Level 5
2 More London Riverside
London
SE1 2AP

tel +44 20 7260 2000
fax +44 20 7260 2001
www.markit.com

Markit Credit Research

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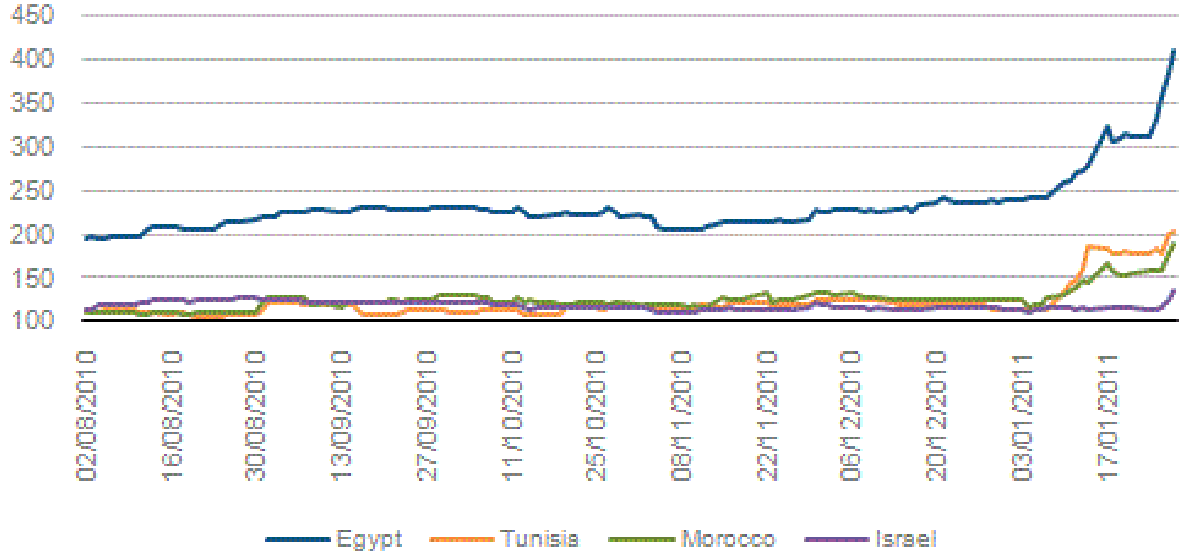
Markit Credit Wrap: It's the politics stupid

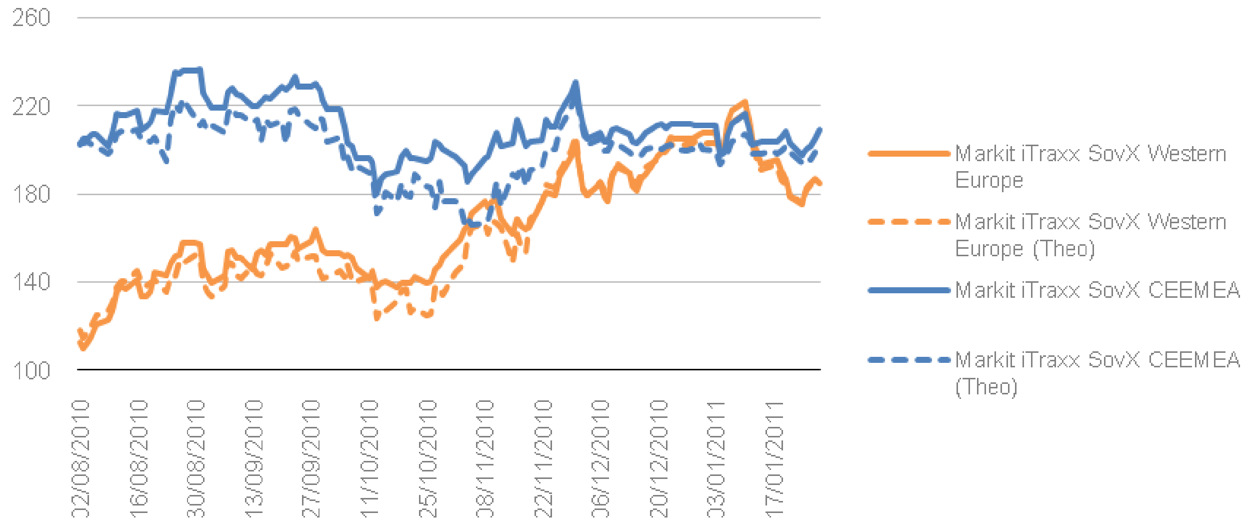


Mention the word "contagion" to people in the credit markets and most of them will immediately think of the eurozone debt crisis, Greece, Ireland and the rest. This, of course, would be perfectly natural given that the fate of peripheral sovereigns has shaped spread direction over the last year or so. But that cognitive association may be about to change as investors sit up and take notice of events in North Africa. Over the last two weeks we have seen the "Jasmine Revolution" unfold in Tunisia, leading to the overthrow of a dictatorship and ongoing unrest. Investors have been asking is this contained or is it contagious? If it's the latter then who's next?

The last few days have shown that the contagion scenario is more likely than it seemed last week and a frontrunner has emerged for the next country in line. Egypt has seen its fourth consecutive day of protests today, with anti-government demonstrators taking their cue from their Tunisian neighbours and demanding that President Mubarak, Egypt's autocratic president, step down. The authorities have responded by cutting internet access and using force to break up the protests.

Credit investors have taken note, and the sovereign's spreads have widened 17bp today to 405bp and nearly 100bp over the last week. Egypt has always been one the riskier names in the region due to its considerable debt burden, high inflation and current account deficit; its spreads hit 800bp in October 2008 post-Lehman crisis. It is also one of the more liquid credits, having a Markit Liquidity Score of 1 (the highest available). Morocco, a less liquid name (Markit Liquidity Score of 3), has also widened this week.

But now the markets are looking for answers for the "who's next?" question beyond North Africa. Spreads have widened in Lebanon, Jordan and rich Gulf states such as Saudi Arabia, Qatar and Bahrain. Even Israel - a liquid name - has seen its cost of protection rise sharply today. One might ask why spreads should widen in a country that is the only democracy in the region. But Egypt is Israel's closest Arab partner, and the fall of Mubarak could leave it isolated if the dictator is succeeded by a less-friendly regime. Investors are starting to price in this risk.



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In fact, one could take the view that the markets have been under-pricing political risk in emerging markets. Investors have been focused, rightly, on the improving economic fundamentals of many countries in the less developed world. But politics matters, particularly in sovereigns with unstable, undemocratic systems. We remarked last week that the Markit iTraxx SovX CEEMEA was back above the Markit iTraxx SovX Western Europe index, a trend that has continued this week. This is a result of peripheral eurozone sovereigns rallying more than anything else. But the CEEMEA has widened in recent days as investors use the index to reflect their uncertainty on emerging markets. This is despite there being only three Middle Eastern names among the underlying constituents (Turkey, Qatar, Abu Dhabi). The chart above shows that the skew has widened on the CEEMEA, indicative of the widening in the index compared to the relative stability of the constituents. It is likely that the markets will start to differentiate between the countries in focus and price accordingly. But much will depend on how the Egypt story develops and whether the contagion effect swamps attempts at more discerning analysis.

Politicians will also have a role to play in determining spread direction in the developed world. Most of the key policy makers are in Davos, and it seems the informal talks of the forum have pushed opinion towards a more radical response to the sovereign debt crisis. The option of using the EFSF to buyback Greek government bonds is now “on the table”, according to EU officials. The credit markets have been nonplussed by the news thus far; they want concrete measures (unlikely before EU council meeting on March 24).

Aside from sovereigns, investors will be keeping an eye on developments in the banking sector. Spain has announced plans to boost the capital of its cajas, and the markets reacted positively to news of a restructuring at La Caixa, the biggest caja. There was some confusion in the market over whether it would result in a succession event, though the consensus so far is that it isn’t. Earnings will continued to be closely watch, with bullish investors hoping that the broadly positive trend extends into next week.

Level 5
2 More London Riverside
London
SE1 2AP

tel +44 20 7260 2000
fax +44 20 7260 2001
www.markit.com

Gavan Nolan

Credit Analyst
Markit
Tel: +44 20 7260 2232
Email: gavan.nolan@markit.com

For further information, please visit www.markit.com