China's economic growth will decelerate. Last week, Q3-2018 GDP growth declined (a: 6.5% y-o-y; c: 6.6%, p: 6.7%) to a nine-year low, but is expected to stabilize in Q4-2018 as exporters frontload sales, fearing further tariff hikes in January 2019. The CNY remained stable (at USD/CNY 6.929, -0.2% w-o-w) but is expected to rise above 7.000, as the government eases monetary policy to support growth.

The Turkish markets are likely to continue to stabilize, as the government normalizes policy. Last week, the TRY appreciated against the USD (+4.1%, to USD/TRY 5.642) supported by: a) expectations that the US may lift sanctions after the release of Pastor Brunson; b) the issuance of 5y USD-denominated government bonds: USD2bn at a yield of 7.50% (with a bid-to-cover ratio above three, and 60% sold to US investors); and c) Işbank's successful rollover of a USD 969bn syndicated loan.

In the UAE, bond issuance is likely to increase. Last week, the UAE allowed its federal government to issue sovereign bonds. In MENA, supply stands at USD 64.4bn y-t-d, lower than last year's (2017: 86.4bn).

Brent oil price is likely to remain close to 80 USD/b. The price declined to 79.8 USD/b (-0.8% w-o-w), as US crude stockpiles rose for a fourth consecutive week (a: +6.5mn w-o-w; c: +1.6mn; p: +6.0mn).

Last Week's Review

Global stocks prices stabilized (MSCI ACWI, -0.1% w-o-w) after three weeks of declines. In the US, prices were flat (S&P 500, +0.1% w-o-w) as a better-than-expected start of the Q3-2018 earnings season (e.g.: both Morgan Stanley and Goldman Sachs beat EPS expectations) offset ongoing concerns about rising UST yields and global trade tensions. EM stocks declined (MSCI EMs, -0.9% w-o-w), especially in China (SHCOMP, -2.2% w-o-w), as investors focussed on slowing growth and trade risks.

Volatility declined, but remained above its 10y average (VIX, -1.4 points to 19.9; 52w avg.: 14.2; 10y avg.: 19.1).

Global bond indices were unchanged (BAML Global, +0.0%), while EM bonds experienced some inflows (BAML EMs, +0.5%). The UST 10y yield rose by 6bps w-o-w, to 3.20%.

The USD strengthened w-o-w against: 1) a currency basket (DXY, +0.5%); 2) the EUR (EUR/USD -0.4%, to 1.151); and remained stable against: 3) EMs currencies (MSCI EM Currency index, +0.2%).

Pablo Gallego Cuervo *contributed to this Viewsletter.*

The picture in the front page comes from this website

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*	*pw*	*Previous week*
DJIA	*Dow Jones Industrial Average Index*	*QCB*	*Qatar Central Bank*
DJEM	*Dow Jones Emerging Markets Index*	*QAR*	*Qatari Riyal*
d-o-d	*Day-on-day*	*QE*	*Quantitative easing*
DXY	*US Dollar Index*	*q-o-q*	*Quarter-on-quarter*
EC	*European Commission*	*RE*	*Real estate*
ECB	*European Central Bank*	*RBA*	*Reserve Bank of Australia*
ECJ	*European Court of Justice*	*RRR*	*Reserve Requirement Ratio*
EIA	*US Energy Information Agency*	*RUB*	*Russian Rouble*
EM	*Emerging Markets*	*SWF*	*Sovereign Wealth Fund*
EP	*European Parliament*	*tn*	*Trillion*
EPS	*Earnings per share*	*TRY*	*Turkish Lira*
EU	*European Union*	*UAE*	*United Arab Emirates*
EUR	*Euro*	*UK*	*United Kingdom*
EZ	*Eurozone*	*US*	*United States*
Fed	*US Federal Reserve*	*USD*	*United States Dollar*
FOMC	*US Federal Open Market Committee*	*USD/b*	*USD per barrel*
FRB	*US Federal Reserve Board*	*UST*	*US Treasury bills/bonds*
FX	*Foreign exchange*	*VAT*	*Value added tax*
FY	*Fiscal Year*	*VIX*	*Chicago Board Options Exchange Volatility Index*
GCC	*Gulf Cooperation Council*	*WTI*	*West Texas Intermediate*
GBP	*British pound*	*WTO*	*World Trade Organisation*
GDP	*Gross domestic product*	*w*	*Week*
IMF	*International Monetary Fund*	*w-o-w*	*Week-on-week*
INR	*Indian Rupee*	*y*	*Year*
IPO	*Initial public offering*	*y-o-y*	*Year-on-year*
IRR	*Iranian Rial*	*y-t-d*	*Year-to-date*
JPY	*Japanese yen*	*ZAR*	*South African Rand*
k	thousand	*2y; 10y*	*2-year; 10-year*
KSA	*Kingdom of Saudi Arabia*		

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