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Spain's borrowing costs back above 5.5%

By Richard Milne, Capital Markets Editor

Spain's borrowing costs rose above 5.5 per cent for the first time since January as investors fretted about another escalation of the eurozone crisis amid signs of further economic weakening even in Germany.

Investors, already nervous about Madrid's deficit and weak growth prospects, pushed Spain's benchmark 10-year bond yields up 14 basis points to as high as 5.53 per cent. Italy's borrowing costs also rose with the yield on its 10-year bond breaking through 5 per cent.

Markets have been calmed in recent weeks by the European Central Bank's cheap loans for lenders, known as the longer-term refinancing operation. But some investors are now becoming nervous that the impact of the two LTROs is already wearing off.

Marc Chandler, currency strategist at Brown Brothers Harriman, noted Italian 10-year yields have fallen 180bp so far this year while Spain's have risen by 39bp.

"That is after two LTROs," he said. "That definitely concerns me. When the bonds rally it helps the banks' balance sheets. But when yields start rising it hurts the banks even more. It is a vicious circle."

The economic fate of Spain and Italy is both viewed as central to assessing whether the eurozone debt crisis – quiet since Greece's default earlier this month – could re-erupt. Investors worry that weak growth, not just in Italy and Spain but across the rest of the eurozone, could be the spark to reignite the crisis, despite some European politicians' claims that it was largely over.

Eurozone purchasing managers' indices, released on Thursday for March, suggest weakening growth prospects across the continent with an unexpectedly strong decline in Germany, the powerhouse of the eurozone.

Investors have started to focus on Spain again this year after its budget deficit overshot targets last year and the government proposed to cut it less than it had agreed with European authorities for 2012.

After Portugal's bailout a year ago, markets expected Spain to be next in line. But partly due to Italy's high debt burden and the stumbling performance of its former prime minister Silvio Berlusconi, investors turned their sights on Rome first.

Now investors are back to worrying about Madrid with concerns ranging from its extremely high youth unemployment rate to its troubled banking sector and high budget deficit.

"Spain is a problem still," said a fund manager at one large bond investor. "Maybe it doesn't flare up for a while but it is hard to see it just muddling through forever: the numbers, particularly on unemployment, are just too bad."

Investors sought haven bond assets on Thursday with German 10-year Bund yields falling 7bp to 1.91 per cent.

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