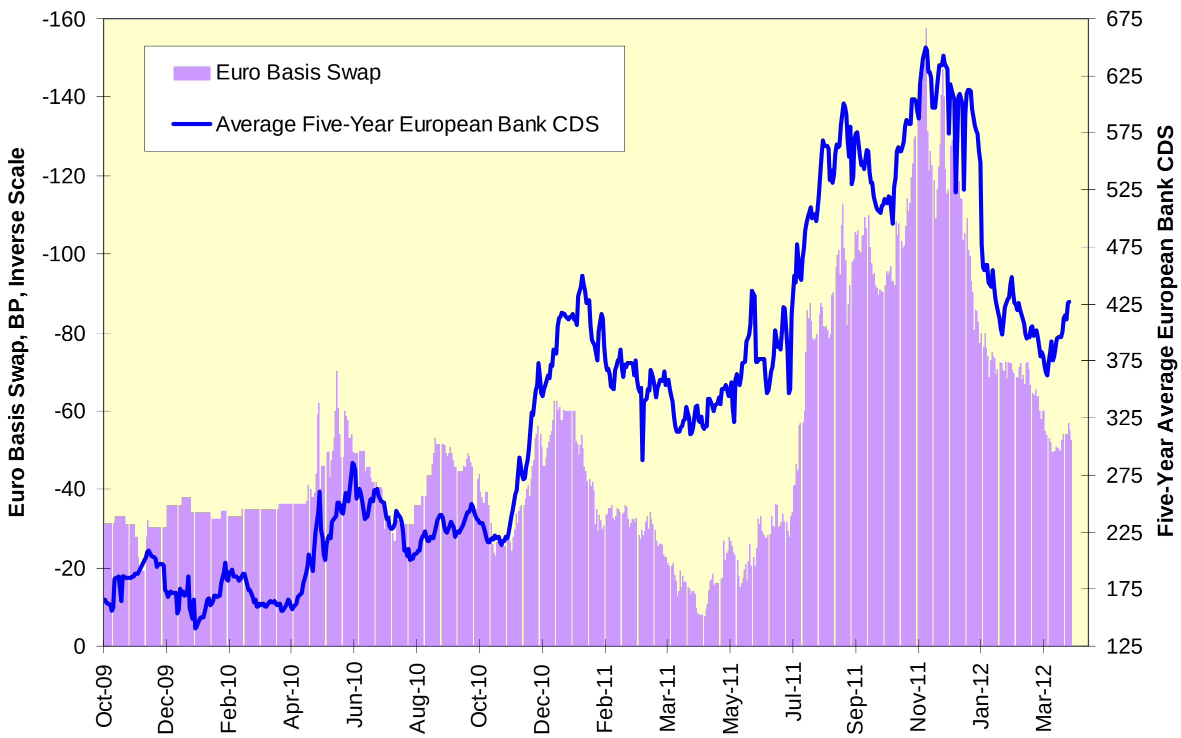
European Banking Hound Did Not Bark

Spanish Debt Problems Did Not Cause CDS Spike

I have marveled over the years how many gaps and reversals occur around market holidays; not only do markets move to the point of maximum confusion, they seem to do it at the point of minimum participation as well. Viewed in that light, the release of U.S. employment data on Good Friday earlier this month and the extended Easter weekend closures in Europe following a poor sovereign debt auction were almost par for the course.

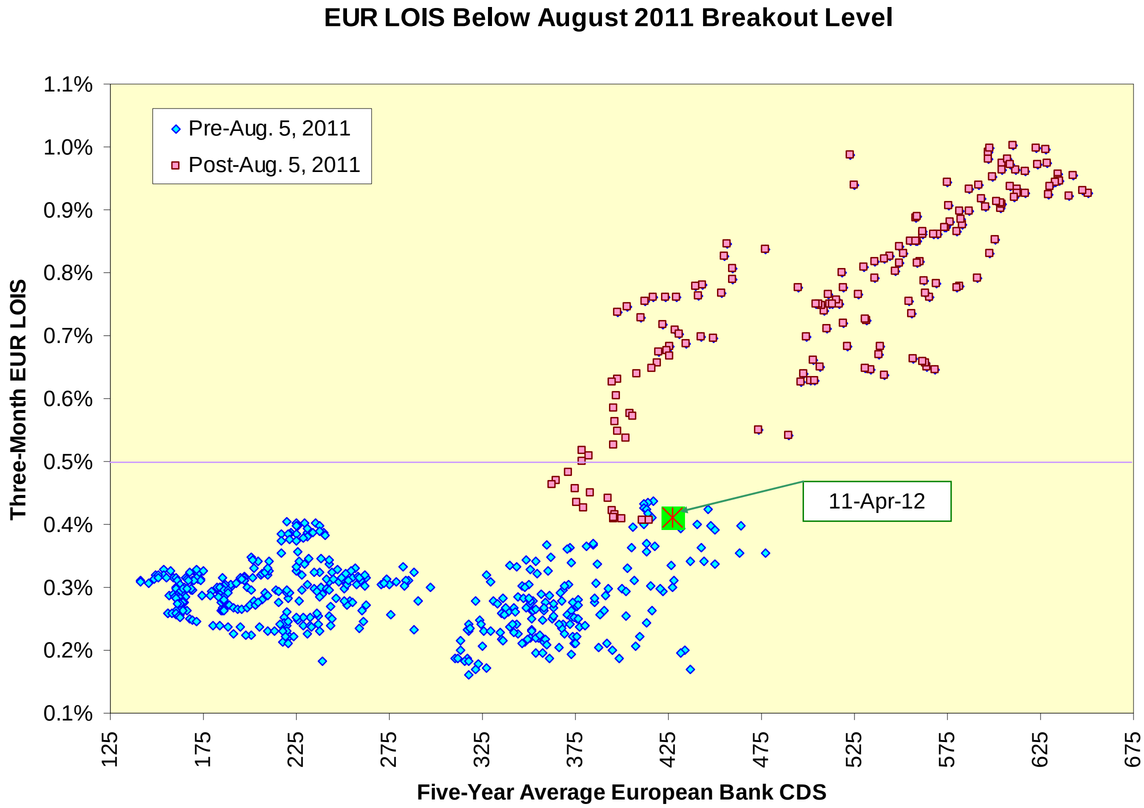
However, when I sat down to tote up the damage done to various European banks, I was surprised at how small it was. This was not a 2011-style banking panic, one in which sovereign offal threatened the banks' funding sources and sent the euro plunging against the dollar. The basis swap, or interest rate spread between floating euros and floating dollars, stopped narrowing, but that is about it. Moreover, the rise in an average of European banks' five-year CDS costs rose, but hardly by a life-threatening amount.

EUR Basis Swap And Bank CDS Costs: Where Is The Crisis?



Last year's explosive widening of the euro basis swap did pose some existential risks to banks whose assets had heavy dollar exposure but whose liabilities were primarily euro. The usual suspects seen standing around burning buildings with kerosene and matches while feigning a "Who? Me?" look included Société Générale (GLE), Deutsche Bank (DBK), UniCredit (UNCFF), BBVA (BBVA, how clever) and Santander (STD).

These banks and their international brethren did not want to lend to each other, which is probably the biggest burst of common sense they have exhibited in years. As a result, the spread between the Euribor and the euro overnight index swap rate widened out to crisis levels. I have split the observations of this LOIS (LIBOR – OIS) spread into before and after August 5, 2011 observations and mapped them against the bank CDS levels. It remains at the low end of the post-August 2011 range; if this is a crisis, we certainly have changed the definition thereof.



What all of this tells us is the hound of the European banking Baskervilles neither barked nor used your portfolio as a convenient substitute for a fire hydrant. The joint central bank extensions of currency credit swaps made at the end of November 2011 alleviated the panicked widening of the basis swap and the availability of LTRO funds alleviated the panicked widening of the LOIS spread. Together they alleviated the need for ululation in the bank CDS market, although here again the usual suspects showed up to sow panic.

Yes, we had a downturn in equity levels immediately after the Easter holiday, and yes, Spanish and Italian stocks look awful as impending austerity programs in both countries (My slogan: “Two countries! One currency! No sense!) will depress business conditions there. But much of this selling seemed like it was seizing on an excuse to take profits after a long and quiet rally and was done out of force of habit more than anything else.