Markets recover from latest jitters

It seems odd, but the Italian coalition government markets once most feared, is now deemed preferable to another election

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Better the devil you barely know...

Markets have recovered their poise now that alternatives are being sought for the Italian finance ministry job after President Mattarella blocked the appointment of Eurosceptic, Paolo Savona. 5-Star's Di Maio has sounded willing to nominate a new Finance Minister, but the League's Salvini is holding back. Failure to find a compromise candidate for the Finance Ministry job could well see Italy going to the polls again, and maybe this time, the election would be fought out along the lines of Euro-membership or exit. We expect to see new suggestions for the cabinet rolled out on Tuesday / Wednesday.

But even then, we don't see an imminent referendum in Italy on Italexit. Firstly, both 5-star and the League have toned down their eurosceptic comments and say they do not intend to lead Italy out of the Eurozone. Secondly, failure to endorse constitutional reforms back when Matteo Renzi was leading the country, means that the constitutional road to euro exit is a long and arduous one for Italy and not even one that would necessarily be voted for. It is not even strictly true to state that Italy is one of the most Eurosceptic members of the single currency. With about 60% of the electorate broadly in favour of remaining in the Euro, it could perhaps be described instead as one of the least Europhilic.

Still, having been away from my desk for the last 4 days, it is remarkable to see how markets have reacted to this turn of news - and scarcely conceivable that this Italian story is entirely to blame for the gyrations in the US Treasury market. Surely there's more?

All is not well on the trade front

Although different members of the US trade negotiating team seem to have different views on how progress with China is going, a more pressing deadline is looming in terms of the deadline for talks between the EU and US on steel and aluminium, which expires tomorrow. The EU has outlined the US goods it will sanction in retaliation for the tariffs. This would push the trade war another step along a path that can only lead to slower global growth, higher prices, and lower profits. That there may be political motivations for the US tariffs we do not dispute. But 3000 years of history strongly demonstrates that more trade makes us better off. We don't think anything has changed in the last few years to change that conclusion.

Inflation dominates G-7 calendar

Following stronger than expected German May inflation data yesterday, that could well translate into a higher figure for the EU as a whole, released later today. The headline numbers are estimated to have picked up from 1.2%YoY in April to 1.6% in May, but the German numbers indicate that a 1.7% or even 1.8% outcome cannot be ruled out. If so, that would put ECB tapering back into the limelight, which given a helpful shove by Italian politics, could see the EUR make back some of its recent lost ground.

PCE inflation in the US is likely to have stayed at 2.0%YoY in April, and the core rate maybe even eased back from 1.9% to 1.8%. But even an upside surprise here is not likely to elicit much response from markets, given the FOMC's recent intimation that is might allow inflation to run a little higher than target until expectations have picked up.

APAC day ahead

The Asia Pacific calendar has got off to a mixed start with the Korean industrial production numbers for April bouncing from -2.2%MoM, to +3.4%MoM, and lifting the year on year rate of growth back into positive territory. The cyclical leading indicator is still looking pretty negative, however, and we aren't completely convinced that this downturn is over. That said, we aren't all that concerned either. This is a good-old-fashioned inventory led production downturn. They come, but they soon go again, and the economy comes back stronger as a result.

Japan also released April industrial production data this morning. The general picture in Japan is similar to that in Korea, with inventories weighing on production. And the 0.3%MoM gain in April was much less than the 1.4% expectation. Electronics were one of the weaker parts of the production story. That said, inventory ratios now seem to be moving in the right direction, and the worst of the inventory correction in Japan may now be over. Better data loom ahead.

India releases 1Q18 GDP later today. We aren't as upbeat as the consensus on this number (see here for more detail) and are looking for the RBI to hike rates again as soon as next week to provide further support for the rupee. Thai Balance of Payments trade data is also released today, but as we have already had the customs basis figures for April, this should not be much of a market mover, and has little impact on our expectations for Bank of Thailand Policy).

Author

Robert Carnell
Regional Head of Research, Asia-Pacific
robert.carnell@asia.ing.com

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