

Peripheral Europe Update

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- **Italy: 2.4% public deficit in 2019 draft budget spooks markets**
- **ECB: Emphasis on inflation pressures lingers on**

Main market events

On Thursday evening the 27th the Italian government presented its 2019 draft budget. Markets participants had been anxiously waiting for the outcome of the 5SM – Lega coalition's first budget. In a surprise move the government announced to increase its fiscal deficit target to 2.4% for 2019 and the following years. This target is 0.6% above a number floated by Finance Minister Tria and much higher than the 0.8% deficit for 2019 agreed with the European commission. These numbers are also higher than what the market and we expected. Earlier in the week Italian press quoted a 1.9% deficit target. The spread with Germany in the run up to the budget announcement declined with about 0.80% over the last weeks, as government rhetoric indicated a more market friendly outcome. On Friday this tightening of the spread was reversed as the Italian government bond market sold off sharply.

ECB

In a speech on Monday ECB president Draghi indicated that the ECB sees a relatively vigorous pickup in inflation. The market seemed to have perceived this as a somewhat hawkish turn and as a result core bond yields sold off. Also the short-end saw a significant repricing, with 19bps of hikes now priced by the end of 2019.

Italy

The market's reaction to the Italian budget plans were fierce. Italian yields spiked higher and equities sold off sharply. The spread with Germany as a result rose with about 0.40% to about 2.70% on Friday. Reduced confidence with regard to Italy's debt sustainability have resurfaced and the fact that the moderate finance Minister Tria seem to have been sidelined also added to the negative sentiment. Chances of a downgrade increased, also as Moody's has Italy on Baa2 (negative credit watch). Moody's has indicated to give more clarity on the outcome of its rating review in October. Whilst the 2.4% deficit number was higher than expected the number will likely not send the debt/gdp ratio into an upward trajectory, as long as nominal is holding up at around 2½%. Later in the day spreads stabilized on the back of more constructive comments from government officials.

Robeco Euro Government Bonds

On Thursday we added a small tactical long position in Italy believing the outcome of the 2019 budget draft could lead to further consolidation of the Italian market. Although Italian yields rose sharply after the disappointing budget announcement, we for now decided to continue with a small overweight. There are still several hurdles for the government to take before the budget can be finalized, especially with the European commission. Pushback by the European commission seems very likely. Currently the fund is 38% invested in peripheral bonds, less than the index level as expressed in market value. Year-to-date the fund's absolute return is -0.54%*.

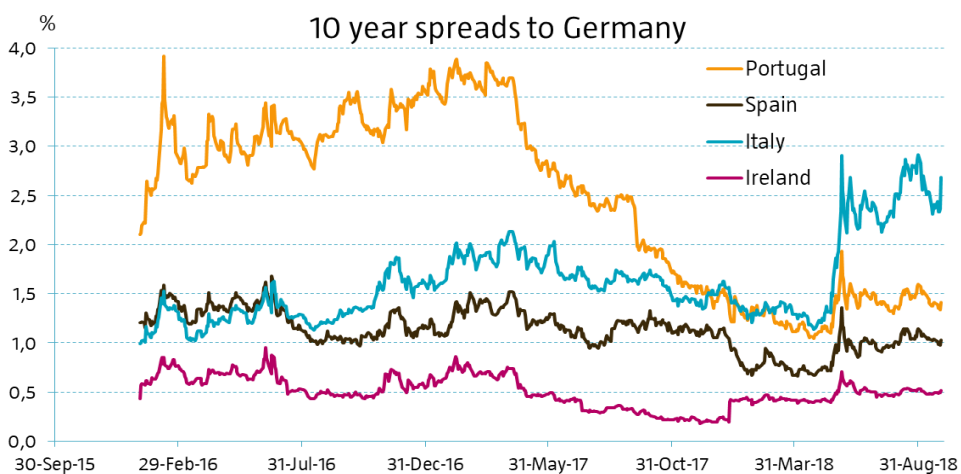
* Robeco Euro Government Bonds, gross of fees, based on Net Asset Value, 27 September, 2018. The value of your investments may fluctuate. Past results are no guarantee of future performance.

Current 10-yr spreads versus Germany

Maturity	German yields	Spreads									
		France	Italy	Spain	Netherlands	Belgium	Austria	Greece	Ireland	Finland	Portugal
1	-0,59	0,07									
2	-0,52	0,17	1,56	0,33	-0,02	0,08	0,10	1,93	0,10	0,06	0,44
3	-0,41	0,23	1,99	0,44	-0,01	0,10	0,09		-0,03	0,02	0,45
4	-0,25	0,24	2,25	0,46	0,00	0,11	0,04		0,16	0,11	0,67
5	-0,09	0,26	2,33	0,61	0,03	0,21	0,10	3,33	0,11	0,13	0,83
6	0,01	0,22	2,67	0,78	0,07	0,20	0,16		0,27	0,10	0,90
7	0,12	0,25	2,69	0,90	0,10	0,27	0,23		0,37	0,20	1,25
8	0,24	0,29	2,58	0,97	0,10	0,31	0,11			0,19	1,32
9	0,35	0,27	2,64	1,02	0,13	0,35	0,24				1,37
10	0,47	0,33	2,68	1,03	0,11	0,36	0,21	3,71	0,52	0,26	1,41
15	0,73	0,46	2,59	1,24		0,49	0,35	4,01	0,73	0,30	1,70
20	0,87	0,42	2,67			0,59	0,26	4,21			1,78
30	1,08	0,58	2,65	1,50	0,01	0,64	0,35			0,18	1,86

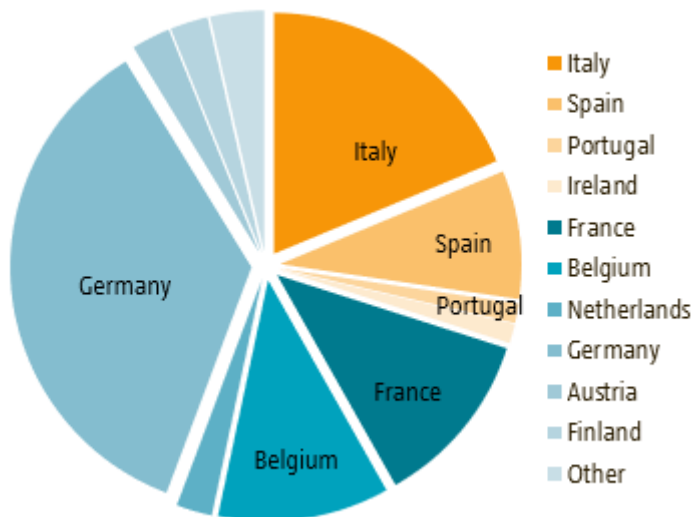
Source: Bloomberg

Movement over time



Source: Bloomberg.

Country allocation Robeco Euro Government Bonds (27 September, 2018)



Source: Robeco

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