

Markit Sovereign Report Q1 2011: A new world order?

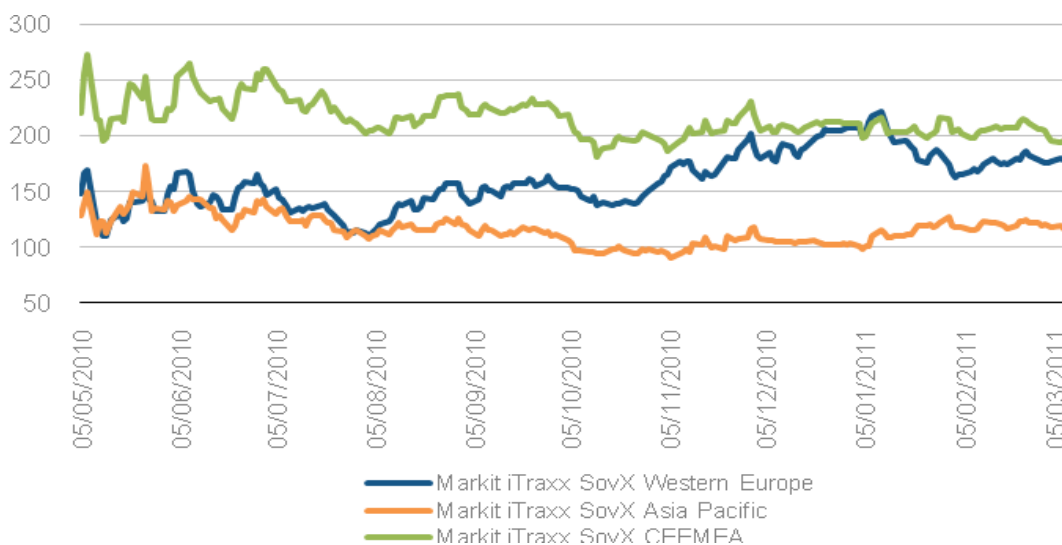


Fig. 1 The West and the Rest

A new world order?

A changing of the guard. A global realignment. A new world order. Just a few of the hackneyed phrases used to describe the shift in power from the developed world to emerging economies in what was formerly known as the “Third World”. Clichés aside, few would doubt that a transition is occurring. It seems likely that the Great Recession accelerated this trend. But there is considerable debate about the pace of change and who the likely winners and losers are. This report does not seek to speculate on whether USA will be usurped by China or what acronym captures the economic zeitgeist. That is best left to headline-seeking think-tanks. This report will look at developments in the sovereign CDS market, an arena that prosaically but accurately reflects sovereign credit risk as it is perceived by the financial markets. Although it doesn’t have the fortune-telling properties that are in demand it does provide short- and medium-term insight that is highly valued by politicians and regulators, as well as market participants.

Sovereign outperformers

Ticker	Name	5Y Spread	Year-end Change	Percentage Change	Markit Implied Rating	Average Rating
AUST	Rep Austria	60	-40	-40.20%	AA	AAA
ITALY	Rep Italy	148	-88	-37.40%	BBB	AA
BELG	Kdom Belgium	139	-81	-36.80%	BBB	AA
SPAIN	Kdom Spain	220	-128	-36.70%	BB	AA
NETHRS	Kdom Neth	40	-22	-35.30%	AA	AAA
REPHUN	Rep Hungary	263	-125	-32.20%	BB	BBB
FRTR	French Rep	74	-33	-30.80%	AA	AAA
DBR	Fed Rep Germany	44	-14	-24.30%	AA	AAA
UKIN	Utd Kdom Gt Britn & Nthn Irlnd	55	-17	-23.50%	AA	AAA
CHILE	Rep of Chile	66	-18	-21.80%	AA	A

For all the talk of the rise of the East, all 10 of the best performing sovereigns over Q1 are in the western hemisphere. Only two – Hungary and Chile - could be described as emerging economies, and even that moniker is doubtful for the latter country given that it is a member of the OECD. The top five have all been members of the eurozone since its inception in 1999. Top of the table is Austria, a AAA-rated country that had been underperforming. The latest Markit Manufacturing PMI shows that its economy is bouncing back. But the widening in its spreads last year was powered by a now familiar factor in the west: sovereign exposure to weak banks. Austrian banks are heavily exposed to central and eastern Europe, particularly Austria's neighbour and another constituent of the best performing 10, Hungary. The latter country's credit risk has perceived to have improved, and this in turn has lightened the bad debt outlook for Austria's banks. The state has guaranteed the banks to the tune of EUR100 billion and has injected significant amounts of capital. If Austria's spreads are to continue their strong performance then the country's debtors to the east will have to hold firm.

The next three sovereigns in the table would probably have been in the bottom 10 credits last year. Italy and Spain are regarded as belonging to the "PIIGS", the acronym given to the laggards in the eurozone (Portugal, Ireland and Greece are the others). And Belgium was seen as somewhere between the core and peripheral credits, and viewed increasingly as closer to the latter group. But there has been a marked change in the first quarter of this year. Belgium, despite having a caretaker government since 13 June 2010 (a world record), has seen its spreads tighten significantly. Although its political instability and high debt levels made it vulnerable in the eyes of many investors, there was the counter-view that its deficit was relatively small and it was unlikely to have any difficulty in raising funds. The latter perspective seems to have won out.

Italy shares Belgium's two economic weaknesses mentioned above. But it too has tightened in Q1 as investors have begun to differentiate between the peripheral credits. Spain has also benefitted from this trend. Its correlation with its smaller Iberian neighbour Portugal has broken down over the last two months (see fig. 2). The market has become more comfortable about the sovereign's exposure to its ailing banking sector, and has been encouraged by the government's energetic approach to reforms. Contagion has been contained, at least for now.

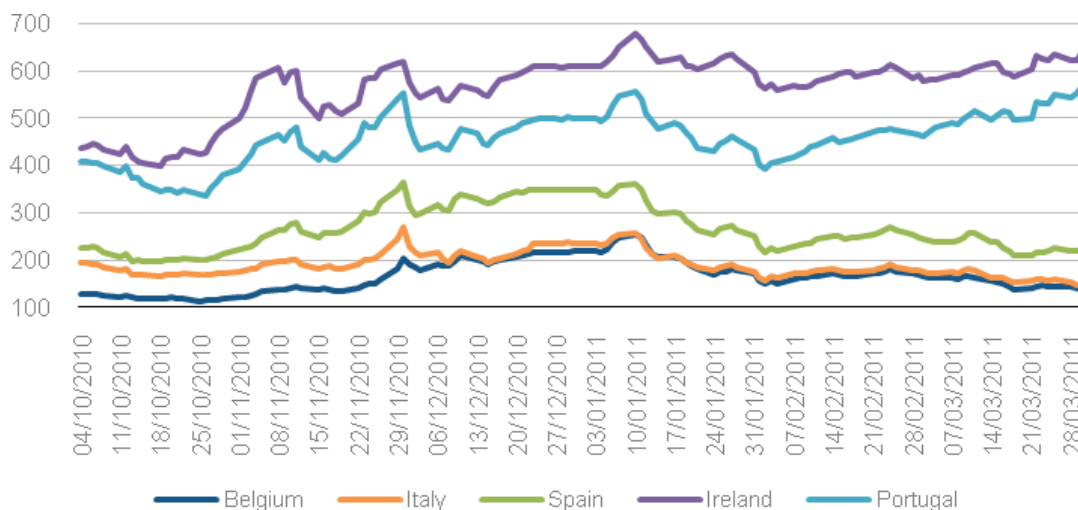


Fig. 2 Leaving the periphery

Sovereign underperformers

Ticker	Name	5Y Spread	Year-end Change	Percentage Change	Markit Implied Rating	Average Rating
BHREIN	Kdom Bahrain	327	152	86.50%	B	A
SAUDI	Kdom Saudi Arabia	123	48	64.60%	AA	AA
BTUN-CentBank	Bqe Cen de Tunisie	174	60	52.50%	A	BBB
EGYPT	Arab Rep Egypt	339	100	41.90%	B	BB
MOROC	Kdom Morocco	171	47	38.00%	BBB	BB
JAPAN	Japan	99	27	37.40%	AA	AA
ISRAEL	St Israel	152	37	32.40%	BBB	A
QATAR	St Qatar	112	24	26.50%	AA	AA
PERU	Rep Peru	140	27	23.50%	BBB	BBB
THAI	Kdom Thailand	118	19	19.60%	AA	BBB

Event risk accounts for the majority of sovereigns in the underperforming table. Seven of the 10 are in the Middle East and North Africa (MENA) region, including Egypt and Tunisia, both subject to revolutions that overturned unpopular autocratic regimes. Fears that the unrest could be contagious have driven spreads wider in sovereigns across the region. Bahrain and Saudi Arabia have widened more than most, and the disturbances in the two countries have been closely watched by western investors. The latter country is crucial as it is OPEC’s biggest oil producer and is relied

upon to fill the shortfalls elsewhere in the world. MENA has faded into the background for now but the elevated credit spreads indicate that it is still a relevant issue for the markets.

Japan's spreads have been highly volatile since the catastrophe earlier this month. Investors are still struggling to ascertain the eventual economic impact of the disaster, though most of the academic literature on natural disasters suggests that the effects on growth for a developed country are limited.

The top 10

Ticker	Name	5Y Spread	Year-end Change	Percentage Change	Markit Implied Rating	Average Rating	Year-end ranking
NORWAY	Kdom Norway	18	-5	-21.10%	AA	AAA	1 (0)
SWED	Kdom Sweden	28	-6	-16.90%	AA	AAA	4 (+2)
FINL	Rep Finland	30	-3	-9.80%	AA	AAA	3 (-1)
DENK	Kdom Denmark	39	-7	-15.80%	AA	AAA	4 (+2)
NETHRS	Kdom Neth	40	-22	-35.30%	AA	AAA	9 (+4)
USGB	Utd Sts Amer	41	-1	-1.40%	AA	AAA	4 (-2)
CHINA-HongKong	Hong Kong Spl Admin Region	43	-1	-2.60%	AA	AA	5 (-2)
DBR	Fed Rep Germany	44	-14	-24.30%	AA	AAA	8 (0)
AUSTLA	Comwth Aust	55	6	11.30%	AA	AAA	7 (-2)
UKIN	Utd Kdom Gt Britn & Nthn Irind	55	-17	-23.50%	AA	AAA	13 (+3)

As expected, western countries make up the bulk of the 10 sovereign credits with the tightest spreads. It is no surprise to see the Scandinavian countries at the top; they occupy that position in human development tables and several other measures of progress. The oil economy of Norway has little chance of being supplanted at the head of the table. The UK government would probably like to take credit for country entering the top 10 but it is more likely that it was part of a general move tighter for Europe's larger economies.

The bottom 10

Ticker	Name	5Y Spread	Year-end Change	Percentage Change	Markit Implied Rating	Average Rating	Year-end ranking
GREECE	Hellenic Rep	965	5	0.50%	CCC	BB	2 (+1)
VENZ	Rep Venezuela	1005	-7	-0.70%	CCC	B	1 (-1)
IRELND	Rep Irlnd	608	15	2.40%	CCC	A	4 (+1)
ARGENT	Argentine Rep	603	1	0.20%	CCC	B	5 (+1)
PORTUG	Rep Portugal	550	53	10.60%	CCC	A	7 (+2)
UKRAIN	Ukraine	441	-80	-15.30%	B	B	6 (0)
DUBGOV	Dubai Govt	397	-36	-8.20%	B		8 (+1)
LEBAN	Lebanese Rep	347	48	16.00%	B	B	18 (+10)
EGYPT	Arab Rep Egypt	339	100	41.90%	B	BB	27 (+18)
VIETNM	Socialist Rep Vietnam	328	27	9.10%	B	BB	19 (+9)

The weakest credits of the eurozone – Greece, Ireland and Portugal - have decoupled from the rest, and it is no surprise to see them in the bottom five sovereigns. Venezuela and Argentina have been bringing up the rear for many years now, a situation that is unlikely to change in the near future. MENA credit Lebanon and Egypt enter the bottom 10 as a result of political risk being priced in by the markets.

CDS-Bond Basis

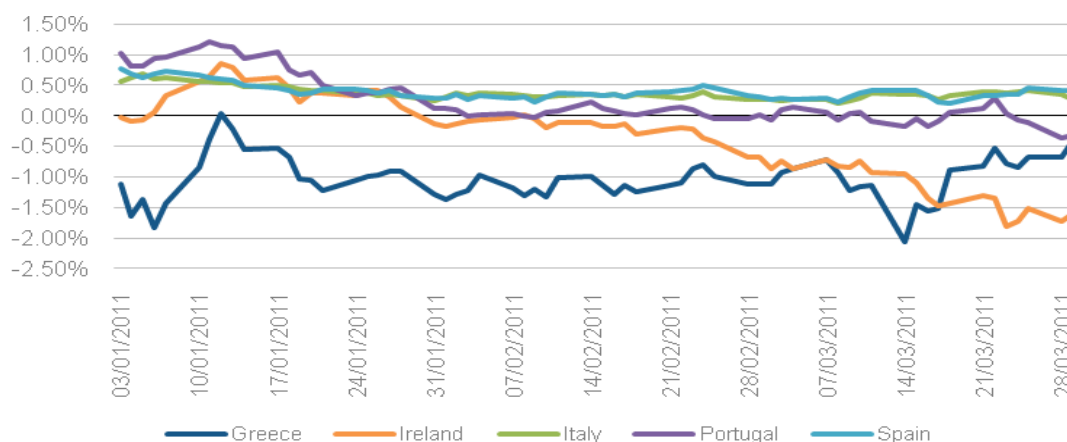


Fig.3 CDS-bond basis in the periphery

Source: Markit Evaluated Bonds

The CDS-bond basis is now negative for the three weakest sovereigns in the eurozone: Greece, Ireland and Portugal. High margin requirements at clearing houses make it costly to hold bonds from these countries, and this could be contributing to the negative basis.

CDS Liquidity

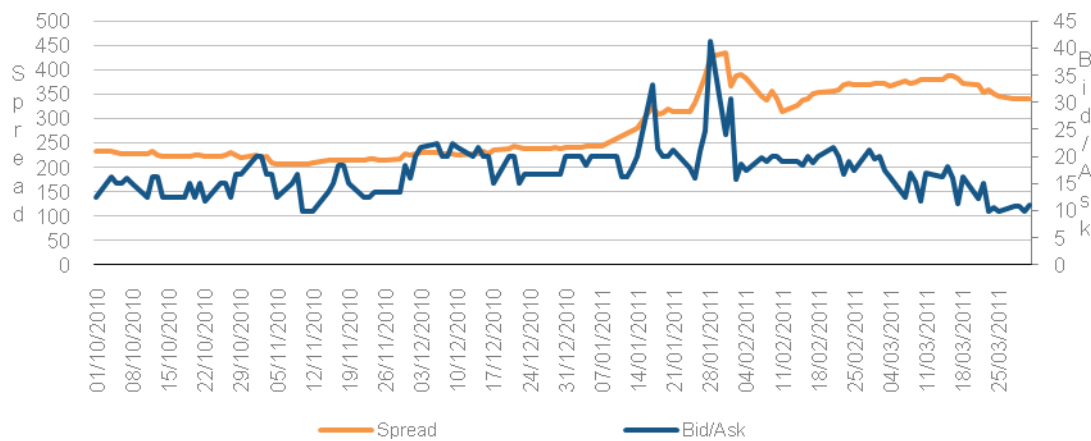


Fig. 4 Egypt liquidity

Source: Markit Liquidity Metrics

It was remarked upon earlier that issues in the MENA region have faded into the background for western investors. Has this had an impact on sovereign CDS liquidity? Fig. 4 shows the volatility in Egypt’s CDS spreads earlier this year. Spreads have stayed at relatively wide levels, reflecting the uncertain political outlook. Bid/ask spreads were suitably volatile during the turmoil, going from around 20bp to 40bp in the space of a few days. But since then they have stabilised, and have tightened to 10bp, a smaller spreads than in Q4 last year, when the CDS spreads was much tighter. This indicates that increased activity has compressed the bid/ask spread, suggesting higher liquidity. DTCC activity data shows that Egypt is trades regularly, though it is not in the same league as Turkey and other popular EM names. It is a similar picture for sovereigns such as Saudi Arabia and Bahrain, whcih were thinly trade until the unrest hit the region.

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