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Markit Recap – 1/19/2015

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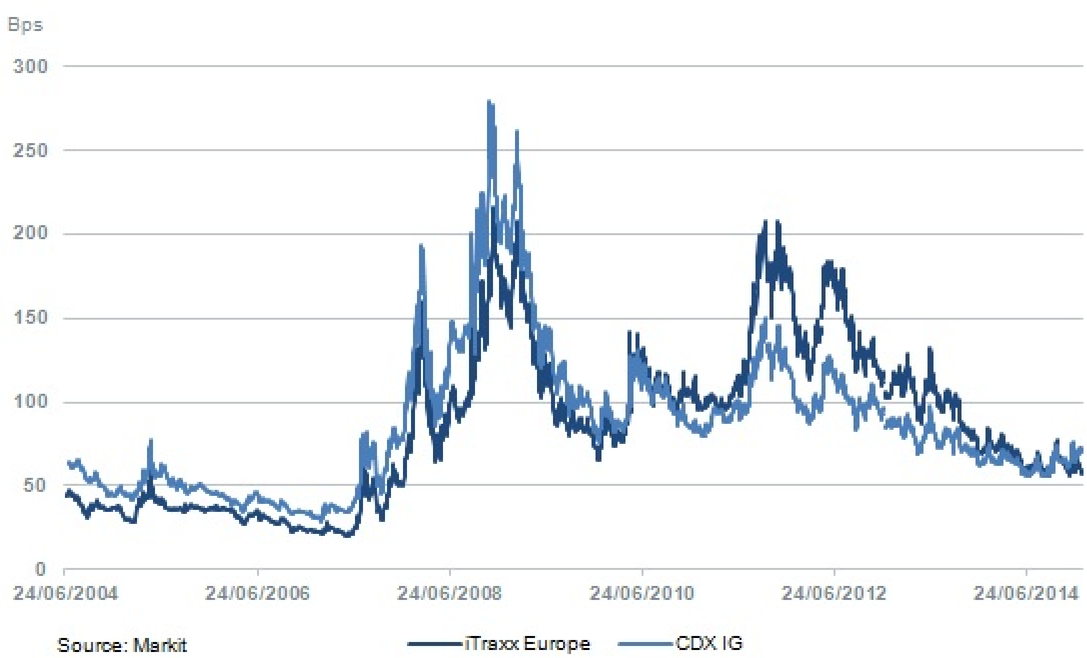
Commentators on the financial markets can sometimes be prone to hyperbole, but it is surely no exaggeration to state that the next few days are crucial in determining sentiment for 2015 and beyond.

First up is the ECB, and the expected QE announcement. But, although the central bank is "expected" to declare its intention to buy securities, at the time of writing there is still some uncertainty on the details of the plan. Reports indicate that the ECB will purchase €50bn in bonds every month until the end of 2016. If true, this will exceed the consensus expectation of a €500m-750m programme, and should receive a positive reception in the credit markets.



As well as size, other components of QE are up in the air. The issue of risk sharing among the member countries is a sensitive one. Some of the creditor countries will probably try and push for part of the credit risk to stay with the national central banks. Full-risk sharing would be preferable to preserve the integrity of the euro, but this may not be feasible politically.

The composition of the purchases is also unknown. Government bonds will clearly make up the bulk of QE, though Greece and Cyprus may be excluded as they have sub-investment grade ratings. Other forms of public debt may also be included, and the addition of corporate debt would no doubt lead to credit spreads tightening.

Regardless of the form it takes, QE has been expected by the credit markets for some time. This is reflected in the relative performance of European and North American spreads. The Markit iTraxx Europe has tightened by 7bps to 56bps since the beginning of the year, while the Markit CDX IG has widened by 4bps to trade at 70bps. The basis between the two indices is now 14bps, which is the widest for five years.

Some participants have expected investment grade credit to outperform high yield, particularly if the ECB buys IG bonds. But we know from recent experience that QE pushes investors into riskier assets, so it is questionable that this strategy will prove profitable.

Volatility, which has flared up again in recent months, could also be suppressed by QE. The Markit VolX Europe, which tracks realised volatility, spiked higher in the last quarter due to concerns about falling oil prices, Russian instability and the impending election in Greece. The latter event could certainly cause disruption, but its effect could be dampened by the ECB’s probable balance sheet expansion.

Contact: Gavan Nolan

Gavan.Nolan@markit.com