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Under the Tuscan Debt Load

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My wife will tell anyone she meets that she could return to visit Italy every single year—anyone who has visited that magical country would likely agree. Just mentioning the name conjures up visions of a glorious lifestyle under the Tuscan sun. However, beyond this idyllic dream lurks a more complicated image of Italy: a country burdened in debt, with sluggish growth, and now facing a difficult stare-down with the rest of Europe over its budget plans. Where do we go from here?

Not to state the obvious, but Italy has a debt issue. The government debt-to-gross domestic product (GDP) ratio sits at over 131%, close to a 90-year high. Italian 10-year bond yields, however, haven't exploded higher, although they have backed up 160 basis points (bps) since April and have reached a 5-year high versus the 10-year Bund.

Chart 1: Italian 10-Year Bond Yields

As of 10/30/2018



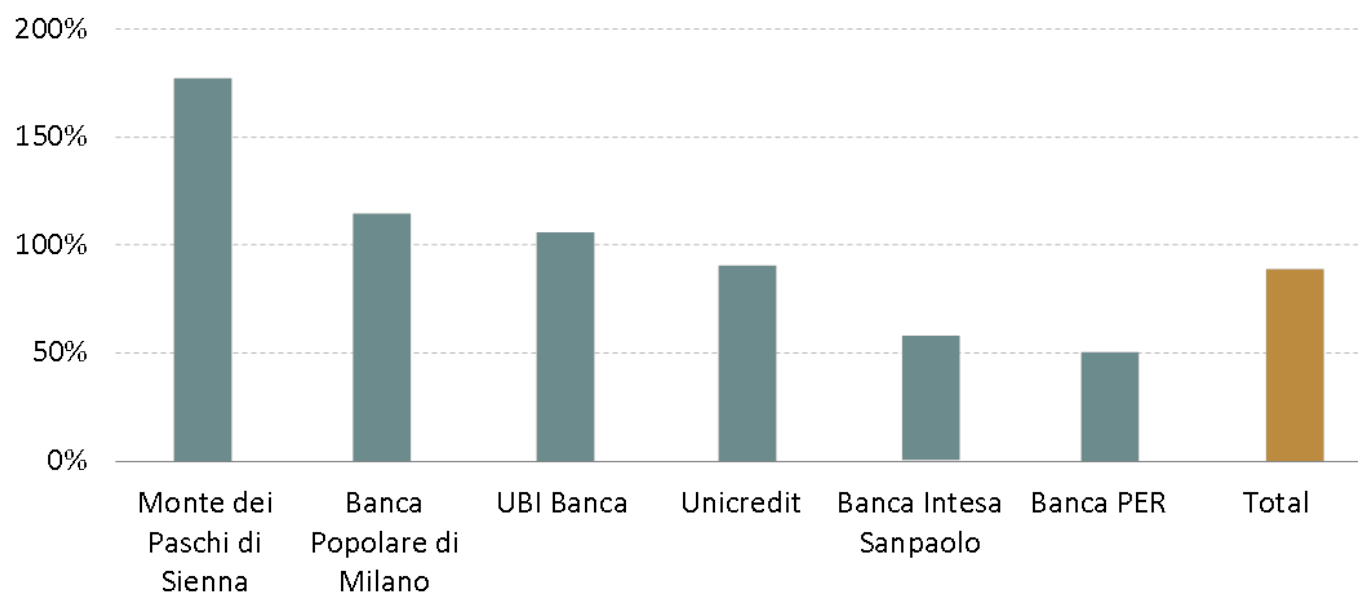
Source: Bloomberg (© 2018, Bloomberg Finance LP)

Why haven't BTPs yields moved higher given the recent standoff? There are two likely reasons why this has been the case:

1. European Central Bank (ECB) quantitative easing (QE) has kept yields generally suppressed across the eurozone, and
2. Over 50% of Italian sovereign debt is domestically owned by Italian banks, which has mitigated yields from having to rise a lot in an attempt to attract more foreign capital.

Chart 2: Banks and Governments: An Intimate Relationship

Italian sovereign bonds at fair value through OCI, % of CET1 capital, As of 03/31/2018

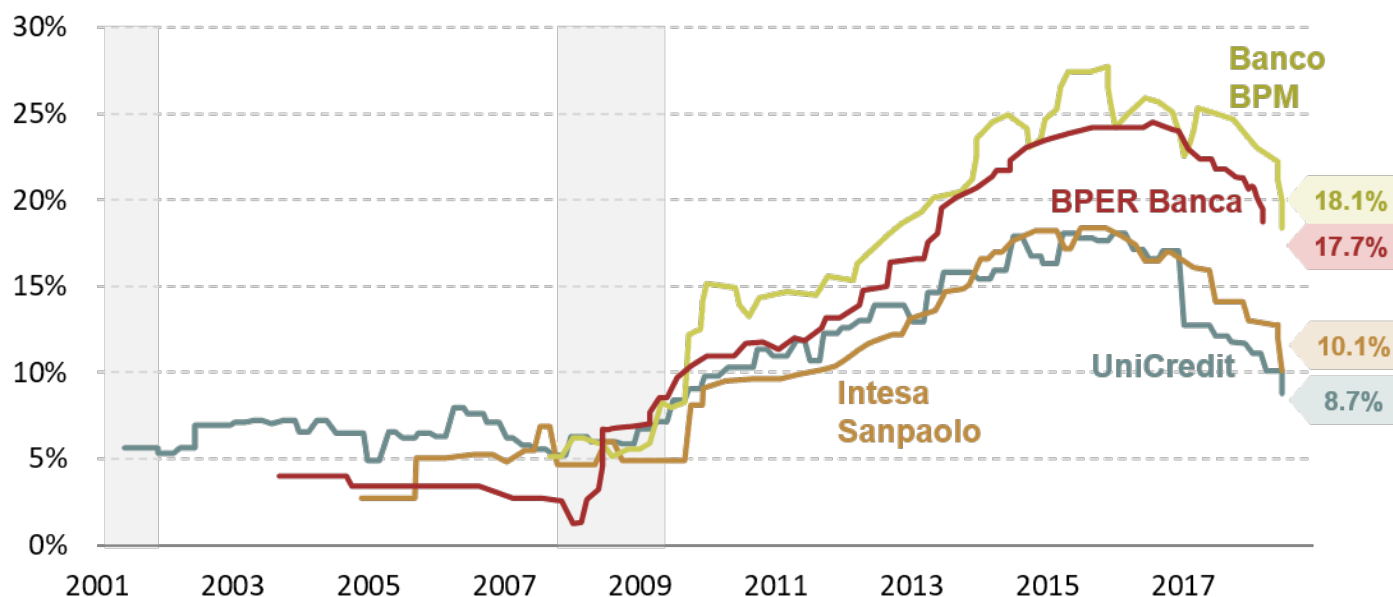


Source: Pavilion Global Markets

However, this domestic ownership creates vulnerability because the Italian banking system itself remains somewhat impaired. While non-performing loan (NPL) ratios have improved over the past three years, they remain at levels that continue to give concern, particularly given the structural headwinds and political uncertainty facing the Italian economy.

Chart 3: Non-Performing Loan (NPL) Ratios of Main Italian Banks

NPLs to total loans, As of 08/09/2018



Source: Bloomberg (© 2018, Bloomberg Finance LP), Pavilion Global Markets
Shaded areas indicate U.S. recessions.

The potential issues created by NPLs are reflected in widening bank credit default swap (CDS) spreads. While CDS spreads remain well below the highs of the eurozone sovereign debt crisis in 2011-2013, the markets appear increasingly concerned about rising solvency risk in Italian banks.

Chart 4: Italy CDS Spreads Since Early 2000s

Average CDS of Intesa, Unibanco, and Mediabanco, As of 11/01/2018



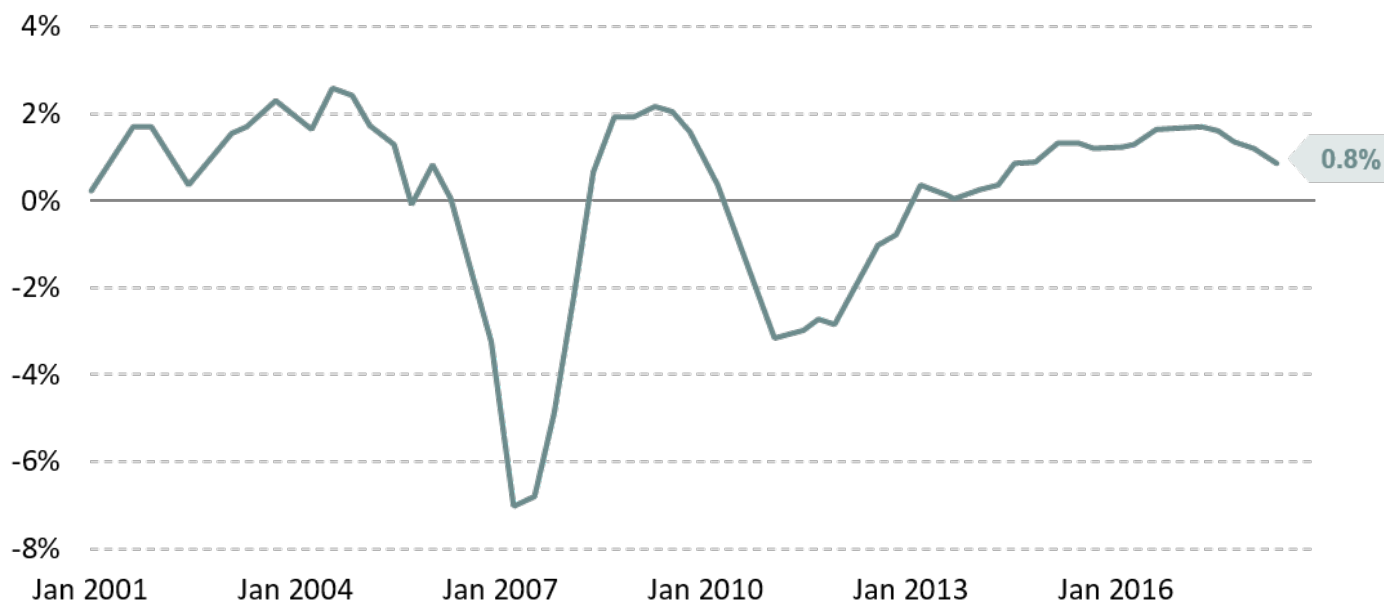
Source: Bloomberg (© 2018, Bloomberg Finance LP)

Moody's recently maintained its "Moderate+" view on the macro profile for Italian banks despite downgrading Italian sovereign debt from Baa3 to Baa2 on October 19. However, further downgrades to BTPs may push yields higher and could spark a negative feedback cycle for bank holdings of BTPs.

Of course, all of this concern might dissipate if the growth outlook in Italy suggested better times ahead for the economy. However, Italy just reported zero growth for 3Q18. Zero. This reduced the current annualized real growth rate to 0.8%, which is significant because it is likely to harden the European Union's (EU) resolve in the budget impasse, which could lead to higher yields and create more pressure on the banks.

Chart 5: Italy Real GDP

%YoY, seasonally adjusted, As of 10/30/2018



Source: Bloomberg (© 2018, Bloomberg Finance LP)

As for the budget impasse, there is currently no obvious path to resolution. The unusual coalition of left and right in Italy is led spiritually—if not in name—by Matteo Salvini. The fact that Salvini is lauded by the likes of Nigel Farage and Steve Bannon gives insight into Salvini's political orientation and possibly to his appetite for a fight with Brussels over the most appropriate policy mix to improve Italian growth prospects, and ultimately reduce the debt burden. It is hard to envision his backing down from a fight with the EU given some of his anti-integration rhetoric. However, it is equally hard to imagine the EU backing down either. As we have seen from the stunted nature of Brexit negotiations, no one should underestimate the political will in Europe to keep the EU intact, and so far the euro doesn't seem to be pricing in any concerns of an Italy exit. Brussels played hardball with Rome last week and sent the Italians back to the drawing board on its budget—the first time the European Commission ever rejected a member country's budget proposal. Our guess is that the two sides will find a way to muddle through, which seems to be *modus operandi* in Europe for deferring real action on difficult decisions. We expect some degree of compromise on both sides that will result in "kicking the can down the road" once again. Although difficult decisions may be left for another day, a compromise might represent an opportunity to evaluate owning some Italian bonds—but not quite yet.

The next key date is November 13 when Italy will present a revised budget proposal. Until then, expect bond yields to be quite volatile as they react to new information and headlines. However, the trickier issue of where yields will be a year from now remains a question unanswered.

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