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Stressed out

Results of the EU stress tests on Sunday could be crucial in determining spread direction.

- ECB rumour on corporate bond buying fuelled this week's rally in credit
- Stress test results could prove cathartic for European banking sector
- But ECB and EBA face tough balancing act between credibility and pragmatism

If there were any doubts that credit markets are dependent on central banks for their sustenance, then events this week would surely have laid them to rest.

All it took was a report that stated the ECB is considering buying corporate bonds in the secondary markets, possibly as soon as the first quarter of next year. The report cited sources "familiar with the situation", and a later news story denied that the ECB was placing corporate bond buying on the agenda for its December meeting.

Despite the dubious provenance of the report, it was enough to trigger a rally in risk assets. The Markit iTraxx Europe, which widened to over 80bps last week, tightened to 66.5bps on October 23rd. The ECB started its programme to buy covered bonds earlier this week, and will also commence the purchase of ABS later this year. Combined with the targeted LTROs and negative deposit rates already announced by the central bank, it seems clear that Mario Draghi and his fellow governors are trying to stimulate the eurozone economy and fight deflation. However, there are major question marks on the ECB's ability to expand its balance sheet without buying government bonds, a measure that remains controversial in the corridors of power in some European countries.

The fate of the eurozone's ailing economy, and the policies undertaken to tackle the malaise, should have the biggest influence on spread direction in the coming months. But in the near term, Europe's banking sector will be under scrutiny with the announcement of the ECB's Asset Quality Review and the EBA's stress test results on October 26th.

Several banks are rumoured to have failed the tests, though it should be remembered that some of the tests were taken at a snapshot at the end of 2013. Many banks have raised capital in the meantime, and the headlines engendered by the "failed" institutions may not give a true reflection of the current state of the sector.

If the tests are viewed as credible, then the results on October 26th could prove cathartic for the European economy as a whole. But it will also pose questions on whether the troubled banks can raise capital without the assistance of the state. If governments have to get involved, then it is likely that bondholders could also share the burden.

The key indicators to watch during this crucial time are the Markit iTraxx Senior Financials and the Markit iTraxx Subordinated Financials indices. The latter index is now trading significantly wider than a few weeks ago due to the introduction of ISDA 2014 CDS definitions on October 6th. The new definitions cover the possibility of government enforced bail-in of bondholders, which could come into play if banks are unable to source private capital.

Subordinated bondholders will then find themselves in the firing line, and this is reflected in the ratio between the sub and senior indices. The Markit iTraxx Sub Financials index was trading at 164bps on October 22nd, almost two and a half times the level of the senior index. Prior to the last roll, the ratio was about 1.4, which demonstrates the value of the new definitions to protection buyers.

Whether the stress tests lead to a bondholder bail-in and a consequent credit event is another matter. Less than half of the 150 banks tested by the ECB and EBA have active CDS markets, so the smaller institutions that might fail the tests could pass by without triggering a credit event. Nonetheless, there will be intense scrutiny of banks with weak balance sheets, and how the ECB's negotiates the balancing act between credibility and pragmatism will have a major influence on sentiment going into year-end.

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