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Eurozone update – Italy

It is amazing how quickly attention has turned from Greece to Italy. Have Greece's problems simply disappeared or does old news not sell newspapers? Greece is of course still in a mess, but Italy's problems are potentially even more dangerous for the future of the eurozone. In this update we will examine the facts and impact.

Italian bond yields have increased substantially in recent months to worryingly high levels. However, it is important to note that current yields are only important from Italy's perspective as and when they come to refinance. A Morgan Stanley study from July (shown below and still relevant today) calculated that it would take five years for a 1% rise in yields to reflect a 1% rise in the overall cost of Italian borrowing. Italy can afford higher rates but not for a sustained period.

Year	Size of debt (€bn)	New issuance (€bn)	Interest cost at 4.04%(€bn)	1% rise in yield on day 1 (€bn)	Incremental cost (€bn)	New interest rate (%)
2011	1,626	202	64	64.6	0.6	4.1
2012	1,654	343	65.6	69.6	4	4.3
2013	1,677	288	66.7	73.7	6.9	4.5
2014	1,700	285	67.7	77	9.4	4.6
2015	1,728	339	68.6	81.6	13	4.8
2016	1,752	271	69.7	84.9	15.2	4.9
2017	1,776	286	70.7	88.4	17.7	5
2018	1,802	265	71.7	91.7	20	5.2

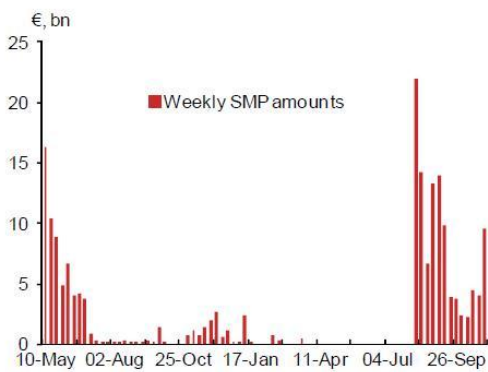
Source: Morgan Stanley, July 2011

Italy's primary bond market issuances are being taken up strongly (presumably due to the pressure on banks to buy). A recent one-year €5bn issue was bought at a yield of 6.09%, which is still high but lower than the 8% yield quoted for one-year money earlier that morning. The issue was twice covered, meaning there was over €10bn of offers. The problems are in the secondary market. For the period July to September (Q3), €26 billion of Italian government bonds were sold by European banks. This flood of sales has pushed down prices, whilst increasing yields. The Italian government bond market is the third largest in the world behind the US and Japan but market liquidity has dried up. Banks and traders are now asking for large premiums to buy or sell Italian bonds.

Examples include a December 2012 maturity with a bid/offer spread of 7.15/5.9% and June 2013 maturity with a 9.3/5.86% spread. This results in an immediate 37% loss for the buyer, which is clearly not conducive.

The short-term solution for Italy is either for the European Central Bank (ECB) or the bailout fund (European Financial Stability Facility) to increase their support in the Italian government bond market. This would increase liquidity and demand, bringing in spreads and pushing up prices. The ECB has bought Italian debt but it has been sporadic (part of the SMP purchases in the below graph). The ECB sees the support of peripheral bond markets as creating a potential moral hazard; if the ECB supports Italy, it does not have the same level of need or desire to push through cuts and reforms. It also creates the potential of other eurozone members to ask for ECB support. However, as we have seen with other central bank interventions (such as in the US or Switzerland), it can give markets more confidence and direction if the intervention (mostly in terms of words rather than actions) is strong enough.

Fig. 5: ECB SMP weekly purchases



Conclusion

The recent developments in Italian (as well as Spanish and French) bond markets are concerning. However, the media is not helping by sensationalising the news and not offering balanced arguments. It is concentrating solely on a dramatic worst case scenario, which remains the least probable outcome. Germany, at the heart of the eurozone, is facing some stark decisions. It has benefited greatly from the euro and whilst they still see the euro as a benefit, they will support the region through the ECB and EFSF.

The eurozone is clearly dominating investment markets and it is easy to forget that companies are still doing what they do, day-in day-out. Companies have high cash and low debt levels. Profit margins are also high as costs were stripped out and demand returned. However, investors are not focusing on value as they are dominated by fear. For investors who are willing to be patient, there are, as always, opportunities.

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