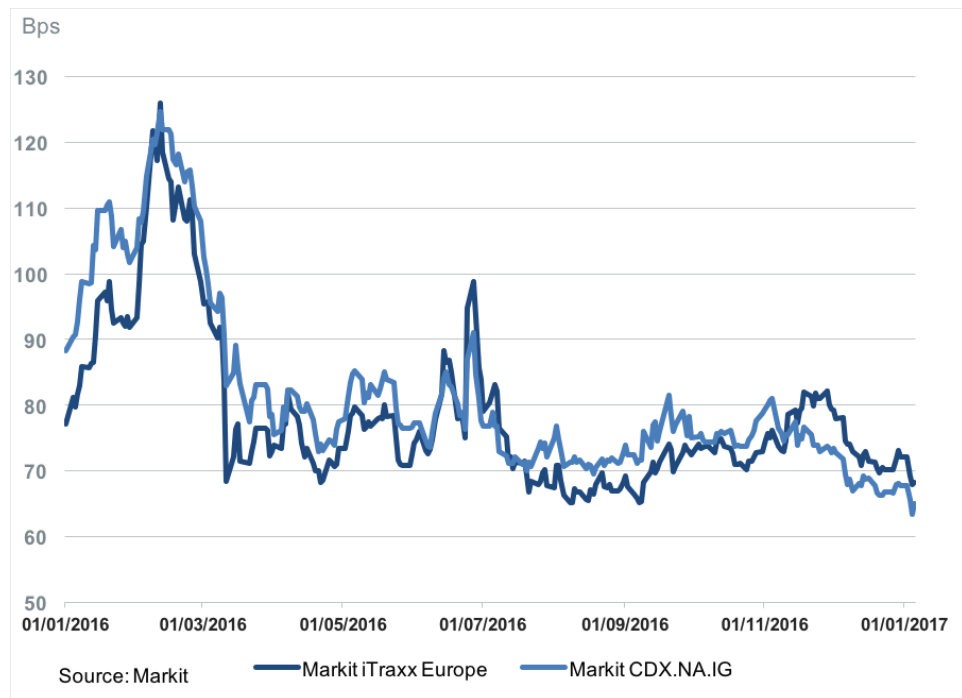


Markit Recap – 1/2/2017

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John Maynard Keynes said we live in a world of irreducible uncertainty, while neoclassical economists state that perfect information is available and people make rational expectations. The events of the last decade suggest that the former school of thought has more credence, though “freshwater” economists would no doubt disagree.

Uncertainty of the political variety looks set to be the overriding theme for 2017, regardless of whether one thinks the market is driven by rational agents or not. A new US president promising radical policy changes; elections in France, Germany and the Netherlands; ongoing banking instability in Italy – not to mention the vulnerability of China’s credit fuelled economy. These are just some of the “known unknowns” that investors need to assess to the best of their limited abilities.



Given this formidable list of potential obstacles to growth, it might be expected that the credit markets would open the year on a risk averse note. But there is little evidence of concern in the main CDS indices. The Markit iTraxx Europe ended 2016 at 72bps and was 4bps tighter three days into the new business year. Similarly, the Markit CDX.NA.IG tightened by 3bps over the same short period. When the rally in December is taken into account, the performance is impressive. Indeed, the Markit CDX.NA.IG is now at its tightest level since May 2015.

The US index outperformed its European counterpart in 2016 by some margin, particularly in the last quarter, and that trend helps explain why the markets are sanguine. President-elect Donald Trump has promised a raft of business-friendly measures, including lower taxes and higher infrastructure spending. Corporate profitability is already considerably stronger in the US than Europe, and Trump’s policy shift could accentuate this relationship.

It should also be noted that credit fundamentals are relatively robust on both sides of the Atlantic, and default rates remain low.

So, bullish investors have a number of reasons to support their directional view, particularly in the US, where could see the basis between iTraxx Europe and CDX.NA.IG widen. But market have a habit of underpricing political risk, and it would be no surprise to an event – known or unknown – cause a serious reversal in sentiment and spreads. Recent experience tells us that the world is becoming less predictable, and investors would be wise to prepare for volatility in the year ahead.

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