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THE EU PERIPHERY: SPAIN, PORTUGAL & GREECE: TIME TO INVEST CAUTIOUSLY

Summary

- The fact that the ECB promised to "do what it takes" to remove the threat of a sovereign crisis did not mean a guaranteed path to recovery, but it did remove the extremes of risk from fixed income and equities. The macro performance of the three most afflicted economies in the region, Spain, Portugal and Greece are all very different, although all three are far from recovered or back to normal.
- In pure macro terms Spain has done best followed by Portugal, and then trailing, Greece. Their equity markets are among the best in the EU and their sovereigns offer attractive yields although they are becoming quite expensive.

Investment Conclusions

- The recovery phase of economies which experienced deep recession, supposedly, offers attractive investment opportunities. That assumes that the factors which caused the recessions to start with have been eliminated. Spain, in relative term, seems to have done better in the reform process than Portugal, let alone Greece. Spanish and Portuguese sovereigns are now expensive but Greece's offer high returns for suitably structured high risk portfolios subject always to the threat of a weaker EUR
- Buying cyclical equities in Spain should be focused and modest

Cyclicals first and then policies

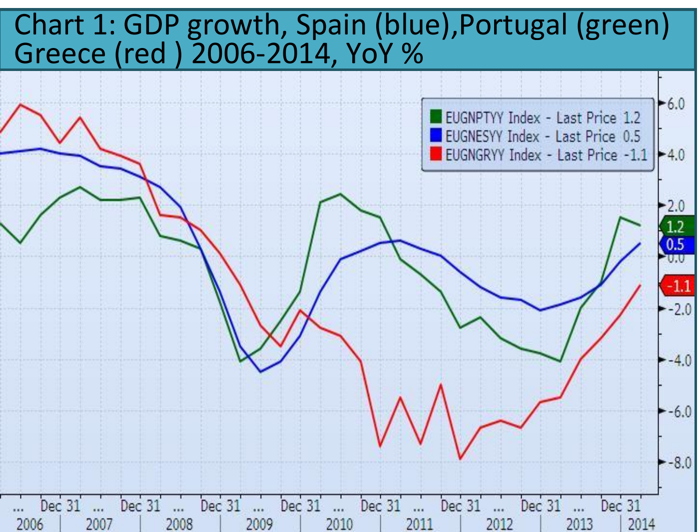
In purely macro GDP growth terms **Spain** exited recession about a year ago when it last registered two consecutive QoQ negative growth rates. As Chart 1 shows GDP growth, still modest but positive, appears to be on accelerating path. Inflation has been decelerating but has not entered yet to deflation, one of the key concerns of the ECB. Unemployment, however, remains extremely high, 26.0%, and might be peaking but may take a lot to actually decline. With youth unemployment of particular concern, the recovery in Spain will remain a politically sensitive issue as long as more than a quarter of the labour force is not participating, and the benefits of the tough labour reforms and fall in real wages are not yet obvious in terms of creating more jobs.

In January 2014 Spain exited from the EU bank bailout and its banking system has been strengthened through special funding and additional prudential rules. Political difficulties still remain with Catalonia insisting on independence and a new king taking over in order to open a new page on the Spanish royalty which had been plagued by scandals. The government has a stable majority in Parliament with no prospects for election for at least another 18 months

Portugal also exited from the EU-IMF bailout scheme in May this year and has been to able to sell bonds in the markets.The economy, however, registers a very volatile GDP growth on a QoQ basis, pushing the economy to negative growth in 1Q14, and with inflation slipping to deflation in ealry 2014.

Unemployment, however, is better than Spain's or Greece's at 15.0%. The government has a solid majority in Parliament but it is still faced with a series of politically sensitive reforms.

Chart 1: GDP growth, Spain (blue),Portugal (green) Greece (red) 2006-2014, YoY %



Source: Bloomberg

Is Greece still unstable ?

It is difficult to forget that Greece's default triggered the sovereign crisis in the EU and the subsequent soul-searching over the economic and financial stability of the EU. Greece is still under the "troika" control and continues to receive funding under the European Financial Stability Facility, a tranche already received in April this year with more to come in June and July, subject always to compliance with preset economic and administrative reforms.

GDP continues to shrink, albeit at a slower rate (Chart 1) but deflation is persisting since 2013.Unemployment seems to have flattened out rather than peaked at 27.4% with equally distressingly high youth unemployment. Not surprisingly retail sales growth have been shrinking since 2010, although the current account is now improving. The budget is now registering a primary surplus, that is after paying for all expenses other than for debt, there is a surplus left over which can be used to pay interest and redeem debt.

The probability of Greece defaulting again is now quite small not only because of the improvement in its fiscal management and the emergency measures instituted by the ECB, but also because most of the Greek sovereign debt is in the hands of the IMF and of ECB and so a default would become an "internal" affair as it would not involve private financial institutions.

As Chart 2 shows the yields of the Spanish sovereigns have now dropped to 10Y UST levels !

FACTBOX : Greece- take a scissor to the deficit

In 1922 the Greek state was in dire straits after it had been defeated in an ill-advised all-out war against Turkey. Unable to borrow from anyone, the state resorted to an extraordinary measure. It legislated the cutting in half of all banknotes. Half of the note continue to act as paper money, but at half its value, while the other half was declared void for transactions and was forcibly exchanged for a 20Y government bond ! The issuing bank had its cash liabilities cut in half, but it promptly made them up by printing an equivalent amount which it lent to the government. Simple. The "experiment" was repeated in 1926 on an unsuspecting population!

Chart 2: Yields of 10Y govt bonds,Germany (red) Spain (orange),Portugal (green),Greece (blue)

Source: Bloomberg

Where and what to invest

The yields of the sovereigns of Spain and Portugal are low enough to raise the issue of their competitiveness versus UST yields given also the likelihood that further easing by the ECB may, finally, cause the EUR to weaken, especially if rises in USD rates are imminent. This leaves the high yielding Greek sovereigns where the main concern would be default-still unlikely- and a weaker EUR. The latter however would also impact equities.

All the three economies have strongly performing equities (YTD in USD terms), indeed easily the best in the EU bar Denmark. The Eurostoxxx stands at ytd 4.8% with a 12M forward P/E of 14.7 and P/B at 1.5. The IBEX index clocks at 11.2 ytd with 17.7 and 1.5 metrics respectively, while the figures for Portugal are 11.4 % with 26.8 and 1.4 and, last but not least, the Athens ASE index at 8.3% ytd with 45.9 and 1.2 metrics respectively. Clearly Athens is way too expensive as is Portugal, which leaves Spain as a pro-cyclical play with a strong export sector. (Research completed on 24/6/14)