Weekly Update

C0 | EXTERNAL PUBLICATION

Italy's budget – Dov'é l'uscita ?


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All data taken from Bloomberg (04/10/2018).

On September 27, Italy's coalition announced a 2019 deficit target of 2.4% of gross domestic product (GDP), or three times the previous government's target of 0.8%. What does this mean for the economy and markets?

Last week's announcement was sketchy on details. The main contributors to the increased deficit were a flat tax for small and medium sized enterprises (SMEs), costing 0.3% of GDP; guaranteed minimum income for the poorest, at 0.5%; improved pension entitlements, 0.7%; and repeal of the planned value-added tax (VAT) hike, 0.7%. On the plus side, the coalition plans a tax amnesty and cost savings of around 1% of GDP.

Further details will be released when the government presents its medium-term analysis of growth and spending projections to the lower house of parliament on October 10th. Thereafter, Italy has until the 15th to submit its 2019 budget to the European Commission (EC), which in turn has until month-end to decide if the plans are compatible with EU treaties.

The deficit matters to markets because Italy's overall debt burden is so heavy at 132% of GDP. This has forced Italian governments in recent years to run primary budget surpluses to keep the debt-to-GDP ratio stable. With next year's nominal growth expected at 2.2%, the 2.4% budget deficit seems over-ambitious, especially as the interest payments on Italy's debt amount to 3.8% of GDP.

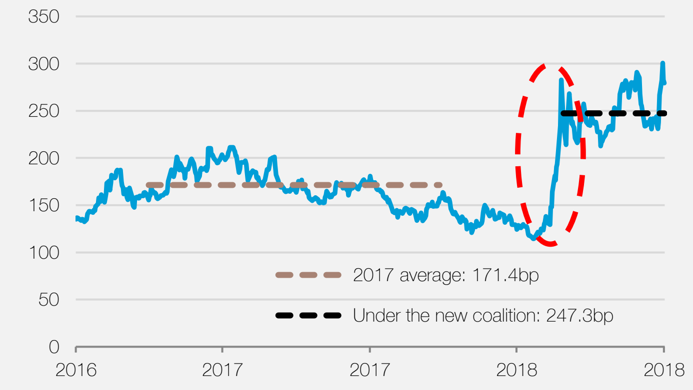
In coming weeks, much will hinge on the EC's reaction. The defiant stance taken by the coalition partners has proved popular with voters – their joint share in opinion polls has risen from 50.1% to over 60%, suggesting the EC might want to avoid exacerbating eurosceptic sentiment with a hard line approach.

Bond market vigilantes seem to be doing the EC's work. The cost of insuring against Italy defaulting on its debt obligations shot up this week, as has the yield on 10-year government bonds (BTPs). And rating agencies will publish updated assessments of Italy's credit quality later this month. At present, Italy's ratings are only two notches above High Yield status, a level which would make Italian bonds ineligible for European Central Bank purchases. Already, shares of Italy's banks, large holders of BTPs, have tumbled.

Putting it all together. On Wednesday, Italy's Finance Minister suggested projected deficits for 2020 and 2021 might be lower than planned, triggering a rally in BTPs. In addition, recent polls have shown a surge in support for La Lega, whose roots are in the more prosperous North where businesses and households might have more to lose from a eurozone and Italian banking crisis. Tensions will run high this month, as will volatility in Italian markets, but we expect a compromise to be struck in due course.

Italian bond yields surged with the new coalition

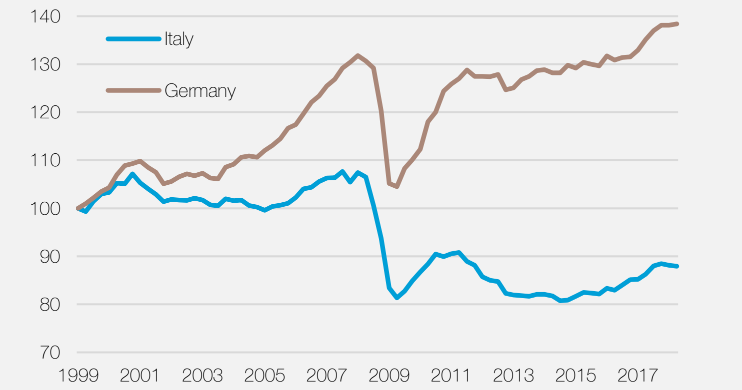
Italy-Germany 10-year bond spread (bp)



Sources: SGPB, Datastream, 04/10/2018.

Italian industrial production has not even regained its pre-crisis level

Industrial production ex. construction, seasonally adjusted, Q1 1999=100



Sources: SGPB, Datastream, Q2 2018.

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

This week and next

EUROZONE

- Eurozone manufacturing PMI fell to a two-year low of 53.2 in September, from 54.6 in August. Note however, that the ongoing US-China trade war also hurt production sites in other areas around the globe.
- The unemployment rate fell to 8.1% in August, from 8.2% in July. This is encouraging for policy-makers as it reflects sustained economic growth and increased new jobs creation, despite a slight slowdown this year versus last.
- Eurozone PPI rose 4.2% YoY in August, above expectation of 3.9%, driven by more costly energy prices.
- The composite PMI fell to 54.1 in September, from 54.5 in August, indicating slower growth in the eurozone private sector.
- Eurozone retail sales fell for the second month in a row, by respectively -0.2% MoM in August and -0.6% in July.

Next week's key events		Per.	Prev.	Cons.
8 Oct	Investors sentiment index	Oct	12	
12 Oct	Industrial production YoY	Aug	-0.1%	

UNITED KINGDOM

- Consumer credit growth accelerated to £1.1 billion, from £0.8 billion last month. However, the annual rate came in at 8.1%, i.e. the lowest since August 2015
- UK manufacturing PMI unexpectedly rebounded to 53.8 in September, from 52.8 in August. This is partly due to greater output and new order growth.
- UIK construction PMI fell to 52.1 in September, from 52.9 in August.
- UK Nationwide House Price index rose 0.3% MoM in September, up from -0.5% in August, suggesting that home buyers are back on the market.

Next week's key events		Per.	Prev.	Cons.
10 Oct	GDP Estimate YoY	Aug	1.6%	--
10 Oct	Manufacturing Output YoY	Aug	1.1%	1.1%

UNITED STATES

- US ISM Manufacturing PMI fell to 59.8 in September, from 61.3 in August – the highest level since 2004. The Non-manufacturing PMI rose to 61.6 in September, from 58.5 a month earlier, or to its highest level since the index was created in 2008.
- US vehicle sales unexpectedly rose to $17.4 million in September, from $16.6 million in August.
- US private sector employment added another 230,000 jobs in September, after a total of 163,000 in August. US employment continues to climb steadily, with job increases in nearly every sector.
- Initial jobless claims fell to 207,000, down 8,000 from the previous week's revised level of 215,000.

Next week's key events		Per.	Prev.	Cons.
11 Oct	Inflation rate YoY	Sep	2.7%	2.8%
12 Oct	U. Michigan consumer sentiment	Oct	100.1	98.5

ASIA & EMERGING COUNTRIES

- Japanese manufacturing PMI was steady in September at 52.5, indicating a relatively sound improvement in goods-producing.
- Japan's large companies plan to increase capital expenditure by 13.4% in the current fiscal year ending end March 2019, compared with 13.6% in the previous Tankan survey.
- South Korea industrial production rose 1.4% MoM in August, from 0.5% in July, a rather encouraging figure amid the ongoing trade war.
- The Turkish inflation rate increased to 6.3% MoM in September, well above expectations of 3.6%, underscoring the deep impact of the Lira crisis on the economy and consumers.

Next week's key events		Per.	Prev.	Cons.
10 Oct	Japan: Machinery orders YoY	Aug	13.9%	1.6%
12 Oct	China: Trade balance ($bn)	Sep	27.9	19.4

Sources: Datastream, Bloomberg, 5 October 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 3-month targets for currencies and commodities

	Thursday close	3mth target
EUR/USD	1.15	1.15
GBP/USD	1.30	1.32
EUR/CHF	1.14	1.09
USD/JPY	114	110
Brent	$84.5	$80
Gold	$1199	$1220

Changes made to our 3-month targets

Forecast figures are not a reliable indicator of future performance

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)	241 bp	1 bp	↑	7 bp	72 bp	106 bp
3mth Libor (GBP)	80 bp	0 bp	→	10 bp	28 bp	46 bp
10-year US Treasury bond	320 bp	14 bp	↑	rke	78 bp	86 bp
10-year German bond	54 bp	1 bp	→	23 bp	11 bp	8 bp
10-year French bond	88 bp	4 bp	↑	24 bp	10 bp	13 bp
10-year UK bond	167 bp	7 bp	↑	39 bp	48 bp	29 bp

Credit

Credit	1wk		3mth	YTD	12mth
BAML EURO Corp. IG	0.0%	→	-0.2 %	-0.7 %	-0.2 %
BAML EURO Corp HY	0.0%	→	1.6 %	0.1 %	0.7 %
BAML GBP Corp IG	-0.3%	↓	-0.6 %	-2.4 %	-0.5 %
BAML US IG	-0.8%	↓	0.0 %	-3.0 %	-2.1 %
BAML US HY	-0.2%	↓	2.3 %	2.2 %	2.5 %
JPM Global EM Sov. Plus	-1.3%	↓	0.6 %	-5.3 %	-4.3 %

Exchange rates

Exchange rates	Last	1wk		3mth	YTD	12mth
EUR/USD	1.15	-1.1 %	↓	-1.2 %	-4.1 %	-2.1%
EUR/CHF	1.14	0.4 %	↑	-1.3 %	-2.4 %	-0.4%
GBP/USD	1.30	-0.5 %	↓	-1.6 %	-3.6 %	-1.7%
USD/JPY	114	0.5 %	↑	3.1 %	1.1 %	1.0%
USD/BRL	3.87	-3.4 %	↓	-1.0 %	17.0 %	23.6%
USD/CNY	6.87	-0.3 %	↓	3.6 %	5.6 %	3.2%
USD/RUB	67.0	2.2 %	↑	5.8 %	16.2 %	16.2%

Government bonds*

Government bonds*	1wk		3mth	YTD	12mth
United States (3-7yr)	-0.4 %	↓	-0.7 %	-1.6 %	-2.2 %
United Kingdom (3-7yr)	-0.2 %	↓	-0.7 %	-1.0 %	-0.5 %
Germany (3-7yr)	0.0 %	→	-0.9 %	-0.2 %	-0.6 %
Japan (3-7yr)	-0.1 %	→	-0.3 %	-0.3 %	-0.2 %

Equities*

Equities*	Last	1wk		3mth	YTD	12mth
MSCI AC World	518	-1.3 %	↓	3.7 %	3.1 %	8.4 %
Eurostoxx 50	3 375	-2.2 %	↓	-0.8 %	-0.6 %	-2.8 %
DAX	12 244	-1.5 %	↓	-0.6 %	-5.2 %	-5.6 %
CAC 40	5 411	-2.3 %	↓	1.8 %	4.8 %	4.2 %
S&P 500	2 902	-0.4 %	↓	7.5 %	10.1 %	16.6 %
FTSE 100	7 418	-1.6 %	↓	-1.0 %	-0.1 %	3.6 %
SMI	9 098	-0.2 %	↓	5.1 %	0.3 %	1.4 %
Topix	1 801	0.1 %	→	7.3 %	1.1 %	9.2 %
IBOV Brazil	82 953	3.7 %	↑	11.0 %	8.6 %	8.3 %
MICEX Russia *	2 465	-0.4 %	↓	7.0 %	16.8 %	18.7 %
MSCI EM	1 010	-3.9 %	↓	-3.3 %	-10.6 %	-5.8 %
SENSEX 30 India	35 169	-3.2 %	↓	-1.0 %	5.1 %	12.3 %
Hang Seng (H-K)	26 624	-3.9 %	↓	-4.3 %	-8.1 %	-2.9 %
Shanghaï Composite	2 821	1.1 %	↑	2.3 %	-14.7 %	-15.8 %

Commodities

Commodities	Last	1wk		3mth	YTD	12mth
Brent	$86	5.2 %	↑	9.7 %	28.8 %	53.1 %
Gold	$1 203	1.8 %	↑	-4.2 %	-7.7 %	-5.6 %
Silver	$14.6	2.6 %	↑	-8.8 %	-14.0 %	-12.0 %

Source: DataStream, on 04/10/2018. 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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