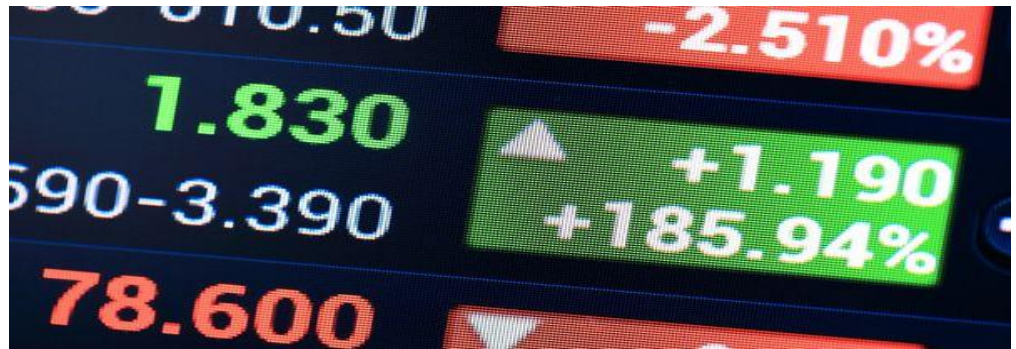


MAKING SENSE OF *THIS* WORLD

4 November 2019



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

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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.).



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Abbreviations, Acronyms and Definitions

a	Actual	LN	Northern League, Italy
AKP	Justice and Development Party, Turkey	MSS	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



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