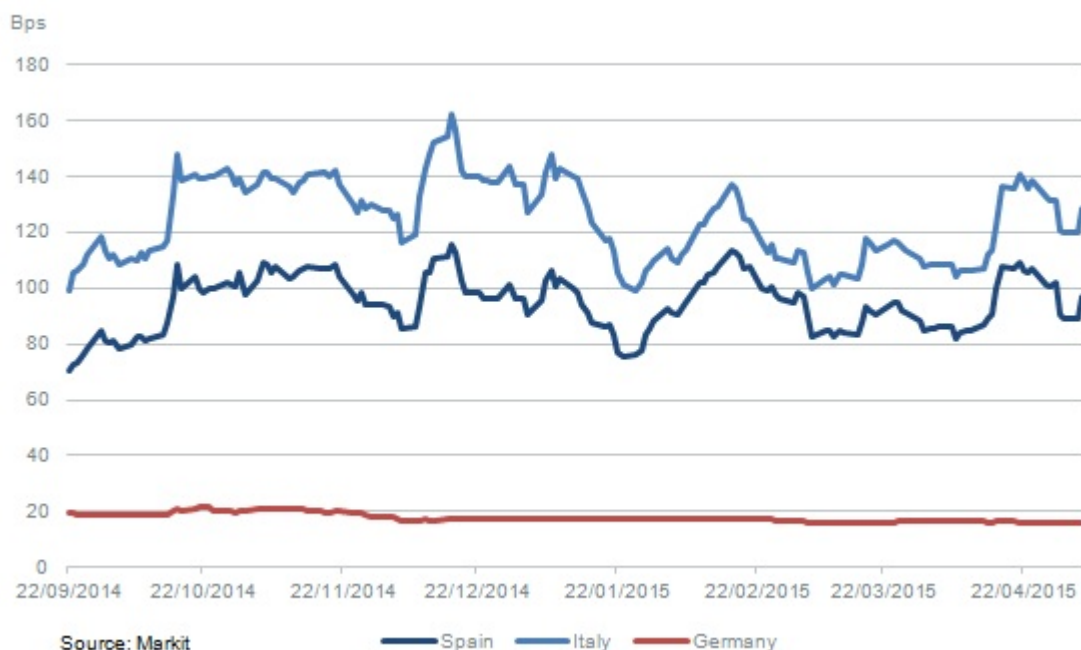


Markit Recap – 5/4/2015

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It wasn't so long ago – in fact, less than three weeks ago – that the big story in European financial markets was very low, or even negative, government bond yields. Germany's 10-year bunds were trading below 0.05% in mid-April, while bonds in the eurozone's periphery were quoted at significantly lower yields than the US.



With the exception of Portugal, this is still the case. But in recent weeks there has been a marked reversal in sovereign bonds. Germany 10-year yields are now at 0.69%, not high in absolute terms, but nonetheless a dramatic percentage move. The comparable Spanish bonds were yielding 1.15% in March; now they are at 1.91%, their highest level this year.

The conventional wisdom was that the ECB's QE programme had ushered in an era of negative, or close to negative, rates. But inflation expectations seem to have readjusted, no doubt helped by the sharp increase in the price of oil. A barrel of Brent crude now costs \$68, more than \$20 higher than the bottom it reached in January. Tentative optimism on the eurozone's economy may also have played a part.

However, it is likely that the bugbear of the bond markets – liquidity – contributed to the fluctuating yields. The ECB's overwhelming intervention reduces supply and could make the market more susceptible to volatility. Prudential regulation is making banks cut their bond inventories, adding to the fragile secondary market conditions.

And bonds are not the only asset class affected by regulatory change. CDS are also significantly less active than they once were, particularly in western European sovereign names, where the EU ban on naked short positions has led to many buy-side participants exiting the market.

But many banks use sovereign CDS for CVA (counterparty credit risk) hedging, and the names remain among the most liquid in the market. The instrument provides a valuable service in this regard, but it may also make them less reliable as a pure arbiter of sovereign credit risk. Germany's 10-year CDS spreads have barely budged from the 35-36bps range over the same period that Bund yields were swinging wildly. Spain's spreads are trading at 93bps, 10bps wider than March levels. This is not an insignificant move but is certainly nothing out of the ordinary.

Unsurprisingly, the CDS bond-basis in western European sovereigns has shifted. Germany always has a positive basis as is bonds trade with negative asset swap spreads, but the 10-year basis has still moved from 60bp down to 50bps, its lowest this year. Spain's positive basis has shrunk from 50bps to 30bps. The volatility in the basis is largely down to the oscillations in the bond, rather than CDS, market, and it would be no surprise if we see further such episodes in the near future.

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