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MARKET Commentary

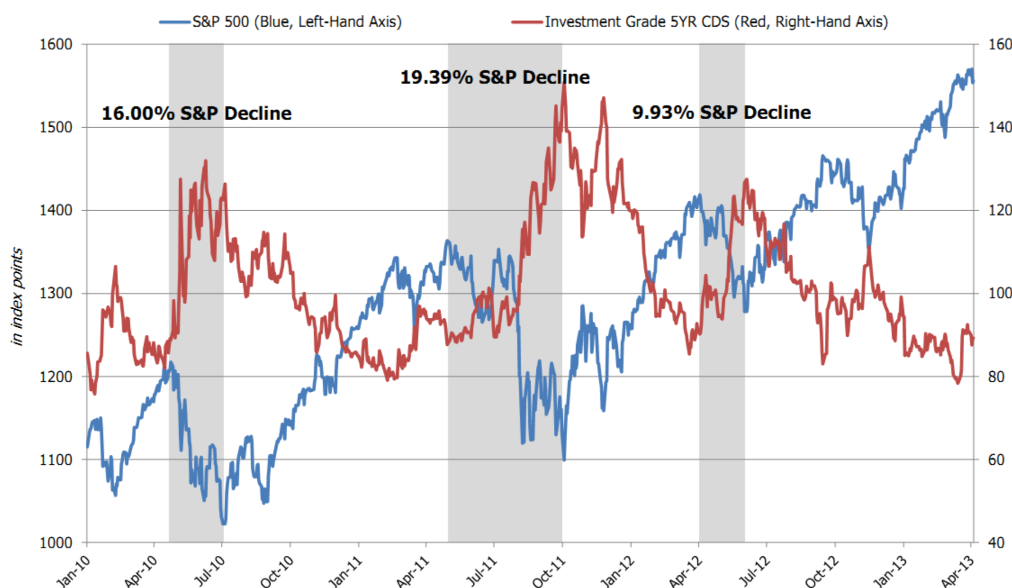
Volatility Awakens

April 2013

Risk markets rallied strongly in the first quarter spurred on by accommodative global central bank policy and positive economic data out of the United States. If, as Ben Graham opined, in the short run, the market is a voting machine – participants are voting for the accommodative policies of Federal Reserve Chairman Bernanke and his global peers at the Bank of England, European Central Bank and Bank of Japan.

In April, in each of the last three years, the clamor for risk assets has taken a breather as volatility awakes from its winter hibernation. In each of the last three years, the S&P 500 has peaked in April and subsequently declined appreciably over the succeeding months (see Figure 1). Credit spreads experienced similar weakness over these periods, widening on risk aversion. European sovereign solvency, the Arab Spring and a significant trading loss at JP Morgan were the primary catalysts of past market sell-offs. Additionally, early year investor optimism eroded as economic activity proved to be less robust than initially believed. The botched bailout of the Cyprus banking system may be the precursor to a similar let-down in 2013. If so, we would view wider credit spreads as an opportunity to selectively add risk rather than avoid it.

Figure 1: S&P 500 and Investment Grade Spreads (5 Yr CDS)



Source: Bloomberg

US Treasuries

As of 29-March

Benchmark	Yield
3 Month	0.07%
6 Month	0.10%
1 Year	0.12%
2 Year	0.24%
5 Year	0.77%
10 Year	1.85%
30 Year	3.10%

Bank of America/Merrill Lynch Indexes

28-Feb to 29-Mar

Index	Return
1-3 Yr Gov/Corp ≥ A	0.04%
1-3 Yr Municipals	0.05%
1-3 Yr Agencies	0.05%
0-3 Month UST	0.01%
S&P 500	3.75%

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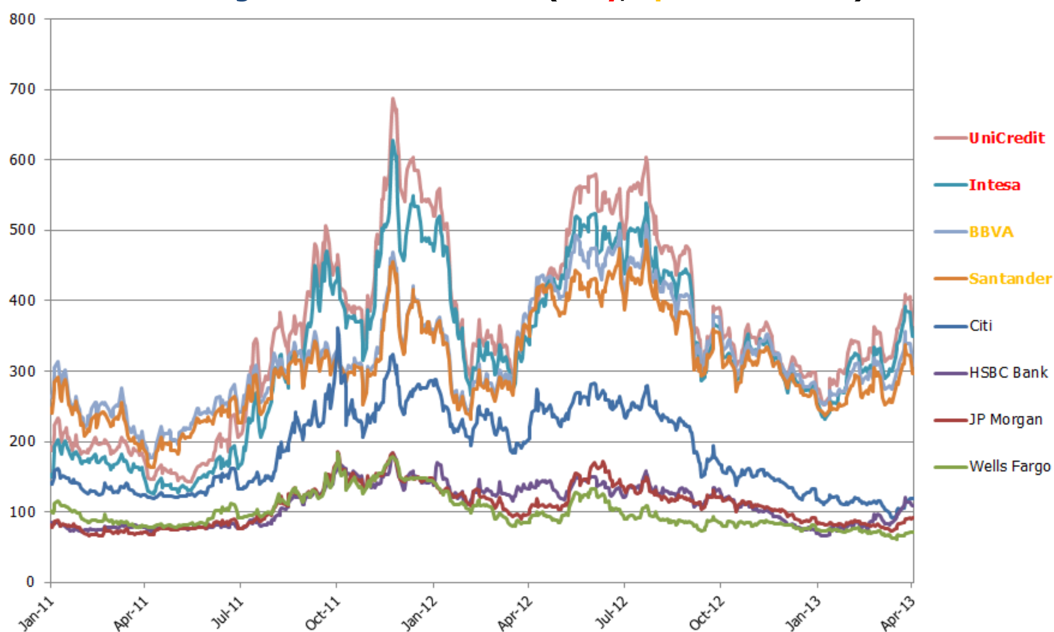
Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan, The Economist, S&P and Center on Budget and Policy Priorities, Wall Street Journal

March Madness

The crisis in Cyprus served as a stark reminder that the issues plaguing the Eurozone are still very much a factor. Excessive debt, questionable bank balance sheets, weak economic activity and disparate national interests continue to haunt policymakers and will do so for the foreseeable future. Granted, a banking crisis requiring a €17 billion bailout in a country that represents just 0.2% of European Union GDP should probably generate little fanfare given what has transpired in Spain, Greece, Portugal and Ireland. In those countries' respective banking bailouts, insured and uninsured deposits were unscathed by international aid to bolster capital in the banking systems. Bank deposits in the euro zone were safe.

No longer – the crisis in Cyprus suggests that Eurozone depositors have reason to fear. The mad scramble began when an initial proposal to recapitalize Cypriot banks included a tax of 6.7% on deposits of up to €100,000, the ceiling for deposit insurance in the euro zone, and 9.9% on deposits above €100,000. Suddenly, bank deposits had a significant element of risk to them. Markets shuddered. Despite claims that Cyprus was a unique situation, Italian and Spanish bank risk premiums rose (see Figure 2) as investors priced in this new uncertainty. Ultimately, bank deposits under €100,000 were left untouched while those above that threshold were subject to massive haircuts (up to 80%) to help fill the bank capital shortfall. Capital controls were introduced, effectively fencing the Cyprus economy off from the rest of the monetary union. A euro in Cypress is no longer the same as one in Germany – a Cypriot euro can't be easily spent, withdrawn or converted.

Figure 2: Bank 5 Yr CDS (Italy, Spain and Other)

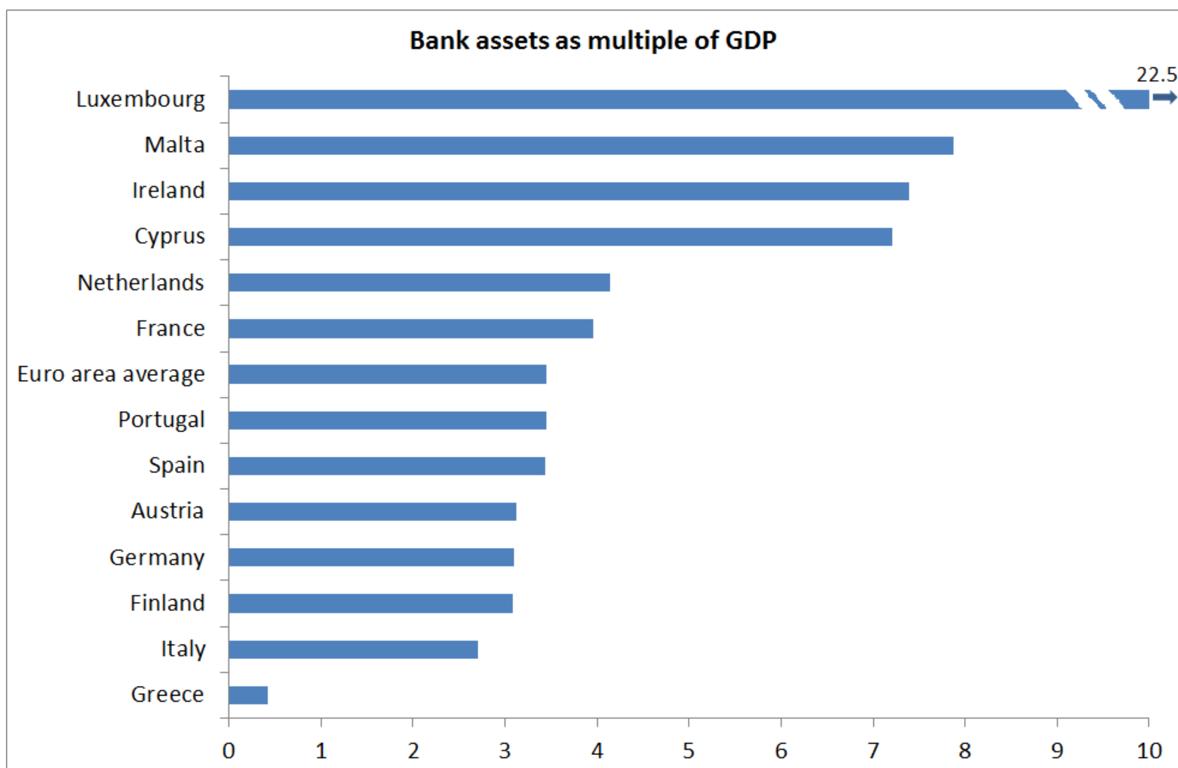


Source: Bloomberg

It should come as no surprise that Cyprus' banks were in trouble, but the manner in which they were dealt with signaled a significant shift in policy. The insipid state of the Cyprus banking sector was known well in advance. The banks, flush with Russian deposits, invested heavily in Greek government bonds which were ultimately written down in the 2011 Greek debt restructuring creating gaping holes

in their balance sheets. The Cypriot government couldn't rescue their banking sector as it was eight times the size of the country's economy. Thus, they were at the mercy of the troika (European Central Bank, the European Commission and the International Monetary Fund). Slovenia will be next in line and should expect similar treatment. Other countries with outsized financial industries would be wise to keep a close eye on their banks (see Figure 3), like Luxembourg at 22 times the size of their economy.

Figure 3: Eurozone Bank Assets to GDP



Source: Lombard Street Research/ NY Times

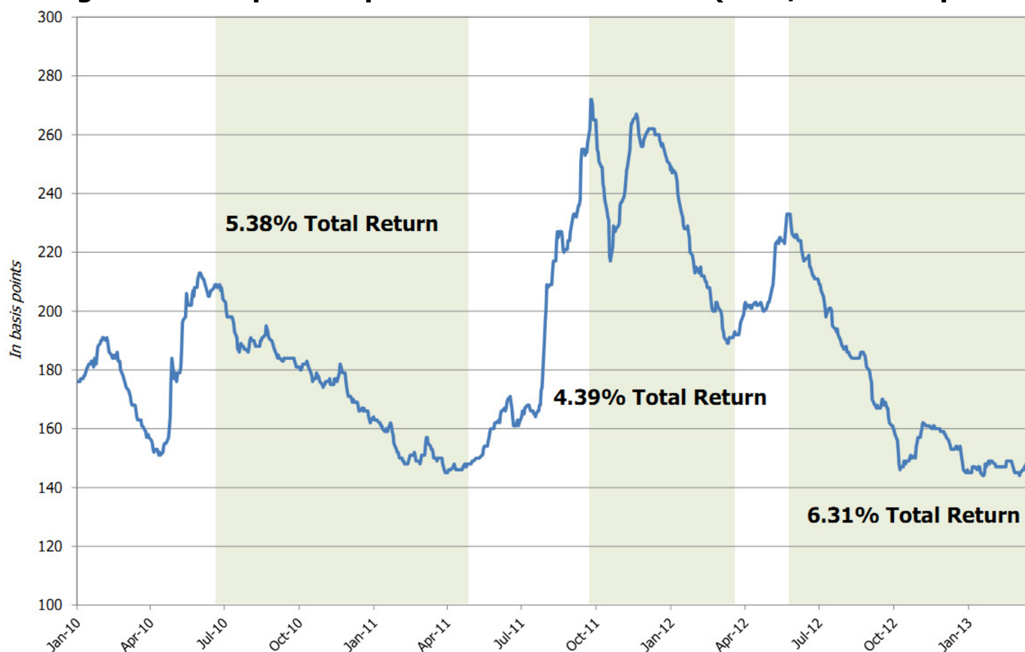
Unfortunately, inconsistent policy creates uncertainty in the European banking system, putting weaker banks under pressure as depositors and investors cut their exposure. The market is prudent to price in a greater premium for risky banks, and uninsured deposit holders are now on notice that their money can and will be taken from them. Depositors and creditors would be wise to review their European banking exposure and eliminate exposure to banks with little national support.

The European Union should move forward to develop a central bank regulator with resolution authority, similar to the FDIC, to provide uniform oversight and policy. Uninsured bank deposits, no matter the country, are not without risk and should be treated accordingly. It should be noted that in recent years, U.S. uninsured depositors have borne losses in bank failures. From 2003-2007, of the ten banks failures, nine resulted in an average loss of 22% to uninsured depositors, while the financial crisis years pushed losses on uninsured deposits to 41% in 409 of the 465 bank failures, according to the FDIC and JP Morgan. If U.S. banks deemed by many to be safer than their European counterparts warrant such caution, how should investors view the risk of troubled European banks?

Volatility Offers an Opportunity

While the markets recovered from a brief sell-off due to the situation in Cyprus, there are many factors such as ongoing budget negotiations, the looming debt ceiling debate, North Korea saber rattling, the Italian government in flux, and an upcoming earnings season which could serve as catalysts for a credit market sell-off. We view potential spread widening events as opportunities to selectively add credit exposure rather than shy away from it. Performance after credit spreads peaked has been strong (see Figure 4). We expect the U.S. economy to continue to muddle along and global central bank policy to be accommodative. Overlay a strong demand element and credit spreads look well supported even at current levels. We remain cautious on European credit with the expectation of further volatility as policymakers deal with each new "unique" situation.

Figure 4: High Grade Corporate Spread Over US Treasuries (BofA/ML US Corporate Index)



Source: BofA/ML & Clearwater

Looking Forward

Risk assets have performed well over the last several months. We suspect that volatility has been hibernating, as there are many catalysts for a market sell-off. We would view market weakness as a potentially attractive buying point, especially in U.S. and selective global credit, as central banks will keep their feet firmly on the accelerator for some time. However, we are wary of Europe as policymakers continue to offer ad hoc responses to crises and do not see this pattern shifting anytime soon.

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