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MACROCOSM

Spanish Flu?

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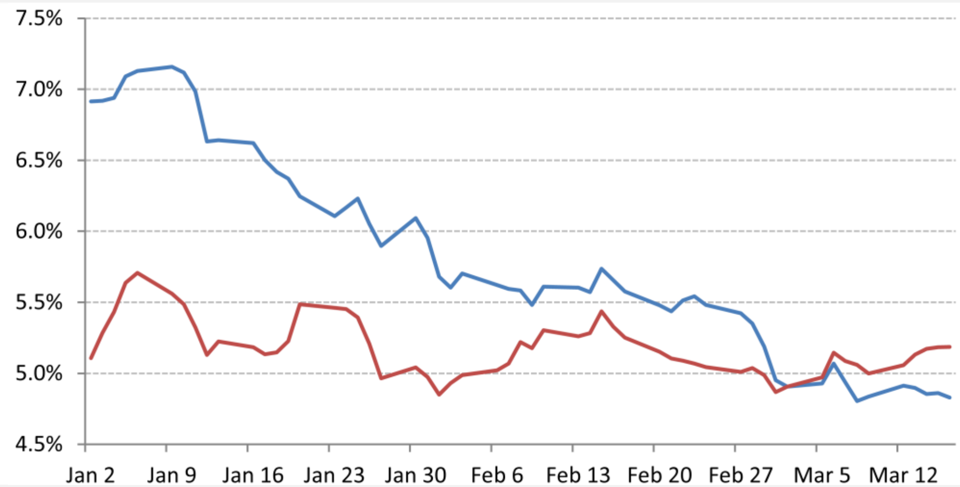
Spain is Europe's post-crisis laggard. If reform is sustained, it can catch up.

Yields on Spanish debt have risen above those of Italy in recent weeks (see chart below). This has been driven by short-term worries about Spain's deficit, but it also has important longer-term implications for understanding stock market investment opportunities across Europe.

10-year sovereign bond yield — Italy — Spain



Source: Bloomberg

Both Italy and Spain have started to implement structural reforms that had been avoided for too long, goaded to overdue action by last year's crisis (see "Europe's Supply-Side Revolution" February 17, 2012). However, while there are similarities between the problems faced by both countries, it is the differences that will drive their respective risk premiums.

- Spain is over-spending now -- high *deficit.* Italy has overspent in the past -- high *debt*.
- Spanish government debt is the lowest of major euro area economies as a share of GDP. Italy is currently running a primary budget surplus.
- The Spain's unemployment rate is 23.3%. Italy's is 9.2%.

Update to strategic view

EUROPE MACRO, EUROPE STOCKS, EUROPE BONDS: Spanish debt yields have moved higher than Italian yields, and Spanish stocks have underperformed Italian stocks. While superficially the two economies face similar problems, Spain has the extra drags of a property overhang, higher current deficit and higher unemployment. If current reforms aimed at these problems are sustained, then the Spanish stock market will move from being the laggard of the major euro area indices to regain previous crisis era highs, with Spanish 10-year bond yields at least keeping its 5-handle.

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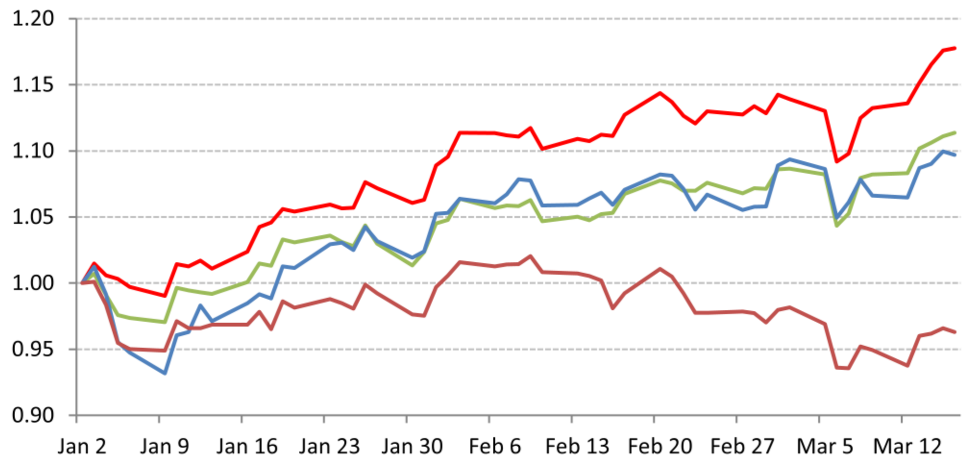
- Spain still has a [major real estate headache](), with the property market yet to clear amid continuing falling prices. Italy did not have a property bubble in the last business cycle, so it does not have the same overhang.

Taking the list above, things do not look good for Spain, and this has been reflected in the performance of Spain's IBEX market index --- the laggard among major euro area indexes so far this year (see chart below).

Stock indices — Italy MIB — Spain IBEX — Germany DAX — France CAC
Indexed to 1 at 1/2/2012



Source: Bloomberg, TrendMacro calculations

None of this means that Spain is going to be another Greece. The newly elected Prime Minister Mariano Rajoy was elected on a reform agenda, and is pushing those reforms through, despite heavy union protest (see "Unquestionable Success?" March 9, 2012). Rajoy's center-right People's Party has a reasonably strong majority, and does not need to rely on the support of a coalition partner to implement legislation.

The major reform is to shake up the rigid labor market in Spain -- similar to Mario Monti's moves in Italy, and very much along the lines of the German Agenda 2010 template (again, see "Europe's Supply-Side Revolution").

- For full time employees, maximum severance pay has been reduced by 25%, making it cheaper for companies to fire non-productive full time staff.
- Wage agreements in Spain are made at the national level. This means that wage rises are not linked to productivity. Rajoy's government has allowed companies to opt out of these national agreements.
- Youth unemployment in Spain is 49.9%. This is due to the huge difference between the entitlements of permanent and contract staff. If employers are unable to *fire* full-time staff, then they are -- as the data shows -- unwilling to *hire* full-time staff in the first place.

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Recommended Reading

Greece Is Making Historic Reforms
Vassilis Kaskarelis
Wall Street Journal
March 16, 2012

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These reforms are critical for Spain to return to growth. Yes, Spain's export sector is already showing signs of improvement, with exports up 11% year-on-year in 2011. But exports only account for 20% of Spain's GDP. Spain does rely heavily on the tourist sector, therefore despite low exports as percentage of GDP, it is heavily reliant on external demand.

- But labor market reforms need time to work, as the German experience from 2003 shows. After the introduction of the Agenda 2010 reforms in Germany, unemployment went up for two years, as employers cut unwanted staff. But employers realized that if employees are easier to fire, they are also less risky to hire. This supply-side reform has been a major factor in transforming the German economy into the best-performing in the developed world. But it takes time. As in Germany, Spain's already high unemployment will have to go up before it goes down. Once the short-term pain of labor market reform has been digested, we still wouldn't expect to see Spanish unemployment in single digits. But changing expectations of both employees and employers is a proven recipe for labor market success.

With the gift of time provided by the ECB (see "How Big was the LTRO, Really?" February 29, 2012) and the euro area recession forecasted by the ECB to be a shallow one, it seems that Spain has the necessary external factors in place to allow Rajoy's reforms be effective.

It is internal Spanish factors that are the biggest threats.

- The Spanish property market still needs to clear. In February, the Spanish Central Bank announced a further €50 billion to help banks restructure legacy property loans. According to the Bank of Spain, this will bring the total restructuring to €155 billion since the property market started to collapse in 2008. As part of the plan, the Fund for Orderly Bank Restructuring (*Fondo de Reestructuración Ordenada Bancaria*, or FROB) can take shares in institutions in exchange for capital. For the *cajas* (Spanish mortgage banks similar to US savings and loan institutions) that are unlikely to remain independent, mergers, takeovers and administration are the preferred solution.
- Vested interests oppose the reform process. Labor unions have already protested against Rajoy's measures, and a national strike has been called for March 29.
- Spain agreed under European Union pressure to a deficit target of 5.3% for 2012 at last Monday's Eurogroup (euro area finance ministers) meeting. This is 0.5% of GDP lower than Rajoy's previously announced target of 5.8% for 2012. The perception internally of outsider-imposed further austerity coupled with very high youth unemployment raises the outlier risk of the kind of social breakdown we have seen in Greece.

We do not view the union threat as significant -- only 20% of Spanish employees are union members -- and while there is no denying the scale of Spanish youth unemployment, protests from that sector have been limited.

The future of the Spanish economy, in the immediate term, is going to be driven by the Spanish property market, and the ability of the Spanish banks to work through their property loan books.

In the medium to longer term, it will be based on the effective implementation of the supply-side policies that have become the template for reform across Europe.

We think the Spanish stock market will recover in the medium term. It is strongly contingent on the FROB banking reforms taking effect. But it needn't be derailed by a short-term increase in unemployment, provided that is only the price paid for long-term pro-growth labor reforms. Spanish stocks should -- at least -- catch up with those of Italy, Germany and France in their post-crisis recoveries.

Bottom line

Spanish debt yields have moved higher than Italian yields, and Spanish stocks have underperformed Italian stocks. While superficially the two economies face similar problems, Spain has the extra drags of a property overhang, higher current deficit and higher unemployment. If current reforms aimed at these problems are sustained, then the Spanish stock market will move from being the laggard of the major euro area indices to regain previous crisis era highs, with Spanish 10-year bond yields at least keeping its 5-handle.