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Markit Recap – 10/20/2014

THE LEAD | October 22, 2014

If there was any doubt that credit markets are dependent on central banks for their sustenance, then events this weeks would surely have laid them to rest.
All it took was a report that stated the ECB is considering buying corporate bonds in the secondary markets, possibly as soon as the first-quarter of next year. The report cited sources “familiar with the situation”, and a later news story denied that the ECB was placing corporate bond buying on the agenda for its December meeting.

Despite the dubious provenance of the report, it was enough to trigger a rally in risk assets. The Markit iTraxx Europe, which widened to over 80bps last week, tightened to 68bps on October 22. The ECB started its programme to buy covered bonds earlier this week, and will also commence the purchase of ABS later this year. Combined with the targeted LTROs and negative deposit rates already announced by the central bank, it seems clear that Mario Draghi and his fellow governors are trying to stimulate the eurozone economy and fight deflation. However, there are major question marks on the ECB’s ability to expand its balance sheet without buying government bonds, a measure that remains controversial in the corridors of power in some European countries.
The fate of the eurozone’s ailing economy, and the policies undertaken to tackle the malaise, should have the biggest influence on spread direction in the coming months. But in the near-term, Europe’s banking sector will be under scrutiny with the announcement of the ECB’s Asset Quality Review and the EBA’s stress test results. Several banks are rumoured to have failed the tests, though it should be remembered that some of the tests were taken at a snapshot at the end of 2013. Many banks have raised capital in the meantime, and the headlines engendered by the “failed” institutions may not give a true reflection of the state of the sector today.

If the tests are viewed as credible, then the results on October 26 could prove cathartic for the European economy as a whole. But it will also pose questions on whether the troubled banks can raise capital without the assistance of the state. If governments have to get involved, then it is likely that bondholders could also share the burden. The key indicators to watch during this crucial time are the Markit iTraxx Senior Financials and the Markit iTraxx Subordinated Financials indices.

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