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Markit Commentary

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Credit spreads converge despite diverging policies

A brighter economic outlook has seen US and European credit indices converge, despite credit investors facing the prospect of diverging monetary policies

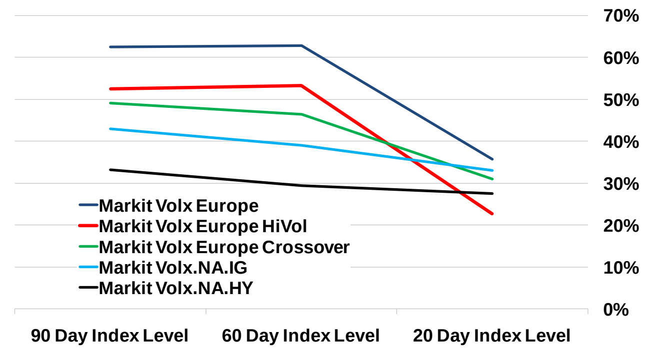
- US and European monetary policy looks set to diverge
- Markit VolX Indices show a sharp drop in credit index volatility over the past 90 days
- The basis between iTraxx Europe index and CDX IG index has tightened to 1bps

Tumbling volatility over the past months has seen US and European corporate credit risk converge, despite credit investors bracing themselves for diverging monetary policies.

In a speech yesterday, Fed chair Janet Yellen remained positive about an interest rate hike in the coming months, while tomorrow marks the start of the ECB's corporate bond buying programme. The positive risk sentiment in both regions has seen corporate credit risk fall since February's highs and credit index volatility has fallen in tandem.

Falling volatility

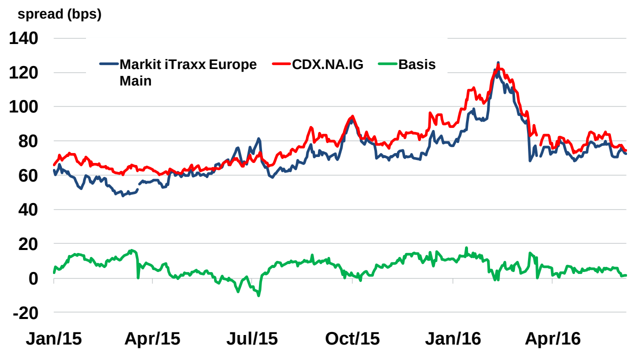
Credit index volatility



Source: Markit

The Markit VolX Indices, which track the realised volatility in the European and North American credit derivatives markets have seen levels fall. The Markit Volx Europe index, which tracks volatility among European corporate credits, has seen its level drop to 35.73%, from 62.57%, for 20 and 90 trading day rolling periods, respectively. Likewise, the Markit Volx.NA.IG index, which tracks US corporate credit volatility, has seen its level fall to 33.07%, from 43.06%. Volatility among European names remains higher, having yet to fully shake off worries around its banking sector and uncertainty around the upcoming Brexit vote. It has meant despite diverging monetary policies, credit risk among both regions has converged.

Credit indices



Source: Markit

This is demonstrated by the basis (spread differential) between the Markit iTraxx Main Europe index and the CDX IG index, which has tightened to 1bps over the past week. This is in stark contrast to the last time monetary policies were set to diverge. Last December, the Fed started tightening and this saw the basis spike to 15bps as investors foresaw greater risks stemming from higher rates in the US. In the end, market volatility called for caution, while the ECB bolstered monetary stimulus in Europe. Yet latest levels show the Markit iTraxx Europe main index and the CDX.NA.IG index currently trading at 73bps and 74bps, respectively. If short term worries were to dissipate in Europe (eg Brexit), and/or risks in the US flare up again, (overseas volatility, weak inflation, weak demand, low productivity) the basis between European and US corporate credit has reason to widen once again.

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