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Markit Recap – 6/27/2016

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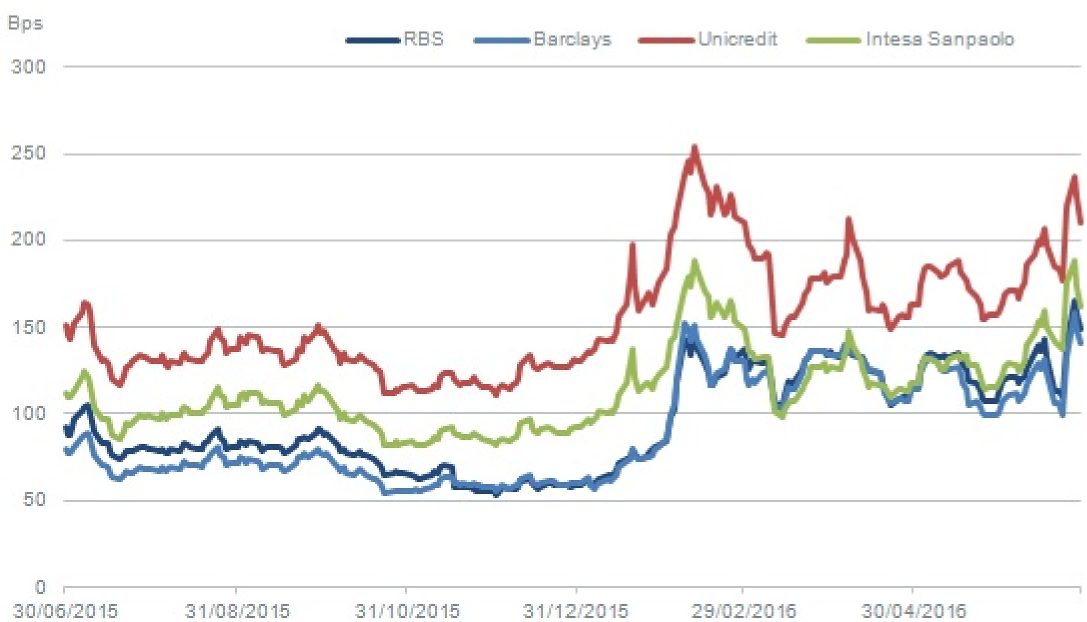
Those of us who stayed up to watch the Brexit television coverage knew that in a few hours' time the June 24 trading session would go down in history. The mainstream media were inevitably obsessing about the post-Brexit collapse in sterling, but the credit markets were focused on the Markit iTraxx indices. Big moves were expected by market participants, and they weren't disappointed.

The Markit iTraxx Europe opened the day at 75bps; it closed at 95bps, a widening of 26%. To put this in perspective, the move in the index after the Lehman failure was 22% (September 15 2008) and 18% immediately prior to the first Greek bailout (May 7 2010). The Markit VolX Europe, which shows realised volatility in the iTraxx Europe, was indeed at its highest level since Greece was forced into the hands of the Troika.



The magnitude of the moves is striking when placed in a historical context. But the subsequent days following the seismic impact of the Brexit referendum result suggest that we are in slight calmer waters. The Markit iTraxx Europe had recovered to 84.5bps by Thursday, just 8bps wider than where it started the year. As recently as February this year, the index was trading in excess of 125bps.

So, it seems that credit markets are not retreating to the panic room, at least not yet. Why is this time different from previous crises? We have credible commitments from central banks to do "whatever it takes" and the financial system is better capitalised (though few would say it is completely robust). Changes in OTC market structure have helped internalise systemic risk, with the caveat that the recovery and resolution of CCPs is still to be adequately determined.

But politics caused this crisis, and it is more than likely that political factors are tempering the credit deterioration. The view that Brexit may be delayed by the new Prime Minister, or even taken off the agenda entirely, is gaining traction. Given the rhetoric from both the Brexiteers and EU leaders, this seems far-fetched. But the enormity of the implications of the result is now setting in, both for the politicians and the electorate. A fresh general election, which could serve as a proxy second referendum, cannot be ruled out.

UK banks are clearly suffering from the uncertainty, and their spreads hit new wides for this year. Italian banks also spreads blow out, though the damage was limited by the Italian government providing liquidity support through government guarantees. This was approved by the European Commission under “extraordinary crisis rules for state aid”. More than anything else, the EU fears Brexit leading to contagion through the currency bloc. The narrow vote for the UK leaving the EU could yet lead to another, more serious phase in the eurozone crisis, and the ECB and Commission will do their utmost to prevent this happening.

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