



EURO ZONE

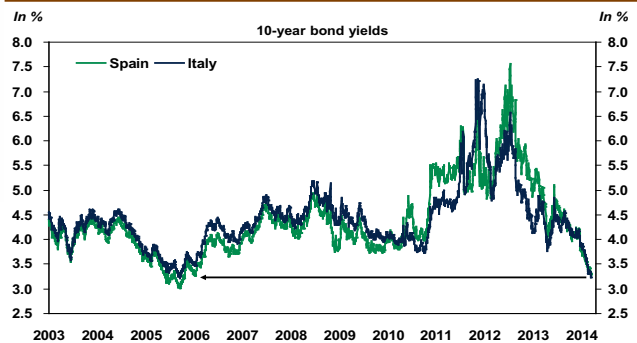
Are low yields justified in Europe?

In 2012, the euro zone was facing a crisis of confidence acute financial markets. Uncertainty about the survival of the monetary union, financial difficulties of some countries struggling with budget issues, as well as fears of contagion, then pushed investors to flee bond markets of these countries, raising borrowing costs. Eighteen months after Mario Draghi issued assurances that the European Central Bank would make every effort to save the euro, the situation of European bond markets contrast particularly strikingly with that of 2012. Bond yields in some of the troubled countries have not only fallen dramatically, but they have even touched bottoms dating from 2006 (see graph). For example, the Spanish 10-year yield, which exceeded 7.5% in July 2012, is currently at around 3.3% only slightly more than 50 basis points above the U.S. yield something not seen since the crisis. Only two years after restructuring its debt, Greece is even already contemplating issuing new bonds, given these conditions.

Have risks dissipated to this extent in the euro zone? Although the Eurozone economy emerges from recession, growth is set to remain very weak in the coming years. Political constraints mean that structural reforms are likely to continue to evolve at a slow pace and in an environment of high unemployment and weak inflation, one can hardly expect robust growth in budget revenues. Meanwhile, the counter-productive aspect of draconian austerity has been demonstrated and it is expected that governments will play it safe on the expenditure side. It is therefore not surprising that countries like Spain, Italy and also France, are experiencing difficulty meeting fiscal targets set by the European Commission, even after these targets were somewhat relaxed.

On the banking side, negotiations surrounding the establishment of a single fund resolution are still sluggish and the European interbank market remains for all intents and purposes paralyzed since the financial crisis of 2008–2009. The banking system is thus in a highly

In Spain and Italy, yields have dropped to their pre-crisis levels



Sources: Bloomberg and Desjardins, Economic Studies

dysfunctional state, making the granting of credit, which could finance expenditures and investments, severely rationed. Furthermore delays in the risk-pooling effort ensures that at the country level, the transmission channel between the risks in sovereign bond markets and those in the banking system, remains potent.

Implications: Recent trends in euro zone bond markets seem to embellish the progress made on the economic, fiscal and institutional fronts. To a large extent, this reflects the frantic search for yield globally, the same that has guided several major financial market themes in recent years, both positive and negative. In our opinion, there is a non-trivial possibility for risks to be improperly assessed and as a result, a burst of tension causing further turmoil and higher yields is a possibility in European markets.

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