MARKET OUTLOOK

Will the Spanish Crisis Lead to a Banking Union?

Citi analysts view the acceleration of the economic crisis in Spain as a consequence of the incapacity of Fiscal Authorities to recognize the full extent of the real estate bubble burst on banks balance sheet and to properly address recapitalization needs. As the Spanish crisis unfolds, they think that the European Stability Mechanism combined with ECB lending appears to be the most relevant tool to counter contagion risks and address recapitalization where needed, paving the way for a European Banking Union.

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Still far from a hard landing

As the Euro Area crisis progressed over the last 3 years, Citi analysts have repeated that while the broad euro area crisis consecutive to the flaws of the Euro construction needed to be addressed in a structural way; each country's intrinsic troubles are different and required to be addressed in a proper manner. However, European policymakers have opted for a "one solution fits all" strategy, focusing on sovereign access to bond markets and deficit reduction by forcing "Austerity Union" for lack of Fiscal Union. Spain appears to be an unfortunate illustration of this lack of appropriate approach.

Similarly to Ireland, Spain experienced, back in 2008, a major bubble burst in its real estate sector which left the banking sector, and particularly the numerous small regional banks, on the brink of collapse. This bubble burst triggered a sharp recession in an economy largely relying on domestic consumption, investments and credit growth. 4 years later, Spain is still struggling to reduce its fiscal deficit via an ambitious austerity program in a context of credit freeze, record-25% unemployment rate and lack of competitiveness. Citi analysts observe that by underestimating the banks' recapitalization needs and by focusing on deficit reduction via public expenses cuts and tax hikes, Policymakers have increased the burdens on the economic activity and on the country's banking system. Spain appears to be caught in a vicious circle as higher yields generate austerity which generates slower economic activity which in turns leads to higher credit risk and banks recapitalization needs which in turn drive sovereign yields higher.

Worsening rather than improving

Looking at the evolution of the problems of Spain over the last 3 years, Citi analysts observe that all indicators show that the efforts done by the fiscal authority to bring the country back on the path of recovery have failed: the deficit is still slipping too fast, the government debt to GDP ratio has increased significantly, credit delinquency has increased and unemployment is record. Citi analysts observe that the only period when some of these indicators showed a sign of improvement was when the European Central Bank launched its 3-year Long Term Refinancing Operation (LTRO).

However, even the positive effects of the 3-year LTRO program have been short lived with Spain's CDS reaching new highs in May and the spread of its 10-year sovereign over the German bund having reached 4.5%, a level viewed as significant for triggering bailouts in both Portugal and Ireland. At a time when profitability is falling due to new provision rules, elevated sovereign CDS and spreads will also drive higher funding costs for Spain's banks. Citi analysts point out that if ECB cash injections significantly improved bank liquidity conditions, total euro-zone bank lending to governments has grown 135 billion Euros since 2009, tying banks' fates increasingly closely with their sovereigns. Spanish banks increased their sovereign holdings by 48% since November 2011 bringing their share of their government's debt to 35 percent from 24 percent in one year. In other words, Banks get money from the government, which turns around and borrows from the banks. But how long can this game go on?

By comparison, Argentine bank sovereign holdings and government loans rose to 21% from 10% of total assets in 1995-01. A consequence of this was less private sector funding, a risk for Spain and also Italy, should conditions worsen and deleveraging continue.

Excessive Underestimation of Recapitalization Needs

Citi analysts think that the Spanish government urgently needs to correctly recognize the risks remaining in banks' balance sheets and properly estimate the necessary recapitalization efforts to be done. The recent example of the bailout of Bankia, Spain's 4th biggest bank, which alone is estimated at 19 billion Euros while the government had till then estimated the full sector needs at 15 billion Euros, suffices to illustrate the importance of estimation gap.

Spanish banks hold a total of more than 300 billion Euros in real estate assets, including about 180 billion Euros in toxic assets in the form of housing, land and loans following the meltdown of the country's real estate bubble four years ago. The new reform pushed by the government orders banks to raise 28 billion Euros in provisions to cover sound assets in their real estate portfolios, in addition to 54 billion Euros in provisions against sour assets which they were told to set aside earlier on. However, while the government advances that Spain's bad debt ratio of 8.37% remains below its February 1994 high of 9.15% in an attempt to reassure markets, Citi analysts point out that it current bad debt outstanding is more than 6x the 1994 equivalent (see chart 1) and question the extent to which the remaining 90% can indeed qualified as "performing debt". According to Nomura estimates, If Spain took losses on real estate developer loans like Ireland did, Spanish banks would need 8.9 billion Euros under the best case to 76.5 billion Euros of additional provisions in the worst scenario, which would materially offset 37 billion of announced austerity cuts.

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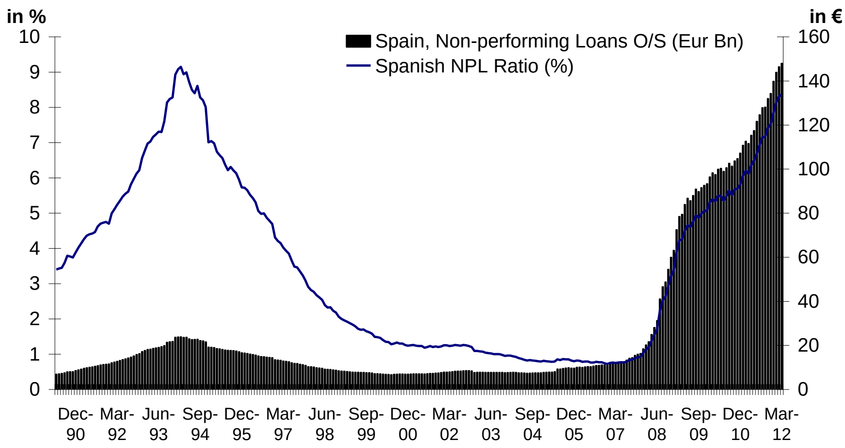
Chart1: Spanish Bad Debt (in volumes and %age)



Source: Bank of Spain, Blomberg

Towards a Banking Union?

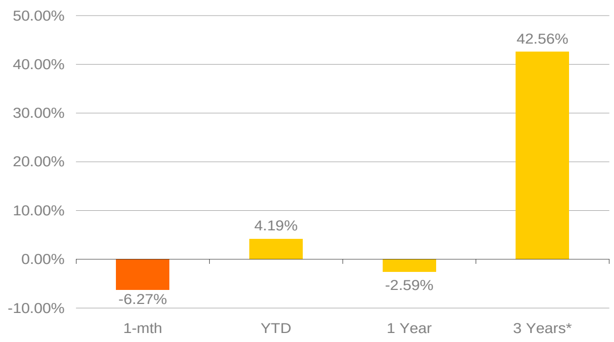
Along the lines of the ECB governor Mario Draghi's appeal for further centralization of banking supervision, Citi analysts think that the process by which each European Union member assesses individually its bank sector recapitalization needs and then proceeds via public debt increase or via a request to the European Stability Mechanism (ESM) has shown its limits.

Indeed, under the current process, the fate of the fiscal authority and of its banking sector turns out to be increasingly intertwined. Governments are tempted to underestimate the recapitalization needs in order to prevent an increase of its own debt yields, governments deteriorate their credit worthiness and their deficit when they intervene while making a bailout request to the ESM is interpreted as a policy failure which opens the door to external supervision synonym of more austerity pressures.

Citi analyst think that by creating a Banking Union, under which the European Commission, or another European supervision authority, could make use of the ESM funds to recapitalize directly banks where needed and to the extent needed, would improve transparency and reduce the contagion factor between banks and governments.

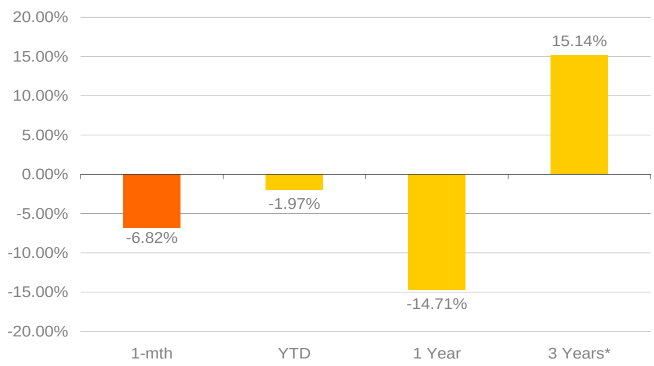
Equity markets

Chart 2:
S&P 500 Index



*Denotes cumulative performance
Performance data as of 31 May 2012
Source: Bloomberg

Chart 3:
Dow Jones Stoxx 600 Index



*Denotes cumulative performance
Performance data as of 31 May 2012
Source: Bloomberg

United States
No Monetary Stimulus Expected Before 2013

- Economic growth in the US is still continuing at a subdued but markedly positive pace of 2%. Demand has been a little stronger than anticipated by Citi analysts at the beginning of the second quarter. Consumer spending has held up and there are a few tentative signs of a return towards modest growth in the housing sector. Despite the positive indicators, Citi analysts expect US economic growth will be tempered by the ongoing fiscal drag and continued deleveraging.

- Federal Reserve officials (Fed) have yet to signal any further monetary stimulus following the completion of Operation Twist next month; however Citi analysts feel the balance of probabilities lie with further Fed accommodation. The case for further Fed easing is supported by the risks to growth from fiscal tightening rather than from low levels of inflation, which is running comfortably within the desired ranges. The major fiscal tightening is due to begin in 2013, after the elections, and citi analysts expect the debate over further Quantitative Easing to persist for some time.

- Citi's US analysts expect that a contraction in the Euro area for 2012 may not completely overwhelm US stocks with a global exposure, as long as the rest of the world continues to grow. Furthermore, Citi has recently upgraded their Earnings per Share forecasts for the S&P 500 to 5.5% growth, up from 3.3% on the back of positive earnings surprises in the first quarter. Valuations remain the main obstruction to equity investing in the region: the Cyclical Adjusted Price to Earnings ratio (CAPE), which is Citi analysts preferred long term valuation measure, is almost double that of Europe, indicating that the risks to global growth are better reflected in the price of equities outside of the US.

Euro-Area
Grexit Probability Estimated at 50-75%

- Citi economists now put the probability of Greece leaving the euro area at 50% to 75%, most likely in the beginning of 2012. For that reason Citi's euro area forecasts for 2013 onwards exclude Greece. The effect of this revision has been to decrease GDP forecasts for all euro area countries by 0.7% next year.

- Citi's chief economist, Willem Buiter, believes the euro area is in a better position to prevent contagion from a Greece exit ("Grexit") from the euro. Action is expected from both the governments and the ECB, with the timing and the size of the measures dependent on the pressure applied by the markets and probably the deposit holders at the periphery banks. Use of the European financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) can be used to provide support to euro area banks and sovereigns.

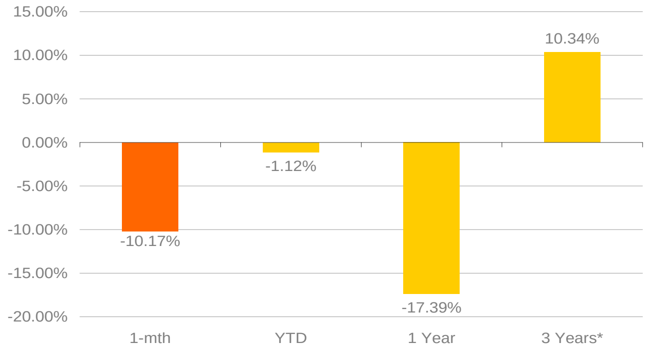
- Citi also expects support to extend to a euro area wide special resolution regime for banks and a possible resolution fund to back large cross-border financial institutions. A deposit 'run' on the periphery banks is a very real risk and therefore Citi analysts think an eventual euro area wide deposit guarantee scheme will eventually be agreed to by Germany. Additionally further Long Term Refinancing Operation (LTROs) which provided the earlier support to banks and, indirectly, to sovereigns are expected by Citi economists.

- Equity markets in the euro area periphery have been significantly de-rated to levels between 60-90% below their 2007 highs – Citis European strategists observe this is similar to falls in emerging markets equities following crises over the past few decades. Although valuations have not fallen to this extent in the more stabile core euro area regions, such as Germany, Citi analysts note that valuations are priced to reflect the risks and, considered over a longer time frame, offer significant value.

Equity markets

Chart 4:

MSCI Asia Pacific Index



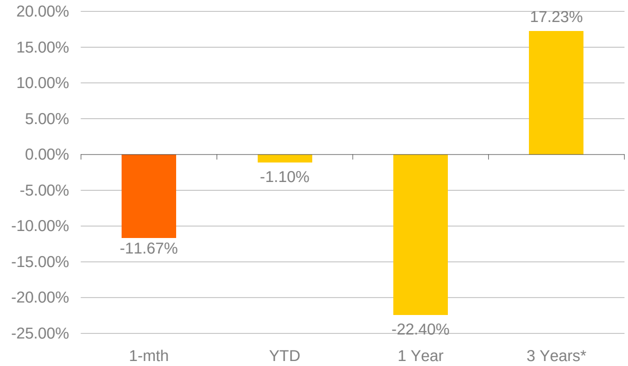
*Denotes cumulative performance

Performance data as of 31 May 2012

Source: Bloomberg

Chart 5:

MSCI Emerging Market Index



*Denotes cumulative performance

Performance data as of 31 May 2012

Source: Bloomberg

Japan

BoJ Expected to Ease Further

- Citi analysts 1.5 to 2% GDP growth in the coming quarters as reconstruction demand and consumer spending should remain resilient on the back of government subsidies while exports could find support from a Chinese rebound should the Chinese government implement stimulus programs in the second half of the year.

- Citi analysts expect the Bank of Japan (BoJ) to go for further easing measures for the following reasons. First, if the size of the asset purchase program is not expanded further, starting next January the amount of JGBs purchased under the program would roughly halve from the current level of ¥2.1trn per month. Second, the BoJ's core inflation (ex fresh food) forecasts are unlikely to be met and this could provide room for further easing.

Asia Pacific

Monetary policy is in a period of stasis

- While growth risks are rising, hurdles to monetary easing are high for many central banks (CBs) in Asia. With the exception of Vietnam, China and India, Citi's base case almost everywhere else is an extended pause in monetary policy (MP). Future G4 central bank policy action is another consideration to MP decisions. Still, Asian CBs' "rhetoric" has room to turn more dovish as oil price risk recedes, and growth visibility poorer.

- Citi analysts assessed the odds of additional MP easing if growth risks escalate based on four factors – 1) vulnerability to downside growth risk; 2) where inflation is vis-à-vis CB targets; 3) risks to external and financial imbalances from lowering rates further; and 4) availability of counter-cyclical fiscal policy tools to support growth. Overall, they think monetary policy flexibility screens are relatively high in Vietnam and China. While not their base case, they believe Korea and Thailand are, at the margin, more likely to cut rates than Malaysia or the Philippines.

Emerging Markets

Grexit Scenario to Drive Monetary Policy

- Citi analysts see a number of elements to the argument that EM policymakers will ease policy. Above all is the idea that the Eurozone crisis could produce Lehman-like outcomes for the global economy that would require aggressive loosening by policymakers almost everywhere. Citi analysts also see elements such as the downside risk to global, weakening economic surprises from the US and falling commodity prices and oil in particular.

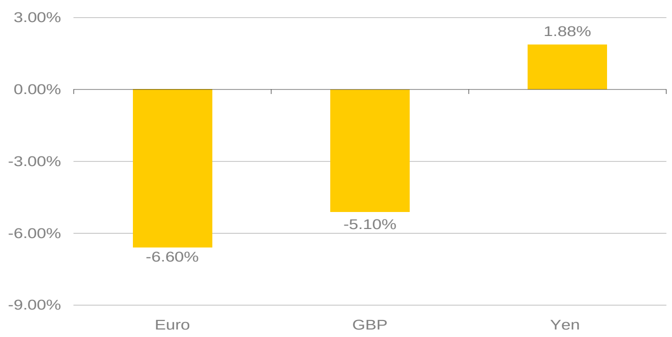
- Under the base case scenario of a Greek exit, Citi analysts think that the risk to see Greek banks repatriate funding that is in place in the subsidiaries of Greek banks would increase significantly. Greek banks are important players in the banking markets of Bulgaria, Romania, and Serbia, with the key Greek banks representing c 25%, 15%, and 16% of sector assets, respectively. The absolute exposure to Turkey is also worth noting, as the Greek banks would be likely to find it more difficult to fund their subsidiaries in these markets if we see a "Grexit". This in turn could lead to liquidity problems, which if inadequately managed by local and regional authorities, could lead to a loss of confidence and potential bank runs.

- According to Citi analysts, the joint movement in EM currencies, with only a relatively secondary role for intrinsic factors, is suggestive that risk aversion remains prevalent in driving EM currencies. Indeed, the first principal component across most of the leading EM currencies explains close to 72% of the total variation in the period March-May 21st, 2012.

- Citi analysts continue to like EM equities long term, but accept the case for further short-term softness ahead of the Greek vote. The obvious trigger for an eventual big rally is further injections of liquidity by DM central banks. Their preference goes to non-financial domestics, notably Cons Discretionary, Industrials and IT, as well as Energy.

Currencies

Chart 6:
Currencies (vs USD 1 Month)



*Denotes cumulative performance
Performance data as of 31 April 2012
Source: Bloomberg

Currencies

- As we approach the end of Operation Twist, Citi analysts anticipate that FX market participants will pay increasing attention to the impact of European events and economic data on the Fed's thinking. As a result, labor market and inflation data are likely to drive the trajectory of the USD in the coming weeks.

- EURUSD broke below year low level and traded around 1.25 – 1.26 level for this time being. Citi analysts suspect that slow policy response could add to the headwinds for the single currency. Also, growing concerns on Greece appear to weigh on the single currency. While market participants think market is too short on, CitiFX's PAIN index on EUR indicates that it is still not at 'stretched' level.

- A less dovish BoE appeared to keep GBP supported since we run into another episode of acute EUR pressures. Citi abalysts are skeptical that GBPUSD can fully decouple from EURUSD, however. GBP could also underperform other risk correlated currencies such as CAD and AUD.

- Citi analysts think more uncertainty on Greece will weigh on EURCHF. In addition, given a series of comments by the SNB officials, the chances for a higher peg seem to be limited. Longs would continue to struggle to gain traction until there is some easing pressure in Europe or a shift in Swiss fundamentals, according to them.

- The overhang of short JPY positioning should limit yen downside in Citi analysts' view. While the PAIN index for JPY has bounced off recent lows, pointing at some short covering, it remains close to oversold territory. Since they are skeptical about further lasting rise in US yields from current levels they think that USDJPY could struggle to extend its gains on a sustainable basis

Bond markets

US Treasuries

Citi analysts increased their position in US Treasuries to overweight as they believe Treasuries are the only thing to diversify portfolios in period of distress.

US Corporates

While further spread tightening is likely to be more gradual, Citi analysts believe that valuations are still attractive and the high grade credit market continues to offer potential for positive performance this year. Meanwhile, any pull-back in high yield could disproportionately impact the lowest quality issuers. They continue to avoid financials

Euro Bonds

Uncertainties about periphery market contagion combined with declining growth and inflation expectations are likely to keep rates low. In Europe, Citi analysts still recommend only short-dated Bunds and they continue to be underweight in UK gilts where valuations are rich.

Emerging Market Debt

EM sovereign bonds are under pressure due to capital flight overgrowth fears and stresses in the eurozone. However, unlike the beginning of 2011, EM central banks have much greater scope to ease monetary policy to combat strong currencies and external weaknesses. Citi analysts are overweight EM foreign currency bonds, though investors should stay defensive in higher quality issuers.