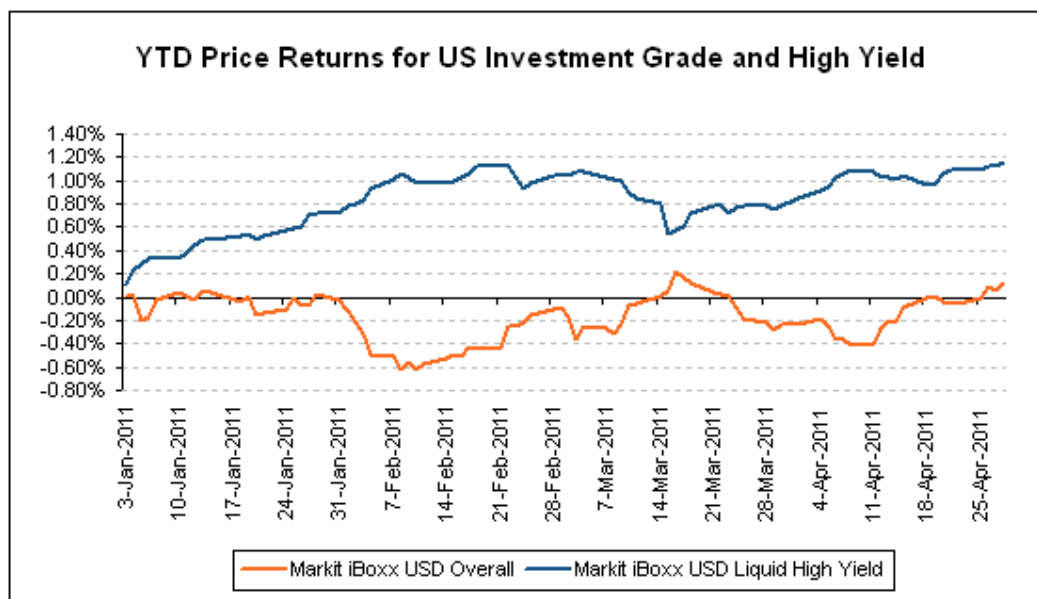


## Markit Credit Wrap: A Perfect Dry Spell



Sometimes events align in a way to lead to a broad sell-off of risky assets and escalated volatility prompting pundits to use the overused descriptor: 'a perfect storm'. That is not what happened this past week. Coming out of the Easter holiday and going into a royal wedding helped give Londoners back-to-back four day weekends. Many took some of their vacation days on the three workdays and extended the stretch to eleven days, a virtual "August in April". In addition to the market holidays in London, month end positioning by investors and a historic but uneventful post-FOMC press conference all translated into fairly low liquidity in the credit markets. Rather than a 'perfect storm', it was a 'perfect dry spell' and risky assets rallied. Short credit investors seemed to be caught flat footed. Even the peripherals rallied a bit heading into the weekend, in spite of the fact that investors have not altered their assessment of the potential for a Greek debt restructuring.

To suggest that the week's rally in risky assets though was due solely to the lack of liquidity would be incorrect. First quarter earnings results in the US are coming in very strong. It could end up being a record quarter for profit. YTD price return for US high yield is at a new high and close to the previous high for US investment grade. Positive sentiment in earnings really got a boost from results by heavy equipment manufacturers which revealed strong demand from emerging economies. Rising oil and materials prices have not fully worked their way into earnings yet clearly although some companies did offer comments that seem quite bearish for future guidance.. The more notable statements to this effect came from Wal-Mart, a bellwether for US consumer sentiment, and Kimberly-Clark. The former suggested that their core consumer base seems geared to spend less in the face of rising oil and food prices, making a renewed focus on the company's low price leader and one-stop shopping strategies paramount to its ongoing success. Kimberly-Clark's management suggested that companies, which have been downsizing product rather than passing higher costs onto consumers, may reason that consumers have become desensitized to sticker shock with the implication that companies should have flexibility now in starting to raising prices. If they are right about companies starting to pass on costs but wrong about price-desensitized consumers, the implications for the US economy could be grave. That said, investors seem focused on current earnings results rather than imagining the worst for future guidance.

While it is really hard to draw conclusions from market movements due to the lack of liquidity this week, it may get even more challenging when liquidity returns to the market. Also next week, investors will have more data to digest with Markit PMI data releases and an ECB decision on Thursday. As the ECB raised rates 25 bp at its last meeting, most observers are not expecting an additional increase for this round particularly in light of Trichet's statement that

the last raise was not necessarily part of a series of hikes. Lastly, newswire reports suggest that an EU-IMF bailout package for Portugal could be announced next week. While there should be no surprises there, investors will be focused on it nevertheless. Despite the small rally in sovereign spreads, yesterday, investors have not fundamentally altered their views on the potential for a Greek debt restructuring.

On the US side, Fed Chairman Ben Bernanke indicated that the S&P revision of the outlook to negative could help motivate policymakers to focus on meaningful deficit reduction. While that is certainly the hope, this week's events so far fall a bit short of that hope. Political discussions seemed more focused on President Obama's birth certificate and whether or not Donald Trump wears a hairpiece. To the extent there were substantive conversations on the US budget situation, they seem to be developing rather slowly. President Obama focused on saving \$4 billion instead of \$4 trillion by attacking tax subsidies for the oil industry and deferring the task of serious budget negotiations to Vice President Biden—both a clear signal that campaigning for the 2012 presidential race has already begun. Republican House Speaker John Boehner stated that he could not guarantee a vote on raising the debt ceiling. Whether a negotiating tactic to extract more spending cuts from Democrats or a genuine indication that there are deep divisions within his caucus, it is another factor that helps set the stage for potential volatility in the financial markets.

Congratulations to the Duke and Duchess of Cambridge. May your union be a loving, prosperous and enduring one.

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