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Amundi ASSET MANAGEMENT

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INVESTMENT TALKS

Spain: Forming a coalition will take time, but the picture looks benign for investors


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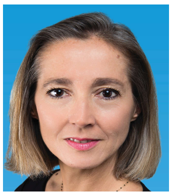
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"Forming a coalition will require some time, but this is not a threat for the Spanish economic outlook."

The outcome: *The ruling Socialist Party of Pedro Sánchez came first, however without an absolute majority in Parliament. The new, far-right, VOX party also entered Parliament.*
The next step *will be the search for a majority coalition. The design of the next "Coalition in power" is not an easy task for two main reasons: the harsh words exchanged between contenders during the Parliamentary campaign and the next regional elections, that will take place the same day as the EU elections (May 26th). The negotiation process could take some time.*
Risk assessment*: No imminent threat to economic stability, considering the strong economic improvement already achieved by the country. Fiscal discipline should be monitored, especially in the case of a coalition or alliance with the far-left.*
Long term risks, similar to the rest of Europe, relate to the emergence of more extreme political forces. However, we do not see the Spanish election as a game changer for the European elections, although they may give even more impetus to those anti-institutional forces that make subsequent national elections less predictible.
Bond Market assessment*: In Spain, Government Bonds remain supported by the good momentum of the economy and their risk adjusted return is still fair, in comparison with other peripheral bonds (Portugal relatively rich, Italy more volatile). Spanish IG credit also relatively attractive (hunt for yields is set to continue).*

What is your analysis of the Spanish election results for the stability of the government and economic conditions?

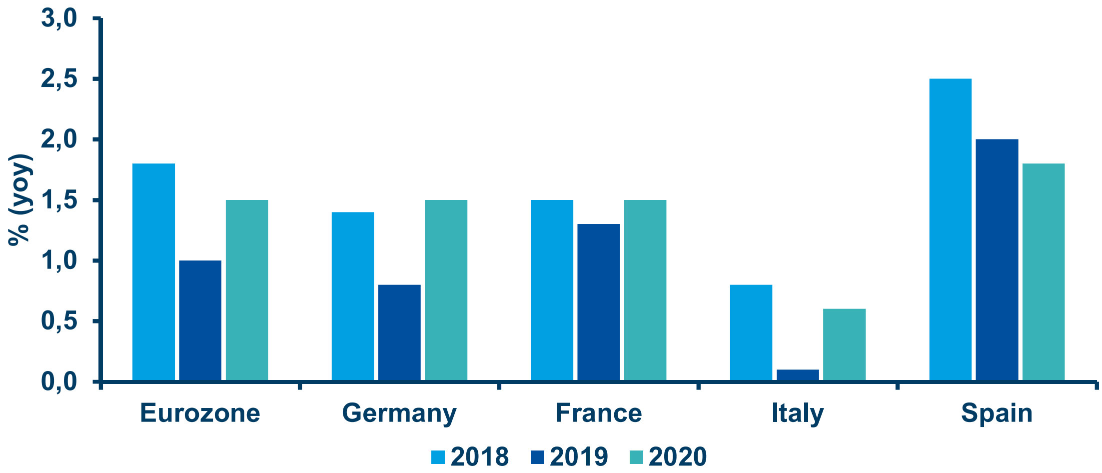
The result is generally in line with what could be expected from the polls: The PSOE (Socialist) Party of PM Sánchez came first, securing a large increase in its number of Members of Parliament (MPs) (123 vs. 85 in the June 2016 election), which are now almost twice as many as those of the other historical party, the right-wing PP (only 66 MPs). However, this is still well below the 176 MPs required for a majority in Parliament. The other notable outcome, also well expected, is that the new, far-right, VOX party also entered Parliament (with 24 MPs), whereas Spain was until now an exception in Europe with no significant far-right political force.

The next step will be the search for a majority coalition. In theory, the PSOE could form one with the *Ciudadanos* party (center-right, 57 MPs), which would be the most market-friendly outcome, but *Ciudadanos*'s leadership has already announced that it rejects such a deal. Another option would be a coalition between the PSOE and the UP party (far-left, 42 MPs) which could work, even though it would be slightly short of an absolute majority: This may be the most likely option. A third combination would be the same PSOE-UP coalition together with the Catalan pro-independence parties: Enough for a majority, but raising difficult issues. In any case, negotiations may take a few weeks, and leaders may wait until after the European election (May 23-26) to make their choices.

There is no imminent threat to Spanish political or economic stability. Ever since the PP lost its absolute majority in December 2015, Spain has been ruled either by interim or by minority governments, with the last government (that of PM Sánchez since June 2017) only relying on a small minority. This has not prevented the Spanish economy from continuing its strong recovery.
Several risks must nonetheless be monitored, notably because a PSOE-led government that would form a coalition with UP and/or with Catalan independentist (or a minority PSOE government that would rely on their support) could either take measures that would be seen as market-adverse (i.e. excessive fiscal loosening or reversal of pro-business reforms) or decisions on Catalonia that could infuriate conservative segments of public opinion.

However, at this stage, given the strong economic improvement already achieved by Spain, we see no systemic risk to the Eurozone emanating from the country. Longer term, as elsewhere in Europe, the rise of the far-right complicates political life and decision-making is more problematic, especially if tough times come that require difficult action.

Spain leading among main countries in real GDP growth



Source: Amundi Research, as of 30 April 2019.

"Spain can probably afford a fiscal stimulus in 2019/20, but over the medium term, fiscal fragilities will re-appear."

How do you think this result will impact fiscal policy? Do you see a trend of fiscal stimulation here like in the rest of Europe?

A strengthened PSOE could well pursue slightly looser fiscal policies, all the more so in a coalition or alliance with the far-left. Spain can probably afford it this year or the next, but this is mainly due to the strong current GDP growth impulse, which will not last forever as the economy's pace will gradually converge with that of the rest of the Eurozone. Over the medium term, fiscal weaknesses could re-appear: the country has not fully taken advantage of growth windfalls to bring its fiscal metrics fully in order and its structural deficit, at more than 3% of GDP (according to EC metrics), is one of the Eurozone's largest.

It is true that more fiscal easing in Spain seems to be in line with spending increases and tax cuts in Germany, France and Italy this year. However, this is far from being a coordinated trend: While the Eurozone has largely turned its back on austerity policies, fiscal stimulus efforts differ considerably in their structure across countries and result from specific national equilibriums and events. There is low visibility on the willingness and capacity to deploy any significant fiscal stimulus at the scale of the Eurozone in 2020 or later.

What can we take from this result, with a view to the upcoming European elections?

We do not see the Spanish election as a game changer for the European election. It has essentially confirmed that far-right parties are making progress all over the continent and that, even though they are still far from participating in governments in most countries (and very far from achieving an absolute majority), they do make the building of majority coalitions more difficult and create an incentive for "mainstream" right-wing parties to try to adopt some of their themes.

When it comes to the European elections, we believe, as most observers do, that far-right parties will make some progress and that the two traditional mainstream parties (the Social-Democrats and Christian-Democrats) will lose the combined majority that they have had since the creation of the European Parliament.

However a "pro-institution" majority could probably still be achieved, although with some additional delays and negotiations, by working with center parties or with the Greens. We do not therefore see the European elections triggering a new systemic crisis in the Eurozone in

2019, although they may give even more impetus to those anti-institutional forces that will make subsequent national elections less predictable.

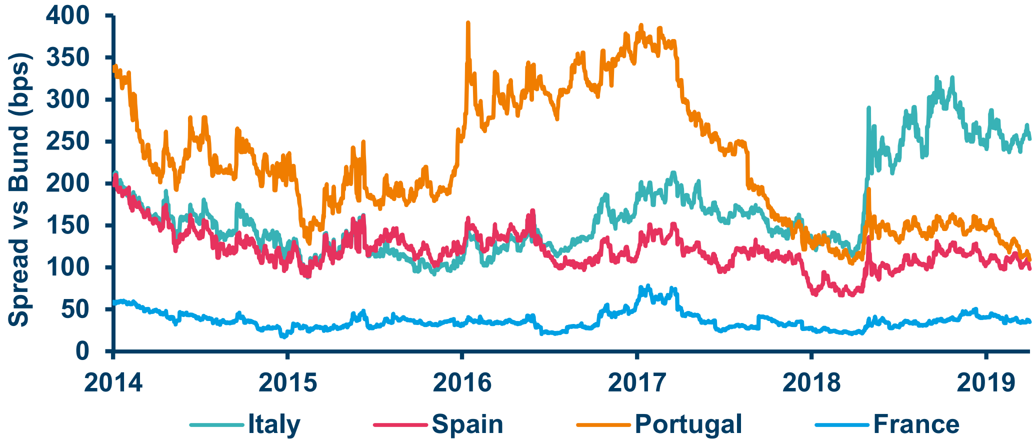
Do you see implications of this results on your outlook for Spanish government bonds? What is your view on this market and your assessment vs other peripheral markets?

The result of the Parliamentary elections is broadly in line with market expectations as no single party was able to get a majority. Being the most represented party (28.7% - 123 seats), PSOE will be in charge of forming a new Government. In fact, the design of the next "Coalition in power" is not an easy task for two main reasons: the harsh words exchanged between contenders during the Parliamentary campaign and, more seriously, the next regional elections that will take place the very same day as the EU elections (May 26th). The negotiation process could take some time.

We do not expect a significant change for the outlook on Spanish Government Bonds as long as the economic situation remains unaltered.

"Spanish Government Bonds will continue to benefit from the strong pace of the economy."

10Y Government Bond Spreads vs Bund



Source: Amundi, Bloomberg, as of 30 April 2019.

Spanish Government bonds are well supported by the strong momentum on the economic front with higher growth data versus European peers, a current account surplus and better achievements on the budgetary front. Rating agencies should continue to acknowledge this improving trend (the next review will be done by Moody's on May 24th 2019, currently Baa1). We estimate that Spanish spreads will be supported by these fundamentals and may tighten further at some stage.

Moreover, **their risk-adjusted return is still fair, in comparison with other peripheral bonds**. Portugal is now quite "rich" versus Spain; Italy is the main competitor but lagging behind, with much more volatility linked to the unclear fiscal and political situation.

Beyond peripheral bonds, what are, in your view, the strategies that should generate returns for Euro fixed income investors?

The decrease of interest rates since the beginning of the year has reactivated the hunt for yields: Investors are chasing any premium on sovereigns, covered bonds and investment grade credit. We have also cautiously increased our preference for a blend of those asset classes. Country wise, due to the risks in the banking sector, we prefer Spain to Italy for the time being.

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