SUPERVISED INVESTMENTS AUSTRALIA

SHAKY ITALIAN BANKS REINFORCE UNCERTAINTY IN EUROPE

Italy's political stability is precarious due to the perturbing condition of its banks. The most recent data published by the European Banking Authority on 22 July recorded the nonperforming loan (NPL) ratio of Italy's banks at 17%, compared with a 5.7% average amongst EU members.[1] The total value of bad loans in Italy is €360 billion, 20% of its GDP, whilst the banks have only provided for €144 billion.[2] Furthermore, constant reductions in benchmark interest rates have reduced income margins for the banks. Suffice to say, the outlook for the sector is not rosy. Monte dei Paschi di Siena (BMPS) has been one of the most detrimentally affected banks in Italy. On 4 July, it received an order from the European Central Bank (ECB) to lower its gross exposure to NPLs from €46.9 billion in July 2015 (29% of total loans) to €32.6 billion in July 2018 (20% of total loans).[3] Its share price has fallen 87.1% year–to–date.[4] BMPS needs capital.

However, recapitalising banks in Italy effectively requires ECB approval, and herein lies the problem. EU rules introduced on 1 August 2013 prohibit governments from using taxpayer money to bail out banks.[5] Equity and subordinated debt holders are to take the first loss (known as bail–in). In Italy, approximately one–third of subordinated bonds are held by retail investors.[6] Within the EU, only Malta, Lithuania, and Belgium have a higher proportion of retail–held bank bonds. Italy's elevated level is due in part to the preferential tax treatment of interest income on bonds between 1996 and 2011. Consequently, if the banks are unable to pay bondholders, there will be major political repercussions for Prime Minister Matteo Renzi.

Any chance of the EU exempting the Italian government from the new rules was extinguished on 19 July, when the EU Court of Justice ruled against a group of junior debt holders in Slovenia from recouping losses from Slovenia's decision in December 2003 to wipe out €600 million of subordinated debt.[7] Renzi's other option is to join Greece by accepting a crisis resolution under the European Stability Mechanism (ESM) scheme. However, the political ramifications of this move make it unlikely in the short term.

There is little solace in the general state of Italy's economy. GDP growth in the second quarter of 2016 was 0.02%, compared to an expected 0.2%. This was surprising, given the supportive monetary policy and seemingly expansionary fiscal stance. Further, the manufacturing Purchasing Managers' Index (PMI) fell to 49.8 in August, the lowest level since December 2014.[8] A score below 50 indicates a decline in manufacturing. Economists at Citibank forecast 0.7% GDP growth for 2016, slowing to 0.3% for 2017.[9]

[1] http://www.eba.europa.eu/documents/10180/1360107/EBA+Report+on+NPLs.pdf
[2] http://www.economist.com/news/leaders/21701756-italys-teetering-banks-will-be-europes-next-crisis-italian-job
[3] http://english.mps.it/media-and-news/press-releases/2016/Pages/press_release_20160704.aspx
[4] Bloomberg.
[5] http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A52013XC0730(01)
[6] http://bruegel.org/2016/07/italys-bail-in-headache/
[7] http://curia.europa.eu/juris/document/document.jsf?text=&docid=181842&pageIndex=0&doclang=en&mode=req&dir=&occ=first&part=1&cid=91948
[8] http://www.tradingeconomics.com/italy/manufacturing-pmi
[9] https://www.ft.com/content/3ce85dc1-f45e-3a05-957f-0423130a1693

The Italian Prime Minister is consequently in a perilous position. The dire banking circumstances come at a critical time. In late October or early November 2016 (date TBA), Italy is holding a referendum concerning a constitutional bill proposed by Renzi. The bill attempts to reorganise Italy's senate, reduce the number of members of parliament, and lower operating costs. If the referendum is decided in the negative, Renzi has indicated he will stand down as Prime Minister. The concern is that this could pave the way for the Five Star Movement, a political party that blames the country's woes on its membership of the EU, and seeks to withdraw Italy from the bloc. If the party attains power, they have promised a referendum on EU membership. With an Italian exit, the future of the EU becomes increasingly parlous.

Clearly, there are many conditionals involved in such a result, and the EU will work intently on avoiding a collapse of Italy's banks. However, the possibility of such a grave outcome could lead to growing uncertainty concerning Europe's near–term stability. On a global scale, the trouble faced by the Italian banking sector is not the sole source of consternation. It accompanies several other worldwide political and economic predicaments, including China's expanding debt balloon, historically low interest rates, the ECB's program of quantitative easing, and the future of a post–Brexit Europe.

It is impossible to predict how this will play out, and we remind ourselves there is an equally conceivable rosy outcome. Nevertheless, the uncertainty leaves fiduciaries in an unenviable position. How should investors respond? In murky economic conditions, gold can become alluring. Although gold has already experienced considerable growth this year, at its current price of $1,346 there is a way to go to its September 2011 high of $1,921.[10] Further flow into gold could be expected as a safeguard against increasing macroeconomic apprehension. With this in mind, we aim to maintain gold exposure of 8% to 10% of our portfolio in the Supervised Fund.

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[10] Bloomberg.