Markit Recap – 6/23/2014

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We remarked last week that, while Argentina is among the favourites to lift the World Cup, it is the outstanding favourite to be the next sovereign to default. Events since have strengthened that assertion – the football team has made an impressive start, and the country's CDS spreads have widened sharply.

The latter occurrence was due to the US Supreme Court refusing to hear Argentina's appeal against a lower court ruling that ordered the government to pay holdout creditors at the same time as bondholders who participated in previous restructurings. The next payment is due on June 30 (with a grace period of one month), and Argentina has said repeatedly that it cannot afford to pay both the holdouts and exchange bondholders. Indeed, President Christina Kirchner's initial reaction to the news was that she wouldn't submit to "extortion" from the so-called "vulture" funds.

Under the ruling, if Argentina refuses to pay the holdouts, then they cannot pay the restructured bondholders. The probability of a near-term default is therefore high, and the sovereign's CDS spreads responded in kind. On June 13 they were trading at 35.75 points upfront; by June 17 they were quoted at over 50 points. This was the highest level since January, though not quite as high as the 58 points reached a year ago.

But on June 20 they had recovered to trade at 41 points upfront amid reports that Argentina had agreed to meet the holdout creditors in New York. It remains to be seen whether meaningful negotiations will take place, but the rally in Argentina's CDS suggests that the market is more optimistic than it was that a settlement can be reached. The sovereign's credit curve, though, remains steeply inverted, indicating that the risk of a default in the near-term is high.

We will find out in the coming weeks if Argentina is able to step back from the brink and retain partial access to international capital markets. But the risk of contagion to the broader emerging markets appears to be low.

Ecuador, which defaulted as recently as 2009, managed to sell $2bn of bonds at a yield of 7.95% when the concerns about Argentina were at their peak. This demonstrates that even a proven anti-capitailist government such as President Correa’s Ecuador can raise funds in the current climate.

Excess liquidity from unconventional monetary policies continues to drive sentiment and the chase for yield is as frantic as ever. Emerging market debt may well be vulnerable to a reversal in policy from developed market central banks, but investors should be cognisant that the asset class is not homogeneous and there will be winners and losers in this process.

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