Erste Group Research
Week ahead | Macro, Fixed Income | Eurozone, US
19 October 2018

Week ahead

IT – Brussels sees an 'unprecedented deviation' from budget rules
ECB-Council – steady monetary policy in unsteady environment
CH – EU exerts pressure on Swiss financial center
EZ – will manufacturing sector sentiment decline further?

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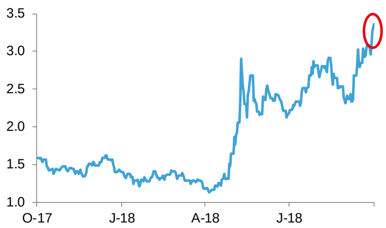
Italy 10 year bond spread above Germany, in %



Source: Bloomberg, Erste Group Research

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Italy - Brussels is alarmed and requested opinion on Italy's budget proposal

Just two days after receiving Italy's draft budget, the European Commission sent a letter to Rome with a request for a detailed statement. An '**obvious significant deviation of the recommendations adopted by the Council under the Stability and Growth Pact'** is cause for major concern by the Commission. The increase in public expenditure planned for 2019 (+2.7% of GDP compared to a target of +0.1% of GDP) and structural deterioration amounting to 0.8% of GDP (which should improve by 0.6% of GDP) are the most significant deviations from the objectives of the Stability and Growth Pact. The Commission points out that such a planned deviation is '**unprecedented in the history of the Stability and Growth Pact'**. Furthermore, the Commission wants to know why the Parliamentary Budget Office, as an independent body, did not approve Italy's budget for 2019 as planned. All these factors indicate '**particularly serious violations of the budgetary commitments in the Stability and Growth Pact'**. The Commission seeks to continue a constructive dialogue with Italy in order to reach a final assessment and asks Italy for its opinion by October 22.

The reaction from Brussels is not unexpected. In our view, the opening of an excessive deficit procedure against Italy can hardly be averted. We do not believe that the government in Rome will be ready to make substantial concessions, which would mean a loss of face. The conflict between Brussels and Rome will probably continue to build up over the coming weeks. The markets have already reacted to the latest developments by further extending spreads on Italian government bonds. This sell-off of Italian government bonds will probably continue in the case of an escalation of the conflict. Besides the unsustainable path of the Italian public budget, the markets also fear that the voices in Italy, which demand an exit from the monetary union, may become louder again. We give an exit of Italy from the monetary union a very low probability. At the same time, however, the lack of restoration of the budget in an environment of low interest rates and a good economy provide significant medium-term risks, to which the market has rightly responded, in our view. Due to the high level of public debt (as analyzed last week in our Week ahead), developments on the financial markets are of major importance to Italy's national budget.

ECB Council: Markets to devote attention to political topics

The next ECB Council meeting is scheduled for Thursday next week. Any significant decision on monetary policy can be ruled out. Instead, the committee will confirm the current course, which comprises an end to net securities purchases at the end of the year, unchanged interest rates at least through the summer of 2019 and reinvestments of redemption payments well after the end of net purchases. Referring to the latter, the markets are still waiting for clarification on the distribution of reinvestments, which was promised by the end of the year. Until the end of the net purchases (i.e. until December) it has been determined that public issuers' securities must be reinvested in a security of an issuer of the same jurisdiction no later than three months after redemption. In contrast, there are only very rough guidelines for reinvestment in privately-issued securities (corporate bonds, covered bonds, ABS). ECB President Draghi has repeatedly confirmed that the capital key will remain the benchmark for country weighting of reinvestments. Therefore, significant changes are very unlikely, in our view. The whole topic is probably only relevant for the securities of private issuers mentioned above, whose repayments are distributed very diversely over the months. Currently, the ECB's net purchases still have a stabilizing effect. However, to ensure that the reinvestment and thus ECB demand will not vary too much from next year onwards, leading to erratic movements on the market, there could be a little more leeway for reinvestments. For this purpose, the weighting between the asset classes could (temporarily) be softened somewhat.

In addition to this technical issue, President Draghi will certainly be interviewed regarding the current political conflicts: Italy's public budget as well as Brexit. The focus could be on possible effects on the economy. Historically, the ECB Council tries to lay low regarding political issues, which is why it seems unlikely that Draghi will make any concrete assessment next week, although it is still possible that he will want to communicate something to the markets.

Uncertain outlook for the Swiss financial center could put Swiss francs under pressure

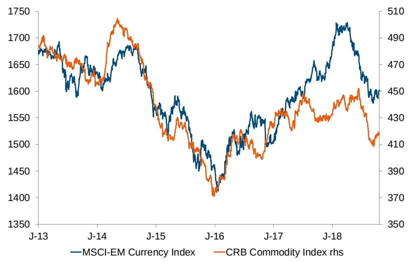
In the shadow of the Brexit negotiations, negotiations between the EU and Switzerland on an institutional framework agreement have been going on since 2014. Brussels wants to ensure with this agreement that the rules of the EU internal market are also interpreted and applied homogeneously by third countries with privileged access to the market (such as Switzerland). However, the negotiations are extremely difficult and this week the deadline set by the EU has expired without completion. The EU is not able to make concessions to its basic principles due to the Brexit negotiations. Switzerland, on the other hand, may wish to wait to see to what degree the United Kingdom succeeds in softening the basic principles of the EU single market in the context of a Brexit deal in order to be able to insist on equal treatment for Switzerland. However, Switzerland is running out of time due to the introduction of MiFID II. The EU has recognized (equivalence decision) trading venues in Switzerland as eligible for compliance with MiFID II only until 31 December 2018. The EU has consciously linked sufficient progress in the negotiations on the institutional framework agreement to an extension of this decision. If there is no extension of the equivalence recognition, the Swiss stock exchange is threatened by negative impacts, which in the worst case could induce large Swiss companies to transfer their listing to EU trading venues.

*Essentially, what the EU intends to create is **a dispute settlement mechanism (arbitral tribunals vs. ECJ).** In addition, the EU wants to **enforce a dynamic adoption of legislation.** This is because EU laws governing the internal market are evolving dynamically, whereas Switzerland's bilateral agreements are static. If there are no adjustments, Switzerland would gradually lose access to the EU's internal market. Since* *the EU is Switzerland's most important trading partner, this would have a negative impact on the growth prospects of the Swiss economy in our assessment. Currently, the biggest obstacles to reaching an agreement are the issue of jurisdiction in case of conflicts and the "accompanying" measures that have up to now served to protect the Swiss working population from abusive breaches of Swiss pay and working conditions. The longer it takes to reach an agreement, the greater the uncertainty on the financial markets will be due to the impending exclusion of the financial center Switzerland from the EU internal market.* ***In this environment, the volatility of the Swiss franc might rise and the franc could temporarily come under stronger pressure against the euro.***

EA – Industry sentiment expected to stabilize in October

Next week (October 24), a first flash estimate for October's industry PMI data will be released for the Eurozone, Germany and France. Influenced by the global trade war, sentiment has been on a continuous decline since the beginning of the year, reaching a record low of 53.2 index points in September. The main burdening factor in September had been weak world trade figures, which almost lead to a standstill of export demand.

Emerging Markets currency index vs. commodity prices

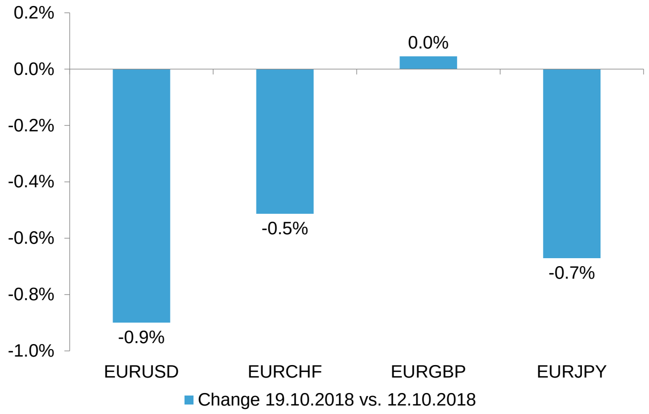


Source: Bloomberg, Erste Group Research

Given the importance of the export sector, the Eurozone industry is heavily dependent on the development of world trade. *The situation of world trade has not deteriorated, at least since the last round of sanctions between the USA and China. Despite these tensions, there are first signs of a slight improvement of the environment. For example, based on survey data from the Ifo Institute, export expectations in the manufacturing industry in Germany have risen steadily since August, mainly due to mechanical engineering and the pharmaceutical industry. Furthermore, global commodity prices and emerging market currencies have recovered slightly since mid-September. We classify this as leading indicators for a gradual improvement in economic activity on a global scale. If this trend continues, it should be reflected in a slight improvement of Eurozone industry sentiment in the coming months, whereby Eurozone exports should benefit subsequently.* ***However, at first we expect a stabilization of survey results in October.***

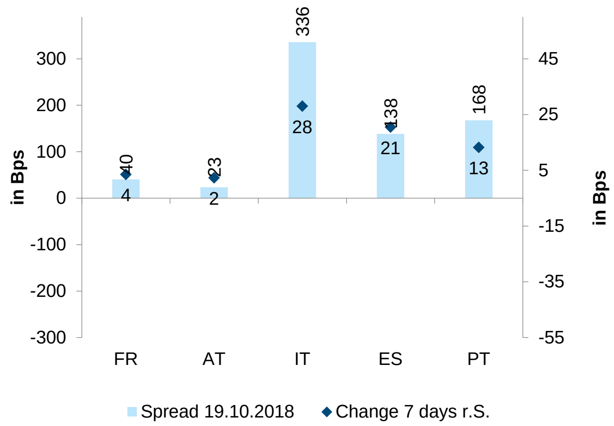
Forex and government bond markets

Exchange rates EUR: USD, CHF, GBP and JPY
change last week
(+ stronger euro / - weaker euro)



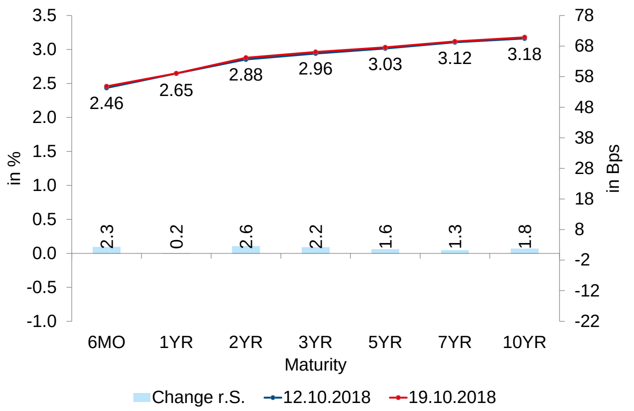
Source: Bloomberg, Erste Group Research

Eurozone – spreads vs. Germany
10Y government bonds



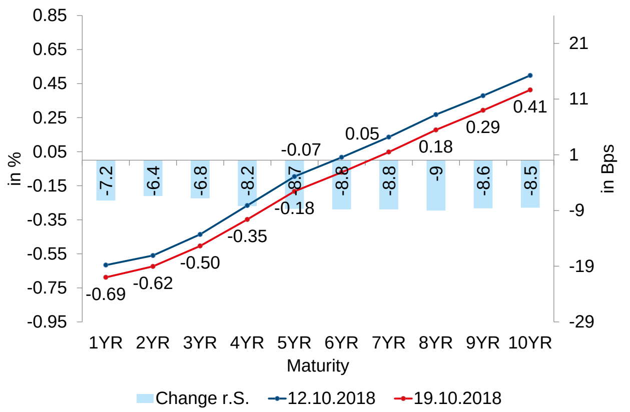
Source: Bloomberg, Erste Group Research

US Treasuries yield curve
change last week



Source: Bloomberg, Erste Group Research

DE Bund yield curve
change last week



Source: Bloomberg, Erste Group Research

Economic calendar

Date	Time	Ctry	Release	Period	Consens	Prior
19-Oct	n.a.	CN	Ind. Prod. y/y	Sep	6.0%	5.8%
		CN	Unempl. Rate	3Q		3.8%
	10:00	IT	CA Balance (m)	Aug		4994 m
		EA	CA Balance (m)	Aug		24 m
	16:00	US	Existing Home Sales	Sep	5.3 m	5.3 m
23-Oct	8:00	DE	PPI y/y	Sep	3.0%	3.1%
	16:00	EA	Consumer Conf.	Oct A	-3.2 index	-2.9 index
24-Oct	9:15	FR	PMI Manufacturing	Oct P	52.0 index	52.5 index
	9:30	DE	PMI Manufacturing	Oct P	53.4 index	53.7 index
	10:00	EA	PMI Manufacturing	Oct P	53.0 index	53.2 index
	16:00	US	New Home Sales	Sep	624.6 thd	629.0 thd
25-Oct	9:00	AT	Ind. Prod. y/y	Aug		4.8%
	13:45	EA	Target Rate (lending)	-	-0.40%	-0.40%
		EA	Target Rate	-		0.00%
	14:30	US	Durable Goods Orders	Sep P	-1.0%	4.4%
		US	Jobless Claims	Oct 20	213.6 thd	210.0 thd
26-Oct	8:45	FR	PPI y/y	Sep		3.7%
	14:30	US	GDP q/q	3Q A	3.3%	4.2%
	16:00	US	Univ. Michigan Index	Oct F	99.1 index	99.0 index

Source: Bloomberg, Erste Group Research

FORECASTS[1])

GDP	2015	2016	2017	2018	2019
Eurozone	2.0	1.8	2.4	2.1	1.9
US	2.9	1.5	2.3	2.9	2.3

Inflation	2015	2016	2017	2018	2019
Eurozone	0.1	0.2	1.5	1.7	1.8
US	0.1	1.2	2.2	2.4	1.8

Interest rates	current	Dec.18	Mar.19	Jun.19	Sep.19
ECB MRR	0.00	0.00	0.00	0.00	0.00
3M Euribor	-0.32	-0.30	-0.30	-0.30	-0.10
Germany Govt. 10Y	0.40	0.50	0.70	0.90	1.10
Swap 10Y	0.98	0.80	1.00	1.20	1.40

Interest rates	current	Dec.18	Mar.19	Jun.19	Sep.19
Fed Funds Target Rate*	2.19	2.38	2.63	2.88	3.13
3M Libor	2.45	2.70	2.90	3.20	3.40
US Govt. 10Y	3.17	3.00	3.20	3.40	3.50
EURUSD	1.15	1.13	1.15	1.16	1.18

*Mid of target range

In case of changes to our forecasts compared to the previous issue, arrows show the direction of the change.

Source: Bloomberg, Erste Group Research

[1] By regulations we are obliged to issue the following statement: Forecasts are no reliable indicator for future performance

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