Markit Recap – 10/22/2018

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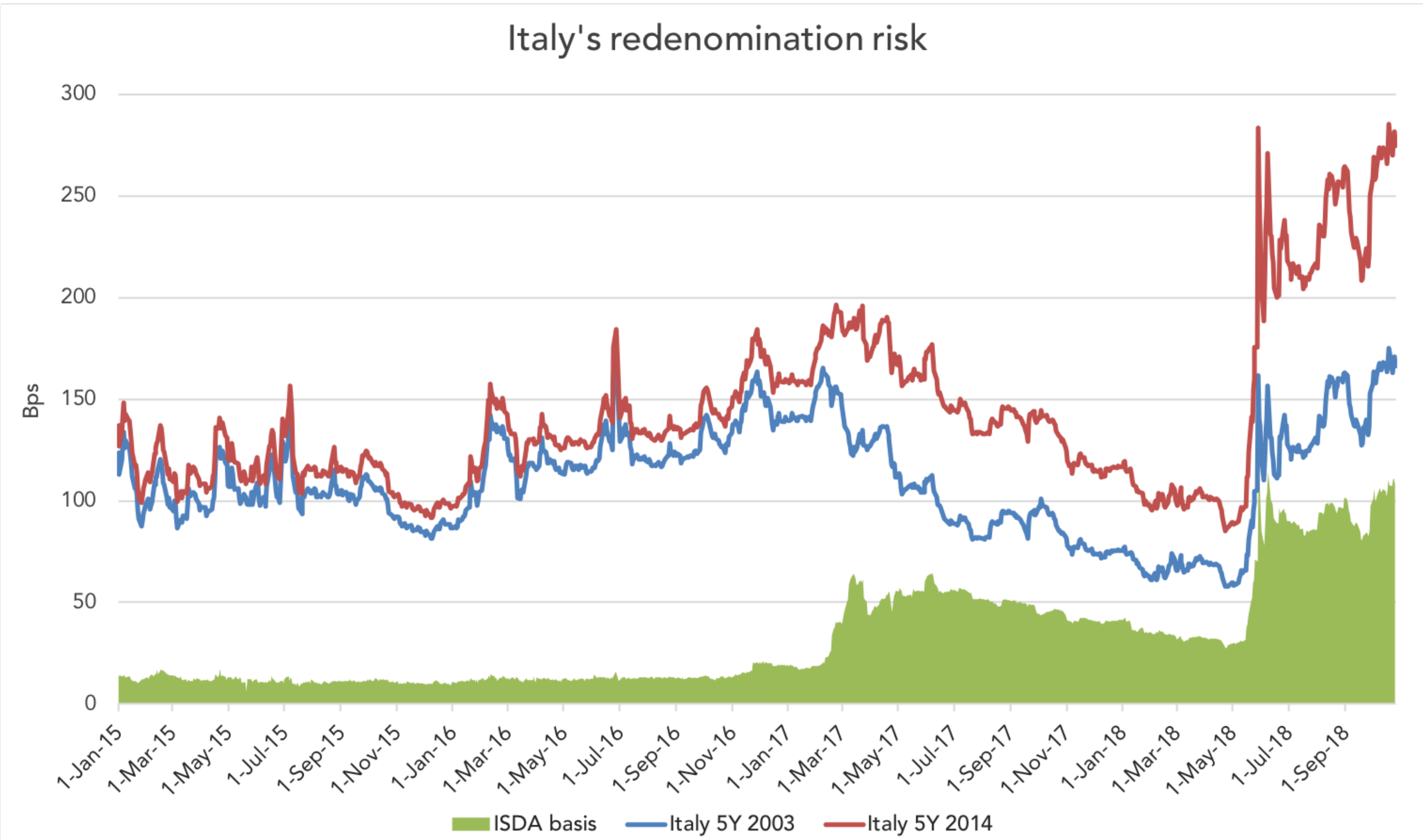
Chart



Mario Draghi, in a press conference confirming that market rate expectations were intact, stated that the risks to the eurozone's economy are "broadly balanced". His view may have merit, but there is little doubt that the situation is looking more precarious than a few weeks ago.

If negative sentiment does permeate the market and spark a comprehensive bout of risk aversion, it could be Draghi's home country that acts as a catalyst. The European Commission took the unprecedented step of rejecting Italy's draft 2019 budget, citing the government's planned 2.4% deficit for next year as non-compliant with EU rules. Italy's populist leaders were typically bullish in their response and show little sign of compromise.

It is clear that the EU is relying on the bond markets to apply pressure on Italy, and the oft cited Bund-BTP spread will be closely watched. But the more astute investors will also be monitoring the CDS market, in particular the basis between sovereign spreads based on 2003 and 2014 definitions. This can be viewed as a proxy for redenomination risk as the 2014 contracts cover a eurozone exit and subsequent redenomination as a credit event trigger, while the 2003 terms include a clause excluding G7 countries. The basis has been over 100bps throughout October, the longest period since the introduction of the definitions in 2014.

But it would take a drastic deterioration in relations between Italy and the EU to even contemplate a euro exit scenario. Italy's banks are heavily exposed to sovereign risk through their holdings of government bonds and the latest contretemps has had a marked impact on the sector's credit standing. Contagion in the other peripheral countries such as Spain and Portugal has been limited, suggesting that the market has faith in the EU's ability to backstop the integrity of the euro.

We know from the sovereign debt crisis of 2010-2012 that the ECB's role was crucial. It will be again, though it is obvious that Italy will be much harder to coerce than Greece. It is far larger, in better fiscal shape and the government will want to continue riding the populist wave into the European Parliament elections next year. These conditions make a compromise a likely scenario, as neither will gain from an intensified conflict, particularly when the ECB is preparing to withdraw QE. But the path to an agreement where both parties can save face will probably be a rocky one and the ISDA CDS basis should be one of the key indicators for investors during this tumultuous time.

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