

## MARKET CONCERNS OVER ITALY

***The ongoing debt crisis in Europe shows little progress in the governments' efforts to contain the problem. Greece's political in-fighting continues which threatens the release of the bailout tranche payment. But an even bigger problem is brewing. There is now a growing concern that Italy, which represents an even greater systemic risk both to Europe and the world economy, would soon have difficulty accessing the capital market if the government bond yields continue to escalate. This article examines the implications of this development.***

### Event

Italian 10-year bond yields rose nearly 75 basis points to a historic high of 7.48% on November 9<sup>th</sup> (since the Euro was introduced in 1999), which is well above the 7% threshold level typically considered unsustainable. Indeed, this was precipitated by market doubts over Italy's ability to lower its debt level. Additionally, the months of bickering within Silvio Berlusconi's Cabinet over the necessary budget measures to lower the country's fiscal deficit also did not help matters and push yields higher. On November 8<sup>th</sup>, Berlusconi finally offered to resign after defections from his ruling People of Liberty party left him without a majority in Parliament. Once the measures, which include a pledge to raise €15 billion from real estate sales over the next three years, a two-year increase in the retirement age to 67 by 2026 and the gradual reduction in government ownership of local services, are passed by the Senate on November 11<sup>th</sup> and by the Chamber of Deputies on November 13<sup>th</sup>, Berlusconi will have to step down. Subsequently, the Italian President Giorgio Napolitano will begin consultation with all the political parties to see if they can agree to form a new government, or whether Italy will go to elections. This entire episode introduces more uncertainty to the market, further exacerbating the volatility.

### Italy's Fiscal Position

Italy has a public debt of 120% of GDP or €1.9 trillion, a fiscal deficit of an estimated 4.0% of GDP in 2011, which is less than that of the U.K. and France. The country also has a small primary surplus of around 0.5% of GDP, thus making Italy the second Euro-country to have such a surplus after Germany. So why is the market so nervous?

The worrying aspect of Italy's debt dynamics is its sheer size and thus its contagion effect on Europe and the global economies. Italy is particularly vulnerable because the country's weak economic growth makes it vulnerable to any uncontrolled interest rate spikes. It has been estimated that Italy's projected GDP growth is around 0.1% per annum over the period 2012-13 compared with the current 10-year government bond yield of 7.4%. Barclays Capital has estimated that interest rates above 5.5% will lead to the situation where the rate of debt growth far exceeds Italy's GDP growth. Thus, a debt restructuring is inevitable.

Our recent observations suggest that 7% seem to be the tipping threshold for the other European peripheral countries. In April 2010, 10-year bond yields in Greece hit 7% and then hit 12% within a month, prompting Greece's first bailout package. Similarly, in Ireland, 10-year bond yield hit 7% in November 2010 and rose to above 9% a month later. Subsequently, this also triggered a bailout. In Portugal, yields hit 7% in November 2010 and the country was under the European Financial Stability Facility ("EFSF") programme by May 2011. Therefore, Italy is in a dangerous position and strong action is required to prevent the yields from escalating beyond 7%.

## No Adequate Safety-Net

However, the actions taken by the European leaders have been disappointing on the lack of actual policy flow-through. The market requires a comprehensive measure or safety net to encourage investors' continued interest in the European capital market. During the G20 Summit on November 3<sup>rd</sup> and 4<sup>th</sup> Europe was supposed to announce a plan to enhance EFSF beyond its current size of €440 billion. The only announcement was a form of insurance scheme and the creation of a Special Purpose Investment Vehicle (SPIV) to tap external public and private sector funds.

Essentially, the EFSF needs to be levered up significantly to at least €1.5 trillion in size in order to meet the financing needs for all the peripheral sovereigns for the next 3 years. Italy, alone, requires an estimated €736.4 billion over the same period. The only official announcement so far is that Europe will adopt some form of an insurance option scheme. Assuming that the scheme is able to lever the EFSF by three to five times to around €860 billion to €1.3 trillion via credit guarantees for newly issued European sovereign debt using a first loss guarantee of 20% to 30%, this will not be sufficient to bail out all the peripheral countries if Italy is involved. Therefore, the remaining amount has to come from the SPIV. But Europe's appeal to international countries to support the Fund has been very poorly received during the recently concluded G20 Summit.

## Negative Consequences If Italy Yields Do Not Come Down

If Italian interest rates do not come down and a bail-out is required for Italy, the effect will be disastrous for both Europe and the global economies. Italy matters because of its size. Italy is the eighth largest economy in the world and the third largest in Europe. It accounts for 17% of Euro-zone GDP. In contrast, Greece is comparatively much smaller, accounting for slightly over 2% of euro-zone GDP. The economies of Ireland and Portugal account for a combined 3.5% of Euro-zone GDP. If Italian debt needs to be written down as in the case of Greece, this will immediately be transmitted to core Europe via the banking transmission.

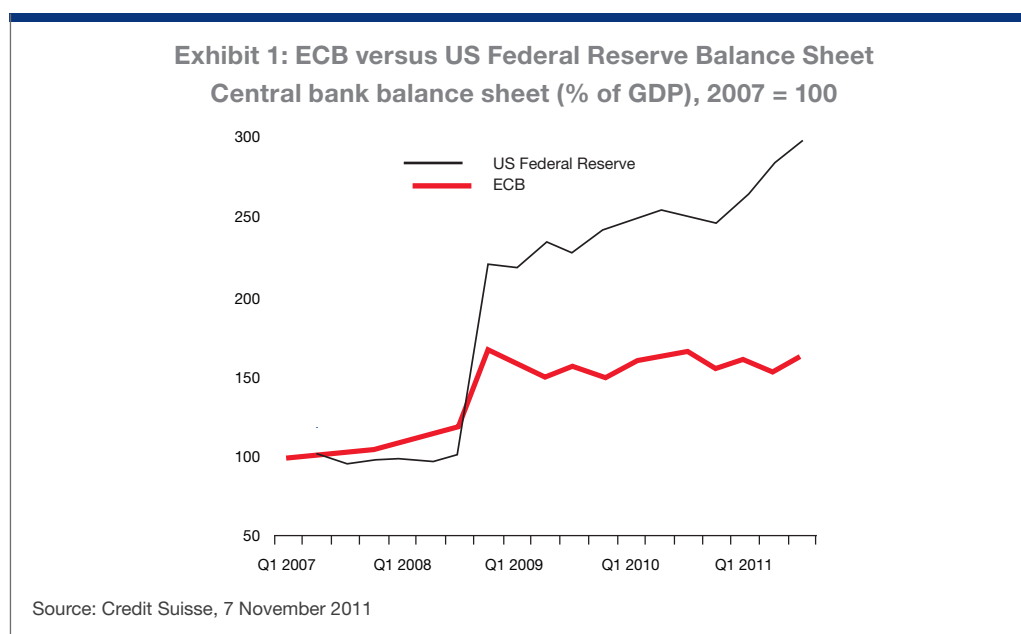
Firstly, any Italian debt write-down or losses will immediately hit the Italian banks. The latter's tangible common equity is about €100 billion but they own about €300 billion of Italian sovereign bonds and €220 billion of cross-holdings of Italian bonds. Thus, the Italian banking sector will require massive bail-out if Italian bond yields continue to rise and shut the banks out of the funding market. If the Italian government bails out the banks, then it is vulnerable to further rating cuts.

Outside Italy, European banks hold an estimated €1.2 trillion of cross-border exposure to the European periphery, of which €230 billion is in the form of government debt. In the event of an Italian debt disruption, Germany and France banks will take severe hits. French banks have about €140 billion in tangible common equity but €300 billion exposure to Italian bonds and €490 billion when Greece, Italy, Ireland, Spain and Portugal are included. Germany banks' tangible common equity is about €60 billion compared with around €120 billion exposure to Italian bonds, and €381 billion if all the peripheral European countries are included. So a default or a capital loss on the Italian bonds will severely impair the balance sheets of the French and German banking sectors. Then, they will require national bail-outs and, in turn, the EFSF triple A rating will look vulnerable. Hence, a vicious loop is created which is difficult to break.

## The Effective Solutions

A possible solution right now for Europe is a greatly enhanced EFSF but this does not seem to be taking any shape. If anything, the outcome of all the talks in past weeks was disappointing.

This leaves the European Central Bank (“ECB”) as the only institution with the balance sheet flexibility to play the required role. Over the period from 2007 Q1 to 2011 Q1, the ECB has expanded its balance sheet by 70% compared with the US Federal Reserve’s corresponding 300%. Therefore, ECB could potentially spend €2 trillion to €2.5 trillion which will help bring bond yields down and give markets a measure of assurance. The amount needed to restore confidence could be less, as was the case with the SNB’s defense of the Swiss franc. It is hoped that in the longer term, institutional reforms in Italy and the other indebted European countries will eventually allow the ECB eventually to step back from a role as lender-of-last resort to governments. However, ECB is not likely to use its theoretically unlimited printing ability to calm the debt market unless the situation deteriorates significantly from here. This is partly due to Germany’s history of hyper-inflation and hence fears of a repeat episode. And there is also the moral hazard problem which discourages active ECB intervention until all options are exhausted.



## Investment implications

Italy, unlike the other peripheral indebted countries, is in a better fiscal position. The country does not have a housing or private sector leverage bubble in the last decade and total debt-to-GDP is the third lowest in Europe at 246% of GDP compared to 260% in the Euro-area. Additionally, half of Italy’s debt is held by domestic parties with an average 7.2 years maturity thus making the debt profile relatively more stable. Ultimately, Italy’s problem is one of competitiveness which can be corrected through thoughtful economic reforms and deregulation. Therefore, if Italy can demonstrate that the country is capable of taking painful but necessary fiscal measures, we believe this will help to lower interest rates in the market. The new austerity package of €60 billion or 3.8% of GDP will also have to be adhered to. In the meantime, we maintain our defensive stance in the European markets with an Underweight rating for banks.

Asia remains dependent on exports to the developed world. So whilst the Asian markets will experience some level of volatility from the European crisis, Asian markets will also benefit from the resultant lowering of commodity prices on the inflationary pressures, allowing the governments to loosen fiscal and monetary policies, mitigating some of the negative external impact. In terms of investments, we manage our risks by investing in the top quality stocks for each industry. These are the ones that are better positioned to weather the storm and in doing so, we hedge our risks against further market downside.

As for emerging market bonds, we do not see any direct impact on this asset class given that Italy is not classified as an emerging market. However, the spillover effects from the market uncertainty will result in higher volatility of prices, increased risk adversity of investors and negative price action in the short run. That said, emerging market bonds are still expected to outperform developed market bonds in the near term due to relatively strong economic and fiscal fundamentals.

## Contact Details

**Address** 80 Raffles Place UOB Plaza 2 Level 3 Singapore 048624

**24-hour Hotline** 1800 222 2228 (Local) • (65) 6222 2228 (International)

**Fax** (65) 6532 3868

**Email** uobam@uobgroup.com

**Website** uobam.com.sg

## Business Offices

### Singapore

Institutional Business

Dennis Siew

Senior Director

Retail Business

Norman Wu

Senior Director

New Strategic Markets & Private Banks

Rachel Ong

Director

### Brunei

Kamal Muhd

General Manager

---

### Japan

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Chief Executive Officer

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### Thailand

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