Rosa & Roubini ASSOCIATES

MAKING SENSE OF *THIS* WORLD

18 July 2022

R&R Weekly Column
By Brunello Rosa

A Government Crisis In Italy Erupts Just Days Before The ECB Unveils Its Anti-Spread Facility

A government crisis occurred in Italy last week. The Five Star Movement (M5S), a major component of the national unity parliamentary majority, did not participate in the confidence vote over the Draghi government's large package of fiscal aid for households and businesses hit by the cost-of-living crisis. The M5S's parliamentary group had recently splintered as the faction loyal to foreign minister Luigi Di Maio formed a new group (*Insieme per il Futuro, IPF*) to support Draghi in his anti-Russian and pro-American stance.

Theoretically speaking, Draghi, having received the confidence vote both from the Chamber and the Senate (in this latter case, with an absolute majority), could have continued to govern and disregard this rebellion. But Draghi wanted to highlight the political relevance of the event. He went to Italy's President Sergio Mattarella to resign, but Mattarella rejected the resignations and invited Draghi to go back to parliament this Wednesday, to "verify" the existence of its parliamentary and political majority. What will happen next?

Draghi is reportedly tempted to give up. Apparently he is tired of the cross-vetoes on all major pieces of legislation from the parties supporting his government. We anticipated that the various components of his composite majority could start dis-engaging with one another by autumn or winter, as the 2023 elections approached. But clearly the M5S wanted to exploit the first-mover advantage and leave the majority before anyone else, to spend a few months in opposition and regain the sort of anti-system credentials it has often had before the general election.

The problem is that, once a component element of Draghi's parliamentary majority leaves, there is a strong incentive for all other components to do the same, instead of being held responsible for continuing to support a semi-technocratic government, even if for the greater good of the country. Thus Draghi will either manage to obtain a strong commitment from all remaining parties (and the component of the M5S that is still loyal to him), that they will support his government until the end of this parliament, without undermining his action with continued cross-vetoes – in which case the government will carry on – or else Draghi will clarify in parliament that the conditions to continue his tenure do not exist anymore, and he will resign.

Whatever happens, something is clear: political risk is on the rise in Italy. And with it, the 10y BTP-Bund spread, which has reached 220bps recently. And all this is happening during the week in which the ECB is expected to unveil its new anti-fragmentation facility, which is aimed exactly of containing the widening of spreads, when *unwarranted* by fundamentals. Italy is expected to be the largest and most relevant beneficiary of this facility. And just at the time when the technocrats in Frankfurt need to decide the crucial details of this facility, Italy is providing a clear example of a *warranted* increase in its sovereign yields and widening of the spreads, justified indeed by the rise of domestic political risks.

Italy is also supposed to be the largest recipient of the recovery funds from the EU, agreed upon during the pandemic. These funds can only be unlocked if Italy approves the necessary reforms, with the last batch expected to be finalised at the end of the year.

So, in theory money could be ready to help Italy recover from its traditional economic underperformance and defend its sovereign bonds from speculative attacks. But the recent political turmoil risks jeopardising this favourable course of action. Clearly, the events of these days are not bringing any favour to the country's cause.

Our Recent Publications

- Flash Preview: ECB To Start Its Policy Rate Normalisation and Launch Its Anti-Fragmentation Facility in July, *by Brunello Rosa, Nouriel Roubini and Nato Balavadze, 15 July 2022*
- Bold and Intriguing Reforms in Post-Qaboos Oman, *by Gulf State Analytics, 7 July 2022*

Looking Ahead

The Week Ahead: Headline Inflation To Accelerate, While Core Inflation To Fall in EZ And UK; PMIs To Fall In DMs

In the US, in June, flash estimates are likely to show: *i)* manufacturing PMI decreasing to 52 (*p:* 52.7); and *ii)* services PMI declining to 52.6 (*p:* 52.7).

In the Eurozone, the ECB is likely to increase its key interest rates by 25 basis points and to launch its anti-fragmentation facility.

In the EZ, in June, headline inflation is likely to surge to 8.6% y-o-y (*p:* 8.1%), whereas core inflation is expected to ease off slightly to 3.7% y-o-y (*p:* 3.8%). Monthly inflation is seen remaining unchanged at 0.8%. In June, flash estimates are likely to show: *i)* manufacturing and services PMI decreasing to 51 (*p:* 52.1) and 52 (*p*: 53) respectively; and *ii)* composite PMI declining to 51 (*p:* 52).

In the UK, June's unemployment rate is expected to stay unchanged at 3.8%. In June, headline inflation is likely to increase to 9.2% y-o-y (*p*: 9.1%), whereas core inflation is seen cooling down to 5.8% y-o-y (*p*: 5.9%). Monthly inflation is expected to stay unchanged at 0.7%. Retail sales are likely to shrink further to -5.3% y-o-y (*p*: -4.7%). In June, flash estimates are likely to show: *i)* manufacturing and services PMI decreasing to 51 (*p:* 52.8) and 53.1 (*p*: 54.3) respectively; and *ii)* composite PMI declining to 52.5 (*p:* 53.7).

The Quarter Ahead: 2022 Italian Government Crisis; Biden's Visit To Saudi Arabia; China's GDP Growth Contracts In Q2

Rome plunges into a political crisis. On July 13, Giuseppe Conte reported that the M5S would abstain during the confidence vote on the government bill worth about EUR 23 bn aimed to help combat surging inflation. Despite having largely won the confidence vote, Mario Draghi said he would quit as Italian leader after a party in his coalition government sat out a confidence vote, a result of the broken 'pact of trust'. However, Draghi's resignation was rejected by President Sergio Mattarella.

Biden meets the Saudi crown prince. Biden once vowed to make Saudi Arabia a global pariah over its human rights records, including the 2018 murder of journalist Jamal Khashoggi. As the president said, they accomplished 'significant business' in normalizing relations. Amid rising gas prices, Biden discussed oil supply during the meeting.

Following the COVID-19 lockdown, China's economy shrinks sharply in Q2, recording the slowest growth since the start of 2020. COVID-19 restrictions weighed on industrial activity.

Last Week's Review

Real Economy: Headline Inflation Rose, While Core Inflation Fell In US; QoQ GDP Shrank In China; Economic Sentiment Fell In EZ

In the US, June's headline inflation increased by 9.1% y-o-y (*c:* 8.8%; *p:* 8.6%), whereas core-inflation decreased to 5.9% y-o-y (*c:* 8.8%; *p:* 8.6%),. Monthly inflation stood at 1.3% (*c*: 1.1%; *p:* 1.0%). In June, retail sales rose by 8.4% y-o-y (*p:* 8.2%). Also in June, IP increased by 4.2% (*p:* 4.8%). According to a preliminary estimate, July's Michigan consumer sentiment rose slightly to 51.1 (*c*: 49.9; *p:* 50)

In the EZ, in July, Economic Sentiment index deteriorated further to -53.8 (*p:* -28). May's IP increased by 1.6% y-o-y (*c:* 0.3%; *p:* -2.5%).

In the UK, May's IP increased by 1.4% y-o-y (*c:* -0.3%; *p:* 1.6%).

In China, in Q2 GDP growth decelerated to 0.4% y-o-y (*c:* 1.0%; *p:* 4.8%). The economy shrank by -2.6% q-o-q (*c:* -1.5%; *p:* 1.4%).

Financial Markets: Equities Fell; US Yield Curve Inverts; Dollar Is Up, Whereas Oil And Gold Prices Are Down

Market Drivers: Investors paid a close attention to the week's important inflation data. As readings came hotter-than-expected, markets went sharply lower. Investors remained pessimistic, as the key yield curve inversion deepens, especially in the US. In the US, shares slip as the ECB is likely to tighten monetary policy to tame rampant inflation. Europe energy crisis further weigh on recession fears, sending euro below parity with the U.S. dollar.

Global Equities: Decreased *w-o-w* (MSCI ACWI, -1.6%, to 598.71). The US S&P 500 index fell (-0.9% w-o-w, to 3,863.16). In the EZ, shares were down (Eurostoxx 50, -0.8% w-o-w, to 3,477.2). In EMs, equities decreased (MSCI EMs, -3.8%, to 961.85) following China's dampening economic growth. Volatility rose to 25.4 (VIX S&P 500, 52w avg.: 23.0; 10y avg.: 18.1).

Fixed Income: *w-o-w*, 10-year US treasury yields fell (-15 bps to 2.93%). The 2-year US Treasury yields were up too (+3 bps to 3.13%). The German 10-year bund yield decreased (-22 bps to 1.13%).

FX: *w-o-w,* the US Dollar Index was up (DXY, +0.9%, to 107.8; EUR/USD -1.0%, to 1.00). In EMs, currencies weakened (MSCI EM Currency Index, -0.9% w-o-w, to 1,645.23).

Commodities: *w-o-w,* oil prices fell (Brent, -5.5% to 101.1 USD/b). Gold prices decreased w-o-w (-2.1% to 1,706.5 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

Nato Balavadze *contributed to this Viewsletter.*

The picture in the front page comes from this website

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*
MPC	*Monetary Policy Committee*
NAFTA	*North-American Free Trade Agreement*
NATO	*North Atlantic Treaty Organization*
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*

Rosa & Roubini ASSOCIATES

Rosa & Roubini Associates Ltd is a private limited company registered in England and Wales (Registration number: 10975116) with registered office at 118 Pall Mall, St. James's, London SW1Y 5ED, United Kingdom. VAT registration number GB 278 7297 39. ***Analyst Certification****: We, Brunello Rosa and Nouriel Roubini, hereby certify that all the views expressed in this report reflect our personal opinion, which has not been influenced by considerations of Rosa&Roubini Associates's business, nor by personal or client relationships. We also certify that no part of our compensation was, is or will be, directly or indirectly, related to the views expressed in this report.* ***Disclaimer****: All material presented in this report is provided by Rosa & Roubini Associates-Limited for informational purposes only and is not to be used or considered as an offer or a solicitation to sell or to buy, or subscribe for securities, investment products or other financial instruments. Rosa & Roubini Associates Limited does not conduct "investment research" as defined in the FCA Conduct of Business Sourcebook (COBS) section 12 nor does it provide "advice about securities" as defined in the Regulation of Investment Advisors by the U.S. SEC. Rosa & Roubini Associates Limited is not regulated by the FCA, SEC or by any other regulatory body. Nothing in this report shall be deemed to constitute financial or other professional advice in any way, and under no circumstances shall we be liable for any direct or indirect losses, costs or expenses nor for any loss of profit that results from the content of this report or any material in it or website links or references embedded within it. The price and value of financial instruments, securities and investment products referred to in this research and the income from them may fluctuate. Past performance and forecasts should not be treated as a reliable guide of future performance or results; future returns are not guaranteed; and a loss of original capital may occur. This research is based on current public information that Rosa & Roubini Associates considers reliable, but we do not represent it is accurate or complete, and it should not be relied on as such. Rosa & Roubini Associates, its contributors, partners and employees make no representation about the completeness or accuracy of the data, calculations, information or opinions contained in this report. Rosa & Roubini Associates has an internal policy designed to minimize the risk of receiving or misusing confidential or potentially material non-public information. We seek to update our research as appropriate, but the large majority of reports are published at irregular intervals as appropriate in the author's judgment. The information, opinions, estimates and forecasts contained herein are as of the date hereof and may be changed without prior notification. This research is for our clients only and is disseminated and available to all clients simultaneously through electronic publication. Rosa & Roubini Associates is not responsible for the redistribution of our research by third party aggregators. This report is not directed to you if Rosa & Roubini Associates is barred from doing so in your jurisdiction. This report and its content cannot be copied, redistributed or reproduced in part or whole without Rosa & Roubini Associates' written permission.*