

## Italy: The Hero or the Villain of the Euro

For more than two years, we have witnessed the economic demise of several European countries. This soon led to the financial community systematically assessing the health of several peripheral southern European countries, tumbling investment grade ratings and spikes in required rates of return on government debt of these sovereigns. As the European Central Bank continues to dole out rescue packages, many are now looking for the next to suffer a financial attack and, when the carnage stops, wondering if the Euro will even survive.

Some analysts feel that Spain is the last bastion for the Euro's survival. We do not. We believe that the final battle will be fought on the picturesque shores and cathedrals of Italy, the second "i" in the so-called "Piigs" mess, resulting in Rome's emergence as either hero or villain with respect to the survival of the Euro.

Most European politicians dearly want the "run" on several of its "club" members to end and its rescues to restore confidence. This is, unfortunately, a dream that is likely to be shattered as the next domino - - Spain - suffers the scrutiny of intense solvency analysis. Spain, which has almost twice the amount of government debt outstanding as Greece, has well known infirmities - - namely an anemic economy, an unemployment rate over 20% and a devastating real estate debacle and a consequent banking crisis. The need for a potential bailout of Spain is not only possible, but likely and manageable even with the mounting aggregate debt assumption by the other, stronger Euro partners, its Central Bank and the IMF.

Thus, we turn to Italy. The country has far more sovereign debt outstanding, almost US\$2 trillion, than any of the other heretofore problematic governments. While ultimately the Euro's survival will come down to political realities, such as if the stronger European nations conclude that they will or will not continue to support the weaker peripheral Euro countries (witness the recent ascendancy to power of anti-bailout sentiment in Finland), we feel that the Euro's financial market "battle" will come down to the plight of Italy. Its debt, if added to the mounting EU and IMF's responsibility, may simply be too much, and the Euro will then crumble. In a sense, Italy is the "fulcrum" country for the Euro.

Our theory is rooted in the use of a new metric to estimate the financial health of sovereigns, used throughout this recent period of sovereign financial distress. In addition to the standard sovereign risk "top-down" macroeconomic analytics, whose variables are consistently reported and debated, we believe that most nations can be evaluated by the health and robustness of their private sectors. The metric we developed, is simple in concept and a new and more powerful version of the well known "Altman Z-Score." It involves the calculation of a company's credit score distilled from three types of variables: (1) fundamental firm performance and risk ratios, like profitability, leverage and liquidity, (2) stock market equity measures and (3) capital market and economic statistics, like corporate debt risk premiums and unemployment rates. We applied our model to nine European countries, and the USA, before the crisis was apparent in early 2009 and again in early 2010, and found that for the most part, the now well understood hierarchy of sovereign risk was observed.

The result of the Italian "battle" is not clear. We know that despite its huge public debt, sluggish economy, aging population and political uncertainties, Italy enjoys a wealthy consumer and corporate reservoir of capital. (More than 65% of its outstanding public debt is held by Italian private individuals and institutions.) In addition, Italy has several global comparative advantages that are not evident in most, if not all of the other Piigs, namely tourism, fashion, some very strong companies and an improving banking sector, not to mention its dynamic, but fragile small and medium size firm sector. Still, our overall credit risk metric places Italy amongst the most risky private corporate sectors, and if the stock market in Europe, especially in Italy, suffers another downturn, our risk measure will surely deepen and leave the Italian Government debt vulnerable to the same type of financial market attack as the other "Piigs" have had to endure, with the attendant increase in interest rates and credit insurance premiums that we have observed several times before. Even today, despite low interest rates, the European commission reports that Italy's government interest payments as a percentage of

GDP is almost 5% (4.8%), second only to Greece's 6.7% and considerably higher than all other major European countries and the USA (2.9%); even Portugal's ratio is lower at 4.2%.

So far, the credit default swap (CDS) insurance market and other market measures have not shown concern with Italy. Its five-year implied probability of default based on CDS spreads is relatively average (9% as of April 25, 2011). But, in our opinion, it is just a matter of time before we will see whether Italy becomes the Euro's hero or villain. Showing concern about Italy, similar to ours, S&P just (May 21) downgraded its outlook for Italy's sovereign debt.

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