

Global Credit Markets

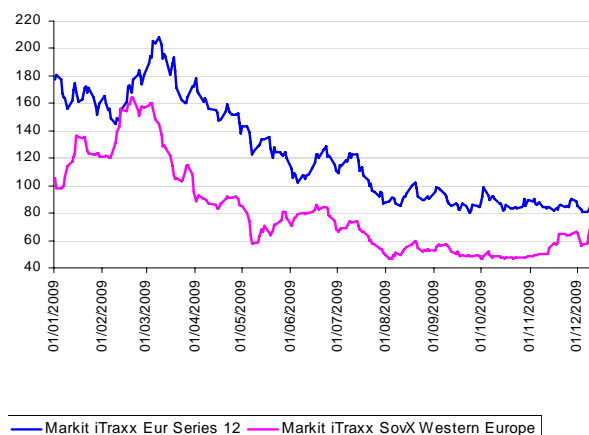
Markets rally as risk appetite returns, but concerns grow regarding government finances

- **Fear of corporate default has diminished as investors gain confidence in economic recoveries.**
- **But worries turn to government debt servicing.**
- **Investors looking for decisive action in cutting deficits.**

Benign conditions for equity and credit

Investors remain largely relaxed about fear of corporate default, especially compared to earlier in the year. Economic recoveries appear to be progressing, stock markets are at their highest levels for over a year, interest rates are close to zero in most of the major economies and a weak dollar is fuelling demand for risky assets. Industrialised economies are expected to expand in the fourth quarter, with the exception of a few laggards. The Markit iTraxx Europe and the Markit CDX IG indices, the benchmarks for European and North American corporate credit default swaps (CDS), are hovering around their tightest levels since June 2008 as a result.

Chart 1: Sovereign vs. Corporate CDS



Source: Markit.

A rally, but at what expense?

This rally has come at a price. Governments are running large fiscal deficits to help support their economies. This commitment, as well as expansionary monetary policies, has been taken as a cue by investors to push capital into riskier assets such as stocks, corporate bonds and commodities.

The unwelcome flip-side of the rally has not gone altogether unnoticed by investors. Sovereign CDS spreads, after rallying in tandem with the corporate market and the improving global economy, have widened significantly in recent weeks, indicating growing concerns about government credit worthiness.

Chart 1 compares the Markit iTraxx Europe index, which provides an indication of the perceived risk of corporate default, with the Markit iTraxx SovX Western Europe index, which provides an indication of the perceived risk of sovereign (government) default. It shows that while the iTraxx Europe has stayed at tight levels (suggesting low risk of default), the SovX has widened recently (suggesting increased risk of default). The differential between the two indices is at its smallest since the height of the financial crisis in the first quarter of this year, as sovereign credit risk approaches that of corporates.

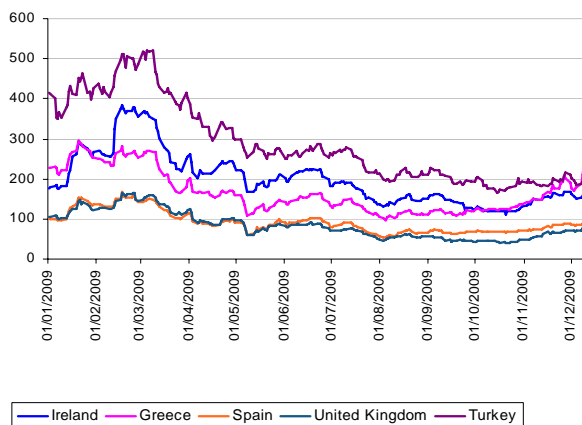
The guilty culprits

The widening in sovereign CDS spreads reflects concerns that governments are failing to address their deteriorating public finances. But some are guiltier in this respect than others. Greece has been singled out as the worst culprit. Its budget deficit is expected to be in excess of 12% of GDP this year and its debt burden is projected to rise to 120% by 2010.

Its CDS spreads have been widening for some weeks (see chart 2), with investors unimpressed by the government's response to its difficult situation. The reliance of the country's banks on European Central Bank special funding facilities hasn't helped.

But things took another turn for the worse when the rating agencies decided to take action. Fitch downgraded Greece's rating to BBB+, making it the only country in the eurozone with a rating below single A. Greece's spreads widened sharply, triggering negative sentiment in both the corporate and sovereign markets. Its spreads now trade wider than its neighbour Turkey, a single B credit dependent on International Monetary Fund assistance.

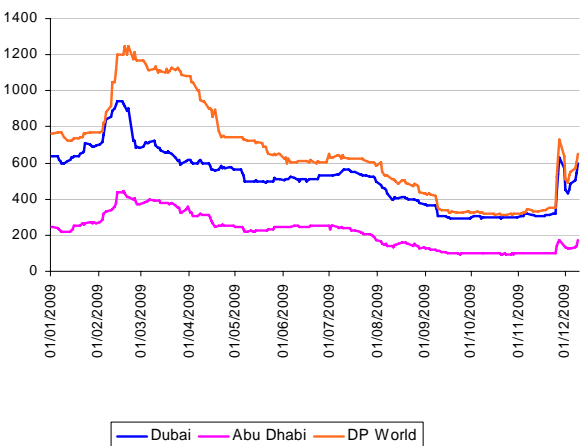
Chart 2: European Sovereign CDS



Source: Markit.

Other European countries are also struggling under the weight of their deficits. The UK and Ireland are both borrowing similar amounts as a proportion of their GDP as Greece, though their debt burdens are significantly smaller. Spain's AA+ rating was put on negative outlook by S&P this week, the rating agency citing the country's rising deficit and low growth expectations.

Chart 3: Trouble in UAE



Source: Markit

Emerging markets have fared better, with one notable exception. The government of Dubai, a city state within the United Arab Emirates, announced that it is restructuring Dubai World, an investment company wholly-owned by the state, with immediate effect. This sparked a dramatic widening in Dubai's spreads, as well as its neighbours in the Middle East (see chart 3). There were brief fears that it would cause contagion throughout the financial markets, though these concerns have since dissipated. Investors now view the situation as localised, with European banks' exposure thought to be manageable.

Sovereigns will remain the issue

However, the episode in Dubai highlighted the crucial importance of government solvency. Investors are benefitting from government largesse but are all too aware that there will be severe ramifications if public finances are not placed on a sustainable level. On the other hand, governments run the risk of a double dip recession if stimuli are withdrawn too soon. This is the balancing act that investors will be monitoring closely in 2010.

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