REDUCING EUROPEAN EXPOSURE AS ITALY COMES INTO FOCUS

BEFORE GETTING TO THE ISSUE — A RECAP OF THE EUROPEAN DEBT CRISIS

Investors have grown accustomed to negative, debt-related headlines flowing out of Europe since Greece's austerity measures first made headlines in February of last year. A month later the credit markets were focusing on Portugal and Spain which subsequently announced their own austerity and deficit-reduction programs. From the inception of the European debt crisis, the overarching worry was less about whether Greece would default on its debt obligations than whether certain other, larger, debt-laden countries might follow suit.

Despite the fact that euro-zone members and the International Monetary Fund reached a deal to bail Greece out, the yields associated with Greek debt spiked early last year as skepticism grew about Greece's ability to service its debt obligations. To the extent governments are considered to be less than creditworthy, they either can't borrow money at all, or they are forced to borrow at exceedingly high rates of interest. Either situation can wreck a country's economy.

Euro-zone members later agreed to lend Greece some €30 billion (about $40 billion) at a more affordable 5% interest rate. By May of 2010 Greece reached a deal with other euro-zone members and the International Monetary Fund to receive around €100 billion ($133 billion) in exchange for the implementation of further deficit-reducing measures. Shortly thereafter, government yields on Portugal's debt spiked to over 7% which signaled investors' fear that Portugal might default on its government-issued debt. By the summer of 2010, Spain and Portugal had joined Greece in suffering credit downgrades of their own and Ireland was next in line due to weakness within its banking system.

By the fall of 2010, Europe had analyzed its banking system by conducting a series of stress tests and found the capital cushion to be inadequate in five Spanish banks, one German Bank, and a Greek Bank. Ireland's credit rating was cut and Spain's was cut again. Talk then shifted to how much bondholders ought to share in the credit-related losses of the various euro-zone economies as Ireland began to realize that its previously agreed upon austerity measures would not be adequate to meet the European Union's deficit-reduction targets. It then applied for financial aid from the European Union and the International Monetary Fund, later receiving €68 billion in bailout funds. Despite its previous financial aid and austerity measures, Greece's credit rating was once again downgraded this past spring as it became apparent that its fiscal and political situation had deteriorated further. About that time, Portugal's economy collapsed in a fight over austerity measures and its prime minister resigned. Greece, Portugal, and Ireland suffered another round of credit downgrades in the spring of 2011 despite the various austerity measures, loans, and bailout packages.

That's enough of a summary for me to make the points I want to make, but the storylines that have come to us from Europe over the past year and a half have been, on balance, negative:

- Policymakers have tended to take too long to act and to assemble workable solutions.
- Resistance (e.g., riots) from the mass affected has interrupted the policymaking process.
- Economic performance of ailing economies has typically been worse than expected.
- Austerity measures have repeatedly needed to be followed by further austerity measures.
- Bailouts have tended to be larger and/or be needed more frequently than anticipated.

The track record here is not particularly good.

YIELDS ON ITALIAN DEBT SURPASS 7%

Last Tuesday, amid an equity market rally, the news began to center around the fact that the yields on Italian debt had spiked to almost 7%, but many consider yields beyond 5% or 5.5% to be unsustainable. Once yields on Portugal's and Ireland's debt surpassed 7%, policymakers in those countries knew that creditors lacked confidence they would be repaid. And more importantly, each country subsequently needed to be bailed out (as had Greece). By last Wednesday, the yields on Italian debt actually did surpass the 7% mark — serving notice to Italy that creditors are losing confidence.

News that Italy's Prime Minister Silvio Berlusconi would resign (under pressure) once certain budget reforms were passed by Italy's Parliament have since reassured creditors and yields on

Italian debt have since fallen beneath 7%. However, they may still be too high for Italy to remain independently viable. No one knows for sure, but the warning shot the credit markets have delivered to Italy is similar to the ones that triggered the tumult that befell the other economies I mentioned earlier.

In addition to news that Silvio Berlusconi would likely be replaced (even if not by election) by a well regarded central banker (Mario Monti), the rally in the equities market that occurred late last week may have been driven by the fact that Greece has also named a new Prime Minister. So while there might have been some euphoria that Greece and Italy now have new leadership, not much of anything has actually been solved yet. The market rally that occurred on Friday could also be discounted on the grounds that Friday was a quasi-holiday where trading volume was very light. That is, investors did not cast many votes that day.

ITALY IS MUCH LARGER ... POSSIBLY TOO LARGE TO SAVE

For the sake of comparison, the size of Greece’s public debt (in dollars, this time) was on the order of $370 billion before being statutorily written down recently. Portugal’s public debt load recently amounted to about $870 billion while Ireland’s stood at about $160 billion. This represents a total of about $1.4 trillion. In contrast, Italy’s $2.6 trillion in debt is almost twice as much debt as Greece, Portugal, and Ireland combined. Italy may be too large to save.

And, even though Italy now has a new government in place, it does not have the complete backing of its people. If history is a guide, Italian policymakers may face internal resistance. Some reforms were already passed this weekend (higher retirement age and sales taxes, the privatization of certain municipal services), but near universal agreement exists that these reforms by themselves will be inadequate to fix Italy’s ills. Fortunately, Italy has a dynamic economy that may be able to grow its way out of its fiscal mess, but the warning shot that the credit markets fired last week sends a powerful message.

$410 BILLION OF ITALIAN DEBT MATURING IN 2012 ALONE

Of the $2.6 trillion that Italy owes to its creditors, some $410 billion matures during 2012 alone which represents about 10% more than Greece owed, in total. This means that pressure for some type of resolution will build in a hurry during 2012. Hopefully, Italy will be able to refinance its debt at interest rates that are low enough for it to remain fiscally viable, but this may be difficult.

SPAIN

Spain has already been in the news, but its problems persist. And unlike Italy, the prospects of Spain being able to grow its way out of its fiscal mess are worse since its economy is generally regarded as being less dynamic. Therefore, even if Italy is able to get back on track, Spain still has the potential to cause a lot trouble.

CONTRACTION SEEMS NECESSARY WITHIN THE EUROPEAN BANKING SYSTEM

If meaningful credit losses are sustained within the European banking system, it will need to either raise capital or shrink its asset base in order to allow its remaining capital to go further. Both may be required. That story unfolded in this country after the recent financial meltdown. As banks endeavored to shrink to stretch their remaining capital further, they curtailed their lending efforts which exacerbated the resulting downturn.

This note is not meant to weigh in on the likelihood of recession in Europe, but the next global recession could begin with a contraction within Europe's banking system. Since somewhere between 10 and 20% of U.S. exports are delivered to Europe, the U.S. would be impacted too.

SUMMARY

Italy is Europe's third largest economy (behind Germany and France) and it is far larger than the other economies that have already created so many negative headlines. Now that it has attracted the attention of the bond market, we have already begun to reduce many of our clients' European exposure. In summary, I regard the bond market's recent reaction to the riskiness of Italian debt as a warning rather than as a buying opportunity.

— Glenn Wessel