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MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
By Brunello Rosa

Financial Markets Celebrate Reduced Tail Risks And Increased Monetary Stimulus

In our column two weeks ago, we discussed how several key tail risks that were weighing on the global economy were in the process of being reduced, and how that could prove beneficial for risky asset prices. In particular, we noted the following: how the risk of hard Brexit was diminished since Boris Johnson had obtained a new deal from the EU and managed to obtain early elections; US-China trade tensions were lower after the Phase 1 agreement was reached between President Trump and Chinese Vice Premier Liu He; the risk of an open confrontation in the Middle East involving Iran, Saudi Arabia and the US currently seems to be relatively low; the risk of a collision course between Argentina and the IMF seems contained for now, even after the victory of Alberto Fernández in recent presidential elections.

Together with these reduced tail risks, there have been also some positive surprises from the real economy, in particular in the US. Last week, the advanced reading of Q3 US GDP showed a smaller deceleration of growth than initially feared (from 2.0% to 1.9% SAAR, versus 1.6% expected), and October's Non-Farm Payroll increase was 128,000 (versus 89,000 expected), with September's data upwardly revised from 136,000 to 180,000. Other positive figures from the US labour market were a small increase in average hourly earnings (3.0%) and an increase in the labour force participation rate (to 63.3%, versus an expected decrease to 63.1%, from September's 63.2%), which partially justify the uptick seen in the unemployment rate, from 3.5% to 3.6%. Finally, the Federal Reserve provided an additional kick, with its third back-to-back insurance cut last week, which brought the Fed funds target range to 1.50%-1.75%. The impact on financial markets was powerful, with global equity indices rising substantially: MSCI ACWI was up +1.3% on a weekly basis, driven by strong performance in both DMs (MSCI World, +1.3% w-o-w and S&P 500, +1.5% w-o-w, to 3,067, its all-time high) and EMs (MSCI EMs, +1.3% w-o-w).

Some analysts even wondered whether the easing the Fed has provided since July 2019 (and the interrupting of its tightening cycle since last December) were actually necessary. In our view the answer is yes, the easing was necessary. The manufacturing recession is still ongoing; on Monday the manufacturing ISM rose less than expected to 48.3, still well below the 50 mark, which separates expansion from contraction. Consumer and business sentiment remains fragile, and the risk of an increase in consumer tariffs on December 15th remains present, albeit diminished. So, most likely a mid-cycle policy adjustment was warranted, especially considering a reduced neutral real rate (r*), as was mentioned by Chair Powell during his latest press conference.

Where do we go from here? The Fed has already clearly signalled a period of long pause, which would require dramatic changes in economic and financial conditions in either direction to be interrupted. Indeed, it would likely require either a sharp and persistent increase in inflation above the 2% target, or a consistent deterioration in economic growth, for this pause to be ended. Other central banks are taking a cue from the Fed, meanwhile. The Bank of Canada left its policy rates unchanged (even if with a clear easing bias) in October. The Bank of Japan bought more time before providing more stimulus. The Riksbank even signalled its intention to increase its policy rate (and "normalise" it to 0%) before entering a long pause. This week, the Reserve Bank of Australia is expected to pause its easing cycle (after three 25-bps cuts this year). The Bank of England will remain on hold ahead of the December 12th general election. As a result, some of the euphoria currently observed in financial markets might be tamed in coming weeks. But don't worry: in due course, when the situation will have deteriorated enough, central banks will be ready to deploy "helicopter money" to support the global economy and financial markets.

Our Recent Publications

- BoE To Remain in Wait–And–See Mode Before The General Election, *by Brunello Rosa, 1 November 2019*
- RBA to Stay On Hold In November, *by Brunello Rosa, 1 November 2019*
- *BoJ Remains On Hold, But Changes Forward Guidance To Signal Increased Readiness To Ease Policy, by Brunello Rosa, 31 October 2019*
- *Review: Fed Cuts Rates And Signals A Pause, by Brunello Rosa, 30 October 2019*
- Flash Review: BoC Remains On Hold, But With A Clear Easing Bias, *by Brunello Rosa, 30 October 2019*
- Federal Reserve Preview: A 25-bps Rate Cut, And a Likely Pause After, *by Nouriel Roubini and Brunello Rosa, 28 October 2019*

Looking Ahead

The Week Ahead: Manufacturing Expected To Weaken, CBs To Remain Accommodative

Globally, further indications of manufacturing weaknesses are expected (US Factory orders, c: -0.3% m-o-m; p: -0.1; Germany IP, c: -2.9% y-o-y; p: -4.0).

In the UK and Australia, the BoE and RBA are both likely to keep their key policy rates unchanged at 0.75%.

In Turkey, inflation is expected to slow further (c: 8.6% y-o-y; p: 9.3).

The Quarter Ahead: Downside Risks Will Continue To Hamper The Global Economy

US-China tensions are likely to ease; however, risks of further escalations remain high. The November 16-17 Asia-Pacific (Apec) meeting in Chile, where President Xi and President Trump were due to meet and sign an interim trade deal, was cancelled due to civil unrest. After ruling that "US tariffs on steel and other products were illegally inflated", the WTO authorised China to impose retaliatory tariffs on American goods worth USD 3.6bn, a moderate amount if compared to the levies already imposed by China on the US.

In the US, the House approved a resolution to lay out the framework for the next phase of the impeachment inquiry into President Trump's dealings with Ukraine.

In the UK, after PM Johnson's failure to deliver Brexit by October 31: 1) the EU approved a fourth extension to Article 50, to January 31; and 2) MPs backed PM Johnson's plan for a snap general election on December 12. PM Johnson believes an early vote would restore the conservative party's majority in the House of Commons, ending the political stalemate over Brexit.

Last Week's Review

Real Economy: DM Economic Growth Remains Stable, Manufacturing Weaknesses Continue

In the US, the economy slowed down less than expected (GDP Q3, a: 1.9% y-o-y; c: 1.6%; p: 2.0%), driven by consumer spending – about 70% of US GDP – against a decline in business investment. In October, the labor market remained resilient, as: *i)* payrolls increased (a: 128K; c: 80K; p: 180K); *ii)* the unemployment rate mildly rose from historical lows (a: 3.6%; c: 3.6; p: 3.5); and *iii)* average hourly earnings continued to rise (a: 3.0% y-o-y; c: 3.0; p: 3.0). Inflation remained soft in September (PCE, a: 1.3% y-o-y; c: 1.4%; p: 1.4; Core PCE, a: 1.7% y-o-y; c: 1.7%; p: 1.8%), as wage growth remained modest. Manufacturing activity dropped to the weakest production levels since the last recession, and a key leading indicator signaled the third consecutive month of contraction (ISM Manuf. PMI Oct., a: 48.3; c: 47.8; p: 48.9).

Still in the US, As expected, the Fed cut its Fed funds target range by 25 bps to 1.5% - 1.75% (p: 1.75% - 2.00%). The policy statement signaled a shift from 'readiness to act' to 'assessment of further developments'; in particular, the wording 'the Fed would act as appropriate to sustain the expansion' changed to 'the FOMC will continue to monitor the implications of incoming information'. The market probability of no further rate cuts in 2019 increased to 87.5% (p: 73.3). Yet, the Fed's decision to increase temporary liquidity injections from USD75 to 120bn a day further supported the markets.

In the EZ, the economy continued to grow at a modest pace (GDP Q3, a: 1.1% y-o-y; c: 1.0; p: 1.1), amid fears of a slowdown. Inflation softened further (CPI Oct., a: 0.7% y-o-y; c: 0.7%; p: 0.8%), well below the ECB's 'close to but below 2%' target. However, core inflation – excluding energy and food prices – rose to 1.1% y-o-y (c: 1.0; p: 1.0), driven by rising prices of services.

In Canada and Japan, CBs kept their key interest rates unchanged at 1.75% and -0.1%, respectively.

In Hong Kong, the economy contracted more than expected (GDP Q3, a: -2.9% y-o-y; c: -0.3%; p: +0.5%).

Financial Markets: As Fears Of Recession Ease, Accommodative CBs Spur Risk Appetite

Market drivers: Stable growth, supportive monetary policy, a strong October job report in the US, and declining uncertainty levels kept sentiments constructive in global equities and EM FX.

Stocks: w-o-w, global equity indices rose (MSCI ACWI, +1.3% to 539), driven by both DMs (MSCI World, +1.3% to 2,252; S&P 500, +1.5% to 3,067) and EMs (MSCI EMs, +1.3% to 1,049). Volatility continues to fall below historical averages (VIX S&P 500, -0.4 points to 12.3, 52w avg.: 16.8; 10y avg.: 17.0).

Bonds: w-o-w, sovereign bond yields remained stable (BAML Global bond index, +0.3%). The 10y UST yield fell by 7bps to 1.73%.

FX: w-o-w, the USD weakened against a basket of currencies following the Fed rate-cut (DXY, -0.6% to 97.239) while the EUR (EUR/USD, +0.8% to 1.117) and the GBP (GBP/USD, +0.9% to 1.293) rose. The TRY strengthened (USD/TRY, +1.3% to 5.699) as Fitch raised Turkey's outlook from 'negative' to 'stable'.

Commodities: Oil prices fell (Brent, -0.5% to 61.7 USD/b), dragged by uncertainty over future demand and abundant US stockpiles. Gold prices keep rising, continuing to show safe-haven appeal (Gold, +0.6% to 1,514 USD/Oz.).

@RosaRoubini Rosa & Roubini Rosa&Roubini Associates

For more information, please call us on +44 (0)207 1010 718 or send us an email to info@rosa-roubini-associates.com

www.rosa-roubini-associates.com

118 Pall Mall. London SW1Y 5ED

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*