Weekly Update

C0 | EXTERNAL PUBLICATION

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Italy – Not so *Dolce*

Ever since a coalition was cobbled together by the populists on opposite ends of the political spectrum, investors have worried that their eurosceptic posture and spending plans could end up pushing Italy out of the eurozone. The country's role as a founding member of the European Union and its sheer size – the third largest economy in the zone – mean that contagion of such problems to its neighbours could be swift.

While Italy has experienced a cyclical recovery in recent quarters, the country has lagged its peers since the introduction of the euro. Its sclerotic parliamentary system – both chambers have equal powers – and inability to implement structural reforms have seen growth stagnate and debt-to-GDP ratios remain double the limits set out in 1992's Maastricht treaty. This has forced the country to maintain fiscal austerity via a primary budget surplus (i.e. 2017 tax revenues exceeded government spending, before taking into account debt service, to the tune of 1.5% of GDP according to OECD data), ensuring its continued investment-grade rating, access to capital markets and support from the ECB's asset purchase programme.

This helps explain why the new government's spending plans have so worried markets. They combine key manifesto promises from both La Liga (e.g. flat tax rates for businesses and households) and Movimento 5 Stelle (universal basic income) and add up to around €120bn or 6.7% of GDP. Of course, the 2019 budget will be scrutinized by the European Commission. This will happen in two stages: the Finance Ministry must submit the annual update to its medium-term fiscal plans before September 27, and then the draft budget by October 15.

There are two conflicting approaches. The Finance Minister has outlined plans which would increase the overall 2019 budget deficit from 0.8% to 2.0% of GDP while the two deputy Prime Ministers – and heads of the coalition partners – are pushing for 3.0%, putting the country at risk of breaching the Maastricht threshold. Given the risk of a marked deterioration of public finances, it is no surprise that Italian government bond (BTP) yield spreads over Germany have widened since coalition talks began in the spring, from around 115bp to 265bp. At the same time, 5yr credit default swaps (which measure the cost of insuring against default) have shot up from below 100 to 250.

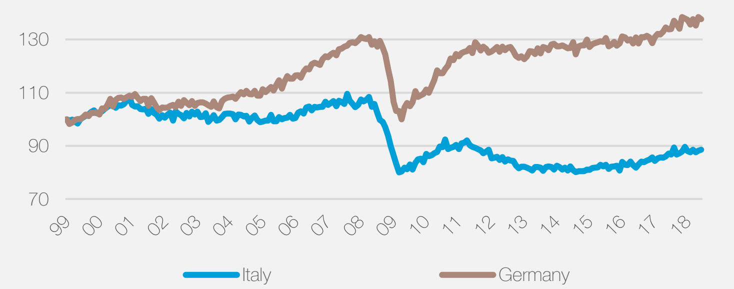
Italy's woes are also under scrutiny by debt-rating agencies, which have BTPs on negative watch. Moody's ranks BTPs at Baa2, just two notches above High Yield, a level below which they might no longer be eligible for ECB buying. Moody's next review, due by end August, has now been postponed until October so as to factor in the draft budget. However, nothing on the table today looks like preventing downward pressure on the rating.

This puts pressure on Italy's banks, which hold some €350bn in BTPs. According to Reuters, the ratio of Common Equity Tier 1 capital of Italy's 10 largest banks to their risk-weighted assets would fall by 40bp for every 100bp rise in BTP spreads vs Bunds. This negative spiral would do much to undo the benefit that Italy's banking system has gained by reducing the drag from non-performing loans, still the largest in the eurozone but well down from 2015's highs.

Bottom line. If Italy's budget is rejected by parliament or by the Commission, the viability of the coalition would be called into question, possibly opening the door to new elections next spring. Moreover, the negative feedback loop – higher deficits bring higher spreads, meaning weaker banks and slower growth – could create a snowballing of government debt. In this context, we would expect BTPs to continue to underperform Spanish bonds.

Italian industrial production is not even back to pre-crisis levels

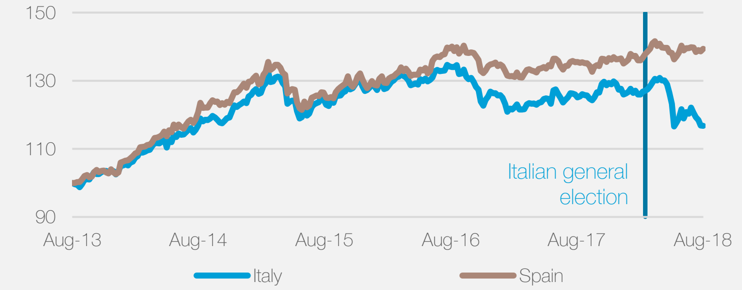
Industrial production ex construction, seasonally-adjusted, 100 = 01/01/1999



Source: Datastream, latest data = June 2018

Political tensions have erased three years of gains on Italian bonds

10-year government bond cumulative performance, 100 = 21/08/2013



Source: Datastream, 22/08/2018

This week and next

EUROZONE

- The eurozone's current account surplus narrowed from €24.4bn to €23.5bn in June but the 12-month cumulative surplus rose to 3.6% of GDP vs 3.2% a year ago.
- Headline inflation was confirmed at 2.1% YoY in July, its highest level since January 2013, while the index excluding volatile items edged up from 0.9% to 1.1% YoY in July.
- The flash estimate for eurozone manufacturing confidence fell from 55.1 to 54.6 in August – a 21-month low – while services confidence rose from 54.2 to a 2-month record of 54.4 sending the composite index to 54.4, a 2-month high.
- Consumer confidence for August (advanced figures) declined further and posted its lowest level in a year at -1.9 in August, well below expectations (-0.7).

Next week's key events	*Per.*	*Prev.*	*Cons.*
30 Aug Economic sentiment	Aug	112.1	111.9
31 Aug Unemployment rate	Jul	8.3%	8.2%
31 Aug Core CPI	Aug A	1.1%	1.1%

UNITED KINGDOM

- The CBI industrial trends survey saw total orders fall from 11% to 7% in August, while expectations were for 8%.
- Public sector net borrowing (ex. banks) dropped from £4.2bn to £-2bn in July, its lowest level since 2002.

Next week's key events	*Per.*	*Prev.*	*Cons.*
30 Aug Consumer credit (£bn)	Jul	1.57	1.60
31 Aug GfK consumer confidence	Aug	-10	--11

UNITED STATES

- The University of Michigan sentiment index fell more than expected, reaching its lowest level since September 2017 at 95.3 in August.
- On first estimate, US manufacturing confidence hit a 9-month low at 54.5 in August (after 55.3) while expectations were for 55.0. The services business activity index was down from 56.0 to 55.2, a 4-month low. The composite index decreased to a 4-month low of 55.0 from 55.7 in July.
- Existing home sales narrowed for the fourth straight month in July to 5.34m while new homes sales recorded a 9-month low.

Next week's key events	*Per.*	*Prev.*	*Cons.*
28 Aug Consumer conf. (conf. board)	Aug	127.4	126.2
29 Aug GDP growth, % YoY	Q2 A	2.2%	4.0%

ASIA & EMERGING COUNTRIES

- In Japan, manufacturing confidence picked up from 52.3 to 52.5 on first estimate although export orders failed to rise for a third straight month. The Tankan business survey among 400 major firms improved from 25 to 30 in August after a low at 21 in April.
- Japanese core inflation remained unchanged at 0.8% YoY in July, just below expectations (0.9%).
- In China, M2 money supply beat expectations and rebounded from its June all-time low (8% YoY) to 8.5% in July. Loan growth returned to its January levels (13.2% YoY in July), beating expectations.
- Malaysian GDP growth declined from 5.4% to 4.5% YoY in Q2 and the growth forecast for this year was revised down to 5%.

Next week's key events	*Per.*	*Prev.*	*Cons.*
30 Aug Japan: retail sales, % YoY	Jul	1.7%	1.2%
31 Aug Japan: unemployment rate	Jul	2.4%	2.4%

Sources: Datastream, Bloomberg, 24 August 2018, Note: YoY = year-on-year; QoQ = quarter-on-quarter; MoM = month-on-month, P = preliminary figure, A = advanced figure, F = final figure, seasonally adjusted, ECB = European Central Bank

Our 6-month targets for currencies and commodities

	Thursday close	6mth target
EUR/USD	1.15	1.20
GBP/USD	1.28	1.35
EUR/CHF	1.14	1.18
USD/JPY	111	110
Brent	$74.7	$75
Gold	$1190	$1250

No change to our 6-month targets this week.

Question time

Past performance should not be seen as a guarantee of future returns.

No Q&A this week.

Market performance

Past performance should not be seen as a guarantee of future returns.

Interest rates

Interest rates	Last	1wk		3mth	YTD	12mth
EONIA (EUR)	-36 bp	0 bp	→	0 bp	-2 bp	-1 bp
3mth Euribor (EUR)	-32 bp	0 bp	→	0 bp	1 bp	1 bp
3mth Libor (USD)	231 bp	-1 bp	↓	-2 bp	62 bp	99 bp
3mth Libor (GBP)	81 bp	0 bp	→	19 bp	28 bp	53 bp
10-year US Treasury bond	283 bp	-5 bp	↓	-19 bp	42 bp	66 bp
10-year German bond	34 bp	3 bp	↑	-16 bp	-8 bp	4 bp
10-year French bond	62 bp	2 bp	↑	-18 bp	-4 bp	-6 bp
10-year UK bond	132 bp	4 bp	↑	-16 bp	9 bp	22 bp

Credit

Credit	1wk		3mth	YTD	12mth
BAML EURO Corp. IG	-0.2%	↓	0.6 %	-0.1 %	0.3 %
BAML EURO Corp HY	0.2%	↑	0.5 %	-0.1 %	1.4 %
BAML GBP Corp IG	-0.3%	↓	1.3 %	-0.8 %	-0.5 %
BAML US IG	0.3%	↑	1.9 %	-1.6 %	-0.5 %
BAML US HY	0.3%	↑	2.1 %	1.8 %	3.7 %
JPM Global EM Sov. Plus	0.8%	↑	-0.5 %	-5.3 %	-3.3 %

Exchange rates

Exchange rates	Last	1wk		3mth	YTD	12mth
EUR/USD	1.15	1.4 %	↑	-1.4 %	-3.9 %	-2.3%
EUR/CHF	1.14	0.3 %	↑	-2.3 %	-2.8 %	-0.2%
GBP/USD	1.28	0.7 %	↑	-4.0 %	-5.1 %	0.1%
USD/JPY	111	0.4 %	↑	1.1 %	-1.2 %	2.1%
USD/BRL	4.12	5.3 %	↑	13.4 %	24.2 %	31.0%
USD/CNY	6.88	-0.1 %	→	7.7 %	5.7 %	3.3%
USD/RUB	68.2	2.1 %	↑	11.3 %	18.3 %	15.5%

Government bonds*

Government bonds*	1wk		3mth	YTD	12mth
United States (3-7yr)	0.2 %	↑	1.2 %	-0.5 %	-1.6 %
United Kingdom (3-7yr)	-0.1 %	↓	0.7 %	-0.2 %	-1.0 %
Germany (3-7yr)	-0.2 %	↓	0.6 %	0.7 %	0.0 %
Japan (3-7yr)	0.0 %	→	-0.1 %	-0.1 %	-0.1 %

Equities*

Equities*	Last	1wk		3mth	YTD	12mth
MSCI AC World	517	1.1 %	↑	0.8 %	2.5 %	11.7 %
Eurostoxx 50	3 419	1.2 %	↑	-2.7 %	0.6 %	3.0 %
DAX	12 366	1.1 %	↑	-4.7 %	-4.3 %	1.6 %
CAC 40	5 419	1.3 %	↑	-1.6 %	4.9 %	9.4 %
S&P 500	2 857	0.6 %	↑	5.0 %	8.2 %	19.2 %
FTSE 100	7 563	0.2 %	↑	-1.6 %	1.6 %	6.7 %
SMI	9 050	0.6 %	↑	2.9 %	-0.3 %	4.5 %
Topix	1 698	0.7 %	↑	-5.3 %	-5.5 %	8.4 %
IBOV Brazil	75 634	-1.5 %	↓	-6.5 %	-1.0 %	7.3 %
MICEX Russia *	2 260	0.0 %	→	-1.6 %	7.1 %	15.4 %
MSCI EM	1 048	2.7 %	↑	-6.2 %	-7.6 %	0.1 %
SENSEX 30 India	38 337	1.8 %	↑	12.4 %	14.4 %	22.9 %
Hang Seng (H-K)	27 790	2.6 %	↑	-7.8 %	-4.6 %	5.1 %
Shanghaï Composite	2 725	0.7 %	↑	-14.0 %	-17.6 %	-17.1 %

Commodities

Commodities	Last	1wk		3mth	YTD	12mth
Brent	$75	4.9 %	↑	-5.5 %	12.2 %	42.6 %
Gold	$1 190	0.7 %	↑	-8.1 %	-8.7 %	-7.7 %
Silver	$14.6	-1.3 %	↓	-11.0 %	-14.2 %	-14.2 %

Source: DataStream, on 24/08/2018. 1wk = 1-week change, 3mth = 3-month change, 12mth = 12-month change, YTD = year-to-date change, YoY = year-on-year change, BAML = Bank of America Merrill Lynch, JPM = JP Morgan, IG = Investment Grade, EM = emerging markets. * Price return for MICEX equity index. Equities; total return in local currency. Government bonds = 3-7 year returns. Figures are rounded.

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