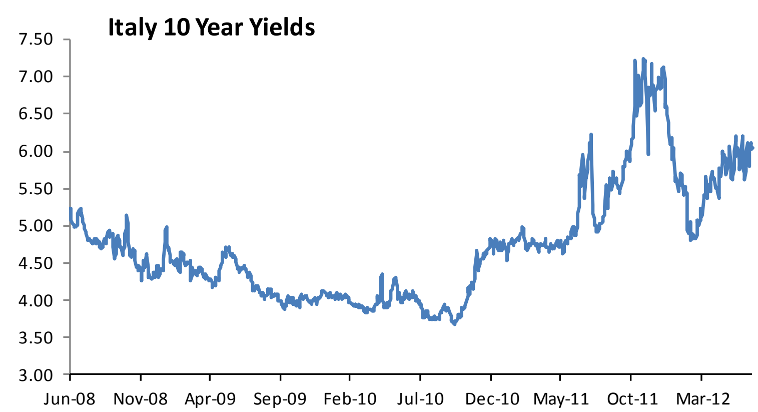
After recently returning from Italy and France and analyzing the economic data coming out of Italy, we have a higher conviction that Italy will be stuck in a severe recession and has an elevated probability of requiring a bailout. Our main theme, which is similar to our view of the United States, is that Italy has too much public debt and is lacking the political will to make the necessary expense cuts and stimulate its economy to successfully navigate the deleveraging that is required. In addition, the structural problems imbedded in Italy's economy and the broader Eurozone are an impediment to fixed investment and private capital expansion which is forcing Italy's economy to slow. The economy is further challenged by an entrenched political environment, aggressive labor unions and large underground economy all of which has made commerce and tax collections more difficult. We expect that Italy, like the rest of the Eurozone countries, will not have the political will to implement the austerity measures they need to cut spending and help relieve their debt burden.

The Numbers Don't Add Up

While Spain is currently the main focus of the financial media, we expect Italy's fiscal problems to escalate over the next six months which will further pressure the European Union and the European Central Bank to constrain the growing debt problems of Europe. Italy is struggling under a huge debt burden, crony politics, an inefficient economic model and a weak banking system. To be clear, none of this is a surprise. The members of the European Union have consistently shown a lack of accountability to address the rapid growth in government debt to support their expenses and the political will to address the fiscal problems. With the meager government initiated austerity measures (which are considerably weak compared to what is needed) coupled with the contraction in credit and the growing economic gridlock, we expect Italy's economy to contract by -2.2% in 2012. This is a much larger slowing in the economy than projected by the government.

With roughly €1.9 trillion in government debt, Italy is the third largest bond market in the world behind the United States and Japan. As the Eurozone struggles to gain investor confidence in the face of new rescue funds and broader banking powers, yields on Italy's notes have increased since the beginning of the year. Effectively, there are no buyers for Italian debt other than the Italian banks at this point.



Source: Barclays Capital

The EU established two rescue funds, the European Financial Stability Fund (EFSF) and the new European Stability Mechanism (ESM), which are designed to provide funding to assist EU member sovereign governments in distress. After much dithering by the EU, these rescue funds, which total roughly €780 billion, are now allowed to purchase directly the sovereign debt of a member country. *However, we believe there is simply not enough capacity within these rescue funds to purchase enough debt and at the same time build investor confidence over the long term.* Combined, Italy and Spain's bond market exceeds €2.5 trillion. Ultimately, there has to be a meaningful attempt at deleveraging. The Debt to GDP ratio in Italy has exceeded 100% since 1995 and is currently near 120%. We expect debt to continue to grow to €1.91 trillion while GDP shrinks by -0.5% in 2013. *As a result, we expect the ratio of debt to GDP to increase to over 123% next year. At the same time, the absence of any meaningful entrepreneurship and job creation coupled with the lack of private credit expansion will act to prohibit economic growth.*

Socialism is Not Capitalism

The economic and political culture of Italy is rooted in socialism and fascism which goes back to World War I. Integrated with their political history is a strong union labor force and a high level of social services and welfare benefits provided to its citizens. We believe the fiscal problems of Italy are a function of their socialistic heritage and a lack of accountability within the government sector. In general, with capitalism, political power is accessible by all citizens and economic power is concentrated in the wealthy elite. However, with socialism both economic and political power is concentrated in the governing elite (which is typically the political bureaucracy). Capitalism leans toward a materialistic ideology and system which ignores the growing income insecurity of non-owning workers facing displacement by technology or lower-paid workers. In contrast, socialism leans toward a materialistic ideology and system which fosters the absolute dependency of all citizens on the state for their income security and well-being.

The government is one of the major employers in Italy. Anecdotally, we were told that anyone looking for a job through the government needs to have connections. It is not a meritocracy. From everything we could observe, it appears Italy has not implemented much in the way of austerity measures. The government is still entrenched and has not made the cuts that are needed in benefits and compensation. For example, it has been reported that Italy has over 700,000 state-owned vehicles and they still have not begun a meaningful process to sell them. A recent article in *The Wall Street Journal* reported that the government in Rome is considering its options for Sicily which is considering bankruptcy. The article goes on to report that the funding provided through the local government of Sicily was squandered and used to pay friends and family. We believe this is more prevalent throughout local governments in Italy.

In addition, the political environment in Italy (as well as the broader Eurozone) appears to be contributing to the lack of meaningful economic growth. While it appears that Prime Minister, Mario Monti, has the support of the political parties, former Prime Minister, Silvio Berlusconi, has made strong suggestions that he will attempt to return as prime minister and run in the spring 2013 elections. Berlusconi still wields significant power in his party, and through his media properties, controls much of the spin on the content delivered through the media channels.

While the business environment in northern Italy includes more manufacturing, the economy in mid and southern Italy is more agriculture and tourism. In general, the work ethic throughout Italy is fairly relaxed relative to the United States, Japan and Germany. As a result, productivity and commerce are challenged and we find it difficult to believe the average work week data published on the Eurostat database of 37.5 hours for Italy. We estimate that in 2011, Italy collected an average of €12,414 per person in tax revenue but then spent €5,058 on social programs and benefits. The result is a labor force that lacks much incentive to actually seek employment and pay taxes since the government already provides a high subsidy. We were told that in the Italian culture young people do not even begin looking for a job until they are 25, and they live at home. Unemployment for young people right now is near 25%.

Florence, one of the most beautiful cities in Europe we visited, relies heavily on government jobs and the tourism industry to support its economy. The end of June marks the start of the tourist season and judging by the length of the lines to get into the museums, the season is off to a reasonably solid start in Florence. The restaurants and shops were vibrant and the shop owners we talked to acknowledged that the economy has been tough but believe that things will pick up for the summer.

Rome is a major international city with over 2.8 million people; however, it is a study in contrast. Rome, like much of Italy, relies on the government for jobs. Consumption in Rome appears to be very inefficient. So is their traffic. The areas that we visited did not have any “big box” stores similar to our Wal-Marts, Targets and Best Buys. The open market is still the primary means of shopping for Italians.

Italy's Banking System – Expect More Problems in the Loan Portfolio

An economy cannot grow without private credit expansion, and a well capitalized financial system is the foundation for credit growth. Unfortunately, the Italian banks are over leveraged and suffer from deteriorating asset quality and weakening capital positions. Last quarter, Moody's downgraded several Italian banks, underscoring the operating challenges in a slowing economy. UniCredit SpA, the largest bank in Italy, had its long term debt rating lowered to A3 and its junior subordinated debt lowered to Ba1 with a negative outlook last quarter.

Like much of Europe, the Italian government used its banks as a means to finance their social service programs. As the Italian government sold bonds, the banks, in turn purchased them using repurchase agreements and a wholesale funding base. After years of layering on government debt through wholesale deposits, the system became over-leveraged to the point where the banks could no longer roll their funding base. Without a funding base, they couldn't purchase the next round of Italian debt.

Every financial crisis is spread through the banking system and when banks stop lending to each other, liquidity grinds to a halt. Like Spain, the Italian banks are nearing the point where funding is becoming problematic. In December last year, the European Central Bank provided the initial tranche (known as the LTRO program) which ultimately grew to €1 trillion in low interest rate loans for troubled banks. Slurped up largely by the Spanish and Italian banks, these three year loans helped to close the funding gap, but have not completely filled it. Records show that *over 60% of the proceeds from the LTRO programs were used to buy their own sovereign debt*. Now, foreign lenders are pulling back as funding needs remain large since the Italian government still needs to fund its deficit.

The conundrum is that the Italian government needs the banks to buy their sovereign debt at a time when the banks are deleveraging, need to reduce their assets, and do not have the demand for the Italian government's bonds. As Europe moves through the process of deleveraging, the impact on each country's banking system is different depending on access to capital, asset quality and availability of credit. We are concerned with the liquidity circle that both Spain and Italy are currently gripped. Already facing weakened capital positions, we expect the Italian banks have not been forthright with the write downs in their loan portfolios. Additional write-downs will put pressure on the fragile capital position. As capital deteriorates, more pressure will be placed on the government of Italy to support the deteriorating banks which will force interest rates higher and restrict funding for the banks.

In Rome, we were startled to see a large number of apartments and residential buildings that were dark in the evening. Our suspicion is that Italy has a residential real estate problem similar to Spain, but perhaps not of the same magnitude. Yet, if there was a catalyst that would continue to drive the liquidity cycle we discussed, it would be a spike in delinquencies in residential real estate loans.

We expect that Italy will eventually require a bailout similar to Greece, Portugal and Ireland. While Greece has not completely stabilized, the total price so far to prop up the country exceeds €300 billion. *There simply is not enough money within the European Union to bailout Spain and Italy in addition to the other commitments.* Further, the use of accounting gimmicks in an attempt to fix the fiscal problems is ridiculous and does not address the long term core issue of reducing expenses and raising government revenue. In addition, the use of aggressive monetary policies and bailout funds to purchase sovereign debt in the open market only distorts the price of risk and is a short term fix, at best, which will eventually fail. Italy has little choice but to implement austerity measures designed to cut spending, but we expect the political culture will protect the government elite. *We expect that Italy will be mired in a deep recession well into 2013 which will put further pressure on the Euro.*

Italy

Annual Revenue and Expense Statement (Financial figures in millions of Euros unless otherwise stated)

	2009	% Total	2010	% Total	2011*	% Total	2012*	% Total	2013*	% Total
Revenues										
Taxes	445,564	*61.61*	448,572	*61.49*	463,385	*61.57*	483,369	*61.88*	503,659	*62.20*
Social Contributions	214,119	*29.61*	217,723	*29.84*	224,690	*29.85*	231,456	*29.63*	238,658	*29.47*
Other Revenue	57,308	*7.92*	57,979	*7.95*	58,623	*7.79*	60,407	*7.73*	61,418	*7.58*
Capital account non-tax revenues	6,216	*0.86*	5,280	*0.72*	5,920	*0.79*	5,957	*0.76*	6,000	*0.74*
Total Revenue	723,207	*100.00*	729,554	*100.00*	752,618	*100.00*	781,189	*100.00*	809,735	*100.00*
Total Revenue as a % of GDP	*47.59%*		*46.97%*		*47.63%*		*50.56%*		*52.41%*	
Expenses										
Compensation of Employees	175,041	*21.76*	175,368	*21.75*	176,409	*21.43*	178,287	*20.97*	180,157	*20.62*
Intermediate consumption	133,096	*16.54*	133,313	*16.53*	135,167	*16.42*	138,958	*16.35*	143,172	*16.39*
Social Benefits	291,280	*36.21*	298,020	*36.95*	306,640	*37.24*	316,380	*37.22*	328,650	*37.62*
Other Expenses	61,375	*7.63*	59,625	*7.39*	59,885	*7.27*	59,844	*7.04*	60,538	*6.93*
Capital expenditure	68,003	*8.45*	60,639	*7.52*	56,590	*6.87*	58,919	*6.93*	57,606	*6.59*
Interest Expense	75,724	*9.41*	79,493	*9.86*	88,685	*10.77*	97,656	*11.49*	103,544	*11.85*
Interest Expense as a % of Expenses	*9.41%*		*9.86%*		*10.77%*		*11.49%*		*11.85%*	
Interest Expense as a % of Revenue	*10.47%*		*10.90%*		*11.78%*		*12.50%*		*12.79%*	
Total Expenses	804,519	*100.00*	806,458	*100.00*	823,376	*100.00*	850,044	*100.00*	873,667	*100.00*
Surplus/Deficit	**(81,312)**		**(76,904)**		**(70,758)**		**(68,855)**		**(63,932)**	

	2009	2010	2011*	2012*	2013*
GDP	1,519,695	1,553,166	1,580,220	1,545,000	1,545,000
% Change in GDP, YoY	*-3.52%*	*2.20%*	*1.74%*	*-2.23%*	*0.00%*
Per capita GDP (not in millions)	25,309	25,740	26,065	25,605	25,707
Population	60,045,068	60,340,328	60,626,442	60,340,300	60,100,500
Interest expense/population (not in millions)	1,261	1,317	1,463	1,618	1,723
GDP/population (not in millions)	25,309	25,740	26,065	25,605	25,707
Total revenue/population (not in millions)	12,044	12,091	12,414	12,946	13,473
Social Protection/population (not in millions)	4,851	4,939	5,058	5,243	5,468
Net	7,193	7,152	7,356	7,703	8,005
Total Debt/GDP	116.05%	118.65%	120.06%	123.33%	123.66%
Change in Total Reveune	*-1.19%*	*0.88%*	*3.16%*	*3.80%*	*3.65%*
Change in Total Expenses	*3.82%*	*0.24%*	*2.10%*	*3.24%*	*2.78%*
Surplus/Deficit as a % of GDP	*-5.35%*	*-4.95%*	*-4.48%*	*-4.46%*	*-4.14%*
Total Public Debt	1,763,629	1,842,826	1,897,179	1,905,500	1,910,500
Current Year Public Debt Maturing**				428,000	

*GDP for 2011-2013 are estimates from Eurostat or WCM.

**Source: http://finance.yahoo.com/news/World-Largest-Economies-Face-wscheats-1787189171.html

Source: Population, GDP, and Public Debt figures are from Eurostat. All other figures, unless otherwise noted, are from the Italy 2010-2013 Economic and Financial Planning Document.