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Markit Recap – 6/11/2018

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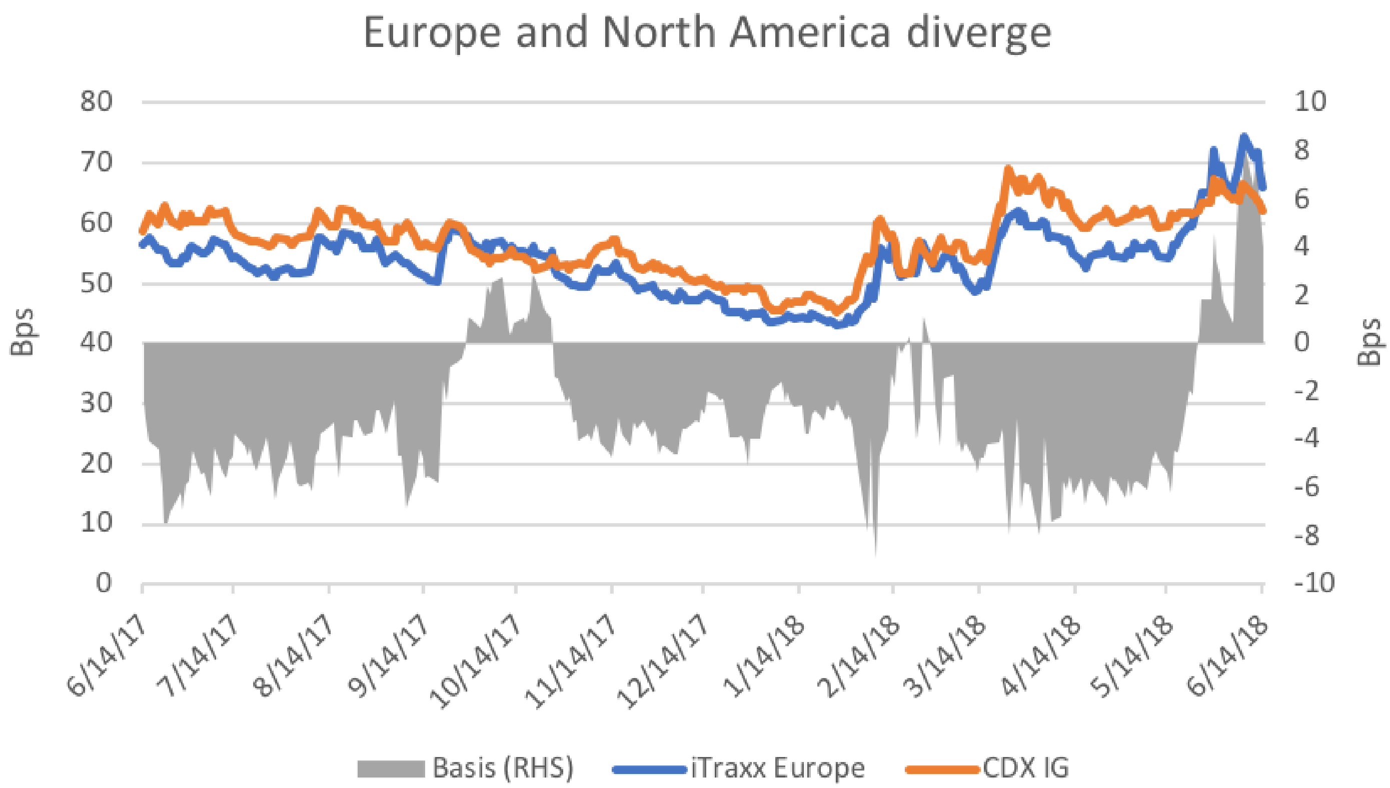

In the political sphere, Europe and North America appear to be going on separate ways since the election of Donald Trump, as was evident in the recent G7 talks. In the credit world, however, they are closely correlated, reflecting the global scope of corporates on both sides of the Atlantic.

But the two markets don’t always move in tandem. The recent political turmoil in Italy was the catalyst for a reversal in the usual relationship between the Markit iTraxx Europe and Markit CDX.NA.IG indices. Over the past year, the North American index has typically been trading between 2bps and 9bps wider than its European counterpart, apart from a few short periods. But the spike in European spreads – driven by the Italy situation and a spillover into financials – led to the iTraxx Europe trading as much as 8bps wider than the CDX IG.

A perceived stabilisation in Italy, helped by some soothing comments on the euro from the new economy minister, has led to a partial recovery in the sovereign’s spreads. Italy’s five-year CDS are trading around 220bps, significantly tighter than the 28bps reached on May 29. Banks duly took their cue from the sovereign – the EU banking union is incomplete – and rallied, particularly in the subordinated tier. This provides support to the broader market and the iTraxx Europe is now trading just 4bps wider than the CDX IG.

Monetary policy is another area where the US has diverged from Europe. So the news that the ECB plans to phase out its QE programme by the end of the year – aligning it with the US, where normalisation of policy was implemented some time ago – would normally be interpreted as a hawkish move. But Mario Draghi couched the announcement in dovish language and added some important caveats, crucially that the withdrawal of purchases will be conditional on the medium-term outlook. Draghi made it clear that this may not be the end of QE – it remains very much part of the monetary policy toolkit. This assuaged fears that the central bank will dogmatically tighten policy, a mounting concern given the recent disappointing economic data and political uncertainty.

On the last point, it should be noted that even though Italy's spreads have partially recovered, they are still some way off the levels before the emergence of the populist coalition government. The CDS market is pricing in uncertainty – the fragility of the current administration is all too evident and its policy programme still puts it on a potential collision course with the EU. A default remains unlikely, so some participants may view a long risk position through the CDS market as an attractive trade. But the ISDA basis – which largely represents redenomination risk – is still around 100bps, suggesting the markets have not discounted the possibility of Italy leaving the euro. A continuation of volatility in Italian credit, generated by incendiary newsflow from the government, would be no surprise.

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