22 May 2018 /// n°6-2018

Markets unsettled by Italian politics

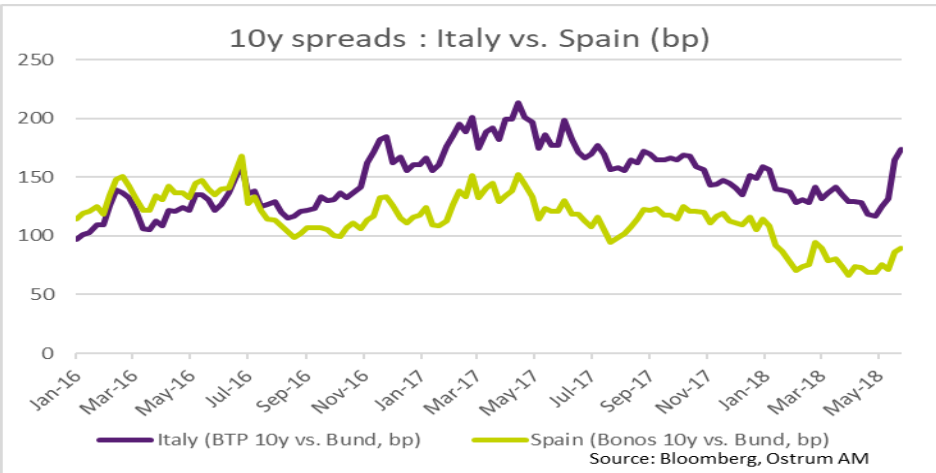
Key Points

- **Italy: M5S-Lega platform will increase deficits substantially**
- **Italian BTPs move closer to 180bp vs. Bunds, contagion to Spain, Portugal**
- **Renewed tensions on T-note yields**
- **Emerging spreads increase, dollar strength continues**

A reality check on the Italian political situation moved financial markets last week. The final outcome of the March elections jeopardizes fiscal consolidation efforts initiated by the technical government headed by Mario Monti. Months of complacency regarding Italian political risks finally gave way to risk aversion against Italian bonds. Ten-year BTPs are now trading about 180bp compared with 110bp tights on April 25th. The spread widening logically led to an increase in spreads on Bonos (90bp) and Portugal (140bps). German risk-free bond yields declined towards 0.55%. Euro IG corporate bonds are underperforming despite stable equities with the IG yield gap back about 100bp vs. Bunds. European high yield stands near 330bp. In parallel, activity and inflation still push US yields higher. Ten-year notes hit a high at 3.12% last week.

Emerging bonds was wider at 334bp. The dollar rise continues against the yen (111) and the euro (1.18). Brazil's real remains penalized by internal politics and the Argentinean situation and trades about 3.70 (down 6% in the past month). Outflows from emerging bond funds in local currencies are gaining traction. Malaysia and Indonesia have each raised rates by 25bp but most Central Banks in emerging markets keep sitting on their hands.

Chart of the week



Italian spreads have blown out after a prolonged period of low volatility.

The movement justified by fiscal measures announced by the new government led to increased risk premiums in Spain albeit to a more limited extent.

The upshift is likely a "beta" effect unrelated to Spanish fundamentals.

Italy rattles markets

Market complacency vis-à-vis Italy is coming to an end. The first measures coming out of the joint M5S-Lega program appear inconsistent with a sustained adjustment in the public debt ratio. Announced income tax cuts, the lowering of retirement age and the introduction of citizenship (universal) income would imply a sharp increase in the public borrowing shortfall to the tune of 6pp of GDP. Such a deterioration in in the fiscal balance would rapidly wipe out the current account surplus.

Furthermore, the ECB confirmed its intention to end the asset purchase program in September or December. Inflation has fallen back to 1.2%y In April. Hence, the ECB is de facto admitting that asset purchases have had little impact on prices. Italy is one of countries that benefitted the most from the program's departure from the ECB capital key and would now have to fund a large deficit on its own. One should expect that the European commission will make it clear that fiscal slippage will have to be avoided, if Italy is to escape Greece's down spiral from 2009.

As regards bond markets, Italian spreads shot up to 190bp intraday on Monday, May the 21st before falling back to about 175bp. Volumes on BTP futures reached record levels last week. After the Constitutional referendum lost by Matteo Renzi, BTP spreads touched 210bp. A sovereign downgrade appears likely when Fitch (BBB) and Moody's (Baa2 neg) update their views on August 31st and September 7th. Deterioration in Italy's risk premium has a knock-on effect on banks' spreads and peripheral sovereign bonds. Spain, which growth held up at 0.7%q in the three months to March, is now trading at 90bp spreads against Bunds. The Bonos' spread rise is comparable to that observed during the January volatility spurt. The proportional increase in spreads likely represents opportunity. Portugal is trading at 140bp relative to German bonds. Holding on to overexposures on Bonos and PGBs remains warranted.

In duration terms, neutrality should prevail euro area. Economic slowdown and flight to safety underpin Bund prices, which evolve some 10bp below fair value (0.64%). A break below the 0.54% threshold may represent a bullish signal towards 0.30%. That said, tensions in US 10-year rates which briefly breached 3.10% contribute to pull Bund yields up.

In sum, Bunds face opposing forces. The rise in US bond yields is slowed by the massive short positioning of speculative accounts. In turn, foreign central banks are now less inclined to support the dollar, which is significantly up since mid-April. US corporations are also buying less Treasury bonds than before.

We recommend maintaining a short stance on Treasuries. Curve positioning is harder to apprehend. One-year bill rate is now 2.30% and flows into money market funds appear to be recovering. Indeed, carry on curve flatters in negative.

Stable equities, but wider credit spreads

The gradual rise in US yields ignited selling in higher-risk assets except for equities. The S&P index is indeed insensitive to European political woes. The benchmark is up about 3% since April-end despite a stronger dollar and higher yields. The energy sector and technology stocks have pulled markets higher. Consumer staples and utilities have however been more fragile. Europe is holding up well thanks to a weaker currency (+1.4% since April-end). The current economic slowdown may weigh on 2Q18 earnings despite favourable currency price changes.

European credit markets have underperformed. Bond spreads are trading about 100bp vs. German Bunds (+7bp). Financials widened by 9bp and the higher beta (credit index sensitivity) of subordinated debt weighed on their performance. In CDS markets, the iTraxx IG benchmark is 5bp wider in the past week to 60bp. The widening in the crossover index to 280bp was relatively limited so that spread compressed further in synthetic space. The spread ratio (4.71) fell to a low since November.

Turbulence in emerging markets

Emerging debt has been under selling pressure for some time. The Argentinean situation is worrying but is it a surprise at this point? Most emerging market currencies are falling, and some countries have adjusted rates higher (+25bp in Malaysia and Indonesia, where more hikes are possible). The first bout of indiscriminate selling (April end) stopped for a while and resumed last week as yields crept higher in the US.

That said, fund outflows are modest compared with inflows between December and March. It may be too early to figure out the consequences of capital outflows on these economies. Currency adjustment could prove stabilising in some cases but very low interest rates in real terms also favour internal imbalances.

Main Market Indicators

G4 Government Bonds	23-May-18	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.57 %	+1	-2	+6
EUR Bunds 10y	0.52%	-9	-12	+9
EUR Bunds 2s10s	109 bp	-9	-10	+3
USD Treasuries 2y	2.56 %	-2	+8	+68
USD Treasuries 10y	3.01 %	-8	+4	+61
USD Treasuries 2s10s	45 bp	-6	-5	-7
GBP Gilt 10y	1.46 %	-4	-8	+27
JPY JGB 10y	0.05 %	-1	-2	0
€ Sovereign Spreads (10y)	**23-May-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	28 bp	+4	+7	-8
Italy	184 bp	+33	+68	+25
Spain	94 bp	+13	+26	-20
Inflation Break-evens (10y)	**23-May-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	149 bp	+0	+4	+6
USD TIPS	217 bp	-3	-2	+18
GBP Gilt Index-Linked	309 bp	+1	+4	+3
EUR Credit Indices	**23-May-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	100 bp	+7	+9	+14
EUR Agencies OAS	43 bp	+5	+6	+5
EUR Securitized - Covered OAS	45 bp	+5	+5	+5
EUR Pan-European High Yield OAS	332 bp	+31	+25	+38
EUR/USD CDS Indices 5y	**23-May-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	61 bp	+5	+6	+16
iTraxx Crossover	284 bp	+10	+8	+51
CDX IG	62 bp	+1	+0	+13
CDX High Yield	337 bp	-2	-9	+29
Emerging Markets	**23-May-18**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	327 bp	+3	+30	+42
Currencies	**23-May-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.172	-0.79	-4.08	-2.37
GBP/USD	$1.338	-0.9	-4.08	-1.01
USD/JPY	¥110.11	-0.03	-1.33	+2.34
Commodity Futures	**23-May-18**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$79.1	-$0.2	$5.1	$13.6
Gold	$1 293.0	$1.3	-$30.7	-$9.8
Equity Market Indices	**23-May-18**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 724	0.48	2.03	1.90
EuroStoxx 50	3 561	-0.05	1.37	1.63
CAC 40	5 597	0.53	2.91	5.35
Nikkei 225	22 690	-0.12	2.72	-0.33
Shanghai Composite	3 169	-0.02	3.29	-4.18
VIX - Implied Volatility Index	13.49	0.52	-17.44	22.19

Source: Bloomberg, Ostrum Asset Management

Writing

Additional Notes

This material has been provided for information purposes only to investment service providers or other Professional Clients, Qualified or Institutional Investors and, when required by local regulation, only at their written request. This material must not be used with Retail Investors.
In the E.U. (outside of the UK): Provided by Natixis Investment Managers S.A. or one of its branch offices listed below. Natixis Investment Managers S.A. is a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of Natixis Investment Managers S.A.: 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. France: Natixis Investment Managers Distribution (n.509 471 173 RCS Paris). Registered office: 43 avenue Pierre Mendès France, 75013 Paris. Italy: Natixis Investment Managers S.A., Succursale Italiana (Bank of Italy Register of Italian Asset Management Companies no 23458.3). Registered office: Via Larga, 2 - 20122, Milan, Italy. Germany: Natixis Investment Managers S.A., Zweigniederlassung Deutschland (Registration number: HRB 88541). Registered office: Im Trutz Frankfurt 55, Westend Carrée, 7. Floor, Frankfurt am Main 60322, Germany. Netherlands: Natixis Investment Managers, Nederlands (Registration number 50774670). Registered office: World Trade Center Amsterdam, Strawinskylaan 1259, D-Tower, Floor 12, 1077 XX Amsterdam, the Netherlands. Sweden: Natixis Investment Managers, Nordics Filial (Registration number 516405-9601 - Swedish Companies Registration Office). Registered office: Kungsgatan 48 5tr, Stockholm 111 35, Sweden. Spain: Natixis Investment Managers, Sucursal en España. Serrano n°90, 6th Floor, 28006, Madrid, Spain.
In Switzerland: Provided for information purposes only by Natixis Investment Managers, Switzerland Sàrl, Rue du Vieux Collège 10, 1204 Geneva, Switzerland or its representative office in Zurich, Schweizergasse 6, 8001 Zürich.
In the U.K.: Provided by Natixis Investment Managers UK Limited which is authorised and regulated by the UK Financial Conduct Authority (register no. 190258). This material is intended to be communicated to and/or directed at persons (1) in the United Kingdom, and should not to be regarded as an offer to buy or sell, or the solicitation of any offer to buy or sell securities in any other jurisdiction than the United Kingdom; and (2) who are authorised under the Financial Services and Markets Act 2000 (FSMA 2000); or are high net worth businesses with called up share capital or net assets of at least £5 million or in the case of a trust assets of at least £10 million; or any other person to whom the material may otherwise lawfully be distributed in accordance with the FSMA 2000 (Financial Promotion) Order 2005 or the FSMA 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (the "Intended Recipients"). The fund, services or opinions referred to in this material are only available to the Intended Recipients and this material must not be relied nor acted upon by any other persons. Registered Office: Natixis Investment Managers UK Limited, One Carter Lane, London, EC4V 5ER.
In the DIFC: Provided in and from the DIFC financial district by Natixis Investment Managers Middle East (DIFC Branch) which is regulated by the DFSA. Related financial products or services are only available to persons who have sufficient financial experience and understanding to participate in financial markets within the DIFC, and qualify as Professional Clients as defined by the DFSA. Registered office: Office 603 - Level 6, Currency House Tower 2, PO Box 118257, DIFC, Dubai, United Arab Emirates.
In Japan: Provided by Natixis Investment Managers Japan Co., Ltd., Registration No.: Director-General of the Kanto Local Financial Bureau (kinsho) No. 425. Content of Business: The Company conducts discretionary asset management business and investment advisory and agency business as a Financial Instruments Business Operator. Registered address: 1-4-5, Roppongi, Minato-ku, Tokyo.
In Taiwan: Provided by Natixis Investment Managers Securities Investment Consulting (Taipei) Co., Ltd., a Securities Investment Consulting Enterprise regulated by the Financial Supervisory Commission of the R.O.C . Registered address: 16F-1, No. 76, Section 2, Tun Hwa South Road, Taipei, Taiwan, Da-An District, 106 (Ruentex Financial Building I), R.O.C., license number 2017 FSC SICE No. 018, Tel. +886 2 2784 5777.
In Singapore: Provided by Natixis Investment Managers Singapore (name registration no. 53102724D) to distributors and institutional investors for informational purposes only. Natixis Investment Managers Singapore is a division of Ostrum Asset Management Asia Limited (company registration no. 199801044D). Registered address of Natixis Investment Managers Singapore: 10 Collyer Quay, #14-07/08 Ocean Financial Centre, Singapore 049315.
In Hong Kong: Provided by Natixis Investment Managers Hong Kong Limited to institutional/ corporate professional investors only.
In Australia: Provided by Natixis Investment Managers Australia Pty Limited (ABN 60 088 786 289) (AFSL No. 246830) and is intended for the general information of financial advisers and wholesale clients only .
In New Zealand: This document is intended for the general information of New Zealand wholesale investors only and does not constitute financial advice. This is not a regulated offer for the purposes of the Financial Markets Conduct Act 2013 (FMCA) and is only available to New Zealand investors who have certified that they meet the requirements in the FMCA for wholesale investors. Natixis Investment Managers Australia Pty Limited is not a registered financial service provider in New Zealand.
In Latin America: Provided by Natixis Investment Managers S.A.
In Uruguay: Provided by Natixis Investment Managers Uruguay S.A., a duly registered investment advisor, authorised and supervised by the Central Bank of Uruguay. Office: San Lucar 1491, oficina 102B, Montevideo, Uruguay, CP 11500. The sale or offer of any units of a fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627.
In Colombia: Provided by Natixis Investment Managers S.A. Oficina de Representación (Colombia) to professional clients for informational purposes only as permitted under Decree 2555 of 2010. Any products, services or investments referred to herein are rendered exclusively outside of Colombia. This material does not constitute a public offering in Colombia and is addressed to less than 100 specifically identified investors.
In Mexico: Provided by Natixis IM Mexico, S. de R.L. de C.V., which is not a regulated financial entity or an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores) and is not registered with the Comisión Nacional Bancaria y de Valores (CNBV) or any other Mexican authority. Any products, services or investments referred to herein that require authorization or license are rendered exclusively outside of Mexico. Natixis Investment Managers is an entity organized under the laws of France and is not authorized by or registered with the CNBV or any other Mexican authority to operate within Mexico as an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores). Any use of the expression or reference contained herein to “Investment Managers” is made to Natixis Investment Managers and/or any of the investment management subsidiaries of Natixis Investment Managers, which are also not authorized by or registered with the CNBV or any other Mexican authority to operate within Mexico as investment managers.
The above referenced entities are business development units of Natixis Investment Managers, the holding company of a diverse line-up of specialised investment management and distribution entities worldwide. The investment management subsidiaries of Natixis Investment Managers conduct any regulated activities only in and from the jurisdictions in which they are licensed or authorized. Their services and the products they manage are not available to all investors in all jurisdictions. It is the responsibility of each investment service provider to ensure that the offering or sale of fund shares or third party investment services to its clients complies with the relevant national law.
The provision of this material and/or reference to specific securities, sectors, or markets within this material does not constitute investment advice, or a recommendation or an offer to buy or to sell any security, or an offer of any regulated financial activity. Investors should consider the investment objectives, risks and expenses of any investment carefully before investing. The analyses, opinions, and certain of the investment themes and processes referenced herein represent the views of the portfolio manager(s) as of the date indicated. These, as well as the portfolio holdings and characteristics shown, are subject to change. There can be no assurance that developments will transpire as may be forecasted in this material. Past performance information presented is not indicative of future performance.
Although Natixis Investment Managers believes the information provided in this material to be reliable, including that from third party sources, it does not guarantee the accuracy, adequacy, or completeness of such information. This material may not be distributed, published, or reproduced, in whole or in part.
All amounts shown are expressed in USD unless otherwise indicated.