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Markit Recap – 2/16/2015

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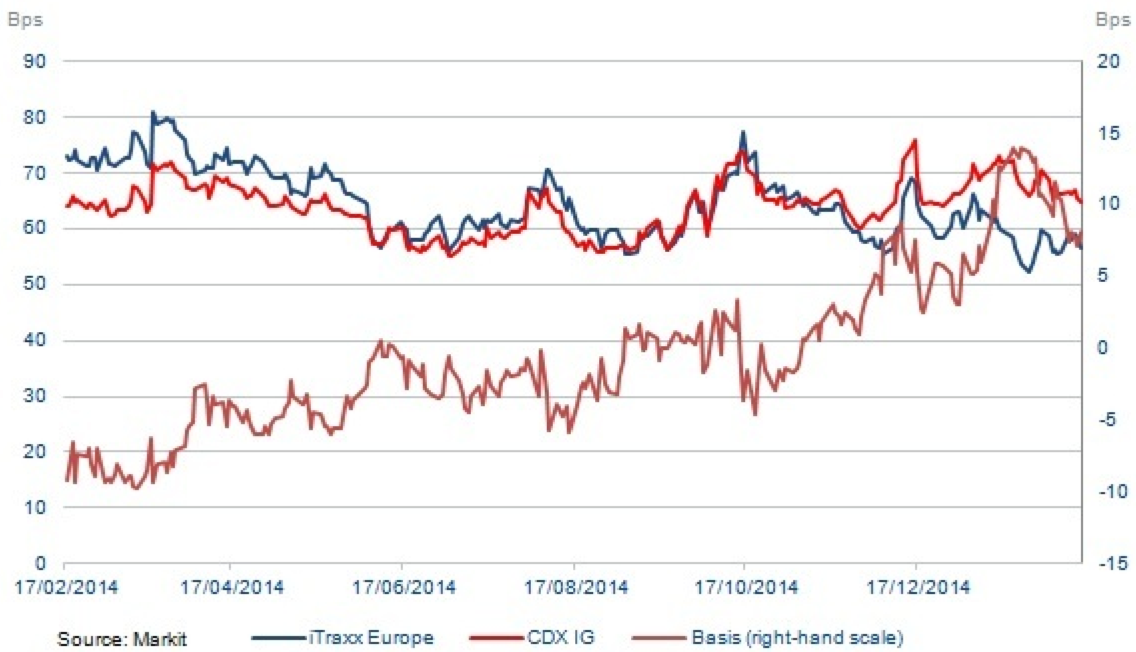
European investment grade credit has comfortably outperformed its US counterpart over the past 12 months. Based on the differing fortunes of the respective economies in the two regions, this might seem surprising. But the basis between the Markit iTraxx Europe and the Markit CDX IG indices demonstrates the trend quite clearly.



In the first-quarter of 2014, the European index was trading up to 10bps wider. The basis gradually narrowed throughout the year, and by the fourth-quarter and in the initial weeks of 2015 the Markit iTraxx Europe was trading well over 10bps tighter than the Markit CDX IG. Compositional effects probably account for a significant portion of the divergence. US credit is more heavily exposed to energy exploration and production, and the precipitous decline in the price of oil can have negative impacts for certain names, if not for the broader economy.

But in recent days the trend has gone into reverse. The basis has shrank from 12bps to 6bps as US credit rallied and Europe lost ground. It is more than likely that the uncertainty around Greece is weighing disproportionately on European credit. There was a flickering of contagion after Greek Prime Minister Tsipras made a defiant speech earlier this month, and risk aversion can flare up following news of the continued impasse between Greece and its European creditors.

However, this needs to be kept in context. Spread widening has been limited – at 58bps the Markit iTraxx Europe is only 8bps wider since the beginning of February. The ECB‘s full QE programme will surely act as a compressing factor, particularly for names at the lower end of the credit spectrum. The chase for yield may get even more competitive.

The conventional wisdom is that a deal will be reached on Greece, even if it is only a short-term agreement for the next few months. This remains the most likely scenario. But the probability of a disorderly exit from the euro is certainly higher than it was last year, and the hedging of tail risk is no doubt driving some of the recent volume in the main index. Investors may also be using CDS index options as a cheaper method of protecting against a “Grexit”.

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