05 October 2018

Week ahead – A Bolognese full of "Erdoganish" deficit signals

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Italian turmoil has hit European risk appetite this week, while Chair Powell once again lifted US bond yields. The 10yr treasury yield now trades around 3.20% - a substantial break of the post-1984 downtrend. Global risk appetite is at a cross roads.

Italian headlines have filled up most of the news flow this week, as DAX underperformed S&P 500 (again). **It is no wonder that markets are getting concerned about Italy given how "Erdoganish" Luigi Di Maio from the Five Start Movement has sounded in recent weeks.** Subsequently the 10yr Italian bond yield has returned to more normalized levels above 3.30% (Italian bond yields have been too low for years), but with the current pace of the Italian bond sell-off, **it won't take long until Italian debt reaches unsustainable territory.**

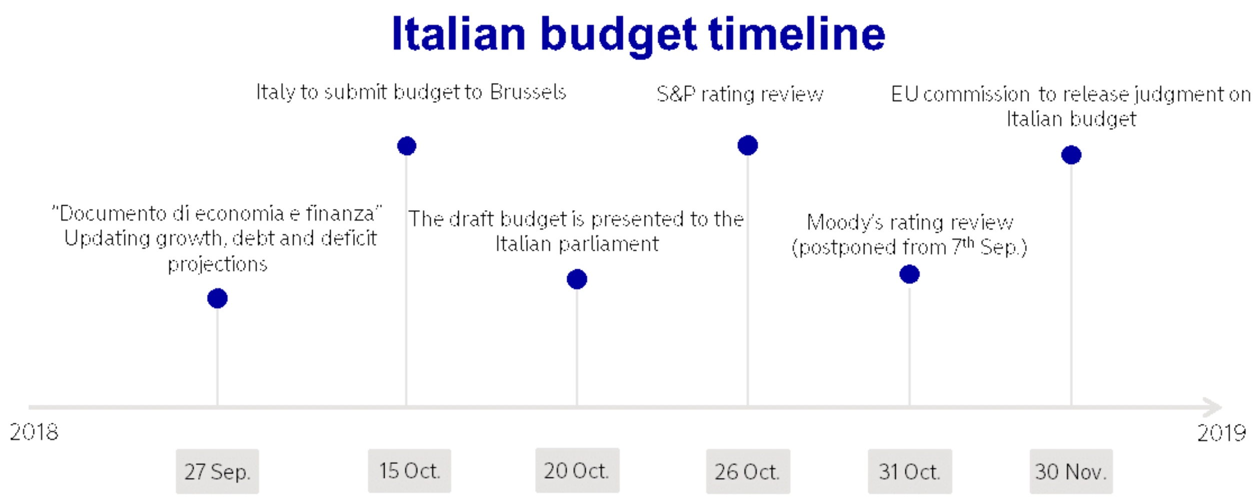
Its concession time, Italy

After the big moves in the Italian bond yields Friday last week and Monday this week, **there have been some early tentative signs that the Italian party leaders Luigi Di Maio and Matteo Salvini will soften the confrontational stance a little.** Even though Di Maio and Salvini will never publicly admit it, they are forced to dance to the market's tune to a certain extent. In May, they moved swiftly to put a lid on the "Italeave" discussion as the rapid Italian bond sell-off forced them to think twice.

So far, the concessions from Italy surround the budget targets for 2020 and 2021. The 2019 proposal of a 2.4% deficit seems carved in stone. **Concessions on the 2019 target are needed as well**, before the market and Brussels will take material comfort in the slightly more conciliatory tone. The markets have heard the "We will deliver next year" phrase too many times from the Italians to really trust it. **Results are needed now**, not later.

Continuing down the initial confrontational path would be suicidal; therefore, **Di Maio and Salvini will start dancing to the market's tune sooner or later.** The big question is whether it will be in time to avoid a downgrade in S&P and Moody's rating reviews later in October. **Overall, we judge that if Italy will be downgraded later this month, markets will have traded on that story already.**

Table1: Important key dates are still ahead for the Italian budget for 2019



Since Feb-2015 <u>the only</u> "funding source" of the Italian deficit has been Banca D'Italia/ECB (no other source has net bought Italian debt since Feb-15), so who will fund the increased deficit plans, when the ECB stops the net purchases of government debt in the QE programme at new year? The short answer is domestic Italian banks. Exactly as they did during the debt crisis in 2011-2012 (see chart 1). It is hard to see how that can fly without a further sell-off in BTPs, why Di Maio and Salvini need to take the recent market reaction very seriously. **Had it been in the spring next year (without the ECB underpinning markets with purchases), it would have been even more dramatic.**

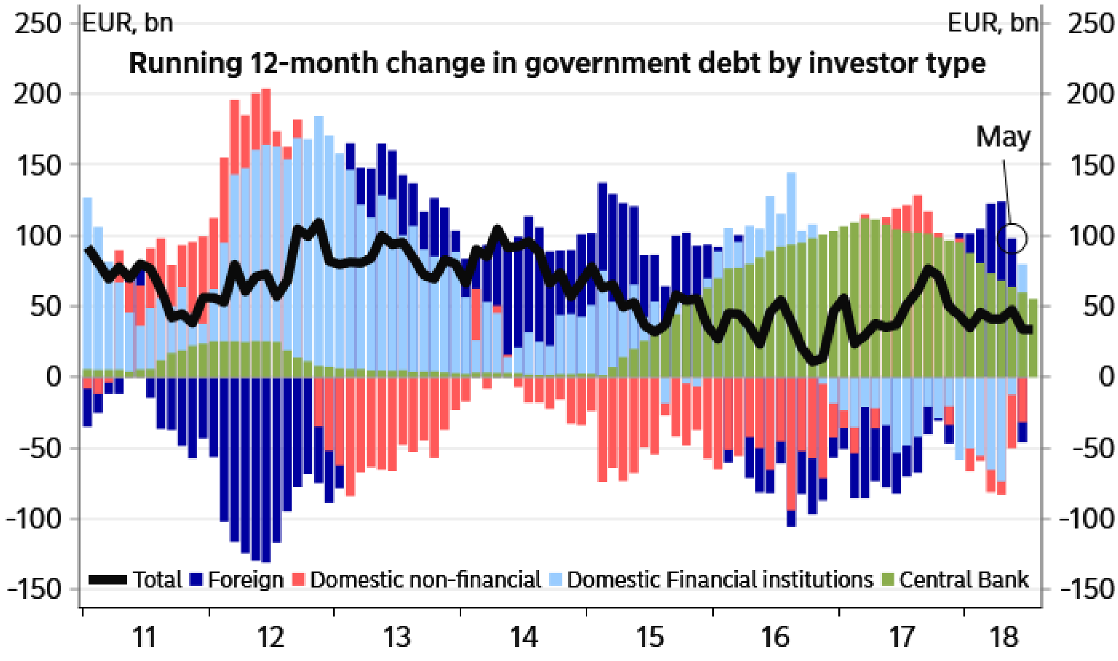
In our models, Italy's debt is roughly sustainable as long as the average bond yield doesn't exceed 3.8% (we are still some 70-100bps from that), but a country with as big a debt burden as Italy ought to have a substantial buffer in case of shocks. That buffer is getting worryingly small.

In the meanwhile, most forward-looking indicators for Italy (and for the Euro area in general) still point south, albeit not dramatically. If i) Italian PMIs drop below or close to 50 (as the leading versus lagging components of the Euro area PMI indicate), ii) the ECB stops net purchases at year-end **and iii) Di Maio/Salvini don't change course, then Italian markets risk facing a Siberian winter rather than an Italian spring when the calendar writes 2019.**

Di Maio and Salvini still have time to soften up and sooner not later Di Maio and Salvini will start dancing to the market's tune. **After all, Italy is not Turkey, why there is a fair chance that calm will be restored.**

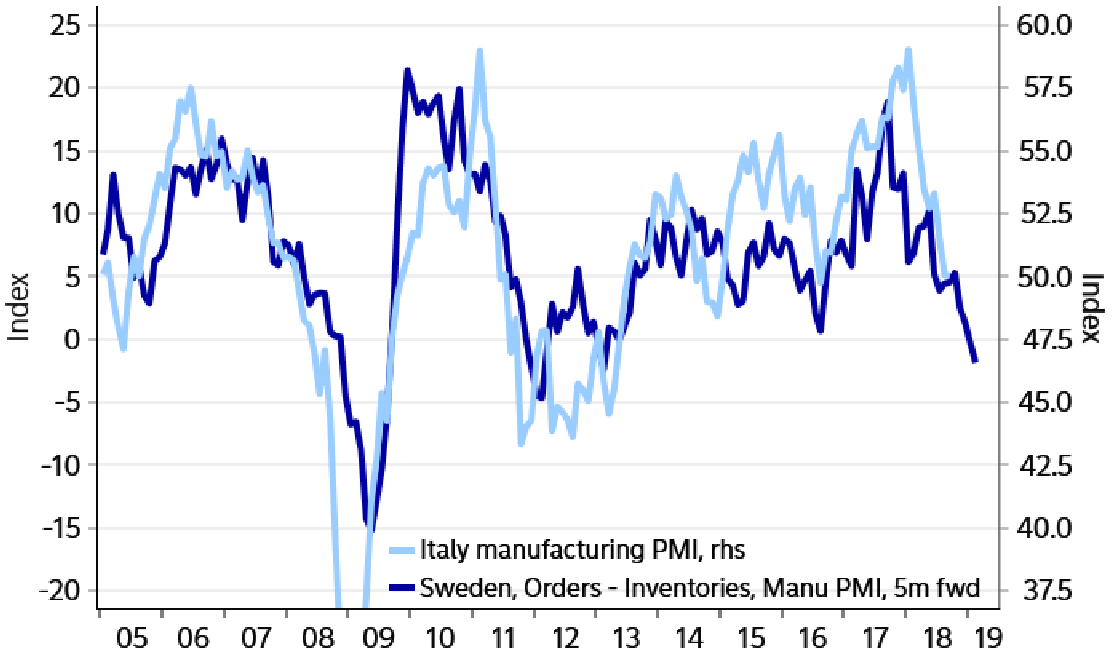
Widening Italian spreads have been a factor behind the re-weakening of the EUR against the USD, but **if the Italy story had been the primary driver, we would have expected EUR/CHF to trade lower as well.** EUR/USD has also dropped due to hawkish Fed signals and year-turn effects in the USD rates space.

Chart 1: Who will fund the Italian deficit, when the ECB "exits". Most likely domestic banks as in 2011-2012



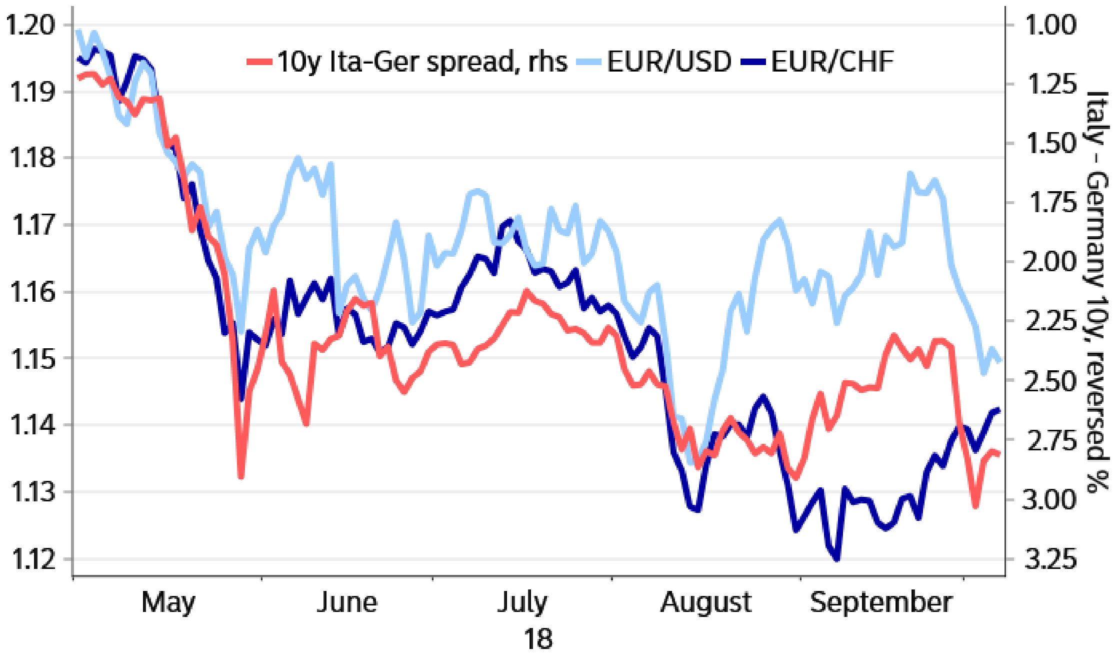
Source: Nordea and Macrobond

Chart 2: Downside risks for Italian PMIs are material



Source: Macrobond and Nordea

Chart 3: Higher EUR/CHF and lower EUR/USD tells us that Italy is not the primary reason for lower EUR/USD



Source: Nordea Markets and Macrobond

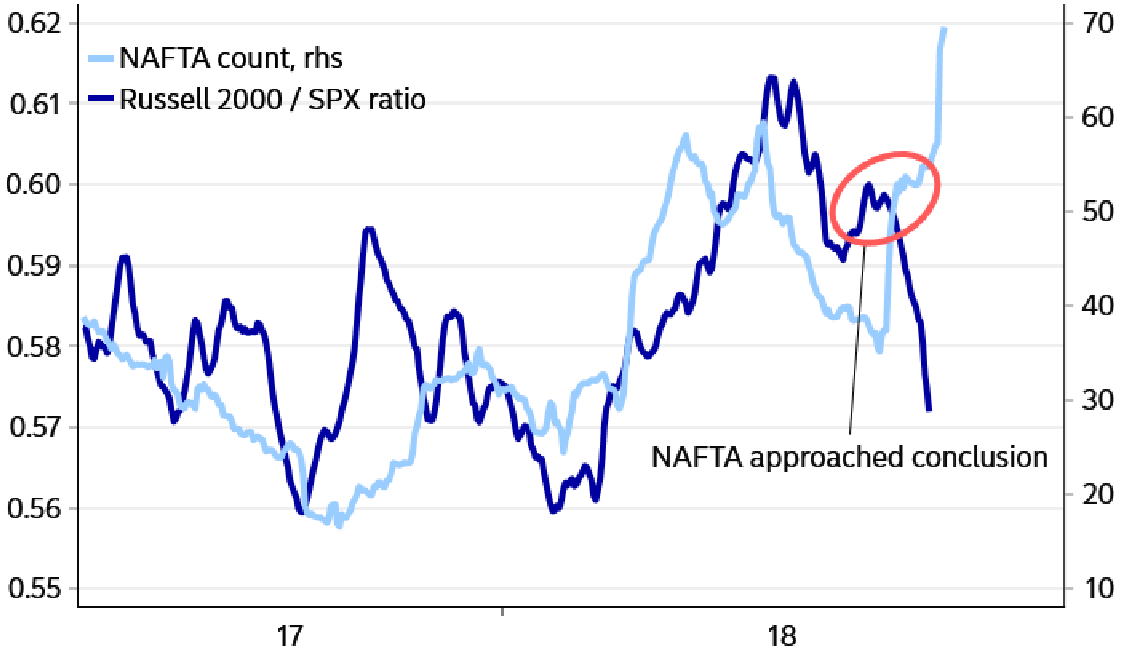
Risk appetite is at a crossroad

Italy woes are though not the only headwinds facing global risk appetite. **Recently small caps have sold off compared to large caps** – and **one potential trigger for that is likely the recent re-signing of NAFTA** between US and Canada. Small caps (more domestically based) have performed relatively to large caps (more vulnerable to international trade) when NAFTA tensions were the highest – now that the trade roadblock is cleared in that regards, small cap underperform again.

This is though the rosy version of the story. The post September sell-off in small caps globally could also be seen as an early signal that the growth momentum is slowing and that investors are moving inwards on the risk curve consequently. **We also argue that small caps are often associated with the kind growth style**, which is the most vulnerable to the rising interest rates that we are witnessing. In general, small caps also have a higher proportion of their cost base in labour and with wage costs on the rise earnings estimate risks should hence be greater in small caps versus large caps. Finally, it's worth remembering that small caps carry greater liquidity risk now that central banks start reducing excess liquidity. **We subscribe to a combination of these explanations.**

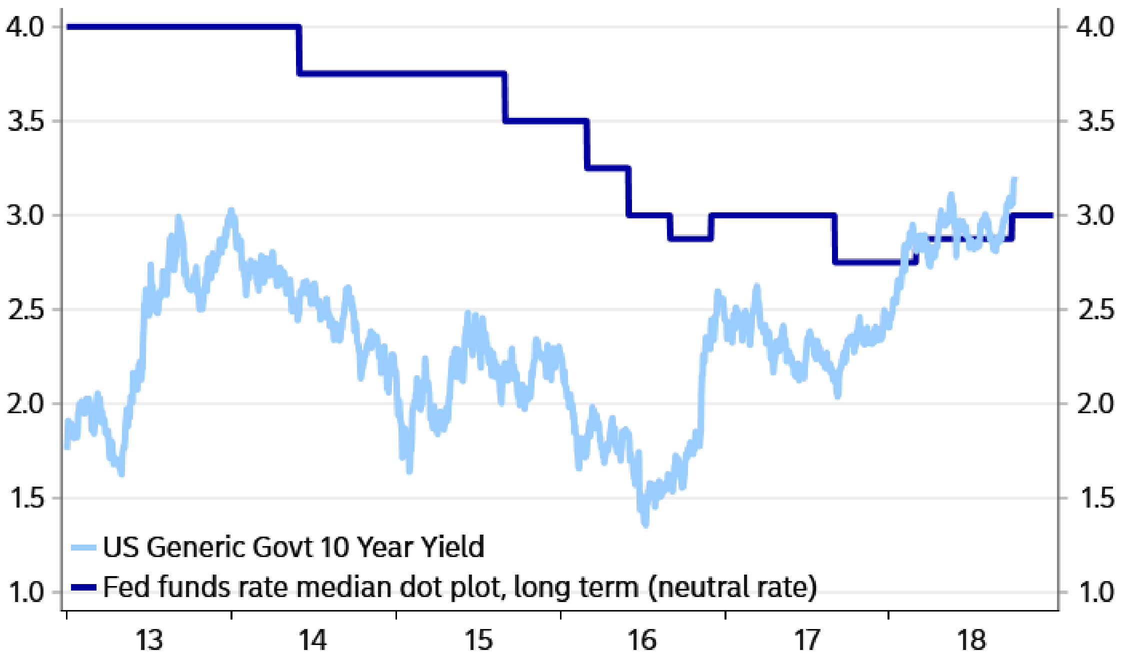
On Wednesday, Fed Chair Powell once again confirmed the hawkish stance by hinting that the Fed "may go above neutral" in the Fed Funds (currently the dot plot indicates a neutral nominal rate at 3% in the dot plot). Powell comments were the final trigger that allowed the 10yr treasury yield to take off compared to the long-term assessment of the Fed Funds rate in the dot plot. **Clearing this hurdle in principle leaves the door wide open to further upside for the 10yr treasury yield** (the strong ISM composite figure from this week indicates a 3.25-3.50% range next up) – **this also leaves the possibility of a temporary re-steepening of the curve elevated in to year-end.**

Chart 4: More NAFTA stories, better relative small cap performance and vice versa



Source: Macrobond and Nordea

Chart 5: The 10yr treasury yield has now cleared the long-term dot plot hurdle



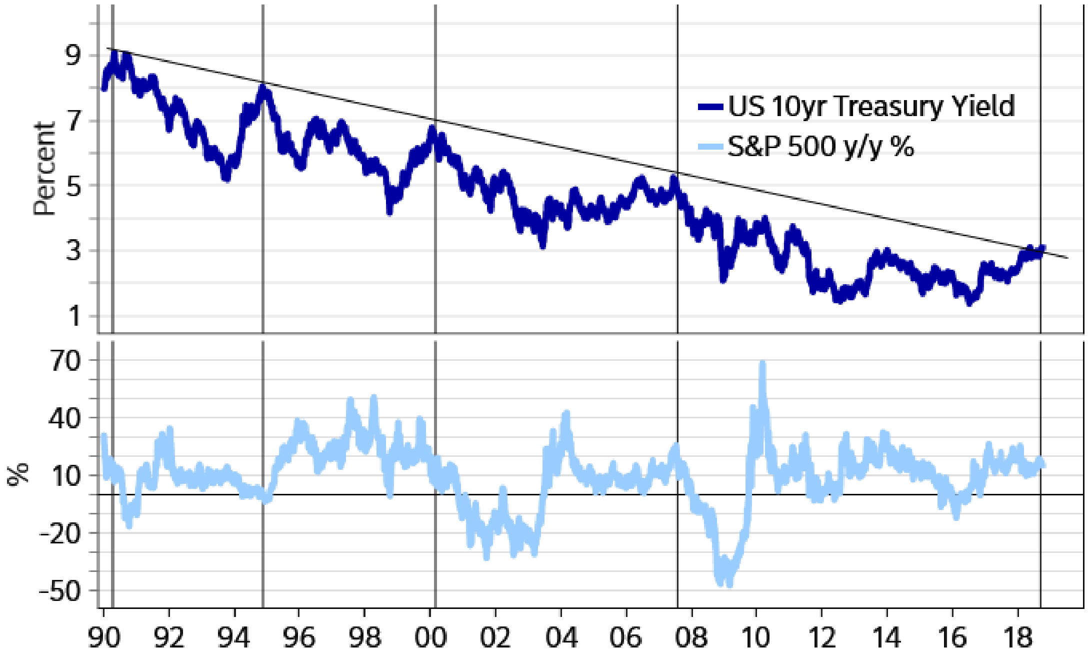
Source: Nordea Markets and Macrobond

A break on the top side of the 3.12% level in the 10yr treasury yield, as we have seen this week, will also reignite the discussion **whether the break of the post-1984 downtrend in the 10yr treasury yield is a signal to worry about for risky assets. Every major test of the post 1984-downtrend has coincided**

with a subsequent turbulent period in S&P 500. Will history rhyme again, now that the trend is not just tested, but broken? We keep a negative tilt for risky assets.

Our story that the US vs. Rest-of-World outperformance is suffering from metal fatigue currently hinges more on the valuation aspect (US equity valuations are very stretched) than the relative macro picture.

Chart 6: Every major test of the post 1984 downtrend in the 10yr treasury yield has coincide with turbulence in S&P 500



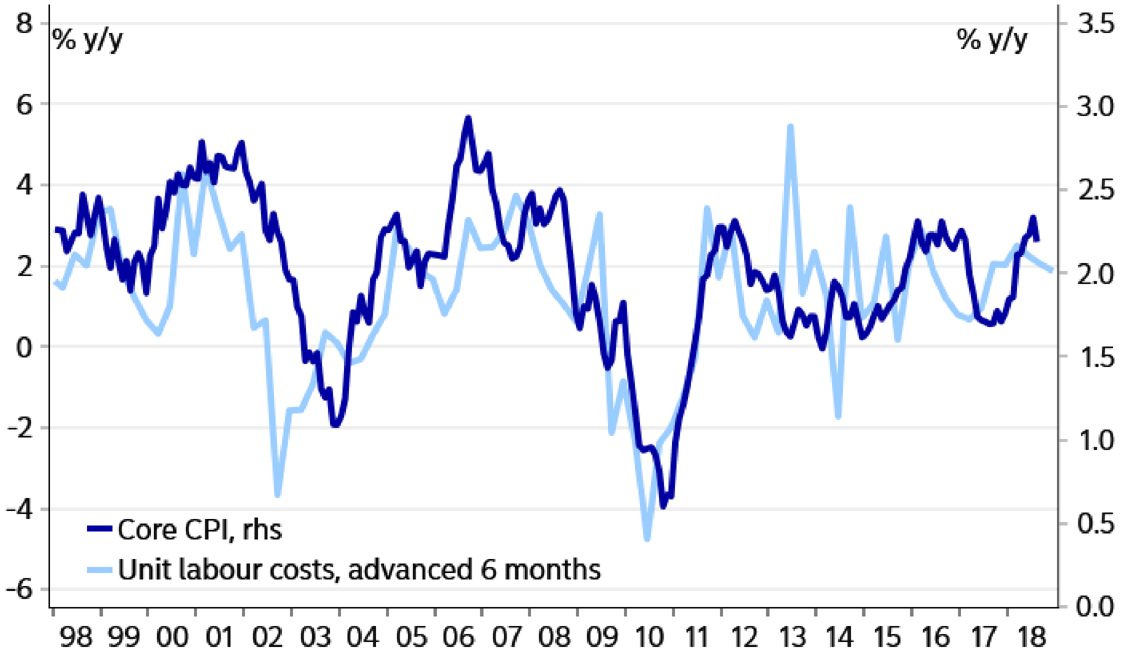
Source: Macrobond and Nordea

What is most important in the week ahead?

We have a big inflation week ahead of us. Both in the US, Norway and Sweden the monthly inflation figures are published with potential important bearing for the monetary policy outlooks.

On Thursday, US inflation is out and it will be interesting to see whether the weaker-than-anticipated inflation from August will slide further. We expect a rebound from 2.2% to 2.3% in the core inflation measure in September with roughly balanced risks. However, we don't see big risks of a sharper acceleration in US core inflation on this side of new year due to the sharp rise in productivity in Q2 (with all the uncertainties surrounding such measure) that kept unit labour costs relatively subdued (productivity adjusted wage growth), among other things. Should US core inflation fade a little towards new year, we don't see it as a big game changer for the Fed, as they have recently started citing financial excess as another reason to continue quarterly rate hikes.

Chart 7: US core inflation will not accelerate further on this side of 2019. Expect 2.3% in September



Source: Nordea Markets and Macrobond

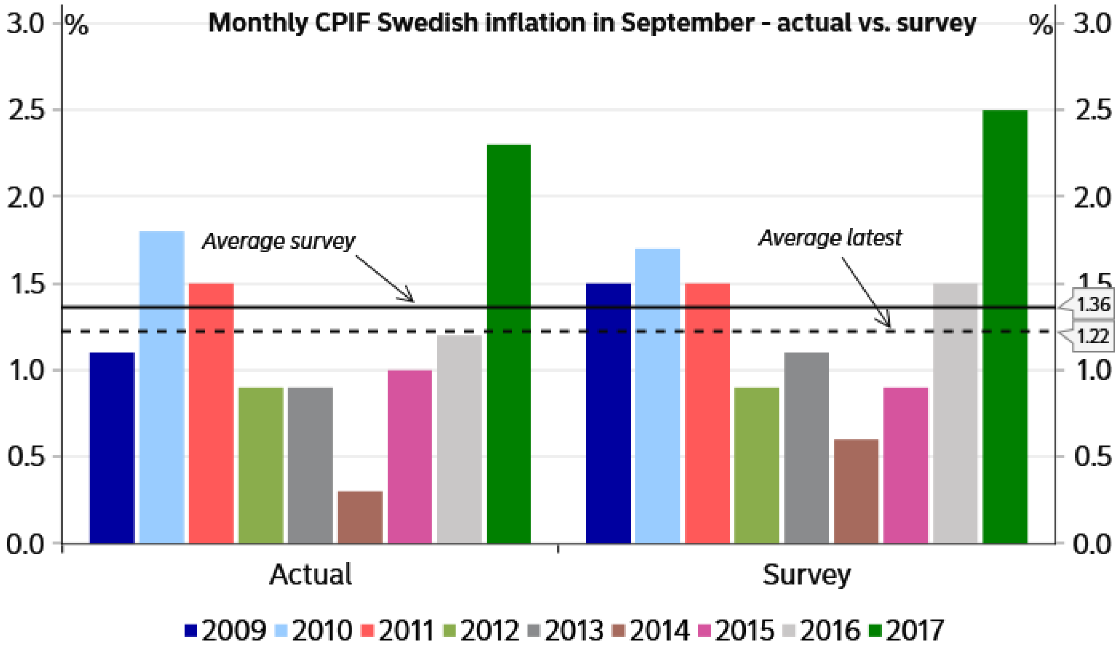
After a light news week in Scandinavia, **inflation data are out from Norway and Sweden on Wednesday and Thursday, respectively.** We forecast Norwegian core inflation at 1.8% in September (Norway inflation preview: Was the August rise temporary?), above Norges Bank's view of 1.6%. The 1.9% core inflation (CPI-ATE) was not fully discounted in Norges Bank's rate path in September, as they viewed the 1.9% reading as temporarily high. This month's figure is thus a litmus test of that view from Norges Bank. **We bet that they will be hawkishly surprised.**

In Sweden the inflation figure on Thursday is kind of a make or break it data point for the potential Riksbank hike in December. Last week the important deputy governor Per Jansson pre-warned that a rebound in Swedish core inflation (and service inflation in particular) is a prerequisite for a tighter Swedish monetary policy. On average September has been a month **when the consensus has been negatively surprised by the actual CPIF price growth in Sweden.** Estimates have on average been roughly 0.15 percentage points too high since 2009 and even more so in the last two consecutive years.

Nordea sees CPIF inflation at 2.3% (1.5% in CPIF ex. energy) in Sweden on Wednesday. Our forecasts are below the Riksbank's view. In addition, the risks to our forecast are on the downside. (Swedish September CPIF preview: Risks on the downside).

We keep our more positive view on NOK compared to SEK intact as a consequence.

Chart 8: Consensus expectations are usually too high in September for Swedish inflation



Source: Nordea and Macrobond

Lastly, we need to keep a watchful eye on the ECB's monetary policy account on Thursday. Usually it is not a market mover, but it could be this time around, if early discussions on the reinvestment programme next year are revealed. Recently rumours surrounding a potential operation twist (buying more long-dated bonds in exchange for less ownership of shorter running bonds) have swirled. More clarity on a potential operation twist could help calm markets surrounding Italian debt.

Editorial by Senior Global Strategist, Andreas Steno Larsen

Key research pieces over the past week:

FX weekly: Along came year-end (30 September)

NOK: How far can you go? (02 October)

EM Traffic Light September 2018 (02 October)

China monthly: Looking beyond the trade war (04 October)

Brazil election: a hope for a lesser evil (04 October)

Norway inflation preview: Was the August rise temporary? (04 October)

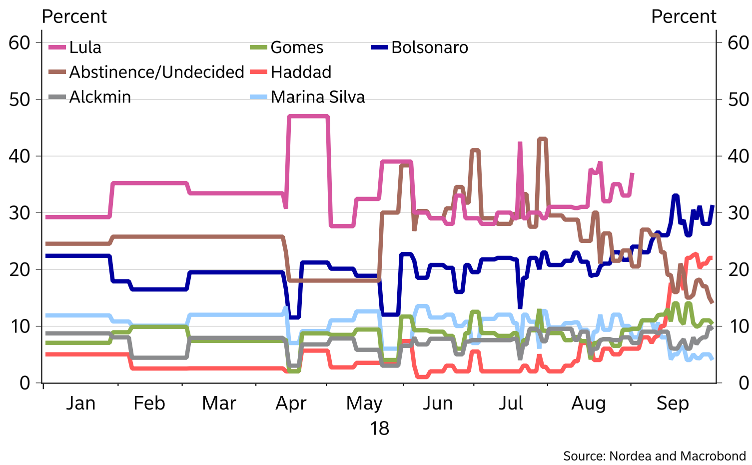
Swedish September CPIF preview: Risks on the downside (05 October)

Table 1: Main releases to watch

Date	Key figure	Nordea	Consensus	Last
10-Oct	NO: CPI, core (y/y)	1.8%		1.9%
11-Oct	SE: CPIF (y/y)	2.3%		2.2%
11-Oct	US: CPI, core (y/y)	2.3%	2.3%	2.3%
11-Oct	EU: ECB monetary policy accounts			

Sunday

Sunday, 08/10/2018				Nordea	Consensus	Previous
	BR	**Presidential election**				



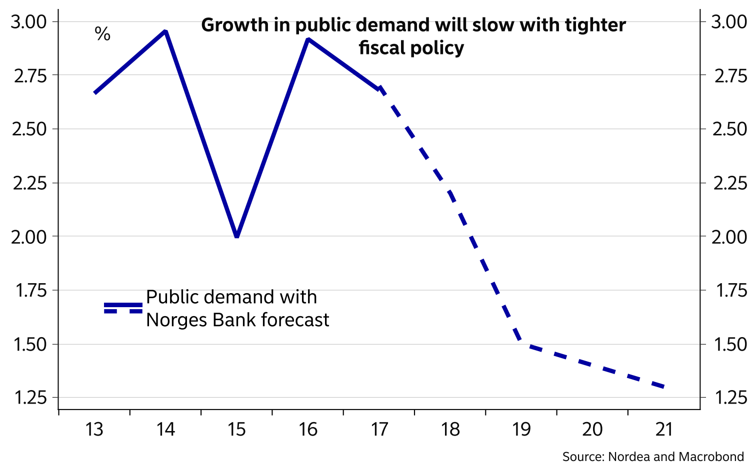
Brazilians will go to the polls on Sunday. Besides electing a new president, all members in the Chamber of Deputies and two-thirds of the 81 senators will be contested. The markets will especially be following the presidential election with some nervousness, as the Brazilian economy is screaming for a reform front-runner who can secure the long-term sustainability of public finances. Leftist "Lula proxy", Fernando Haddad, is along with far-right and populist candidate, Jair Bolsonaro, the two the favourites. None of these candidates are, however, ideal in the eyes of the markets. As Brazil's electoral system requires a candidate receiving more than 50% to get elected in the first round, the most likely outcome is Bolsonaro and Haddad facing each other in a second run-off scheduled 28 October. Read more here.

By Morten Lund

Monday

The week starts off with a light day on the data front. From Norway we get manufacturing production numbers. The Fed's Bullard (dove, non-voter) speaks during the day.

Monday, 08/10/2018				Nordea	Consensus	Previous
08:00	DE	Industrial production (m/m)	Aug		0.5%	-1.1%
08:00	NO	Manufacturing production (m/m)	Aug			
10:00	**NO**	**Government Budget**				



There will be a lot of media coverage of the government's 2019 budget proposal, but it is seldom given much weight in the market. However, Norges Bank makes explicit fiscal policy assumption. For 2019 Norges Bank expects the deficit on the non-oil structural budget ("spending of oil money") to increase by 0.1% of mainland GDP, which means a very minor fiscal stimulus. There is room for a stronger increase in deficit while still keeping the budget in line with the spending rule. But given the Finance minister's talk about a "tight" budget and the outlook for the economy, we share Norges Bank's assumptions about only a minor deficit increase.

By Erik Bruce

11:30	US	Fed's Bullard Speaking in Singapore				

Tuesday

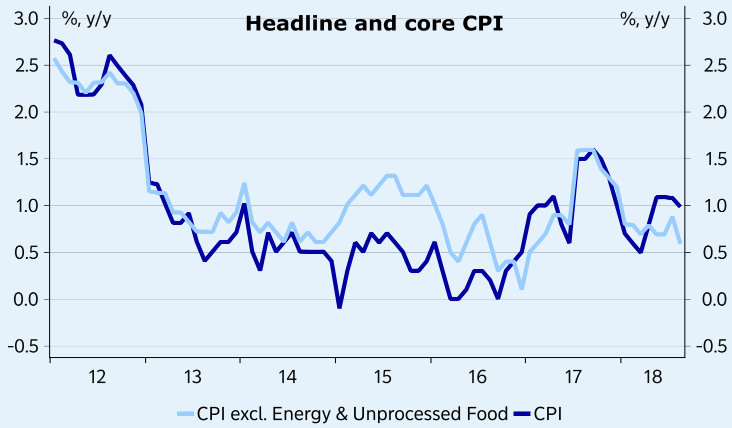
Tuesday is also a light day with regard to key events. From Norway we receive monthly GDP data – a new figure which has just recently started to be published. From the US we receive the NFIB Small Business Optimism. The FOMC members Williams (hawk/neutral, voter) and Harker (neutral, non-voter) speak during the day.

Tuesday, 09/10/2018				Nordea	Consensus	Previous
08:00	DK	Trade balance, ex. ships (sa)	Aug			7.4bn
08:00	NO	Mainland GDP (m/m)	Aug	0.2%		0.2%
08:00	NO	Øystein Olsen - Speech at Bank of Thailand				
09:00	SE	Riksbank's Skingsley: 10 years after the financial crisis (not published)				
12:00	US	NFIB small business optimism index	Sep		109.0	108.8
15:30	EU	ECB's Francois Villeroy de Galhau speaks in Paris				
16:35	US	Fed's Williams, Indonesia Cen. Bank's Warjiyo speak to press				
19:00	US	Fed's Harker Speaks on Importance of Education to the Economy				

Wednesday

Wednesday is a big Scandi inflation day. We receive inflation numbers from both Denmark and Norway, and from Sweden we get unemployment rate. The Fed's Williams (hawk/neutral, voter) and Evans (dove, non-voter) speak during the day.

Wednesday, 10/10/2018				Nordea	Consensus	Previous
03:15	US	Fed's Williams Speaks on Recent Monetary Policy Developments				
06:00	SE	Unemployment, Swedish Public Employment Service				3.9%
08:00	DK	CPI (m/m)	Sep	0.1%		-0.4%
08:00	**DK**	**CPI (y/y)**	**Sep**	**1.0%**		**1.0%**



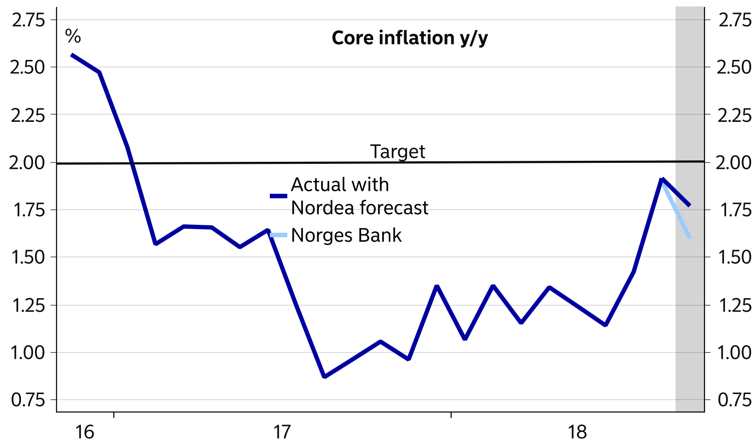
Source: Nordea Markets and Macrobond

In August Danish CPI fell by 0.4% m/m, mainly due to seasonal effects from lower rents on summer houses and falling prices on package holidays. This made the year-over-year change drop to 1.0%, down from previously 1.1%. In September we expect CPI to increase by 0.1% m/m, mainly driven by higher prices of clothes and footwear. Also, higher prices of energy are expected to have made a positive contribution. Measured year-over-year we expect consumer prices to have stayed unchanged at 1.0% in September.

By Jan Størup Nielsen

08:00	DK	Current account balance (sa)	Aug			14.4bn
08:00	NO	CPI (y/y)	Sep	3.1%		3.4%

Wednesday, 10/10/2018 (continued)				Nordea	Consensus	Previous
08:00	NO	CPI, core (y/y)	Sep	1.8%		1.9%



Source: Nordea Markets and Macrobond

Norges Bank surprised with a downward adjustment of the rate path at the latest MPC meeting. One reason for this was that Norges Bank saw the high August inflation figure at 1.9% as temporarily high, driven up partly by a sharp rise in price growth of clothes and shoes. It forecasts inflation to drop to 1.6% in September. We also forecast lower inflation in September, but only down to 1.8%. Our forecast is based on lower price growth y/yof clothes and shoes (from +1% to -1.6% y/y), but if we are to guess, Norges Bank is based on a much sharper drop. If we are right, it will indicate that the August raise was more lasting, and it will point to an upward revision to the December path.

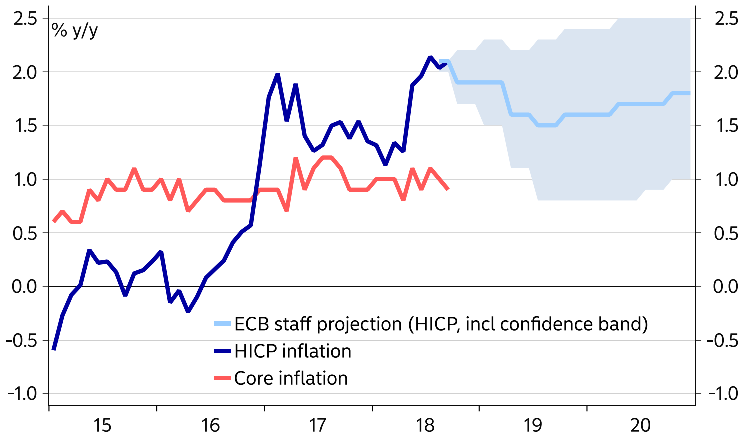
By Erik Bruce

08:00	SE	Prospera, inflation expectations, monthly survey				
08:45	FR	Industrial production (m/m)	Aug			0.7%
09:15	SE	NIER publish their forecasts				
09:30	SE	Household Consumption (m/m)	Aug			-2.1%
09:30	SE	Household Consumption (y/y)	Aug			-0.1%
10:30	GB	Industrial production (m/m)	Aug		0.1%	0.1%
10:30	GB	Industrial production (y/y)	Aug		1.0%	0.9%
10:30	GB	Manufacturing production (m/m)	Aug		0.1%	-0.2%
10:30	GB	Manufacturing production (y/y)	Aug		1.1%	1.1%
11:00	NO	Auction of Treasury Bonds				
13:00	US	Mortgage applications, MBA	Oct			
14:00	RU	CPI (y/y)	Sep	3.3%	3.3%	3.1%
14:30	US	PPI final demand (m/m)	Sep		0.2%	-0.1%
14:30	US	PPI final demand (y/y)	Sep		2.7%	2.8%
14:30	US	PPI, core (m/m)	Sep		0.2%	-0.1%
14:30	US	PPI, core (y/y)	Sep		2.6%	2.3%
18:15	US	Fed's Evans Speaks on Economy and Monetary Policy				

Thursday

Today is filled with interesting releases. From the US, we get inflation figures and the ECB publishes its monetary policy accounts. From Sweden we get inflation figures and housing prices. The Fed's Bostic (dove, voter) speaks during the day.

Thursday, 11/10/2018				Nordea	Consensus	Previous
	US	Fed's Bostic Speaks on Economic Outlook				
01:01	GB	House price balance, RICS	Sep		1.0%	2.0%
07:30	**EU**	**ECB monetary policy accounts**				



Source: Nordea Markets and Macrobond

The minutes of the ECB meeting that ended 13 September will be released today. The minutes usually do not lead to market reactions, but it could this time if revealing early discussions about the reinvestment policy after QE, although President Draghi said at the press meeting that it would be discussed at one of the two last meetings of the year. Moreover, discussions about the growth outlook will be watched carefully too, given the stories ahead of the meeting that the growth outlook could be revised to a "negative" from "broadly balanced" risk assessment.

By Anders Svendsen

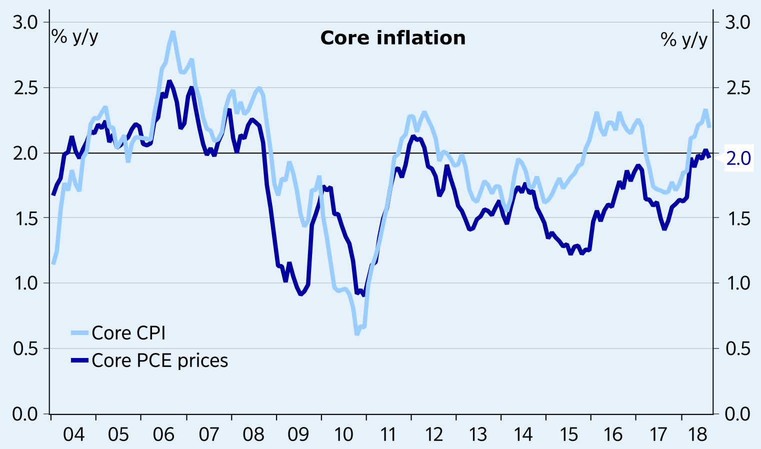
08:45	FR	HICP (y/y)	Sep			2.5%
09:30	SE	CPI(m/m)	Sep	0.3%		-0.2%
09:30	SE	CPI(y/y)	Sep	2.2%		2.0%
09:30	SE	CPI, index	Sep	330.60		329.63
09:30	SE	CPIF excl. energy (y/y)	Sep	1.5%		1.2%
09:30	SE	CPIF(m/m)	Sep	0.3%		-0.2%
09:30	**SE**	**CPIF(y/y)**	**Sep**	**2.3%**		**2.2%**

Source: Nordea Markets and Macrobond

We expect CPIF inflation reading to be 2.3% and see CPIF ex energy at 1.5% y/y for September. Our forecast is below the Riksbank's view. In addition, the risks to our forecast are on the downside. Still, the bank seems to have set its sights on a rate hike around the turn of the year. We believe that it will be sanctioned in December. It will be a one-off rate hike. In our view, inflation will fall back mid-next year, making further rate hikes unlikely until late 2019 when the ECB is expected to take the first step. Read more here.

By Torbjörn Isaksson

Thursday, 11/10/2018 (continued)				Nordea	Consensus	Previous
09:30	SE	House prices, Statistics Sweden (y/y)	Sep			
11:00	SE	SNDO to auction inflation-linked bonds				
14:30	US	CPI (m/m)	Sep	0.3%	0.2%	0.2%
14:30	US	CPI (y/y)	Sep	2.5%	2.4%	2.7%
14:30	US	CPI, core (m/m)	Sep	0.2%	0.2%	0.1%
14:30	**US**	**CPI, core (y/y)**	**Sep**	**2.3%**	**2.3%**	**2.2%**



Source: Nordea and Macrobond

We expect a small rebound in US core CPI in September - following the downside surprise in August - with an increase of 0.2% m/m, corresponding to a small increase to 2.3% y/y from 2.2% y/y in August. Temporary drops in goods prices and in medicare services in August are likely to reverse slightly. Risks are balanced. October and November are likely to see slightly higher core inflation. We expect headline CPI to have increased by 0.3% m/m in September, corresponding to a drop to 2.5% y/y from 2.7% y/y in August.

By Anders Svendsen

14:30	US	Jobless claims, continuing	Oct			1650k
14:30	US	Jobless claims, initial	Oct			207k

Friday

On Friday the calendar is light. Final German inflation figures are released, and we receive trade balance numbers from both the US and China, which could prove interesting given the ongoing trade dispute between the two countries. The Fed’s Evans (dove, non-voter) and Bostic (dove, voter) speak during the day.

Friday, 12/10/2018				Nordea	Consensus	Previous
01:00	IN	CPI (y/y)	Sep			3.7%
04:00	CN	Exports (y/y)	Sep		8.7%	9.8%
04:00	CN	Imports (y/y)	Sep		14.5%	19.9%
04:00	CN	Trade balance (USD)	Sep		24.6bn	27.9bn
08:00	DE	HICP (y/y, final)	Sep		2.2%	2.2%
11:00	EU	Industrial production (m/m, sa)	Aug		0.5%	-0.8%
12:00	RU	Trade balance (USD)	Aug		15.0bn	13.4bn
14:30	US	Import prices (m/m)	Sep		0.3%	-0.6%
14:30	US	Import prices (y/y)	Sep			3.7%
15:30	US	Fed's Evans Takes Part in Moderated Discussion on Economy				
16:00	US	Consumer confidence, U. of Mich., 5-10Y inflation (prelim.)	Oct			2.5%
16:00	US	Consumer confidence, University of Michigan (preliminary)	Oct		100.8	100.1
18:30	US	Fed's Bostic Discusses Recruitment, Economics & Public Policy				

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