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This Is The Most Important Chart To Watch On Italy

by Tyler Durden
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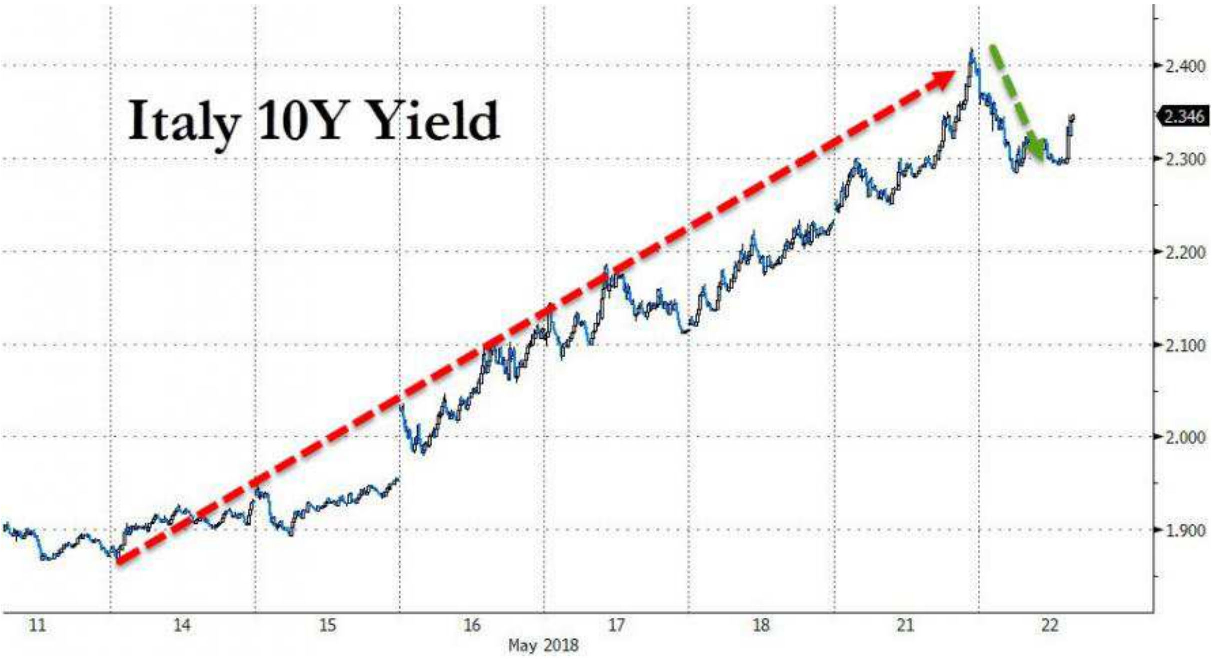
As traders arrive at their desks this morning across America, one could be forgiven for exclaiming *"I love the smell of relief rallies in the morning"* as Italian bond yields are lower and Italian bank stocks are not tumbling (for the first time since Five-Star and The League joined forces)...



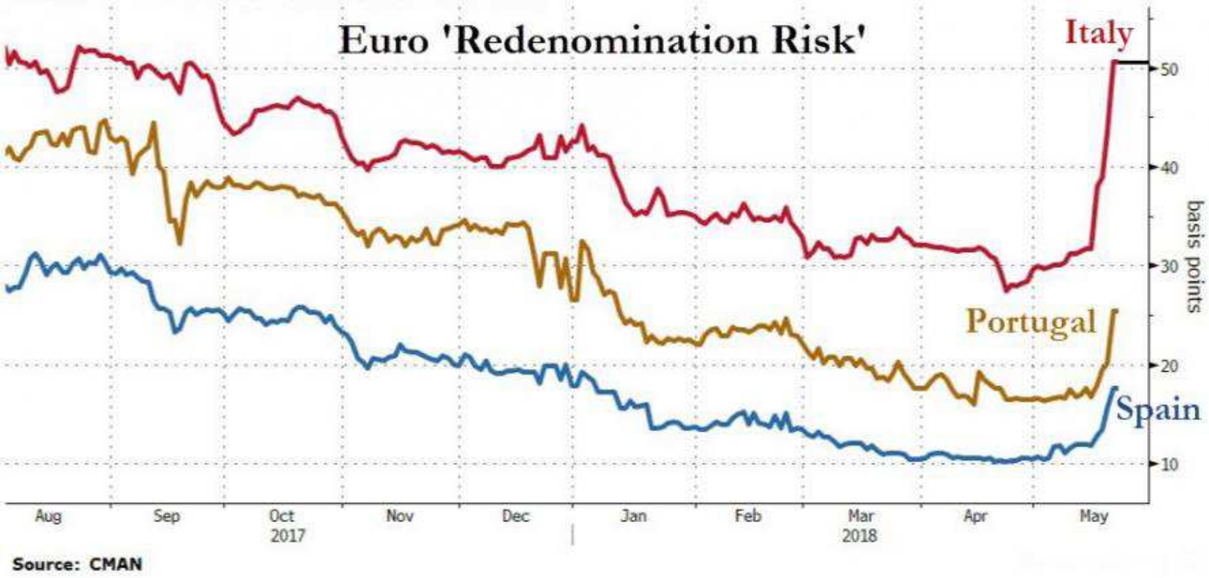
...and US equity futures are holding gains (from yesterday's Trump Trade Truce)...

There's just one thing...

The Italian crisis is far from over and the concept of [their 'mini-BoT' parallel currency] is throwing up **some very red flags about the future of the European Union**...
You just have to know where to look.

As Bloomberg's Tasos Vossos notes, **a gauge of euro re-denomination risk (based on the so-called 'ISDA Basis' in Italy's credit default swaps) blew out.**

What's more, redenomination risks are spreading as **the measure widened in Portugal, Spain, and in France** to a lesser extent, according to CMAN data.
As parallel currencies and debt-cancellation become serious discussion points for an Italian government, so European break-up risk is resurging.



Simply put, the higher this chart goes, the lower the market 'values' an Italian Euro relative to say a German Euro... and thus it is measuring the risk that the European Union - so long defended by Draghi et al. as indestructible - will break up.

As Marcello Minenna, head of Quantitative Analysis and Financial Innovation at Consob - the Italian securities regulator, previously noted, ***"markets do not lie... Italy must avoid remaining with short end of the stick. I wonder if our leadership will rise to the challenge."***

> *While the European Central Bank's commitment to defend the irreversibility of the euro is based as much on threats as on positive pledges, **financial markets understand the risks of "Italeave" even if the likelihood of the event is still judged to be low.***
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> *This can be seen in the data on credit default swaps (CDS), which offer protection in the case of an "insured event" or, in the jargon, a credit event. The widening gap in prices between different types of CDS contracts reflects the rising risk that some euro area sovereign debts may be redenominated into new, depreciating, currencies, which would probably lead to real losses for investors.*
>
> *To correctly interpret the data on CDS prices, we need a quick flashback to 2012, another year of great tension for the single currency. While the center of the crisis was in Greek sovereign debt and the Spanish banking sector, institutional investors had*

already begun to think of how to protect themselves from the danger of the euro's total dissolution, which might be prompted by the exit of a big country such as Italy or France.

Back then, there were no good options available. Buying CDS wouldn't have helped because the standard contract explicitly excluded debt redenomination from the list of credit events if the issuer were a member of the G7 or an OECD investment-grade sovereign.

Two years later, new ISDA standards entered into force: contracts made since 2014 protect against euro area countries redenominating their debt into new national currencies.

Strictly speaking, it's still possible to redenominate debt into a different currency without triggering a credit event, but this only works if the debt is switched into a reserve currency: the US dollar, the Canadian dollar, the British pound, the Japanese yen, or the Swiss franc. In all other cases, the only way to avoid the triggering of a credit event is if the switch to the new currency does not result in a loss for the investor: "no reduction in the rate or amount of interest, principal or premium payable".

Since 2014 two types of sovereign CDS therefore coexist: the old (ISDA 2003) and the new (ISDA 2014). The latter has always traded at spreads wider than the CDS-2003, but the difference (the ISDA basis) had generally been small *until: 15-25 bps for Portugal, 10-15 bps for Italy, 8-12 bps for Spain, 2-4 bps for France, and 1-2 bps for Germany.*

<u>The width of the spread between the two types of CDS - the ISDA basis - reflects both the perceived risk of redenomination risk and, in addition, the potential scope for depreciation in the event of a return to a national currency.</u>

This year, something has changed.