Credit Strategy - Europe

Follow the Flow

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Europe

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Central banks in the driver's seat

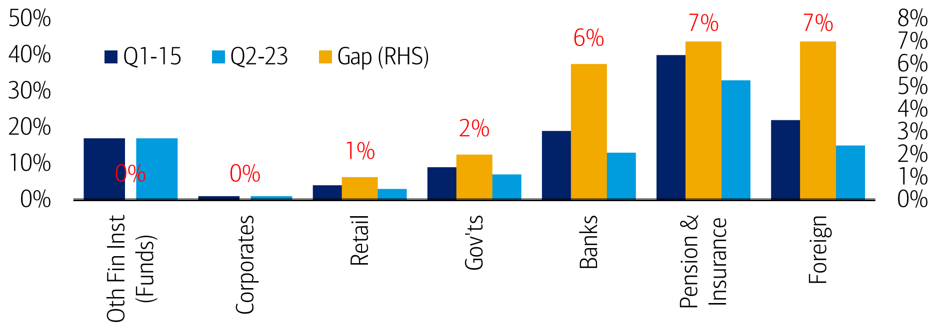
In the years of monetary policy easing and a plethora of negative-yielding assets, investors had to resort to taking on more risk to add yield. Credit was the place to be. However, as inflation began skyrocketing two years ago and central banks across the globe embarked on rapid monetary policy tightening, yields on assets that had been "uninvestable" for years rose to multi-year highs, attracting notable inflows.

Asset managers to embrace credit again, amid lower yields

But ECB monetary policy is too restrictive for an economy that is facing anaemic potential growth. Inflation is declining rapidly and should soon be on target. We think that, in a world of lower yields, on offer, credit will benefit from better technicals as institutional investors will likely increase their risk allocations back into the asset class. The backdrop of low sovereign bond yields should structurally support inflows into credit funds, while inverted curves are still a tailwind for shorter dated exposures.

Exhibit 1: Who is likely to buy government debt and who is likely not…

Demand for gov't debt is likely to remain robust for P&I funds & foreign investors. However, asset managers gov't bond allocations are already in line with historical levels; thus could gravitate towards credit.



Source: ECB

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History says: credit's optimal tenor is the front-end

Evidence of the past 24 years shows that shorter credit exposures have been more rewarding, risk-adjusted, than gov't debt exposures. We think those looking for longer-duration exposure are better placed via the rates market, on a risk-adjusted returns perspective, as credit tends to offer little additional risk-reward beyond the 5y tenor.

EGB (Euro government bond) buyer base trends

EGB markets are seeing solid demand from foreign investors so far this year; and should continue for the rest of '24 given how underweight this investor base is. Without a deterioration in the macro, asset managers are unlikely to be the marginal buyer, although there is room to rebalance towards the periphery. Retail flow should continue to underpin the front-end of BTPs, unless rates drop significantly more than we project. The combination of the flow and macro story (too many early cuts priced) means that long duration expressions are likely better around the 10y vs the front-end. For credit-like expressions within the EGB world (I.e. in BTPs), we like 5s10s ASW steepeners.

Refer to important disclosures on page 8 to 10.
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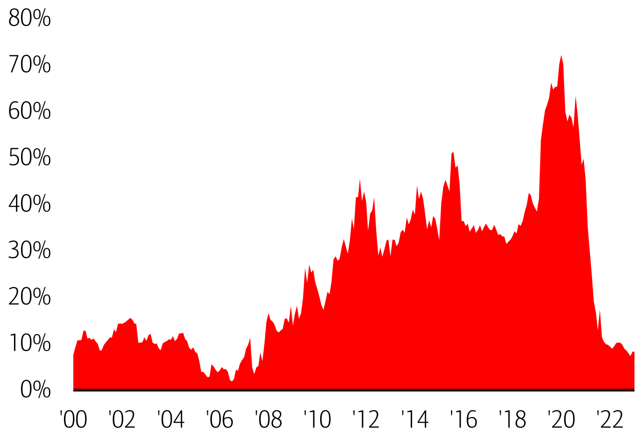
In the years of monetary policy easing and a plethora of negative-yielding assets, investors had to resort to taking on more risk to add yield. In late 2020, 70% of the global fixed-income market was yielding less than 1%. This resulted in a notable bid for risky assets. As exhibit 3 showcases, inflows were strong into IG/HY/EM debt, but much less so into government debt and money market funds in 2008 to 2020.

Exhibit 2: The lack of yield in the global fixed income market peaked in early 2021 (% of FI assets yielding less than 1%).

However, since then and amid higher rates, yields on offer across FI world increased notably and to levels not seen in years. Reversal is likely amid rate cuts looming this year.



Source: ICE Data Indices, LLC

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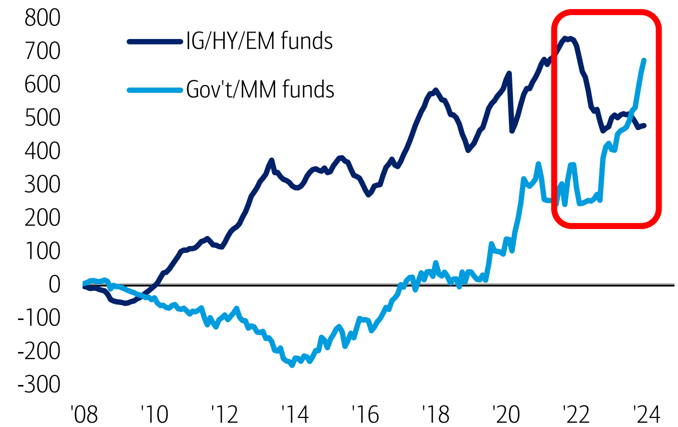
Exhibit 3: Inflows into government and MM funds have been very strong over the past 2yrs, while inflows into credit has slowed down notably

Cumulative monthly inflows in $bn



Source: EPFR Global

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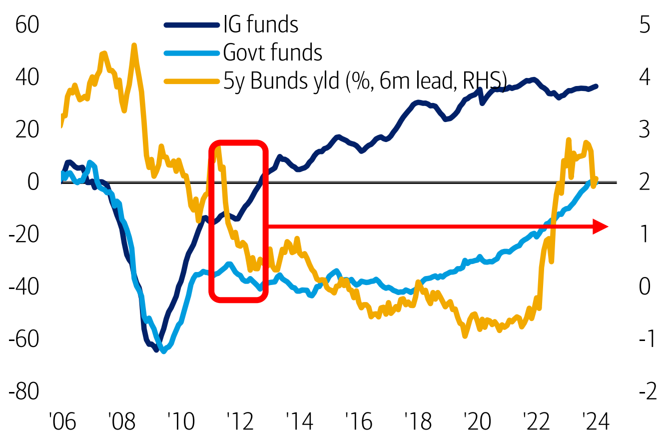
However, inflation started rising in the aftermath of the Covid-19 pandemic and growing geopolitical tensions did not help either. As inflation across the globe skyrocketed to levels not seen in decades, investors had to adjust their investment choices accordingly.

Exhibit 4: The drop in the "risk-free" rate below the 1% handle, prompted a shift into IG funds

We see stronger flow trend into IG as yields decline in 2024 and beyond



Source: BofA Global Research, Bloomberg, EPFR.
European domiciled funds cumulative % of AUM flow

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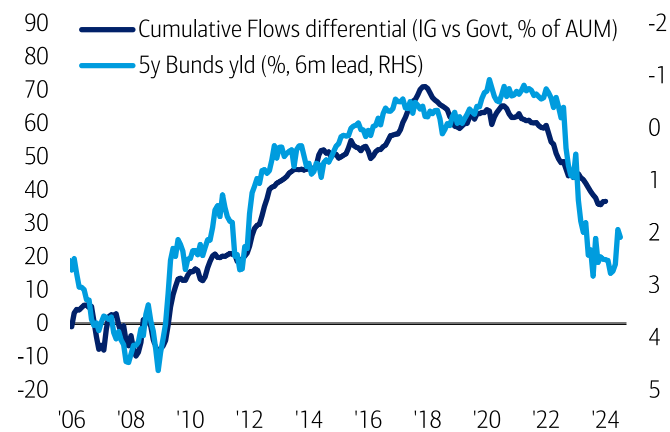
Exhibit 5: Higher rates have been a headwind for IG funds for most of 2022-23. Investors have preferred assets like gov't debt

Credit flows have strengthened over the past three months as bund yields head lower



Source: Bloomberg, EPFR Global. European domiciled funds monthly flows as % of AUM (cumulative); 6m lead for bund yield trends

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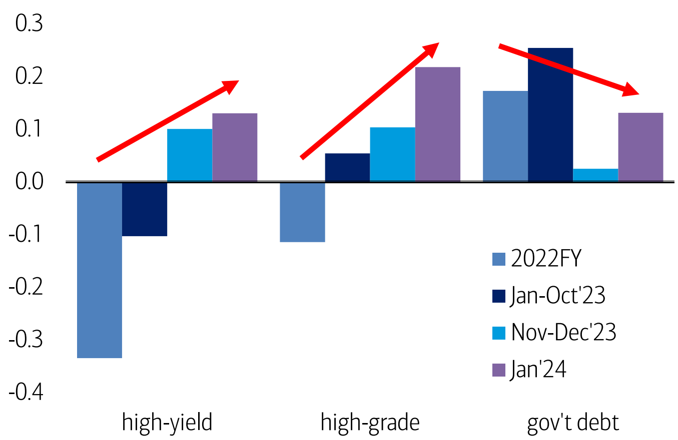
Yields started to rise rapidly on the back of higher inflation but also much more hawkish central banks. A backdrop that fixed-income investors were not accustomed to or expecting unfolded at pace. Within just 14 months, the ECB hiked from -50bp to 400bp. **This had a tremendous effect on risk allocation across the bond market. Assets that had previously been "uninvestable" for investors, like money-market funds and sovereign debt, were able to capture "risk-free" yields not seen in decades.** Ultimately, this resulted in a trend shift in the bond world, whereby investors could reduce ratings risk and still harvest superior returns.

Amid higher macroeconomic uncertainty resulting from a rapidly tightening monetary policy cycle, investors wanted to embrace the "safety" of lower-risk assets, without taking on credit risk on the back of higher default risk expectations. In 2022 and most of 2023, inflows gravitated predominantly to government bond funds and money-markets.

Exhibit 6: Inflows into credit funds accelerate over the past couple of months, while inflows into sovereign debt are slowing down
Average weekly flows in % of AUM terms



Source: EPFR Global

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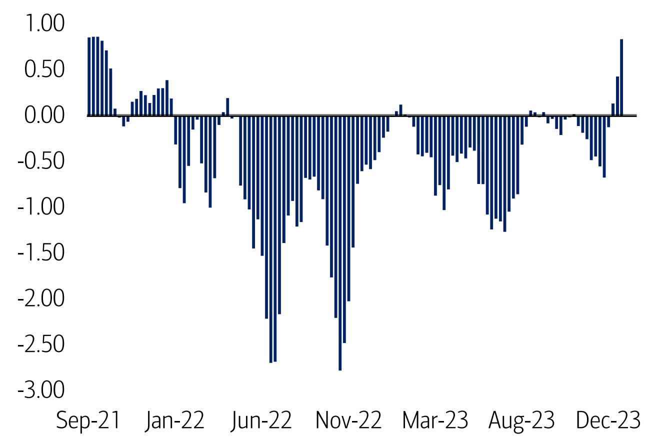
Exhibit 7: Investors are embracing front-end credit as depo rates remain high and back-end yields are declining rapidly
Flat credit curves have incentivized credit investors to buy front-end



Source: EPFR Global. 4week rolling cumulative flow into short-term IG funds (% of AUM terms)

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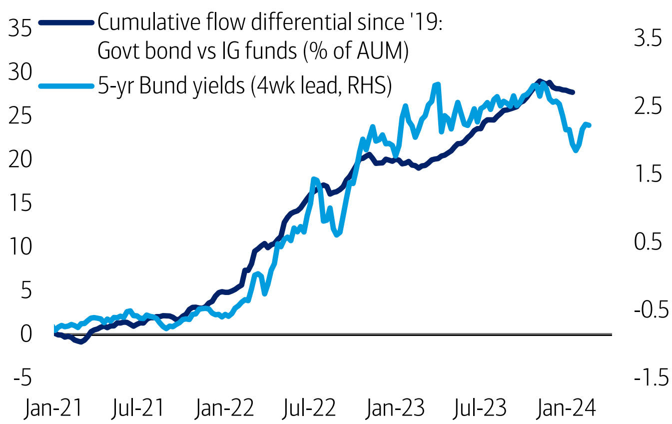
However, as central banks reached terminals and inflation started to slow (and more recently move notably lower), rates markets stabilised. They ultimately started to price in significant monetary policy easing and a raft of rate cuts (at some point 7x 25bp from the ECB) for 2024. In a world of lower yields, the crowding-out effect away from credit lost its steam.

Flows into credit to remain strong in 2024

A lower rates vol backdrop across the globe, and lower yields in government bond-land, are tailwinds for flows back into credit funds. Should inflation head lower and the ECB in the long run push depo rates back to neutral (2% or even lower, see report: Global Economics: Year Ahead 2024: Growing apart, cutting together 19 November 2023), we see the flow trend strengthening in the IG funds space – something we have already seen and that should continue if "risk-free" rates head lower from here.

Our work highlights that both a lower vol backdrop and, importantly, a lower yield backdrop are beneficial for flows into credit funds. Over the past couple of months, IG and HY funds have seen a notable trend reversal and improvement in flow trends, as inflows into government debt funds have softened, in relative terms.

Exhibit 8: Lower risk-free yields will boost inflows into credit
Higher yields were a headwind for the IG market…but 2024 looks like a year of stronger inflows for IG funds vs. government debt funds



Source: EPFR Global, Bloomberg

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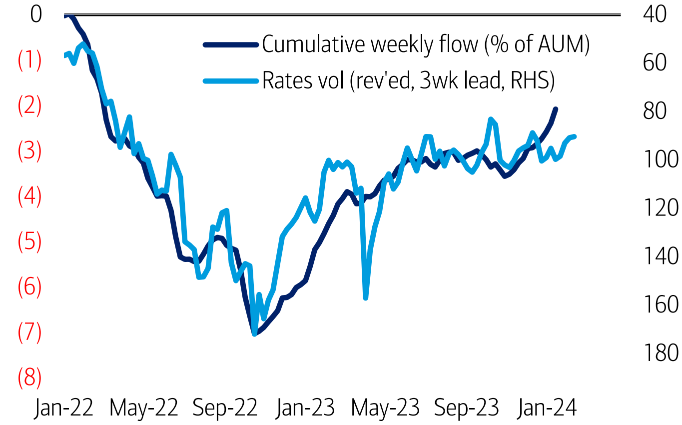
Exhibit 9: A low rates vol backdrop can support more risk-taking and stronger flows into high-grade funds
A rates vol backdrop below 90pts will further accelerate flows into IG funds



Source: EPFR Global, Bloomberg

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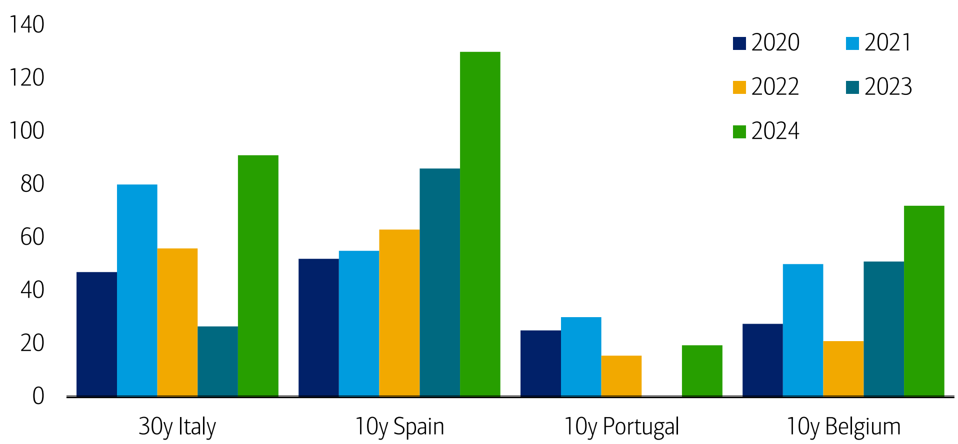
EGB demand: foreigners, domestic banks/P&I, retail

One of the top themes in the Eurozone Government Debt (EGB) market so far this year has been the large amount of investor bids at issuance operations (especially syndications). These have reached record-highs in most cases and registered marked increases relative to comparable operations over the same period in 2023.

Exhibit 10: Bidding volume at syndications for selected countries at the start of the year
2024 has so far seen sizeable bidding activity from private investors



Source: Bloomberg. Numbers in EUR billions

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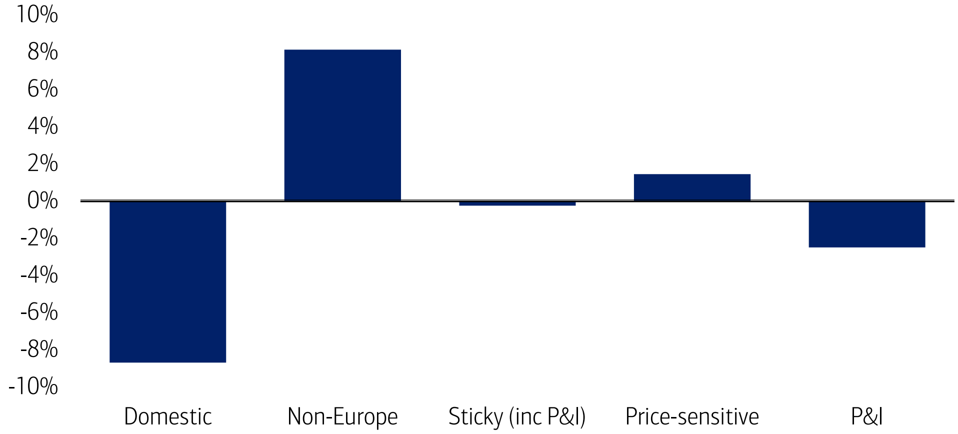
Using syndication book statistics to assess demand is riddled with caveats, but considering the context it is still rich in information, in our view. The bottom line is that EGBs will likely see an increase in marginal potential buyers this year relative to last, even if supply net of all flows is not projected to increase materially.

The geographic distribution of syndication allocations (a proxy of demand, in our view) sees more interest from foreign investors, quite significantly so. On average, syndications this year saw 8% of total volume moving to these types of accounts – that is a significant change.

Exhibit 11: Italian, Portuguese, Belgian, Spanish syndication allocation changes by type
Non-European investors bidding more aggressively so far. Investor types shuffle bonds between themselves. Pension/Insurance is relatively weak



Source: Bloomberg, national treasuries. Compares bonds with 2023. Sticky investors include central banks, banks. Pension/insurance (P&I). Price sensitive investors are considered to be hedge funds and asset managers. We do not weigh allocation variations by size.
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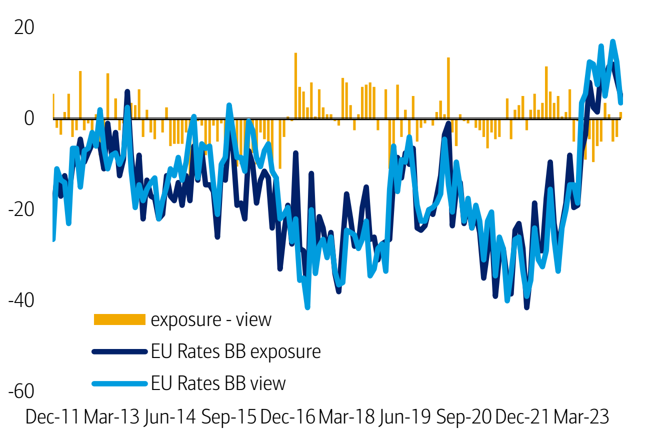
The picture of investment funds seems "rosier" for credit than rates products. The slower growth in government bond-focused funds is not completely surprising – a number of indicators confirm that asset managers are already relatively long EUR govies (or not as underweight as in the past – Exhibit 12). This is less the case for the EUR periphery (Exhibit 13). Indeed, the distribution of allocations at syndications so far confirms this (asset managers have taken a bigger portion of allocations for periphery bond sales).

Exhibit 12: Duration exposure and view: Core Europe
Duration overweights were cut back further in line with sentiment...



Source: BofA Global Research FX and Rates Sentiment Survey
BB is the Bull-Bear Index for exposure and view. It weights responses to create an index ranging from -100 to + 100, zero representing neutral. See appendix for formulas.
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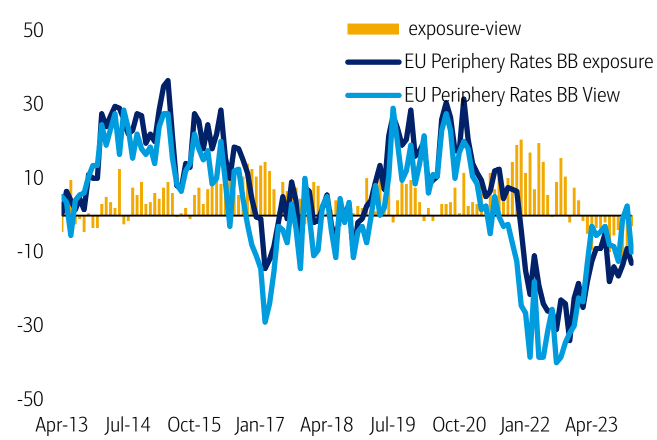
Exhibit 13: Duration exposure and view: Peripheral Europe
...which turned negative in the periphery



Source: BofA Global Research FX and Rates Sentiment Survey
BB is the Bull-Bear Index for exposure and view. It weights responses to create an index ranging from -100 to + 100, zero representing neutral. See appendix for formulas.
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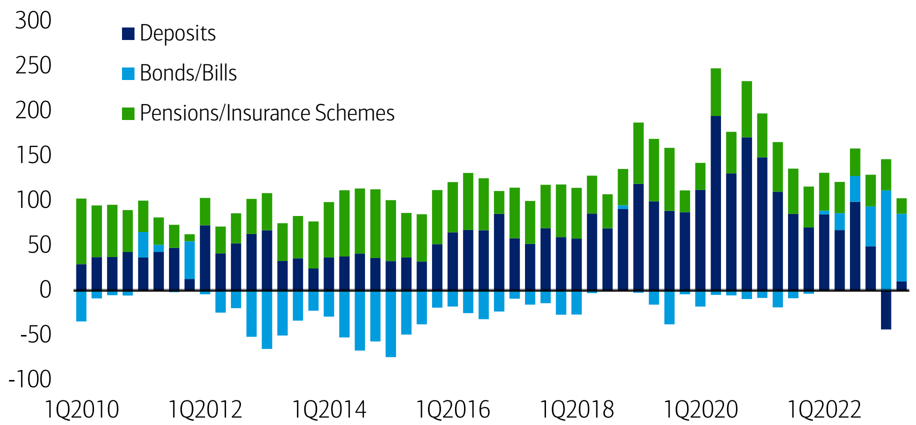
Bank allocations are down significantly, with the exception of Portugal. ECB balance sheet reduction (through QT and TLTRO repayments), as well as its spring review, may understandably keep banks a bit more cautious with risks (we are looking at only 10y+ bonds).

Pension & Insurance is one of the investor types that saw fewer allocations across the board, potentially a function of the lower pace of policy subscriptions they have seen since we exited negative rates. We will be monitoring long-end syndications (mostly due in February/March) carefully to verify this as early as possible. For now, we keep the expectation that the level of rates and their exposure to rates (lower than it could/should be) will push pension funds and life insurance companies to increase demand for fixed income relative to last year.

Retail demand for EGBs through direct ownership should remain solid as long as rates do not fall markedly from here.

Exhibit 14: Euro Area household transactions (quarterly, EURbn)
Households' financial transactions switching from bank deposits and P&I policies to debt securities, in size



Source: ECB. P&I indicates pension and insurance

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In essence, the demand picture for EGBs in 2024 is quite supportive, despite asset managers already largely being positioned long in the asset class. Looking at the current portfolio mix for different types of investors, we note that the majority of them (again, barring investment funds) need to purchase EUR debt for their portfolio mix to be similar to the pre-QE era (Q1 2015). In total, such demand can amount to €6tr. This currently "underweight" position vs the pre-QE era is especially large for non-residents and domestic banks. We think the trend of high demand we have seen so far, especially from these investor types, can continue for the rest of 2024 at least.

The main risk to this view is rates declining well below 1.5% while other currencies' debt retains higher yields.

Exhibit 15: Necessary debt securities net buying flows (in EUR billions) to bring financial portfolio composition to pre-QE levels by country, investor type
Barring that from investment funds, positioning in Euro Area debt securities is fundamentally underweight across investor types

	Austria	Belgium	Finland	France	Germany	Greece	Ireland	Italy	Netherlands	Portugal	Spain	EA Aggregate
Eurosystem	-36	-72	-28	-339	-633	-116	282	-216	-27	-32	-289	-1,820
Banks	58	82	27	616	662	-28	0	56	222	-11	145	2,133
P&I	11	73	13	385	42	-3	0	158	-67	5	10	786
Funds*	6	11	11	59	503	-4	-145	122	171	-8	-29	32
Govt	11	1	32	45	51	13	6	-52	0	4	70	162
Corps	5	13	1	31	23	0	-2	32	5	-2	20	161
Retail	31	60	5	64	89	-1	0	297	5	12	19	630
Foreign	54	-41	-33	663	978	27	-18	540	535	45	201	2,284

Source: ECB *given the geographic localization of funds, we would look mostly at the EA aggregate instead of the country breakdown. Eurosytem = ECB and Euro Area national central banks.

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A balancing act – front-end credit vs. longer dated rates

Amid high levels of front-end yields and flat corporate bond spreads and yield curves, we think that shorter-duration credit offers very compelling risk-adjusted spreads for investors (see report: Credit Strategy - Europe: Euro credit RV panorama).

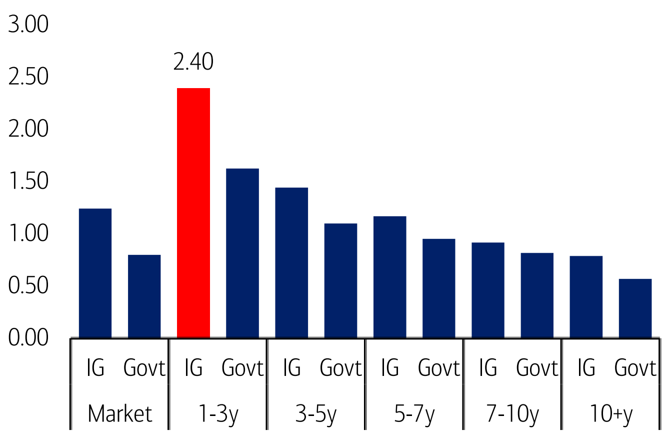
With still relatively high uncertainty about the pace and scale of ECB rate cuts this year, we prefer to own bonds that exhibit lower sensitivity to the rates market. At the same time, we feel that longer duration exposure is better implemented via the rates market. Our risk-adjusted historical performance work highlights that credit has historically offered superior risk-reward in shorter-duration pockets, but not as much as duration is extended.

Credit vs. sovereign debt – what history tells us

One way to assess the relative attractiveness of the credit and government bond market is via historical returns, but also risk-adjusted returns (info ratios). To do this, we look at daily total returns across IG (ER00 index) and government bond debt (EG00) in Europe, based on data since 2000. We compare information ratios across the two markets and different maturity buckets.

Exhibit 16: IG credit tends to produce stronger risk-reward vs. euro sovereign debt

Based on data since 2000 the risk-adjusted returns for ER00 have been stronger than those generated by the euro-sovereign debt market (EG00)



Source: ICE Data Indices, LLC. Based on daily total returns data since mid-2000. Info ratios

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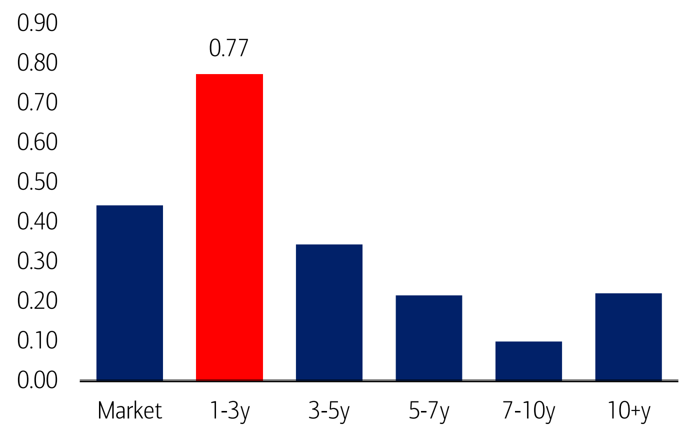
Exhibit 17: The strongest risk reward pick-up is offered in the front-end of the fixed income market, when a bond investors embraces IG credit over sovereign debt

Differential of info ratios as presented in the left hand side chart



Source: ICE Data Indices, LLC. Based on daily total returns data since mid-2000. Info ratios

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From a risk-reward point of view, the credit market benefits significantly from better info ratios historically. But this is the case particularly in shorter-duration exposures. When looking at historical performance, we find that 1-3yr high-grade euro-denominated credit tends to present much stronger risk-adjusted returns vs. government bond debt. Note that the risk-reward is not significantly stronger for bonds with duration beyond the 5yr point. Evidence shows that shorter credit exposures have been more rewarding than government debt exposures. So, we think those fixed-income investors that want longer-duration exposure are better placed via the rates market than credit.

From a macro perspective, in EUR rates, given aggressive current market expectations for the pace of central bank cuts this year, long-duration expressions are better off around the 10y part of the curve.

Within the Euro Govie complex, credit-like products such as BTPs should see a steepening in spread to swaps/Germany terms in the 5y vs 10y maturities as retail buying flows are concentrated in the short-end, while high issuance pressures valuations at the longer-end (position trades at 53bp currently).

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