MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
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With Market Sentiment Subdued Even in Davos, Central Banks Are Becoming More Cautious

The 2019 annual meeting of the World Economic Forum highlighted a number of themes and risks, most of them related to the effects of climate change on the global environment and its repercussions for human conditions and economic activity. Participants highlighted rising political and geopolitical risks (as exemplified by the recent leadership challenge in Venezuela, which is polarising the positions of the most influential nations in the world), as well as the possibility of a bursting bubble in risky asset prices. Overall, the sentiment of market participants and policy makers was quite subdued, in spite of the underlying optimism encouraged by the prospects of the Fourth Industrial Revolution (a theme launched by the Forum's founder, Klaus Schwab). Nouriel Roubini presented R&R's views on the possibility of a new global financial crisis and recession taking place in 2020 and found a very attentive audience, much less sceptical than it was in 2006 when he predicted the Global Financial Crisis of 2008. Having said that, sentiment in the Forum has been in the past a contrarian indicator of eventual outcomes, as participants might tend to have adaptive, rather than forward-looking expectations. Within the context of a weakening global economic expansion, the endogenous policy response we expected to take place is materialising. Last week the Bank of Japan left its policy stance unchanged but downwardly revised its inflation projections, suggesting that it might remain on autopilot even beyond spring this year. The ECB, meanwhile, downgraded its risk distribution around the growth projections from "balanced" to "negative", suggesting that it might take longer before starting to normalise rates, and that new forms of monetary stimulus (such as a new round of (T)LTROs) might be adopted quite soon. In its first January press conference this week, we expect the Fed to signal (without pre-committing) the possibility that a pause in the tightening cycle might take place as early as March. Conversely, confirming its hawkish bias, Norges Bank left its policy stance unchanged but confirmed that a new rate increase might still occur in March.

Financial markets are buffeted by worries about the weakening global economy, rising geopolitical risks, and the endogenous policy response that these risks are generating. For the time being, they are still recovering the losses made in the last few weeks of 2018, but have not yet completed that process. As we said in previous columns, 2019 will be all about this tug of war between bad macro and geopolitical news on the one hand and policy responses on the other. By 2020 it should be clearer which of the two sides has prevailed. Certainly, a risk that is worth monitoring is the solidity of the global financial system, of which banks are a crucial component. In 2008, the fragile global banking system was the propagator of the financial crisis, triggered by the small sub-prime mortgage market. In 2019, banks are generally better capitalised, with sounder business models, and with higher levels of liquidity to face sudden market reversals. However, as some notable examples have shown in recent months, banks nevertheless remain exposed to all sorts of risks: market, credit (with particular reference to the leveraged loan market), reputational, legal, business. In our recent report on the future of banking, we discuss all these risks and suggest the market implications of these developments. It is not yet known whether a new global financial crisis is coming. Certainly, if banks will once again be part of the problem instead of the solution, such a crisis is likely to be much worse than it would be otherwise. We hope this is not going to be the case.

Our Recent Publications:

- *FED PREVIEW: Opening The Door To A Pause In The Hiking Cycle, by A. Waters and B. Rosa, 25 January 2019*
- *REVIEW: ECB Twists Risks To The Growth Outlook To The Downside, by Brunello Rosa, 24 January 2019*
- *The Future Of Banking: Small Is The New Big, by A. Magnoli Bocchi, M. Yildiz, 24 January 2019*
- *BoJ REVIEW: BoJ Lowers Inflation Projections and Remains On Auto-Pilot, by A. Waters, 23 January 2019*
- ***Geopolitical Corner:** Brexit: Ways to Get Unstuck, by John C. Hulsman, 22 January 2019*

Looking Ahead

In the US, the Fed is expected to leave rates unchanged this week (c: 2.5%; p: 2.5%); the probability of no rate hikes in 2019 fell to 72% (p: 74%). In the short term, the US economy is likely to show resilience: while the PMI rose (Markit manuf. PMI January, a: 54.9; c: 53.5; p: 53.8), labor market indicators show strength: the unemployment rate (c: 3.9% y-oy; p: 3.9%) and hourly earnings (Average hourly earnings January, c: 3.2% y-oy; p: 3.2%) are expected to remain unchanged; yet, nonfarm pay-rolls are likely to decline (January, c: 168k; p: 312k).

This week in the UK, parliament will vote on a modified version of May's Brexit deal which, if rejected, could increase the likelihood of a second referendum or a general election.

In the EU, economic growth is expected to show further signs of deceleration (GDP Q4, c: 1.2% y-o-y; p: 1.6%).

In Kuwait, KFH and Ahli United Bank potential merger could create the GCC's sixth-biggest lender, with USD 92bn in assets.

Last Week's Review

Real Economy: Rising Uncertainty Hampers Global Growth

The IMF lowered its global growth forecasts to 3.5% in 2019 (p: 3.7%) and 3.6% in 2020 (p: 3.8%) on account of: *i)* rising trade risks; *ii)* a potential 'no-deal' withdrawal of the UK from the EU; and *iii)* the rapid slowdown in China.

In the US, President Trump signed a funding package—not including the border wall—to temporarily reopen the federal government after a 35-day stand-off.

In China, ongoing policy efforts are preventing a sharp economic slowdown (GDP Q4, a: 6.4%; y-o-y c: 6.4%; p: 6.5%).

In the EU, the January PMI fell to a 66-month low (EZ Markit manuf. PMI January, a: 50.5; c: 51.4; p: 51.4).

In Germany, business sentiment hit a three-year low, signalling rising concerns about global growth and trade tensions (IFO Business Climate Expectations, a: 94.2; c: 97.0; p: 97.3).

In Turkey, both consumer (a: 58.2; p: 58.7) and business confidence (a: 95.4; p: 97.7) indices fell to a three-month low.

In the GCC the IMF cut growth expectations for KSA to 1.8 (p: 2.4) and 2.1% (p: 1.9) in 2019 and 2020.

Monetary Policy: The Ongoing Economic Deceleration Is Likely To Delay Monetary Policy Normalization

In the EU, the ECB left rates unchanged (a: 0%; c: 0%; p: 0%) and lowered its balance of risk to "negative" on account of: *i)* geopolitical risks; *ii)* EM vulnerabilities; *iii)* threat of protectionism; and *iv)* financial market volatility.

In Japan, the BoJ maintained its accommodative stance (a: -0.1%; c: -0.1%; p: -0.1%) and lowered inflation forecasts for the year to 0.9% (p: 1.4).

Financial Markets: Monetary Tightening Is Increasingly Unlikely, Bond Prices Rose

Press reports that the Fed is considering an early end to its balance sheet reduction program lifted bond and stock prices and weakened the USD.

Global stocks rose w-o-w (MSCI ACWI, +0.2%) driven by the EU (Euro Stoxx 50, +0.9%), and EMs (MSCI EMs, USD +1.4%). Volatility decreased (VIX S&P 500, 0.4 points to 17.4, below its 10y average; *52w avg.:* 17.8; *10y avg*.: 18.2).

Fixed-income indices rose during the week (BAML Global bond index, +0.4%), driven by the US (Reuters US bond index, +0.6%). Sovereign bond yields fell across DMs, in particular in Germany (10y yield, -6 bps to 0.20%) and in the US (10y yield, -3 bps to 2.75%). Lower rates expectations in the US are providing support to EM fixed income; ***Turkey*** issued EUR1.25bn worth of 6y EUR-denominated bonds, at 4.75% yield and with a bid-to-cover ratio above 3. Y-t-d, Turkey's total borrowing in international markets reached USD3.4bn, vs a year-end target of USD8.0b.

Currencies: w-o-w, the USD fell against a basket of currencies (DXY, -0.6%) and the EUR (EUR/USD, +0.4%). The GBP rose (GBP/USD, +2.5% to 1.320) on hopes of a Brexit delay.

Commodities: Brent prices fell (Brent USD/b) -1.7%to USD 61.6 as fears about the global economic slowdown regained grounds.

Farah Aladsani *contributed to this Viewsletter*

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*		