

STRATEGY WEEKLY

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Italy: the predictable crisis

Key Points

- **Projected Italian deficits look inconsistent with planned debt reduction**
- **BTP under pressure leads to weakness in bank stocks**
- **Fed eludes balance sheet policy**
- **Nikkei (+1.5%) gains on cheaper yen (114 against the dollar)**
- **North American trade agreement benefits CAD**

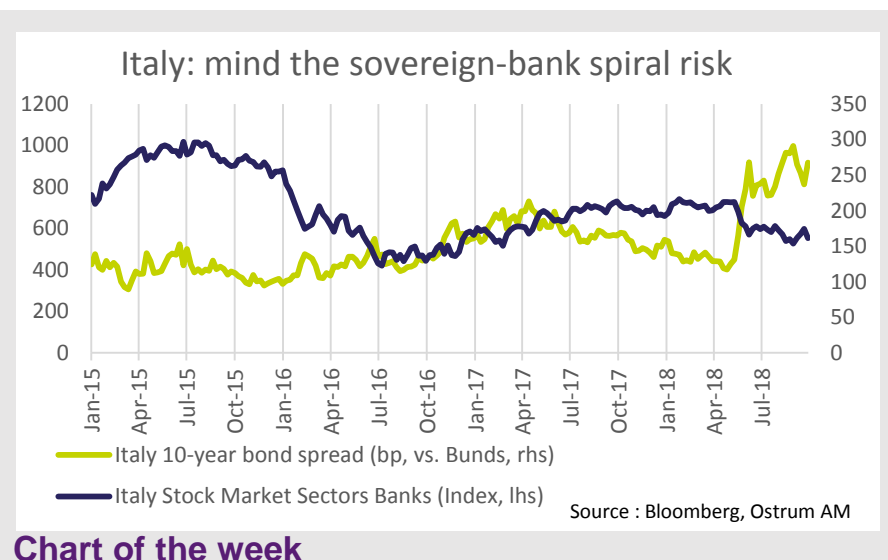
Italy remains the main risk across financial markets. Forecasted budgets for the 2019-2021 period appear to contradict commitments to fiscal soundness. Italian spreads shot up to 285bp as bank stocks plunged. The euro, pricing in political risk, weakened below the 1.16\$ threshold. Bund played its safe haven role, dipping back below 0.50%.

In the US, Powell confirmed the upward trend on rates until 2020 but failed to provide guidance on the balance sheet policy. T-note yields briefly touched 3.10% before easing. Equity markets traded sideways last week. Energy gained on dearer oil prices. In Asia, stock markets rose thanks

in part to cheaper currencies. The Nikkei gained 1.5% as the dollar-exchange rate crossed 114. North-American currencies (CAD, MXN) appreciated as Canada joined the Mexico-US trade deal.

Credit spreads in euro IG space were slightly wider (+1pb). CDS indices over-reacted especially subordinated financials (+8bp last week). European bonds rated in speculative category however tightened by about 5bp.

Emerging bonds keep rallying. Final investor flows trend higher and the pickup in foreign exchange has led to tighter spreads. Overall, the EMBI is now under the 340bp mark.



Fiscal outlook looks inconsistent with reduction in Italy's public debt.

Spreads have widened towards high end of prior range.

Banks' BTP exposure increased to the tune of 50b this year as lenders absorbed selling from non-resident investors.

The plunge in bank stocks highlights the risk of a negative self-reinforcing spiral between the sovereign and the local banking sector.

Chart of the week

Italy: the predictable crisis

Italian political risk is again on everyone's minds in financial markets. Whilst details lack at this juncture, the government announced an agreement to raise the deficit to 2.4% of GDP over the 2019-2021 period. Growth forecasts used in government figures is believed to be as high as 1.6% next year. Whilst government forecasts always fall on the optimistic side, this particular assumption hints at significant fiscal slippage risk ahead in case of an economic slowdown. Current economic surveys certainly do not support a recovery scenario. The 2016 deficit stood at 2.4%, including 0.5pp tied to bank recapitalisation. The latest 0.1pp upward revision stems from higher spending and lower tax revenue. Italy has little room for manoeuvre indeed, so that the debt load is unlikely to shrink in the short run. As regards new spending, M5S's Luigi DiMaio presumably secured €10b worth of funding for the citizens' income plan in 2019. Finance Minister Giovanni Tria also committed to a doubling of public investment spending that had fallen to a mere 1.5% of GDP in the past few years. Infrastructure notoriously requires immediate improvement. Without a VAT hike, it is hard to predict a pickup in government revenue.

In bond markets, spreads (285bp, close to August highs) rose as predicted. The possible dismissal of Tria, after the budget vote, may feed volatility further. Italian rating cut look inevitable. Downgrades may alter repo conditions in BTP space. In this context, we hold on to an underweight stance on Italian bonds. Bunds benefitted from flight to safety bids. The 10-year German bonds outperformed swaps to the tune of 2bp last week and trades under the 0.50% mark. Mario Draghi's comments pointing to core inflation robustness had sparked Bund selling earlier on. September inflation data were sobering with core inflation running at a 0.9% clip from a year ago. Inflation-linked bonds may nevertheless be protected by improving price seasonality and higher oil prices. Low inflation still limits downside risk on bonds especially as 10-year yield are back within their 0.30-0.50% range. Fair value remains at 0.43% on our estimates.

Italian budget outlook weighs on bank stocks. Italy's banks lost 8% on Friday. Financials' subordinated bonds also weakened. Selling from non-resident investors since the formation of the M5S-Lega government have been absorbed by local banks. Exposure to Italian sovereign bonds increased by as much as \$50b in 2018, which only adds to the risk of downward spiral between banks and the Italian sovereign. In general, political risk took a toll on euro-denominated assets. Hence stocks fell in response to a weaker currency. Automobile stocks were under

pressure, just as chemicals and transport hit by elevated oil prices.

Fed: Powell remains silent on balance-sheet policy

In the United States, Jerome Powell raised rates as planned but did not unveil his balance sheet plans for next year. In our view, this should be the Fed's primary focus. Treasuries on fed balance sheet will amortize at a pace of \$30b a month in 4Q18. If the current cap is maintained, reinvestments will stop in January 2019. Furthermore, MBS redemption payments have fallen below the threshold set by the Fed (\$20b in 4Q18), so that the Central Bank no longer reinvests. As concerns the rate guidance, three hikes appear likely next year before an additional move the year after. A first rate cut is projected in 2021. In this context, speculative positioning had been short heading into the FOMC. Buybacks brought yields back towards 3.05% after the decision was made public. That said, from a week ago, yields are basically unchanged and close to 3.05%, our fair value estimate. The absence of surprises in the Fed's statement held volatility at low levels. Neutral stance looks warranted. That said, we hold on to our steepener on 10s30s.

The strong growth backdrop (3-3.5%qa in the three months to September) continue to support US equities. On a sector basis, curve flatness seemingly hurts financials. The rise in oil prices benefits energy stocks despite current supply constraints in Texas. Lastly, Technology keeps pulling markets higher. In turn USD credit has seen some selling flows, including in high yield space.

The euro falls back, whilst North-American trade deal benefits CAD, MXN

In foreign-exchange markets, tentative signs of a euro rebound towards \$1.18 disappeared as the Italian situation took a turn for the worse. The short speculative base in the euro is already quite wide, which still entails support. Draghi seemingly helped the currency higher insisting on the outlook for a pickup in inflation.

The yen remains quite weak despite higher JGB yields. The dollar-ten has crossed the 114 threshold. Inclusion of Canada in the US-Mexico trade deal led to CAD appreciation. BoC rate rises may resume shortly.

Lastly, emerging currencies (BRL, TRY) rebounded. In turn, currency appreciation helped dollar-debt spreads tighter across the board.

Main Market Indicators

G4 Government Bonds	01-Oct-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.54 %	-3	+6	+9
EUR Bunds 10y	0.47%	-4	+15	+4
EUR Bunds 2s10s	101 bp	-1	+8	-4
USD Treasuries 2y	2.82 %	+0	+19	+94
USD Treasuries 10y	3.07 %	-2	+21	+67
USD Treasuries 2s10s	25 bp	-2	+2	-27
GBP Gilt 10y	1.59 %	-3	+16	+40
JPY JGB 10y	0.14 %	+0	+3	+9
€ Sovereign Spreads (10y)	01-Oct-18	-1w k (bp)	-1m (bp)	Ytd (bp)
France	35 bp	+3	0	0
Italy	283 bp	+39	-8	+124
Spain	106 bp	+4	-9	-8
Inflation Break-evens (10y)	01-Oct-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR OATi	141 bp	+1	+2	-2
USD TIPS	214 bp	-2	+5	+16
GBP Gilt Index-Linked	322 bp	+4	+17	+16
EUR Credit Indices	01-Oct-18	-1w k (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	114 bp	+1	-2	+28
EUR Agencies OAS	50 bp	+2	+1	+12
EUR Securitized - Covered OAS	50 bp	+1	-1	+10
EUR Pan-European High Yield OAS	346 bp	+0	-4	+52
EUR/USD CDS Indices 5y	01-Oct-18	-1w k (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	67 bp	-2	-1	+23
iTraxx Crossover	273 bp	+2	-25	+40
CDX IG	59 bp	-3	-1	+10
CDX High Yield	332 bp	+13	+2	+24
Emerging Markets	01-Oct-18	-1w k (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	335 bp	-8	-20	+50
Currencies	01-Oct-18	-1w k (%)	-1m (%)	Ytd (%)
EUR/USD	\$1.157	-1.7	-0.39	-3.61
GBP/USD	\$1.304	-0.99	+1.22	-3.52
USD/JPY	¥113.98	-0.93	-2.53	-1.13
Commodity Futures	01-Oct-18	-1w k (\$)	-1m (\$)	Ytd (\$)
Crude Brent	\$84.3	\$3.8	\$6.9	\$20.7
Gold	\$1 188.3	-\$12.8	-\$13.1	-\$114.6
Equity Market Indices	01-Oct-18	-1w k (%)	-1m (%)	Ytd (%)
S&P 500	2 929	0.31	0.93	9.53
EuroStoxx 50	3 414	0.11	0.63	-2.56
CAC 40	5 507	0.56	1.85	3.66
Nikkei 225	24 246	1.57	6.04	6.50
Shanghai Composite	2 821	3.37	3.53	-14.69
VIX - Implied Volatility Index	11.87	-2.70	-7.70	7.52

Source: Bloomberg, Ostrum Asset Management

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