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MARKIT RECAP

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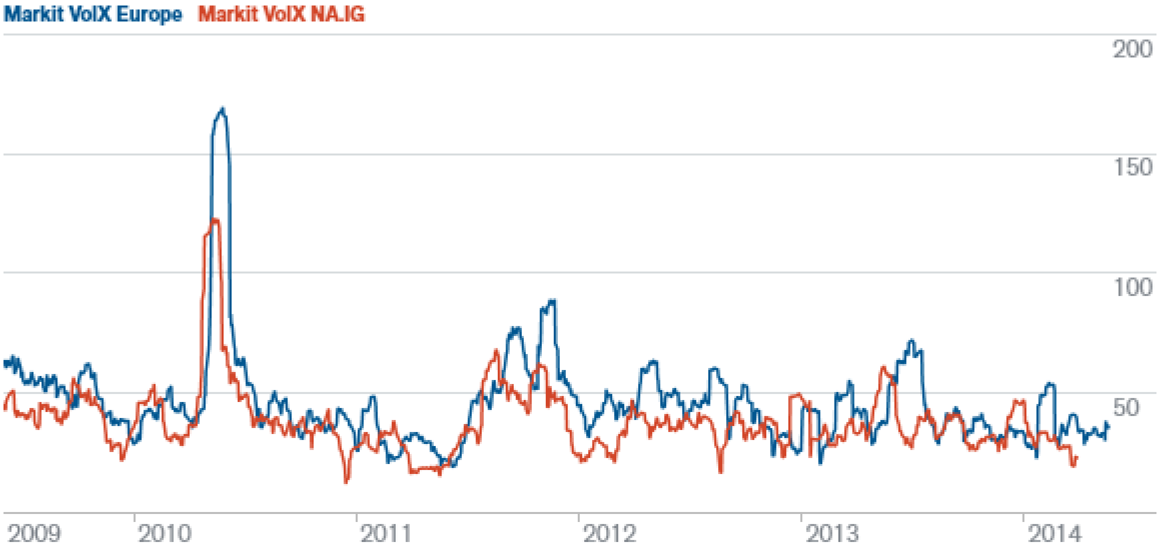

The apparent contradiction between optimism on economic growth and ultra-low government bond yields is preoccupying investors as we head into the summer.

Leading indicators, such as the Markit PMIs, point towards continued improvement in most of the major economies. Normally, this would cause yields to rise as bonds sell-off in anticipation of higher rates. But that isn't happening in 2014, with US treasuries yielding 2.4% and yields in many European countries at their lowest levels for over a hundred years.

Credit spreads tracked equity markets, which are trading at record highs in the US. The Markit CDX.NA.IG index was quoted at 62.5bps on Ma y 29, the tightest level since November 2007, while the Markit iTraxx Europe's 66bps mark is the tightest since January 2010.

Supporters of the rally in US treasuries would point towards the disappointing US GDP figures published on May 29. The US economy shrank by 1% (annualised) in the first quarter, down sharply from the positive 0.1% initial estimate. But GDP is a backward-looking indicator, and fixed-income and equity markets were unmoved after the release of the news.

So, it seems that inflation expectations are firmly anchored. Indeed, in Europe it is the threat of deflation that is worrying policymakers. The ECB is expected to cut deposit rates into negative territory next week, and this could be the precursor to quantitative easing, though such a radical step would not be entered into hastily by the notoriously conservative central bank.

Nonetheless, the prospect of QE has probably played a role in supressing yields and CDS spreads in Europe, as we have seen from previous experience in the US. It may also serve to keep credit volatility at already low levels. The Markit VolX Europe and VolX IG indices, which track realised volatility in the Markit iTraxx

Europe and Markit CDX.NA.IG indices respectively, are at 36% and 22%. The European index includes banks and peripheral corporates, so it is to be expected that volatility is higher than in North America. But the levels are low by historical standards and are nowhere near the heights reached during the financial and sovereign crises of recent years.

If one expected volatility to pick up in North America compared to Europe, an efficient method of implementing this view would be through the CDS index options market. This product is growing in popularity and liquidity is improving on both sides of the Atlantic. The current stability won't last for ever.

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