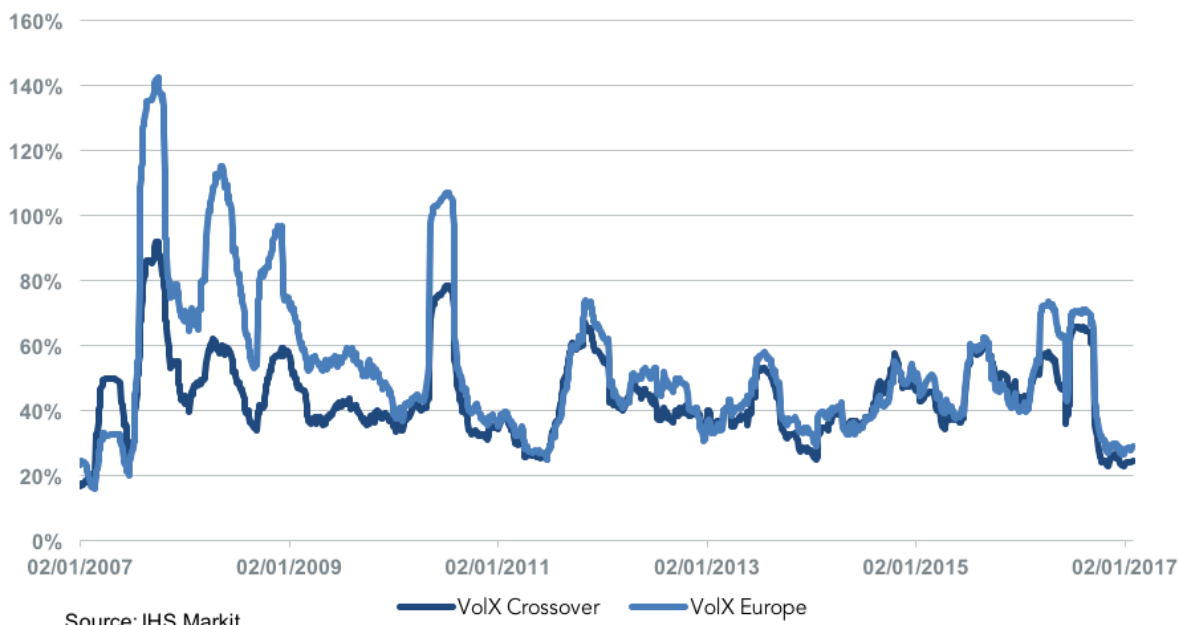


Markit Recap – 1/30/2017

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60-day Volatility - European CDS indices



Many market commentators have commented that 2017 will be the year of political risk. Ongoing uncertainty around Brexit, Donald Trump’s inaugural year as US president and a series of elections in continental Europe make conditions ripe for bouts of volatility.

This may be self-evident, but so far the credit markets are taking little heed. Realised volatility in the Markit iTraxx Europe, as measured by the VolX index, dropped sharply in Q4 and has remained around the 28-29% level this year. Indeed, the last three months have been the longest period of low volatility since March 2007, when the first signs of the US sub-prime crisis emerged. It was a similar story with the Markit iTraxx Crossover.

Volatility in the Crossover is usually lower than the iTraxx Europe, particularly during crisis periods. This may seem counter-intuitive given the weaker credit quality of the Crossover constituents, but it makes perfect sense when the high weighting of banks in the investment grade index and its widespread use as a hedging instrument are taken into account.

So are the concerns about political turmoil overdone? Maybe, but the last couple of weeks we saw tentative signs that sentiment may be shifting. Spreads in the French sovereign hit 45bps on February 2, which is the widest level since Brexit. The presidential election is in May, and the widely held expectation that the right-wing, business-friendly Les Republicains candidate Francois Fillon would comfortably win the race in the run-off is looking more fragile by the day. A scandal involving allegedly fraudulent payments to Fillon’s wife has now

enveloped his children, putting his candidacy in doubt. A National Front president in the form of Marine Le Pen, with all the uncertainty that would create around France's position in the EU, is no longer so implausible.

Italy has also seen its sovereign spreads widen, though it hasn't reached the same milestones as France. Its five-year spreads have widened 19bps in the last two weeks after a constitutional court ruling increased the chances of an early election (they were scheduled for 2018). The court ruling makes it more difficult for the populist Five Star Movement to gain an absolute majority, which is probably positive for the country's spreads, but it also raises the probability of political deadlock. Italy's banking problem is still unresolved, and the market would welcome strong leadership that seems unlikely to emerge.

Credit markets still locked into tight trading ranges, and it may take a decisive event for this to change. But there is no shortage of potential catalysts, and investors would be wise to monitor the early warning signals of sovereign CDS and implied volatility in credit swaptions.

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