risk outlook

1

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The present report has been prepared by:

Giovanni Siciliano and Nadia Linciano (coordinators)

Monica Gentile

Renato Grasso

Lucia Pierantoni

Paola Soccorso

Eugenia Della Libera

For more information write to: studi_analisi@consob.it.

Trends and risks

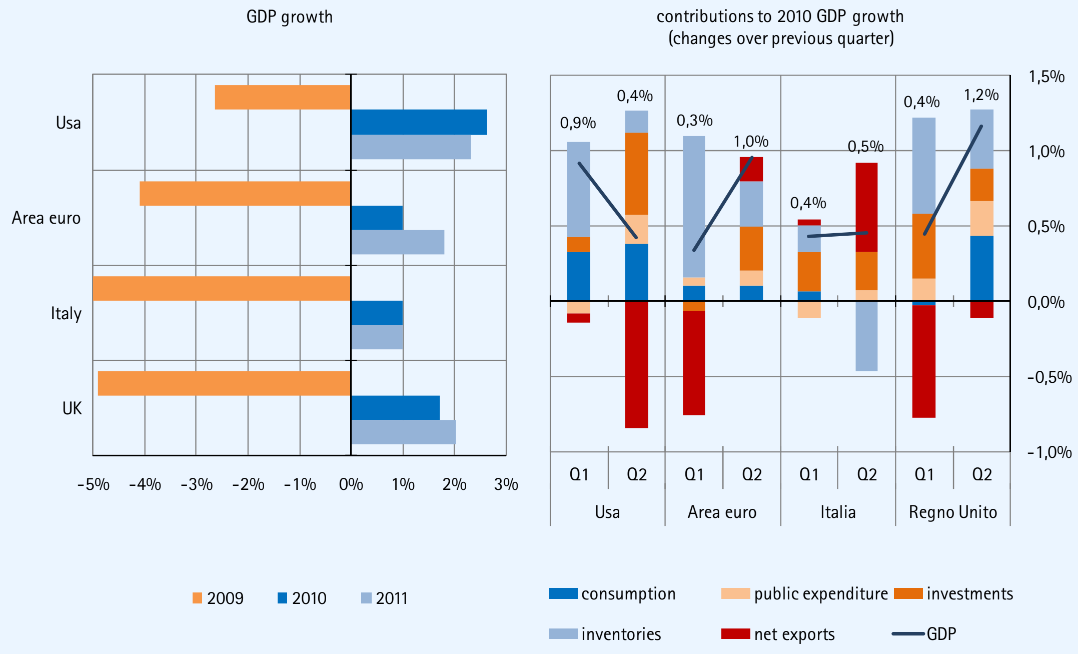
Most developed countries are recovering, although non homogeneously, but fragility features make the economic outlook uncertain. The actions taken to stabilize public finances as well as sovereign risk of some peripheral countries of the Euro area may be the main risk drivers for the economic cycle. Despite FED and ECB quantitative easing measures and the reduction of policy interest rates, interbank market is not yet firm. In the second-half of the year, equity markets were unsteady without showing a clear trend, driven both by positive macroeconomic outlook and fears about banks exposure to sovereign debt; nonetheless volatility is falling. Downturn of exchange multipliers negatively affected risk capital funding. As shown by the income statements for the first-half year, the corporate sector is recovering, after 2009 turnover and profit squeeze, while the banking sector (in the euro area particularly) is in troubles, experiencing profitability lower than before the crisis. Rating changes give unclear indication as well: credit quality of corporate sector is improving, but the situation of financial sector is still critical (even if credit quality of issuers with speculative rating is getting better). Despite banks lending constraints, credit quality indicators (CDS and bond spread) point out stable condition for the main listed non financial companies. Deleveraging is taking place in the corporate sector across Europe; banks net worth is growing, although for some intermediaries concerns around the sustainability of sovereign debt in some European countries triggered market perception of heightening risk. Corporate bond markets are still strong, mainly in the US, whereas in Europe banks bond funding is stable on the whole, thanks to covered bond issues. Securitization primary market has not yet recovered. As regards to investment management, liquidity funds redemptions drove fund raising overdraft in Europe and in the US, whereas hedge fund outflows decreased; private equity market is still dull.

Macroeconomic background

Recovery seems well underway, although signs of weakness and fragilities persist

Data for the first half of 2010 confirmed the recovery in all advanced economies, although its intensity was not homogeneous across geographical areas. US GDP growth in the second quarter slowed down to 1,6% on an annual basis, compared to 3,6% in the previous quarter, due to poor consumer spending and widening current account imbalances. In the Euro area and in the United Kingdom, contribution to growth came from the increase in inventories and exports. In particular, Germany grew by more than 2% in the second quarter tanks to investments and exports. Net exports fuelled growth in Italy, where GDP increased by 0,5% in the second quarter, in line with a 0,4% growth rate in the previous quarter, despite consumptions weakness.

Figure 1.1 – GDP growth in advanced economies

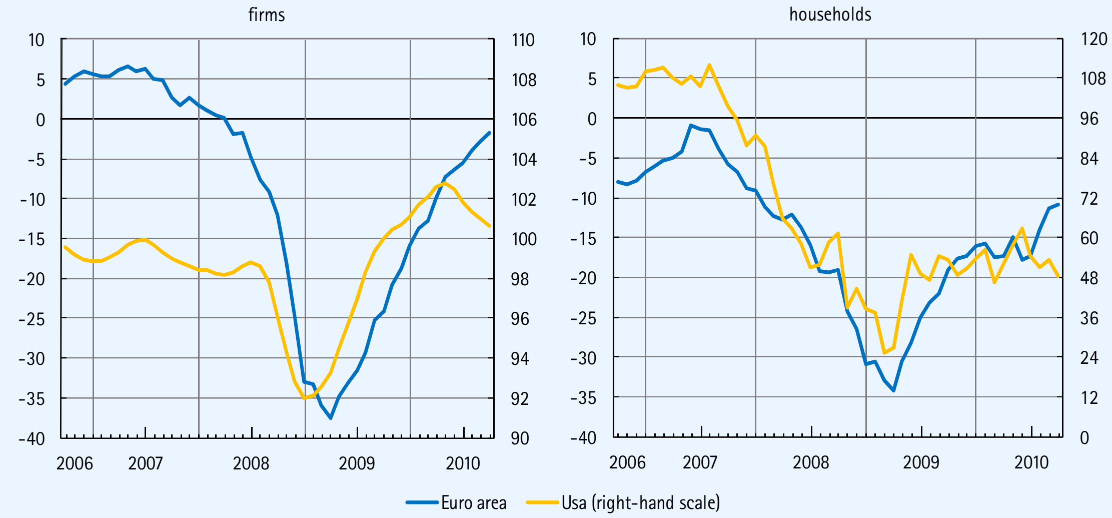


Source: IMF and Thomson Reuters.

Forecasts indicate a modest growth rate for 2011 in all advanced economies

Forecasts indicate a modest growth rate for 2011, especially in the Euro area (and in Italy), and remain surrounded by significant uncertainties and concerns about risks of a new slowdown in economic activity. In the US consumers and firms' confidence declined compared to the previous quarter, while in the Euro area expectations have improved. The main developing countries are still expecting a sustained growth: in China and India output should grow by 10% in 2010, and then might slightly slacken in 2011. Forecasts are positive for Russia and Brazil, as well, even in the light of an expected increase in raw materials prices.

Figure 1.2 – Firms and consumers confidence

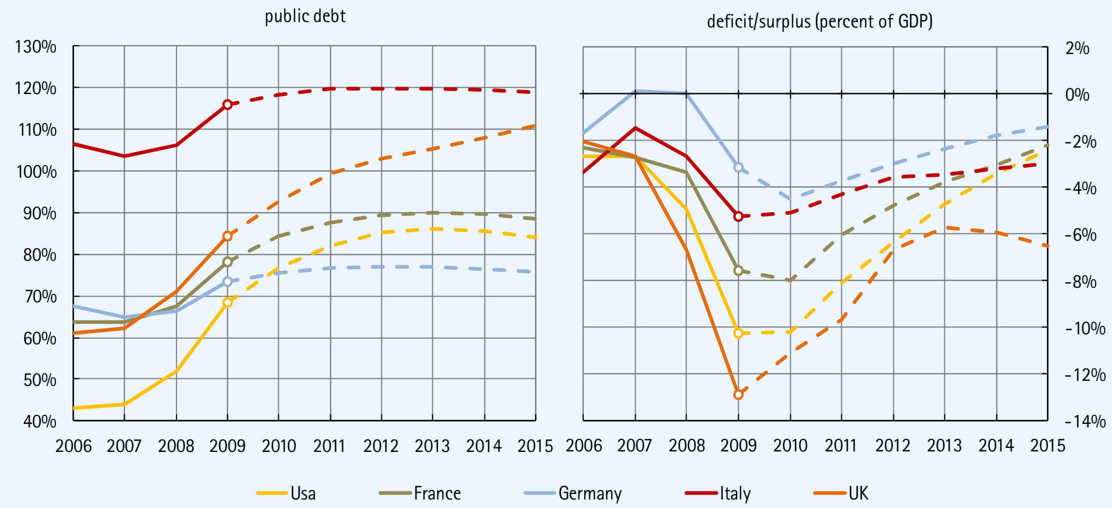


Source: Thomson Reuters.

The main risk for advanced economies recovery may come from the impact of fiscal consolidation

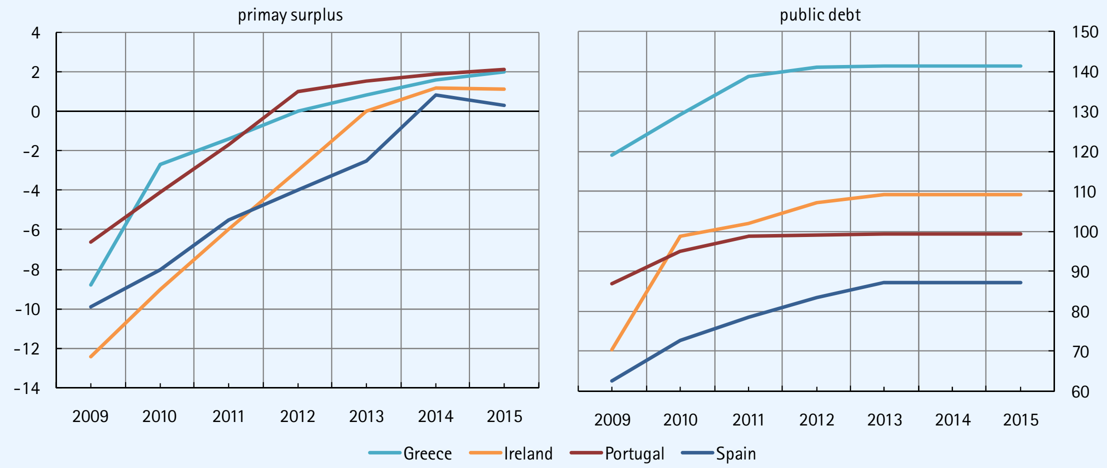
The main risk for economic activity in developed countries may come from the impact of fiscal policies needed to correct public finance imbalances. Given the sluggish growth, huge deficits that will accumulate in 2010 will continue to increase debt/GDP ratio in all advanced countries. In 2011, debt/GDP ratio could exceed 90% in the US and in the UK and reach 100% in the Euro area. Corrective measures approved so far should affect deficit/GDP ratio from 2011 on, but a further deterioration in public accounts is expected in next years, since drastic fiscal consolidation seems not feasible without laying recovery on the line. In the European countries with the greatest public debt sustainability problem, corrective measures necessary to bring the primary surplus to a level needed to balance the debt service expenditure must be implemented gradually, otherwise a new recession would widen sovereign risk. In these countries, even in the best scenario, debt/GDP ratio stabilization would inevitably require a long time.

Figure 1.3 – Public deficit and debt in advanced economies



Source: IMF.

Figure 1.4 – Primary surplus needed to stabilize debt/GDP ratio in some peripheral European countries
(percent of GDP)

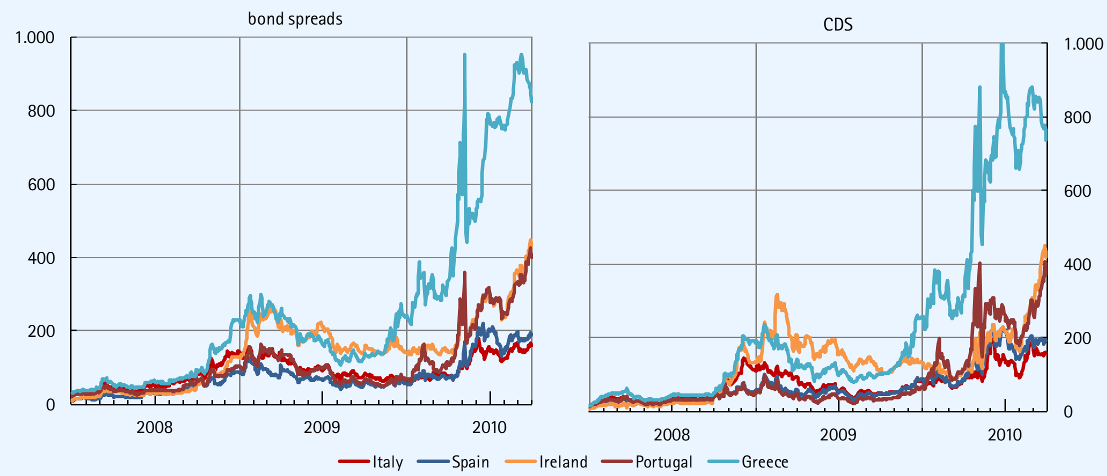


Source: OECD model and forecasts.

The sovereign debt crisis in some peripheral European countries remains a source of potential instability for the whole financial system

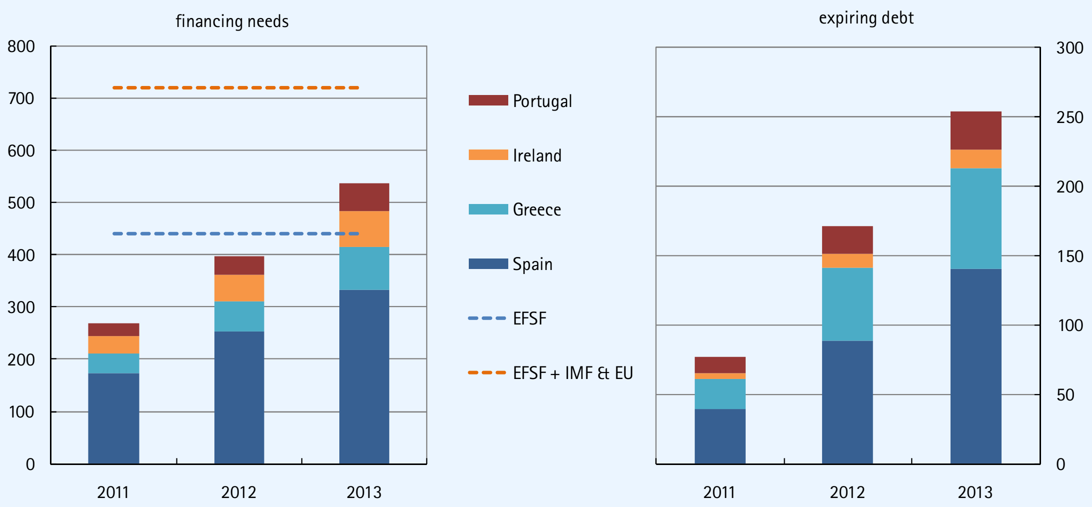
The sovereign debt crisis in some peripheral European countries, emerged in May, remains a source of potential instability for the whole financial system, because of possible spillover to the other European countries and because of its consequences on banks balance sheet. Results of the stress tests on the major European intermediaries, made public in July, were received positively by the market, although concerns still remain. Although EFSF funds could cover deficit and refinancing needs of peripheral European countries for at least 3 years, CDS and interest rate spreads reflect high default/restructuring probabilities for Greece, Portugal and Ireland. Pressure on Greek sovereign debt eased off in the second-half of September, even though CDS and interest rate spreads remain very high (800 basis points), while spreads and CDS on Portuguese and Irish public debt further increased (to more than 400 basis points against German bonds).

Figure 1.5 – Spreads and CDS for Euro area peripheral countries
(difference against German debt; basis points)



Source: Thomson Reuters.

Figure 1.6 – Deficit and expiring debt for Euro area peripheral countries
(cumulative values in billions of euro)

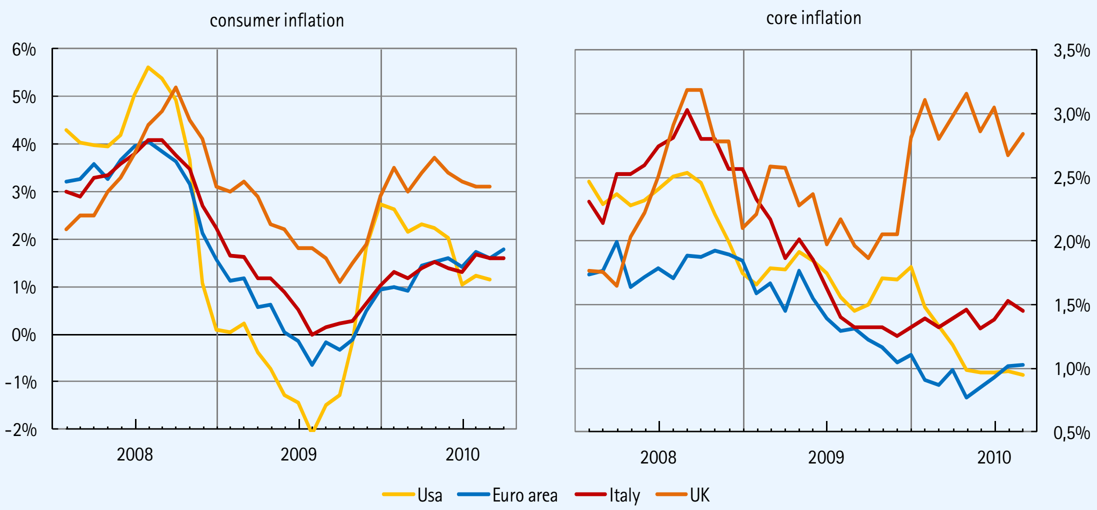


Source: OCSE forecasts and Dealogic.

High unemployment and excess capacity choke inflation pressures in the US and in the Euro area

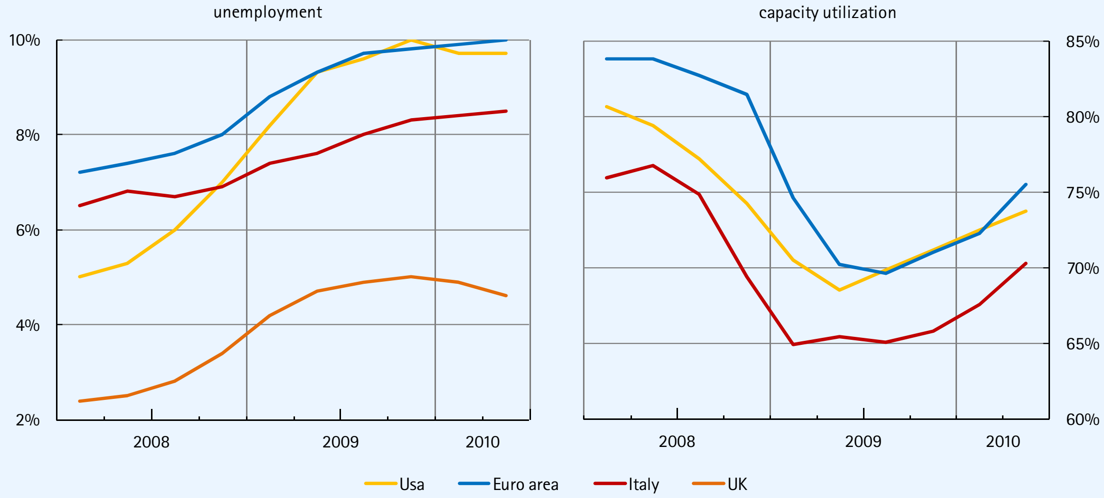
Risks of inflationary pressure remain weak, at least in the short run, despite the upward trend in raw materials and oil consumer prices. Inflation may stay around 2% in the main advanced economies (excluding UK), whereas core inflation (excluding food and energy prices) could lower further. This trend is due to excess capacity, low labour cost and to relatively high unemployment combined with the propensity to reduce debt by household (in particular in the US). In the major developed countries fiscal consolidation could further contribute to curb consumption and therefore inflationary pressures. Real estate trends also contribute to choke off inflationary pressures, especially in the US.

Figure 1.7 – Inflation in advanced economies
(12 months percentage change)



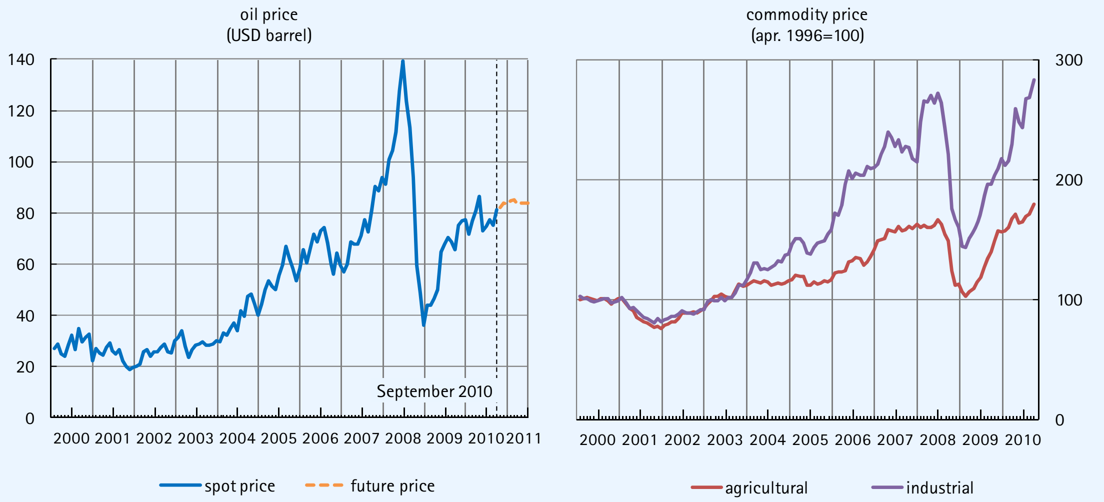
Source: Thomson Reuters.

Figure 1.8 – Unemployment and capacity utilization



Source: Thomson Reuters.

Figure 1.9 – Oil and commodity prices



Source: Thomson Reuters.

The FED and the ECB continue to hold an expansionary stance, but interbank markets didn't completely normalized

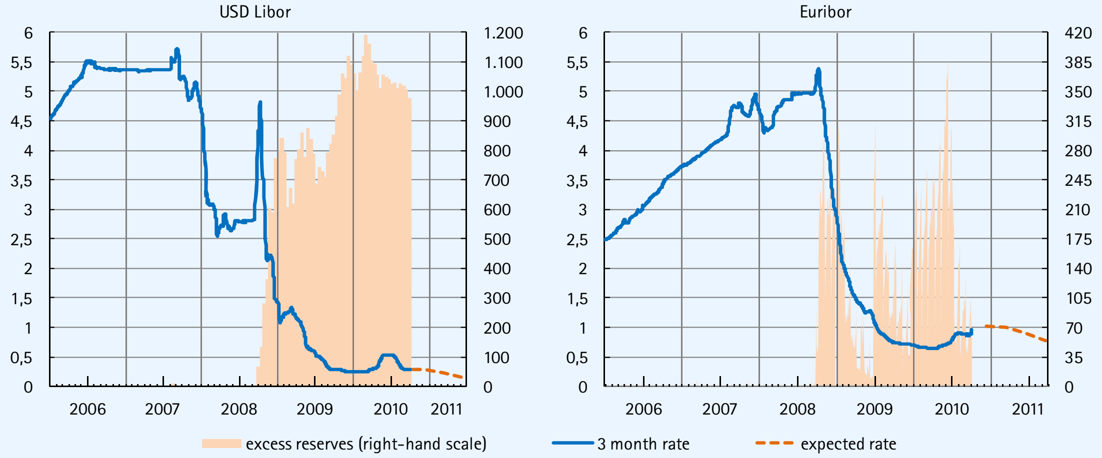
The FED and the ECB continue to hold an expansionary stance, which keeps short term interest rates well below 1%. The ECB should continue to fully accommodate liquidity needs of the banking system at the main refinancing rate, whereas the FED announced a new quantitative easing program based on Treasuries purchase. The ECB choices reflect the uncertainty on the economic situation and the pressures stemming from sovereign debt crisis, while the FED seems to be more concerned about deflationary risks and weakness of domestic demand.

Despite abundant liquidity, operations on interbank market didn't fully normalize as banks with excess liquidity continue to use to a large extent central bank deposit facilities. However, indicators of counterpart risk (deposits rate - OIS) are much lower than during the crisis.

Compared with the beginning of the year, the yield curve flattened by around 100 basis points, both in the US and in the Euro area, although it remains quite steep. In the Euro area, after the sovereign debt crisis, flight-to-quality on German bonds pushed down long rates. Carry trade strategies, low inflation expectations and Treasury purchase by the FED affected US long rates in the same way. Interest rate swap are still equal or lower than government bond rates for longest maturity; such "anomaly" is probably due to the uncertainty about long run trends in public finance.

Figure 1.10 – Three months interest rate and central banks excess reserves

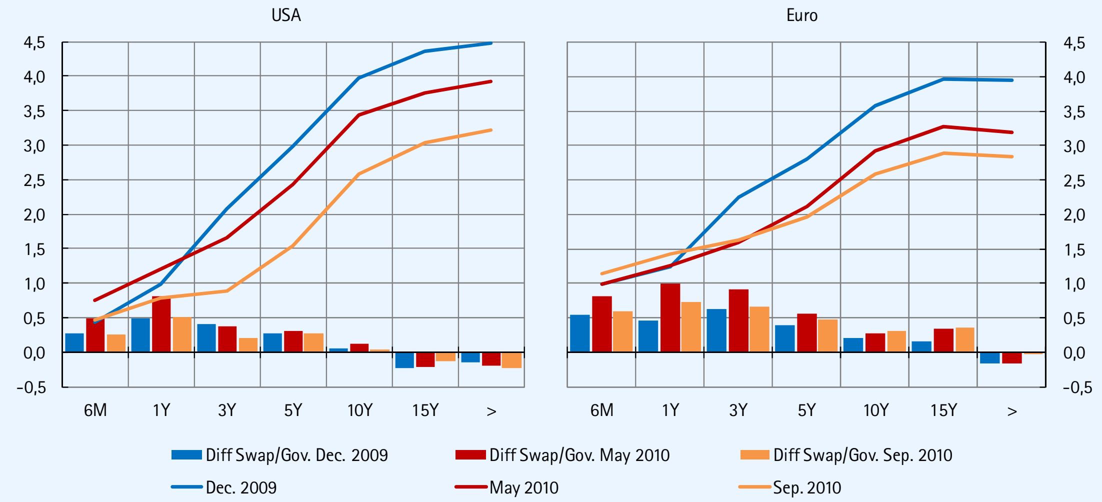
(monetary value in billions of domestic currency)



Source: Thomson Reuters. Expectations based on future prices.

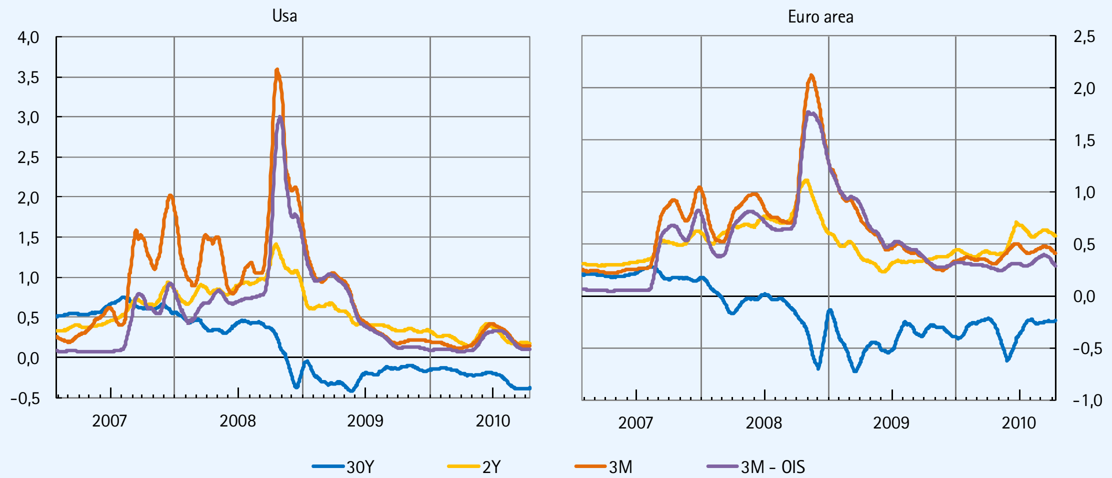
Figure 1.11 – Yield curves

(monthly data January 2006 - April 2010)



Source: Thomson Reuters.

Figure 1.12 – Risk premia and interbank spreads



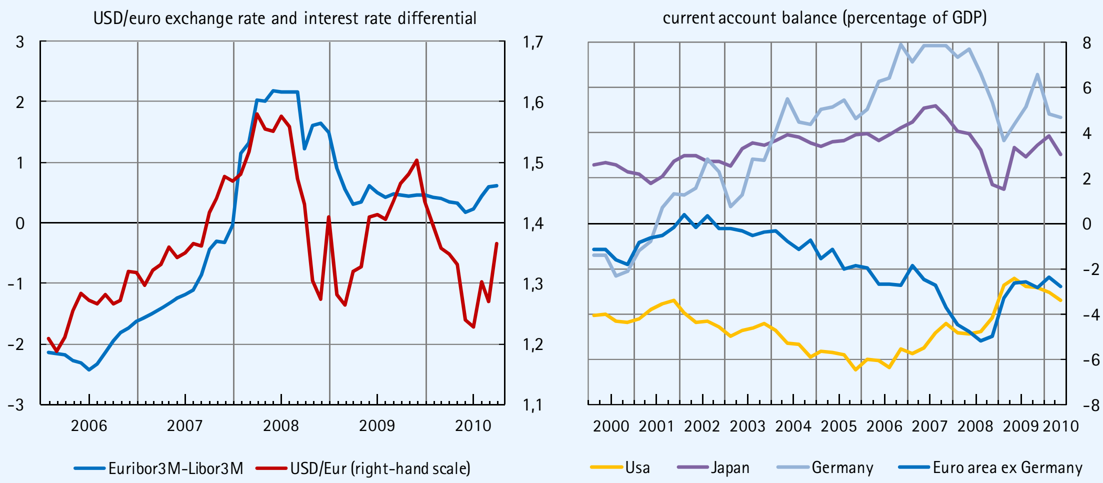
Source: Thomson Reuters. Risk premia based on the swap-Government (Treasury and Bund) spread. Interbank spread is the 3 months interbank rate minus the 3 months Government bond yield.

US dollar weakness is linked to widening interest rate differential and current account imbalances

The new weakness of US dollar, emerged in the second-half of the year, is partially due to increasing interest rate spreads against other currencies. Despite the dollar weakness, global current accounts imbalances show a new tendency to widen. These imbalances are due to structural and to competitive advantage factors that cannot be neutralized in the short run through exchange rates adjustments. Japanese current account surplus has risen since 2009, in spite of yen appreciation; German surplus remains large too; China, even though actively intervening on the foreign exchange market to stabilize the value of the renminbi, holds a huge surplus, largely stemming from exports towards United States.

Structural factors that originate global imbalances induce expectations of a persistent dollar weakness; together with Treasuries yield decline, such expectations generate capital outflows towards commodity markets and emerging capital markets and short carry trade strategies on higher yield currencies.

Figure 1.13 – USD/euro exchange rate and current account imbalances



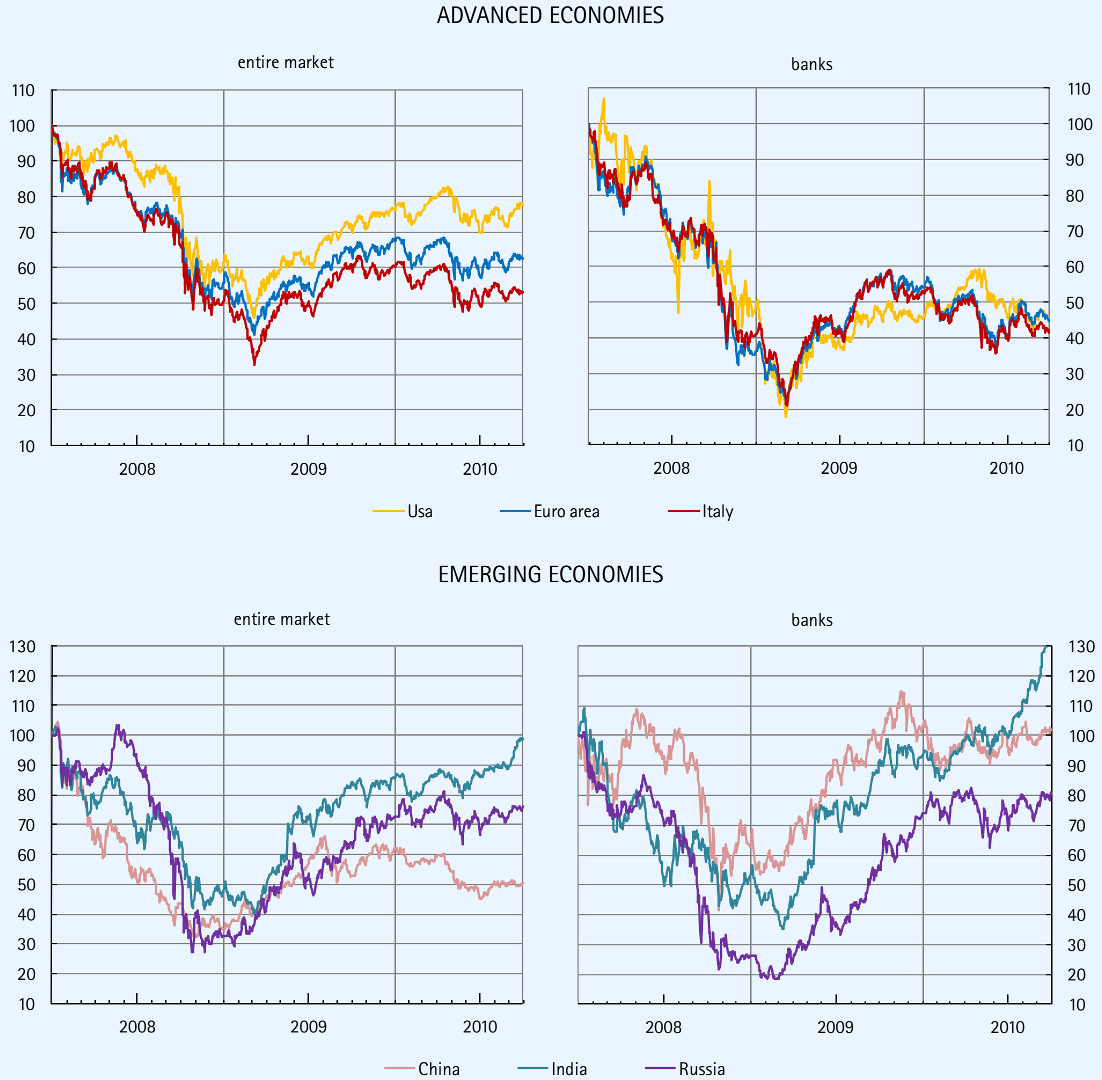
Source: Thomson Reuters and IMF.

Equity market

Equity markets bounced back after the sovereign debt crisis, with volatility significantly decreasing

After the outbreak of the sovereign debt crisis in May, which drove down stock prices by around 10% in most advanced economies, equity markets have been partially bouncing back although showing no clear directional trend. Overall positive data on the pace of economic recovery in the second quarter strengthened market confidence, but concerns about banks exposure towards peripheral European countries continued to sparkle worries, even though the results of stress test for sovereign exposure by major intermediaries, published in July, mitigated market nervousness. At the end of September, banks equity prices were still 50% lower than at the beginning of 2008. Equity prices in emerging markets behaved similarly, even though with more dispersion of performances across countries. Volatility reduced significantly after the spike in the first part of the year stemming from the re-pricing of sovereign risk in some European countries. Expectations on short equity returns at the end of September were slightly more optimistic than in May, especially for Euro area markets.

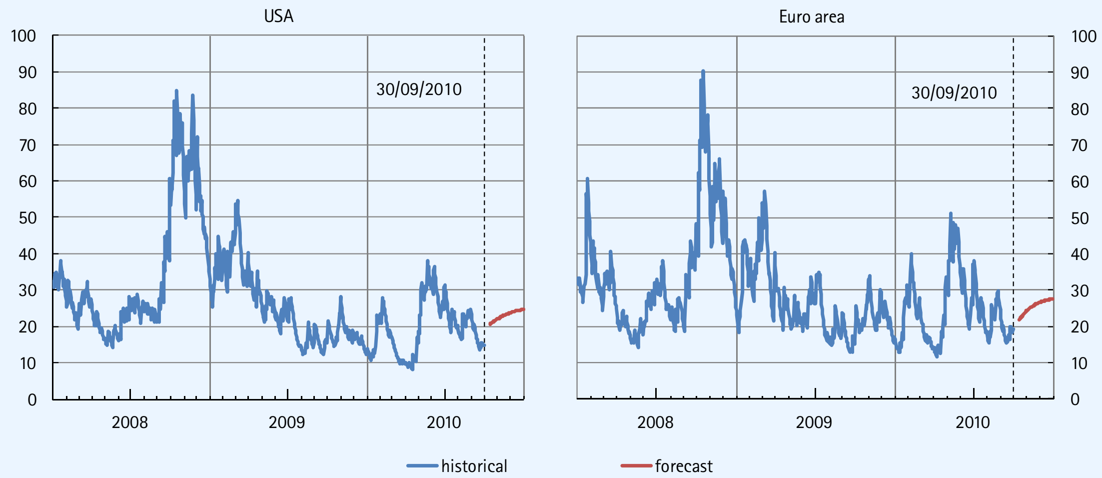
Figure 2.1 – Equity indices
(daily data 01/01/2008 - 30/09/2010; 01/01/2008 = 100)



Source: Thomson Reuters.

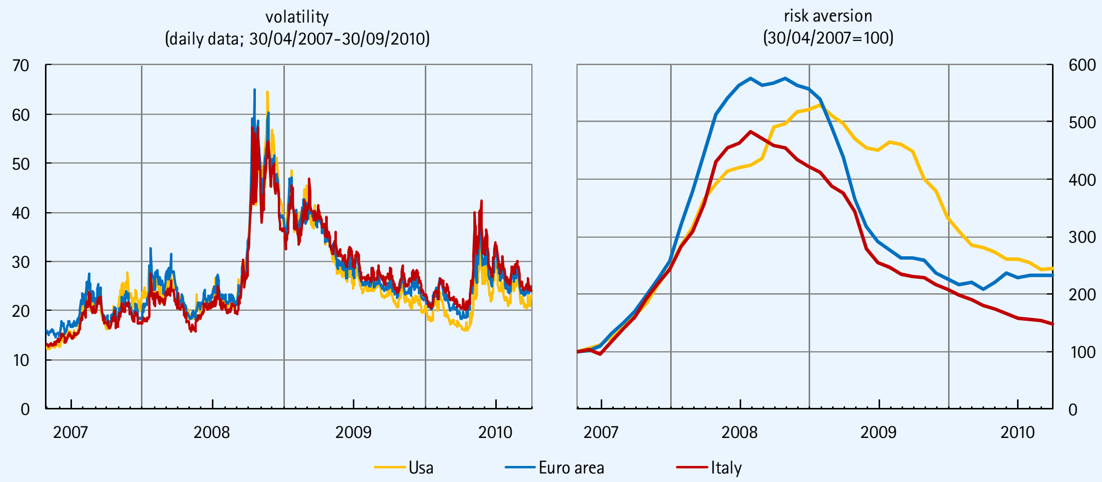
Figure 2.2 – Historical and forecasted volatility

(daily data 01/01/2008 - 30/09/2010; annualized data in percentage)



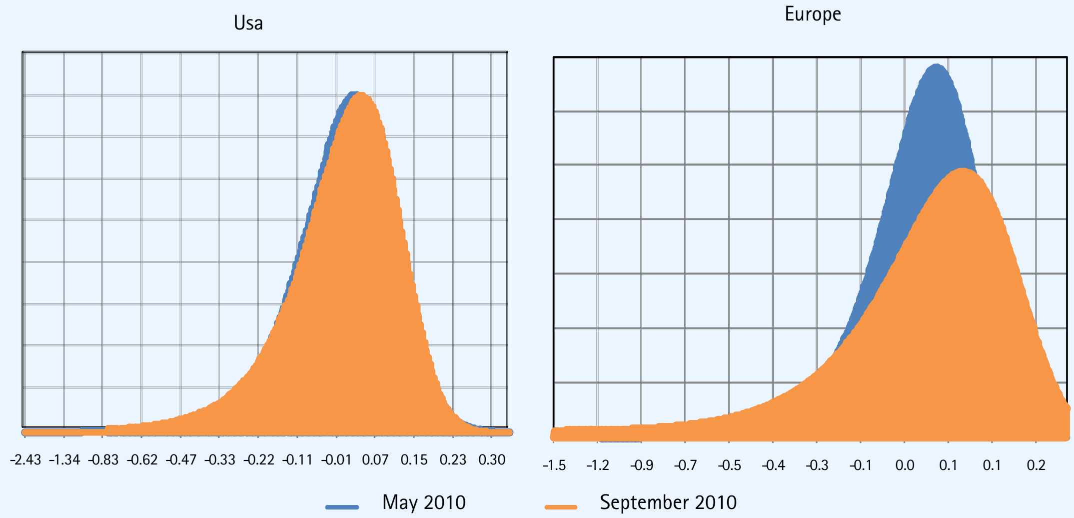
Note: Forecast based on EGARCH model applied on equity indices daily returns.

Figure 2.3 – Implied volatility and risk aversion



Note: Risk aversion indicators based on the comparison of equity yield historical distribution with implied distribution of equity indices options prices; 12 months moving average.

Figure 2.4 – Expected probability distribution of 3-months equity returns



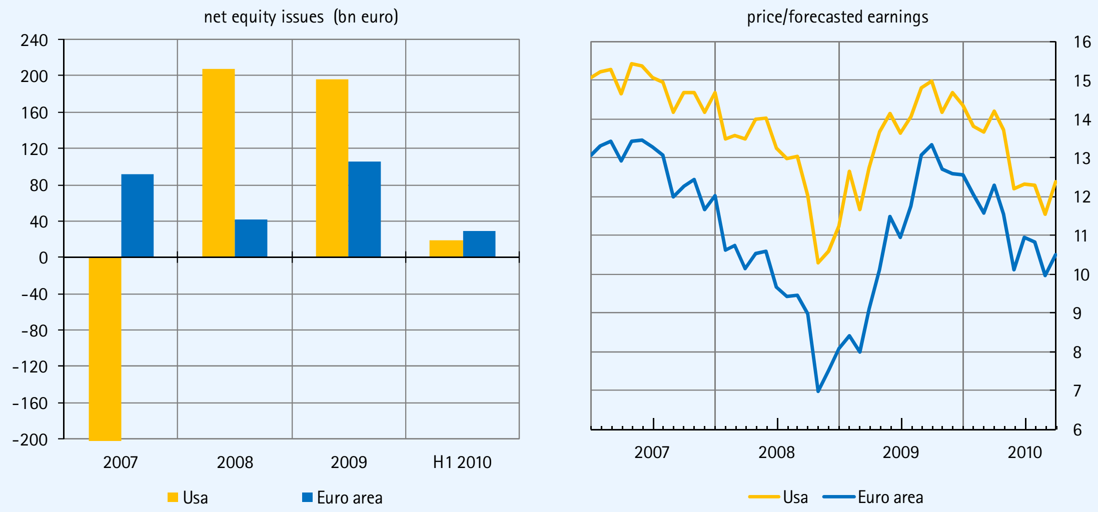
Note: Forecasts based on the estimates of the implied probability distribution of index options prices.

Equity capital raising dropped off in the first half of the year as market multipliers showed a new downward trend

Net equity issues declined sharply in the first part of the year, both in the US and in the Euro area. This was partially due to a new downward trend in market multipliers (after the increase in 2009) both in the corporate and financial sector. Accounting data for the first half of 2010 show a moderate reduction of price-earnings ratio in the corporate sector, while price-to-book values in the banking sector further declined after having stabilized in 2009. After the sharp drop or revenues and profitability in 2009, financial accounts of major non financial listed companies for the first half of 2010 have shown a more stable situation in line with better macroeconomic condition and the upturn in economic activity. In the banking sector, revenues of the major European intermediaries went down significantly in the first six months of 2010 compared to the same period of 2009.

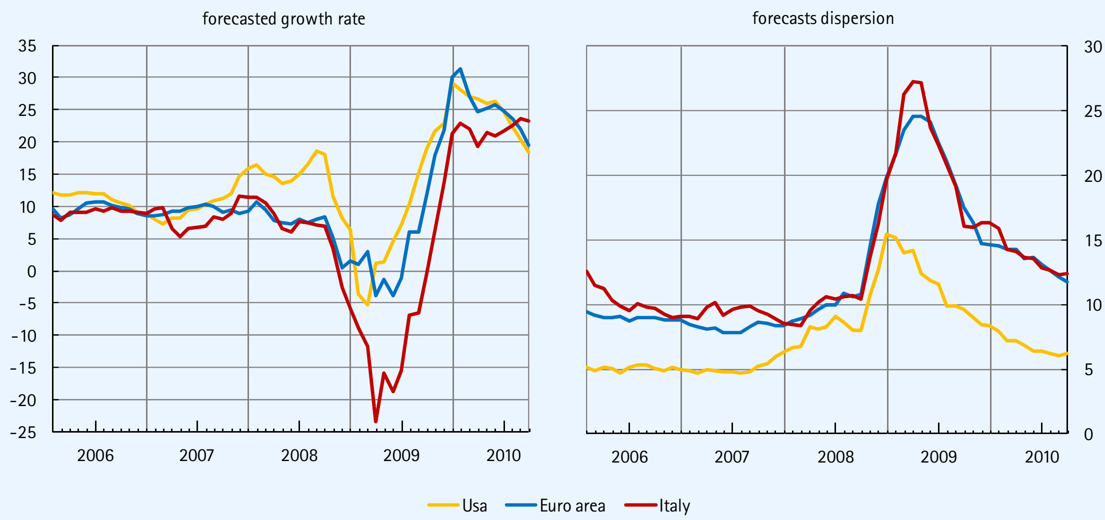
Banks profitability remains stable, but on lower levels compared to the pre-crisis period, both in Europe and in the USA.

Figure 2.5 – Net equity issues and price/earnings ratio



Source: FED, ECB and Thomson Reuters.

Figure 2.6 – Earnings forecasts
(percent; monthly data, January 2006 – September 2010)



Source: Thomson Reuters-IBES. Weighted averages of earnings growth rate forecasts of companies included in S&P500 (USA), Dow Jones Euro Stoxx (Euro area) and FTSE MIB (Italy).

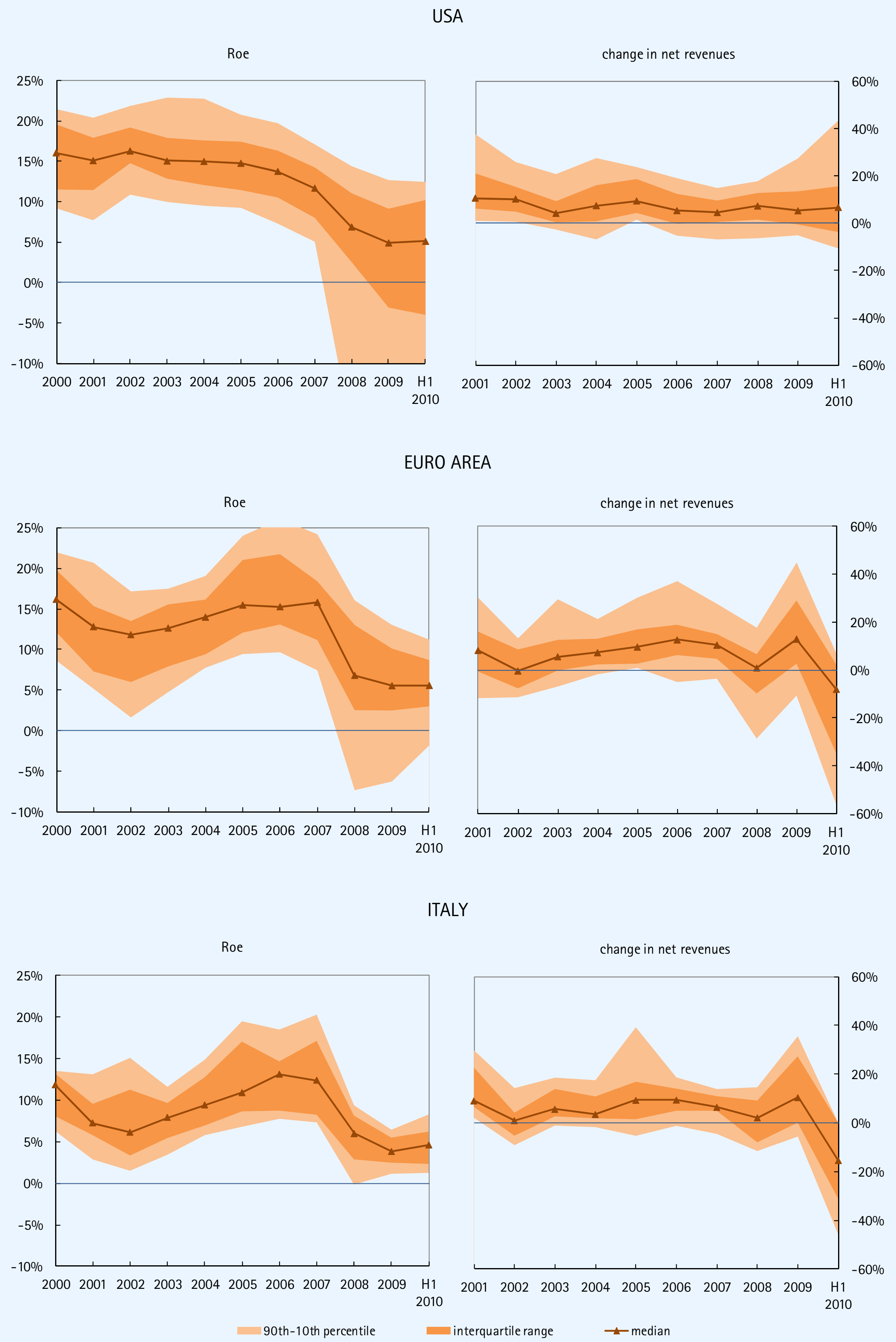
Figure 2.7 – Market multipliers for the major listed companies

Source: calculation on Worldscope data. Non financial companies included in the S&P 100 (USA) index, Dow Jones Euro Stoxx 50 (Euro area) index and FTSE MIB (Italy) index; banks included in S&P 1500 Bank (USA) index, Dow Jones Euro Stoxx Bank (Euro area) index and Italian listed banks. P/E calculated for companies with positive earnings only.

Figure 2.8 –Profit and revenues growth for the major non financial listed companies

Source: calculation on Worldscope data. Companies included in S&P 100 (USA) index, Dow Jones Euro Stoxx 50 (Euro area) index, FTSE MIB (Italy) index. Annual variation of operating profit calculated only when both values are positive; annual variation of returns refers to restated datum of the previous year.

Figure 2.9 – Return on equity and revenues growth for the major listed banks



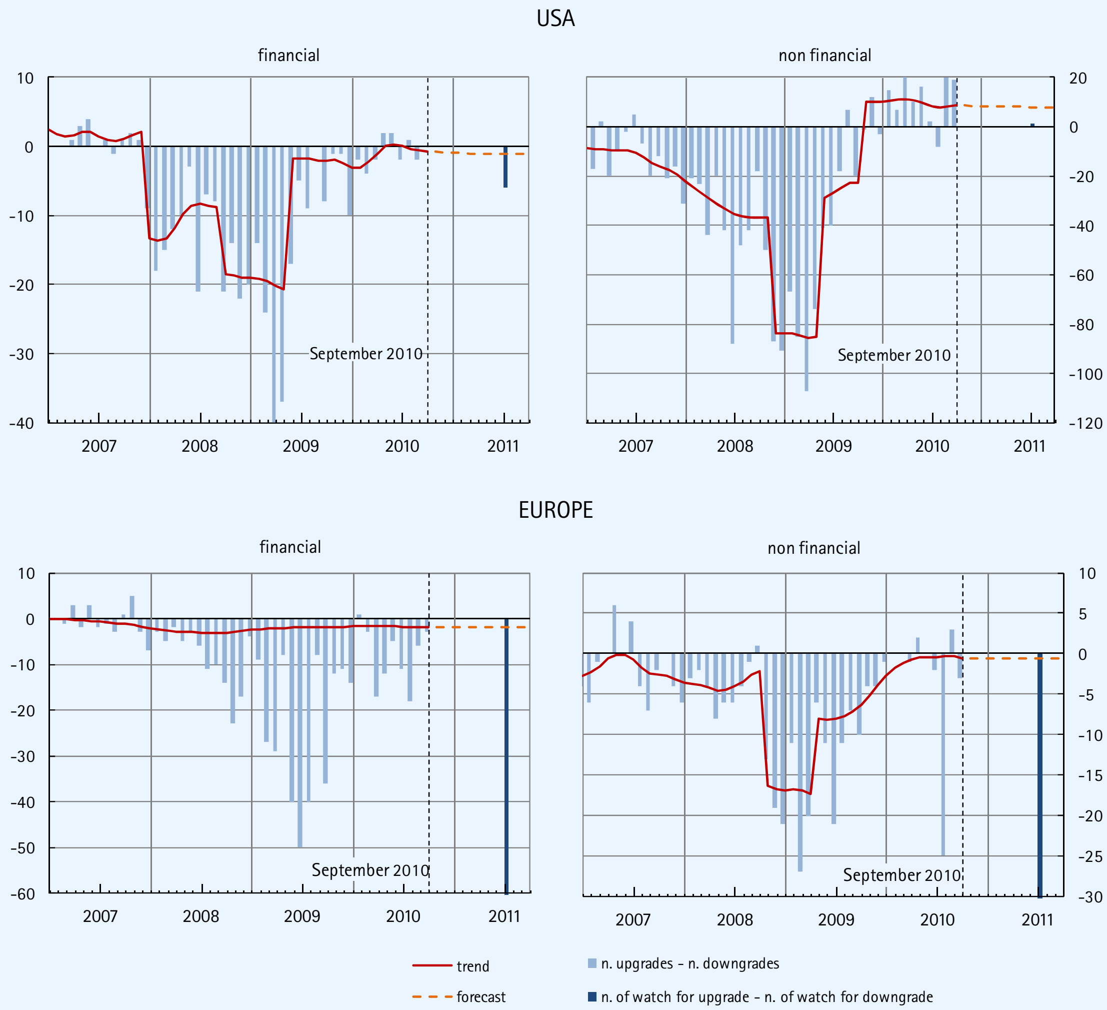
Source: calculation on Worldscope data. Banks included in the S&P 1500 Bank (USA) index, Dow Jones Euro Stoxx Bank (Euro area) index and Italian listed banks. Annual variation of earning margin refers to the restated datum of the previous year.

Credit quality

Rating changes provide a mixed picture of the evolution of credit quality, with clear improvements in the corporate sector and the financial sector afflicted by new uncertainties, especially in Europe, linked to the sovereign debt crisis

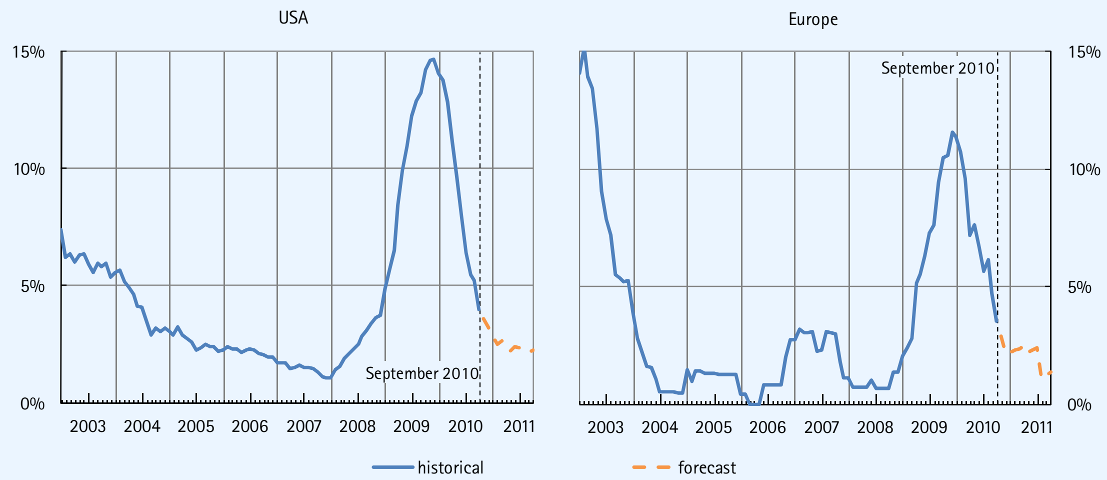
Data on rating changes provide a mixed picture on the evolution of credit quality in the corporate and financial sector. In the USA, the rating drift (upgrade/downgrade differential) confirms the favorable trend in the corporate sector emerged at the beginning of the year; in the financial sector, the picture is less encouraging, due also to a significant number of firms under review for a possible downgrade. The outlook remains negative for the European financial sector, whereas credit quality in the corporate sector is gradually improving; in both sectors there are several firms that could be downgraded in the next months. Overall, data on rating changes confirm the cyclical inversion connected with the improvement in the economic situation, but for the European financial sector concerns about sovereign risk exposures still persist. Default rate for speculative issuers (steadily decreasing since last quarter of 2009) continue to provide positive evidences on credit quality of firms in the lowest rating categories. Rating changes for structured products (data available up to the first quarter of the year) showed some signs of deceleration in the downgrading of RMBS, especially in the US.

Figure 3.1 – Upgrades/downgrades differential for corporate issuers
(monthly data)



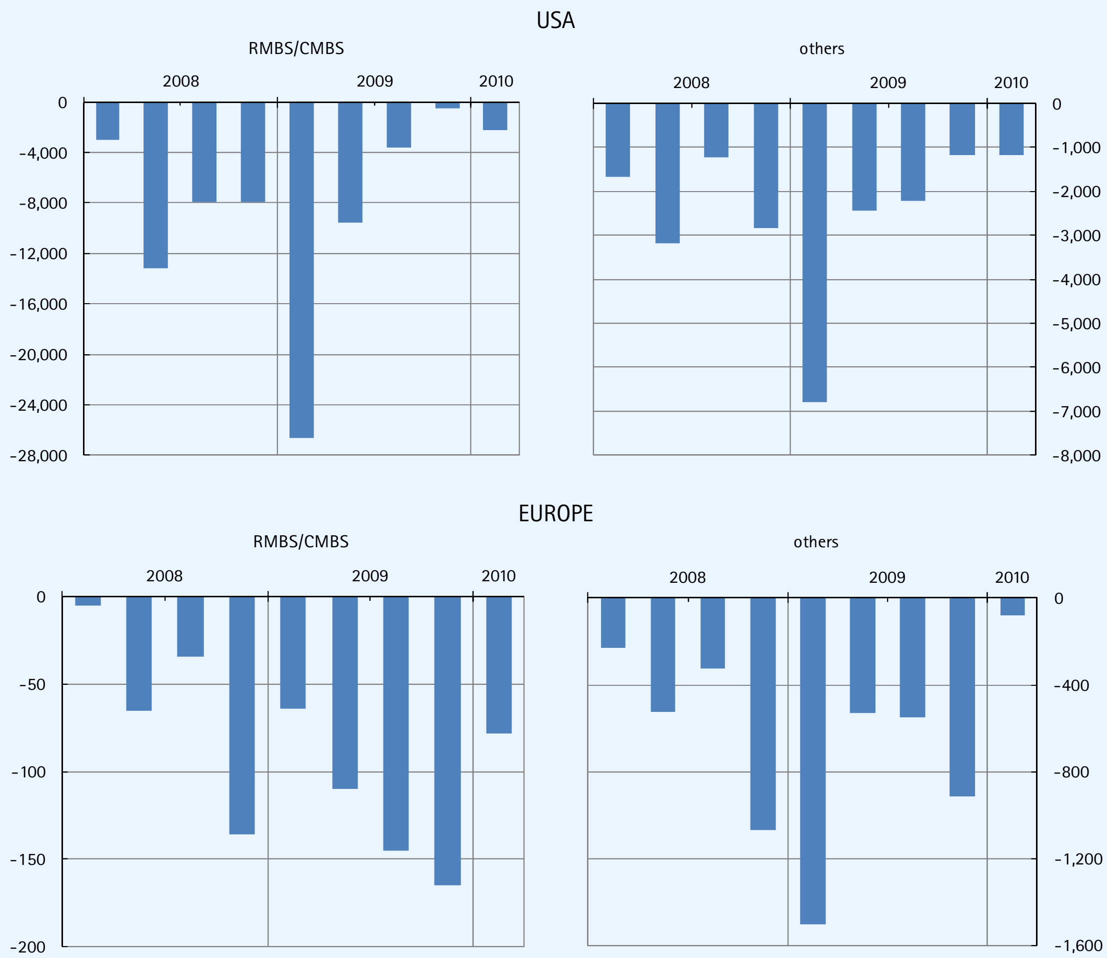
Source: Moody's. Trend calculated applying non parametric techniques of historical series analysis.

Figure 3.2 – Default rate for speculative issuers



Source: Moody's.

Figure 3.3 – Upgrades/downgrades differential for structured products

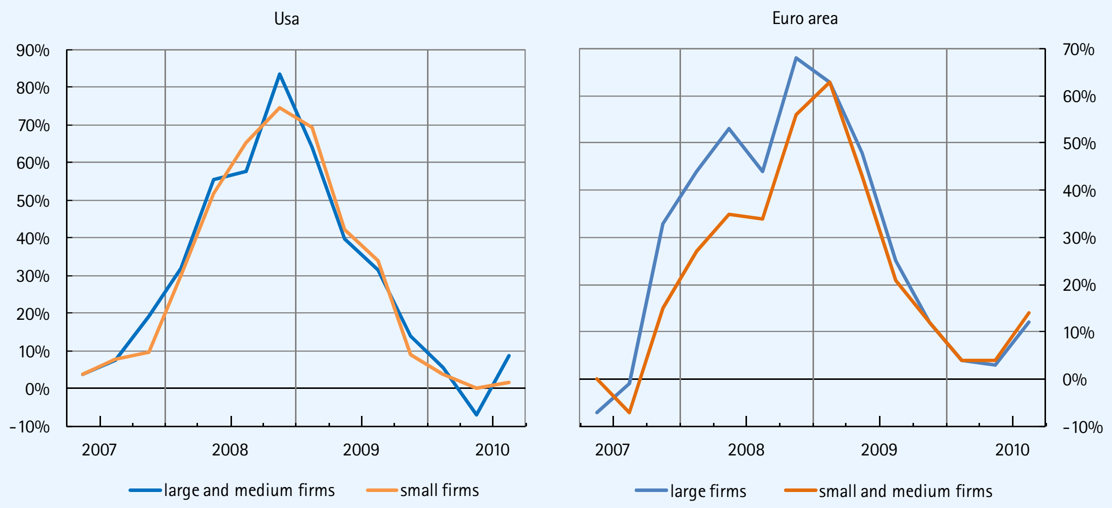


Source: Moody's.

Though there is some evidence of lending standards tightening, credit to the private sector may start to grow again

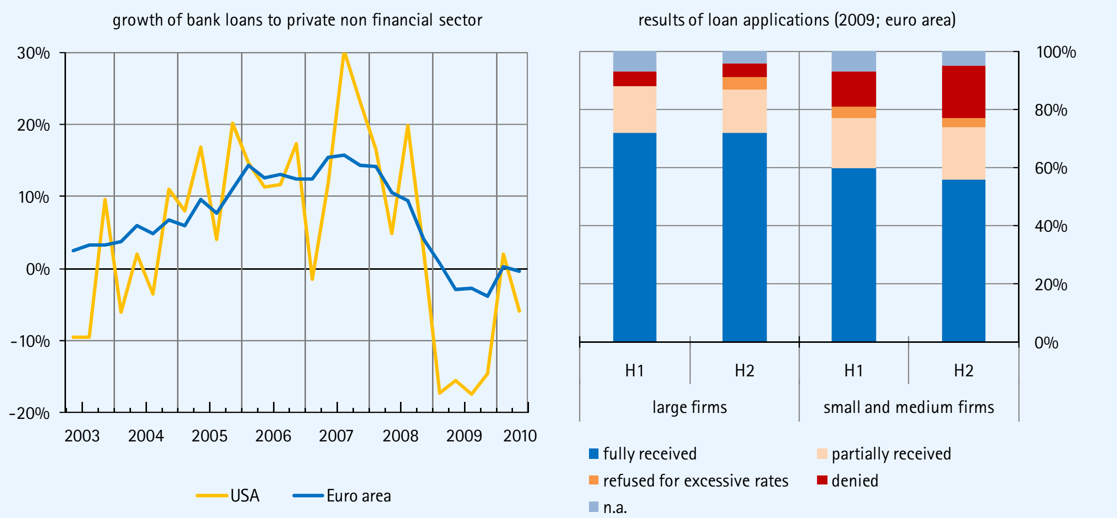
Evidences from bank lending surveys confirm the improvement in corporate sector credit quality, emerged since the beginning of 2009, both in the USA and in Europe, although, since the second quarter of the year, data have shown a slight increase in the percentage of banks signaling a tightening in lending standards. Bank loans to private non financial sector may start to grow again, as recovery consolidates.

Figure 3.4 – Bank lending standard indicator



Source: FED and BCE lending survey. Net percentages of banks contributing to tightening standards.

Figure 3.5 – Bank lending to the private non financial sector results loan applications

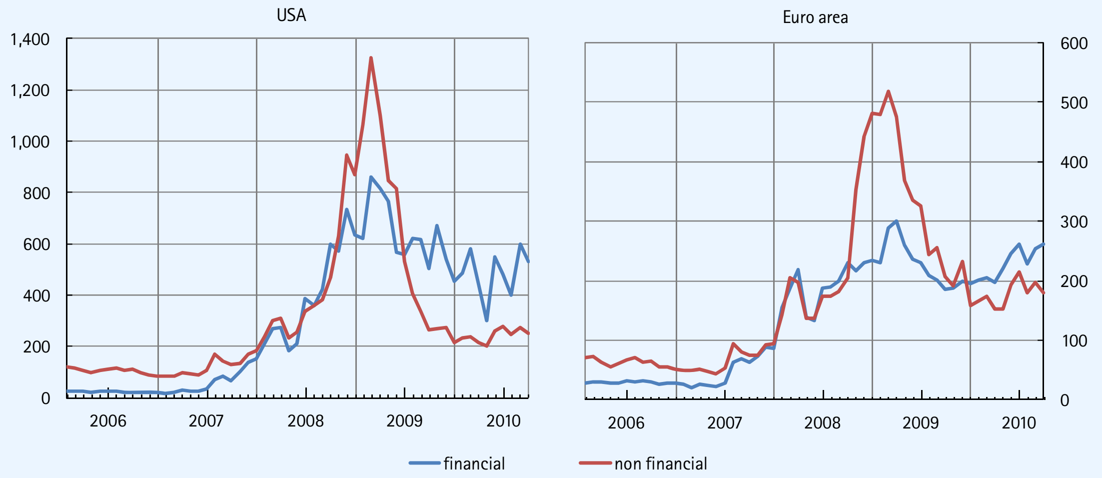


Source: calculation on FED and BCE data.

Credit quality for the major non financial listed issuer is stable, although bond issuance in the first 3 quarters of the year has remained subdued, especially in the Euro area

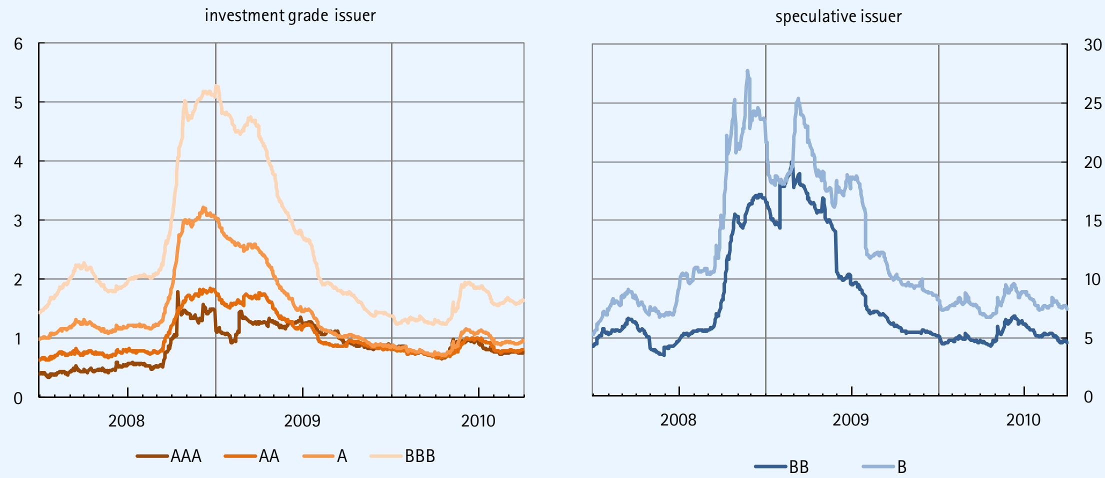
CDS and bond spreads show expectations of a stable default probability for the major corporate listed companies, whereas CDS spreads for European financial issuers registered a significant increase as a consequence of the sovereign debt crisis emerged in the second quarter of the year. Expected default probabilities (EDP) for listed companies indicate a slight increase in the European financial sector risk (although EDP remains much lower on average than for US banks). Corporate bond issues are growing in the US, whereas they are slowing down in Europe; banks bond market remains weak in USA and is recovering in Europe, thanks to covered bond issues. The securitization market remains halted especially in Europe, where even the issues intended to create collateral for ECB re-financing operations dropped, while in the US the market is driven almost exclusively by federal agencies' issues.

Figure 3.6 – CDS of listed issuers
(5 years CDS; basis points; monthly data, January 2006 – September 2010)



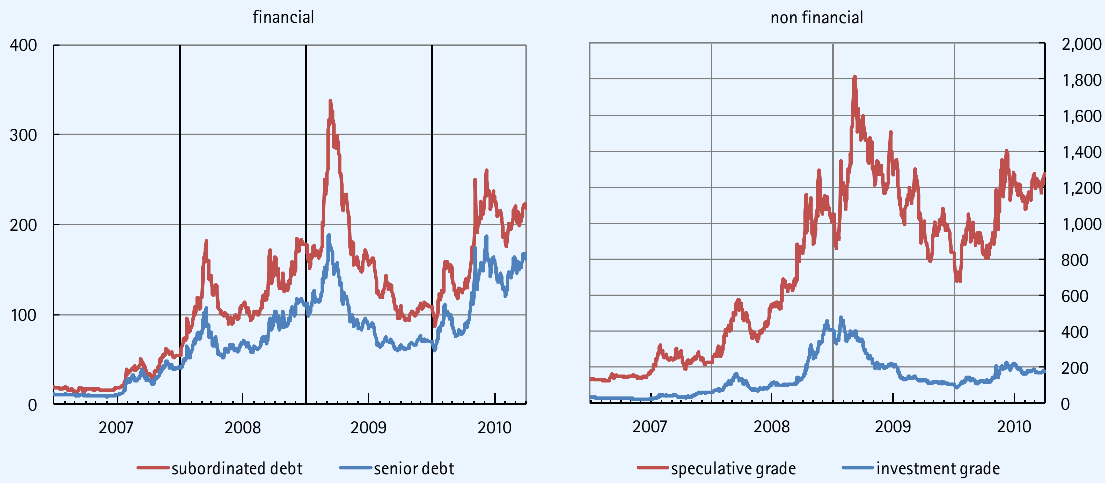
Source: calculation on Thomson Reuters data.

Figure 3.7 –Eurobonds spreads for non financial companies
(percent; daily data 31/12/2007 – 30/04/2010)



Source: calculation on Merril Lynch and Thomson Reuters data. Spreads calculated against German treasury.

Figure 3.8 – CDS of Italian listed issuers
(5 years CDS; basis points; daily data 31/12/2006 – 30/04/2010)



Source: calculation on Thomson Reuters data.

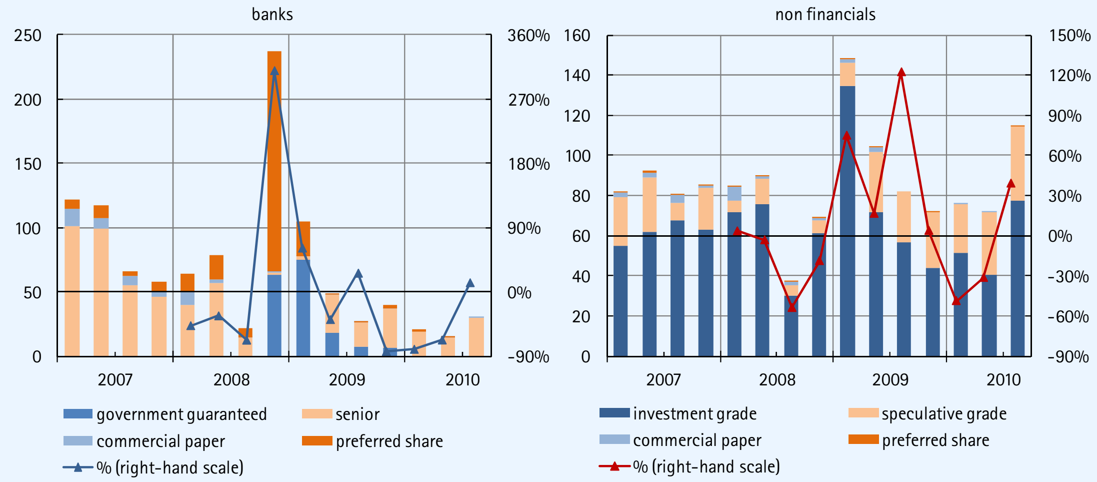
Figure 3.9 – Expected default probability for listed companies
(daily data; 31/01/2007 – 30/09/2010; percent)

Source: Credit Edge.

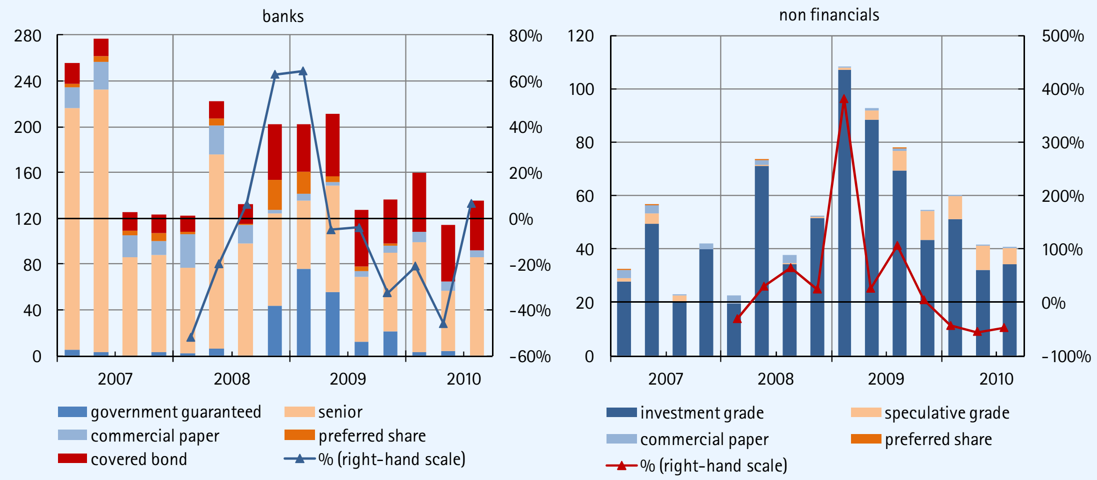
Figure 3.10 – Bond issues

(quarterly data in billions of euro; percentage change over the same quarter of previous year)

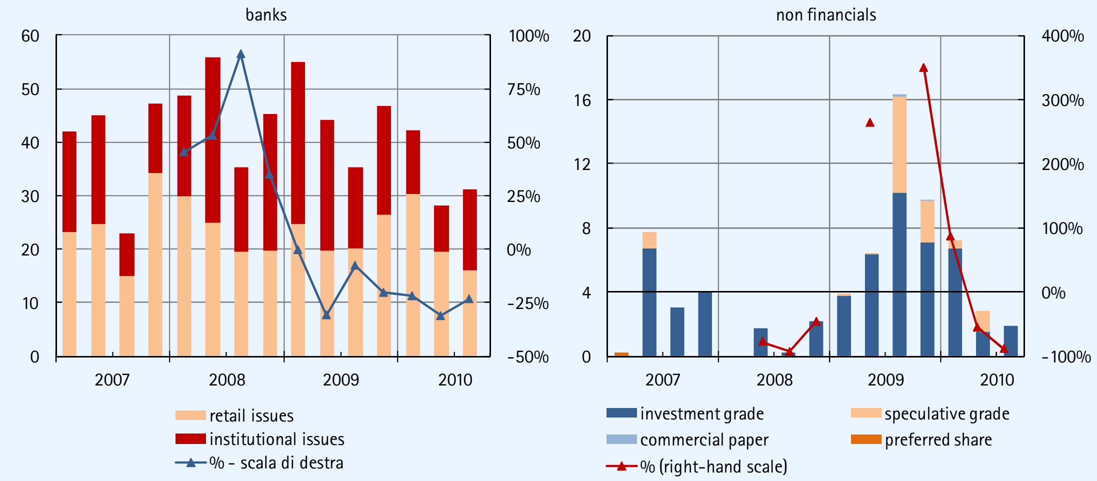
USA



EUROPE

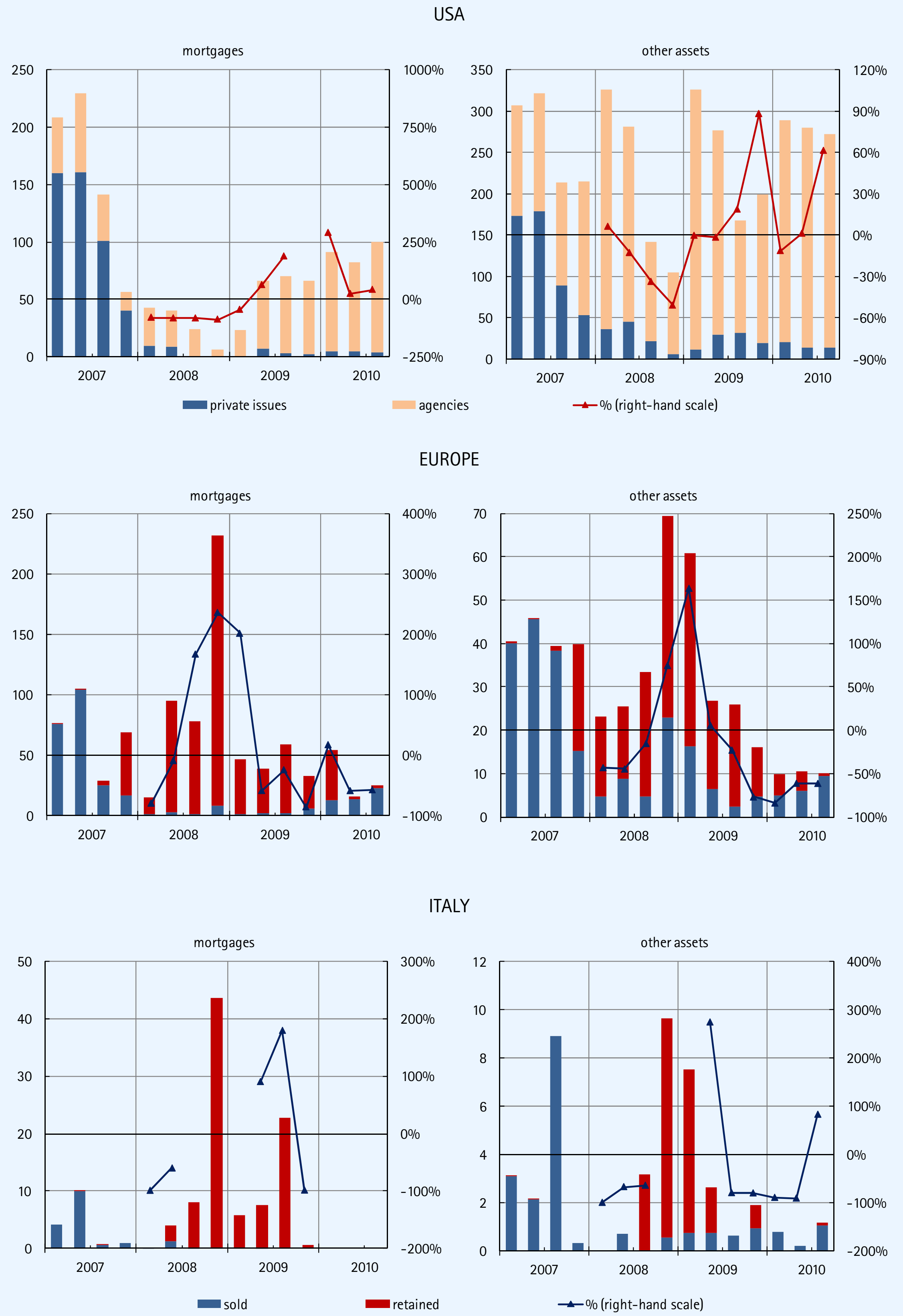


ITALY



Source: Dealogic, Consob and Kler's. European data refer to placements of companies based in Italy, France, Germany, Spain, Holland and UK and of their subsidiaries (even if based in other countries).

Figure 3.11 – Securitizations issues
(quarterly data in billions of euro; percentage change over the same quarter of previous year)

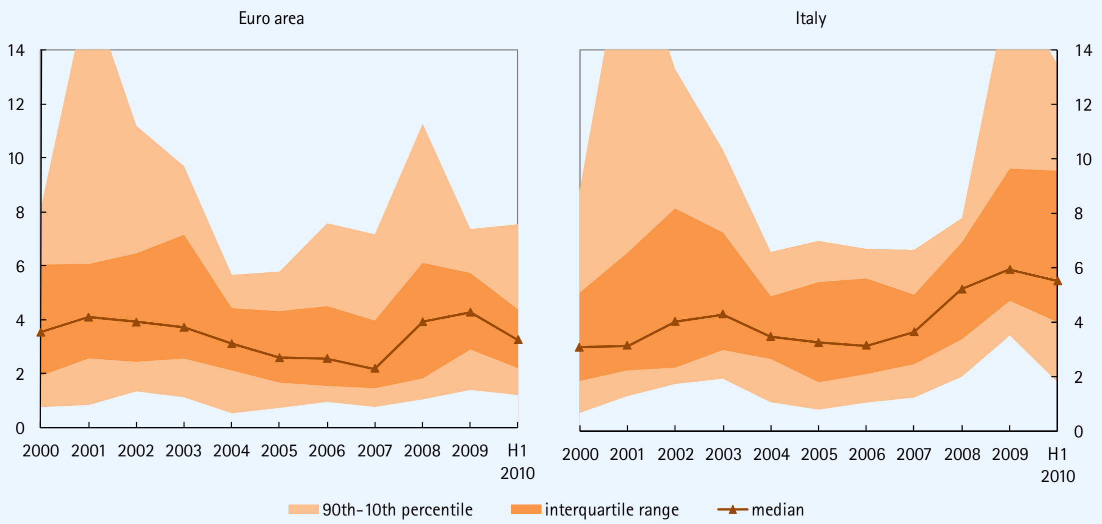


Source: calculation on Dealogic data. European data refer to securitization of assets of companies based in Italy, France, Germany, Spain, Netherland and UK or of their subsidiaries (even if based in other countries).

Corporate sector is starting to deleverage while banks strengthen their capital position, although they may face re-financing risk on maturity bonds

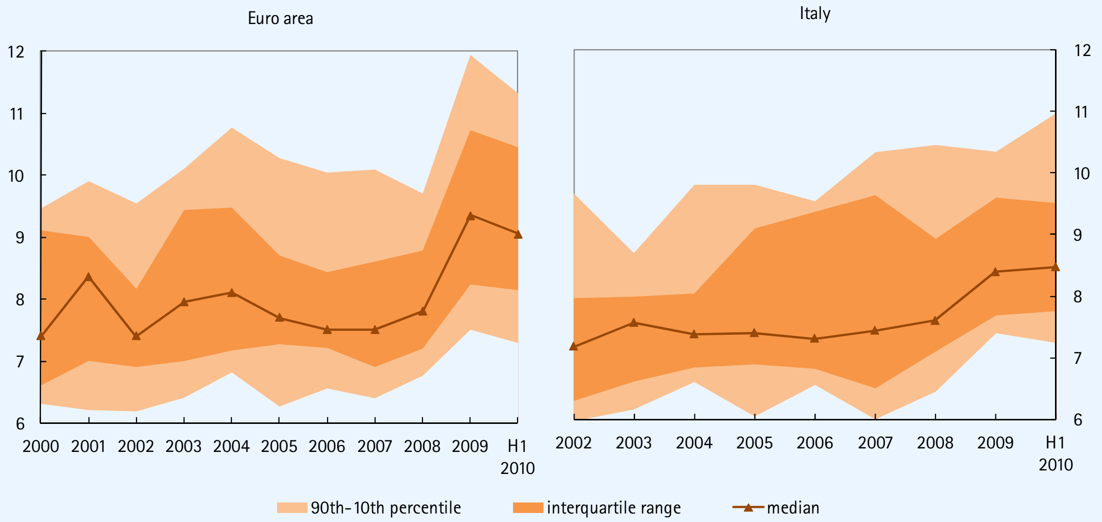
The positive evolution of CDS and bond spreads for the major European non financial listed companies reflects the stabilization of turnover and profitability and the decrease in leverage emerged from accounting data for the first part of 2010. Tier 1 of European banking groups has increased significantly since 2009. This trend is less marked for Italian banks, but data for the major groups show solvency ratios increasing significantly in the first six months of 2010. For these groups write-off and provisions for bad loans in the first half of 2010 have reduced compared to the same period of 2009, but net profits declined as a consequence of the drop in revenues. Main banks EDP shows an increase of risk for intermediaries with lower solvency ratios after the sovereign debt crisis. Moreover, there are concerns about a strong concentration of bond maturities in the next few years since the re-financing could take place in more troubled market conditions and at higher costs.

Figure 3.12 – Leverage of non financial listed companies (financial debts/Ebit)



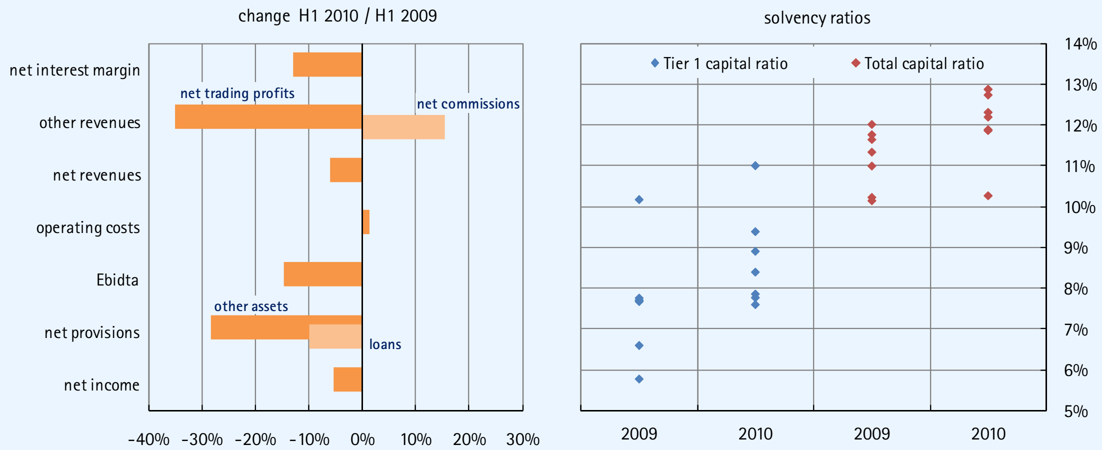
Source: calculation on Worldscope data. Companies included in Dow Jones Euro Stoxx 50 (Euro area) index and in FTSE MIB (Italy) index. Income statement data for the first-half of 2010 are annualised. Financial debts/Ebit ratio calculated only for companies with positive Ebit.

Figure 3.13 – Listed banks Tier 1



Source: calculation on Worldscope data. Banks included in Dow Jones Euro Stoxx Bank (Europe) index and Italian listed banks.

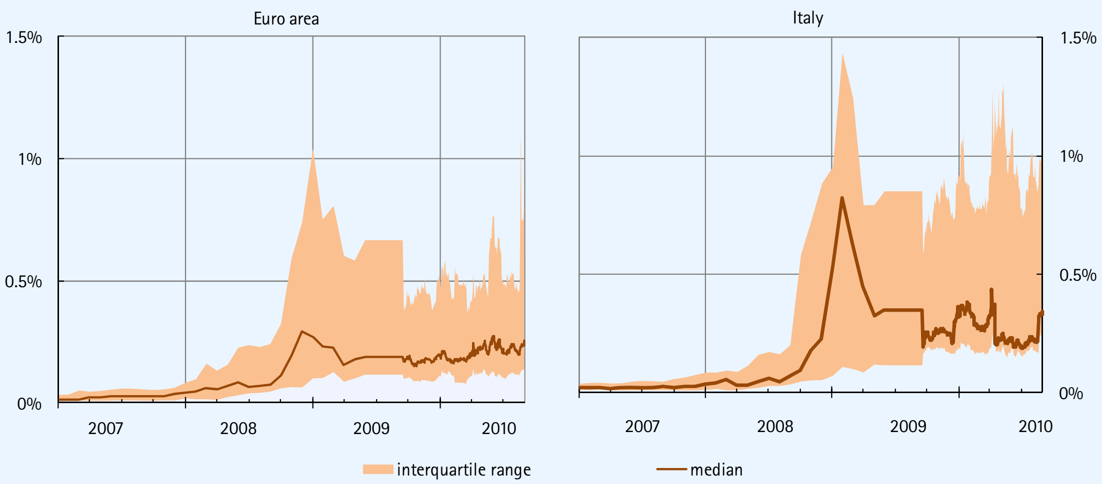
Figure 3.14 – Income statement and solvency ratios for the major Italian banking groups



Source: calculation on balance sheet data for the first 8 banking groups by total assets.

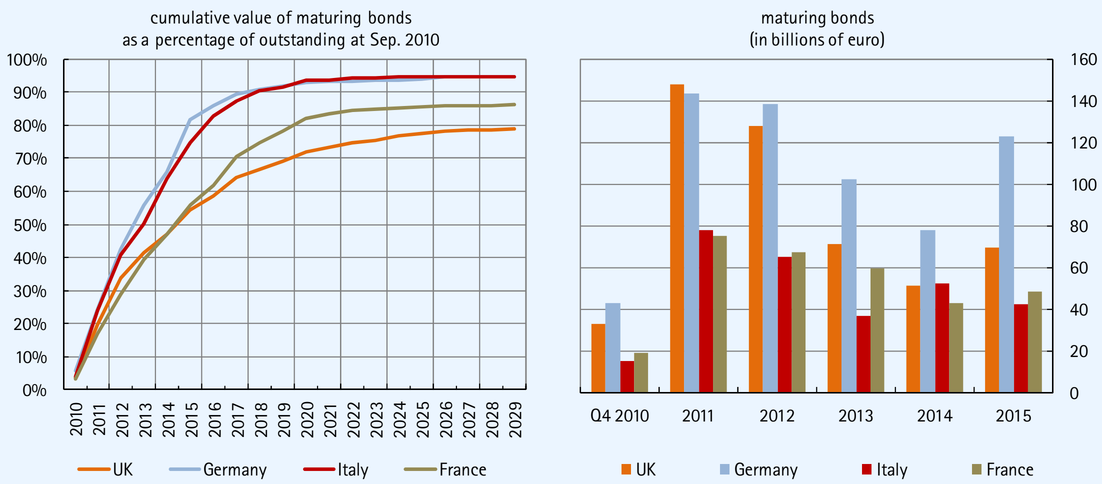
Figure 3.15 – Expected default probability for the major banking groups

(daily data; 31/01/2007 – 30/09/2010; percent)



Source: calculation on Credit Edge data. Banks included in Dow Jones Euro Stoxx 50 index for Euro area (excluding Italian banks) and first six Italian banking groups by total assets.

Figure 3.16 – Maturity of bank bonds



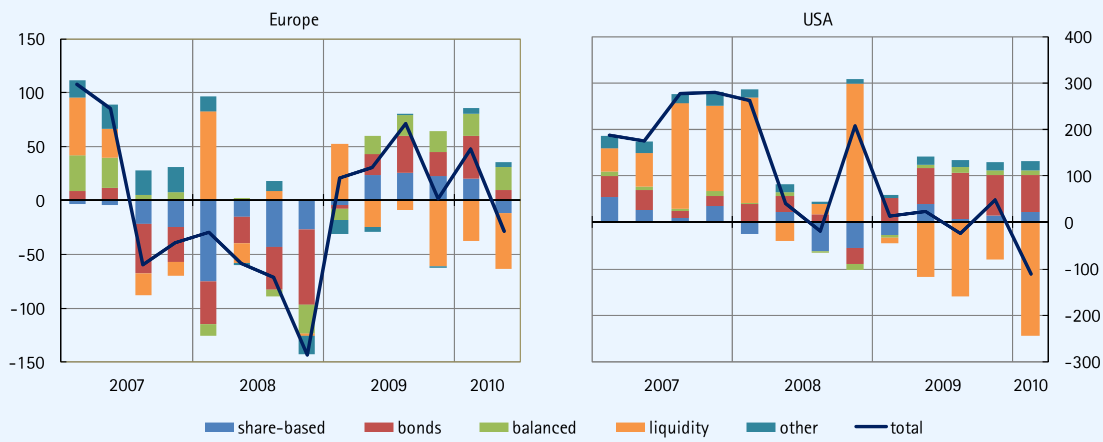
Source: calculation on Dealogic data.

Asset management

Strong outflows from liquidity funds have driven down mutual funds net sales both in Europe and US. Outflows from hedge funds have halted while the private equity market shows no signs of recovery

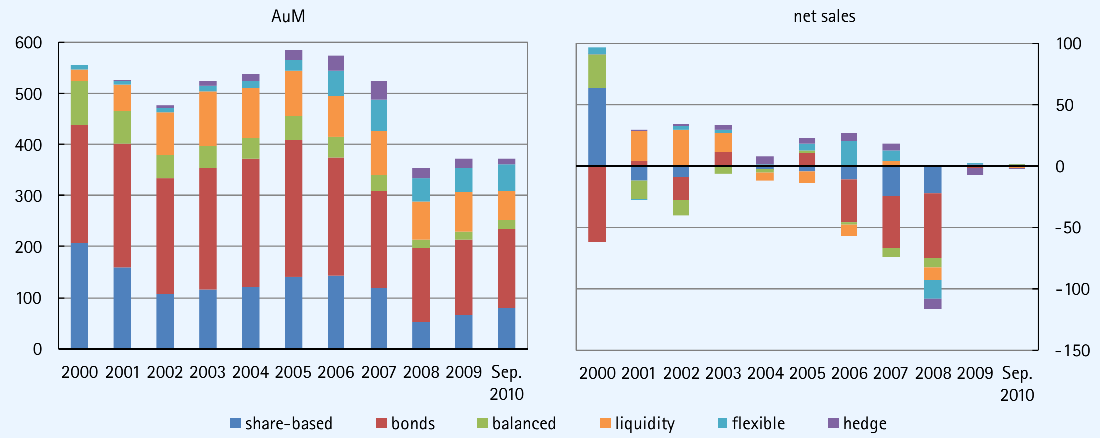
After a positive trend in 2009 and in the first quarter of 2010, European mutual funds registered net outflows in the second quarter of 2010 (by around 30 billions of euro), mainly as a consequence of liquidity funds redemptions; however, inflows for the first 6 months of 2010 remain positive (by around 20 billions of euro). In the US, huge outflows in the first quarter of 2010 were due to redemption of liquidity funds (for more than 200 billions of euro). In Italy, outflows from mutual funds reached 1,8 billions of euro in the first nine months of 2010, though remaining lower than the yearly average for the 2006-2008 period (around -68 billions of euro each year) and 2009 (-4,8 billions of euro). The market of non-harmonised funds distributed to retail investors (ETF, real estate funds, etc.) continues to expand: assets under management grew by 9% in the first six months of 2010. Data on hedge funds for the first six months of 2010 show close to zero net inflows, after considerable outflows in the 2008-2009 period. Hedge funds yields have returned positive since the beginning of 2010 for all the main strategies, but then fell significantly further to tensions on sovereign debt. Risk level (VaR indicator) remains steady (except for emerging and short bias funds). The private equity market does not show any sign of recovery yet.

Figure 4.1 – Net sales of Ucits
(in billions of euro)



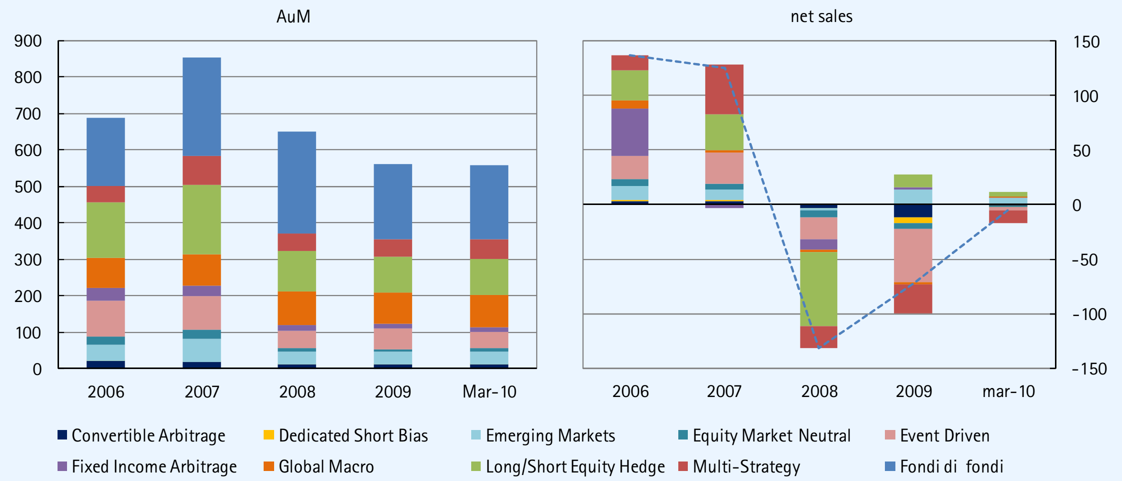
Source: EFAMA and ICI.

Figure 4.2 – Assets under management and net sales of Ucits managed by Italian intermediaries
(in billions of euro)



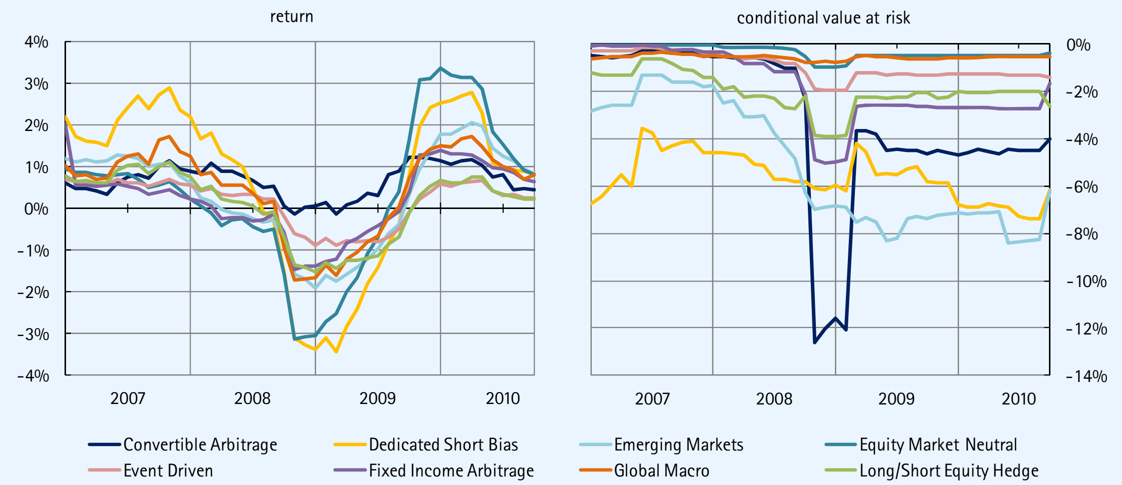
Source: Assogestioni

Figure 4.3 – Net sales and asset under management of hedge funds
(in billions of US dollars)



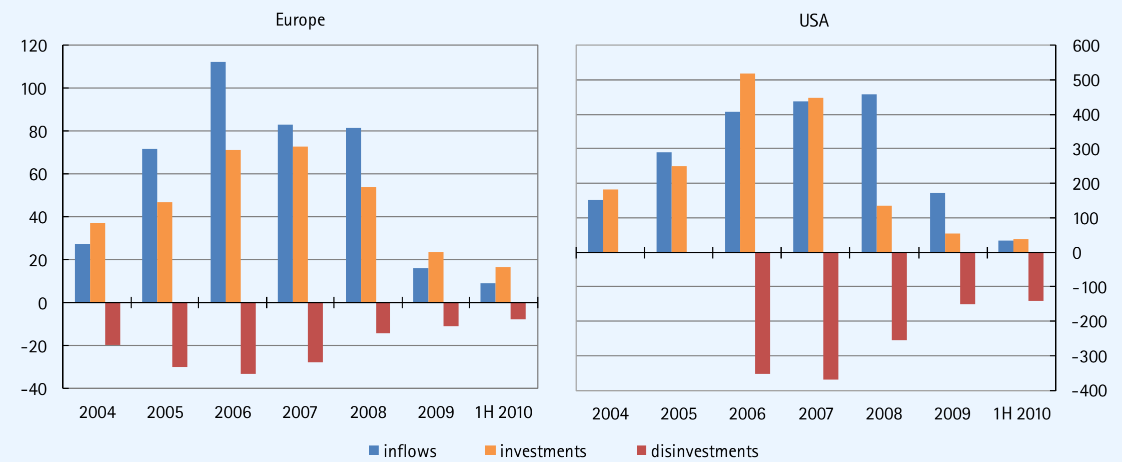
Source: calculation on HedgeWorld data. Net inflow does not include funds of funds.

Figure 4.4 – Hedge fund risk and return



Source: calculation on HedgeWorld data.

Figure 4.5 – Inflows and investments of private equity funds
(in billions of US dollars)



Source: EVCA and PitchBook.