Markit Recap – 6/26/2017

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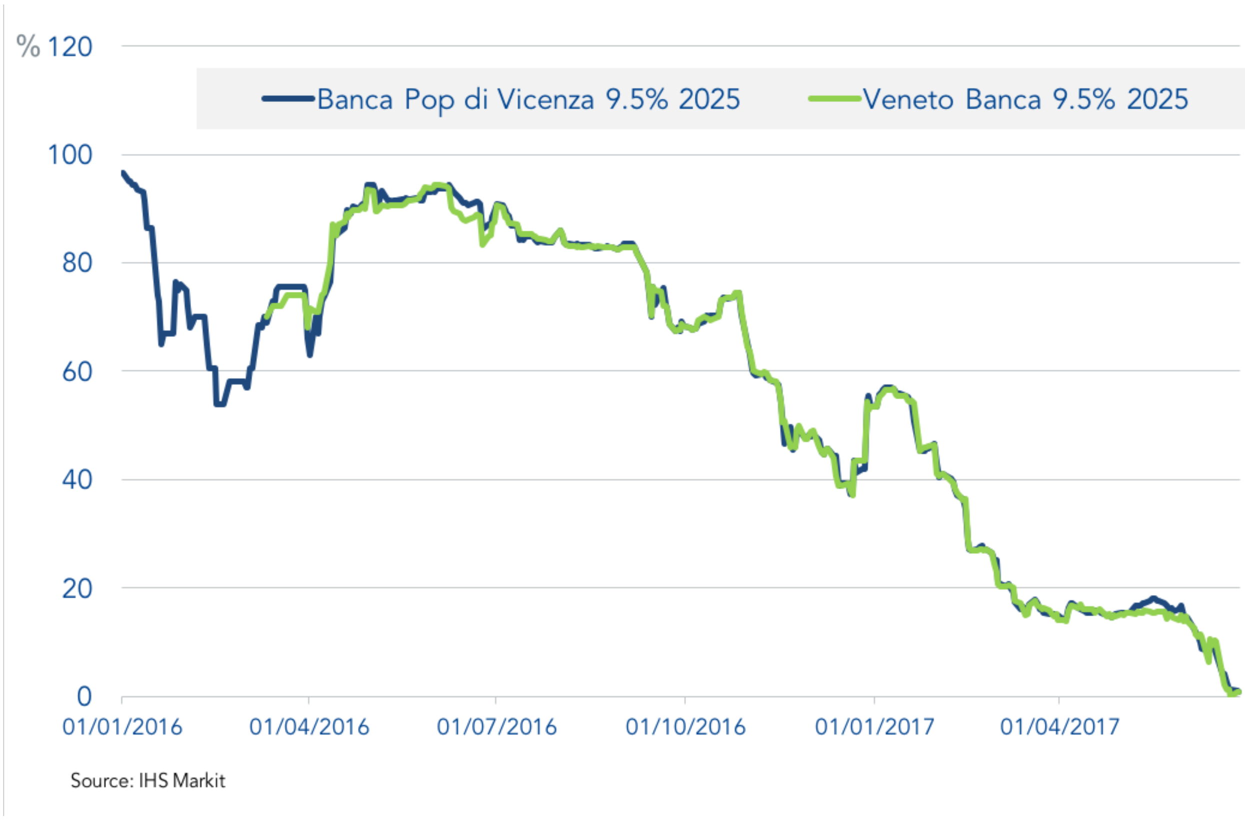
Italian bank sub paper now worthless



We noted last week that investors need to be aware of idiosyncratic risk and not be lulled into complacency by the languid market conditions. Monetary policy surprises were also highlighted as potential events that could disrupt the somnolent summer.

Both of these factors materialised this week in Europe, and yet spreads barely budged. Granted, the Markit iTraxx Europe did widen by 1.25bps on June 27, only the sixth time in the last three months that the index has given up more than 1bp (itself indicative of the extant low volatility). But the current level of 54.5bps is still more than 20bps tighter than where the index hit in mid-April, and the iTraxx Europe is trading 7bps inside its US counterpart, the Markit CDX.NA.IG.

So what were the drivers of sentiment this week, and why did they have so little impact? On the central bank front, we had comments from both the ECB president and the Bank of England governor, suggesting that policy was on a tightening trajectory. Mario Draghi highlighted reflationary forces replacing deflationary ones, while Mark Carney said that rates could rise if higher business investment compensates for weakening consumption.

But the ECB clarified the following day that Draghi’s remarks were misinterpreted by the markets. Carney’s comments, meanwhile, contained his usual caveats about wage stagnation and Brexit, indicating that he hasn’t become a hawk overnight. By the close of play on June 28 spreads had recovered and were marginally tighter.

Earlier in the week we had two more banks collapsing, following on from Banco Popular Espanol (BPE). This time the culprits were Italian – Veneto Banca and Banca Popolare di Vicenza. However, though the Spanish bank’s “rescue” was held up as a textbook resolution under new rules in the EU Banking Union, this Italian job was more reminiscent of the old days of state-backed bailouts.

Subordinated bondholders were bailed-in and this was expected, as can be seen be seen by prices in the 2025 paper issued by both banks declining this year and eventually falling to zero (data from Markit Price Viewer). But the similarities with BPE end there. The Italian banks were taken into liquidation, rather than resolution, meaning that the national authorities have responsibility (not the pan-EU SRB for resolutions). Intesa Sanpaolo has taken on the “good” assets of the two banks, while senior bondholders and depositors will emerge unscathed. The former might not have been so fortunate under a resolution. Ultimately, this is a bailout driven by political pragmatism; damaging retail bondholders would have been toxic and bailing-in senior debt could have had systemic effects.

Monte dei Paschi’s rescue, if and when it eventually happens, will likely go down the route of precautionary recapitalization, which again involves state aid. Perhaps the problematic Italian banks are an obstacle to the functioning of the banking union, and the structure will be more credible after they are cleansed. But there are reasons to think that European taxpayers remain on the hook and the sovereign/banking negative feedback loop hasn’t been broken.

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