

The return of volatility?

Recent spread actions suggests that volatility may be returning, while the index roll on October 6th could accentuate fluctuations.

- Relatively large swings in spreads
- Direction of monetary policy diverging between US and Europe
- Credit indices roll on Monday

Credit markets have become accustomed to low volatility, but recent spread action hints that times are changing.

North American CDS, as represented by the Markit CDX.NA.IG index, traded in a relatively broad range during the third-quarter. The index hit 55bps in early July, its tightest level since October 2007. But it soon began to widen and little more than a month later was trading at 67bps. The European equivalent, the Markit iTraxx Europe, followed a similar pattern and traded in a 56-70bps range.



The first spell of widening was triggered by geopolitical risk, predominantly the conflict in Ukraine. Technical factors have probably played a larger role in the second reversal during the latter part of September. The mere presence of quarter-end may have prompted

participants to take risk off the table, as is often the case. The departure of fund manager Bill Gross from PIMCO may also have caused some volatility in both cash and derivatives markets.

That's not to say fundamentals were irrelevant. Geopolitical risk is omnipresent, from the recent referendum in Scotland, to the protests in Hong Kong and the upcoming Brazilian elections. Emerging markets have experienced a tough third-quarter, and remain vulnerable to negative news flow.

But monetary policy remains the key driver of risk appetite, and some investors will no doubt see the recent reversal as an opportunity to increase long positions. The Federal Reserve may be tapering its quantitative easing programme, but the clamour for the ECB to start its own government bond purchase is growing. Deflation is a real concern for European policymakers, and if the ECB responds with further measures to expand its balance sheet, history tells us risk assets should benefit.

On Thursday, Mario Draghi outlined the ECB's plans to buy ABS and covered bonds, or "private QE" as it is sometimes called. There is considerable pressure on the asset purchase programme to succeed, not least

because the recent take up of the first four-year TLTRO was a disappointing €82.6bn. But it will be a tall order for the ABS and covered bond purchase programmes to meet the ECB's implied target of increasing its balances sheet by €1 trillion.

Capital rules disincentivise holding ABS, and it would need changes in Basel II and Solvency II to make the asset class more attractive and encourage issuance. The market expects full QE – purchases of government bonds – to commence next year, though there are formidable legal obstacles in Germany that make it far from certain.

The lack of clarity on the ECB's eligibility rules for the ABS programme dampened the ECB's announcement and initially led to CDS spreads widening. But sentiment was already shifting on Friday before a bumper US Jobs report ensured that the week ended on a high. The US unemployment rate is now at 5.9%, the first time it has dipped below the 6% threshold since July 2008.

Index Roll

The majority of CDS indices roll on October 6th. This was later than the initial date of September 22nd due to the ISDA 2014 protocol adherence date being pushed back.

Markit iTraxx Europe

Five of the excluded names (Gecina, Linde, Unibail, Swiss Re and SES) didn't make the cut due to insufficient liquidity. Electrolux, Henkel and Kingfisher all had less than €100 million in outstanding debt. Imperial Tobacco didn't meet the rating criteria.

Ticker	Name	5Y Today	6 month change
ALSTOM	ALSTOM	87	-109
PNL	PostNL NV	91	-38
WENL	WENDEL	120	-63
BRYBDC-Brew	Carlsberg Breweries A S	89	-1
DBB	Deutsche Bahn AG	28	-9
ISSAS-Global	ISS Glob A S	72	-23
SCACAP	Svenska Cellulosa AB SCA	57	-5
INTNED-BankNV	ING Bk N V	54	-19
STM	Stmicroelectronics N V	94	11
Average		77	

Fig. 1 New names in Series 22

Ticker	Name	5Y Today	6 month change
GFCFP	Gecina	77	-31
LINDE	Linde AG	32	-4
UNROSE	UNIBAIL RODAMCO SE	61	-12
ELTLX	AB Electrolux	74	-16
HENAGK	Henkel AG & Co KGaA	27	-9
IMPTOB	Imperial Tob Gp PLC	78	2
KINGFI	Kingfisher PLC	69	0
SWREL	Swiss Reins Co Ltd	41	-23
SESG	SES	64	-2
Average		58	

Fig. 2 Names excluded from Series 22

Markit iTraxx Crossover

The Markit iTraxx Crossover is expanding from 60 names in Series 21 to 75 names in Series 22. The majority of additions have been included from the supplementary list.

Many investors feel that the relatively small number of CDS names in the European high-yield universe doesn't adequately reflect the large number of issuers in the cash market. The expansion of the Crossover should help

to rectify this, as the inclusion of a name in the index can make it more attractive to market participants and therefore increase liquidity.

Ticker	Name	5Y Today	6 month change
EILEAB	Eileme 2 AB publ	162	17
NUMEGRO	NUMERICABLE GROUP SA	321	N/A
BOPAFIN	Boparan Fin PLC	509	N/A
CARUK	CARE UK HEALTH SOCIAL CARE PLC	757	N/A
DRYMIIX	Dry Mix Solutions Investissements	437	N/A
FNCREQCK	Financiere Quick	852	N/A
GALAPHO	Galapagos Hldg SA	606	N/A
GRUPOIS	Grupo Isolux Corsan Fin BV	566	N/A
HEMABON	HEMA BondCo I BV	742	N/A
LOCKLOW	Lock Lower Hldg AS	680	N/A
LOXAAA	LOXAM	646	N/A
MATAFIN	MATALAN FIN PLC	806	269
MONITHO	Monithem Holdco 3 SA	429	N/A
NOVAFIV	NOVAFIVES	331	N/A
PREMFOO	Premier Foods Fin PLC	626	N/A
PUBLIPO	Pub Pwr Corp Fin PLC	516	N/A
RRICEAA	RR Ice Cream plc	368	N/A
SELEGRO	Selecta Group BV	668	N/A
STONPUB	Stonegate Pub Co Fing PLC	361	N/A
STREPLC	Stretford 79 PLC	589	N/A
TWINPIZ	Twinkle Pizza Hldgs PLC	621	N/A
Average		552	

Fig.3 New names in Series 22

Ticker	Name	5Y Today	6 month change
ALSTOM	ALSTOM	87	-109
DIXON	Dixons Retail plc	80	-125
LAFCP	Lafarge	97	-105
AF-AirFrance	SOCIETE AIR FRANCE	128	-159
UCB	UCB	95	-115
WENL	WENDEL	120	-63
Average		101	

Fig. 4 Names excluded from Series 22

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For further information, please visit www.markit.com