

ARTICLE

For professional investors
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ROBECO
The Investment Engineers

Political risks in Eurozone without safety net

- French and Italian government bond spreads widen sharply
- Political risks drive bond markets as ECB gradually withdraws
- Active country allocation in Eurozone is crucial

Turmoil in EMU bond markets

Political risk is back in the Eurozone and it impacts bond markets like its 2011 all over again. The spread between French and German 10-year bond yields has risen quickly from just 0.3% in early November to nearly 0.8% in early February. This is the highest spread since late 2012. Italian bond spreads rose above 2% for the first time since 2014. EMU countries' bond markets have not diverged this much since the start of the ECB's QE program.

Rising political risk in France...

Political risk is clearly elevated this year with elections in France, Germany, the Netherlands and potentially in Italy as well. Moreover, populist anti-EMU parties rank strongly in the polls. In France polls indicate that Le Pen will win the first round of the presidential election. Her Front National promises a referendum on EMU membership and it wants to repay the government debt in French Francs instead of in euros. Polls also indicate that she will be defeated in the second round by Macron or Fillon. These candidates propose the kind of structural reforms that France needs to unleash its economic potential. According to the polls her party surely won't win the parliamentary elections in June. But polls did not predict the Brexit or Trump. French bonds have sold off sharply on the back of these political risks.

and populism as a threat to the entire Eurozone...

Coupled with the strong support for euro-sceptic party PVV of Geert Wilders in the Dutch polls, the ascent of the AfD in Germany and the likely arduous Brexit negotiations the risks to the Eurozone as a whole are rising. Especially Italian bonds were also hit strongly by this

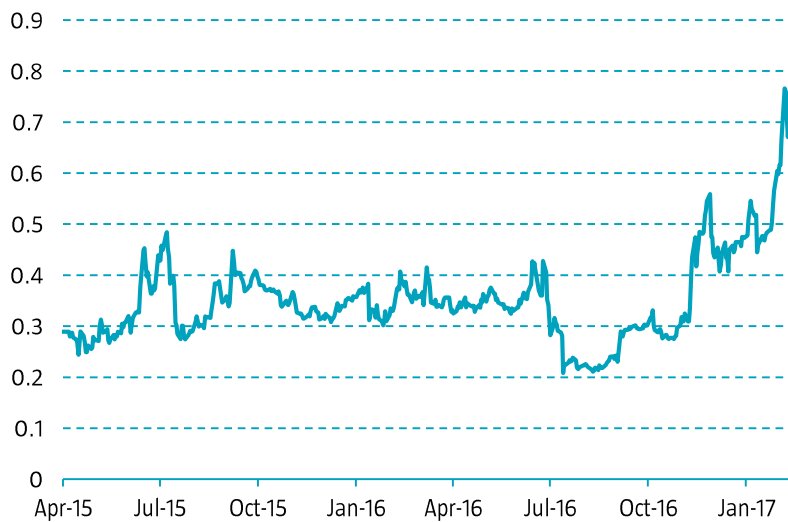


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'Markets are reacting strongly to country-specific weaknesses and risks, offering opportunities to add value.'

risk. As mentioned in our [article Italian unrest returns with a vengeance](#)¹, our fundamental view on Italy is rather bearish. Structurally weak growth has led to high unemployment, feeding political discontent. The rise in political risks became clear last December when Prime Minister Renzi stepped down after constitutional reform was rejected by referendum. Early elections are a risk, while the anti-euro 5 Star Movement is in a neck-and-neck race with Renzi's centre-left PD party in the polls. While the risks are clear, the strong market reaction remains notable. Bond markets easily ignored similar risks in recent years, helped by the supportive stance of the ECB.

Figure 1 | Spread of French 10-year government bonds versus German bonds



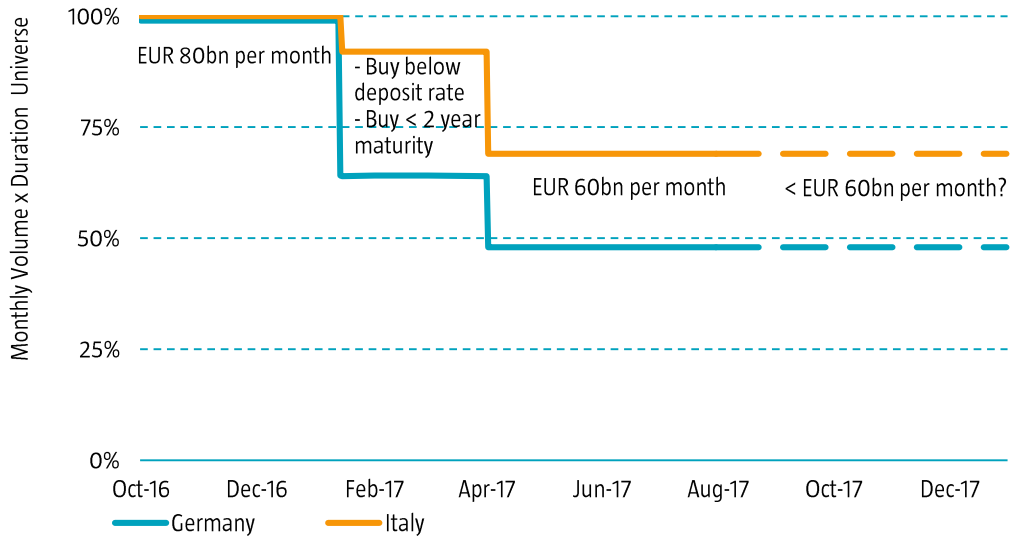
Source: Bloomberg, Robeco

... while the ECB is stepping back

This support from the ECB - however - is starting to fade. This explains why bond markets are now clearly more vulnerable to bad news than in recent years. Last December the ECB announced that it will reduce its monthly bond buying from EUR 80bn to EUR 60bn in April 2017. Furthermore the ECB has already implemented two other changes to its Quantitative Easing (QE) program that together result in a significant reduction in the duration (interest-rate risk) of the bonds that the ECB buys. The ECB reduced the minimum maturity to 1 year and it started to buy bonds with a yield below the deposit rate. The ECB will effectively absorb a third less Italian bond risk in April than late last year and even take less than half as much German bond risk from the markets (as is shown in Figure 2). And with headline inflation now close to target, economic growth decent and the technical limits of the ECB's bond buying coming closer, markets have to get used to the idea that the QE program might be reduced further already this year and will end next year.

¹ <https://www.robeco.com/en/insights/2017/01/italian-unrest-returns-with-a-vengeance.html>

Figure 2 | Substantial decrease in risk absorption by ECB



Source: Robeco

Active country allocation necessary

The ECB’s Quantitative Easing has effectively reduced country spreads and volatility in the Eurozone bond markets. While we benefited from this spread compression in 2013-2015, it also meant that there were fewer opportunities to add value with active country allocation in 2015 and 2016, as markets could ignore country fundamentals. This has now changed. Markets are reacting strongly to country-specific weaknesses and risks, offering opportunities to add value with our proven active country allocation.

Robeco Global Total Return Bond Fund and Robeco Euro Government Bonds were correctly positioned for wider spreads in Italy and France in early 2017. This contributed positively to the performance in January. Late last year, the funds also were positioned for the spread widening in the run-up to the Italian referendum. We temporarily closed these positions in December, but again sold Italian bonds after these had recovered from the referendum, anticipating renewed widening this year.

Our active country allocation, based on in-depth country research including ESG factors, has proven its value in the euro sovereign debt crisis and in the ensuing spread tightening. Rising political risk and the ECB stepping back offer great opportunities for Robeco Global Total Return Bonds and Robeco Euro Government Bonds to add value with country allocation.

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