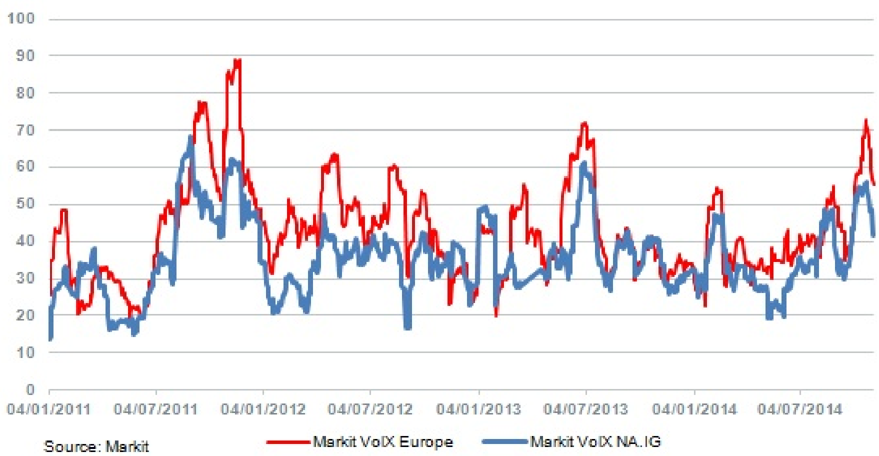
Markit Recap – 11/3/2014

THE LEAD | November 5, 2014

It is apparent to all market participants that volatility, so long dormant in this QE-saturated era, has returned in recent weeks.

The credit asset class is no exception. The Markit VolX Europe, which measures realised volatility in the Markit iTraxx Europe index, reached its highest point since the "taper tantrum" last year and was approaching levels seen during theeurozone sovereign crisis in 2011. North American volatility, as measured by the Markit VolX NA.IG, also rose, though it remains significantly lower than its European counterpart. The presence of financials in the Markit iTraxx Europe, as well as the less favourable economic outlook, no doubt lay behind the basis. Investment banks welcomed the positive effect of volatility on fixed-income profits in the third-quarter, but some were more successful than others in reaping the benefits.



There are several reasons driving the increase in volatility. Geopolitical risk, mainly in the form of the simmering conflict in eastern Ukraine and the potential for a further deterioration in relations between Russia and the West, is a factor. But the worsening European economic climate referred to above is probably a more powerful instigator of volatility. Deflation is looming, a scenario that was studiously ignored in the recent bank stress tests. If the ECB is unable – or unwilling – to prevent prices from falling, and Germany refuses to increase move away from its reliance on external demand and increase domestic consumption, then deflation may well set in. Such an outcome will be highly damaging for the region's banks, and will probably result in Europe continuing to show higher volatility than the US.

Will volatility extend through until year-end? The last couple of months are traditionally strong for risk assets, and it would be no surprise to see spreads grind tighter in a relatively narrow range. The VolX in both Europe and North America has dropped in recent days. But the ECB has the power to change sentiment decisively, and if the newsflow indicates that the central bank is unlikely to implement full QE – purchases of government bonds – then we could see further oscillations in spreads.

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