

ECOWEEK

No. 18-22, 1 June, 2018

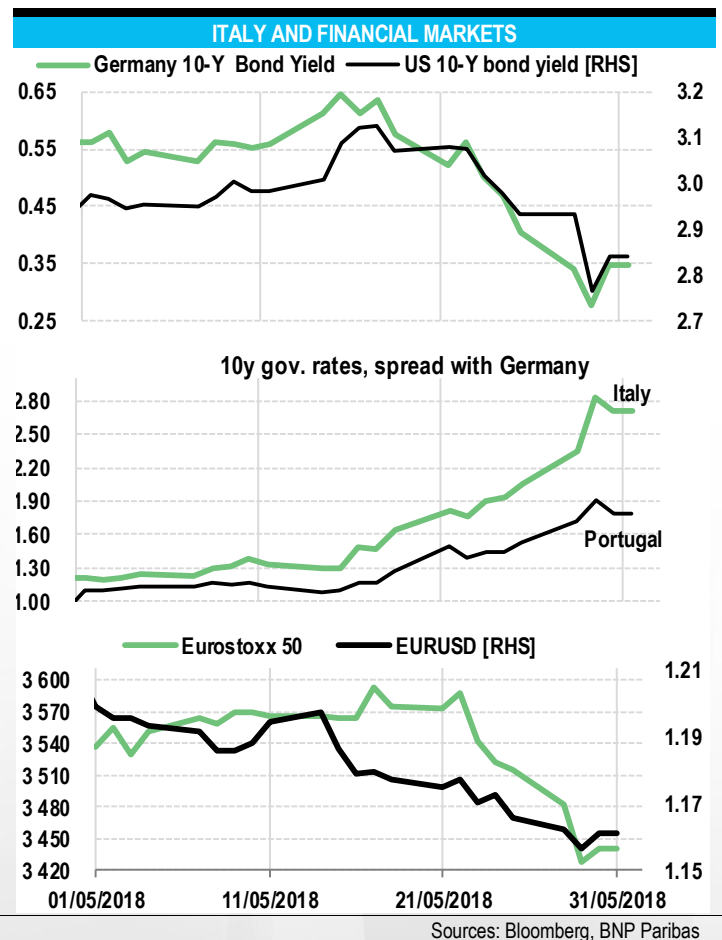
Italy: markets act as the boy who cried wolf

- Political uncertainty in Italy has caused market turmoil with significant spillover effects within but also beyond the Eurozone
- Contagion within the eurozone was of a different nature than in 2011 ■ With a new government in place, attention will now focus on its economic policy, in particular in terms of public finances

Italy has seen a strong pick-up in growth and in 2017 real GDP increased 1.5%, the fastest pace since the crisis. This has translated into a significant drop in the unemployment rate and considerable job creation. In 2017, the country had a current account surplus of 2.8% of GDP, and in recent years its net foreign asset position has improved significantly, reaching a very low -7% of GDP. Since 2014 the public sector deficit has been below 3% of GDP. Most importantly, European Union data show that since 1995 the country has been running a primary fiscal surplus for 22 years (only the year 2009, in the depths of a worldwide recession, saw a small primary deficit). Most (65%) of public debt is domestically held. Admittedly, the country faces many economic challenges - it's not alone in that respect - a key one of which is boosting potential growth. Nevertheless, it is worth keeping these numbers in mind when observing market behaviour over the past 10 days. It showed that the spread's widening reflects an increase in worries rather than a deterioration in fundamentals.

The source of these worries was the uncertainty about how the coalition-government-in-the making would handle a number of issues (allowing a considerable increase in the public sector deficit, its relationship with 'Brussels'). Following the proposed appointment of Professor Savona, who is considered to be a eurosceptic, as Treasury Minister, markets went so far as to start to doubt Italy's commitment to the eurozone. All this is reminiscent of the fable about the shepherd boy who cried wolf, frightening the villagers with the danger that their flock of sheep would be attacked by wolves whereas nothing happening. Indeed, it is worth remembering that in the 57-page contract for the new government signed by 5 Star and the Northern League no mention is made of the issue of abandoning the euro.

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Moreover, in recent days Professor Savona explained that his past proposal of a plan B for an “Italexit” was to be used as simply a sort of bargaining chip, a threat to be made in order to obtain more in the attempt to change European rules.

To some degree, the market's reaction doesn't come as a surprise, if only because of its earlier complacency. Quite unusually, both in the run-up to the elections on 4 March and thereafter, the spread with Bunds has narrowed and Italian equities have outperformed the Euro Stoxx 50 index. Understandably, when uncertainty increases, there is a backlash. The prospect of new elections poured oil on the fire lit by fears they would turn into a de facto referendum on eurozone membership.

With respect to the euro, in addition to what has previously been said (no mention of abandoning it was made in the coalition program), it is good to keep in mind the presidential elections in France last year when an anti-euro stance was severely sanctioned by voters and the fact that the European Union's Eurobarometer 461 of April 2017 shows that 58% of Italians are in favour of the euro (35% against, 7% uncertain). Admittedly, Italy is in the second part of the league table but there's a majority nevertheless. Another point to be taken into account is what the other parties would have said. During the sell-off, markets were increasingly pricing extreme scenarios. Preparing for elections would have meant that more and less extreme scenarios would need to be priced. With the spread between Italy and Germany reflecting a probability-weighted average of possible outcomes, the multiplication of scenarios can actually help to calm things down.

News on Wednesday of a renewed effort to form a coalition was met with a big sigh of relief as the BTP-Bund spread narrowed 40 basis points: markets acted as a pinball machine. The appointment on Thursday of a new government under the leadership of Giuseppe Conte, who in an interview emphasised the absence in the coalition contract of any reference to leaving the euro, should bring more relief. Yet markets will stay on their toes. The focus will be on the public sector deficit and whether the relationship with the EU on this matter will be confrontational or cooperative (on both sides). The importance goes well beyond Italy. As the charts show, the spread's widening has created a contagion effect (the Portuguese spread, to name just one, widened), weighed on the euro and the equity market and caused safe-haven buying that has resulted in a decline in Bund yields and even US treasury yields. On contagion in the eurozone, it should be

emphasised that this is not like 2011 when several countries were suffering from the same illness. Today contagion is a reflection of risk arbitrage: investors who feel confident about Italy in the medium term and count on the spread narrowing in due course seize the opportunity of a more attractive return/risk trade-off in Italy by lowering positions in other markets, causing their spread to increase as well.

A final word on ‘the boy who cried wolf’: whereas the fable has a sad ending when for once the villagers did not react when the boy raised the alarm and the wolves attacked the flock, we can be confident that markets will always cry out when they see fit, thereby sending signals to be taken on board by policy makers. Moreover, eurozone governance is such that the shepherds, unlike the boy the fable, will be sure to protect their flock of sheep.

William De Vijlder



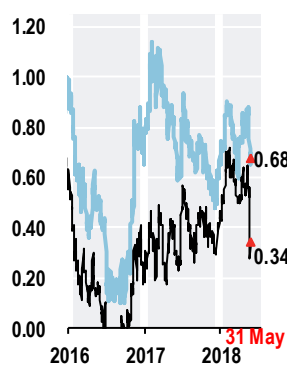
Markets overview

The essentials

Week 25-5 18 > 31-5-18

➤ CAC 40	5 543	➤ 5 398	-2.6 %
➤ S&P 500	2 721	➤ 2 705	-0.6 %
➤ Volatility (VIX)	13.2	➤ 15.4	+2.2 pb
➤ Euribor 3M (%)	-0.32	➤ -0.32	+0.2 bp
➤ Libor \$ 3M (%)	2.32	➤ 2.30	-1.8 bp
➤ OAT 10y (%)	0.72	➤ 0.68	-3.8 bp
➤ Bund 10y (%)	0.41	➤ 0.34	-6.3 bp
➤ US Tr. 10y (%)	2.93	➤ 2.86	-7.5 bp
➤ Euro vs dollar	1.17	➤ 1.17	+0.2 %
➤ Gold (ounce, \$)	1 304	➤ 1 304	+0.0 %
➤ Oil (Brent, \$)	76.4	➤ 77.1	+0.9 %

10 y bond yield, OAT vs Bund



— Bunds — OAT

Euro-dollar



CAC 40



Money & Bond Markets

Interest Rates	highest' 18	lowest' 18
€ ECB	0.00 at 01/01	0.00 at 01/01
Eonia	-0.35 at 01/01	-0.37 at 18/05
Euribor 3M	-0.32 at 29/05	-0.33 at 01/01
Euribor 12M	-0.18 at 30/05	-0.19 at 19/02
\$ FED	1.75 at 22/03	1.50 at 01/01
Libor 3M	2.37 at 04/05	1.69 at 01/01
Libor 12M	2.78 at 27/04	2.11 at 01/01
£ BoE	0.50 at 01/01	0.50 at 01/01
Libor 3M	0.79 at 19/04	0.52 at 04/01
Libor 12M	1.06 at 17/04	0.76 at 03/01

At 31-5-18

Yield (%)	highest' 18	lowest' 18
€ AVG 5-7y	0.74 at 31/05	0.41 at 18/04
Bund 2y	-0.69 at 07/03	-0.79 at 29/05
Bund 10y	0.34 at 15/02	0.28 at 29/05
OAT 10y	0.68 at 08/02	0.60 at 30/03
Corp. BBB	1.57 at 30/05	1.17 at 08/01
\$ Treas. 2y	2.43 at 16/05	1.89 at 01/01
Treas. 10y	2.86 at 17/05	2.41 at 01/01
Corp. BBB	4.24 at 17/05	3.59 at 01/01
£ Treas. 2y	0.51 at 21/03	0.40 at 01/01
Treas. 10y	1.28 at 15/02	1.23 at 01/01

At 31-5-18

10y bond yield & spreads

4.78%	Greece	443 pb
2.84%	Italy	249 pb
1.96%	Portugal	162 pb
1.48%	Spain	114 pb
0.75%	Belgium	40 pb
0.70%	Austria	35 pb
0.68%	France	33 pb
0.65%	Ireland	30 pb
0.53%	Finland	19 pb
0.53%	Netherlands	18 pb
0.34%	Germany	

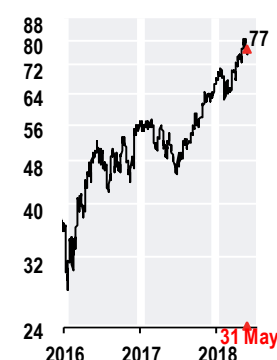
Commodities

Spot price in dollars	lowest' 18	2018(€)
Oil, Brent	62.2 at 13/02	+19.1%
Gold (ounce)	1 288 at 17/05	+2.9%
Metals, LMEX	3 184 at 26/03	+0.8%
Copper (ton)	6 556 at 26/03	-2.3%
CRB Foods	335 at 04/04	+9.0%
wheat (ton)	155 at 16/01	+28.3%
Corn (ton)	126 at 08/01	+16.6%

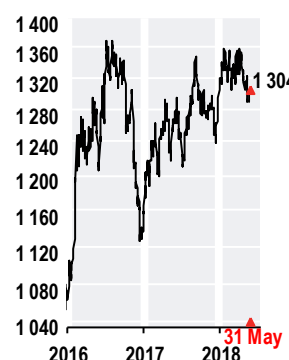
At 31-5-18

Variations

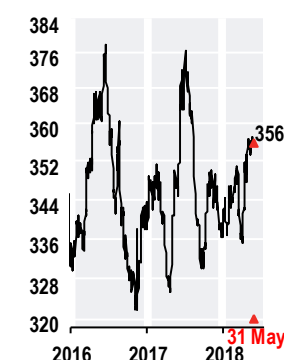
Oil (Brent, \$)



Gold (Ounce, \$)



CRB Foods



Exchange Rates

€ =	highest' 18	lowest' 18	2018
USD	1.25 at 25/01	1.16 at 29/05	-2.8%
GBP	0.89 at 02/03	0.86 at 17/04	-1.2%
CHF	1.20 at 19/04	1.15 at 31/05	-1.9%
JPY	126.82 at 02/02	125.87 at 29/05	-6.2%
AUD	1.61 at 26/03	1.53 at 09/01	+0.5%
CNY	7.92 at 25/01	7.42 at 29/05	-4.4%
BRL	4.41 at 18/05	3.87 at 08/01	+9.1%
RUB	79.12 at 11/04	68.06 at 09/01	+5.2%
INR	81.39 at 25/04	75.92 at 08/01	+2.8%

At 31-5-18

Variations

Equity indices

Index	highest' 18	lowest' 18	2018	2018(€)
CAC 40	5 640 at 22/05	5 066 at 26/03	+1.6%	+1.6%
S&P500	2 873 at 26/01	2 581 at 08/02	+1.2%	+4.1%
DAX	13 560 at 23/01	11 787 at 26/03	-2.4%	-2.4%
Nikkei	24 124 at 23/01	20 618 at 23/03	-2.5%	+4.0%
China*	101 at 26/01	88 at 09/02	+3.5%	+6.2%
India*	642 at 29/01	547 at 23/05	-1.8%	-4.4%
Brazil*	2 393 at 26/01	1 774 at 28/05	-0.1%	-8.5%
Russia*	707 at 26/02	571 at 16/04	+9.5%	+5.1%

At 31-5-18

Variations

* MSCI index



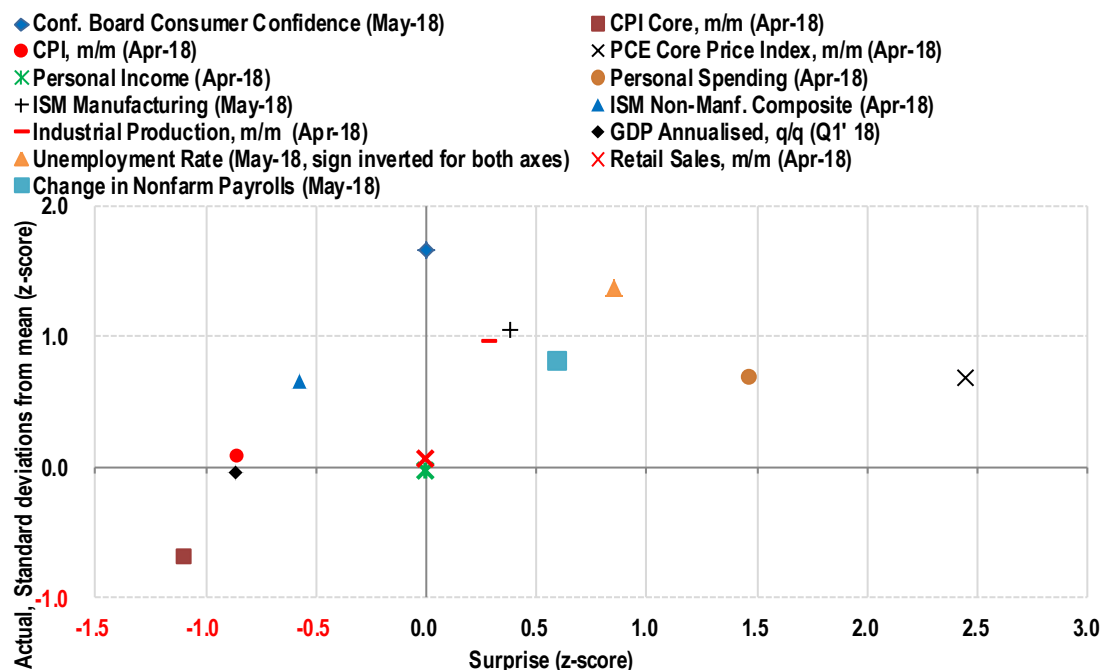
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Pulse

United States: Strong data

The majority of the economic indicators with respect to sentiment, activity, spending are above the long term average and reflect the strong growth environment in the US. The picture is more mixed concerning inflation where the reading very much depends on the metric used. In terms of surprises, activity, spending as well as the employment data for the month of May have surprised to the upside. That was also the case for the ISM manufacturing survey. All in all this shows an economy growing strongly. Monitoring sentiment will be particularly important in the coming months given the softer survey data we have seen in Europe, the turmoil in emerging markets and the concerns of US industry about the domestic consequences (inflation) of the tariff increases imposed by the US administration.



Indicators preview

A rather light week ahead of us on the data front with the services and composite Markit PMIs in several countries, the non-manufacturing ISM in the US and the Eco Watchers Survey in Japan. We will also have new estimates of GDP growth for the first quarter in the eurozone and Japan.

Date	Country/Region	Event	Period	Survey	Prior
06/04/18	United States	Durable Goods Orders	April	--	--
06/05/18	France	Markit France Composite PMI	May	--	54.5
06/05/18	Eurozone	Markit Eurozone Composite PMI	May	--	54.1
06/05/18	Eurozone	Retail Sales MoM	April	--	0.1%
06/05/18	United States	ISM Non-Manf. Composite	May	57.0	56.8
06/07/18	Eurozone	GDP SA QoQ	1Q	--	0.4%
06/08/18	Japan	GDP SA QoQ	1Q	--	-0.2%
06/08/18	France	Industrial Production MoM	April	--	-0.4%
06/08/18	Japan	Eco Watchers Survey Current SA	May	--	49.0

Sources: Bloomberg, BNP Paribas



Economic scenario

UNITED STATES

■ Despite slow start, economy is expected to expand at a 3% or so in 2018, thanks to tax cuts, booming profits and credit. However, the current weakening in external trade indexes put the risk on the downside.

■ Inflation is accelerating in the wake of higher oil prices and more evident tensions in the labour market.

■ The Fed will keep on normalizing monetary conditions. We forecast the Fed Funds target rate to reach 2.75% by early 2019.

CHINA

■ Economic growth will decelerate in 2018. Despite the slowdown, the central bank will have to continue to act to encourage the deleveraging of financial institutions and corporates and reduce financial instability risks. Fiscal policy should remain expansionist.

■ The outlook for exports and household spending is rather favourable in the short term, but the tightening of domestic credit conditions, restructuring measures in the industry and less buoyant property market will weigh on economic activity.

EUROZONE

■ The recovery is continuing, although it has been weaker than expected at the start of the year. Intra-EU trade builds with domestic demand, especially corporate investment.

■ Inflation has rebounded in the wake of higher oil prices, but the core CPI trend remains subdued. Along with renewed tensions over sovereign debt spreads (Italy) this argues for the ECB to keep on buying until year end at least, and to maintain the status quo on key rates thereafter (first hike seen in Q4'19).

FRANCE

■ Growth remains robust but gets back down to a less rapid pace than in 2017. Households' consumption is supported by the jobs recovery but restrained by the upturn in inflation. Investment and exports dynamics remain favourable. Risks are on the downside. A slight rise in core inflation is appearing but remains to be confirmed.

INTEREST RATES AND FX RATES

■ In the US, ongoing strong growth and a very low unemployment rate pave the way for several rate hikes (we expect 4 this year and 1 next). This will put upward pressure on bond yields in 2018. The ECB is expected to stop its QE programme at the end of 2018 and to hike its rates by the middle of 2019. As a consequence, bond yields should follow a rising trend, including in 2019. No change expected in Japan

■ The narrowing bond yield differential between the US and the eurozone should cause a strengthening of the euro, all the more so considering it is still below its long-term fair value (around 1.34).

SUMMARY

%	GDP Growth			Inflation		
	2017	2018 e	2019 e	2017	2018 e	2019 e
Advanced	2.2	2.4	1.7	1.8	2.1	1.9
United-States	2.3	3.0	2.0	2.1	2.5	2.1
Japan	1.7	0.8	0.6	0.5	0.9	0.8
United-Kingdom	1.8	1.4	1.3	2.7	2.8	2.2
Euro Area	2.5	2.2	1.7	1.5	1.8	1.8
Germany	2.5	2.1	1.9	1.7	1.9	2.0
France	2.3	2.1	1.9	1.2	2.0	1.6
Italy	1.6	1.4	1.2	1.3	1.4	1.7
Spain	3.1	2.8	2.2	2.0	1.7	1.7
Netherlands	3.3	2.3	1.7	1.3	1.7	1.8
Emerging						
China	6.9	6.4	6.3	1.6	2.3	2.5
India	6.7	7.4	7.6	3.6	4.5	4.4
Brazil	1.0	2.0	3.5	3.4	3.0	3.3
Russia	1.5	1.8	1.7	3.7	3.0	4.0

Source : BNP Paribas Group Economic Research (e: Estimates & forecasts)

INTEREST RATES & FX RATES

End of period		2018				2017	2018e	2019e
		Q1	Q2e	Q3e	Q4e			
US	Fed Funds	1.75	2.00	2.25	2.50	1.50	2.50	2.75
	Libor 3m \$	2.31	2.20	2.50	2.65	1.69	2.65	2.55
	T-Notes 10y	2.75	3.07	3.20	3.25	2.41	3.25	3.00
Ezone	ECB Refi	0.00	0.00	0.00	0.00	0.00	0.00	0.25
	Euribor 3m	-0.33	-0.33	-0.33	-0.33	-0.33	-0.33	0.07
	Bund 10y	0.50	0.53	0.90	1.10	0.42	1.10	1.50
	OAT 10y	0.60	0.84	1.15	1.35	0.66	1.35	1.75
UK	Base rate	0.50	0.50	0.75	0.75	0.50	0.75	1.25
	Gilts 10y	1.39	1.50	1.60	1.75	1.23	1.75	2.10
Japan	BoJ Rate	-0.07	-0.10	-0.10	-0.10	-0.04	-0.10	-0.10
	JGB 10y	0.04	0.05	0.05	0.05	0.05	0.05	0.00

End of period		2018				2017	2018e	2019e
		Q1	Q2e	Q3e	Q4e			
USD	EUR / USD	1.23	1.18	1.23	1.28	1.20	1.28	1.34
	USD / JPY	106	108	105	104	113	104	98
	GBP / USD	1.40	1.33	1.38	1.45	1.35	1.45	1.52
	USD / CHF	0.96	1.00	0.97	0.94	0.97	0.94	0.93
EUR	EUR / GBP	0.88	0.89	0.89	0.88	0.89	0.88	0.88
	EUR / CHF	1.18	1.18	1.19	1.20	1.17	1.20	1.25
	EUR / JPY	131	127	129	133	135	133	131

Source: GlobalMarkets BNP Paribas (e: estimates & forecasts)



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 Prepared by Economic Research – BNP PARIBAS
 Registered Office: 16 boulevard des Italiens – 75009 PARIS
 Tel: +33 (0) 1.42.98.12.34 – Internet :
www.group.bnpparibas.com
 Publisher: Jean Lemierre. Editor: William De Vijlder



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