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Markit Credit Research

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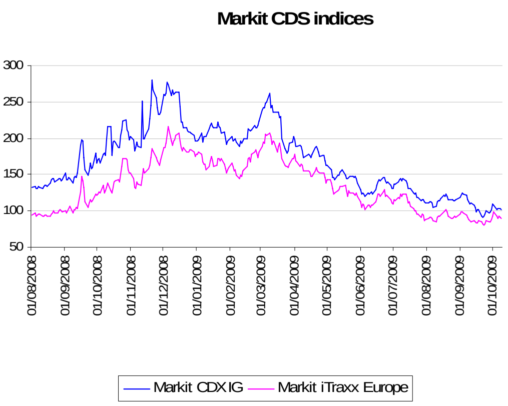
Global Credit Markets

- **Corporate CDS spreads volatile amid mixed economic data**
- **Developed country sovereign CDS holding firm**
- **US earnings season crucial**

The credit default swap (CDS) market, a financial arena renowned for drama in recent years, has enjoyed a relatively calm summer by its standards. The Markit iTraxx Europe and Markit CDX IG, the benchmark investment grade CDS indices, have tightened to levels seen prior to the Lehman-induced crisis of September 2008. A tightening of these indices means that investors perceive a lower risk of companies defaulting on their debt. Periods of credit deterioration have been short-lived over the summer, and bearish investors have found themselves isolated.

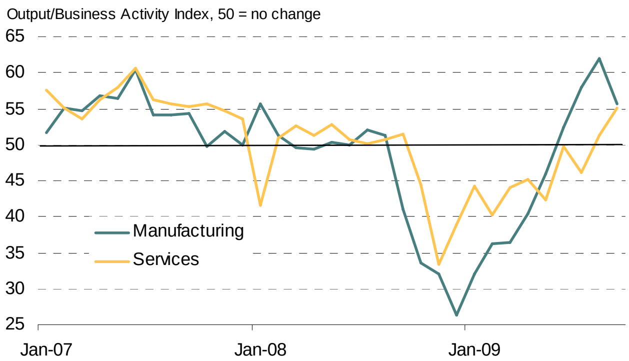


But the markets returned to their volatile ways of old at the beginning of October as a mixed batch of economic data caused investors to question the v-shaped economic recovery which appears to have already been priced into the market. Credit spreads initially widened as disappointing manufacturing PMI surveys from Markit and the ISM triggered a sell-off. The CIPS/Markit UK Manufacturing PMI showed yet another month of contraction, disheartening investors encouraged by the improvement in previous months. The equivalent ISM Manufacturing survey in the US did show an expanding manufacturing sector, though its reading was down on last month and below expectations.

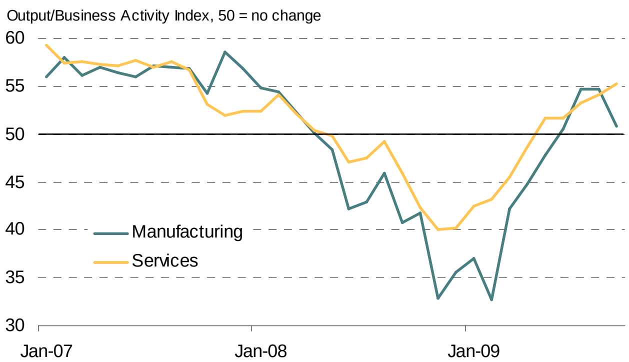
A sense of foreboding enveloped the markets ahead of September's US non-farm payrolls report. But the 263,000 jobs lost and 9.8% unemployment rate surpassed even the worst expectations.

It might be expected that the CDS market would continue to widen after such dire data. But another set of leading indicators were released soon after, this time providing positive news. The CIPS/Markit UK PMI for the services sector painted a different picture than its manufacturing counterpart, showing the strongest rise in activity since September 2007. The performance of the US ISM services index was not quite as impressive, but the 50.9 reading was again better than expected and the first month of expansion in nearly a year. Unsurprisingly, credit spreads rallied on the news.

United States PMI surveys (ISM)

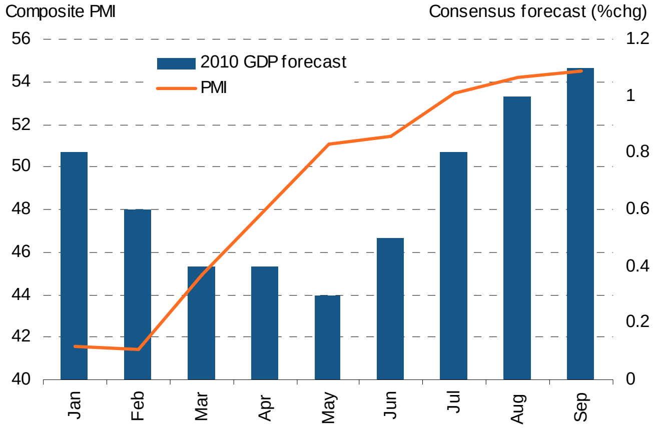


United Kingdom PMI surveys (CIPS/Markit)



The general trend of tightening credit indices over the summer corresponds with the improved flow of economic data from the historic lows that many indicators hit at the start of the year, which in turn fuelled upward revisions to many economic forecasts. The consensus forecast among economists for UK GDP in 2010, for example, has risen from a low of 0.3% in the May poll to 1.1% in the September poll. A steady upward revision process to these revisions reflected a marked improvement in economic data such as the PMIs, which bottomed out during the first quarter and have since risen surprisingly strongly.

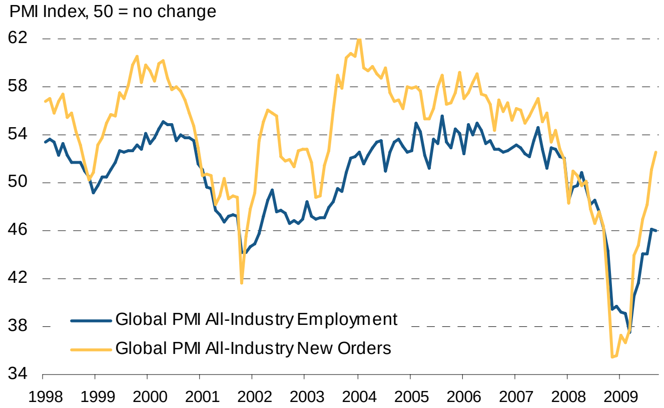
UK 2010 GDP forecast revisions



Sources: Markit, Thomson Reuters.

The weaker than expected US payroll numbers and disappointing employment indices from the PMI surveys raised fears of a jobless recovery. However, the upside to rising levels of new orders but falling employment is that productivity is likely to have improved. In addition to lower staff costs, companies have also cut dramatically their inventory levels compared to last year, and have also reduced expenditure on many discretionary activities such as marketing.

Global output and employment growth



Source: Markit, JPMorgan.

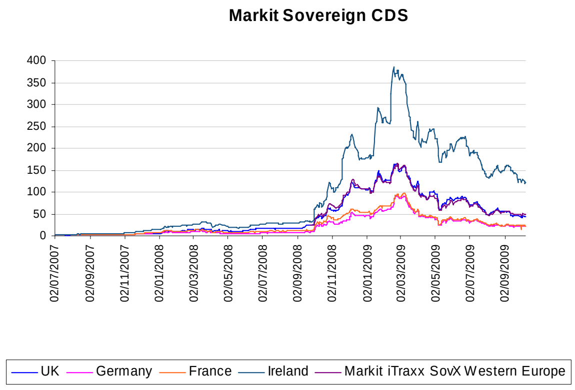
In theory, this should feed through to improved profitability and higher corporate earnings. The Q3 corporate earnings season is therefore likely to provide a key test of how companies are faring in the recovery, and whether leaner cost structures are indeed sufficient to drive better earnings growth in an environment of only modest economic expansion. A failure of earnings to meet estimates will no doubt rekindle fears of corporate default, especially as economic growth in developed economies is generally expected to remain lacklustre throughout 2010, according to consensus forecasts. Although forecasts have been revised up in recent months, the International Monetary Fund (IMF) is only expecting a 1.3% expansion of developed world economies next year.

Sovereign debt not an issue?

Sovereign CDS and corporate CDS, though representing different types of credit risk, are often closely correlated. This is to be expected. Both markets are sensitive to economic indicators: companies need a confident consumer and growing markets to support profitability; governments need an expanding economy to maintain a strong fiscal position.

But the sovereign CDS market was relatively untouched by the recent volatility in its corporate sibling. This is by no means the norm. Spreads widened sharply in the latter part of 2008 and earlier this year as fears grew about the ability of governments to meet debt obligations as they scrambled to save their beleaguered banks. The actions worked; financial Armageddon was averted and sovereign CDS spreads tightened.

The emergency measures left many governments with spiralling deficits. The UK is a prominent example. Its deficit is expected to be about 13% of GDP this year, according to the International Monetary Fund (IMF), and the media continues to be awash with reports about the dire consequences of the UK being unable to service its debt.



But the reality is that gilt auctions have been met with high demand, easing concerns in the financial markets. UK sovereign CDS spreads have therefore continued to tighten, and have moved in tandem with the Markit iTraxx SovX Western Europe index, the benchmark for sovereign credit risk (see chart above).

So the UK is mid-table in the league of western European sovereign credits. Why does it not languish near the bottom with the Mediterranean nations and Ireland? The political discourse has shifted, and the state of the government finances will be the dominant issue in the upcoming election. Both the government and the opposition are beginning to outline their plans to cut public expenditure. Alistair Darling, the UK Chancellor, has announced plans to set deficit reductions in binding legislation, a policy welcomed by the markets. His pre-Budget report in November will be closely watched for further concrete measures. But the Conservative Party is well ahead in the polls, and it is likely that the markets are pricing in the severe cuts that would follow from a change in government.

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