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Funds cut exposure to eurozone banks

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Just another day in the eurozone. Spain's stock market tumbles to nine-year lows, its borrowing costs soar, and shares in one of the country's biggest banks fall nearly 30 per cent after Madrid announces a planned multibillion euro nationalisation.

Faced with so much market volatility and uncertainty, fund managers say they have sharply scaled back their exposure to countries in the euro-era "periphery". They have, moreover, become highly selective about investing in banks.

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And it is not just Spain that keeps them awake at night. With political deadlock in Athens raising the prospect that Greece could soon leave the euro, the biggest worry, say strategists, is the threat of contagion to other parts of the eurozone.

"Nobody knows what would happen if Greece left the euro. But it's not really about Greece, it's about one or two steps after that," says Andrew Jackson, chief investment officer of Cairn Capital.

Spain's banking system is at the centre of the storm. For many, Friday's news of a €19bn capital injection into Bankia only served to highlight concerns that the level of provisions lenders have taken against distressed property portfolios are too low, while the burden on the government could prove too great.

That interconnectedness between sovereign issuer and banks underlies fund managers' thinking. One of Europe's largest managers has sold all its shares in BBVA, Spain's second-largest bank, in recent weeks, citing worries about contagion and the lack of a convincing firewall to protect Spain from the turmoil in Greece.

The portfolio manager at the group, which has been reducing its holdings in peripheral eurozone companies over the past year, says BBVA would be a definite buy in another jurisdiction. But fears that the Spanish government will eventually force the country's biggest banks to take over the struggling *cajas*, or saving banks, is considered a big risk, prompting the sale of equity in these assets.

Another says that in Spain anything considered less creditworthy than BBVA and Santander is unattractive. But amid very thin trading in debt markets a few investors are being forced to sit on their bond holdings even when they want to sell.

Other fund managers say they are reducing risk on their portfolios in both equities and fixed income.

They are shedding eurozone bank assets in spite of the recent success of the European Central Bank's €1tn injection of cheap three-year loans into the eurozone banking system. One fund says it pulled out of all peripheral banks some time ago and now only has a scattering of assets in mainland Europe, focusing on solid names such as Rabobank.

Even German banks have come under pressure, with some asset managers warning that the crisis could spread to Berlin. John Stopford, head of fixed income at Investec Asset Management, says: "There is a worry over contingent liabilities as Germany might have to start paying out to stop the spread of the crisis."

He adds: "Overall, we remain risk averse as the situation continues to unravel and it's not clear whether there is the political will to put the brakes on and tackle the problems. That means avoiding eurozone financials."

The performance of shares in big Spanish and Italian banks point to such worries. Since mid-March, Santander and BBVA, Spain's two biggest banks, have dropped about 30 per cent, while UniCredit and Intesa Sanpaolo, Italy's top two banks, have tumbled about 40 per cent and 35 per cent respectively.

Among the French banks, Crédit Agricole's credit default swap – a form of insurance against default – and bond spreads have been hit by the lender's exposure to Greece via its Emporiki Bank unit. One fund manager at a big UK institution says: "It doesn't matter how strong a bank is. If the eurozone crisis deepens, it will take their share price down and push up yields on their debt. Eurozone financials are very risky. They are better avoided."

According to Fitch, US money market funds have over the past year cut back their exposure to eurozone banks by 63 per cent. The rating agency says many are now in a "holding pattern" as they monitor developments. They have also significantly increased their holdings of secured debt such as repo transactions, where banks pledge their securities as collateral for short-term loans.

Others are more sanguine though. Eric Brard, global head of fixed income at Amundi, Europe's second-biggest private fund manager, says having a diversified portfolio that is not focused on just one asset class is important. "Our scenario is not for a break-up of the eurozone. But we remain cautious."

"We have been increasing exposure towards internationally diversified corporates," says Mr Brard.

- Amundi continues to hold financials but remains focused on northern Europeans and national champions in the periphery. "We choose names that will not suffer or suffer less in the crisis ... We are not out of Italy, have limited investment in Spain. But we are out of Greece, Portugal and Ireland," Mr Brard says.

Mr Jackson says there are opportunities, pinpointing subordinated financials and corporate credits as well as differentials between US and European assets as interesting. "Different investor universes are reacting in ways that present value differentials, an example of which could be dollar-denominated issues from French banks," he says.