



Euro Debt Crisis Update

Introduction

Another week, another crisis point in the eurozone debt melodrama: developments this week are typical of the trend we have witnessed in the last year. The euro finance ministers have again failed to come to an agreement on the medium term financing of the Greek state (particularly around the possible private sector participation in any lengthening in duration or reduction in its debt pile). In addition, the focus on the distressed market in Spanish and Italian sovereigns is simply confined to further calls for austerity measures. Once again, eurozone policy makers are seen to be at the mercy of events. Quite apart from negotiations over the second Greek bailout package, last week's dramatic downgrading of Portuguese debt to junk status by Moody's completely undermined any notion that Athens' problems could be placed in quarantine.

And finally, the expected publication of the European bank stress test results this Friday, while beneficial in the longer term, right now draws attention to where and how banks' losses on sovereign holdings might fall across the region. Altogether, a noxious mix indeed!

Italy - Panic stations justified?

Market moves in Italian and Spanish bond and equity markets suggest the contagion from Portugal and Greece has now moved fully into core Europe. What triggered this move in such short time, and is it justified?

1. Bank stress tests and private participation

Possibly, the combination of the political establishment view that the private sector should participate (take losses) in the Greek bailout and the upcoming European bank stress tests were the proximate cause of the current round of distress. In the event of a Greek "default", the numbers involved for the banking sector is generally manageable, especially if a trigger on the credit default swaps (CDS) contracts can be avoided. The magnitude of losses in the event of widespread private participation in periphery-wide defaults would be a different matter altogether. The failure to have any agreement across eurozone policymakers on the issue of default (selective or otherwise) only adds further worry to an already jittery eurozone bond market. Furthermore, the European Banking Authority is reported to favour an approach requiring failing banks to present capital raising plans by September this year. This looks to be an interesting challenge in the current market.

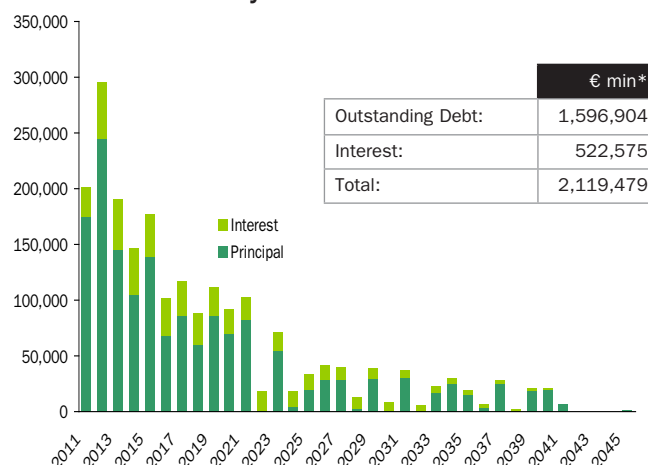
Unlike Ireland and possibly Spain, the Italian banking system does not appear to be in deep trouble. It is true that some banks are in need of additional capital. That is possibly where the similarities end. In Italy, the banks face a troublesome operating environment - new lending is slow and profits are hard to come by - but balance sheet quality

is probably not in the sort of shape that warrants fears of a collapse. There was no large-scale property bubble in Italy that fed its way onto bank balance sheets, necessitating the sort of bailout seen in Ireland. Equally, the risk of a large deposit flight out of Italian banks looks quite remote. This keeps emergency European Central Bank (ECB) funding out of the equation for now.

2. Debt dynamics and sustainable fiscal policy

Unlike Greece, there is little reason to be sceptical of Italy's ability to sustain its fiscal position. In short, Italy is running a total debt/GDP burden of 120%. This is a very large number, and equates to EUR 2.1 trillion in total principal and interest outstanding, according to Bloomberg data. However, Italy has a respectable track record over the last number of decades (since the ERM crisis of 1992/3) of preventing this number from spiralling out of control. The most recent budget calls for an overall (not just primary) balance by 2014. One concern within the austerity plan is the package is back-loaded with the majority of budget cuts taking place in 2013 and 2014. With the Italian general election to be in 2013, this clouds confidence in the necessary measures being enacted. While these smaller details have little impact under 'normal' times, under current circumstances and with the threat of contagion not eliminated, such details are likely to have contributed to the new-found fears on Italy. It is also worth noting that a larger proportion of Italian sovereign debt is held internally within Italy than when compared with the situation that was faced by Greece. This reduces the immediate risk of a liquidity crisis to some degree.

Italy Debt Distribution



Source: Bloomberg as of 12 July 2011

* Due to constant fluctuations in the exchange rates, this amount could slightly change

Unlike Greece, the average maturity on Italian government debt is very long indeed. In the wider northern Europe, only the U.K. has a maturity profile of longer average duration than Italy. The positive implication of this is that the actual interest sensitivity of the Italian debt pile is pretty low. By some (admittedly optimistic) estimates in the market, an interest rate spike of cataclysmic proportions (say 10-year yields rising to 10%) only adversely affects the overall debt/GDP ratio by 2014. **BofA Merrill Lynch Economics Research is less sanguine, but nonetheless estimates that if the average interest rate on Italian government debt rises to 7%, the debt/GDP ratio only gradually deteriorates to 126% of GDP by 2020 under fairly realistic economic assumptions.**

What these estimates fail to take into consideration, though, is what state of the world we will be in if rates were to rise to those sorts of levels and remained there. Presumably, the national banking sectors in Italy and Spain would be wearing a serious degree of distress if government rates were to rise that steeply.

In conclusion: policy options from here

With Italian government debt floundering, the good news is that debt sustainability or solvency is finally coming centre stage **where it should have been from the very outset**. Plan A, involving funding until such time as the recipient economies either miraculously recover or when eurozone banks can safely write off their loans to the same governments, is simply not working. The fact that peripheral bond yields have risen in an almost uninterrupted fashion in the last year is a symptom of the inappropriateness of the response. Prepare for Plans B, C and D to emerge in the coming weeks. The cure has to start where the well has been poisoned with Greece's inevitable restructuring of its enormous and unsustainable debt burden. Some of the more obvious policy choices include:

- Using the EFSF (European Financial Stability Facility) to buy the debt of distressed nations in the secondary market. This option has previously been ruled out, but may be revived in an attempt to bring order to the market.
- Allowing Greece to impose a haircut on existing debt holders in a voluntary exchange of some sort. This has also previously been halted as the ECB is especially against it and ratings agencies will view it as a default. Wider systemic implications are unknown and unpredictable. One possible suggestion is that this occurs in conjunction with the EFSF recapitalising the banks which is not at present permitted.
- In the short term, additional funding for the EFSF to persuade the markets that there is ample funding available for any additional emergencies.
- The preferred option in the long run would clearly be the creation of the much-talked about ESM (European Stability Mechanism), with possibly a centralised bond market and a more robust fiscal enforcement mechanism.

The CIO Office continues to recommend an underweight exposure to continental Europe within a global equity portfolio, and has raised the risk of a setback in the value of the euro especially if debt ceiling negotiations in the U.S. lead to a longer term strategy that stabilises federal debt.

The clear risk of spill-over effects into the global economy has grown. The next few weeks will be crucial, but we still hold to the view that the value in equities at present combined with stronger second half growth will provide the basis for a rebound late in this current quarter. In bond markets, our exposure has been very light of peripheral risk, and we hold to this view until further notice.

This is issued in the UK by Merrill Lynch International Bank Limited ("MLIB"), which is authorised by the Central Bank of Ireland and subject to limited regulation by the Financial Services Authority. Details on the extent of MLIB's regulation by the Financial Services Authority are available from us on request. Registered Office: Central Park, Leopardstown, Dublin 18, Ireland. Branch Office: Bank of America Merrill Lynch Financial Centre, 2 King Edward Street, London EC1A 1HQ. This material is intended to provide information only and is not intended to be construed as a solicitation for the sale of any particular investment. It does not have regard to the specific investment objectives, financial situation, and particular needs of, and does not represent investment advice or personal recommendation to, any person. Changes in exchange rates may have an adverse effect on the value of and income from investments. The value of investments and their income can go down as well as up, and could rise or fall dramatically. Investors may not get back the full amount invested. If you have any doubt about the suitability of investments for you, you should consult your Financial Advisor. Merrill Lynch International Bank Limited and/or any of our associates has or may have a position or a material interest in any investment referred to in this material, or related investments, and an associate is or may be the only market maker in certain investments. Merrill Lynch, as a full service firm, may have, or may have had within the previous 12 months, business relationships, including investment banking relationships, with, or provided significant advice to, companies referred to in this material or related investments. The information included herein was obtained from sources we believe are reliable, but we have not verified and cannot ensure its accuracy.

Past performance should not be seen as an indication of future performance and no projection, representation or warranty is made regarding future performance.



A subsidiary of Bank of America Corporation