

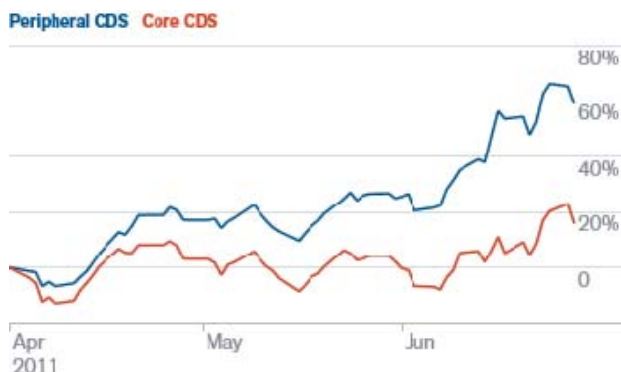
Markit Sovereign Report Q2 2011

- **Another difficult quarter for sovereign CDS**
- **Spain and Italy acting as contagion indicators**
- **China attracting more interest in CDS market**

The sovereign CDS market really came of age in the second-quarter of 2010. It seemed unlikely that such extreme volatility could ever be matched. But the second-quarter of 2011 has come close, with the asset class performing poorly and dragging the rest of the financial markets with it. Greece has been an open wound that Europe's powerbrokers have been unable to heal. But the real worry has been contagion through the region, in particular to the larger economies of Spain and Italy. If the sovereign debt crisis threatens to escalate then it will manifest itself in the CDS of these sovereigns. China, which has weathered the economic storm better than most, is attracting more interest in the CDS market.

A core exposed

Periphery leaving core vulnerable



Source: Markit

The first half of 2011 ended on a high. The two factors that caused so much volatility in the first quarter – the Japan earthquake and turmoil in the MENA region – are less toxic, though both are still having some impact on the global economy. The Markit SovX Western

Europe index tightened by 25bp during the last week of June to close at 219bp. But this is still nearly 50p wider than at the end of Q1 2011. If unforeseen events are no longer having a material impact, it only leaves one factor that is all too well-known to the markets – the eurozone sovereign debt crisis.

The failure of the EU to come up with radical measures to address Greece's solvency issues has weighed on credit spreads, particularly in the eurozone's periphery. Chart one shows that the spreads of the peripheral sovereigns – Greece, Portugal, Ireland, Spain and Italy – have widened by over 60% since the beginning of the second-quarter. Spreads in the core of the eurozone – Germany, France, Belgium and the Netherlands – have not been immune to the turmoil.

However, most of the widening in the core can be accounted for by Belgium and France, with Germany and the Netherlands holding firm. Indeed, the two latter countries rank in the Top 10 least risky sovereigns, as shown later in the document. France's banks are heavily exposed to Greece while Belgium has high debt levels and still doesn't have a government. But the euro is a joint enterprise and every sovereign in the club is exposed to its frailties. Spain's spreads have decoupled from the eurozone's three dependents: Greece, Ireland and Portugal. But there is still some correlation when the markets are febrile. Contagion is the real fear of the market, making Spain – and perhaps Italy – the key CDS to watch.

Sovereign outperformers

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

Name	5Y Spread	Q2 Change	% Change	Net Notional (USD)
Bahrain	239	-86	-27%	N/A
Saudi Arabia	98	-22	-18%	498,550,000
Dubai	347	-52	-13%	540,401,160
Abu Dhabi	97	-13	-12%	1,469,823,090
Qatar	99	-11	-10%	1,081,045,323
Egypt	307	-32	-9%	960,833,588
Japan	92	-7	-7%	8,340,304,386
Israel	142	-9	-6%	1,390,273,531
Lithuania	209	-13	-6%	631,539,125
Latvia	212	-12	-5%	609,859,130

Sources: Markit, DTCC

The easing of tensions in the MENA region is reflected in the list of sovereign outperformers over Q1. Seven of the top 10 belong to this grouping.

Bahrain heads the table, tightening by over 25% during the quarter. The wave of unrest appears to have subsided, though it is not clear that the underlying issues have been addressed. Spreads remain over 50bp wider than pre-turmoil levels. It should be noted that Bahrain is one of the less liquid sovereigns in the region, with a Markit Liquidity Score of 2 (1 is the highest). It doesn't even rank in the DTCC's top 1000 entities, hence the net notional can't be published. Saudi Arabia, the second best performer, doesn't have any CDS deliverables but still trades in the market. It is likely that participants use the sovereign CDS market to hedge country and counterparty risk.

Japan's spreads have tightened over the quarter but are still 20bp wider than pre-catastrophe levels. The damage wrought by the earthquake and consequent tsunami was larger than most of the initial estimates and the country is still struggling to get back on its feet. But Japan is an advanced economy that will bounce back, and that is reflected in its relatively tight spreads. The sovereign's large debt burden is a concern but its high private savings levels mean that it can fund domestically.

Sovereign underperformers

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

Name	5Y Spread	Q2 Change	% Change	Net Notional (USD)
Greece	1990	996	100%	4,812,048,218
Hong Kong	60	17	40%	N/A
Slovenia	112	32	40%	995,852,145
Portugal	794	216	37%	6,107,031,199
Slovak Rep.	108	26	32%	881,611,165
Malaysia	97	23	31%	1,675,142,530
Finland	39	9	30%	2,423,321,300
Italy	191	42	28%	23,761,461,515
USA	53	12	28%	4,458,225,738
Thailand	147	31	27%	1,547,378,349

Sources: Markit, DTCC

Perhaps the most predictable part of this report is the top of the underperformers table. Greece's spreads have doubled over the second-quarter, making it quite comfortably the worst performer. Portugal, another recipient of EU/IMF bailout funds, has also widened sharply.

Another peripheral in the form of Italy – though it was a founder member of the EEC – saw significant deterioration, widening by 28%. Italy is the most widely trade name in the CDS universe and has the highest amount of debt outstanding in Europe. It is of fundamental importance to the eurozone both from a political and economic perspective. The concerns over contagion and its banking sector have affected its spreads, and the European authorities will surely do everything in their power to prevent the crisis spreading beyond Greece, Portugal and Ireland.

Two of the most recent entrants to the eurozone have also felt the pressure. Slovenia and the Slovak Republic both feature in the top 5. Central and eastern Europe has performed relatively well as a whole but the region remains vulnerable to a slowdown in the West.

And then in ninth place is the USA. If the table had been ranked on the one-year spread instead of the five-year then it would have placed even higher. The near-term solvency of the world's largest economy is not in doubt. But the political wrangling over the raising of the debt ceiling has triggered fears of a technical default. If this is resolved in the coming weeks, as expected, then it would be no surprise to see the US credit curve normalise.

The top 10

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

Name	5Y Spread	Q2 Change	% Change	Q1 ranking
Norway	21	4	22%	1 (0)
Sweden	28	1	5%	2 (0)
Finland	39	9	30%	3 (0)
Netherlands	40	2	4%	5 (+1)
Denmark	44	5	14%	4 (-1)
Germany	44	0	0%	8 (+2)
USA	53	12	28%	6 (-1)
Australia	56	3	6%	9 (+1)
Hong Kong	60	17	40%	7 (-2)
UK	66	10	19%	10 (0)

Source: Markit

The Scandinavian countries are used to occupying the top of social and economic development tables, and their prudent fiscal policies see them at the summit of the least risky sovereign credits, as indicated by the CDS market. However, it has been such a weak quarter for sovereigns that even these stellar names have seen some widening. Oil rich Norway has widened by 22%, though its spread of 21bp is hardly cause for concern. Finland is a member of the eurozone and has been affected by the peripheral fallout. Two of Denmark's banks have failed and the state of the domestic finance industry is becoming a concern for the market.

The seventh place of the US serves as a reminder that it is still a very strong credit.

The bottom 10

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

Name	5Y Spread	Q2 Change	% Change	Q1 ranking
Greece	1990	996	100%	1 (0)
Venezuela	1036	18	2%	2 (0)
Portugal	794	216	37%	5 (+2)
Ireland	782	141	22%	3 (-1)
Argentina	634	47	8%	4 (-1)
Ukraine	478	38	9%	6 (0)
Dubai	347	-52	-13%	7 (0)
Lebanon	345	-2	-1%	8 (0)
Vietnam	340	18	6%	10 (+1)
Croatia	291	53	22%	15 (+5)

Source: Markit

Greece, Portugal and Ireland speak for themselves and it is no surprise to see them in the top 5. Venezuela is perennially one of the worst sovereign credits, and this is likely to continue even though rumours about President Hugo Chavez's death have triggered some recent tightening.

CDS Liquidity

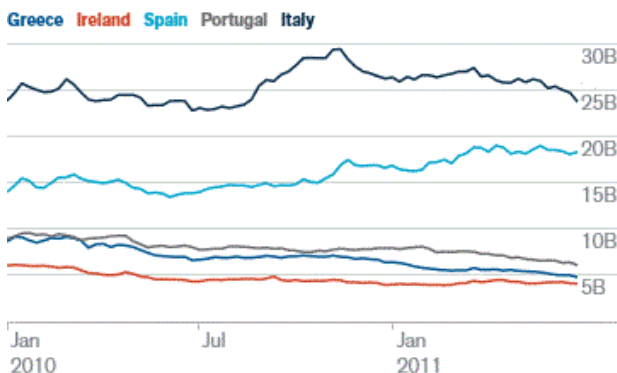
Name	5Y Spread	Q2 Change	% Change	Net Notional (USD)
Italy	191	42	28%	23,761,461,515
France	87	13	17%	20,154,702,328
Spain	287	53	23%	18,358,459,560
Brazil	116	5	5%	16,959,776,520
Germany	44	0	0%	16,306,698,757
UK	66	10	19%	11,929,343,762
Mexico	113	8	8%	8,717,511,102
Japan	92	-7	-7%	8,340,304,386
Belgium	159	19	13%	7,207,855,298
China	88	18	25%	7,097,284,545

Sources: Markit, DTCC

The four largest economies in the eurozone - Italy, France, Spain and Germany – are all in the top 5 sovereigns as determined by CDS net notional outstanding. All of them, with the exception of Germany, have seen their spreads widen significantly over the quarter. A large chunk of the CDS activity is likely to have been driven by bank CVA desks, i.e. hedging counterparty risk.

Brazil and Mexico are the two most liquid names in Latin America and net notionals can be expected to stay high as they become more integrated into the economy. Unsurprisingly all 10 of the names have the top Markit Liquidity score of 1.

Peripheral net notionals

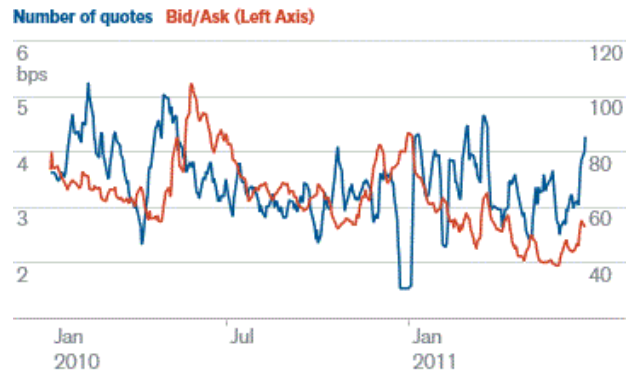


It might be expected that Greece, Portugal and Ireland would figure in the top given the amount of publicity they generate. Reports of the alleged huge exposure to banks from Greek CDS have been appearing with regularity in newspapers across the world. But the chart shows that Greek net notional is just under EUR5 billion, less than 25% of France total net notional. Not only that, it has been falling steadily, as have Portugal and Ireland's exposures. Spain, on the other hand, has seen a significant increase. It is now the main contagion gauge of the eurozone and the increased exposure perhaps reflects this.

Exposure to China is rising



A sovereign that has received less media exposure, at least in CDS terms, is China. Its spreads have widened by 25% over the second quarter and it now ranks in the net notional top 10. Exposure to the sovereign has quadrupled over the last two years. Markit Liquidity Metrics show that its bid/ask spread has been tightening steadily in recent months, an indicator of rising liquidity.



Source: Markit Liquidity Metrics

It is difficult to say what has been driving the increased activity but there is no doubt that a hard landing for the

Chinese economy is one of the main fears gripping the market at the moment. There are also widespread concerns about debt at the local authority level and the state of domestic bank balance sheets. Premier Wen Jiabao recently declared victory on inflation. The rise in CDS activity, however, suggests it may face further challenges ahead.

Gavan Nolan

Credit Analyst

Markit

Tel: +44 20 7260 2232

Email: gavan.nolan@markit.com

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