

Peripheral Europe Update

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- **Confrontation between Italy and the European Commission**
- **Watch Moody's this evening on possible rating action for Italy**

Main market events

Against a background of escalating tensions between the European Commission and the Italian populist coalition, Italian but also Spanish spreads widened sharply over the past week. Italy is now trading at circa 320 basis points over Germany. Up to last week, contagion effects remained relatively contained, but the stubborn stance of the Italian coalition and its confronting stance vis-à-vis European institutions has started to contaminate the Spanish and to a lesser extent the French and other semi-core bond markets. Italian bonds have returned -7.7% year-to-date, Spanish bonds 0.25%, Portuguese bonds 0.9% and Irish bonds -0.2%.

ECB/EC

After having made it clear that the Italian 2019 draft budget was not in line with EU rule, the European Commission is likely to reject it outright. This quick decision would then give the Italian populist coalition some time to amend its budget before the formal assessment by the EC at the end of November. It would be the first time that the EC rejects a whole budget plan.

Italy

The concerns to the Italian budget highlighted by the Commission were not only on the level of the deficit but also on its composition. In short, the budget draft plans to increase the tax burden on the productive sector in order to finance the non-productive ones. It may be difficult for Lega and Five Star to step back as backtracking would involve giving up on some electoral promise. That said, eventually we believe they will have to, probably driven by market pressures. In the meantime, the EC and Italy can find some sort of a middle way to reduce tensions. Also Moody's could publish its rating verdict on Italy tonight, although next Friday is also a possibility. It is expected that Moody's will downgrade Italy with one notch to Baa3. The main question is if there will be a stable or negative outlook attached to this. A stable outlook is likely to lead to some relief in the market.

Robeco Euro Government Bonds

We remain a touch overweight Italian BTPs (5y maturity) given valuations are now at multi year highs. However we did reduce Portugal exposure and exposure to semi core countries. We also have a significant underweight in France. The outlook for French OATs has not improved much. Spreads are still priced at the average of the past years, while contagion risks from political tensions between the EC and Italy have grown. We think these risks are underpriced. Currently the fund is 33% invested in peripheral bonds, less than the index level as expressed in market value. Year-to-date the fund's absolute return is -1.80%*.

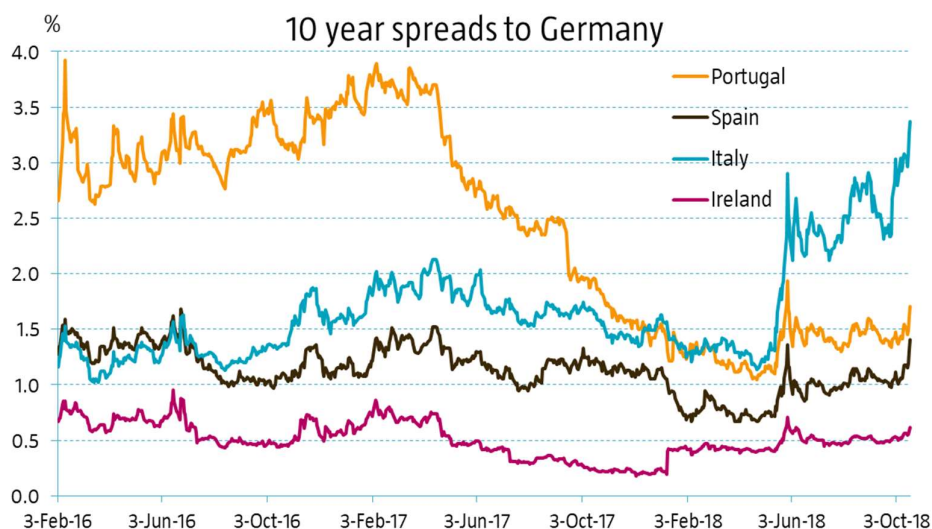
* Robeco Euro Government Bonds, gross of fees, based on Net Asset Value, 18 October, 2018. The value of your investments may fluctuate. Past results are no guarantee of future performance.

Current 10-yr spreads versus Germany

Maturity	German yields	Spreads										
		France	Italy	Spain	Netherlands	Belgium	Austria	Greece	Ireland	Finland	Portugal	
1	-0.69	0.05										
2	-0.62	0.21	2.30	0.54	-0.03	0.10	0.07	2.03	0.18	0.05	0.54	
3	-0.51	0.28	2.85	0.69	0.00	0.13	0.08		0.06	0.02	0.67	
4	-0.35	0.30	3.19	0.76	0.02	0.18	0.17		0.28	0.14	0.97	
5	-0.19	0.33	3.25	0.96	0.04	0.29	0.13	3.78	0.21	0.15	1.13	
6	-0.08	0.30	3.48	1.15	0.10	0.28	0.19		0.38	0.12	1.19	
7	0.04	0.34	3.52	1.27	0.13	0.34	0.24		0.48	0.24	1.54	
8	0.17	0.37	3.26	1.34	0.12	0.40	0.27			0.21	1.61	
9	0.28	0.35	3.35	1.40	0.15	0.45	0.25				1.67	
10	0.41	0.41	3.37	1.41	0.14	0.46	0.23	4.10	0.61	0.28	1.70	
15	0.68	0.54	3.18	1.62		0.59	0.39	4.28	0.82	0.33	1.96	
20	0.83	0.50	3.22			0.69	0.30	4.43			2.04	
30	1.04	0.65	3.09	1.86	0.03	0.75	0.38			0.20	2.11	

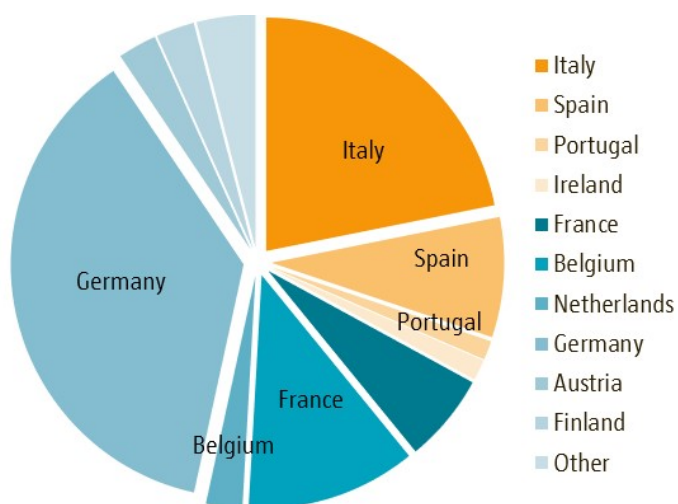
Source: Bloomberg

Movement over time



Source: Bloomberg.

Country allocation Robeco Euro Government Bonds (18 October, 2018)



Source: Robeco

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