Stock Market Review

The pain in Spain

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The eurozone sovereign debt crisis flared up again over the past few weeks as the financial markets grew increasingly concerned about the fate of Spain. In fact, the yields for 10 year Spanish bonds which gauge the market's risk perception for a country's debt shot up and passed the six per cent level on speculation that Spain will be the fourth eurozone country (following Greece, Ireland and Portugal) to require a bailout. Spanish 10 year bond yields soared to 6.15 per cent on April 16 (the highest level since December 2011) as the effects of the liquidity injection by the European Central Bank have faded away. The renewed increase in Spanish bond yields has raised concerns since various commentators view a level beyond six per cent as not sustainable without external support.

Spain is a bigger threat to the future of the eurozone than any of the three countries that required a bailout in recent years due to the sheer size of the Spanish economy which is twice that of Greece, Ireland and Portugal combined and ranks as the fourth largest in the eurozone. While the focus on the three other peripheral countries was the overall level of debt accumulated by their respective governments, Spain's official debt to GDP ratio at 68.5 per cent is still among the lowest across the eurozone. However, if the liabilities of all state-owned companies are included in the statistics, this key measure of the country's indebtedness jumps to over 82 per cent.

The real concerns in Spain centre around the property sector, the level of unemployment and the sizeable budget deficit. Unemployment statistics indicate a level of 23 per cent across the entire working force – more than double the EU average of 10 per cent. However, the major worries are on the overall level of youth unemployment which is close to 50 per cent. The structural policies of Spanish unemployment benefits seem to be escalating this problem as those people who are made redundant and who had worked for more than two years, get a state benefit of 60 per cent of their salary for the first two years of unemployment. Many critics claim that this benefit has provided little to find work in the initial period and in fact statistics reveal that many people actually register for a new job on the 23rd month just before the generous benefits are reduced substantially.

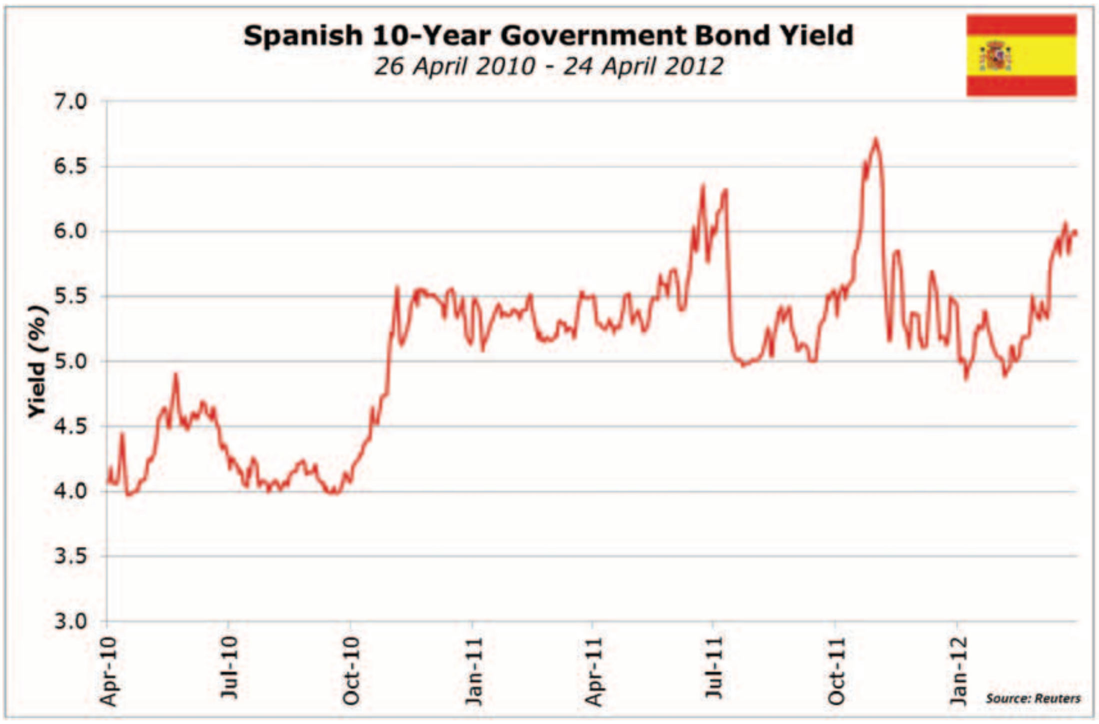
The Spanish economy is continuing to suffer from structural problems. Earlier this week, the Spanish economy was officially back in recession as the Bank of Spain estimated that the country's economy shrank by 0.4 per cent during the first quarter of the year following a 0.3 per cent contraction during the last three months of 2011. The Bank of Spain estimates a contraction of 1.5 per cent of GDP in 2012 while the International Monetary Fund expects the Spanish economy to be in a recession for a further two years.

The property market has been one of the major causes of the sudden downturn and the deteriorating state of the banking industry. Property prices skidded by between 30 per cent and 40 per cent from the peak in 2007 as the construction boom came to a standstill and house prices are expected to fall by another 25 per cent in the coming years. The construction sector continues to be among the hardest hit sectors with a decline of over 17 per cent in activity in February 2012.

In recent weeks, economists at the US bank Citigroup fuelled further anxiousness across the financial markets as it claimed that Spain will be forced to seek the necessary funding from the European Union and the International Monetary Fund by the end of this year.

Moreover, on April 13 statistics issued by the Bank of Spain revealed that lending by the European Central Bank to Spain's largest banking institutions doubled since February. Additionally, it was also announced that non-performing loans at Spanish banks reached an 18-year high of 8.16 per cent in February.

Despite these renewed concerns, Spain successfully tapped the bond markets last week as it raised in excess of €5.7 billion across Treasury bills and bonds with various maturities. According to the Finance Minister, the Spanish government has successfully financed almost 50 per cent of its borrowings requirements for 2012 amounting to €86 billion. Although yields increased substantially from previous auctions, there was strong demand for the Spanish government paper and the total amount raised actually exceeded the government's minimum requirements after various ECB policy makers and the Governor of the Bank of Spain appealed for calm and insisted that Spain does not require a bailout. The key tests for the bond market will be next Monday April 30 and at the end of July as the government requires to finance two hefty redemptions of €11.9 billion and €12.8 billion respectively.



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The steady demand at the Spanish auctions helped calm the markets slightly and following the successful bond sale, Spanish 10 year yields dropped below the six per cent level last week but approached six per cent again in recent days following the political uncertainty in France and the Netherlands which impacted global bond and equity markets. As prices of Spanish Government bonds dropped and corresponding yields increased, the equity market dropped to a three year low on April 13 after the announcement of the increased reliance by the Spanish banks on the ECB for their necessary funding requirements. Spanish credit institutions seem to be finding it difficult to tap the wholesale credit markets amid fears that the banks still need to make further provisions on their significant amount of property loans as the recessionary environment becomes more prolonged.

The maiden Budget of the new government at the end of March sought to dispel market fears with significant austerity measures totalling €27 billion in tax rises and spending cuts including a 17 per cent reduction in expenditure by the central government and a sharp fall in infrastructure investment. The measures also include a wage freeze for civil servants following a five per cent drop in salaries during 2010, income tax rises for the top earners, hikes in electricity and gas bills and restricting the loopholes in corporate tax which aim to generate an additional €5.3 billion following the adjustments. The new budget measures approved by the Spanish Parliament also bind Spain to achieve a balanced budget by 2020.

The renewed fears about Spain also escalated following the worse-than-expected state of the government's finances.

Spain had initially promised the EU that its budget deficit will be equivalent to six per cent of GDP during 2011, but the deficit grew to an extraordinary 8.5 per cent largely due to overspending by the country's autonomous regions. Spain again failed to meet expectations a few weeks ago when after a meeting of the European Union's Council of Ministers it was revealed that the 2012 deficit target was raised to 5.3 per cent from the initial forecast of 4.4 per cent of GDP. The challenge being faced by the Spanish government is to achieve a sharp reduction in the deficit during a recessionary environment coupled with the high unemployment. Despite the market's scepticism, the government is anticipating that the deficit will be further reduced to three per cent of GDP in 2013.

Since there is not sufficient liquidity in the rescue funds set up by the EU to support a possible Spanish bailout, the policies of the European Central Bank seem to be key in avoiding a worsening of the crisis and supporting the Spanish government in the coming years.