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Markit Credit Research

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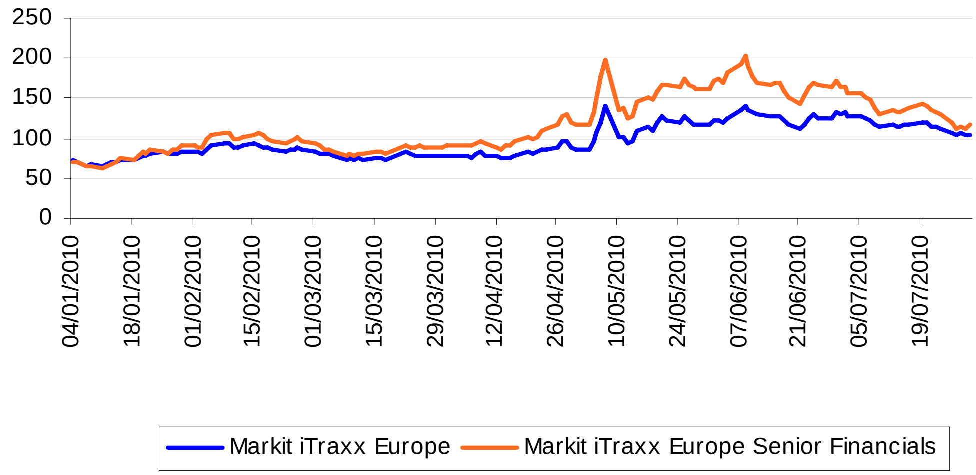
Markit Credit Wrap: The Week in Perspective



Source: Markit

It's been 14 years since Alan Greenspan coined the phrase "irrational exuberance". The Fed chairman's memorable utterance came to embody the excesses of the dot.com era, though many would say that he did little to prevent them expanding to bubble proportions. Ben Bernanke, Greenspan's successor, might well have found his own era-defining catchphrase. There is "unusual uncertainty" about the US economic outlook at the moment, according to Bernanke in a testimony made to Congress last week. Bank of England MPC member David Miles borrowed the phrase in a written statement to Treasury Select Committee on Monday.

The economic data released this week would seem to support both Bernanke and Miles. Investors have struggled for direction as the many data releases over the past few days pointed in different directions. On the negative side we had disappointing US durable goods orders. Relatively positive data has come in the form of a better than expected Case-Shiller house price index, an EC economic sentiment index beating consensus estimates and German unemployment posting an unexpected decline.

Today was no different. The main event was Q2 US GDP, and the market was already nervous after Spanish unemployment and German retail sales missed expectations. When the crucial figure was released the market reacted badly. A headline figure of 2.4% growth was below the 2.5% consensus estimate. The slew of negative data relating to the US consumer - the bulwark of the global economy - was reflected in the GDP data, which showed consumer spending rising by just 1.6%. Investment made the biggest contribution to the growth rate, with capital spending by businesses increasing by 21%.

But the market has taken stock after the initial reaction and mounted a tentative recovery. A closer examination of the GDP figures showed that Q1 growth was revised upwards to 3.7, a full percentage point higher that the first estimate. Investors also took heart from the stronger business confidence implied by the sharp rise in capital spending. Two later economic releases also provided support. The University of Michigan consumer sentiment survey fell to 67.8 this month from 76 in June. Hardly a cause for celebration, one might think. But it was better than expected and an improvement from the 66.5 preliminary measure. A higher than expected reading from the Chicago PMI provided another fillip.

That the economic data is receiving such close attention is perhaps a product of last week's main event - the European bank stress tests. The low number of banks that failed the tests - just 7 - and the relatively small amount of capital that needs to be raised (EUR3.5 bn) led many to question the credibility of the tests. Were the adverse scenarios really that adverse? Why wasn't the loan book tested? Should the tougher core capital ratio have been the benchmark? These are all valid questions and they are still being asked.

Nonetheless, the markets responded on Monday with a strong rally in financials that continued through most of the week. Rather than focusing on the tests' credibility, investors were cheering the increased balance sheet transparency brought about by the testing process. The uncertainty surrounding banks' sovereign debt exposure made a major contribution to the spread volatility seen during May and June. Nearly all of the 91 banks – with the exception of some German banks – have now published their government bond holdings in both trading and banking books. This transparency is the main positive to take away from the tests.

The Markit iTraxx Senior Financials index tightened from 131bp at Friday's close to 110bp on Tuesday. It has since settled back to 115bp. The positive sentiment emanating from banks – the relaxation of Basel III proposals also played a major part - pulled along the broader corporate market. But the differential between the financials index and the Markit iTraxx Europe is now around 10bp, the smallest since mid-March and a stark contrast to 63bp in June 8. This reflects some normalisation from the panic conditions seen recently. Sovereigns, the ultimate guarantors of banks, have also gained and the correlation between banks and their respective governments is likely to remain high.

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