Rosa & Roubini
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R&R Weekly Column
By Brunello Rosa

Reduced Tail Risks Do Not Fully Justify Market Euphoria

Financial markets became excited at the end of last week, by signals that some of the most feared tail risks hanging over the global economy could be diminishing. On a weekly basis, global stock indices rose (MSCI ACWI rose by +0.6%, to 570), driven by DM equities (S&P 500 +0.9% to 3,265; Eurostoxx 50 +0.4% to 3,790). EM indices also rose (MSCI EMs +0.9% to 1,134), and, as markets rallied, volatility fell (VIX S&P 500 fell by -1.4 points to 12.6, below its annual average of 15.0).

Regarding tensions between US and Iran, the "measured" retaliation by Iran to the killing of Quassem Soleimani, in which rockets were fired at two US military bases in Iraq without causing casualties and major damages, and the decision by the US not to respond to that attack, was interpreted by market participants as a signal of de-escalation. Some might even hope that, after a period of increased tension, the *status quo ante* between the two countries might return. While it is certainly a positive development that Iran's retaliation was not followed by further US counter-attacks, we would be much more cautious before considering the events of the last few days to be merely isolated incidents that are now effectively concluded.

In our scenario analysis, we discussed how events might still develop less favourably than markets currently imply they will be and Nouriel Roubini argued that financial markets are still seriously under-pricing the possible future evolution of events. This is true for a number of reasons. First, Iran's Supreme Leader Khamenei said that the initial attack on US bases was just the beginning of the retaliation, and that much more will occur in coming weeks. Secondly, President Trump's invitation to the UK, France and Germany to also abandon the Joint Comprehensive Plan of Action (JCPOA) means that tensions will remain elevated for some time. Third, Iran would benefit from striking closer to the November Presidential elections, when mis-calculations could lead to Trump's defeat. Fourth, the US has in any case launched a new series of sanctions against Iran, which could eventually lead to a further reaction by Tehran. And finally, the unintentional downing of the Ukrainian plan by Iran on the night of the retaliation show how things can go wrong even when there is no intention to kill. In his upcoming Geopolitical Corner, John Hulsman will discuss how the Iranian story is intertwined with the electoral campaign and Trump's impeachment process.

The second piece of good news that excited market participants was that the market *the announcement by the US President that he is "ready for the Phase-1 trade deal with China to be signed on January 15th at the White House"*. Trump also said he would "sign the deal with high-level representatives of China", and that he would later "travel to Beijing to begin talks for the next phase". The market believes that this might signal the end of the saga that rattled the global economy during the past couple of years. But again, reality might be slightly harsher than what is being hoped for. Until the deal is actually signed, anything can happen, and time is on China's side. Why should the Chinese government provide Trump with the argument that he succeeded in containing China's trade mis-practices ahead of the election? Moreover, even if the trade tensions do ease, the geo-strategic rivalry between the two countries will continue, with its impact on global supply chains and technological developments. In any event, once the China issue *is* finally considered to be done with, Trump will then simply be ready to start a fight with Europe, over various issues such as Airbus versus Boeing, auto sector trade, digital taxes, etc. So, trade tensions worldwide could very well continue going forward.

Finally, the UK parliament has at last approved the PM's Brexit deal, opening the gates to an orderly Brexit on January 31st, if the House of Lords does not object. At the same time, a series of cliff-edges are likely to present themselves in the next 11 months, especially now that the possibility of extending the transition period beyond 31 December 2020 has been excluded by law.

All this is to say that, while some tail risks have not materialised so far, market participants should remain aware of their presence and remember the stretched valuations that now exist in most asset classes.

Our Recent Publications

- US-Iran Scenario Analysis: Risk-off Ahead – An Update On The Conflict And Implications For The Global Economy, Policies And Markets, *by Nouriel Roubini and Giorgio Cafiero, 8 January 2020*
- ***WORKING PAPER SERIES***: 2019 GDP Growth Slowdown Set To Continue In 2020, *by Joseph Shupac, 9 January 2020*

Looking Ahead

The Week Ahead: US Retail Sales Set To Improve And Chinese GDP To Accelerate

In the US, retail sales data are expected to show a marginal improvement (Dec., c: 0.4% m-o-m; p: 0.2%), while IP is expected to decline in December (c: 0.2% m-om; p: 1.1%). December's CPI data is anticipated to fall slightly to 2.0% y-o-y (p: 2.1%).

In the EZ, November's IP data is anticipated to slightly deteriorate (c: -2.3%; p: -2.2%).

In China, Q4-2019 GDP is expected to rise to 6.1% (p: 6.0%).

The Quarter Ahead: Tensions In The Middle East To Ease Somewhat For Some Time

After Iran fired missiles at ***US forces in Iraq***, both sides made efforts to defuse a crisis after the recent killing of a prominent Iranian general. However, President Trump is likely to announce tighter sanctions on Iran.

US-China trade tensions expected to ease further. US President is "ready for the Phase 1 deal with China to be signed on January 15 at the White House". Trump also said he would "sign the deal with high-level representatives of China", and that he would later "travel to Beijing to begin talks for the next phase".

In the US, impeachment process is likely to face further delays. President Trump's political trial cannot begin until the Democratic-controlled House sends its articles of impeachment to the Republican-controlled Senate. The Speaker of the US House of Representatives Ms. Nancy Pelosi is coming under pressure from Senate allies, as she delayed the process in a tussle over rules.

In the US, analysts expect the Fed's to cut policy rates given the recent economic weakening, due to a muted job growth and declining wage growth; the market-probability of a 'one rate cut' in 2020 increased to 66% (p: 62%).

In the UK, Brexit uncertainties ease. The House of Commons voted overwhelmingly in favour of PM Johnson's Brexit deal (330 to 231), paving the way for the UK to leave the EU by January 31st - after more than four decades of membership.

Turkey sent troops to Libya to support the embattled UN-backed government. Turkish and Russian presidents called for a ceasefire, after both countries launched the TurkStream natural gas pipeline, designed to ship Russian gas to Turkey and South-Eastern Europe.

Last Week's Review

Real Economy: Economic Activity Picks Up In DMs, Geopolitical Uncertainties Recede

In the US, December labour market data weakened, as: *i)* nonfarm payrolls fell below expectations (a: 145K; c: 164K; p: 256K); *ii)* wage gains declined below-consensus (Avg. hourly earnings, a: 2.9% y-o-y; c: 3.1 y-o-y; p: 3.1); and *iii)* the unemployment rate remained unchanged (a: 3.5%; c: 3.5; p: 3.5).

In the EZ, consumer spending rose more-than-expected, a sign of rising household demand (Retail sales Nov., a: 2.2% y-o-y; c: 1.3% y-o-y; p: 1.7%). Inflation spiked to a 6-month high as a result of higher energy and oil prices, while core inflation remained muted (CPI Dec., a: 1.3% y-o-y; c: 1.3%; p: 1%; Core CPI Dec., a: 1.3% y-o-y; c: 1.3%; p: 1.3%), well-below the ECB's target 2%.

In Germany, industrial output improved above-expectations, registering its biggest monthly recovery in almost two years (IP Nov., a: -2.6% y-o-y; c: -3.8%; p: -4.6%), driven by manufacturing growth and rising construction; however, declining factory orders hinted at further weakness for Europe's largest economy (Factory orders, a: -6.5% y-o-y; c: -5.5%; p: -5.6%).

In China, as of January 6, the PBoC cut commercial banks' RRRs by 50 bps. The move: *i)* will increase bank lending; and *ii)* free up CNY 800 bn (USD 115 bn) of liquidity into the financial system.

Financial Markets: Risk-On Mood Returned After US-Iran Tensions Ease

Market drivers: w-o-w, investors' risk appetite improved, due to: *i)* confirmation of the US-China "Phase 1" trade deal; *ii)* improved geopolitical relations in the ME and reduced uncertainties over Brexit; and *iii)* the belief that most CBs will stand ready to contain market volatility.

Stocks: w-o-w, global indices rose (MSCI ACWI, +0.6% at 570), driven by DMs (S&P 500, +0.9% to 3,265; Eurostoxx 50, +0.4% to 3,790); EMs also rose (MSCI EMs, +0.9% to 1,134). As markets rallied, volatility fell (VIX S&P 500, -1.4 points to 12.6, 52w avg.: 15.0; 10y avg.: 16.8).

Bonds: w-o-w, returns fell (BAML Global, -0.2% to 285.4), driven by 'risk-on' outflows; across DMs yields rose (10y UST, +4 bps to 1.83%; 10y German bund, +5 bps to -0.23%).

FX: w-o-w, the USD strengthened (DXY, +0.5% to 97.356), while the EUR and JPY depreciated after ME tensions fears eased (EUR/USD, -0.3% to 1.112; USD/JPY, -1.3% to 109.460).

Commodities: w-o-w, oil prices fell (Brent, -5.3% to 65 USD/b) as risks de-escalated, and new US sanctions on Iran will likely aim at the non-oil sector, helping oil prices to ease. Driven by geopolitical tensions, gold approached a seven-year high (+0.7% to 1,562 USD/Oz.).

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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*