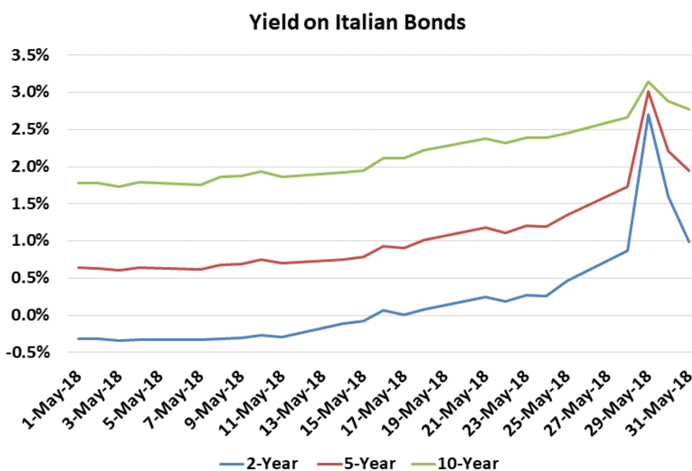
Jason Reed, CFA

Sovereign Risks

Italy's political drama escalated this week as the populist coalition of Five Star Movement and League failed to form a government. On Sunday, Italy's president vetoed the coalition's choice for finance minister, angering the coalition leaders and raising the possibility of new elections. In addition to being skeptical of the single currency, the coalition parties advocate for tax cuts and spending increases. These actions would further increase Italy's debt, currently 132% of GDP.

With confidence shaken, investors reacted this week by selling Italian stocks and government bonds. The two-year Italian bond, for example, which traded at a yield of -0.3% early in May, spiked to 2.7% on Tuesday.



Source: Bloomberg

The sell-off in Italian bonds was exacerbated by poor liquidity, as well as forced selling by institutions who are constrained by risk and volatility limits on sovereign debt. Pricing on Italian debt has improved since Tuesday with an apparent resolution to Italy's latest political crisis, but significant damage has already been done.

Italy's bond auction on Wednesday was less than a perfect success, as the country reduced the size of its offer and was forced to pay higher interest rates. The servicing of Italy's existing debt is only manageable because of the extraordinary intervention by the European Central Bank (ECB), whose bond purchases have driven down interest rates for member countries. More importantly, Italy has another €190 billion to re-finance during the remainder of 2018 and an additional €400 billion through 2020. Italy cannot afford a rapid expanding interest burden.

Although Italy's economy has been strengthening as of late, it still suffers from high unemployment (over 11%) and systemically low productivity. Italy's public institutions and labour market are also very weak. The 2017-2018 Global Competitiveness Index (GCI), places Italy in the bottom quartile in a number of areas such as: public trust in politicians, efficiency of government spending, burden of regulations, soundness of the banking system, and labour market efficiency. The situation in Italy is a stark reminder to both politicians and investors of the importance of managing sovereign risks.

During the height of the Italian market sell off this week, capital flowed to perceived safe havens, including Government of Canada bonds. This is an advantage bestowed upon nations who conduct their affairs with prudence. However, it might be worthwhile for Canadians to view Italy's experience with a touch of humility. Although Canada ranks highly overall in the GCI (14 out of 137, compared to Italy's 43), the report identifies inefficient government bureaucracy as the most problematic factor for doing business in Canada. This we have in common with Italy. The nationalization of the Trans Mountain pipeline on Tuesday was the silver lining to a dark cloud overhanging Canada's confusing and contradictory project approval process. The long drawn out process has led to the perception that foreign investors reconsider Canada as a friendly place for investment.

The biggest risk faced by Italian investors on Tuesday was being all-in on Italy and the Euro. In Canada, we have the advantage of strong institutions and favourable economics, which promote stability in our markets. Nevertheless, the events in Italy this past week are a reminder that no matter where one lives, the best defense against the possibility of a domestic crisis is a healthy exposure to foreign markets.

Copyright © 2018 QV Investors Inc. Readers may forward electronic versions of this Update. All views and projections are the expressed opinion of QV Investors Inc. and are subject to change without notice. This Update is provided for informational purposes only. QV Investors takes no legal responsibility from any losses resulting from investment decisions based on the content of this Update. **Click here** to subscribe to QV Updates.