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Markit Recap – 1/22/2018

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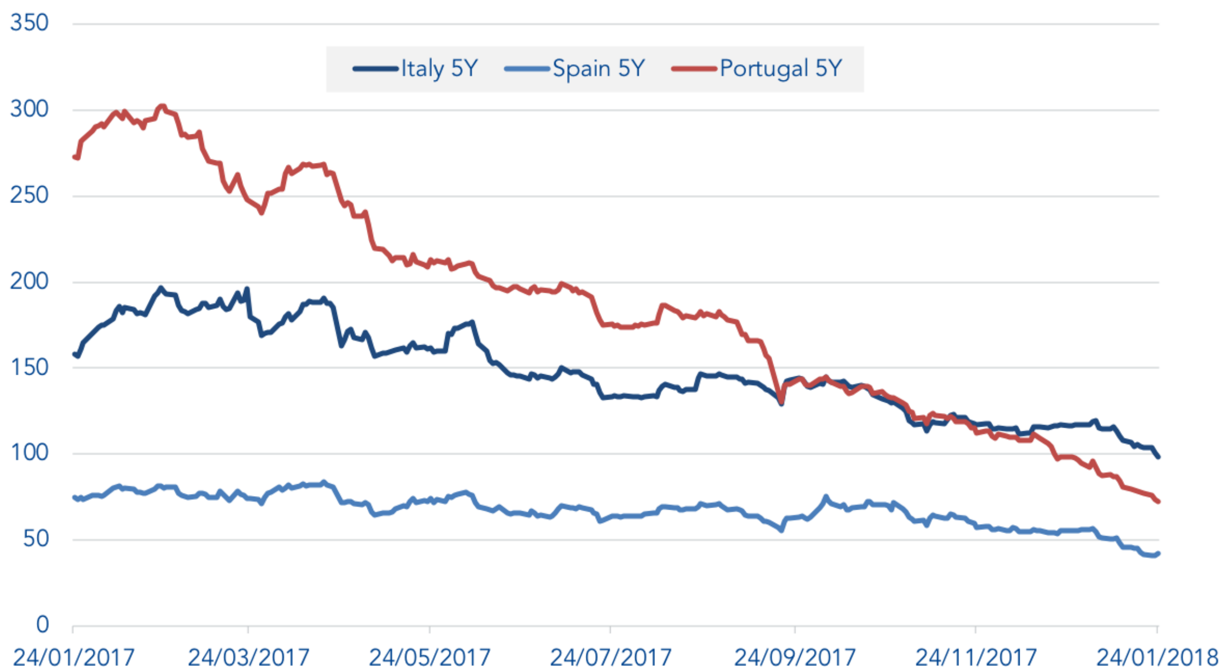
Eurozone periphery CDS rallies



It's that time of year again when plutocrats and power brokers meet in Davos for the World Economic Forum. In recent years this congregation of the great and the good has had to fend off accusations of being out of touch with ordinary people, perhaps not without reason. But there is little doubt in 2018 that the gathering is in tune with the mood of the markets, with optimism being the buzz word in Davos and in financial institutions.

The IMF upgraded its forecasts for 2017, 2018 and 2019, predicting global growth of 3.9% this year and next. IHS Markit Chief Economist Nariman Behravesh is also bullish, highlighting the strength and synchronicity of the global expansion, as well as the low probability of large shocks.

Is this optimism reflected in credit markets (or is the causation the other way around?). Current CDS levels suggest so. Both the Markit iTraxx Europe and Markit CDX.NA.IG have consolidated their strong rallies in Q4 last year, and both indices are now at their tightest levels since 2007. A strong start to earnings season in the US has helped the CDX outperform its European counterpart this year.

Optimistic economic forecasts and evidence of improving profitability; it's not hard to justify the spread compression witnessed recently in corporate credit. But it is the rally in sovereign spreads that is perhaps more noteworthy, particularly in the eurozone's periphery. Italy, where an election in March has the potential to dampen optimism, has seen its five-year spreads tighten from 120bps at the beginning of this month to 98bps only three weeks later. This is the first time in two years that they have dipped below 100bps (under 2014 definitions). The populist Five Star Movement is leading in the polls but has since toned down its anti-euro rhetoric. It appears unlikely to win an outright majority.

Spain and Portugal have also made gains. The former sovereign's five spreads are now trading at a paltry 42bps, while the latter is quoted at 72bps: a remarkable recovery given that it was trading at 300bps less than a year ago. Even the UK, with all its self-inflicted Brexit wounds, is trading at 15bps – 25bps tighter than the levels reached immediately after the referendum result.

Optimism is clearly the order of the day, whether you are sitting in Davos or on a CDS trading desk. But complacency cannot be allowed to set in. The IMF, who released the bullish growth forecasts, has a patchy record on forecasting (anyone remember 2007?). The same organization also published an interesting working paper this week that highlights one of the main risks to global growth (notwithstanding Trump's unpredictability, protectionism, China debt etc). It was titled "Economic Convergence in the Euro Area: Coming Together or Drifting Apart?" .The conclusion is that the euro area economies have not converged as expected, highlighting Germany's continued divergence and the lack of policy tools to manage business cycles, in particular a common fiscal policy. Improvements have been made but the institutional failings in the Eurozone are still there. Accommodative monetary policies have hid the weaknesses, but unless Germany and France grasp the nettle the fault lines will again come to the surface.

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