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Debt fears hit Europe's markets

Investors give a 'thumbs down' to aid package for Greece; focus shifts to 'cross-market contamination'

Investors remain skeptical about whether the bailout will be approved by Europe's national parliaments in time for Greece to avoid at least a technical default.

BY NEIL SHAH

European financial markets tumbled Tuesday and the euro hit a one-year low against the dollar as the Greek bailout package failed to allay concern about sovereign-debt problems along the euro zone's periphery.

Euro-zone governments and the International Monetary Fund hoped that a €110 billion ($145.14 billion) rescue package for Greece would soothe investors' nerves over high sovereign-debt levels in Spain, Italy, Portugal and Ireland. Instead, it had the opposite effect, with fears of contagion rising throughout the day.

"The new stage of the crisis is cross-market contamination," says Claire Dissaux, head of global economics and strategy at Millennium Global Investments in London.

Ms. Dissaux says sovereign debt fears haven't yet crippled activity in the world's corporate debt markets—where companies raise cash—but this will be an important sector to watch. Many corporate bonds were hit hard during Tuesday's selloff.

More immediately, investors are concerned that the three-year financial package won't fix Greece's longer-term funding problems. Moreover, the difficulty in crafting a rescue for Greece has made investors edgy about far larger economies such as Spain and Italy.

In Spain, bank shares led a broad stock-market slide, with **Banco Santander** and **Banco Popular** each down more than 7%. Speculation about a possible debt downgrade rose to such a level that Fitch Ratings and Moody's Investors Service reiterated their top-notch triple-A ratings for the country. Despite their efforts, Madrid's blue-chip IBEX 35 index shed 5.4% to close at 9859.1.

The pan-European Stoxx 600 Index dropped 2.9% to 252.96, erasing its gains for the year, while Italy's FTSE MIB lost 4.7% to close at 20613.25. Greece's ASE index skidded 6.7% amid widespread protests, Ireland's ISEQ slid 4.2% to 3254.71, and Portugal's PSI General fell 3.8% to 2485.43.

The U.K.'s FTSE-100 index fell 2.6% to 5411.11, also going into the red for the year, after a long weekend kept traders away on Monday. France's CAC-40 index lost 3.6% to close at 3689.29, while Germany's DAX index fell 2.6% to 6006.86.

In the U.S., the Dow Jones Industrial Average ended down 225.06 points, or 2%, to 10926.77. The Nasdaq Composite Index lost 3% and the Standard & Poor's 500-stock index fell 2.4%.

In foreign-exchange markets, the euro dropped to $1.3004. Weighing on Europe's shared currency was the European Central Bank's decision Monday to ease the pressure on Greek banks by accepting any Greek government bonds as collateral for loans, no matter what their rating, a step that ECB President Jean-Claude Trichet previously said he wouldn't take. That reversal was seen as a potentially serious blow to the currency's credibility, analysts said.

For investors, the move highlights how the ECB is effectively absorbing some of the risks facing Greek banks, since these institutions will now be able to exchange even "junk"-rated bonds for cash. Such lenience, some fear, could soon be applied to other profligate European countries, further entrenching Europe's debt problems.

Mr. Trichet is scheduled to address the central bank's about-face at a news conference Thursday.

In midafternoon trade, the euro was at 122.72 yen from 124.81 yen late Monday, and the dollar was at 94.38 yen from 94.60 yen. The British pound weakened to $1.5156 from $1.5244, and the dollar moved to 1.1019 Swiss francs from 1.0859 francs.

The stronger dollar and the sovereign-debt worries pushed crude-oil prices lower. The contract for June delivery settled down $3.45 per barrel, or 4%, at $82.74, its biggest one-day dollar and percentage decline since Feb. 4.

Investors shifted their cash into safer bets like U.S. Treasurys, German bunds and U.K. government bonds, whose prices shot higher. Markets for company bonds in the U.S. and Europe were also hammered by sovereign fears, though bankers were still able to sell some new bond issues in Europe to investors.

A key reason for investor skittishness: soaring prices in the market for insurance-like contracts called credit-default swaps. On Tuesday, it cost $732,000 a year to

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insure $10 million of Greek government bonds against default for five years compared with $647,000 on Monday, suggesting fears of a default or debt restructuring are persisting despite the bailout, according to data provider CMA DataVision.

But it was the CDS activity away from Greece that rattled nerves most. Spain's debt-default insurance cost soared to $208,000 from $158,000, while Portugal's cost jumped to $355,000 from $275,000, underscoring investor skepticism about the Greek bailout plan.

The cost to insure against defaults for Italy, Ireland and the U.K. also jumped. The U.K. remains the lowest priced among this group, but its insurance costs rose 10% to $82,000, according to Markit.

The three-year bailout package for Greece takes care of its most pressing financing needs, including a €8.5 billion bond that comes due May 19. However, investors remain skeptical about whether the bailout will be approved by Europe's national parliaments in time for Greece to avoid at least a technical default. Mounting protests in Greece against the austerity measures the government has agreed upon could also test Greek officials' resolve.

Such worries pushed investors to sell Greek bonds and those of other struggling European countries, effectively raising their cost of borrowing from the private markets. Greece must now pay an interest rate of 9.8% to borrow for 10 years, compared with 8.9% on Monday.

Portugal's cost of borrowing for 10 years hit 5.74% from 5.34%, while Spain's 10-year borrowing rate hit 4.12% from 4.04%. By comparison, German 10-year bond yields fell to 2.96%.

"Markets have given a clear 'thumbs down' to the Greek aid package," said Win Thin, an analyst at Brown Brothers Harriman, in a note. "The entire Greek aid package is predicated on getting market borrowing rates back down so that Greece can issue new debt...That's not happening yet."

European banks took the brunt of the selling, with the Stoxx 600 banking-sector index closing down 3.1%. Investors believe French and German banks have the most exposure to Greek debt, but Portuguese and Spanish banks have come under pressure as worries about those countries mount.

Mining shares also fell, with **Rio Tinto** down 6.4% in London, after a proposal by the Australian government to introduce a 40% tax on profits earned from resources.

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