March 2013

Italian Politics: A Crossroads for Eurozone Government Bond Risk?

Nick Eisinger
Global Research Analyst

Jamie Stuttard
Head of International Bond Portfolio Management

Italy overview and outlook

By Nick Eisinger

The results of the recent Italian election—with no single party in a position to establish a majority in the important Upper House of Parliament—were a disappointment to the market. There is a risk that the formation of a stable government could be weeks away, yet Italy faces significant challenges in terms of undertaking structural reforms and maintaining the market confidence necessary to refinance its large debt burden.

At this stage, however, it is not clear that Italian bond yields are going to widen significantly. There is still a chance for a governing coalition to take shape, and we expect the European Central Bank (ECB) to remain supportive despite the challenging environment, given the globally systemic importance of Italy.

Main points to consider

From here, the two options for the formation of a government are to enter into early elections—six to eight weeks away—or cobble together a compromise political alliance—either majority or minority government. The next two weeks are critical. There are some issues the disparate parties can agree on—we therefore believe that some kind of temporary government is possible. While a political alliance would be unlikely to last long—possibly six months—it could at least allow the country to avoid a damaging period of limbo. A political alliance is not necessarily positive for risk and peripheral government bonds, but may be a stabilizing force. It could mean there is a government in Italy in place to negotiate with the European Union (EU) and ECB, should this be needed; and it might keep market faith in the ECB's outright monetary transactions (OMT)[1] intervention alive.

Given Italy's large bond market and its great systemic import to the global financial system, we believe the ECB will remain supportive, even if the political situation delays the necessary reforms. On the reform front, Italy does not have a pressing need to undertake more austerity. Politics have probably crippled structural reform, and those reforms would have likely taken years to produce a positive impact.

Purchasing Managers' Index (PMI) data suggest that the Italian economy is stabilizing, and although politics might change this again, global economic prospects seem to be at least as important. Italy faces a burdensome sovereign funding calendar in 2013, however it is less onerous than in 2012 and the domestic buyer base offers some resilience.

Italian politics

Resolution to the political crisis in Italy has two possible outcomes:

- A move to early elections as soon as possible—six to eight weeks—which would not be a good outcome in our view.

KEY TAKEAWAYS

- The results of the recent Italian election, with no single party in a position to establish a majority in the important Upper House of parliament, could pose important challenges for financial markets in Europe.
- Given Italy's large bond market and its great systemic import to the global financial system, we believe the ECB will remain supportive, even if the political situation delays reforms.
- From a portfolio perspective, caution is merited in Spain as well as in Italy.
- In our Global Fixed Income 2013 Outlook, we argued there are structural improvement stories in selected emerging markets local bonds and currencies, which have much better prospective risk-adjusted return potential than the eurozone periphery—we continue to hold this view.

Fidelity INVESTMENTS

- Democratic Party (PD) leader Pierluigi Bersani is able to cobble together a minority or "grand alliance" in the Senate—a less bad outcome—that would be cemented by:

  1. A general desire to avoid new elections
  2. Recognition that leaving Italy rudderless at present is dangerous
  3. Common agreement on political/electoral reform
  4. Agreement in certain other areas of policy

We would lean marginally toward the latter of these outcomes at this stage.

Beppe Grillo and his anti-establishment "5-Star Movement" have done well in the elections, but despite his rhetoric about refusing to cooperate with traditional parties, such an outcome could offer him a genuine chance to achieve some meaningful degree of political reform. On his own, he clearly cannot form an administration so he may ultimately be pragmatic.

Any government would be a positive development compared with a lengthy period of limbo and preparation for fresh elections that would probably deliver the same result. Indeed, in the absence of a new electoral law the landscape will probably be unchanged.

We do not think such a government would last long—six months base case, 12 months at best—and structural reform, and probably any additional fiscal reform, would suffer as a consequence of the parties' disparate views and policies.

Under a scenario of a temporary government, Italy will make little or no progress on some of the problems that have burdened it in recent quarters, and therefore the underlying macroeconomic concerns will remain, suggesting periodic market volatility.

However, a government presence may help prevent a wider market sell off. Italy is used to unstable governments, so the election developments are not new from a historical perspective. Meanwhile, having a government in place may lift some of the concern about who the ECB and EU negotiate with should OMT be needed to stabilize the government bond market.

OMT availability

The availability of outright monetary transactions (OMT) is difficult to assess. A reform program or agenda would likely be needed, and would have to be passed by both houses of parliament. The EU—and especially Germany given its own elections—is unlikely to eliminate conditionality for the OMT completely, *but* may be willing to show some compromise. Some of the reasoning for this:

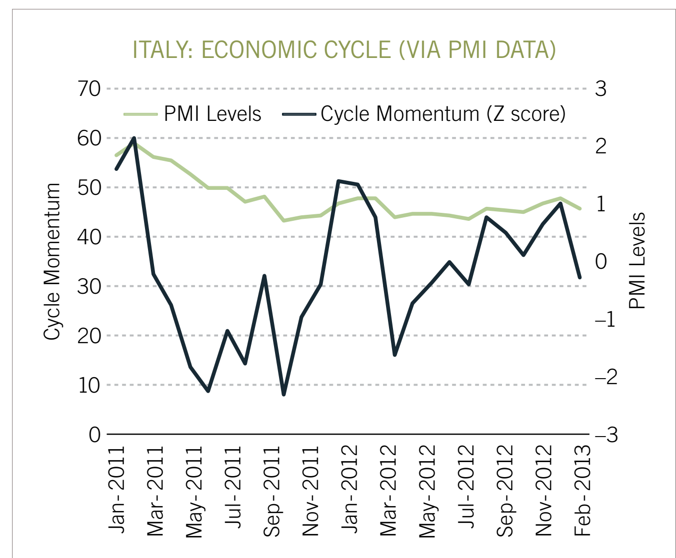
- Italy is systemic. If the EU/ECB let Italy go, then they may not have a euro project any longer—this is not Greece or Cyprus.
- While many people are uncomfortable with this "too big to fail" argument in the case of Italy, it probably carries some weight.
- There is growing consensus about the damage that strict austerity has had on advanced economies, which might suggest that less harsh fiscal conditions can be imposed under a reform package.
- Italy does not have an immediate need for fiscal tightening; it generates a primary budget surplus already and should not have an issue funding the deficit per se.
- This does not mean debt is stabilizing and clearly the need for refinancing is large, but debt is not rising in a stratospheric manner.
- Structural reforms will probably not happen. In any case, these reforms would likely take many quarters (or longer) to pay dividends, so suspending this for some time might not matter too much.

Italian economy

The economy remains quite anemic, but it is not clear that the political impasse will lead to a renewed bout of weakening.

February PMI data came in weaker than anticipated; even with the best of political outcomes this week, Italian growth would have taken a long time to return to "sustainable" levels.

EXHIBIT 1



Source: Markit Economics Limited as of Feb. 28, 2013.

It seems that the global growth situation may, therefore, remain more important for Italy's fortunes rather than domestic politics, at least near term. Here, there is some confidence that a degree of recovery is taking place, including in Germany.

While global growth will likely be positive for Italy, this would be offset by a renewed tightening of domestic financial conditions driven by tighter bank liquidity and an extra sovereign yield premium. Another risk could be that capital flight out of the banking system picks up again, although we think this is a scenario more linked to renewed 'existential' concerns over the longevity of the euro, which is not the current situation. A weaker euro, if sustained, would be marginally beneficial for Italy.

Fiscal funding

Italy has plenty of government funding still to do this year, but it is lower than 2012 due to a smaller budget deficit and lower bond redemptions. It also still generates a primary surplus, which helps the funding picture. Of course it does not take much to go wrong before the sovereign could run into major refinancing issues, but at the margin the pressure is lower than in 2011 and 2012.

The domestic investor market also seems to be more robust than is perhaps the case in Spain or other peripheral countries, in part because private debt levels are lower and because Italy did not have an asset bubble (see Exhibit 2, below). The country still needs foreign investors to buy its debt, but perhaps at the margin it has more leeway here. That said, the banking and financial systems are clearly heavily exposed to the government bond market and in general the banks are reluctant to buy too much duration.

EXHIBIT 2

2013: Central Government Funding Needs						
	Primary Budget	Coupons	MLT Repayment*	Bills	Total	% GDP
Germany	–11	31	157	56	233	8.6
France	29	41	108	171	349	16.9
Netherlands	–4	10	32	21	58.5	9.5
Italy	–14	54	158	154	352	22.3
Spain**	61	22	62	70	215	20.4

**Bond amortizations—medium and long-term repayment of principal.*
***Spain includes €33 billion in funding transfers to regions. Source: National Treasuries, Fidelity Investments.*

Global Portfolio Strategy Update

By Jamie Stuttard

Questions raised by Italian elections

The Italian election surprise has the potential to challenge a market rally in peripheral debt that has been in place for seven months. Italian 10-year government bonds trading around 4.7% to 4.8% have come a long way since July 26, 2012—when they traded at 6.60% on a daily closing basis. Additionally, because July 2012 was more about imminent concerns with Spain rather than Italy, the Italian government bond (BTP) market itself has enjoyed a further rally beginning with the peak in Italian bond yields in November 2011, when Silvio Berlusconi was ousted as Prime Minister and replaced by Mario Monti's "technocratic" government (the Italy 10-year bond was 7.26%). In light of the results from February's election and the potential scenarios from here for government formation (not least the risk of more elections at some point), the market will be considering the following:

1. Does the substantial rejection by Italian voters of austerity (Monti polled just 10%—or only 7.5% of the electorate) upset the conditionality-based crisis management approach of the ECB and broader eurozone authorities—an approach that has been present throughout the eurozone crisis?

2. Does the arrival of Beppe Grillo and the resurgence of Silvio Berlusconi threaten to reintroduce a significant "credibility premium" into Italian bonds, which existed toward the end of Berlusconi's previous administration?

3. Is the post-election "hung Senate" in Italy merely similar to the Netherlands, UK, and Belgium—countries that also had to find post-election coalitions in the past few years? Or, is Italy's political vacuum and prospect of weak governments and new elections much more concerning given: 1) Italy's more volatile bond market in recent times, 2) its reliance on the OMT "bazooka" threat from the ECB for market stability, and 3) the need for a stable Italian leadership to provide a counterparty to the ECB for its conditional agreement?

The backdrop - Too big to fail?

As we noted earlier, Italy is systemic; as the third largest Eurozone economy and largest government bond market in the zone, it is fundamental to the euro project. This suggests that an ECB response can ultimately be expected if there is significant market volatility. That said, there are two issues with Italy here:

1. **Since 2011, the ECB has stepped up its crisis response mechanism only when Italy/Spain have traded above 7% yields.**

   There is precedent (three occasions) of the ECB intervening when yields breach 7% in the two "systemic" peripheral countries—Italy and Spain. We think it is unlikely that the ECB will change its pattern and become more generous by interven-

ing at lower yield levels, given the conditionality challenges now in place with sharply lower voter acceptance of austerity and the need for a stable OMT counterparty. With 10-year yields in the 4.6% to 4.8% area, this suggests the potential for a substantial rise in Italian yields before any ECB response could be expected. While some of the more bearish Wall Street strategists are now forecasting a 7% 10-year yield, markets are likely to anticipate renewed ECB action above 7%. As such, we would argue Italian yields are unlikely to get all the way to 7% without a major new negative shock. Still, a 6% target under bearish scenarios is not unreasonable. This would be a substantial move: a 125 basis point (bp) increase in yield implies nearly a 10-point price drop. The main message is that the ECB is unlikely to intervene at yield levels 200 to 250 bps below the "stress levels" of 2011 and 2012.

Market support from the authorities does rely on willing political partners in each country—in a world where there are strong views within Germany, in particular, on monetary financing, moral hazard, and inflation—in order to accept conditionality and provide "cover" for domestic northern European audiences that aid is being sent to a sensible destination. The good news for the bullish view that either Italy or Spain would receive support above 7% is that as November 2011 showed, willing political partners can be "forced in" as with the ouster of Prime Minister Berlusconi and unelected imposition of Mario Monti. The bad news is that democracies do not seem to react well to those moves. They can easily be characterized as external meddling, which weakens and undermines the ability of eurozone authorities to influence politics in the future. This adds weight to the idea that the ECB will not want to intervene too soon at low yields.

2. **The ECB created the OMT backstop and articulated it as a mechanism to address convertability premia—not solvency risk.**

When Mario Draghi introduced the OMT threat in the third quarter of 2012—to near unanimous ECB approval but to public rejection by Jens Weidmann of the Bundesbank and some broader concern within parts of Germany—the key reasons given were the reduction of convertibility premia (i.e., euro breakup risk) and the need to restore the monetary transmission mechanism. While financial market instability is clearly undesirable for the ECB, euro breakup represents an existential threat. No euro means no ECB. The possibility of breakup is therefore an overtly strong motivation for ECB action.

However, what Draghi did not address in the summer of 2012 was solvency risk. In the view of some former policymakers,[2] a restructuring of Italian and selected other peripheral government and bank debt is highly likely one day. This solvency risk—or in other words, the existence of unsustainable debt trajectories in over-indebted issuers with poor long-term trend growth prospects—is a separate issue to euro break-up risk. We believe that markets have tended to conflate the two issues. It was commonplace, for example, to hear market participants equate Greek default risk with Greek exit risk—they were treated as one and the same. Yet Greek private sector involvement (PSI) in the first half of 2012 showed that private sector bondholders could experience a haircut—a default of government debt in all but name—without a country leaving the eurozone.

Further, the haircut itself took place without broader market risk implications and contagion—the risk of Greek exit from the eurozone posed by Greek elections, and the problems with Spanish banks, were both considered far greater risks in 2012. If the private sector Greek government debt burden could be cut by €200 billion in an arguably more stressful economic and market environment—pre-OMT, deeper recession—why should an ECB backstop for the euro project necessarily mean a backstop for solvency risk in the future? In other words, why should market participants be confident that all bondholders will always get par henceforth in the eurozone, regardless of their sovereign fundamentals, political leaders chosen, and so on?

To be clear, Italian bond haircuts are not on the table in the short or medium term in our view, but the future risk (the Greenspan and Buiter scenario) still needs to be factored into the price. While the probability remains low—equating to single digit yields—it should fluctuate within the single digit spectrum higher than 4%. It has arguably risen given the mix of candidates endorsed at the polls and the weak political backdrop post-Monti that has been created. The market had almost universally assumed a Monti-Bersani coalition: This we do not have and will not have. A Renzi-Passera coalition may be possible one day—likely very positive for the market—but there are apt to be chapters of market volatility that would occur first.

Bottom line: Italy remains asymmetric

From a portfolio perspective, we believe the risk to the BTP market remains asymmetric. While yields could certainly rise to 6% or more, they are arguably unlikely to fall within the 3% to 4% range. Therefore, the potential downside in price for bondholders remains larger at this point, despite the increase of 50 bps from the lows in yields. The Bank of Italy itself suggested that a spread of +200 bps over German Bunds was appropriate in the long term. This would equate to around the 3.5% area based on current levels. On the basis that the Bank of Italy is arguably not an objective observer—and so could be at the bullish end—the 4% level could be tough for the market to rally beyond. That therefore skews the range of potential outcomes for Italy to higher yields than here.

Broader periphery

For the broader periphery, we believe there are two main scenarios.

First, we believe Spain and Ireland could outperform Italy, in the scenario that Italian market volatility remains within a +100 bps widening range from the 4.20% lows. Surveys from Wall Street

sell-side firms and manager websites suggest that investors are overweight the periphery. We view this as a source of potential market instability, given we tend to take a contrarian stance. Within this environment, the underperformance of Spain in the past 12 months suggests that investors are more overweight in Italy than Spain. It is likely that investors will be re-evaluating this positioning, leading to Italian underperformance as risks there have re-surfaced. This does not mean that risk has disappeared in Spain (ratings downgrades to junk, the graft allegations facing Prime Minister Rajoy, the contracting economy, and regional tensions) or even in Ireland—yield compensation now the lowest in the periphery, and legacy bank debt questions can still be asked. But it does argue for a peripheral rotation out of the immediate threat and existing favored overweight for most investors (Italy) into other high-yielding debt.

Second, should Italian volatility be more meaningful—much greater than +100 bps of widening—we would expect the Spanish yield curve in particular to undergo a regime shift again, and become unhinged. Because of Spain's higher beta versus Italy during the past 12 months (and notwithstanding the peripheral rotation above that which could occur in a lower volatility scenario), Spain remains vulnerable to a renewed phase of selling (further capital flight from the Bonos market, reductions in holdings by the very largest banks, and other domestic players). Just as the "frontier" of the eurozone crisis was first in Greece—ultimately leading to PSI—and then in Ireland followed by Portugal (leading in both cases to greater than 15% yield peaks), and most recently at Cyprus, so it also remains at Spain's door. This makes Spain particularly vulnerable to volatility should a eurozone event—and Italian politics have been and remain the main contender in the first half of 2013—upset peripheral government bond markets.

Caution is therefore merited in Spain as well as in Italy in our view.

Broader eurozone

For investors with currencies unhedged, we do believe the euro is at risk of weakening. Political crises and government bond market volatility have historically been the biggest drivers of falls in the euro/U.S. dollar exchange rate since the euro crisis began in October 2009. That said, the euro has already fallen 4% from its first quarter 2012 highs (1.364 to 1.307), which is more than one third of the way to the July 2012 lows around 1.206 (during last summer's Spanish Balance of Payments crisis). The direction of travel for the euro against the U.S. dollar is also not necessarily one way given the Federal Reserve's constant $85 billion per month of central bank balance sheet expansion.

For investors hedging currencies, European fixed income—representing 25% of the Barclays Global Aggregate Index as opposed to the mere 6.45% in Spain/Italy—is broadly well supported, even if we see more opportunities outside Europe in general. Supporting euro-based fixed income, the Economic and Monetary Union (EMU) economy is forecast by the European Commission to contract another 0.3% this year, inflation is contained—perhaps even rolling over, the latest PMIs have been surprisingly weak (albeit broader survey data is more mixed), and most importantly, there tends to be a bid to core fixed income, so long as there is a fire in the periphery.

While we don't see much value in German Bund yields at current levels, we do believe that northern European corporates—at yields of 2.5% to 3.5%—continue to make sense versus cash and other fixed income alternatives. Often, there is a market misconception that bad news in the periphery is "bad for Europe." For currency hedged investors, this couldn't be much further from the truth. The fact that non-Spain/Italy European fixed income is more than 300% the size of Spain/Italy, and the point that core performs well when periphery is weak, should put this in perspective.

Broader global fixed income markets

In our 2013 outlook, we argued there are structural improvement stories in selected emerging-markets local bonds and currencies, which have much better prospective risk-adjusted return potential than the eurozone periphery. Over a secular horizon, countries with trend real GDP growth of 2% to 4%, rising GDP per capita, and institutional improvements/reforms, will likely be more stable, profitable, currency unhedged bond destinations than those experiencing 0% or even negative growth over rolling 10-year periods. This is particularly important when contrasting declining countries at risk from weak international investment positions or low scores on various institutional measures, such as Transparency International's Corruption Perceptions Indices, "Ease of Doing Business" surveys, and so on.

The Italian elections suggest that a strategy of structurally replacing risk in the periphery with risk in currencies and local emerging-market bond markets that screen much more favorably under a sovereign risk framework, remains fully on track. In the end, fundamentals tend to win. For shorter-term periods, central bank liquidity and market factors—positioning, valuations—can alter the course of events for some time (several quarters or more, even ten years when Greece traded at very tight spreads to Germany from 1999 to 2007), but fundamentals tend to exert in the end. For this reason, sovereign risk analysis remains alive and opportunities in the better end of Latin America, Eastern Europe, and South East Asia should be pursued at the expense of risks in the eurozone periphery. While the outcome in Italy may not ultimately be as bearish as the Greenspan/Buiter scenarios that have been predicted, it is brave at best to ignore that, and better volatility-adjusted returns can be had elsewhere in the global bond universe.

Authors

Nick Eisinger
Research Analyst

Jamie Stuttard
Head of International Bond Portfolio Management

Views expressed are as of the date indicated, based on the information available at that time, and may change based on market and other conditions. Unless otherwise noted, the opinions provided are those of the authors and not necessarily those of Fidelity Investments or its affiliates. Fidelity does not assume any duty to update any of the information.

Past performance does not guarantee future results.

Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

Investing involves risk, including risk of loss.

Stock markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments.

It is not possible to invest directly in an index. All indices are unmanaged.

In general the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.) Fixed income securities also carry inflation, credit, and default risks for both issuers and counterparties.

Foreign securities are subject to interest rate, currency exchange rate, economic, and political risks, all of which are magnified in emerging markets. The risks are particularly significant for funds that focus on a single country or region.

Endnotes

[1] European Central Bank bond purchase program.

[2] Former Federal Reserve Chairman Greenspan and former economist for the European Bank for Reconstruction and Development Willem Buiter, among others.

Purchasing Managers' Index (PMI) is a survey of purchasing managers in a certain economic sector. A PMI over 50 represents expansion of the sector compared to the previous month, and under 50 represents a contraction, while a reading of 50 indicates no change. Markit compiles non-U.S. PMIs.

Barclays Global Aggregate Bond Index is a broad-based, market value weighted index that measures the performance of the global investment-grade fixed-rate bond market. Sectors in the index include Treasuries, government-related and corporate securities, mortgage-backed securities (MBS) – agency fixed-rate and hybrid ARM pass-throughs – asset-backed securities (ABS), and commercial mortgage-backed securities (CMBS).

Third-party marks are the property of their respective owners; all other marks are the property of FMR LLC.

Products and services provided through Fidelity Personal & Workplace Investing (PWI) to investors and plan sponsors by Fidelity Brokerage Services LLC, Member NYSE, SIPC, 900 Salem Street, Smithfield, RI 02917.

Products and services provided through Fidelity Financial Advisor Solutions (FFAS) to investment professionals, plan sponsors, and institutional investors by Fidelity Investments Institutional Services Company, Inc., 500 Salem Street, Smithfield, RI 02917.

643365.1.0

© 2013 FMR LLC. All rights reserved.