

## Markets Losing Faith In Italy

### Markets Losing Faith in the World's Third-Biggest Sovereign-Bond Market

Italy's 10y yields broke through the critical 7% level on Wednesday – a level that is widely deemed unsustainable and that forced Portugal and Ireland to seek EU-IMF bailouts. Closing at around 7.25% on Wednesday, 10y yields had hit as high as 7.46%, more than 100bps higher than just a week ago and now around 553bps over the bund.

Exacerbating the situation were reports suggesting that Angela Merkel's party is seeking to make a possible for countries to exit the Euro but retain EU membership. EU officials reportedly said a Brussels meeting is scheduled for December 9 to discuss changes to the EU treaty. Wider contagion was alarmingly clear as French 10y bond yields now yield 148bps more than the equivalent bund, about double what it was just a month ago.

The major US equity indexes suffered deep losses on Wednesday, and Asian equity markets are seen tumbling today. As of writing, the S&P/ASX 200 is down 2.4%; Hang Seng is down 5% and STI down more than 3%. EUR/USD has also reacted, falling to lows of 1.3484 so far.

### Too Big to Fail?

Italy is the Eurozone's third-biggest economy, and is often described as being "too big to bail" or "too big to fail" in contrast to other Eurozone countries like Greece. In comparison, Italy's debt (EUR1.9tn) is 2.5times that of Spain, which is equivalent to the total debt of Greece, Ireland and Portugal added together. However, the country is almost certainly in recession already, the result of combined monetary and fiscal tightening across the Eurozone earlier this year.

As we have highlighted before, Italy is not fundamentally insolvent. Public debt has been stable for several years at about 120% of GDP. The country has a primary budget surplus. Household debt is low at 42% of GDP. Net household wealth is EUR2.3tn, higher in per capita terms than in Germany. Combined public and private debt is under 260%, lower than in Holland, France, Britain, the US and Japan. However, if yield levels continue to head higher, the country's debt burden will no longer be sustainable.

### ECB Bond-Buying Too Slow in Stemming Debt Spiral

According to ECB data released on Monday, the ECB has more than doubled its purchases of government bonds in the first week of Mario Draghi's presidency, even though we recall that the new ECB chief had kicked off his term with a blunt warning that it would be "pointless" for the bank to try to cap the yields of struggling debtors for long. Besides, to do so would breach European law. The European treaty is unequivocal: Article 101 prohibits the ECB from lending to governments, while Article 103 says the euro zone shouldn't become liable for the debts of member states.

Even if the ECB offered to buy unlimited bonds in the secondary markets, Italy might still struggle to raise money in the primary market. In fact, despite intervening heavily on Wednesday, the ECB's bond buying has not stopped markets from selling. Note that whilst the market was rife with rumours of an emergency ECB meeting overnight, ECB policymaker Juergen Stark warned European governments against asking the ECB for support in dealing with the region's sovereign debt crisis, saying this would put the central bank's independence at risk. Stark said the ECB backstopping would not solve structural problems in such countries, adding that such measures would more likely lead to moral hazard.



### Berlusconi Resignation Fails to Convince Markets

The resignation of Italian PM Silvio Berlusconi was supposed to be a pivot point. Unlike Greek leaders who have been unwilling to cede control over their country, the Italian PM heeded calls for his resignation seriously. However, now that Berlusconi is ready to take his curtain call and leave the European debt crisis stage, the composition of the next Italian government and the question of who will pull Italy from the brink have also dominated markets' attention.

### Going Forward...

Today's 12m bill auction in Italy will be eyed as a litmus test of market sentiment. But further out, it is increasingly clear that if the Eurozone wants to stay afloat and keep the common market together, ECB action, just as we have pointed out before, might be the only way to settle the market. Note that the central bank has stopped short of the full-blown quantitative easing policies pursued by the Fed and the BoE.

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