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STRATEGY WEEKLY

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Italian stalemate jolts markets

Key Points

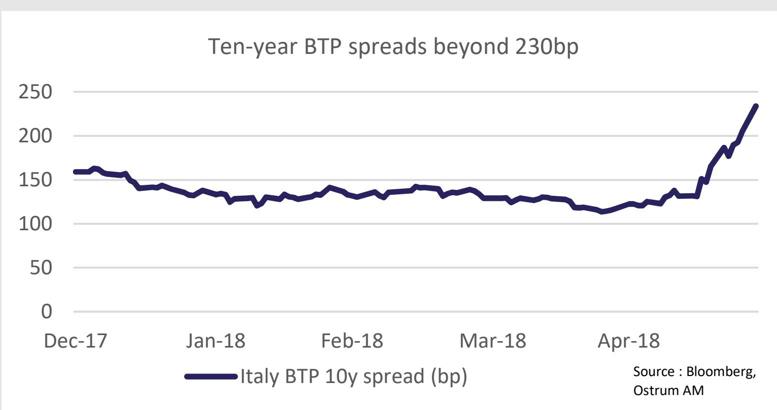
- **Political impasse in Italy: technical government and new elections this autumn**
- **Flight to quality on Bunds (0.35%) and Treasuries (sub 3%)**
- **BTPs trading about 230bp vs. Bunds**
- **Wider credit spreads, especially in high yield whilst volatility dissipates across emerging debt markets**

Italian political stalemate is turning into a constitutional crisis. Italian spreads (234bp) have deteriorated considerably surpassing levels seen in the wake of the December 2016 referendum. A technical government will be formed shortly and new elections may take place this autumn. Uncertainty buys G4 bond markets. T-note yields dipped below 3% last week while Bund yields broke the 0.40% threshold. Equity market reaction has been muted so far although Italy's MIB is down some 9% in May.Bond spreads have widened in Spain and Portugal in the wake of BTPs and a confidence vote in Parliament now threatens to take Rajoy's government down. The euro depreciates on political tensions ($1.16). In turn, the Japanese yen reclaimed its safe haven status.

Credit markets underperform with spreads about 110bp over Bunds. Peripheral financials and high yield have been attacked (+35bp in HY last week). Synthetic indices have widened.

Emerging debt benefitted from lower US yields. Average spreads in external debt markets hover about 326bp. We have observed some stabilization in local currency debt markets as selling pressure abated. There are nevertheless still fragilities in Turkey and Brazil notably.

Chart of the week



Italian benchmark bonds have been trading above 230bp against Bund.

Political impasse has raised aversion against Italy's risk assets.

In equity space, Italy's MIB is down about 9% compared with a 2% loss on large European indices.

Euro ($1.16) also prices in the return of political risk in Europe.

Political impasse in Italy shakes financial markets

President Mattarella opposed the nomination of Paolo Savona, notoriously anti-euro, to the finance Minister post put an end to the possibility of a M5S-Lega government. The urgency is to ensure that Italy complies with earlier commitments to EU. A technical government led by Carlo Cottarelli, who had directed a spending review under Enrico Letta's government, will oversee current affairs until new elections in Autumn. October 5 appears a possible date for these elections. This could be an institutional crisis in the making. Sergio Mattarella is threatened of impeachment by Lega leaders. On financial grounds, Italy's sovereign rating could be cut. Moody's (Baa2, negative outlook) has put the rating under negative watch. The agency will communicate on September 7, a week after Fitch's rating review (BBB). A one-notch downgrade in Italy's rating could have material consequences on Italian bank debt, the bulk of which would fall into speculative-grade category.

Market dynamics are quite characteristic of sharp corrections. Volumes seen in BTP futures' markets have been 1.5 times above average last week. A decline in open interest signals that long positions have been trimmed. In cash bond markets, Italian spread doubled from a month ago to 230bp on 10-year maturities. Investors have naturally turned to 10-year Bunds, where yields seemingly head towards 0.30%. The fall in T-note yields was even sharper. Acceleration to the downside in BTP futures was initiated in the US, hence Treasuries' outperformance. Us notes trade near 2.93%.

Potential Bund rally limited to 0.30%

In terms of duration exposure, neutrality is recommended on Bunds. Market dynamics are quite dependent upon Italy's headlines or possibly Spain, as a confidence vote against Rajoy is due to take place in parliament on June 1st. A deterioration in the political backdrop would trigger buying of German bonds and a widening in swap spreads. Five-year swap spreads are close to 55bp.

Economic growth in the United States is gathering pace in 2Q18, which should lead to higher yields. A short stance is still valid on US bonds. Notwithstanding flight to quality, the sizeable bearish consensus appears to slow the trend rise in yields. Fair value is close to current levels which also limits upside potential on yields. In turn, a break below 2.87% on 10-year yields would jeopardize our short stance. Neutrality will prevail in Gilt markets.

On euro sovereign markets, the risk on Italian debt argues for underexposure to BTPs across all maturities. We remain confident that on Spain bonds despite the scheduled confidence vote in a troubled European context. Cutback in our Portugal holdings relates to profit-taking. High-rated countries offer little relative value vs. Bunds. That said, OATs have been insensitive to Italian volatility.

Equity markets did not markedly react to political woes, except for the MIB index obviously penalized by the risk a self-fulfilling feedback loop between the sovereign and the banks. Still, European indices lost some 2.5% last week. Milan's benchmark stock index is down about 9% in May compared with just around 2% for European indices. On a sectoral basis, the announcement of output increase by OPEC due to high prices and likely cutbacks in Iran production have logically triggered profit-taking in the energy sector. The $3.8 weekly drop in Brent prices ($75). That being said, volatility is not excessive at 17% (VStoxx).

As concerns credit, technical signals point to further spread upside. Indeed, iTraxx XO is close to 300bp and speculative-grade bonds are under pressure. The average spread on high yield corporate bonds is now above 350bp after a 35bp increase in spread last week. However, final investor flows appear to be stabilizing across credit markets compared with selling in peripheral sovereign bonds. In the euro IG universe, spreads are now near 110bp vs. Bunds. Subordinated financials have suffered the most (+15bp last week).

Volatility down in emerging markets

With Italian politics are on everyone's mind, emerging markets are seemingly falling out of investors' radar screens. The average spread on emerging debt in US dollars is now 325bp against Treasuries. The average local-currency bond yield has stabilized as G4 yields fell back last week. Investors have sold the asset class albeit in measured proportions compared with large the inflows recorded in December and January.

Turkey raised rates to the tune of 300bp and will benefit from lower oil prices. The simpler monetary policy framework is a favorable signal in the currently troubled international context. The Turkish lira appreciated slightly to 4.58 against the US dollar last week but is still quite vulnerable.

Main Market Indicators

G4 Government Bonds	28-May-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.67 %	-5	-9	-4
EUR Bunds 10y	0.34%	-18	-23	-8
EUR Bunds 2s10s	102 bp	-13	-13	-4
USD Treasuries 2y	2.48 %	-9	-1	+59
USD Treasuries 10y	2.93 %	-13	-3	+53
USD Treasuries 2s10s	46 bp	-4	-2	-7
GBP Gilt 10y	1.32 %	-16	-12	+13
JPY JGB 10y	0.04 %	-2	-1	-1
€ Sovereign Spreads (10y)	28-May-18	-1wk (bp)	-1m (bp)	Ytd (bp)
France	35 bp	+6	+13	0
Italy	234 bp	+47	+117	+75
Spain	118 bp	+20	+49	+4
Inflation Break-evens (10y)	28-May-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR OATi	145 bp	-4	-1	+2
USD TIPS	211 bp	-7	-7	+12
GBP Gilt Index-Linked	303 bp	-5	-1	-3
EUR Credit Indices	28-May-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Corporate Credit OAS	110 bp	+13	+19	+24
EUR Agencies OAS	49 bp	+7	+12	+11
EUR Securitized - Covered OAS	50 bp	+7	+10	+10
EUR Pan-European High Yield OAS	357 bp	+35	+51	+63
EUR/USD CDS Indices 5y	28-May-18	-1wk (bp)	-1m (bp)	Ytd (bp)
iTraxx IG	65 bp	+6	+11	+20
iTraxx Crossover	298 bp	+18	+27	+66
CDX IG	63 bp	+1	+3	+14
CDX High Yield	343 bp	+5	+5	+36
Emerging Markets	28-May-18	-1wk (bp)	-1m (bp)	Ytd (bp)
JPM EMBI Global Div. Spread	326 bp	-6	+24	+41
Currencies	28-May-18	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.163	-1.34	-3.92	-3.15
GBP/USD	$1.331	-0.89	-3.28	-1.48
USD/JPY	¥109.34	+1.46	-0.2	+3.06
Commodity Futures	28-May-18	-1wk ($)	-1m ($)	Ytd ($)
Crude Brent	$75.3	-$3.9	$1.5	$9.8
Gold	$1 299.0	$4.8	-$18.1	-$3.8
Equity Market Indices	28-May-18	-1wk (%)	-1m (%)	Ytd (%)
S&P 500	2 721	0.31	1.93	1.78
EuroStoxx 50	3 483	-2.52	-1.03	-0.61
CAC 40	5 509	-2.28	0.47	3.70
Nikkei 225	22 481	-2.27	0.06	-1.25
Shanghai Composite	3 135	-2.45	1.71	-5.20
VIX - Implied Volatility Index	13.22	-1.49	-14.21	19.75

Source: Bloomberg, Ostrum Asset Management

Writing

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