Markit Recap – 7/28/2014

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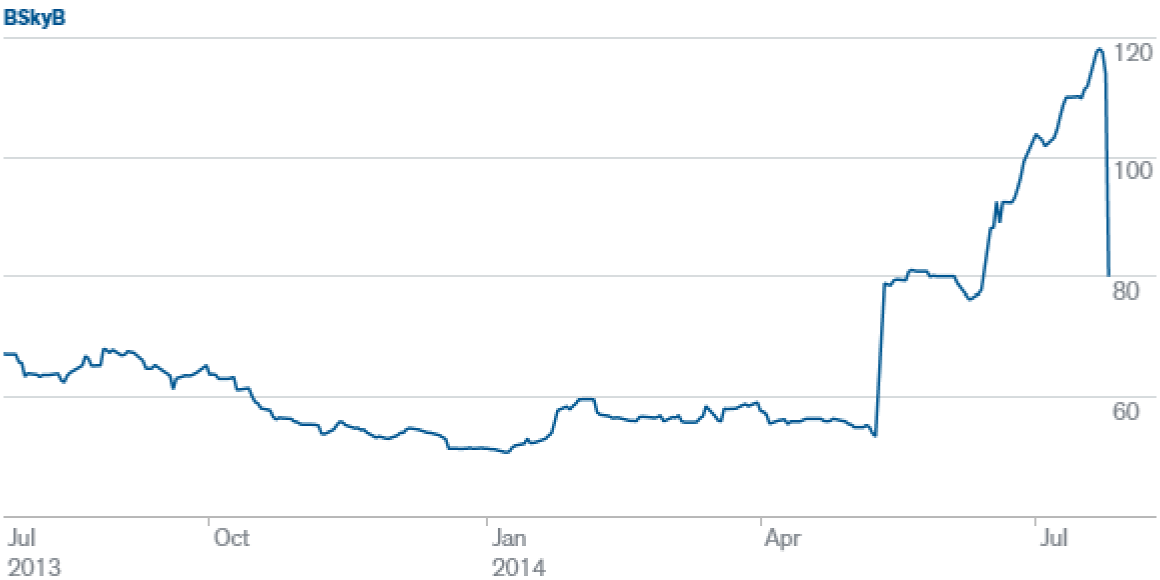
A company's credit rating gets placed on review for downgrade, and its CDS spreads stage their biggest one-day rally on record? This appears like a contrarian market reaction, regardless of one's views on the rating agencies and their performance in recent times.



But that is precisely what happened on July 25 in the case of BSkyB. The UK pay-TV firm agreed to acquire Fox's stakes in Sky Italia and Sky Deutschland for about £5.3bn, financed through a combination of cash, asset sales, new debt and stock. According to BSkyB management projections, the firm's net leverage will climb to 2.9X-4.0X from the current c.1.0X.

So BSkyB's financial position will clearly weaken post-transaction. And yet its CDS spreads rallied from 114bps to 80bps, a massive daily move for an investment grade credit. How can this be explained? It seems that expectations have a major part to play. The market expected that BSkyB's IG rating would be in danger from the deal, which has been mooted for some time. But the company's management said that they expect IG ratings from S&P and Moody's, even if all of the credit negative contingencies in the deal are realised. Moody's subsequently placed BSkyB's Baa1 rating on review for downgrade, but crucially said that the rating would only be cut by up to two notches. The probable retention of its investment grade rating was no doubt a major factor driving BSkyB's rally.

Even if the British company was downgraded to junk, it wouldn't have lost access to capital markets. Far from it -the sub-investment grade market has boomed this year, and firms will weak credit quality have had little problem in selling debt. But talk of a bubble in high-yield, particularly in the US, has ratcheted up recently. Money has been flowing out of HY funds at an increasing rate over the last two weeks, though this appears to driven by retail investors closing out ETF positions.

There is no questioning the hot conditions in the primary market, and spreads in the HY CDS market are at their tightest levels for years. The Markit CDX.NA.HY is around 320bps (spread basis), some 120bps tighter than the 2012 end-of-year level, but slightly wider than where it started this year. In Europe, the Markit iTraxx Crossover is at 249bps, 37bps tighter than the 2013 end-of-year level. The outperformance of European HY compared to its US equivalent is probably due to the differing outlooks for monetary policy. European markets are expecting the ECB to ease further and possibly introduce QE, while the Federal Reserve is tapering QE and is forecast to raise rates next year.

The glut of liquidity created by unconventional monetary policies has almost certainly fuelled demand for high-yield debt, as well as other asset classes. We can expect talk of bubbles to be a fixture in the financial discourse in anticipation of the interest rate cycle turning.

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