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UNCERTAINTY OVER ITALY

Bond yields are too high. EU may forego a bailout.

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The Eurozone has another mess on its hands. On November 9, the yield on Italy's 10-year bond soared to 7.46% - an interest rate clearly unthinkable in the long run, a danger signal EU leaders had to address immediately.[1]

Bond yields above 7% have served as a kind of litmus test for the European Union. When 10-year yields topped 7% in Portugal and Ireland, those countries got bailouts, but a bailout for Italy is unlikely. Quite simply, Italy is too big to be rescued; it appears the nation will just have to save itself.

"Financial assistance is not in the cards." So said one Eurozone official (who preferred to remain anonymous) to Reuters; that official said that Italy would not even get a preventive credit line from the EU.[1]

Italy dwarfs Greece in economic magnitude. The Dallas-Fort Worth metroplex contributes about as much to the world economy as Greece does. In contrast, Italy is the third-largest economy in the Eurozone and the eighth-largest economy in the world. It is now carrying somewhere between $2.2-2.6 trillion in debt, making its debt ratio 110-130% of its 2010 GDP.[1,2,3]

Here's why a bailout seems off the table. Italy's sovereign debt is about €1.7 trillion; three times that of Spain, and almost six times that of Greece. Across the next three years, it will have to come up with roughly €650-700 billion to avoid default (so estimates a forecast from Capital Economics). Even with its future increase, the European Financial Stability Fund would be drawn down alarmingly by a bailout of that size. Since Italy is hardly the only EU nation still in trouble, the EFSF would probably be loath to commit to such a mammoth rescue. The three major players funding the EFSF are Germany, France and Italy.[2,4]

Guess what EU nation is one of the world's key government bond markets. That's right: Italy. Its 10-year note rates rose above 7% on fear that it won't be able to repay what it owes on government debt. Are the higher yields going to be attractive to foreign investors? Hardly, given that Moody's and other credit rating agencies have given Italy downgrades.[2]

Name the EU member economy to which U.S. banks are most exposed. Again, the answer is Italy. According to Barclays Capital, that exposure amounted to about $269 billion in total claims as of July. European banks are six times as exposed to Italy ($998.7 billion) as they are to Greece ($162.4 billion).[5]

A call for a core Eurozone. Not surprisingly, French president Nicolas Sarkozy and German chancellor Angela Merkel have visions of an altered EU. On November 8, Sarkozy spoke of a two-tier Europe. It would feature a smaller and more financially integrated core Eurozone comprised of the most economically influential nations on the continent, with the bulk of the EU as a confederation of less economically influential countries with less say in policymaking.[6]

The weeks ahead are crucial. With the debt issues in Italy escalating, the European (and global) economy is looking at another major challenge. Can the European Central Bank buy up a whole bunch of Italian paper? If so, what concessions will Italy have to make? How contagious will this crisis prove, and how will it impact America?

Pronounced volatility may be the norm for the next few weeks or months on Wall Street. It is a good time to take a look at where and how you are invested, and a time to review your diversification and your outlook.

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