Markit Recap – 6/15/2015

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There are many words synonymous with the European sovereign debt crisis, the portmanteau 'Grexit' being the most in vogue. But a word that was thought to have been banished by the ECB – contagion – has returned to the discourse this week.

Spreads in Italy, Spain and Portugal – the peripheral countries most exposed to Greece – have proved largely resistant to credit deterioration since the ECB announced its Outright Monetary Transaction programme in 2012. But in recent weeks we have seen signs that the central bank's cloak of safety may be wearing thin.

Portugal's CDS spreads widened to 202bps (2014 definitions), some 80bps wider over the last three months. CDS spreads for Italy have widened from 100bps to 133bps since early March, while Spain has gone from 82bps to 108bps. These are significant percentage moves, particularly in a low spread environment.

But they also need to be placed in historical context. Portugal was trading wider than 200bps in Q4 last year, when the latest flare-up in Greece started. Less than two years ago it was trading at over 500bps, and in 2012 it touched 1,500bps. The recent widening in Italy and Spain is even less notable – both were trading in the 600bps range in 2012.

So, it might be somewhat premature to declare that contagion is back. However, it is possible that the markets underestimating the risks emanating from Greece. The impasse between the Greek government and the EU/IMF has seemingly widened as both sides refuse to compromise – the Greeks on reforms and the creditors on debt restructuring.

At the time of writing, it appears unlikely that the Eurogroup meeting on June 18 will achieve the elusive agreement. An emergency summit over the weekend has been mooted, which may be the last chance to head off a default on the IMF payments due at the end of the month. If Greece fails to make the payment, this doesn't necessarily mean that an exit from the euro is inevitable. But we could see capital controls introduced as they were in Cyprus, and the inviolability of the euro will be in serious doubt. Maybe then we will see real contagion, and peripheral sovereign CDS will be the indicators to watch.

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