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Political risk returns to eurozone debt crisis

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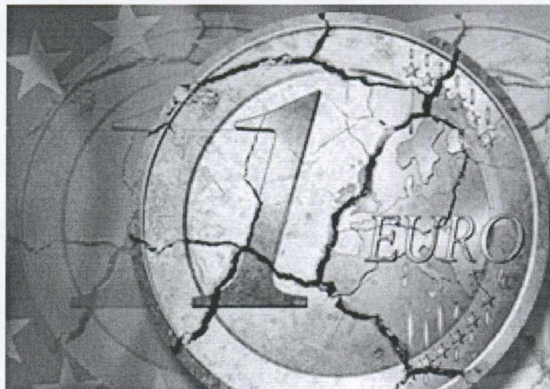
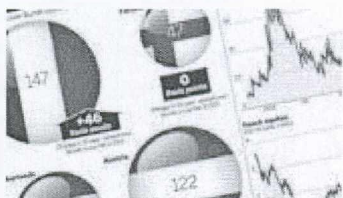
By Richard Milne



The debt crisis has once more infected the core of the eurozone.

Political uncertainty in France and the collapse of the coalition in the Netherlands, both countries until now regarded as relatively safe from contagion in Europe, have stoked fears the eurozone crisis could be about to intensify further.



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The last time Dutch and French borrowing costs jumped relative to Germany's was in November as worries surfaced about a possible break-up of the euro. Few governments apart from Berlin were spared as markets suffered a miserable final quarter of the year, only to be saved at the start of 2012 by action from the European Central Bank.

Now the effect of cheap ECB loans has worn off, with Dutch 10-year yield spreads tripling since early January to stand at 79 basis points over Germany on Monday. French spreads are at 145bp, the highest in three months, ahead of the final round of the presidential election in two weeks' time.

"For investors the political backdrop is really uncertain. In an environment of risk aversion, the movement in spreads suggests investors have been searching for cheap protection," says Stephen Major, head of fixed income research at HSBC.

With German 10-year Bund levels hitting a new all-time low of 1.634 per cent on Monday, investors looking for an inexpensive hedge have had to look elsewhere.

Many, according to Mr Major and others, have chosen in recent weeks to bet that countries with relatively tight spreads to Germany would see their premiums rise. "They are already in the money quite a lot," says one trader.

The problem this time round for markets is austerity, rather than the break-up worries of November. Economists at Citi, the US bank, warned last month that the Netherlands was no longer core as weak growth made its debt-cutting plans tricky to achieve. The collapse of the

government yesterday and the prospect of early elections bear out that analysis, highlighting the irony for some of the core countries pressing the peripheral nations for ever more austerity.

“The Netherlands is facing some of the problems that the peripheral countries are. [It is] finding that it is difficult to implement a fiscal tightening when the economy is weak,” says Jürgen Michels, an economist at Citi.

Fitch this month expressed doubts about the Netherlands’ triple A rating. That would leave the real core of the eurozone reduced to just Germany, Finland and Luxembourg for many investors.

Mr Major points to the way long-held alliances in European politics – such as those between Germany and the Netherlands as well as Berlin and Paris – are being put under strain by the latest leg of the crisis and the difficulties arising out of the European Union’s fiscal compact, meant to enforce stricter budgetary discipline.

He says the French first round results, where incumbent Nicolas Sarkozy lost to Socialist François Hollande while the far-right enjoyed record returns, was “a huge ‘no vote’ to austerity”.

Both the French election and the Dutch government collapse highlight how many political leaders have lost their jobs as a result of the eurozone crisis. But the situation also underlines to investors the importance of political risk in a big election year, with possible leadership changes in China and the US as well.

The lesson for many outside Europe is to avoid large swaths of the continent. John Wraith, fixed -income strategist at BofA Merrill Lynch, says: “Many investors based outside Europe no longer see sovereign debt, with the exception of Germany, in the eurozone as safe because of the precedent of restructuring and principal losses that has been set in Greece. Yields and spreads therefore start to rise and widen.”

European investors have also grown wary. The ECB’s longer-term refinancing operations certainly calmed the waters for several months but many analysts and investors believe they have led to bond markets becoming increasingly domestic. Investors are happy to own their own government’s paper but reluctant to hold much else apart from Bunds.

That stance makes sense from a risk management perspective as investments previously seen as totally secure have soured. The amount of eurozone sovereign debt that trades with a spread of more than 140bp over Bunds and where the country is no longer rated triple A by all agencies is now about €4tn. This dwarfs the $2tn worth of triple A collateralised debt obligations (CDOs) at the peak of the market in 2008, shortly before investors proceeded to sell out at almost any price.

The uncertainty is also visible in equity markets. France’s CAC 40 index of leading shares yesterday moved below its starting level of the year. Spain’s Ibex-35 is faring even worse, coming within a few points of reaching its lowest point since 2003.

Analysts caution against extrapolating too much from short-term market swings but many believe more upheaval is likely in the core and periphery alike. “There is always a tendency to exaggerate some moves. But we shouldn’t forget that the problems didn’t go away with the ECB liquidity,” says Mr Michels.

Talking of the big political change in the eurozone since the crisis broke two years ago, he says: “It has not ended yet.”

Additional reporting by David Oakley

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