KBC Market Research Desk - Havenlaan 12, 1080 Brussel

Sunrise

Monday, 28 May 2018

Rates: Worst case scenario avoided short term, but medium term risks increase

Risk sentiment improved overnight with the US/North Korean Summit back alive and the worst case short term scenario avoided on the Italian political scene. However, snap elections risk strengthening Populist parties' hands in the medium term. We wouldn't buy into any BTP relief rally. UK and US markets are closed today, suggesting low volume trading.

Currencies: EUR to enjoy a temporary short-squeeze?

EUR/USD set a new 2018 correction low on Friday as political tensions in Italy and Spain weighed. EUR/USD rebounds this morning as Italian president Mattarella vetoed a euro-skeptic finance Minister. However, for now, we assume that this is nothing more than a technical short-squeeze on a protracted EUR/USD decline since mid-April.

Calendar

Headlines

- **US stock markets ended mixed on Friday** with main indices recording small losses (-0.25%) or gains (+0.15%). **Asian stock markets gains ground overnight** with Japan (flat) underperforming.
- Italy's leading populist political parties dropped their bid to form a government following a **dramatic decision by President Mattarella to block the nomination of an avowedly Eurosceptic FM. New elections (in September?) are likely.** (FT)
- **Profits earned by Chinese industrial firms in April rose at their fastest pace in six months,** as factories benefited from higher prices and strong demand. Profits in April rose 21.9% Y/Y to 576 bn yuan.
- US officials met with their North Korean counterparts following a surprise meeting between the leaders of the two Koreas aimed at **reviving a summit between President Trump and North Korean leader Kim Jong Un.** (WSJ)
- **Moody's placed Italian's Baa2 rating on review for possible downgrade.** Key drivers are a significant risk of a material weakening in Italy's fiscal strength and the risk that structural reform efforts stall.
- **OPEC and allied oil producers including Russia concluded that the crude market re-balanced in April,** when their output cuts achieved a key goal of eliminating the global surplus. Brent crude dropped to $75/barrel. (BB)
- **Today's eco calendar** only contains second tier eco data. UK (Spring Bank Holiday) and US (Memorial Day) markets are closed, suggesting low volume trading.

S&P	→
Eurostoxx 50	→
Nikkei	→
Oil	↓
CRB	↓
Gold	↘
2 yr US	↘
10 yr US	↘
2yr DE	↘
10 yr DE	↓
EUR/USD	↘
USD/JPY	→
EUR/GBP	→

Rates

ST worst case scenario avoided, but MT risks increase

	US yield	-1d
2	2,48	-0,03
5	2,77	-0,05
10	2,93	-0,05
30	3,09	-0,03

	DE yield	-1d
2	-0,62	-0,03
5	-0,18	-0,06
10	0,41	-0,07
30	1,16	-0,05

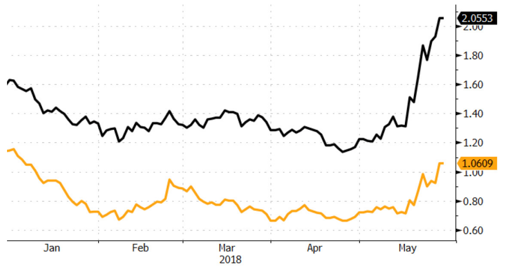
Political developments in Italy and Spain dominated last Friday's trading session. 10-yr yield spreads vs Germany widened by 14 bps for both countries. The Greek (+21 bps) and Portuguese (+11 bps) spreads widened in lockstep. Core bonds profited from a safe haven bid with Bunds outperforming US Treasuries. German yields dropped by 2.9 bps (2-yr) to 6.6 bps (10-yr) with the belly of the curve outperforming. **The 10-yr yield fell below the 0.46% support area.** US yields declined by 3.2 bps (2-yr) to 4.9 bps (5-yr). **The drop in the oil price (from $80/barrel on Thursday to $75/barrel currently) was probably at play as well.** OPEC and its main allies are steering to and end of the production cuts as they achieved in clearing the oil surplus.

Risk sentiment improves this morning. A weekend of intense diplomacy revived last week's cancelled Summit between the US and North Korea. Italian President Mattarella blocked the nomination of a Eurosceptic FM in the 5SM-Lega coalition. The coalition partners decided to end their attempt in forming a government. **Mattarella will probably appoint a technocrat PM now, but we are heading towards new elections (September?). A short term relief rally is likely this morning, but the President's move risks strengthening Populist parties' hands in the medium term.**

Today's eco calendar only contains second tier eco data and won't influence trading. UK and US markets are closed for Spring Banking Holiday and Memorial Day respectively, suggesting very low trading volumes. Overnight moves suggest a weaker opening for the Bund and stronger one for BTP's. **We wouldn't buy into any BTP rally though given heightened medium term risk.** EUR/USD erased Friday's losses, rising back above 1.17. Asian stock markets are mostly positive while the US Note future loses ground.

Technically, the German 10-yr yield lost 0.46% support. A potential uptrend line could give support around 0.37% to keep the modest upward momentum intact. The US 10-yr yield approaches intermediate support at 2.9%. This week's US eco calendar is very busy with several Fed speakers and key eco data. Will they confirm Q2 eco data strength and end the correction lower?

German 10-yr yield dropped below 0.46% following last week's political related short squeeze in the Bund



Italian (black) and Spanish (orange) 10-yr yield spreads widen significantly as snap elections loom in both countries

Currencies

Euro gains on Mattarella's veto, but for how long?

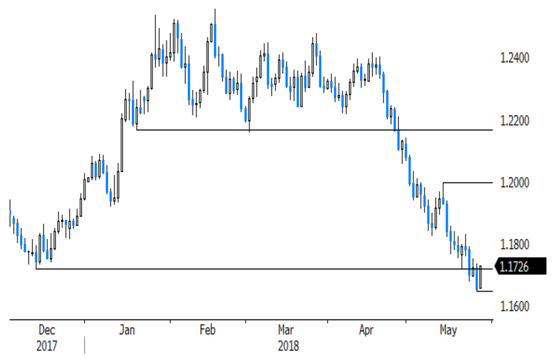
R2	1,2598	-1d
R1	1,2555	
EUR/USD	1,1651	-0,0069
S1	1,1812	
S2	1,1718	

R2	0,9307	-1d
R1	0,9033	
EUR/GBP	0,8755	-0,0002
S1	0,8627	
S2	0,8541	

On Friday, **European bonds and the euro were captured by a regional risk-off trade.** Political uncertainty in Italy was the dominant factor but there was also a growing chance of Spanish PM Rajoy losing support in Parliament. Government bond spreads of Italy and Spain, but also of Greece and Portugal, widened sharply. This European risk off trade also weighed on the euro. **Eco data,** including German IFO sentiment, were OK, but were no big issue for trading. German yields were hammered and fell below key support levels. **EUR/USD dropped from the 1.1730 area to the mid 1.16 area.** Still, the euro correction stayed orderly, taking into account the sharp repositioning on EMU bond markets. USD/JPY was hardly affected by the uncertainty on Europe. The pair held a sideways consolidation pattern in the mid-to low 109 area.

During the weekend, politics remained omnipresent. US President Trump changed course again on North Korea and indicated that a US/North Korea summit will probably still take place. In Italy, **President Matarella rejected the choice of euro-sceptic Poalo Savona for finance minister.** The euro shows some kind of a relief rally. EUR/USD is again trading north of 1.17. Asian equties are mostly trading in positive territory supported by the news on Korea, but USD/JPY hardly profits.

Today, the eco calendar is thin with US and UK markets closed. There are no important data. So the focus will remain on European politics. The single currency this morning shows some kind of a tentative relief rally. However, the question remains open whether the action of President Matarella will ease the anti-EMU feelings in Italy further down the road. After a protracted, almost uninterrupted decline of EUR/USD since mid-April, there is apparently room for a EUR/USD short squeeze. **However, for now, there is not that much reason to expect a sustained rebound of the euro and/or a decline of the dollar.** EMU political uncertainty is probably here to stay. At the same time, economic sentiment on the US might remain constructive with Friday's payrolls the next high profile reference for markets to update their assessment on the Fed policy and on the dollar. **EUR/USD rebounding north of the 1.1996/1.20 area would call off the ST downward alert. We consider this scenario unlikely in the short-term.**



EUR/USD: Mattarella veto to trigger a temporary euro short squeeze?

USD/JPY doesn't profit from easing of tensions on Korea.

Calendar

Monday, 28 May		Consensus	Previous
Japan			
01:50	PPI Services YoY (Apr)	0.9% A	0.5%
UK			
28MAY-03JUN	Nationwide House PX MoM (May)	0.2%	0.2%
Italy			
10:00	PPI MoM/YoY (Apr)	--	0.4%/2.4%
Events			
11:00	Italy to Sell 0.1% 2022 and 1.3% 2028 Linkers		
09:00	Villeroy (ECB) spreekt		
	US markets closed due to Memorial Day		
	UK markets closed due to Spring Bank Holiday		

10-year	Close	-1d		**2-year**	Close	-1d	**Stocks**	Close	-1d
US	2,93	-0,05		**US**	2,48	-0,03	**DOW**	24753,09	-58,67
DE	0,41	-0,07		**DE**	-0,62	-0,03	**NASDAQ**	7433,854	9,43
BE	0,77	-0,05		**BE**	-0,52	0,01	**NIKKEI**	22481,09	30,30
UK	1,32	-0,08		**UK**	0,69	-0,06	**DAX**	12938,01	82,92
JP	0,04	0,00		**JP**	-0,14	0,00	**DJ euro-50**	3515,36	-6,40
IRS	EUR	USD	GBP	**EUR**	-1d	-2d	**USD**	-1d	-2d
3y	-0,01	2,80	1,10	**Eonia**	-0,3660	-0,0020			
5y	0,30	2,87	1,29	**Euribor-1**	-0,3690	0,0020	**Libor-1**	1,9756	0,0074
10y	0,92	2,97	1,52	**Euribor-3**	-0,3230	0,0010	**Libor-3**	2,3181	-0,0012
				Euribor-6	-0,2710	0,0000	**Libor-6**	2,4819	-0,0031
Currencies	Close	-1d		**Currencies**	Close	-1d	**Commodities**	Close	-1d
EUR/USD	1,1651	-0,0069		**EUR/JPY**	127,44	-0,59	**CRB**	203,34	-2,32
USD/JPY	109,41	0,15		**EUR/GBP**	0,8755	-0,0002	**Gold**	1309,00	-0,80
GBP/USD	1,3309	-0,0071		**EUR/CHF**	1,1538	-0,0082	**Brent**	76,44	-2,35
AUD/USD	0,7548	-0,0028		**EUR/SEK**	10,2162	-0,0516			
USD/CAD	1,2973	0,0091		**EUR/NOK**	9,5231	0,0315			

Contacts

Brussels Research (KBC)		Global Sales Force	
Mathias Van der Jeugt	+32 2 417 51 94	Corporate Desk(Brussels)	+32 2 417 45 82
Peter Wuyts	+32 2 417 32 35	Institutional Desk(Brussels)	+32 2 417 46 25
Mathias Janssens	+32 2 417 51 95	CBC Desk (Brussels)	+32 2 547 19 19
Dublin Research		France	+32 2 417 32 65
Austin Hughes	+353 1 664 6889	London	+44 207 256 4848
Shawn Britton	+353 1 664 6892	Singapore	+65 533 34 10
Prague Research (CSOB)			
Jan Cermak	+420 2 6135 3578	**Prague**	+420 2 6135 3535
Jan Bures	+420 2 6135 3574		
Bratislava Research (CSOB)			
Marek Gabris	+421 2 5966 8809	**Bratislava**	+421 2 5966 8820
Budapest Research			
David Nemeth	+36 1 328 9989	**Budapest**	+36 1 328 99 85

ALL OUR REPORTS ARE AVAILABLE VIA OUR KBC RESEARCH APP (iPhone, iPad, Android)