MARKET FLASH

LA FRANÇAISE – 29 May 2018

# ITALIAN TURBULENCE & OUR CONVICTIONS

**Our market analyses take full account of the significant uncertainty about the situation in Italy but currently exclude the systematic risk of it leaving the Eurozone. We believe that a certain number of market movements have been exaggerated and this has opened up considerable rebound opportunities.**

## The political context

Giuseppe Conte, appointed head of government a few days ago, has this weekend given up his mandate to be President of the Council: the sticking point with President Sergio Mattarella is the future Minister of Finance, the very eurosceptic Paolo Savona. The President of the Republic has vetoed this and now has his hands free to appoint a technocrat, without having the agreement of the parties that came first in the legislative elections. This morning, he proposed as candidate for the position of the new President of the Council, former International Monetary Fund (IMF) director of fiscal affairs, Carlo Cottarelli. However, M5S and the League have already announced that they will not give a vote of confidence in the two Houses: new elections should therefore be announced, but cannot be held before September.

Several questions arise, it seems to us, if such a political scenario materialises:

**How would the voters react, if the President of the Republic ignores the outcome of the legislative elections of 4 March? Will the score of the right-wing coalition in the polls confirm its strong rise, which is key in the polls today?**
This point is crucial but it is very difficult to answer. In the short term, Di Maio and Salvini have maintained their stance and are pounding out their desire to govern. Any new statement is likely to fuel volatility, especially since the volumes traded on the 10 year BTP future come largely from the hedge fund community, which calls for caution in the coming days.

A technical government will be appointed to manage current business before the next elections, which should take place after the summer. This means that nothing will happen in terms of reforms, but it avoids the establishment of unorthodox budgetary measures. Today, the President of the Republic is blocking the application of a policy which is openly sceptical towards the Eurozone and Silvio Berlusconi, who is attached to the European positioning of his country, sided with Mattarella last Sunday. This points towards future difficulties for the right-wing coalition and probably for an election campaign that is more focused on the European project for Italy. Italy is therefore likely to remain in political limbo until the autumn, which does not necessarily mean chaos on the financial markets.

In this context**, the rating agency Moody's has placed Italy's Baa2 rating** under surveillance and is particularly concerned about the potential backtracking on the pension reform and the budgetary projections of the new government.

**What about the ECB?**

Its room for manoeuvre is narrow on Italian debt (respect of the capital key in its public asset purchase program). The events in Italy make it all the more difficult as the Eurozone is experiencing a more moderate period of growth, headline inflation should accelerate to levels close to 1.8% this summer and the balance of risks is deteriorating. It may revise its growth forecasts down slightly; to be communicated on 14 June: remember it revised forecasts upwards by 1/10th to 2.4% for 2018 on 8 March this year.

## OUR CONVICTIONS

May witnessed a sharp return to risk aversion. While the results of the Italian elections didn't have much effect on the markets, they finally generated repricing in many assets, mainly in the bond sphere. Today, it seems appropriate to provide a factual view of these market movements and to analyse their justification, scale and coherence in order to identify, where appropriate, certain opportunities once the Italian issue has been closed:

- This situation has logically generated a rise in the Italian risk premium since early May, but the levels reached and the flattening of the curve now reflect the fear of a systemic risk. The 2-year BTP yield is above 2.2% with a spread of 270 bp against Germany, close to the spread of 263 bp on the 10-year yield. It is always particularly difficult to express oneself in a configuration like this, but we think that the low liquidity of recent days has played an important role in this movement, with notable gaps in the trading spreads. More fundamentally, we do not consider the medium-term challenge to be Italy's exit from the Eurozone but rather a European governance largely complicated by an Italian government that is possibly eurosceptic. Indeed, if we believe the polls, the Italian people have never wanted to leave the Eurozone and the newly elected parties are not proposing this anymore. Finally, the Constitution does not authorise holding a referendum on this subject. Thus it seems that in the event of new Italian elections in autumn 2018, the markets could, in the summer, once more focus on more global economic fundamentals and we believe that the current levels may be opportunities. **We remain positive on the 2-year maturity which is our longest position on Italian debt.** This topic will resurface in September with more serenity for investors as the polls are showing an exit from this political impasse with, for example, the victory of a right-wing coalition.

- The German 10-year Bund has lost more than 30 bp since the high of mid-May and has traded at less than 0.30%, enjoying a flight to quality in the Eurozone. The German 2-year yield has returned to the lows of December 2017, to -0.7% and expectations on the increase of the ECB's deposit rate in 2019 are now lower than 15 bp compared with 40 bp at the highest this year. It does seem logical today to value lower German yields, which are reference rates, because of a possible, albeit limited, effect on growth in the Eurozone and because of a possible communication lag from the ECB regarding the end Quantitative Easing. But in a scenario that excludes a systemic situation in Italy, it seems that the situation is not likely to significantly deform the economic trajectory of the Eurozone and consequently the ECB's monetary policy. **We consider the level of the Core rates to be decidedly too low.**

- After last month's disappointing European underlying inflation figure, we expect a return to levels close to 1% this month. Even after its recent correction, oil has increased in euros since early 2018 by more than 22%, implying positive base effects over the year as a whole (if prices stabilise). The 5-year inflation expectation is currently 1.19%, whereas during the summer, total inflation should rise to above 1.8%. This recovery is therefore only very partially anticipated by the markets. **We are strengthening the long positions on 5-year breakeven inflation rates in the Eurozone via Germany**. In the United States, the situation is a little different. Specific elements (telecom price war, lower drug prices) negatively impacted inflation in the second quarter of 2017 and created positive base effects for 2018. During the summer, the annual rate of US inflation will rise to 3% and will have an upward impact on inflation expectations, which are currently only at 2.1%. **We remain positive on US break-even inflation rates.**

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