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MAKING SENSE OF *THIS* WORLD — *24 September 2018*

R&R Weekly Column
By Brunello Rosa

In Q3 Final Week, Investors will Focus on the Fed, Brexit and Italy

This is the final week of the 2018 third quarter, a quarter which saw some diverging trends take place within the global economy. On the one hand, the US has continued to grow at a robust pace, adding 200K jobs per month and reaching an unemployment rate that is below 4%. Inflation in the US is now consistently above the Fed's 2% target. As a result, equity markets have registered new record highs, the yield curve is almost inverted, and the US dollar is stronger than it was at the beginning of the year (in trade-weighted terms). Conversely, the stock market indices of many emerging economies, including China, have entered bear-market territory, and their currencies have depreciated significantly against the USD. This divergence between the US and emerging economies has been partially a consequence of the intensification of trade skirmishes between the US and China (and between the US and the rest of the world, in spite of its recent deals with Mexico and the EU), and of their underlying technological war. As we discuss in our preview, the Fed will increase its policy target range by 25bps this week, but it will also have to address the following issues: the inversion of the yield curve and its implications for the real economy; USD strength; effects on EMs; and US policy normalisation occurring during a period in which the world economy is weakening. With the 2021 "SEP dots" being revealed for the first time, will the Fed start taking into account the mounting concerns about a 2020 recession? Or will it ignore these concerns, as it did when it carried out is most recent rate increase in June? After all, during this quarter the 10th anniversary of Lehman's collapse took place, and there is a risk that a new financial crisis might already be brewing.

In the final week of the third quarter, two long-standing issues will come to the fore: Brexit and Italy's budget. In the wake of the EU having rebuffed Theresa May's Chequers proposal, we are entering the final stage of the Brexit negotiations. These should lead to an agreement on the Withdrawal Treaty being reached by the end of October, in time for UK and EU approval before the date of Brexit on March 29th, 2019. This week, the Labour Party conference will help to clarify the party's position on the Withdrawal bill; Jeremy Corbyn recently said that Labour MPs are ready to vote against the bill if it fails the Six Tests (as it is certain to do). Labour seems ready to exploit May's failure in the negotiations in order to return to power after eight years in opposition. As discussed in our column on September 3rd, next week's Tory party conference will be the last chance for the Conservatives to find a common position on Brexit negotiations. Also this week, as we discussed in our recent trip report, the Italian government will have to present its update of the Document of Economy and Finance, i.e. the draft of the budget for the 2019-21 period. There is an ongoing tug of war between the prudent finance minister Giovanni Tria and his technocrats (who recently came under heavy attack from one of Prime Minister Conte's spokesmen), and the political leaders of the Five Star and Lega, who are pushing for the budget to include at least a preliminary implementation of the massive fiscal promises made during the electoral campaign, such as the introduction of a minimum income, the reduction of pensionable ages, and the introduction of a flat tax regime. The market expects the finance minister's prudent approach to eventually prevail; it expects the budget to indicate a fiscal deficit for 2019 that will not be too far from the 1.6% level that would allow Italy to remain committed to its fiscal consolidation plan. Should this fail to occur, a new period of market volatility, accompanied by rating agencies' downgrades of Italy's creditworthiness, would be likely to ensue.

Our Recent Publications

- *PREVIEW: Fed Continues to Normalize At a Steady Pace, by Brunello Rosa and Nouriel Roubini, 24 September 2018*
- *REVIEW: Norges Bank Begins Its Well-Telegraphed Tightening Cycle, by Brunello Rosa, 21 September 2018*
- *The European "Musical Chairs" Game Continues, by Nouriel Roubini and Brunello Rosa, 20 September 2018*
- *TRAVEL NOTES: Focus on Italy's First "Populist" Budget, by Brunello Rosa and Nouriel Roubini, 17 September 2018*
- **The Geopolitical Corner** – *Why A Real Russia-China Axis Will Never Happen, by John Hulsman, 19 September 2018*

The Week Ahead

In the US, the Fed will hike rates by 25bps (to 2.00-2.25%; p: 1.75-2.00%). The FOMC economic projections and the press conference of Fed Chairman Powell will likely point to further monetary tightening.

In the US and the EZ, inflation data are expected to be in line with the Fed and ECB's 2% target. Inflation is expected to remain flat, both in the US (PCE August, c: 2.3% y-o-y; p: 2.3%; Core PCE August, c: 2.0% y-o-y; p: 2.0%) and in the EZ (September preliminary, c: 2.0% y-o-y; p: 2.0%), due to stable energy prices (Core CPI September preliminary, c: 1.1% y-o-y; p: 1.1%).

In Italy, the government will release its Update of the "Economic and Financial Document". Contentious tax cuts and welfare-spending could increase both budget deficit and debt and: a) trigger EC demands and warnings; and b) increase the likelihood of downgrades by credit rating agencies.

The Quarter Ahead

The US Federal Reserve will continue to normalize policy. Market expectations about two further hikes in 2018 (September and December) rose to 85.7% (pw: 83.5%), while the likelihood of "at least 4 additional hikes by September 2019" decreased to 46.5% (pw: 48.7%).

In the EZ, economic growth will likely continue to decelerate. Last week: a) the preliminary reading of the EZ September consumer confidence index fell more than expected (a: -2.9; c: -2.0; p: -1.9), its 4th consecutive decline; and b) the EZ manufacturing PMI declined to its lowest level in 2 years (a: 53.3; c: 54.4; p: 54.6).

In the UK, the likelihood of a no-deal Brexit will likely increase. Last week, after the EU summit ended with "no progress", UK PM May acknowledged "a negotiation impasse". The GBP remained flat against the USD (at GBP/USD 1.308, +0.1% w-o-w) but depreciated against the EUR (to GBP/EUR 1.113, -1.0% w-o-w).

The mutual imposition of tariffs between the US and China is unlikely to lead to a trade war. Last week, both countries imposed tariffs at lower-than-expected levels (10 instead of 25%) on each other's goods: a) the US announced a 10% tariff on USD 200bn of Chinese imports—effective from September 24; the tariff will be increased to 25% if no trade deal is reached by year-end; while b) China retaliated by imposing a 5-10% tariff on USD 60bn of US imports—effective from September 24. The CNY remained flat against the USD (at USD/CNY 6.856, +0.2% w-o-w; -5.1% y-t-d), as PM Li Keqiang pledged not to engage in devaluations to boost exports.

EM weakness is likely to continue. Last week, the OECD cut its 2019 EM GDP growth forecasts, with declines for Turkey (0.5% y-o-y; p: 5.0%) and Argentina (0.1%; p: 2.6%). Argentina's economy contracted sharply in Q2-2018 (a: -4.2% y-o-y; p: 0.7%), its steepest decline since Q3-2014.

In Turkey, the economy will likely continue to weaken. Last week, the government announced its medium-term economic plan, and: a) lowered the 2019 GDP growth target to 2.3% (p: 5.5%); b) raised the inflation forecast to 15.9%; and c) set ambitious targets to reduce the fiscal deficit. As the plan lacked a detailed implementation schedule, the TRY depreciated (USD/TRY 6.292, +1.9% w-o-w).

In MENA, tensions will increase and bond issuance will remain subdued. Last week, an attack on a military parade in southwestern Iran killed at least 25. The Iranian government accused "regional sponsors and the US" of supporting the attackers. In the fixed-income space, 2018 y-t-d supply from MENA stands at USD 58.8bn, compared to USD 86.4bn total for 2017.

Brent oil price will likely remain above 70 USD/b, Opec could loosen output restrictions. Last week, the price of Brent oil rose to 78.8 USD/b (+0.9% w-o-w), as US oil inventories continued to decrease (a: -2.1mb w-o-w; p: -5.2). The September 23 Opec meeting is likely to allow producers a higher output.

Last Week's Review

Global stocks rose by 1.6% w-o-w (MSCI AWCI). Lower concerns about a "US-China trade war" supported stocks (S&P500 +0.8%; Eurostoxx 50 +2.6%; Nikkei 225 +3.4%). Volatility remained low (VIX, -0.4 points to 11.7; 52w avg.: 13.6; 10y avg.: 19.5). As perceived risks declined: 1) the 10-y UST yield rose by 8bps w-o-w to 3.07%; and 2) the USD weakened w-o-w, against: a) a currency basket (DXY -0.8%); and b) the EUR (EUR/USD 1.175, +1.0%)—supporting EM stocks (DJEM +1.6% w-o-w) and currencies (MSCI EM Currency index, +0.7% w-o-w).

Norges Bank increased its key policy rate by 25bps to 0.75%, in a move well telegraphed to the market. The Swiss National Bank kept its policy target rate range unchanged.

__Pablo Gallego Cuervo__ contributed to this Viewsletter.

The picture in the front page comes from this website

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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*		