MAKING SENSE OF *THIS* WORLD 2 September 2019

R&R Weekly Column
By Brunello Rosa

Crucial Week Ahead For Governments In Italy And The UK

This week will be a crucial one for determining the fate of governments in Italy and the UK. In Italy, Giuseppe Conte will come back to President Mattarella to announce whether or not he has been able to form a coalition between the Five Star Movement, the Democratic Party, and other smaller parties. As we discussed in our scenario analysis, there are a number of unresolved issues between Five Star and the Democratic Party, including as to what their government's program and composition would be. Di Maio's tough speech last Friday ("either the PD accepts these 20 points, or better to vote. And I may add: the sooner, the better"), was widely regarded as an obstacle to eventual solving of the crisis (hence the fall in equity markets and the spike in the BTP/Bund spread). Additionally, there is a Damocles' sword hanging over the coalition deal; that is, the vote on Five Star's online platform Rousseau to ratify such a decision.

Nonetheless, in our baseline scenario, we expect Conte to be able to positively resolve the "reservation" with which he accepted the charge of forming the government. The government would initially be very fragile, as Conte will have a strong political and social opposition to face, as well as a difficult economic condition (GDP contracted in Q2, among other concerns). At the same time, such a government could also count on some powerful allies. The US President openly hoped for Conte to be confirmed as PM. The outgoing European Commission, even with one of its most hawkish representatives (Guenther Oettinger) said it welcomes the possible formation of a pro-European parliament in Italy. The new Commission led by Ursula Von Der Leyen made Conte understand that Brussels will close an eye regarding the budget, so long as Italy remains fiscally prudent and moves in the right direction (even if not at the ideal speed). Even the Vatican showed sign of sympathy for the new government, with a short meeting between the Pope and Conte on Friday. So, while the navigation could be bumpy, the government's ship does not necessarily need to sink if the coalition partners do not fight too much amongst themselves.

Market concerns are now actually higher for the government in the UK than for Italy, for a change. During the past week PM Boris Johnson obtained from the Queen the possibility to suspend parliament for five weeks between September 9th -12th and October 14th, ahead of a new Queen's speech. As discussed in our analysis, Johnson claims that this is a normal procedure to allow the new government to focus on its new legislative agenda. But the reality is that the decision was made to prevent opponents of Brexit (or at least, opponents of a no-deal Brexit), who are a majority in parliament, to undertake the legislative actions that would prevent a no-deal Brexit from occurring. When parliament reconvenes on September 3rd, after the summer recess, it will now only have 6 days, and even fewer working days, to try and react to this move.

Though legal challenges have been made against Johnson's decision, including from the former leader of the Tory party Sir John Major, the possibility that the Labour party will table a no-confidence vote to oust Johnson during this week are much higher now. It is yet to be seen whether this will be a feasible initiative and, if so, whether it will be a successful one. For the time being, markets are skeptical and the pound sterling is reaching all-time lows.

Our Recent Publications

- BOC, RBA and Riksbank Preview: On Hold, With A Dovish Bias, *by Francesca Panelli and Brunello Rosa, 30 August 2019*
- TRAVEL NOTES - TURKEY: In A Crisis-Prone Environment, There Are Signs Of Normalization, *by Alessandro Magnoli Bocchi and Farah Aladsani, 29 August 2019*
- Conte Tries To Forge A Five Star – PD Alliance - An Initially Fragile Government Is Emerging, *by B. Rosa, 29 August 2019*
- Brexit Update: Johnson "Shuts Down" Parliament And Hardens His Brexit Stance, *by Brunello Rosa, 28 August 2019*
- **GEOPOLITICAL CORNER:** *Argentina Hurtles Toward The Abyss, by John C. Hulsman, 28 August 2019*

Looking Ahead

The Week Ahead: Resilient US Labor Market And New Tariffs On Chinese Imports

In the US, the US labor market is expected to remain resilient (Nonfarm payrolls Aug., c: 159K; p: 164K; Avg. hourly earnings, c: 3.2% y-o-y; p: 3.1). President Trump's next round of tariffs as come into effect on September 1. The new tariffs will cover more than USD300bn worth of Chinese imports and will hit key consumer products. ***US-China*** negotiations are likely to resume this week, after Beijing said it "will not immediately retaliate against the latest US tariff increase".

In Turkey, the ongoing growth contraction is expected to decelerate (GDP Q2, c: -2.0% q-o-q; p: -2.6); as a result, disinflation is likely to continue (Aug., c: 15.5% y-o-y; p: 16.7).

Interest rates are likely to remain unchanged ***in Canada*** (c: 1.75%; p: 1.75), ***Australia*** (c: 1.0%; p: 1.0) and ***Sweden*** (c: -0.25%; p: -0.25).

The Quarter Ahead: Geopolitical Tensions Will Remain High

In the US, the market probability of "one rate cut" of 25bps in September increased to 96.9% (p: 94.6).

In the EU, given: 1) a manufacturing contraction; 2) weak inflation; and 3) Brexit risks, the ECB is expected to: i) reduce its deposit rate by 20bps, to -60bps; and ii) restart QE, announcing plans to buy EUR 40bn a month of debt.

In the UK, on September 9 - 12 PM Boris Johnson will suspend parliament, leaving it with just a few days to draft a law to stop the UK from leaving the EU without a deal on October 31.

In Iran, President Rouhani rejected the possibility of meeting with President Trump as long as the US sanctioned his country.

In Argentina, the restructuring of the USD 101bn debt could create EM tensions, as it prompted S&P to: 1) issue a "selective default" rating; and 2) lower the country's long-term rating to CCC- (p: CCC), due to default risks. Fitch downgraded Argentina's debt to "restricted default."

Last Week's Review

Real Economy: Risks Remain High, EM Growth Prospects Weaken

In the US, consumer sentiment fell in August (Michigan consumer sentiment survey: a: 89.8; c: 92.1; p: 98.4) – by the most since 2012 and to the lowest level during Trump's presidency – amid concerns about the impact on the US economy of the ongoing trade war. Weaker shipments of non-defense capital goods (Durable good orders exc. defense, a: 1.4%; p: 2.9) signaled a frail outlook for the industrial sector. Yet, overall durable-goods orders rose for second consecutive month (Jul., a: 2.1% m-o-m; c: 1.2; p: 1.8). Inflation was flat (PCE Jul. a: 1.3% y-o-y; p: 1.3%; Core PCE Jul., a: 1.6% y-o-y; c: 1.6; p: 1.6).

In China, the manufacturing PMI fell to 49.5 in August (c: 49.6; p: 49.7).

In Argentina, after failing to sell new short-term bonds, President Macri's government announced that they will unilaterally postpone payments worth USD7bn on short-term local bonds, while: i) starting talks "to reprofile debt that matures in less than 10 years"; and ii) delaying a USD 44bn debt repayments to the IMF.

In India, economic growth declined to its slowest rate in six years (GDP Q2, a: 5.0% y-o-y; c: 5.7; p: 5.8), as a result of: i) lower private consumption (a: 3.1% y-o-y; p: 7.2%), a key engine of growth; and ii) a deteriorating global environment.

Financial Markets: Investors Chase US Assets (Stocks, Bonds, USD)

Market drivers: A rebound in risky assets was supported by: i) renewed hopes for progress in the US-China trade dispute; and ii) upcoming monetary easing by the Fed and the ECB.

Stocks: w-o-w, global stocks rose (MSCI ACWI, +2.0%) driven by both DMs (S&P500, 2.8% to 2,926; Eurostoxx, +2.8% to 3,427) and EMs (MSCI EMs, +1.1% to 984). In August, EM stocks were hit by: i) trade tensions; ii) the Argentine crisis; and iii) slowing global growth, leading to a 3.4% fall m-t-d, erasing USD 673bn in market value. Volatility declined (VIX S&P 500, +0.9 points to 19.9, 52w avg.: 16.9; 10y avg.: 17.1).

Bonds: w-o-w, global indices rose (BAML Global bond index, +0.4%). In the US, in August: 1) the 30yUST yield fell to its lowest level ever; 2) at 1.503%, the 10yUST declined more than 100bps y-t-d; and 3) the 2y-10yUST yield spread reached 5.3bps – the largest gap since before the financial crisis.

FX: the USD strengthened (DXY, 1.3%) against a basket of currencies. The GBP fell (GBP/USD, -1.0% to 1.216). EM FX fell (MSCI EMs, -0.5% at 1,595). The CNY August decline (USD/CNY, -3.8% to 7.154): i) marks the largest monthly fall in more than 20 years; but ii) will help mitigate the impact of US tariffs, set to expand to cover almost all Chinese exports.

Commodities: Oil prices rose on US-China trade talk hopes (Brent, +1.8% to 60.4 USD/b). Gold closed August at USD1,519.10, up 6.5% m-o-m and 19% y-t-d.

Farah Aladsani *contributed to this Viewsletter.*

The picture in the front page comes from this website

Abbreviations, Acronyms and Definitions

a	*Actual*
AKP	*Justice and Development Party, Turkey*
ann.	*annualized*
ARS	*Argentinian Peso*
avg.	*Average*
bn	*Billion*
BoC	*Bank of Canada*
BoE	*Bank of England*
BoJ	*Bank of Japan*
bpd	*Barrels per day*
bps	*Basis points*
BS	*Balance sheet*
c	*Consensus*
C/A	*Current account*
CB	*Central bank*
CBB	*Central Bank of Bahrain*
CBK	*Central Bank of Kuwait*
CBT	*Central Bank of Turkey*
CDU	*Christian Democratic Union, Germany*
CNY	*Chinese Yuan*
CPI	*Consumer Price Index*
DJIA	*Dow Jones Industrial Average Index*
DJEM	*Dow Jones Emerging Markets Index*
d-o-d	*Day-on-day*
DXY	*US Dollar Index*
EC	*European Commission*
ECB	*European Central Bank*
ECJ	*European Court of Justice*
EIA	*US Energy Information Agency*
EM	*Emerging Markets*
EP	*European Parliament*
EPS	*Earnings per share*
EU	*European Union*
EUR	*Euro*
EZ	*Eurozone*
Fed	*US Federal Reserve*
FOMC	*US Federal Open Market Committee*
FRB	*US Federal Reserve Board*
FX	*Foreign exchange*
FY	*Fiscal Year*
GCC	*Gulf Cooperation Council*
GBP	*British pound*
GDP	*Gross domestic product*
IMF	*International Monetary Fund*
INR	*Indian Rupee*
IPO	*Initial public offering*
IRR	*Iranian Rial*
JPY	*Japanese yen*
k	thousand
KSA	*Kingdom of Saudi Arabia*
LN	*Northern League, Italy*
M5S	*Five Star Movement, Italy*
m-o-m	*Month-on-month*
mb	*Million barrels*
mb/d	*Million barrels per day*
MENA	*Middle East and North Africa*
MHP	*Nationalist Movement Party, Turkey*
mn	*Million*
MPC	*Monetary Policy Committee*
NAFTA	*North-American Free Trade Agreement*
NATO	*North Atlantic Treaty Organization*
OECD	*Organization for Economic Cooperation and Development*
Opec	*Organization of Petroleum Exporting Countries*
p	*Previous*
P2P	*Peer-to-peer*
PBoC	*People's Bank of China*
PCE	*Personal Consumption Expenditures*
PE	*Price to earnings ratio*
PM	*Prime minister*
PMI	*Purchasing managers' index*
pps	*Percentage points*
pw	*Previous week*
QCB	*Qatar Central Bank*
QAR	*Qatari Riyal*
QE	*Quantitative easing*
q-o-q	*Quarter-on-quarter*
RE	*Real estate*
RBA	*Reserve Bank of Australia*
RRR	*Reserve Requirement Ratio*
RUB	*Russian Rouble*
SWF	*Sovereign Wealth Fund*
tn	*Trillion*
TRY	*Turkish Lira*
UAE	*United Arab Emirates*
UK	*United Kingdom*
US	*United States*
USD	*United States Dollar*
USD/b	*USD per barrel*
UST	*US Treasury bills/bonds*
VAT	*Value added tax*
VIX	*Chicago Board Options Exchange Volatility Index*
WTI	*West Texas Intermediate*
WTO	*World Trade Organisation*
w	*Week*
w-o-w	*Week-on-week*
y	*Year*
y-o-y	*Year-on-year*
y-t-d	*Year-to-date*
ZAR	*South African Rand*
2y; 10y	*2-year; 10-year*