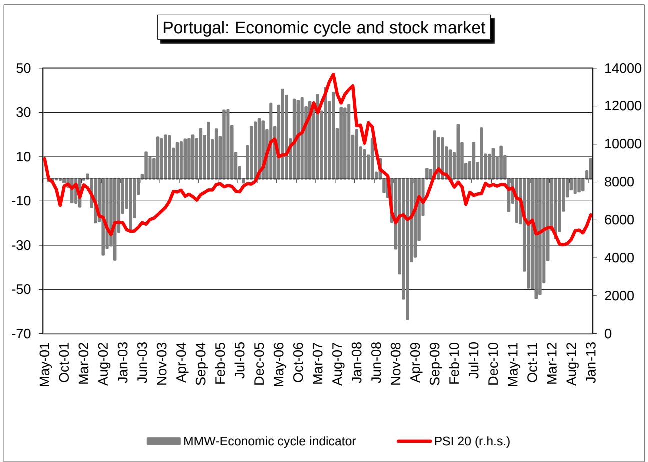
ECONOMIC SITUATION AND STRATEGY

Greece and Portugal: Stocks in demand again

Stocks from Portugal and Greece have soared in the past months. Since June 2012, the PSI 20, the benchmark Portuguese stock market index, has advanced by more than 40%, and its Greek counterpart, the FTSE/ATHEX, has gained nearly 90%. This is likely to have surprised many who had become accustomed to mostly bad news about Lisbon and Athens. However, they are comparatively small stock exchange centers, in which large and conservative investors have in any case sought little or no exposure in the past years.

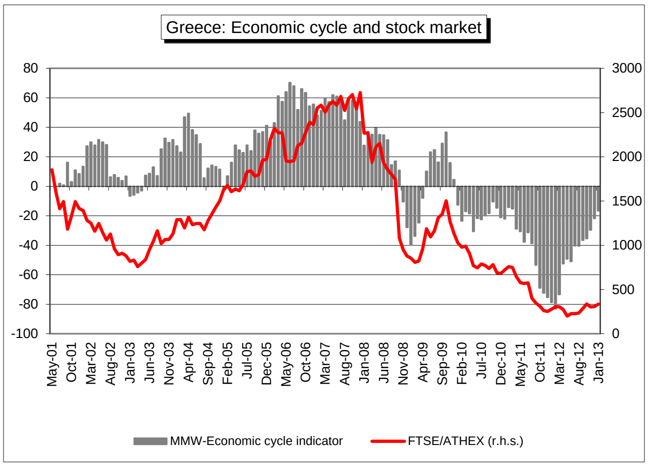


The situation in both countries continues to be very difficult. The Portuguese economy probably contracted by about 3% in 2012 compared with the preceding year, and another minus of 2.3% is expected for this year according to Consensus Economics surveys. Greece also remains in a recession. After a likely decline of 6.5% last year, the economy will probably contract again in 2013 by 4.5% according to Consensus Economics. Despite significantly lower interest rates, both countries still face huge questions about whether and when their national debts will ever become sustainable. Against this background, the strong price performance of recent months seems remarkable at first.

In fact, however, there are signs that the economic downswing may have bottomed out. That is shown, for example, by our country allocation model, with which we follow the most important economic data from 36 countries. In the area of leading indicators, in particular, there has been movement in Portugal and Greece in the past months. Although some leading indicators are still very low, practically all areas have improved recently. Companies from the manufacturing and services sectors have been less pessimistic, as have consumers and retailers.

Portugal and Greece have also registered advances in competitiveness. Unit labor costs have fallen sharply in Greece and somewhat in Portugal. However, it is still too soon to signal “all clear,” especially in the case of Greece. Unit labor costs increased there in the preceding years by more than 40%, so competitiveness remains limited in large parts of the Greek economy.

Moreover, the outlook in real economic terms is still bleak in both countries, and scarcely any improvement has been observed except in foreign trade and construction activity. In particular, the labor market situation remains precarious. The unemployment rate in Portugal stands at more than 16% according to the latest data, while about 25% of the workforce is idle in Greece. Against the background of persisting competitive disadvantages, we expect the pressure on the labor market and wages to continue for some time, even if the general economic situation should not be as negative in the coming months as it was in 2012. This will undoubtedly limit the speed at which the countries will be able to recover economically in the months and years ahead.



Nevertheless, identifying a cyclical turning point has proven a quite reliable signal for the stock market in the past, even if it only means that a national economy might contract less severely in the future than it has before. The results of our country allocation model indicate that both Portugal and Greece have reached such a turning point.

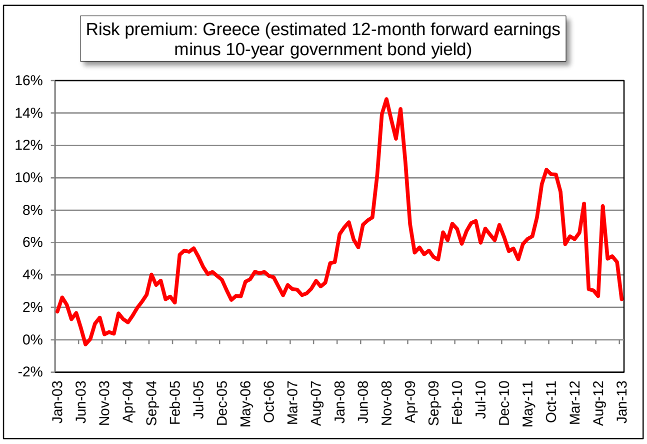
Given the strong price performance in recent months, however, the question arises whether this has already been fully priced in on the stock market. This cannot be answered with certainty, but there are indications that the upward movement on both stock markets may not be completely over yet.

For the time being, the future course of stock prices is likely to depend crucially on whether economic data continue to improve. In view of their still very low level, we consider it quite possible that they will. That the ECB has considerably reduced the risk of individual countries exiting the EMU should provide support and thus contribute to somewhat more confidence (from low levels) on the part of Portuguese and Greek businesses and consumers. Moreover, we expect European economic development to improve in 2013, which should also have a moderately positive effect on Portugal and Greece. However, if our expectation is not met, the correction on the stock exchanges in Lisbon and Athens might be severe.

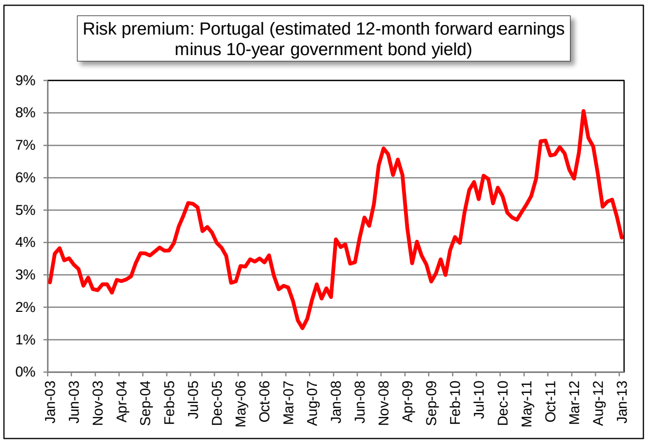
On the valuation side, there would still be room for upward movement of the Portuguese and Greek stock markets, if one does not rely solely on the price-earnings ratio (P/E). In our valuation model, they are still considered “cheap” despite high P/Es. The model assesses the stock markets of more than 50 countries according to six valuation figures, including the P/E, the price-book value ratio, and the dividend yield, and classifies them into a five-stage scale (very cheap, cheap, neutral, expensive, very expensive). Other stock markets – including Italy and Spain – are in the “very cheap” category and thus appear more attractive from a valuation standpoint. But positive stock market development in Portugal and Greece would nevertheless be possible in the coming months, without those markets having to be rated as especially expensive thereafter.

Valuation models like the one we use should always be treated with a bit of caution, however. Depending on exactly how they are set up, the results can turn out differently, and we could write a report dedicated solely to explaining what ratio in such a model should be used for what purpose. Moreover, a cheap market may remain cheap for a long time, and there are often good reasons for an overvaluation or undervaluation. It would thus not be enough simply to invest in the cheapest markets and avoid the expensive ones. Nevertheless, such models may prove helpful in rounding out an overall picture concerning one or several markets.

A mixed picture emerges, however, when one considers the risk premiums implicitly contained in the Portuguese and Greek stock markets. From this perspective, the question is what expected additional return the stock market promises compared with a bond that is considered safe. Unlike in our valuation model, which takes into account several valuation ratios, risk premiums are influenced substantially by analysts’ earnings expectations. Dividend yields, price-book value ratios, and other key figures have no direct influence.



The risk premium should be higher, the less confidence investors have in a country’s earnings estimates and stock market. Risk premiums reached peaks in many countries last year, and the stock market in some cases promised additional return of more than 10% compared with the bond market. In many countries, risk premiums only began to decline again in mid-2012.



The risk premium on the Greek stock market has fallen quite significantly. It is now at the lowest level since the beginning of 2006. The decline of the risk premium is somewhat less pronounced in Portugal, but at current prices, a lower premium is demanded than on the larger German, French, Japanese, and US stock markets (as measured by the DAX, CAC 40, Nikkei 225, and S&P 500). Risk premiums there are still between 6% and 8%, which in percentage terms is 50% to 100% more than in Portugal.

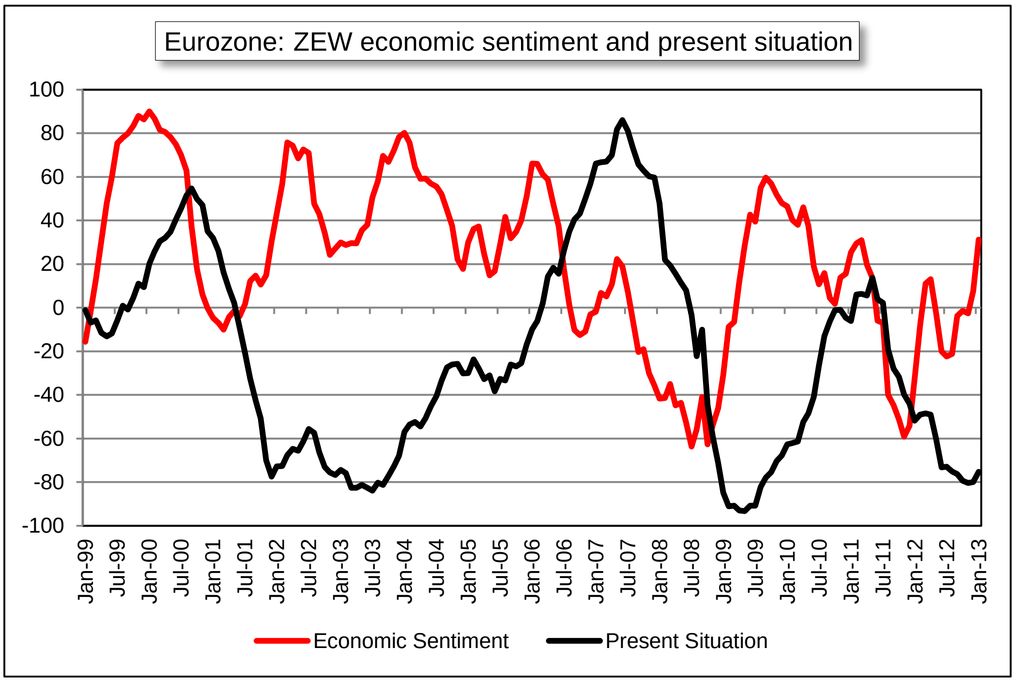
The calculation of the risk premium depends crucially on whether earnings estimates for the stock market prove accurate. If the economic recovery continues, that should positively influence corporate earnings. The consequence would be that the actual risk premiums in Portugal and Greece would be higher than in our assessment. We nevertheless conclude that investors who bet on a comeback of the Portuguese and Greek stock markets will have to accept significantly higher downside risks than they would on many large stock markets. That will be the case particularly if the recovery does not continue or negative headlines emerge again about Portugal and Greece.

Weekly outlook for January 28-February 1, 2013

	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	Release
DE: Import prices, m/m	-0.7%	-0.6%	0.0%	-0.2%			from Jan. 28
DE: Import prices, y/y	1.8%	1.5%	1.1%	0.7%			from Jan. 28
DE: GfK consumer climate	6.0	6.1	6.1	5.9	5.6	5.8	Jan. 29
DE: Consumer prices, m/m	0.0%	0.0%	-0.1%	0.9%	-0.6%		Jan. 31
DE: Consumer prices, y/y	2.0%	2.0%	1.9%	2.1%	1.9%		Jan. 31
DE: Unemployment rate	6.8%	6.9%	6.9%	6.9%	6.9%		Jan. 31
DE: PMI, manufacturing	47.4	46.0	46.8	46.0	48.8		Feb. 1
EU17: M3 money supply, y/y	2.6%	3.9%	3.8%	3.9%			Jan. 28
EU17: Business confidence	-16	-18	-15	-14	-14		Jan. 30
EU17: Consumer confidence	-26	-26	-27	-26	-24		Jan. 30
EU17: PMI, manufacturing	46.1	45.4	46.2	46.1	47.5		Feb. 1
EU17: Consumer prices, y/y	2.6%	2.5%	2.2%	2.2%	2.2%		Feb. 1
EU17: Unemployment rate	11.6%	11.7%	11.8%	11.9%			Feb. 1

MMWB estimates in red

Chart of the week: Will hope be enough?



Economic prospects for the euro zone have brightened significantly in January. At least that is the conclusion to which financial analysts and investors surveyed by the Center for European Economic Research (ZEW) have come. The level of the index for economic expectations is similar to that of the ZEW expectations index for the German national economy. Unlike in Germany, however, current conditions continue to be judged very critically, and only a slight improvement on the preceding month has been reported. A considerable gap is thus opening up between expectations and conditions. Other leading indicators likewise suggest that economic prospects for the euro zone have brightened somewhat lately. The purchasing manager index (PMI) for the euro zone has risen surprisingly sharply. In the manufacturing sector, it has reached a 10-month high at 48.0 points. Purchasing managers from the services sector have also expressed more confidence, and their index has risen to 48.3 points, thus also exceeding expectations. Like the ZEW survey, the PMI indexes suggest a cyclical turning point, even though their levels are below 50 points and thus still indicate a contracting economy. However, we would note one negative point in this regard. Economic momentum in France has weakened to a surprising extent both in manufacturing (from 44.6 to 42.9 points) and services (from 45.2 to 43.6 points). So, although an economic recovery in the euro zone is likely in the coming months, it will probably be stronger in some places than in others.

Financial markets at a glance

Stock markets	As of 24.01.2013	Change versus 18.01.2013 -1 week	24.12.2012 -1 month	24.10.2012 -3 months	31.12.2012 YTD
Dow Jones	13,825	1.3%	5.2%	5.7%	5.5%
S&P 500	1,495	0.6%	4.8%	6.1%	4.8%
Nasdaq	3,130	-0.1%	3.9%	5.0%	3.7%
DAX	7,748	0.6%	1.5%	7.7%	1.8%
MDAX	12,675	1.0%	5.7%	11.9%	6.4%
TecDAX	888	1.9%	6.3%	11.0%	7.3%
EuroStoxx 50	2,723	0.5%	2.8%	9.3%	3.3%
Stoxx 50	2,654	0.8%	2.6%	5.1%	3.0%
SMI (Swiss Market Index)	7,458	1.2%	8.2%	12.5%	9.3%
Nikkei 225	10,621	-2.7%	6.8%	18.6%	2.2%
Topix	898	-1.5%	7.8%	20.8%	4.4%
Bond markets					
3 months Euribor	0.21	0	3	1	2
3 months Treasury Bill	0.08	0	2	-3	3
10 year US Treasuries	1.84	0	7	7	9
10 year Bunds	1.49	-3	10	-8	19
10 year JGB	0.73	-3	-3	-5	-6
US mortgage rate	3.38	0	1	1	3
IBOXX AAA, €	1.64	-1	14	-12	18
IBOXX BBB, €	3.17	9	8	-35	13
Convertible Bonds, Exane 25	5,510	0.1%	1.3%	5.5%	1.4%
Commodities					
CRB Index	563.26	-0.6%	0.8%	-0.7%	1.6%
MG Base Metal Index	363.53	0.1%	1.9%	6.1%	1.7%
Crude oil Brent	112.72	1.9%	3.1%	3.8%	1.9%
Gold	1674.74	-0.7%	0.9%	-1.8%	0.7%
Freight rates Baltic Dry Index	808	-3.5%	15.6%	-25.7%	15.6%
Currencies					
EUR/ USD	1.3349	0.2%	1.0%	3.1%	1.2%
EUR/ GBP	0.8474	1.1%	3.5%	4.7%	4.5%
EUR/ JPY	119.73	-0.1%	7.2%	15.9%	5.4%
EUR/ CHF	1.2417	-0.2%	2.9%	2.6%	2.9%
USD/JPY	90.34	0.3%	6.4%	13.2%	4.1%

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