Weekly Market Commentary

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Euro 2012: Spain Wins!

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Highlights

Spain secured a big win this weekend. While the defending champions in the Euro 2012 soccer tournament were unable to best Italy on the soccer field, Spain fared better against Germany by winning the best European bailout deal yet.

While Spain is not in the same degree of fiscal distress as the other bailout countries, any contagion to Spain is of concern, since Spain's outstanding government debt is roughly the size of Greece, Portugal, and Ireland combined.

While Spain's bailout may reinforce the notion held by some that all of the "PIGS" can be lumped together, the loss by Greece in Friday's opening game of the Euro 2012 and Spain's draw is symbolic of how successfully these different countries are dealing with their respective fiscal challenges.

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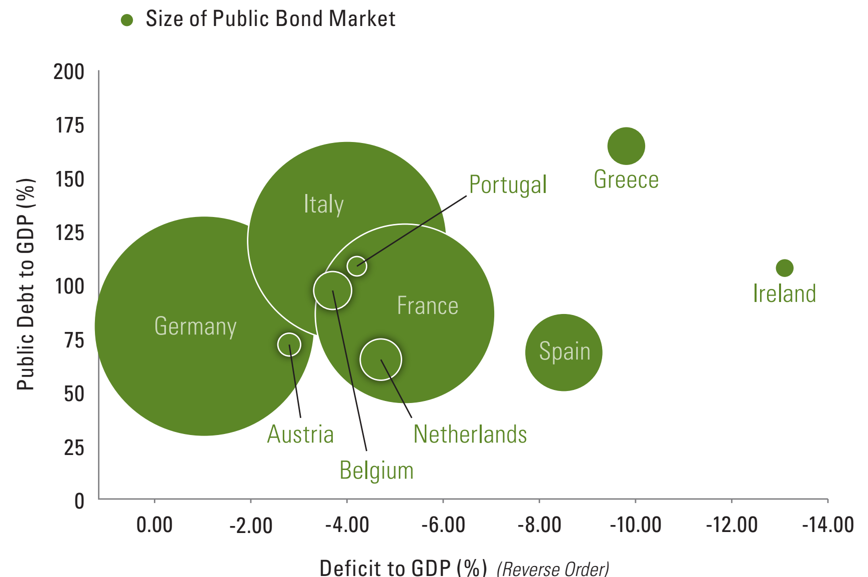
Spain will become the fourth country to receive a European bailout as they request the 100 billion euro offer made by European officials this past weekend to rescue the Spanish banking system. The bailout, if the full 100 billion euro loan is requested, brings the total of the bailouts to Portugal, Ireland, Greece, and now Spain—often collectively referred to in the media by the derogatory acronym "PIGS"—to about 400 billion euros. While Spain is not in the same degree of fiscal distress as the other bailout countries, any contagion to Spain is of concern, since Spain's outstanding government debt is roughly the size of Greece, Portugal, and Ireland combined (Figure 1).

1 Fiscal Status of Largest 10 Bond Issuers in Europe



Source: LPL Financial, International Monetary Fund 06/11/12

This was a big win for Spain for several reasons:

- **Just asking for the deal lowered borrowing costs.** The yield on Spain's 10-year government bond soared during May after the government announced the nationalization of a troubled bank to 6.78% — very close to the 7% level that prompted other countries to seek bailouts. However, after it became clear Spain would seek a bailout, the yield slipped back to 6.17% on Friday as a bailout deal appeared imminent.
- **No new austerity measures or other penalties were imposed.** The Spanish government will not be forced to take additional measures on the budget or economy in exchange for the bailout. This is the most remarkable aspect of the deal. European leaders, most importantly those from Germany, have now demonstrated willingness to bail out a country's banks without penalizing the country's economy with added austerity measures.
- **Yet the deal still helps to finance the government.** Since foreigners have increasingly been cutting back on buying Spanish government bonds, Spain has become more reliant on the Spanish banks to buy government bonds. The loans to banks will ease pressure on financing the Spanish government. However, it is likely that the loans would be senior to outstanding government debt, which could result in ratings downgrades and boost yields on existing government debt.

How was Spain able to score the win?

Securing the rescue a week before elections in Greece that risk prompting that country's exit from the euro and further movement of deposits out of southern European banks is of particular importance at building a firewall against contagion in the European banking system.

- **The loan is only for the banks.** One reason the deal is much more favorable to Spain than the rescue terms offered to other countries is that the loans to the Spanish government are being made only for use by Spanish banks, rather than for general government use. The deepening recession is resulting in loan losses for the banks. The loans will be channeled through Spain's bank rescue fund.
- **Spain elected leaders committed to fiscal discipline.** In contrast to the elections in Greece, last November's elections in Spain produced a clear win and mandate for fiscal discipline for the conservative People's Party and Prime Minister Mariano Rajoy.
- **Spain's debt burden is more manageable.** While the loan will add about 10 percentage points to Spain's debt-to-GDP ratio, which was 68.5% last year, this remains well below the debt-to-GDP ratios (in excess of 100%) of Portugal, Ireland, and Greece. It is also below the ratios of Germany and France, considered the most fiscally stable countries of the Eurozone.
- **Spain has already made progress on its budget deficit.** While the recession makes Spain likely to miss the 6% budget deficit target for 2012, Spain has cut its budget deficit successfully in each of the past two years. The deficit went from 11.2% of GDP in 2009 to 9.2% in 2010 and 8.5% in 2011. Spain has a goal of a 3% deficit by 2014 and enacted a constitutional mandate to have a balanced budget by 2020.

Though Spain will likely request the full 100 billion euros offered, the exact amount announced this week will depend on audits of the condition of Spanish banks, which are in progress. Securing the rescue a week before elections in Greece that risk prompting that country's exit from the euro and further movement of deposits out of southern European banks is of particular importance at building a firewall against contagion in the European banking system.

It has been widely expected that Spain may need a bailout for some time due to the condition of its banking system, and Portugal may soon request a second bailout package. However, this should not be seen as a dramatic worsening of the European debt situation, since progress is being made by these countries toward fiscal stability. Last week, the European Commission, European Central Bank, and International Monetary Fund all certified at the conclusion of a review that Portugal is on track to meet the terms of the agreement including Portugal's goal of cutting its deficit to 4.5% of gross domestic product in 2012.

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We believe the events in Europe this weekend suggest a stronger firewall is being put in place against a contagion effect that could trigger a market plunge. However, Europe is not the only issue overhanging the markets. Other overhangs include: the end of the Federal Reserve's Operation Twist this month as U.S. economic data continues to disappoint and earnings estimates are revised lower, China's continuing economic slowdown, rising geopolitical risks as the deadline on Iran's oil exports draws near, along with rising election uncertainty and anticipation of the budget bombshell of tax hikes and spending cuts on the horizon. ■

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Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

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