UBS

Global Research

27 June 2016

Macro-Strategy Key Issue

Spain elections: " Parliament more right oriented but still unclear how a coalition could be formed"

Economics

Spain

Bosco Ojeda
Analyst
bosco.ojeda@ubs.com
+34-91-436 9078

Reinhard Cluse
Economist
reinhard.cluse@ubs.com
+44-20-7568 6722

Justin Knight
Strategist
justin.knight@ubs.com
+44-20-7568 8450

Sunday's election: no clear majority, but shift to the right

Provisional results from the Spanish parliamentary elections show that Partido Popular (PP) increased its share as the strongest party (with 33% of the vote, 137 seats). But PP once again fell short of a majority in the 350-seat parliament. The second place in the elections going to PSOE (85 seats, 23% of votes) should be seen as a more market friendly vs. recent opinion polls that awarded Podemos more votes. Unidos Podemos reached 71 seats similar to latest election but below recent opinion polls. A grand coalition PP-PSOE is still possible. The centrist Ciudadanos had 32 seats. The election outcome represents a move to the political right, as opposed to recent polls. We expect a mildly favourable reaction in equity and bonds markets despite is still not completely clear how a coalition will be formed. For the bond market, we would anticipate a mild tightening of yield spreads, but with some volatility until a government is formed.

There is still a good degree of uncertainty.

In our recent report "Spain: Just 3 Things" (17 June 2016), we described four potential scenarios: 1) Left-wing coalition PSOE-Podemos; 2) Grand coalition PP+PSOE; 3) Centre-right coalition; and 4) Political impasse/new elections. The election results do not yet provide for clarity, but suggest that scenarios 2, 3 or 4 could be more feasible while scenario 1 would only happen with full support of all small regional parties, which appears difficult. Coalition between PP/PSOE and PP/PSOE/C might potentially be able to mobilise enough seats to form a new government, but uncertainty remains: PSOE has stated it would not support PP. Ciudadanos previously agreed with PSOE, but would not support Podemos.

Parliament to be formed on 21 July, but new government could take longer

The new parliament will be formed on 21 July. At best, we could have a first voting season by early August, but we cannot rule out that this might be delayed for months. If stalemate persists, new elections are also a possibility, possibly in December or even as late Q1 2017.

Our preferred equities: Abertis, Telefonica, Grifols, IAG

As highlighted in our recent report, different coalitions would affect various asset classes differently. Scenarios 2 (grand coalition) and 3 (centre-right coalition) would push local cyclicals stocks, such as real estate (Hispania), hotels (NH Hotels, Melia), IT (Indra), concessions (AENA, Abertis) or local banks. Other non-cyclical stocks are likely to be less affected by macro, such as Telefonica, Euskaltel and Grifols, which should outperform in an environment of ongoing uncertainty.

REVERSE ROADSHOW INVITE, 6 July, Madrid:

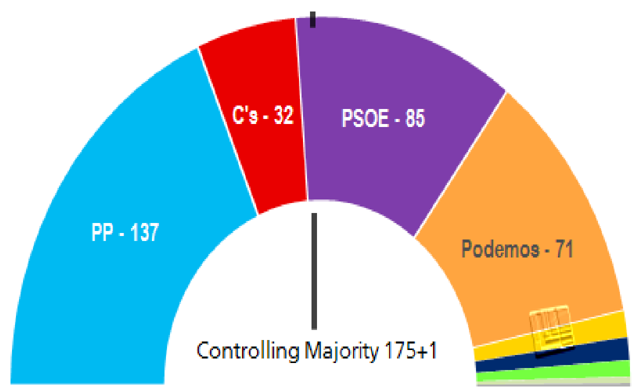
UBS has organised a reverse roadshow taking place in Madrid on 6 July 2016, where we will meet Spanish corporates (**Bankia, BBVA, Merlin, Indra, NH Hotels, Mediaset**). We will also discuss the political outlook with a member of the Spanish Parliament (Mr. Toni Roldan, Ciudadanos) and with two independent experts, Federico Steinberg (Senior Analyst at the Elcano Royal Institute and Professor of Political Economy at Madrid's Universidad Autónoma) and Antonio Barroso (Senior Vice President, Europe at Teneo Intelligence).

www.ubs.com/economics

Spain's elections – an initial assessment

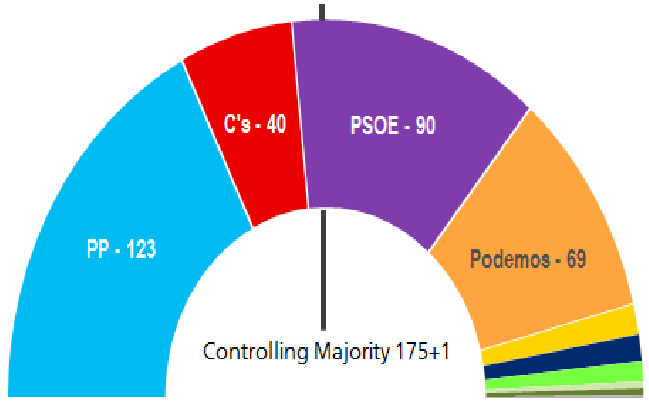
The result of yesterday's election is still provisional, but with but with 100% of the votes counted by the time of writing, the final outcome should in principle not change much. Market could see as a relief that Podemos has not outpaced PSOE, but PP would only be able to form a government with PSOE. A PP-Ciudadanos coalition (169 votes vs 163 in previous election) would not reach enough majority (176 seats). A coalition PSOE+Podemos (156 vs 159 in previous elections) is below majority, requires the difficult support from nationalist regional parties. So now either a grand coalition (PP+PSOE) seems possible while a left coalition requires the agreement of all minority regional parties which seems difficult).

Figure 1: Elections June 2016 (provisional result)



Source: Ministerio del Interior, Spain government

Figure 2: Elections December 2015



Source: Ministerio del Interior, Spain government

What's next? The new Spanish parliament will be formed on 21 July. The political parties will then have to negotiate, with the aim of generating a majority of more than 175 seats in the 350-seat parliament. This will take at least two weeks, but could well drag on for several months. In absence of an absolute majority (>175 seats) a new government can be formed with a simple majority, i.e. meaning more votes in favour than against.

Scenarios: In our recent report we sketched four possible scenarios: (1) A left-wing coalition of PSOE and the far left Podemos-IU, possibly involving other smaller parties; (2) A grand coalition of centre-right Partido Popular (PP) and PSOE, possibly including the centrist Ciudadanos; (3) A centre-right coalition involving PP and Ciudadanos; or (4) Political impasse followed by repeat elections. The election outcome does not yet provide clarity, but points to scenarios 2. 3 or 4 as possible outcomes. In contrast, scenario 1 is possible but appears difficult. Results are not similar to the latest opinion polls and thus we expect a favourable reaction in equity and bonds markets. For the bond market, we would anticipate some tightening of yield spreads, but with some volatility until a stable government is formed.

What is the likely market reaction? We think this outcome was not fully discounted in the market which feared a coalition with far left Podemos and thus expect a mild favourable reaction of both equities and bonds in Spain. For the bond market, we would expect some tightening of yield spreads in the 10-year sector since results seems to point to scenario 2, 3 or 4 as more likely, though still uncertain.

Our preferred equities: As highlighted in our recent report, different coalition outcomes would have different effects on various assets classes. Scenarios 2 and 3 would push local cyclicals stocks, such as real estate (Hispania), hotels (NH Hotels, Melia), IT (Indra), concessions (AENA, Abertis) or local banks. Other non-cyclical stocks are likely to be less affected by macro, such as Telefonica, Euskaltel, Ebro Foods, Grifols, which should outperform if there is uncertainty**.** But this would all depend on the final government outcome. We provide below the most likely scenarios and how we believe asset classes would be affected.

Figure 3: Economic and asset price implications of different election outcomes

Election outcome	Economy	Fixed income markets	Equity markets
Left-wing coalition	• Increased uncertainty for corporates, households, and financial markets • Weaker private-sector activity, stronger public spending • Lack of structural reform progress to affect long-term growth potential negatively	• Podemos policy agenda to trigger increased uncertainty in markets • Spread widening versus Germany (50bps) and Italy (30bp)	• Valuation discount vs Europe to widen. • Banks and utilities stocks most exposed
Grand coalition (PP/PSOE)	• Political stability • Some uncertainty over future path of fiscal consolidation, taxation, and labour market policies • Moderate progress in growth-enhancing structural reforms	• Some spread tightening versus Germany (25bps) and Italy (15bps) • But perceived stability of coalition would be crucial • Further spread tightening as economic fundamentals improve	• Country specific 9% relative discount to Europe to narrow. • Beyond the short term, specifics of the new government programme crucial
Centre-right coalition	• Economic policy continuity • Positive impact on economic confidence • New momentum for growth-enhancing structural reforms	• Market to imply further reforms and fiscal consolidation • Spread tightening versus Germany (35bps) and Italy (20bps) • But perceived stability of coalition would be crucial	• Country specific 9% relative discount to Europe to narrow… • …provided coalition seen as stable
Hung parliament and repeat elections	• Continuation of political uncertainty • Negative impact on economic confidence • Slow progress in fiscal consolidation • Slow progress in growth-enhancing structural reforms	• Spreads to widen versus Germany (15-20bps) and Italy (10bps)	• Political risk to continue to weigh on Spanish equities

Source: UBS

Valuation Method and Risk Statement

Risks include macroeconomic variables (such as GDP growth rates and inflation), economic slowdown, a weakening currency, global economic events, and government policy changes.

Required Disclosures

This report has been prepared by UBS Limited, an affiliate of UBS AG. UBS AG, its subsidiaries, branches and affiliates are referred to herein as UBS.

For information on the ways in which UBS manages conflicts and maintains independence of its research product; historical performance information; and certain additional disclosures concerning UBS research recommendations, please visit www.ubs.com/disclosures. The figures contained in performance charts refer to the past; past performance is not a reliable indicator of future results. Additional information will be made available upon request. UBS Securities Co. Limited is licensed to conduct securities investment consultancy businesses by the China Securities Regulatory Commission. UBS acts or may act as principal in the debt securities (or in related derivatives) that may be the subject of this report.

Analyst Certification: Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers and were prepared in an independent manner, including with respect to UBS, and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

UBS Investment Research: Global Equity Rating Definitions

12-Month Rating	**Definition**	**Coverage**[1]	**IB Services**[2]
Buy	FSR is > 6% above the MRA.	49%	32%
Neutral	FSR is between -6% and 6% of the MRA.	38%	26%
Sell	FSR is > 6% below the MRA.	14%	19%
Short-Term Rating	**Definition**	**Coverage**[3]	**IB Services**[4]
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 31 March 2016.
1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category.
4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

KEY DEFINITIONS: Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months. **Market Return Assumption (MRA)** is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium). **Under Review (UR)** Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation. **Short-Term Ratings** reflect the expected near-term (up to three months) performance of the stock and do not reflect any change in the fundamental view or investment case. **Equity Price Targets** have an investment horizon of 12 months.

EXCEPTIONS AND SPECIAL CASES: UK and European Investment Fund ratings and definitions are: Buy: Positive on factors such as structure, management, performance record, discount; **Neutral:** Neutral on factors such as structure, management, performance record, discount; **Sell:** Negative on factors such as structure, management, performance record, discount. **Core Banding Exceptions (CBE):** Exceptions to the standard +/-6% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Company Disclosures table in the relevant research piece.

Research analysts contributing to this report who are employed by any non-US affiliate of UBS Securities LLC are not registered/qualified as research analysts with FINRA. Such analysts may not be associated persons of UBS Securities LLC and therefore are not subject to the FINRA restrictions on communications with a subject company, public appearances, and trading securities held by a research analyst account. The name of each affiliate and analyst employed by that affiliate contributing to this report, if any, follows.

UBS Securities España SV, SA: Bosco Ojeda.

Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Abertis[1, 5, 22]	ABE.MC	Buy	N/A	€12.85	24 Jun 2016
AENA S.A.	AENA.MC	Buy	N/A	€110.00	24 Jun 2016
Bankia[2, 4, 5, 7]	BKIA.MC	Buy	N/A	€0.57	24 Jun 2016
BBVA[2, 4, 5, 7, 16]	BBVA.MC	Sell	N/A	€4.84	24 Jun 2016
Ebro Foods	EBRO.MC	Buy	N/A	€19.41	24 Jun 2016
Euskaltel SA[2, 4]	EKTL.MC	Buy	N/A	€8.00	24 Jun 2016
Grifols[16]	GRLS.MC	Buy	N/A	€18.86	24 Jun 2016
Hispania[5, 13]	HIS.MC	Buy	N/A	€10.00	24 Jun 2016
Indra	IDR.MC	Buy	N/A	€8.97	24 Jun 2016
International Airlines Group[2, 4, 5, 7]	ICAG.L	Buy	N/A	409p	24 Jun 2016
Mediaset Espana	TL5.MC	Buy	N/A	€10.22	24 Jun 2016
Melia Hotels[4, 5, 7]	MEL.MC	Buy	N/A	€9.59	24 Jun 2016
Merlin Properties[2, 4, 13]	MRL.MC	Neutral (UR)	N/A	€8.34	24 Jun 2016
NH Hotel Group	NHH.MC	Buy	N/A	€3.98	24 Jun 2016
Telefonica[3a, 3b, 4, 5, 7, 16]	TEF.MC	Buy	N/A	€7.73	24 Jun 2016

Source: UBS. All prices as of local market close.
Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

Issuer Name
Spain[4, 5, 7]

1. UBS Limited is acting as manager/co-manager, underwriter, placement or sales agent in regard to an offering of securities of this company/entity or one of its affiliates.
2. UBS AG, its affiliates or subsidiaries has acted as manager/co-manager in the underwriting or placement of securities of this company/entity or one of its affiliates within the past 12 months.

3a. UBS Limited is acting as advisor to Telefonica SA on the acquisition of 11.1% stake in Mediaset Premium

3b. UBS Ltd is advising Telefonica SA on the potential sale of its UK subsidiary Telefonica 02 UK to Hutchinson Whampoa Ltd.

4. Within the past 12 months, UBS AG, its affiliates or subsidiaries has received compensation for investment banking services from this company/entity or one of its affiliates.
5. UBS AG, its affiliates or subsidiaries expect to receive or intend to seek compensation for investment banking services from this company/entity within the next three months.
7. Within the past 12 months, UBS Securities LLC and/or its affiliates have received compensation for products and services other than investment banking services from this company/entity.
13. UBS AG, its affiliates or subsidiaries beneficially owned 1% or more of a class of this company`s common equity securities as of last month`s end (or the prior month`s end if this report is dated less than 10 days after the most recent month`s end).
16. UBS Securities LLC makes a market in the securities and/or ADRs of this company.
22. UBS AG, its affiliates or subsidiaries held other significant financial interests in this company/entity as of last month`s end (or the prior month`s end if this report is dated less than 10 working days after the most recent month`s end).

Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report. For a complete set of disclosure statements associated with the companies discussed in this report, including information on valuation and risk, please contact UBS Securities LLC, 1285 Avenue of Americas, New York, NY 10019, USA, Attention: Investment Research.

Global Disclaimer

This document has been prepared by UBS Limited, an affiliate of UBS AG. UBS AG, its subsidiaries, branches and affiliates are referred to herein as UBS.

Global Research is provided to our clients through UBS Neo and, in certain instances, UBS.com (each a "System"). It may also be made available through third party vendors and distributed by UBS and/or third parties via e-mail or alternative electronic means. The level and types of services provided by Global Research to a client may vary depending upon various factors such as a client's individual preferences as to the frequency and manner of receiving communications, a client's risk profile and investment focus and perspective (e.g., market wide, sector specific, long-term, short-term, etc.), the size and scope of the overall client relationship with UBS and legal and regulatory constraints.

All Global Research is available on UBS Neo. Please contact your UBS sales representative if you wish to discuss your access to UBS Neo.

When you receive Global Research through a System, your access and/or use of such Global Research is subject to this Global Research Disclaimer and to the terms of use governing the applicable System.

When you receive Global Research via a third party vendor, e-mail or other electronic means, your use shall be subject to this Global Research Disclaimer and to UBS's Terms of Use/Disclaimer (http://www.ubs.com/global/en/legalinfo2/disclaimer.html). By accessing and/or using Global Research in this manner, you are indicating that you have read and agree to be bound by our Terms of Use/Disclaimer. In addition, you consent to UBS processing your personal data and using cookies in accordance with our Privacy Statement (http://www.ubs.com/global/en/legalinfo2/privacy.html) and cookie notice (http://www.ubs.com/global/en/homepage/cookies/cookie-management.html).

If you receive Global Research, whether through a System or by any other means, you agree that you shall not copy, revise, amend, create a derivative work, transfer to any third party, or in any way commercially exploit any UBS research provided via Global Research or otherwise, and that you shall not extract data from any research or estimates provided to you via Global Research or otherwise, without the prior written consent of UBS.

This document is for distribution only as may be permitted by law. It is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject UBS to any registration or licensing requirement within such jurisdiction. It is published solely for information purposes; it is not an advertisement nor is it a solicitation or an offer to buy or sell any financial instruments or to participate in any particular trading strategy. No representation or warranty, either expressed or implied, is provided in relation to the accuracy, completeness or reliability of the information contained in this document ("the Information"), except with respect to Information concerning UBS. The Information is not intended to be a complete statement or summary of the securities, markets or developments referred to in the document. UBS does not undertake to update or keep current the Information. Any opinions expressed in this document may change without notice and may differ or be contrary to opinions expressed by other business areas or groups of UBS. Any statements contained in this report attributed to a third party represent UBS's interpretation of the data, information and/or opinions provided by that third party either publicly or through a subscription service, and such use and interpretation have not been reviewed by the third party.

Nothing in this document constitutes a representation that any investment strategy or recommendation is suitable or appropriate to an investor’s individual circumstances or otherwise constitutes a personal recommendation. Investments involve risks, and investors should exercise prudence and their own judgement in making their investment decisions. The financial instruments described in the document may not be eligible for sale in all jurisdictions or to certain categories of investors. Options, derivative products and futures are not suitable for all investors, and trading in these instruments is considered risky. Mortgage and asset-backed securities may involve a high degree of risk and may be highly volatile in response to fluctuations in interest rates or other market conditions. Foreign currency rates of exchange may adversely affect the value, price or income of any security or related instrument referred to in the document. For investment advice, trade execution or other enquiries, clients should contact their local sales representative.

The value of any investment or income may go down as well as up, and investors may not get back the full (or any) amount invested. Past performance is not necessarily a guide to future performance. Neither UBS nor any of its directors, employees or agents accepts any liability for any loss (including investment loss) or damage arising out of the use of all or any of the Information.

Any prices stated in this document are for information purposes only and do not represent valuations for individual securities or other financial instruments. There is no representation that any transaction can or could have been effected at those prices, and any prices do not necessarily reflect UBS's internal books and records or theoretical model-based valuations and may be based on certain assumptions. Different assumptions by UBS or any other source may yield substantially different results.

This document and the Information are produced by UBS as part of its research function and are provided to you solely for general background information. UBS has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. In no circumstances may this document or any of the Information be used for any of the following purposes:

(i) valuation or accounting purposes;

(ii) to determine the amounts due or payable, the price or the value of any financial instrument or financial contract; or

(iii) to measure the performance of any financial instrument.

By receiving this document and the Information you will be deemed to represent and warrant to UBS that you will not use this document or any of the Information for any of the above purposes or otherwise rely upon this document or any of the Information.

UBS has policies and procedures, which include, without limitation, independence policies and permanent information barriers, that are intended, and upon which UBS relies, to manage potential conflicts of interest and control the flow of information within divisions of UBS and among its subsidiaries, branches and affiliates. For further information on the ways in which UBS manages conflicts and maintains independence of its research products, historical performance information and certain additional disclosures concerning UBS research recommendations, please visit www.ubs.com/disclosures.

Research will initiate, update and cease coverage solely at the discretion of UBS Investment Bank Research Management, which will also have sole discretion on the timing and frequency of any published research product. The analysis contained in this document is based on numerous assumptions. All material information in relation to published research reports, such as valuation methodology, risk statements, underlying assumptions (including sensitivity analysis of those assumptions), ratings history etc. as required by the Market Abuse Regulation, can be found on NEO. Different assumptions could result in materially different results.

The analyst(s) responsible for the preparation of this document may interact with trading desk personnel, sales personnel and other parties for the purpose of gathering, applying and interpreting market information. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS into other areas, units, groups or affiliates of UBS. The compensation of the analyst who prepared this document is determined exclusively by research management and senior management (not including investment banking). Analyst compensation is not based on investment banking revenues; however, compensation may relate to the revenues of UBS Investment Bank as a whole, of which investment banking, sales and trading are a part, and UBS's subsidiaries, branches and affiliates as a whole.

For financial instruments admitted to trading on an EU regulated market: UBS AG, its affiliates or subsidiaries (excluding UBS Securities LLC) acts as a market maker or liquidity provider (in accordance with the interpretation of these terms in the UK) in the financial instruments of the issuer save that where the activity of liquidity provider is carried out in accordance with the definition given to it by the laws and regulations of any other EU jurisdictions, such information is separately disclosed in this document. For financial instruments admitted to trading on a non-EU regulated market: UBS may act as a market maker save that where this activity is carried out in the US in accordance with the definition given to it by the relevant laws and regulations, such activity will be specifically disclosed in this document. UBS may have issued a warrant the value of which is based on one or more of the financial instruments referred to in the document. UBS and its affiliates and employees may have long or short positions, trade as principal and buy and sell in instruments or derivatives identified herein; such transactions or positions may be inconsistent with the opinions expressed in this document.

United Kingdom and the rest of Europe: Except as otherwise specified herein, this material is distributed by UBS Limited to persons who are eligible counterparties or professional clients. UBS Limited is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. **France:** Prepared by UBS Limited and distributed by UBS Limited and UBS Securities France S.A. UBS Securities France S.A. is regulated by the ACPR (Autorité de Contrôle Prudentiel et de Résolution) and the Autorité des Marchés Financiers (AMF). Where an analyst of UBS Securities France S.A. has contributed to this document, the document is also deemed to have been prepared by UBS Securities France S.A. **Germany:** Prepared by UBS Limited and distributed by UBS Limited and UBS Deutschland AG. UBS Deutschland AG is regulated by the Bundesanstalt fur Finanzdienstleistungsaufsicht (BaFin). **Spain:** Prepared by UBS Limited and distributed by UBS Limited and UBS Securities España SV, SA. UBS Securities España SV, SA is regulated by the Comisión Nacional del Mercado de Valores (CNMV). **Turkey:**

UBS