CRISIS BASICS: PREVENTING A CREDIT CRUNCH (UPDATE 3)

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Mixed news: We continue to watch key indicators of credit stress to gauge the risk that the coronavirus recession could turn into a financial crisis. Two trends have emerged during the past fortnight:

1) Signs of stress in North American and European corporate debt markets have receded materially from the late-March uptick. Versus the most recent peak on 4 April, a range of credit default swap indexes have fallen: North American high yield credit down by c175bps (Chart 1); North American investment grade credit down by c40bps (Chart 2); and European investment grade credit down by 30bps (Chart 3).

2) Sovereign risks in the Eurozone have increased somewhat. The Italian sovereign credit default swap index has risen by c100bps since its recent low on 26 March, although it remains below the 18 March peak – Chart 4. Peripheral Eurozone bonds spreads have started to edge up again too – Chart 5.

Clear success in reducing corporate debt risks: It is still too early to conclude that the risk of a financial crisis has been averted. Global policymakers deserve credit for their swift and decisive action which ended the panic in corporate debt markets that was stirring in March. The combination of aggressive central bank action to flood financial and credit markets with liquidity and generous loan guarantees by governments seem to be working. In the US, the Fed’s decision on 9 April (details here) to buy some high-yield (junk) debt along with exchange traded funds with exposure to high-yield debt appears to have had a decisive effect on the North American market for such paper. Corporate debt risks can continue to fade as we get more positive news on the virus and as lockdowns are gradually eased – see here.

Eurozone debt risks edge higher: The €500bn support package which Eurogroup finance ministers approved last Thursday may well be the most generous case of cross-border solidarity ever – see here. But the ongoing dispute about joint bonds and Italy’s refusal to apply for a credit line from the European Stability Mechanism (ESM) have rattled markets. The ECB has already taken key decisions to support member states as much as is necessary. It will not allow a repeat of the Euro crisis during the coronavirus recession. However, the failure of EU leaders to send a clear and impressive signal of solidarity continues to feed an anti-EU backlash, especially in Italy. The risk that radical political forces will rise to power in Italy in a few years time and take the country out of the euro remains remote - but less so than before. Eurozone leaders have done a poor job selling the fiscal deal to their voters at home. They will need to do better at the next EU video summit on 23 April to dispel these concerns which markets have started to price in.

See also
COVID-19: The macro essentials
Crisis basics: preventing a credit crunch (update 2)
Crisis basics: preventing a credit crunch (update 1)
Crisis basics: preventing a credit crunch.

Chart 1: CDS index for North American high yield credit

Chart 2: CDS index for North American investment grade credit
Chart 3: CDS index for European investment grade credit

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Chart 4: Italy sovereign CDS index

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Chart 5: Eurozone sovereign bond spreads

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