By **Laurence Fletcher**
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(Reuters) - Hedge funds have spotted money-making opportunities in Spain, betting that market fears over the southern European country's deepening debt crisis have made some assets too cheap relative to other securities.

Managers have been exploiting what they see as the mispricing of credit default swaps, government and corporate bonds and stocks, after months of growing market concern that Spain might need an international bailout, using relative value trades - betting on one security versus another.

"There's probably more juice for relative value trades than directional plays," said one fund of funds manager who spoke on condition of anonymity.

"It's a pretty well-flagged story. I don't know how much juice they think is in it," the fund manager said of Spanish CDS bets.

The moves echo the earlier stages of the euro zone crisis, when hedge funds - renowned as being among the nimblest of investors - bought CDS - designed to pay out in the event of default - on Greece and other weaker euro zone countries.

When the trade became more popular they quickly took profits and moved onto countries such as France and Belgium.

Spain's stocks .IBEX have tumbled 17.1 percent this year while the 10-year government bond yield has risen from less than 4.7 percent at the start of February to more than 6 percent earlier this week as investors fretted over its debt-laden banks and consumers and its shrinking economy.

A number of hedge funds bought Spanish CDS at the start of the month, say industry insiders, helping drive up the price to more than 500 basis points earlier this week from below 350 basis points in February.

While funds have kept positions relatively small on concerns over lower liquidity in some credit markets and a fast-changing political environment, managers are generally still short stocks - betting on falling prices - looking at sectors such as banks.

"We're seeing a little bit of dabbling... Funds are taking a small part of their portfolios, a few percent," said one prime broker, who spoke on condition of anonymity.

"European equity managers see a lot of fundamental drivers. They're putting on bets to benefit... Spanish banks can be quite volatile. My perception is that a problem with the sovereign automatically has a bad effect on banks."

RELATIVE VALUE

Louis Gargour, chief investment officer at London-based hedge fund manager LNG Capital, has bought bonds in Spanish companies earning the bulk of their revenues overseas as he thinks they have been harshly sold off in recent months.

"The real opportunity is in Spanish companies that have strong business models, global footprints and are in sound financial shape regardless of Spain. An example of this is

Telefonica (TEF.MC), which only produces 33 percent of its revenues in Europe and 67 percent from Latin America.

"It's an attractive telecom with an emerging market footprint, increasing revenues (and) strong margins but it's price and yield have been affected by the widening in Spain and it's pulled Telefonica with it."

He has paired this position with a short bet on Spanish government bonds.

"We expect the sovereign spread could go wider whereas the corporate fundamentals of strong well run companies will be realised by the market," he said.

He has also put on relative value bets between different maturities of Spanish government bonds. For instance, he has bought one-year bonds, which currently yield 2.54 percent, and has shorted five-year bonds, which yield 4.66 percent - a trade that has moved in his favour in recent days as one-year yields have dropped sharply.

"I think the Spanish yield curve is too flat... I think Spain will be around in a year," he said. "Sovereigns will have cash for the shorter maturity bonds. It's only in the longer-term that it (the debt problem) is really reflected."

CAUTION

Most hedge funds are still bearish on the euro zone's debt crisis, which was evidenced on Thursday in a string of quarterly reports from some of Europe's top banks.

BH Macro (BHMG.L), a feeder fund into the Brevan Howard's Master fund, one of the world's biggest and most successful hedge funds, said last week that: "Looking forward, the outlook for the peripheral economies remains bleak, due to both the fiscal drag and low availability of credit, with rising energy prices acting as an additional burden."

Some funds who have long-term bets on Spanish banks recovering and who are unwilling to sell at current prices have gone short a basket of Spanish stocks as a hedge, specially weighted to counter further sharp falls in bank stocks.

"If banks are a long-term position for you you've maybe put on a market hedge, but because banks have higher beta you've overhedged," the prime broker said.

However, not everyone is so cautious. Man Group's (EMG.L) "spike detection" computer programme, which looks for unusual price movements to try and predict crises and which snapped up protection before last summer's debt crisis, has not bought heavily into protection in recent weeks.

"Recently the market has been extremely twitchy. But what do we know about Spain that we didn't know three weeks ago? It's getting warmer, so the desire to protest (on the streets of peripheral European countries) has grown," said Sandy Rattray, CIO of the Systematic Strategies unit.

"The cost of insurance has risen more rapidly than our model suggests it should have done. We haven't been significant buyers of insurance."

Meanwhile, some managers have already moved beyond Spain. Philippe Gougenheim, who is set to launch a global macro fund later this year, prefers CDS on France, which is midway through its presidential election, or Portugal.

"We all agree that Spain is facing many difficulties, but so are other neighbouring countries. I find it more interesting to buy France or Portugal CDS at current levels," he said.

"France is interesting, as, if Mr (Francois) Hollande is elected President, he will certainly request an audit of public accounts, which will certainly not look nice."

(Reporting by Laurence Fletcher, Editing by Sinead Cruise and Peter Graff)