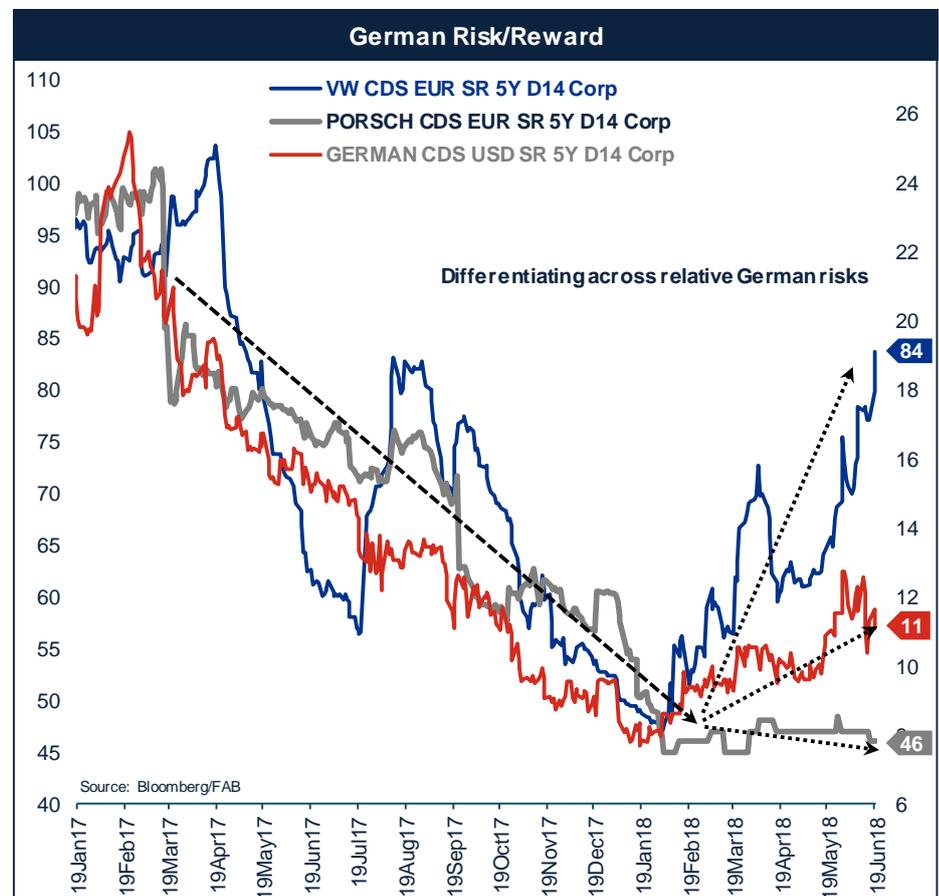


Macro Strategy View: All German Risk is Not Made Equal

The benefits of differentiation across German risk assets. While risk pricing across the three entities of the German sovereign, Volkswagen and Porsche CDS contracts may have all enjoyed the same direction of travel through much of last year, and investors would have gained from a net short protection (CDS) position in any of the three amid the risk on trade, the relative relationship has been significantly different over the first 6 months of 2018. Investors in German risk will have been rewarded for a much more discerning approach to risk/reward dynamics this year.



Embroided in the diesel emissions scandal that dates back to 2014, VW CDS has experienced renewed steady underperformance since the beginning of this year, widening over 35bps (c.75%) from its February low of 46.95. The latest negative draft has been fueled by the arrest of Audi CEO Robert Stadler earlier this week. Meanwhile there has also been notable uncertainty and weakness over the past month in the political situation in Germany – and in particular the fragility of Chancellor Merkel’s position itself – which has fueled volatility and a widening in the German 5Y CDS contract. While the latter may have tarnished German assets more broadly, as per the above chart we note that there has been a clear and meaningful relative underperformance by VW CDS over the period.

20 June 2018

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What is perhaps more interesting is the relative strength and resilience of the Porsche CDS price over the past 5 months, in the face of the aforementioned evolving political and corporate strains. Porsche as parent company and majority shareholder (30.8% as of Dec 31. 2017) in Volkswagen may have been expected to experience a greater degree of negative impact (or at least marginal price weakness) from the VW news flow.

Moreover, in the scenario that the German coalition unwinds, Angela Merkel falls from the Chancellorship and political instability envelops Europe, we cannot believe that Porsche would remain isolated from the pressures of a subsequently ,more risk averse environment. Thus far, however, Porsche CDS has traded in just a 3.5bps range since February and is 14bps tighter ytd. If investors expect deeper deterioration in the VW scandal or the German political outlook over the coming months, then perhaps one of the key indicators to watch could be the Porsche 5Y CDS contract and its potential to play a degree of catch up.

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