



Adviser Soapbox

Casa En Peligro

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Over the past several months, much ink has been spilled on the U.S. housing market, and whether declining home sales and rising inventories will precipitate a downward spiral in consumer spending.

At the same time, there is a growing consensus among economists and strategists that the global economy is "decoupling" from the U.S. This view is reinforced by the 4% expansion rate outside the U.S. during the past year (near the strongest level this decade), with some of the most impressive growth numbers coming out of Europe.

The pace of growth in America has fallen below 2.5% (the slowest since early 2003), but if the decoupling thesis is correct, then the blow to worldwide growth from continued weakness in the U.S. will be much softer than it would have been in years past.

But just because the rest of the world in general--and Europe in particular--can handle a U.S. slowdown does not necessarily mean there is clear sailing ahead. The problems in today's U.S. housing and mortgage sectors may in fact be signs of things to come in parts of Europe that have seen enormous price appreciation and rampant speculation in residential real estate. One country that appears to us to be especially vulnerable to a U.S.-style property-market implosion is Spain.

What is the significance of the recent drop in Spanish real estate firms? What is the trade? Click here for details in Inside Global Markets.

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Spain's Economic Miracle

Not long ago, Spain was regarded as something of an economic also-ran in Europe. Yet today, Spain is becoming a global economic powerhouse, having undergone an astonishing transformation over the past decade. Unemployment in Spain is running at about 8%, down from well over 20% in the early 1990s, and Spain's per-capita income may overtake Italy's as early as next year.

Spain is now in its 14th year of uninterrupted economic growth and has outpaced its European neighbors since the beginning of the decade. Spain's gross domestic product increased 4% in 2006, compared with 3.7% for Germany, 2.5% for France, 2.8% for Italy and an average of 3.3% for the Eurozone as a whole. And according to the World Bank, Spain recently overtook Canada as the world's eighth-largest economy.

Spanish companies, which struggled for years to compete internationally outside of Latin America, are boldly expanding across mainland Europe, Great Britain and even into the U.S. via a series of acquisitions. Banco Santander-Chile is right in the thick of the battle for ABN Amro.

Last year, Spanish telecom giant Telefonica SA purchased Britain's O2 in a huge \$31.5 billion deal. And earlier this year, Spain's fourth-largest bank, Banco Sabadell, acquired Miami-based TransAtlantic Bank, while Spain's Grupo Ferrovial led a group of investors in the \$19.5 billion acquisition of Britain's BAA, the world's largest airport operator.

The acquisition spree has not just been limited to Spain's largest companies, those held in the iShares MSCI Spain Index. Many smaller businesses have taken advantage of low financing costs to snap up companies in several European countries.

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Will Spain's Housing Market Follow America's?

Nowhere has Spain's newfound progress and prosperity been more clearly manifested than in the country's booming real estate market. According to the Spanish Central Bank, home prices have more than tripled over the past decade, surpassing the gains seen in most U.S. residential real estate during the same period.

Yet, in Spain, real estate lenders have increasingly targeted the country's burgeoning population of poor, young immigrants, who very often have short and/or sketchy credit histories. It does not strain the imagination to see how many of these Spanish lenders could suffer the same fate as the countless U.S. subprime mortgage companies that collapsed earlier this year under the weight of loan defaults that far exceeded their worst-case estimates. Just look at the charts of Accredited Home Lenders and, even more broadly, the price action in Countrywide Financial.

In fact, Spanish homeowners may be much more vulnerable than their American counterparts to default risk in the face of rising interest rates, with a striking 98% of mortgages in Spain structured as variable-rate loans. With Spanish real short-term interest rates having been very low for the past decade (averaging 0.1% since the late 1990s), both real estate agents and home buyers may be assuming that low rates will continue indefinitely.

After seven rate hikes by the European Central Bank (ECB) since 2005, some holders of variable-rate mortgages in Spain already appear to be feeling the pain. Delinquencies on Spanish home loans reached the highest level in at least four years in the fourth quarter of 2006, according to Standard & Poor's.

The similarities between the real estate markets of Spain and the U.S. do not end there. As was seen in the hottest areas of the U.S. housing sector--such as the coastal areas of Florida and California--the boom in Spanish real estate has been fueled to a large extent by investors from outside of Spain.

Long regarded as the "Florida of Europe," Spain's coastal regions have attracted a flood of home buyers from Britain, Ireland, Germany and other parts of Europe during the past few years, fueling sales of a staggering 4 million homes to foreigners, according to the Vacation Homes Agency in Madrid. The influx of buyers from abroad has been so great that several of Spain's coastal towns now have more foreign residents than Spaniards.

As is always the case, rising prices are a powerful incentive to create more supply, and this basic supply-and-demand tenet has certainly been manifest in Spain's home-building sector over the past few years. Although the population of Spain is 20% smaller than that of the U.K., Spanish home builders have created five times the number of new homes that British builders have done during the past few years, nearly 2 million of them on the Spanish coasts alone. And with the Spanish housing sector having started more than 700,000 housing units in 2006 (a number well above the rate of new household creation in Spain, which is approximately 500,000), a slowdown in the rate of foreign buying could prove devastating to the sector.

Indeed, there is evidence that a downturn may already be under way in Spain. The rate of increase in Spanish home prices slowed to 9.1% year-over-year in the fourth quarter of 2006, down from nearly 13% a year earlier and 17% two years earlier; and housing starts increased a meager 2% in 2006. Moreover, since we published our research piece for subscribers of Inside Global Markets on April 17, Spanish property companies have experienced significant corrections in their stock prices. Astroc Mediterraneo, one of Spain's largest real estate firms, has lost two-thirds of its value since April 19. There are rumors that the firm has been purchasing its own inventory to support real estate prices.

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According to the Bank of Spain, real estate spending by foreigners fell 11% during 2006, and according to the Spanish Mortgage Association, new mortgages sold to Spanish families fell 10%. And, recent comments by ECB officials leave little doubt that more rate hikes are to be expected in the coming months.

Since the interest charged on all Spanish mortgages is calculated as a function of the base rate set by the ECB, the prospect of further hikes does not bode well for the Spanish housing market. Indeed, Euribor futures contracts (which forecast the base

interest rate set by the ECB and are used as a base for mortgage lending in Spain) have already more than doubled from below 2% in 2004 to over 4% today.

Recent experience, as evidenced by the action in the SPDR S&P Homebuilders (amex: XHB) in the U.S., demonstrates that corrections in the housing sector can occur very fast, even when other economic fundamentals appear solid.

Excerpted from the April 17 issue of Inside Global Markets, which includes expanded analysis and a trade recommendation. [Click here for more information about Inside Global Markets and subscription details.](#)