DOUBLE-DIP FEARS OVER WORLDWIDE CREDIT STRESS[1]

Ambrose Evans-Pritchard©

The global credit system is flashing the most serious warning signals in almost a year on triple fears of a Spanish banking crisis, escalating political risk in Asia, and a second leg to the US housing slump. Flight to safety drove yields on 10-year German Bunds to 2.56pc, below the levels touched in the depths of the Great Depression. The spreads over peripheral European debt rose sharply again, jumping to 137 basis points for Italy, 157 for Spain and 220 for Ireland. The strains in Europe's sovereign debt markets are nearing levels that forced EU leaders to launch their "shock and awe" rescue package. "If a $1 trillion (£700bn) bail-out did not finally turn sentiment, I struggle to see what can," said Tim Ash, an economist at RBS.

Dollar Libor rates gauging stress within the interbank lending market have jumped to a 10-month high of 0.5363pc, with credit contagion spreading to every area. The iTraxx Senior financials index – banks' "fear gauge" – rose 20 basis points on Tuesday to 184. "It turns out we weren't seeing the light at the end of the tunnel after all, but a train with a big light on it coming towards us of double-dip," said Dr. Suki Mann, at Société Generale. While the Libor rate is still far below peaks reached during the Lehman crisis, the pattern has ominous echoes of credit market strains before the two big "pulses" of the credit crisis in August 2007 and September 2008. In each case a breakdown of trust in the interbank market was a harbinger of violent moves in equities and the real economy weeks later.

RBS's credit team said Libor strains were worse than they looked since most banks in Europe were paying much higher spreads, especially in Spain. The "implied" forward spreads were nearer 1.1pc. The damage has spilt over to corporate bonds, effectively shutting the market for new issues. May will be the worst single month for debt issues since December 1999, with seven deals being cancelled in recent days. Volume has collapsed to $47bn from $183bn in April, according to Bloomberg.

Mr. Ash said North Korea's decision to cut all ties with the South and abrogate its non-aggression pact – coming days after Thailand sent tanks into Bangkok to crush the Red Shirts – has played into the chemistry of angst gripping markets, adding it was a reminder that Asia has "political/social stress points". This risk was overlooked during the honeymoon phase of emerging markets when investors were intoxicated by the China story.

Fears that America may slip back into a double-dip recession are returning. Larry Summers, the White House economic tsar, has called for a second stimulus package to keep the recovery on track, warning that the US economy is still in a "very deep valley". The S&P Case-Shiller index of home prices is declining again as incentives for homebuyers expire and the slow-burn effect of rising delinquencies exacts its toll. Prices fell 3.2pc in the first quarter of this year. "There are signs of some renewed weakening in home prices", said David Blitzer from S&P.

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[1] www.telegraph.co.uk, May 25, 2010

The epicentre of the credit crisis is moving to Spain where the seizure by the central bank of CajaSur over the weekend has torn away the veil on credit damage from Spain's property crash. Bank stocks fell 6pc in Madrid in early trading on Tuesday on fears that funding will dry up for the cajas – or the savings banks – setting off a broader credit crunch. The cajas hold the lion's share of loans to property companies and developers, estimated at €445bn (£380bn) or 45pc of GDP by Goldman Sachs. Spanish construction reached 17pc of GDP at the height of the bubble as real interest rates of minus 2pc set by the European Central Bank for German needs played havoc with the Spanish economy. This was almost double the level in the US during the sub-prime booms. The result is an overhang of unsold Spanish properties equal to four years' demand.

Markets have been rattled by reports in the German media that the Greek rescue deal contains two secret clauses. The package will be "immediately and irrevocably cancelled" if it is found to breach the EU Treaty's "no bail-out" clause, either in a ruling by the European court or the constitutional courts of any eurozone state. While such an event is unlikely, it is not impossible. There are two cases already pending at Germany's top court in Karlsruhe, perhaps Europe's most "eurosceptic" tribunal.

The second clause said that if any country finds it cannot raise funding for the rescue at interest rates below the 5pc charge agreed for Greece, it may opt out of the bail-out. BNP Paribas said this would escalate quickly into a systemic crisis if Spain were in such a position, because the other countries cannot carry an ever-rising burden. The bank warned the euro project itself may start to disintegrate rapidly if these rescue provisions are ever seriously put to the test