

## Macro-Strategy Key Issue

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

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#### 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 cyclical 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).

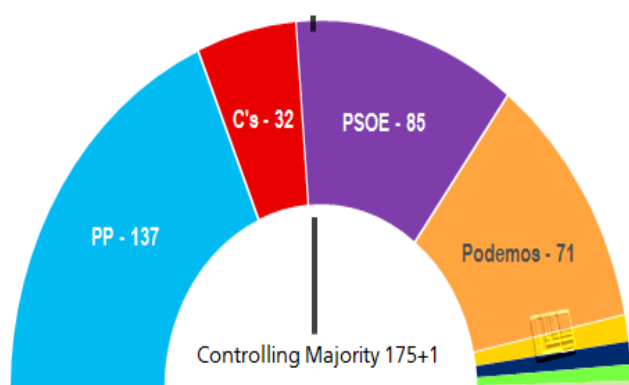
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# Spain's elections – an initial assessment

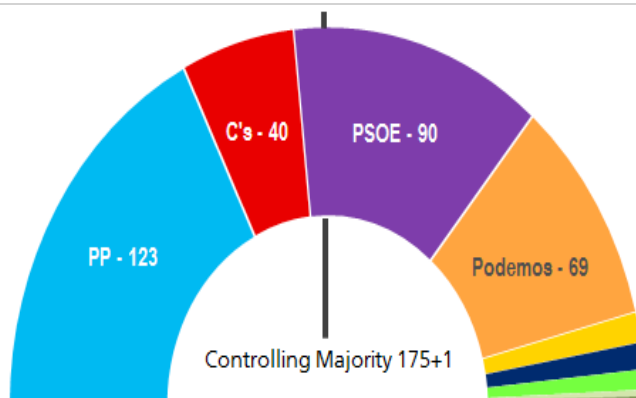
The result of yesterday's election is still provisional, but with but with 100% of the votes counted by the time of writing, the final outcome should in principle not change much. Market could see as a relief that Podemos has not outpaced PSOE, but PP would only be able to form a government with PSOE. 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 cyclical 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
<b>Left-wing coalition</b>	<ul style="list-style-type: none"> <li>Increased uncertainty for corporates, households, and financial markets</li> <li>Weaker private-sector activity, stronger public spending</li> <li>Lack of structural reform progress to affect long-term growth potential negatively</li> </ul>	<ul style="list-style-type: none"> <li>Podemos policy agenda to trigger increased uncertainty in markets</li> <li>Spread widening versus Germany (50bps) and Italy (30bp)</li> </ul>	<ul style="list-style-type: none"> <li>Valuation discount vs Europe to widen.</li> <li>Banks and utilities stocks most exposed</li> </ul>
<b>Grand coalition (PP/PSOE)</b>	<ul style="list-style-type: none"> <li>Political stability</li> <li>Some uncertainty over future path of fiscal consolidation, taxation, and labour market policies</li> <li>Moderate progress in growth-enhancing structural reforms</li> </ul>	<ul style="list-style-type: none"> <li>Some spread tightening versus Germany (25bps) and Italy (15bps)</li> <li>But perceived stability of coalition would be crucial</li> <li>Further spread tightening as economic fundamentals improve</li> </ul>	<ul style="list-style-type: none"> <li>Country specific 9% relative discount to Europe to narrow.</li> <li>Beyond the short term, specifics of the new government programme crucial</li> </ul>
<b>Centre-right coalition</b>	<ul style="list-style-type: none"> <li>Economic policy continuity</li> <li>Positive impact on economic confidence</li> <li>New momentum for growth-enhancing structural reforms</li> </ul>	<ul style="list-style-type: none"> <li>Market to imply further reforms and fiscal consolidation</li> <li>Spread tightening versus Germany (35bps) and Italy (20bps)</li> <li>But perceived stability of coalition would be crucial</li> </ul>	<ul style="list-style-type: none"> <li>Country specific 9% relative discount to Europe to narrow...</li> <li>...provided coalition seen as stable</li> </ul>
<b>Hung parliament and repeat elections</b>	<ul style="list-style-type: none"> <li>Continuation of political uncertainty</li> <li>Negative impact on economic confidence</li> <li>Slow progress in fiscal consolidation</li> <li>Slow progress in growth-enhancing structural reforms</li> </ul>	<ul style="list-style-type: none"> <li>Spreads to widen versus Germany (15-20bps) and Italy (10bps)</li> </ul>	<ul style="list-style-type: none"> <li>Political risk to continue to weigh on Spanish equities</li> </ul>

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.

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Neutral	FSR is between -6% and 6% of the MRA.	38%	26%
Sell	FSR is > 6% below the MRA.	14%	19%
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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.

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2: Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

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

Source: UBS. All prices as of local market close.

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