Rosa & Roubini

MAKING SENSE OF *THIS* WORLD **14 October 2019**

R&R Weekly Column
By Brunello Rosa

Erdoğan's War In Syria Poses An Existential Threat To Europe

During a week in which the Nobel Peace Prize was granted to Ethiopia's Prime Minister Abiy Ahmed Ali, for his "efforts to achieve peace and international cooperation, and in particular for his decisive initiative to resolve the border conflict with neighbouring Eritrea," still another new conflict is starting in the Middle East. After Donald Trump's decision to withdraw US troops from the north-eastern corner of Syria, Turkey decided to occupy a strip of 20km inside that region to create a buffer zone. The occupation has two declared goals: to make it easier for the Turkish army to defend Turkey's borders, and to relocate to Syria a portion of the 3.6m Syrian refugees currently living in Turkey.

As part of this offensive (somehow ironically named "Operation Peace Spring") Turkish troops have launched a series of airstrikes and artillery bombardment against the Syrian Democratic Forces (SDF), forces which have helped the US-led coalition in Syria to fight ISIS, but which Erdoğan considers effectively a terrorist organisation. This is because the SDF are led by the Kurdish People's Protection Units (YPG), which Turkey considers a terrorist group. So, this "Operation Peace Spring" will be directed mainly against the Kurdish ethnic groups, which Erdoğan has long considered a threat to Turkey's national unity and security.

The US position on this issue is contradictory at best. The US Department of Defense was reportedly against the abandonment of Northern Syria by US troops, and even Lindsey Graham, an ally of President Trump, said he would seek to introduce a bi-partisan resolution in the US Senate to reverse the decision and punish Turkey, if Turkey decides to attack the SDF. Trump himself, after giving green light to the Turkish invasion of Northern Syria, said that he would "obliterate" the Turkish economy if its actions were to be "off-limits", or "inhumane." In a spectacular U-turn, US Secretary of State Mike Pompeo said that the US did not give green light to the Turkish offensive in Syria, even as the official press statement following the phone call between Trump and Erdoğan states that "*Turkey will soon be moving forward with its long-planned operation into Northern Syria*".

Europe's reaction has, for a change, been to unanimously condemn this brutal military operation. But it has also, as usual, been ineffective. This is because the EU is in no position to tell Erdoğan what to do, after making a treaty with him on 18 March 2016, the result of which has been that the EU has paid Turkey EUR 6bn for two years in return for keeping the Syrian refugees on Turkish territory. Ahead of the renegotiation of this atrocious deal in 2020, Erdoğan is now threatening to open the gates of its refugee camps and flood Europe with migrants, as happened in 2015. Then, Angela Merkel decided to accept 1.1 million refugees in Germany (and, in so doing, marked the beginning of her own political decline) and Italy and Greece also dealt with hundreds of thousands of migrants coming from (or through) the Middle East by land and sea, while Hungary and other countries closed their borders.

If Erdoğan were to do what he is threatening to do – a scenario we do not expect to happen – the EU would not now be able to cope with such a migration crisis the same way it did in 2015. Germany would be unwilling and unable to accept more migrants, since the CDU has been severely punished for that humanitarian decision by Merkel in 2015. Italy, after the "security decrees" by Salvini (which are still active), has closed its ports to the ships rescuing migrants. Greece is now governed by a centre-right government much tougher on migration than Syriza's far-left positions were. The *Viségrad* group (Poland, Hungary, Czechia and Slovakia) remains resolutely against any re-distribution of migrants within the EU (even as they continue to collect, financially, the "solidarity contributions" from larger EU countries). The EU Commission is in the middle of a difficult transition from Juncker's presidency to Von Der Leyen's, preventing it from making any big decisions. So, another migration crisis would most likely destabilize Europe, sending it close to collapse. A dis-integration of Europe would have large economic, financial and social consequences. This means that Erdoğan's threat is credible. Unfortunately, the likely conclusion to all this is that the EU will renew its deal with Turkey, and receive only a somewhat less "inhumane" war in Northern Syria than would otherwise occur.

Our Recent Publications

- EU Update: A Challenging Start For The "Geopolitical Commission", *by Grégoire Roos and Brunello Rosa, 11 October 2019*
- Trump's Impeachment Would Benefit No One… But Trump Himself, *by John C. Hulsman, 8 October 2019*

Looking Ahead

The Week Ahead: Manufacturing Sector To Remain Weak Around The World And Chinese Growth To Slow Down

Across DMs, the manufacturing sector is expected to remain weak (IP EZ Aug., c: -2.5% y-o-y; p: -2.0; IP Japan, c: -4.7% y-o-y; p: -4.7).

In China, growth is expected to mildly slow down (GDP Q3 c: 6.1% y-o-y; p: 6.2), hampered by the external sector, where trade tensions keep weakening export growth (Exports Sep., c: -3.0% y-o-y; p :-1.0); yet, the domestic sector is likely to remain healthy, driven by industrial activity and consumption (IP Sep., c: 5.0% y-o-y; p: 4.4; Retail sales, c: 7.8% y-o-y; p: 7.5).

In the US, on October 15 the Fed will start purchasing USTs (USD 60bn a month) to keep short-term interest-rates in check, until 'at least into Q2-2020'.

In Japan, inflation is expected to decelerate (National CPI ex. fresh food Sep.; c: 0.3% y-o-y; p: 0.5).

The Quarter Ahead: Recession Fears Recede, Supported By Rising Prospects Of A US-China Trade-Deal

US and China announced: 1) a partial agreement; and 2) a more comprehensive deal, likely to be signed 'a month from now'. As part of the pact, China will: *i)* increase purchases of US agricultural commodities; and *ii)* agree to still-unspecified IP, FX, and financial services measures; in exchange, the US will further delay the announced tariff increases (to date, tariffs remain in place on USD 360bn of Chinese imports). The trade deal will leave some key issues unaddressed, such as: *i)* US restrictions on Huawei; and *ii)* the enforcement mechanism able to ensure compliance on both sides.

In the US, the market-probability of 'one rate cut' in the Fed's October meeting stands at 75.4% (p: 78.0).

In the UK, the EU's Chief Brexit negotiator Barnier, announced that UK's PM Johnson "shifted his position on several central demands by the EU" – including accepting that "there could not be a border across the island of Ireland". If a Brexit deal is finalized on October 17-18 at the EC meeting, PM Johnson will attempt to win UK parliamentary approval at a special Commons sitting on October 19.

In Turkey, tensions with the US are likely to rise due to the Turkish invasion of north-eastern Syria, as: *i)* the Pentagon stated that "US troops had come under Turkish fire"; and *ii)* the US Treasury announced it is "drafting very powerful sanctions against Turkey, to be activated if needed".

In Hong Kong, a recession is likely, as key indicators weaken (i.e. in August: retail sales fell by 23% y-o-y; tourist arrivals declined by 40% y-o-y), as a result of: i) the violent, ongoing protests; ii) US-China trade tensions; and iii) declining tourist spending power.

Last Week's Review

Real Economy: A Manufacturing-Led Slowdown Hampers The Global Outlook

In the US, consumer sentiment rose above-consensus (Michigan Consumer Sentiment Index Oct., a: 96.0; c: 92.0; p: 93.2), as incomes rise and inflation remains subdued (CPI Sep., a: 1.7% y-o-y; c: 1.7; p: 1.8; CPI ex. food & energy, a: 2.4% y-o-y; c: 2.4; p: 2.4).

In Germany, industrial activity keeps declining (German factory orders Aug., a: -6.7% y-o-y; c: -4.6; p: -5.0; IP, a: -4.0% y-o-y; c: -2.7; p: -3.9), as trade tensions hinder businesses confidence and waken demand.

In the UK, the economy contracted in August (GDP, a: -0.1% m-o-m; c: 0.0; p: 0.4), due to weakness in both manufacturing and services.

In China, the Caixin Services PMI fell to a seven-month low (Sep., a: 51.3; c: 52.9; p: 52.1), as a rise in operating expenses outweighed an increase in 'new orders'.

Financial Markets: Optimism over US-China trade negotiations and Brexit lifted the markets

Market drivers: Following progress on US-China trade negotiations equities rose and DM bonds fell.

Stocks: w-o-w, global equity indices rose (MSCI ACWI, +1.2% to 521), driven by both DMs (S&P500, +0.6% to 2,970, breaking a three-week losing streak) and EMs (MSCI EMs, +1.5% to 1,012). Volatility fell below historical averages (VIX S&P 500, -1.4 points to 15.6, 52w avg.: 17.2; 10y avg.: 17.0).

Bonds: w-o-w, global indices fell (BAML Global bond index, -1.0% to 285.5) led by DMs (S&P Global, -0.9% to 110.8), as two risk factors that had so far driven bond performance – US-China trade tensions and Brexit uncertainties – showed signs of easing. Across DMs, bond yields rose: *i)* 10y UST by 24 bps to 1.75%; *ii)* German bund by 15 bps to -0.44%; and *iii)* 10y UK sovereign bond by 26 bps to 0.71%. In MENA, debt capital supply stands at USD85.6bn y-t-d, higher than last year (USD 68.4bn over the same period).

FX: w-o-w, the USD weakened against a basket of currencies (DXY, -0.5% to 98.301), the EUR (EUR/USD, +0.6 to 1.104) and the GBP (GBP/USD, +2.6% to 1.265). While EM FX strengthened (MSCI EMs, +0.4% at 1,621), the Turkish lira - hit by rising tensions - weakened (USD/TRY, -3.2% to 5.883).

Commodities: Oil prices rose (Brent, +3.7% to 60.5 USD/b) following a missile attack on an Iranian oil tanker in the Red Sea. Gold prices fell (Gold, -1.0% to 1,489 USD/Oz.).

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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*