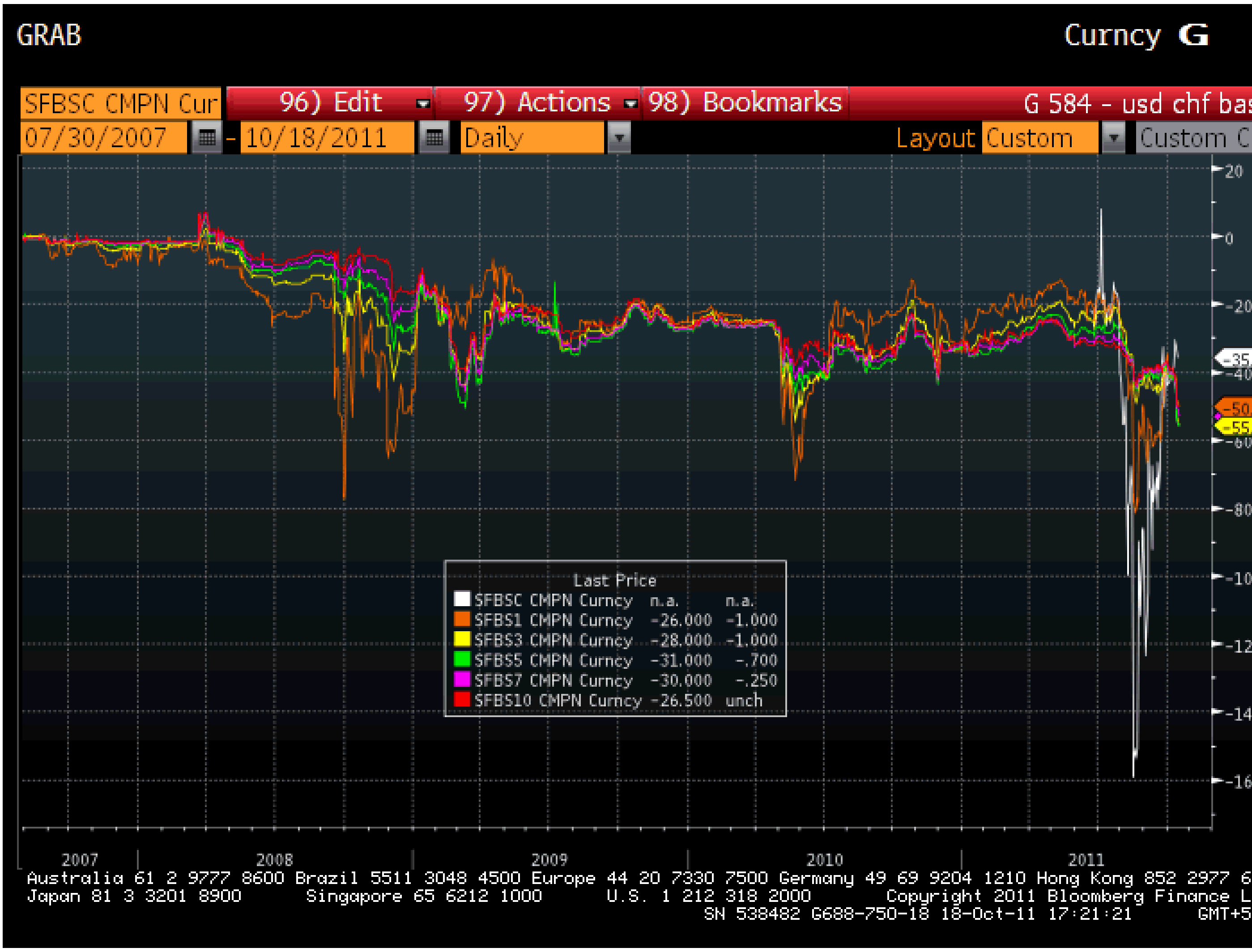
CHF BASIS SWAPS - LONG END CRASHING

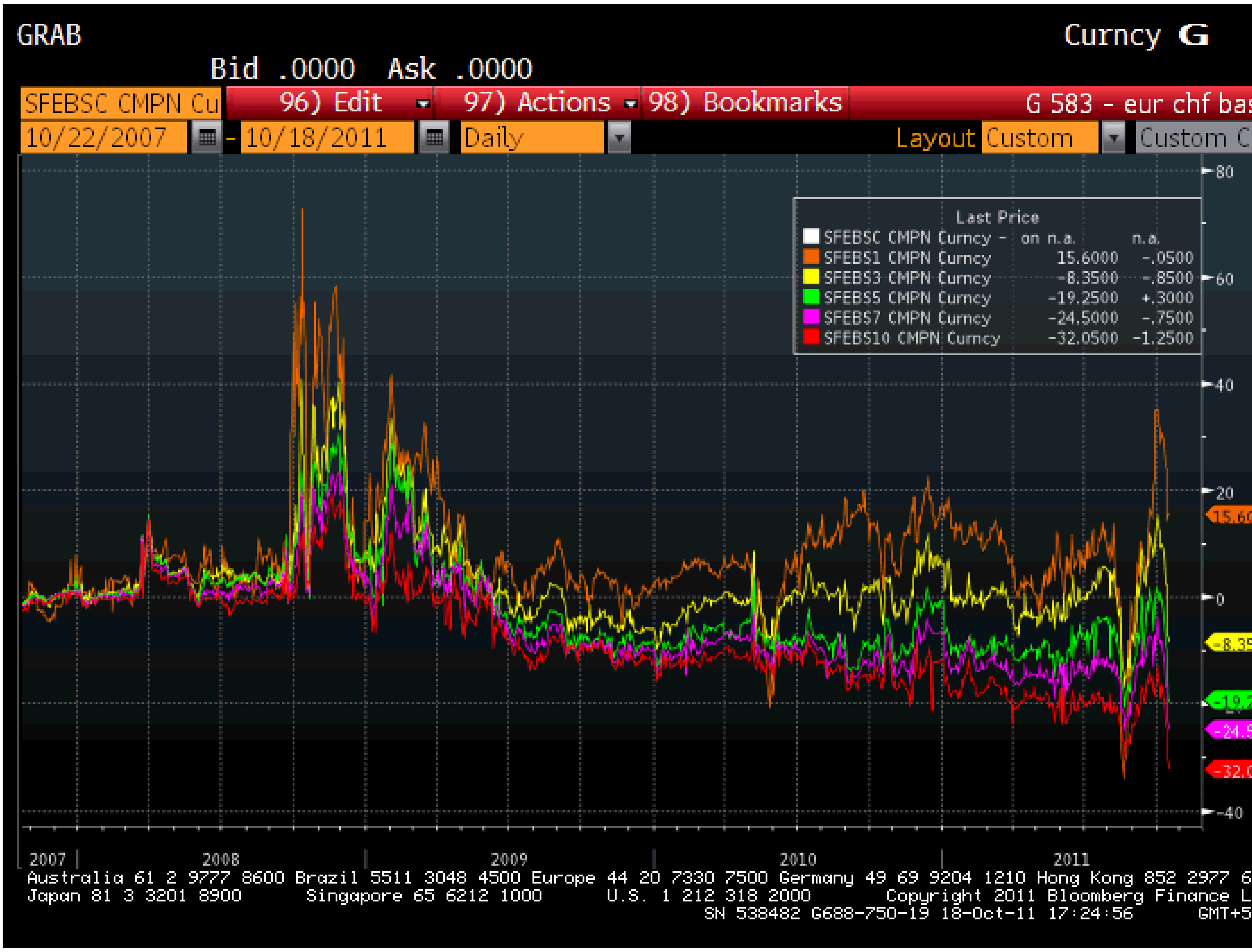
Basis swap costs indicate the cost that is required to move from one currency to another.

Generally the market focuses on the short end Basis swaps to draw conclusions about funding issues . In August, September and in the first week of October the shorter end basis swaps were exploding. Then these started normalizing and everybody thought that funding problems have ceased for now. Even today, shorter end basis swaps are not behaving unusually. However what has caught this observer by surprise is the unusual movement in Swiss Franc Basis swaps of longer tenor > 6 years. So much so that these are now at historical lows. Though this does not signal an instant panic in funding markets in Switzerland's interbank market, what it does signify is that Swiss banks are requiring Long tenor USD funds against CHF funds and they require this USD so badly that they are willing to pay through their nose to obtain 6yr - 10yr USD funds.

USD/CHF Basis swaps indicates the cost that is incurred to move from CHF to USD.



EUR/CHF Basis swaps indicates the cost that is incurred to move from CHF to EUR.



CHF Basis swaps are crashing - This time it is the longer end that is crashing. Most market participants look at the shorter end of the basis swap curve to detect market panic, however this time around it is the longer end of the basis swap curve that is crashing and is now at it's historical lows.

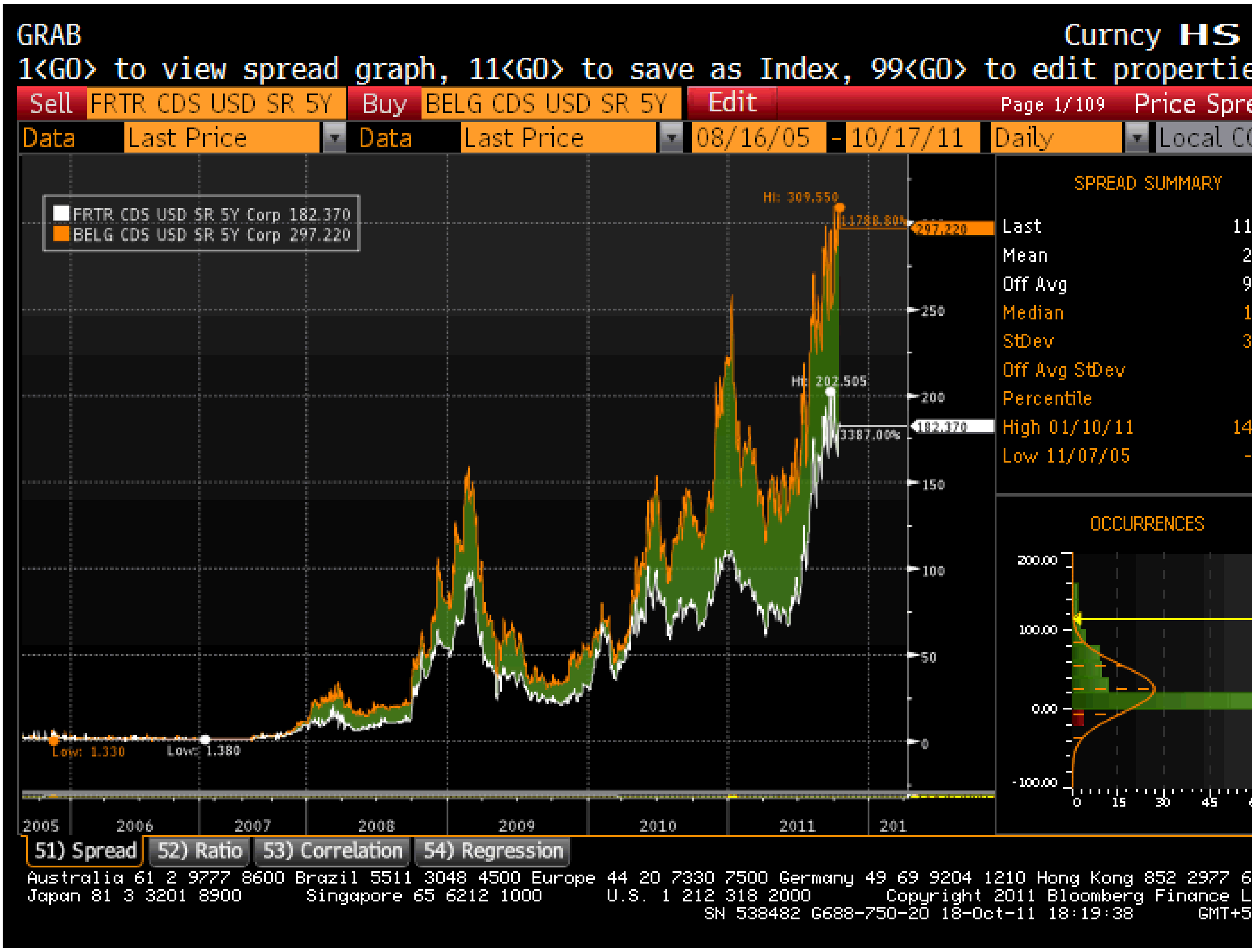
Let us spend a moment to try and understand the reason behind such a pressing requirement for 6yr to 10yr USD or Euro funding for a Switzerland based institution/corporate. Is it that a long tenor loan denominated in either USD or Euro has been suddenly recalled by a lender? Given the state of the market , it is quite likely that an European or an American bank had lent long tenor loan to a Swiss entity and now that loan is being suddenly recalled for some reason leading to a sudden spike in CHF basis swaps. The reason for a loan recall , in addition to a deterioration in creditworthiness of the borrower, may also be due to the deterioration of the market outlook for the Swiss Franc currency or the sovereign rating of the Switzerland Government . Sovereign CDS spreads are relatively benign. However, the corporates and FIs in Switzerland look to be in a spot of bother as seen from the movement in CDS spreads:

CDS spread		6mth Change in CDS spread (absolute)
Holcim	340	+212
Clariant AG	344	+ 225
Adeco SA	238	+148
Credit Suisse	282	+54
UBS AG	177	+82

The other possible reasons are either the fears of a rapid depreciation of the Swiss currency or else the lender is itself in dire straits and is unable to fund long tenor assets in USD or Euro and is now recalling these loans; both of which are are relevant given the penchant of the SNB to forcefully depreciate the CHF and the asset liquidation being carried out by EU zone banks to plug liquidity and solvency gaps in their balance sheets. So now that we have identified key risks behind the unusual movement in long tenor CHF Basis swaps, we move onto other EU zone trouble spots- France, Belgium, and China where High yield vs. High Grade (HY-HG)bond spreads continue to trend upwards signifying further deterioration in credit conditions.

French - German 10 yr yield spreads went up to 113 bps from 96 bps yesterday.

Belgian and French CDS spreads continue to trend upwards.



Chinese High yield -High Grade (HY-HG)bond spreads

Key takeaway- As we highlighted yesterday, risks continue to ratchet up globally and the investment environment is very weak. It is advisable that committing to positions which assume that the current market condition will quickly reverse should be either postponed or should be taken with great care and all efforts must me made to reduce such positions, if any.

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