

## Make up or break up?

### *Trouble in sovereigns means disturbance in credit*

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**Will the euro marriage hold?**

**Why credit gets caught in the crossfire**

# The root of the problem ...

## Born out of crises

*A brief history of European integration*

	Problem	Response
1940s	WWII legacy + bilateral trade	ECSC, EPU
1970-80s	Bretton Woods collapse	Snake & ERM
1980s	"Euroclerosis"	Single market
1990s	German reunification	EMU
2010s	Debt crisis	Fiscal & banking union?

Source: CIRA

## Is EMU a fair-weather union?

*Lending of last resort is constrained*



**Caps on EFSF & ESM**



**"No Eurobonds"**



**No 'proper' Deposit Guarantee Scheme**



**ELAs**

Source: CIRA

# ... is the limit to European 'solidarity'

# Running away – the rational thing to do?

**Required premium > sustainable yield?**  
*Stylised investor risk/reward calculation*

Assume:

- 5yr bond w. 4% coupon
- 10% prob. of exit w. 20% recovery
- 20% prob. of default w. 40% recovery
- Risk-averse investor\*

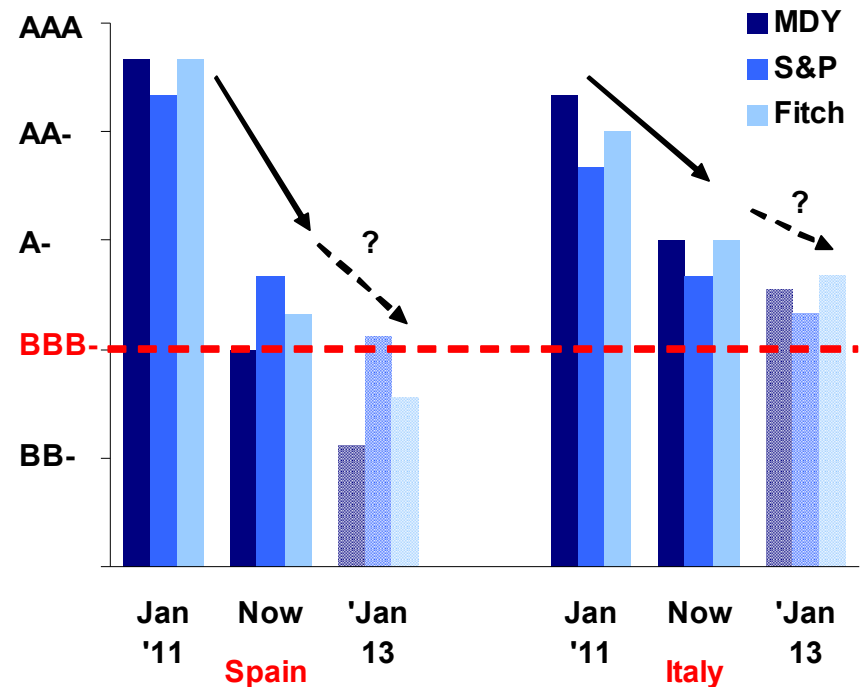
=>

Spread required to compensate for risk:

**~ 800bp**

Source: CIRA, Bloomberg. \* Investor requires an expected excess return equating to a Sharpe ratio of 0.5, using annualised vol. on a 5yr SPGB YTD.

**Heading for the benchmark cliff?**  
*Rating transition, 2011 to now with extrapolation*



Source: CIRA, Moody's, S&P, Fitch

## Risk/reward in Spanish & Italian debt still seems poor

# Eurobonds – nice solution ...



## The plans are there

*EU Parliament Eurobond proposal, June 2012*

### Phase I (“German Wise Men”):

- T-bills up to 10% of GDP
- **EU Redemption Fund for debt >60% of GDP**
- 25yr pay-down period

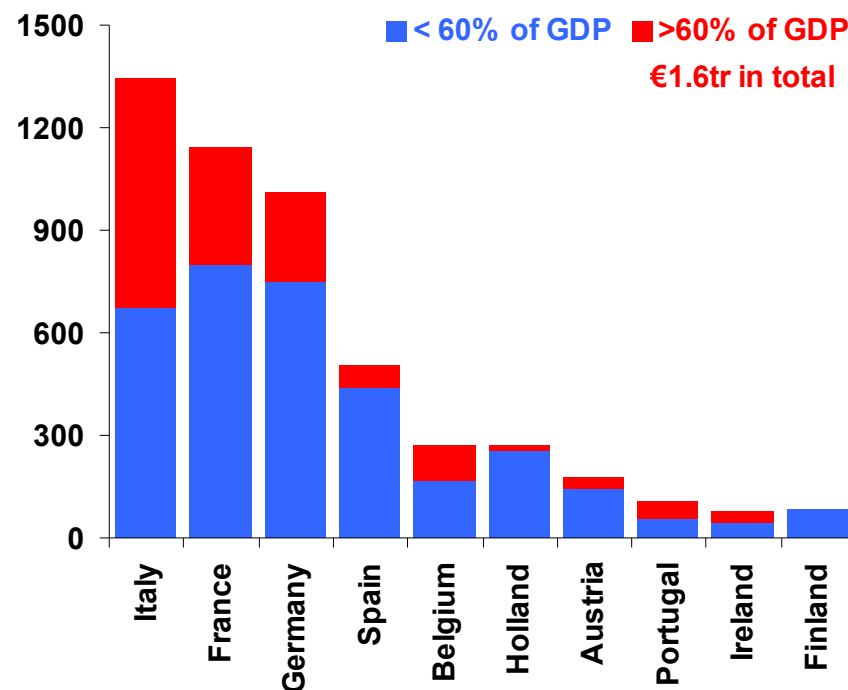
### Phase II (“Bruegel”):

- **Common issuance of debt up to 60% of GDP**

Source: CIRA

## But will the core take on the liability?

*European sovereign debt, €bn*

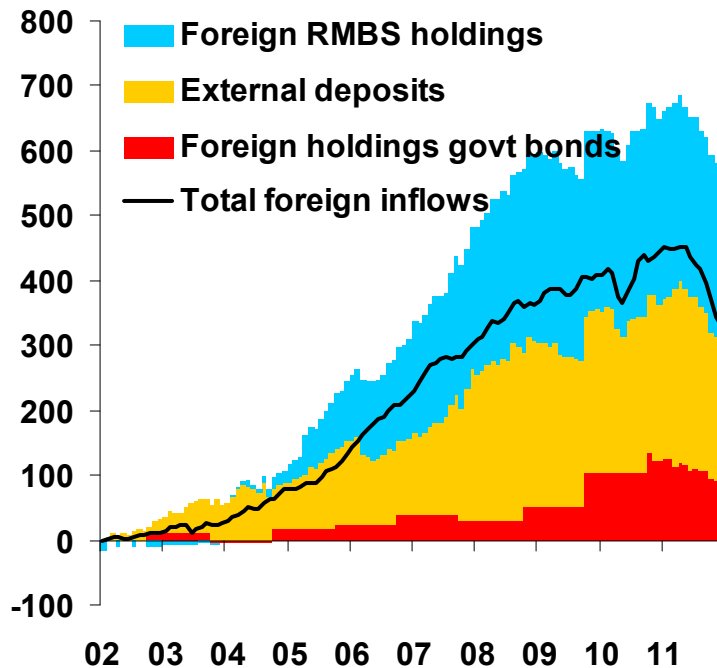


Source: CIRA. See [“Ebonds are the answer. What is the question?”](#), International Interest Rate Strategist, 14 June 2012.

## ... but likely too far off for this crisis

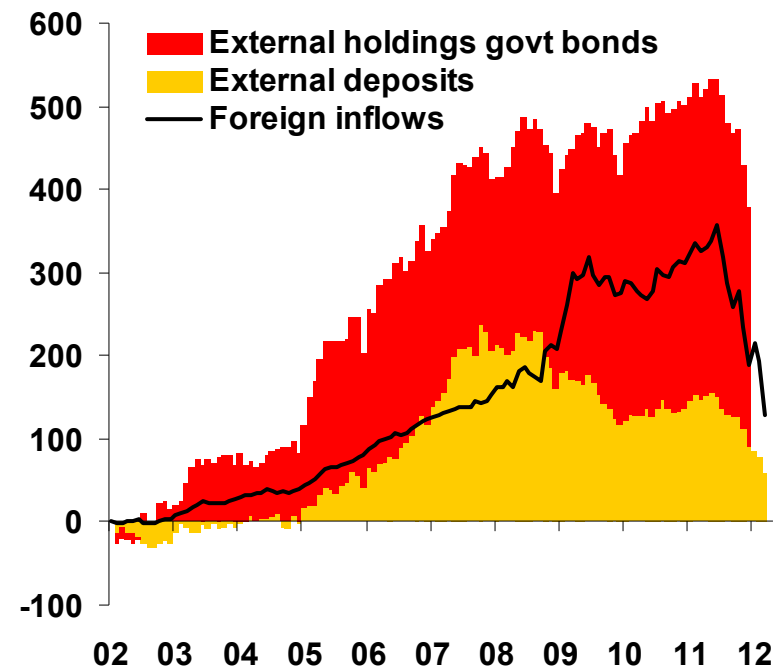
# Foreign money is taking flight

## Mostly private sector in Spain... *Cumulative sources of capital inflow, €bn*



Source: CIRA, Bank of Spain, Spanish Treasury, Haver Analytics.

## ...mostly govt bond selling in Italy *Cumulative sources of capital inflow, €bn*



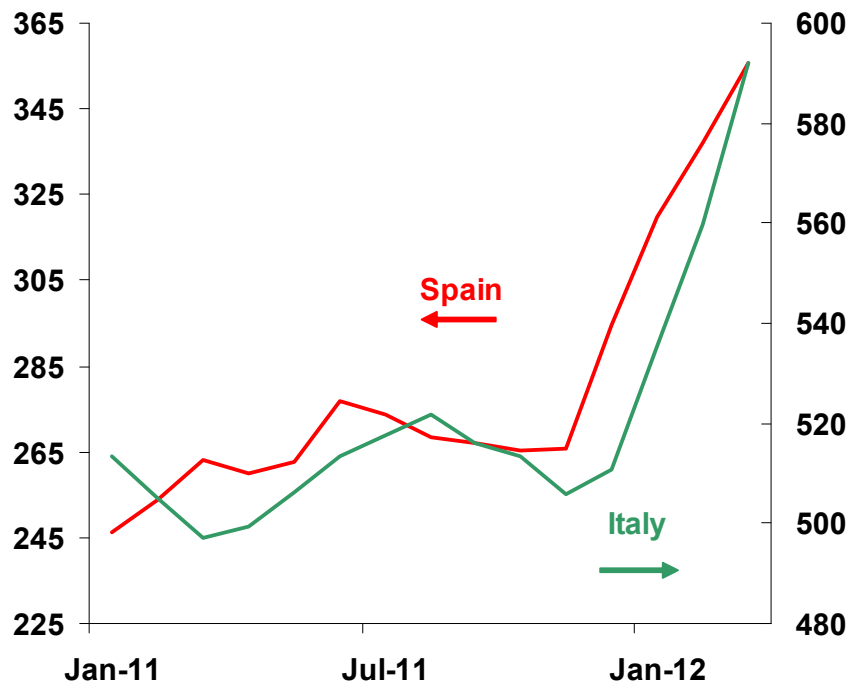
Source: CIRA, Bank of Italy.

## How do you stop it?

# Bank recaps alone won't do

## Captive buyers of sovereign debt

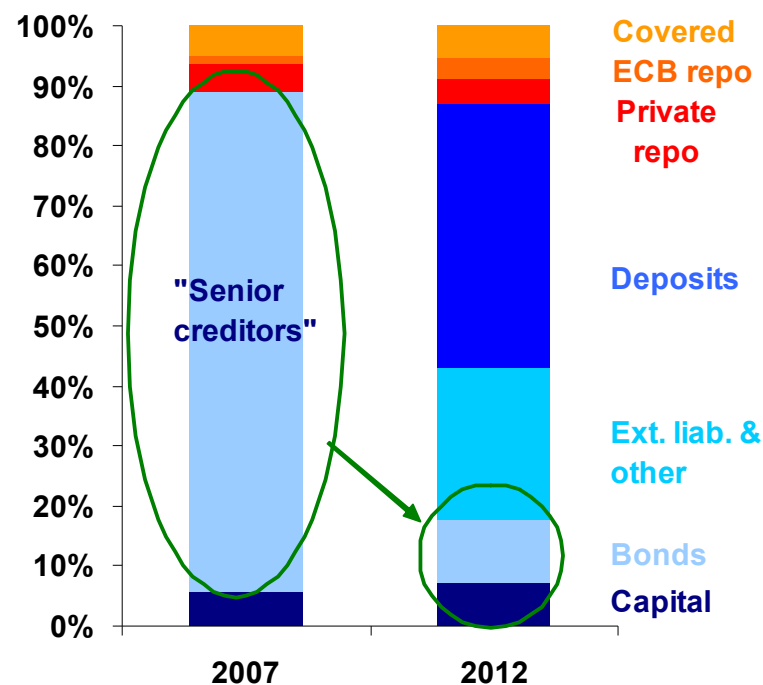
*Bank holdings of dom. sov. debt, €bn*



Source: CIRA, Banca d'Italia, Banco d'Espana

## Bondholder subordination

*Stylised Eurozone bank capital structure*



Source: CIRA, ECB, Haver Analytics.

# Banking system only as good as sovereigns backing it

# Heading for a banking union?



## Mind the imitations

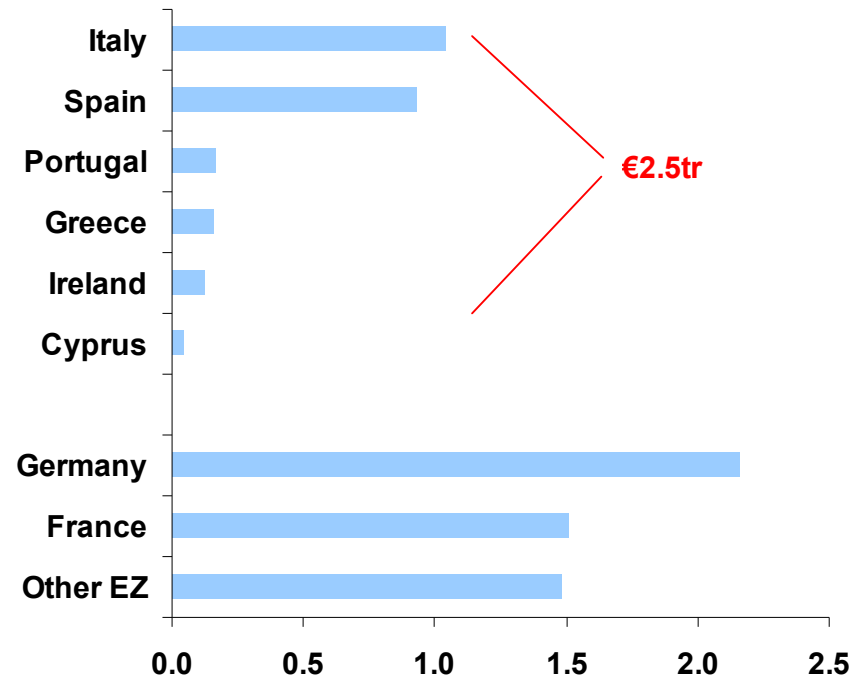
*A wish list for a banking union*

- Common banking regulation
- Resolution regime
- Mutualised recapitalisation fund
- Mutualised deposit guarantee scheme
- Needs to address redenomination risk

Source: CIRA

## An awfully large contingent liability

*Household & Corporate deposits, €tr*



Source: CIRA, ECB

# Summit timetable unlikely to address market concerns

# If the outflows continue?

## Read the fine print

### Article 65 (TEU)

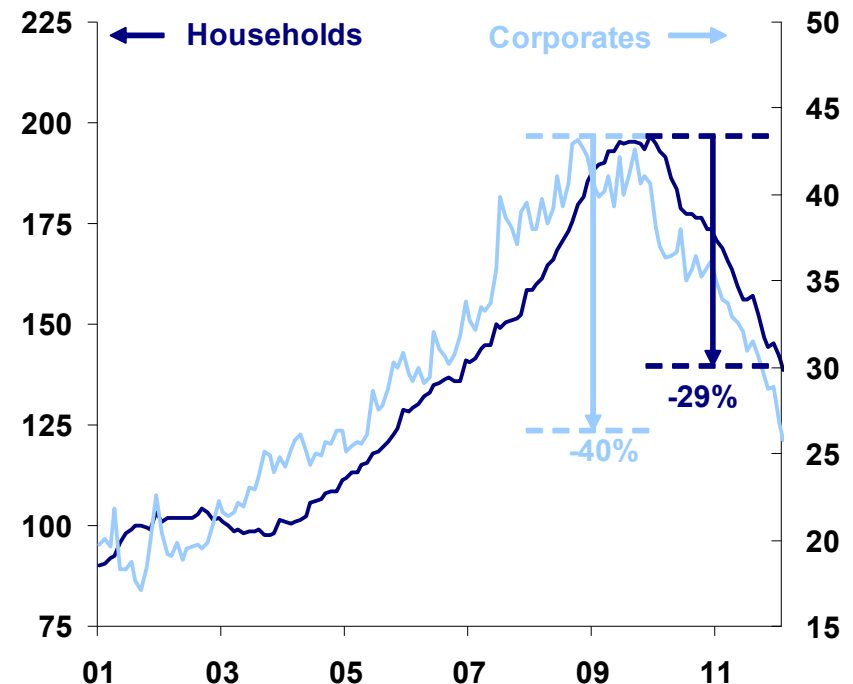
*[Member states have the right...]*

*... to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security.*

Source: CIRA, EU Commission

## Time to get the lawyers involved?

### Household & corp. deposits, Greek banks, €bn



Source: CIRA, Bank of Greece

## Then capital controls might be the next step

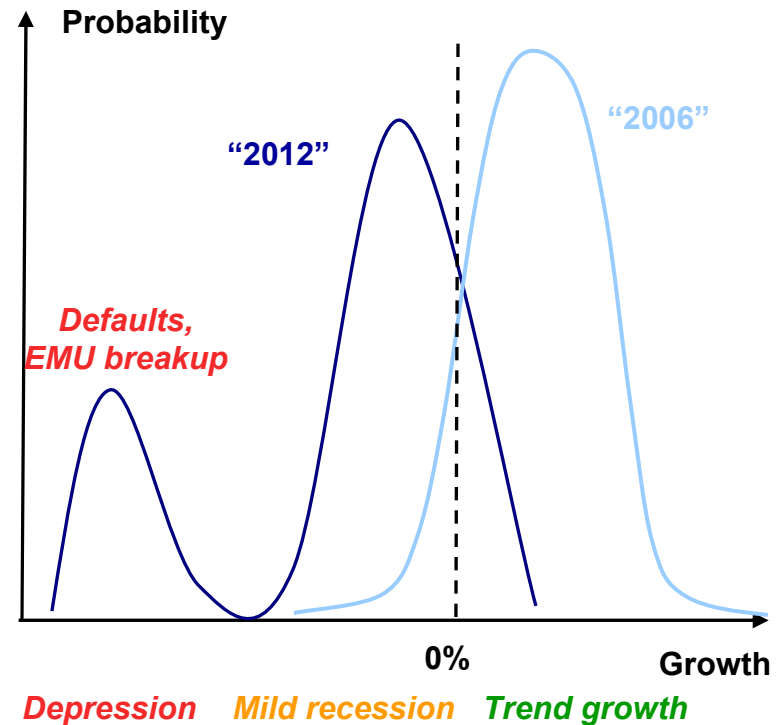
# Until the answer is definitive ...

Repeat with increasing vigour



What's behind a forecast

*Stylised distribution of growth probabilities*



Source: CIRA

Source: CIRA

## ...binary implications set to sustain market volatility

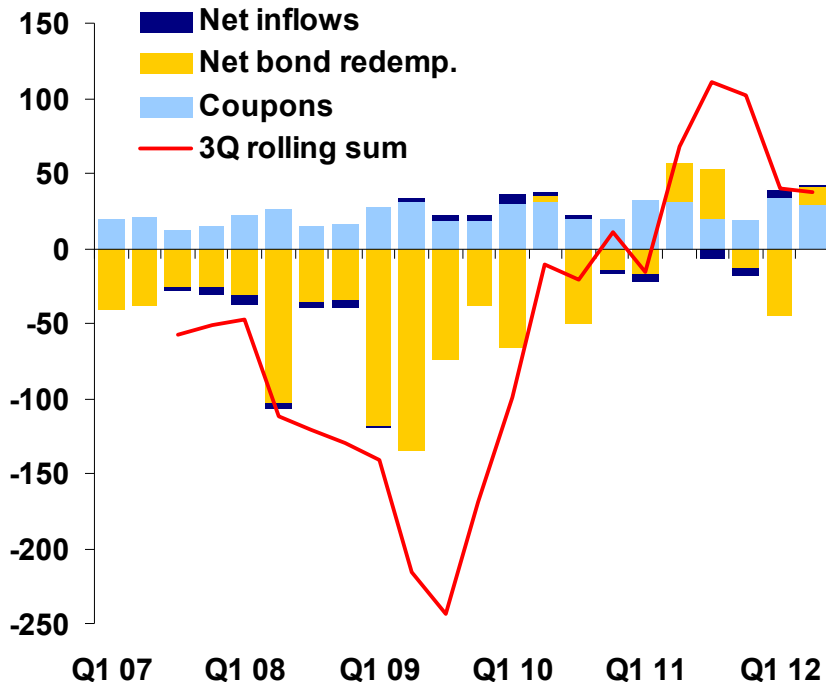
**Will the euro marriage hold?**

**Why credit gets caught in the crossfire**

# So much money to invest

## Cash has been building up

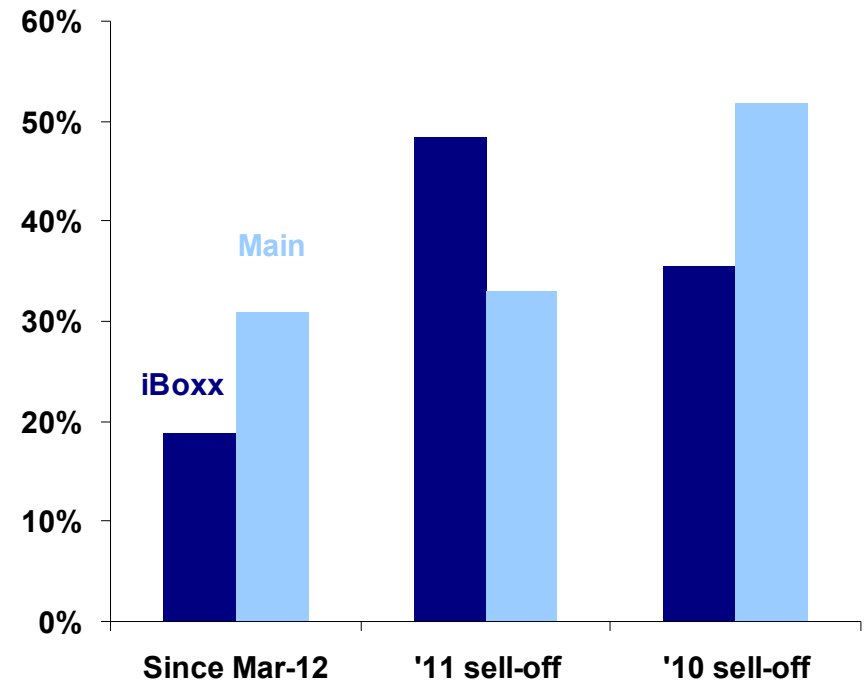
€ IG net inflows, redemptions & coupons, €bn



Source: CIRA, Dealogic

## Bonds less responsive to sovereigns?

Widening in credit relative to Spain 5yr CDS, %



Source: CIRA, Markit

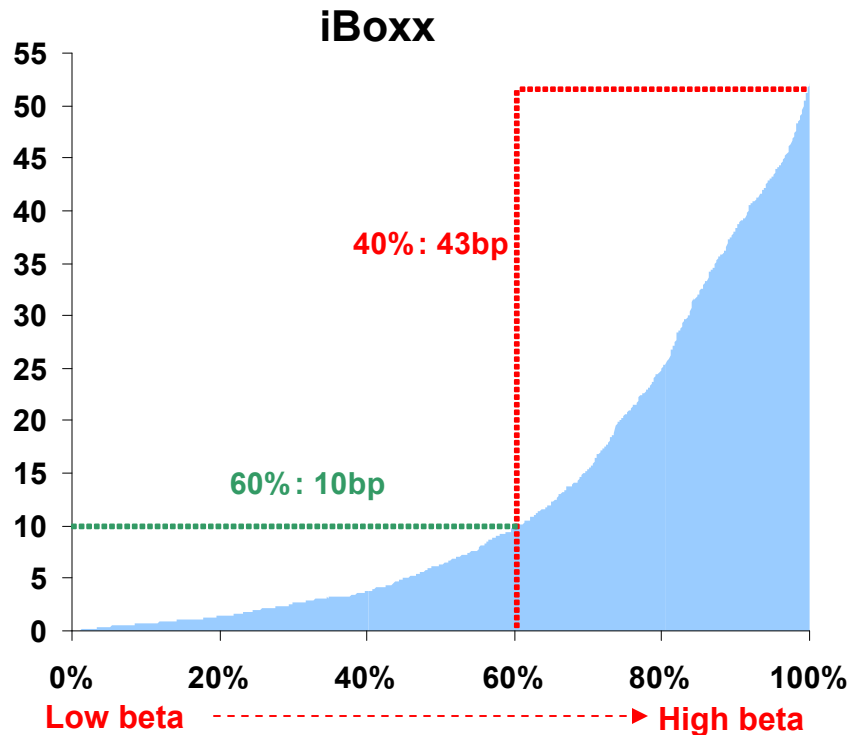
## Credit markets *want* to tighten

# A very concentrated sell-off in cash

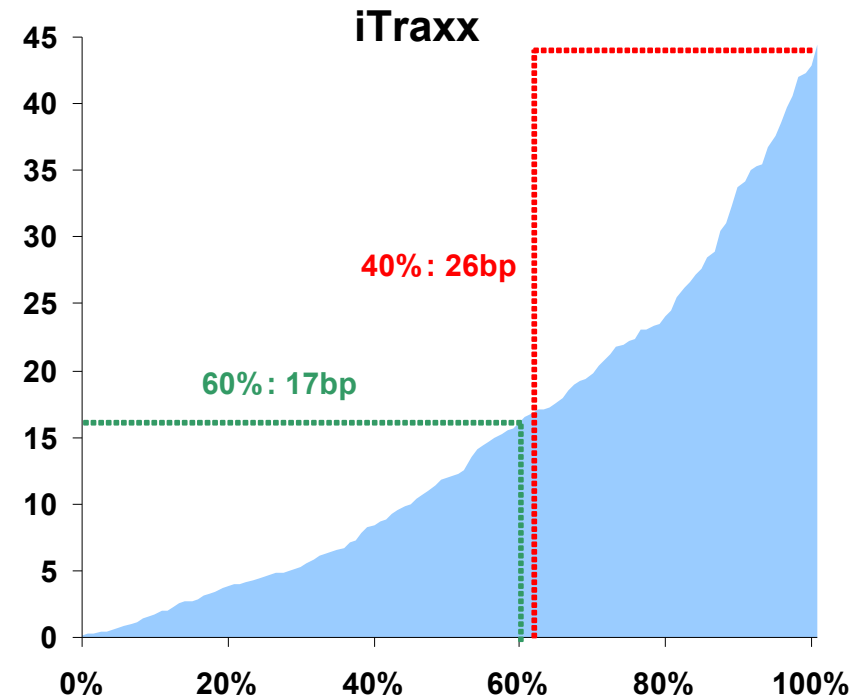
**Cash: 60% of names barely budged**

**CDS: sell-off much more broad-based**

*Cumulative contribution to index change from tightens, ranked by beta, bp*



Source: CIRA, Markit



Source: CIRA, Markit

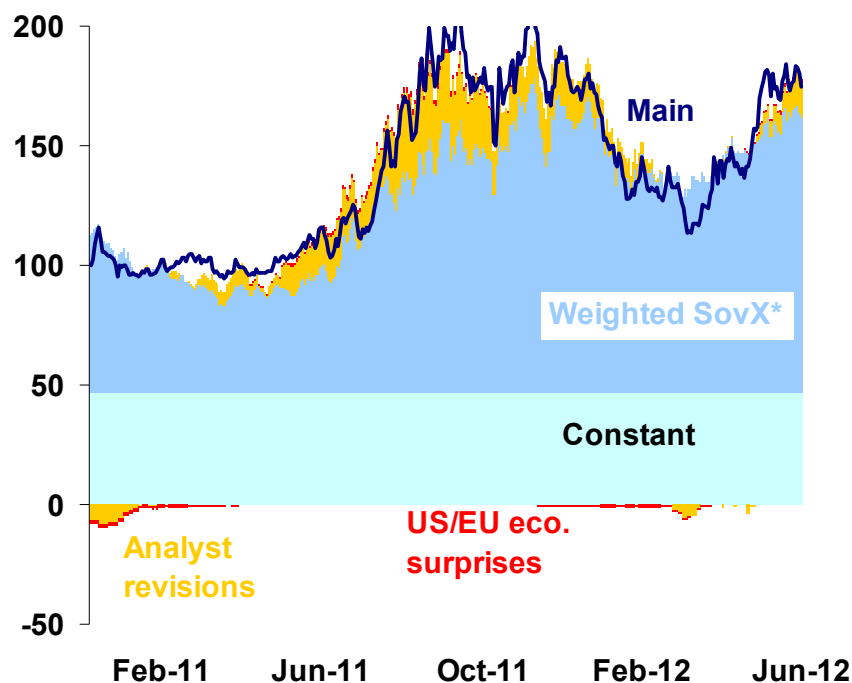
## Investors really don't want to part with core holdings

# But children have to follow their parents



## Sovereigns driving credit

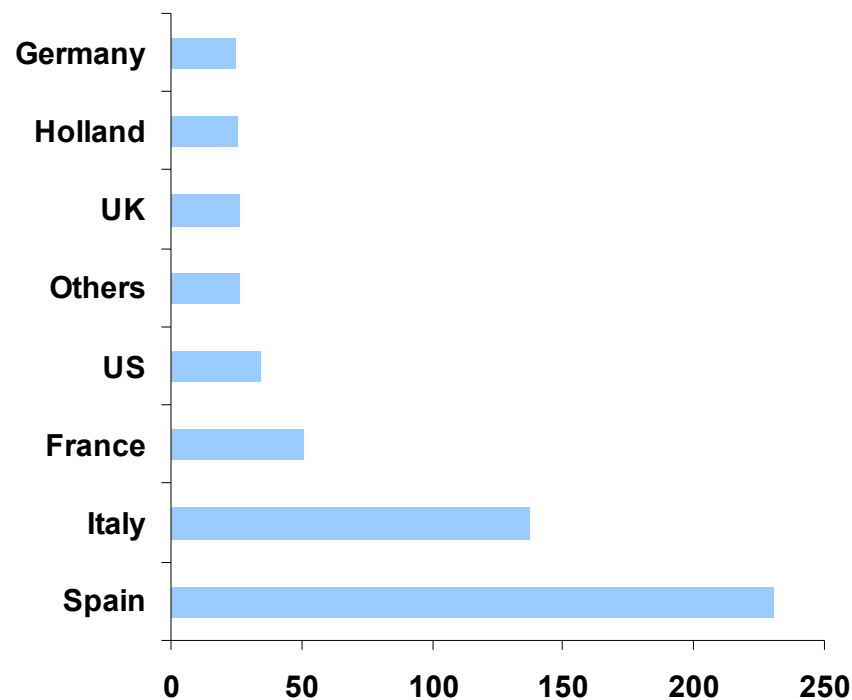
*Regression of Main: contributions from SovX, analyst revisions & US-EU eco. surprises, bp*



Source: CIRA, MarkIt. \* SovX is weighted by the distribution of domicile in the Main

## Location, location, location

*iBoxx spread change since April by domicile, bp*



Source: CIRA, MarkIt

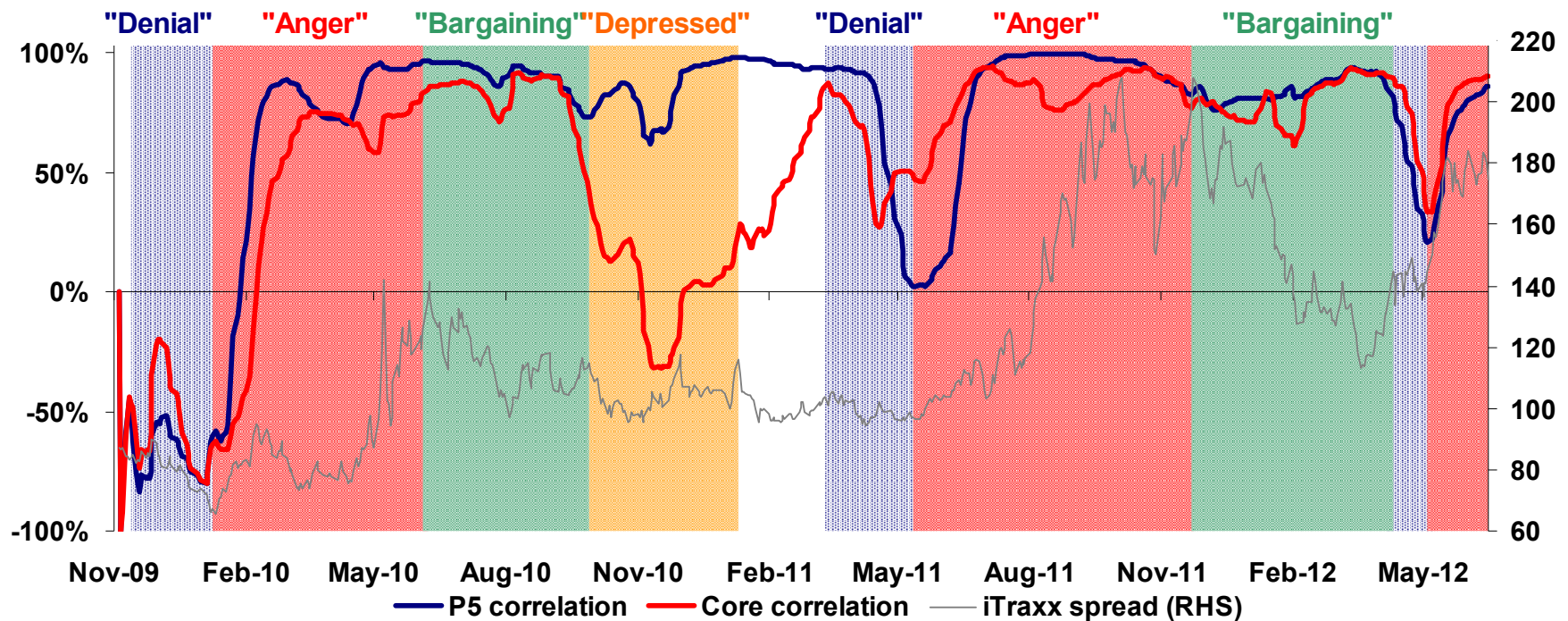
## Sovereigns driving about 85% of credit risk premia

# Still trading through the trauma



**Corporate credit follows the pattern of the Kübler-Ross model (5 stages of grief)**

*Correlation of SovX with P5 and core corporates respectively vs iTraxx Main, bp*

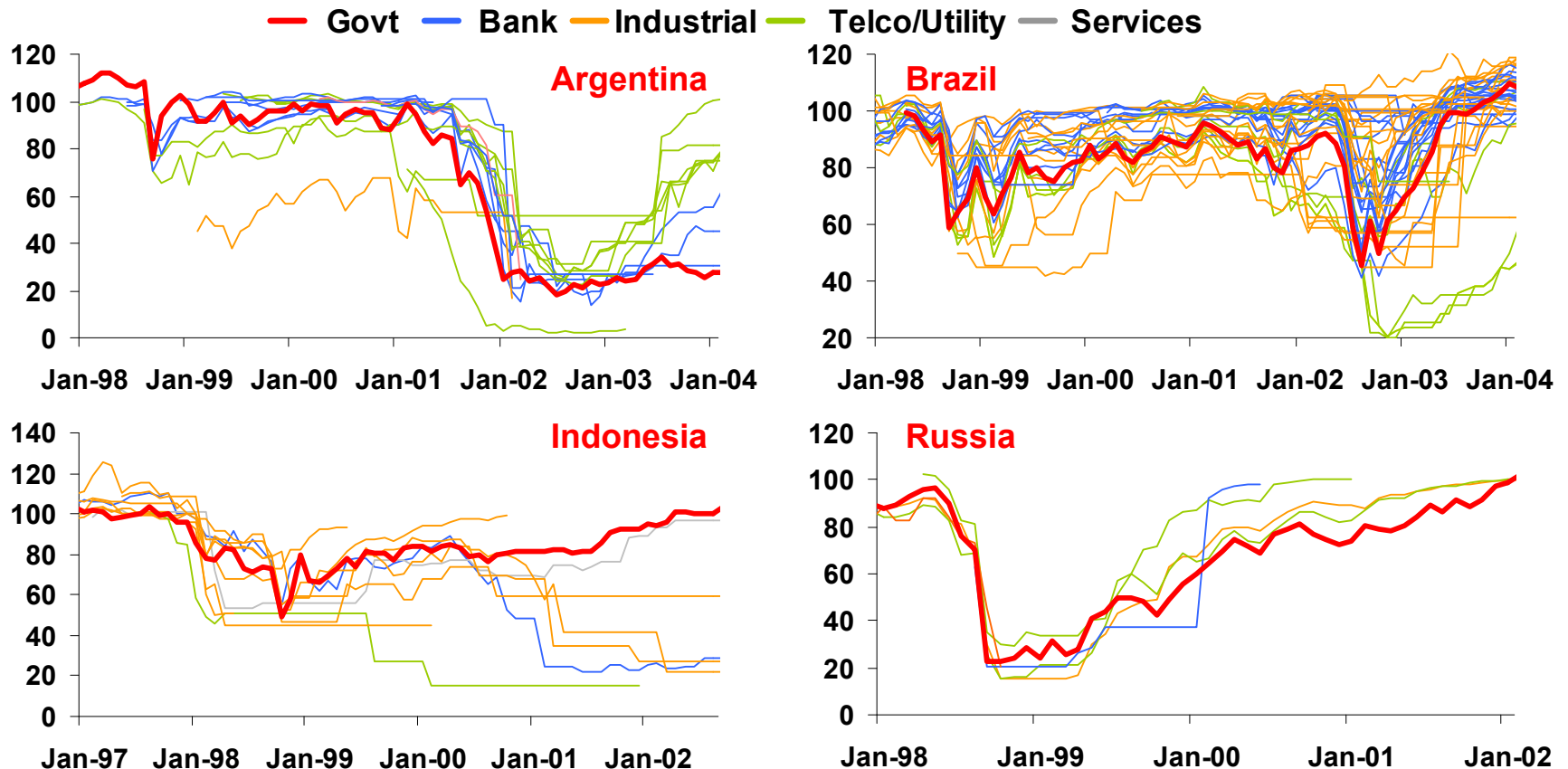


Source: CIRA, Markit

## Back to anger phase?

# Lessons from past EM crises

## Select corporate vs. sovereign bond prices



Source: CIRA, Datastream

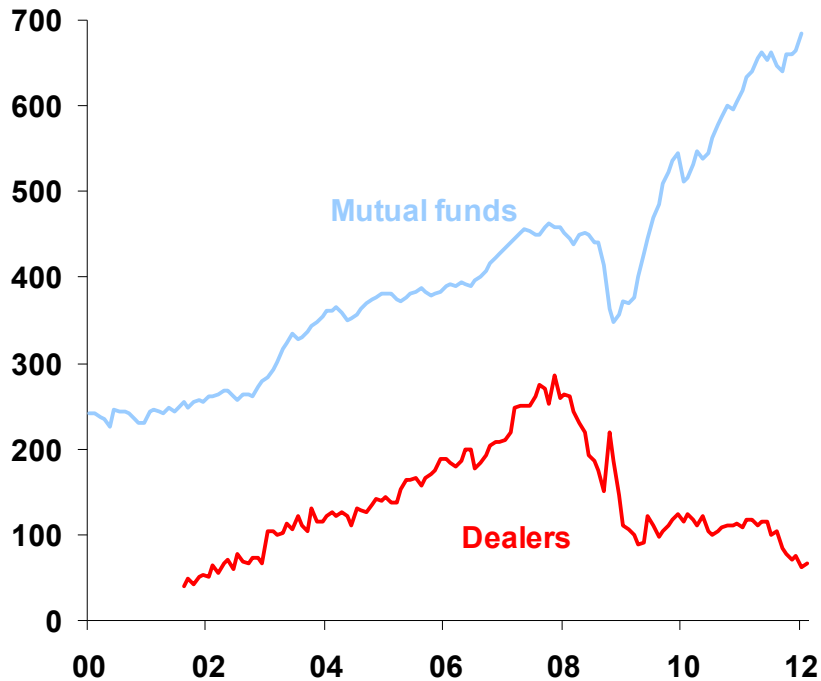
## Years of volatility and no decoupling

# With liquidity this poor...



## A Colossus with feet of clay

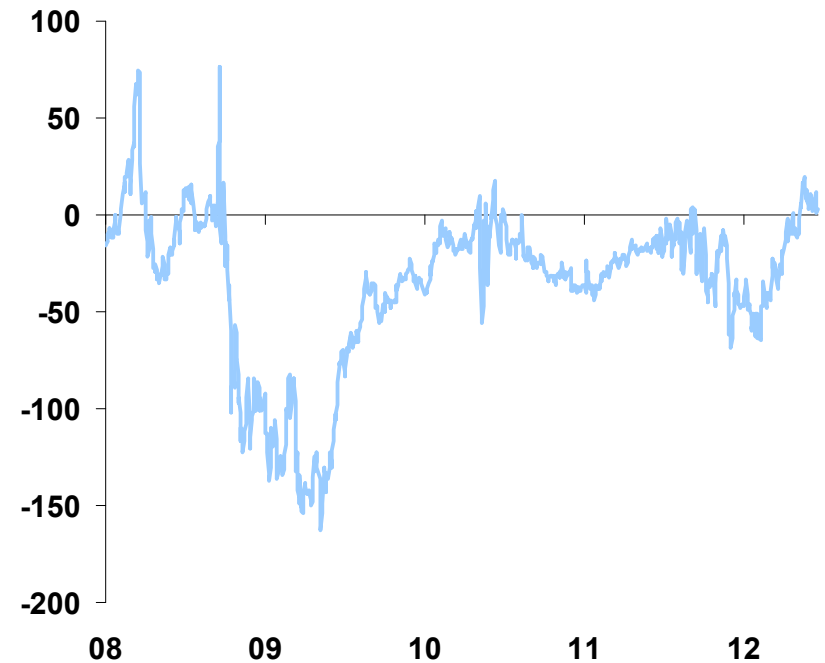
*US mutual fund holdings vs dealer inventory, \$bn*



Source: CIRA, Haver

## CDS says more about perceived risks

*European cash-CDS basis, bp*

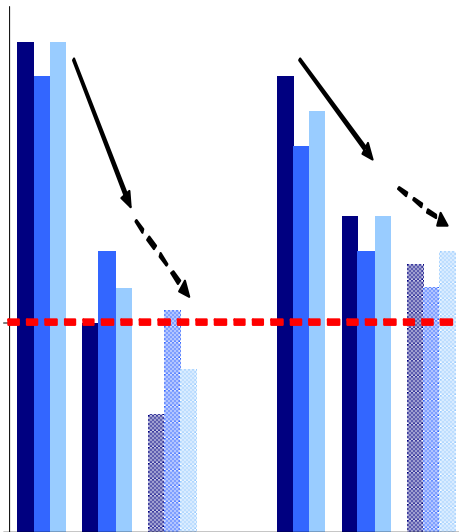


Source: CIRA, Markit

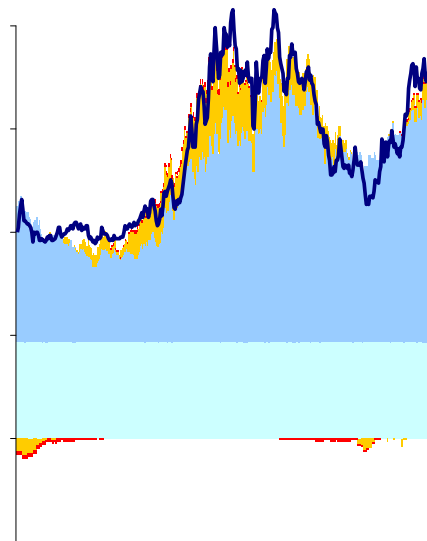
# ... cash market resilience hinges on just a few sellers

# Conclusion

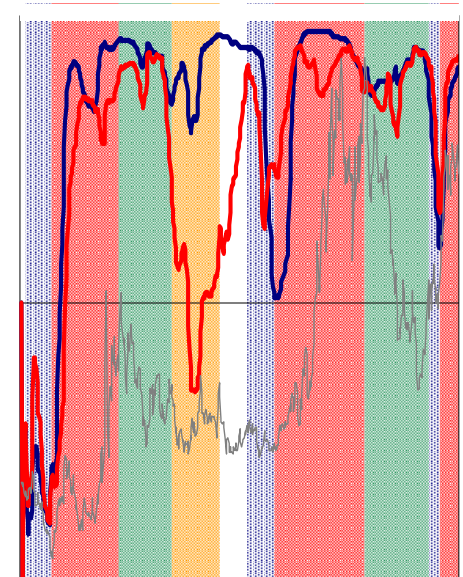
**Systemic risks remain unresolved**



**Top-down the only story in credit**



**So keep trading the phases**



**While sovereigns are in counselling,  
the children suffer too**

# Appendix A-1

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