

Markit Sovereign Report January 2012

- **Strong start to the year for sovereign credit**
- **Jury still out on austerity policies**
- **Solvency problems remain**

Sovereign credit experienced a strong, albeit volatile, start to 2012. The Markit iTraxx SovX Western Europe ended January at 339bps, about 15bps tighter than the 2011 year-end level. Over the month it traded in a wide range, reaching a peak of 383bps on January 9 then rallying to close at 322bps on January 22. Successful government bond auctions, an improved liquidity outlook for banks and tentative optimism on the eurozone debt crisis all contributed to the compression in spreads. But the peripheral countries are still in a very difficult predicament and debt levels might not be sustainable unless they can return to growth sooner rather than later.

Sovereign outperformers

Top-10: best performing sovereign CDS (ranked by % change over month)

Name	5Y Spread	Change	% Change	Net Notional (USD)
Belgium	243	-66	-21%	5,344,057,481
Sweden	61	-16	-21%	3,005,744,700
Russia	222	-57	-21%	4,102,642,435
Estonia	133	-34	-20%	397,253,656
UK	81	-17	-18%	12,220,302,953
Norway	36	-7	-17%	1,123,149,427
France	179	-35	-17%	21,978,490,769
Bulgaria	345	-66	-16%	726,796,494
Czech Rep	143	-27	-16%	929,503,404
Argentina	767	-147	-16%	2,368,024,583

Sources: Markit, DTCC

Sovereign credit rallied in January, and the table of outperformers shows that the rally was concentrated in

Europe. Five of the European names are from the west of the continent, the remainder from the east. Of the western names, three are outside the eurozone while two are members of the currency union. Norway and Sweden are well established as among the very best sovereign credits (see Top 10 table below) and it is no surprise to see them bounce back from the volatility of H2 2011. The UK, on the other hand, has had its credit standing called into question, not least by the French government. But the UK's coalition government uses the rock-bottom interest rates paid on gilts as a justification for its austerity policies. A confusing picture. Who is right?

The CDS market's verdict seems to be quite clear. While both sovereigns have rallied by a similar amount over January, the UK's spreads are less than half of France. Britain is now the eight-strongest sovereign credit in the world; France isn't remotely close to entering the Top 10 (it is ranked 31st). Chancellor George Osborne would no doubt feel vindicated if he saw this data, if he hasn't already.

But the French have pointed towards Britain's ailing economy and its poor fiscal metrics, and it's true that they are nothing to be proud of. Public sector net debt (excluding bank bailouts) recently passed £1 trillion, or 64.2% of GDP. The budget deficit is coming down but lower growth last year and in the coming years means that it is unlikely that the deficit will be eliminated by 2015, as originally intended.

Osborne's commitment to cutting the deficit is probably a contributory factor to the UK enjoying such tight spreads. But there are other reasons that are at least, if not more, important to the UK's credit standing. The UK has a stellar record as a borrower. It has never defaulted outright on external debt (although England defaulted three times prior to the formation of the UK in 1801). It has an unusually long debt maturity profile. And, most crucially, it has its own currency and independent monetary policy.

Despite Britain's gloomy economic prospects its position outside of the euro and its ability to use its currency to boost competitiveness means that the UK

is seen as something of a safe haven. France, on the other hand, has a banking system heavily exposed to the periphery and potentially painful contingent liabilities via bailouts in the years ahead. This is unlikely to change in the near future, and neither is the spread differential with the UK.

Sovereign underperformers

Bottom-10: worst performing sovereign CDS (ranked by % change over month)

Name	5Y Spread	Change	% Change	Net Notional (USD)
Portugal	1486	406	38%	4,989,409,014
Abu Dhabi	138	12	10%	1,423,490,128
Saudi Arabia	137	10	8%	462,050,000
Qatar	137	7	6%	689,401,748
Bahrain	401	17	4%	
Tunisia	266	7	3%	252,918,939
Morocco	257	4	2%	
Dubai	434	0	0%	479,607,878
Lebanon	465	-5	-1%	471,350,000
Slovenia	396	-6	-2%	740,581,297

Sources: Markit, DTCC

It has already been noted that January was an unusually strong month for sovereign credit. That only seven of the top 10 underperformers widened at all speaks volumes. Eight of the names are from the MENA region; it is likely that the renewed tensions between Iran and the US have stoked political risk on sovereigns neighbouring the Gulf.

But the table is headed by a western European sovereign, and by a massive margin. Portugal's spiralled upwards by over 400bp in the latter half of January, a performance all the more worrying given the becalmed conditions in the broader sovereign market. The Iberian country is now perceived as the most likely focal point for contagion in the eurozone. It was downgraded to junk by S&P in January, a move that certainly didn't help its situation. Forced selling in the cash market fed into the CDS market, pushing spreads wider. Traders attracted by the negative basis also had an impact on spreads.

But it seems likely that events on the eastern side of the periphery are also having a detrimental impact on Portugal's credit profile. It is now being compared to Greece on a regular basis, and the comparison doesn't look as frivolous as it did a year ago. Portugal's economy is in a slump, and its growth prospects look grim for the foreseeable future. Debt sustainability then comes into question, as it did with Greece. On the plus side, Portugal is funded through the rest of this year due to the bailout it received from the EU/IMF. But its chances of returning to the capital markets in 2013 look slim at this moment in time, and another bailout is not a remote possibility.

The talks over private sector involvement (PSI) in the Greek bailout – still going on at the time of writing – are also having an impact on Portugal's spreads. The EU has insisted that Greece is a special case in this regard but the markets are sceptical. Then there is also the contentious issue of official sector involvement (OSI), i.e. the ECB. If the central bank is forced to take losses on its Greek debt holdings, or even accept the discount price for which it bought the bonds, then it might prove more reluctant to support other peripheral countries.

Is austerity working?...

Iceland Italy Spain Portugal



Fig. 1

Ultimately, though, it will come down to growth. Austerity policies have been imposed on the periphery, and these have been implemented with varying degrees of vigour. But it is clear that with private sectors deleveraging and unable to contribute significantly to aggregate demand, a concurrent public sector fiscal tightening is sure to impact on growth. This worsens the periphery's fiscal metrics and leads to wider spreads.

It is interesting to look at Iceland, a country that took a somewhat different approach. In a recent blog post Poul Thomsen, the IMF official in charge of the IMF programmes in Greece and Portugal formerly in charge of the Iceland programme, noted that a delay in fiscal adjustment was a crucial ingredient in returning Iceland to growth. Controlling the exchange rate through capital controls was also cited as one of the reasons for Iceland's success. Neither of these policies is synonymous with the IMF, as many developing countries could attest to. Figure 1 shows that Iceland's CDS spreads have outperformed the peripheral countries by some margin over the last two years, and the country recently returned to the capital markets.

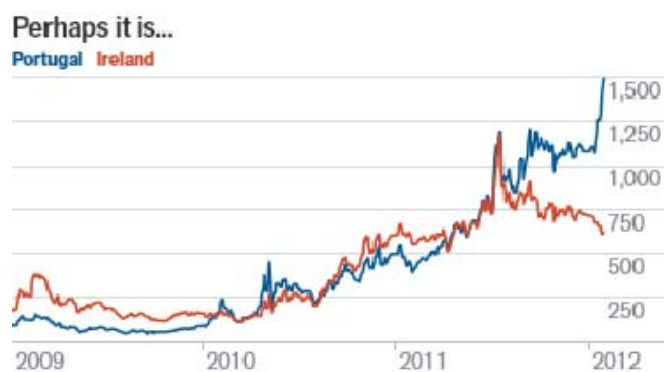


Fig. 2

So are the austerity policies favoured by Angela Merkel and her acolytes mistaken? Possibly, but the experience of Ireland provides evidence in the other direction. The Irish people have been stoic in accepting public spending cuts and tax rises, and their efforts appear to have made Ireland more competitive. Its external position has improved and growth is expected to pick up this year.

All of the peripheral countries had become uncompetitive compared to Germany and other core countries; hence a painful adjustment is necessary if they are to stay in the eurozone. Ireland's policies have been rewarded by the financial markets; its spreads have rallied to less than 600bp for the first time since April 2011. The contrast with Portugal is stark, as shown in figure 2. So the jury is still out on austerity but its effects on growth will be the key question in the credit markets over 2012

The top 10

Top 10 Sovereign CDS ranked by spread at end-January 2012

Name	5Y Spread	Change	% Change	2011 ranking
Norway	36	-7	-17%	1 (0)
USA	44	-7	-14%	2 (0)
Sweden	61	-16	-21%	4 (+1)
Finland	70	-6	-8%	3 (-1)
Australia	77	-5	-6%	5 (0)
UK	81	-17	-18%	8 (+2)
Hong Kong	83	-8	-8%	6 (-1)
New Zealand	87	-7	-8%	7 (-1)
Germany	89	-12	-12%	9 (0)
Netherlands	105	-14	-12%	10 (0)

Source: Markit

There are no surprises in the Top 10 strongest sovereigns. The usual suspects occupy the first five slots, and the UK's considerable improvement was noted earlier. Tentative optimism around the eurozone debt crisis ensures that the core countries of Germany and the Netherlands keep their places in the table.

The bottom 10

Bottom 10 Sovereign CDS ranked by spread at end-January 2012

Name	5Y Spread	Change	% Change	2011 ranking
Greece	64			1 (0)
Portugal	1486	406	38%	2 (0)
Venezuela	856	-67	-7%	3 (0)
Ukraine	830	-23	-3%	5 (+1)
Argentina	767	-147	-16%	4 (-1)
Ireland	630	-109	-15%	6 (0)
Hungary	583	-24	-4%	8 (+1)
Egypt	561	-65	-10%	7 (-1)
Croatia	490	-56	-10%	9 (0)
Lebanon	465	-5	-1%	11 (+1)

Source: Markit

Again, no real surprises in the Bottom 10 sovereigns. Greece is out in the stratosphere and Portugal appears to be going in the same direction. Portugal's spreads are now over 600bp wider than Venezuela and nearly double that of Argentina; two sovereigns with dismal reputations in the credit markets.

Eurozone rankings*

Name	5Y Spread	Change	% Change	2011 ranking
Finland	70	-6	-8%	1 (0)
Germany	89	-12	-12%	2 (0)
Netherlands	105	-14	-12%	3 (0)
Estonia	133	-34	-20%	4 (0)
Austria	175	-12	-6%	5 (0)
France	179	-35	-17%	6 (0)
Belgium	243	-66	-21%	8 (+1)
Slovakia	282	-18	-6%	7 (-1)
Spain	371	-7	-2%	9 (0)
Slovenia	396	-6	-2%	10 (0)
Italy	414	-70	-14%	11 (0)
Ireland	630	-109	-15%	12 (0)
Portugal	1486	406	38%	13(0)
Greece	64			14 (0)

*Cyprus, Luxembourg and Malta rarely trade in the CDS market

CDS Liquidity

Name	5Y Spread	% Change	Net Notional (USD)	% Change
France	179	-17%	21,978,490,769	1%
Italy	414	-14%	21,832,086,388	7%
Germany	89	-12%	19,264,903,493	-1%
Brazil	145	-9%	17,736,645,344	-3%
Spain	371	-2%	14,253,512,254	-10%
UK	81	-18%	12,220,302,953	0%
Japan	137	-4%	8,984,308,053	1%
China	137	-7%	8,829,130,187	-4%
Mexico	142	-7%	8,389,429,852	-3%

Austria	175	-6%	5,894,251,701	-1%
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Sources: Markit, DTCC

Volumes have been subdued across the credit and equity markets for some time. But trading in the main Markit indices has held up relatively well, as shown by the MarkitServ data in Figure 3. The ongoing uncertainty in the eurozone will continue to have an impact on risk appetite, and the outcome of the Greek bailout talks will also have a bearing on demand for sovereign CDS protection.

Index volumes (net notionals) haven't collapsed

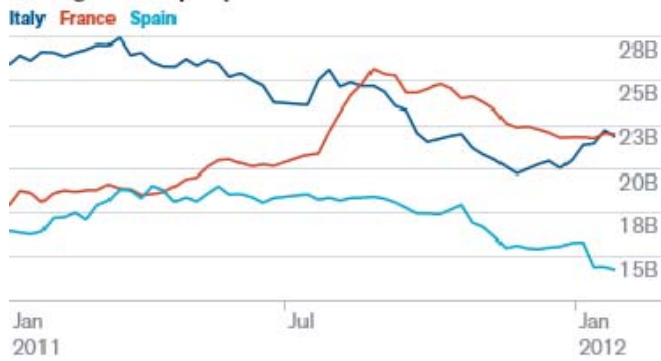


Source: MarkitServ

Fig. 3

Figure 4 shows that there has been a marked divergence in peripheral net notionals. Italy started off 2011 with far more CDS exposure than either France or Spain. By August France had overtaken it as the most heavily traded sovereign. However, in recent months the relationship has gone in the other direction and they are now neck and neck. Italy's net notional outstanding increased by 7% in January and France's rose by a modest amount. Meanwhile Spain saw its net notional decline by a significant 10% over January, continuing the recent trend. It is likely that bank CVA desks are driving much of this activity, as well as more traditional CDS participants.

Divergence in peripheral net notionals



Source: DTCC

Fig. 4

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