

Week ahead

Italy – Constitutional referendum to take place on December 4

US – Labor market strong overall in November

China – Further decline of FX reserves in November to be expected

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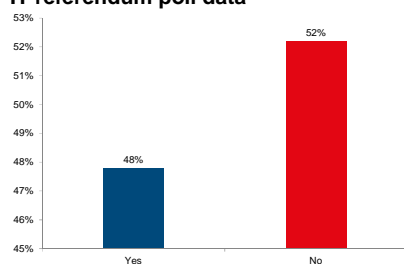
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Rejection of constitutional reform to be expected, based on latest poll data

Whether PM Renzi will step down in case of 'no' vote is unclear

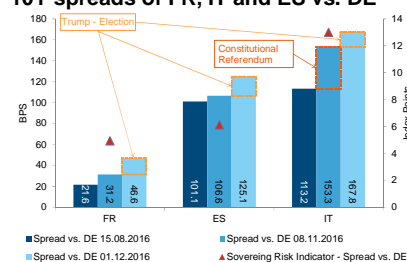
Italy is going to decide about a substantial constitutional reform on December 4. The reform intends to bring the current political system based on two chambers to an end by substantially curtailing the rights of the Senate. Due to the differing composition of the Senate and the Parliament, changes of law have sometimes been a complex and time-consuming affair. In addition, the reform intends to transfer several competences from the regions to the central government in Rome. The ongoing weakness of Italy's economy shows how important further reform steps are for the country. In the case of a 'yes' vote in the referendum, the government of Renzi could step up its reform efforts in order to lower the bureaucracy and improve competition on product markets. A 'no' vote would mean the opposite and Renzi's political future would be in doubt. In addition, Italy's already weak growth prospects would weaken further (the EC estimates Italy's potential growth at 0.3% for 2017/18), since the probability for further reforms would decline as well.

IT referendum poll data



Source: Index Research

10Y spreads of FR, IT and ES vs. DE



Source: Eurostat, Erste Group Research

The increase of the spreads for Italian vs. German government bonds since summer (the lowest level was seen on August 15) indicates that financial markets have started to price in the increased risks stemming from the poll data, with a tendency towards a 'no' vote. In addition, the election of Trump as US president has increased general political risks, which has led to a further rise of Italian credit risk spreads. This development, however, also resulted in increased risk premiums for French and Spanish government bonds.

How markets react to a 'no' vote (poll data attach a high probability to a 'no' vote) depends largely on whether Renzi would step down or not. If the government would step down and new elections would be held next year in spring or summer, this would of course increase the political risk for Italy. The toughest opponent in this election would be the 5-star movement, which seeks a referendum on Italy's membership in the Euro Area. We consider Italy exiting the Euro Area a tail risk. The main reasons are that, legally, this would only be possible if a country exits the EU, which, for the time being, no political party in Italy supports. On top of that, substantial economic disruption could be expected, because a looming exit from the Euro Area would probably trigger capital controls and banks would be under pressure. We therefore believe that, in the case of a 'no' vote, the credit spreads for Italian government bonds would rise, due to the rising political and economic risks; however, we do not expect a sell-off. Several reasons speak against this. For example, the market has already prepared itself for such an outcome to a certain extent, the purchase program of the ECB will support the Italian bond market for the foreseeable time, and, in this low interest rate environment, investors are

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Indications of past performance are no guarantee of a positive performance in the future!

always searching for higher-yielding assets.

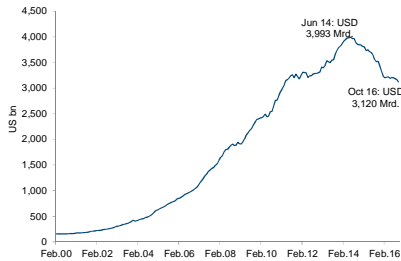
Strong decline of unemployment rate shows tightening US labor market

The US labor market report for November signaled the ongoing strength of the labor market. Gains in non-farm payrolls were reported at 178,000, marginally below market expectations. This constitutes a considerable improvement compared to the previous month’s revised increase of 142,000. Wages disappointed. Average hourly earnings fell by 0.1% m/m, whereas the market had expected an increase of 0.2% m/m. However, the strong decline in unemployment from 4.9% to 4.6% in our view more than compensated for the shortfall in wages. The development of the unemployment rate, together with the slight decline in the participation rate, shows that the labor market is becoming tighter, which is a prerequisite for higher wages. Accordingly, we see the soft wage data as a fluctuation and not meaningful. Overall, we see the data as pointing to an ongoing cyclical upswing of the US labor market.

Further decline of China’s FX reserves expected in November

China is going to release the November value of its FX reserves on December 7. The short-term development of China’s FX reserves is closely tied to the US dollar. Already in October, the strong rise of the US dollar index (+3% m/m) led to an acceleration of the decline of China’s FX reserves to USD 3,120bn. The strength of the US dollar puts pressure on China’s FX reserves for two reasons. On one hand, the US dollar rises due to expected interest rate hikes by the Fed, which in turn lowers the relative attractiveness of investments in other currencies, such as the Chinese renminbi. In addition, the valuation of assets of China’s FX reserves that are not denominated in USD suffers as well.

China FX reserves

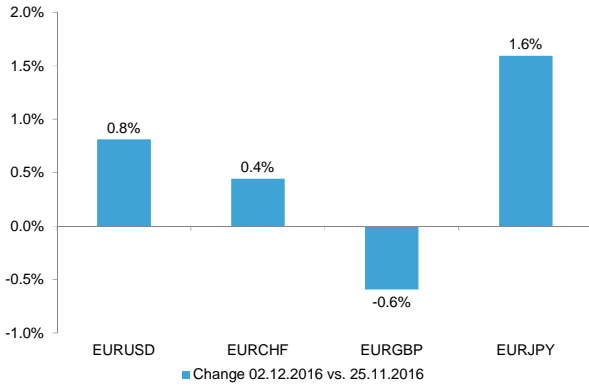


Source: Bloomberg, Erste Group Research

Given the prolonged relative strength of the US dollar in November (US dollar index up another 3.1% m/m), we expect another sharp decline of China’s FX reserves in November in the magnitude of USD 40-60bn. Over the longer term, the gradual liberalization of China’s capital account supports the continuous decline of China’s FX reserves because it allows Chinese investors to diversify their capital abroad. China finds itself in the classic dilemma that a country cannot sustain an independent monetary policy, a fixed exchange rate and open capital borders. Thus far, China has opted for a controlled weakening of the renminbi in order to keep control over its monetary policy. As long as this process runs in an orderly manner, capital markets should not be too worried about it. China’s economy stabilized in 2016 and leading indicators point towards GDP growth of 7% in 4Q16. China’s positive economic development is also supportive for the exports of the Eurozone.

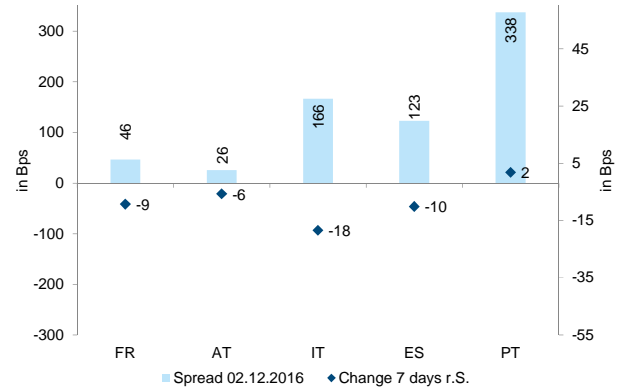
Forex and government bond markets

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



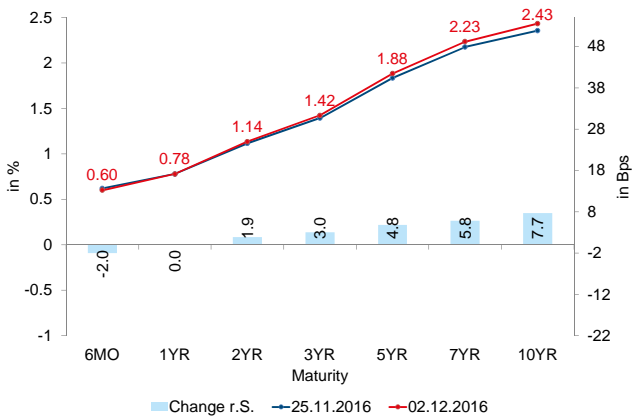
Source: Bloomberg, Erste Group Research

Eurozone – spreads vs. Germany 10Y government bonds



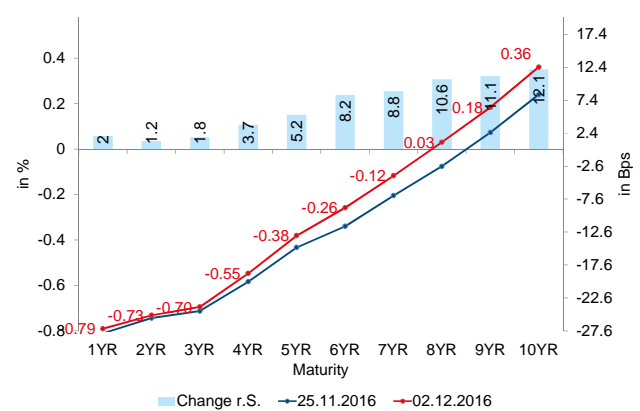
Source: Bloomberg, Erste Group Research

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
2-Dec	11:00	EA	PPI y/y	Oct	-0.9%	-1.5%
	14:30	US	Wages y/y	Nov	2.8%	2.8%
		US	Unempl. Rate	Nov	4.9%	4.9%
		US	Chg. Non-Farm Payrolls	Nov	183.5 thd	161.0 thd
5-Dec	11:00	EA	Retail Sales y/y	Oct	1.5%	1.1%
	16:00	US	ISM Non-Manufacturing	Nov	55.3 index	54.8 index
6-Dec	11:00	EA	GDP q/q	3Q F	0.3%	0.3%
		EA	GDP y/y	3Q F	1.5%	1.6%
		US	Trade Balance	Oct	-41m	-36m
7-Dec	16:00	US	Durable Goods Orders	Oct F	0.2%	4.8%
		n.a.	CN	Forex Reserves	Nov	3071bn
	8:00	DE	Ind. Prod. y/y	Oct	1.0%	-1.8%
		FR	Trade Balance	Oct		-4769m
8-Dec	n.a.	FR	CA Balance (m)	Oct		-3413 m
		FR	Cap Util.	Nov		77.6%
	13:45	EA	Target Rate (lending)	-	-0.40%	-0.40%
		EA	Target Rate	-		0.00%
9-Dec	14:30	US	Jobless Claims	Dec 3	253.3 thd	268.0 thd
	3:30	CN	Inflation y/y	Nov	2.2%	2.1%
		CN	PPI y/y	Nov	2.1%	1.2%
	8:00	DE	CA Balance (m)	Oct		24 m
		DE	Trade Balance	Oct	22m	24m
	8:45	FR	Ind. Prod. y/y	Oct	-0.8%	-1.1%
16:00	US	Univ. Michigan Index	Dec P	94.5 index	93.8 index	

Source: Bloomberg, Erste Group Research

FORECASTS¹⁾

GDP	2013	2014	2015	2016	2017
Eurozone	-0.3	1.2	2.0	1.5	1.7
US	1.9	2.4	2.4	1.6	2.1

Inflation	2013	2014	2015	2016	2017
Eurozone	1.3	0.5	0.1	0.2	1.3
US	1.5	1.6	0.1	1.2	2.1

	current	Dec.16	Mar.17	Jun.17	Sep.17
ECB MRR	0.00	0.00	0.00	0.00	0.00
3M Euribor	-0.31	-0.30	-0.30	-0.30	-0.30
Germany Govt. 10Y	0.33	0.30	0.50	0.80	0.80
Swap 10Y	0.73	0.60	0.80	1.10	1.10

	current	Dec.16	Mar.17	Jun.17	Sep.17
Fed Funds Target Rate*	0.31	0.63	0.88	1.13	1.38
3M Libor	0.93	0.94	1.19	1.44	1.70
US Govt. 10Y	2.43	2.20	2.30	2.60	2.70
EURUSD	1.06	1.05	1.06	1.08	1.10

*Mid of target range

	current	Dec.16	Mar.17	Jun.17	Sep.17
Austria 10Y	0.58	0.50	0.70	1.00	1.00
Spread AT - DE	0.24	0.20	0.20	0.20	0.20

Source: Bloomberg, Erste Group Research

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

Erste Group Research

Week ahead | Macro, Fixed Income | Eurozone, USA

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