Markit Recap – 7/11/2016

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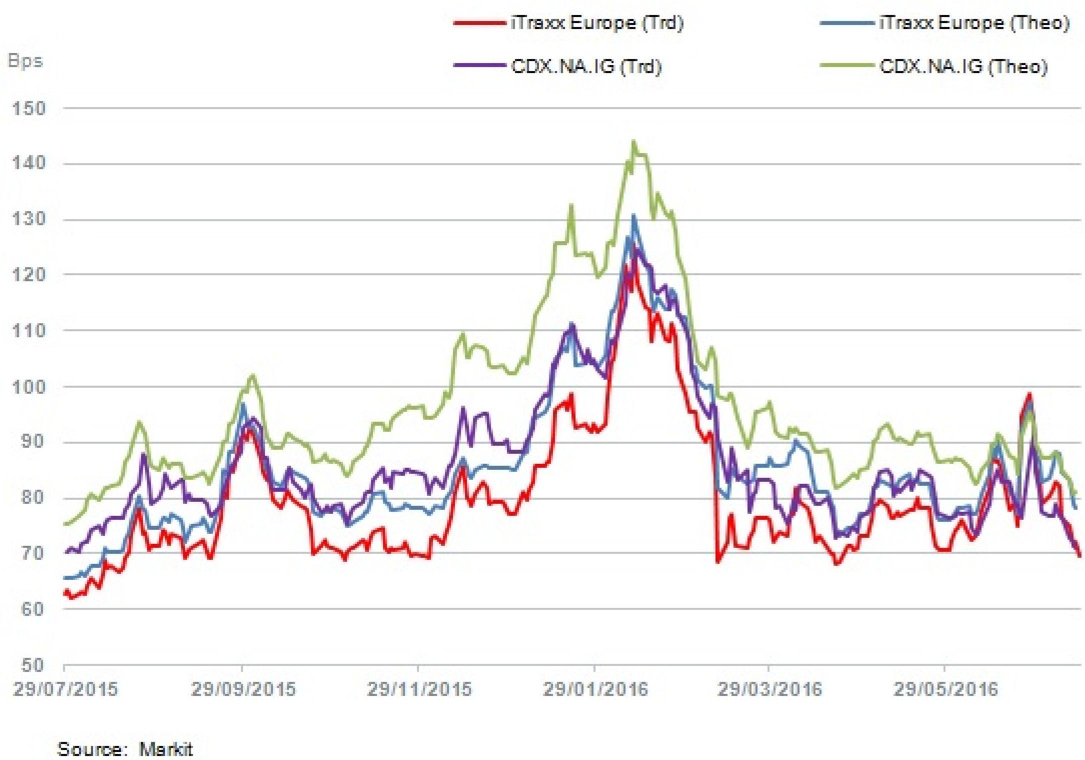
In the heady days of 2004-2007, before the Great Moderation came to a shuddering halt, it seemed set in stone that European investment grade CDS traded tighter than their North American counterparts. In May 2007, the Markit iTraxx Europe was trading at 20bps and the Markit CDX.NA.IG was quoted 15bps wider at 35bps. This 15bps basis was fairly typical of a time when the CDS market was dominated by synthetic CDO issuance.



US IG credit spreads remained at elevated levels compared to levels across the Atlantic, right through the sub-prime market collapse in 2007 and subsequent Great Financial Crisis. It was only when the eurozone sovereign debt crisis hit in 2010 that European spreads started to trade consistently wider than those in North America.

Fast forward to the Brexit world of 2016, and we find the Markit iTraxx Europe once again trading tighter than the Markit CDX.NA.IG. But the Brexit referendum result caused a brief – but significant – reversal in the relationship. On June 24, immediately after the shock vote, the European index spiked and was trading 8bps wider than the CDX IG. A rally soon followed and by July 14 the iTraxx Main was back at 69.5bps, marginally tighter than the CDX IG.

One might think that it is no surprise that the European index reacted more violently to the UK referendum. But the fundamental reason why the iTraxx exhibited such volatility is the high weighting of financials in the index. Banks make up 21 of the 125 names in the iTraxx Main, while there are no banks in the CDX IG. As we noted last week, the latest bout of European credit deterioration was driven by financial names, unlike the energy inspired volatility earlier this year. Italian banks, in particular, have seen their spreads widen sharply, and a partial recovery in recent days helps explain the rally in the index.

But the indices shouldn't be analysed in isolation. We also need to look at single name performance and the index skew (the basis between the traded index level and the theoretical level calculated from the single name constituents). We can see that the theoretical levels in both the iTraxx Main and CDX IG are wider than the traded levels, which has been the case for some time. This changed briefly for the iTraxx in the immediate aftermath of the Brexit vote, but the CDX IG relationship was unaffected. We can also observe that the theoretical iTraxx levels returned to their usual status, i.e. tighter than the CDX IG, faster than the traded index. Both trends reflect the higher liquidity in the index compared to single names and the index's role as a tool for macro hedging and positioning. Activity tends to migrate to the guaranteed liquidity of the indices in times of crises, and this will remain the case as the UK tries to extricate itself from the EU.

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