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MAKING SENSE OF *THIS* WORLD — *12 August 2019*

R&R Weekly Column
By Brunello Rosa

Geopolitical and Political Risks Are On The Rise, In A Globally Fragile Economic Environment

Last week, we observed that political risk has been rising again, especially in Europe. In Italy, following months of indecision, Lega's leader Matteo Salvini decided to pull the plug on Conte's government by tabling a no-confidence motion in the Senate. As we discussed in our flash update last week, that officially marked the beginning of a government crisis which is expected to lead to a snap election being held in late October. If that election takes place, Salvini – who has asked the Italian voters to given him "full powers" – could become Italy's Prime Minister by the end of the year. Salvini's budget plans are certainly not in line with Italy's budget discipline of the last few years, and therefore Italy is likely to soon be on a collision course with the EU Commission (again!). Markets are already reflecting these developments, with the 10y BTP-bund spread back to 240bps, and equity prices having fallen by 2.5% last Friday. Also on Friday, Fitch kept Italy's rating at BBB, with a negative outlook, clarifying that a government collapse in H2 2019 was already part of their baseline. As we discussed in our medium-term scenario analysis in October 2018, Italy is now choosing what we labelled an *Austro-Hungarian* path. This could eventually lead the country to become an "illiberal democracy," as theorised by Salvini's maestro, Hungary's Prime Minister Victor Orban.

Italy is not the only country to be experiencing a political drama. In the UK, PM Johnson has confirmed that the country is ready to leave the EU with "no ifs and no buts" by October 31st, with or without a deal. He might have been lured into doing so by US assurances that the Trump administration will be at the UK's doorsteps "pen in hand" to sign a free-trade agreement with the country. In fact, such a deal might be difficult to achieve: a number of US politicians with Irish roots would reportedly be very reluctant to ratify any trade deal that risks endangering the provisions of the Good Friday Agreement for Ireland, and in particular the existence of an open border between the two sides of the island. Also, former US Secretary to the Treasury Larry Summers said that any trade deal signed with the US after a "no-deal" Brexit would be particularly advantageous for the US (for example, health insurance companies could try to replace the NHS), but very dis-advantageous for the UK, given that the UK may be in a desperate position after crashing out of the EU. (Brexit uncertainty has already caused UK's GDP to fall in Q2 2019). As a result of all of this, a new standoff between the UK and the EU Commission is likely to begin soon, which might lead to new elections. Press reports suggest these might take place immediately after Brexit, possibly even on November 1st. The effects of the no-deal would then not yet be immediately visible or able to influence voters' opinion.

All these domestic political risks are resurfacing at a time when geopolitical risks are also on the rise, and as the global economy is particularly fragile. As we will discuss in greater detail in John Hulsman's Geopolitical Corner later this week, a few days ago India's PM Modi reduced Kashmir's autonomy, and by doing so inflamed a region that is geopolitically one of the hottest in the world (especially given that both India and Pakistan have nuclear military capabilities). Meanwhile the US has decided to rebrand China as a currency manipulator after many years, following the depreciation of the RMB to above 7 US dollars for the first time since 2008. (The RMB depreciation was caused by the threat of new US tariffs on Chinese imports, which we discussed last week). With this move by the US, the risk of a currency war has been added to the ongoing trade and tech wars between China and the US. It should not come as a surprise that all these political and geopolitical risks are taking a tolls on the global economy.

Our Recent Publications

- Italy Flash Update: Salvini Pulls The Plug On Conte's Government and Seeks "Full Powers" With Early Elections, *by Brunello Rosa, 9 August 2019*
- Flash Review: RBNZ Cuts Rates More Than Expected And Signals Further Easing, *by Brunello Rosa, 7 August 2019*
- Flash Preview: Norges Bank To Remain On Hold, But Still Open To Future Hikes, *by Brunello Rosa, 9 August 2019*
- **Geopolitical Corner:** A Revolutionary Premiership: Boris Johnson and the Anglosphere, *By John C. Hulsman, 30 July 2019*

Looking Ahead

The Week Ahead: US Inflation Expected to Pick Up, Growth Likely to Stall In EZ And Chinese Sales Likely to Slow Down

In the US, inflation is expected to pick up (CPI July, c: 1.7% y-o-y; p: 1.6%).

In the EZ, Q2 growth is expected to stall (EZ GDP Q2, c: 1.1% y-o-y; p: 1.1%) while German growth is likely to slightly pick up (German GDP Q2, c: 0.7% y-o-y; p: 0.6%).

In China, IP and retail sales are expected to slow down (IP July, c: 5.8% y-o-y; p: 6.3%; Retail sales July, c: 8.6% y-o-y; p: 9.8%).

The Quarter Ahead: Geopolitical Tensions Will Remain High

Global economic activity will remain supported by: 1) CBs easing; 2) a still-robust US domestic demand; and 3) fiscal stimulus in China. Most leading indicators – i.e.: global shipping, financial and USD funding conditions, currency market volatility, and credit spreads – remain resilient, with no signs of a global credit crunch. However, recession fears – currently driven by: i) trade tensions; and ii) the ongoing slowdown in China and Europe - could be enhanced by a softening of US data.

The probability of a ***'US-China trade deal'*** by year-end has been reduced by the latest escalating moves: 1) ***in the US***, President Trump ordered the imposition of a 10% tariff on the remainder USD 300bn of Chinese imports, effective September 1st; and 2) ***in China***, the PBoC devalued the USD/CNY above the symbolic level of 7, for the first time in 10 years. The US labeled China "a currency manipulator"; however, an all-out currency war remains unlikely at this stage.

In the UK, a 'no confidence vote' in parliament after the Summer recess could force an election; the election-date will be decided by PM Boris Johnson, who is reportedly aiming at November 1, one day after the 'leave date' (perhaps with "no deal).

In Japan, the government approved shipments to South Korea of a key material used in computer chips, to ease concerns that export restrictions would disrupt the 'global tech supply chains'.

Globally, CBs will keep easing. Over the next few months, the global rate-cut cycle will gather steam. ***In the US,*** further Fed cuts are expected: market expectation of a 50bps cut in September rose to 14% (p: 4%) and the probability of 25bps cut fell to 86% (p: 96%). 10y UST rallied, and yields briefly breached 1.60%, hitting a three-year low; the 10y-3m UST spread increased by the most in 12 years.

Last Week's Review

Real Economy: Growth And Inflation Remain Weak. Global Easing Gathers Pace

In the US, in July the service sector decelerated (ISM non-manufacturing PMI July, a: 53.7; c: 55.5; p: 55.1) below expectations and to its weakest level in three years – as trade worries weighed on the economy's outlook and business orders.

In the EZ, German industrial production suffered in June the biggest decline in 9 years (IP June, a: -5.2% y-o-y; c: -1.8%; p: -3.7) - as slowing global growth, trade uncertainty and escalating tensions between the US and China take a toll on exports; however, factory orders – a leading indicator of the health of Europe's largest economy – recovered unexpectedly (Factory orders June, a: -3.6 y-o-y; c: -7.0% y-o-y; p: -8.4), driven by stronger Asian demand.

In Japan growth in Q2 was weak, but above expectations (Japan GDP, a: 1.8%; c: 0.4% y-o-y; p: 2.2).

In the UK, economic activity contracted in Q2, reporting the slowest quarter since 2012 (UK GDP, a: 1.2%; c: 1.4% y-o-y; p: 1.8).

In Turkey, after the expiration of tax cuts on core goods, inflation rose to 16.65% in July (p: 15.72), briefly disrupting a downward trend that is expected to resume in the coming months, creating the conditions for further interest-rate cuts.

Due to subdued growth and below-target inflation: 1) ***in New Zealand***, the RBNZ cut its cash rate by 50bps (a: 1.00%; c: 1.25%; p: 1.50%); 2) ***in India,*** the RBI lowered its repo rate by 35 bps to 5.40%; and 3) ***in Thailand,*** the BOT delivered a 25bps cut to 1.50%. Conversely, ***in Australia,*** the RBA kept interest rates unchanged at 1%.

Financial Markets: Flight To Safety Has Accelerated

Market drivers: escalating trade tensions and looming Brexit risks drove investors to safe-haven assets. Bond markets rallied, driven by expectations of further policy rate cuts. Equities sold off, and currency volatility spiked.

Stocks: w-o-w, global stocks fell (MSCI ACWI, -0.9%) driven by both DMs (S&P500, -0.5% to 2,919; Eurostoxx, -1.3% to 3,334) and EMs (MSCI EMs, -2.2% to 981). Volatility rose (VIX S&P 500, +0.4 points to 18.0, 52w avg.: 16.6; 10y avg.: 17.2).

Bonds: w-o-w, global indices rose (BAML Global bond index, +0.5%).

FX: w-o-w the USD depreciated (DXY, -0.6%) against a basket of currencies. The GBP fell (GBP/USD, -1.0% to 1.203). While EM FX fell (MSCI EMs, -1.0% at 1,611), the TRY continues to gain strength (USD/TRY, +1.2% to 5.491).

Commodities: Oil prices declined, dragged down by lower global demand (Brent, -5.4% to 58.5 USD/b). Gold rose (3.9% to 1,497 USD/Oz.).

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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*