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LUND UNIVERSITY FINANCE SOCIETY EST 1991

INVESTMENT RESEARCH REPORT

The Elephant Next Door

“Yield curve anomaly provides free leverage for hedged speculation in the yield curve front end”

HEADLINE

CASE SUMMARY: Growing concerns of an imminent economic slowdown has triggered investors to look for safer alternatives. Portugal has shown strength by recovering since the crisis in 2012, with persistent growth and a declining unemployment. Amongst the love clouds, we find several warning signs that might affect their 10-year government bond yield. At the same time, we see a malformed front end of the Portuguese yield curve, which although shows stable growth and a healthy political environment, are susceptible to contagion risk from Spain, which is enough for a correction of this anomaly to give opportunity for great profits with low risk. We suggest taking a short position in the Portuguese one-year bonds and a long position in the Portuguese six-month bonds to limit the downside risk.

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- **With Spain as the largest customer** of Portugal's exports, making up 26% of exports in 2017, the spillover effects of Spanish economic conditions have historically been large. Although conditions in Portugal have drastically improved in recent years, the high correlations with Spain in both GDP and 10-year yields suggest this trend may be short-lived as Spain faces economic and political risks.
- **A decreasing budget deficit**, debt to GDP ratio, and a decreasing unemployment rate all makes the outlook for Portugal seem great at the surface. Risk premia in the bond market have come down and yields are at all-time lows. The real risks lies in Spanish contagion.
- **In the Political Stability Index** provided by the World Bank, Spain is rated at 0.27 (-2.5 weak; 2.5 strong). After the ousting of Mariano Rajoy as prime minister in Spain, the new government is currently struggling with the approval of their expansionary budget. This occurs as rising labour costs risks reducing their international competitiveness, while spiking oil price volatility poses additional pressure.
- **The current near-equal yields** of the six-month and one-year bonds suggest that the near-term contagion risk is currently not being priced in. When the market eventually adjusts its required risk premium, the higher duration of the one-year bond should push one-year yields higher than six-month yields. We suggest a short position in one-year bonds and a long in six-month bonds, a trade with minimal cost of carry at current spreads.

EXHIBIT 1: Portuguese Imports & Exports

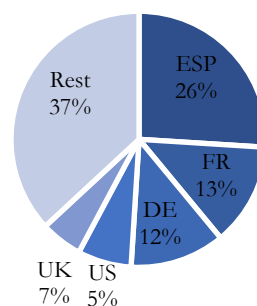


EXHIBIT 2: Portuguese Government Deficit

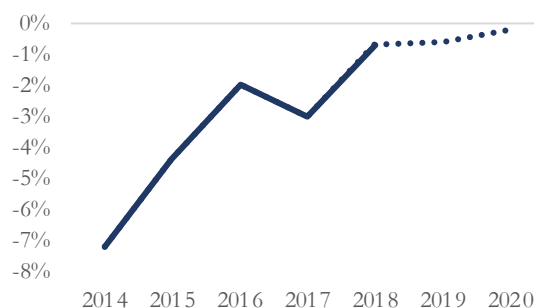


EXHIBIT 3: Portuguese Yield Curve



THE ELEPHANT NEXT DOOR

EXHIBIT 4: Spanish (dark) & Portuguese (light) 10-year yields

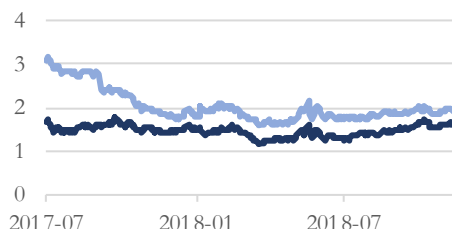


EXHIBIT 4: Portuguese Unemployment Rate

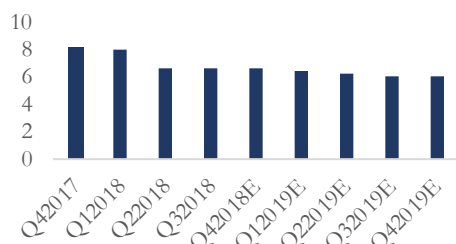
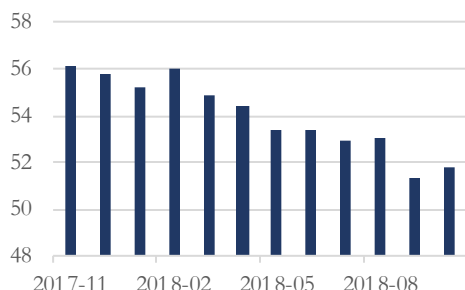


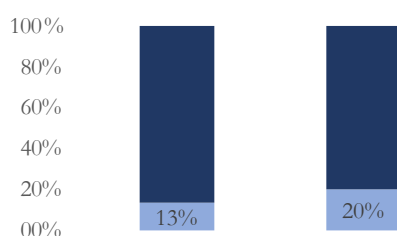
EXHIBIT 5: Portuguese PMI



”The opposite effect to that intended”

- Pablo Hernandez about the minimum wage increase,
1 Nov 2018

EXHIBIT 4: ECB APP Port. (L) & Sp. (R)



The risk of Portuguese recovery being a brief story is starting to appear increasingly prominent. It is easy to be misled when most indicators do show great strength, however the risks mostly lies aggregated in a single external factor, the Spanish economy. While Portugal as destination of Spanish exports only makes up 7.3% of the total, Spain makes up 26% of the Portuguese. The Portuguese issues thus have not severely affected Spain, however Portuguese vigor definitely may end up being weighed down by its six times larger eastern neighbour. This tendency can be seen in both GDP and yield correlations.

Although the Portuguese deficit increased from 2.1% to 3% in 2017, when adjusted for a one-time cost of rescuing the state-owned bank CGD it continued the trend of rapidly decreasing the budget deficit. Moreover, the government is projected to achieve a surplus in 2020 by continuously decreasing its debt. Economic indicators give bullish signals: non-performing loans are coming down, unemployment is decreasing and closing in on German levels and growth is stable. It is easy to believe the hype, these factors have misled investors into developing an overly optimistic view of the Portuguese outlooks, so optimistic that the front end of the yield curve shows distortions.

Credit rating agencies consider the outlook of the Spanish economy stable or even positive. Just as in Portugal, they see the decreasing budget deficits, the decreasing public debt, the decreasing unemployment rate and otherwise prospective increasing welfare for the, by European standards, rather large poor share of the population. With the top credit rating agencies S&P, Moody's and Fitch all having made their forecasts in the beginning of this year, certain factors have definitely changed. Since then, political risks have increased with the ousting of former prime minister Mariano Rajoy and the difficulties surrounding the approval of their budget proposal. The budget proposal entails a tax increase on wealth as a part of financing an increased social spending, however whether they could actually entirely finance the increased spending is uncertain as wealthy people have the possibility of moving their money. Producer-side indicators such as PMI are already showing signs of weakness, further pressure on producers and investors through taxing wealthy may be a mistake, even though the consumer side may strengthen. In addition, the Spanish tradition of overshooting deficit targets should further provoke doubts about whether Spain can actually comply with EU rules.

While the government has its problems, the economic conditions overall seem increasingly gloomy. This year's emerging markets crisis exposes external risks for a Spain that has immediate claims in Turkey of \$74bn, \$152bn in Brazil and \$25bn in Argentina. Many borrowers in these markets that otherwise would face even larger issues will not immediately show up in statistics over the non-performing part since large parts of the claims are denominated in local currencies. Instead the issues in these markets first show up on the exchange rate effects line on the initially less-visible income statements of Spanish banks as the emerging markets currencies weaken. In addition to this we have a trade deficit that is already increasing in 2018, and the new government plans to increase minimum wages across all sectors by a massive 22% would worsen the already lacking competitiveness of the Spanish economy. At the same time, as a big importer of oil, the recent spike in oil price volatility could prove to be another headache for Spanish businesses.

Our proposal is a short position in the Portuguese 1-year government bond and a long position in the 6-month government bond. They are currently priced to the same yield, providing near-costless leverage. Not only should anomalies such as this one correct themselves in the near-term, but with the rather poor outlooks for both countries outlined above, we expect yields to rise. With the longer duration of the 1-year, its yield is likely to rise more than the 6-month yield, an effect that may be further exacerbated with the ECB tapering of QE. This dynamic will cause any losses in the long position to be more than compensated for with the gains in the short position. As this part of the yield curve is unlikely to get flatter, the long position acts as a hedge to minimize downside risk

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