Philequity Corner (November 11, 2011)

By Valentino Sy

Too Big to Fail, Too Big to Save

Last week, we wrote about the unfolding Greek drama and how it has gripped global equity markets over the past few months (*The Greek Drama Continues*, November 7, 2011). In that article, we warned that Italy should also be monitored closely as negative developments from the country could pose further downside risks to investors. True enough, Italy shocked the investments world when their 10-year bond yields soared past 7% and closed at a euro-area high of 7.25%. Note that the 7% threshold is considered an unsustainable level for 10-year borrowing costs as Greece, Ireland and Portugal have been forced to seek bailouts when their 10-year bond yields breached 7%.

The surge in Italy's bond yields was triggered by an increase in margin requirements for Italian sovereign bonds, causing some forced selling by bond holders such as banks and hedge funds. This brought another round of volatility to global stock markets, as the Dow Jones Industrial Index dropped 389 points and the S&P 500 declined by 3.7% last Wednesday. Asia was not spared, as the Hang Seng Index dropped by a staggering 5.2% the following day. Our PSE Index, though not as badly hurt, also declined by 1.4%.

Though Italy's 10-year bond yields have since fallen below 7% last Friday, it is clear that the European debt contagion has spread to EU's 3rd largest economy.

The Perils of Size

Italy's debt stock amounts to $2.60T, making it the 3rd largest bond market in the world, next only to US and Japan. Italy has a population of 60M and 2010 GDP of $2.06T. Aside from being the 3rd most populated EU country and the 3rd largest EU economy (only after Germany and France), Italy is also the 8th largest economy in the world.

Because of the sheer size of its economy and debt, the International Monetary Fund, the European Central Bank and neighboring countries will find it very difficult to save Italy if its fiscal situation continues to deteriorate. Italy will be too big to rescue.

On the other hand, failure to backstop Italy will deeply aggravate the European debt crisis, cause a seismic shock on the global economy and pose significant downside risks to global equities. Unlike Greece, Ireland or Portugal, a failure in Italy would be unacceptable to the financial markets. Italy is simply too big to fail.

Glimmer of Hope

The resignation of former Greek Prime Minister (PM) George Papandreou paved the way for the appointment of a new one. Last week, Lucas Papademos, a former European Central Banker with a PhD in Economics from MIT, was appointed as the new Greek PM. He will head an interim Greek government that is tasked to prevent the country's bankruptcy. Similarly, the pledged resignation of Italian PM Silvio Berlusconi has raised expectations that an interim Italian government will be formed. This will be led by Mario Monti, a former EU Commission member and a respected economist. The formation of new governments to be led by bankers and economists has fueled hopes that Greece and Italy may finally be on the right path to improve their fiscal positions and redirect their respective economies back to growth.

The Philippine Experience

We cannot overemphasize the benefits that a healthy change in leadership can bring. History tells us that the positive changes are more pronounced when a government mired by political survival and questionable economic policies is replaced by more enlightened leaders who are widely respected by their constituents. This is what we saw in EDSA 1 and EDSA 2, when the leadership changes brought about renewed optimism and confidence, which eventually led to a significantly stronger economy and a more vibrant stock market. We are also experiencing this now, as President Noynoy Aquino's administration enjoys a high level of trust and confidence. In Greece and Italy's cases, the changes in leadership from traditional politicians to enlightened technocrats may significantly strengthen their economies and improve the outlook for global equities. Moreover, the changes in the leadership of Greece and Italy have reinforced our positive view on the local stock market.

Strategy Pays Dividends

Yesterday's Manny Pacquiao fight was a much welcome respite to the very challenging trading environment that local stock market traders are confronted with. It is thrilling to watch our favorite Filipino boxer overcome adversity and implement his strategy to secure a close victory over his valiant and equally-skilled foe. Moreover, it is amazing to witness how Pacquiao's dedication and hard work, along with the guidance of boxing coach Freddie Roach, have transformed him into a more refined fighter and the world's best boxer, pound-for-pound.

As such, it would be wise for investors to take inspiration from Pacquiao's strategic approach to boxing by devising an investment strategy that they can implement even in the face of extreme market volatility. We continue to advise investors to employ a 'buy-on-dips' strategy and focus on companies with strong franchises, solid business models and robust growth potential. We urge investors to look for knockout opportunities as we are optimistic that our stock market will deliver positive results over a long-term investment time horizon. While all the attention is on Europe, we remind investors to be mindful of other macroeconomic headwinds, such as the US deficit-reduction program and the slowing global economic recovery, which can pose further volatility and downside risks to financial markets.

Just as Pacquiao was guided by the expert advice of Roach, investors can seek the help of professionals by consulting their stockbrokers. Alternatively, investors can also look at UITFs and mutual funds, such as the Philequity Fund, and rely on professional fund managers to handle their investments during difficult times such as now.

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