Weekly Market Summary

June 1st, 2018

With Friends Like Donald Trump, Matteo Salvini & Luigi Di Maio…… Who Really Needs Enemies??

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As the auspicious month of Ramadan prevails, I wish - once more - our valuable readers (especially the new joiners!) Peace, Serenity and utmost Happiness!! Ramadan Kareem and "Kul 3Am Wa Entom Bi-Khair"!

If it looks like a duck, swims like a duck, and quacks like a duck, it probably is a duck! And right now, this duck is looking a lot like those foolish and inexperienced politicians enjoying fresh powers !!

George Santayana is a Spanish-American philosopher, poet and humanist who made important contributions to aesthetics (set of principles concerned with the nature and appreciation of beauty), speculative philosophy and literacy criticism in the early parts of the 20th century. According to Santayana, "*those who cannot remember the past are condemned to repeat it.*" (In other words, history repeats itself). The sentiment that history repeats aspires to common sense and is hard to disagree with, especially in the context of recent developments in Europe and the US.

Back in early 2016, many available surveys did indicate that a significant proportion of Europe's population - more than one-third in the UK, Italy, France, Austria, Greece - believed that their respective country would be in a better situation by leaving the EU. Few months later, the Brexit decision in the UK (actual referendum took place on June 23rd 2016, expected UK departure from the EU planned for Friday 29th March 2019) became the first logical consequence of this situation (the "*angry*" vote that upsets the status quo!). And whilst the French election – almost a year later - ended in a landscape victory for Emmanuel Macron (66.1% of the votes, versus 33.9% for Front National's right-wing leader Marine Le Pen), clearing a major hurdle thought to threaten global stability and the strength of the European political establishment, it was just a matter of time before this fragile political stability gets once again put to test!

More importantly, the events of the past 2 years had clearly shown just how disillusioned Western voters had become with EU agencies / existing political establishment for failing to deliver more inclusive economic growth in the era of globalization (not to downplay the non-economic causes for calls towards Europe rejection, such as the refusal of EU immigration policies and European bureaucracy). However, Europe's responsibility in this economic deterioration could be limited and its causes might be elsewhere. Additionally, history had shown that the development of new political formulations rarely goes smoothly, and therefore one would have expected the large divisions, between those who can imagine a better life in the new system and those who cannot, to continue driving politics in the EU and elsewhere for years to come.

Fast forward to May 2018 ….

May 23rd: Italian President Sergio Mattarella asks Giuseppe Conte, a law professor backed by a populist coalition but with no political experience, to form a government whose policy agenda has already alarmed markets.

Conte has the support of Luigi Di Maio of the anti-establishment Five Star Movement and Matteo Salvini of the anti-immigrant League, who have agreed on a so-called "*Contract for a Government of Change*." A Euroskeptic government, to be led by Conte, has unnerved markets even before its birth, with the policy program drawn up by Di Maio and Salvini promising a spending spree and tax cuts in deliberate defiance of European Union fiscal rules. ***Italian bonds continue their slide, with the Italian 10-year yield spread over German bunds widening to 190 basis points, the most in a year (flight to quality into German govt. paper). Outright, the yield on the country's benchmark rises to 2.41%, its highest level in almost three years. Italy's FTSE MIB equity index drops in excess of 300 points (1.3% drop), while EUR/USD sinks to 1.1690.***

May 27th: Less than a week after Italy's populist parties ironed out their policy differences and jubilantly received a mandate to form a government that they said would usher in a new era in Italian and European history, their designated Prime Minister Conte announces on Sunday evening that he has failed to form a government. The announcement, a result of an impasse over the future government's economics minister candidate Paolo Savona - an 81-year-old economist and company executive who had repeatedly called on the government to plan for a possible euro exit - seems likely to prompt the creation of a technical caretaker government on Monday morning. Markets are closed for the weekend, whilst economists scramble to analyse this latest twist of events and its potential market impact.
"***Good luck to anyone. And especially Italy," Mr. Conte tells the Italian news wire ANSA.***

May 28th & 29th: Italy sinks deeper into political turmoil as populist leaders pull the plug on their attempt to form a government after the Italian president rejects the choice of a Euro-skeptic, whilst it remains unclear if a technical caretaker government – headed by Carlo Cottarelli, a former executive director of the International Monetary Fund - could be swiftly put in pace and also receive enough support to pass a confidence vote in Parliament. Aggrieved parties demand a return to the polls, with the League's leader doubting Italy's democracy and the Five Star leader raising the prospect of the impeachment of President Sergio Mattarella. With new elections all-but certain and the anti-euro League gaining support, polls suggest the populists can only benefit from the chaos - raising the threat of more market turbulence ahead.
Markets in full panic mode! Italian bonds crash, with the Italian 10-year yield spread over German bunds approaching 300 basis points, and yields on the country's benchmark rising to 3.17%. Italy's FTSE MIB equity index drops to a low 21,125 on Tuesday, in excess of 3,400 points from highs registered just 3 weeks earlier (a nearly 14% drop). EUR/USD dips to 1.1500! German & US bond rallies (flight to quality again), with German and US 10-year yields sliding to 0.21% and 2.76% respectively.

May 30th & 31st: Italy's premier-designate – Carlo Cottarelli – confirms on Wednesday that "*new possibilities*" have emerged to form a government based on the outcome of the March 4th vote. Carlo Cottarelli adds that he wanted to give the option time to mature given the negative market reaction to the prospect of new elections. As he leaves Italy's lower chamber, Fabrizio Cicchitto, a lawmaker from Forza Italia (Let's Go Italy - former Prime Minister Silvio Berlusconi's party), calls the political situation "*the most serious institutional, political, financial crisis that Italy has been through since the war*". Thursday evening, Italy's anti-establishment Five Star Movement and the far-right League clinch the approval of President Sergio Mattarella for the launch of a populist government, all but ending a political crisis that has gripped the country for nearly three months and spooked investors. Giuseppe Conte, the designated prime minister for the alliance, presents a list of ministers to Mr. Mattarella, which the Italian president accepts, paving the way for the new government to be sworn in on Friday afternoon. Thursday's deal avoids an even longer political stalemate that would have led to fresh elections in the autumn, which could have turned into a de facto referendum on Italy's ties with the Eurozone.
Markets breathe a sigh of relief! Italian bonds and stocks rally on the news, with Italian 10-year yield back down at 2.80% while the FTSE MIB rallies 500 points from the lows. EUR bulls jump in and bid EUR/USD up to 1.1700! Total financial meltdown has been averted, at least for now (but hey…don't push your luck for 2019!☺). Yields on two-year Italian bonds drop to 0.95%, 178 basis points lower from highs recorded earlier in the week.

And if all the above chaos was still not enough to keep traders/investors/economists busy, one could add two latest market developments that will surely have a meaningful impact on market trends, as we head into the second half of 2018.

May 31st: The US just announced the removal of exemptions of tariffs on aluminium and steel imports from the EU, Canada and Mexico. In response, the EU will initiate a case against the US at the WTO, and all partners announced they will retaliate and impose tariffs against different US imports. The macroeconomic implication of these tariffs should be very limited, even if some individual firms and sectors will be affected. However, fears of escalating tit for tat, which could derail global growth, and lead to more risk-off sentiment in markets. Economies deeply intertwined in global value chains would be more at risk in case there is a severe global protectionist escalation. The EU said it would take immediate steps to retaliate, while Mexico vowed to impose duties on everything from U.S. flat steel to cheese. Canada's government announced it will impose tariffs on as much as C$16.6 billion ($12.8 billion) of U.S. steel, aluminium and other products from July 1st.

June 1st: Mariano Rajoy has become the first prime minister in Spain's democratic history to be ousted by parliament after losing a vote of no-confidence amid a corruption scandal engulfing his Popular party. He will be replaced by the Socialist opposition leader Pedro Sánchez. A slim majority of 180 lawmakers in the 350 seat parliament on Friday chose to remove the leader from power, following a corruption scandal where former senior officials in his popular party were found guilty of operating a slush fund. In a brief final speech to parliament, Mr Rajoy bade farewell to the country after seven years in power: "*It has been an honour to leave Spain better than I found it. Thank you to all Spaniards and good luck*." The challenge of managing the Eurozone's fourth-largest economy and dealing with internal problems such as the crisis in Catalonia will now fall on Mr Sánchez, who will lead a weak minority government with just 84 seats in parliament. The abrupt leadership change adds to the sense of political turmoil in southern Europe in a week where fraught attempts to form a government in Italy three months after a national election have already spooked financial markets. However, the situation in Spain is different from Italy: Not only is Spain's economy seeing strong growth, but none of the main parties are questioning the country's membership in the European single currency or promising an immigration clampdown!

This afternoon brings the release of the all-important US payroll release** (one has to wonder if that remains the case, given all the political/geopolitical mess around)! Bloomberg consensus is for May payrolls to have risen by a strong 190,000 (following a weakfish 164,000 jump in NFP for the month of April). A print in excess of 200,000 would surely seal a 25 bps rate hike for the US o/n Fed funds rate at the upcoming June 13th FOMC meeting (interest rate market already assigning an 85% probability for such outcome). As always, it will also be worth keeping a close eye on the other important elements of the report, namely the unemployment rate (expected to remain unchanged at 3.9% - lowest since December 2000!) average hourly earnings (likely to rise by +0.2% mom & +2.6% yoy, in line with the April print), the participation rate (last at a still depressed 62.8%) and average weekly hours (expected unchanged at 34.5 hours).

***After a couple of "weakfish" months, job and wage growth heated up again in May. The 223,000 gain in payrolls was above the 190,000 consensus and came with cumulative upwards revisions of 15,000 to the prior two months. Following a modest 0.1% rise in the prior month, wages were up 0.3% in May to take the annual rate up to 2.7%. While that is still within the range it has trended in since mid-2016 and not high enough to warrant a faster pace of rate hikes, it is slightly above the consensus and as a result will likely support the USD and weigh on fixed income, with yields rising. On the household survey, the unemployment rate ticked down further to 3.8%, driven both by a slight fall in participation but also a rise in employment on that survey as well.*

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