Thoughts On Sovereign Debt CDS

I last visited the topic of credit default swaps (CDS) on sovereign debt in early June and concluded that with the exception of a few wayward players such as Greece and Portugal, the market was calming down. A repeat of that analysis today would show nearly all of the Eurozone's members have higher sovereign CDS costs. We can throw Norway and Sweden, neither of whom uses the euro, onto that pile as well. And, for those of you who need a good laugh, the euro-denominated CDS costs on U.S. sovereign debt have increased as well.

The real question at this point is why this market continues to exist. CDS have proven their utility in the corporate world as a way of creating synthetic corporate bonds; a fixed-income manager can buy a Treasury or become a fixed-rate receiver on a swap and then sell the CDS to replicate the less-liquid and supply-constrained corporate bonds.

It is different in public life. The European governments never have been bashful in expressing their disdain for these instruments, especially when traded "naked," or without the underlying bonds being owned. This is of no great concern; should we expect governments to embrace a real-time public scorecard of their shortcomings?

What is and should be a greater concern, though, it how CDS buyers have been shown they may not be able to collect on a winning bet. Did Greece default on its debt? Technically no; European bondholders have been forced into accepting "voluntary" losses; as they say in the Army, never volunteer for anything. Thus they are stuck with the marked-to-market losses on their bonds and will not be made whole by the CDS they bought for the occasion.

While this apparently gives the governments and the ECB, which campaigned against any losses on sovereign debt, some measure of pleasure, it most assuredly should not. Lenders have been shown they can and will be treated high-handedly and will protect themselves by demanding higher interest rates, both absolutely and as a spread to a benchmark. The most expensive credit is the money you wanted and could not get; this market niche traditionally was filled by subprime lenders and loan sharks.

As an aside, I tested to see whether rising credit spreads and interest rates were supplanting CDS in the Eurozone. The answer, for now, is indeterminate as the Greek situation happened too recently and everything else has been nothing more than a series of special events. I would expect, though, long-term yields and yield spreads alike to rise in the Eurozone with negative consequences for economic growth and capital formation. I would also expect the European banks, all of whom have relied on a public put option, to be a little more circumspect in borrowing short from the ECB to lend long to various European sovereigns. This will reduce their lendable capital and be a negative for economic growth in Europe.

Governments always and everywhere have had a compulsion to remove the thermometer from the room to pretend it is not getting hot. This instinct is and always has been wrong: You want the greatest transparency possible, bad news included, to go to your creditors. If the feedback is you are on the wrong path, listen. It works for people, it works for companies and it works for governments.

The only upside from all of this is maybe, maybe, there will be fewer of those endless meetings with all of the pictures of Angela Merkel and Nicolas Sarkozy talking to each other and looking like punch-and-judy characters in the process.