Europe’s lowest government bond yields since the Napoleonic Wars are signaling investors want more action from Mario Draghi.

Instead of a vote of confidence, the most pronounced rally in 200 years suggests the European Central Bank president needs to stave off the risks of stagnation and deflation. Austria, Belgium, France (GFRN10) and Germany can borrow at lower rates (GDBR10) than the U.S. as inflation less than half the ECB’s target stokes concern the euro zone will take many years to recover from its longest-ever recession.

While bond, currency and derivative markets show an abatement in the contagion that began in Greece in 2009 before engulfing Spain and Italy, a closer look reveals high debt and deficits that have yet to be addressed, unemployment near record levels and a banking system still to be fixed.

ECB policy makers will share their outlook in two days, when they probably will lower the 18-nation currency bloc’s official rate toward zero and take the deposit rate negative for the first time.

“The outright level of yields is suggesting an incredibly weak outlook for growth,” Russell Silberston, a London-based money manager at Investec Asset Management, which oversees $110 billion, said in a May 30 phone interview. “It’s a powerful signal telling you policy is too tight and that there’s complacency toward the risks. Not a great deal has been solved. We’ve still got bank stress tests to come, too low growth and too low inflation.”

More Stimulus

Speculation the ECB will provide more stimulus pushed yields on euro-region sovereign debt to a record-low 1.43 percent on May 30, according to Bank of America Merrill Lynch’s Euro Government Bond Index. Draghi said May 8 the Governing Council is “comfortable” taking action to boost consumer-price growth. Data today showed inflation cooled to 0.5 percent in May, well below the ECB’s aim of keeping it just under 2 percent.

Yet there is little evidence that record-low borrowing costs and bond yields are feeding through to the economy. While the central bank’s lending survey
showed conditions for new loans stabilized in the first quarter, lending to companies and households has been contracting for almost two years.

“A lot of borrowing rates are still very elevated across the euro zone, and they haven’t responded to the yield reductions,” said Keith Wade, the London-based chief economist at Schroders Plc, which has $447 billion of assets under management. “It comes down to the banking system, which wants to try and rebuild profitability and is happy to ration lending to their best borrowers at higher rates.”

**Napoleon’s Forces**

Bond yields in Germany and its predecessors haven’t been this low since at least the early 1800s, when French forces under Napoleon Bonaparte fought wars throughout the European continent.

Rates on German 10-year bonds were at 1.40 percent at 1:20 p.m. London time, a quarter of a percentage point away from 1.127 percent reached in 2012, the lowest since at least 1815, according to “The History of Interest Rates” by Sidney Homer and Richard Sylla. That was the year of Napoleon’s final defeat at Waterloo, after which the Congress of Vienna redrew the map of Europe, leading to the creation of the German Confederation.

Germany’s current yield compares with an average of 3.03 percent in the past 10 years. The rate for government loans was 3.6 percent in 1944 during World War II and 12.5 percent in 1931 amid the Great Depression, according to the book.

**Possible Measures**

Draghi’s headache may be compounded by longer-term issues that take years to solve. To kick-start the economy, officials have said they’re working on a package of possible measures to announce this week, including rate cuts, liquidity injections and a plan to free up lending.

A combination of constrained credit conditions, high levels of debt, an aging population and fiscal tightening will keep growth -- and interest rates -- low, according to Andrew Balls, deputy chief investment officer at Pacific Investment Management Co. in London. Pimco predicts the euro area will grow at 1 percent to 1.5 percent during the next three to five years. That compares with contractions in each of the past two years and expansion of 2.9 percent in 2007, before the crisis struck.

**Deflation Risk**

“Europe is going to be stuck in a low-yield environment,” Balls said May 28. “Our baseline is for a stable, but not particularly healthy, euro zone with a low potential growth rate and high, but stable, levels of debt. We see deflation as a real risk.”
With the recovery struggling to gather momentum in the first quarter as stronger growth in Germany failed to offset weakness across the region, Balls said he sees a better-than 50 percent chance the ECB will have to go even further and buy assets under a quantitative-easing program, similar to those adopted by the Federal Reserve and the Bank of England.

The rally in German bonds, the region’s benchmark, was driven predominantly by demand for safety, while the gain in peripheral securities, such as Spain’s and Italy’s, was fueled by a hunt for yield. Still, they have one common denominator: the ECB.

Draghi’s July 2012 pledge to do “whatever it takes” to backstop the currency bloc boosted investor confidence that the euro region wouldn’t break up, which would have meant debt repaid in local currencies. This spurred demand for European assets and started the slide in yields. Spain’s 10-year rate, which reached a euro-era record 7.75 percent that month, is now 2.84 percent. Italy’s declined to a record-low 2.89 percent last month, from 6.71 percent in 2012.

‘Debt Problem’

The rally has extended across the region: yields on bonds from Belgium, Austria and France also dropped to all-time lows last month.

“These bond rates have so far not translated into a strong recovery because of structural issues,” said Steven Major, a global head of fixed-income research at HSBC Holdings Plc in London. “The debt problem has not gone away, but the very low yields are saying these countries have no solvency risk. What is the incentive for the governments to do anything when they are given record-low refinancing costs?”

Draghi repeatedly has called on euro-region nations not to “unravel” the progress they’ve made in reducing their long-term obligations as yields drop.

‘Buoyant Market’

In Greece, where the European Commission predicts government debt will increase to 177 percent of gross domestic product this year and growth will languish at 0.6 percent, 10-year yields slid to 6.24 percent this week from 44 percent at the height of the crisis. The rate on similar-maturity Portuguese securities tumbled to 3.44 percent last month, from a peak of more than 18 percent in 2012, even though the nation’s debt pile remained elevated.

“There’s no doubt that there are sort of quite sizable flows now, that are the main reason for this buoyant market,” the ECB president told reporters at a May 8 press conference. “But that’s exactly why one should be extremely careful about not thinking that this would be a good reason for relaxing the policy effort, both on the budgetary and especially on the structural reforms.”
Uneven Recovery

UBS AG Chairman and former ECB official Axel Weber wrote in the Financial Times today that the euro-region recovery “remains weak and uneven despite buoyant financial markets.”

Still, Greece’s government securities returned an average of 27 percent so far this year, making them the best performers tracked by Bloomberg World Bond Indexes. Portugal’s returned 14 percent and Spain’s 8 percent. That compares with 4.1 percent for German bonds and 3.2 percent for U.S. debt.

There is an “asymmetry of risk and an asymmetry of return,” said Grant Peterkin, a money manager at Lombard Odier Asset Management in Geneva. “Yields are extremely low and you can argue they are not pricing in the full extent of the concerns the ECB have around inflation and growth.”

The ECB’s Governing Council meets on June 5 in Frankfurt to decide on monetary policy, four weeks after Draghi said officials are “dissatisfied” with the inflation outlook. European expectations on consumer-price growth, as implied by swaps, dropped to 1.62 percent on March 27, the lowest since 2008. The rate was at 1.66 percent today, compared with the 10-year average of 2.11 percent.

Officials probably will cut the benchmark rate, currently at a record low 0.25 percent, to 0.1 percent and the deposit rate, which is at zero, to minus 0.1 percent, according to Bloomberg surveys of economists.

“I don’t see a trigger for yields to rise at the moment, in fact they are pushing in the other direction,” said Craig Veysey, head of fixed income at Sanlam Private Investments Ltd. in London, which has $10 billion of assets under management. “It’s not going to be easy for the ECB to achieve some reasonable economic momentum and get back to a more normalized rate environment any time soon.”

To contact the reporters on this story: Emma Charlton in London at echarlton1@bloomberg.net; Anchalee Worrachate in London at aworrachate@bloomberg.net

To contact the editors responsible for this story: Craig Stirling at cstirling1@bloomberg.net; Paul Dobson at pdobson2@bloomberg.net Melinda Grenier

©2014 BLOOMBERG L.P. ALL RIGHTS RESERVED.