Capital Market Dynamics

- **Sovereign Debt & Credit Ratings** ► Italy's creditworthiness continues to deteriorate in the wake of the ongoing European sovereign debt and banking crises. Moody's Investors Service downgraded the nation's long-term foreign-currency credit rating to "Baa2" in July, citing a weakened growth outlook and an increased risk of losing market access due to waning confidence and adverse spillovers from the Spanish banking sector and a possible Greek exit from the currency union. Italy's credit rating has dropped six notches in the last year and is now just two steps away from speculative-grade status. Meanwhile, both Standard & Poor's ("BBB+") and Fitch ("A-"), maintain a "negative" outlook on their ratings, which were downgraded in January. Funding pressures have escalated in recent months - approaching late-2011 highs - as investors grow increasingly uncertain of Italy's ability to implement vital structural reforms and withstand financial shocks. The yield on the government's 2-year (3.4%) and 10-year (5.9%) bonds are now higher than their Irish counterparts, while the spread over the 10-year German bund currently measures 450 basis points (bps), and the credit default swap is valued at 457 bps.

- **Equity Market** ► Italian equity securities suffered considerably as a direct result of the resurgence in euro-related risk aversion earlier this year, with the benchmark FTSE MIB index losing roughly 25% from mid-March through May. Year-to-date, the index is down 3.6% (8.8% in US dollar terms). Though Italy accounts for 5% of the global stock of sovereign bonds, its equity market is relatively small, representing only 0.9% of world market capitalization.

Economic Outlook

- **Growth** ► The Italian economy is four quarters in to a recession that will likely see output contract by around 3-3½% between mid-2011 and early 2013 (with a 2¼% loss expected for 2012). A very gradual export-driven recovery will emerge next year, though on a year-over-year basis growth will remain negative, in the range of ½%. According to a preliminary report, real GDP dropped 0.7% q/q (-2.5% y/y) in the second quarter, with weakness widespread across industries. Domestic demand is exceptionally weak, hampered by fiscal consolidation, rising unemployment (at a record-high 10.8% in June, up from 8.1% a year ago), and restricted lending conditions (private sector credit growth slowed to 1.3% y/y in May from near 20% in early 2011).The general global deceleration and, in particular, the recession underway elsewhere in the currency union will also weigh on growth, with 40% of Italy's exports destined for euro area partners. The International Monetary Fund (IMF) projects that the output gap will remain negative for several years. However, labour and product market reforms, if implemented swiftly, could improve confidence, productivity and potential growth over the longer term.

- **Inflation & Monetary Context** ► Inflation remains elevated, measuring 3.7% y/y in July (above the euro area average of 2.4%), boosted by indirect and value-added tax increases. Underlying wage and cost pressures are low. Continued demand softness and rising unemployment will cause inflation to ease, and we expect the headline rate to reach 2% y/y by year-end and remain in that range in 2013. The European Central Bank (ECB) is expected to resume purchases of Italian government securities, complemented by another quarter-point reduction in the policy rate to 0.50% in order to facilitate the difficult process of debt refinancing.

- **Fiscal & Current Account Balance** ► Italy's public debt will continue to rise through 2013 (reaching at least 126% of GDP). Considerable risks, related to the stability of the currency union and the domestic political commitment to fiscal rehabilitation and structural reform, cloud the outlook thereafter. Responding to market panic in the latter half of 2011, the government passed a series of consolidation and reform initiatives, with a bias toward revenue-increasing measures. Notwithstanding a notable primary surplus (excluding interest payments) expected to average 3½% of GDP in 2012-13, the overall fiscal balance will remain in modest deficit over the forecast horizon (averaging 2% in 2012-13). Thus, with interest rates currently hovering close to unsustainable levels, the overall debt profile is critically exposed to funding shocks. The non-resident investor base has been eroded by the sharp deterioration in confidence over the last year, with the share of government bonds held by foreigners falling from 52% in 2010 to around 35% in early 2012. Meanwhile, holdings at both the ECB and Italian banks (supported by ECB liquidity provision measures) have risen. The current account deficit is trending lower, and should reach 2% of GDP next year.

Institutional Framework & Political Environment

- **Governance** ► The technocratic government led by Mario Monti, initially widely accepted following the resignation of Silvio Berlusconi in November 2011, has suffered a loss of public and political support in recent months. Political parties across the spectrum are already gearing up for the next general election, which will take place by April 2013 and likely result in a left-of-centre coalition administration. Investors will be wary of the risk of social unrest and political reform fatigue over the medium term, which may also extend to any conditionality implied by official intervention (i.e., ECB bond-buying).

- **Financial Sector** ► The Italian financial system has been significantly weakened by the euro crisis and is currently heavily reliant on Eurosystem support, despite its relatively low degree of leverage. The high direct exposure of the banking system to the sovereign, combined with the deterioration in the domestic economy and subsequent rise in impaired loans, underpinned a recent wave of financial institution rating downgrades. Italian banks have seen their access to wholesale funding markets restricted, and have thus turned to the ECB's long-term refinancing operations (LTROs) in order to satisfy their funding needs. The average core tier 1 ratio for the five biggest banks was 9.5% at the end of March (below the euro area average of 10.3%), and some institutions still need to boost their capital in accordance with European Banking Authority standards. The IMF foresees a contraction in private sector borrowing of nearly 3% in 2012-13.

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