

# Markit Sovereign Report Q3 2011

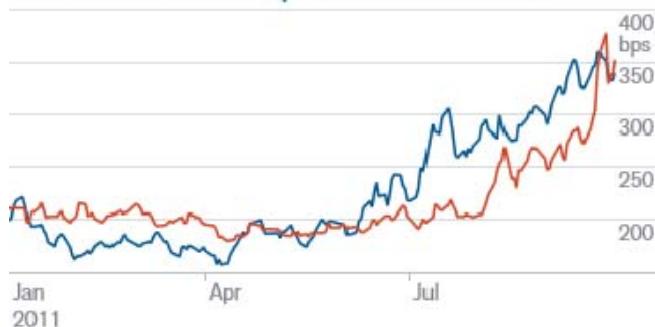
- Core is feeling the heat
- Emerging markets catching up with developed world
- China is now in the sights of the credit markets

The third-quarter of 2011 will be remembered in the credit markets as one of the worst in recent memory. A sovereign debt crisis that began in Greece now threatened to engulf the core of the eurozone. And it wasn't just confined to Europe: emerging markets suffered from the swathe of risk aversion that afflicted global markets. Even China, the sole growth engine to have weathered the Great Recession, is now coming under scrutiny from the credit markets.

## A “systemic dimension”

### Emerging markets playing catch-up

Markit iTraxx SovX Western Europe    Markit iTraxx SovX CEEMEA



Source: Markit

Europe's sovereign and financial crisis had reached a “systemic dimension” as we entered the fourth-quarter of 2011. No less a figure than Jean-Claude Trichet, the outgoing ECB president, declared as such in an address to the European Parliament. His words captured why sovereign credit had experienced a torrid time during the third-quarter.

The Markit iTraxx SovX Western Europe widened from 219bp at the beginning of the quarter to 340bp on September 30 – an increase of 56%. The problems in the periphery of the eurozone are well established; the spreads of Greece, Portugal and Ireland were already

at very wide levels. But the situation deteriorated rapidly as the summer drew to a close. Greece appeared to be on the verge of default and the long-feared contagion across the periphery looked like it was about to materialise.

It soon became clear that Greece would require another bailout and it duly came on July 21. New funds were promised, along with radical changes to the European Financial Stability Facility (EFSF). This entailed greater financial commitments from the core eurozone members, in particular France and Germany.

But the bailout didn't stop the rot and spreads continued to reach new records. The focus switched to the core countries as it became evident that some of Europe's largest banks were exposed to peripheral defaults. Sovereigns are on the hook for EFSF bailout funding as well as potential bank recapitalisations; it's no wonder that spreads hit stratospheric levels.

Emerging markets initially showed resilience as the crisis worsened in Western Europe. But it didn't last as leading indicators showed that exports were falling due to lower demand; the decoupling theory suffered another blow. China, the world's largest exporter, wasn't immune, and its manufacturing sector went into contraction. Fears of a bubble in the property markets and a potential hard landing for the Chinese economy also weighed on the minds of investors.

## Sovereign outperformers

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

Name	5Y Spread	Q3 Change	% Change	Net Notional (USD)
Ireland	730	-34	-4%	4,177,631,388
Iceland	296	17	6%	845,509,700
Lebanon	403	52	15%	503,850,000
Venezuela	1196	247	26%	2,311,422,753
Qatar	124	27	28%	619,005,040
Saudi Arabia	126	31	32%	443,050,000
Abu Dhabi	124	31	33%	1,357,226,090
Israel	197	58	42%	1,412,037,565
Spain	379	124	49%	17,470,420,071
Vietnam	479	160	50%	795,530,001

#### Sources: Markit, DTCC

The first thing one notices when looking at the outperformers table is that only one sovereign has actually tightened over the quarter! This reflects the brutal correction that ensued over this period. Vietnam, the 10<sup>th</sup> best performing sovereign, widened by a not inconsiderable 50%.

### The periphery splits

Ireland Portugal



It might surprise some that Ireland is heading the table. After all, it has already been forced to receive a bailout from the EU/IMF, and its budget deficit - forecast to be about 10% this year - is still one of the highest in the world. But, unlike other peripheral countries, Ireland is viewed by many in the markets as a credible long-term member of the eurozone. It appears to have proven that austerity and an internal devaluation can be

effective in returning a country to competitiveness. Unit labour costs have fallen sharply and its external balance has improved significantly. The government forecasts that the economy will grow by 2.5% next year, though that could be overly optimistic.

The contrast with Portugal, another peripheral member of the eurozone, is stark. Earlier this year Ireland's spreads were trading significantly wider than Portugal's, and post-July 21 bailout they were trading at about the same levels. Now Ireland is trading about 400bp tighter than the Iberian country. Portugal's efforts to become competitive within the eurozone have been far less successful than Ireland, hence it is perceived as the second-most vulnerable country after Greece.

Iceland, in second place, took a different route to competitiveness. The austerity measures that it implemented were far less painful than Ireland's; its public sector has been more or less left intact. Instead it relied on depreciating its currency; an option, of course, that the peripheral countries did not have.

## Sovereign underperformers

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

Name	5Y Spread	Q3 Change	% Change	Net Notional (USD)
Greece*	61			3,741,562,852
Denmark	146	102	232%	3,208,577,616
Germany	111	72	182%	18,786,433,353
Netherlands	104	66	178%	2,963,999,820
Austria	170	108	176%	6,265,760,527
Italy	469	292	164%	21,535,769,555
Norway	51	32	160%	1,197,955,000
Slovenia	277	166	151%	1,016,892,130
Slovak Republic	250	148	146%	955,390,185
China	195	113	136%	8,344,489,334

\*Greece is points upfront

#### Sources: Markit, DTCC

Greece, predictably, tops the underperformers table. Most in the market think it is a matter of when not if the country defaults. The next four countries are in far

better fiscal shape than Greece, so their deterioration needs some explaining. Denmark is not a eurozone member, so is not directly exposed to the problems in the periphery. But its banks are going through a crisis that is dragging the rest of the economy down. About 75 regional lenders need to be either wound down or bought, according to some estimates. Funding is hard to come by and the subsequent deleveraging is choking growth and impinging on the country's credit standing. Hence the spread widening of over 200%.

Germany, the Netherlands and Austria: three core members of the eurozone with strong fundamentals. Yet it is their membership of the currency union that accounts for their spreads widening by well over 100%. As the year has drawn on it has dawned on the markets that the creditor countries of the eurozone will have to foot the bill for bailing out sovereigns and recapitalising banks. All three of these countries face popular discontent on this issue. Nonetheless, if the euro is to survive in its current form then it is difficult to see any alternative.

Two of the newest – and poorest – eurozone members are also among the top 10. Slovenia and the Slovak Republic have inevitably felt the fallout from the debt crisis in the periphery, even though their finances are in comparatively good shape. The bailouts are also unpopular in Eastern Europe; the Slovak's were the only country to reject the July 21 changes.

## The top 10

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

Name	5Y Spread	Q3 Change	% Change	Q3 ranking
Norway	51	32	160%	1 (0)
Sweden	62	35	135%	2 (0)
Finland	81	46	131%	3 (0)
United Kingdom	94	33	54%	10 (+6)
Australia	99	44	79%	8 (+3)
Netherlands	104	66	178%	4 (-2)
New Zealand	110	45	70%	12 (-5)
Germany	111	72	182%	6(-2)
Hong Kong	119	64	117%	9 (0)
Qatar	124	27	28%	22 (-12)

#### Source: Markit

None of the top 10 strongest sovereigns emerged unscathed over the third-quarter. Even Norway, the world's most robust credit, has seen its spreads widen by 160%. It is followed by Nordic neighbours Sweden and Finland, two countries that have solid fiscal positions.

The UK's fourth position is somewhat surprising given its large budget deficit and anaemic growth. Chancellor George Osborne would no doubt point towards his austerity policies keeping a lid on yields. That may be a factor, but it is also likely that the UK having its own currency allows an adjustment mechanism not available to eurozone members. In addition, its position outside the eurozone means it doesn't have the same contingent liabilities as Germany, France etc.

## The bottom 10

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

Name	5Y Spread	Q3 Change	% Change	Q3 ranking
Greece	61			1 (0)
Portugal	1205	432	56%	3 (+1)
Venezuela	1196	247	26%	2 (-1)
Argentina	1054	483	85%	5 (+1)
Ukraine	890	429	93%	6 (+1)
Ireland	730	-34	-4%	4 (-3)
Hungary	524	260	98%	14 (+7)
El Salvador	521	188	57%	10 (+2)
Dubai	504	176	54%	7 (-2)
Rep Croatia	503	229	84%	12 (-2)

Source: Markit

As expected, Greece has the unenviable title of the weakest sovereign credit. Portugal has supplanted Venezuela as the second weakest; some feat given the South America country's poor standing in the international capital markets. Ireland is the most improved in the table for reasons outlined above.

Hungary's credit profile has clearly deteriorated; it has shot up 14 places to become the seventh weakest sovereign. As well as being affected by contagion from Greece and the other peripherals, investors are singling out the central European country due to its high level of debt denominated in foreign currencies and potential political risk.

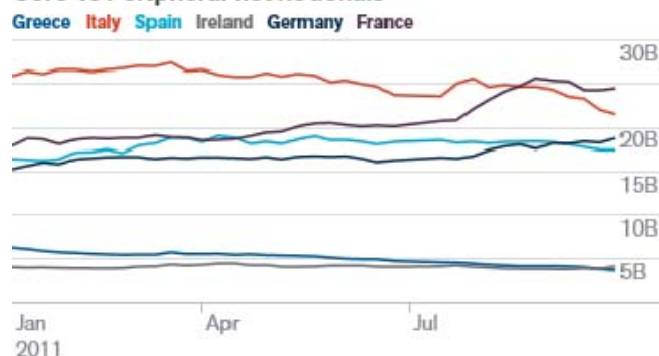
## CDS Liquidity

Name	5Y Spread	% Change	Net Notional (USD)	% Change
France	170	103%	24,527,940,661	21%
Italy	446	152%	21,535,769,555	-11%
Germany	99	137%	18,786,433,353	14%
Brazil	179	57%	17,609,339,237	4%
Spain	367	33%	17,470,420,071	-7%
UK	86	35%	12,507,250,024	4%
Japan	140	53%	9,441,983,732	13%
Mexico	180	62%	9,037,315,076	3%
China	159	82%	8,344,489,334	11%
Belgium	250	67%	6,595,020,329	-7%

Sources: Markit, DTCC

It is often remarked – with some justification – that the CDS market suffers from poor liquidity. But there is no doubt that sovereigns are among the most heavily traded names in the asset class. In the second-quarter the focus was on Italy and Spain, then ranked first and third by net notional outstanding. But it was noted earlier that attention has shifted to the eurozone's core, and this is evident in the liquidity table. France has surged to the top, with an increase in net notional of 21% over the quarter. Germany has jumped from fifth to third with an increase of 14%

### Core vs Peripheral net notionals



Source: DTCC

Rumours of France losing its AAA rating having been circulating in the markets for months, and the high exposure of French banks to the periphery has only

placed more pressure on the sovereign. France is the second biggest contributor to the EFSF, and the share will increase if some of the other countries cannot honour their obligations. Germany, the primary paymaster of the eurozone, is still one of the world's strongest sovereigns but its export-driven economy has slowed sharply and it will reluctantly have to bear much of the cost of the region's bailouts

Of course, a large portion of the CDS activity in these names is driven by bank CVA desks. As most developed market sovereigns don't post collateral with counterparties on derivative trades, banks use sovereign CDS as a means of managing counterparty risk.

**Exposure to China is rising**

**China exposure continues to grow**

China 5-year CDS China net notional (Left Axis)



With all eyes on Europe, western investors were sometimes guilty of forgetting about China this year. That changed as the third-quarter unfolded. China's CDS spreads spiralled upwards from a respectable 75bp to 200bp as investors feared that the world's most resilient growth engine was faltering. Exports, though still rising, were doing so at a lower rate, indicating that China is far from immune to the malaise afflicting western economies.

There also widespread concerns about overheating in the Chinese property market. The central government appears determined to release some of the steam that has been building up in the real estate industry. Local governments are less keen, and the danger is that tightening measures burst the bubble and cause a hard landing for the Chinese economy. CDS exposure increased sharply during the third-quarter but had already been building steadily since the beginning of 2010. Proof, if any was needed, that the much-criticised CDS market is a vital early-warning indicator.

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