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Germany Overtakes Spain in Debt Wagers Amid Crisis: Euro Credit
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By Abigail Moses

Sept. 16 (Bloomberg) -- Bets on German credit quality overtook those on Spain for the first time in a year as the mounting cost of bailing out the region’s most indebted nations infects Europe’s largest economy.

The net amount of German debt covered by credit-default swaps surged 20 percent this year to $18.2 billion, making it the third most-referenced European sovereign after France and Italy, according to the Depository Trust & Clearing Corp.
Germany’s debt-insurance costs, which have doubled since July, are still the lowest of the 17 countries sharing the euro.

Germany has provided the biggest share of the rescue packages for Greece, Ireland and Portugal, and Chancellor Angela Merkel is struggling to maintain taxpayer support after a string of election defeats. Attempts to end the two-year-old crisis failed to stop the rot spreading to Italy and Spain, which now risk missing deficit-reduction targets.

“It’s an acknowledgement that the pressure is moving into the core,” said Graham Neilson, chief investment strategist at Cairn Capital Ltd., a London-based credit asset manager overseeing $24 billion. “The more the dithering, the bigger the cost.”

Credit-default swaps are derivatives that allow investors to hedge against losses on sovereign or corporate debt or speculate on creditworthiness.

Record Amounts

The net amounts of contracts outstanding on France and Germany are the highest ever, while the sums bet on Italy, Portugal, Greece and Ireland’s credit have declined, according to the New York-based DTCC, which runs a central registry for the market. The $18.1 billion of swaps on Spain rose from $16.9 billion at the beginning of 2011.

France surpassed Italy as the most-traded default-swap contract worldwide last month and now has $25.3 billion of bonds covered compared with $23.5 billion for its Mediterranean neighbor. France is the second-biggest contributor to the euro- region rescues after Germany. The U.S. overtook Portugal.

“The extent of the European sovereign debt crisis became apparent recently when, for the first time on record, the single-name CDS referencing France became the most important one in terms of risk tranfer,” said Tim Brunne, a strategist at UniCredit SpA in Munich.

The cost of credit-default swaps protecting German government debt rose to 82 basis points from 39 on July 1, according to CMA. A basis point on a contract insuring $10 million of debt is equivalent to $1,000 a year. In the same period, contracts on France soared to 170 basis points from 80, making it the most costly top-rated government to insure.

Peripheral Debt

That's still a fraction of the price of insuring peripheral government debt. Credit swaps on Greece cost the equivalent of about 5,500 basis points and signal a near-certain probability of default within five years, according to CMA, which is owned by CME Group Inc. and compiles prices from dealers.

The price of contracts in basis points on Portugal and Spain jumped by half since the beginning of July to 1,058 and 372. Swaps insuring Ireland rose 10 percent to 820 and those on Italian debt almost trebled to 450, CMA prices show.

Even as credit-swap prices for Germany rise, yields on its governments bonds plunged to records this week because they're seen as havens amid the market turmoil. Benchmark 10-year bund yields dropped to 1.68 percent on Sept. 13, while the yield on two-year notes fell to 0.36 percent a day earlier.

Spanish 10-year yield spreads over similar-maturity bunds soared as much as 70 percent since the start of the year to a euro-era record 418 basis points on Aug. 5, and were 348 yesterday. The Italian-German spread more than doubled to a peak of 416 basis points in the same period, and was 367 yesterday.

Greek spreads over bunds fell to 2,090 basis points, after reaching a euro-era record 2,482 earlier in the day.

Small Proportion

Credit-default swaps cover only a small proportion of governments' outstanding debt, protecting about 1 percent of German, Italian and French sovereign securities and 2 percent of Spanish bonds, according to data compiled by Bloomberg.

An increase in swaps trading and a rise in the price of the debt-insurance contracts may be a wager on whether a nation's fortunes will improve or deteriorate and doesn't necessarily signal investors forecast a default. Credit-default swaps pay the buyer face value in exchange for the underlying securities or the cash equivalent should a borrower fail to adhere to its debt agreements.

Swaps trading on Germany and France is also increasing as near-record high prices attract sellers of default protection, while on the other hand the relatively low cost compared with contracts on peripheral European governments draws buyers.

'Cheaper Hedge'

"Germany is a cheaper hedge and is a key player in politics and banking irrespective of its fiscal make up,"
Cairn's Neilson said. "It's a cheap systemic hedge."

Debt insurance costs for Europe's periphery are soaring on speculation more countries will need bailouts and that the bloc is in danger of breaking up. The region's richest governments are also being hurt as the global economy slows and on concern their banks will suffer losses on debt holdings.

German banks have about 9 percent of the 98.2 billion euros ($136 billion) of Greek sovereign bonds held by the 90 lenders that took part in the stress tests run this year by the European Banking Authority and published in July. French lenders have about 8 percent of the aggregate amount under the EBA tests and top the list of Greek creditors overall, with $56.7 billion of private and public debt, according to a June report by the Basel, Switzerland-based Bank for International Settlements.

Moody's Investors Service cut its credit ratings on Credit Agricole SA and Societe Generale SA this week and kept its biggest lender, BNP Paribas SA, on review for a possible downgrade because of the risks posed by their investments in Greece.

"The focus is shifting and people are trading more on core names," said Simon Ballard, a credit strategist at RBC Capital Markets in London. "It's just a reflection of the fiscal pressure at the core to continuing the life support system for periphery."

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