

MARKET SIGNALS REVIEW

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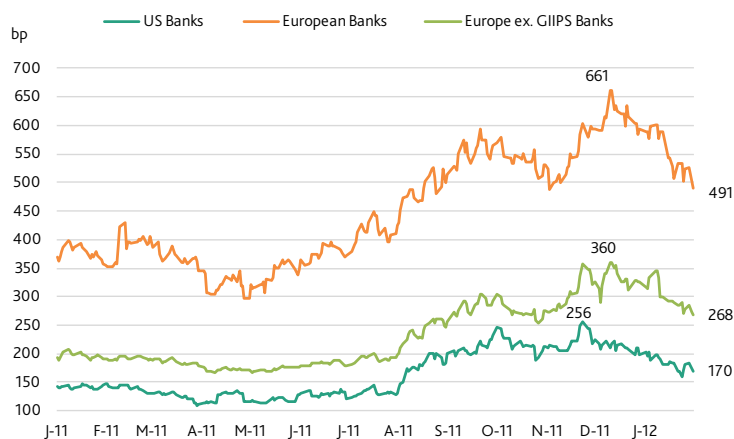
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Global Bank Credit Spreads and Implied Ratings Begin a Slow Recovery

Spreads for the CDS and cash bond markets for banking companies in the US and Europe improved steadily since the height of contagion risk concern last fall. While volatility in spread movements remains evident, the clear trend is for credit spread contraction. Over the last eight weeks the CDS-implied ratings for the three peer groups we assembled for banks in the US and in Europe outperformed the broad market. The average CDS-implied rating for US bank peer group rose by one notch from Baa3 in November to Baa2 currently. The CDS-implied rating for the non-GIIPS European bank group improved from Ba1 in December to Baa3, and the average CDS-implied rating for the peer group of all European banks improved from Ba3 in December to Ba2. Spreads in the cash bond market also got better over the last month, but not enough to improve this market's implied ratings for these three peer groups.

However, the speed of return to pre-crisis normalcy in banks' spreads remains sluggish, reflecting continuing investor caution despite recent CDS market outperformance (Figure 1). The average CDS spread for all European banks peaked in December at 661 bp, and since then has tightened to 491 bp. For the non-GIIPS European bank peer group, the CDS spread peaked at 360 bp in late November, but has now tightened to 268 bp. The US banks' average CDS spread reached its highest point in late November at 256 bp, and has recovered to 170 bp.

Figure 1. Major banks CDS spreads - last 12 months



Source: Markit

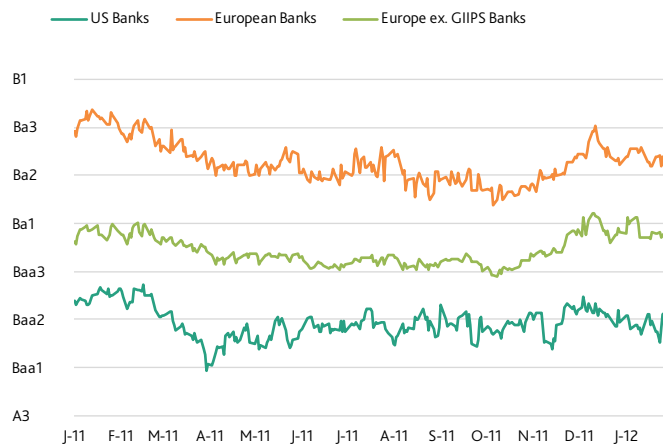
Despite the relief rally in the CDS market as the euro contagion appeared more manageable, the bond market has been less ebullient. After 31 months into the two previous economic recoveries, in the cash bond market the average yield spread over Treasuries of US high grade financial company bonds was 75 bp versus 274 bp today. At November 30, 2011, the average

high grade US financial spread over Treasuries was 349 bp, so the average spread has improved by 75 bp since then. Not that long ago, in April 2011, the US high grade financial spread bottomed at 161 bp. In comparison, the current average high grade company corporate bond spread is 171 bp, 68 bp wider than the 103 average spread 31 months after the start of the prior two economic recoveries.

Banks' CDS spreads improved early in 2011, reflecting optimism that the mortgage mess was moving towards a resolution. However, the appearance of the Greek problems last summer widened spreads significantly. The average CDS spread for US banks for the year 2011 was 163 bp, and the current observation is wider at 170 bp. For the non-GIIPS European banks, the average CDS spread in 2011 was 232 bp, but the current average is 268 bp. For all European banks the 2011 average CDS spread was 450 bp, and the recent observation is wider at 491 bp.

The CDS-implied ratings for each of the three banking peer groups shown in Figures 1 and 2 has returned to the same level as a year ago (Figure 2). The US banks' CDS-implied rating average returned to Baa2, the non-GIIPS European banks' average CDS-implied rating went back to Baa3, and the CDS-implied rating for all European banks recovered to Ba2. A more sluggish trend is evident in cash bond market-implied ratings, where the average bond-implied rating for the US banks slipped from A3 a year ago to Baa1. This one notch decline represents a -2 notch bond-implied ratings gap. In Europe, the bond-implied rating for all banks is Baa3, which is one notch below a year ago. Readers will recall that when an implied rating gap worsens (widens, as with banks' bond-implied ratings) the underlying securities have underperformed the broad market.

Figure 2. Major banks CDS-implied ratings - last 12 months



Source: Moody's Analytics

Globally banks are likely to remain a sector where investors are cautious. Many of the largest banks globally have negative outlooks or ratings under review for downgrade from Moody's Investors Service, as the appropriate level of ratings uplift from systemic support continues to be evaluated. In many areas, slowing economies and credit exposure issues, as well as the slowdown in banking fees and trading revenues, are weighing on the fundamental analysis of the banks. Yet we do expect many banks' credit market valuations to grind tighter, if slowly. A combination of better fundamentals and more certainty over future ratings will likely be necessary for banks' credit spreads to recover to pre-crisis levels.

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