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MACROCOSM

SpanDax

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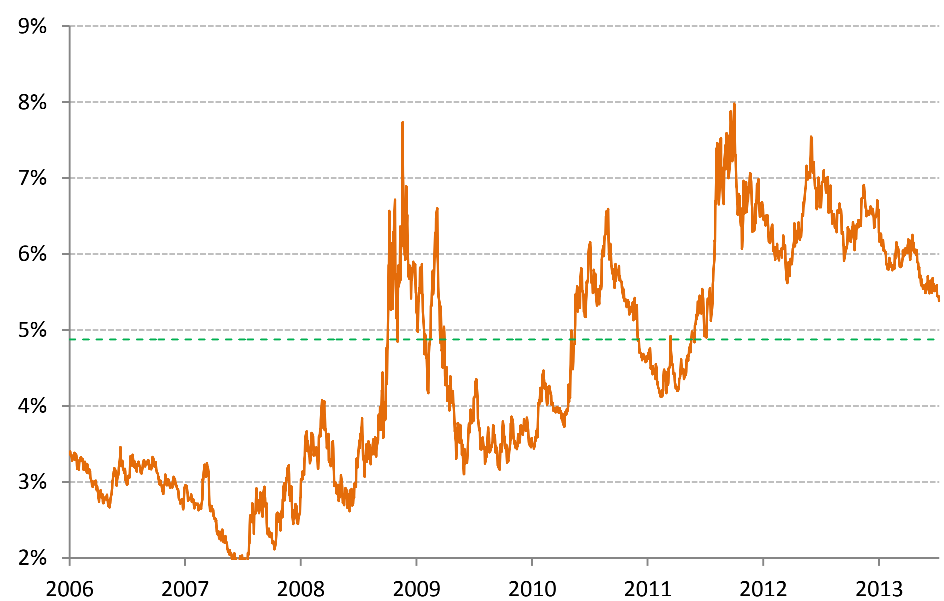
Spanish bonds and German stocks are best for a summer of euro area muddle-through.

Despite Portuguese political troubles, an Italian downgrade and Bundesbank President Jens Weidmann's continued mealy-mouthedness, Mario Draghi's recent timid venture into forward guidance may be enough to give the euro area a crisis-free summer ahead of the German elections in September (see "On the July ECB and BOE Policy Decisions" July 4, 2013 and "Bundesblock" June 19). At least by the standards of the previous four years.

In the absence of crisis, we favor a euro area debt-and-equity pair that have virtually been a slogan for our overall bullishness on the region: German stocks and Spanish sovereign bonds.

- The equity risk premium (ERP) for Germany's DAX is the only one in the euro area that is currently above its crisis era mean (please see chart below).

— DAX equity risk premium --- Crisis-era mean
Consensus forward earnings yield minus 10-year bund yield



Source: Bloomberg, TrendMacro calculations

Update to strategic view

EUROPE STOCKS, EUROPE BONDS: Spanish sovereign debt and German stocks have the best upside in the euro area across the summer. Most downside risks are off the table in a summer of euro area muddle-though ahead of Germany's September elections. In that environment Spain offers the least risk for the most reward among peripheral sovereigns, and German equities will continue to melt up on valuations, if nothing else.

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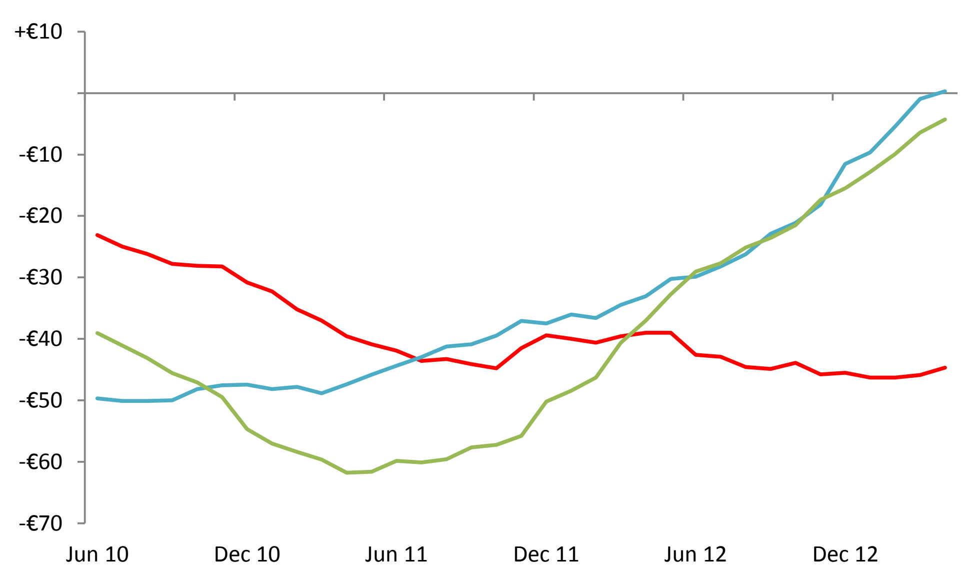
- The DAX has underperformed both the S&P 500 and the UK's FTSE 100 in 2013, and despite making a new all-time high in May, still has considerable upside with a price/book ratio of 1.49, compared to 2.47 for the S&P500 and 1.88 for the FTSE 100 -- and a forward price/earnings ratio of 11.1 compared to 14.3 for both the S&P and the FTSE.
- Spanish sovereign debt -- currently yielding 4.8% on the 10-year -- still carries a large risk premium that does not reflect the reality of Spain's fiscal situation.
- Until recently, there have been two big risks facing peripheral sovereign debt -- default and "convertibility risk."
- The stock of Spanish debt -- projected to be over 91% by year-end 2013 -- is certainly not high enough to suggest an imminent default. Neither -- following Draghi's "whatever it takes" speech (see "On Draghi in London" July 26, 2012) -- is "convertibility risk," that is, the risk of a euro currency break-up, which if it did occur would be a catastrophe for peripheral debt.
- In the past two months Spain has gotten agreement from the euro area on a one year extension on its deficit target and a €30 billion contingency in case of further problems with its banks.
- The Spanish economy is showing signs of emerging from its long economic crisis. Its 12-month trailing current account has just turned positive (please see the chart below), the government has been shielded from its troubled banking sector by the bank bailout,

Current account EUR billions, trailing 12 months **Italy** **Spain** **France**



Source: Bloomberg, TrendMacro calculations

and though it is early days yet, the labor market finally seems to be starting to turn the corner.

- *The risks that drove the yield on the 10-year from 4.8% in March 2012 to over 7.5% by July 2012 simply do not exist anymore.*

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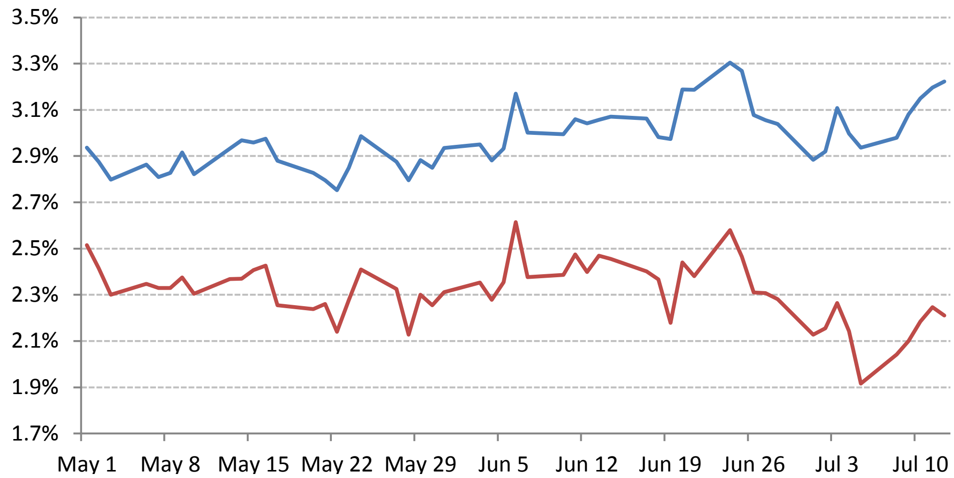
- Interestingly, despite the recent widening of spreads between Spanish debt and the German bund, there has been no widening of the Spain/US treasury spread (please see chart below).

10-year bond spread — Spain-Germany — Spain-US



Source: Bloomberg, TrendMacro calculations

- While it is true that similar arguments can be made for even higher yielding Portuguese debt, we think that the liquidity in the Spanish market, and the political stability of the Spanish government, trumps the extra yield that could be earned in Portugal.

Bottom line

Spanish sovereign debt and German stocks have the best upside in the euro area across the summer. Most downside risks are off the table in a summer of euro area muddle-though ahead of Germany's September elections. In that environment Spain offers the least risk for the most reward among peripheral sovereigns, and German equities will continue to melt up on valuations, if nothing else.