One highlight for 2013 would certainly be the calm of the European financial markets. Remember that from the end of 2009 up to mid-2012, the financial crisis was raging in the euro zone, even threatening to unravel the Economic and Monetary Union. The last serious episode of this crisis ended as summer 2012 wound down, after the European Central Bank’s (ECB) commitment to take every measure to preserve the euro and implement a new program—Outright Monetary Transaction (OMT)—allowing it to buy an unlimited amount of government securities, under certain conditions. Until now, the OMT has not been used, but its existence is enough to reassure investors.

Lesser financial strains are particularly visible in the ongoing slide of financing premiums in euro zone countries to which investors had previously turned their backs. The surge in European exchanges, up about 40% since mid-2012, and the strength of the euro are also signs of improved investor sentiment.

Note that the recession plaguing the euro zone since the fourth quarter of 2011 ended in spring 2013, and several confidence indexes began to trend upwards. Despite this improvement, the growth outlook is still modest, and the unemployment rate in the euro zone remains above 12%.

Ireland’s triumphant return to the bond market may also create the impression that the crisis is over. This country, which had to resort to a bailout plan after its financial sector collapsed, should post economic growth that is higher than the euro zone average this year, and it can now issue bonds at quite reasonable rates. This gives hope that Portugal could be next to re-enter the market when its assistance plan is completed next spring.

Even though Portuguese bond yields were down recently, the country’s economic and budgetary situation, like other peripheral euro zone countries, is still problematic, and nothing guarantees a sustained rebound in investor confidence.

Europe’s financial sector also continues to cause concern. The economic challenges of recent years is apparent on the banks’ balance sheets, particularly in Spain where the proportion of non-performing loans reached a historic high last September. In this context, the stress tests to be conducted by the ECB this year will like show that certain institutions have insufficient capital. These banks will have to get things on track, which could mean losses for shareholders and creditors as well as costs for national governments.

Implications: Despite some encouraging developments, the situation is far from normal in the euro zone and there is still a significant risk of a rebound in financial strains. Accordingly, we would advise caution as regards European stock and bond markets, and to expect a retreating euro in 2014.

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Sources: Datastream and Desjardins, Economic Studies