Market action in European government bonds in the first two weeks of the year seems to suggest that when the clock struck midnight on the 31st December, the crisis, as well as the year, ended. Yields have come down significantly and the spread between peripherals and German bunds has decreased to lows last seen before the crisis. However, since the current pace of yield compression may not last even as long as your new found dedication to the gym, we will further examine how policy makers will likely act in 2013 and how the crisis is likely to develop.

LOOKING BACK AT 2012

Market confidence in Europe has returned and the region’s asset prices reflect this, but the current pace of compression probably displays more enthusiasm than the fundamentals warrant.

In 2012 there was significant progress towards building a stronger, more integrated Europe. The announcement of the creation of the Outright Monetary Transactions (OMT) programme at the European Central Bank anchors most of this progress. Whilst the inauguration of the European Stability Mechanism (ESM) also contributed to the market’s growing comfort with the aid of mechanisms available to European countries in crisis as well as policy makers’ willingness to provide support. However, despite the steps forward, there were also steps backwards; in many ways, the ESM prompted as many questions as it provided answers: Will legacy banking assets in Spain and Italy be excluded going forward? Will the ESM be able to directly recapitalise banks? Will each of the sovereigns be on the hook for all of the ESM funds to their country’s banks?

Overall, the OMT and the ESM were meaningful developments in 2012 but still exist without explicit tests of their robustness. Additionally, the EU Commission announced extremely ambitious goals for the creation of a banking union and only met its year-end deadline by fragmenting the legislation and pushing banking union implementation into 2014. The steps taken by the authorities in Europe in 2012 were positive, even if they lacked implementation, and the market rewarded the progress with shrinking spreads. There has been piecemeal reform from almost all countries but yield movement, in our opinion seems excessive in light of the scope of the reforms implemented.

HOW WILL POLICY MAKERS ACT IN 2013?

We do not foresee the sovereign crisis being fully resolved before the clock strikes midnight at the end of 2013, nor do we expect a reversal of the progress made. We continue to believe there will be convergence in European bond yields as the European Economic and Monetary Union (EMU) move towards greater integration. The risk of an EU collapse is significantly diminished but developments towards further integration in 2013 will be at a much slower pace, if they occur at all.
There still remains a significant amount of work to be done by policy makers to resolve the fundamental issues that led to the crisis. However, the combination of positive market environment and domestic political pressures puts the region at risk of complacency in 2013 which could leave investors looking for further progress on full EU integration out in the cold.

There are also darker spots in the region that could taint the current rally. Spain remains a major issue as its economy continues to struggle to rebalance. While the Spanish bank recapitalisation programme is up and running, concerns remain that the combination of a weakening Rajoy administration, economic contraction, high unemployment and continued separatist unrest will push Spain into economic and political chaos and, therefore, into an assistance program. Furthermore, the February elections in Italy seem destined to push the country back into the same political environment of weak coalitions that threaten the nascent reform programme. EU policy makers are half way along the road to full integration which would help fade those darker spots. But as they pause so does any impetus to regain the momentum found in mid-2012.

If EU policy makers were able to accelerate the implementation of the banking union and make the existing guidelines more robust, to include full financial sector regulation through the ECB, a deposit guarantee fund, harmonisation of bank rules and some sort of institutionalised resolution process, it is likely we would see a continuation of the yield compression at a similar exuberant pace. However it is difficult to imagine that the EU policy makers would, without market pressure, undertake the task of such a challenging process. There will also be an absence of leadership on reform as the German government focuses on domestic politics while trying to keep the sovereign crisis on the backburner until after general elections in September.

**CONCLUSION – THE END OF THE BEGINNING**

We have seen throughout history that economic and political crises are rarely resolved through tough choices by politicians without intense market or political pressure. EU policy makers did enough in 2012 to push the region down the path of integration and provide markets with the confidence to re-engage with the region. They did not finish the job but it seems unlikely that there will be further movement while the market is content with policy. There is extensive discourse on why bond vigilantes don’t work in the US Treasury market but we’ve seen them work with exacting measure in Europe. We continue to expect further integration and further compression in bond yields but it will not be a smooth path. While European leadership is focused elsewhere, we will have to wait until there is loss of market confidence, possibly triggered by one of those darker spots which re-invigorate policy makers to push further down the path of integration.