Italian Risk

Trade Idea

04 March 2013

Summary

- **Elections in Italy last week increase uncertainty as the composition of the coalition, its ability to govern and the possibility of a need for reelections are all up in the air**
- **A move away from the austerity policies that former PM Monti advocated may be seen and could undermine the sovereign bond market, and weaken the broader European equity markets**
- **Following the election, Italian treasuries sold at yields that are 0.65% higher than before the election and the FTSE MIB dropped over 4.5% on the day after the election**
- **Concerns regarding the continental implications of the elections saw the euro drop from $1.33 to $1.30 and the EuroSTOXX 50 fall over 3%**
- **Investors who believe that the EuroSTOXX 50 index will fall further as the effort to build a government unfolds could buy the Boost EURO STOXX 50 3x Short Daily ETP to provide a leveraged inverse return or hedge their portfolio**

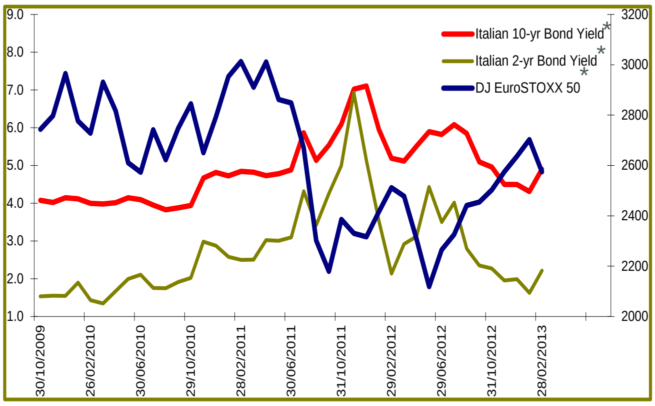
The Italian election last week rattled the sovereign debt maket and the major equity markets as investors were forced to price in some ‘disruption’ risk once again.

The net result after the election seems to be that on the current results over 50% of the voters are not supporting the economic austerity program put in by former PM Monti. There is a considerable risk that a coalition government won’t be formed, forcing another round of elections in a few months. Unless something changes dramatically, it would seem that however the next government is formed, the plans that garnered so much favour from the ‘core’ Eurozone members (and more importantly, the ECB) will be under pressure and many may be revoked or watered down. This may not matter, if one takes the view that Italy will see their economy rebound and the debt market calm down. But it seems more likely that the fears that kept bond market investors on the sidelines in late 2011 and summer 2012 will return. This may drive bond yields higher, and put pressure on Italian, Eurozone and even global equity markets. The backstop that the ECB provided the Italian bond market in 2012 was predicated on the Italian government implementing very difficult spending cuts, reforms and restructuring in the economy.

If Italy is seen as stepping away from the austerity program, the ECB may find it more difficult to justify intervening to support Italian bonds in the secondary market if called upon to do so in the future. To be fair, odds are that the ECB will ‘look the other way’ and attempt to support the market if the risk of not doing so is seen as being too disruptive for the broader Eurozone markets (other ‘soft’ bond markets like Spain’s could be caught in a ‘contagion’ trade and equity markets would be under pressure as the risk of any Italian failure to fund their bond market borrowing or exit from the Eurozone would increase wider investment risk). However there are justifiable fears that it will be difficult for German politicians to explain to their electorate (elections in September) why they are participating in any bailout of the Italian bond market if Italy is not seen to be doing ‘their part’ in sticking with the economic reforms that won them so much praise (even though it sunk the economy deeper into recession).

The fear of an Italian Eurozone exit may seem unfounded, but the ‘5 Star’ party did pull over 25% of the vote, and they advocate a referendum on the euro. Italy needs to tap the bond market for over 400 bn EUR this year, and a ‘buyers strike’ would not help. The ‘knee-jerk’ reaction on Tuesday saw the EuroSTOXX 50 index fall by over 3% (and the Boost EURO STOXX 50 3x Short Daily ETP rise by over 9% - see chart on next page), if Italian bond yields continue to rise then previous market reactions would suggest that the stock market index will fall further.

The charts below highlight the effect of higher bond yields (2-yr and 10-yr bond yields) on the EuroSTOXX 50 index. While Italian companies only make up around 10% of the index, the cross border banking and lending implications are much bigger.



Source: Boost, Bloomberg. The prices used to calculate Boost’s ETP returns are primary market closing prices from Oct 18th 2012 to Mar. 01st 2013, and are given in the base currency of each index. The returns for the ETPs may rely in part on back-tested prices prior to the inception of some ETPs. Past performance and back-tested performance are not indicators of future performance. Back-tested prices are those which precede Dec 4th 2012 for ETPs referencing the FTSE 100, Dec 7th for the DAX, Dec 10th for EURO STOXX 50, Russell 100 or NASDAQ-100, and Dec 17th for the commodities. Returns quoted for commodities may refer to the relevant NASDAQ Commodity ER (Excess-Return) Index, the front-month contract for that commodity or the spot price of the commodity.

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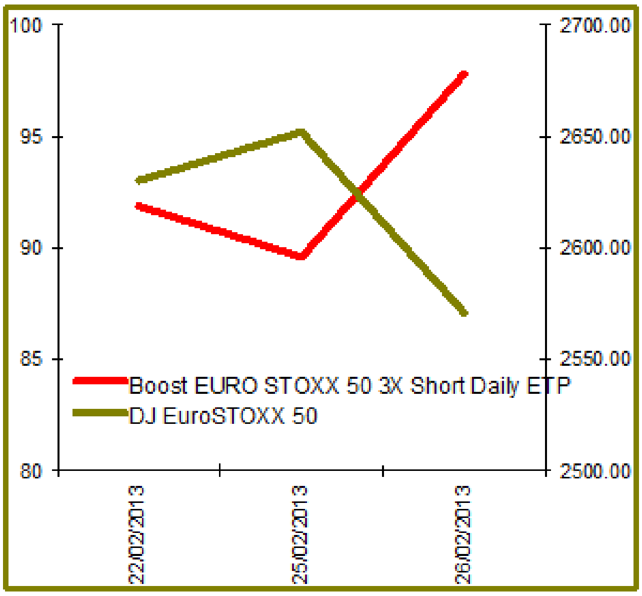
EuroSTOXX 50 Index and Boost EUROSTOXX 50 3x Short Daily ETP daily prices* before and after the announcement of the Italian election results:



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