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Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist
John Clinton, Principal

MACROCOSM

A Spaniard in the Works

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Lorcan Roche Kelly

Spanish fears take the forefront, but it's just part of Europe's painful equilibrium.

With Spanish sovereign bond yields rising, and Spanish stocks making new lows for the year, is Spain now ushering in a new chapter in Europe's ongoing financial crisis? The answer is both "yes" and "no."

- "Yes," it's a new chapter in the crisis. As we have said so many times, the fundamental nature of Europe's crisis is to be ongoing -- because crisis is necessary to sustain the difficult twin reforms of labor market liberalization and political integration. We called the bottom in sovereign bond yields for Europe's troubled periphery a month ago precisely because the crisis had receded so much it was inevitable that reform would stall (see "Unquestionable Success?" March 9, 2012).
- "No," because another chapter in the ongoing crisis will in turn restore the needed urgency for reform.
- Such is the unpleasant duality of Europe's equilibrium.
- The ECB has the tools to keep any incipient crisis from spinning out of control and ruining the very reforms they would otherwise encourage.

As to Spain specifically, we have called it the laggard of the euro area (see "Spanish Flu?" March 16, 2012), and we have already focused on two ways in which reform there has stalled (see "Crunch Time for Reform in Europe" March 28, 2012). The Spanish budget was a disappointment in that the measures it targeted -- tax rises, spending cuts -- can be seen as traditional "austerity."

- The budget contained little to improve investor sentiment. There were reductions in allowances on corporate tax, which will increase the cost of doing business.
- There was a freeze in civil service wages, which is a positive move in the face of union protest, but this only affects the public sector, not the private sector.
- Add to this the defeat of reformist Prime Minister Mariano Rajoy's People's Party in the Andalusia regional election -- an election he was expected to win -- and things in Spain seem to have taken a step for the worse.

Update to strategic view

EUROPE MACRO, EUROPE STOCKS, EUROPE FINANCIAL STOCKS, EUROPE BONDS, ECB: Spain is once again under the gun, with bond yields rising and stock prices falling. We view this as a natural correction to the excessive euphoria in the wake of the LTRO operations, an over-reaction to a disappointing budget, and exaggerated worries about the banking sector. Yes, Spain still has the flu, and will take a long time to recover -- but it is nothing terminal. At new 12-month lows, Spanish stocks are an interesting contrarian trading play. But they are not a powerful value proposition, because forward earnings have fallen sharply and bond yields have risen. Euro area banks, broadly, are the more attractive strategic play.

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However, these disappointments have a context:

- The difference between any short term measures and the longer term structural changes being made in the Spanish economy is important.
- The government has introduced historic labor market reforms (again, see "Spanish Flu?" March 16, 2012), and is implementing the supply-side measures called for by ECB President Mario Draghi (see "On the April ECB Rate Decision" April 4, 2012).
- Deep structural changes take time to implement throughout the economy, and then to bear fruit. In the case of the German Agenda 2010 reforms introduced in 2003 (see "Europe's Supply-Side Revolution" February 17, 2012), it took two years of rising unemployment before improvement finally started to kick in -- and when it did, the results were spectacular.

So is it best to ignore Spain for the next two years and allow its reform process to bear fruit? No, we think to wait would be to miss the opportunity. In Germany in 2003, the stock market rallied from the start of the process. So far just the opposite has happened in Spain, where there is no doubt that things are more difficult now than they were for Germany in 2003. Spain is heavily reliant on external factors -- such as a return of global growth, which Germany was fortunate enough to enjoy in 2003 -- to support its domestic recovery.

But there are other external factors working in Spain's favor.

- In 2003 Germany's recovery was helped by ECB monetary policy, with interest rates at 2% between June 2003 and December 2005. Spain has even lower ECB policy rates -- currently at 1% -- and also an ECB that is much more interventionist than it has ever been.
- The ECB has been positive about Spanish reforms, and today even hinted that the Securities Markets Programme -- in which the ECB buys sovereign debt from the market -- could be reactivated from its months-long dormancy to aid Spain if yields move too adversely.
- There is also support from other EU institutions. The European Commission seems set to unveil a growth plan that is in line with the supply-side measures introduced in Spain. Support from the Commission is important for Spain, considering its recent disagreements over budget deficits.

What about the Spanish banks, which have been widely regarded for several years as terribly vulnerable to Spain's enfeebled housing sector?

- We remain confident in the largest Spanish banks. It is already clear that the smaller *cajas* are going to need continued support (again, see "Spanish Flu?" March 16, 2012). But while this will lead to unhelpful noise, the largest Spanish banks are cautiously optimistic.

Contact TrendMacro

On the web at
trendmacro.com

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Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland
212 537 9067
lorcan@trendmacro.com

John Clinton
Charlotte NC
704 552 3629
jclinton@trendmacro.com

[About us]

- While the ECB LTRO-led rally in sovereign debt has faded for good reason (again, see "Unquestionable Success?"), we still think the sell-off in the banking sector is overdone. Euro area banks are once again being priced as though they will be destroyed in a Lehman-type funding crisis -- yet the LTRO operations are a 3-year advance commitment of funding that virtually rules out that risk. They deserve to be priced at least as zombies -- not as though they were completely dead.
- The current chatter is that the banks have made a mistake by buying sovereign debt to do the "carry trade" -- that they've just dug themselves deeper by increasing their already large commitment to what are arguably very risky assets. Yes, they have increased that exposure -- but we are confident that the ECB's stabilization of the banks is a gift of time that will allow countries like Spain and Italy to stabilize their fiscal profiles -- in which case the banks have three years of spreads to earn with the ECB's money.

Bottom line

Spain is once again under the gun, with bond yields rising and stock prices falling. We view this as a natural correction to the excessive euphoria in the wake of the LTRO operations, an over-reaction to a disappointing budget, and exaggerated worries about the banking sector. Yes, Spain still has the flu, and will take a long time to recover -- but it is nothing terminal. At new 12-month lows, Spanish stocks are an interesting contrarian trading play. But they are not a powerful value proposition, because forward earnings have fallen sharply and bond yields have risen. Euro area banks, broadly, are the more attractive strategic play.