ANALYSIS & STRATEGY

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A TIME FOR POLITICS

Having already covered the various stages that finally enabled Italy's political classes to form a government (Flash of 30 May 2018), we won't repeat ourselves here. The situation now seems to have stabilised, at least for the short term, and we would highlight the following factors:

- The two parties in the coalition, the Five Star Movement and the League, are not talking about leaving the eurozone. They have criticised it as dysfunctional, but they were not elected on a pledge to ditch the euro
- Surveys show that a large majority of Italians want to stay in the eurozone (around two-thirds)
- The constitutional reform adopted in 2012 prohibits a referendum on eurozone membership

For all these reasons, we do not envisage a scenario in which Italy leaves the eurozone. That being said, it should be borne in mind that the new government's economic programme will almost certainly lead to some difficult discussions with the European authorities in the coming months. So no systemic risk, but no appetite either for long-dated Italian securities, which are likely to remain volatile.

Moreover, this European sovereign crisis is taking place in a context of growth, which although less dynamic than at end-2017, remains steady in most developed countries. It is also worth noting the strength of US growth. In this favourable environment, it will be interesting to observe the moves of the central banks with inflation picking up, impacted by the positive base effects from commodities as well as labour market tensions in some countries. The three main central bank committees meet in June, and they will have further opportunities for discussion in Sintra on 18 June.

We should also mention, though not for the first time, the latent trade war that is ongoing between the USA and the rest of the world. Beyond the systematic smokescreen, Donald Trump's announcements are having a waning effect on the financial markets, but that does not mean that this state of affairs will continue in the medium term. This explains our fairly cautious positioning on the equity markets, which nonetheless showed remarkable resilience in May.

Lastly, we think we should take advantage of May's period of volatility to reaffirm some of our main convictions. Accordingly, we have increased our positions on inflation breakevens and our short positions on core inflation. We have also slightly increased our positions on subordinated bank debt, mainly on short-dated securities.

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FIXED INCOME

THE BUTTERFLY EFFECT

There was a sudden return to risk aversion in May. Although the markets had not reacted much to the results of the Italian elections, a contagion effect finally had a significant impact on assets, especially bonds.

Eurozone inflation at 1.9% y/y

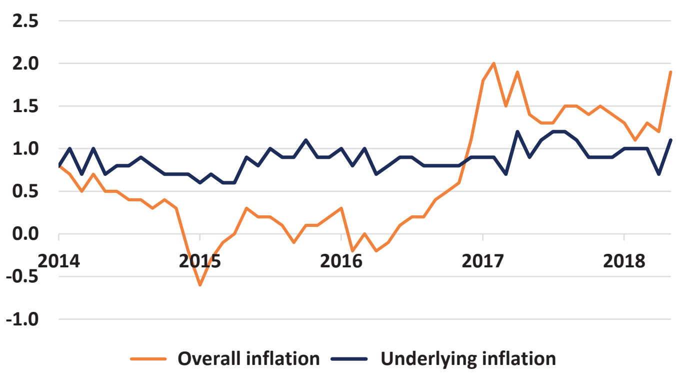
(vs forecast of 1.6 %, and 1.2 % last month)

We held positions on short-term peripheral debt, which we kept throughout the period of stress: we aim to remain nimble on Italy as concerns arise and ease due to the difficulties that the government will have in implementing its programme.

The 10-year Bund lost up to 30 bp from its high in mid-May and was trading at 0.20%, benefiting from a flight to quality in the eurozone. It would seem logical, however, to now attribute a lower valuation to German yields (a reference point), in view of the potential, albeit limited, effect on eurozone growth due to a possible delay in the ECB announcing the end to its quantitative easing programme. But in a scenario that does not include a systemic issue in Italy, we are unlikely to see a significant change in the eurozone's economic trajectory, and indirectly, in ECB monetary policy. In a historical irony, the day after the sharp drop in the 10-year Bund yield to 0.20%, an inflation figure of 2.2% y/y was published on Wednesday in Germany, significantly higher than the 1.8% forecast. The level of core inflation seems way too low to us.

Even after the recent correction, oil in EUR has risen by 13% since the start of 2018, implying positive base effects over the entire year (if prices stabilise). 5-year inflation expectations are currently 1.45% in the eurozone: overall inflation should remain close to 2% until the summer, which has only been factored in by the markets to a very limited degree. In the USA, specific factors (telecoms price war, fall in the price of prescription drugs) had a negative impact on inflation in 2Q 2017, generating positive base effects for 2018. During the summer, with the USA in a trade war against the rest of the world and tensions on the country's labour market, annual inflation is likely to rise towards 3%, which should drive up inflation expectations from the current 2.1% on the 10-year maturity. We remain positive on US and European inflation breakevens.

Eurozone inflation



(Source: Bloomberg, as at 31 May 2018)

EQUITY MARKETS

THEY HAVE LEARNED NOTHING AND FORGOTTEN NOTHING(1)

The eurozone is an economic power, but its survival depends on its ability to implement a common economic policy. Investors have factored in this equation since the 2011-2012 Greek crisis: how cohesive is the eurozone, and alternatively, what is its risk of breaking up? The subsidiary question is: is Italy its Achilles heel?

While the equity markets do not like uncertainty, the Italian political situation has been a source of agitation in recent days. As such, the 10-year yield on Italian government bonds tightened by 98 bp to 3.44%, the Milan stock market fell by almost 6% and Italian banks, which hold a substantial portion of Italy's public debt (over €600bn), fared particularly badly. Calm returned to the markets on May 30th when the Five Star Movement (M5S) and the League were able to form a government acceptable to the Italian president. It took this unprecedented political situation for the markets to take account of the political factor again, with risk peaking around the issue of eurozone cohesion. Despite this turbulent episode, equities were largely sheltered and there was no major impact on the euro, while at the same time, the Spanish prime minister lost a confidence vote in parliament. The European markets eventually bounced back, the euro picked up to 1.16 against the dollar and bond yields eased.

The markets' ability to absorb the events, with the ECB looking on approvingly, does not mean that the risk has disappeared. The crux of the matter for Italy is its weak growth coupled with a high level of public debt (132% of GDP). Italy is not Greece in 2012, but the coalition of two extreme parties that hold opposing views is unlikely to bring stability, nor the hope for change to address Italy's weaknesses, such as its ability to undertake reforms. The implementation of the "common programme" proposed by the new Italian government would cost 6-7% of GDP, and while the primary budget surplus (1.7% of GDP) provides some room for manoeuvre, the opportunities for a stimulus from tax cuts are limited. The lack of flexibility in the Italian economy is weighing on its productivity, its banking system is still recovering and very few family-owned companies are capable of attaining the kind of critical mass that would attract investors.

14%

Underperformance of Italian banks vs European banks in May

Italian equities represent around 7% of the Eurostoxx300. A large proportion are banks and companies that operate on international markets. These two segments put in similar performances during the eurozone's return to a faster pace of growth at the start of the year. At this stage, and even though we can envisage some technical rebounds, we remain cautious with regard to Italian banks, which will feel the impact of each new episode in the political crisis. We are maintaining a constructive view on companies with international exposure, which will benefit from the fall in their valuation and the EUR/USD cross. Medium-sized Italian companies should receive support from the Individual Savings Plan (PIR).

For the eurozone, the political risk premium is likely to be in place for some time to come. Although corporate earnings growth continues to encourage us to buy on weakness on a year-end horizon, we will remain cautious on this market in the coming weeks given the unfavourable trend in recent eurozone statistics along with the political risk.

(1) Charles Maurice de Talleyrand

POLITICAL RISK TO THE FORE

With tensions running high in Italy, and after a number of setbacks, the Five Star Movement and the League finally managed to form a government. In a change from the initial agreement that was rejected by President Mattarella, the two party leaders Matteo Salvini and Luigi Di Maio had to appoint a Finance Minister, Giovanni Tria, who favours keeping Italy in the euro.

In the USA, Donald Trump reignited fears of a trade war after imposing protectionist measures on steel and aluminium on some of his key partners, despite an agreement being reached with China. The USA's withdrawal from the multilateral nuclear accord with Iran and the crisis in Venezuela (re-election of Nicolas Maduro) pushed the barrel price of Brent above USD 80. On the forex markets, USD is continuing to rise against most international currencies.

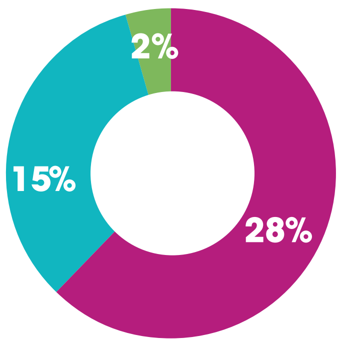
On the data front, the business confidence surveys were generally good in the USA and slightly below expectations in the eurozone.

It was therefore only to be expected that equities, led by the European markets, would undergo a correction at the end of the month (DJ Eurostoxx 50: -4 %; MIB: -9%). Conversely, the yield on Germany's 10-year Bund, which is considered a safe haven, hit a bottom at 0.22%, before closing at 0.34% on 31 May (-22 bp over the month). Meanwhile, Italian government bond yields rose sharply (2Y: 1.07%, +137 bp; 10Y: 2.79%, +101 bp). Yields on Spanish and Portuguese bonds suffered due to a contagion effect.

On the eurozone credit markets, contingent convertible bonds (CoCos), subordinated insurance debt and corporate hybrids were most affected, widening by 63 bp, 123 bp and 44 bp respectively.

Between market exaggeration and genuine stress, we will be slightly less active on the equity markets in June (45%). For now, we think it advisable to remain focused on the USA and Europe. On European yields, we are maintaining our low duration exposure to core nominal yields, and increasing diversification in inflation-linked bonds. On the peripherals side, we still favour Portuguese and Spanish debt.

We will continue to have low exposure to good quality credit and maintain a small component in emerging debt and subordinated financials.



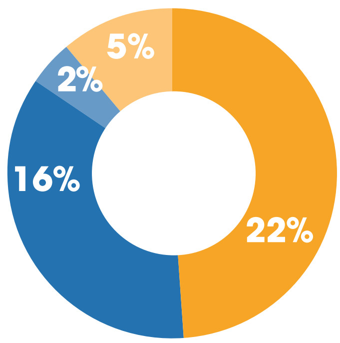
EQUITY EXPOSURE: 45%

UNITED STATES
We are taking some profits on US equities after a period of outperformance in May.

EUROPE
We have sold off some European equities to reduce our overall risk.

JAPAN
We are maintaining a 2% position in Japanese equities.

EMERGING MARKETS
We are steering clear of this asset class.



FIXED INCOME EXPOSURE: 45%

DEVELOPED GOVERNMENT BONDS
Reduced weighting after May's flight to quality.

INFLATION-LINKED BONDS
We have increased our bet on inflation-linked bonds.

FINANCIAL/SUBORDINATED DEBT
We are maintaining an investment on this theme.

EMERGING MARKET DEBT
We will continue to increase our exposure gradually following the major correction in recent weeks.

HIGH YIELD CREDIT
We are still avoiding this asset class.

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