Spain in Detail

23rd April 2012

In our estimation Spain's situation will almost certainly require some form of intervention by the ECB. The Spanish situation is dire and should result in the Spanish bond yields moving a lot wider without intervention. At the heart of the Spanish crisis is an enormous property bubble and the economy that Spain built around it.

Spanish delinquent loans stand at 8.6% (of 1.4 trillion Euro), up from approximately 7.5% as at 31 December 11. At the peak of the Spanish housing boom there were more houses being built in Spain than the rest of Europe put together. The key issue is that Spanish banks are providing forbearance to households; this is heavily distorting the numbers around true arrears and foreclosures. These numbers seem set to rise a lot further.

This is now coming to a head as the ECB is pushing through laws to limit forbearance by requiring banks to properly provision for bad and doubtful debts. The ECB view is this is fundamentally important to address the crisis in confidence that has impacted the European interbank market. The Spanish banks receive approximately 9% of their capital from the ECB (compared to Ireland and Greece at 11 to 12%), conversely Euro core banks from Germany, Netherland and France receive only 1 to 2% in funding.

This has put the Spanish government in a difficult situation. The collateral (property) is already off 30-40% from its 2007 peak, obviously the market would be incapable of absorbing a significant amount of new supply, plus it would be a difficult call to foreclose on 10-15% of the population, so the solution then becomes Prime Minister Rajoy's proposed code of practice, which encourages banks to forgive debt on a means tested basis. One way or the other the ECB laws will lead to these assets (loans) being written down. The big discussion is around whether the Spanish government will legislate this or not? If it is legislated it will vaporize the holders of securitized debt as well as leading to significant bank write downs, this has already been foreshadowed by last week's announcement by the Prime Minister around the requirement for Spanish banks to raise an additional 40 to 50 billion in capital.

Ultimately the likelihood is that this debt will be transferred to the government and more specifically the Spanish taxpayer through deeper and harsher austerity. This could well increase the Spanish Government debt to GDP from approximately 70% closer to 100% (after adding 8.0% of deficits and working on the assumption of a 5% reduction in GDP).

The other side of the coin relates to the Spanish economy and the likely impact of fiscal withdrawal. Spain ran a $61 billion trade deficit in 2011 (176 of 210 countries on a relative basis and one of the biggest trade deficits in the world in absolute terms). There have been no profound labour market reforms as yet; in addition, cuts to their public service have been limited as is evidence by the significant deficits being run by their regional governments (currently 14% of GDP and rising). Regional governments in some areas are providing real resistance against cuts, (people sometimes forget that Spain is a union within a union).

Spain is pre-severe austerity, unlike the Greeks who are now more than a year into this odyssey. As the Greeks realised the first cut isn't necessarily the deepest, unfortunately for Spain this isn't as bad as it gets. Meeting their budget target would require 30 billion in savings, however perversely as GDP is sucked down the debt spiral the absolute saving required rises to make up for an absence of revenue.

The problem for the Spanish economy was that it was driven by property and the wealth it created, while construction provided 16% of GDP and employed 12% of the workforce the multiplier effect was significantly larger. The only way forward now is to focus on productivity and competitiveness, which comes in the form of currency devaluation (not currently an option) or microeconomic policy and reform. Without the luxury of devaluation to re-invigorate areas such as agriculture, tourism and manufacturing this will be a long arduous road without a clear end in sight.

All of this is known to most market participants, with the question not about whether Spain is or is not insolvent but rather what the European Union will do about it? The spreads should in truth be a lot wider than where they are if Spain's bonds were left to trade on fundamentals, however there are plenty that are betting that too big to fail applies here and as a consequence the ECB/FED/BOJ/IMF/PBOC are all bail in.

In essence it is about providing a credible threat to the shorts, more specifically placing doubt in the minds of bears by virtue of how governments and the European banking sector could conspire to supress yields in the event that Spanish spreads went on a greater run.

In many ways it's a game of momentum, pre LTRO Spanish 10-year bonds surged to 6.75%, it seemed that they were well on the way to a bailout however LTRO changed that in two ways.

By providing cheap money to banks and taking sovereign bonds as collateral, this allowed banks in troubled jurisdictions like Spain to borrow and buy Spanish government debt, thus providing the liquidity required to drive down spreads.

By providing clear evidence of the ECB's will and ability to act.

While the impact of the first factor has already seemingly worn off, the second factor remains an implicit threat for those traders and investors who are looking to go short on the basis of fundamentals. As such while spreads have run, they haven't exploded, despite a wide array of negative information coming through.

In the centrally managed world, what the government does next (or the ECB in this case), is just as important as the fundamentals.

That said the momentum of market data is very likely to drive spreads to test the implicit threat of action. What is that level, how long do spreads have to stay there and what will action look like are all key questions?

Our feeling is that the sheer size of Spain means that another meaningful surge in spreads that threatens sustainability will push the ECB to make the European cross collateralization either explicit (through a guarantee), non-existent (a pre-cursor to the end of the EU leading to denomination risk as well as a likely haircut on the face value) or conditional (a Greek type scenario where there is a mediated default or a scenario where inferior Spanish bonds are replaced for superior Euro area bonds on some kind of formula). There are a myriad of considerations and potential outcomes here such as bond contracts, CDS triggers, structural political factors (like the need for referendums) to name but a few.

The ramifications of a spread surge would result in a meaningful risk off mood which would impact spreads and carry trade performance through rising interbank and funding stress. The current trading level of Spanish sovereign and bank CDS does not seemingly capture the potential severity of this outcome, despite having risen strongly already. Our view remains that this will likely lead to the usual risk off response across rates, paper and currencies.

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