S&P DOW JONES INDICES

INDEX INVESTMENT STRATEGY

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EUROPEAN BANK WOES REFELCTED ACROSS ASSET CLASSES

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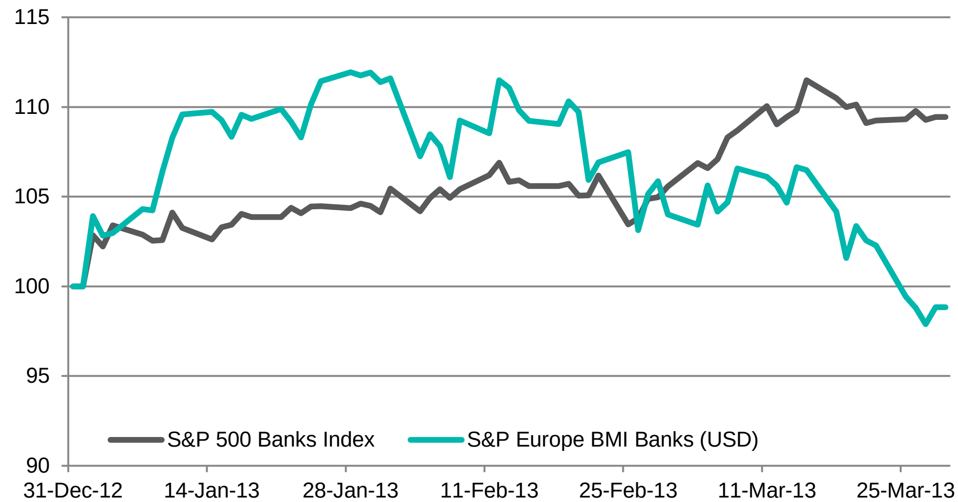
As attractive as U.S. bank returns have been recently, it seems that European banks have experienced an equal amount of pain.

In the first quarter of 2013, the S&P Europe BMI Banks index declined 1.16% while the S&P 500® Banks index gained 10.61%. But this snapshot of European bank performance obscures the stellar performance of this industry in the earlier part of the year. In January, the S&P Europe BMI Banks posted a gain of 11.38% while the S&P 500 Banks posted a return of 4.12%. As shown in Exhibit 1, until mid-February, there seemed to be no indication that trouble was ahead for European banks.

Exhibit 1: Total Return of S&P 500 Banks vs. S&P Europe BMI Banks



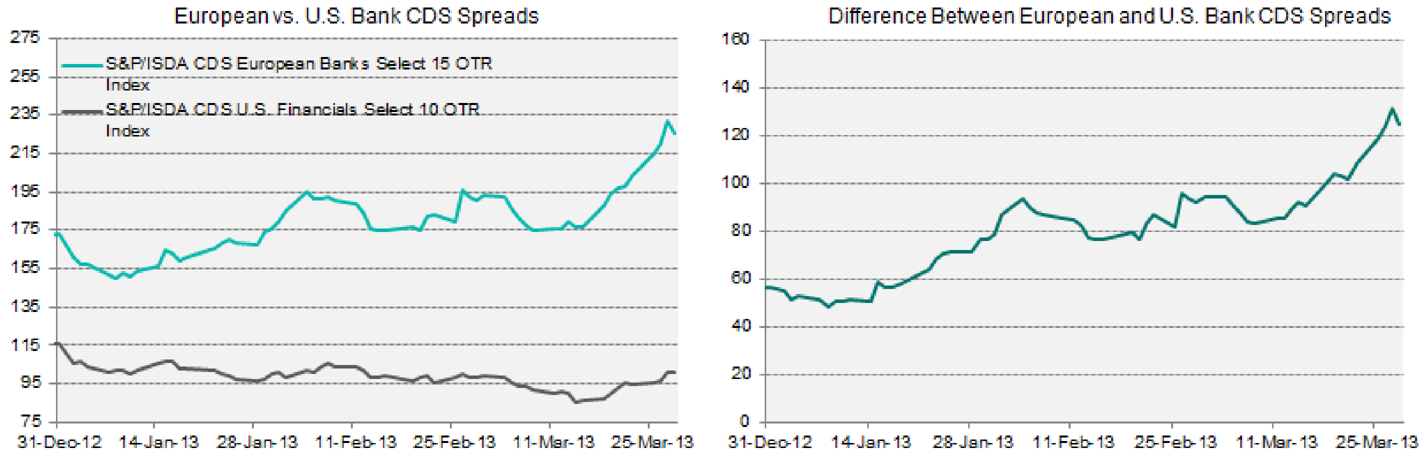
Source: S&P Dow Jones Indices. Data from December 31, 2012 through March 31, 2013. Charts are provided for illustrative purposes. Past performance is no guarantee of future results.

Or was there? A look at the credit default swap (CDS) data in the parallel period paints an interesting picture. The CDS market offers an assessment of the risks associated with the debt of a particular sector. On a relative basis, the risks of European bank debt have been steadily rising since the beginning of the year compared to the debt of its U.S. counterpart.

In Exhibit 2, the chart on the left shows us that spreads for European bank CDS started out the year higher than U.S. spreads.[1] (This means that it cost more to insure European bank debt than to insure its U.S. counterpart.) The chart on the right illustrates that, aside from a brief period in the beginning of the year, the difference between the two spreads has been steadily increasing throughout the quarter.

[1] CDS spread data are reported in basis points. A spread of "100" means it cost 100 basis points to insure USD 10 million of debt against loss for five years.

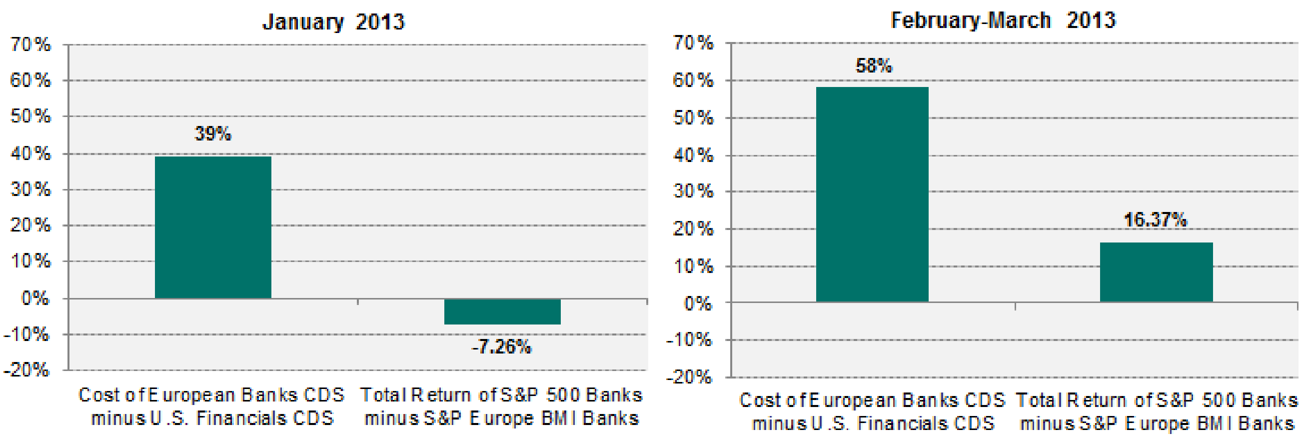
Exhibit 2: European vs. U.S. Bank CDS Spreads and the Difference in Spreads



Source: S&P Dow Jones Indices. Data from December 31, 2012 through March 31, 2013. Charts are provided for illustrative purposes. Past performance is no guarantee of future results.

In January, it appears that the equity and CDS markets "disagreed" about the relative prospects of European banks.[2] The equity market tilted toward European banks, which outperformed their U.S. counterparts by 7.26%. At the same time, the relative cost of insuring European bank debt rose by 39%. It seemed as though something had to give, and something did. In the subsequent two months, European bank stocks *underperformed* U.S. banks by 16.37%, while the relative cost of insuring their debt continued to increase (see rightmost chart in Exhibit 3).

Exhibit 3: Performance of Fixed Income vs. Equity Markets for European Banks



Source: S&P Dow Jones Indices. Data from December 31, 2012 through March 31, 2013. Charts are provided for illustrative purposes. Past performance is no guarantee of future results.

Of course, performance patterns are easy to identify in hindsight, and it is difficult to identify precisely when CDS data offer a glimpse of things to come in the equity market. But while precise relationships might elude us, industry woes eventually reverberate across asset classes.

[2] See, e.g., Craig Lazzara and J.R. Rieger, “Leading Indicator or Confirming Evidence?” S&P Dow Jones Indices, February 2013, http://us.spindices.com/documents/research/iis-leading-indicator-or-confirming-evidence.pdf?force_download=true.

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