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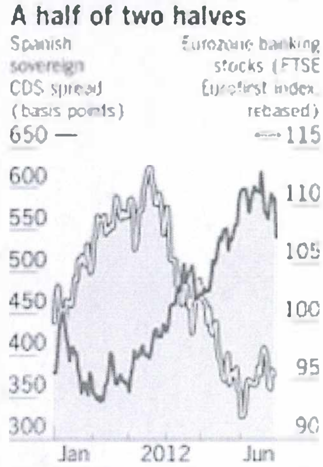
The Long View: testing Spain and Italy defences

Thirty months of hurt never stopped me dreaming. As so often, football mirrors life. On Thursday night, hours after Italy surprisingly but convincingly defeated Germany in the semi-final of Europe's football championship, Germany took another defeat at the EU summit.

A half of two halves



Sources: Markit, Thomson Reuters Datastream

Judging by the market reaction, traders were hoping for a German defeat, but surprised that it happened. The result was the latest politically driven bounce for risk markets, continuing a pattern that has persisted for about 30 months, since Greece's fiscal crisis erupted in early 2010.

For the eurozone, the longer term trajectory is unmistakable. The crisis continues to worsen. But every few months, politicians create an excuse for a rally.

Proof lies in the spread between the yields payable by Spanish government bonds and German Bunds, which shows the perceived risk of a Spanish sovereign default – an event that might well bring an end to the euro. The summit sparked the sharpest improvement in this spread since August last year. Its tightening was even greater than following last December's news that the European Central Bank would lend money on lenient terms to banks in a series of long-term refinancing operations – a manoeuvre that sparked a three-month rally.

This big surprise could change the terms of reference for many, as it happened on the last day of the first half of 2012. Like football, investing is a game of two halves. Many look at six-monthly figures and, thanks to Friday's return of confidence, the FTSE-Eurofirst 300 is back almost exactly where it started the year, in dollar terms. Other stock markets have been somewhat positive, while commodities have done badly.

Broadly, there were two ways to make serious money. One was to time the shifts in sentiment; buy European stocks at the outset, because the ECB had spurred a boom, switch to sell them short (profiting from a price fall) on March 13 when the Eurofirst peaked for the year, then buy again on June 4. It adds up to a gain of 50 per cent. Perform the same trick with the volatile eurozone banks index and there was an 82 per cent gain by the beginning of March. The problem is that such market timing requires betting on politicians, which is dangerous.

The other way to make money, much more stably, was to bet at the outset that the crisis would worsen. Borrowing Spanish 10-year bonds and selling them in order to buy 10-year US Treasuries would have made you 19 per cent. Buying protection against Spanish default on the swaps market would have made 42 per cent.

Could the summit really have reversed this? Could it have sparked another "risk-on" rally? Or will it be forgotten by next week?

The politicians do appear to have made more progress than expected. Critically, the European Stability Mechanism (ESM), the main EU-wide vehicle for aiding sovereigns in trouble, can henceforth aid banks directly. Until now, it needed to help banks via loans to their sovereign governments – meaning that the debt for those sovereigns would increase with any bank bailout. This could be important; the crisis is so severe in large part because it links two crises, for banks and governments.

Secondly, when the ESM makes "bailout" loans to governments, starting with Spain, it will not automatically enjoy sovereignty over other creditors. This could also matter a lot. Bailout funds so far have perversely driven existing private sector investors out, because they have been forced further back in the queue for repayment in the event of any default. Their exit pushes up bond yields (which are governments' borrowing costs). So this could help to fix the dynamic that has pushed up sovereign borrowing costs throughout the crisis.

Finally, the ESM will be allowed to dive into bond markets to bring down yields, rather than make loans direct to governments, and it will be empowered to do so without first waiting for the politicians to agree to new austerity measures. That should make the ESM much nimbler.

But, conditions and timing remain unclear. Central problems remain: governments are running unsustainable deficits; austerity policies are only worsening government finances; Greece remains at risk of bankruptcy; and the moves to pool borrowing and banking regulation among the eurozone's members, which would solve the crisis, continue to require the kind of ceding of sovereignty that could take years to negotiate, and that electorates may not accept.

In sum, this summit sharply improves the chances of keeping the capital markets in check, but does little to deal with the longer-term problem. A logical outcome for markets would be a recovery for a while, followed by another downturn. The two halves of this year could look very similar. But at least one of Italy and Spain will enjoy a moment of triumph before it is over.