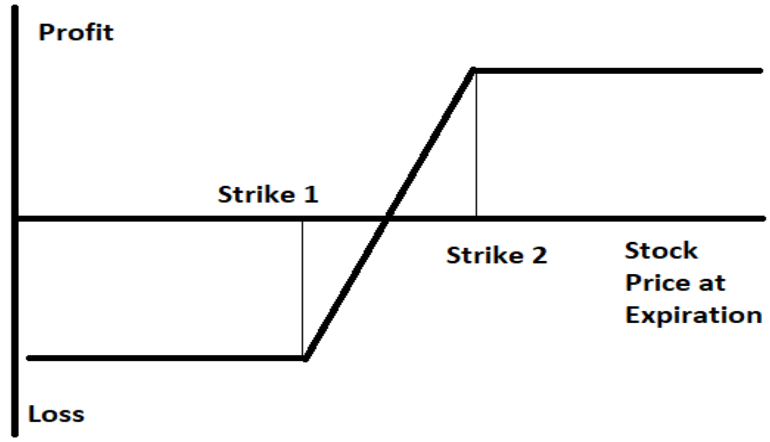
MAKING SENSE OF *THIS* WORLD **4 March 2019**



R&R Weekly Column
By Brunello Rosa

A Fed "Collar" To Support Markets in 2019

During the 1990s, the tendency by the US Federal Reserve to backstop the stock market was named "Greenspan's put", after the then-chairman Alan Greenspan. This was named for the option strategy by which the buyer of a "protective put" has the right to sell the underlying asset at a pre-determined "strike" price. If equity prices fell more than 20%, the Fed led by Greenspan would cut rates to allow equity prices to bounce back (since equity valuations would be inflated by a lower discount rate). This happened on occasions such as the "Savings and Loans" crisis in 1986, the stock market crash in 1987, the Asian financial crisis in 1997, and the dot-com bubble bursting in 2000.

When Ben Bernanke succeeded Greenspan in 2006, he inherited this put (which duly became the "Bernanke's put"). This was proved by the decision to slash Fed funds rates to zero during the global financial crisis of 2008 following the collapse of the US housing market and sub-prime mortgages. But in December 2015 the Fed timidly started to normalise its policy rates, bringing them to 2.50% by the end of last year. As we discussed in our review of the FOMC meeting held then, the market was very upset by the Fed's decision to increase its target range by 25bps to 2.25%-2.50%. That action was accompanied by a press conference by Fed Chairman Jay Powell that was considered too hawkish, in spite of the reduction in expected additional rates increases signalled by the "Dot Plot". As a result, equity markets collapsed at the end of last year. In January this year, the unexpected U-turn by the Fed, which wiped out any indication of further monetary tightening, marked the return of the Fed's "put", according to some market commentators.

In our recent analysis by Alessandro Magnoli Bocchi, we discuss why we do not believe the FOMC's U-turn marks the arrival of "Powell's put" on the market, but rather the implementation of a "collar" strategy, aimed at supporting the market to the downside while limiting the upside. A collar option strategy, which provides a pay-off at expiration like the one depicted in the picture above, is obtained by financing the purchase of a traditional (protective) put option by selling a call option with a higher strike price. This way, if the price of the underlying asset (say, the S&P 500 index) falls below the level of the put's strike price, the buyer of the put option is protected (its protection getting larger as the size of the stock market's fall increases). If instead the stock market index rises above the strike price of the sold call option, the upside is limited as the seller of the option will have to pay the difference between the strike price and the level of the stock market index.

In fact, we expect the Fed to protect the downside, as it did in January, but not unconditionally and not to the point of inflating a stock market rally that could reignite inflation and financial stability fears. If core inflation were to again rise above 2% (for example as a result of higher wages deriving from the current tight labour market) the Fed would not hesitate in raising rates again, thus likely limiting the possibility of further rapid increases in stock market prices. Thus, in our view the Fed is more likely to introduce pauses in its tightening cycles rather than cutting rates. We re-affirm our view that 2019 will be a transition year characterised by looser monetary (and fiscal) policy, endogenously responding to the macroeconomic slowdown and weakness in risky asset prices.

The Fed is not alone in taking this approach. The ECB as well is likely to shift towards a more accommodative approach when the Governing Council meets this week, while the Bank of Canada and the Reserve Bank of Australia too are likely to remain on hold this week.

Our Recent Publications

- *WORKING PAPER – Albania: Opposition Triggers Political Crisis, Putting EU Negotiations at Risk, by Arlind Rama, 1 March 2019*
- *MARKET VIEW: A "Fed Collar Is Likely To Support The Markets in H1-2019, by Alessandro Magnoli Bocchi, 27 February 2019*

Looking Ahead

The Week Ahead: Global Slowdown To Continue

In the US, President Trump's declaration of "*a national emergency on the US-Mexican border*" may be blocked also by the Senate, after the House of Representatives.

In the EZ, Q4 GDP is expected lower than previous readings (*p:* 1.2% y-o-y) following growth slowdowns or contractions across large member states (including Italy and Germany).

The ECB (*p:* 0%) and CBT (*p:* 24%) are expected to keep interest rates unchanged in upcoming meetings.

The Quarter Ahead: Political Uncertainty Will Likely Hamper Growth

In the US, tightening financial conditions will support keeping monetary policy rates on hold: the probability of: *i)* no Fed hikes in 2019 rose to 96% (*p:* 95); and *ii)* a rate cut rose to 15% (p: 6).

While a trade deal between ***the US*** and ***China*** is likely, the two sides are far from an agreement on: *i)* technology fundamentals; *ii)* market access; and *iii)* policy intervention.

In the EU, parliamentary elections are scheduled on May 23rd, and the EPP is expected to win most seats (around 175).

In the UK, PM May is allowing MPs to vote in three stages: *i)* on March 12, on her current or slightly modified Brexit agreement; *ii)* on March 13, should her agreement be rejected, on whether the UK should leave the EU without a deal (i.e.: a hard-Brexit on March 29); and *iii)* on March 14, should hard-Brexit be rejected, on whether the UK should seek an extension of Article 50.

Last Week's Review

Real Economy: Persistent Political Uncertainties Continue To Hamper Growth and World Trade

In the US, the administration announced, "*substantial progress in negotiations with China*" and "*a delay of tariff hikes until further notice*". Originally set to increase from 10 to 25% on March 1st, the tariffs would have impacted USD200 bn of Chinese imports (in 2018, the total value of US imports from China was USD 493 bn). The US economy grew more than expected but weakened q-o-q (GDP Q4, *a:* 2.6%; *c:* 2.3; *p:* 3.4). In a speech to congress Fed Chairman Jerome Powell declared "*the Fed will be paying attention to financial-market volatility if it threatens economic stability*", showing no bias toward further interest-rate hikes or cuts.

In China, 'new export orders' declined at the fastest rate since 2009; hence, the manufacturing sector is expected to keep contracting (Manuf. PMI Feb, a: 49.2; c: 49.5; p: 49.5). The non-manufacturing PMI also declined (Feb, a: 54.3; p: 54.7), signaling slower services sector growth.

In Japan, sluggish export demand caused industrial production to fall m-o-m (Jan., *a:* -3.7%; *c*: -2.5; *p:* 0.1). Inflation rose slightly (CPI Feb., *a:* 0.6% y-o-y; *c:* 0.4; *p:* 0.4).

In the EZ, a low CPI provided the ECB with "*the evidence needed to shift monetary policy in a more dovish direction*" (CPI Feb., *a:* 1.0% y-o-y; *c:* 1.1; *p:* 1.1). As expected, CPI increased to 1.1% y-o-y (*p:* 0.9) in Italy and to 1.5% (*p:* 1.4) in Germany.

In Italy, the economy grew less than expected in 2018 (GDP, *a:* 0.9%; *p:* 1.0), while both budget deficit (*a:* 2.1% of GDP) and public debt (*a:* 131.1% of GDP) overshot the government's targets (1.9 and 121.7, respectively).

In Turkey, PMI has recovered slightly to 46.4 (p: 44.2) signaling a milder contraction in industrial production.

Financial Markets: Lower Risks And CB Liquidity Keep Supporting Asset Performance

Stocks rose despite concerns over trade and geopolitical risks.

Global stocks rose w-o-w ((MSCI ACWI, 0.3%) driven by the US (S&P 500, 0.4%) and the EZ (Euro Stoxx 50, 1.3%). EM indices declined (MSCI EMs, -0.7%). Volatility rose (VIX S&P 500, 0.1 points to 13.6, *52w avg.:* 16.8; *10y avg*.: 18.0).

Fixed-income indices: global bonds declined w-o-w, (BAML Global index, -0.4%); EM issuance volume increased in USD (*a*: 15.3bn; *p:* 11.7bn) and declined in EUR (*a*: 0.0bn; *p:* 1.2bn). ***In Turkey***, between March and May the Treasury plans to borrow TRY14.6bn from the domestic market; gross domestic borrowing is planned at TRY36.1bn and debt servicing at TRY 62.6bn, including TRY 25.4bn of external debt repayments. ***Fitch downgrades Bahrain*** to BB- with stable outlook.

Currencies: w-o-w the USD remains stable (DXY, 0.0%), while the EUR and GBP rose (EUR/USD, 0.3% to 1.137; GBP/USD, 1.1% to 1.320).

Commodities: Brent prices fell on surging US supply (Brent, -3.1% to 65.1).

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*		