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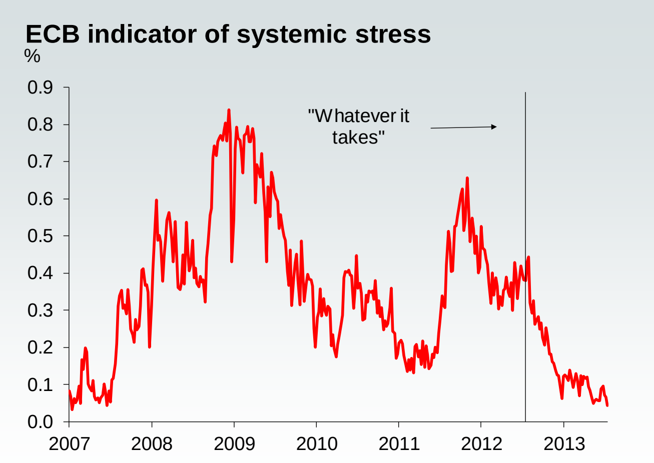
Market analysis

"Whatever it takes" speech looks to have been an important turning point in the euro crisis

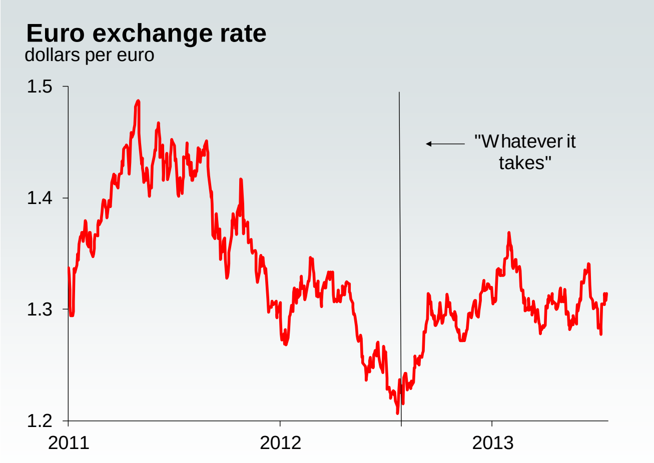
Mario Draghi's commitment a year ago to do "whatever it takes" to save the euro looks to have been an important turning point in the Eurozone crisis. Systemic risk has fallen, the euro has strengthened, spreads on peripheral debt have narrowed and bond and equity markets have become less sensitive to bad Eurozone news flow. Indeed, to date markets seem to have taken Draghi at his word and seem unwilling to test his resolve. But although confidence in the outlook for the Eurozone among investors has risen over the past year, the real economy is yet to emerge from recession. We continue to expect this to happen in the second half of this year, a view supported by this week's improvement in the PMI data. However, unless action is taken to reduce borrowing costs paid by households and companies in the peripheral economies, the recovery will be anaemic. With that in mind, the ECB's announcement that it will ease its collateral rules only marginally is disappointing.

One year on, "whatever it takes" speech marked a turning point in the euro crisis…

It is a year since Mario Draghi said at a conference in London on the eve of the 2012 Olympics that "the ECB is ready to do whatever it takes to preserve the euro" and that if the ECB did have to act "believe me, it will be enough." At the time, speculation was rampant that the Eurozone was heading for a breakup as borrowing costs soared in Spain and Italy. It had been a gruesome week for the Eurozone; Spain had been hit by a barrage of bad economic data and rumours that Greece might be forced out of the euro were circulating in financial markets.



Source : Oxford Economics/Haver Analytics



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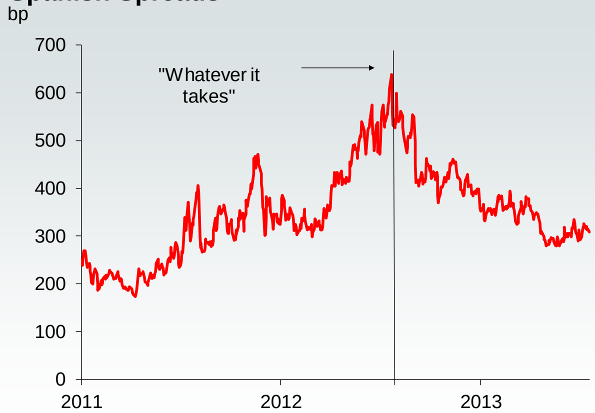
With a year's worth of hindsight, those few words uttered by the ECB president on 26 July 2012 appear to have marked a major turning point in the three-and-a-half-year Eurozone crisis. Over the past year there has been a marked improvement in a number of financial market variables and a reduction in signs of systemic risk. The ECB's measure of systemic risk has fallen sharply and is now back at a level last seen in 2007 before the global financial crisis commenced. Meanwhile the euro, which we would expect to weaken were the Eurozone to break up, has risen by around 8% against the US dollar. Improvements in these indicators reflect a decline in the probability of a Eurozone breakup since Draghi made his speech.

Although Greek and Portuguese bond yields rose in the weeks running up to Draghi's speech, the most dramatic increases were in Italian and Spanish government bond yields and in their spreads over German bond yields. Spanish 10-year spreads widened to a euro-era high of 639bp as Spanish bond yields rose to 7.63% and safe-haven flows pushed German yields down to 2.3%. Meanwhile, Italian spreads widened to 537bp, close to their euro-era high. In the year since Draghi's commitment to safeguard the euro, Italian and Spanish yields have fallen sharply and the spreads have reversed their earlier widening.

Spanish Spreads



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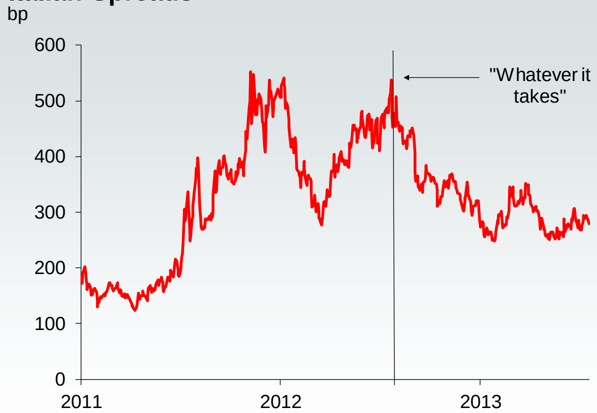
Italian Spreads



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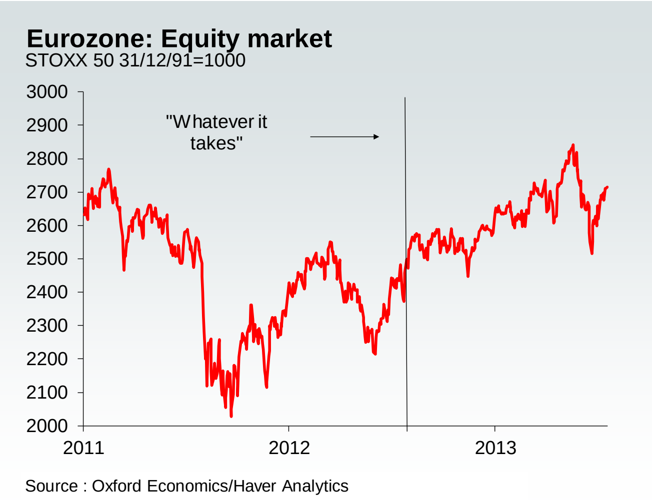
…as bond markets have been unwilling to test Draghi's resolve so far

The fall in Italian and Spanish bond yields seen over the last year suggests that bond markets believe that the ECB president is indeed committed to saving the Eurozone and has the firepower to back up his words with action even though the ECB confirmed in September that it would only purchase bonds of between one and three year maturities. So far this year, European bond markets have taken in their stride events that would probably have worried them far more had they taken place in 2011 or 2012. These include a failed Italian election, a botched bailout of Cyprus' banks and, in recent weeks, turmoil within Portugal's coalition government due to diminishing support for austerity plans. Although it is unusual for markets not to test a policymaker's resolve, they have so far passed up a number of opportunities to do so.

As well as peripheral economy government debt rallying over the past year, so have equity markets. Eurozone equity prices as measured by the STOXX 50 have risen by 14%. But although the Eurozone equity market has risen, it is worth noting that is has underperformed the US equity market since the start of the year as consensus expectations for Eurozone growth have fallen by more than those for the US.

Global equity market volatility did spike a little ahead of Draghi's speech last year. But on the whole, the equity market, like the bond market, has taken economic and political events in the Eurozone in its stride. The two notable spikes in volatility this year relate not to events in the Eurozone but to events in the US: first, concerns around the turn of the year that the fiscal cliff would derail the US recovery; and second, more recently, that a scaling back of quantitative easing by the Federal Reserve could knock the US economy off course later this year.



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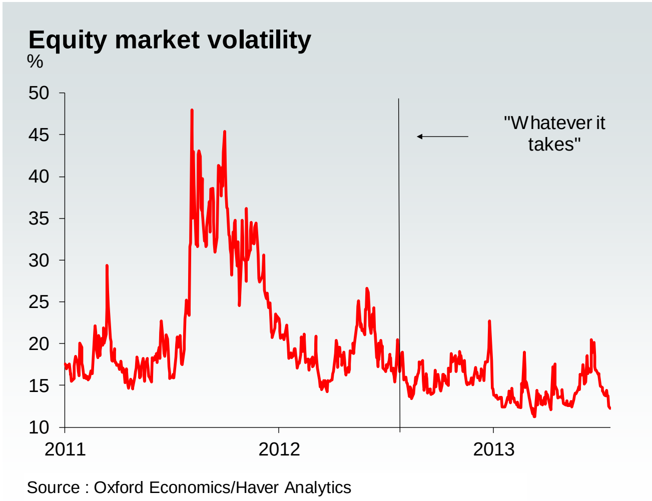
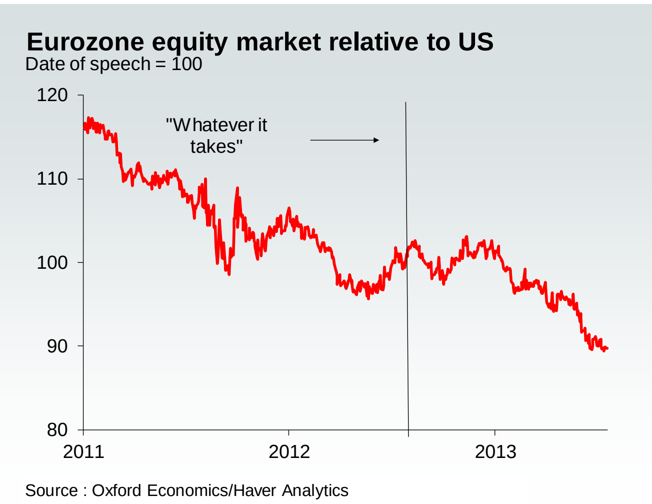


Source : Oxford Economics/Haver Analytics

A turning point in the economy is on the horizon…

Although confidence in the outlook for the Eurozone among investors has risen over the past year, the improvements in business and consumer confidence and in the economic data have as yet been far less convincing. For example, when the GDP data for the second quarter is released it will probably show that the Eurozone economy was flat, after contracting for six consecutive quarters. Our forecast envisages a return to growth in the second half of this year. This week's rise in the Eurozone composite purchasing managers' index from 48.7 in June to 50.4 in July – its best reading for 18 months – is consistent with our view.



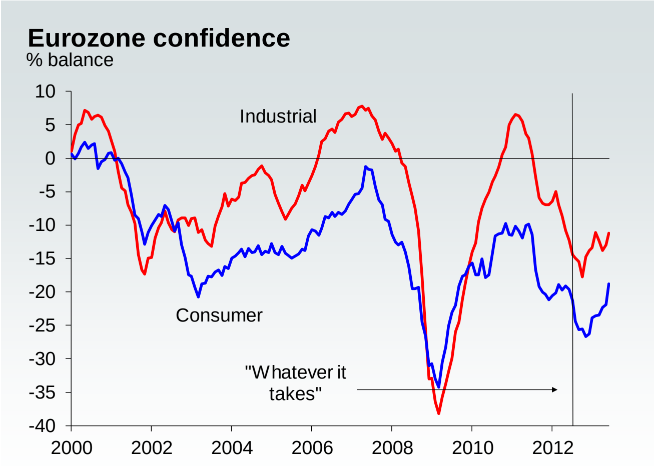
Source : Oxford Economics/Haver Analytics

Source : ECB, Citi Group

…but the ECB could do more

We expect the recovery when it comes to be anaemic, due to a plethora of difficulties, including fiscal austerity, consumer and financial sector deleveraging, weaker than expected foreign demand and a relatively strong exchange rate, all of which will limit growth in the first year of recovery to just 1%. If the economy is to experience faster growth, then the ECB's next focus should be on reducing borrowing costs for households and companies in the peripheral economies. Although spreads on the government debt of peripheral economies relative to Germany have fallen sharply over the past year, the additional interest rates charged by banks when lending to peripheral households and companies in many cases have not. With that in mind, the ECB's announcement in recent days that it is extending the pool of collateral it will accept from banks by just €20bn out of a total theoretical pool of €15trn seems like a missed opportunity. This suggests that the ECB still sees the European Investment Bank (EIB) as the main institution able to improve credit conditions for SMEs. This is unfortunate given that our simulations suggest that a significant easing of credit conditions could reduce the number of unemployed by around one million within a few years, helping to alleviate the social cost of this crisis and thereby further reduce the risk of a Eurozone breakup.

It also seems likely that at some point markets will test the ECB's resolve. It is difficult to know what will trigger this, but it is possible to speculate about plenty of potential triggers, including a collapse of the Portuguese or Italian governments, renewed bad data or Portugal applying for a credit line.



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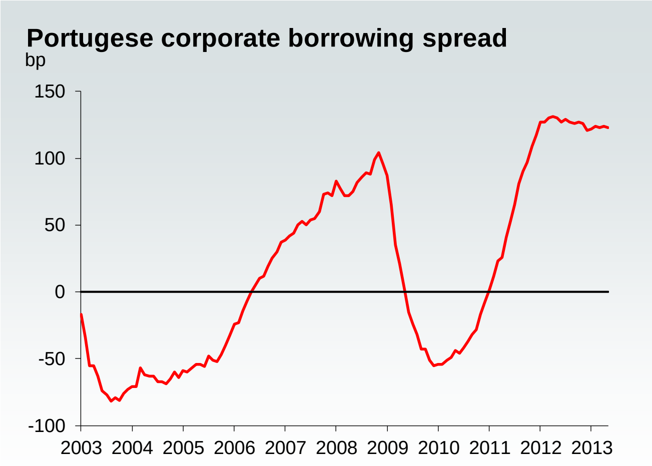

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