European Bonds Are Defying Gravity

By CHARLES FORELLE

LONDON—The bond markets and the economies of Europe's struggling countries tell two very different stories this year: One is rallying; the other, sinking.

In July 2012, Italian 10-year bonds yielded more than 6%; this week they fell below 4%. Falling yields mean rising prices. The Italian economy, meanwhile, has been ugly. Gross domestic product in the fourth quarter of 2012 slid 2.8% from the same period in 2011, the sharpest quarterly fall since 2009. Italian unemployment was 11.6% in February, up from 10.6% in July. The tale is similar in Spain.

The bond-market rally has broad implications for the euro zone. At a basic level, access to financing is the measure of the crisis. Greece, Ireland, Portugal and Cyprus ultimately needed bailouts because they couldn't persuade investors to lend them money. Spain and Italy can avoid similar fates so long as investors are buying bonds.

Right now, demand seems robust: Wednesday, Italy sold €2.5 billion ($3.25 billion) of two-year zero-coupon bonds at the lowest yield it has received for the instrument since the introduction of the euro. Such bonds are sold at below face value and repaid in full upon maturity.

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Job seekers line up outside an employment office in Madrid earlier this month. Despite a struggling economy, Spanish bonds have been rallying.
Much of the rally, say many market participants, can be attributed to the ECB’s pledge last year to backstop euro-zone government-bond markets if they get into trouble, and to the flood of cheap money that has been poured in to economies by central banks around the world.

That has prodded investors to buy assets they might otherwise have seen as too risky—precisely the point of the policy. But the economic gloom has cast a long shadow over the rally. “It’d be hard to depict this as a big vote of confidence in Italy and Spain,” said David Griffiths, a portfolio manager in London for Stone Harbor Investment Partners, which has $68 billion invested in global fixed income. He said the firm has reduced its Spanish holdings and was already light on Italian bonds because of political seesawing in the country. “I think this is starting to get a bit overdone,” he said.

Pacific Investment Management Co., home to the world’s biggest bond fund, also is “lightening up” on holdings of Italian and Spanish bonds, Andrew Balls, its head of European portfolio management, said Wednesday. Pimco has “sold into the rally because we remain worried over the fundamentals in the euro zone,” Mr. Balls said.

In a sense, the bond-market optimism smacks of a return to more normal times: Government bonds, at least of major developed countries that issue their own currency, tend to get stronger when the economy gets weaker; investors snap them up because they are nervous about the outlook for stocks and corporate debt, which are dependent on economic growth.

That hasn’t been true in Spain, Italy and other troubled countries during the euro crisis, because low economic growth makes it less likely that their economies will generate the tax revenue needed to repay their debts.

Bulls say the ECB’s intervention has significantly reduced the risk that Italy or Spain could default on its debts. Nick Gartside, international chief investment officer for fixed income at J.P. Morgan Asset Management, says the ECB’s pledges “provide a sort of cloak of certainty and a very important foundation.”

Mr. Gartside said he has been positive on Italian bonds since earlier this year and has been buying when they weaken. “Is there a question over the ability or the willingness to repay? We would say no,” he said. Mr. Gartside points to Italy’s long record of relatively contained budget deficits, even amid what seems like perpetual political turmoil.

Others are less sanguine. “The markets are overestimating the capacity of the European Central Bank to intervene in case of need,” said Roberto Perotti, an economist at Bocconi University in Milan. He argues that Italy is essentially too big to save, even by the ECB, if it ran seriously aground.

And Italy’s weak economy raises its risk: Without economic growth, it is difficult to contain Italy’s huge public debt—the second-largest as a proportion of GDP in the euro zone, after Greece.

Moreover, restarting economic growth will be a significant challenge. Low rates from the central bank—the ECB’s main interest rate is 0.75%, and many analysts now expect a cut as soon as next week—haven’t effectively percolated down to small businesses and consumers in Italy or Spain.

“On our reckoning, liquidity conditions in the euro zone are as poor as they’ve been at any time in the past four or five years,” said Mike Howell of CrossBorder Capital, a London research firm that tracks money flows.

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