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Market-Moving Indicators for Monitoring Europe

If you've struggled to make sense of the ongoing European debt debacle, you're not alone. It's difficult even to keep track of all the pieces of this financial Rube Goldberg puzzle, let alone understand how they can influence one another.

Though new aspects of the situation seem to crop up every month, here are some of the most common factors that either reflect or affect sentiment about what's happening in Europe. Knowing about them might help you understand why markets react to a seemingly obscure headline. After all, one of the few things that almost everyone seems to agree on is that the situation isn't likely to be solved overnight.

Take an interest in interest rates

Interest rates on sovereign debt are perhaps the most closely watched indicator. When demand for a country's bonds is low because investors are concerned about the possibility that they might not be repaid in full and on time, that country must offer a higher interest rate in order to borrow money to finance its day-to-day operations.

Interest rates become particularly worrisome when they reach or exceed 7%. That's the level that prompted Greece, Ireland, and Portugal to seek bailouts from their European peers, and it's widely seen as unsustainable. When a country must pay that much simply to service its debt, investors become concerned that high borrowing costs will make a country's financial situation even worse.

Watch credit ratings

Troubled European countries are struggling to deal with a devilish Catch-22. In many cases, unsustainable debt burdens have led to stringent austerity measures; however, such measures also can hamper economic growth, which reduces tax revenue and can potentially increase deficits. Higher deficits can lead to a lower credit rating that in turn can mean higher borrowing costs, bringing on the problems discussed above and potentially launching a new downward economic cycle. Thus, a downgrade to a country's credit rating tends to raise concerns.

However, investor reaction also can be unpredictable. For example, Standard & Poor's January downgrade of nine sovereign nations and the European Financial Stability Fund was largely met with a shrug by investors. There's been so much pessimism about Europe for so long that in some cases, markets may already have priced in much of the bad news.

Monitor credit default swap costs

A credit default swap (CDS) is a form of insurance against the possibility that a bond issuer might default or fail to make a payment on its obligations. Bondholders buy a CDS from a financial institution or insurance company that promises to reimburse the bondholder for any losses sustained in the event of a default. The cost of that insurance is seen as a proxy for the perceived risk involved in investing in a particular country's bonds. The higher the cost of a CDS on, say, Italian sovereign debt, the greater the anxiety about whether the bond issuer will default and the CDS issuer will have to pay.

Follow the money

To prevent credit markets from seizing up, the European Central Bank late last year provided almost €500 billion in three-year loans to European banks, making it easier for them to refinance their debt. The level of borrowing at the ECB is seen as one indicator of how banks are being affected by their holdings of sovereign debt. The greater the need to borrow from the ECB, the greater the banks' perceived level of vulnerability.

Bailouts: Nein nein nein?

U.S. voters aren't the only ones who are sensitive about bailouts; so are Germans. As Europe's most powerful economy and the one with the best credit rating, Germany is the tentpole upon which European financial stability hangs. However, by the end of 2011, the German economy had begun to slow. Any indications that economic pressure could threaten Germany's ability and willingness to remain strong in its support of the eurozone can spook anxious investors.

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