

JVB Financial Group, LLC

CRONIN'S CORNER MONTHLY

A Perspective on the International Economy

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The sea's power cascades its panoply of intentions, unapologetically and with a surreptitious beauty. Festooning the planet with an undulating dominance the seas of Neptune have brought both terror and life to our exposed ancestors. A vessel of discovery, her tides have bobbed man to lands erstwhile unexplored and even today her beauty continues to draw the poet from the recesses of the banal. Thus it was the sea that enabled history's greatest explorers to wield their craft and to scythe the virgin lands for Queen and country. Voyages that ripple across the curtains of romantic fiction lathered with exotic spices, demonic sea creatures, and pestilent pirates. However, that romance is but a speckled phantom upon history's cane. Exploration upon the seas came to imbue ruthlessness upon its own crucifix of power, as demonstrated by the conquistadors, history's chosen soldiers, who essentially succeeded in bringing most of the Americas to crumple and eventually redefine itself at the feet of a European master. The conquest of the Aztecs and the Incas are childhood examples of the new power that the discovery of the new world had sprinkled upon the Europeans. The warrior sailors set forth to plunder pillage and to profit. To bulk the crown's coffers with stolen gold and silver and to stretch her powerful tentacles across conquerable seas and the cradle of centuries. For almost four hundred years the Spanish empire's roar was aloud, but, as empires inevitably do, it toppled. Spain's 'glorious' past reeks of the epic. But what about her future?

If it was a musical that made the phrase 'the rain in Spain falls mainly on the plain' a catchphrase, it is a tragedy that will prove its inaccuracy. In fact most of the rain in Spain falls in the mountains, but, at the risk of weaving a metaphorical dalliance, the whole country is, and remains, drenched. Soaked, saturated, and seeped in a recession. The world's ninth largest economy is drowning whilst some of her European counterparts are, for now, at least, afloat. The knot that began to choke the Spanish economy was of course tied to property and the bubble that it created saw real estate prices rise almost two hundred percent in the decade from 1997 to 2007. We had deliberated in previous scrawl that the Irish obsession with home ownership eradicated itself from history's domain. Spain's story seems a little different. Spanish compulsion to drive home ownership to over eighty percent seems to have been driven more by legislation than inspiration. The government roundly encouraged home ownership and discouraged renting and as pliable tax regulation allowed a portion of mortgage payments to be tax deductible the 'ole's' from the construction industry began to hum of an almost anthem-esque importance. The reason being that, at its height, the construction industry represented just under twenty percent of GDP — an eye-watering number that spindles along the spine of financial vertigo. With such a disproportionate effect upon the country's growth data the construction sector was also responsible for skewing its employment influence and thus when the bubble popped the fiesta flat lined. As the construction calliope cavorted around the country, houses were being built at a maniacal pace. The legacy of the boom years was that, on average, Spain birthed over four hundred thousand new houses a year which was more than France and the United Kingdom combined. The industry and its participants had become recalcitrant in their thinking and relentless in their doing. Despite the supply of new properties, house prices continued to hike upwards and as the Spanish families clamored for ownership it became more and more of a struggle for them to be able to pay

the prices that were demanded. The result was that the average level of Spanish household debt tripled in about ten years and this would eventually succeed in crumpling the consumption cart. Thus, with the onslaught of the financial crisis, Spain's recession was infected with plunging property prices, a mountainous supply of unsold homes and a consumer resembling a fallen entrant at Pamplona's bull running festival. Hardly a paella pastiche of comfort. What did provide a modicum of light salvation was, perhaps ironically, the banking sector. Spanish regulations require their banks to have high capital provisions in place and the country's rather strict banking rules and practices meant that the larger financial houses and banks were able to endure the financial strain a little easier than some of their European (and indeed global) peers. However, the problem (and there's always a problem) was seeping from the smaller local savings banks known as *cajas*. These unlisted banks dictate about half of Spain's lending business and during the property boom they often lent to local and regional developers. Needless to say, these investments went the way of the oft spoke White Elephant. As the Spanish authorities aggressively tried to assuage the global raised eyebrow of concern, these *cajas* were forced to raise private capital to resuscitate their balance sheets following their cataclysmic lending sprees, resulting in mergers and acquisitions which are still ongoing and continue to re-shape the face of Spain's banking sector. At the outset, the leading Spanish banks were probably never as vulnerable as, we'll say, the Irish banks, because of the above-mentioned tighter regulatory oversights. However, these perceived stalwarts are not impenetrable even now because of their exposure to Portugal, which some estimates peg could run over one hundred billion Euros. Therefore, we expect more verbal histrionics from Spanish officials promoting the financial sector's improving health. We also expect further consolidation within the banking sector as the *cajas* continue to be merged and pinched by further and more severe passages of reform. The banking sector is, alas, but one red flag to the ever-petrified investor charging away from Spain. The web of fiscal degeneracy that has slithered from the Aegean Sea across the Irish Sea now threatens to turn south and envelop Portugal. Therein lays the petrification of contagion. A Portuguese bailout would almost inevitably invoke fears of a Spanish knock-on and we would see fiscal fear flinging once again with, by now, the all-too-familiar and predictable consequences. Whilst we cannot question a strain being put upon Spain with a Portuguese capitulation, we do question whether Spain's own capitulation would be a subsequent inevitability to such an event. Much of that destiny will, of course, be determined by Spain itself based on the tenet that credence will be crucial. It is imperative that Spain convince the market that she is not just seriously confronting her issues but mending them. The obligatory rash of mergers, as discussed above, remains in an ongoing space but some deals are getting stuck in the jumble of dispute. Discord over the structure and governance of the newly created entities is causing lethargy at a time when Spain needs decisiveness aboard swiftness. The government needs to continue to incite these deals to completion and convince investors that these newly formed financial houses are sound, solvent, and open for (continuously highly-regulated) business. But at least the process has begun and an aroma of progress wafts of a perceptible unguent. Additionally, the minority

(Continued on page 2)

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(Continued from page 1)

Socialist government of Senor Zapatero has acted to bring forward long overdue pension reforms which the cabinet has already acted on and has approved a bill to raise the retirement age from 65 to 67. The austerity measures imposed and the cut in public spending already seem to be succeeding in shrinking the country's budget deficit, which is the Eurozone's third largest. If the budget deficit can continue its diminution then that may ease concerns across investor land regarding the cost of reinforcing the country's banks, if it becomes necessary. In fact it is likely that any cost associated with providing a financial fillip to the banks will be paid for by the capital markets. Spain's total debt as a percentage of GDP is actually less than that of Germany and France, thus the option to tap the markets should exist as a very viable one to raise any required capital. It will result in Spain's debt-to-GDP ratio rising (which we think it has room to do) but at the same time we should continue to see the fiscal deficit shrink, wherein should lie a modicum of assurance for an oft-times gibbering market.

between ten-year German bunds and ten-year Spanish bonds narrow. The widest point of last year witnessed that spread at about two hundred and eighty basis points. At the time of writing, the spread stands at less than two hundred. One significant point, though, is that during the first ten years of the Euro, that spread averaged about twenty basis points. (That statistic is sobering enough to neutralize even the most potent of Riojas.) Standard and Poor's has reaffirmed their AA rating and the Chinese (not the Germans) continue to buy the country's debt. These signs may encourage further buying, thus narrowing spreads further and making it cheaper for Spain to borrow. Spain probably won't become a lethal issue, in the market's conscience, until Portugal does, but until then a twenty percent unemployment rate and a penurious consumer will keep her vulnerable to speculative invaders that may or may not carry a Queen's decree.

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The recent signs seem to augur a less dystopian outcome for Spain than it does for some of her more beleaguered neighbors. The positive noise economically and politically has assuaged the market's trepidation (at least for now), as evidenced by the performance of the sovereign debt which has seen the spread



Image source:
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*Fiscal dementia has driven German/Spanish spreads to all time highs,
but recent events have poured a modicum of serenity over frenzied markets.*



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