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MARKET SIGNALS REVIEW

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Egypt Update: Credit Markets Price in Limited Contagion Risk, at Least So Far

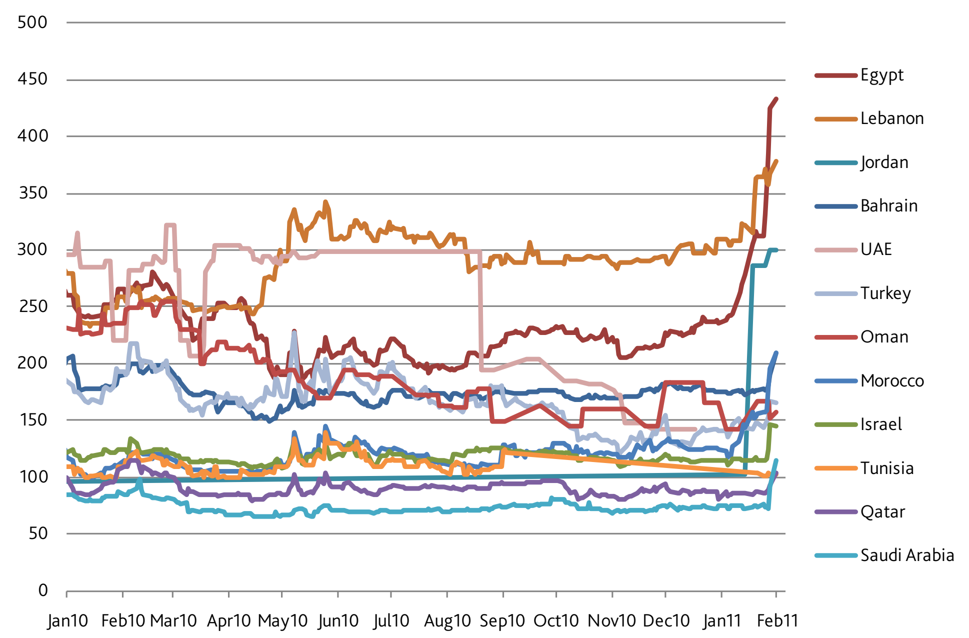
» *Political unrest in the Middle East is having an impact on the pricing of bonds and credit default swaps of regional sovereigns, but any wider fallout has thus far been limited.*

» *Two key gauges in assessing the broader impact of events in the Middle East are the price of oil and the CDS spread of Israeli government debt.*

EGYPT, GOVERNMENT OF	
Moody's Senior Unsecured Rating	Ba2
Moody's Outlook	Neg
Bond-Implied Rating	Ba3
CDS-Implied Rating	B2
Equity-Implied Rating	N/A
Loan CDS-Implied Rating	N/A
	As of 01/31/2011

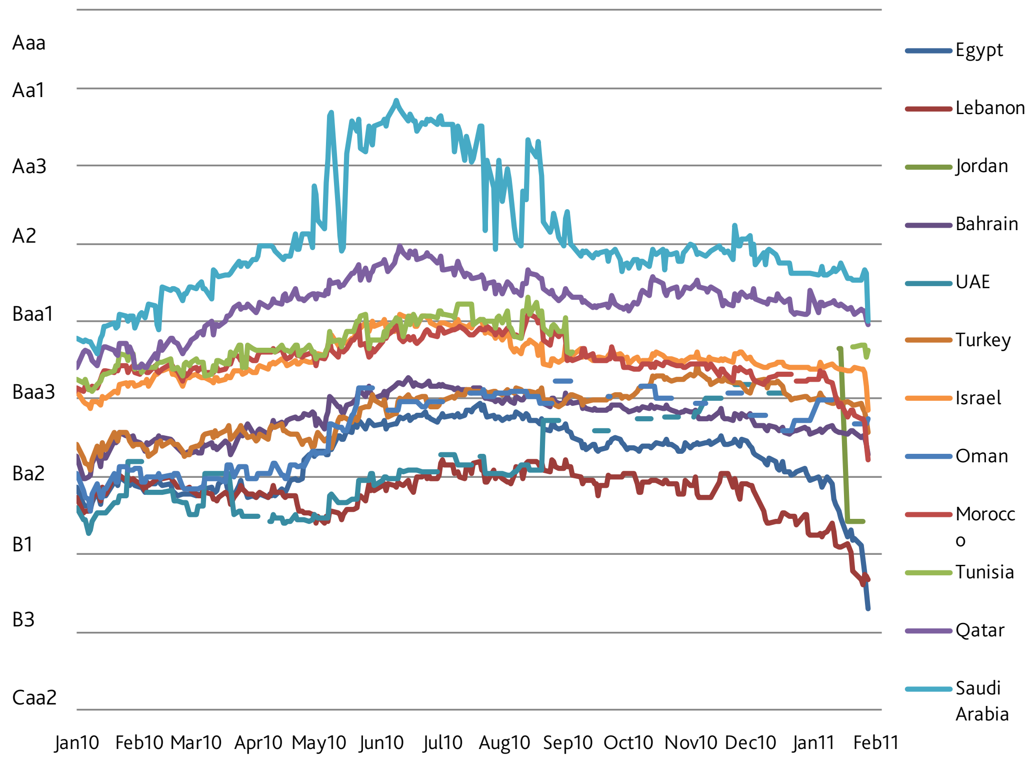
Credit spreads on sovereign entities in the Middle East have widened sharply due to the political unrest in Egypt. The spread increase began last November, but accelerated following the regime change in Tunisia in the middle of January (Figure 1). By contrast, since November spreads in the broader credit markets have tightened. CDS-implied ratings are determined with reference to the broad market, so the upshot is that implied ratings for Middle Eastern sovereigns have deteriorated sharply, as we see in Figure 2.[1] Egypt's sovereign five-year CDS spread is now 433 bp, which roughly equals that of Portugal. Currently, Egypt and Portugal have B2 CDS-implied ratings.

Figure 1. Five-year CDS spread of selected sovereign entities



[1] For definitions of Moody's Market Implied Ratings, please see the Note at the end of this report, or refer to the CMR FAQ.

Figure 2. CDS-implied rating of selected sovereign entities



Contagion risk

Thus far, the main impact of the political unrest has been limited to the pricing of securities of issuers in the Middle East. But perhaps of greater interest is the risk of contagion beyond the region.

Broadly speaking, we envision two possible outcomes, a *benign* and a *severe* one. Under the *benign* scenario, the Egyptian government evidences sufficient change to diffuse the political unrest. Alternatively, an orderly transition occurs to a new government, but Egypt remains a moderate, secular state. The key point for the larger world is that interruptions, if any, in the flow of oil to Europe through the Suez Canal are short-lived. And a peaceful outcome in Egypt means that no further political dominos fall in other nations in the region.

Under the more *severe* scenario, the current Egyptian government falls and a period of turmoil follows. The political fallout spreads to other nations in the region, including important oil-exporting ones such as Saudi Arabia. Under the worst-case versions of this scenario, the oil supply relationship between the major Gulf state oil producers and the United States, which dates back as far as 1945, is impaired.

Thus far, markets are pricing in the more benign scenario. The price of oil has increased, but not all that much. At $91–92 per barrel, it is still far below the $145 set in the summer of 2008 (Figure 3). Another point is that the dollar/euro exchange rate, currently $1.38, might be expected to decline if the supply of oil through the Suez Canal were perceived to be under serious threat. Finally, stock prices of E&P companies have outperformed the broader equity markets since the beginning of the year, but not by a huge amount (Figure 4). We presume that the equity markets are reflecting the prospect of higher energy prices (good for Big Oil) and no severe supply disruptions (which would be very bad for the producers).

Figure 3. Oil price and Euro/$ exchange rate

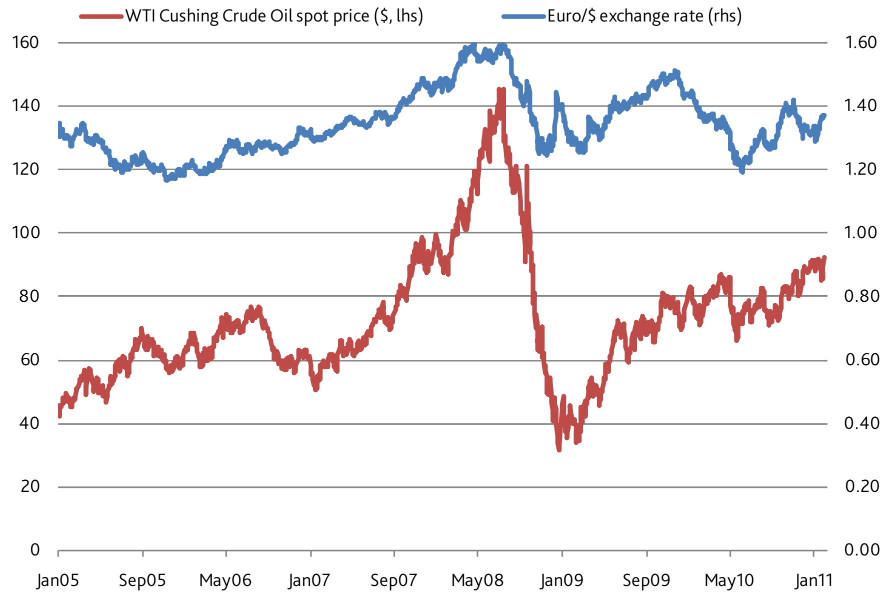
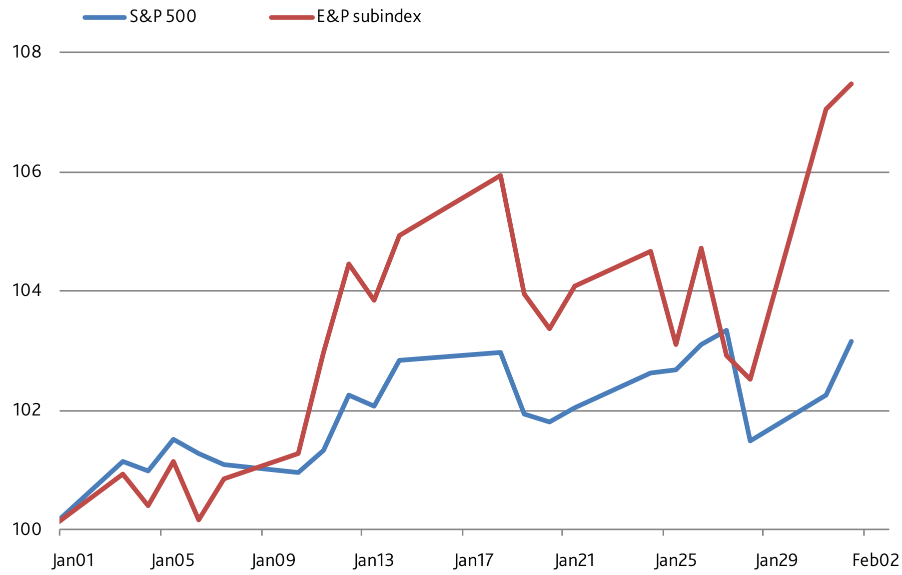


Figure 4. S&P 500 vs. E&P subindex (indexed at 12/31/2010 = 100)



Two gauges warrant monitoring in assessing the broader impact of events in the Middle East. First is the price of oil. Considering the strength of the US economy right now, oil might have to go to $120 per barrel to have any meaningful negative impact on the pace of economic growth.[2] Such a sharp price increase is unlikely to happen under the benign scenario, but it could well occur if market participants begin pricing in the tail risk of the more severe outcome.

The other gauge is the CDS spread of Israeli government debt. Israel's five-year CDS spread has widened recently, from 116 bp on January 26 to 145 bp on February 1, but not nearly as much as that of other countries in the region (Figure 1). Israel's CDS-implied rating dropped only a single notch last week, from Baa2 to Baa3. A substantial widening of Israel's CDS spread, and a

[2] Estimate from John Lonski, Moody's Analytic's capital markets economist.

concurrent drop in its CDS-implied rating, would indicate that market participants are beginning to assign a higher probability to the severe scenario.

Egyptian default risk

Changes in credit spreads serve as proxies for shifts in the markets' assessment of sector or entity-level default risk. But readers should recall that credit spreads not only represent default risk, but also other factors such as liquidity, investor sentiment and risk aversion etc. The latter factors can be grouped together under the rubric of the "market price of risk". Removing the market price of risk from an entity's credit spread, plus adjusting for an assumed loss-given-default rate, leaves a "pure" probability of default estimate. Moody's analytics expresses this in its CDS-implied Expected Default Frequency (EDF™) metrics.[3] Since early November, Egypt's five-year CDS-implied EDF metric has increased from less than 1% to 2.2% (Figure 5).[4] This, of course, is considerably less than the country's CDS spread shown in Figure 1, with the difference mainly reflecting the market price of risk.

Figure 5. Egypt's five-year CDS-implied EDF metric

Ratings view

On January 31, Moody's lowered Egypt's government bond rating from Ba1 to Ba2, and changed its outlook from negative to stable. The downgrade was triggered by an increase in event risk stemming from the country's political unrest and the potential impact on its already weak government finances. Moody's noted Egypt's "deep-seated political and socio-economic challenges…high rate of unemployment, elevated inflation and widespread poverty", along with a fiscal deficit of approximately 8 percent of GDP. Offsetting factors include the country's "robust external position…well-diversified economy [and] favourable public debt structure with limited financing risk". In addition, Moody's noted that the Egyptian government has demonstrated "a high degree of willingness to repay and has never defaulted on its bonds."

[3] For more details, please see Douglas Dwyer, Zan Li, Shisheng Qu, Heather Russell and Jing Zhang, "CDS-implied EDF™ Credit Measures and Fair-Value Spreads", New York: Moody's Analytics, March 11, 2010. The paper also discusses the differences between physical probabilities of default and risk-neutral default rates (the latter include the market price of risk. The paper is available at http://www.moodyskmv.com/research/files/CDS_Implied_EDF_Credit_Measures_and_Fair_Value_Spreads_PUBLIC.pdf

[4] Sovereign CDS-implied EDF metrics are published weekly in the *Sovereign Risk Report*, available on moodys.com.

Note on Moody's Market Implied Ratings: Moody's bond- and CDS-implied ratings are part of the Market Implied Ratings platform. The bond-implied ratings, for example, measure the trading level of an issuer's bonds and compare this to the issuer's Moody's rating. Thus, if an issuer's bonds trade in line with B3-rated bonds, the issuer's bond-implied rating is B3. If the issuer's Moody's rating is B1, the ratings gap is -2. Conversely, issuers whose bonds trade expensively to their Moody's rating have positive ratings gaps. Implied ratings are determined with reference to market-wide credit spreads, which are updated daily. If an issuer's implied rating increases (decreases), this is because its credit spread has tightened (widened) by an amount in excess of any general market movement.

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