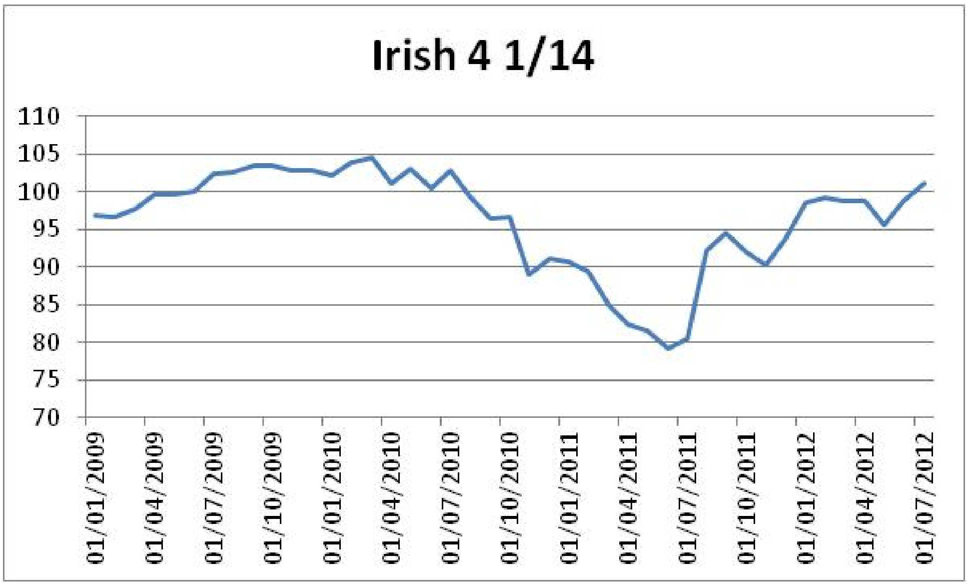
Sovereign Debt – Italy

In my last note on Sovereign debt – sent out in October 2011 – I noted that in all the debt crises that I have looked at, the turning point occurs when the troubled country can turn its current account deficit into surplus. I noted that of the distressed peripheral countries in Europe only Ireland had achieved current account surplus, and hence we were buyers of Irish bonds.

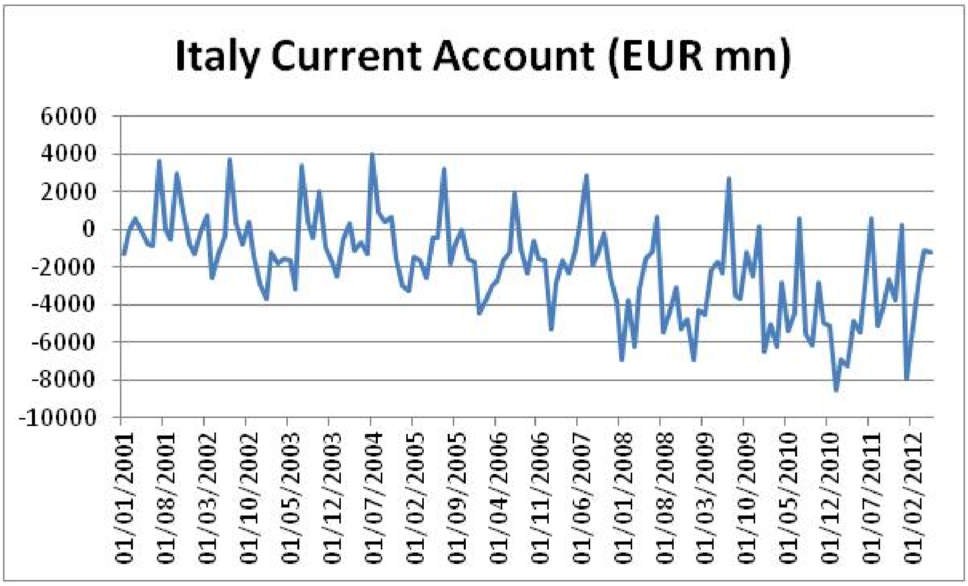


Since then Irish bonds have recovered most of their losses of 2011, and the Irish government has been able to return to the bond market. This is during a period of sustained instability in the far bigger bond markets of Spain and Italy.

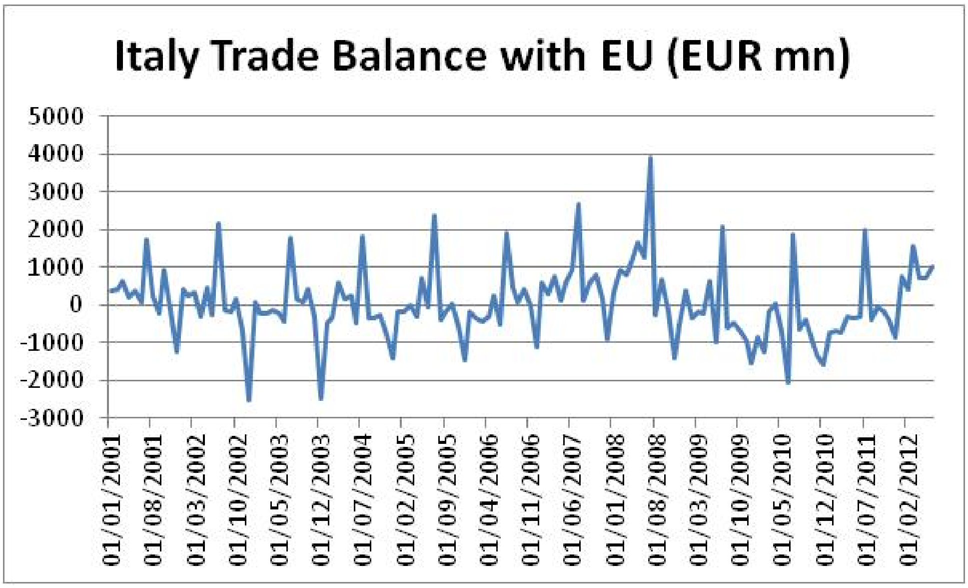
Italy

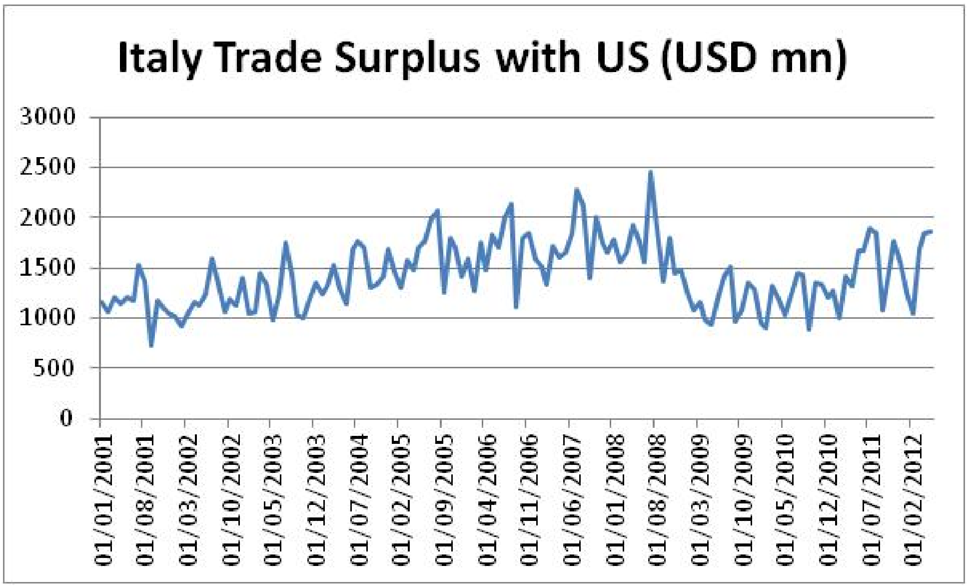
Italy has one of the biggest bond markets in the world, and financial commentators quite rightly point out that its size means that it would be difficult if not impossible to implement the same programs that have been used by the European authorities in Portugal, Ireland and Greece. Hence, in my view the future of the Italian bond market is probably a key determinant of the survival of the Euro in its current form.

Like the other troubled nations of Europe, Italy has been running a current account deficit for a prolonged period of time. There have been recent signs of improvement, but not enough to move Italy to a current account surplus. The Economist estimates that Italy will run a 2.4% current account deficit for 2012.

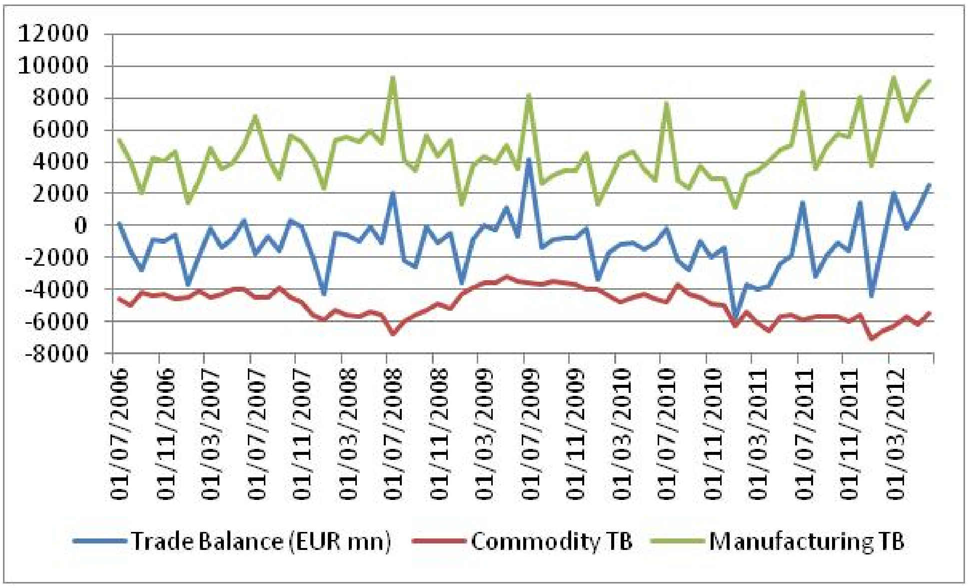


However, beneath the slowly improving current account numbers, Italy's bilateral trade numbers are showing signs of big improvements. Italy has shown a dramatic improvement in its trade deficit with China, the EU and the US.

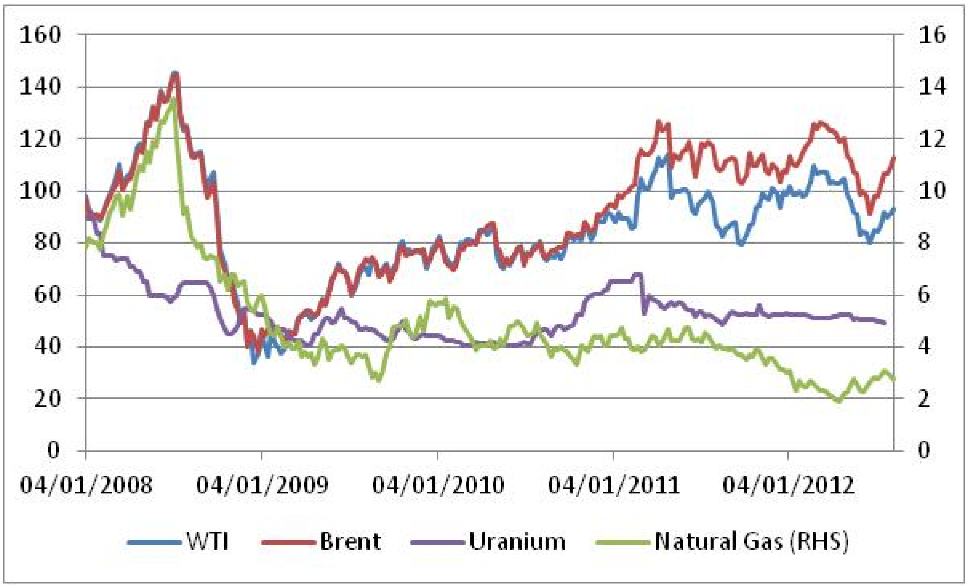




If Italy has improved the trade positions with three biggest economic regions of the world, why have we not seen better improvement in the Italian current account? The answer is apparent when we look at the break down of Italian trade by category. As can be seen below, Italy has improved its manufacturing trade balance significantly, but all the gains in this area have been lost due to increasing commodity (mainly energy) trade deficit.



Should we see lower energy costs, I believe we would see a significant fall in the Italian current account, potentially pushing Italy to a current account surplus. For investors looking to play lower commodity prices via a long position in fixed income, Italian bonds look attractive in my view.



Almost all of Italy's energy needs are priced off the Brent oil price. In 2008, all energy sources were comparably priced, but since then we have seen large divergences, which have put Italy at a disadvantage. Should we see a convergence in energy prices, Italy should be a relative winner, and Italian bonds should also prove to be relative winners.

Information

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