Country Risk: The Italian Election Meltdown

Can country risk change significantly on one day? Sure, and the reporting of the results from the Italian elections on February 25 provides an example. The day started with exit polls that suggested that Berzani, the leader of the center-left, would win the election. Since he was perceived as more likely to continue with the austerity program, designed to bring Italy back from the brink, markets reacted positively. Later in the day, though, the news changed with the actual vote counting indicating that Berlusconi's coalition would be able to get enough seats in the upper house to deadlock action. Not surprisingly, the markets reacted to that news by collapsing across the board.

In the attached file, you will see the intraday movements of three markets: the Italian Sovereign CDS, the yield on the 10-year Euro denominated Italian bond rate and the Italian equity index (MIB). As you look at them, here are things to consider:

1. The default spread that I estimated for Italy at the start of 2013, based upon Italy's rating (Baa2 from Moody's) was 1.75%. Scaling this up to reflect the higher volatility of equity markets in Italy (about 1.5 times as volatile as the bond market), this resulted in an added country risk premium for Italy of 2.63%. Added to the mature market premium of 5.8% (based on US), this yielded a total equity risk premium for Italy of 8.43%.
    a. Using the CDS market, estimate the new default spread and equity risk premium for Italy after February 26.
    b. Using the ten-year Italian government bond, estimate the new default spread and equity risk premium for Italy after February 26.
    c. The default spread on Spanish bonds also increased after the Italian election news hit. What would you read into that reaction?
2. When equity risk premiums go up, stock prices go down. So, it is no surprise that the MIB was down.
    a. Is there a way to evaluate whether the drop in the equity index is consistent with the change in the default spreads?
    b. If you were looking across Italian companies, in terms of their exposure to country risk, what companies will be most impacted by the increase in equity risk premiums? Which ones will be least impacted?