MARKET INSIGHTS

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Italy – an atypical peripheral country

Maria Paola Toschi

Vice President
Market Strategist - Milan

Introduction

Eurozone sovereign risk concerns are back in the spotlight following the Irish bailout. Yield spreads of eurozone peripheral countries over German Bunds have reached new highs. However, markets are recognising differences in terms of risk levels and Italy, despite its very high debt/GDP ratio, appears less vulnerable than other peripheral countries.

In this paper we highlight why Italy is considered an atypical peripheral eurozone country and ask whether Italian sovereign debt can represent an investment opportunity within European government bond markets.

Summary

From 2003 to the end of 2008, Italy was considered one of the less virtuous countries in the eurozone. Italian yield spreads over German Bunds were lower than they are currently, but Italian spreads were wider than other peripheral countries (namely Greece, Spain, Portugal and Ireland), and Italy's default protection costs were also higher.

Today, Italy is passing through the eurozone sovereign turmoil in a safer position. The yield spread versus Bunds has remained below the average of the other peripheral countries (see exhibit 1) and Italy's default risk is also lower. Italy has not suffered any rating agency downgrade since 2006 and the current outlook is stable.

Despite a very high level of debt to GDP, Italy benefits from several factors. Italy's deficit as a proportion of GDP remains lower than the average for other European countries, while Italy also has lower private debt levels and a higher savings rate. In addition, the Italian financial system is considered less vulnerable in terms of contagion risk from the international financial turmoil, and the Italian real estate sector was less exposed to speculative bubbles than many other countries.

2010 – Sovereign risks to the fore

2010 will be remembered as the year of that eurozone sovereign risks exploded into the spotlight. After Greece, the Irish bailout again illustrated the unsustainably high levels of public debt in some eurozone countries, and the very long process of deleveraging that these highly indebted countries face in the coming years. This is not an issue specific only to eurozone countries. The majority of developed countries have seen their debt climb to never previously experienced levels.

The strong recent growth in public debt is a consequence of the fiscal stimuli introduced to boost growth after recent recessions, but it is also due to the link between banking systems and government aid. Goverments in many countries intervened to strengthen their banks in order to avoid liquidity and credit constraints and to lessen bankruptcy risks. The bailout process transferred debt and default risks from the private sector to the public sector.

Ireland is the emblematic case for the link between the banking crisis and the increase in sovereign risk. Ireland's deficit for 2010 is estimated at 14% of GDP, but will be more like 32% once the bailout of its banking system is included – a clearly unsustainable level.

Ireland's debt crisis stems from several factors, but the main cause is related to the very high exposure of the Irish banking system to the real estate sector and to poor banking regulation, which became a problem after cheap borrowing created a bubble in the Irish housing market.

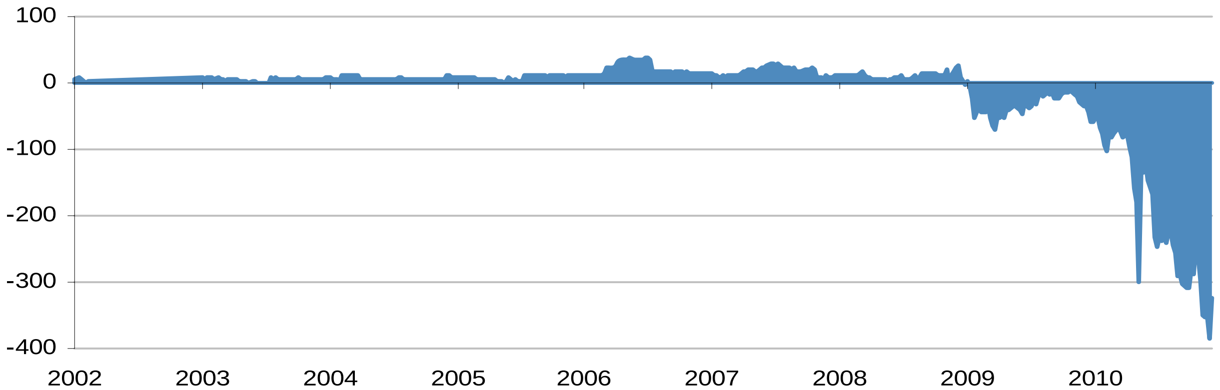
Different risk levels

The deleveraging process still faces various obstacles. First, the more vulnerable countries are having to pay higher interest rates, which increases the cost of debt and makes debt reduction more complicated. Second, tighter fiscal policies increase the threat of social turbulence and can be very hard to introduce in countries that are facing elections. However, the main problem is probably related to expectations for low future GDP growth rates. Many of the more indebted countries have the lowest growth outlooks and this makes it tougher to implement austerity programmes based on public spending cuts and tax increases.

Markets are defining different levels of risk to different countries. At the top of the list is Greece, which is still characterised by a very difficult economic environment with expected 2010 GDP growth of roughly -4% (year on year). Ireland and Spain follow with estimates for stable 2010 growth, or for a moderate contraction.

Exhibit 1 – **Difference between Italian bond spreads and the eurozone peripheral average compared to ten-year Bund yields ***

Basis points



Source: J.P.Morgan Asset Management. * Note: From 2002 to the end of 2008 Italian govies showed a higher yield spread versus Bund compared to the average of the periphery area. The situation has changed since the beginning of 2009. The periphery area includes: Spain, Greece, Portugal and Ireland.

The Italian case – strengths and weaknesses

Italy's debt-to-GDP ratio is reaching 120%. This is one of the highest debt-to-GDP ratios among European countries. Nevertheless, Italy is considered to be in a better position compared to other peripheral countries, with markets allocating a relatively lower risk profile to Italian debt.

There are still a lot of structural limits and constraints to Italy's economic outlook, including an historically high level of public debt to GDP, coupled with low growth rates and the lack of competitiveness of domestic Italian companies compared to their European peers. In addition, Italian companies face a higher fiscal burden and more bureaucracy, which sometimes makes it more onerous to compete in the business arena.

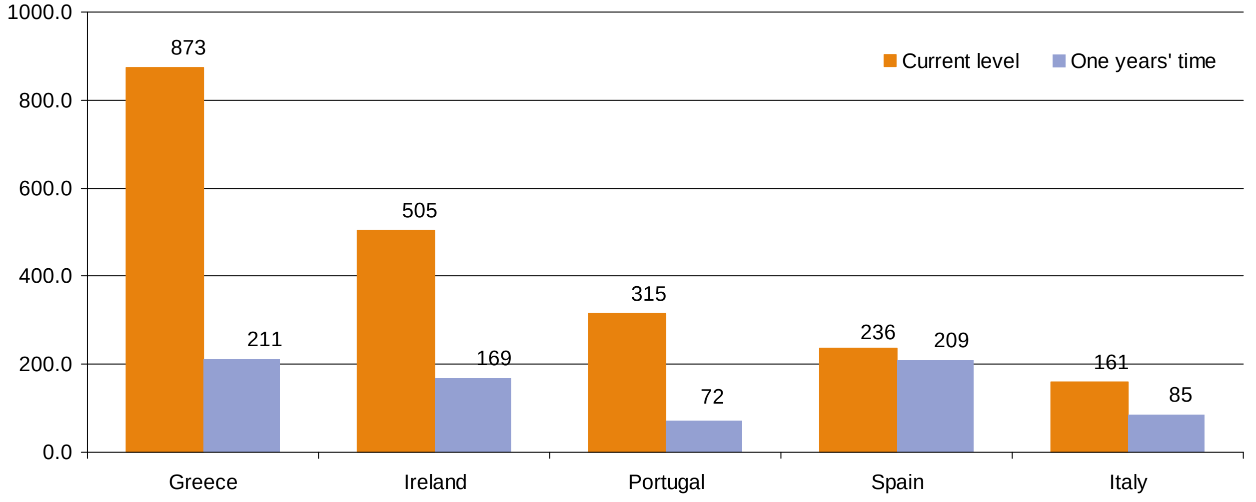
The Italian industrial framework is characterised by the presence of a few very compelling niche operators that have very strong and trustworthy reputations and are competitively positioned. But there are a few big players making the domestic industrial structure more vulnerable in relation to the growing global marketplace. Furthermore, there are still huge economic and cultural differences between the north and south of Italy.

Italian politics are also inherently unstable. The reduced support for the current government could make it more difficult to bring the deficit back below 3% of GDP, while political uncertainty is making it more difficult to proceed with structural reforms – for example, the lack of pension and retirement legislation is holding up the country's modernisation process.

Finally, the privatisation pipeline is almost over. During the 1990s the Italian government began a huge privatisation process, attracting global inflows estimated at roughly 12% of 1992 GDP. The privatisation programme involved mainly energy, banking, insurance and telecom sectors. 1999 was the peak year, but by 2002 disposals had started to fall. Today there appears to be less scope for the government to raise significant money from additional privatisation deals.

Exhibit 2 – **Eurozone peripheral ten-year yield differentials versus Bunds. Current level versus one year ago.**

Basis points



Source: Bloomberg. J.P.Morgan AM. Data at 10 December 2010.

Ratings agencies have not made any downward revisions to Italy since 2006. Last December Standard & Poor's confirmed its A+/A-1+ rating with a stable outlook. The agency highlighted that the Italian economy is in relatively good shape and is well diversified, but also warned that the rating could come under pressure if political instability prevents the government from implementing the important fiscal adjustments needed to reach its financial targets, leading to higher debt to GDP levels after 2011.

Why is Italy less vulnerable?

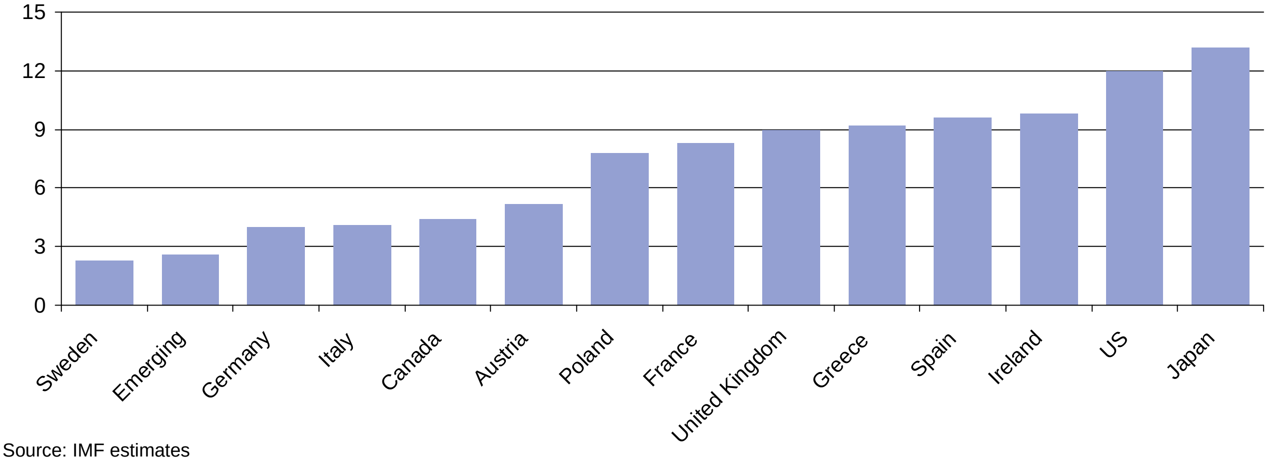
1. A lower deficit

We have already highlighted that in terms of the debt-to-GDP ratio Italy is close to the top in comparison to other European countries. However, Italy's positioning in terms of its deficit to GDP ratio is much better. The Italian deficit is 5% of GDP compared to 9.3% for Spain, 7.3% for Portugal, and 9.6% for Greece (Source: European Commission, 2010 estimates). The Italian deficit-to-GDP ratio is second only to Germany, at 3.7%. This is the consequence of Italy's negligible fiscal stimulus that was introduced in 2009 and 2010, and means that relative to other peripheral countries Italy's debt path appears far less treacherous.

Since 1992 the Italian primary balance has been positive. At the end of 2008 it was above 2% of GDP and is expected to be -0,7% at the end of 2010. The International Monetary Fund (IMF) estimates that Italy's primary balance will come back to roughly 2.3% at the end of 2015. In exhibit 3, the IMF estimates the extent of the primary deficit cuts that different countries need to make as a proportion of their GDP over the next decade in order to stabilise

Exhibit 3 – **Primary balance variation estimated in 2010/2020 by IMF to stabilise debt/GDP ratio**

% of GDP



Source: IMF estimates

2. The absence of real estate bubble

Italy's domestic real estate sector did not suffer a similar speculative bubble to the ones that were experienced by Spain and Ireland, or see property price decreases on the scale of the United States or the United Kingdom. The number of transactions declined by 15-20% in 2009-2010 and the average time to close deals lengthened, but the Italian market was more resilient than many others. Prices declined by roughly 10-15%, substantially less than the 50-60% loss registered in Spain. The demand of houses for investment purposes is very limited in Italy (less than 15%). Acquisitions dedicated to residential personal use are much more relevant and this makes Italy's property market relatively less volatile.

3. Lower contagion risk for domestic banks

In this to high sovereign debt environment investors are worried about the solvency of European banks, given the presence of illiquid or devalued assets on their balance sheets. Banks in Germany, France and the United Kingdom appear to be more exposed to this risk than Italian lenders.

The Italian banking system was less exposed to the global financial crisis thanks to a more cautious and traditional investment approach. According to data from the BIS (Bank for International Settlements), the exposure of the four biggest Italian banks to debt issued by Greece, Ireland, Portugal and Spain is lower than 6% of the aggregate amount estimated for Germany, Italy, France and the UK (see exhibit 4).

In July 2010 the CEBS (Committee of European Banking Supervisors) announced the results of the stress tests carried out on 91 European banks in the eurozone, corresponding to roughly 65% of total assets. The goal of the tests was to evaluate the vulnerability profile of the analysed banks, including their sovereign risk exposure. The total loss has been estimated at EUR 566 billion in 2010-11 due to provisions and write off needs.

The five biggest Italian banks (corresponding to roughly 60% of domestic market assets) showed a worst case loss of roughly EUR 51 billion (9% of the total European estimate). The test also indicated that Italy's domestic bank had a high exposure to Italian bonds (75%), and limited exposure peripheral sovereign debt (2%).

Exhibit 4 – **Exposure of European banks to peripheral debt ***

Billion dollars

	Greece	Ireland	Portugal	Spain
Germany	65	186	44	217
Italy	7	25	8	37
France	83	77	49	201
United Kingdom	17	188	29	137
Italy weight (%)	**4.1**	**5.5**	**6.2**	**6.7**

Source: Bank for International Settlements. * Note: Data at the end of the second quarter, 2010.

4. Low household debts

If we widen our scope to include household debt we can see that Italy is in good shape. In 2009 Italian household debt corresponded to roughly 40% of domestic GDP versus a European average of 65%.

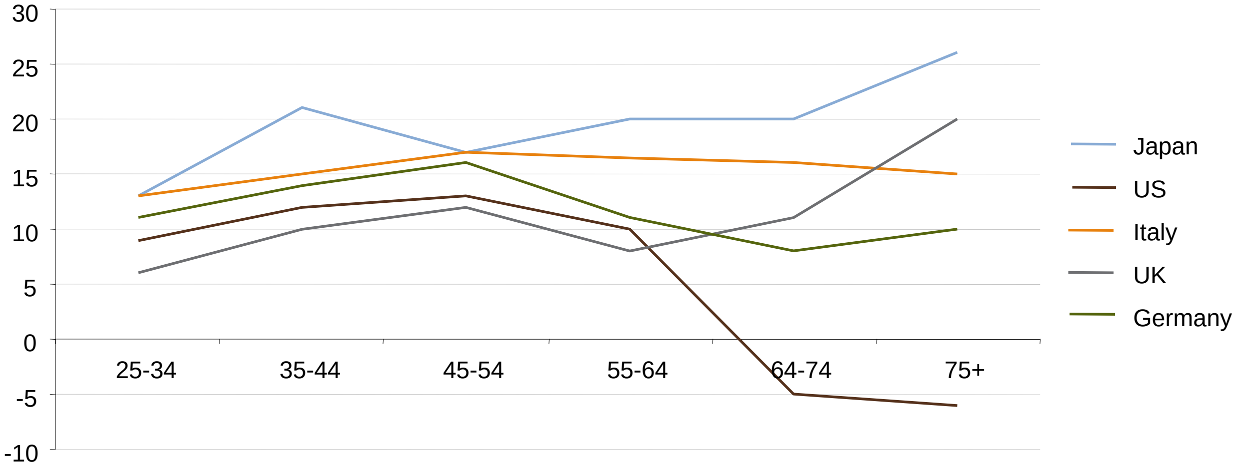
In addition, Italy has a very high private savings ratio, behind only Japan, which corresponds to about 15% of disposable income (Source: ISTAT, see following chart).

As a consequence, the portion of private domestic underwriters of BTPs (Italian government bonds) is high at roughly 40%, followed by domestic banks at 15% (the remaining 55% being foreign investors), compared to 30% in Greece and 20% in Portugal (Source: World Bank and ECB). The lower dependence on foreign investors makes the Italian government bond market less exposed to global trends, which are more related to macro events than domestic fundamentals.

Despite the unbalanced economic development between the north and south of Italy, the household sector on average appears to be in a good shape. According to World Bank data, Italy has a relatively high per capita income (at 22nd position in the global ranking) roughly in-line with the United Kingdom and higher than other peripheral European countries (Spain, Greece, Portugal).

In a recent report on global wealth, Italy also ranks in a favourable position in terms of wealth distribution, with limited poverty niches and a rather large portion of citizens at the top end of global wealth distribution.* These characteristics create a more stable and supportive social environment.

Exhibit 5 – **Household savings rates at different age levels and compared to disposable income, %**



Source: IMF. *Note: Global Wealth Report. Research Institute, Credit Suisse

What are the ratings agencies saying?

In the last few months, following the Greek debt crisis, ratings agencies have started to downgrade sovereign ratings. Spain, Ireland, Portugal and Greece have all seen their ratings reduced several times by the three main agencies – Fitch, Moody's and Standard & Poor's (S&P). The reasons for these downgrades were related to the consequences of real estate bubbles, banking system contagion risks, poor expected growth rates, and the challenging fiscal retrenchment programmes in these countries.

S&P downgraded Greece in April by three notches, from BBB+ to BB+, taking Greece's rating below investment grade. Portugal's rating was reduced to A- (from A+), and Spain's to AA (from AA+) by S&P. In December Moody's put Spain on credit watch with negative implications due to fears of excessive refinancing needs in the coming months. Belgium was also put on negative credit watch after a very long period of political uncertainty. Markets and spread levels are discounting new possible downgrades.

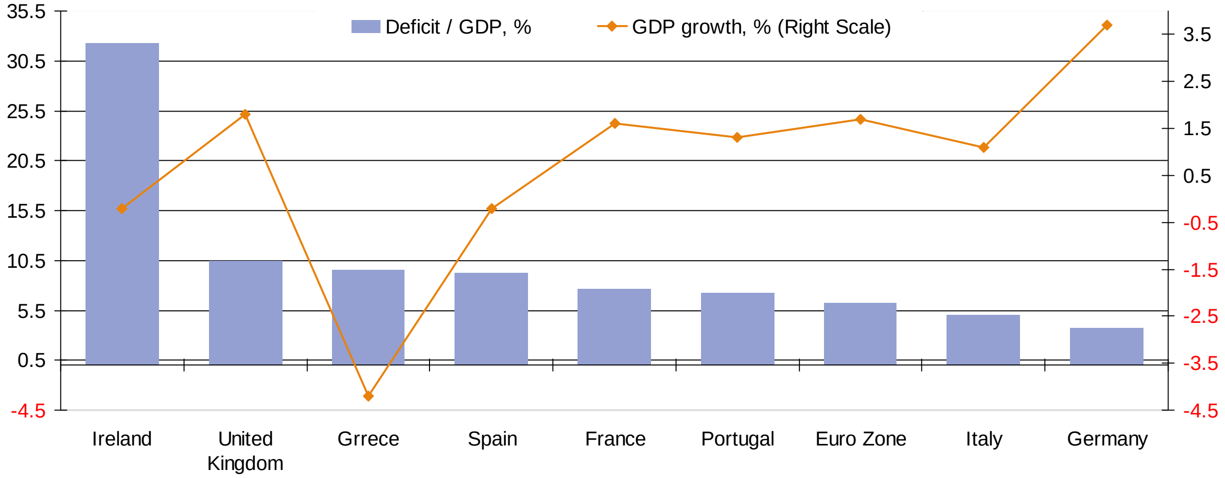
In contrast, the agencies are more sanguine over the outlook for Italian debt. In November 2010 Fitch confirmed its AA- rating with a stable outlook, declaring that 'Italy's sovereign creditworthiness is supported by 'its wealthy, high-income and diversified economy, low and stable inflation'. In addition the agency highlighted the 'moderate level of private sector and external indebtness.'

In August Moody's confirmed its Aa2 rating with a stable outlook highlighting 'the country's very advanced economy given its scale, diversification and per capita wealth'. The main risks identified by Moody's are related to a 'lack of productive competitiveness in some sectors and a population that is both aging and declining'.

In December 2010 S&P confirmed its A+ rating with a stable outlook, highlighting 'a relatively prosperous, diversified economy' and 'moderate private sector leverage.'

On the other hand, among the weaknesses, S&P identified a 'very high level of general government debt and interest burden', and a 'low economic growth potential.' S&P also indicated that 'long- and short-term ratings could come under downward pressure if political instability were to impede the implementation of the current plan, or if the government fails to make further robust adjustments should fiscal targets be missed, leading to a further increase of the debt ratio beyond 2011.'

Exhibit 6– **Deficit/GDP and GDP growth estimated in 2010 for some European Countries** (%)



Source: European Commission estimates.

Enterprise versus sovereign risk

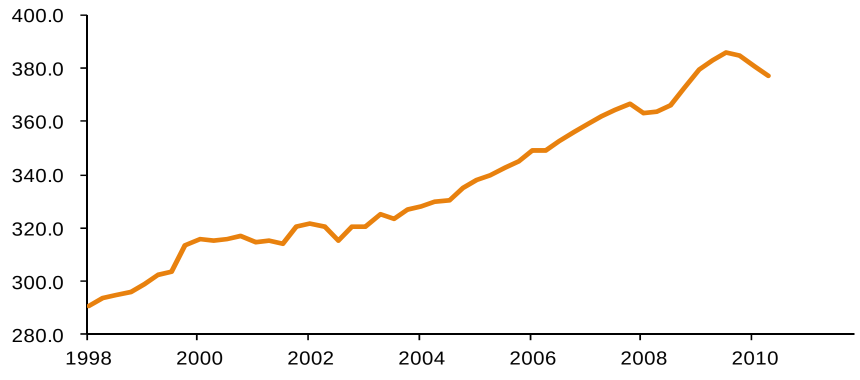
In November, ENI, the domestic energy company, issued a bond at a lower rate (3.56%) than the equivalent BTP (3.71%, at 23/11/2010). Similar cases have occurred in other European countries. It seems a negligible spread, but it is a symptom that markets are changing their risk perceptions between private and public issuers. Private company solvency appears to be higher than public solvency levels. The increased default risks of some countries are penalising the government bond asset class, creating in some cases distortions that are expected to last.

Conclusion

The deleveraging process of advanced countries will be a very long lasting process. The path towards a more stable environment could also see the introduction of mechanisms devoted to face the crisis in a more structured manner. The proposed introduction of Collective Active Clauses (CACs) has the objective of involving private investors in the bailout processes of countries with solvency problems.

The proposal for joint eurozone bonds would imply a higher degree of economic policy coordination. This is not a new idea but more virtuous countries are strongly resistant to the idea as it could increase their interest rate levels and their refinancing costs.

Exhibit 7 – **G3 estimated total private and public debt**



Source: Federal Reserve, IMF, OECD. Data at 30 June 2010

All this is increasing the risk profile of government bonds, putting interest rates under upward pressure due to a higher level of scepticism towards an asset class traditionally considered as 'risk free'.

Italy, among the more indebted eurozone countries, is showing some structural points of strength, but a less stable political environment could reduce its competitive advantage.

For the future we have the following outlook:

- A volatile bond market environment with upward pressure on European peripheral yield spreads. Peripheral European countries are still facing very challenging deleveraging processes in a complex economic and social context.
- A relatively safer and more stable position for Italy, but with a questionmark related to the political context, which could make it harder to bring the deficit back below 3% of GDP.
- An increased risk level for government bonds issued by the more virtuous 'core' eurozone countries, that recently contributed to the sharp upward movement in interest rates.

Exhibit 8 – **Italian government bonds – positives and risks**

Positives
Lower deficit-to-GDP ratio compared to other European countries
Absence of a real estate bubble
Low exposure of the domestic financial sector to international financial turmoil
Low private debt and high household savings rates
A high degree of domestic investors underwriting government bond demand
A sound household profile in terms of income and wealth
Risks
Low country growth expectations
Modest industrial competitive positioning
Very strong leadership in niche sectors but limited presence of big and global industrial players
Political uncertainty and slow expected reform process

Maria Paola Toschi, *vice president*, is a market strategist at J.P. Morgan Asset Management in the Milan Office, in charge of communications to domestic retail and institutional clients. She worked from 1986 to 2003 as a sell-side equity analyst in different Italian Banking Institutions and has spent the last eight years in Banca IMI, Intesa Sanpaolo Banking Group, mainly covering small-mid Industrial companies and following several IPOs. In 2003 she became responsible for the retail investment communications team dedicated to the Sanpaolo Retail and Private Banking network. She graduated in Economics at the Milan L. Bocconi University and has been a Member of the Italian Financial Analysts Association since 1989. She joined J.P.Morgan Asset Management Milan in November 2008.