Federated

# Market Memo: The Italian job

**As of 01-24-2012**

An argument can be made that, relative to bond yields and history, the U.S. equity market continues to be radically mispriced. This has everything to do with risk, or more precisely, investors' persistent desire to avoid it. The latest refrain we hear regarding this risk-avoidance mentality is Italy. It's one thing if Greece were to default (though that's looking less likely); it's entirely another if the euro-zone's third-largest economy struggles to pay up. The worry is that nearly $260 billion of Italy's sovereign debt rolls over this year, with a significant chunk coming due next month. If investor appetite for Italian debt doesn't hold up, Italian bond yields may spike, Spain may follow and the risk-off trade is back on with a vengeance.

We think this sort of thinking is misguided. For one, even though Italy's debt needs are not a surprise, its 10-year yields have fallen a full percentage point in the past few months and its auction of short-term debt earlier this month was well received—suggesting strengthening, not weakening, investor confidence. There are several reasons for this, starting with the European Central Bank. It may eschew "quantitative easing'' for political reasons, but December's $623 billion in three-year loans to banks that hold the bulk of Europe's sovereign debt represented de facto QE. A second, potentially larger round of three-year loans is coming next month, which also happens to be when Italy must deal with $78 billion of debt rollovers and financing needs. These ECB loans are in addition to other measures it and fellow central banks have taken to boost liquidity in Europe's short-term credit markets.

## The German path

Moreover, new Italian Prime Minister Mario Monti appears to be following the path Germany took when integrating East Germany into its Western-oriented economy in the 1990s. By successfully combining fiscal austerity with labor and economic reforms, Germany paid down debt even as it revitalized manufacturing and strengthened its position as a leading global exporter. Monti, a former European Union commissioner whose appointment to replace Italy's Silvio Berlusconi was reportedly pushed by German Chancellor Angela Merkel, is employing a similar dual strategy, working to rein in government spending while enacting pro-growth policies and labor reforms. While his overall plan is still a work in progress, it is progress, nonetheless. Further, as we've noted previously (*"Looking back, Looking ahead''*), it's hard to envision an Italian default when that country's assets and household wealth dwarf its sovereign obligations.

Finally, if we look at the risk-off/risk-on trading patterns dating back to 2008, each crisis—Lehman, concerns about Greek default in May 2010, and a return of Greek default talk this past summer—spawned waterfall declines followed by massive policy responses and, subsequently, substantial equity rallies. While the Greece/euro crisis is still playing itself out and will for some time, it would seem the actions by the ECB and EU leaders effectively have taken Italian debt rollover concerns off the table this year. That's not to say some other crisis may not crop up. But once investors realize Italy is not going to blow up, the risk premium they are demanding should fall way off, helping catapult the S&P 500 to our 1,450 target. Some view this as excessive. But, in reality, based on current below-trend P/Es and above-trend earnings, it's in line with the fundamentals and, barring economic catastrophe, may be conservative.

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