Markit Recap – 11/27/2017

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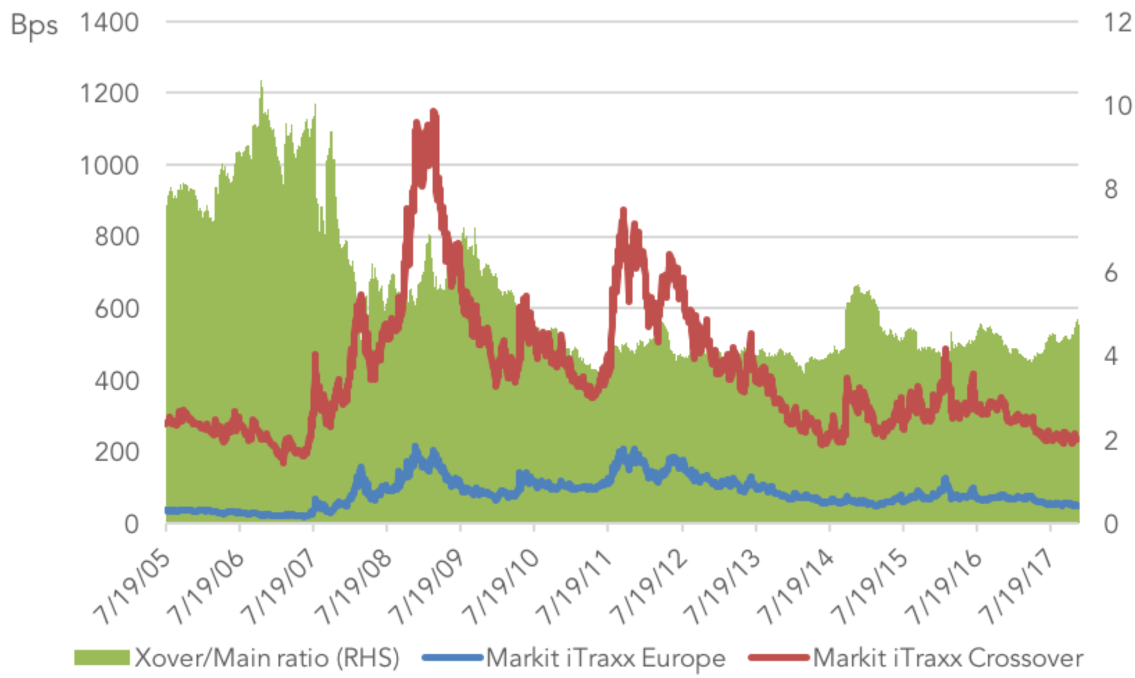
iTraxx Crossover underperforming?



Here in the UK there is no end of doom and gloom about Brexit and the state of the economy. One could be forgiven for approaching the end of 2017 in a bleak mood.

But the European investment grade market appears immune to this despondency; indeed, we are going into year-end in positively benign conditions. The Markit iTraxx Europe has closed tighter than 50bps over seven consecutive days, the first time it has done so in just over 10 years. Realized 20-day volatility on the index is at 23%, and this period of low volatility hasn't been seen since the pre-crisis days.

Perhaps the UK doesn't carry the weight in the world that proponents of Brexit assert. It is certainly clear that the upwards trajectory of the Eurozone economy, backed by loose monetary policy, far outweighs any political concerns.

It is worth noting, however, that the picture outside of highly-rated credit isn't quite as rosy. The Markit iTraxx Crossover index has indeed tightened in recent weeks, from 250bps to 230bps. But this is still wider than the 223bps reached earlier in November and the 222bps level prior to the index roll in September.

A number of names in the Crossover, particularly Astaldi and Altice, have been under intense pressure. Italian firm Astaldi's CDS widened dramatically amid uncertainty over its financial policy and debt reduction efforts. Its CDS went from 12 points upfront to over 50 points in the space of less than a month and its credit curve is now steeply inverted, indicating high near-term probability of default. Altice is not in such dire straits, but the spread widening from 250bps to over 400bps during November is significant. The credit deterioration follows disappointing results and concerns over its balance sheet strength.

The idiosyncratic risk supplied by these credits has no doubt contributed to the Crossover's underperformance. The ratio between the Crossover and Main hit 4.87X in November, the highest level since March 2015 and up from the 3.8X level reached earlier this year. This is noteworthy, but it also needs to be placed in a historical context. Prior to the financial crisis the ratio was consistently in the range of 7-10X and since 2011 it has general been in the 3-5X range.

In the heady days of 2005-2007, investment grade spreads were compressed by synthetic activity, which helps explain the large differential with Crossover. Given that rampant CSO issuance is unlikely to return in the foreseeable future, it will take a major increase in the default rate to push the ratio to levels anywhere levels seen 10 years ago.

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