

Peripheral Europe Update

Olaf Penninga, Lead Portfolio Manager Robeco Euro Government Bonds
Bronka Rzepkowski, Portfolio Manager

- **Fitch may revise downward its rating outlook this evening**
- **Risk-off mood hurts periphery**

Main market events

This risk-off mood this week has hurt peripheral bonds significantly, pushing Italian spreads to 5-year highs. The ongoing re-pricing of risk in Emerging Markets may continue to fuel some volatility in the periphery, as liquidity will become increasingly less abundant with the Fed reducing its balance sheet and the ECB ending its QE by the end of the year. This context is not favorable to risky assets and further episodes of stress may be expected. Italian bonds have returned -6.0% year-to-date, Spanish bonds 2.0%, Portuguese bonds 1.4% and Irish bonds 0.6%.

Europe

This week, wage growth prints in the Eurozone came as a relative positive surprise, especially its broad-based nature. While Germany saw the highest growth in negotiated wages at 3.1% yoy, Italy recorded a good 2.2% progression over the year, mainly driven by the first pay rise in the public sector over the past 7 years. Interestingly, the improvement was widespread, including total compensation per employee and hourly labor cost beyond trade union negotiations. Against this background, we could have expected the market to price in the first ECB rate hike earlier. But a rate hike by the end of next year is hardly priced in.

Italy

This evening, Fitch will publish its decision regarding Italy's rating. The most likely scenario is a downgrade of the outlook rather than of the rating itself. Clarification about the 2019 budget is needed in order to revise the rating below BBB that prevailed since April last year. This is especially the case as the agency already rates Italy 4 notches below the rating consistent with their model. By contrast, a negative outlook is likely amid rising fiscal slippage in 2019 budget that could jeopardize the sustainability of the public debt in the medium term. This week, business confidence fell to a 20-month low – especially in the manufacturing and production sectors – while consumer sentiment has remained quite resilient near its historical high. This decline in business confidence since the summer appears to be idiosyncratic and related to the uncertainties fueled by the populist government, as no such deterioration has been observed in other eurozone countries.

Robeco Euro Government Bonds

We have not changed our slightly defensive stance towards periphery last week. The fund is slightly overweight long dated peripheral bonds, while it does not hold any Irish, Portuguese or Spanish bonds with up to 7-year maturities. We do expect the spread curve to flatten in case of a further deterioration of the sentiment around the 2019 budget negotiations. Currently the fund is 30% invested in peripheral bonds, less than the index level as expressed in market value. Year-to-date the fund's absolute return is -0.64%*.

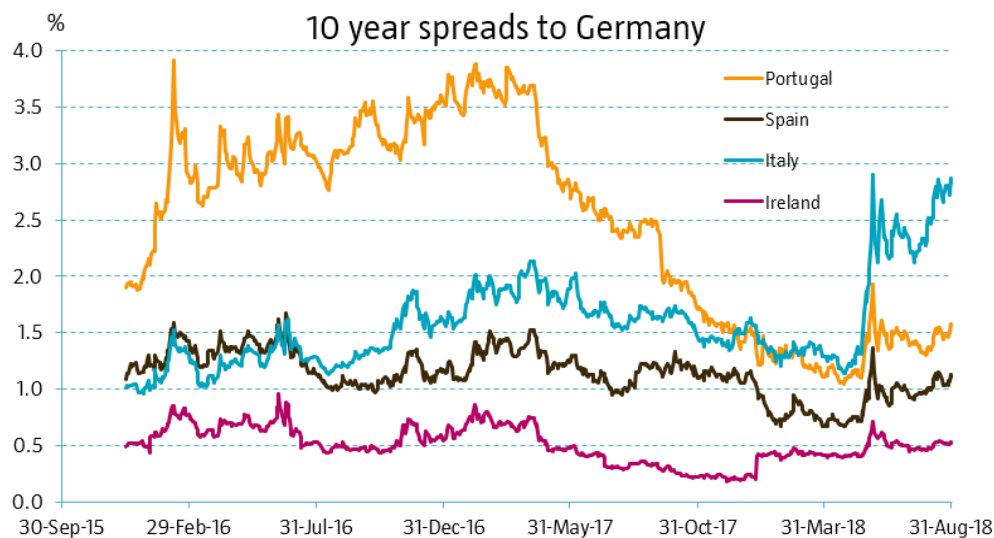
* Robeco Euro Government Bonds, gross of fees, based on Net Asset Value, 30 August, 2018. The value of your investments may fluctuate. Past results are no guarantee of future performance.

Current 10-yr spreads versus Germany

Maturity	German yields	Spreads										
		France	Italy	Spain	Netherlands	Belgium	Austria	Greece	Ireland	Finland	Portugal	
1	-0.62	0.08										
2	-0.59	0.16	1.92	0.32	0.00	0.10	0.10	2.00	0.13	0.06	0.47	
3	-0.50	0.22	2.33	0.42	0.01	0.11	0.10		0.05	0.04	0.44	
4	-0.37	0.23	2.63	0.47	0.01	0.11	0.08		0.20	0.11	0.72	
5	-0.22	0.26	2.69	0.65	0.02	0.21	0.13	3.62	0.15	0.14	0.92	
6	-0.13	0.23	2.93	0.84	0.10	0.23	0.20		0.31	0.12	1.03	
7	-0.02	0.27	2.96	0.97	0.12	0.29	0.26		0.39	0.22	1.39	
8	0.11	0.30	2.89	1.04	0.11	0.31	0.12			0.20	1.47	
9	0.23	0.28	2.93	1.09	0.13	0.36	0.25				1.52	
10	0.35	0.35	2.83	1.11	0.12	0.37	0.22	4.04	0.52	0.13	1.56	
15	0.63	0.48	2.81	1.32		0.49	0.36	4.37	0.74	0.30	1.82	
20	0.79	0.43	2.87			0.60	0.27	4.49			1.93	
30	1.03	0.57	2.75	1.59	0.00	0.64	0.35			0.18	1.98	

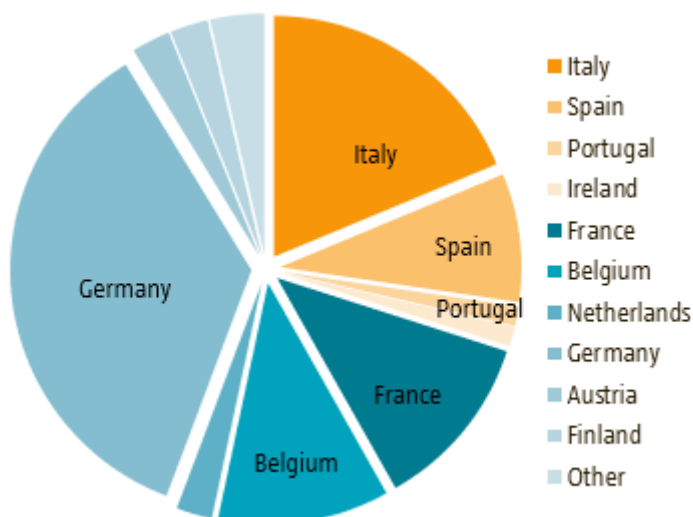
Source: Bloomberg

Movement over time



Source: Bloomberg.

Country allocation Robeco Euro Government Bonds (30 August, 2018)



Source: Robeco

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