Credit Strategy - Europe

Euro credit RV panorama

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Credit Strategy
Europe

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Choosing wisely

Inflation is declining, and rates markets are taking a dovish stance on cuts ahead. Even still, we think CDS markets are pricing-in even more optimistic easing cycles. With IG spreads offering much better value than HY spreads, we look for up-in-quality trades. As the eurozone growth trend remains anaemic, we think that IG cash spreads should relatively outperform high-yield spreads this year.

Rate cuts should also bring steeper credit curves, in our view, supporting our call for front-end bond outperformance. The fins outperformance over the past few months has been in line with rates trends; we need lower risk-free rates to see further outperformance.

Lower depo rates will support the front-end credit

The ECB is likely to start its cutting cycle in June this year. In the long run, we expect 2% rates in 2025 and potentially even lower in 2026, as terminals should go back closer to 1%. We think this will likely lead to supply gravitating towards longer-duration pockets, hence credit curve steepening. We see front-end cash bonds offering much better risk/reward in 2024. We prefer to reduce duration risk.

Corporate hybrids – preferred over other beta pockets

Corporate hybrids have bounced back over the past couple of months amid tighter spreads across the board. While subs have outperformed seniors recently, and so are more fairly valued currently, we think they still present a strong yield proposition among credit beta pockets. We think that subs would fare better in a market sell-off than double-Bs, and they offer a much better entry point for longs vs long-dated credit bonds.

We prefer to own subordination risk, vs ratings (i.e. HY) and duration (i.e. back-ends) risk. We are looking for sub paper that benefits from above-average yield and spread pick-up vs. seniors. We think these instruments could fare better if the recent rally loses steam.

Banks have further upside, should rates decline further

Financials have underperformed corporates over the past two years, as rates rose. Thus, In a declining yield environment, and with better deposit stability in the US, we believe that banks' seniors and subs can outperform. US bank deposit outflow trends have been much more benign over the past few months. Using the synthetics market as a guide, we think that bank bond spreads are more attractive than non-fins, if "risk-free" rates decline further.

In a world of higher "risk-free" rates in 2022 and 2023, investors reached for better yields via less risky assets. Inflows into money market and government bond funds surpassed those into IG funds. Additionally, investors, due to lower yields in bank deposits, also gravitated into sovereign debt. As rates reverse course in the following months and years, we see better fortunes for banks vs non-banks spreads.

Refer to important disclosures on page 11 to 13. 12645367

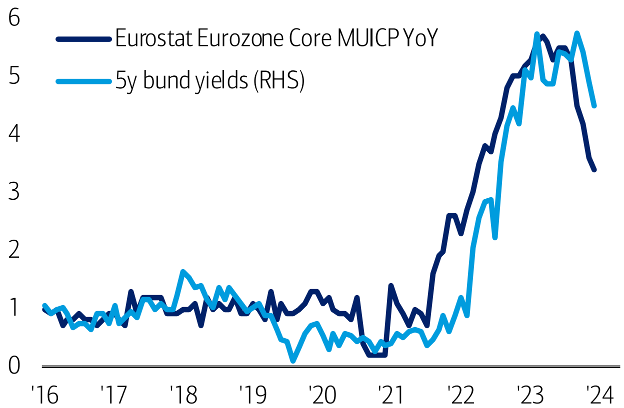
Timestamp: 15 January 2024 01:00AM EST

Credit RV panorama

Inflation is declining. Rates markets are taking a dovish stance on market developments. While the rates market is almost pricing-in six 25bp ECB rate cuts by the end of the year, we think the CDS market is way more optimistic (see report: [Credit Derivatives Strategist: Who needs QE when rate cuts are coming?]), and thus we struggle to see much upside from here. We see RV opportunities returning in credit, and credit fundamentals taking centre-stage for the rest of the year. With IG spreads offering much better value than HY spreads, we look for up-in-quality trades. As the eurozone growth trend remains anaemic, we think that high-yield bond spreads should underperform IG bond spreads this year. Rate cuts will also bring steeper curves, in our view, supporting our call for front-end bond outperformance. The fins outperformance over the past few months has been in line with rates trends; we need lower risk-free rates to see further outperformance.

Exhibit 1: A lower inflation backdrop is pushing down "risk-free" rates

Against a lower yield backdrop, credit is likely to do well this year



Source: Bloomberg

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Exhibit 2: Inflation surprise levels dropping to the lowest in 3yrs or so

Inflation has surprised to the downside over the past couple of months

Source: Bloomberg

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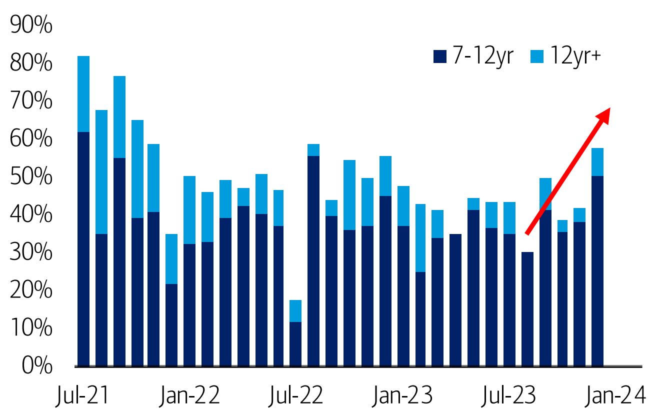
Flows should continue to gravitate towards IG funds vs. government debt funds, however, the recent rate market wobble might present some headwinds in the short term. We see IG front-end credit becoming the new "money-market" with better flows vs. the back-end of the credit market.

Exhibit 3: As terminals are set to decline, and funding costs have been much lower over the past few months...

...supply will shift to longer-duration as issuers look to lock-in lower costs



Source: ICE Data Indices, LLC

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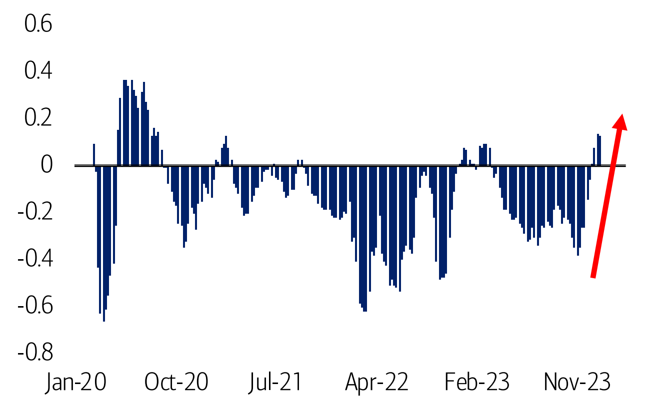
Exhibit 4: Credit inflows trend is surpassing that into government bond funds.

In a world of lower rates, technicals for the IG market are improving



Source: EPFR Global. We present the differential of 8wk average of % of AUM flows for IG vs. Gov't bond funds.

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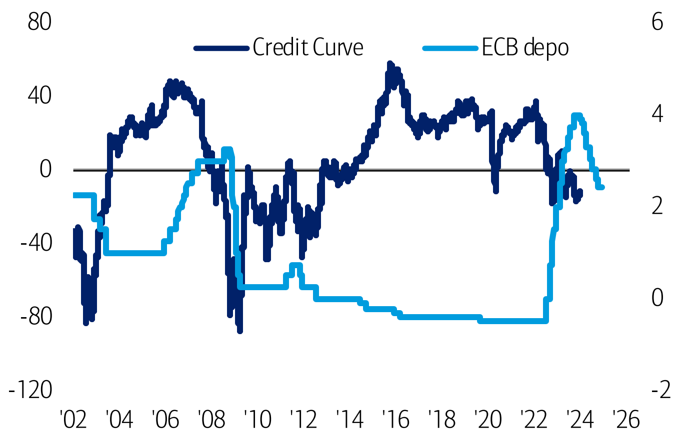
As terminals are set to decline, and funding costs have been much lower over the past few months, supply will shift to longer-duration pockets as issuers look to lock-in better funding costs (exhibit 3). We think that will be a positive technical in lower-duration pockets, but not a tailwind for longer-duration instruments.

Lower depo rates will support the front-end credit

The ECB is likely to start its cutting cycle in June this year. In the long run, we expect 2% rates in 2025 and potentially even lower in 2026, as terminals should go back closer to 1% than 2% (see report: Global Economics: Year Ahead 2024: Growing apart, cutting together). We think this will likely lead to supply gravitating towards longer-duration pockets, credit curves steepening, and thus the front-end of the market offering much better risk/reward in 2024 and beyond. We prefer to reduce duration risk.

Exhibit 5: Steeper curves should be expected amid 2024 ECB rate cuts
A lower rates backdrop should be supportive for steeper credit curves



Source: ICE Data Indices, LLC, Bloomberg. ER02 vs ER09 OAS vs. Gov't spread differential for credit curve. ECB depo rate on the RHS axis (using also WIRP)

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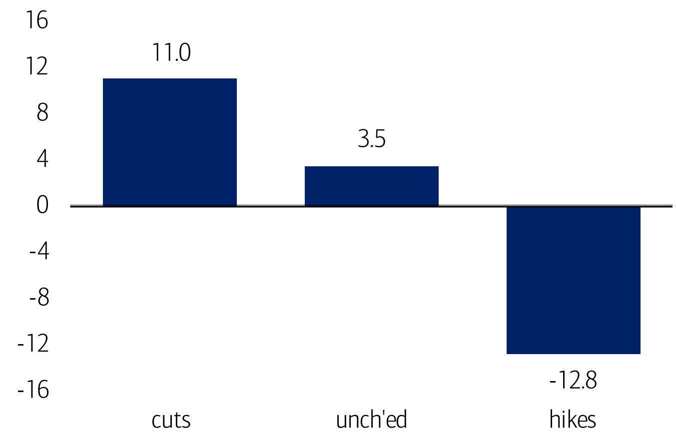
Exhibit 6: When the ECB cuts or keeps depo rates unchanged...
...curves tend to steepen (average, in bps, based on 12m daily rolling daily data)



Source: ICE Data Indices, LLC, Bloomberg

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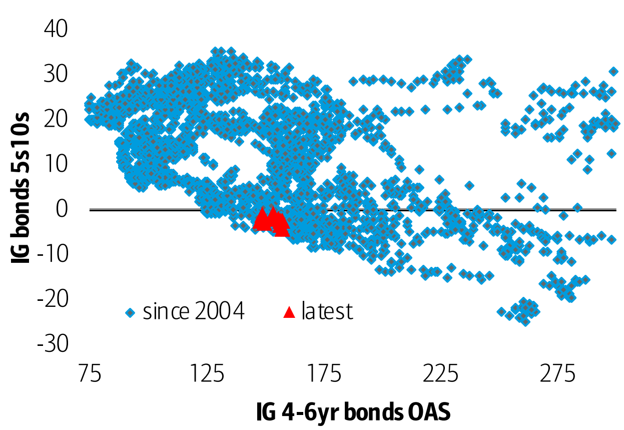
Exhibit 7: IG bond curves are very flat vis-à-vis broader high-grade credit market spreads
Corporate bond 5s10s vs corporate bond market levels (OAS vs. Gov't)



Source: ICE Data Indices, LLC. OAS

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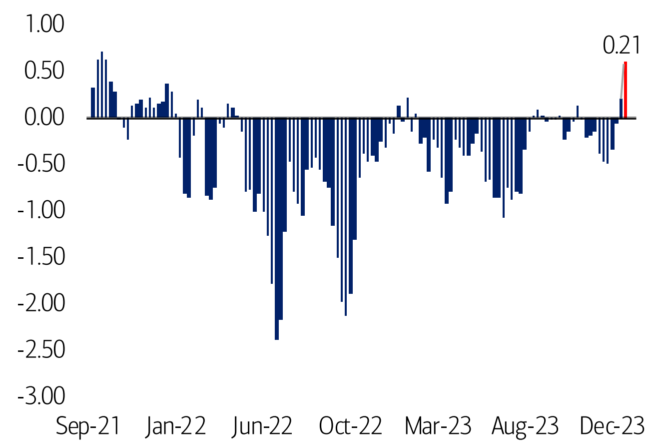
Exhibit 8: The largest three-week inflow in more than two years into short-term IG funds
We expect inflows to gravitate to short-term duration pockets amid attractive valuations and lower rates market sensitivity



Source: Bloomberg, EPFR Global. Cumulative flows, in % of AUM terms, 3wk rolling.

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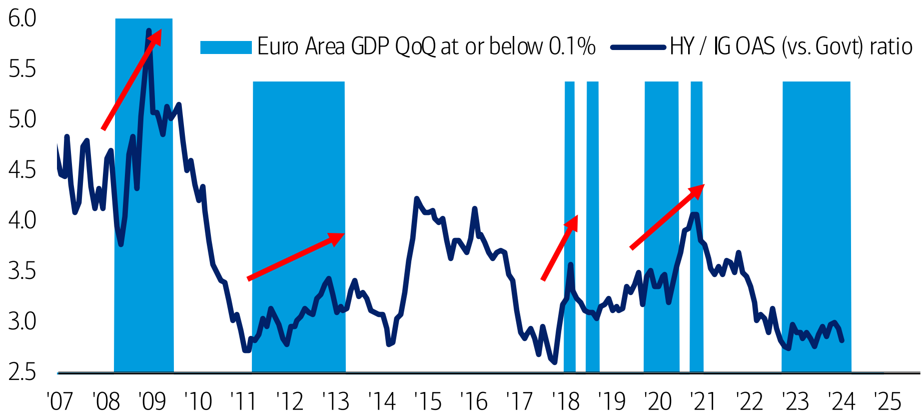
Credit beta – better in synthetics

The macro recovery in Europe seems to be an anaemic one. Our econ team sees mediocre 0.4% GDP growth YoY in 2024 and 0% in Q1 '24; note also we expect only a marginal improvement for the rest of the year (see report: Europe Economic Weekly: Back to school: it's really never easy 12 January 2024). In that environment, we see limited beta upside and outperformance of high-yield over high-grade bond spreads.

Exhibit 9: A low growth backdrop has never allowed for beta-compression in corporate bond land
We think that the HY/IG OAS (vs. gov't) spread ratio is likely to head higher in a low growth environment



Source: Bloomberg, ICE Data Indices, LLC. BofA Global Research economic forecasts

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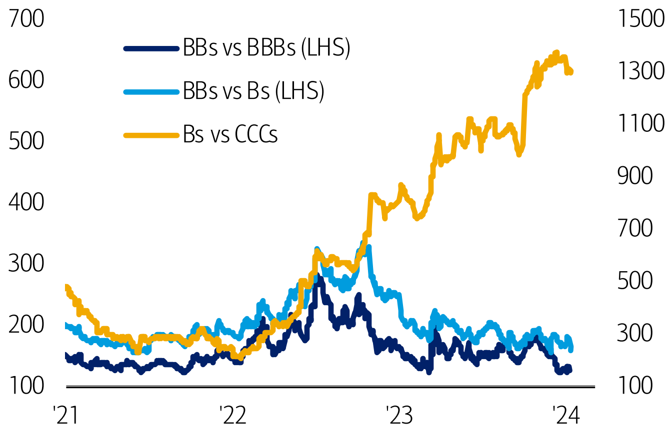
While on an absolute performance basis HY spreads (both in cash and synthetics) should do better than their IG counterparts in a tightening spread market, we struggle to see HY bonds relatively outperforming IG debt this year. We see better beta upside in CDS, though.

Exhibit 10: Risk-premia have compressed notably to levels...

...seen before ECB rate hikes...HY would struggle to perform further if CCCs do not recover



Source: ICE Data Indices, LLC

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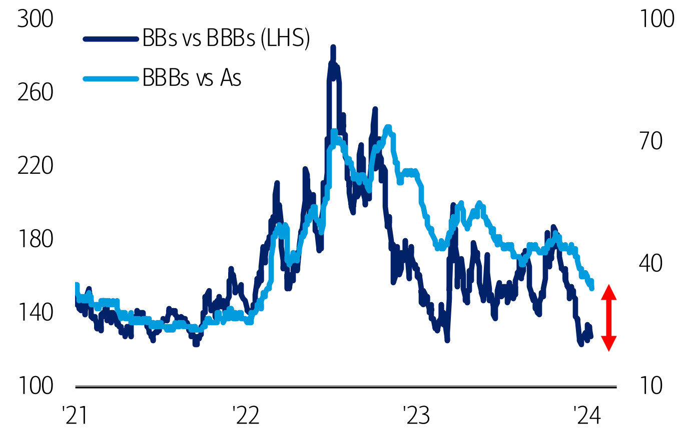
Exhibit 11: BBBs have much more room to perform and push IG spreads tighter in 2024
While BBs are very tight to BBBs and thus we think beta decompression is the case for IG vs. HY spreads



Source: ICE Data Indices, LLC

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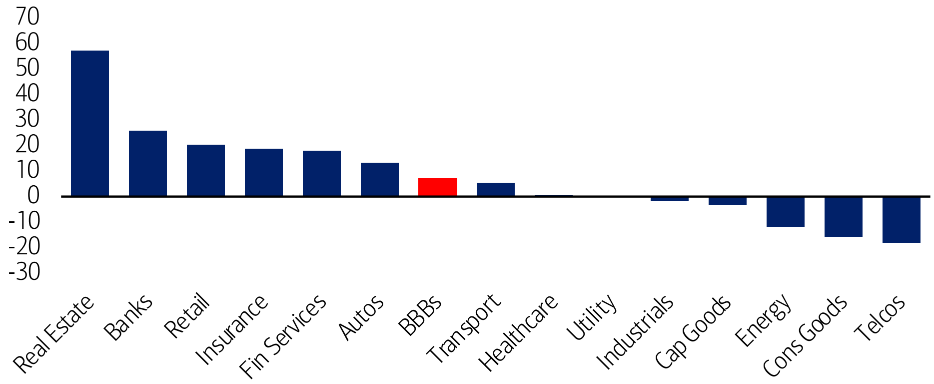
The credit risk premium between ratings has compressed notably over the past year or so in the high-yield market. The spread differential between single-Bs and BBs, and BBs and BBBs is close to three-year tights; thus there is less spread tightening capacity between credit ratings. Also note the notable premium that has been built in the CCC space, but this is for the right reason amid significant idiosyncratic risks. Therefore, strong beta compression in the high-yield market would need to come from a notable rally in CCC spreads, or single-B rating-upgrades.

Exhibit 12: There is still space for spread compression in some large sectors in the BBB space
A lower rates environment should be beneficial for real estate and financials (BBB rated credits only)



Source: ICE Data Indices, LLC. OAS vs. Govt changes since December 2021 (before the rates market sell-off)
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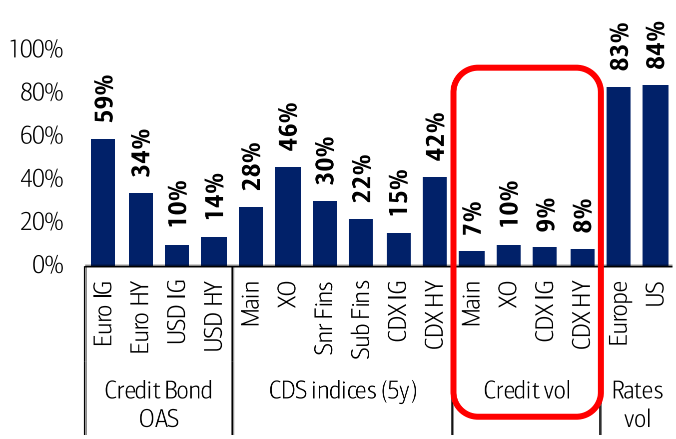
We also highlight that the BBB market has much more potential to rally than single-As. Arguably, lots of the upside could come from sectors that underperformed in 2023, like real estate bonds. But we think there is upside in that space (see report: European Real Estate: Selectively bullish) and also in other rate-sensitive pockets like fins that could do well in a lower rates backdrop environment (see report: YA 2024: Back on the menu).

We consider the XO index a better long than high-yield corporate bonds. Not only is the liquidity provision better in the CDS index space (see our latest credit market liquidity report: Credit market liquidity – 2023 edition), but we also think XO offers much better entry points for market longs. We would not be surprised to see beta performing better in the CDS vs. the bond space.

Valuations heatmap

A strong rally in December has left the synthetics market exposed in January. Volatility spiked and longs that have been added in the latter parts of the year have been under pressure. We think that Main still looks tight to other risk gauges, like XO and equity vol.

Exhibit 13: IG bonds > HY bonds, IG bonds > iTraxx Main, XO > HY bonds
Crossover 5y CDS is a better long vis-à-vis euro-HY corporate bonds. XO vs iTraxx Main easier to compress than HY vs. IG cash. Credit vol way too low.



Source: Bloomberg, ICE Data Indices. Based on data since Nov-08. Presenting percentile rankings
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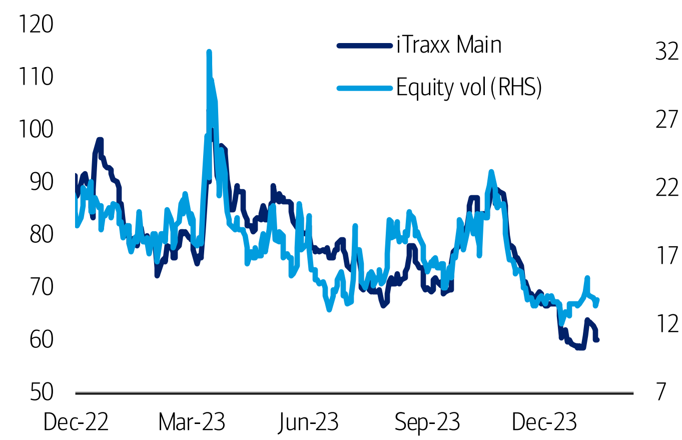
Exhibit 14: iTraxx Main tight to equity vols...
We struggle to see much tighter Main spreads



Source: Bloomberg
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On the flipside, we believe XO longs are better value vs. iTraxx Main, which is more at risk of underperformance at current levels (exhibit 13).

Our work on seasonality shows that IG bonds perform stronger in the first part of the year vs. synthetics (see report: [Who needs QE when rate cuts are coming?]) – another reason to prefer corporate bond longs to CDS. Euro-denominated 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.

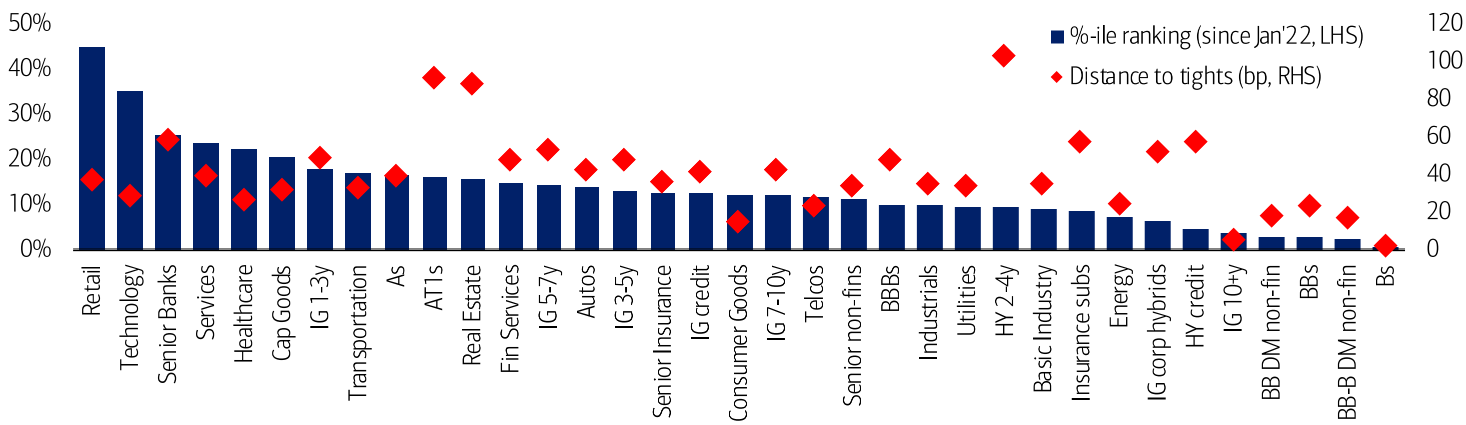
Finally, we think credit implied vols – across the CDS index market – are on the low side vis-à-vis other risk metrics, and present good value to own via out-of-the-money puts.

Own the laggards, reduce risk in the outperformers

Spreads compressed notably in Nov-Dec 2023. We think those sectors that still trade closer to the tight prints of early 2022 (and before rates moved higher) have less capacity to outperform than the rest of the market. Such sectors are likely to be prone to downside if the credit market stalls or even credit spreads move wider.

Exhibit 15: 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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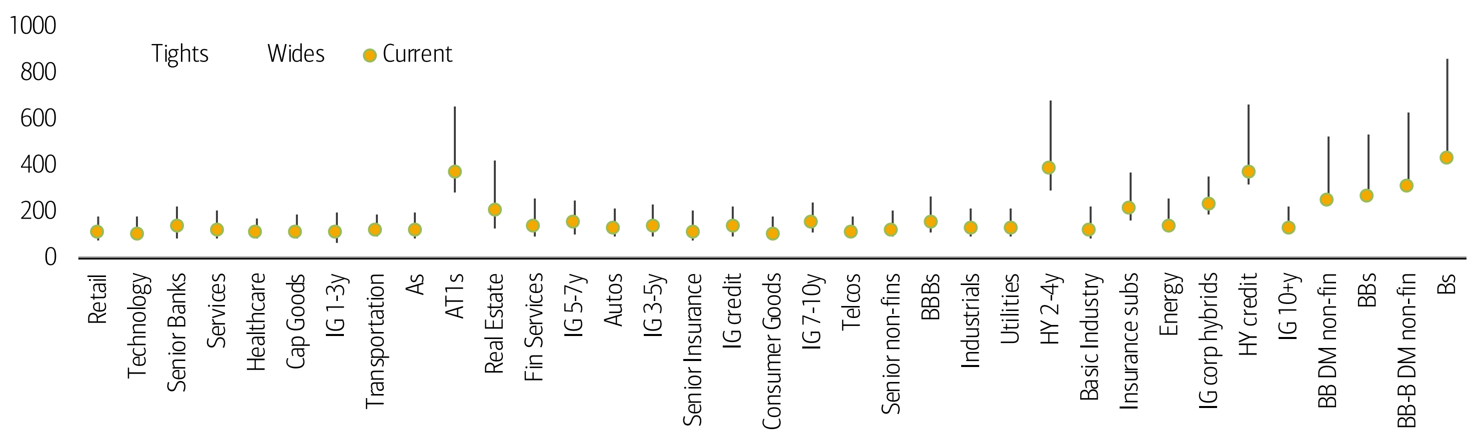
Exhibit 16: RV across credit sectors and risk-pockets

IG credit presents better value than HY. Reduce duration risk as back-ends have outperformed.



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

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- In exhibit 15, we present the latest market OAS (vs Govt) levels for a large number of sectors/risk-pockets of credit risk vs. the historical trading ranges (percentile rankings quantify at which percentile (%-ile) of the distribution the latest trading level sits). We also show the difference between the current OAS levels and the tightest print since early 2022.

- In exhibit 16, we present the trading ranges and latest closing market OAS levels across the same sectors/risk-pockets of credit risk as in exhibit 15.

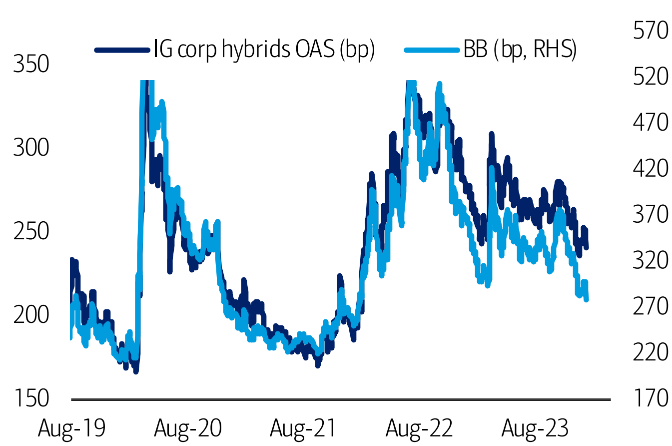
Below we highlight the key takeaways of our analysis:

- We think short-dated high-grade paper screens at the part of the curve that gives the best entry point for longs as it offers strong spread pick-up while currently trading far from tights. Short-dated credit is one of the best places to "hide" if spreads head wider, in our view, on the back of very suppressed credit curves. Note that 10yr+ credit trades much closer to the tights and is one of the risk pockets that looks the most overvalued (lowest percentile ranking).
- Front-end high yield had a good run in the latter part of 2023 and thus is currently more fairly valued among the risk assets we track.
- Corporate hybrids have done very well recently, and currently look somewhat tight compared to seniors (non-fins). However, they remain our preferred pocket of IG beta to own at the current juncture. We prefer subs over double-Bs and longer-duration IG paper.
- In banks, we prefer seniors over subs, as seniors offer better entry points (OAS sit at higher %-ile rankings).
- **Sectors:** In line with our macro cycle work (see report: Credit Derivatives Strategist: Too much, too fast? 05 December 2023), we do not think that consumer goods and utilities offer attractive entry points at this juncture. Both these sectors have done better than expected in the "recovery" phase, and thus we look to trim risk. We see more upside for cap goods and retailers in particular on the back of better entry points (wider in RV terms spreads) but also because these sectors have lagged.

Corporate hybrids – preferred over other beta pockets

Corporate hybrids have bounced back over the past couple of months amid tighter spreads across the board. While subs have outperformed seniors recently, and so are more fairly valued currently (and possible in RV terms tighter than seniors), we think they still present a strong yield proposition among credit beta pockets.

Exhibit 17: Corporate hybrids present better value to own...
...vs. double-Bs



Source: ICE Data Indices, LLC

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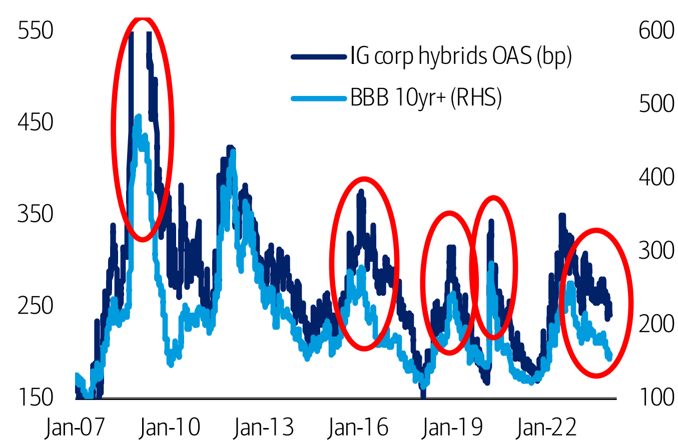
Exhibit 18: Corporate subs present better value vs. longer-dated paper
BBB back-ends have done better so far this year



Source: ICE Data Indices, LLC. GNEC vs ER49 indices

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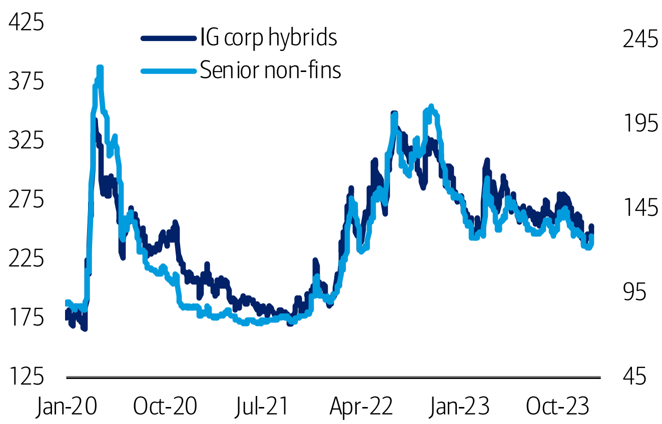
We think that subs would fare better in a market sell-off than double-Bs, and they offer a much better entry point for longs vs long-dated credit bonds. We prefer to own subordination risk, vs ratings (i.e. HY) and duration (i.e. back-ends) risk.

As "risk-free" rates have declined over the past few months and fixed income investors are seeking to add credit risk (see report: 2023 flows recap and More into credit), we look for those subs that offer above-average spreads and yields across the euro-denominated market despite the lack of "cheap" levels in the broader subs space.

Staying defensive – looking for best pick-up

With market valuations less attractive than couple of months ago, we are cautious about adding beta in pockets that have already done well. As positioning currently looks stretched, as our latest Credit Investor Survey highlights (see report: Credit Investor Survey: Flip-flopping fantastic 12 December 2023), we want to look for the best value proposition paper in subs.

Exhibit 19: Corporate hybrids trade in line with seniors
GNEC vs ENS0 indices OAS vs. Gov't



Source: ICE Data Indices, LLC. Senior fins spreads on RHS axis

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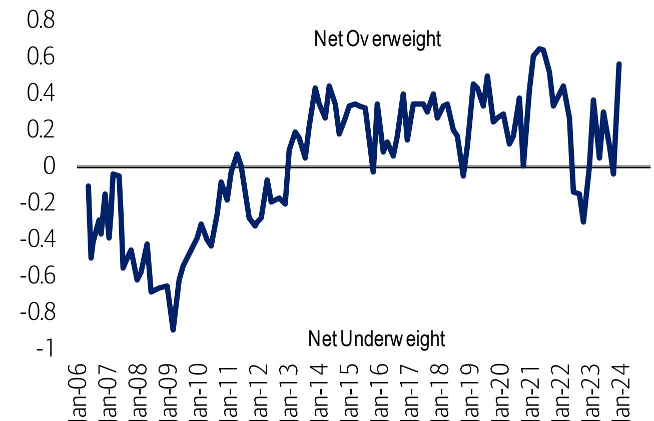
Exhibit 20: Net positioning in corporate hybrids
57% net overweight in Dec '23



Source: BofA Global Research. Net percentage of investors.

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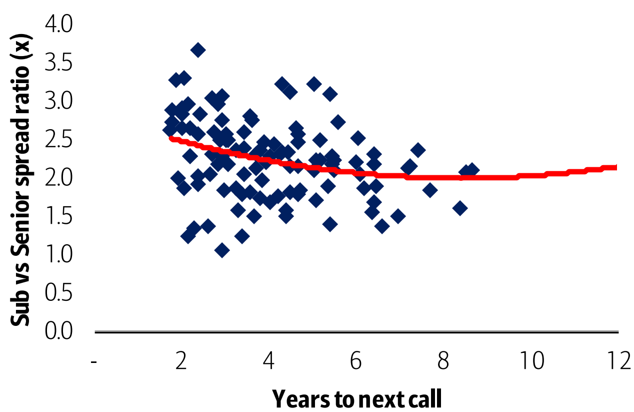
We are looking for sub paper that benefits from above-average yield and spread pick-up vs. seniors. We think these instruments could fare better if the recent rally loses steam. Picking the right bond is important.

Exhibit 21: The spread pick-up (corporate hybrids vs. seniors) curve
There is slightly more value in front end bonds (OAS vs. Gov't ratio)



Source: BofA Global Research, ICE Data Indices, LLC

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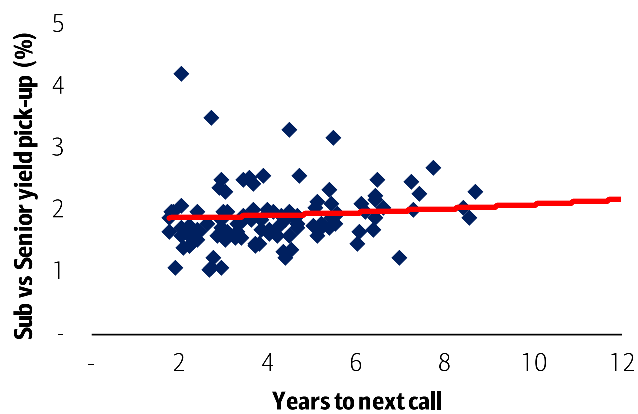
Exhibit 22: The yield pick-up (corporate hybrids vs. seniors) curve
The yield pick-up curve is relatively flat



Source: BofA Global Research, ICE Data Indices, LLC

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For that reason, we look at the entire euro-denominated corporate hybrid market and compare the sub yields on an issuer- and maturity-matched basis. We compare the sub bond yield to the euro equivalent senior bond yield on a matched-maturity basis (hybrid's call-date vs. senior's maturity). We use the respective issuer's senior yield curve and extrapolate the yield of a senior bond with the same maturity to the hybrid instrument's next call date. We run a similar screen for best pick-up in spread terms (OAS vs. Gov't).

In our universe we include only hybrids with at least 5 senior bonds (to build a senior curve we use seniors of up to 2040 maturities), 1.5yrs duration (to next call date) and price of above 70pts (to exclude names that price to perp). Overall, we have more than 100 corporate hybrids under our microscope.

The results are presented in exhibits 21 and 22. The red line is the trend line that captures the yield pick-up (vs. seniors) or the spread pick-up (in ratio terms vs. seniors), for different maturities for the corporate hybrid universe. In exhibit 23, we present the names that provide the best "above-the-trend-line" yield (as per exhibit 22) and spread pick-up (as per exhibit 21) in the high-grade and the high-yield market. We think these bonds that are priced more attractively to seniors could fare better if markets become volatile.

Exhibit 23: Best yield/spread pick-up in the IG corporate hybrids bonds space
Hybrids that offer above average spread ratios and yield pick-up vs. the subordinated market

			OAS vs. Gov't				Eff Yield		
ISIN	**Issue**	**Rating**	**Senior**	**Subs**	**pick-up**	**ratio (x)**	**Senior**	**Subs**	**pick-up**
FR0013330537	ULFP 2.875% 26s	BBB3	101	269	168	2.7	3.6	7.9	4.2
XS2391779134	BATSLN 3% 26s	BB1	117	356	239	3.1	3.6	7.1	3.5
FR001400IU83	ULFP 7.25% 28s	BBB3	133	417	284	3.1	3.6	6.9	3.3
FR0014003S56	EDF 2.625% 27s	BB2	112	279	167	2.5	3.4	6.0	2.6
FR0013534351	EDF 2.875% 26s	BB2	97	299	202	3.1	3.3	5.8	2.5
FR0013464922	EDF 3% 27s	BB2	109	300	191	2.8	3.4	5.8	2.4
XS2224439971	OMVAV 2.875% 29s	BBB2	101	315	214	3.1	3.1	5.4	2.4
XS2282606578	ABESM 2.625% 27s	BB2	117	302	185	2.6	3.5	5.9	2.3
XS2646608401	TELEFO 6.75% 31s	BB2	134	321	187	2.4	3.4	5.7	2.3
FR0013534336	EDF 3.375% 30s	BB2	143	331	188	2.3	3.6	5.8	2.2
XS2187689380	VW 3.875% 29s	BBB2	154	354	200	2.3	3.6	5.7	2.1
FR0011697028	EDF 5% 26s	BB2	82	232	150	2.8	3.2	5.3	2.1
XS2244941147	IBESM 2.25% 29s	BBB3	75	241	166	3.2	2.8	4.8	2.0
XS2410367747	TELEFO 2.88% 28s	BB2	107	262	155	2.4	3.4	5.4	2.0
XS2109819859	TELEFO 2.502% 27s	BB2	95	240	145	2.5	3.4	5.4	2.0
XS2256949749	ABESM 3.248% 25s	BB2	88	289	201	3.3	3.6	5.6	2.0
XS2224439385	OMVAV 2.5% 26s	BBB2	74	274	200	3.7	3.3	5.3	2.0
FR0013331949	FRPTT 3.125% 25s	BB1	78	227	149	2.9	3.4	5.4	2.0
XS1799939027	VW 4.625% 28s	BBB2	143	335	192	2.3	3.6	5.6	2.0
XS2295333988	IBESM 1.825% 29s	BBB3	79	216	137	2.7	2.8	4.8	2.0
FR001400EFQ6	EDF 7.5% 28s	BB2	123	305	182	2.5	3.5	5.4	1.9
XS2580221658	IBESM 4.875% 28s	BBB3	70	228	158	3.2	2.8	4.8	1.9

Source: BofA Global Research, ICE Data Indices, LLC. We rank based on the highest yield pickup. We present the subs that offer above average yield pickup over their seniors (>1.93%) and above average spread ratio pickup over seniors (>2.25x). This screen is not a recommended list either individually or as a group of stocks. Investors should consider the fundamentals of the companies and their own individual circumstances/objectives before making any investment decisions.

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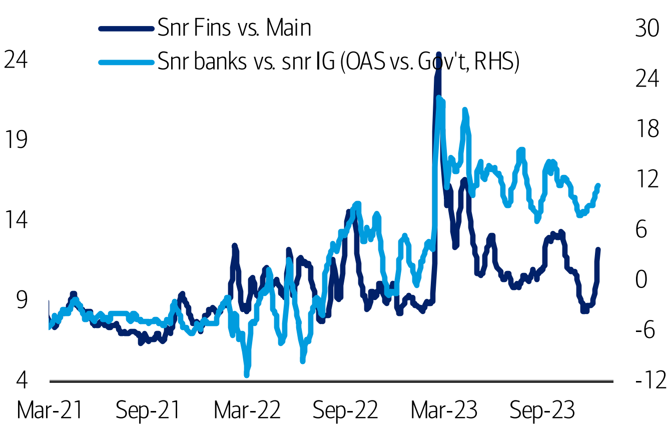
Banks have further upside, should rates decline further

Financials have underperformed over the past two years up to last October. In a declining yield environment, and with better deposit stability, we believe that banks' seniors and subs can outperform. US (and European) bank deposits outflow trends have been much more benign over the past few months. Using the synthetics market as a guide, we think that bank bond spreads are more attractive than non-fins if "risk-free" rates decline further.

In a world of higher "risk-free" rates in 2022 and 2023, investors have reached for better yields via less risky assets. Inflows into money market and government bond funds surpassed those into IG funds. Additionally, investors, due to lower yields in bank deposits, also gravitated into sovereign debt. As rates reverse course in the following months and years, we see better fortunes for banks vs non-banks spreads.

Exhibit 24: Bank bond spreads trade wide to non-fins...
...and vs. CDS spread differentials



Source: ICE Data Indices, LLC, Bloomberg

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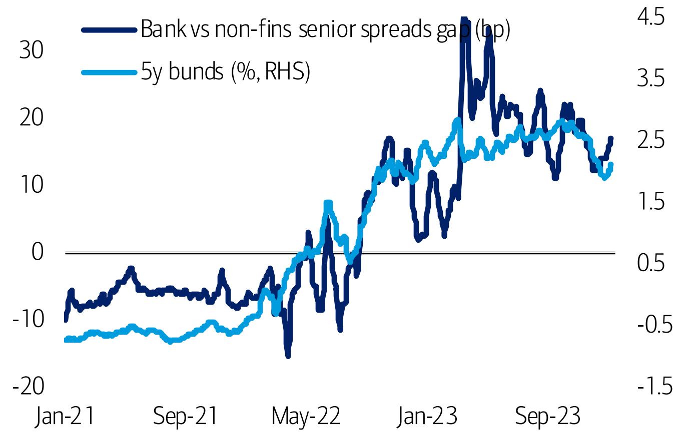
Exhibit 25: In a lower yield environment...
...bank spreads should outperform non-fins spreads (OAS vs. Gov't)



Source: ICE Data Indices, LLC, Bloomberg

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