Cyprus – lessons learnt

Cyprus, the tiny island in the Mediterranean, with a population of 1 m people and a GDP of about EUR 18 bn (0.2% of Euroland's GDP) has become the major focus of financial market players, has created renewed uncertainties about the future of the Euro area, and has sent shudders through financial markets. We discuss the situation in this month's review and conclude that more than the complexity and size of the problem, it is primarily a problematic policy response which — once again — is worrying. As Cyprus dominated the headlines, other significant developments received far less attention than they deserved, including the uncertain political future of Italy, the post-Chavez situation in Venezuela, and the tensions between North and South Korea.

Macro-economic developments and financial markets

Economic data were mixed in March. Not only did European data indicate that recovery from recession is taking longer than anticipated, but also leading US indicators disappointed, most notably the US ISM purchasing managers index, which declined to 51.3 in March from 54.2 in February. Since, in addition to weaker US data, the fiscal drag, including higher taxes, will dent economic activity and consumer sentiment, we expect US growth to slow down in quarter 2 and pick up again in the second half of the year. As far as China is concerned, we think that the Chinese authorities will be able to manage their problems of rising inflation, overcapacity, and high bank leverage.

Fig. 1: Major equity markets in 2013

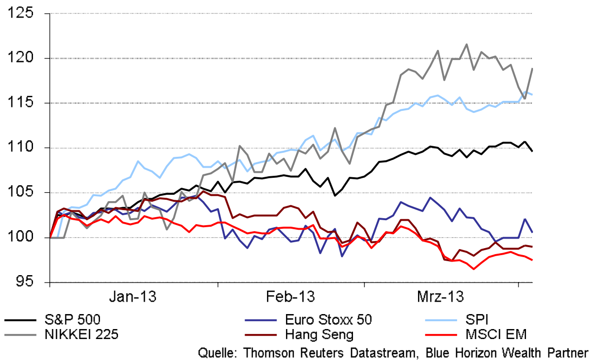
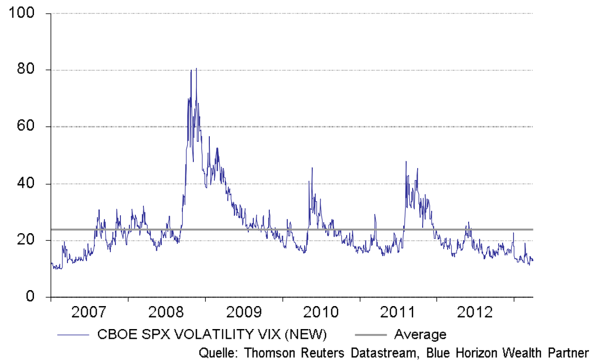


Fig 2: VIX index - S&P500 implied volatility



Given the above-mentioned weaker economic data, the messy situation in Cyprus and rising geopolitical risks, the financial market reactions were relatively benign in March. European equity markets ended the month of March about flat month over month, while the US S&P500 index gained 3.8%, the Swiss SPI 3.1%, and the Japanese Nikkei index even 7.3%. The S&P500 index actually reached its all-time high at the end of March, beating its previous record set on October 9, 2007. The market volatility index VIX – the price for insurance against equity market losses – rose only slightly and remains clearly below its long-term average. Currency and fixed income markets, however, showed more significant movements: The EUR-USD exchange rate fell in March by about 2% to 1.28, the sovereign spreads of peripheral countries widened (see fig. 4) and CDS spreads – the price of insurance against default – of European senior and subordinated financials also widened significantly. Safe-haven assets, like US treasuries, bonds, and gold gained only marginally.

Cyprus –lessons learnt

Before we discuss the lessons learnt from the Cyprus crisis, we would like to briefly review the events which led to it. Cyprus is a small island, which was able to develop itself into a financial center with low taxes and strong secrecy rules. Cyprus played a very prominent role as a turntable, especially for Russian money. Banks grew large and banking debt at the end of 2010 amounted to about nine times Cyprus's GDP. At the same time the public debt to GDP ratio was relatively moderate at about 60%.

Fig. 3: EUR-USD exchange rate

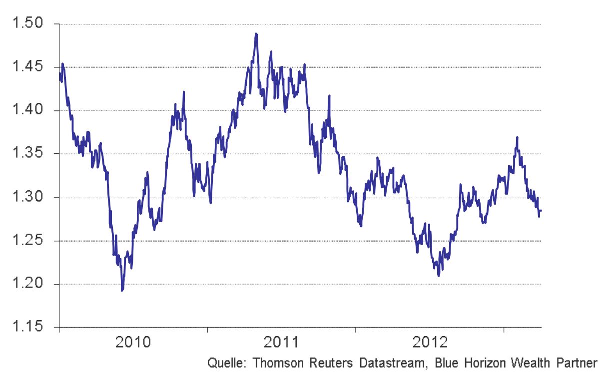
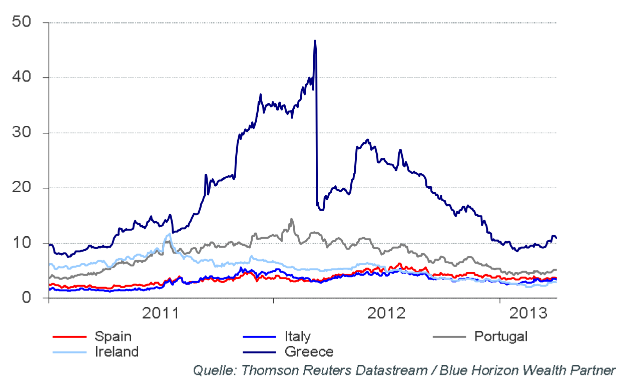


Fig 4: Peripheral sovereign spreads over Bunds



The sub-prime crisis in 2007 and 2008 pushed Cyprus into a recession as tourism and the shipping business were contracting. The second hit came in 2011 when the European Union decided on a haircut of 50% and more on Greek government bonds, in which Cypriot banks were heavily invested. The Cypriot financial system was not able to absorb these losses. In January 2012 an emergency loan of EUR 2.5 bn from Russia to cover Cyprus's budget deficit and to re-finance its maturing debt only served to postpone the collapse. In June 2012 the Cypriot Government requested a bailout from the European Union, but could not agree with the EU on the terms.

On 16 March 2013, the so-called troika (the European Commission, the ECB and the IMF) agreed on a EUR 10 bn deal with Cyprus, making it the fifth country—after Greece, Ireland, Portugal and Spain—to receive money from the EU-IMF. As part of the deal, a one-off bank deposit levy of 6.7% for deposits up to EUR 100,000 and 9.9% for higher deposits, was announced on all domestic bank accounts. The deal required the approval of the Cypriot parliament, which rejected it, however, on 19 March 2013.

On 25 March a new deal was closed, keeping Cyprus in the eurozone and restoring the promise to protect bank deposits covered by the EU-mandated EUR 100,000 deposit guarantee. However, the deal incurs the following consequences:

- The country's second-biggest bank, Laiki, will be wound down. Insured deposits will be transferred to a "good bank", eventually to be merged with the Bank of Cyprus. Uninsured deposits, which amount to EUR 4.2 bn, will be transferred to a bad bank with no guarantee that depositors will get anything back.
- The largest bank, Bank of Cyprus, will be restructured. Shareholders as well as bondholders will most likely lose their investments. Uninsured depositors will suffer a hefty haircut of 35%-40%.
- The major depositors are wealthy Russians and Russian corporates.
- Banks in Cyprus were closed for a couple of days and big deposits remain frozen for the foreseeable future. Capital controls have been put in place.
- In addition, Cyprus has to introduce more stringent anti-money-laundering regulations.

After this restructuring, the public debt to GDP ratio will not rise above 100% and will thus remain sustainable, but Cyprus is very likely to be pushed into recession. Some experts expect Cyprus's GDP to shrink by 10%. In addition, its financial center is being wiped out.

We think there are a number of important conclusions to draw from the Cyprus crisis and the respective policy responses:

- You should be aware that your deposits in a bank are basically a loan to that bank. With a bank deposit you are exposed to counterparty risk vis-a-vis the bank. If the bank fails, your deposits can be used to fund other claims on the bank's balance sheet. As a rule, claims are covered first by shareholders, second by bondholders and third by depositors with a special status for insured deposits below EUR 100,000.
- The bank offering the highest interest rate may not be the safest bank. Usually, deposit rates rise with higher funding costs in the inter-bank market, a phenomenon associated with higher counter-party risks, and the funding needs of the bank.
- Avoid weak banks, especially those in weak countries. In the wake of the Cyprus crisis, depositors will become more careful and selective and may start withdrawing deposits from weaker banks.
- The risk of capital controls is not to be underestimated. If a national banking system needs to be restructured, the country in question may decide to protect its banks and prevent capital flight. This happened in Iceland five years ago and is now happening in Cyprus.
- Diversify your banking relationships across institutes and across jurisdictions. It is not always possible to foresee a bank's balance sheet issues. In addition, as mentioned above, countries can very quickly introduce capital controls. If, for example, accounts in one country are frozen you can fall back on on any accounts you have in other countries.
- During a crisis, policy-makers may decide on measures which contravene existing rules. In the first Cypriot deal proposal, for instance, the bank deposit guarantee was not honored and deposits below EUR 100,000 were subject to a haircut of almost 7%. In addition, deposits in Cyprus remain frozen so far, and tight capital controls have been put in place.

Heightened (geo)political risks

In our view, despite gradual improvements in the macro conditions, fiscal and geo-political risks increased strikingly in March. We do not think that Cyprus considered alone is a major concern. But we think the policy response to the Cyprus issue could make the European banking sector more vulnerable in the future. We are especially concerned about the developments outlined below and consider them to constitute major risks with regard to our market expectations.

Italy's political pat situation and the fact that Monti's reform policy has been rejected by such a wide margin does not bode well for further prudent macro policymaking at the core of Europe. Italy's President Napolitano has asked ten independent wise men to come up with suggestions for economic and structural reforms within the next ten days. This is an attempt to channel the unsuccessful discussions of the three equally strong and starkly divided political parties to form the new Italian government. The size of Italy's economy and public debt – EUR 2 trn or almost 130% of GDP, of which EUR 47 bn will become due in April – implies macro-economic risks as well as major risks in the event that Italian debt should need to be restructured at some point in the future. European banks, insurance companies, and pension funds have huge Italian bond holdings.

Following the death of Venezuela's president Hugo Chavez, new elections will be held on April 14. Venezuela has some of the largest oil and natural gas reserves in the world, and it ranks among the top ten world crude oil producers. Chavez made clear that he would like Nicolás Maduro to follow his footsteps and to ensure political continuity. Mr Maduro has been sworn in as interim president and is currently campaigning for the presidency. In fact, it would be very surprising if Maduro did not win. However, he will be faced with immense political, social, and economic challenges, including an opposition which will strive to gain much more influence.

Last but not least, we are especially concerned about the situation in Korea. North Korea has declared war against South Korea and threatens to strike South Korean and US targets with atomic weapons. So far, the world community and financial markets have taken a fairly relaxed position. North Korea is relatively isolated internationally – with some support from China, however. Further, there is doubt about the technical capabilities of the North Korean army, and the country's martial rhetoric sounds familiar. However, we think that it is very early to comprehensively judge Kim Jong-un, who came to power on December 29, 2011 following the death of his father. Without doubt, North Korea would be able to do serious damage to important South Korean infrastructure, which, in turn, would inevitably provoke the involvement of the US military. South Korea has reacted with very strong rhetoric. There is a real danger that minor military events could escalate uncontrolledly.

Outlook

Despite rising macro-economic and political risks, we still consider that monetary expansion provides sufficient support for financial markets. We continue to believe that equity markets will be able to perform well, although possibly with some setbacks in Q2, on the back of moderate valuations and their relative attractiveness vis-à-vis bonds and cash (see our last Wealth Management Review). The US stock market will most likely continue to outperform European stock markets in the coming weeks. However, we expect that in the medium term the widening valuation gap between the US and Europe will narrow again, with European stock markets catching up somewhat. The Euro will probably stay on the weak side for now, although we expect EUR-USD to bottom at about 1.25. We also expect Europe to protest any further significant appreciation of its currency.

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