ANDBANK RESEARCH

Global Economics & Markets

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Working paper - 43

Really a Germanization? Do not be fooled. What we have is the necessary balance to achieve the optimal economic solution

ANDBANK
Private Bankers

April, 2013

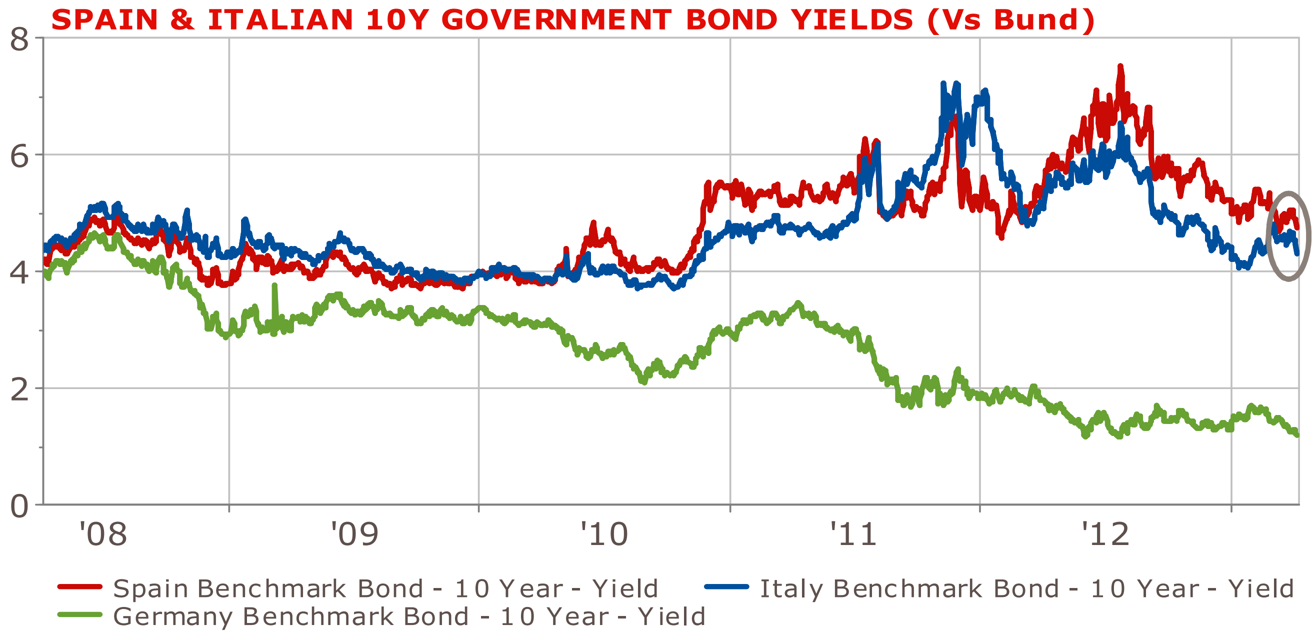
People in the Eurozone wrongly believes that countries have experienced a rigorous Germanization of the wide economic policy.
This is simply untrue…

… What we have is a Germanization of fiscal policies … in exchange of a de-Germanization of monetary and financial policies.

Maybe the best , and probably the only balance to fix short-term problems … and address the structural issues.

Has the Cypriot issue raised the systemic risks that ECB so successfully buried last summer?

Judging by market reaction … systemic risk has not bloomed again.



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… and the most striking is that Systemic Risk remains apparently controlled **despite the evident Political Dissonance**

On the one hand, with the Teutonic attack:

- ✓ Dutch Finance Minister (Dijsselbloem): *"Cypriot bank depositors may be a template for other eurozone bailouts"*
- ✓ German Finance Minister (Schaeuble): *"Deposit guarantees are only as good as state's solvency"*

On the other one hand, with the Chess Sicilian Defense

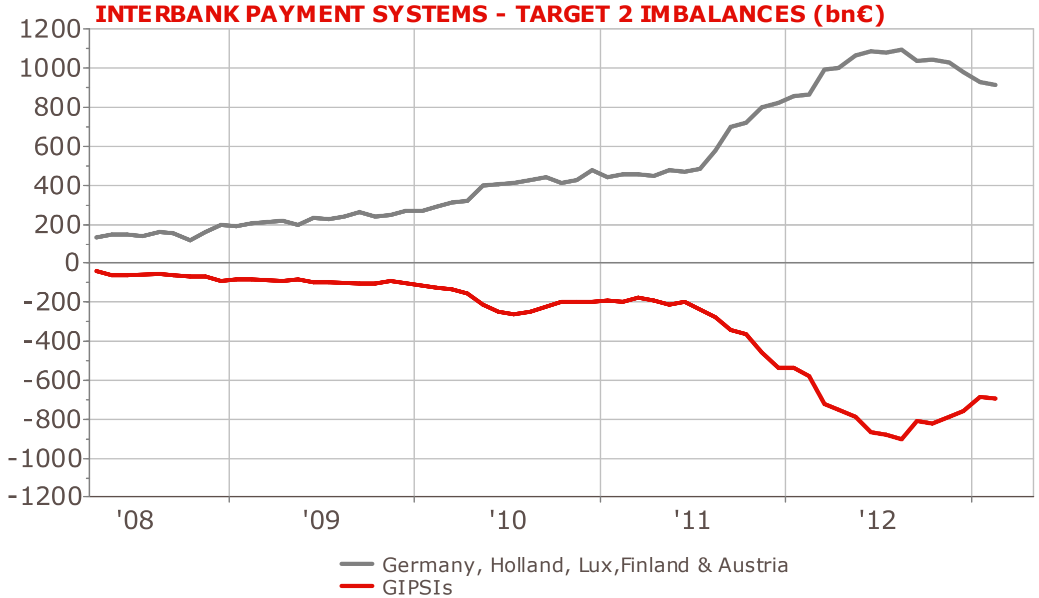
- ✓ Draghi's and his "*whatever it takes*" pledge.

But we have clear one thing ...

The bleeding details of the Cypriot bailout have been taken in the best possible time within the crisis.

1. Imbalances in the Interbank Payment Systems (Target 2) are clearly improving…

2. … what means that financial conditions in the GIPSIs are also improving. **A key pillar for improvement in economic outlook.**



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What we must assess now is whether this dynamic in Target 2 can be reversed. If this were the case, the entire strategy of ECB would be called into question.

Here are the Risks that could cause a reversal in Target 2	Andbank's Assessment	Potential effect of that Risk
The Cypriot Solution was politically motivated	Where is the problem in taking actions targeting tax havens, Russian clients benefiting from tax havens, and troublesome financial institutions based in tax havens?	LOW
Investors again doubt the permanence of a particular member of the Eurozone	Greece & Cyprus are the paradigm of that risk. Nevertheless, it seems that they have decided to stay.	LOW
Euroland's new equilibrium has been forged by a "GERMANIZATION" of fiscal policies	Yes, but in exchange of a "de-GERMANIZATION" of monetary and financial policy (LTRO & OMT)	LOW

We consider that probabilities are low for a reversal in Target 2

Additionally, dynamics in flows from Japan will help to maintain the market mood

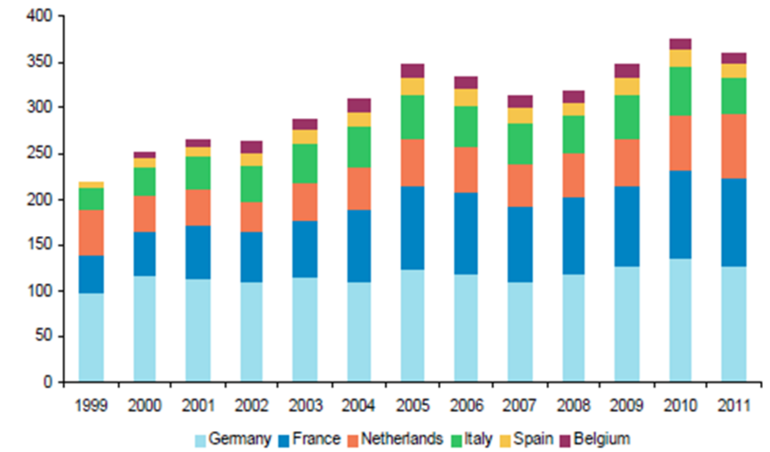
- ✓ Japanese pension funds have liability costs close to 1.30%, … meaning that with 10yr JGB near 0,30% they need alternatives that are probably located abroad.
- ✓ 35% of JGBs are in hands of insurance companies and pension plans. A mere 5% would represent $100bn of purchasing capacity in other assets.
- ✓ Some sources pointed later last month that these pension funds are already buying a lot of european paper (essentially French government bonds since German bonds do not cover liability costs)…
- ✓ In turn, French pension funds maintain liability costs near the 2,5% level. Which in turn (with 10yr yield in government bonds at 1,80%) forces them to find investment alternatives abroad, … let's say, Spain? Italy?
- ✓ This dynamic will continue for a "long period of time" if the new BOJs governor decides to implement what has already promised … as it seems he will do.
- ✓ BoJ's aggressive action to raise inflation by increasing the size of QE will push JGB yields even lower, pushing Japanese investors away from lower yielding JGB market, increasing marginal demand for EGBs, given their higher yield.
- ✓ Japanese investors own about €350bn European bonds, of which €250bn are EGB (€120bn less than the exposure seen at the onset of the financial crisis.

Why do we think that Japanese influence on peripheral rally (bonds & equity) has still a long way to go?

Because of the downtrend in core countries yields, and the limited exposure of Japanese investors to non-core European governments…

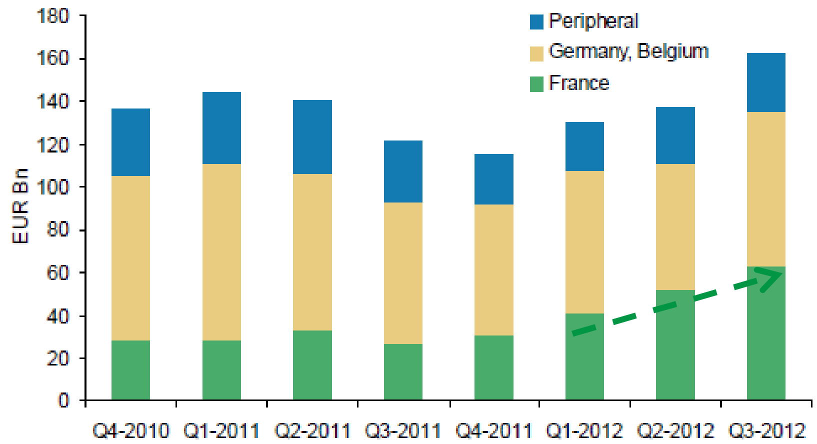
… and because of the evidence of the last few months, according to which banks would already be modifying their exposure.

Japanese investors – Exposures to EGB



Source: Haver, MoF, Morgan Stanley Research

Japanese Banks – Exposures to EGB



Source: BIS, Morgan Stanley Research

Conclusions.

- **Reflationary policies will probably intensify,** since the weak European growth outlook offers no credible alternative…,
- … ensuring that a **de-Germanization of monetary & financial policy will continue**, as opposed to **Germanization of fiscal policy** …
- … giving rise to the **necessary balance** to achieve the optimal economic solution for the region.
- Although the ECB may seem paralyzed and slow to react, this would be because of the imminence of German elections in September but …
- … we have reasons to think that **paralysis in ECB will not be the most probable scenario**:

    1. Eurozone CPI stands at 1,8% and any further decline will provide cover for the doves
    2. Ireland managed to issue a 10yr bond in March, almost fulfilling the conditions of "full market access" for the activation of the ECB's OMT.
    3. If Draghi produces such development, market participants will conclude that he remains in command.

- Additionally, dynamics in flows from Japan will help to maintain the market mood
- If all the aforementioned happens (as we project), rally in peripheral bonds could resume, with positive implications for the rest of risky assets, especially equity markets of "euro area victims".

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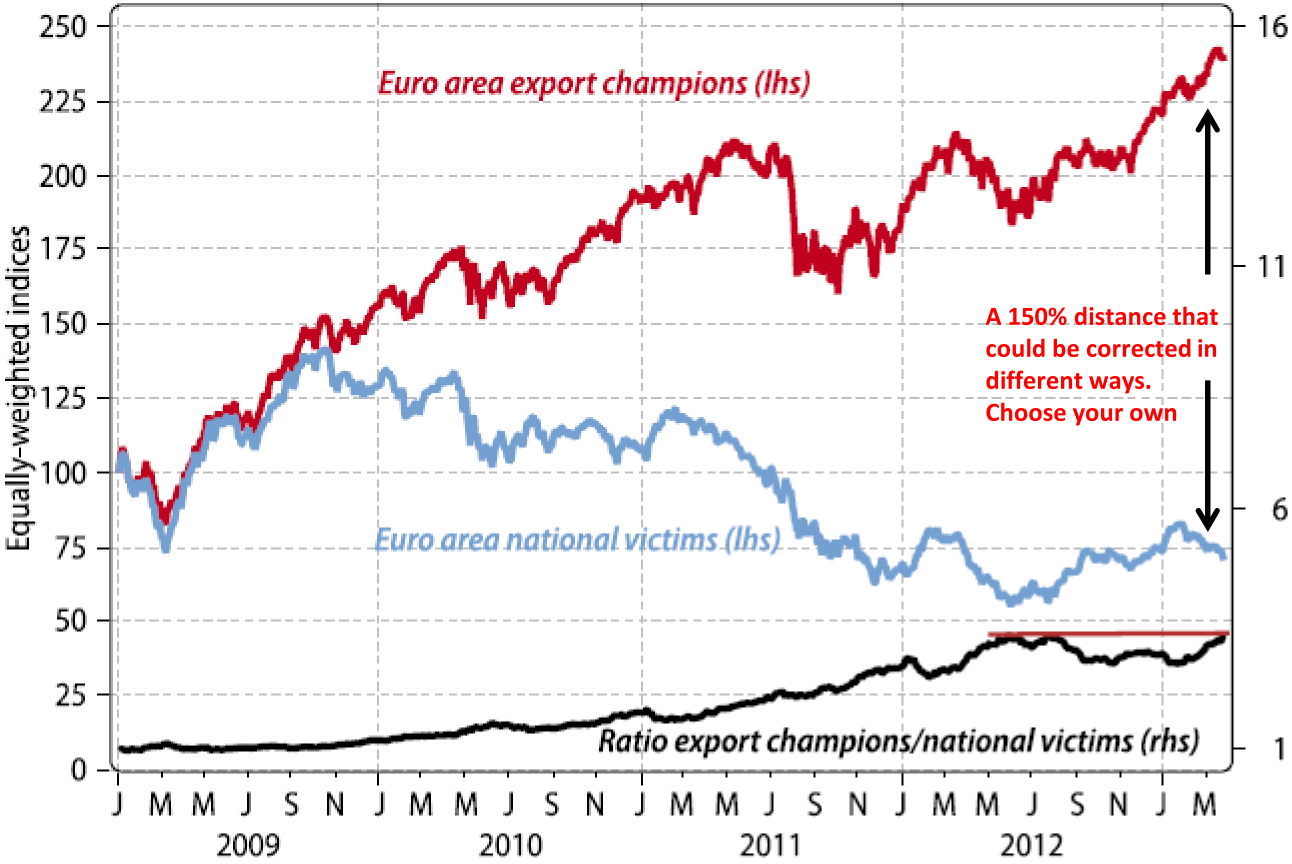
To get a rough idea about the potential recovery of these markets, please consider the chart



Instruments that suit best the environment described

- **Fixed Income & Fx Instruments**
  - ✓ Bond Fund Sovereign EUR – A (Andbank Asset Management)
  - ✓ Bond Fund Global – A (Andbank Asset Management)
  - ✓ Bond Fund Opportunities EUR – A (Andbank Asset Management)

- **Equity Instruments**

  Portfolios
  - ✓ Top Dividend Euro (perfil 155)
  - ✓ Select Euro Equity (perfil 130)
  - ✓ Select Spain (perfil 129)

  Funds
  - ✓ Equity Fund Top Exporters EUR – A (Andbank Asset Management)
  - ✓ Equity Fund Spain – A (Andbank Asset Management)
  - ✓ Equity Fund Euro Active Value EUR – A (Andbank Asset Management)
  - ✓ Halley European Equities – Andbank Asset Magment Lux (LU07800569322)
  - ✓ Pioneer Funds Euroland Equity A USD Non-Distributing (LU0132181453)
  - ✓ Pioneer Funds - European Potential A USD ND (LU0398873470)
  - ✓ Allianz RCM Euroland Equity Growth AT EUR Acc (LU0256840447)
  - ✓ Natixis Actions Small & Mid Cap Euro R (FR0010666560)

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