Rosa & Roubini

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R&R Weekly Column
By Brunello Rosa

End of Political "Musical Chairs" Game Still Leaves the EU Vulnerable To Systemic Crisis

We have been following the "musical chairs" game that was the selection process for the EU's top jobs since January 2018, when it began, well before it attracted the attention of investors, market participants, and a wider audience informed by the media. We followed its evolution closely; we noted, for example, when Mario Centeno was appointed as head of the Eurogroup in September 2008, and continued to monitor the selection process until its recent, final rush, which began with the Special EU Council meeting on June 30th. On July 2nd an agreement was reached that included the following appointments: EU Commission (EC) President: Ursula Von Der Leyen (Germany, CDU); EU Council President: Charles Michel (Belgium, Liberal); European Central Bank (ECB) President: Christine Lagarde (France, formerly EPP); EU Parliament (EP) President: David Sassoli (Italy, S&D), who will most likely serve half of the 5-year term (as usual convention); and EU High Representative (HR) for Foreign Policy: Josep Borrel (Spain, S&D).

As we said in our recent in-depth analysis of the European leadership selection process, our overall impression is that the outcome of this lengthy musical chairs game could have been worse. After all, the chosen leaders are all political heavyweights, and the main criteria to achieve a political equilibrium within the EU have been respected (with the exception of the Union's East-West criterion, mostly because Eastern European countries were identified with the Viségrad group, which positioned itself in opposition of the solutions proposed by France and Germany). The fact that Germany will lead the Commission directly means that the country is taking direct responsibility for what takes place in the EU in the next five years. Even if Germany intends to slow down the Union's integration process, it will still not oversee the collapse of the European project. At the same time, a high-profile French policymaker, Lagarde, has been given responsibility for providing the liquidity that might prove necessary to the EU in moments of crisis. Germany could distance itself from the more radical choices the ECB might take under her leadership (as Germany did previously, with Draghi), while still benefiting from their results.

With the selection of Von Der Leyen and Lagarde, Germany and France are personalising their joint commitment to on the continuation of the European project. This is a plus, especially if means that they will be willing to put their money on the table, so to speak, in terms of increased risk-sharing (something Germany always opposes) and additional sovereignty transfers from the national level to EU institutions (something France always despises), to ensure the project can be maintained.

Together with these *pluses*, there are the *minuses*. First, the entire selection process has exposed once again how messy EU policymaking is, and how ugly it is to watch for the average EU citizen. Second, the compromise reached today is the result of the internal political equilibria that exist currently within the various EU countries. But these politics may change a lot, as elections in Germany (2021), France (2022) and most likely Italy are going to be held before the end of this EU parliamentary term. Third, as we said in previous analysis, with all the mainstream parties now lumped together at the EU level, it will be easy for the populist parties to blame the mainstream parties for whatever goes wrong in the next few years. And a lot could go wrong in the years ahead, including: 1) a recession is very likely to occur. We can see already the ECB preparing the ground for renewed easing in coming months. 2) Germany is in the middle of a challenge to its business model, deriving from trade tensions and the overhaul of its banking system; 3) Brexit is a process yet to be finalised (with a likely showdown by the end of October), and the UK is likely to enter a technical recession from Q2; 4) In Greece, the victory of New Democracy in the general election marks the end of the post-crisis era, but also the return to power of the party that caused the Greek crisis in the first place. Thus, it is very likely that the EU, Eurozone and Europe in general will face an existential threat in coming years. The people at the helm of the EU institutions are equipped to face it. The real question is whether they will actually have the needed political support and mandate to solve it.

Our Recent Publications

- *BoC Preview: Balancing Global Headwinds with Domestic Resilience, by Francesca Panelli and Brunello Rosa, 5 July 2019*
- *MONETARY AFFAIRS: G10 Central Banks Preparing For Their Easing Moves, by Brunello Rosa, 4 July 2019*
- *EU: The End Of The Musical Chairs Game Delivers A Fragile Political Equilibrium, by Brunello Rosa, 3 July 2019*
- *Flash Review: Riksbank Remains Cautious And Leaves Outlook Unchanged, by Alex Waters and Brunello Rosa, 3 July 2019*
- *RBA Cuts Rates Again, With The Possibility Of More Easing Ahead, by B.Rosa and A. Waters, 2 July 2019*
- *Tactical Risk-On In The Liquid Space, While Keeping Focus On Capital Preservation, By Alessandro Magnoli Bocchi, Fawaz Sulaiman Al Mughrabi and Farah Aladsani, 1 July 2019*

Looking Ahead

The Week Ahead: Inflation Likely To Remain Subdued

In the US, inflation will stay below the Fed's 2% target (CPI Jun., c: 1.5% y-o-y; p:1.8%).

In the EZ, industrial production for May is likely to weaken (c: -0.5% y-o-y; p: -0.4%).

In China, inflation is expected to remain muted, and below the PBoC's 3% target (CPI May, c: 2.7% y-o-y, p: 2.7%); imports are expected to have softened, albeit at a slower pace (c: -3.0% y-o-y; p: -8.5%).

The Quarter Ahead: US-China Trade Talks To Resume

At the G20 Summit on June 29, the ***US and China*** agreed on tariff-ceasefire. President Trump, as a goodwill gesture: *i)* "paused any additional tariffs on Chinese goods for an indefinite period"; *ii)* pledged to allow US companies to sell technology and components to Huawei–effectively removing Huawei from the blacklist–; and *iii)* became the first sitting US president to enter North Korea–after meeting Kim Jong-un in the area dividing the two Koreas–to resume stalled nuclear talks.

In the EU, Ms. Ursula von der Leyen will become EC President, MEP David Maria Sassoli was elected President of the European Parliament, and Ms. Christine Lagarde will replace Mario Draghi as ECB President. Ms. Lagarde is: *i)* likely to call for stronger European institutions; and *ii)* unlikely to deviate from President Draghi's dovish path; a deterioration of the global outlook will prompt further ECB easing.

In the US, price pressures will remain contained and inflation below Fed-target (2%). The Fed pushed back against political and market pressures for an aggressive (i.e.: 50 bps) easing, by stating: "an insurance cut of 25 bps to policy rates would be sufficient to protect against a sharper-than-expected economic slowdown". The market expectations for "one rate cut" in July rose to 95% (p: 73%).

In the UK, the country will likely suffer a Brexit-induced recession, as fears grow over a "no-deal" scenario, because: *i)* the EU is highly unlikely to renegotiate the existing deal; and *ii)* both Mr. Boris Johnson and Mr. Jeremy Hunt–Tory leadership-challengers to replace PM Theresa May by July 23–said "we are prepared to walk away from the EU without a deal on October 31".

In China, the government has warned the UK "not to interfere in its domestic affairs", amid a growing diplomatic row over the recent Hong Kong protests, which led to the storming and vandalizing of the city state's parliament.

In Turkey President Erdogan unexpectedly removed the CB governor, Mr. Murat Cetinkaya; the dismissal could reignite investors' concern about CB independence, and may derail the TRY appreciation-rally, which started at the beginning of May.

In Iran, the government is likely to refuse talks with the US, unless sanctions are removed.

Last Week's Review

Real Economy: Globally, Manufacturing Sentiment Remains Weak–Except In The US, Where Labor Data Shows Strength

In the US, manufacturing data were better than expected, with PMI above the 50-benchmark (ISM manuf. Jun., a: 51.7; c: 51.0; p: 52.1); nonfarm payroll data surprised on the upside (a: 224K; c: 165k; p: 75k), while average hourly earnings remained unchanged (a: 3.1% y-o-y; c: 3.2%; p: 3.1).

In the EZ, manufacturing PMI remains in contraction, with PMI below the 50-benchmark (Markit Manuf. Jun., a: 47.6; c: 47.7; p: 47.8).

In Japan, manufacturing PMI were weaker than expected (Nikkei Manuf. Jun., a: 49.3; c: 49.5; p: 49.8).

In Turkey, inflation declined faster than expected, but remains in double-digit territory (CPI Jun., a: 15.72% y-o-y; c: 15.74%; p: 18.71%).

In Australia, the RBA cut interest rates by 25 bps (a: 1.00%; p: 1.25%), due to a slowing economy.

Financial Markets: US Labor Data Lifted The Markets

Market drivers: Equity markets continued to rise, with the S&P 500 reaching new highs.

Stocks: w-o-w, global stocks rose (MSCI ACWI, +1.6%). US equities rebounded (S&P 500, +1.8%) and the EZ rose (Eurostoxx, +1.6%).

Bonds: globally, indices rose w-o-w (BAML Global bond index, +0.2%). Italian banks benefited from the outperformance of Italian 10y government debt (+3.7% w-o-w). In 2019, y-t-d MENA supply stands at USD 55.6bn, compared to 53.2bn over the same period in 2018.

FX: the USD appreciated (DXY, -1.2%) and EM FX remained flat (MSCI EMs, -0.1% at 1,647), except the TRY, which appreciated on the back of declining inflation (USD/TRY, +2.8% at 5.628).

Commodities: Oil prices declined w-o-w, as concerns about the global economic slowdown outweighed: i) still elevated US-Iran tensions; and ii) OPEC production cuts in 2020 (Brent, -3.5% to 64.2 USD/b).

Farah Aladsani *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*	*MPC*	*Monetary Policy Committee*
bpd	*Barrels per day*	*NAFTA*	*North-American Free Trade Agreement*
bps	*Basis points*	*NATO*	*North Atlantic Treaty Organization*
BS	*Balance sheet*	*OECD*	*Organization for Economic Cooperation and Development*
c	*Consensus*	*Opec*	*Organization of Petroleum Exporting Countries*
C/A	*Current account*	*p*	*Previous*
CB	*Central bank*	*P2P*	*Peer-to-peer*
CBB	*Central Bank of Bahrain*	*PBoC*	*People's Bank of China*
CBK	*Central Bank of Kuwait*	*PCE*	*Personal Consumption Expenditures*
CBT	*Central Bank of Turkey*	*PE*	*Price to earnings ratio*
CDU	*Christian Democratic Union, Germany*	*PM*	*Prime minister*
CNY	*Chinese Yuan*	*PMI*	*Purchasing managers' index*
CPI	*Consumer Price Index*	*pps*	*Percentage points*
DJIA	*Dow Jones Industrial Average Index*	*pw*	*Previous week*
DJEM	*Dow Jones Emerging Markets Index*	*QCB*	*Qatar Central Bank*
d-o-d	*Day-on-day*	*QAR*	*Qatari Riyal*
DXY	*US Dollar Index*	*QE*	*Quantitative easing*
EC	*European Commission*	*q-o-q*	*Quarter-on-quarter*
ECB	*European Central Bank*	*RE*	*Real estate*
ECJ	*European Court of Justice*	*RBA*	*Reserve Bank of Australia*
EIA	*US Energy Information Agency*	*RRR*	*Reserve Requirement Ratio*
EM	*Emerging Markets*	*RUB*	*Russian Rouble*
EP	*European Parliament*	*SWF*	*Sovereign Wealth Fund*
EPS	*Earnings per share*	*tn*	*Trillion*
EU	*European Union*	*TRY*	*Turkish Lira*
EUR	*Euro*	*UAE*	*United Arab Emirates*
EZ	*Eurozone*	*UK*	*United Kingdom*
Fed	*US Federal Reserve*	*US*	*United States*
FOMC	*US Federal Open Market Committee*	*USD*	*United States Dollar*
FRB	*US Federal Reserve Board*	*USD/b*	*USD per barrel*
FX	*Foreign exchange*	*UST*	*US Treasury bills/bonds*
FY	*Fiscal Year*	*VAT*	*Value added tax*
GCC	*Gulf Cooperation Council*	*VIX*	*Chicago Board Options Exchange Volatility Index*
GBP	*British pound*	*WTI*	*West Texas Intermediate*
GDP	*Gross domestic product*	*WTO*	*World Trade Organisation*
IMF	*International Monetary Fund*	*w*	*Week*
INR	*Indian Rupee*	*w-o-w*	*Week-on-week*
IPO	*Initial public offering*	*y*	*Year*
IRR	*Iranian Rial*	*y-o-y*	*Year-on-year*
JPY	*Japanese yen*	*y-t-d*	*Year-to-date*
k	thousand	*ZAR*	*South African Rand*
KSA	*Kingdom of Saudi Arabia*	*2y; 10y*	*2-year; 10-year*