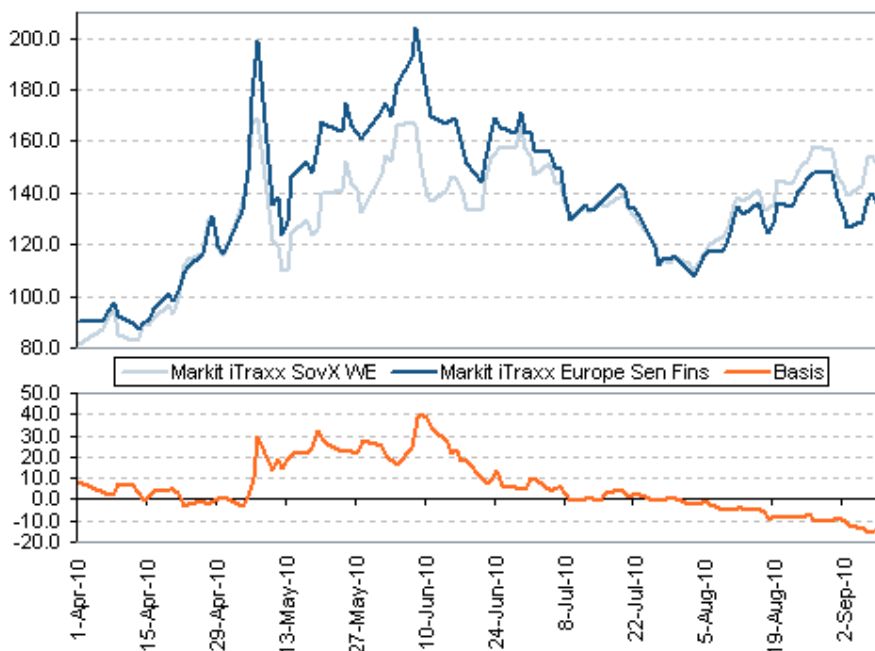


## Markit Credit Wrap: Of Banks and Sovereigns

Index Levels and Basis: Markit iTraxx SovX Western Europe vs Markit iTraxx Europe Senior Financials



This week was quite light on activity from significant economic releases compared to last week. This allowed the markets to focus almost exclusively on the sovereign debt challenges of the European periphery and even allow time for renewed reflection on the robustness of the bank stress tests. The latter point was all the more in vogue following an article from the Wall Street Journal indicating that some banks may not have fully disclosed the extent of their holdings in certain sovereign debt. But the focus quickly shifted to the Irish banks and Anglo Irish, in particular. CDS spreads on Anglo Irish had been widening recently along with those of Ireland on concerns that loan impairments for the bank would continue to grow on an economic slowdown and thus the cost to its owner, the Irish government, would continue to increase.

By week's end though, some of the concerns from the beginning of the week had abated. First, Ireland extended its guarantee of bank liabilities to the end of the year. The guarantee was set to expire at the end of the month. Second, the finance ministry announced its plan to divide Anglo Irish into two separate banks, one for deposits only and the second for bad loans—think the second coming of NAMA. Then yesterday, demand and pricing for the Irish government bond auction demonstrated somewhat convincingly that the government not only continued to enjoy access to the capital markets but does so with strong demand and at average yields comparable or lower to the previous auction.

For all the focus on Ireland and its financial system this week, it is simply a part of an overall story that is repetitive certainly across the periphery but even among its core to a degree as well. There is no shortage in Europe of things to be concerned about and these things are impacting sovereigns and financials alike: the deceleration in growth across the Eurozone in Q3 due to economic conditions as well as from any impact of austerity measures, the divergence in economic performance between core and periphery; and the renewed concern about the stress tests and reporting of banks' sovereign holdings.

If these qualitative arguments are not enough, comparing the index levels for the Markit iTraxx SovX Western Europe and Markit iTraxx Europe Senior Financials demonstrates how closely sovereigns and banks are closely linked. Correlation between the indices since April 1<sup>st</sup> registers at 0.87. The basis between the two indices going inverted in July reflects that the markets not only believe that the destinies of sovereigns and banks are closely intertwined, but there is an implication for potential risk transfer to sovereigns (as lenders of last resort) if their financial systems become inadequately capitalized. This makes the final version of Basel III all the more eagerly anticipated as regulators try to find the right balance between keeping banks competitive on a global basis and ensuring that banks have adequate capital to safely operate.

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