

Here we go again? – the pain in Spain and other annoyances

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Key points

- > After strong share market gains in the March quarter a correction or rough patch was inevitable and we now may have entered just that, particularly with the Euro-zone debt crisis making a bit of a comeback. Spain and Italy certainly remain high risk and further volatility is likely.
- > However, better share valuations, easier global monetary conditions and less risk of a Euro-zone banking meltdown suggest any share market correction should be less than the 15-20% falls seen following April highs over the last two years.

Introduction

This year started on a strong note with global shares up 11% in the March quarter, Asian shares up 12% and Australian shares up 7%. However, investors could be forgiven for getting that “d  ja vu all over again” feeling. Share markets also had solid runs into April 2010 and April 2011 only to be dragged lower by flare ups in the Euro-zone debt crisis, worries about a double dip recession in the US and concerns about a hard landing in China. And here we are again with worries about Spain, softer employment data in the US and ongoing concerns about a hard landing in China making it feel like the start of an eerie replay of the last two years. From the April 2010 high, global and Australian shares fell around 15% & from the April 2011 high they fell around 20%.

China has certainly slowed but with inflation trending lower and property prices coming down there is plenty of scope for the authorities to ease and ensure a soft landing, which is what we think they will do as there is no stomach in China for a job destroying hard landing and associated social unrest.

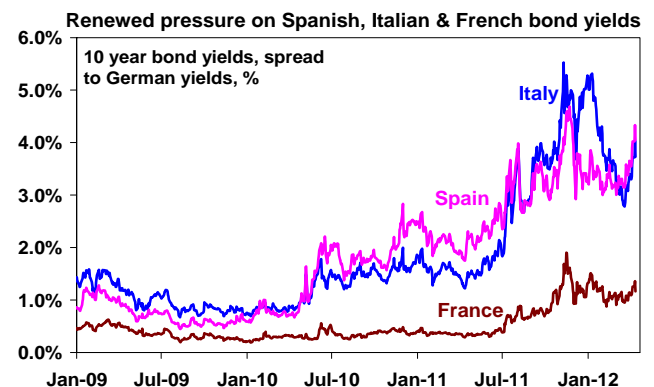
In the US, while March payroll employment growth was far less than expected, monthly payroll data is notoriously volatile. A downside surprise was inevitable after months of upside surprises, and jobless claims & various business and consumer surveys suggest the job market is still strong.

By contrast Spain and the wider problems in Europe are judged a more serious threat and are worth taking a look at.

Other worries in the Euro-zone

During the second half of last year it was increasingly feared the Euro-zone debt crisis was spreading to Spain and Italy. However, the last four months or so have seen a lull in the crisis as the European Central Bank provided super cheap 3 year funding to European banks (removing the threat of a GFC style crisis where they couldn't get funding), Greece received another bailout and a substantial debt write down and Europe increased the effective size of its debt firewall. The improvement in Europe was illustrated by a fall in the spreads between Italian, Spanish and French bond yields on the one hand and German bond yields on the other.

However, over the last month these spreads have started to blow out again, particularly in Spain where the 10 year bond yield has jumped 100 basis points since early March when the Spanish Government announced it will not meet its 2012 budget deficit goals agreed with the EU.



Source: Bloomberg, AMP Capital

Four key threats remain in Europe and are likely to ensure a bumpy ride in global financial markets. First, Greece is still likely to struggle to meet its deficit reduction targets as the economy continues to contract, possibly leading to an eventual default if Germany says no to any more handouts and/or a new Greek Government post the upcoming elections decides it has had enough. Our assessment remains that provided the rest of Europe is reasonably stable, Greece is becoming less of a threat as private sector exposure to it has diminished with write downs etc. But it's still a source of volatility.

Second, the French presidential election starting later this month could see a Socialist victory with President Sarkozy trailing in the polls for the May run-off. This could weaken France's commitment to the fiscal compact agreed with Germany and the adoption of even less growth friendly policies. French shares fell by a third when their last socialist president, Fran  ois Mitterrand, was elected in 1981.

Third, tighter conditions in Germany with a 20 year low in unemployment and interest rates well below inflation could yet again prevent the ECB from acting quickly enough if trouble blows up in the peripherals again.

Fourth, conditions could deteriorate further in Portugal, Spain and Italy. At the moment this is the bigger threat.

The pain in Spain

For some time it's been thought Portugal will require further EU/IMF assistance. This is likely to be granted as Portugal is seen as having delivered on agreed reforms, it's not seen as “accident prone” like Greece, Germany has already signalled a willingness to provide further assistance and the amount of money required to fully fund Portugal out to 2014 is low. And as shown in the next table Portugal is small, accounting for just 2% of Euro-zone GDP and public debt.

Spain is a different story as it accounts for 11% of Euro-zone GDP and 9% of its debt, more than double the size of Greece, Portugal and Ireland combined. Spain actually has a

relatively low public debt to GDP ratio of less than 70%, compared to 88% for the Euro-zone as a whole. However, investors are concerned about it for two reasons. First, Spanish banks are vulnerable with a €60bn exposure to Portugal, a high level of non-performing loans and a high vulnerability should Spanish house prices keep falling. A Government recapitalisation of Spanish banks will add to public sector debt, as in Ireland. Second, the Government is struggling to bring its budget deficit (8.5% of GDP in 2011) under control. While it has announced significant budget cutbacks the deficit is still projected to be 5.3% of GDP this year as against a previously agreed target of 4.4%. Furthermore, the economy is already in deep recession, with unemployment of 23.6% and youth unemployment near 50% and so the Government faces a very difficult balancing act in trying to ensure that fiscal austerity doesn't just result in a worse budget deficit.

Euro-zone (EZ) public debt and GDP compared

Sept 2011 data	GDP, billion euros	%of Euro-zone total	Gross public debt billion euros	% of GDP	% of Euro-zone total
Austria	297	3	214	72	3
Belgium	365	4	361	99	4
Cyprus	18	0	12	68	0
Estonia	16	0	1	6	0
Finland	189	2	89	47	1
France	1987	21	1689	85	21
Germany	2549	27	2090	82	26
Greece	218	2	347*	159	4
Ireland	154	2	162	105	2
Italy	1570	17	1884	120	23
Luxembourg	42	0	8	19	0
Netherlands	598	6	389	65	5
Portugal	173	2	190	110	2
Slovakia	69	1	29	42	0
Slovenia	36	0	16	44	0
Spain	1070	11	706	66	9
Total	9357	100	8191	88	100

Source: Eurostat, AMP Capital. * Before the private sector debt haircut.

And if Spain gets into serious trouble, it's hard to see Italy remaining immune as it has a smaller budget deficit but a higher public debt to GDP ratio and is also facing a serious recession. So there's still plenty to worry about in Europe.

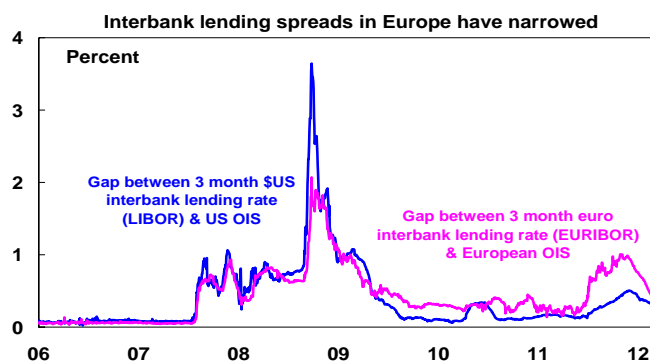
Some offsetting positives

However, there are several positives compared to a year ago when the Euro-zone crisis last flared up in a big way.

First, Spain is solvent at reasonable levels for borrowing rates (unlike Greece), the Euro-zone's expanded rescue fund with €500bn in fresh funding has enough to fully fund Spain's borrowing needs out to the end of 2014 (€245bn) should it need a bailout, and even if the Spanish Government has to recapitalise its banks it would only boost public debt by 8% of GDP (ie it would still be below the Euro-zone average).

Second, the provision of cheap 3 year funding to European banks under the ECB's 3 year LTRO program has substantially reduced the risk of banks not being able to fund themselves. In this regard it's worth noting that interbank

lending spreads (the difference between what banks charge to lend to each other and expected official short term interest rates) remain well below last year's high. See the next chart.



Source: Bloomberg, AMP Capital

Third, the US economy is arguably in better shape than was the case a year ago with labour market indicators looking stronger, the housing sector looking like it's bottoming and the manufacturing sector hasn't been hit by the supply chain disruptions that followed the Japanese earthquake.

Fourth, China is now gradually easing policy whereas a year ago inflation was still rising (to a peak of 6.5% last July) and it was still tightening.

Fifth, share markets are cheaper than at their April 2010 and 2011 peaks in terms of the earnings yield pick up they provide over Government bonds. Also, bond yields are much lower than they were a year ago suggesting far less scope for capital growth and returns from bonds. For example, the US 10 year bond yield is now 2% whereas in April 2011 it was around 3.5%. Likewise, the Australian ten year bond yield is now 3.9% compared to around 5.5% in April last year. Similarly, Australian shares have been running around 4300 on the ASX 200 compared to near 5000 in April last year and commodity prices are far lower than they were a year ago, eg base metal prices are around 20% lower.

Finally, global monetary conditions are easier with central banks easing whereas a year ago central banks in the emerging world, the ECB and Australia were tightening.

So where does all this leave investors?

After strong gains through the March quarter, it was inevitable share markets would hit a rough patch. Further volatility and weakness is possible over the next few months given normal seasonal weakness between May and September, the risks in Europe, uncertainty about a hard landing in China and if US economic data goes through a soft patch. However, any correction should hopefully be milder, say 5 to 10% rather than the 15 to 20% plunges that followed the April highs of the last two years, as shares are cheaper today, the normal safe haven of sovereign bonds are less attractive, global monetary conditions are easier and the risk of a Euro-zone banking meltdown has faded. For these reasons we also still see share markets as being higher by year end, so would see any weakness in coming months as providing attractive entry points.

Key indicators to keep an eye on though are Spanish and Italian bond yields, the US ISM business conditions index which gave a good lead on the problems last year, Chinese money supply growth and the \$A (which is a good barometer of global economic confidence).

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