



Economics Weekly

8 March 2010

Sovereign credit risk to remain in the spotlight?

The fiscal crisis in Greece has again shifted the market's focus to sovereign credit spreads

Ongoing economic and fiscal uncertainty poses a risk that sovereign credit spreads could rise further, particularly in highly-indebted countries

While credit spreads have risen in the UK, they remain well below those of the highly-indebted peripheral countries in Europe

There are various way of measuring sovereign credit premia, but we believe OIS-adjusted spreads are the best

The travails of Ireland and, more recently, Greece have turned the spotlight back on the sovereign credit markets. Since November last year, sovereign credit spreads in Greece have widened sharply amid growing fears that the country's fiscal problems could precipitate a prolonged economic stagnation or a sovereign default. It is not only Greece, however, that has been affected. Fears of contagion have pushed the spreads of other countries higher, particularly those perceived to have weak fiscal positions. In this weekly we look at some of the main measures of sovereign credit risk and assess what they imply for country default in 2010.

Government bond spreads

For countries which share the same currency, such as members of the Euro-zone, the easiest way of measuring sovereign credit risk is to assess the cost of each country's government borrowing in relation to a benchmark - namely Germany (widely seen as the anchor for inflation expectations). Chart a shows the evolution of 10-yr spreads over German bunds since 2005 for a select group of Euro-zone countries. Perhaps not surprisingly, the under-performance of Greece and Ireland has been marked. With 10-yr German bunds currently yielding 3.1%, the spread indicates that Greece is having to pay over twice as much as Germany for 10-year euro-denominated debt.

While comparisons of sovereign bond spreads provide an accurate assessment of credit risk within the Euro-zone, they cannot be accurately applied to countries that have their own currency. This is because the prevailing level of short-term interest rates also has a key bearing on the level of government bond yields. Abstracting from credit and liquidity issues, a 10-year government bond

yield can, broadly speaking, be considered to be the market's best guess of what the official short-term policy rate is likely to average over the life of the bond. For countries that have independent currencies and so different inflation targets (either implicit or explicit), the expected evolution of the short-term policy rate is likely to be very different.

OIS-adjusted spreads

In order to adjust for this, a better way of looking at sovereign credit spreads is on a swap-adjusted basis. This gives an indication of the credit risk relative to either three-month Libor or, more appropriately, the overnight index swap rate (OIS) - the benchmark cost of risk-free overnight money.

Chart b shows the OIS-adjusted sovereign credit spreads for a selection of countries. Although OIS rates fluctuate in response to changes in liquidity conditions in the wholesale market, the OIS-adjusted spread is, we believe, the cleanest measure of sovereign credit risk available. As the chart shows, spreads for all these countries have widened since early 2008. Since the start of the year, however, the sovereign credit premia of Greece and the UK have risen the most. Nevertheless, UK spreads are not out of line with Germany or the US, despite popular belief. On this measure, the real risk is, indeed, Greece and Ireland.

CDS spreads

There is another measure of sovereign credit risk which has received a high degree of publicity in the recent past - namely, sovereign credit default swaps (CDS). Sovereign CDS spreads measure the annual premium payable to protect against a sovereign default. For example, a spread of 100bp on a 5-year US dollar CDS contract with a notional

Chart a: Selected Euro-area 10-yr sovereign bond spreads (vs Germany)

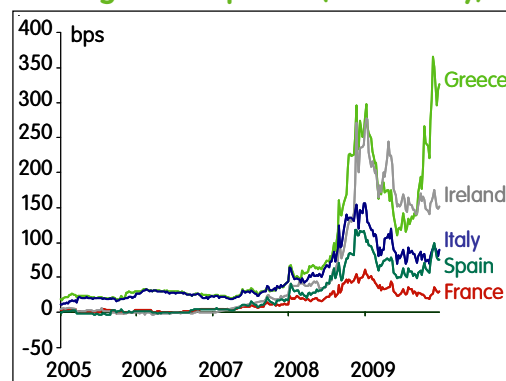
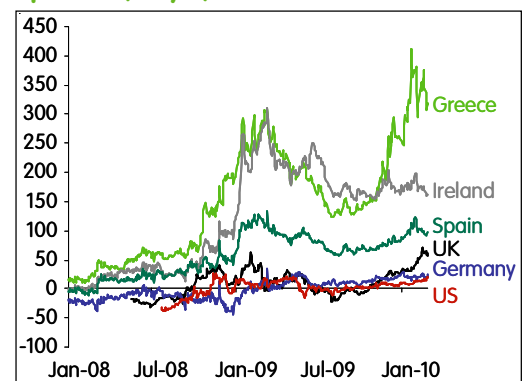


Chart b: OIS adjusted sovereign bond spreads (10-yrs)



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2010 calendar of central bank meetings

European ECB (1.00%) 8 April, 6 May, 10 June, 8 July
US FOMC (0-0.25%)
 16 March, 28 April, 23 June
UK MPC (0.50%)
 8 April, 6 May, 10 June, 6 July

Rolling calendar of UK data releases and events

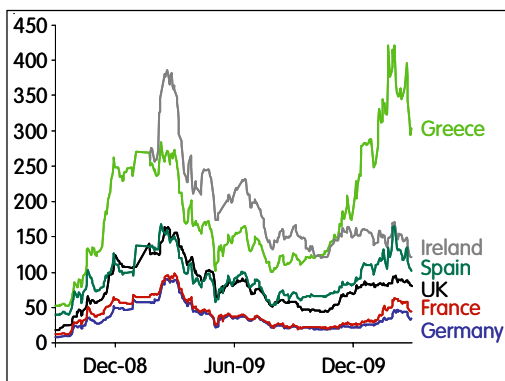
Trade balance (09/03)
 Industrial production (10/03)
 NIESR GDP est (10/03)
 BoE MPC minutes (17/03)
 Labour market stats (17/03)

Rolling calendar of US data releases and events

Retail sales (12/03)
 Industrial production (15/03)
 Producer prices (17/03)
 Consumer prices (18/03)
 Phil. Fed survey (18/03)
 Chicago PMI (22/03)

* All charts are sourced to Lloyds TSB Corporate Markets Economic Research, Bloomberg, and Thomson Datastream

Chart c: 5-yr sovereign CDS spreads



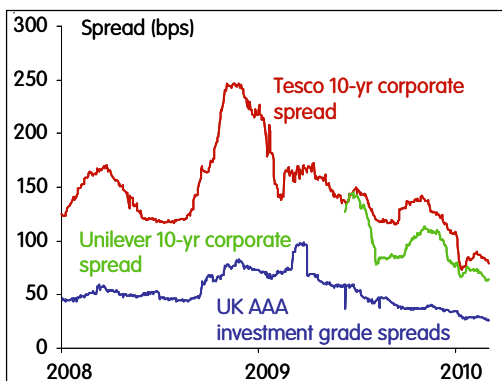
value of \$10m would cost \$100k per annum - implying a probability of default over 5 years of 5%. Chart c shows how various sovereign CDS spreads have moved since September 2008. Not surprisingly, those countries that have experienced a widening in their bond spreads have also seen their CDS spreads move higher.

While useful as a gauge, CDS data should be treated with caution. Firstly, because they are relatively illiquid, they can easily be distorted by sudden bouts of speculative pressure (as has already been the case in a number of markets). Second, CDS are used for purposes other than default protection. For example, an asset manager that has an overweight position in a region can rebalance a portfolio by buying the region's sovereign CDS, without needing to sell the underlying assets. Thus, market activity may have little to do with the underlying perception of default, but still move the price significantly.

Investment-grade bonds outperform

While sovereign credit premia have risen, interestingly this has not been reflected in non-sovereign credit spreads: AAA investment-grade spreads have narrowed sharply (see chart d). In the sterling markets, the reduction in investment grade spreads has been accentuated by corporate bond purchases by the BoE as part of its asset purchase programme. Taken at face value, the reduction in the spreads of blue-chip companies like Unilever, 3i and Tesco suggests the market now views these names to be nearly as safe as the sovereign credit that underpins them. This calls into question whether the widening in sovereign spreads is really justified.

Chart d: UK Investment grade spreads



What is the outlook for sovereign risk?

Over the coming months, ongoing uncertainty about the economic and fiscal outlook risks putting further upward pressure on sovereign credit spreads, particularly those countries where public sector indebtedness is under the microscope. While there is a possibility that Greece could default if its fiscal austerity programme is unsuccessful, good demand for last week's 10-yr bond offering suggests the market still has an appetite for Greek debt, albeit at a price.

In the UK, credit spreads have widened but they remain well below the peripheral highly indebted countries of Europe. Indeed, the probability of a UK sovereign default remains negligible. Firstly, the size and dynamics of the UK are very different to Greece. Secondly, although the UK's budget deficit is at record high (close to 13% of GDP), the level of public sector debt is no worse than in many of the other major economies. Third, the average duration of UK government debt is far longer than most other countries; thus the UK is not exposed to significant roll-over risk.

Lastly, and perhaps more importantly, in contrast to Greece, the UK can, in theory, in a worse case scenario resort to eroding the real value of its debt through debasing its currency. Given the long-term cost to economic stability, we suspect this would only ever be considered as a last resort. Nevertheless, it underscores the point that sovereign credit spreads on countries with independent monetary policies are more a reflection of their perceived volatility than they are about the sovereign's true probability of default.

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Weekly economic data preview

8 March 2010

UK RICS and BRC surveys may show a thaw in economic activity

- The British may be obsessed with the weather, but unusually cold conditions in January certainly affected some high-frequency economic indicators, weighing on UK retail sales and mortgage approvals. However, the arctic weather is likely to have supported January industrial production, due this week, via a boost to utilities output, while manufacturing output is forecast to have been more subdued. Some February data are due from the British Retail Consortium (BRC) and Royal Institute of Chartered Surveyors (RICS) and the better weather should have supported activity. Indeed, the CBI distributive sales survey was surprisingly strong in February and we should get a rebound in the new buyer enquiries index in the RICS survey, though the house price balance may be little changed. Overall, it looks as if the economy continued to expand in the first quarter, but there are certainly good reasons to be cautious about prospects, not least because underlying domestic demand is likely to remain subdued and export growth has yet to benefit fully from the weaker pound. MPC members, including Barker and Dale, will provide their thinking on economic prospects this week. Following Greece's bond sale success last week (see below), it will be the turn of the UK this week to offer £3bn of 2022 nominal bonds and £0.9bn of 2032 linkers.
- Last week saw a generally higher level of confidence in euro-zone government bond markets as Greece announced a further €4.8bn of fiscal consolidation measures and launched a keenly anticipated €5bn 10-year bond issue. In response, the spread of 10-year Greek government bond yields over comparable German bunds has narrowed further to around 290bp, compared with 350bp or so a week earlier. But for all this relief, Greece remains under pressure from the ratings agencies and so must adhere to the fiscal consolidation plan in its enhanced form. That will involve considerable sacrifice for some time to come. Following March's ECB monetary policy decision where the main refinancing rate was left on hold at 1% but further steps were taken to unwind 'unconventional' policy stimulus measures, this week sees a fairly light economic data calendar. The main highlight is likely to be January industrial production figures for the euro-zone along with associated national data in a variety of countries including Germany, France and Italy. Exports - widely acknowledged as a volatile driver of overall economic activity - remain healthy and we look for January euro-zone industrial production to rise by 1.3% month-on-month following a decline of 1.6% previously. Beyond this, final Q4 GDP data will be released for Italy, following the preliminary Q4 estimate of a 0.2% quarter-on-quarter contraction.
- The relative excitement of the US labour market report last week gives way to retail sales, consumer confidence and trade data this week, while the Treasury will issue \$74bn of notes and bonds. The near 10-point fall in the Conference Board's consumer confidence index in February caused jitters in the financial markets, though this was not reflected in the University of Michigan (UoM) consumer sentiment survey. We will get the preliminary March reading of the UoM survey this week. Official February retail sales are also due and may fall back after a stronger-than-expected monthly rise of 0.5% in January. US trade data are also due and may show a widening of the deficit in January. The bottom line is that, with underlying inflation remaining low and economic recovery in its early stages, supported by an inventory rebound and policy stimulus measures, the Fed is not likely to raise interest rates until the latter part of the year at the earliest.

Hann-Ju Ho, Mark Miller

Chart 1: UK RICS new buyer enquiries has trended lower in recent months

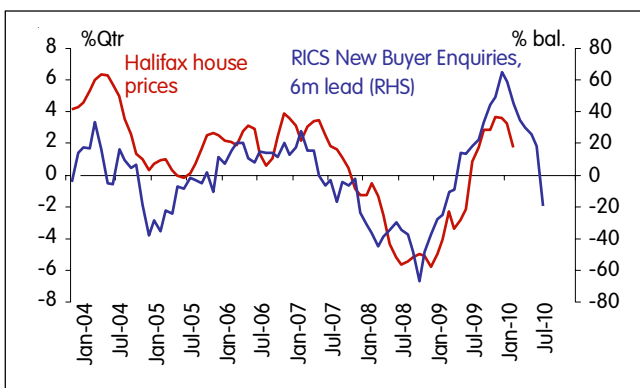
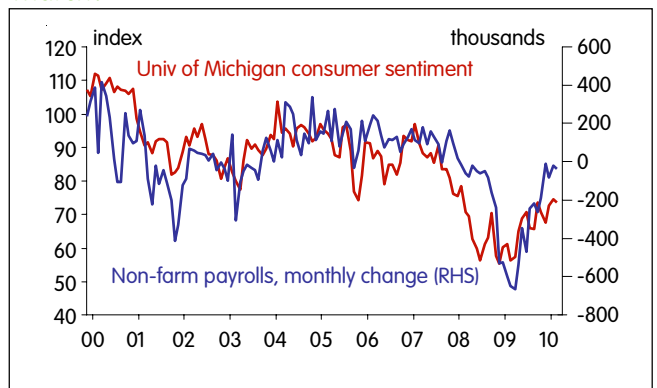


Chart 2: Will US consumer sentiment rise or fall in March?





8 - 12 March 2010

Country	Time	Event	Actual	Consensus	Forecast	Previous
Mon 8th						
07:30	FR	Bank of France bus. Sentiment (Feb)		104	n/a	104
09:30	EZ	Sentix investor confidence (Mar)		-9.3	n/a	-8.2
11:00	GE	Industrial production (Jan)		1.00% (0.90%)	1.80% (1.70%)	-2.60% (-7.10%)
14:00	CA	Housing starts (Feb)		186.0k		186.3K
Tue 9th						
00:01	UK	BRC retail sales monitor (Feb)		-	-	-
00:01	UK	RICS house price balance (Feb)		30%	28%	32%
05:00	JN	Leading index (pJan)		96.6	96.6	94.3
05:00	JN	Coincident index (pJan)		99.6	99.6	97.4
07:45	FR	Trade balance (euros) (Jan)		-4.0bn	n/a	-4.3bn
09:30	UK	Visible trade balance (Jan)		-£7.0bn	-£6.8bn	-£7.3bn
09:30	UK	Trade balance non eu (Jan)		-£3.4bn	-£3.3bn	-£3.5bn
09:30	UK	Total trade balance (Jan)		-£3.1bn	-£3.1bn	-£3.3bn
15:00	US	LBD/TIPP economic optimism (Mar)		n/a	n/a	46.8
22:00	US	ABC consumer confidence (w/e 7th Mar)		-48	n/a	-49
23:30	AU	Westpac consumer confidence (Mar)		n/a	n/a	-2.60%
23:50	JN	Machine orders (Jan)		-3.50%	-3.50%	20.10%
23:50	JN	Domestic CGPI (Feb)		0.10% (-1.50%)	0.1% (-1.50%)	0.30% (-2.10%)
Wed 10th						
05:00	CH	Trade balance (Feb)		\$7.15B	n/a	\$14.17B
07:00	GE	Trade balance (euros) (Jan)		15.00bn	n/a	13.50bn
07:00	GE	Current account (euro) (Jan)		17.00bn	n/a	20.60bn
07:00	GE	CPI EU-Harmonised (fFeb)		0.20% (0.30%)	0.20% (0.3%)	0.20% (0.30%)
07:45	FR	Industrial production (Jan)		0.20% (1.70%)	0.00% (1.50%)	-0.10% (-2.30%)
09:30	UK	Industrial production (Jan)		0.20% (-0.80%)	0.30% (-0.60%)	0.50% (-3.60%)
09:30	UK	Manufacturing production (Jan)		0.20% (1.40%)	0.10% (1.40%)	0.90% (-1.90%)
-	UK	NIESR GDP estimate (Feb)		n/a	n/a	0.40%
12:00	US	MBA mortgage applications (5th Mar)		n/a	n/a	14.60%
15:00	US	Wholesale inventories (Jan)		0.20%	0.30%	-0.80%
19:00	US	Monthly budget statement (Feb)		-\$202.0bn	-\$200.0bn	-\$42.6bn
23:50	JN	GDP annualised (fQ4)		4.00%	4.00%	4.60%
23:50	JN	GDP deflator (fQ4)		(-3.00%)	(-3.00%)	(-3.00%)
Thu 11th						
00:30	AU	Employment change (Feb)		15.0k	20.0k	52.7K
00:30	AU	Unemployment rate (Feb)		5.30%	5.30%	5.30%
02:00	CH	CPI (Feb)		(2.50%)	(2.50%)	(1.50%)
02:00	CH	Industrial production (Feb)		(19.60%)	n/a	(18.50%) - Dec
07:45	FR	Non-farm payrolls (fQ4)		-0.40%	n/a	-0.40%
13:30	CA	Capacity utilization rate (Q4)		70.0%	70.0%	67.50%
13:30	CA	New housing price index (Jan)		0.40%	0.50%	0.40%
13:30	CA	Int'l merchandise trade (Jan)		c\$0.10bn	c\$0.2bn	-c\$0.2bn
13:30	US	Trade balance (Jan)		-\$41.0bn	-\$41.0bn	-\$40.2bn
13:30	US	Initial jobless claims (w/e 6th Mar)		450k	450k	469k

**8 - 12 March 2010**

Country	Time	Event	Actual	Consensus	Forecast	Previous
Fri 12th						
04:30	JN	Industrial production (fJan)		n/a	n/a	2.50% (5.10%)
07:00	GE	Wholesale Price Index		n/a	n/a	1.30% (1.90%)
11:00	EZ	Industrial Production (Jan)		0.70% (-1.80%)	1.30% (-1.20%)	-1.70% (-5.0%)
12:00	CA	Net change in employment (Feb)		17.5K	15.0k	43.0K
12:00	CA	Unemployment rate (Feb)		8.30%	8.30%	8.30%
13:30	US	Advance retail sales (Feb)		-0.20%	0.10%	0.50%
13:30	US	Retail sales less autos (Feb)		0.10%	0.20%	0.60%
14:55	US	U. of Michigan confidence (pMar)		73.9	73.5	73.6
15:00	US	Business inventories (Jan)		0.10%	0.20%	-0.20%

Key events of the week

Mon 8th	UK	BoE's Barker speaks at NIESR (13:00)
	EZ	ECB's Stark speaks in Arlington (17:00)
	US	Fed's Sack speaks in Arlington (22:00)
Tue 9th	JN	30-year bond auction (03:45)
	UK	£3bn 4% 2022 gilt auction (11:30)
	US	Fed's Evans speaks to economists in Arlington, US Treasury to sell \$40bn 3-year notes (18:00)
Wed 10th	EC	ECB's Trichet speaks in Frankfurt (18:00)
	AU	Australia to sell a\$0.7bn 6.25% bonds due 2014 (00:00)
	UK	BoE's Haldane speaks at RICS (10:00)
	GE	EUR6bn 2-year note and EUR1bn I/L note auctions (11:15)
	CA	2-year notes auction (17:00)
	US	\$21bn 10-year Note reopening (18:00)
Thu 11th	EC	ECB publishes March monthly report (10:00)
	JN	5-year bond auction (03:45)
	UK	Bank of England releases inflation attitudes survey (09:30)
	UK	\$0.9bn 1.25% 2032 i/l bonds auction (11:30)
	US	30-year bonds reopening (18:00)
	CA	Bank of Canada governor Carney speaks in Ottawa (18:50)
	US	Fed's Dudley speaks at the SBE (19:00)
Fri 12th	EC	ECB's Trichet speaking in Stanford (20:45)
	UK	BoE's Dale speaks in Cambridge (10:00)

Source: Bloomberg

NB: Data in brackets denote YoY. Market consensus estimates are taken the preceding Friday.