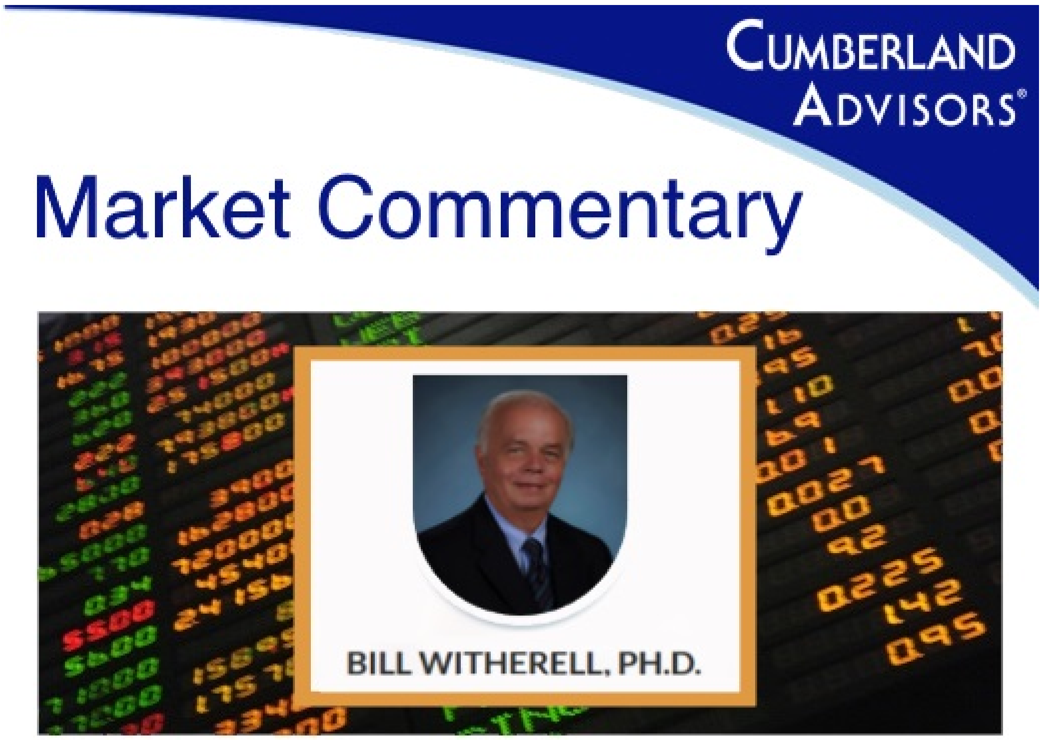
Italy Update: Still a Concern for Investors

The Italian drama continues, with the European bond markets demonstrating great resilience despite the risks presented by the Italian government's proposed fiscal policy stance, which has been rejected by the European Commission (EC). Earlier, after receiving Italy's draft budget, the EC had asked Italy to explain why the government decided not to comply with European Union rules and the agreed government deficit targets for the years 2019–2021. The Draft Budgetary Plan calls for increasing the deficit to 2.4% of GDP in 2019 from 1.8% this year. Italy responded that it is unwilling to modify its draft budget. This stance led the EC, in an unprecedented move, to formally reject the Italian budget and request the government to submit within three weeks a revised budget that complies with European Union fiscal rules.



The EC will then have to decide what to do about Italy's response (or lack of response) by the end of November. If

Italy fails to take decisive steps to bring its budget within or at least closer to EU rules, the EC could begin the process leading to the opening of an Excessive Deficit Procedure, which could result in significant fines. The scene is set for an extended period of tension between the Italian government and Brussels. Italy appears determined to stick to its budget plan as long as market pressures remain within tolerable limits, which has been the case thus far. Resisting EC demands is popular domestically, but the Italian government appears to be keeping a lid on rhetoric in an effort not to stoke market concerns. The EC similarly wishes to avoid increasing tensions, with the economic commissioner, Pierre Moscovici, stressing that he wishes to “maintain a constructive dialogue” with Italy.

Italian financial markets obtained some relief through credit rating agency actions in October. First, on October 19, Moody’s downgraded Italy’s sovereign debt to Baa3 with a stable rating outlook, the lowest investment-grade rating. A week later Standard and Poor’s left Italy’s rating at BBB, two notches above its sub-investment (junk) category, and lowering its outlook to negative from stable. The market’s relief was due to concerns that the ratings decisions could well have been worse. Maintenance of investment-grade ratings is important for portfolio managers. The 10-year Italian government bond yield eased to 3.33% Monday, October 29, a one-week low; and the spread over the equivalent German Bund eased to 299 basis points. The next day the rally reversed and the 10-year rate rose back to 3.45%. On October 19, the spread had reached 333 basis points, the highest since April 2013. The deputy prime minister has suggested that it would take a spread of at least 400 basis points for the government to rethink the budget.

One of the problems with the Italian budget plans is that the deficit outcome is likely to be even worse than the government projects, since the economic growth assumptions look unrealistic. While we expect Italy’s economy to expand no more than 1% in 2019, the budget assumes a growth rate of 1.5%, with the economy’s getting a significant boost from fiscal easing. Experience has shown that the impact of higher government spending and tax cuts is small for economies with already high debts. The Bank of Italy, Italy’s central bank, reported that the Italian economy has ground almost to a halt, advancing by just 0.1% in the third quarter. The annual rate of growth, y/y, for the third quarter was reported Tuesday to be only 0.8%, less than the expected 1.0% that was expected

On the other hand, there are some positive considerations that Moody’s cited as justification for a stable outlook for Italy’s sovereign debt. While the economy’s growth is slow, the economy is very large, the third largest in the Eurozone, and it is diversified. Italian household wealth is relatively high. Moreover, Italy has a substantial current account position, and its international investment position is nearly balanced. There is little doubt that Italy will be able to service its massive 2.3 trillion euro public debt as long as responsible economic policies are pursued. However, a further significant deterioration in the economy and the country’s fiscal condition, coupled with an unwillingness on the part of the government to take needed corrective fiscal measures, would increase debt-service costs and raise the risk of losing market access.

So far there have been only very limited signs of contagion to other European bond markets from the sell-off of Italian bonds. The overall situation of European sovereign borrowers is robust, with strong macroeconomic conditions and supportive European Central Bank policies. The main peripheral countries where spillovers might be most likely, Spain and Portugal, have stabilized their debt situations, and their economies are doing well. As we noted in our October 3 commentary, “Another Italian Drama – Why It Matters,” our most immediate concerns relate instead to the health of the Italian banks because of their large holdings of Italian government debt, some 378 billion euros. The Fitch credit rating agency noted that banks' balance sheets are under pressure. Wider spreads on the bonds held by the banks would lead to capital erosion. Should any Italian banks need support, there are EC rules as to how that can be done. Of course, any negative effects on the supply of credit to the economy would be a downside risk for the economic outlook.

Italy's stocks have been weak recently, but so have other European equities. The FTSE MLB (Milano Italia Borsa) Index did bounce up by 1.91% on Monday, October 29, following Italian relief that S&P kept its rating unchanged. Similarly, the iShares MSCI Italy capped ETF, EWI, which also includes the effects of changes in the US dollar-euro exchange rate, rose a bit, 0.44%, on Monday. The 30 day performance of EWI was a decline of 9.47%, and the three month loss was 15.18%.The Germany ETF, EWG, performed similarly over the past 30 days, dropping 9.48%, and declined 14.06% over the past three months. The broader iShares MSCI Eurozone ETF, EZU, is down 9.99% over the past 30 days and 13.13% over the past 30 months. While weakness in Italy's bank stocks contributed to the decline in the Italian ETF, EWI, it is difficult to separate the effects of the situation in Italy from the broad market decline in Europe and indeed in the global market. We continue not to hold EWI in our International and Global Portfolios and remain underweight for the Eurozone.

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Sources: CNBC.com, Financial Times, Barclays Research, Reuters.com, Goldman Sachs Economic Research; Bloomberg

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