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Euphoria over Spain bailout shortlived

By Robin Wigglesworth and Mary Watkins

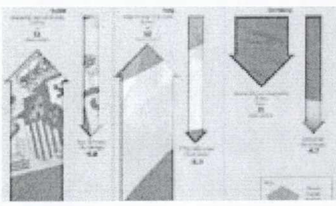
Initial market surge to the news of pre-emptive strike fades fast

Not for the first time, the boost from a eurozone bailout was shortlived.

This time, though, the market rally was over in just hours. The rescue package for Spain's banks was greeted with initial euphoria, only to be followed by creeping doubts.

Spanish and Italian stocks erased their early gains to trade firmly in the red, while the Eurofirst 300 index ended flat.

Bond investors punished peripheral debt. Yields for Madrid and Rome, which move inversely to prices, rose, sending their borrowing costs sharply higher, and the euro reversed its initial surge to end the day lower.



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"Equity investors are easy to please, but bond investors are more sceptical. This addresses the immediate problem for Spanish banks, but doesn't solve the underlying dynamic," says John Stopford, head of fixed income and currencies at Investec Asset Management.

Investors and analysts welcomed policy makers making a pre-emptive strike to tackle the problems of Spanish banks ahead of crucial elections in Greece on Sunday.

Moreover, the use of Spain's state-backed Fund for Orderly Restructuring (Frob) to channel funds to the banking sector from either the European Financial Stability Facility or its successor, the European Stability Mechanism, showed that the eurozone was capable of a nuanced response, some said.

Yet few believe that the bailout will provide anything more than a short-term fix for Spain – or for the eurozone's wider debt crisis.

If the full €100bn rescue loan is drawn, it will increase Spain's debt-to-gross domestic product ratio by about 9 percentage points to roughly 90 per cent, underlining the bigger challenge facing Spain as it is hit by a double-dip recession. Without growth, it will struggle to reduce that debt burden.

Even the full package may not be enough. Independent analysts at Oliver Wyman and Roland Berger will announce their estimate of Spanish banks' capital shortfall after June 21, but JPMorgan analysts say as much as €150bn could be required.

The emergency rescue package is likely to trigger further ratings downgrades for Spain, potentially to below investment grade, or junk. This could lead to selling by investors who are only allowed to hold highly rated debt. That would put further pressure on Spanish government bonds.

Many investors, too, are concerned about how they would be treated in an unlikely, but possible, sovereign debt restructuring. The EFSF is designed to be on an equal footing with private bondholders while the ESM is expected to be senior – or be repaid before private creditors.

"It's not a huge amount of money for now, but if Spain gets dependent on money from Europe and ends up having to restructure its debts, it will be the private sector that will suffer the most," Mr Stopford says.

The duration of the EFSF/ESM loan to Frob is also uncertain. If the loan is for 10 years or longer, then investors would be more positive. But if the length of the loan is for less than 10 years, then investors say they would become more concerned.

While the bailout increases the overall debt burden of Spain, Michael Krautzberger, head of European fixed income at BlackRock, says it could help the government access debt markets by shifting the immediate burden of borrowing to the European rescue facilities.

However, others say the fact that Spain has been unable to prop up its banks itself is ominous. "There's no such thing as a partial bailout. The reason they're asking Europe for funds to rescue the banks is because the sovereign cannot fund itself," says Pavan Wadhwa, global fixed-income strategist at JPMorgan.

Attention is shifting to Greece, which holds potentially pivotal elections on Sunday. Gains for parties that oppose the terms of the country's latest international rescue could fuel speculation that it would leave the single currency, leading to greater turmoil in the financial markets.

"The bigger issue is that Spanish banks are really only a small part of the puzzle. We still have to worry about Greece and the whole European construct," says Philippe Bodereau, head of European credit research at Pimco.

European leaders will meet later this month to discuss the crisis. Investors are hoping for measurable progress towards more lasting solutions, such as concrete moves towards a fiscal union and bonds issued and guaranteed jointly by the eurozone.

"I hope policy makers now understand the price of muddling through," says Mr Krautzberger. "At one point waiting was a rational, even logical, thing to do, but it's now clear that the situation is not turning around."

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