Markit Recap – 9/21/2015

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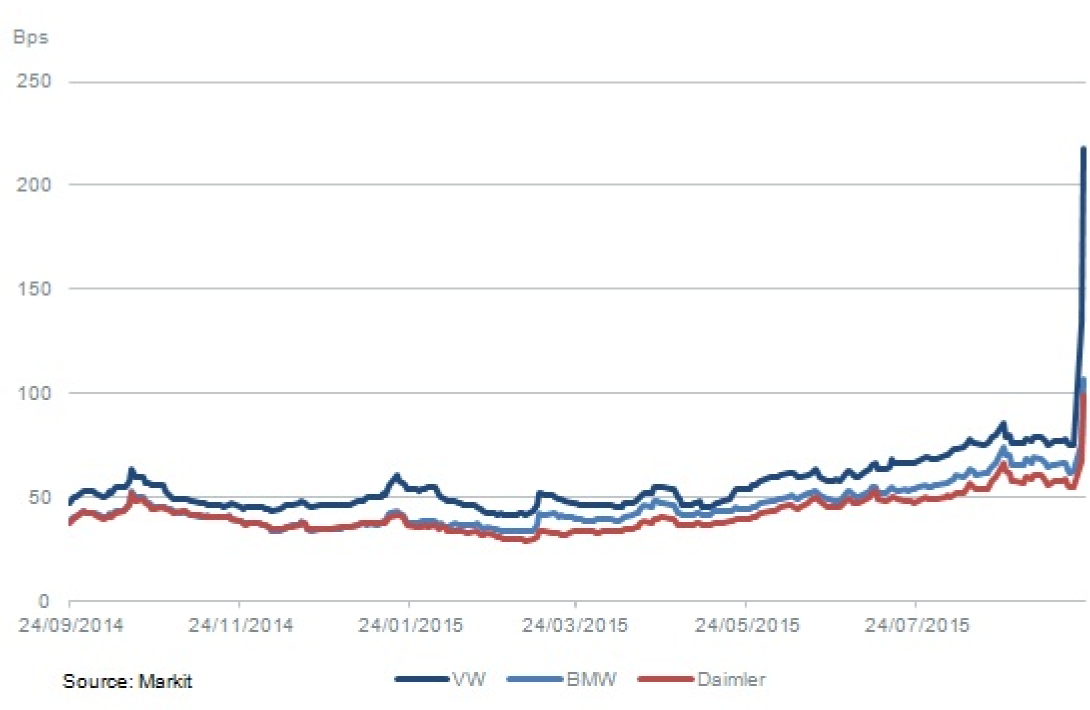
German corporate credit, generally regarded as a safe bet, has had a torrid time of late. Last week we looked at how the costs of transitioning from nuclear to clean energy had inflicted damage on German utilities and sent credit spreads spiralling wider. This week it was the turn of the auto industry, and Germany's largest car producer: Volkswagen.

News that the firm had installed software in its vehicles that deliberately deceived authorities testing for harmful emissions sent shockwaves through the market. At the beginning of the week, Volkswagen was trading at 75bps, a level typical of its single A rating and in line with the Markit iTraxx Europe. Two days later it was quoted at 217bps, a dramatic deterioration and relegating it to the fourth worst credit in the index (only Glencore, Anglo American and Casino Guichard Perrachon trade wider.)



Is VW the only carmaker violating environmental laws? Perhaps, but VW's actions appear to have tainted other firms in the industry, particularly in Germany. BMW and Daimler, two credits that are always closely correlated, saw their spreads widen sharply. Reports that one of BMW's SUVs emits 11 times the European limit for air pollution saw its spreads more than double to 142bps. Daimler isn't far behind at 125bps.

Previous scandals in other industries have seen spreads recover when the settlements are finalised. But the uncertainty in assessing the litigation risk, as well as the reputational damage and the effect on future sales, mean that it is unsurprising that a sizable risk premium is attached to credits in the auto industry. Further volatility is inevitable as more news emerges around the extent and severity of the violations.

VW's travails only added to what was a difficult week for credit. Indices and single names rolled (the latter for the last time quarterly ahead of the planned ISDA changes), and the technical flows obscured some of the fundamental sentiment. But there was little doubt the mood was negative, with the mining/commodities sector bearing the brunt. China's growth trajectory remains one of the key drivers of spread direction, as does the uncertainty over the timing of US rate hikes. This will be the case for the rest of the year, but as we have seen this week, micro themes can also cause disruption.

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