MAKING SENSE OF *THIS* WORLD

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Economic Hiccups And Political Risk Raise Questions Over Global Monetary Policy

Before the October market sell-off and the recent outbursts of political risk, the direction of monetary policy stances taken by the major central banks over the next 12 months seemed to be pretty much set, within limited "confidence intervals". The Fed seemed destined to increase its Fed funds rate once again in 2018 and another 3-4 times in 2019. The ECB seemed destined to finish QE in December 2018 and then carry out a first rate increase around September 2019. The Bank of England seemed likely to continue its "gradual and limited" rate normalisation process, and the BOJ to only start removing some of its extraordinary measures of monetary accommodation very gradually in 2019.

However, the October sell-off *did* take place, as a result of fears over a global growth slowdown, with China having joined the economic deceleration in the Eurozone, Japan and EMs, and oil prices having risen substantially - given renewed US sanctions on Iran. The correction carried with it a tightening in financial conditions, exacerbated by the further strengthening of the USD as compared to the EUR, GBP and most EM currencies. The US economy is still in very good shape, adding jobs at an extraordinarily good pace given the point in the business cycle it appears to be in. That is the reason why the Fed is likely to carry on with its additional 25-bps rate increase in December (as hinted in the November FOMC statement), taking the upper end of the Fed funds range to 2.5%, in spite of President Trump's discontent with such increases. At the same time, however, the strength of the dollar, the impact on long-term rates deriving from the reduction in the Federal Reserve's balance sheet (the so-called Quantitative Tightening) and the economic hiccups coming from Europe and Japan might convince Jay Powell to display some caution regarding future rate hikes, leaving the door open to some pauses in the normalisation process.

Indeed, in Q3 Germany recorded a 0.2% contraction in its quarterly GDP, mostly due to the impact on the car industry of new regulations on emission standards. Italy's economic performance was also flat, with 0% growth registered in Q3, a result of the collapse in business investment due to the uncertainty generated by the government's bickering with the EU Commission on the budget. Q3 GDP was also negative in Japan (-0.3% q/q), where natural disasters weighed on personal consumption, investment levels and exports. These sobering figures suggest prudence is likely to be shown in the next monetary policy announcements by the ECB and the BOJ. As far as the ECB is concerned, in a recent speech President Draghi remarked how the Governing Council will use the new set of forecasts that become available in December to decide on the Bank's re-investment policy, forward guidance on rates, and the possible adoption of a new round of long-term repo operations (LTROs or TLTROs). The BOJ, as we discussed in our recent analysis, remains very cautious regarding any possible changes to its policy stance. As such, the newly available data on GDP growth will only serve to confirm the BOJ's prudent position. As far as the BOE is concerned, as we discussed in our recent trip report, everything is dependent on the outcome of the Brexit process. As Governor Carney said during his latest press conference, a swift resolution of the uncertainty surrounding Brexit negotiations could unleash pent-up demand for consumption and investment, leading to an acceleration of the BOE's normalisation process. However, recent developments on the Brexit front seem to suggest instead that a political (and possibly economic) crisis might be needed to break the Brexit impasse. In that case, the BOE can only remain in a wait-and-see mode, ready to react in either direction depending on developments impacting supply, demand, and the FX rate.

In conclusion, the possibility of a more gradual policy normalization by the major central banks, the aggressive monetary easing adopted by China's PBOC and the waivers given by the US to several countries on oil imports from Iran (which led to a substantial fall in oil prices) have helped the recent recovery in risky asset prices.

The Week Ahead

In the EZ, growth is expected to decelerate further. Across the EZ, PMIs are expected to soften, both in manufacturing (c: 51.7; p: 52.0) and services (c: 53.5; p: 53.7).

In Japan, inflation is expected to remain flat (October, y-o-y, c: 1.2%; p: 1.2%).

The Quarter Ahead

The global economy will likely lose some steam. In the US, the Fed will increase policy rates. A December hike remains the base case. However, last week, lower-than-expected core inflation (October y-o-y, c: 2.1%; c: 2.2%; p: 2.2%) and lack of progress in the trade dispute with China reduced the market's expectations to 65.8% (pw: 75.8%).

In the EU, growth will likely continue to soften, and political risk to rise. The German economy—around a third of the EZ output—contracted for the first time in three years (GDP Q3 q-o-q, a: -0.2%; c: -0.1%; p: 0.5%) driven by a slowdown in vehicle production. Germany's "Council of Economic Experts" reduced its forecast for GDP growth to 1.6% in 2018 (from 2.3%), and to 1.5% in 2019 (1.8%). ***Across Europe, inflation has flattened*** (EZ CPI October y-o-y, a: 2.2%; c: 2.2%; p: 2.2%) ***and political tensions continues to rise:*** a) in Italy, the government refused to cut its expected budget deficit, as requested by the EC, edging closer to a formal disciplinary procedure; the EC will respond next Wednesday. Italy's 10-year government bond yield rose by 10bps to 3.49%, and stocks fell by 2.0% w-o-w; and b) in the UK, a draft Brexit agreement resulted in: i) political uncertainty, as several ministers, including the Brexit secretary, resigned over the deal, while conservative MPs challenged PM May's leadership; and, as a result: ii) a weaker GBP (-1.1% w-o-w to GBP/USD 1.284) and stocks falling by 1.3% w-o-w. The EUR benefitted (EUR/USD +0.7% w-o-w to 1.142). Meanwhile, Germany and France reached an agreement on an EZ budget "aimed at co-financing public spending to enhance growth", to be presented next week to the Eurogroup.

In Japan, the economy contracted in Q3. Japan's economy—hit by a number of natural disasters, including floods in the south of the country in July—contracted (GDP Q3 q-o-q, a: -0.3%; c: -0.3%; p: 0.7%).

China will soften its stance on trade. China is offering "trade concessions" to the US, which could result in a partial deal at the G20 meeting in late November. Yet, a full deal is unlikely in the near term.

EMs fixed income will continue to enjoy robust demand. Last week, the government of Khazakhstan issued EUR1.05bn of 5 and 10-year bonds, four times oversubscribed, yielding 1.55 and 2.375% respectively.

In the GCC, US sanctions on KSA will have a limited impact. The sanctions, announced to be in relation with the Khashoggi case, will be targeted and limited in scope: 17 individuals will have their US assets frozen. Local markets are unlikely to be hit and no near-term economic impact is expected.

Opec will reduce output to support oil prices. After Opec lowered its forecast for 2019 oil demand growth, and Iraq announced the resumption of exports from the Kurdish-controlled area of Kirkuk, Brent prices fell by 4.9% w-o-w. WTI prices also fell, by 6.2% w-o-w. The recent sharp fall in oil prices sets the stage for further weakness in 2019. In December, Opec is expected to announce a decline in output of at least 1mb/d, of which 500k/b a day will come from KSA's export cuts.

Last Week's Review

In DMs, ***stocks declined w-o-w*** (S&P 500, -1.6%; Eurostoxx 50, -1.5%) due to: a) growing scepticism about an improvement in US-China trade relations at the November G20 meeting; b) in the EZ, rising political tensions; c) a negative outlook for the energy sector, as oil demand was forecasted to decline; and d) in the US, company-specific issues (Apple, Nvidia) hampering the tech sector. Volatility rose marginally (VIX, +0.7 points to 17.4; 52w avg.: 15.0; 10y avg.: 18.8), and the ongoing rotation from stocks to bonds continued. In the fixed income space, demand for safer bonds increased w-o-w (UST 10y yield, -12bps to 3.07%; Germany 10y yield, -4bps to 0.37%; bond indices for the US, EZ and Germany rose by 0.5%).

Conversely, EMs experienced inflows into stocks (MSCI EMs +1.0%) from bonds (BAML EM bond index, -0.9%), driven by improvements in sentiment (i.e.: Argentina, Brazil, Turkey). As demand for EM risky assets rose, ***the USD weakened*** w-o-w against: 1) a currency basket (DXY, -0.5%); and 2) EMs currencies (MSCI EM Currency index, +0.4%).

__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*		