Occasional signs of life

- Occasional signs of life in the EUR new issue market
- New issue premiums pushing secondary wider
- Wide Stibor and Euribor fixings cause dislocations to short-end SEK credit curve and basis swaps

Close to all-time wides in SenFin and iTraxx at 175bp constitute a tough environment for new issue markets. Credit markets continue to take a more downbeat view on the economic outlook and the European sovereign crisis than equities. There is a worrying tendency for cash spreads to drift slowly wider also on days when equities are up.

New issue premiums push covered spreads wider
The new issue market for EUR covered was active for two weeks before renewed volatility caused a new slowdown this week. Some EUR 20bn of covered supply in two weeks (including benchmarks from Swedbank, Nordea and Sparebank Boligkreditt) had a marked impact on secondary market spreads, where especially French and Italian covered turned out to be sensitive. For a brief period covered underperformed senior. To a large extent, we think the widening in covered reflects generous new issue premiums which have caused the secondary curve to re-price. However, the bigger picture is that covered spreads have remained resilient relative to unsecured spreads over the past month.

A lesson for unsecured markets?
The experience with covered new-issue premiums pushing secondary spreads wider is worth keeping in mind whenever the new issue market opens for senior banks debt, a market that has been quiet since mid-July. The odds seem better for corporates to avoid a similar gradual re-pricing from new issues, but we would still be careful. As this is being written, KPN (Baa2/BBB) prints 500m EUR 10Y @ ms+193bp which is some 15-20bp outside where secondary spreads closed the day before. RCI Banque tapped EUR 250m 3.75% 07/2014 some 40bp outside yesterday’s close.

Basis swap trades become attractive again
Libor spreads have followed senior unsecured spreads to wide levels, which have caused a number of dislocations. Euribor and Stibor spreads are not only wide but unusually upward sloping. As a result of wide Euribor spreads on the EUR side, the EURSEK basis swaps are again wide making assets swapped to SEK attractive. Six-month spreads also seem attractive compared to three-month spreads.

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For full disclaimer and definitions, please refer to the end of this report.
Credit spread views

iTraxx & iBoxx non-financials – bearish
- We expect continued volatility and wider peaks over the next few months, driven by a view that the EUR sovereign crisis has further to go.
- Non-financial spreads are pricing in an economic slowdown but not yet a full recession, in our view.
- There is considerable risk near-term that new EUR supply offering wide new-issue premiums will push secondary spreads wider, especially compared to CDS.

iTraxx & iBoxx senior financials – bearish
- The problems with European banks have not gone away and are likely to get worse before they get better. Sovereign turmoil and bank funding concerns are likely to remain with us for some time.
- Any improvement in sentiment will result in new supply which will likely re-price the secondary market.
- Significant positive cash-CDS basis will continue to put negative pressure on cash spreads.

Scandi EUR covered – bullish
- New issuance pushed secondary spreads a few bp but spreads are still rock-solid compared to most sectors. With EURSEK basis swaps being prohibitively expensive, we expect new supply to focus on the USD market for size and the domestic SEK market for taps.
- The aggregate iBoxx EUR covered index suffers from a high content of poorly performing countries, notably France, Spain and Italy, which is likely to push the index wider.

EURSEK basis swaps – neutral
- We think the recent spike in EURSEK basis swaps have widened partly driven by wider Euribor spreads. “Safe haven” strengthening of the SEK has tended to push in the same direction. A partial offsetting factor is the risk for wider Stibor spreads.
Senior spreads give opportunities in basis swaps

Senior unsecured spreads and Libor – OIS
Senior bank unsecured spreads are at historically high levels. This is also reflected in wide interbank spreads (see Figures 7 and 9). Euribor has been much more impacted than Stibor, which makes sense with European banks trading at much wider unsecured spreads.

Steep slope in Libor spreads
In EUR the 3m vs. 6m basis swap have widened in line with bank spreads (see Figure 8). We say this is largely an unsecured credit spread which we think may go even wider, so outright positions are in practise have some similarities to positions in iTraxx senior financials. It is interesting that the 1Y is much wider than the 2Y, which suggests that something nasty that blows out bank spreads is more likely to occur near term than further on.

Intuitively receiving 3m Euribor +30bp and paying 6m Euribor seems over 1y seems appealing when 6m Euribor is currently 20bp wider than 3m Euribor. In fact the spread between 6m and 3m Euribor in recent years never exceeded 32bp, not even during the peak of interbank stress in 2008-09. This suggests that the curve may not steepen that much even in a more stressed environment (see Figure 10). At the same time, if one believes that interbank stress is increasing, a 3m receiving position would in practice mean more opportunities to receive potentially elevated Euribor. As shown, if there is escalating interbank stress, Euribor – OIS spreads can become very elevated which would likely benefit a 3m receiving position. However, our bearish view on senior bank spreads in combination with the correlation in Figure 8 suggests that the initial mark-to-market risk in an outright 3m vs. 6m basis may not be the best part of the package.

Inverted spread curve in Swedish CP
In SEK, 6m Stibor is far from as elevated compared to 3m Stibor as in EUR. In Swedish CP we would nevertheless pick as long maturities as possible since corporate CP price with a spread above Stibor, which is curious, since long-term spreads for many high-rated corporates would be inside senior unsecured bank spreads for maturities above 1y.

EURSEK basis swaps spike
Cross currency basis swaps have been volatile against the USD since August, but only recently have we seen swings in the EURSEK basis. We think the elevated Euribor – OIS spread plays a role for the recent movement in basis. As we pointed out above (and shown in Figure 9) Euribor

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**Figure 7: iBoxx SenFin ASW and 12m Euribor spread**

Sources: Bloomberg and Markit

**Figure 8: iBoxx SenFin ASW, 3m vs. 6m basis swap**

Sources: Bloomberg and Markit

**Figure 9: 3m Libor – OIS spreads**

Source: Bloomberg
spreads are much wider than Stibor spreads. Assets paying Euribor will again tend to be attractive in Stibor terms, not least EUR covered and AAA rated issuers.

Please see list of recommendations on page 5.
# Trading recommendations

<table>
<thead>
<tr>
<th>Trade</th>
<th>Entry</th>
<th>Entry date</th>
<th>Stop loss</th>
<th>Target close</th>
<th>Exit date</th>
<th>Status</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buy Spintab 4.25% 06/2014 EUR &amp; Sell SEB 4% 03/2014 EUR covered</td>
<td>2+34bp vs 2+22bp</td>
<td>2011-09-09</td>
<td>20bp spread</td>
<td>6bp spread</td>
<td>Open</td>
<td>Spintab issuance in EUR has pushed secondary spreads wider and 12bp spread to SEB gives narrowing</td>
<td></td>
</tr>
<tr>
<td>Buy Spintab 4.125% 06/2014 EUR and basis swap to 3m Stibor+85bp. Sell Spintab 166@ Stibor +48bp</td>
<td>Stibor 3m +85bp vs Stibor 3m +48bp</td>
<td>2011-09-09</td>
<td>Buy and hold</td>
<td>Buy and hold</td>
<td>Open</td>
<td>Wide EURSEK basis and wide 6m vs 3m basis combined with wide EUR covered spread in the 2014 maturity</td>
<td></td>
</tr>
<tr>
<td>Buy FRA Jun 12 vs RIBA Sep 12</td>
<td>56bp</td>
<td>2011-09-08</td>
<td>52bp</td>
<td>64bp</td>
<td>Open</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Receive 3m Euribor +30bp and pay 6m Euribor in 1Y basis swap</td>
<td>30bp</td>
<td>2011-09-09</td>
<td>Buy and hold</td>
<td>Open</td>
<td>The 3m6m basis is driven wider by high senior spreads. Interestingly the position is likely to overcompensate in a stressed interbank market due to additional opportunities to receive (potentially elevated) fixings in the 3m leg. At the same time the 6m vs 3m spread never exceeded 32bp</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Handelsbanken Capital Markets
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