Markit Recap – 9/29/2014

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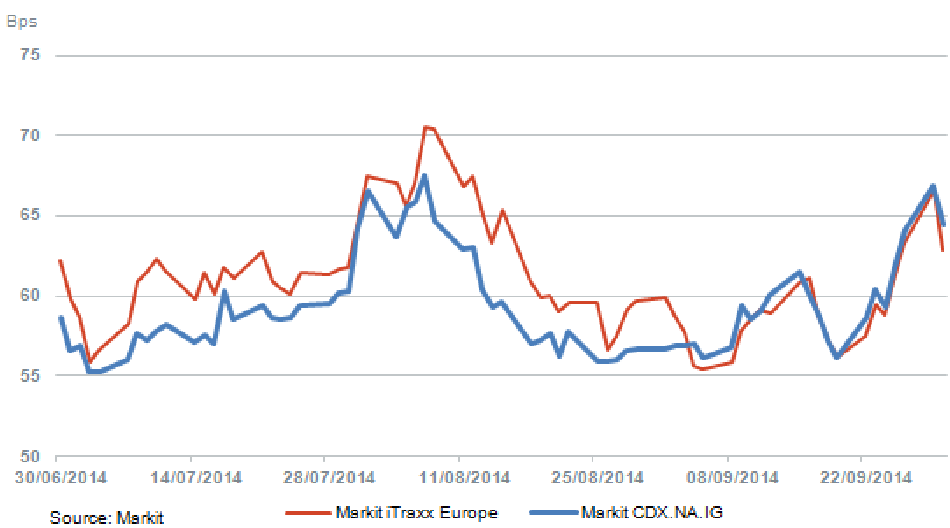
Credit markets are now accustomed to low volatility, but there were signs over the third-quarter that the climate is changing.

North American CDS, as represented by the Markit CDX.NA.IG index, traded in a relatively broad range during the quarter. The index hit 55bps in early July, its tightest level since October 2007. But it soon began to widen and little more than a month later was trading at 67bps. The European equivalent, the Markit iTraxx Europe, followed a similar pattern and traded in a 56-70bps range.



The first spell of widening was triggered by geopolitical risk, predominantly the conflict in Ukraine. Technical factors may have played a larger role in the second reversal during the latter part of September. The mere presence of quarter-end may have prompted participants to take risk off the table, as is often the case. The departure of fund manager Bill Gross form PIMCO may also have caused some volatility in both cash and derivatives markets.

That’s not to say fundamentals were irrelevant. Geopolitical risk is omnipresent, from the recent referendum in Scotland, to the protests in Hong Kong and the upcoming Brazilian elections. Emerging markets have experienced a tough third-quarter, and remain vulnerable to negative news flow.

But monetary policy remains the key driver of risk appetite, and some investors will no doubt see the recent reversal as an opportunity to increase long positions. The Federal Reserve may be tapering its quantitative easing programme, but the clamour for the ECB to start its own government bond purchase is growing. Deflation is a real concern for European policiymakers, and if the ECB responds with further measures to expand its balance sheet, history tells us risk assets should benefit.

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