GLOBAL
ECONOMY

1/18

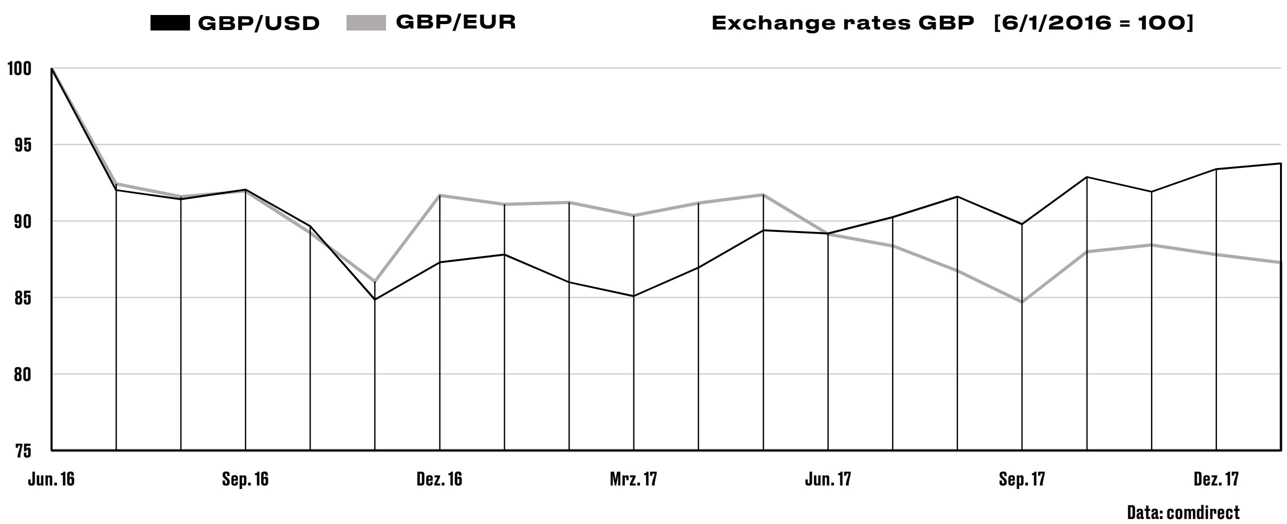
Populists loom large in Italy's elections

Aussie-Dollar might be about to appreciate markedly

J.S. Research

Government goes down to defeat in the Commons eventually while breakthrough honeymoon in Brussels proves to be very short-lived

We had been anticipating as much all over those months between the introduction of the centre piece of Brexit legislation to Parliament, the “Great Repeal Bill”, and its passage through the Commons: In the end, Theresa May’s government went down to defeat by a handful of the most visceral of Tory Europhile rebels. Thus, a rift has opened in the Conservative Parliamentary Party for everyone to see, a rift almost certain to widen once Parliament will begin to debate the shape of the future relationship between Britain and the EU. That is why back in June last year already, we were warning against the very likely scenario of another general election before Brexit becomes legally effective in March 2019, and so far, this becomes ever more likely: Theresa May cannot yield too much to the Europhile rebels or risk being deposed by backbench Brexiteers, yet staying her hard Brexit course, she risks defeat in the Commons which eventually will bring about her government’s fall. It fits that quandary that on the other side of affairs, over in Brussels, Donald Tusk, the president of the European Council, has seen his language toughened by EU officials yet again, stipulating that no matter what course the negotiations will take during the first two months of the year, the EU will not begin trade talks before March - with the time in between reserved for negotiations over the mooted transition between Brexit-legal on March 29, 2019 and Brexit-effective some two years later. The possibly most contentious positioning by the EU, however, ought to be its demand that Britain will not be allowed to strike her own trade deals during transition even though it inevitably will drop out of the EU’s trade arrangements with the rest of the world post Brexit-legal. Michel Barnier, additionally, has made it clear that the UK financial sector will lose its EU “passport” after that date, to be substituted by so-called equivalence arrangements with Singapore, for example, where third countries gain preferred access to the EU common market if their regulations are tuned to those of the EU. Mr Barnier made these explicit comments to vent his irritation at the British conviction that a deal might be struck after Brexit without any friction for the UK financial industry whatsoever – while doing away with the ECJ’s



jurisdiction. Meanwhile, business has become rather restive after a prolonged period of virtual inertia: In November, Wall Street warned against its imminent decision to relocate operations away from London if an agreement on transition had not been reached until year's end; which, of course, was not the case. Relocations from the City to the continent, however, have been scaled back for the time being, with financial institutions holding their major fire until the matter of transition will have been settled within the quarter – for good or bad.

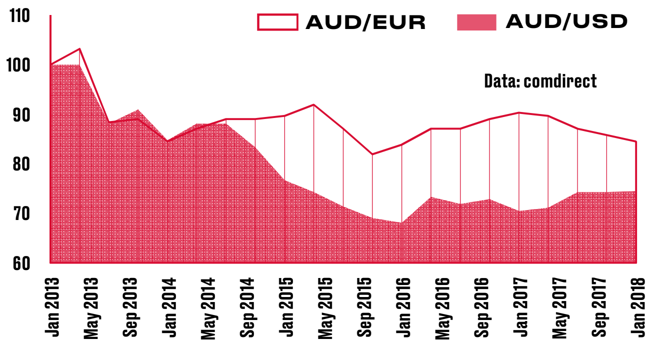
Italy's election sees populists battling it out among themselves

Just in October of last year, both houses of the Italian parliament agreed on a compromise, piecemeal reform of the then obsolete electoral law "Italicum". The most important result of this reform is the abolition of the rule that the largest party gets additional seats in the lower house so as to able to form a government on its own. The new law, the so called Rosatellum by contrast provides for coalition governments only, save for the highly unlikely case that a single party gets the majority of seats. On the one hand, that at least has reduced the prospect of the populist, Eurosceptic Five Star Movement coming in on top in the elections this March, eventually ruling alone; yet is has not obliterated the substantial threat this election presents to the euro all the same. Though oscillating in the pithiness of their messages tuned to different audiences, both the leaders of Five Star and the (Northern) League (the party is in the process of rebranding itself, underlining its ambitions to become a national political force), Messrs Di Maio and Salvini, respectively, have said that their parties would aim for a referendum on Italy remaining a member of the Eurozone if Brussels would not soften its rules on fiscal policy and banking supervision substantially. At the very least, the spectre of a parallel currency yet to be defined, favoured by former prime minister and political phoenix-resurgent Silvio Berlusconi, stands to haunt the EU as much as the markets if the centre-right of Mr Berlusconi finishes first. Recent local elections, furthermore, saw the currently ruling centre-left Party of Democracy (PD) of former prime minister Matteo Renzi finishing third behind both the centre-right of Mr Berlusconi and Five Star; the very fall from grace we have been projecting ever since the PD split over Mr Renzi's gamble to first surrender the party chairmanship and then successfully stand to get re-elected in some kind of confidence vote in March of last year (see related post in section "Economic Ticker" on our website). Put succinctly, just as Paolo Gentiloni, the foreign-minister-turned-premier after Mr Renzi's seeming fall from power (while he has pulling the strings backstage all the time) has proven a very suave, effective head of government, Renzi and indeed the PD are increasingly seen as a spent force vis-à-vis the energetic campaigning of the centre-right as well as Five Star. Just another example for the inauspicious state of the PD is its inability so far to maintain its coalitions with other, small centre-left parties such as "More Europe" which, thanks to the Rosatellum, are more important than ever to have a shot at forming a government. Mr Salvini's League, by contrast, has been very successful to harness frustration at migration, the recurring theme upsetting European politics all over the past two years. Slowly but persistently, the party has extended its base to regions far from its roots North of the river Po, regions which had been leaning left before. Thus, many observers now expect a close race not between the familiar coalitions from the centre-right and the centre-left, but rather between the two leading populist parties in Italian politics, both intent on rewriting the Eurozone's rules. Only a surprising resurgence of the centre-left, for example by the improbable formation of a coalition between the PD and its spin-off, then, might change this unpromising outlook on yet another European election with hugely disruptive potential. On a side note, Brexit negotiations might well become affected, too, when in an outlier scenario Germany might still beset by woes to form a government just when Italy tumbles into the selfsame mess, obstructing decision making when Brexit dealmaking will be reaching crunchtime.

Aussie-Dollar among the most underrated currencies at start of new year

It is possibly one of the most underrated major currencies right now: The destination for the mother of all carry trades, where investors have typically borrowed in low-yielding Japanese Yen to invest the proceeds in high-yielding Down Under debt, the Australian dollar or "Aussie" all the same was

Exchange rates AUD [Jan. 2013 = 100]



shaken by major depreciation between 2013 and 2015/16, depending on the currency pair. Against both the US Dollar and the Euro, the commodity-dependent Aussie took a massive double-digit hit when commodity prices tumbled and the economy Down Under even made an unsettling hiccup in Q3/16 when it registered its first quarterly contraction in years. Since then, however, GDP growth has been proving rather resilient, settling at around 0.6 per cent on a quarterly basis. The labour market is thus becoming increasingly tight: Unemployment has started to come down markedly, while wage growth has been bottoming out at some 2 per cent on an annual basis. Consequently, and with regards to the Aussie's substantial long-term depreciation, inflation expectations have been hovering around 4 per cent all through 2017, with the actual inflation rate at around 2 per cent. Yet all through the time since the inception of the downturn of commodity prices, Australian interest rates have known but one direction: downwards.

Apart from the deflationary effects from deteriorating terms of trade, one of the other elements specifically critical for Australian monetary policy have been frothy house prices driven by domestic as much as foreign (speculative) demand, mostly from China (see issue 06/17 of this report). It was only recently that, after first interventions by the government against perceived exaggerated investment demand from China, house price inflation has begun to weaken somewhat. Now, in a counterintuitive way, this has opened the way for the central bank to follow the rest of the world and begin tightening, since the risk of inadvertently pricking a house price bubble has abated. Finally, there is trade. With commodity prices picking up of late while import prices of manufactured goods have stayed more or less the same, the terms of trade for the Australian economy have been improving markedly. And even though the government's chief economist expects commodity prices to weaken again during the year, we think the terms of trade ought to have seen their nadir for the time being. Taken together, all these factors point towards an Aussie dollar appreciating substantially, certainly against its US counterpart; against the Euro, its rise might become somewhat subdued, regarding the particularly strong expectations about the ECB's finally coming round to normalise monetary policy, outside of a political shock for the single currency such as a populist victory in the Italian elections in March as described above.

Statistical Bulletin

Retail sales (Nov., y/y, nom.)

UK (real): +1.6 % ↓ Retail sales in the UK continued their recent weakness after inflation has surpassed wage growth in mid-2017. Though still growing on a yearly basis, the figure contains very weak sales of non-food goods which are becoming an ever greater drag on the statistic.
Spain: +2.0% → In Spain, the numbers are healthier by comparison; yet they have been shedding their erstwhile dynamic of late.

Consumer confidence (Dec.)

Australia: 103.3 ↑ Consumer confidence in Australia continued to brighten, underlining the continuously improving backdrop of the economy Down Under (see related article above).
US: 95.9 → In the US, by contrast, it has been stagnating, though on very decent levels.

Changes in inventories (Q3/17, q/q, real)

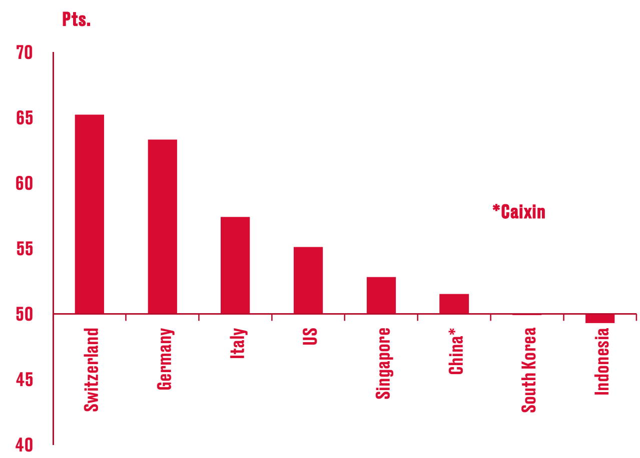
UK: GBP-1.4bn ↓ In another sign of the UK economy losing steam, the country's drag on its inventories in Q3 of 2017 was sizeable and confirmed a, inauspicious, corresponding trend, too.
Canada: CAD+17.1bn ↑ Canada provided the very opposite picture, merrily adding to its inventories by just the right rate to confirm the country's economy upswing.

Unemployment (ILO, Nov.)

Ireland: 6.1% ↓ Unemployment in Ireland improved further and should be lower than 6 per cent as this bulletin gets published. Slowly and steadily, the country's economic convalescence since the shock of the financial crisis has been feeding through to the labour market.
Canada: 5.9% ↓ In Canada, too, the job market gave just another impression of strong economic activity, adding to the expectations of yet another, imminent rate rise by the Bank of Canada at its next policy meeting.

Manufacturing PMI (Dec.)

Globally, sentiment in the manufacturing sector in Switzerland ranked at the very top. For all its political uncertainty, Italy still manages a place in the upper third, while China has been relatively lagging of last. South Korea and Indonesia are among the very few where the index is lower than the neutral 50 points-threshold.



Data: Trading Economics, bloomberg, comdirect, own calculations

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