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MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
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A US-China Trade Agreement Might Not Be Good News for Europe (or the World)

With US-China trade negotiations being granted a deadline extension by President Trump on March 1st, it seems that an agreement between China and the US on their long-lasting trade disputes could finally be at hand. What might the elements of the deal include? In brief, the deal could include a commitment by China to increase its import from the US, while the US is granted increased access to the Chinese market, more protection for its intellectual property, reduced technology transfer via obligatory joint ventures, and other similar guarantees. If we only focus on the quantitative aspects of such an agreement, we could brutally summarise it as follows: China would commit to buy more stuff from the US and the US will be able to sell more stuff to China. (That is, after all, the way to reduce the US' trade deficit with China, which recently reached an all-time high).

Now, would this be a good deal for the world economy? On the one hand, reduced trade tensions would mean less volatility in markets, which could be beneficial for developed economies and emerging markets (EMs) both. Less protectionism would also imply a reduced drag on global growth, which in turn might also imply higher prices for certain commodities, another factor that could be beneficial for commodity-exporting Ems. (Moreover, so long as commodity prices do not increase too much, this would not necessarily impact DMs too negatively). As part of the trade deal China might also commit to stabilizing its trade-weighted exchange rate and allowing more transparency regarding its reserves and reserve policy. Trade-weighted currency stabilization would be better for Europe than China pegging to the US dollar alone, which tends to hurt the Eurozone at times when the dollar is weak.

On the other hand, not all that shines is gold. Even if a temporary agreement were to be agreed on between China and the US, the cold war between the two global geopolitical superpowers will continue. The sub-components of this wider rivalry, such as the technological competition between them and the balkanisation of the global supply chains, will also continue, and, as the recent row around Italy's memorandum with China on the Belt and Road Initiative may show, other countries and regions will be forced to choose sides between either the US or China. In addition, there might be direct losers from a US-China deal of this sort. If China commits to buying more goods from the US, other countries' exports to China might suffer, especially countries or regions which have economies that are export-led, such as Japan and the Eurozone. If China also commits to buying more US goods such as soybeans, fossil fuels, and other commodities, exporting EMs may suffer as well. Thirdly, as we discussed in a recent column, if the US and China come to an agreement , Trump will then be able to devote his full attention to an attack on Germany and its car industry (another popular bipartisan subject in the US), threatening to slap tariffs on US car imports in order to strongarm the Germans into taking a deal that is advantageous to the US.

As we discussed in recent reports, both Japan and Europe are now undergoing a severe economic slowdown, which is having important political repercussions. Germany's slowdown means that other countries in its supply chain, such as Italy, are already in a recession. EMs are stabilising after a difficult 2018 thanks to the Fed's more dovish stance. If those economies were to suffer again, possibly falling into a recession, the world economy as a whole would be affected, being then able to rely only on the US and China, both of which are also slowing down economically. Germany could seize the opportunity to rethink its business model and become less dependent on foreign demand. But that would mean revitalising its domestic demand and promoting the transformation of the EU and the Eurozone into full-fledged transfer unions (perhaps organised in concentric circles), with a vibrant internal market like the US. However, as we discussed in our recent Europe Update this seems very unlikely to happen in the near future. This will leave Europe, Japan, EMs and the world vulnerable to the volatile mood of the US president.

Our Recent Publications

- *POLICY COMPASS - Brexit Update: Going To The Wires, by Brunello Rosa, 15 March 2019*
- *PREVIEW: Norges Bank To Hike In March and Signal Another Hike in 2019, by A. Waters, 15 March 2019*
- *FED PREVIEW: Extended Pause Highly Likely and Treasuries Runoff to End This Year, by N. Roubini, B. Rosa and A. Waters, 14 March 2019*
- *EM Currencies: The Fed's Pause Provides Short-Term Support, by Remi Bourgeot, 13 March 2019*
- *JAPAN: A General Election In July Is A Risk in A Politically Hectic 2019, by Alex Waters, 12 March 2019*
- *Italy Update: The Economic Recession Worsens The Political Landscape (And Vice-Versa), by B. Rosa, 11 March 2019*

Looking Ahead

The Week Ahead: Policy Uncertainties Will Remain High

In the UK, the parliament will vote for the third time on PM May's "revised Brexit deal". Were the parliament to reject the deal, the UK could request the EU for either a: *i)* a "short" delay, i.e. until June 30; or, *ii)* a "long" delay, beyond June 30, which would require the UK to participate in the EU Parliament elections on May 23-26.

In the UK and Japan, CPI figures are expected to remain below 2%, at 1.8% (*p:* 1.8% y-o-y) and 0.3% (*p:* 0.2% y-o-y), respectively.

The Fed and BoE are likely to maintain interest rates unchanged at 2.5% and 0.75%, respectively.

Norges Bank is widely expected to increase its policy rate from 0.75% to 1%.

The Quarter Ahead: US-China Tensions Will Remain Unaddressed

A ***US-China*** deal is yet to be achieved, with many relevant political and economic issues still unresolved.

Globally, monetary and fiscal policies are becoming supportive. In the G3, monetary policy will likely be eased: ***1) in the US***, the probability of: *i) no* Fed hikes in 2019 remains at 100%; and *ii)* a rate cut rose to 28% (*p*: 20%); ***2) in the EZ***, the ECB will to ensure liquidity remains abundant, via TLTROs; and ***3) in Japan***, a deterioration of the growth outlook could justify a shift from tightening to easing.

In China, were the ongoing liquidity shortage to worsen, the PBoC could deliver a 50bp RRR cut.

In Turkey, the CBT is likely to start easing in H2-2019. Going forward, the combination of less stringent monetary and fiscal policy could: *i)* help soften the deceleration of global growth; and *ii)* support the markets.

Last Week's Review

Real Economy: Political Tensions Weigh On The Outlook

In the US consumption showed resilience (retail sales Jan., *a:* 0.2% m-o-m; *c:* 0.0; *p:* -1.6); yet, a weaker-than-expected industrial production (Feb., *a:* 0.1% m-o-m; *c:* 0.4; *p:* -0.4) points to trade-war related headwinds. President Trump vetoed the Congress's measure revoking his declaration of a national emergency at the US-Mexico border. February's headline (CPI, *a:* 1.5% y-o-y; *c:* 1.6; *p:* 1.6), and core inflation (CPI ex. food & energy, *a:* 2.1% y-o-y; *c:* 2.2; *p:* 2.2) fell slightly, and were below consensus.

In the EU, industrial production showed signs of stabilization (*a:* 1.4% m-o-m; *c:* 1.0; *p:* -0.9), helped by a rebound in France, Italy and Spain. However, Germany—the largest EU member—suffered a contraction (*a:* -0.8% m-o-m, *c:* 0.4, *p:* 0.8). The EU parliament voted to suspend Turkey's accession bid, citing "*failures to uphold the rule of law*".

In the EZ, inflation remains muted (CPI Feb., *a:* 1.5% y-o-y; *c:* 1.5; *p:* 1.4).

In the UK, lawmakers voted against: *i)* PM May's "revised Brexit deal" (391-242); and *ii)* a "no-deal Brexit" (312-308); and *iii)* backed the motion to seek a Brexit delay.

In China, industrial output grew at the slowest pace in 17 years (industrial production Jan., a: 5.3% y-o-y; c: 5.5; p: 5.7) but investment spending rose (fixed asset investment Feb., a: 6.1% y-o-y; c: 6.0; p: 5.9), driven by the government's injection of USD 169bn into the financial system.

In Japan, the BoJ held interest rates (*a:* -0.1%; *p:* -0.1) and downgraded its assessment of the economy, due to upcoming declines in exports and factory output.

Financial Markets: Increase In Demand For Riskier Assets

As fears over monetary tightening subsided, core-to-periphery flows supported global stocks and EM bonds.

Global stocks w-o-w rose (MSCI ACWI, 2.8%) driven by the US (S&P 500, 2.9%), EZ (Euro Stoxx 50, 3.1%) and EMs (MSCI EMs, 2.6%). Volatility fell (VIX S&P 500, 3.2 points to 12.9, 52w avg.: 16.7; 10y avg.: 17.8).

Fixed-income indices: while global bonds were flat w-o-w, (BAML Global index, 0.1%), EM bonds performed positively (BAML, 1.4%) and issuance picked up: w-o-w USD22.9bn and EUR0.8bn were raised (last week: USD9.0bn and EUR3.0bn).

Currencies: the USD fell w-o-w (DXY, 0.7%), while the EUR and GBP appreciated (EUR/USD, 0.8% to 1.133; GBP/USD, 2.1% to 1.329).

Commodities: Brent crude hit a 2019-high (Brent, +2.2% to 67.2 USD/b) on OPEC supply cuts and US sanctions on Venezuela and Iran.

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Abbreviations, Acronyms and Definitions

a	*Actual*
AKP	*Justice and Development Party, Turkey*
ann.	*annualized*
ARS	*Argentinian Peso*
avg.	*Average*
bn	*Billion*
BoC	*Bank of Canada*
BoE	*Bank of England*
BoJ	*Bank of Japan*
bpd	*Barrels per day*
bps	*Basis points*
BS	*Balance sheet*
c	*Consensus*
C/A	*Current account*
CB	*Central bank*
CBB	*Central Bank of Bahrain*
CBK	*Central Bank of Kuwait*
CBT	*Central Bank of Turkey*
CDU	*Christian Democratic Union, Germany*
CNY	*Chinese Yuan*
CPI	*Consumer Price Index*
DJIA	*Dow Jones Industrial Average Index*
DJEM	*Dow Jones Emerging Markets Index*
d-o-d	*Day-on-day*
DXY	*US Dollar Index*
EC	*European Commission*
ECB	*European Central Bank*
ECJ	*European Court of Justice*
EIA	*US Energy Information Agency*
EM	*Emerging Markets*
EP	*European Parliament*
EPS	*Earnings per share*
EU	*European Union*
EUR	*Euro*
EZ	*Eurozone*
Fed	*US Federal Reserve*
FOMC	*US Federal Open Market Committee*
FRB	*US Federal Reserve Board*
FX	*Foreign exchange*
FY	*Fiscal Year*
GCC	*Gulf Cooperation Council*
GBP	*British pound*
GDP	*Gross domestic product*
IMF	*International Monetary Fund*
INR	*Indian Rupee*
IPO	*Initial public offering*
IRR	*Iranian Rial*
JPY	*Japanese yen*
k	thousand
KSA	*Kingdom of Saudi Arabia*
LN	*Northern League, Italy*
M5S	*Five Star Movement, Italy*
m-o-m	*Month-on-month*
mb	*Million barrels*
mb/d	*Million barrels per day*
MENA	*Middle East and North Africa*
MHP	*Nationalist Movement Party, Turkey*
mn	*Million*
NAFTA	*North-American Free Trade Agr.*
NATO	*North Atlantic Treaty Organizat.*
OECD	*Organization for Economic Cooperation and Development*
Opec	*Organization of Petroleum Exporting Countries*
p	*Previous*
P2P	*Peer-to-peer*
PBoC	*People's Bank of China*
PCE	*Personal Consumption Expenditures*
PE	*Price to earnings ratio*
PM	*Prime minister*
PMI	*Purchasing managers' index*
pps	*Percentage points*
pw	*Previous week*
QCB	*Qatar Central Bank*
QAR	*Qatari Riyal*
QE	*Quantitative easing*
q-o-q	*Quarter-on-quarter*
RE	*Real estate*
RBA	*Reserve Bank of Australia*
RRR	*Reserve Requirement Ratio*
RUB	*Russian Rouble*
SWF	*Sovereign Wealth Fund*
tn	*Trillion*
TRY	*Turkish Lira*
UAE	*United Arab Emirates*
UK	*United Kingdom*
US	*United States*
USD	*United States Dollar*
USD/b	*USD per barrel*
UST	*US Treasury bills/bonds*
VAT	*Value added tax*
VIX	*Chicago Board Options Exchange Volatility Index*
WTI	*West Texas Intermediate*
WTO	*World Trade Organisation*
w	*Week*
w-o-w	*Week-on-week*
y	*Year*
y-o-y	*Year-on-year*
y-t-d	*Year-to-date*
ZAR	*South African Rand*
2y; 10y	*2-year; 10-year*