4th floor
Ropemaker Place
25 Ropemaker Street
London
EC2Y 9LY
United Kingdom

tel +44 20 7260 2000
fax +44 20 7260 2001
www.markit.com

Markit Commentary

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Caterpillar credit widens; US HY bonds shunned

Slowing global demand for commodities hits Caterpillar's operations, increasing credit risk. Deteriorating credit fundamentals in the HY space is turning ETF investors away.

- Caterpillar's 5-yr CDS spread widens 23% as it announces impact of China slowdown
- US high yield bond ETFs experience their biggest one day outflow since "black Monday"
- Tesco's CDS spread is at a new five year high with other UK grocers following suit

Caterpillar

Construction and mining equipment manufacturing giant Caterpillar has announced 10,000 job cuts as it sets to reorganise operations amid slowing global demand for its products. Sales are expected to fall in the coming years as the mining and oil & gas industry reels back capex spending, a result of weak commodity prices.

Caterpillar 5-yr CDS Conv Spread

Source: Markit

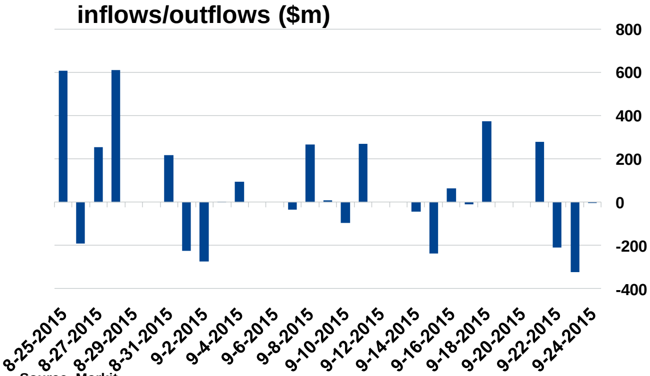
Shares slid 6.5% and credit markets reacted in a similar manner. Caterpillar's 5-yr CDS spread, measuring the cost to protect against the company's debt from defaulting, widened 23% yesterday to 80bps. Caterpillar's CDS was actively quoted in the market, with Markit's CDS pricing service marking the name with a liquidity score of 2 (1=highest, 5=lowest).

Despite the sharp rise in implied credit risk, Caterpillar's credit spread remains below that of the Markit CDS NA IG index, made up of a broad US corporate investment grade universe, which currently stands at 86bps. This indicates that the view from credit investors is that Caterpillar remains a high grade issuer.

US high yield

It has been a bad week for US high yield (HY) bonds. The iBoxx $ Liquid High Yield index now yields 7.33%, up 35bps from the previous week. To put the move into context, it represents approximately a third of the yield widening seen so far this year. The past week has been a volatile period for risky assets with continued downward pressures from China through weak PMI data, deteriorating fundamentals in the mining industry and investor jitters around the auto industry stemming from the Volkswagen scandal.

US High yield bond daily ETFs inflows/outflows ($m)



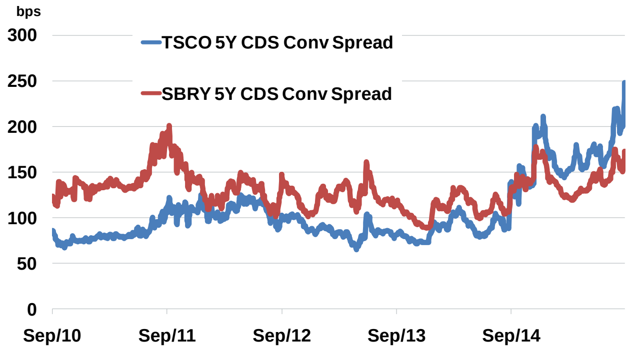
Source: Markit

Investors have been quick to react to the turn in sentiment by dumping HY bonds. ETF funds tracking US high yield indices saw over half a billion dollars of outflows over the past three days alone. An outflow of $325m was seen on September 23rd, the biggest one day outflow since "black Monday" on August 24th.

Tesco

German discount grocers Aldi and Lidl have continued to bite into the UK supermarket industry's market share, heaping further pressure on the "top four": Tesco, Sainsbury's, Morrisons and Asda.

UK grocers 5-yr CDS spread



Source: Markit

Latest figures show Tesco, the UK leader, now has its lowest market share in a decade; while sales are declining for the entire top four bar Sainsbury's. Credit markets have reacted negatively with Tesco's 5-yr CDS spread widening 48bps this week to a new five year high of nearly 250bps. CDS spreads have now surpassed previous highs in January, which were a culmination of the negative sentiment around the accounting scandal that engulfed the firm in September 2014. Tesco isn't the only one that has seen its credit risk widen. Sainsbury's saw its 5-yr CDS spread widen 10% even as sales have grown, highlighting the negative sentiment spread among the top four.

Neil Mehta

Analyst

Markit

Tel: +44 207 260 2298

Email: neil.mehta@markit.com

For further information, please visit www.markit.com