Credit markets point to strains in rich economies

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Sovereign Credit Default Swaps

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In the past week, a significant deterioration in the fundamental outlook of the world's richest economies has provided a golden trading opportunity for the smart hedge fund manager in a corner of the market once considered rather dull.

Trading in sovereign credit default swaps, a form of insurance against a government defaulting, has provided rich pickings for investors who have bought protection in US, UK or eurozone debt in recent months.

For example, a hedge fund which had gone long, or bought protection, in Spanish or Italian CDS on Monday last week would have nearly doubled its money had it sold the position yesterday.

In short, the deepening banking crisis has raised the costs of insuring the debt of the world's richest countries. This is due to a reassessment of the deteriorating fundamentals of these economies as governments have been forced to rescue beleaguered financial institutions.

In the US, moves to support the financial system with a $700bn bail-out fund have meant the cost of insuring US bonds against default has risen above that of McDonald's, the fast food chain - and to double that of Japan and Singapore, considered relative safe havens (see chart).

However, in the eurozone, the impact has been even more striking. Not only has the cost of protection against default risen sharply but - more importantly - it has also led to growing divergences between different eurozone members. That, in turn, highlights a rather ominous development: whether the single currency area is as robust as hitherto assumed.

Meyrick Chapman, fixed income strategist at UBS, says: "We have always seen the credit crisis as the biggest challenge for the eurozone.

"We are now seeing the economies diverge with countries such as Italy carrying large levels of debt. Without the flexibility of devaluing its currency, Italy's lack of competitiveness will mean a big hit to growth.

"Ireland's decisions to take on the liabilities of its banks was also a major turning point. We estimate the Irish government is now guaranteeing 235 per cent of its entire gross domestic product. That move has put pressure on other governments in the eurozone to follow and has pushed CDS spreads out much wider."

Riccardo Barbieri, at Bank of America,observes: "The problem with the lack of an EU-wide response is that it leaves investors fearing a lack of co-ordination that could lead to distortions in the banking system, a reversal of competition policies, nationalisations and, more ominously, mark the beginning of a breakdown of the monetary union."

Most bankers stress that the chance of any such breakdown remains exceedingly remote. Similarly, most traders still consider the chance of a US debt default to be exceedingly small. Nevertheless, as the probabilities of these scenarios have risen, trading volumes in the CDS world have risen sharply. A senior financier in London says: "Trading in sovereign CDS used to be dead. But now it has suddenly become very interesting - volumes have really picked up."

This marks a break from the past. The market for sovereign CDS used to be used primarily by speculative funds as a way to protect themselves - while those writing protection tended to be local banks.

Now it is being used for two-way speculative bets. Appetite for trading is particularly strong from macro-hedge funds, which like the sector because it is easy (and relatively cheap) to use as an avenue for betting on relative sovereign risk.

One result has been a wide divergence in CDS pricing in the eurozone.

For example, the cost to insure some of the weaker eurozone economies has jumped markedly since last week. Greek CDS prices have jumped from 52bp since Monday last week to 83 basis points, or a cost of €83,000 to insure €10m ($13.6m) of debt over five years: Italy has jumped from 42bp to 76bp over the same period; Spain from 40bp to 70bp and Ireland from 28bp to 64bp. This compares with Germany, which has risen from 8bp to 25bp.

"I wouldn't say that the market is saying that the single currency is over, but when you see the gap between Italy and, say, Germany now, that is signalling a marked shift in sentiment and a new appreciation of risks," says Mr Barbieri.

Bond spreads between core 10-year German yields and those of the peripheral nations have also risen to record wides, putting further pressure on the eurozone.

The market is also, like other credit arenas, acting in a dysfunctional way with wide bid-offer spreads or one-way flows, where it is easy to sell protection but harder to find counterparties.

However, volumes could pick up as traders take varying views on the direction of this market. One trader said: "I don't see Greek or Spanish CDS prices rising much higher.

They have gone very high although it depends what happens regarding the capitalisation of the banks."

Mr Chapman says: "The market could prove interesting over the next few weeks. We may see the problems move from the borrowing nations to the lending nations - that is from nations such as the US and the UK to those such as Germany where the banks have been the lenders. The German banks and economy may now be vulnerable."