Investors should continue to steer clear of Europe

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Bond investors are in no mood to cut optimistic European economic heads, such as European Commission vice-president Olli Rehn, seen here Nov. 23, 2011, any slack. (JOHN THYS/AFP/Getty Images)

The politicians and assorted officials misguiding the affairs of the euro zone can be forgiven for thinking their days of blundering in the dark might finally be behind them.

Last week, half a dozen central banks rode to the rescue of European banks hit by a growing market aversion to the euro. Equity investors around the world responded with near-euphoric buying. In Europe, the positive mood led to the biggest weekly stock rally in three years.

The central bankers were quickly followed on stage by French President Nicolas Sarkozy and German Chancellor Angela Merkel. Speaking in advance of a crucial euro-zone summit this coming Friday, the embattled leaders used their strongest language yet to underscore the urgent need for some form of enforceable fiscal union if the euro is to survive.

European Central Bank president Mario Draghi added that closer fiscal co-operation could enable his institution to do more to attack the debt crisis that has spread from small bonfires in Greece, Portugal and Ireland into a full-blown conflagration that has reached the heart of the euro zone. And it looks as if the IMF is prepared to act as loan conduit, albeit relying on the Europeans' own money.

They had better hurry, because unlike the more susceptible equity crowd, bond investors are in no mood to cut the eurocrats any slack. And even rock-solid Germany is feeling the heat. In a general rush for the euro exits, investors pulled more money out of German bond funds in the last week of November than at any time in the past three years. Much to the embarrassment of German finance officials, a recent bond auction failed, and Swedish debt is now more attractive than once sought-after German bunds,

None of this comes as a surprise to Alex Jurshevski, an expert on government debt restructurings. "The market is starting to rebel. What's occurring now is less of a rotating attack on bonds of individual countries. The markets are recoiling from the euro itself," says Mr. Jurshevski, a veteran banker whose Toronto-based firm, Recovery Partners, advised the Icelandic government on how to overcome its near-death experience with debt. "The euro has become toxic, because there's a fear that the euro zone can break up."

What happens next is hard to predict. But the track record does not inspire much confidence. The Europeans were slow to recognize the gravity of the crisis and have failed to deliver on repeated assurances that all would soon be right in euroland once again.

“The eurocrats have to come with a plan in a matter of weeks that makes sense to the markets,” Mr. Jurshevski says, “That’s a pretty tall order, because for the last year and a half, they have been talking through their hats.”

He reserves some of his sharpest criticism for the European Financial Stability Facility, a name only Brussels could have devised for an emergency bailout fund that is supposed to take over the task of recapitalizing banks and getting financing to debt-ridden governments at rates that won’t cripple them.

The EFSF is supposed to total €440-billion in borrowed money backed by another €779-billion in guarantees from euro zone governments. The trouble is it can’t raise the required capital in a sour market. And guarantees provided by the likes of cash-strapped Italy or Spain aren’t worth anything.

“The EFSF is a broken funding model,” Mr. Jurshevski says flatly. “They’ve got to get a credible new funding mechanism in place to ensure that some of these countries’ bond markets remain insulated to these bouts of selling. They have to get off that treadmill of misleading the markets.”

At the end of the day, if the Europeans want to keep the 17-country common currency zone intact, they will have to come up with vast amounts of cash to address yawning gaps in competitiveness and productivity.

The alternative – which the Europeans finally seem willing to embrace, if the latest comments from Ms. Merkel and Mr. Sarkozy are any signal – is a dramatic restructuring that boots out countries unable to meet tough new fiscal criteria. Which means saying farewell to Greece, Portugal and probably Ireland.

This scenario is likely to play out in the months ahead “because the willingness to underwrite the productivity differential is simply not there. Somebody has to pay for it, and I don’t believe the willingness is there among richer euro zone countries.”

In the meantime, investors would be wise to continue steering clear of Europe, says Mr. Jurshevski. In part, that’s because the Brussels crowd has done such a dismal job of shoring up shaken market confidence. If anything, they make things worse just about every time they open their mouths.

Speaking of such key officials as European Commission vice-president Olli Rehn, EFSF chief Klaus Regling and European Council president Herman Van Rompuy, Mr. Jurshevski says they seem clueless about how financial markets actually work.

“If they did understand, they wouldn’t have said a lot of the things they did. They’ve actually damaged investor sentiment.”