CIO Flash

The Euro, Italy and how we reached our dollar call

The woes of the Eurozone have returned with a vengeance, boosting the dollar. It might yet be a while before calm returns.

Our long-term strategic target level of 1.15 dollars per euro has been reached sooner than expected. In less than six weeks, the dollar has appreciated from 1.24 to 1.15 per euro. Initially, this was merely the reversal of the dollar weakness we had been anticipating. This rebound in strength took the greenback to about 1.17 per euro. More recently, and as far as the last two cents on the way towards our target are concerned, it would be more appropriate to talk about a euro weakness. The decline in the exchange rate of the Eurozone's common currency coincided with a drastic widening in spreads on sovereign-bond yields of the periphery, especially the Italian ones.

This time around, it is not hard to identify the primary trigger. Belatedly, markets have woken up to the difficulties surrounding the formation of a new Italian government. This has reduced the appetite for European risky assets across the board, while boosting core-country sovereign bonds (the yield on 10-year German Bunds decreased from 0.64% to 0.28% in less than two weeks). The dynamics in Italy remain unpredictable. The same is true for contagion risks and continuing spillover effects to – and potentially beyond - other Eurozone countries. Against this backdrop, we have reduced risk in many asset classes:

- **Currencies**: Euro-skeptic sentiment and the dollar's status as a safe haven could result in further appreciation. Having reached our strategic goal of 1.15 dollars per euro, we are working on our 12-month orientation and plan to reformulate the new target level shortly on the occasion of our quarterly strategy conference.
- **Equities**: We keep a positive strategic view, because we continue to see a positive economic outlook for Europe as a whole. Tactically, we have downgraded European equities to neutral and wait for better entry levels.
- **Fixed income**: Following the weekend's developments, we have become more skeptical on Italian government bonds. For European corporates, we had already shifted to a neutral stance on both investment-grade and high-yield bonds last week.

In our view, Italian politics could continue to prove a drag on capital markets throughout the summer. Compared to previous episodes of Eurozone troubles, the European Central Bank (ECB) is likely to have less scope to react. This could add to investors' nervousness.

First and foremost, however, developments in Rome look set to dominate sentiment. To be sure, political uncertainty in Italy is

In a nutshell

- The political drama surrounding the new Italian government continues. One way or the other, this is likely to prove a drag on financial markets in coming months.
- As a result of renewed Eurozone concerns, we have reached our EUR/USD target level sooner than expected.
- From a tactical perspective, we prefer to reduce risk, while monitoring how events in Italy and the Eurozone continue to evolve.

nothing new. Nor are the Eurozone's structural weaknesses. Now, our base scenario sees new elections that especially Lega appears to be pushing for. From a narrow, political perspective, this makes sense. Italian opinion polls should be taken with a pinch of salt, but the most recent ones suggest substantial gains for Lega. Mostly, Lega's gains might come at the expense of Forza Italia, its right-wing ally. (For more details on Italian polling, see our preview of the last election "An Italian muddle".)

The majority of Italians maintains a positive view towards Europe. However, last week's events show that the risk potential for the common currency remains high. The election campaign could well turn into a de-facto referendum on the European Union (EU) and the euro. In addition, populist parties may benefit from other topics as well. This includes skepticism towards established parties and the refugee crisis, as well as what Italians perceive as meddling out of Brussels, Paris and Berlin.

Independently of the timing of any new vote, we expect Italy to remain a key topic at the European summit on June 28 and 29. That said, it is still early days. The political landscape of Italy does not look all that different from the picture we warned about back in February, ahead of the last election in March. Uncertainty is high, but as usual that cuts both ways.

Glossary

European Central Bank (ECB)

The **European Central Bank (ECB)** is the central bank for the Eurozone.

European Union (EU)

The **European Union (EU)** is a political and economic union of 28 member states located primarily in Europe.

Eurozone

The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Forza Italia

The current **Forza Italia**, established in 2013, is a centre-right political party in Italy with populist elements. Its leader is once again Silvio Berlusconi, who also led the original Forca Italia, established in 1993, which, however, was much bigger as its contemporary version.

Lega

The **Lega** (formerly "Lega Nord") is a right-wing populist party in Italy. It was founded in 1991 through the merger of various parties. It is considered anti-globalist and Eurosceptic.

Periphery

Periphery countries are less developed than the core countries of a specific region. In the Eurozone, the euro periphery consists of the economically weaker countries such as Greece, Portugal, Italy, Spain and Ireland.

Spread

The **spread** is the difference between the quoted rates of return on two different investments, usually of different credit quality.

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