

Markit Sovereign Report October 2011

- **Emerging markets outperforming**
- **Benefitting from China avoiding a hard landing – so far**
- **Creditor countries will have a major say in direction of world economy**

October was a relatively strong month for sovereign credit. The Markit iTraxx SovX Western Europe went from 340bp at September month-end to 304bp on October 31 – a robust performance. But appearances can be deceptive, and the still elevated level of the index demonstrates that all is not well in the world of sovereign credit. The rally was predicated on a comprehensive solution to eurozone debt crisis; it is still not clear that this can be achieved. Hopes that China can avoid a hard landing have helped emerging market credits outperform the developed world. But we know from recent experience that no country can escape the effects of western growth engines grinding to a halt.

Sovereign outperformers

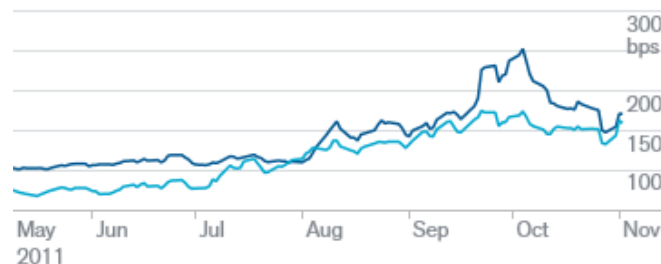
Top-10: best performing sovereign CDS (ranked by % change over quarter)

Name	5Y Spread	Monthly Change	% Change	Net Notional (USD)
Indonesia	197	-113	-36%	3,184,292,758
Korea	149	-80	-35%	5,174,775,871
China	135	-64	-32%	9,446,933,633
Malaysia	142	-67	-32%	1,304,743,902
Australia	71	-33	-32%	5,433,418,467
Philippines	184	-83	-31%	2,893,179,762
Russia	220	-93	-30%	4,667,353,609
Mexico	152	-60	-28%	8,538,790,371
Colombia	153	-59	-28%	1,673,057,070
New Zealand	86	-33	-28%	584,232,240

Sources: Markit, DTCC

One trend stands out when looking at the best performing sovereigns table for October. Eight of the ten names would normally be classified as emerging market sovereigns. The other two – Australia and New Zealand – are economies with close ties to Asia. And it is no great secret that one country in particular drives economic activity in this region and beyond: China.

G7 and BRIC spreads converging
Markit iTraxx SovX BRIC Markit iTraxx SovX G7



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Fig. 1

Three factors have been weighing on the global economy in recent months: the eurozone debt crisis; a stagnant US economy; and fears of a sharp slowdown in the Chinese economy. Of the three the last factor has probably been the least potent as a debilitating force. Spreads in the Chinese sovereign widened sharply in August and September and reached a peak of 200bp at the beginning of October. At this time China was in danger of becoming the main preoccupation of global investors.

It is no secret that the Chinese economy is heavily dependent on manufacturing, so clear signs that the sector was slowing were of obvious concern to the markets. The Markit/HSBC Manufacturing PMI posted a reading of 49.9 in September, the second consecutive month of contraction. New export business declined for the fifth month in succession; the malaise in the developed world was no doubt having an effect on demand for Chinese goods.

But investors were also troubled by another weakness in the Chinese economic model. A property boom had ensued after the government injected a massive fiscal and monetary stimulus into the economy in response to the global slump in 2008. And now it started to show signs that it had turned into a bubble. House prices are falling in some areas and real estate developers are struggling to access funding. The Beijing government had signalled its intention to put the brakes on with a series of monetary tightening measures. A property crash would have serious consequences for the Chinese economy and thus for the rest of the world.

But the widening in China's spreads proved to be ephemeral. A strong rally followed as the markets became convinced that the central government had the tools to loosen policy and ensure a soft landing. The Markit/HSBC Manufacturing PMI also returned to expansion in October.

The recovery in China's spreads helped its neighbouring sovereigns in Asia and Oceania tighten during October. It is also noteworthy that one of the other BRICs, Russia, was one of the strongest performers, though its spreads are the widest in the top 10.

Figure 1 shows a comparison of the Markit iTraxx SovX BRIC and the Markit iTraxx SovX G7, two non-tradable sovereign indices. It shows that their spreads converged as the BRICs rallied and the G7 performed poorly. The differing fiscal situations of the two blocs were laid bare by the grand plan aimed at combating the eurozone debt crisis announced in October. A large part of the plan is dependent on external creditor countries – read the BRICs – injecting capital into a rescue fund. Whether this will be forthcoming is still uncertain but it underlines the shift in the balance of fiscal power.

Sovereign underperformers

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

Name	5Y Spread	Monthly Change	% Change	Net Notional (USD)
Belgium	300	30	11%	6,531,377,220
Italy	513	44	9%	21,201,573,203
Ireland	796	62	9%	3,926,143,906
Spain	388	10	3%	16,933,086,049
France	190	3	2%	24,096,832,558
Hungary	546	6	1%	2,505,422,682
Iceland	301	0	0%	842,045,555
Slovenia	289	-3	-1%	1,030,168,120
Portugal	1145	-59	-5%	5,587,732,254
Lebanon	394	-22	-5%	510,950,000

Sources: Markit, DTCC

It has already been noted that October was a relatively strong month for sovereign credit. That only six of the top 10 underperformers actually widened is evidence enough. But the top 5 names highlight the malaise that is afflicting the global economy at the moment. Earlier it was remarked that of the three factors weighing on global growth a hard landing for the Chinese economy was the least potent. It is quite clear that the eurozone debt crisis is by far the most dangerous, at least in the eyes of the financial markets.

Belgium, Italy, Ireland, Spain and France are all members of the eurozone. Three of these are considered peripheral countries while France and Belgium are considered core (though Belgium's membership of this group is somewhat tenuous). European policymakers have been scrambling to address the debt crisis that threatens to engulf the region and threaten the future of the currency bloc.

Spreads rallied throughout most of October in anticipation of a comprehensive solution to the crisis. A plan was indeed unveiled late in the month and sovereign spreads tightened even further. But since then the flaws in the EU proposals have become clear and there are major doubts that it can be implemented in full. Even if it is, it could well fall short of what is required.

A firewall needs to be created to protect Spain and, in particular, Italy from being dragged in to the mire and unable to access capital markets. China’s uncertain role in boosting the fund has already been noted. Indeed, it is the widening in Italy and France’s spreads that largely account for the underperformance of G7 spreads compared to the BRICs. Political turmoil in Greece has thrown further doubt on the viability of the EU plan. The eurozone looks set to remain the catalyst for determining spread direction.

The top 10

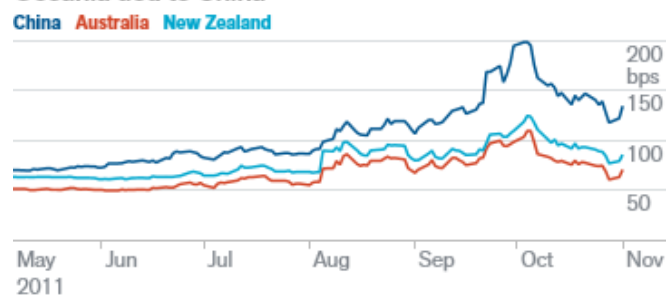
Top 10 Sovereign CDS ranked by spread at end-September 2011

Name	5Y Spread	Monthly Change	% Change	Previous rank
Norway	41	-11	-21%	1 (0)
USA	46	-6	-12%	2 (0)
Sweden	53	-9	-14%	3 (0)
Finland	62	-20	-24%	4 (-1)
Australia	71	-33	-32%	6 (+1)
New Zealand	86	-33	-28%	8 (+2)
United Kingdom	91	-6	-6%	5 (-2)
Germany	95	-21	-18%	8 (0)
Netherlands	102	-9	-8%	6 (-3)
Qatar	109	-18	-14%	10 (0)

Source: Markit

Four of the top 5 strongest sovereign credits are usually ever present in this list. The Nordic countries are well established with their solid fiscal positions and reliable governance. The USA has recovered from the debt ceiling scare and losing its AAA rating; its status as one the world’s main growth engine and owner of the world’s reserve currency shows no sign of changing, at least in the medium-term.

Oceania tied to China



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Fig.2

Places five and six are occupied by Australia and New Zealand, two neighbours that have seen their spreads tighten strongly over October. Both countries are now effectively part of Asia – in economic terms anyway – although their export-driven economies also rely on trade with the US and Europe. But the proportion of exports to China has risen in recent years, and their increasingly close relationship with China can be seen in the correlation in their sovereign spreads.

The bottom 10

Bottom 10 Sovereign CDS ranked by spread at end-September 2011

Name	5Y Spread	Monthly Change	% Change	Previous rank
Greece	60			1 (0)
Portugal	1067	-50	-5%	2 (0)
Venezuela	1002	-202	-17%	3 (0)
Argentina	955	-149	-14%	4 (0)
Ireland	766	60	8%	5 (+1)
Ukraine	735	-167	-19%	5 (-1)
Hungary	546	6	1%	7 (0)
Italy	513	44	9%	11 (+3)
Croatia	467	-47	-9%	10 (+1)
Egypt	429	-45	-10%	12 (+2)

Source: Markit

Greece occupies its usual spot as the world’s weakest sovereign credit. This will only change if (when?) it defaults and a credit event is called, meaning its CDS stop trading. Most of the other constituents of the top 10 also make a regular appearance in the table.

Italy has risen three places into eighth place, putting it above Croatia – still not meeting EU eligibility criteria– and Egypt, a relatively poor African country struggling with political instability. Italy itself has political problems that have contributed to its spreads widening. A considerable increase in the size and scope of the EFSF should ease its funding problems somewhat. But it still faces the fundamental issue of economic growth, and until it makes steps to rectify this then its spreads will remain at elevated levels.

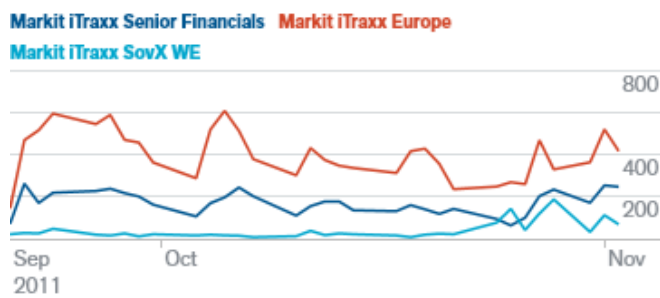
CDS Liquidity

Name	5Y Spread	% Change	Net Notional (USD)	% Change
France	190	2%	24,096,832,558	-2%
Italy	513	9%	21,201,573,203	-2%
Germany	95	-18%	19,549,713,875	4%
Brazil	154	-27%	17,651,172,693	0%
Spain	388	3%	16,933,086,049	-3%
UK	91	-6%	12,599,095,012	1%
China	135	-32%	9,446,933,633	5%
Japan	110	-26%	9,178,265,307	-3%
Mexico	152	-28%	8,538,790,371	2%
Belgium	300	11%	6,531,377,220	-1%

Sources: Markit, DTCC

Volumes in the sovereign CDS market have been buffeted of late by the uncertainty in the eurozone. Question marks over the efficacy of sovereign CDS as a hedge and a bank on naked sovereign CDS positions may also have contributed to drop in trading.

Index trade count



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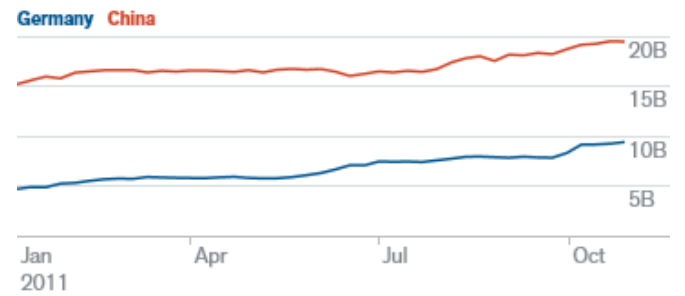


Source: MarkitServ

Fig. 3

Figure 3 shows that trading volumes in the Markit iTraxx SovX Western Europe – the most liquid of all sovereign CDS instruments – were subdued throughout most of October. But they did pick up towards the end of the month, evidence that there is still an active market.

Creditor countries see net notionals climb



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Fig. 4

France and Italy are the two most active single name sovereigns. Italy occupied the top spot for many months but as it has become clear that the core of the eurozone will bear the brunt of the bailout costs attentions have turned to France and Germany.

The latter country saw a 4% increase in net notional over October, a significant number. The only country to challenge it was China with a 5% increase. Both, of course, are two of the world's largest creditor countries. But Germany has been reluctant to use its financial power to fix the fiscal imbalances within the eurozone, preferring to preach the benefits of austerity and lecture the weaker members on their profligacy. Indeed, it has invited China to stump the funds to bailout the peripheral economies. One could ask why China would do so when the eurozone's most powerful member refuses to. The policies of these two creditor countries will have an important bearing on the direction markets take in the coming months and years.

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