MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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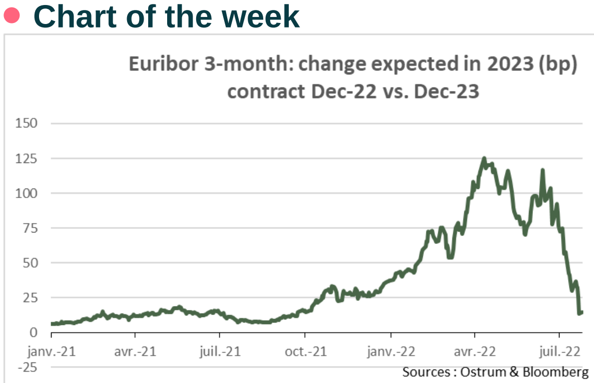
Topic of the week: The market, too complacent about Italy?

- **This is our last weekly before a break month. The next issue is on September 5. In the meantime, we wish you all a great holiday;**
- **Italian assets suffered with the resignation of Draghi and the return of political risk: broader sovereign spreads and underperforming stock exchanges;**
- **A closer analysis shows that the specific risk of the Italian elections is, paradoxically, very little taken into account by the markets. In case of a bad surprise (a poll, an untimely announcement of a policy, etc.), the risk is that Italian assets will suffer much more.**

Market review: Should we buy the recession?

- **The ECB raises rates by 50 bp, first hike since 2011;**
- **The ECB launches a new crisis tool (TPI);**
- **Political crisis in Italy: elections scheduled on September 25;**
- **Extreme volatility in bond complex, risky assets bounce.**

Chart of the week



The ECB surprised with a 50 bps rise last week. Paradoxically, after this bullish surprise, markets are anticipating a lower end-of-year landing.

The aggressive attitude of the ECB but also the very disappointing surveys, especially the PMIs, are driving up recession expectations.

As a result, expectations of rate increases for next year have dropped significantly. In mid-June, the market was expecting five rate hikes in 2023, and we are now only up half a hike.

Figure of the week

30%

Source : Ostrum AM

30% of the countries in the EMBIG index are in “distress”, i.e. with a spread over 1,000 bp.
This is an unusually high proportion, unseen since the 2009 crisis.

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Topic of the week

The market, too complacent about Italy?

At the moment, we don't really see political risk being taken into account by the markets. This is the case for sovereign yields but also for equity markets. Despite the recent poor performance of Italian financial assets, the risk premium does not seem high.

Before I go into the details of our argument, just a reminder. Certainly, Italy has well-identified problems: sluggish growth, very high public debt, etc. The political crisis, one more, puts Italy at risk. However, we have always had a more nuanced view on Italy, which also has assets that are often forgotten, cf. our *MyStratWeekly* "Advocacy for Italy" of 22 February 2021. The Italian economic situation is more complex than what is too often presented.

Rates: political risk is only very partially taken into account

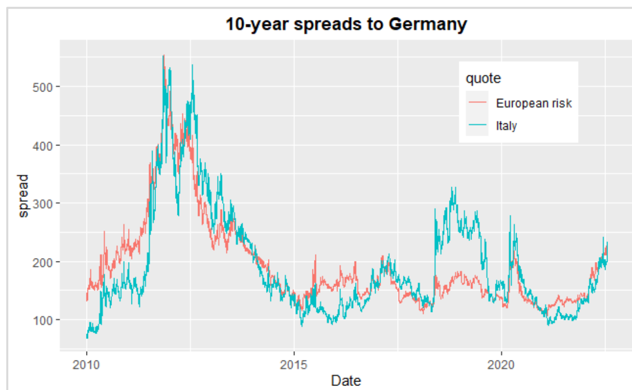
Mario Draghi has therefore bowed out, Italy is heading for elections on 25 September with in all probability a very fragmented chamber that should not lead to a stable government. In short, the commedia dell'arte politique, put in parentheses by the Draghi episode, is back.

The "Draghi premium" on interest rates has therefore partly disappeared and Italian rates have risen significantly as shown in the chart below.

However, account must be taken of the fact that peripheral spreads have generally deviated since the beginning of the year with the withdrawal of the ECB and the end of the QE. A risk premium model in this market leads us to believe that peripheral spreads were abnormally contracted during the QE period (which was also one of the QE goals) and that they have returned to normal.

What about Italy? On the chart below we have the Italian spreads as seen on the markets. The "Europe Risk" is the level of Italian spreads if they had reacted purely according to their usual beta in the market. It is clear that during the period 2018-2019, the last period of significant political stress, the Italian spreads deviated more than expected by the model. This is an idiosyncratic risk specific to Italy and therefore has nothing to do with the movements of other countries. This specific risk premium was then around 100 bps over the period.

Paradoxically, at present, there is really no specific Italian risk premium. While spreads have increased over the past year, they are largely consistent with other countries. This is at least what our modelling with an Italian idiosyncratic risk tells us, which is currently estimated at just under 20 bps. To give a basis for comparison, the specific Italian risk, during the Conte I government, from 1 June 2018 to 5 September 2019, was 95 bps. On the other hand, since the beginning of the year, under the Draghi government, Italy has been treating on average a dozen bps more expensive. So that's our estimate of the "Draghi premium".

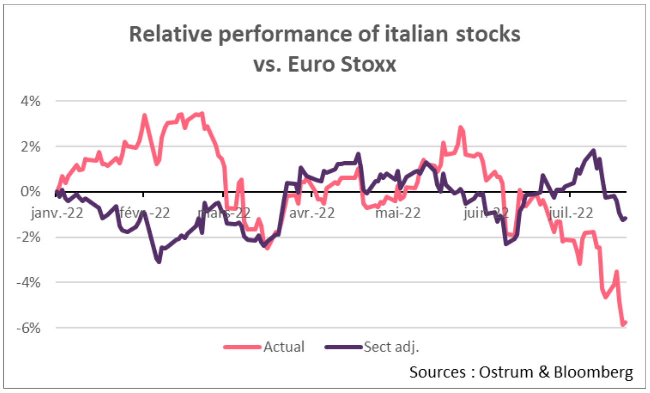


The fact that Italian spreads have reacted, to a very large extent, in line with the spreads of other countries leads to the conclusion that the market only marginally includes a specific Italian risk. Either the market assumes that the political problem is largely negligible, or it assumes that the TPI announced by the ECB is credible.

Two hypotheses that seem very debatable to us. In the absence of any specific risk, Italian spreads should currently be in the 200-230bps range. At the time of writing, we are at 230. In case of major political risk, as we saw in 2018, the target would be above 300 bps.

Actions: same thing

We use the IT30 index of the thirty largest market capitalizations. This index underperformed the Euro Stoxx by almost 6%. Signs that political risk is therefore taken into account by the market?



Here again, the reality is more subtle. The Italian index is highly concentrated in several sectors, with a very strong weighting in Banks, Utilities and Energy. Reflecting sector performance, the index has only underperformed 1.2% YTD. So the underperformance of the Italian index is much more related to the fact, no luck, that the index was concentrated in the wrong sectors.

Here too the specific Italian risk is therefore very marginally taken into account.

It should be noted, however, that even if we adjust for the sectoral composition, the index nevertheless underperformed by 2.5% over the last two weeks. The market is starting to wake up!

Conclusion

Oddly, and despite the recent mediocre performance, it seems that the specific risk of Italian politics is not really taken into account. Put another way, in case of a bad surprise (a poll, an untimely announcement of a policy, etc.), the risk is that Italian assets will suffer much more.

Stéphane Déo

Market review

Should we buy the recession?

The recession priced in by the markets amid showdown with central banks worried about inflation

The sentiment of market participants is by nature sensitive to marginal changes in leading indicators and activity or price surveys. The *perception* of risk, rather than the underlying reality, is the determining factor behind the near-term equilibrium of asset prices. A precarious balance seems to have settled in with an extremely short positioning on risky assets likely to reverse at the slightest sign of monetary easing. Speculative short positioning on S&P 500 futures are, for example, at the same level as at the worst of the pandemic in the spring of 2020. Central banks maintain a hard policy stance on inflation, implementing larger hikes than anticipated at most meetings. The latest decisions of the RBA, the Fed, the ECB or the BoC abound in this direction. Central banks navigate by sight so that their advanced communication appears obsolete. This showdown contributes to the flattening pressure across global yield curves, which eventually drove the US 2-10 year spread into inversion. The paradox is that the drop in long bond yields works as a stabilizing force for equities despite the current economic slowdown.

The outcome of this standoff will depend on several factors, including central bank tolerance for a recession. Christopher Waller's speech in June implied that the Fed would easily accommodate a rise in unemployment towards 4.25% in order to limit inflation expectations. US inflation is at 9.1%, far from the 5.2% that prevailed when Powell was still defending the idea of transitory inflation in Jackson Hole last year. Although the fall in gasoline prices is already reflected in certain price surveys of businesses and households, wage expectations remain high. The median increase in wages for individuals who have changed jobs in the past 12 months thus stands at +7.9% over one year. The bargaining power of workers risks fueling inflation despite the recent adjustment in price expectations. Markets react to marginal changes; the objective of central banks is a level of inflation. The neutrality of monetary policy is also elusive. Current interest rates are far from discouraging household demand for credit in the United States.

In the euro zone, the 50 bp increase in key policy rates puts an end to the absurdity of negative rates and buys the support of ECB hawks for the new crisis management instrument. The ECB is finally forced to react to record inflation. The TPI (Transmission Protection Instrument) is conditional on compliance with budgetary rules and would only be activated after the exhaustion of the resources linked to the reinvestments of the PEPP, described as the “first line of defense” by Christine Lagarde. The ECB is thus seeking to dissociate interest rate policy from the management of financial risks. There is no indication that there is a level of spread that would trigger the TPI and in any case, the solvency of a country depends on the level of interest rates, themselves linked to inflation in the euro zone. The interaction of the different policy tools therefore remains obscure, especially since the TLTRO system will have to be extended or amended to avoid a balance sheet contraction of €1,300 billion in June 2023.

Bond markets have also proven to be sensitive to the price components of the Fed's regional surveys and more generally to signals of a slowdown. The inversion of the US yield curve has become more pronounced. The Fed must become restrictive but will not remain so forever according to the market. In this context, the short-sightedness of stakeholders seems to preclude betting on long-term inflation scenarios, especially as the barrel of WTI is beginning to reflect both the slowdown and the recovery in US output. Breakeven inflation valuations are nevertheless attractive at 2.3% at 10 years.

In the euro area, the behavior of Schatz bond yields remains quite erratic. The 50 bp rise in rates propelled the 2-year German bond yield up to 0.78% before a 30 bp plunge over two trading sessions. The market reversal reflects the ECB's commitment to be data-dependent (oddly echoing the Fed's dual mandate?) and then falling French and German PMIs the next day. The Schatz also reflects scarcity of collateral and the search for security in the face of Italian risk. The TPI is a crisis instrument that will serve more to avoid contagion of Italian political risk to other peripheral debts.

The credit market benefits from redemptions of short positions. Crossover volatility remains high, but the market reacts to the slightest favorable signals such as the resumption of Russian gas flows. The iTraxx is trading almost 100 bps tighter than recent highs and the spread between CDS and underlying bonds is normalizing. Euro IG credit tightened by around 15 bp and high yield by nearly 60 bp. Repurchases are moderating so the movement can amplify in a dip market. Short positioning also tends to be reduced on equities. The indices rebounded from 3 (Euro Stoxx 50) to 7% (Nasdaq) over the week. Bad economic news is finally welcomed as it reduces the probability of a more restrictive monetary policy and implied volatility. This is a recurring paradox in current markets, which also tends to favor growth stocks and the “quality” factor.

The euro rallies 1% to $1.02 awaiting the July 27 FOMC as the dollar-yen stabilizes at high levels.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	25-Jul-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	0.41%	-11	-40	+103
EUR Bunds 10y	1.02%	-19	-42	+120
EUR Bunds 2s10s	60.2bp	-8	-2	+17
USD Treasuries 2y	3%	-17	-6	+227
USD Treasuries 10y	2.81%	-18	-32	+130
USD Treasuries 2s10s	-19.9bp	0	-26	-97
GBP Gilt 10y	1.94%	-22	-36	+97
JPY JGB 10y	0.2%	-4	-7	+0
€ Sovereign Spreads (10y)	**25-Jul-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	59.13bp	-1	+1	+22
Italy	226.74bp	+20	+34	+92
Spain	120.29bp	-2	+12	+46
Inflation Break-evens (10y)	**25-Jul-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.41%	-5	-14	+34
USD 10y Inflation Swap	2.66%	-3	-17	-11
GBP 10y Inflation Swap	3.79%	-13	-26	-39
EUR Credit Indices	**25-Jul-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	192bp	-15	-5	+97
EUR Agencies OAS	83bp	-1	+10	+34
EUR Securitized - Covered OAS	96bp	+2	+15	+50
EUR Pan-European High Yield OAS	603bp	-57	+43	+285
EUR/USD CDS Indices 5y	**25-Jul-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	105bp	-16	-5	+57
iTraxx Crossover	531bp	-63	-6	+289
CDX IG	85bp	-4	-10	+35
CDX High Yield	492bp	-29	-36	+199
Emerging Markets	**25-Jul-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	562bp	-31	+52	+193
Currencies	**25-Jul-22**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.022	0.710	-3.486	-10.2
GBP/USD	$1.204	0.753	-1.810	-11.0
USD/JPY	JPY 137	1.031	-0.929	-15.8
Commodity Futures	**25-Jul-22**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$105.0	-$1.3	-$4.1	40.40
Gold	$1 716.9	$7.7	-$105.9	-6.14
Equity Market Indices	**25-Jul-22**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	3 972	3.69	1.54	-16.7
EuroStoxx 50	3 600	2.50	1.88	-16.3
CAC 40	6 233	2.31	2.63	-12.9
Nikkei 225	27 699	3.40	4.56	-3.8
Shanghai Composite	3 250	-0.85	-2.97	-10.7
VIX - Implied Volatility Index	23.56	-6.88	-13.48	36.8

Source: Bloomberg, Ostrum AM

Additional notes

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