Evidence is piling up that European financial markets think the euro zone's debt crisis is fading—the euro rose to near a 10-month high Thursday—but feeble economic activity suggests the crisis is only in remission.

Among the positive signs: Spanish and Italian government bonds have been strengthening dramatically for six months. Spain successfully sold a raft of new debt Thursday. The acute tensions in Europe's banking system have dulled.

Once-real fears of a cataclysmic euro breakup are now gone. There is confidence that if you put money in the euro zone's periphery, "you will get it back in the currency you started with," says Christine Johnson, a bond investor at Old Mutual Asset Managers in London—a shift she attributes to European Central Bank President Mario Draghi's July pledge to save the euro, "whatever it takes."

In her portfolios, Ms. Johnson has moved toward "normalization": buying bonds of banks, utilities and telecom companies in the periphery.

But the optimism in financial markets isn't yet matched by a recovery in Europe's economies. In Germany, the biggest, gross domestic product fell at an annualized rate of 2% in the fourth quarter, according to an estimate released Tuesday by Germany's statistics office. Economists expect Germany to return to slow growth in the first quarter, but the overall euro-zone economy remains mired in recession.

The underlying sources of the crisis have not gone away, says Jürgen Michels, an economist at Citigroup in London. If concerns flair anew about the robustness of governments or the banking system, he adds, "I think this positive environment that we have for the moment is going to change pretty quickly."

Still, behind European markets' buoyancy lie some real shifts, both in the flows of money that caused the crisis to erupt and in the will of Europe's institutions to tamp it down.

Struggling euro-zone countries such as Spain, Italy and Portugal are steadily curbing their reliance on foreign borrowing to support their economies—the dependence that made them
vulnerable when that foreign capital fled. Mr. Draghi’s vow has also persuaded markets that Europe’s crisis won’t end in catastrophe.

Investors from the savings-rich countries of Northern Europe have paused from pulling their money out of the euro zone’s indebted south. Some are even moving back in.

French asset manager Carmignac Gestion, reassured by the ECB, has sold safe but low-yielding German bonds and scooped up Spanish and Italian debt in recent months. Before the ECB’s move, says Carmignac’s Carlos Galvis, there appeared to be nothing in place to stop troubled countries’ bond markets from collapsing.

Such demand has helped Southern European banks and governments enjoy lower borrowing costs than last year. Spain’s 10-year bond closed Thursday at 5.10% and Italy’s at 4.18%. Six months ago, both were more than two percentage points higher. European bank stocks and other assets have also risen strongly in that time.

Some non-European investors are also returning cautiously to the euro zone. California-based Pacific Investment Management Co., which runs the world’s biggest bond fund, has said it is buying Italian and Spanish bonds.

David Rolley, co-head of global fixed income at Loomis, Sayles & Co., in Boston, says the firm "increased our Mediterranean exposure last summer" and has enjoyed the rally. While Mr. Rolley says he’s not sure the current moment of calm will endure, "I don't think we go back to existential stress," he says.

Besides some investors’ change of heart, rapidly shrinking economic deficits are helping matters. In Spain, where excessive private-sector borrowing from abroad led to the crisis, the current account—a measure that shows whether a national economy is spending more than it earns—is expected to be close to balance this year. The country is living roughly within its means. It needs less foreign borrowing, which in theory means that the funding it needs should be cheaper to get.

But the good news largely ends there. Businesses in southern Europe are still starved for financing, preventing the investment and hiring that would be needed to start an economic recovery.

Across southern Europe, economic activity is shrinking. Industrial output in the euro zone fell 3.7% in November from the prior year, the European Union’s statistical agency said Monday. Italy, Spain, Portugal and Greece all reported drops from October.

GDP isn’t expected to recover to precrisis levels for several more years. That matters because the ability of individuals, companies and governments to repay their debts in full depends on their future incomes. The likelihood of a lost decade in the euro zone suggests some countries might not be able to bear the burden of their foreign debts in the long run.

Persistently weak economies in Spain and Italy will push up public debts as a proportion of GDP, as well as bad loans at banks, says Simon Tilford, chief economist at the Center for European Reform, a London think tank. "Ultimately the debt problem is being made bigger" by Europe’s lack of growth, he says.

Shrinking economies and worsening debt ratios might be what pushes markets to start selling Spanish or Italian debt again, Mr. Tilford says. That would test whether the ECB can make good on its promise to keep bond markets from collapsing.

Margins for error are thin.

Although the murderous capital flight seen at the crisis's peak has abated, the financial system is still far more strained than in normal times: At 35.3%, foreign ownership of regular Spanish
government bonds is up from 33.5% in the dark days of August but still a far cry from 54.8% in 2010. The Spanish banks have by and large picked up the slack, with money borrowed from the ECB.

And while recession is making labor in Spain and Greece cheaper than it once was—which could boost exports and eventually jobs—many of the tough reforms needed to make economies more productive will take time and patience, says Nick Kounis, head of macroeconomic research at ABN Amro in the Netherlands. "There is a long way to go."

Optimists argue that the better conditions in financial markets will feed through to businesses and households during 2013, helping the euro zone to escape the grip of recession. David Mackie, economist at J.P. Morgan in London, predicts a decline in borrowing costs in the first half of this year.

Mr. Mackie argues that the return of confidence in financial markets is premised partly on a European political shift during 2012: toward acceptance that European governments need to deploy their collective financial muscle to keep the euro zone stable. In particular, European leaders have begun to build a "banking union," based on common supervision and financial support for banks, and are discussing ideas for a deeper fiscal union.

But as financial-market panic subsided in late 2012, so did euro-zone leaders' political will to take controversial steps that would mean giving up national sovereignty over budgets, or rising taxpayers' money to save other countries' banks.

"There was a disappointing complacency at the end of last year" among euro-zone leaders, says Jean Pisani-Ferry, director of Brussels think tank Bruegel. "Are we sure we've built a euro zone that is resilient enough?"

—Fiona Law contributed to this article.

Write to Marcus Walker at marcus.walker@wsj.com and Charles Forelle at charles.forelle@wsj.com

Corrections & Amplifications
Jean Pisani-Ferry is the director of Brussels think tank Bruegel. An earlier version of this article incorrectly called it Bruege.

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