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STRATEGY WEEKLY

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Tensions abate gradually after the storm

Key Points

- **Spreads ease in peripheral sovereign markets an high yield**
- **Neutral stance on Bund, Treasuries**
- **Swap spreads likely to come in**
- **Volatility falls back in equity space**
- **US protectionism revives tensions in emerging market currencies**

BTP and Bund bond future markets were extremely volatile last week. BTP futures traded with intra-day volatility of as much as 10 figures, at a time when liquidity in peripheral bond markets had seemingly disappeared. Bund yields traded briefly below 0,20% before rebounding after the announcement of the formation of a government in Italy. Peripheral spreads should continue to ease.

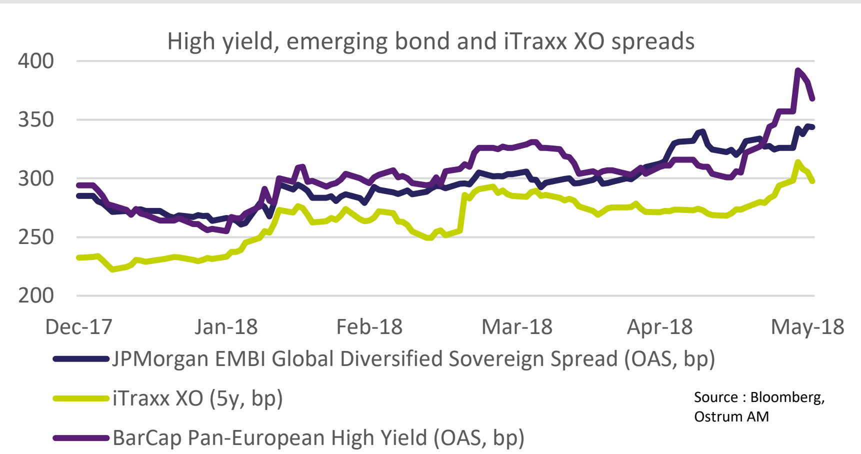
Extreme volatility in bond markets has had little impact on equities. European stock lost about 1% last week. Bank stocks and the automobile industry underperformed.

In the US, flight-to-quality dominated economic releases. Ten-year yields briefly hit 2.75%.

Euro credit widened out last week. Financials did poorly. High yield spreads increased although final investor flows suggested no acceleration in selling. Euro high yield spreads hover about 368bp vs. Bunds.

The euro-dollar exchange rate is trading above $1.17. Other currencies (Turkish Lira, Brazilian real) remain under pressure as is the case in external debt markets. Emerging market debt is trading about 344bp.

Chart of the week



Italian political risk ignited spread widening across various asset classes.

The average spread in high yield hit a high at 392bp. In synthetic markets, iTraxx XO widened out to 314bp before tightening under the 300bp threshold.

Emerging market bonds under-performed Treasuries, due to flight-to-quality and specific risks (Turket, Brazil notably).

Tensions ease somewhat as new government is formed in Italy

President Mattarella finally decided to give additional time to M5S and Lega leaders to form a government. Paolo Savona's candidacy had initially been rejected. The notoriously anti-euro economics professor will finally get the European affairs post whilst Giovanni Tria will be Finance Minister. Luigi Di Miao (M5S) and Matteo Salvini (Lega) will be Deputy Prime Ministers and will likely exert considerable influence on PM Giuseppe Conte. The formation of a government does reduce the changes of new elections but one should not be overly optimistic given current fiscal policy outlook and the fragility of this government coalition.

Official statements indicating the Italy will stay in the euro area have flourished as redenomination risk remains a concern for markets. No exit from the euro area will likely raise the question of debt restructuring if potential growth fails to accelerate in the years to come. Public debt amounts to 132% of GDP. The repeal of labor market reforms implemented by Renzi in 2015 or that of the pension reform introduced by Monti would be bad omen. Furthermore, half of Italian debt is held by resident investors and 17% is on ECB books. Hence, other euro area members may request debt reduction prior to foreign assistance should it become necessary. Sovereign bonds issued since 2013 include collective action clauses that would facilitate the process of debt restructuring. Italy's sovereign debt rating will likely be cut by the end of summer at a time when the budget law will be discussed and before being presented to the European Commission in autumn.

Whilst clouds remain on the horizon, markets are taking a breather. The yield on Italian 10-year bonds is close to 2.50% after a peak at 3.20% last week. Unprecedented volumes in BTP futures early on last week resulted from the lack of liquidity in cash bond markets and fear of massive selling upon US investors' return to markets after a day off. The intraday BTP future price swings reached fully 10 figures last Monday. The relative success of bond auctions on Tuesday seemingly reduces the risk of a loss of market access. BTP spreads hence dropped back to around 210bp on 10-year maturities. Spain's Bonos (94bp on 10-year bonds) breached below the 100bp mark after Parliament voted to take down Mariano Rajoy. Socialist Pedro Sanchez is Spain's new Prime Minister until new elections are held within a year. Portuguese debt, a collateral victim of the Italian crisis, is well supported again (135bp). In terms of strategies, Spain offers better risk-reward than most European sovereign issuers given strong growth and continued effort to consolidate public finances.

Easing tensions should narrow swap spreads

Swap spreads should come in further as Bund yields resume creeping higher. Two-year swap spreads shot up to 62bp before falling back to 50bp. Spread tightening move may extend to 40-45bp area. Inflation rise in May and ECB unwillingness to give in to Italian bond stress will revive selling pressure as QE end nears. Technically, closing above 0.42% would be a sell signal for Bunds. If yields do not break above 0.42%, neutrality will prevail. High US growth seen in non-farm payroll reports (223k gain in May) and surveys argue for higher yields. Short positioning was cut in the flight-to-quality rally last week (yields hit low at 2.75%). This will allow for higher yields possibly after the next Fed meeting. Neutral duration stance will remain valid in the short run all the more so that current market levels are close to fair value.

Low volatility remains in equity markets

Despite high flows towards safe Bunds, equity markets across Europe showed little signs of panic except a drop on market opening on Tuesday. Euro Stoxx is down some 1.7% for the week and implied volatility (V2X) has also reverted to Monday lows. Bank and insurance stocks logically underperformed whilst energy stocks were buoyed by a bounce in Brent prices ($76).

Fears of a downgrade in Italy's sovereign rating have caused significant spread widening in the financials subordinated debt sector. ITraxx sub fin index hit a high near 200bp before rallying to the 160bp area. In turn, iTraxx crossover traded above the 320bp mark but then closed the week about 290bp. However, spread volatility did not cause much investor selling in the credit asset class. Credit ETFs continue to register inflows. Recent IG spread increases to 115bp against Bund on average and the return of sovereign risk justify flows into corporate credit.

In emerging markets, protectionist threats out of the United States maintains risk aversion at a high level and forces currency realignments. The Mexican peso is depreciating towards 20pesos for one dollar.

The political situation in Brazil is also a source of volatility in both currency and spreads on external debt. The yield on 10-year Brazilian bonds denominated in US dollars is now 275bp compared with 220bp earlier this month.

Main Market Indicators

G4 Government Bonds	04-Jun-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.62 %	+5	-4	+1
EUR Bunds 10y	0.42%	+7	-13	-1
EUR Bunds 2s10s	104 bp	+3	-8	-1
USD Treasuries 2y	2.5 %	+2	+0	+62
USD Treasuries 10y	2.93 %	0	-2	+52
USD Treasuries 2s10s	43 bp	-3	-3	-9
GBP Gilt 10y	1.3 %	-2	-10	+11
JPY JGB 10y	0.05 %	+1	+1	+0
€ Sovereign Spreads (10y)	**04-Jun-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	31 bp	-5	+7	-5
Italy	212 bp	-22	+87	+53
Spain	91 bp	-27	+16	-23
Inflation Break-evens (10y)	**04-Jun-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	148 bp	+3	+5	+5
USD TIPS	213 bp	+3	-3	+15
GBP Gilt Index-Linked	308 bp	+5	+1	+2
EUR Credit Indices	**04-Jun-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	115 bp	+5	+23	+29
EUR Agencies OAS	51 bp	+2	+13	+13
EUR Securitized - Covered OAS	53 bp	+4	+12	+14
EUR Pan-European High Yield OAS	368 bp	+11	+57	+74
EUR/USD CDS Indices 5y	**04-Jun-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	66 bp	+0	+10	+21
iTraxx Crossover	290 bp	-8	+16	+57
CDX IG	66 bp	+2	+4	+16
CDX High Yield	346 bp	+2	+4	+38
Emerging Markets	**04-Jun-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	344 bp	+18	+29	+59
Currencies	**04-Jun-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.169	+1.24	-2.04	-2.63
GBP/USD	$1.332	+0.54	-1.83	-1.46
USD/JPY	¥109.7	-0.85	-0.57	+2.73
Commodity Futures	**04-Jun-18**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$75.7	$0.4	$1.2	$10.6
Gold	$1 293.6	-$8.6	-$20.3	-$9.2
Equity Market Indices	**04-Jun-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 746	0.92	3.12	2.73
EuroStoxx 50	3 470	-0.38	-2.28	-0.98
CAC 40	5 473	-0.65	-0.78	3.02
Nikkei 225	22 476	-0.02	0.01	-1.27
Shanghai Composite	3 091	-1.40	0.01	-6.53
VIX - Implied Volatility Index	12.99	-1.74	-12.05	17.66

Source: Bloomberg, Ostrum Asset Management

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Additional Notes

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