Markit Recap – 3/16/2015

THE LEAD | March 18, 2015

It’s that time of the year again when CDS market participants turn their attention to technical, rather than fundamental, factors.

The Markit credit indices (iTraxx and CDX) roll every six months, and March 20 will see the first roll this year. This can result in significant dislocations between the tradable indices and their underlying constituents (often referred to as the skew) due to repositioning of trades into the new, more liquid indices.

We noted last week that the compression of spreads – no doubt driven by QE – had contributed to a rule change in the Markit iTraxx Crossover. Constituents now have to be trading at least 1.5 times the level of the Markit iTraxx Non-Financials, down from the previous threshold of 2.

But that isn’t the only change in this roll. The Markit iTraxx Financials index (both Senior and Subordinated) is expanding from 25 to 30 names. The rationale behind this change is the disproportionate size of financial bond issuance compared to other sectors and the relationship between cash and CDS indices. The Markit iBoxx EUR index, a widely used benchmark, has a far higher weighting of financials (40-50%) than the current Markit iTraxx Europe (20%). Banks and insurers issue significantly more debt than non-financial corporates, and this will be better reflected in the new Series 23 index.

Liquidity in the single name CDS market also plays an important part in constituent selection. Credits such as Swiss Re and Danske Bank are established names and have been heavily traded for some time, hence their inclusion in the new index. The index will remain at 125 names in total, with the consumers sector making the biggest contribution to the removed credits.

Aside from the rule changes, Tesco's "relegation" from the Markit iTraxx Europe to the Crossover may raise eyebrows. The beleaguered UK supermarket group was downgraded to junk in January, a move that didn't surprise the markets as it was trading with an implied rating of 'BB' well before the downgrade, according to Markit data.

Nonetheless, Tesco was regarded as a mainstay of the investment grade universe for many years and its fall from grace is still remarkable. It is joined in the Crossover by its main rival J Sainsbury. Both are struggling with cumbersome business models and competition from discount retailers.

Contact: Gavan Nolan
Gavan.Nolan@markit.com