BofA SECURITIES

Credit Strategy - Europe

Euro credit RV panorama

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Credit Strategy
Europe

Ioannis Angelakis
Credit Derivatives Strategist
MLI (UK)
+44 20 7996 0059
ioannis.angelakis@bofa.com

Barnaby Martin
Credit Strategist
MLI (UK)
+44 20 7995 0458
barnaby.martin@bofa.com

A summer rally, but questions still for 2H

A summer rally in vogue: bond spreads are having a good June and July, while in synthetics, iTraxx Main has been heading tighter to levels not seen since early 2022. We think the CDS market euphoria is pushing bond spreads tighter at this juncture and we see more to come in the summer lull. Central banks are likely to pause, though we struggle to see a positive catalyst to bring depo rates much lower. Slower Euro Area growth leaves credit markets fragile still in 2H.

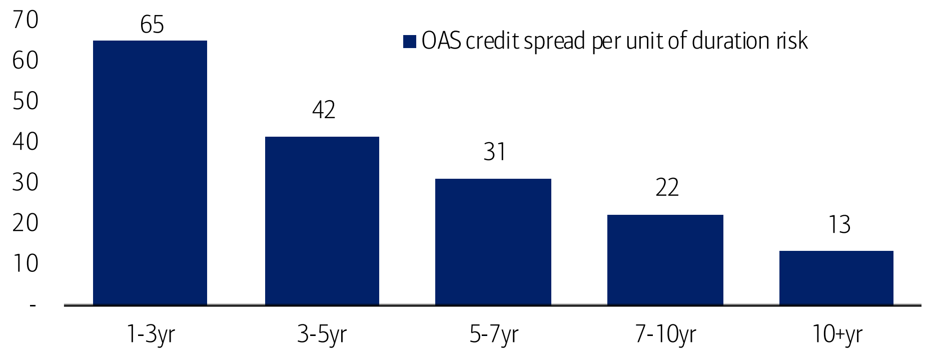
Supply vs. demand – headwinds both ways

Supply is always seasonally large in September, and credit performance, while strong in July, tends to turn in September. Market technicals will face headwinds not only from the supply, but also from the demand side. As long as "risk-free" rates continue to stay elevated, we find it hard to see demand for credit vs government bond debt improving any time soon. Credit flourished in a world of TINA (there is no alternative); this is not the case anymore – cash is "king".

Where tail risks are under-priced

We see three ways to quantify tail/default risks: credit curves, implied vols and spread differential between IGs and Bs. We think at this stage implied vols are too low, while 5s10s could move a bit steeper from here. Bs look to be tighter than can be justified vs. the IG market and for the degree of adverse scenarios currently priced into iTraxx 5s10s.

Exhibit 1: The front-end of the credit market is offering a larger credit risk premium...
...and a better cushion against wider credit spreads



Source: ICE Data Indices, LLC. ER00 index split per duration pocket: OAS vs Govt spreads divided by the effective duration

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Front-end spreads - too good to forgo

Since 2014, when the ECB embraced negative depo rates, investors have been constantly reaching for yield within the fixed income market. With negative-yielding assets expanding rapidly from 2014 until two years ago, investors have had to reach for yield and spread by extending duration. This has flattened the bond credit curve, much more than in the case of the CDS market. However, when corporate bond investors look for yield per unit of duration risk, they should look at short durations, as the credit spread is much more attractive in the front-end of the credit market.

Credit RV panorama

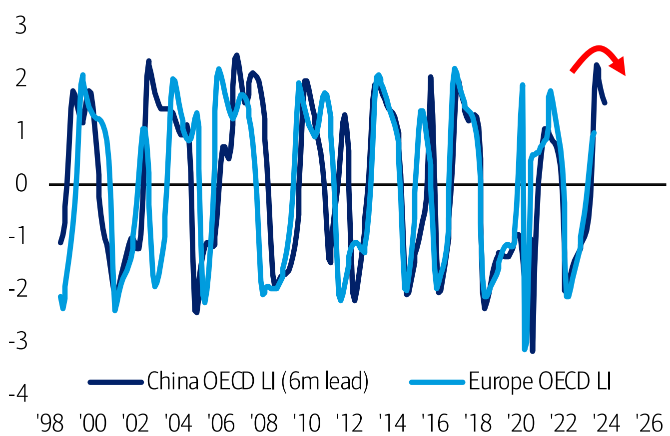
A summer rally in vogue: bond spreads are having a good June and July, while in synthetics, iTraxx Main has been heading tighter to levels not seen since early 2022. We think the CDS market euphoria is pushing bond spreads tighter at this juncture and we see more to come in the summer lull. Central banks are likely to pause, though we struggle to see a positive catalyst to bring depo rates much lower. Slower Euro Area growth leaves credit markets fragile still in 2H.

Market technicals will face headwinds not only from the supply, but also from the demand side. As long as "risk-free" rates continue to stay elevated, we struggle to see demand for credit vs government bond debt improving any time soon. Credit flourished in a world where TINA (there is no alternative) was in vogue; this is not the case anymore, as "risk-free" proxies provide yields not seen in decades.

Macro headwinds to emerge

Macro headwinds are not going away: the China reopening is proving underwhelming. This poses downside risks to the European macroeconomic cycle over the following months. And we believe that these headwinds will be notable for the largest European economy: Germany's manufacturing PMIs remain well below the 50pts level.

Exhibit 2: The Chinese macro cycle usually leads the European one
12-month z-score comparison between the two OECD leading indicators



Source: Bloomberg. Using 12m z-score on OECNKLAC and OE4EKLAC Index
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Exhibit 3: Europe under pressure amid headwinds from the East
German new export orders likely to remain well below 50 amid weak China credit impulse

Source: Bloomberg
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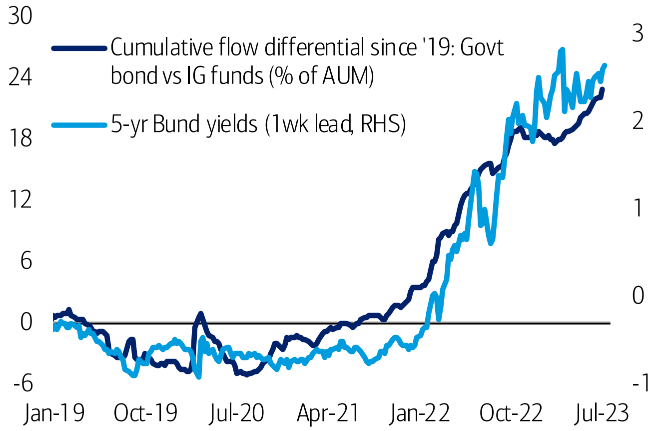
We think slower Euro Area growth will leave fragile credit markets still in 2H. While valuations are much more attractive in the high-grade bond space, we believe very little downside risk is baked into current market pricing across double-Bs and single-Bs. We think that beta decompression is at play.

Demand headwinds - "Quality" over "beta"

Fixed income investors continue to "de-risk" bond allocations. As "risk-free" rates keep heading higher and are almost back to March highs, bond investors are gravitating towards "safer" assets. Assets that for years have been offering little or even negative yields, now offer substantially better income than over the past 15 or so years. With that the need to allocate to "riskier" assets declines, as the risk/reward is not as attractive as it used to be for owning credit, for instance. Our work shows that the higher the yield offered in the bond market, the better the flow trend into government debt funds compared with high-grade funds.

Exhibit 4: Higher for longer is not a tailwind for flows into credit
Should "risk-free" rates head higher this will continue to shift money towards government bond funds, rather than credit funds



Source: BofA Global Research, EPFR, Bloomberg. Cumulative difference of w-o-w change in govt bond funds and IG funds. % of AUM.

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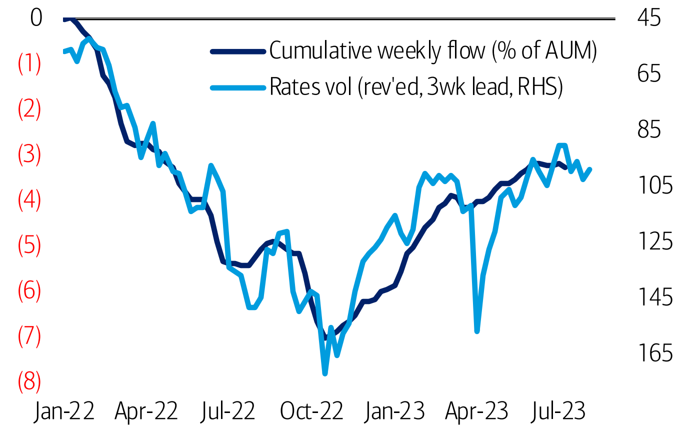
Exhibit 5: Rates vol vs. IG fund flows: higher (lower) rates vol = flows weakness (strength)
Cumulative flows as % of AUM for high-grade funds vs rates vol trends



Source: EPFR Global, Bloomberg. Cumulative weekly flows as % of AUM for high-grade funds. Rates vol index used is the SMOVEU3M index

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Not only that but a monetary policy supernova unwind is not supportive for stability in the rates market. Over the past year or so rates volatility has moved substantially higher and, despite the decline YTD, is still at levels that coincide with significant market stress. As the SMOVEU3M index is still hovering around the 100pts level, we struggle to say that rates market uncertainty is back to levels needed to give the "all-clear" for the big rally.

Rates vol has been a key indicator to follow to demystify flow trends. Typically, rates vol trends can provide great insight into the future path of flows into high-grade funds. The higher the rates vol, the weaker the flow trend into high-grade funds.

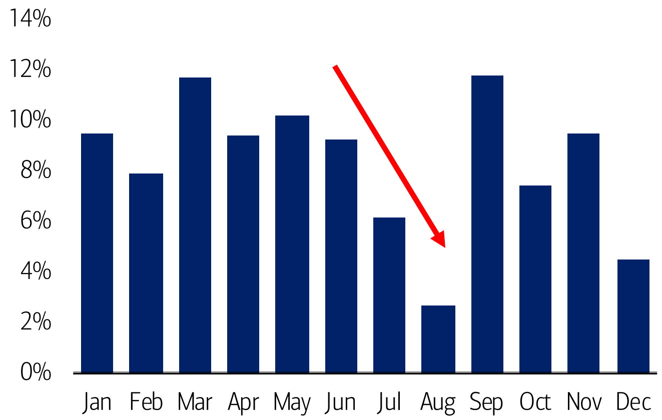
Overall, higher yields and elevated rates vol have never been a tailwind for flows into credit funds. However, should central banks declare a win against inflation, this could be a supporting factor for credit. We think that rate cuts are not as probable as markets are pricing in, and thus flows into credit will remain somewhat capped till the day central banks can clearly say that terminal rates have peaked.

Supply seasonality headwinds to emerge in September

In a world of headwinds for demand dynamics (as we discussed in the previous section), supply is also a key factor to understand technicals going forward. Supply is typically heavier in March and September with the latter usually the heaviest month. Supply patterns over the course of the year have been consistent with slower primary markets in July and August. So far this year we have seen above-trend monthly supply figures almost consistently (except in March and April).

We think that if the supply pipeline in September is heavier than historical standards would justify, it would be a headwind for spreads moving tighter. Note that should the ECB signal the end of the hiking cycle in September, it would calm the rates market and potentially move "risk-free" rates somewhat lower. Ultimately, this could bring issuers back to the market as the rates backdrop would become a bit clearer, at least in the short term.

Exhibit 6: Supply typically declines notably in July and August
...but picks up in September, which has traditionally has been the strongest month



Source: ICE Data Indices, LLC
ER00 index data. Supply split across the year based on average supply figures since 2008.
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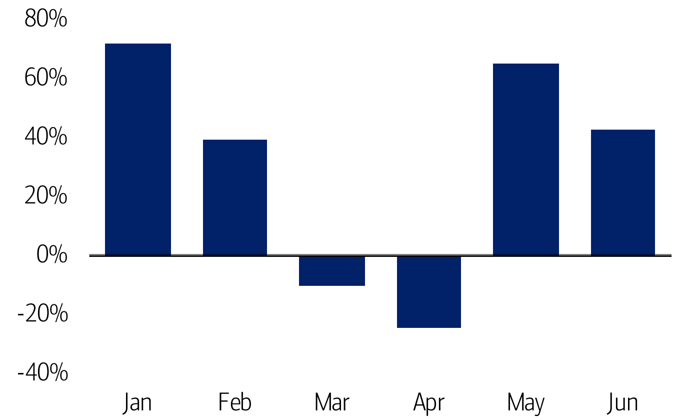
Exhibit 7: Strong supply so far this year
For most of the months so far in 2023, IG supply is up notably vs. historical patterns



Source: ICE Data Indices, LLC
ER00 index data. Supply in 2023 vs 10yr back monthly averages
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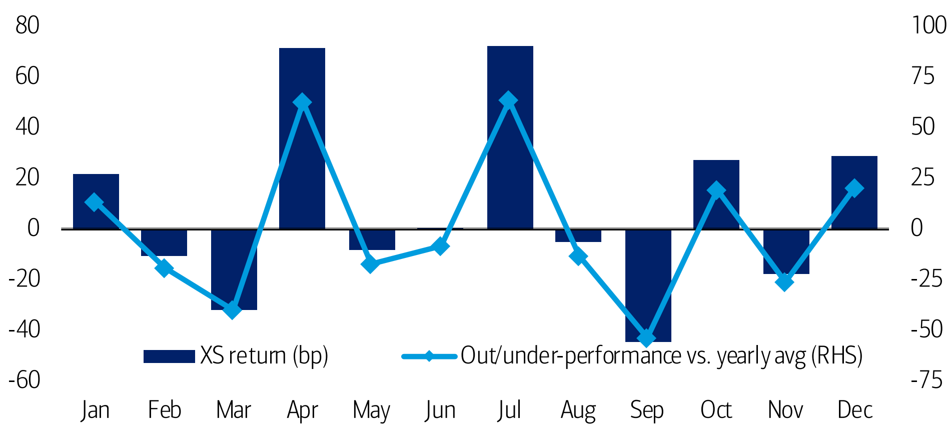
However, supply is a key driver of technicals and thus performance. No doubt high supply in September has traditionally pushed spreads wider, but it has also led to relative underperformance vs July and October, for instance. All in all, we think it is sensible to reduce risk heading towards a heavy supply month in September, which would cap the market euphoria we have seen so far this year.

Exhibit 8: July has traditionally been a strong month in credit land. Meanwhile, August and September have been particularly weak months
We prefer to de-risk in July heading to the more challenging performance months of August and months



Source: ICE Data Indices, LLC
ER00 index data. Excess return performance outright and vs. the yearly average figures
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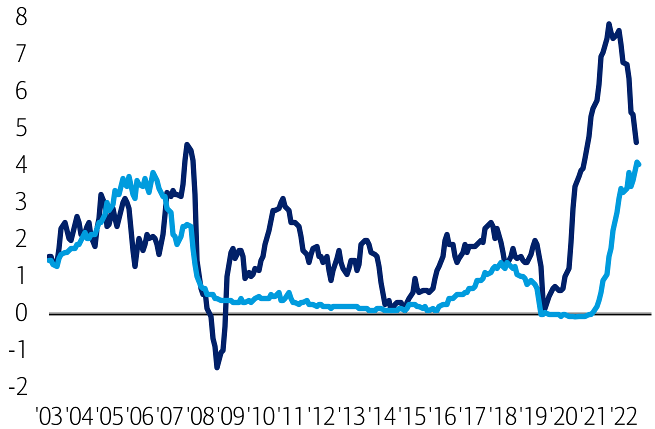
The reach for yield and the fight against inflation

Inflation in decline; funding costs on the rise. Monetary policies are still on the "loose" side, despite a rapidly tightening monetary policy backdrop across the key economies. Should central banks pause and inflation continues to decline, this could ultimately bring better technicals for the credit market. A lower "risk-free" rates backdrop can reverse the relative attractiveness of government debt vs credit.

However, we find that the flatness of the yield curves in both rates and credit still points to the clear benefit of reducing duration exposure heading into the second half of the year. From a pure credit perspective, we think that credit curves remain flat for the level of spreads in the broader IG market. Not only that, we continue to highlight the very strong risk/reward the front-end of the credit market can offer in a world of still elevated rates market volatility.

Exhibit 9: Inflation is dropping rapidly, but still above depo rates

While central banks pause, inflation needs to head lower to result in tighter monetary policy conditions.



Source: Bloomberg and ICE Data Indices, LLC. We use the OEG7GABL and WG7D indices

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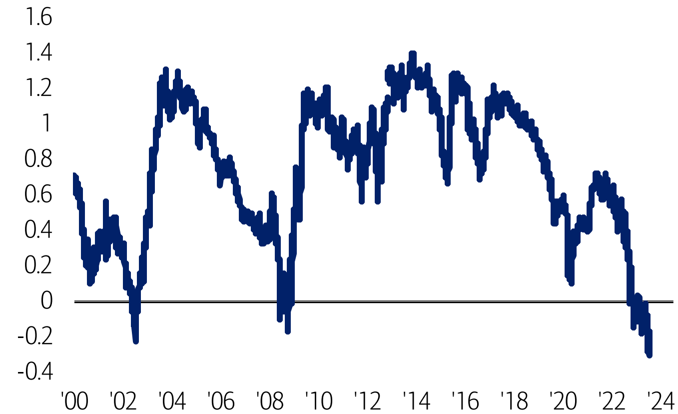
Exhibit 10: Yield inversion at multi-year high levels

The front-end and the belly of the credit market has never provided better entry points to own yield vs. longer duration credit exposures



Source: ICE Data Indices, LLC. IG credit 4-6yr vs 10+yr effective yield differential

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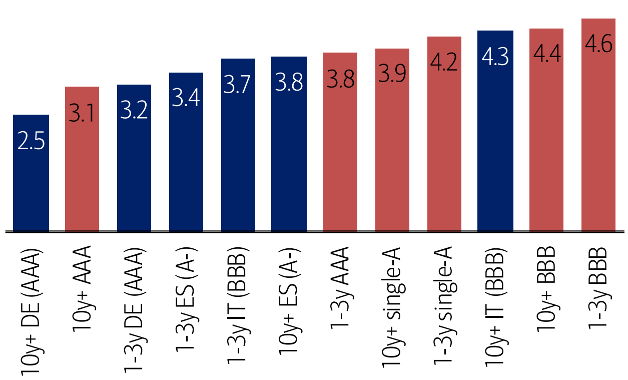
Note that Euro and US rate vols remain very high relative to historical standards. We believe that until inflation is closer to target, shorter-duration exposures compensate for higher rates market uncertainty. A thicker cushion against potential losses from higher rates is paramount.

Exhibit 11: Shorter duration credit and rates provide a better yield proposition in current markets

Government bond funds provide a strong yield proposition vs. credit pockets without the credit risk.



Source: ICE Data Indices, LLC

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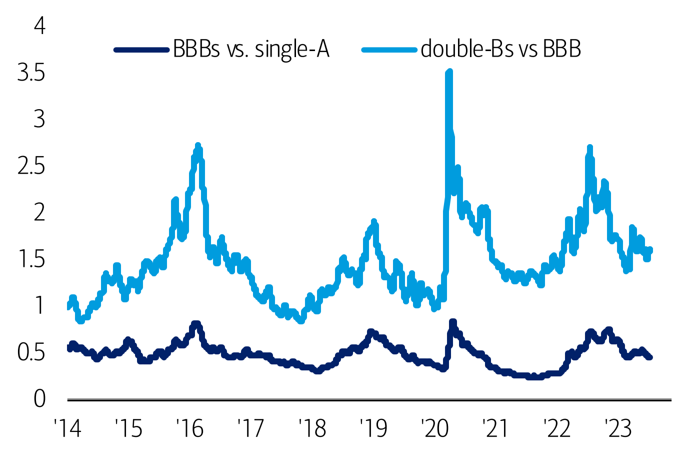
Exhibit 12: When macro strengthens again, investors could reach for yield via lower credit-ratings

A significant "discount" is building between BBs and BBBs. When macro strengthens again, investors could use that to cover the "reinvestment" yield loss from shorter-duration exposures



Source: ICE Data Indices, LLC

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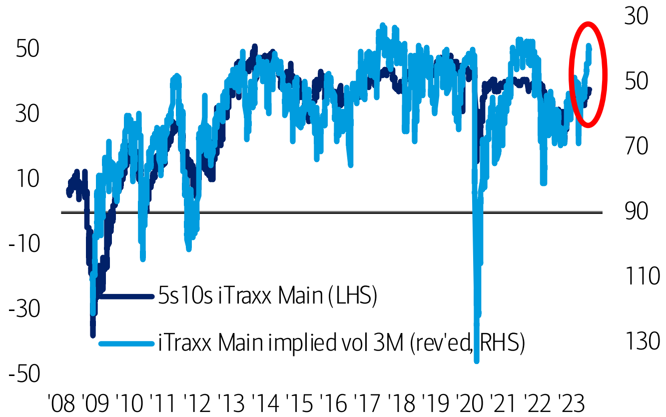
We also think that the "reinvestment" uncertainty, should an investor choose to own shorter credit exposures, can be mitigated via higher risk-taking – in the form of lower credit ratings – if "risk-free" rates decline. In a world of lower rates, and thus lower funding costs overall, default risks ultimately decline. Therefore, investors would be able to move from single-As to BBBs and from BBBs to double-Bs, thus "replenishing" the lost yield after the short-term maturities expire. Our work has shown that beta performs well in periods of improving macro backdrop.

Where tail risks are under-priced

Flatter (steeper) curves are a sign of stress (exuberance), which is ultimately a way to quantify default risk. It's a similar story for implied vols: the higher (lower) they are, the higher (lower) the market stress. In bonds when default risks increase (decline) the discount embedded in single-Bs vs IG credits for instance should increase (decline).

Exhibit 13: Implied vols are much lower than credit curves steepness would justify
Credit curves and vols are different sides of the same coin, effectively different ways to "price" tail risks



Source: BofA Global Research. Bloomberg. ATM vols

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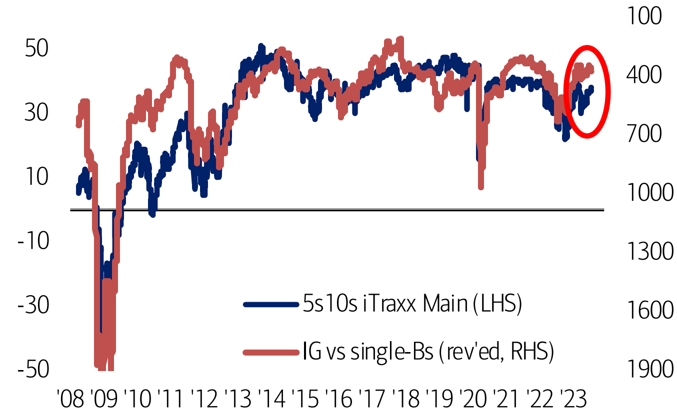
Exhibit 14: iTraxx Main 5s10s are relatively flat vs. default risks currently priced in the bond market
Spread differentials between high-grade and high-yield pockets can be another way to "price" tail/default risks



Source: Bloomberg, ICE Data Indices, LLC

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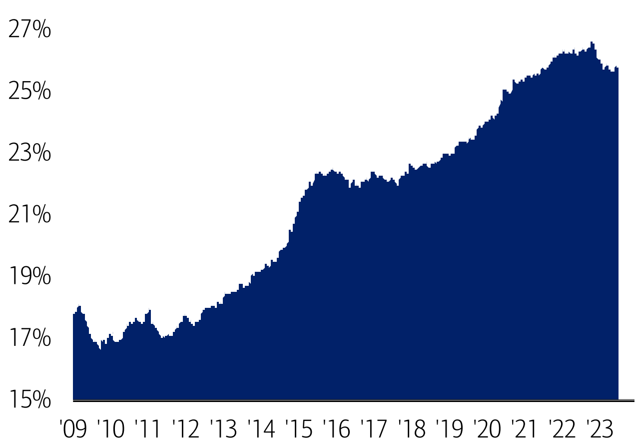
When looking across these three pockets we think that implied vols are under-pricing downside risks at current levels. The current level of iTraxx 5s10s would justify higher levels of implied vols (iTraxx Main). Not only that we think that 5s10s are currently relative flat vs. levels that would be justified by the current level of spread differential between the single-Bs and the high-grade market (a metric to track default risks).

Front-end spreads - too good to forgo

Since 2014, when the ECB embraced negative depo rates, investors have been constantly reaching for yield within the fixed income market. With negative-yielding assets expanding rapidly from 2014 until two years ago, investors have had to reach for yield and spread by extending duration.

Exhibit 15: The credit market has become more longer-dated
Share of 10yr+ paper across global IG corporate credit (G9BC vs. G0BC)



Source: Share of 10yr+ paper across global IG corporate credit (G9BC vs. G0BC)

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Exhibit 16: Share of 10yr+ paper across global IG credit (G9BC vs. G0BC
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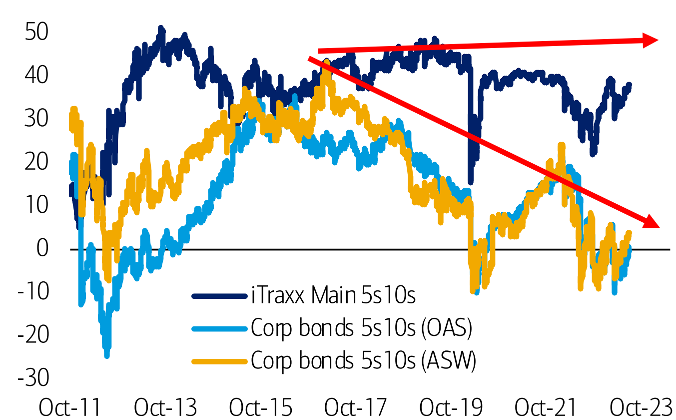

Source: Share of 10yr+ paper across global IG corporate credit (G9BC vs. G0BC)

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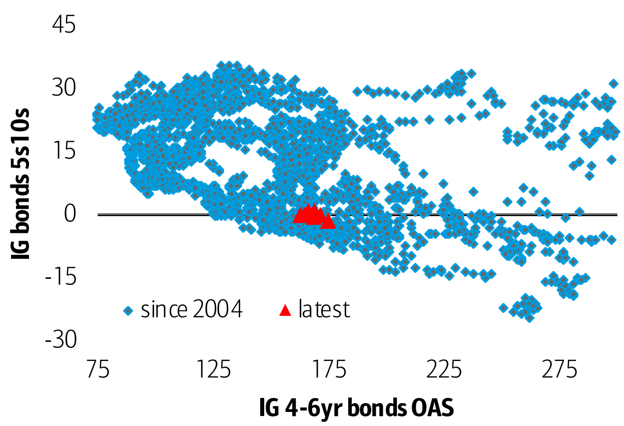
Note, the 10yr-plus share of the global high-grade corporate bond market has expanded dramatically over the past decade. This has resulted in investors reaching for yield, thus flattening the bond credit curve, much more than in the case of the CDS market. However, when corporate bond investors look for yield per unit of duration risk, they should look at short durations, as the credit spread is much more attractive in the front-end of the credit market.

Exhibit 17: Corporate bond curves are flat for the level of spreads currently in the market

Comparing 5s10s vs the belly of the market



Source: ICE Data Indices, LLC. OAS vs Govt

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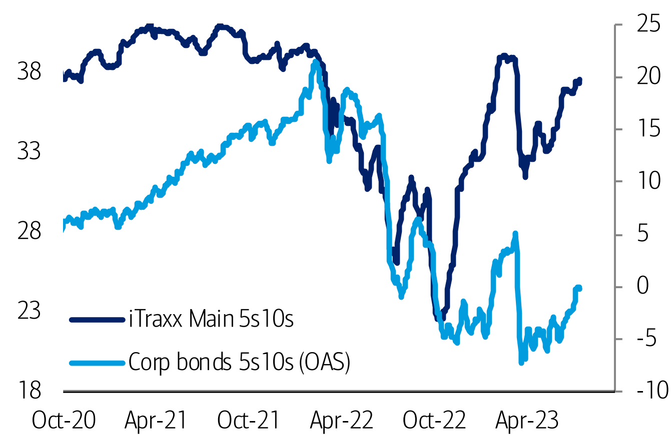
Exhibit 18: Better longs in the front end of the bond market

5s10s in CDS land (iTraxx Main) have moved much steeper



Source: Bloomberg, ICE Data Indices, LLC. We compare spreads of the ER0C index (4-6yr) vs an extrapolated spread for the 10yr that is based on the maturities of the ER04 and ER09 indices (7-10yr and 10yr+, respectively) and their respective spread levels.

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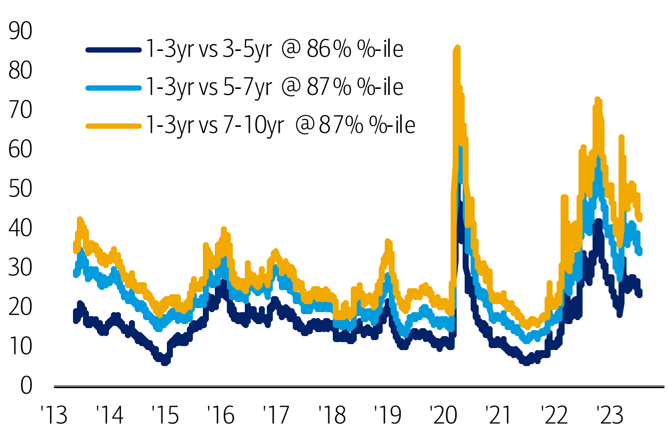
At current levels, we see credit curves sitting on the flat side vs broader credit spreads. Not only that but credit curves in bond land are way flatter than those in synthetics as iTraxx Main 5s10s have steepened much more than bonds. We think this has been on the back of two key technical points.

Exhibit 19: Spread per unit of duration risk differential between different parts of the curve

Despite the rally the front-end gives much better risk reward vs longer-duration credits



Source: ICE Data Indices, LLC

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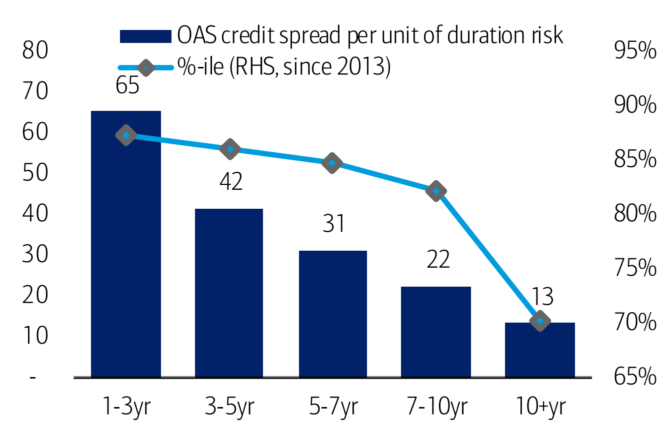
Exhibit 20: The front-end of the credit market is offering a larger *credit risk premium* and a better cushion against wider credit spreads

Flat credit curves do increase the value in the front-end of the credit market



Source: ICE Data Indices, LLC. ER00 index split per duration pocket: OAS vs Govt spreads divided by the effective duration for each duration pocket of the IG corporate bond market

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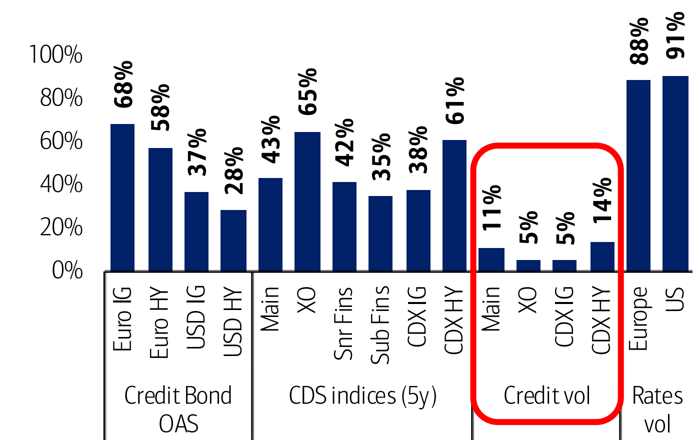
First, the need for yield from insurance companies, which tend to be steady buyers of back-end spreads as yields increase and are thus incentivised to lock better yields. But second, the overall belief that we have seen the worst of rate hikes especially as markets are pricing in cuts in 2024. However, heading to the end of the year, especially in credit spreads terms, we see little benefit in owning longer-duration credit paper. Not only are the curves flat, but the front-end would be much more insulated against potential losses if rates stay high.

Valuations heatmap

Caution is needed at this juncture: post the recent rally we think that HY longs are more difficult to justify than IG bond longs. IG bonds also offer a better entry point to own risk vs iTraxx Main.

Exhibit 21: IG bonds > HY bonds, IG bonds > iTraxx Main
Implied vols are way too low vs. other risk metrics we track



Source: Bloomberg, ICE Data Indices, LLC.
Based on data since November 2008. Presenting percentile rankings

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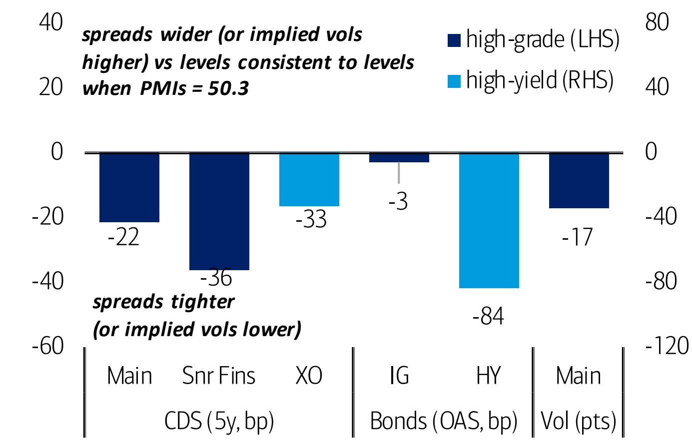
Exhibit 22: Valuations vs PMIs
When PMIs have historically been at 50.3...Where is there value in credit?



Source: BofA Global Research, ICE Data Indices, LLC. Based on MPMIEZCA Index

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Outright longs in high-grade credit will be better positioned to perform more consistently when we are closer to the last ECB depo rate hike. Note that IG bonds are the "cheapest" to own across European and US credit, both in the bond and CDS spaces, as they currently trade at more stretched valuations than the rest of the market. Finally, we think credit implied vols – across the CDS index market – are on the low side compared with other vol markets. There is capacity to move higher should market stress increase again.

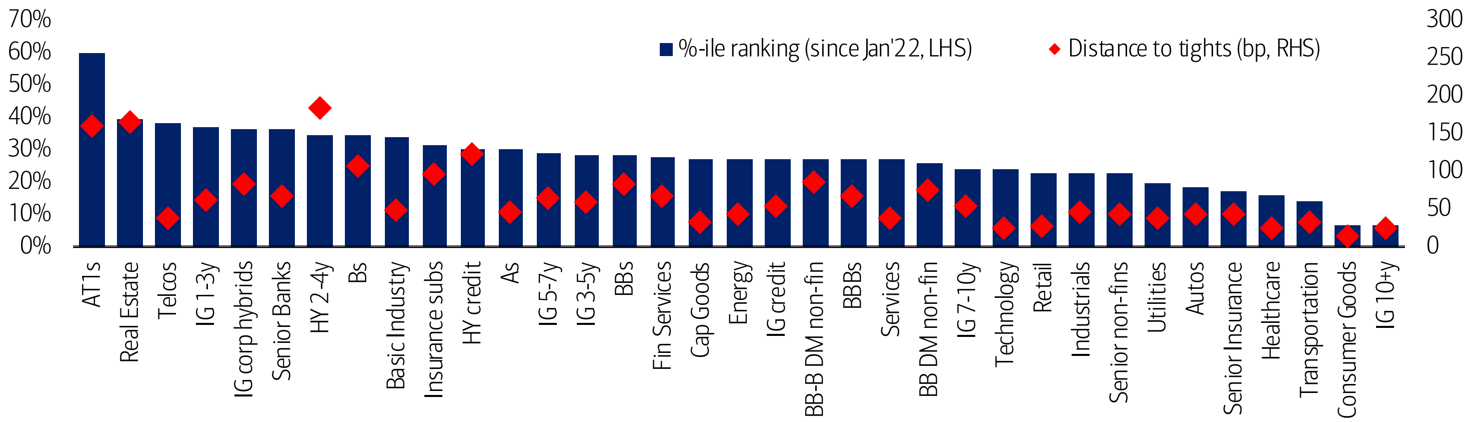
The big rally continues; watch out for the outperformers

Spreads have compressed so far in the summer months. We think those sectors that still trade closer to the tight prints of early 2022 have less capacity to outperform than the rest of the market and might be more prone to downside should credit spreads move wider from here.

- In exhibit 23, we present the latest market OAS (vs Govt) levels for each sector/risk pocket vs the historical trading ranges (percentile rankings quantify at which percentile (%-ile) of the distribution the latest trading level sits) but also the difference between the current OAS levels and the tightest print since early 2022.
- In exhibit 24, we show the trading ranges and latest closing market OAS levels across a large number of different sectors/risk-pockets of credit risk.

Exhibit 23: RV across credit sectors and risk-pockets

We present the current OAS level percentile (%-ile) ranking and the distance to tights (data since early 2022) across a large pool of credit risk pockets and sectors



Source: ICE Data Indices, LLC. We order the risk pockets based on declining %-ile rankings

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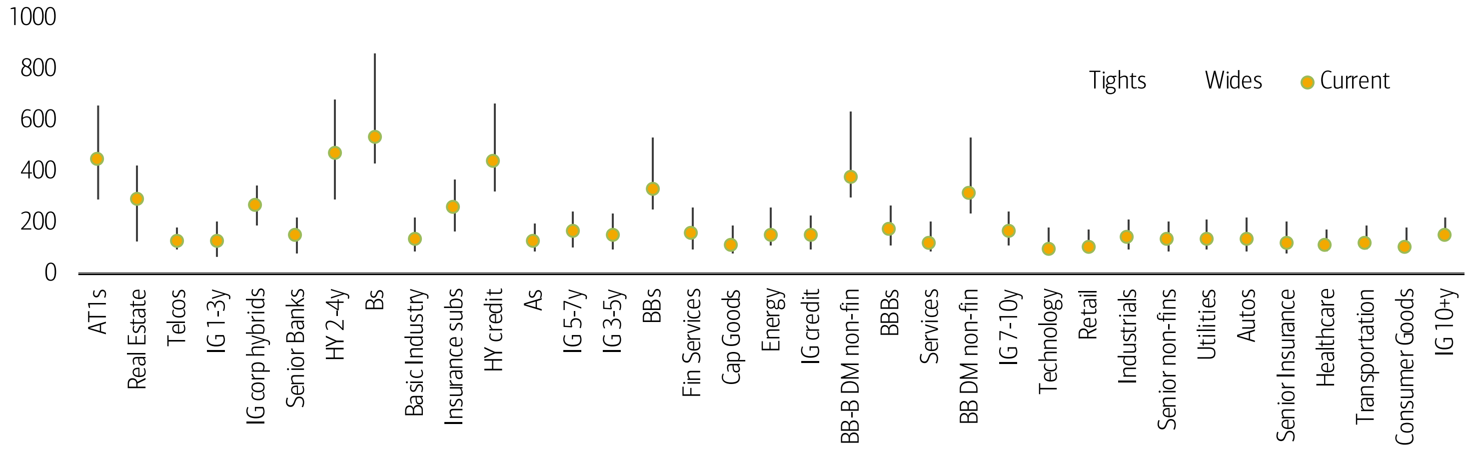
Exhibit 24: RV across credit sectors and risk-pockets

IG credit presents better value than HY. Reduce duration risk as back-ends have outperformed. Corporate hybrids a more "defensive" long in the world of sub debt.



Source: ICE Data Indices, LLC. We apply the same ordering as the exhibit above.

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Below we highlight the key takeaways of our analysis:

- We think short-dated high-grade paper screens as good value as it can offer strong spread pick-up while currently trading at a relatively stretched distance from tights. We consider short-dated credit one of the best places to "hide" should spreads head wider. Front-end credit benefits from lower rate market sensitivity, thus, reducing duration is key here. Note that 10yr+ credit trades much closer to the tights.
- Front-end high yield is not a bad place to be either, compared with the broader HY space.
- While corporate hybrids have done well this year, have underperformed recently and thus remain our preferred pocket of beta to own at the current juncture. We prefer subs over double-Bs and longer-duration IG paper.
- In financials, we prefer seniors over subs, as the former offer better protection against market volatility and potentially higher banking stress. We remain selective in the subs space to higher quality names (see report: European Credit: 3Q23 Best ideas 08 June 2023)

- **Sectors:** *Consumer goods* have held up well during the recent moves and might be exposed to the downside. In *real estate*, the underperformance reflects bank stress. While the situation remains uncertain, a rates rally could be a temporary tailwind for the sector. *Telcos* and *insurers* have already underperformed; we see less downside risk going forward (see report: Too soon to pivot).

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