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Research Analysts
Andrew Garthwaite
44 20 7883 6477
andrew.garthwaite@credit-suisse.com
Luca Paolini
44 20 7883 6480
luca.paolini@credit-suisse.com
Mark Richards
44 20 7883 6484
mark.richards@credit-suisse.com
Marina Pronina
44 20 7883 6476
marina.pronina@credit-suisse.com
Sebastian Raedler
44 20 7888 7554
sebastian.raedler@credit-suisse.com

Italy: time for the ECB to show its hand

We are approaching the point where the ECB has to show its hand and accept its role as a lender of last resort. Yet, the question is how much further turmoil is required for it to do so.

Italy is the linchpin of the Euro-crisis: it accounts for 17% of European GDP, 7% of Germany exports directly and 25% of Euro-area government bonds outstanding. Without Italy, we believe, there is no Euro. If Italy were (somehow) to leave the Euro, the other members of peripheral Europe would be forced to leave as well, given the degree of competitive devaluation.

We have the following main conclusions:

- Italian bond yields need to be below 6%-6.5% for the funding arithmetic to be sustainable. If the Italian parliament passes the austerity measures (as seems near certain) this week-end and then forms a technocratic government enjoying wide-spread support with no elections until summer (a scenario that has a 60% probability, in our view), this, together with some help from the ECB, should help BTP yields to fall to 6%. Yet, there is clearly a lot room for political slippage.
- If BTP yields stay at current levels, the ECB has to significantly step up its purchases of Italian government debt. Yet, it is unlikely to do so if Italy refuses to implement the agreed austerity measures. These are almost certain to pass, in our view. However, if they did not, we would really struggle to see how the Euro survives in its current form. We would then start to get into our "What if"-scenario (-5% GDP, 800 on the S&P500 – see our report *The Euro: what if?,* September 23).
- The moment the ECB starts to act as a genuine lender of last resort, we effectively get open-ended QE (even if the ECB is not printing money). In time, this would lead to QE3 in the US (owing to dollar strength) – and thus the end game: more printing and negative real 10-year bond yields, which would greatly alleviate government debt burdens, drive down savings ratios, reduce the cost of capital and push investors into risk assets.
- The ECB may decide to postpone strong action until Italy's 25 point plan is passed (which we think will happen this weekend). Yet, we believe that ultimately the ECB will be forced to move (not least because of its vested interest, given that it owns/repos around c€600bn, as well as the fact that the ECB looks like it is being increasingly controlled by the periphery). Yet, the ECB would likely insist that the governments whose debt markets it supports are committed to meeting their fiscal targets. The only weapon it has to ensure compliance is its allowing bond yields to rise and thus the threat of a funding crisis.

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- There is widespread political support for austerity in Italy (though different parties disagree on the specifics on pension reform, labour market reform and de-regulation). We suspect that opposition parties will tone down their objections to specific proposals once it looks like they are going to get in power, as was the case in Greece and Ireland.
- There are only two long term solutions to the situation in peripheral Europe: growth (via a weaker Euro in the short term, higher productivity in the long-term) or the mutualisation of debt (via Eurobonds or ECB buying – yet, in the short term, the ECB is the only practical option).
- Italy in many ways is a liquidity problem that only threatens to be a solvency problem if: a) cost of funding is too high (i.e., BTP yields stay above 6%-6.5%); or b) there is no growth (because the ECB is not expanding its balance sheet, the Euro remains too strong and productivity is structurally low). Of course, this becomes a circular argument in both directions. We believe Italy's fundamentals look better than those of Greece, Portugal or Spain.
- On the negative side, the more policy makers in core Europe talk about the possibility of a country leaving the Euro (following Sarkozy's remarks on Greece last week and leaks on Reuters overnight), the greater the possibility of a default. This is because the deposit flight is likely to accelerate (there are still €187bn of deposits with Greek banks). Either this has to be offset by the ECB repoing more domestic bonds (thereby mutualising the debt) or loans in the periphery have to fall a lot further (leading to unsustainable deflation and default).
- Continental Europe looks set to enter a recession, which is likely to get worse on the back of fiscal tightening of at least 1.2% of GDP next year, banks' probably reducing RWA by €1tn as well as the need for wages in Spain and Italy to fall by 5% to 10%. Clearly, the current government funding crisis in the periphery will only add to the negative economic momentum. Consequently, we believe the euro is likely to weaken to around €/$1.20, with the downward pressure reinforced by the ECB eventually having to expand its balance sheet (yet, we note that our FX strategists hold a more positive view on the euro, with a 12-month target of €/$1.52);
- We stay underweight of Continental Europe (it is not yet cheap enough) and of cyclicals (see our note *Cyclicals: stay cautious; buy US exposure*, Nov 9). Yet, we remain benchmark equities (owing to the pick-up in economic momentum in the US and emerging markets, the rise in global excess liquidity as well as attractive valuations relative to bonds).

We look into these points in more detail.

The Greek debacle reminded investors of four key points:

- The threatened referendum showed that Euro exit could really occur, especially with Sarkozy saying that "the question is whether Greece remains in the Euro-zone, that is what we want. But it is up to the Greek people to answer that question" (FT, November 3rd). We note the news reports on Reuters of Germany and France discussing a smaller Euro-area.
- 17 national governments in the Euro-area are involved in negotiations (27 in the EU – and most of the relevant required treaty changes will affect EU treaties), as well as over 100 political parties.

- It is dangerous to assume politicians act rationally.
- Larger PSI haircuts are required to bring government debt to GDP down to sustainable levels – we estimate a 84% haircut on privately held debt is required, assuming the ECB, Eurozone loans and the IMF do not take any losses.

We believe markets are a bit unfair on Italy. Italy has six main advantages over the rest of the periphery, which lead us to believe that Italy is more a liquidity than a solvency problem:

- It has a primary budget surplus of c1% of GDP.
- It has very low total leverage in Europe (254% of GDP, compared to 273% for the Euro-area overall). There was no private sector debt or mortgage boom.
- The average maturity of its public debt is 7.3 years, with half of the debt being owned domestically.
- Its bank sector's loan to deposit ratio is lower than that of the rest of Europe (c120% excluding retail bonds). Partly as a result of this, its borrowing from the ECB, at 7% of GDP, are still pretty small (cf to 45% of GDP for Greece).
- Italy has high private wealth to government debt ratios (5.3X), which means taxing wealth is a more effective way of reducing the debt.
- Italy has the very little net foreign debt (21% of GDP) – and thus even in a worst-case scenario of leaving the Euro, there is less need to default.

The problem is that at a certain level of bond yield, any country is insolvent. With a bond yield at 7%, a government debt to GDP ratio of 120% and trend nominal growth of 1% (0.5% real growth plus 0.5% inflation), a primary budget surplus of 7% of GDP would be required to stabilize the government debt to GDP ratio (on current policies, Italy will have a primary budget surplus of 5% in 2014, so that is not enough). Italy's net interest expense is currently 4½% of GDP, because a lot of the historic debt is on lower rates than those current prevailing in the market. We note that when Greek, Irish and Portuguese bond yields rose above 7% and LCH Clearnet raised margins requirements, all three countries received a Euro bail-out within two months.

If growth slows even further, Italy risks becoming a solvency problem. So, for Italy to be put on a sustainable footing, bond yields need to be lower (below 6% - 6.5% would work) and growth stronger. How can lower bond yields be achieved? One important step would be for there to be a technocratic government with broad support that commits to implementing the agreed austerity measures. We think the probability of this happening is around 60%. Secondly, the ECB has to step up its purchases aggressively to drive down BTP yields and to allow the Euro to weaken (each 10% off the Euro adds 0.7% to GDP growth). Importantly, Italy has to de-regulate its economy, with its productivity per capita 20% below German levels and it ranking 87th on the World Banks' Ease of Doing Business ranking (behind Mongolia, the Bahamas and Zambia!). We continue to believe that there has been a clear loss of competitiveness in Italy: we know that its export market share has been stable, but we still believe that only a loss of competitiveness can explain why the current account deficit is an elevated 4% of GDP, in spite of the fact that GDP growth has been 0.2% pa since 2002. The way to address low competitiveness is via a weakening Euro, de-regulation and a fall in Italian wages of up to 10%.

What if BTP 10 year yield stay at current levels for a prolonged period? In this case, there is likely going to be a negative spiral of events (more deflation, a greater deterioration in credit quality, potentially France being downgraded as growth disappoints). Clearly, in that case deposit flight out of peripheral Europe will accelerate (after all, there are still €187bn of deposits left in Greek banks). If the ECB refuses to make up for this via repoing bonds or the ELA (emergency lending by the national central banks against low quality collateral), there is likely to be a massive contraction in loans in peripheral Europe that could easily end up forcing a default. Recall, Spanish banks still have loan to deposit ratio of 140%, while that of Greek banks stands at 125% (with deposit flight of 20% YTD). In effect, if the ECB were not to step up its bond purchases or repo operations soon, we believe the break up of the euro becomes a distinct possibility, creating widespread panic in financial markets and GDP falling by c5% in Europe (see our report The Euro: what if? 23 September). We note that after the Argentine default in 2001, there was a deposit freeze for a year.

We believe the ECB may postpone its purchases until the Italian parliament approves the latest 25-point plan. The lower chamber votes on Friday and the upper chamber on Saturday (brought forward from November 18th). Most of the details of the 25 plan have now been agreed. These are largely about de-regulation, labour market reform and removing red tape – rather than fiscal austerity. The 25-point plan is almost certain to pass (even if the Democratic Party will likely vote against it). The most likely outcome, in our view, is a technocratic government led by Amato and Monti (recently made a Senator for life), benefiting from widespread support and focused on the implementation of austerity measures and the new electoral law. Yet, we can only put a 60%-70% probability on this. The risk is that Lega Nord and Berlusconi's PDL have rejected the idea so far. Yet, some MPs of both parties appear to be in favour, as well as a large part of the opposition. If there is no majority for an emergency government, fresh elections will be called in January/February with the centre-left coalition (Social Democrats and progressive Christian Democrats) likely to win a majority (they have a 10%-12% lead over the centre right on the latest polls). Currently, the centre left coalition is divided on many key issues, which contributes to the on-going uncertainty.

However, amid all the gloom, we should not forget two key conclusions on politics:

- All parties have agreed in principle on fiscal austerity – it is just a debate about how to implement it
- There has been disagreement about de-regulation and pension reform – but in all probability the threat of a funding crisis will, as in Ireland and Greece, lead to the opposition parties toning down their policies.

What is needed to stabilise the Euro situation on a permanent basis? We continue to believe that the adjustments are not complete in peripheral Europe until there is at least a balanced current account (versus a deficit of 9% of GDP in Portugal & Greece and of c4% of GDP in Spain and Italy). One way or another this requires a contraction in domestic demand (i.e falling wages) in Spain and Italy. So far Italian and Spanish wages have yet to start falling. Remember how much pain has occurred in the economies that have adjusted: Irish public sector pay fell 20%, nominal GDP by 20%, Latvia had GDP falling by 25% to stay in the Euro, while public sector wages fell by 30% and the population fell 10%!). Ireland is the only peripheral European country that is running a current account surplus at the moment!

We note that once we adjust for the cost to the public sector of reducing excess private sector leverage (with private sector leverage standing at 230% of GDP in Spain and Portugal), government debt to GDP will end up close to 100% in Spain and 140% in Portugal.

The long term solution to the Euro, we believe, is either to have growth or to mutualise the debt (via a Eurobond or the ECB buying peripheral European bonds).

- *Growth:* Euro-area PMIs are consistent with a recession. This, as things currently stand, will get worse on the back of fiscal tightening of 1.2% of GDP next year (which is likely to rise further), RWA of banks falling by at least €1trn and the need for wages to fall in the periphery (which accounts for a third of Euro-area GDP). Therefore, we believe that the only practical solution to get growth is de-regulation (but that takes time) or a much weaker Euro. But this requires the ECB to expand its balance sheet.

- *The mutualisation of debt:* The Eurobond solution is impractical (it takes too long, is too political). Therefore the only solution to achieve the mutualisation of debt is the ECB. If the ECB buys more peripheral government bonds and then suffers losses on these purchases, it will have to be recapitalized by core Europe (in passing, the ECB has a balance sheet of €2trn, compared to total loss absorbing capital of €408bn on our calculations). Another way for the ECB to mutualise its debt is by increasing its repo operations with peripheral Europe. It already repos €420bn of bonds with peripheral Europe. This could easily increase to c€800bn as deposit flight increases. The critical issue is that the collateral posted is too small and thus increasing the repo operations is just an indirect way of core Europe bailing out the periphery. Consequently, the ongoing deposit flight, which requires the ECB to increase its exposure to peripheral Europe, will raise the stakes in this game!

Will the ECB move? We believe the answer is yes. Yet, it is important to note that the ECB is caught in a trap. On the one hand, it can't come out with a bazooka statement otherwise core Europe will (correctly) assume that their currency is being debased and that they risk footing the bill (via an ECB recap). On the other hand, the ECB has to convince markets it will act as a lender of last resort. Therefore, Draghi's policy of "constructive obscurity" will have to be pushed to further extremes: the ECB has to act as a lender of last resort (and has to convince the market that it accepts this role), without it explicitly saying that this is what it is doing.

We believe that the ECB will become more aggressive because:

- There is no practical alternative;

- It's quite possible that the Bundesbank vote (5 out of the 23 ECB Governing Council members vote with the Bundesbank) is being outnumbered by the periphery (8 members directly, rising to 10 if we include Malta and Cyprus). Hence, the resignation of Stark and last week's surprise rate cut;

- Draghi is an academic – and they tend to be more aggressive than career central bankers;

- The ECB already have a €600bn exposure to peripheral Europe and thus it is in their vested interest to 'protect' that exposure;

- Without ECB action, Europe is clearly about to enter a big recession (leaving inflation way below target!).

We take it as a positive sign that the ECB has been willing to lend via the ELA (where effectively a bank issues a bond guaranteed by the government, which is then used as collateral against which banks can borrow from their national central bank, even though such bonds would not be eligible collateral for repo operations with the ECB).

Most importantly of all, we believe that core Europe will continue to be committed to supporting the Euro. The most critical reason is that core Europe via its banks holdings in the periphery and via its liabilities to the ECB (both repos and bonds) owns €1.8trn of peripheral European assets. With net foreign liabilities at c100% of GDP in the periphery (ex Italy), the direct losses of a Euro break up (including Italy) will at least €590bn, on our estimates, with the indirect costs from the ensuing logistical nightmare of breaking up the currency union, surging core European currencies, trade wars, etc., many times higher. Just writing out a cheque in worst-case circumstances to get 2014E government debt to GDP in the periphery down to 100% (including Italy) would cost €560bn, on our estimates.

Ultimately, there has to be more pain. William Porter, head of our credit team, puts this very simply: Without the Euro, the currencies in the periphery would have fallen by a third and they represent a third of Euro-area GDP, thus there needs to be a 10% 'loss' of GDP (which incidentally is almost in line with the average cost of a banking crisis). The only other way of getting this 'loss' would be a for a 10% weaker Euro, but again that would require the ECB to expand its balance sheet.

What short term measurers outside of the ECB control can be taken? Almost none. The IMF only have about €300bn of funded capital, which is not enough. The EFSF has only €200bn of funding if Italy and Spain are excluded. If there is no mutualisation of debt via the ECB or a Eurobond solution, the only short term solution we believe would be a €1trn EFSF (the maximum size possible before the contingent liabilities incurred by core Europe lead to a French downgrade). Of this, €200bn could used to recap banks, €300bn lent to national governments to buy in debt a market prices and the rest releveraged via the EFSF.

What are the investment conclusions?

- If the ECB does not act, the likelihood of a Euro break up increases, which, we estimate, will entail a 5% fall in European GDP and will lead the S&P 500 to fall to 800.
- Yet, we believe the ECB will eventually end up with a more open ended commitment to buy peripheral European debt (buying BTPs off French banks/insurance and raising deposits to pay for them). However, it will probably take further turmoil to achieve this. Once the ECB acts as lender of last resort, its balance sheet expands and the quality of its balance sheet deteriorates, leading to a fall in the euro. The weaker euro, in turn, makes QE3 in the US much more likely, in a way that four major central banks would be printing money (the Fed, the BoE, the BoJ and SNB) and one de facto expanding its balance sheet (the ECB). In due course, investors would seek the cheap inflation hedge of equities.
- We stay benchmark equities, on the back of the improvement in US macro momentum, excess liquidity and attractive valuations relative to bonds. Our end-2011 S&P 500 target is 1,270 and 1,340 for end-2012.
- We stay underweight Continental Europe: it is not yet cheap enough to compensate for all the risks it is facing. The P/E ratio is just below its norm, as is the sector-adjusted P/B. Only the utility and leisure sectors are more than one standard deviation relative to their US peers;
- As stated above, we think the probability of a positive political outcome in Italy, at around 60%, is high (bond yields falling as a technocratic government, enjoying widespread support, implements the agreed austerity measures). Yet, it is not high enough to us to invest in risk trades associated with Italy.

- We continue to believe that a Euro break-up has a small probability – and within Europe, we think that the best risk trades are the DAX (the third cheapest market), domestic Germany (which looks set to have an interest rate, currency and above all Bund yields all much lower than it deserves) and EuroStoxx dividend futures that are discounting a decline of 35% to 2015.
- We stay underweight of cyclicals: in our note yesterday (*Cyclicals: stay cautious; buy US exposure*, Nov 9), we downgraded advertising to underweight and reiterated our underweights of capital goods, retailing and hotels. However, we like cyclicals with high US exposure.

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