15 October 2018

Danske Daily

Italian budget and new Brexit concerns

Market movers today

The US Treasury is set to release its biannual report on FX manipulation. We do not expect the report to designate China a currency manipulator, as China meets only one of the three criteria. See *Flash Comment – Will the US label China a currency manipulator? Not likely*, 10 October.

Today is the deadline for the Italian government to present its 2019 budget draft to the European Commission. In light of overly optimistic growth assumptions, significant fiscal weakening and many open questions on the financing side, our base case is now that the Commission will voice a negative opinion and ask for a revision of the budget.

In terms of data released, US September retails sales and the Empire Manufacturing Index are the most interesting on the calendar today. Consumer optimism remains high in the US and we expect private consumption to remain the most important growth driver.

Markets will also keep an eye on the Brexit negotiations, which are entering a hot phase this week, especially after the apparent stalemate over the weekend. So, it is uncertain whether an agreement will be reached ahead of the EU summit starting on Thursday.

Selected market news

The positive sentiment in the US equity market on Friday night, which saw all three major indices ending the day higher, up between 1.2% and 2.3%, has not been carried over to Asia. This morning most Asian equity indices are down more than 1%. The reaction in the US treasury market has been muted, with 10Y yields at 3.15% down less than 1bp since the US close. It confirms our view that US yields have now more consistently moved higher. In *FI Strategy – Next stop is 3.5% for 10Y US Treasury yields*, 15 October, we argue that 3.5% will be reached over the next three to six months.

The market is increasingly concerned about the apparent disappearance or even murder of the *Washington Post* journalist Jamal Khashoggi inside the consulate of Saudi Arabia in Istanbul. The US is now discussing possible sanctions against Saudi Arabia, including downgrading diplomatic ties or sanctioning Saudi officials visiting the US. The aggravation of the relationship between the Saudi and US administrations has pushed Brent oil higher to USD81.5/bbl.

Brexit negotiations have also run into new trouble, as the negotiations between the EU and the UK ended up in a stalemate over the weekend. The impasse comes just days before the EU leaders meet later this week to discuss 'the divorce'. On the one hand, media is now reporting that officials on both sides are increasingly concerned that no deal will be reached before the March break-up date. On the other hand, these kinds of 'breakdowns' are quite normal in negotiations where the involved partners have a lot at stake. Everybody needs to show that they have been fighting hard before a deal can be reached.

Today, the market is likely to focus on Italy presenting its budget to the EU commission. We have seen little contagion to Spain and Portugal from Italy during the Italy budget crisis. Importantly, Portugal regained the missing investment rating from Moody's on Friday night. For more, see *FI Strategy – Portugal upgraded to IG by Moody's*, 14 October.

Selected readings from Danske Bank

- *Flash Comment - Will the US label China a currency manipulator? Not likely*, 10 October
- *US Election Monitor #2 – Kavanaugh confirmation not likely to affect the Senate battle*, 12 October
- *Harr's View - Stock market rout to fade despite looming Italy-EU clash*, 14 October
- *Strategy - Equity sell-off is temporary despite slower growth*, 12 October
- *FI Strategy - Next stop is 3.5% for 10Y US Treasury yields*, 15 October

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Scandi markets

There is no news from Scandinavia today.

Fixed income markets

Portugal received an investment grade rating from Moody's on Friday and now has an investment grade rating from all four rating agencies (Standard & Poor's, Fitch, Moody's and DBRS). The timing is good, as we expect the Portuguese government to present its 2019 budget today. We expect this to show a further strengthening, as we expect the deficit for 2019 to be between 0% and 0.2% relative to 0.7%.

Hence, the developments in Portugal are very different from those in Italy. This has been rewarded by the market as the spill-over effect on Portugal from the Italian budget crisis has been modest. However, spreads have widened and our current recommendation to buy the 15Y benchmark that was launched in April looks cheap. Alternatively, looking at the PGB curve, there is value in the 5Y to 10Y segment given a solid roll-down. For more, see *Fixed Income Strategy – Time to buy Portugal*, 14 October.

Risk markets stabilised on Friday night. However, the impact on US treasuries was muted, probably underlining that the upside pressure on yields, at least for now, has diminished, as it seems that global equities are not ready to 'accept' yields above 3.20%. This said, 10Y yields are a still some 35bp higher since the end of September, while S&P 500 is more than 5% lower.

This week gross issuance is set to amount to approximately EUR20bn but there are plenty of redemptions from Italy, Austria and Ireland. We believe the ECB holds large amounts of all three bonds but the Irish government bond is likely to be held by the SMP portfolio, and this amount will not be reinvested. However, for the Italian and Austrian bonds, there is a reinvestment need, which should provide some relief for the BTPS market. The supply this week is set to come from Germany (EUR5.5bn), France (EUR7-8bn) and Spain (EUR4-5bn). Finally, Finland is doing a small tap in the 10Y segment. In the Scandi area, Sweden is conducting a tap in the 10Y segment. For more see *Government Bonds Weekly – Three reasons for going long Ireland. Significant reinvestment need from ECB*, 14 October, in which we also discuss why we are still positive on Ireland.

FX markets

In the majors, focus remains on the impact of struggling risk appetite and political developments. On the latter, today is set to bring a range of news on the Italian budget draft presentation to the EU, the US Treasury biannual FX manipulation report and, potentially, on the Brexit negotiations. Overall, we still expect EUR/USD to continue its range trading around 1.15, while any confirmation of a UK-EU deal would yield GBP support. We plan to follow the headlines closely.

On the Scandies, we this morning published the latest edition of the biweekly *Reading the Markets Norway – Upside potential in mid-segment interest rates in the wake of the Norges Bank hike*, 15 October. On EUR/NOK, we argue that the balance of risk favours staying short as a break of 9.40 would open up for a test of the low 9.20s. This said, if the 9.40 support level is not broken in coming weeks, we would contemplate taking profit on our short trading recommendation on the balance of risk for year-end seasonality, a high bar for a Norges Bank December hike and technicals. We stay short for now on the fundamental attractiveness and our expectation that risk sentiment will stabilise

In neighbouring Sweden, the SEK has seen support from markets more or less fully pricing in a December Riksbank rate hike. In the near term, the cross remains heavily dependent on global risk appetite as well the development of the formation of a new Swedish government. We maintain our recommendation to use any rallies in EUR/SEK to enter tactical shorts.

Key figures and events

Monday, October 15, 2018				Period	Danske Bank	*Consensus*	Previous
-	USD	US Treasury publishes semi-annual currency manipulation report					
-	EUR	Italy presents 2019 budget proposal to European Commission					
6:30	JPY	Industrial production, final	m/m|y/y	Aug			0.7%|0.6%
8:00	NOK	Trade balance	NOK bn	Sep			31.8
14:30	USD	Empire Manufacturing PMI	Index	Oct		*20.5*	19.0
14:30	USD	Retail sales control group	m/m	Sep		*0.4%*	0.1%
23:45	NZD	CPI	q/q|y/y	3rd quarter		*0.7%|1.7%*	0.4%|1.5%

Source: Bloomberg, Danske Bank

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