The Italian job: fixed interest and credit market update

Global Fixed Interest and Credit Funds

18 November 2011

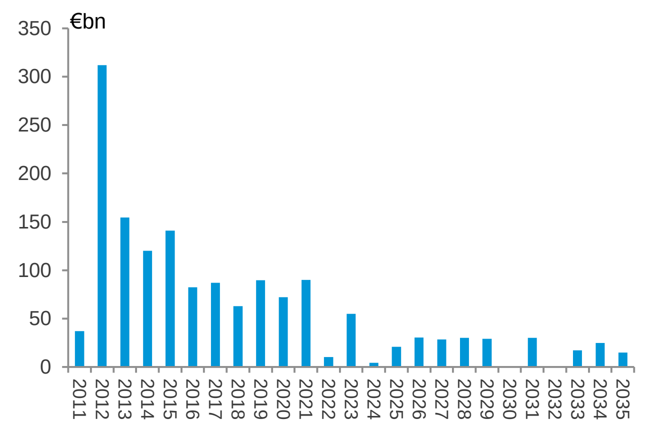
Overview

Last week, Italy moved to centre stage of the Eurozone sovereign debt crisis. The country is under pressure in the markets because it carries high debt levels and is facing a period of uncertain economic growth, making it difficult to see how the deficit can be reined in. Italy has thus become the likely main beneficiary of the recently enlarged regional bail-out fund. The yield on Italy's 10-year government bonds (BTPs) exceeded the 7% threshold that previously prompted the Greek, Portuguese and Irish governments to seek financial assistance from the European Central Bank (ECB), European Union (EU) and International Monetary Fund (IMF) to bail-out their debt-ridden economies.

Bond market participants appeared to lose patience after Prime Minister Silvio Berlusconi's parliamentary majority unravelled during the vote on Italy's financial stability package. An added complication arose when the UK-based clearing house for Italian bond futures, LCH.Clearnet, raised the amount of margin, or collateral, that traders must post to insure trades against losses – increasing the cost of trading Italian government debt.

With BTP yields now exceeding 6% across the curve (from one-year maturities onwards), market participants have become increasingly concerned about Italy's capacity to service its debt load, especially as it's Europe's second biggest debtor. Furthermore, Italy has a very short-term maturity profile with €31.3 billion of debt needing to be refinanced over the remainder of 2011. More importantly, just over €310 billion of this debt will mature in 2012 and require refinancing. This will then trail-off to an estimated €155billion in 2013, around €120 billion in 2013 and back up to €140 billion in 2015. Please see the chart following for Italy's government bond maturity profile.

Italian government bond maturity profile



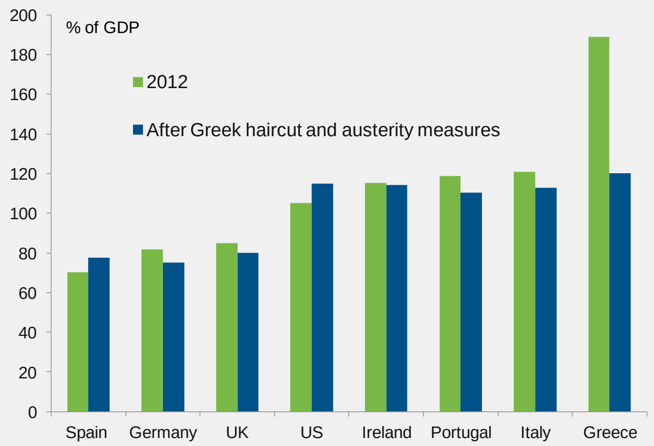
Source: Bloomberg.

Italy's public debt currently stands at around US$2.2 trillion or 118% of gross domestic product (debt-to-GDP ratio). Therefore, at current yields, the cost of financing new and maturing Italian debt has reached unsustainable levels, as yields now exceed the projected growth rate in Italian government revenue collection (as measured by the forecast growth in Italian nominal GDP).

Mr Luigi Speranza[1] forecast that nominal GDP growth of 3.5% is required just to stabilise the debt-to-GDP ratio over time, however, the consensus forecast for Italy's nominal growth rate is to be just 0.6% in 2012, according to the Commonwealth Bank of Australia[2]. Stabilising public debt will remain a challenge for Italy in the medium-term in the absence of aggressive structural reforms such as privatisation. And without a clear path of government reform, Italian bond yields are likely to remain elevated as the risk premium increases.

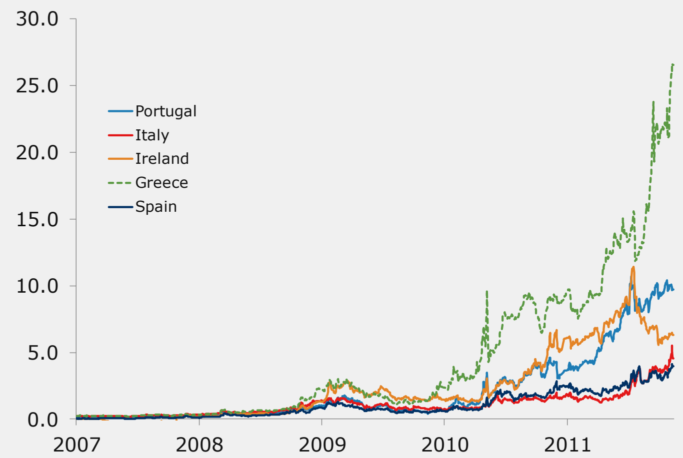
[1] Speranza, L. (2011): Italy: Time for Action, BNP Paribas Global Markets pp. 1-24.
[2] Grace, R. & Dragicevich P. (2011): Eurozone – Italy is likely to ask for EMU/IMF assistance, Commonwealth Bank of Australia Global Markets, 10 November 2011, pp. 1-5.

Government gross debt/GDP



Source: IMF Fiscal Monitor September 2011. Note 'after' is 2016, for all but Greece (2020) and Italy (2014).

Peripheral European bond spreads versus German Bunds



Source: Bloomberg, 15 November 2011.

Why is Italy unlikely to default?

1. Italy is too big to fail

Italy is the seventh largest economy in the world and the third largest economy in Europe in terms of nominal GDP.

Italy is considered to have a highly diversified industrialised economy with a high level of GDP and developed infrastructure by world standards. Italy is not only a member of the EU and OECD, but also of the Group of Eight (G8) most powerful industrialised nations. Italy's gross domestic product was US$2.055trillion in 2010, comprised primarily of the services (73.3%) and industrial (24.9%) sectors[3].

Most European banks own bonds issued by multiple European sovereigns. Given Italy has a high debt level, European banks typically have large holdings of Italian bonds. With European banks in general undercapitalised, the spectre of default by Italy will further undermine European bank stability as the assets they own will plummet in value. The responsibility for supporting the banks ultimately falls to the home sovereign, and hence European countries are working feverishly to ensure such a domino effect does not occur.

Too many undercapitalised European banks own Italian sovereign government bonds for Italy to default without causing extreme panic, a run on the Euro area's banks, massive bank failures and an economic depression in the Eurozone. Moreover, core European sovereign credit ratings would suffer irreversible damage and their governments would be unlikely to prevent a run on their banks should they step-in should they attempt to recapitalise their banks. Markets would also begin questioning their solvency.

Therefore, policy-makers will do whatever it takes to ensure that Italy doesn't default.

2. IMF monitoring and surveillance of Italy

Earlier this month, Italian Prime Minister Berlusconi rejected an offer of financial aid from the IMF, but accepted the IMF's offer to monitor the Italian government's policies in a bid to restore confidence in the country. The IMF confirmed that it would conduct 'surveillance and monitoring' with inspectors likely to scrutinise specific legislative contents, timetables and the implementation of the budgetary measures and reforms promised by the Italian government at the EU Summit in late October. It is expected that a quarterly monitoring mission will commence by the end of November.

3. Formation of new 'technocrat' government

The Italian parliament approved the country's austerity package on 12 November which proposes €59.8 billion in savings from a mixture of spending cuts and tax rises, with the aim of balancing the budget by 2014. Measures include:

- An increase in VAT from 20% to 21%;
- A freeze on public sector salaries until 2014;
- An increase in fuel prices;
- Privatisation of state property;
- An increase in the retirement age for women to 65 by 2026;
- Measures to fight tax evasion will be strengthened including a limit of €2,500 on cash transactions; and
- A 'special' energy sector tax.

[3] OECD website www.oecd.org/

Having just passed these economic measures into law, President Giorgio Napolitano accepted Mr Silvio Berlusconi's resignation as Prime Minister. Mr Mario Monti, a well-respected former EU commissioner and economics lecturer at the University of Turin, has been invited to form a government having been sworn in as a senator for life in the Italian parliament. Most centrists and centre-left parties in the opposition have already pledged their support. The market has reacted favourably to this appointment so far.

4. ECB Italian bond purchases

Despite insisting that it's not a lender of last resort, the ECB has continued to purchase Italian bonds through the Securities Market Programme (SMP). When Italian bonds have plunged, the ECB has intervened in the market, occasionally two or three times daily, to purchase Italian bonds, forcing yields down and boosting market sentiment. ECB purchases now total around €110 billion.

While the ECB is not offering an explicit backstop for Italy, some market participants are now expecting the ECB to guarantee a rate for Italian bonds that is high enough to be a penalty spread to German Bunds – liquidity at a penalty rate. Therefore, the ECB would not have to defend its target as private sector investors would be comforted by the ECB's 'guarantee'. If the ECB does backstop Italy fully and credibly, BTP yields will likely decline. Also, concerns over the Italians being 'free-riders' would also be alleviated by the EU and IMF's joint monitoring of Italy's fiscal consolidation programme.

5. European Financial Stability Facility (EFSF) funding 'insurance'

In the unlikely event of the Italian government effectively being 'locked out' of the bond market in the event of a default, the total financing cost over the next three years (principal plus interest) is estimated to be approximately €733 billion[4] . The EU Summit announcement of a proposal to boost the 'fire-power' of the EFSF from its current €440 billion to €1 trillion could cover the Italian government's financing requirements for three years to end-2014. This could enable the government to get its fiscal consolidation plan in order within a few years. (Though it must be admitted that the market's lack of willingness to purchase EFSF bond issues raises questions about how effective this structure can be in reality).

6. Prudent Italians?

Unlike their counterparts in Spain and Ireland, Italians do not have huge mortgages, and generally have little personal debt in comparison. According to the Bank of International Settlements[5], Italy as a country (not just as a government) is not actually terribly indebted when compared with the likes of France, Canada, the US and UK.

The Italian government has had debt-to-GDP ratios of over 100% since 1991 and not defaulted. The Italians, unlike Greece, spends less on providing public services and benefits to its people than it earns in taxes, and has done so every year since 1992 except when in recession in 2009. Italy borrows simply to meet its principal and interest payments on its existing debts.

7. Italian debt is largely domestically owned

More than 50% of Italian debt is domestically owned – the Italian government owes almost US$37,000 to every person in Italy.

Not surprisingly, Italian banks are the largest holders of Italian sovereign debt with around US$230 billion (or approximately 45% of total Italian sovereign debt held). French and German banks have the next largest exposures at around US$105 billion (approximately 21% of total held) and US$51 billion (approximately 10% of total held), respectively. Fears of large exposures outside of the Eurozone are misplaced with the US having very small exposure to Italian sovereign debt of around $US14 billion[6].

Italian exposures in Colonial First State funds

In total, the Colonial First State funds and mandates have very small total exposures to Italian sovereign debt and corporate names. **As at 31 October 2011, we had A$105.57 million (of our total assets under management of around A$25 billion) total exposure to Italy. Also, we only have exposures to six corporate credit names (all with differing maturities) and Italian government sovereign bonds.** Our active holdings are detailed in the table on page 7.

Below is a summary of our views on these corporate issuers:

Intesa Sanpaolo: is Italy's largest bank with a dominate market share in all product categories. It continues to maintain satisfactory profitability, capital and liquidity and has minimal requirements from the wholesale markets due to a high level of deposits. Recent one notch reductions in their credit ratings to A at S&P, A2 at Moody's and A at Fitch have resulted in an increased cost of funding, however. Asset quality remains weak although increases in non-performing loans have begun to slow. As expected, Italian sovereign bond exposure is high at €63.4 billion, with other sovereign debt exposure considered moderate and is written down as per EU standards. Core Tier 1

[4] Grace, R. & Dragicevich P. (2011): Eurozone – Italy is likely to ask for EMU/IMF assistance, Commonwealth Bank of Australia Global Markets, 10 November 2011, pp. 1-5.

[5] www.bis.org/

[6] www.bis.org/

ratio was 10.2% as at September 2011 and the proforma Basel 3 ratio is estimated at 8.7%. Under the EBA stress test on Core Tier 1 ratios, Intesa scored highly and is estimated to have a Core Tier 1 ratio of 9.2% in 2012.

Enel SpA: is a diversified utility company 31% owned by the Italian government. It has a significant presence in both Italy and Spain (via its Endesa subsidiary). The company is vertically integrated and well diversified geographically and operationally with a significant (around 40%) regulated revenue base, Enel has strong cashflow generation and is moderately geared.

Fiscal strain across the EU may impact the Utilities sector negatively. For example, as a regulated entity, Enel may find the government reluctant to approve price or cost increases. Demonstrating this risk, the Italian Government has recently implemented a 4% increase in tax on utilities. While not material at this stage, we remain vigilant in our monitoring of further government actions.

ENI SpA: is a vertically integrated oil and gas company, the world's seventh largest by reserves excluding Russia and national oil companies. The majority of ENI's profit comes from their exploration and production (E&P) segment and they have benefitted from the increase in oil prices. This has had a positive impact on their cash flow generation and credit metrics, which have strengthened considerably recently.

We continue to monitor the impact of the deteriorating economic situation in Europe in respect to the demand for oil. Moody Investor Services has recently downgraded ENI one notch to A1 from Aa3, removing the benefit of the sovereign relationship from the company. We remain confident that ENI is in a strong business position and capable of generating strong cashflows over the medium term.

Telecom Italia: All three credit rating agencies (S&P, Moody's & Fitch) have revised their ratings outlook (BBB/Baa2/BBB) to negative from stable due to the uncertain economic environment in Italy. This could place additional pressure on the company's domestic performance at a time when it has committed itself to high levels of spending. Therefore, the company's deleveraging target will be challenging.

Despite this, Telecom Italia's credit profile is still considered to be well supported by its dominant market position, robust operating cashflows and the strong performance of its Latin America operations.

Wind Telecomunicazioni SpA: is a large Italian telecommunications company with significant market share across mobile, fixed line and internet services. Like many telecom companies its cashflow generation ability is strong and consequently it carries solid debt levels. As a result any slowdown in the Italian economy is likely to impact the company's credit metrics, albeit moderately given Wind's strong competitive position and track record in debt management.

Cassa Depositi e Prestiti (CDP): CDP is 70% owned by the Italian government. As a result, there is a very strong relationship between the company and the Italian government (including the requirement for the Italian state to maintain majority ownership) and the credit outlook reflect this relationship. While CDP maintains a very strong financial profile, all our holdings are covered bonds which are senior, secured claims against specific assets. Consequently these securities are rated higher than the Italian sovereign at AAA/Aa1/AA by the three rating agencies who monitor the covered bond program regularly. Notwithstanding a negative outlook for the Italian sovereign and consequently CDP, given our secured position we are comfortable with our exposure.

Global credit is still attractive

Volatility in global credit markets is likely to remain elevated in the short-term as market participants continue to cautiously focus on European sovereign debt and financial system risks. Concerns over a possible 'double-dip' recession in Europe, a fledgling US economic recovery, and a hard or soft landing scenario in China is also adding to uncertainty. Market volatility inevitably impacts mark-to-market returns, but we believe that our approach of minimising the impact of defaults allows us to take advantage of current wider spreads.

Global credit spreads are currently well above long-run average levels. However, overall fundamentals remain supportive for credit as company balance sheets around the world have largely been repaired and strengthened through gradual deleveraging following the shock of the financial crisis in 2008-09. Today, company balance sheets, while collectively holding a greater level of borrowings, are also holding significant cash balances. In the US, on average, companies are holding cash equivalent to about one third of borrowings. More importantly, cashflow generation remains strong and rising. These metrics give considerable comfort to credit investors that companies will be able to withstand an uncertain operating environment, while maintaining disciplined financial metrics, for an extended period. Due to the steady and improving profile of corporate balance sheets, the credit rating outlooks from all three rating agencies are moving consistently from negative to positive in-line with rapidly falling default rates.

By contrast, European financials and sovereign exposures still have a great deal of 'repair' ahead of them before they recover. Austerity measures have been implemented across peripheral Europe in particular, in an attempt to 'clamp-down' on burgeoning fiscal deficits, impacting on regional economic growth outcomes and prospects. This fiscal tightening could also have a secondary impact on corporates within those countries.

Australian credit markets remain well supported driven by domestic macroeconomic factors and sovereign and single name credit strengths. Although global credit market issuance will be largely sentiment driven in the short-term given concerns over the US and European sovereign debt risks, overall issuance remains elevated in 2011 when compared with recent years.

Our overall credit strategy employs a disciplined approach in the credit assessment and selection process, as issuer and industry decisions will contribute meaningfully to the overall performance of our funds. Therefore, our 'bottom-up' credit research discipline seeks to gain the most efficient exposure to borrowers, while actively managing our complementary exposures to bonds, floating rate notes and credit default swaps. Our credit process also focuses on minimising tail-risk, a key aspect of our credit ideology and investment process. We consider market inefficiency and dislocation as an opportunity to extract alpha for our suite of funds as securities from the same issuer can trade more cheaply in some currencies than others. It's our belief that credit returns often overcompensate for credit risk and that diversification across a large pool of lowly correlated assets will generate positive 'value-for-risk' outcomes for our funds. We also aim to participate in new issues provided that the risk reward trade-off is positive without elevating portfolio concentration concerns.

Benefits of investing in our Funds

Colonial First State Global Fixed Interest and Credit Funds' provide investors with:

- Immediate access to a highly diversified portfolio of domestic and global fixed interest and credit investments;
- Active management to exploit credit and bond market mispricing by using a broad universe of instruments;
- Competitive returns and a regular income stream (distributions) while minimising portfolio risk;
- The fund is positioned conservatively overweight to credit and short duration to capture these opportunities;
- Access to one of Australia's largest and most experienced fixed interest and credit teams;
- credit risk research undertaken with cutting edge analytical and portfolio management tools;
- Diversifying risk with relentless credit and portfolio monitoring;
- Robust duration, yield curve, sector, inflation and credit management processes; and
- Sophisticated use of derivatives to manage currency, duration and credit risk.

Colonial First State Global Asset Management Italian fixed interest and credit exposures

Security Name	Sector	Market Value ($A m)
Intesa Sanpaolo SpA	Banking	33.75
Enel Finance International SA	Utilities - Electric	19.53
ENI SpA	Industrials - Integrated Energy	16.89
Buoni Poliennali Del Tesero	Sovereign	14.92
Telecom Italia SpA	Industrials - Communications	13.72
Wind Acquisition Finance SA	Industrials - Communications	5.50
Cassa Depositi e Prestiti	Banking	1.06
Republic of Italy	Sovereign	0.20
Total		**105.57**

Colonial First State Global Asset Management Italian fixed interest and credit exposures

Fund Name	Government/Sovereign (% of total Fund)	Corporate (% of total Fund)	Exposure (total % of Fund)
Colonial First State Wholesale Global Bond Fund	6.16	0.00	6.16
Colonial First State Wholesale Global Corporate Bond Fund	0.00	1.13	1.13
Colonial First State Wholesale Global Credit Income Fund	0.00	1.41	1.41
First State Global Bond Fund	2.67	1.97	4.64
First State MPF Global Bond Fund	3.19	0.81	4.00

Source: BlackRock Solutions and Colonial First State Global Asset Management as at 31 October 2011.

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