Drobny Guest Research

June 5, 2007

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Please take a good look at this piece. It seems particularly relevant during a week where European interest rates take center stage. It has been precisely during periods of rising core European rates when inter-European turbulence has emerged. And, the authors suggest the potential for trouble is especially high right now. I did not follow our usual practice and substantially cut the piece down from the original. Apologies if it is too long for many of you, but there was so much good and relevant information in this piece I really didn't want to drop any of it. - *Andres Drobny*

Europe: From Convergence to Divergence

Pivot Capital Management

- **European convergence process facing multiple tension points**. The Southern and Eastern Europe convergence economies, among the fastest growing in the European Union, are now simultaneously facing a multitude of challenges including widening current account deficits, unsustainable credit growth and vulnerable banking systems.

- **Eastern European convergence countries on Asian currency crisis path.** New Eastern European EU members, particularly the Baltic States, are reaching readings comparable to Asia in the mid 1990's in terms of credit expansion, depletion of currency reserves and external liabilities. Similarly to Asia, capital inflows have been predicated on a supposedly inviolable currency peg, meaning there is little tolerance among investors and local banking systems to adverse currency moves.

- **Southern European convergence countries in Argentinean trap.** The region's economies, especially Spain and Portugal, with their addiction to housing, construction and credit expansion to drive growth, are highly vulnerable to deflation, which may become necessary to halt structural losses in competitiveness, similarly to the situation that led to Argentina's collapse in 2001.

- **CDS preferred vehicle for European divergence.** Although equity, credit and currency markets show an equal lack of concern over potential convergence disappointments, our preferred way to exploit future European divergence is CDS (Credit Default Swaps), where leveraged long term positions can be established at close to minimal costs. The Fund has built significant CDS positions in the Baltics, Portugal and Spain.

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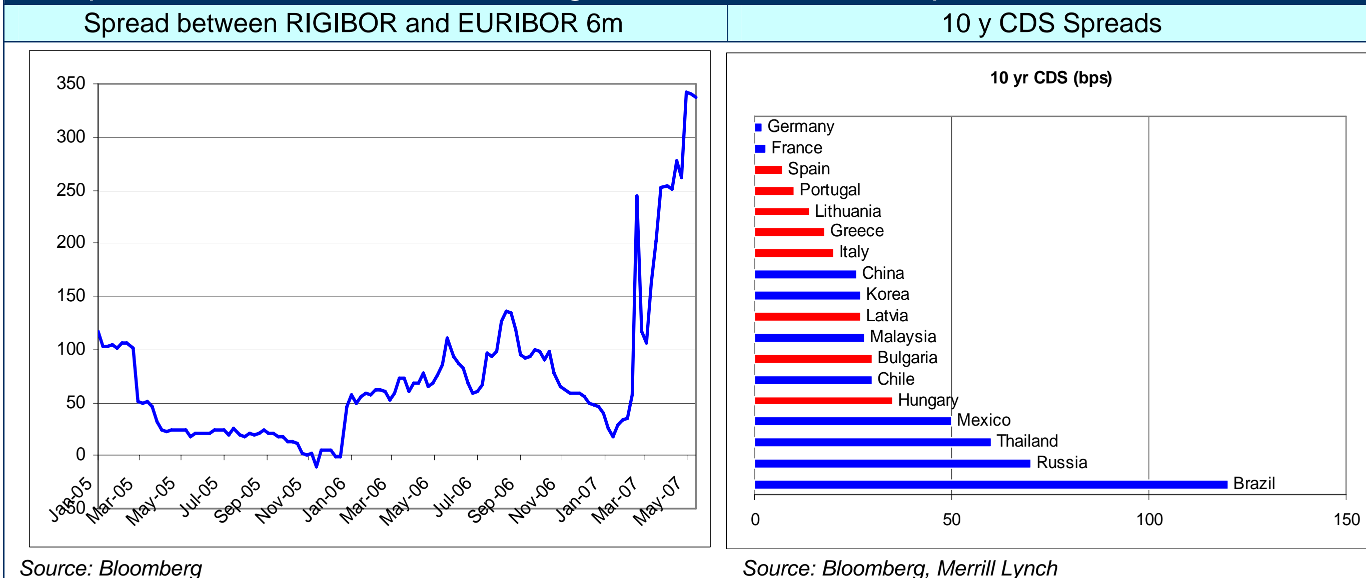
- **Latvia risk reassessment first step in divergence process.** Latvia is the first convergence country to undergo a sharp reappraisal of its convergence outlook, as illustrated by a recent jump in RIGIBOR inter-bank rates and CDS spreads. With growing evidence of stress in the Latvian banking system, we believe this process has further to go and could act as a trigger for a broader reappraisal of the European convergence.

Sharp reassessment of Latvian convergence outlook – a first step



Source: Bloomberg *Source: Bloomberg, Merrill Lynch*

1. European divergence - major investment theme

1.1 Confluence of tension points to test convergence process

While US external balances are monitored closely by financial market participants and are viewed as a threat to global financial market stability, there has been little coverage of the increasing imbalances in the enlarged Europe. For example, based on IMF projections for 2008, there will be around 10 European countries with worse current account deficits than the US, including Spain, with the world's second largest current account deficit in absolute terms. All the European countries with large deficits have one commonality: their association with the Euro, which has led to real currency appreciation, with a concomitant loss in competitiveness. Furthermore, given above EU average inflation

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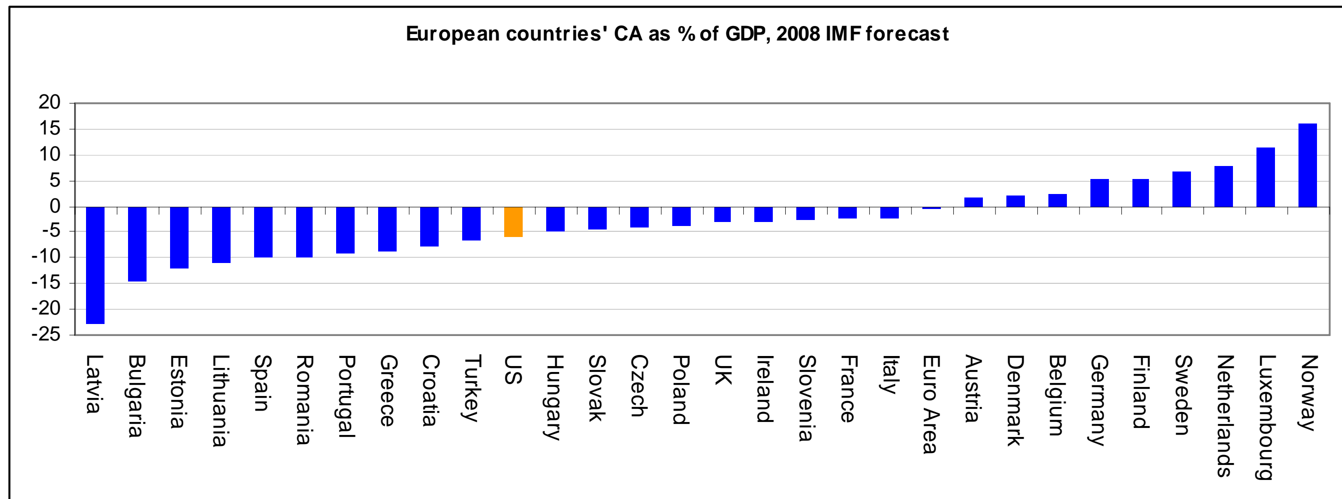
rates, the real cost of borrowing has often been negligible, which has stimulated credit expansion.

US style imbalances evident in European convergence countries…



Source: IMF

The link to the Euro has effectively produced an invitation to borrow or inflate oneself to prosperity, with particular excesses becoming evident in the EU accession countries (Baltic States, Hungary, Poland) and previous convergence countries in Southern Europe (Spain, Portugal, Italy, Greece), on which we focus in this report. In addition to high current account deficits, these countries are also starting to display the typical warning signs of macro and micro vulnerability seen ahead of previous major country crises. Warning signs include accelerating credit growth or capital inflows, often driven by some form of currency peg or banking deregulation. It is especially relevant to note that unhealthy lending practices which exacerbated the crises in Scandinavia and Asia in the 1990's, are becoming more widespread.

Each country's challenges are different and taken in isolation they may appear manageable. However, the fact that virtually all convergence countries are seeing increased imbalances and growing signs of macro and micro vulnerability at the very same time poses a real threat to the European convergence process. Furthermore, this threat is amplified by the important links that exist between the countries, not only in investor perception and positioning, but also in areas like trade flows and policy thinking.

Unsustainable credit growth is the main issue in the EU accession countries, where borrowers have been able to access credit on Euro-zone terms well ahead of full

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membership in the monetary union. The result has been an explosion in credit, led by consumer and property lending. A major systematic risk factor is the high use of foreign currency denominated loans, which puts some of the accession countries in the same situation as some Asian countries in the mid 1990's. The main areas of excess have been in Hungary and the Baltic States.

… where warning signs of financial vulnerability are flashing

	Foreign Capital Inflows	Flawed Currency Peg	Credit Expansion	External Deficit	Public Finances
Previous Crises					
Asia 1997	✖	⬇	✖	⬇	➡
Mexico 1994	✖	✖	⬇	⬇	➡
ERM 1992	➡	✖	⬇	⬇	⬇
Accession Countries					
Hungary	⬇	⬇	✖	⬇	⬇
Poland	⬇	⬇	⬇	⬇	➡
Lithuania	⬇	✖	✖	✖	➡
Latvia	⬇	✖	✖	✖	➡
Southern Europe					
Spain	⬇	➡	✖	✖	➡
Italy	➡	➡	➡	⬇	⬇
Portugal	⬇	➡	⬇	✖	⬇
Greece	➡	➡	⬇	✖	⬇

Legends: Financial vulnerability:: ✖ = Systematic risk factor ⬇ = Vulnerability factor ➡ = No concern

EU accession countries – Credit growth out of control

Key countries	Crisis Model	Main Issues	Vulnerable asset classes	Timing
Baltic States Hungary	ERM 1992 & Asia 1997	Credit growth High FX borrowing Current account deficit	FX Equities Credit spreads	2007-2008

Southern Europe's challenges are more structural. While Italy's and Greece's poor public finances are well publicized, we believe Spain and Portugal have a worse combination of poor competitiveness, unhealthy credit expansion and reliance on construction activity and EU funds for growth. The loss of competitiveness is

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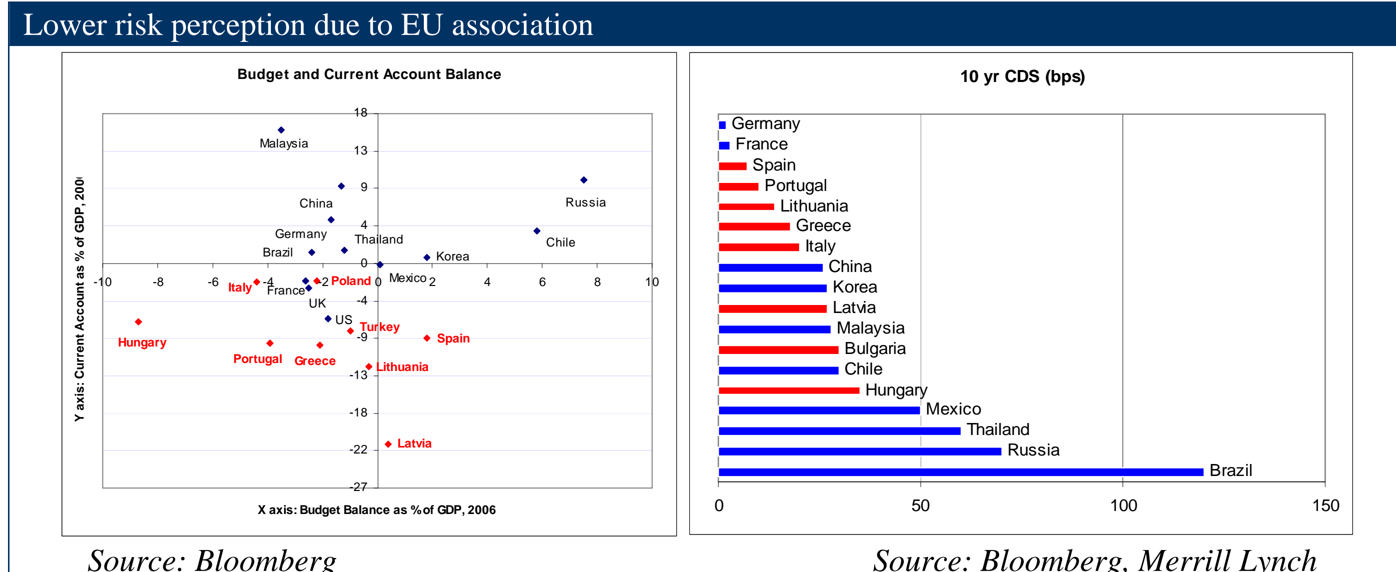
exacerbated by structural factors including a secular shift in European manufacturing towards Central Europe, of which the Iberian Peninsula is the main loser. The crisis model we follow is Argentina, which after being considered best in class in 1998-99, was forced into a period of competitive deflation, eventually erupting into a full blown crisis in 2001. Although, Spain and Portugal may avoid as deep a crisis as Argentina, they still face a painful period of adjustment over the coming years.

Southern Europe – structural growth and competitiveness challenges

Key countries	Crisis Model	Main Issues	Vulnerable asset classes	Timing
Portugal Spain	Argentina 2001	Reliance on construction Credit growth Poor competitiveness	Equities Credit spreads	2008-2011
Greece Italy	Argentina 2001	Government debt	Equities Credit spreads	2008-2011

1.2 Convergence countries still perceived as lower risk markets

Although the outlook is becoming cloudier, the convergence countries still benefit from a lower perceived risk due to their association with the EU and the Euro. The low risk perception is most evident in Credit Default Swaps, where convergence countries have consistently lower credit spreads than non-EU peers.



Source: Bloomberg

Source: Bloomberg, Merrill Lynch

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The lower risk perception is seldom justified by fundamental data. Whether comparisons are made on macro indicators or structural variables including competitiveness and demographics, convergence countries generally appear weaker. A case in point would be Latvia, which in spite of scoring worse on public finances, central bank reserves, current account, etc, is still considered a better credit than Russia. This is all the more surprising given that Latvia is heavily dependent on Russia for trade and capital flows.

Low risk perception seldom justified by fundamentals

	10y CDS Spread	Public Finances	External Balance	Currency Reserves	Household Debt
Latvia vs Russia	-48 bp	⬇	⬇	⬇	⬇
Portugal vs Brazil	-110bp	⬇	⬇	⬇	⬇
Spain vs Chile	-15bp	➡	⬇	⬇	⬇

Legends: ⬇ = Weaker ⬇ = Stronger ➡ = Equal

The lack of concern over potential convergence disappointments can be observed across most asset classes. In equities, investors are even willing to pay a premium on Price/Book Value for banks in many of the convergence countries, due to their supposedly superior growth potential.

Lack of concern across asset classes

Valuation differential / Risk premium relative to Europe by Asset Class				
Key countries	Credit Spreads (10y CDS)	FX carry to Euro	Equity Valuations to Peers	Property Yield Spreads*
Hungary	30bp	Positive carry 4%	In line / premium	0-2%
Baltics	12-20	Positive carry 1-6%	In line	0-2%
Poland	20	No carry	Premium	0-2%
Spain	6	Fixed	Premium	Negative yield spreads
Portugal	8	Fixed	Inline	In line
Greece	12	Fixed	In line / premium	In line
Italy	14	Fixed	Inline	In line

* Relative to average European commercial property yields

While the virtuous circle of European convergence in which all countries have been winners is stretching its limits, the inflection point is more difficult to predict. There are two areas where we look for potential triggers for the divergence process to gather pace: signs of market stress or economic slowdown. Market stress is most pronounced in the Baltic States, where local markets are drying up as market participants are unwilling to take on more local currency risk. Increased market stress could also be triggered by

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general risk reduction in global markets. Slowdown in economic activity is most evident in Latvia, Lithuania and Hungary, where there are increasing concerns over growth prospects.

Whatever the triggering event will be, it is likely to have important contagion effects. For example, a convergence failure in Latvia is bound to have repercussions on currency markets across Eastern Europe, which in turn could put further pressure on the competitiveness of Southern Europe. Equally, growing understanding of the structural challenges facing Southern Europe could force a rethink on the urgency of adopting the Euro in EU accession countries. The possible contagion links extend beyond the convergence countries. For example, a liquidation event in the accession countries would certainly impact carry trades in Turkey and Iceland.

Given the difficulty of predicting the inflection point, our preference has been for 10 year Credit default Swaps (CDS), which we believe offer the most attractive way to get long term exposure to European divergence. At minimal cost one can be positioned for what could be the next Asia / Argentina style blowup within the next 2-5 years. Since the beginning of the year we have significantly expanded our exposure in this area and now have sizeable CDS positions in the Baltics, Portugal and Spain. Currency and equity markets also offer attractive ways to play divergence, but here the cost of being too early is high. We currently have short currency positions in the Baltics and Hungary, as well as short equity positions in Poland, Hungary and Spain.

The analysis in this report is focused on divergence opportunities in Eastern and Southern Europe. However, the European divergence theme has implications beyond those areas, particularly on investors' belief in robust global growth and the elevated role of European assets in global investor portfolios. When the fastest growing areas of the enlarged Europe all start showing signs of vulnerability, the widely held concept of a decoupling between Europe and the US becomes less convincing.

2. Accession Countries – Sharp Contraction Ahead

The convergence between Eastern and Western Europe has been a major success story, culminating in the EU accession for the majority of the region's countries. Although we remain firm believers in continued progress in Eastern Europe, we strongly believe financial markets have priced in full convergence well ahead of the main event, which is the formal adoption of the Euro. This is highly significant, especially as the timetable for Euro zone membership has been pushed ahead over the last year, in some cases indefinitely.

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Euro adoption target dates pushed forward			
Member State	Initial target date for Euro adoption	Current target date for Euro adoption	Current currency mechanism
Estonia	2007	Withdrawn; No new target	ERM II; 15% band from centre
Latvia	2007	2011-2013	ERM II; 15% band from centre
Lithuania	2008	2010	ERM II; 15% band from centre
Czech Rep	2010	Withdrawn; No new target	Managed float with Euro as ref rate
Hungary	2010	Withdrawn; No new target	Shadowing ERM II
Poland	No target date	No target date	Managed float with Euro as ref rate
Slovakia	2009	No change	ERM II; 15% band from centre
Slovenia	2007	Adopted Euro as planned	Euro

2.1 Credit growth and capital inflows in anticipation of Euro

In contrast to Southern European countries, which had to wait for the introduction of the Euro before enjoying lower borrowing costs, Eastern European borrowers and investors have acted on the basis that the Euro was certain to be introduced within the near future. This has fuelled a credit boom that is now increasingly likely to end in a combination of hard landing, currency devaluation or banking crisis in at least one country in the region and a high possibility of regional contagion. The most aggressive expansion of credit has been seen in the Baltic "Tiger" economies: Latvia, Lithuania and Estonia, widely seen as convergence leaders and prime candidates to adopting the Euro.

The most important aspect of the credit explosion is the widespread mismatch between foreign currency liabilities and local currency assets. In most markets, availability of consumer and mortgage credit in foreign currency is the norm, with a preference for Euro, Swiss Franc and Yen. For instance, in Hungary more than half of household consumer credit and around 35% of mortgage loans are in foreign currency. This works while local currencies and assets appreciate in real terms. However, a weakening in the local currency causes significant losses. It is an open secret that in some of the smaller Baltic markets, currency mismatches among investors and borrowers have reached levels that are virtually impossible to hedge. Although there is growing understanding of the mismatched currency exposure within the region, there is a widely held belief that foreign banks which dominate lending in most accession countries, would step in to recapitalize

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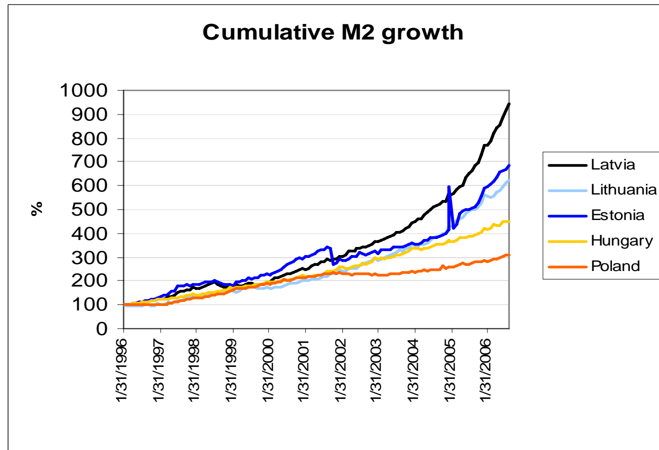
Explosive monetary and credit growth



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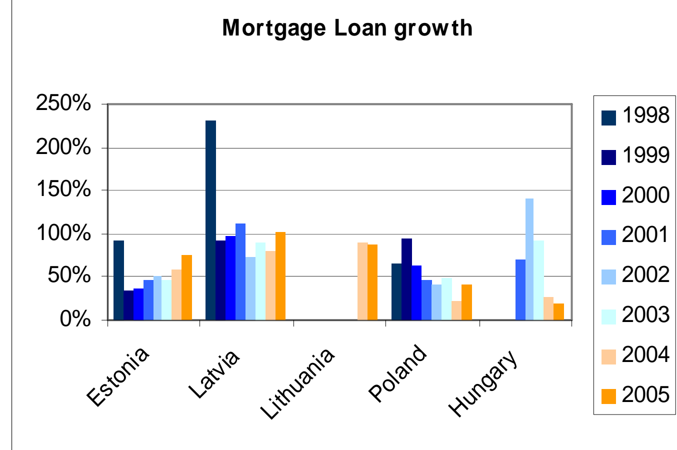
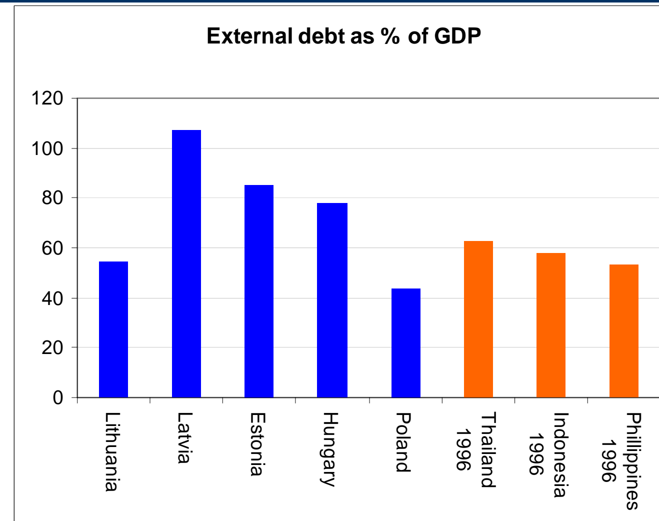


Source: ECB

or support their local subsidiaries in case of rising defaults. This hypothesis is fully untested.

To illustrate the extent of the lending boom, it is noteworthy that in many cases foreign debt has approached levels seen in Asia ahead of the 1997 descent into crisis. Foreign external debt in Latvia, Estonia, and Hungary has grown to more than 60% of GDP. Equally important, most of the growth has been in banking system liabilities, once again showing similarities with Asia in the mid 1990's.

External debt position reminiscent of mid 90's Asia



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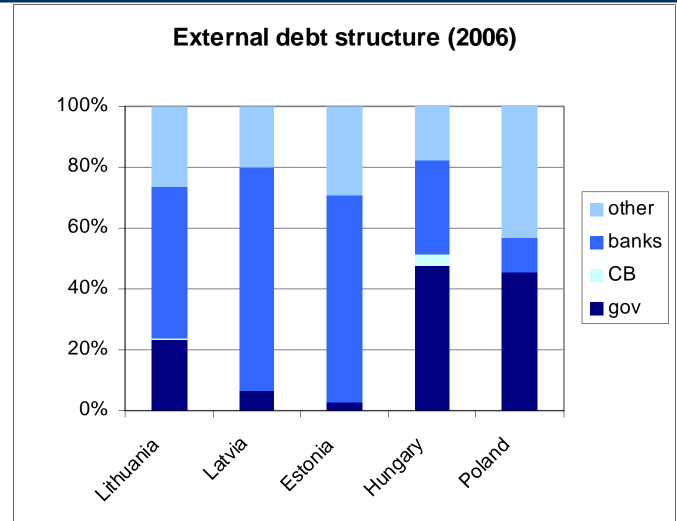

Source: Central Banks

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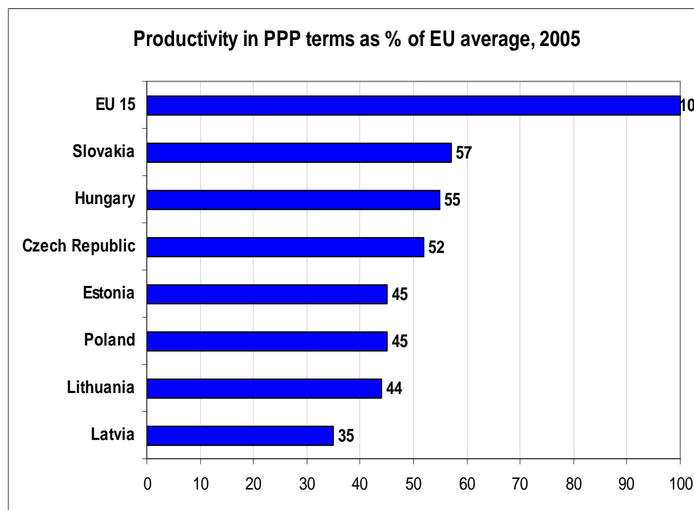
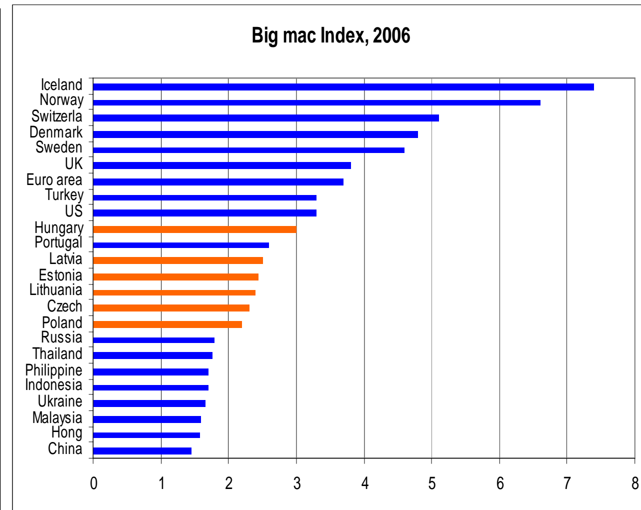
In addition to an explosion in local borrowing, the prospect of a "free lunch" has also attracted substantial amounts of hot money. The key destinations have been property and fixed income. In some countries there have also been important local investor participation in equity markets, both retail (Baltics) and institutional (Poland).

Hot money flowing into property and fixed income markets			
Hot money destinations	Property	Bonds	Equities
Baltic States	High	Low	Medium
Hungary	High	High	High
Poland	High	Medium	Medium

Further convergence asset gains will largely depend on the potential for real exchange rate appreciation. On simple Big Mac index comparisons, Eastern European currencies still appear cheap in relation to the Euro Area, but they are expensive to most Asian countries. Eventually, the speed and extent of real currency appreciation will depend on each country's ability to move toward higher value added manufacturing and service activities. Here rising trade deficits across the region indicate growth in local wages and prices are already outstripping productivity gains. The Czech Republic and Slovakia are best positioned for real currency appreciation, while Lithuania and Latvia are lagging.

Further real exchange rate appreciation dependent on productivity gains





Source: Eurostat

Source: The Economist

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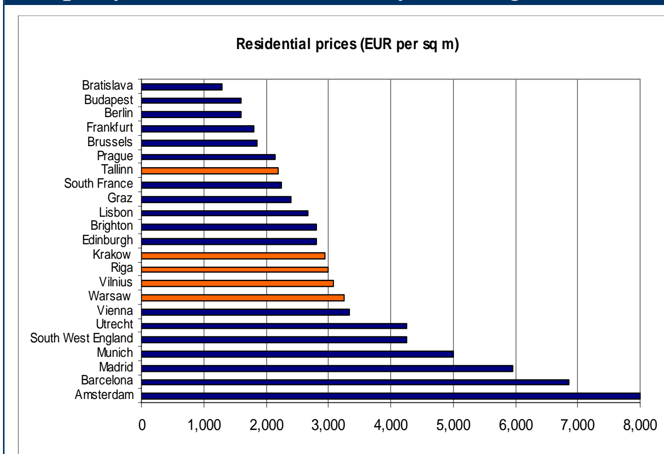
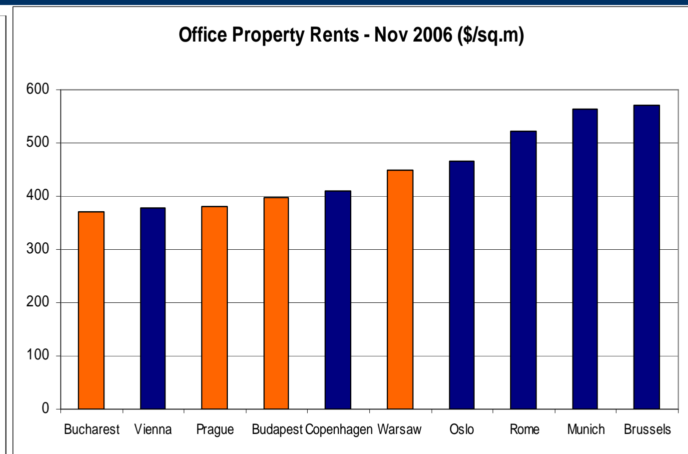
Property markets illustrate well the extent to which price levels in most EU accession countries have already converged with Western Europe. Although local property markets may appear cheap compared to London, Paris or Moscow, we believe prices should be benchmarked against medium sized capitals (e.g. Vienna, Berlin) or large secondary cities (Lyon, Hamburg). On this basis the scope for further convergence gains appears less exciting, especially considering that productivity and average earnings levels seldom exceed half of those in Western Europe.

Property markets close to fully converged





Source: Global Property Guide *Source: CB Richard Ellis*

2.2 Policy makers in a dilemma

The fragility of local currency and asset markets is further highlighted by low currency reserves. International reserves as a percentage of M2 are deteriorating for most of the countries and in some cases approaching record low levels (Lithuania, Estonia, Poland at lowest level since 1993). Central bankers in the region are not in an enviable position, with limited ability to control fixed income and currency markets. Furthermore they are torn between the ambition to adopt the Euro and the high costs it will require in terms of adjustments. *"It's really like a trap,"* Bank of Latvia Governor Rimsevics, recently commented on the current situation. This is a sharp contrast to positive statements from regional officials less than a year ago that the Euro adoption was a done deal.

Signs of market stress are most pronounced in the Baltic countries, where the Latvian central bank has been forced to intervene. Since then currency markets have dried up, making it close to impossible to for investors to hedge local currency exposure. Furthermore, local interbank rates have jumped dramatically after having been in line with Euro rates for over two years. There are now reports of falling local currency lending, although some local borrowers are happy to take on foreign currency debt.

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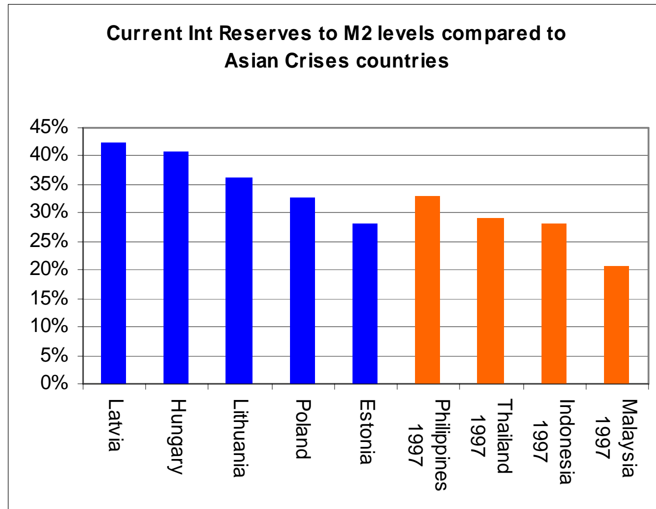
Drobny Guest Research

Currency reserves not sufficient to withstand speculative attack



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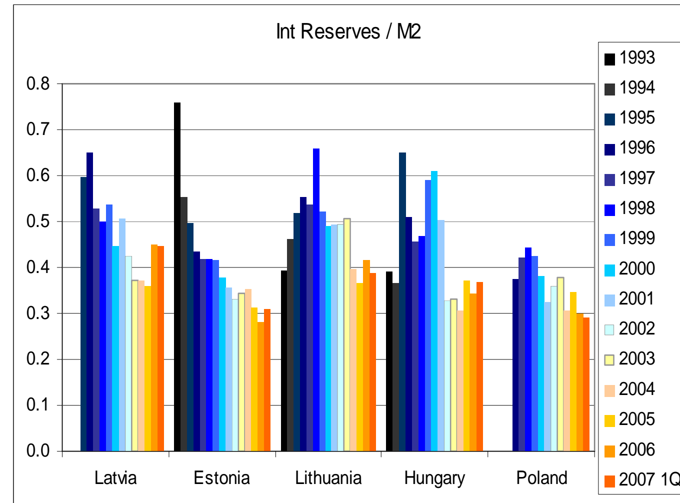
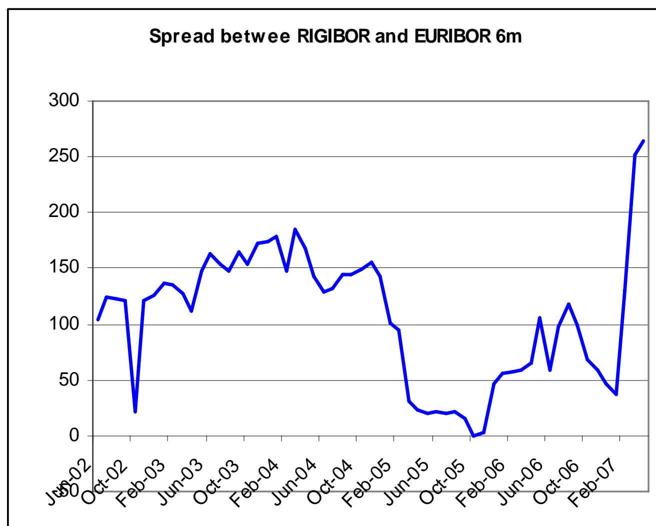


Source: Central Banks

Baltic money markets giving up on Euro parity



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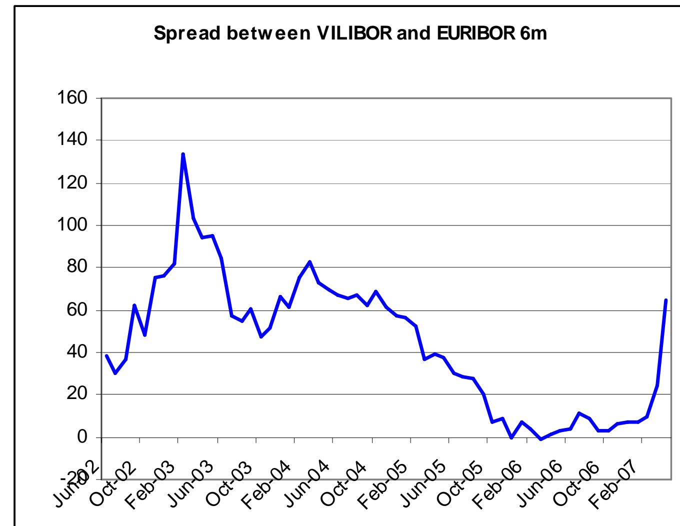

Source: Central Banks

As for economic activity, there is increasing evidence of economies slowing down. Industrial production growth is sharply decelerating in Latvia and Lithuania, while retail sales growth has collapsed in Hungary. Import growth also appears to be slowing down across the region. More ominous is that this appears to be happening in tandem with rising inflation, further complicating the situation of central bankers.

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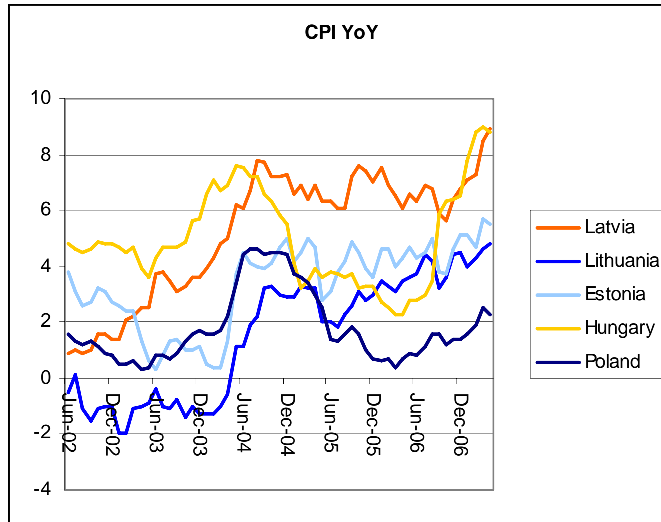
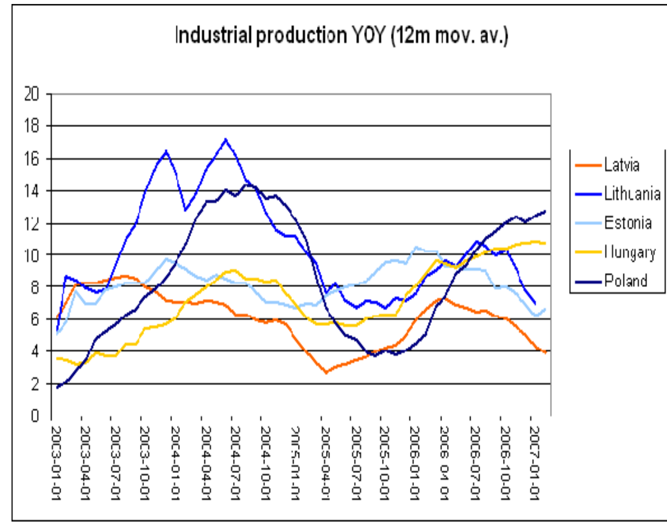
Central banks faced with economic slowdown and accelerating inflation



Source: Statistical Offices



Source: Statistical Offices

3. Southern Europe – Difficult adjustments ahead

The Southern European countries that adopted the Euro in the beginning of this decade are a highly disparate group. We will focus our discussion on Spain and Portugal, where we see the widest gap between investor perception and reality. While Greece and Italy have well known public finance problems, Spain and Portugal are facing more serious structural challenges in competitiveness, EU money flows and consumer housing debt.

Spain and Portugal potentially worse positioned than Italy and Greece

	Competitiveness	Public Debt	EU Fund Flows	Consumer Debt
Greece	Low	High	High	Medium
Portugal	Low	Medium	High	High
Italy	Medium	High	Low	Low
Spain	Low	Low	High	High

The Iberian Peninsula has been the prime success story of European integration and convergence over the last 20 years. Helped by EU structural funds, the adoption of the Euro and economic liberalisation, it has been the fastest growing part of Europe, accounting for up to 40% of European economic growth in recent years. We believe the

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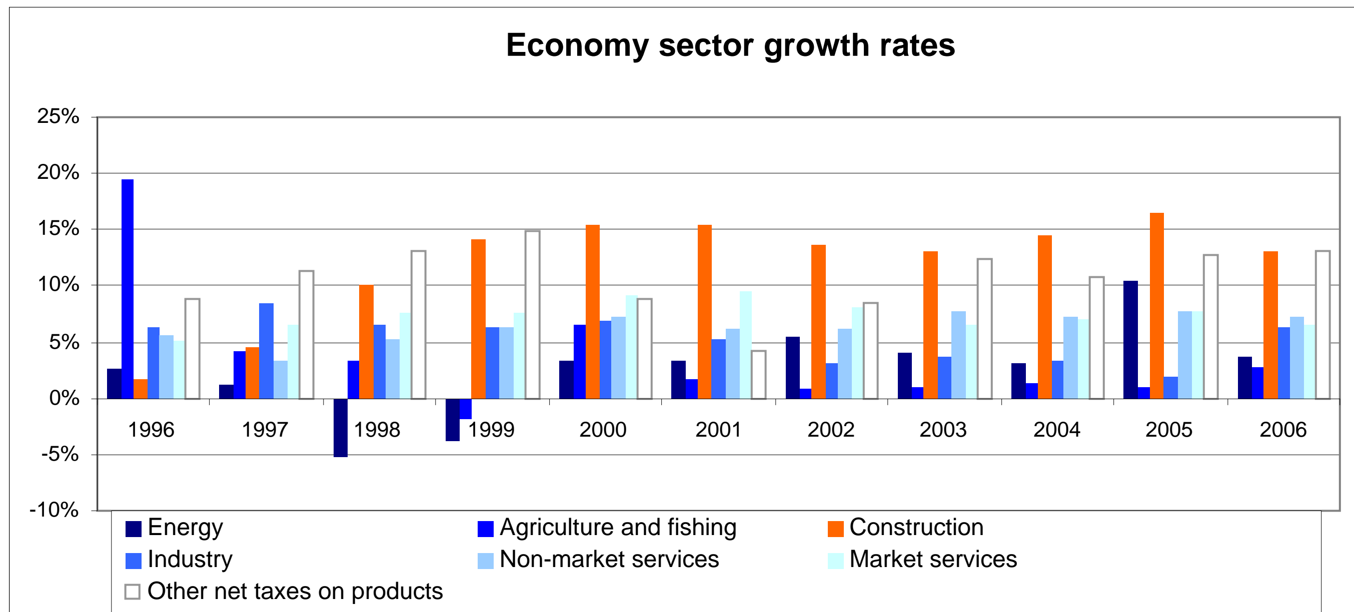
region is about to enter a significantly more difficult period with the potential triple whammy of a slowdown in housing and construction, rising credit defaults and a contracting manufacturing base. Given the inability to run an independent monetary policy, the adjustment process is likely to be painful and lengthy.

3.1 Traditional growth drivers increasingly fragile

Growth in the Iberian economies has been highly dependent on construction, housing and related activities. Spain can boast of having been the fastest growing economy in Europe in recent years, accounting for around 60% of new jobs created. However, it also accounts for 50% of Europe's cement consumption, and is one of the world's hot spots for building cranes together with the Middle East and China. While investors are worried about the US housing sector, it is interesting to note that housing starts in Spain are around 40% of the US, for a population that is $1/6^{th}$. The importance of construction in driving Spanish growth cannot be underestimated, with construction and related activities estimated to account for 20-30% of GDP and employment.

Construction and housing driving Spanish growth



Source: *Instituto Nacional de Estadistica*

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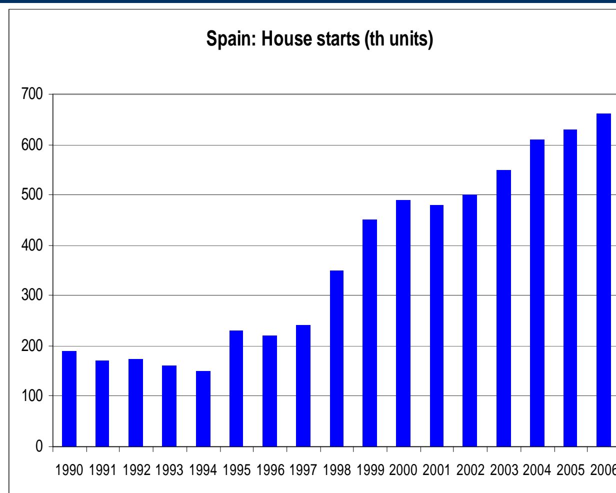
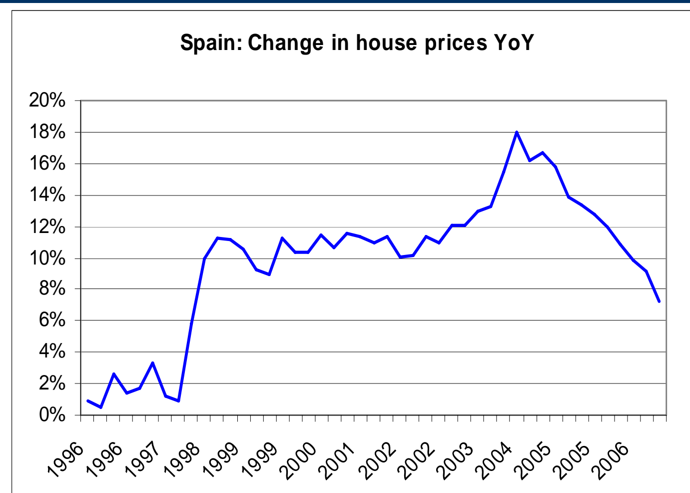
Housing wealth gains (prices up 180% in the last decade) have been an additional driver of strong growth in consumption and economic activity. In this respect, it is noteworthy that house price growth has already decelerated from the peak in 2003 and is now down to single digit figures. Although official house price statistics are still indicating rising prices, anecdotally there are increasing reports of falling prices and increased difficulties of disposing of properties in the market. This is a major development in a country where the real estate market has such a heavy impact on the economy.

Housing market peaking





Source: Instituto Nacional de Estadistica *Source: Instituto Nacional de Estadistica*

Spain and Portugal have also been among the major recipients of EU structural funds. Although the net funds received have been less than 2% of GDP, they have had important multiplier effects, particularly in major infrastructure projects, where the EU support has been instrumental. The EU support funds are now gradually being reduced as income levels in Spain and Portugal have converged with Europe, and EU spending is shifting towards the new accession countries. This will act as a brake on construction activity.

3.2 Unhealthy credit expansion

Southern Europe, led by Spain and Greece, has seen a major credit expansion following the introduction of the Euro. Given above EU average inflation rates, Spanish and other Southern Europe borrowers have benefited from close to zero or even negative real interest rates. The main area of credit growth has been housing and consumer related

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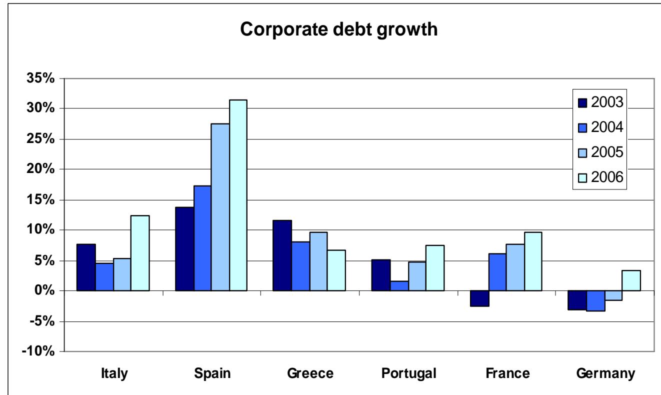
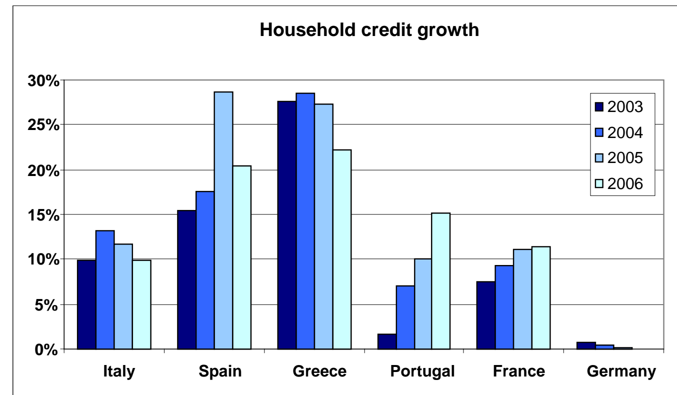
sectors, although Spanish corporates have also added debt aggressively, partly to fund overseas expansion.

Increasing expansion in household and corporate debts



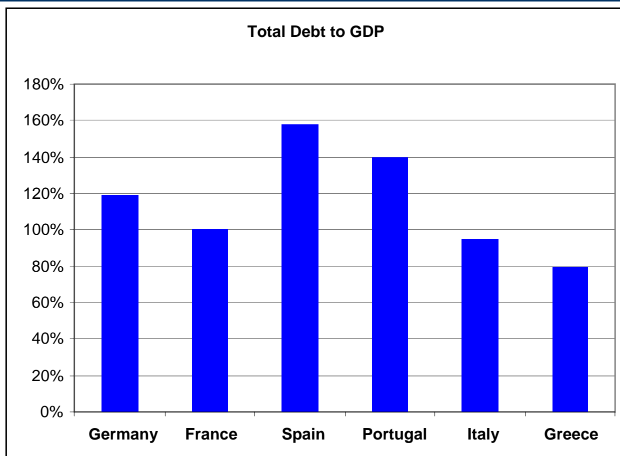
Source: ECB



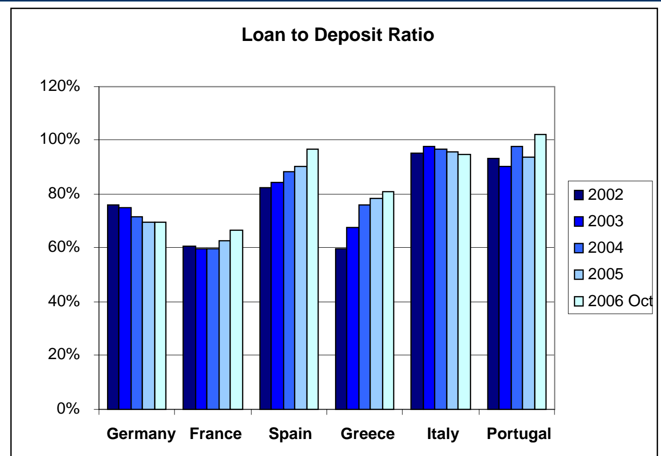
Source: ECB

As a result of their rapid credit expansion Spain and Portugal have become some of the most leveraged economies in Europe. In Spain household debt as a percentage of disposable income has reached more than more than 100%, approaching US levels. With more than 80% of Spanish mortgages structured with variable rates, households are highly vulnerable to rising interest rates. Given the increasing leverage, it is also worrying to note that loan to deposit ratios are approaching 100%, making banking systems less prepared to withstand unexpected shocks.

Spain and Portugal among most leveraged in Europe



Source: ECB, Eurostat



Source: ECB

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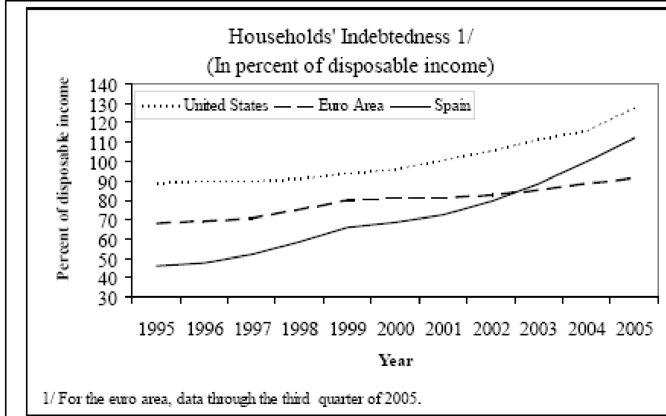

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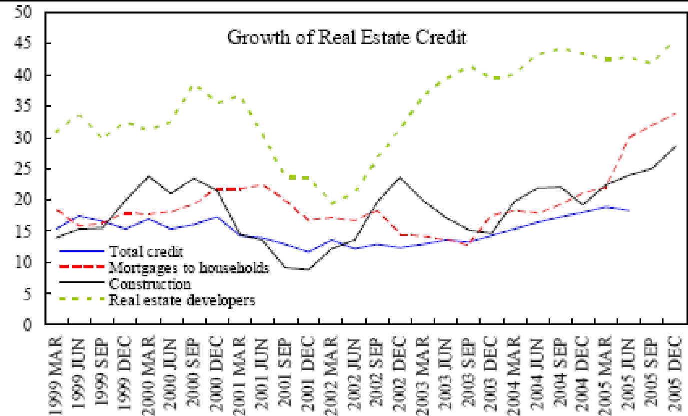
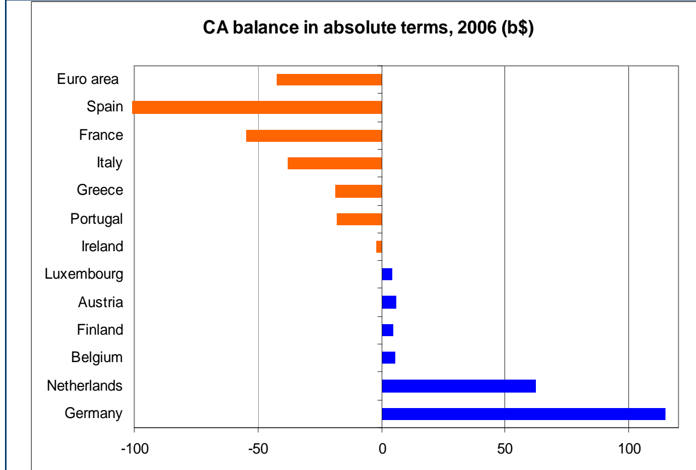


Source: IMF

3.3 Structural loss of competitiveness

Within the Euro area Spain and Portugal stand out in terms of poor current account deficits, approaching 10% of GDP, proportionally bigger than the US deficit. It is noteworthy that the gap between Spanish and German current accounts is now bigger than before the European currency crisis in 1992, when Spain and Portugal were forced to devalue against the D-Mark.

Southern European current account deficits worse than US



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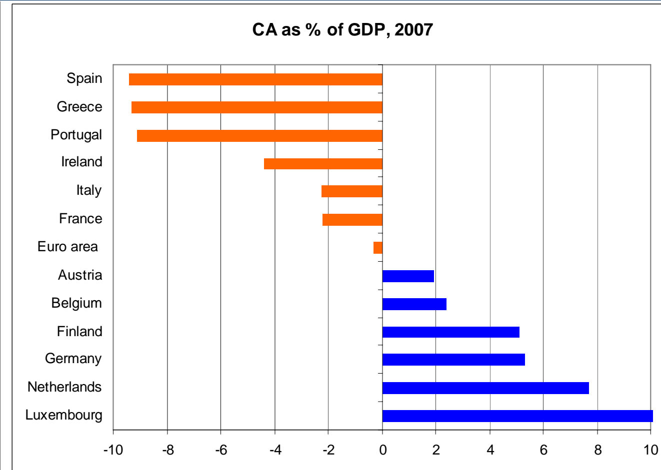

Source: IMF

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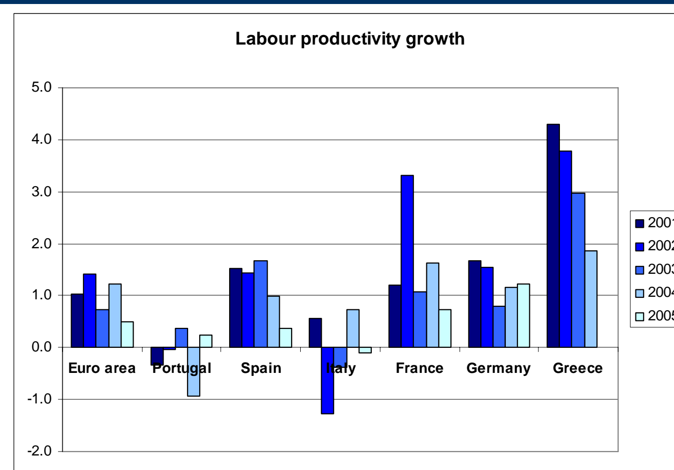
The loss of competitiveness has primarily been driven by real currency appreciation, as the Iberian Peninsula has experienced higher inflation rates than their major trade partners. Currently, real exchange rates of Southern European countries are approaching or in some cases exceeding their level pre 1992 devaluations. In the case of Portugal, IMF staff estimates that a currency depreciation of up to 20% would be needed to generate a trade balance consistent with stabilizing net existing liabilities.

More seriously Spain and Portugal have not kept up with the productivity growth in France and Germany, and have seen the sharpest deterioration in unit labor costs within the Euro area. For example, between 2000 and 2006 there has been a 20-25% drop in German unit labor cost relative to Spain and Portugal.

Consistent deterioration in productivity and unit labour costs



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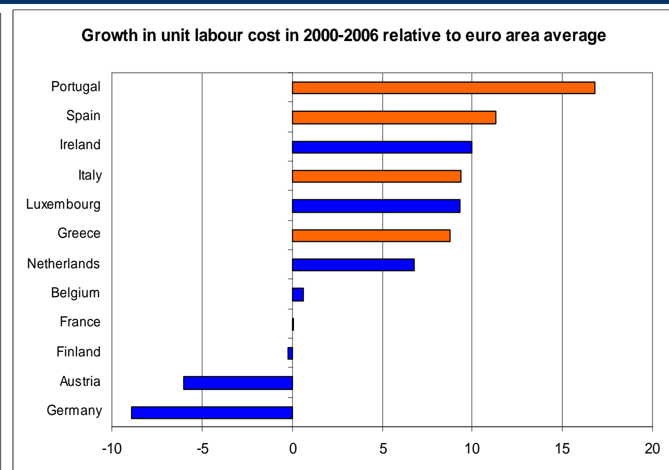

Source: IMF

The structural competitiveness challenge for Spain and Portugal is not only about poor productivity but also about the difficulty of moving higher up the value added chain, with R&D spending as a percentage of GDP one of the lowest in Europe. This is all the more important as trade barriers to low cost competition from Asia and elsewhere are being removed. However, moving up the value added chain is time and resource intensive. In the case of Spain and Portugal this could take decades, especially as everybody else from China and Japan to Germany and Italy have the same ambition.

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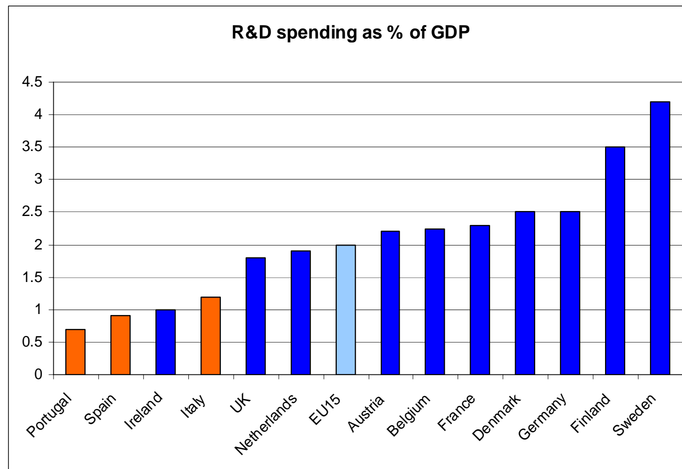
Moving up the value added chain – an impossible task?



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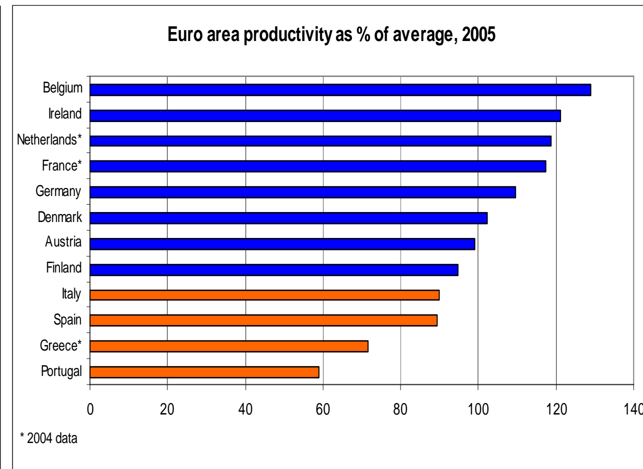

Source: Eurostat

An additional competitive threat to Spain and Portugal is the secular shift of European manufacturing eastwards. That means it may not be enough to be cost competitive, you also need to adapt to logistics requirements of major customers. Here Iberian suppliers are at a geographical disadvantage to Central Europe, who are closer to industrial customers in Germany and Northern Italy, as well as to the growing consumer end markets in Eastern Europe and Russia. The massive expansion of auto manufacturing in Central Europe is a particular threat to Spain, where 5 out of 6 European volume car producers still have plants.

There is no quick solution to improving Spain and Portugal's competitiveness given fixed exchange rates and limited potential for leaps in productivity or innovation. Spain may eventually be forced to deflate itself to competitiveness, similarly to Argentina in the late 1990's, but that will have a negative impact on the housing and consumer sectors of the economy..

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