MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
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"Black Swans" Abound In Fragile Environments

In the beginning there was Minsky. According to Hyman Minsky's financial instability hypothesis, during the expansionary phases of business cycles, the financial position of economic agents – companies, households, sometimes even governments – becomes increasingly fragile, as they move from relatively secure "hedge" positions towards speculative or, in extreme cases, "ultra-speculative" positions; the latter not dissimilar from infamous Ponzi schemes. In a more fragile environment, even a small shock to the system, such as a small increase in interest rates, has the potential to render the most exposed positions illiquid or even insolvent. This eventually leads to a downturn in the financial cycle, not dissimilar to the debt-deflation spiral described by Irving Fisher. In turn, this collapse of financial positions triggers a downturn in the business cycle, which moves from expansion to slowdown and eventually into contraction. From a Shumpeterian perspective, this period of "creative destruction" is very healthy, as this process of selection and "survival of the fittest" allows the system to restore itself, shedding previous excesses that existed and therefore readying itself for the subsequent economic recovery.

The particular segment of the business cycle when the cycle turns as a result of a financial shock has been popularised with the name "Minsky moment." This is considered a real pity by those who are actually scholars of the great post-Keynesian economist, as the term completely misses the fact that Minsky's analysis is a theory of the business cycle: its most interesting part is not the "moment" of shock, but rather is the recovery phase of the cycle, when the financial fragility of the system increases, completely undetected, thus preparing the ground for the later, inevitable downturn. Economic analysis has preferred to focus on the conditions (including shocks) that could trigger these "Minsky moments." For example, Nassim Nicholas Taleb has written convincingly about "black swans", extremely rare events that could trigger major changes in prevailing economic, financial and social conditions.

Moving from theory to practice, press reports recently reported that market participants currently fear many black swans, with a potential spike in oil prices deriving from the US-Iran-Saudi Arabia tensions adding itself to a list that already included a possible collapse in US-China trade talks or UK-EU negotiations regarding Brexit. In his latest column for Project Syndicate, Nouriel Roubini spoke about four collision courses that could derail the global economy, adding to this list the victory by Alberto Fernandez in Argentina's primary presidential election, which has triggered yet another debt restructuring by the Latin American country.

But the list of these potential triggers could be expanded even further. in the US, an impeachment of Trump ahead of the 2020 presidential race could lead, under certain circumstances, to a severe market correction. In Europe, Germany's recession could deepen, potentially leading to a government collapse and further political fragmentation. In Italy, Matteo Renzi's newly formed party could pull the plug on Conte's government, paving the way for a return of Salvini to power. In Asia, an increase in the Japanese consumption tax could lead to an economic contraction, deepening the global slowdown. And other examples could be made for Brazil, China, Russia, etc.

What about the policy response? In the recent decision by the Fed to adopt "insurance cuts" there is a reminiscence of Minsky's theory, insofar as the central bank decided not to increase rates further at a time when the economic and financial system seemed already to be fragile – to avoid providing a shock that might have triggered a downturn. After years of experimenting with monetary policy, there is now a great consensus among economists that fiscal policy should take up the responsibility of being the main counter-cyclical policy instrument. In effect, in Minsky's theory, the policy prescription could be simplified with the expression "Big Government" – in other words, making sure that public expenditure is a large component of national income, so as to stabilize business cycles. As Richard Koo convincingly argued, in a balance sheet recession following a debt-deflation episode, the system needs at least one large borrower that can compensate for the deleveraging of the private sector, and that must be the government.

Our Recent Publications

- MONETARY AFFAIRS - Preview: RBA Ready To Cut Rates Again, *by Brunello Rosa and Francesca Panelli, 27 September 2019*
- An Investor Guide to Navigate Argentina's Debt Restructuring, *by Nouriel Roubini, Alessandro Magnoli Bocchi, 23 September 2019*
- Brexit Update: Despite The Constitutional Crisis, Boris Johnson Remains The Most Popular Leader, *by Brunello Rosa, 26 September 2019*
- **GEOPOLITICAL CORNER:** High Noon: The Brexit Crisis Reaches A Climax, *by John C. Hulsman, 24 September 2019*

Looking Ahead

The Week Ahead: Weak Manufacturing Persists Worldwide

In the US, the labor market is likely to remain healthy (NFP Sep., c: 162K; p: 130K; Avg. hourly earnings, c: 3.1% y-o-y; p: 3.2).

Globally, signs of weak manufacturing activity are expected to continue (Japan IP Aug., c: -1.8% y-o-y; p: 0.7; China NBS Manuf. PMI Sep., c: 49.6; p: 49.5).

In the EZ, inflation is expected to remain subdued (CPI Sep., c: 1.0% y-o-y; p: 1.0).

In Turkey, inflation is expected to slightly accelerate (c: 15.5% y-o-y; p: 15.0), after the stronger-than-expected monetary easing.

In Australia, the RBA is expected to cut its key policy rate by 25 bps to 0.75% (p: 1.00).

The Quarter Ahead: Global Growth Slowing, Trade Tensions, Potential Impeachment Of President Trump, Brexit Risks

As the ***global economy*** is hampered by trade tensions and the disruption of key value chains, the US economic momentum is likely to suffer lower consumer spending and reduced investments.

In the US, congress speaker Nancy Pelosi announced an impeachment enquiry on President Trump, following allegations that Trump improperly solicited the help of Ukrainian President Voldymyr Zelenskiy to investigate a political rival, the Democratic presidential contender Joe Biden. Over the next few weeks, Democratic lawmakers will likely draft one or more articles of impeachment, which require a simple majority vote by the House (where Democrats hold 235 of the 435 seats). In the unlikely case of a support of two-thirds of the Senate (where Republications hold a majority), the President would be forced to step down.

On the trade front, ***US-China*** tensions intensified following news that the Trump administration is likely to limit US portfolio flows into the Chinese economy.

In the UK, after the Supreme Court overruled PM Johnson's decision to suspend parliament ahead of the October 31 deadline, Brexit's outcome depends on: a) the PM securing a deal with the EU at the October 17-18 summit; and b) the UK parliament supporting the deal. The EU is unlikely to grant another Brexit delay without a clear rationale. In the event of no agreement with the EU in October, a UK snap general election is likely.

Last Week's Review

Real Economy: Political Uncertainties (Trump Impeachment, Brexit, Trade) Drag On Global Growth

In the US, manufacturing activity was stronger-than-expected (Markit PMI Comp. Sep., a: 51.0; c: 49.6; p: 50.7); however, concerns about the economy remain as: *a)* consumer spending – a key driver of GDP growth, accounting for more than two-thirds of total output – has weakened to its slowest pace since February (a: 0.1%; c: 0.3; p: 0.5); and *b)* a closely-watched proxy for business investment contracted (Nondefense capital goods orders ex. aircrafts, a: -0.2%; c: 0.0; p: 0.0). The Fed's preferred inflation gauge – the PCE – stagnated in August (PCE, a: 1.4% y-o-y; c: 1.3; p: 1.4; Core PCE, a: 1.8% y-o-y; c: 1.8; p: 1.6).

Still in the US, driven by new UST issuances, the "liquidity-squeeze" continued; the New York Fed was pressured to: *a)* increase the size of its overnight REPO to USD 100bn (p: 75 bn); and, *b)* raise the limit on its 14-day REPO operation to USD 60 bn (p: 30 bn).

In the EZ, economy activity is likely to weaken further (Markit PMI Comp., a: 50.4; c: 51.9; p: 51.9), driven by the ongoing contraction in the manufacturing sector (Markit Manuf. PMI, a: 45.6; p: 47.3; c: 47.0) – particularly in the German industrial sector (Markit Manuf. PMI, a: 41.4; c: 44.0; p: 43.5).

In Japan, inflation remains subdued and weaker-than-expected (Tokyo CPI Sep., a: 0.4%; c: 0.8; p: 0.6)

Financial Markets: Geopolitical Uncertainties Drove Risk-Off Sentiment, Bonds Up

Market drivers: risk-off sentiment supported fixed-income assets. Equities and EM assets suffered weak economic data and a dwindling optimism over trade negotiations.

Stocks: w-o-w, global equity indices fell (MSCI ACWI, -0.7% to 522) driven by both DMs (S&P500, -0.8% to 2,962) and EMs (MSCI EMs, -0.4% to 1,001). Volatility rose (VIX S&P 500, +1.9 points to 17.2, 52w avg.: 17.1; 10y avg.: 17.1).

Bonds: w-o-w, global indices rose (BAML Global bond index, +0.4%). The FTSE Russell decided not to include China in its flagship government bond index, citing "market liquidity and foreign exchange concerns".

FX: w-o-w, the USD strengthened against a basket of currencies (DXY, +0.6% to 99.109). The EUR and GBP fell (EUR/USD, -0.7 to 1.094; GBP/USD, -1.5% to 1.229), EM FX weakened (MSCI EMs, -0.3% at 1,611) bar the Turkish lira (USD/TRY, +1.3% to 5.670).

Commodities: Oil prices fell (Brent, -3.7% to 61.9 USD/b) as Saudi Arabia's oil output recovered to similar levels prior to the drone attacks on its facilities.

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*