The European Credit Strategist

We need to talk about debt

Credit Analysis

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When the world goes "ex liquidity"...

We see the corporate bond market essentially "round tripping" this year, and now expect 1.5% excess returns for high-grade and 2% total returns for high-yield. But we remain of the view that the early months of '19 will be the most vulnerable period for spreads given the combination of shallow Eurozone growth, the lack of marginal bond buyers and the front-loading of supply. Moreover, there are plenty of regime changes which we believe could weigh on the market. The world is going "ex liquidity" as central bank balance sheet growth turns negative…and the drop in global money supply suggests economic data suprises will continue to be biased to the downside.

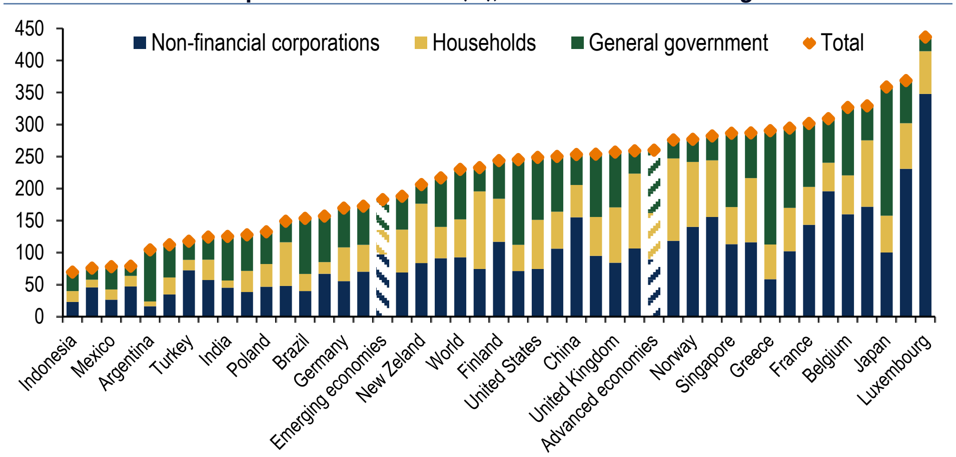
A jumbo-sized headache

Perhaps more than ever before, simple new issues are becoming a detriment to the performance of the European corporate bond market. This week's 1% concession by Telecom Italia on its bond issue highlights how far some companies may need to go to secure debt funding in the new world without QE, and without marginal buyers. We think investors should be careful in the autos, industrial, energy and telecoms sectors. Here, issuers have a higher proportion of front-end debt and thus may be tempted to opt for a "jumbo" new issue to secure refinancing, which will mean a big repricing effect on secondaries. We also see a clear message for the equity market today: debt costs are higher than you think, and EPS expectations may need to come down to reflect this.

Angry voters and the debt of nations

It's not just the European credit market that will be hunting for new marginal buyers. Sovereign markets will also need ready buyers of debt as "angry voters" are leading to a mini, uncoordinated, fiscal push in the Euro Area. The crowding out across bond markets will be apparent in 2019. But if inflation expectations falter, markets risk pivoting back to worrying about global debt levels. The world has become $62tr. more in debt since Lehman, and many of the new vulnerabilities and debt "hotspots" reside now in Europe.

Where are the debt "hotspots"? Total debt/GDP (%), across countries and categories



Source: BIS. Data as of 2Q 2018.

Refer to important disclosures on page 10 to 12.

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We need to talk about debt

April is said to be the cruelest month. Yet for credit strategists with year ahead targets, it can often feel like it's December. Weakness in the final innings of last year has meant that spreads have realised much of our 2019 widening targets already. Time, therefore, for a refresh...

2019: A tiring round trip

We don't think much changes, though, in terms of the sequence of events – and risks – as we see them playing out. We still expect the Euro corporate bond market to experience "peak weakness" in the early part of this year, due to the combination of shallow Eurozone growth, the lack of marginal bond buyers and the front-loading of corporate issuance. Where today's wider spreads will help, in our view, is in the second half of the year, when we expect Eurozone growth to turn up (aided by stronger consumer spending). We think we'll now see a more forceful rally in bond spreads in '2H, as valuations will look interesting for an economy with dissipating recession risks.

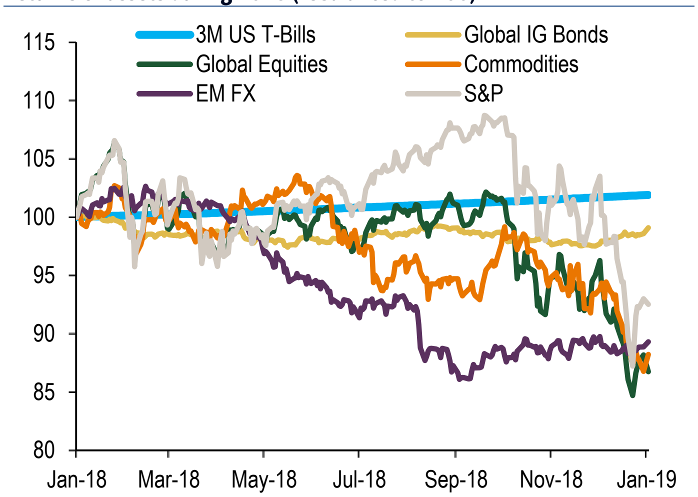
All in all, we see the market essentially "round tripping" this year, and we now forecast spreads to end '19 roughly unchanged to a smidgen wider (5-10bp for IG, 20-40bp for HY). This means a better return picture than we had originally envisaged: 1.5% *excess* returns for high-grade and 2% *total* returns for high-yield (we see bund yields rising).

"One potato, two potato..."

We remain of the view that the early months of 2019 form a vulnerable period for the European corporate bond market. This year marks a regime change, with the ECB no longer participating – in meaningful size – in the credit market (CSPP reinvestments are less than €6bn for the whole of '19). Despite the temptation to berate the ECB at intervening in credit and "distorting", we think the reality is that the ECB *aided* market liquidity by acting as a buyer of last resort, for both the street and investors. ECB participation boosted the market's confidence to support longs, in our view. Yet, without Draghi's end-buying, the market may be reluctant to hang on as diligently to positions now...creating something of a "hot potato" syndrome for corporate bonds.

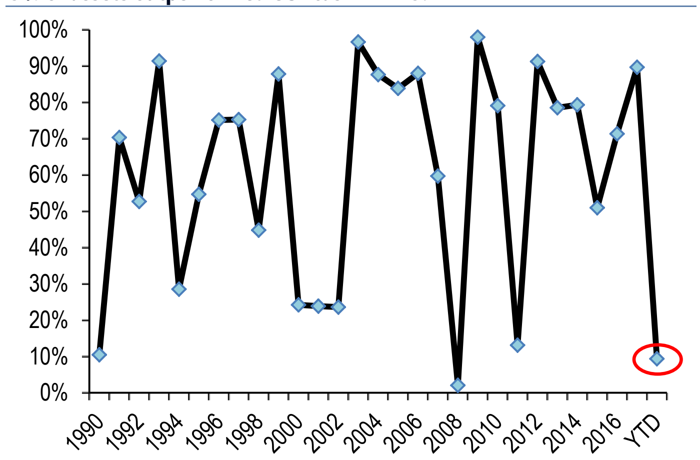
Moreover, we think risk appetite will be low in the early part of this year as cash "embarrassed" so many asset classes in 2018, including European credit, as chart 1 shows. In fact, chart 2 highlights that only 9% of assets across the globe posted better total returns than 3m US Libor last year.

Chart 1: Cash "embarrassed" most risky assets in 2018: cumulative total returns of assets during 2018 (rebalanced to 100)



Source: BofA Merrill Lynch Global Research, Bloomberg. Cumulative total returns across the year.

Chart 2: Percentage of assets outperforming US 3m Libor per year. Just 9% of assets outperformed US "cash" in '19.



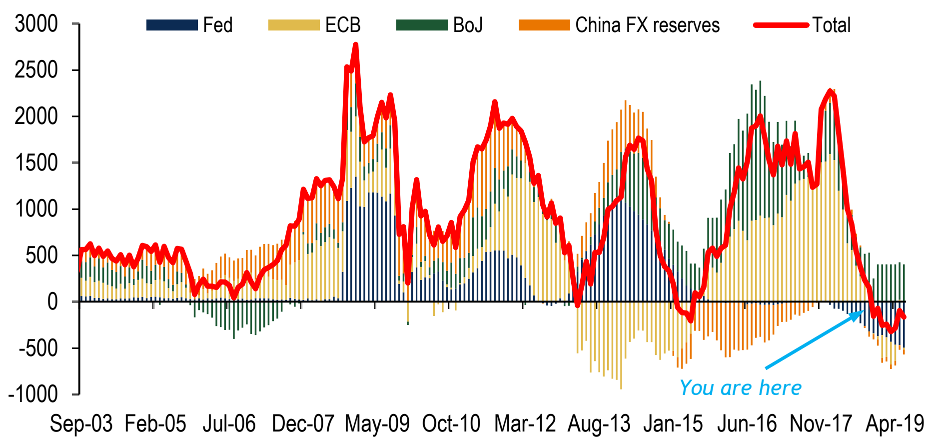
Source: BofA Merrill Lynch, Bloomberg. Yearly total returns. Using a sample of over 300 assets across equities, commodities, FX and credit.

Bank of America Merrill Lynch

The world is going "ex liquidity"

Early 2019 will be uncharted territory for the market. After years of central bank purchases crowding investors into risky assets, this dynamic will now reverse. Note that the yearly growth of central bank balance sheets is turning negative (chart 3). The upshot of this, in our view, is that markets will continue to experience more "corrections" than normal, leading to bigger and fatter trading ranges for credit spreads in Europe this year.

Chart 3: YoY changes in "Global QE", $bn (YoY CB balance sheet growth). Chart projected into '19.

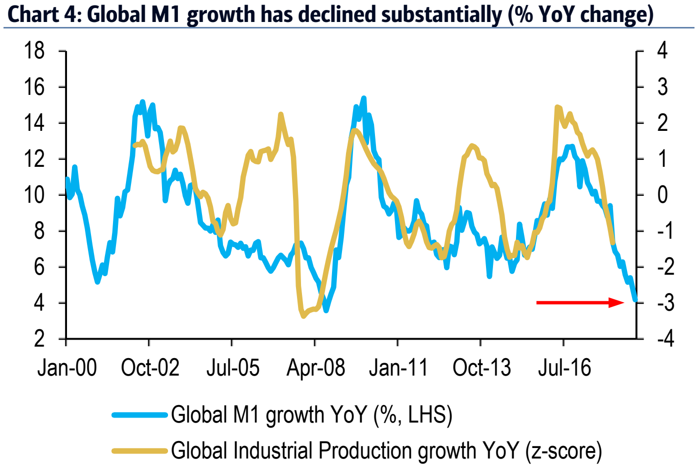


Source: BofA Merrill Lynch, Bloomberg. Converting ECB and BoJ balance sheet numbers into USD equivalents. China FX reserves are reported in USD.

More broadly, though, we worry that a deteriorating liquidity backdrop will weigh on economic growth. As chart 4 highlights, global money supply has declined rapidly over the last year and a half. In fact, global money supply growth (using M1) is flirting with the lows seen in mid-2008. While some economies, such as China, are now pivoting back to supportive measures, high global debt will constrain economies' enthusiasm for engaging in further rounds of stimulus, we think. And as chart 4 suggests, lower money supply growth has often pointed to weaker global economic momentum going forward.

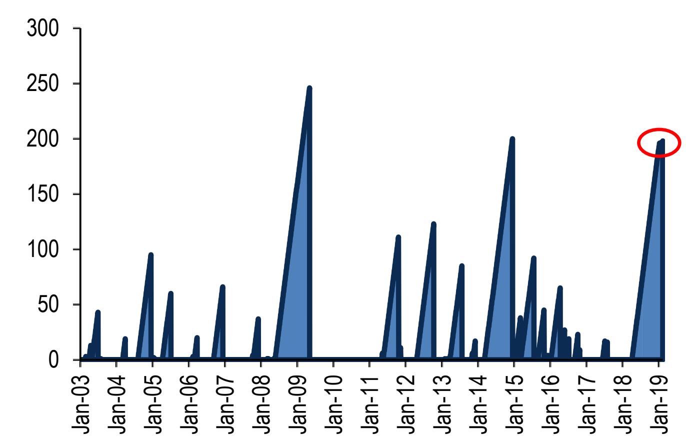
But this story is crucial, in our view, for a Eurozone economy that has already weakened significantly over the last year, and where data surprises remain negative (both regionally and at the global level, chart 5).

Chart 4: Global M1 growth has declined substantially (% YoY change)



Source: BofA Merrill Lynch, Bloomberg, Netherlands Bureau for Economic Policy Analysis. Average M1 for US, EA, Japan, Switzerland, China, Japan, UK.

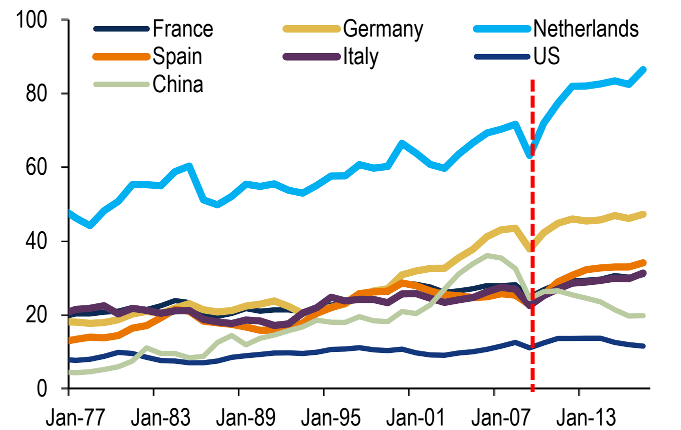
Chart 5: Cumulative number of days of negative global data surprises



Source: Bloomberg, BofA Merrill Lynch Global Research. Global data surprise indices.

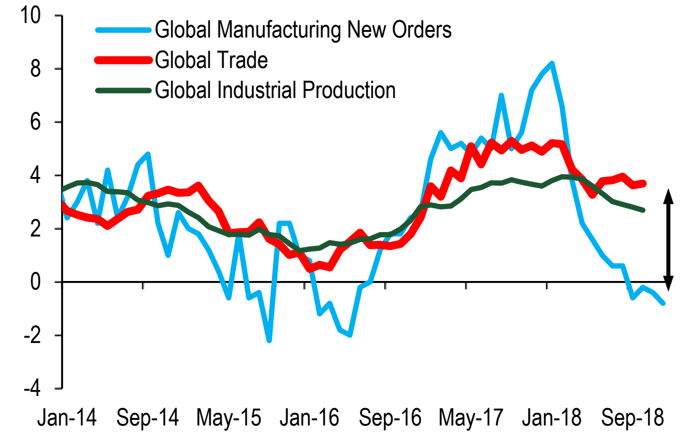
As our economists highlight, global trade remains a downside risk to the Euro Area in the near-term. Chart 6 highlights that Europe has embraced globalization over the last decade, with many countries increasing their reliance on exports. European firms, in particular, have bolted-on emerging market units to diversify revenues, and have expanded their supply chains to snake across the world, funding the expansion with cheap debt. Chart 7, however, suggests to us that global trade volumes may have further to fall…ushering in a longer period of "deglobalization".

Chart 6: A decade of globalization: exports/GDP have risen for many European countries (exports/GDP, %)



Source: OECD, BofA Merrill Lynch Global Research. Exports/GDP (%).

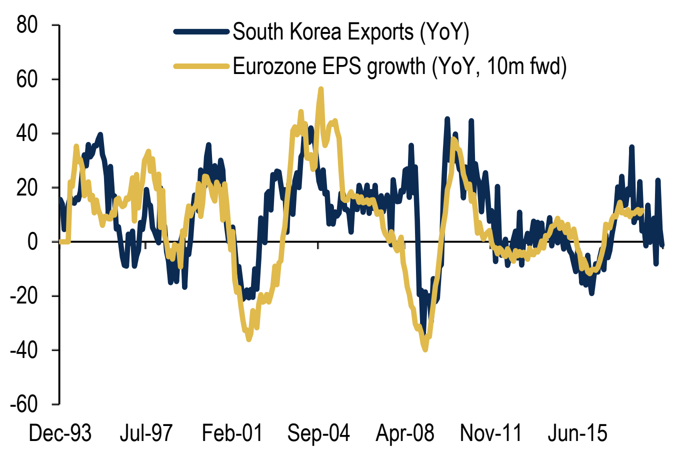
Chart 7: Manufacturing new orders suggest downside to global trade volumes in the near-term (% change YoY)



Source: Bloomberg, BofA Merrill Lynch. Netherlands Bureau for Economic Policy Analysis. Global IP and global trade is YoY change (%). Global Manufacturing is current % above or below 50 though.

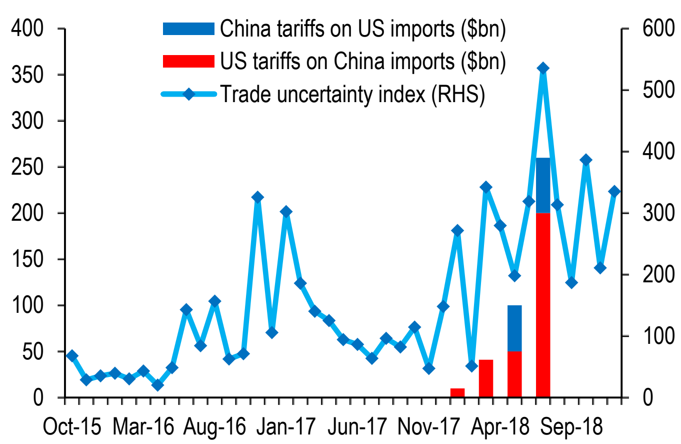
And chart 8 highlights the feedback loop of weaker global trade volumes into European markets. Korean exports – which are often viewed as the "canary" for global trade momentum – dipped into negative territory at the end of last year. Historically, weakening Korean exports have tended to pressure European EPS lower (reflecting the openness of the Eurozone economy and the export-orientated nature of its firms).

Chart 8: Weak Korean exports supports EPS downgrades in Europe



Source: Bloomberg, European Equity Strategy Team. YoY % changes.

Chart 9: Still elevated levels of trade policy uncertainty, post tariffs



Source: Bloomberg, www.policyuncertainty.com, BofA Merrill Lynch US Economics Team.

Our base case remains that we see the European economic cycle start to turn up as we head towards the second half of this year. At this juncture, we will likely take a more bullish stance on credit beta in Europe.

But until then, we favour up-in-quality trades (As over BBBs, and IG over HY) and being long domestically-focused credits over their exporting peers.

A jumbo-sized headache

Perhaps more than ever before, simple new issues are becoming a source of risk for the corporate bond market in Europe. In our year-ahead, we highlighted the lack of marginal buyers of debt currently, given the exit of both the ECB and retail investors from the market. This leaves the big unanswered question, in our view, of: "who buys the bonds this year?".

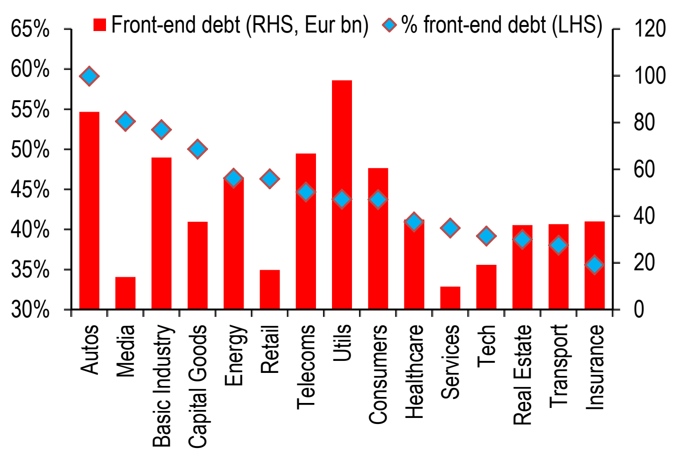
We think the issue is pressing, as the proportion of corporates' front-end debt in Europe has grown since 2016, despite logic suggesting the opposite should have happened during the QE years (see chart 28 in our year ahead). This leaves a classic maturity wall for high-grade companies to think about refinancing over the next few years. We sense that issuers are aware of this, and also that the European primary markets will become more "stop-and-go" for them in the absence of consistent buyers.

Hence, we believe that new issues will pose a risk for the market on two fronts:

- First, new issue premiums will need to be large to tempt marginal buyers back…but this will have the immediate effect of repricing secondary spreads. We thought the very large New Issue Premium on this week's Telecom Italia deal (100bp to start) was particularly eye catching, and existing TI bonds were marked significantly wider as a result.

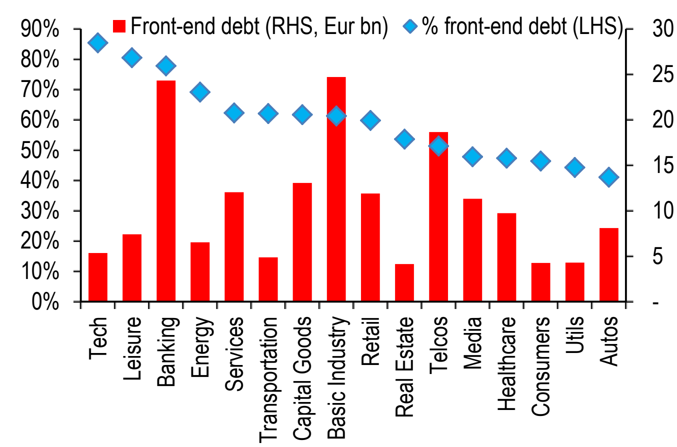
- Second, we think some issuers will decide to launch "jumbo" deals rather than rely on a regular schedule of debt issuance, as has historically been the case. Thus the potential for a wall of supply in the early part of this year, we think. VW's mammoth issuance in November last year (across USD, Euros and JPY) was a case in point, and reflects how some issuers are reluctant now to wait too long before tapping the debt markets.

Chart 10: Which IG sectors have relatively more front-end debt to refinance in coming years (1-5yr debt as a % total high-grade debt)



Source: BofA Merrill Lynch, ICE Data Indices LLC. Percentage of 1-5yr debt LHS, total 1-5yr debt RHS (€bn).

Chart 11: Which HY sectors have relatively more front-end debt to refinance in coming years (1-5yr debt as a % total high-yield debt)



Source: BofA Merrill Lynch, ICE Data Indices LLC. Percentage of 1-5yr debt LHS, total 1-5yr debt RHS (€bn).

The "watch out" screen

Where are credit investors most exposed to the risk of a cheap "jumbo" new deal repricing secondary spreads, or an entire sector? The charts above show 1-5yr debt as a percentage of overall debt across sectors. We show this for both high-grade and high-yield markets.

- High-grade investors should be most cognizant of these risks in the auto, industrial, energy and telecoms sector,

- High-yield investors should also keep an eye on the risk of cheap new issues in the industrials sector, in particular.

The charts below also show which high-grade sectors have seen their debt become *more* front-loaded since QE began in Europe (although for some sectors, such as consumers and retail, this has happened post a significant period of debt term-out).

Chart 12: Progression of 1-5yr debt as a % total debt for the high-grade energy sector

Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC.

Chart 13: Progression of 1-5yr debt as a % total debt for the high-grade consumer sector

Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC.

Chart 14: Progression of 1-5yr debt as a % total debt for the high-grade retail sector

Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC.

Chart 15: Progression of 1-5yr debt as a % total debt for the high-grade healthcare sector

Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC.

The bearish message for equities: debt is more expensive than you think

One thing is clear: today's landscape for corporate financing is less exuberant than the artificial one that existed through the QE years. Now, issuers have to fight over the remaining scraps of demand for low-yielding corporate bonds, rather than take abundant investor appetite for granted.

We see two conclusions from this, both of which we think read negatively for the European equity market:

- First, debt costs will have to head higher to ensure enough marginal buyers of debt emerge at new issue. Moreover, with today's very high new issue premiums in Europe, the real cost of debt for companies is higher than where index yields imply they currently are.

  Hence, just as QE created a short-term boost for company EPS, over time higher debt costs now point to an EPS downgrade cycle in Europe ahead.

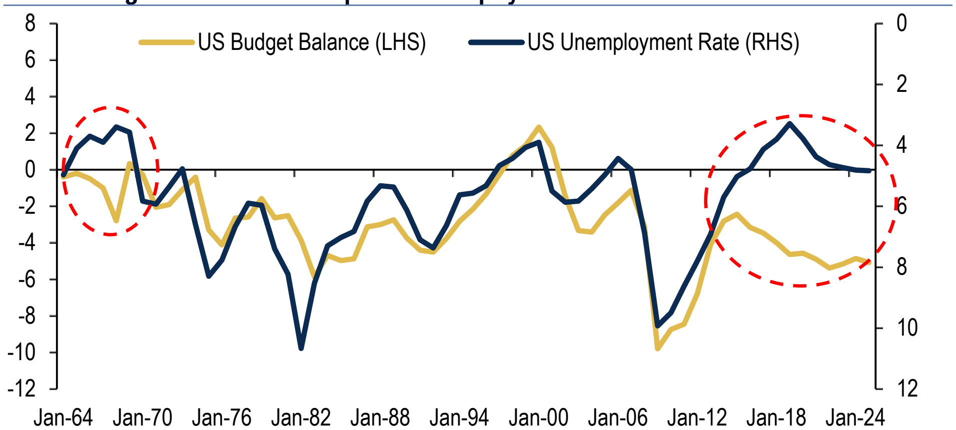
- Second, companies with lots of future debt rollovers may plan ahead and think about ways to shrink their debt capital structures, to better fit today's "slimmed-down" world. We think this points to the need for some dividend cuts and potentially equity raising (to repay debt) by companies in the future, both of which are not equity friendly measures (see here for our refinance screen for Euro credit).

Angry voters and the debt of nations

It's not just the European credit market that will be hunting for new marginal buyers. Many other pockets of the fixed-income world – including sovereign markets – will see funding needs rise this year (and there will be less central bank buying in 2019 to mop it up). Thus, bond markets will increasingly compete and crowd each other out (and note that European IG yields are just 1.3%).

In the US, for instance, chart 16 shows how rare it is to see big, planned, budget deficits in periods of very low unemployment.

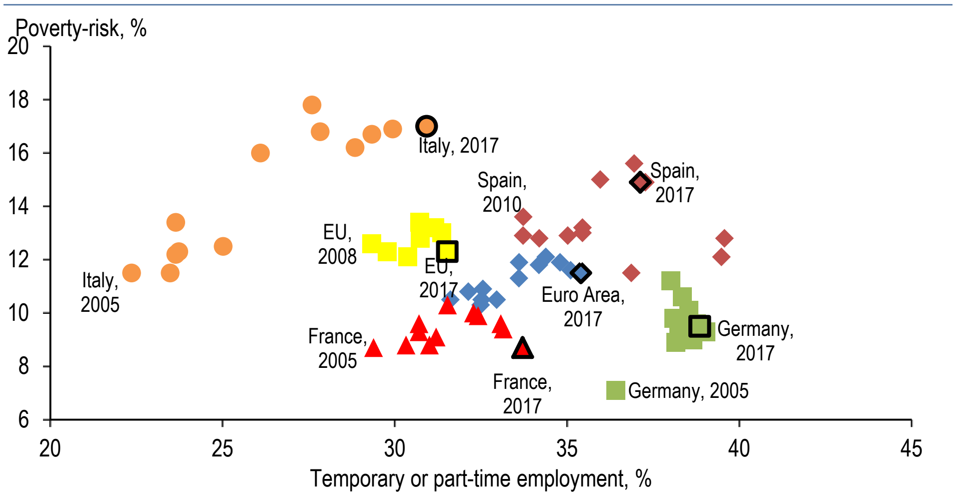
Chart 16: Large US fiscal deficits despite low unemployment



Source: CBO, BofA Merrill Lynch Global Research, % GDP. RHS axis reversed.

In Europe, populism has been an important narrative over the last few years. Signs are emerging, however, that the populism project is running into a bit of trouble, with the Italian government's climbdown on their budget plans, for instance. Could the populism story be peaking? We don't think so. If anything, populist leaders are now springing-up in countries far outside of Europe.

Chart 17: The rise of poverty risk of workers in Europe and the growth in temporary or part-time work.



Source: Datastream, Eurostat. People at risk of poverty or social exclusion by most frequent activity status (population aged 18 and over). Each dot represents a country between 2008-2017

Moreover, the underlying drivers of voter anger – wealth and opportunity inequality – remain firmly in place. Chart 17 shows the rise of poverty risk among workers across the EU over the last decade. The latest data shows that almost 10% of workers in the EU (between 16 and 64) are at risk of poverty – a number unchanged since 2016, but still the highest level on record.

The risk of workers falling into poverty has risen noticeably in the periphery, and especially so for those on temporary or part-time contracts. As our European economists have frequently highlighted, while the unemployment rate has declined impressively in Europe, it's the "quality" of jobs being created that has been questionable.

The "uncoordinated" fiscal push in Europe?

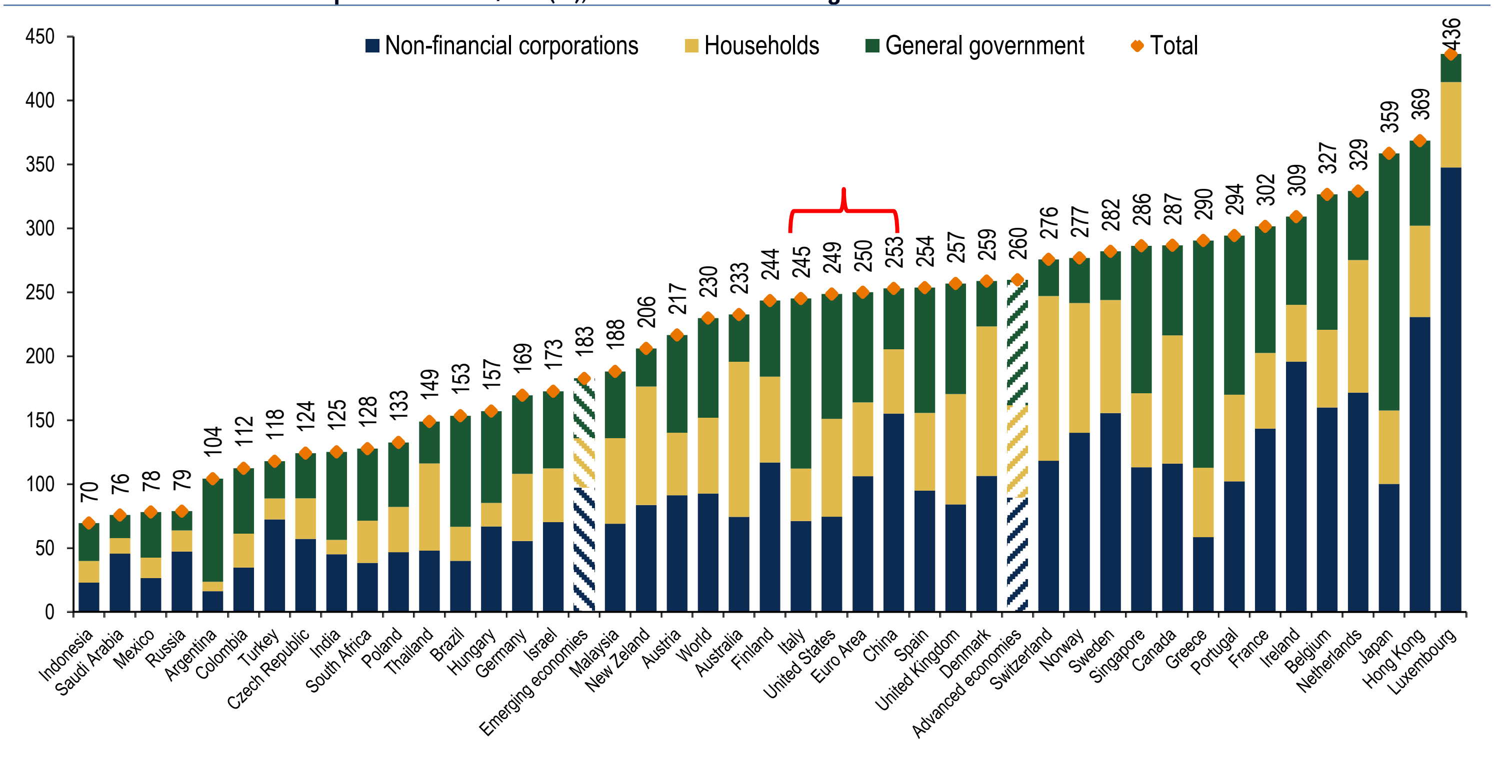
As the Yellow Jacket protest movement in France has highlighted, high voter frustrations with social norms are now forcing governments to move away from the politics of austerity and embrace more fiscally loose ideals. In Europe, there looks to be the beginnings of a small "uncoordinated" fiscal easing (note 1% of GDP in Germany, 0.5% in France, and less in Italy). Yet this points to upward pressure on European government debt levels (again crowding out the European credit market).

Quantitative Failure and debt "hotspots"

Commensurate with the market sell-off and turn in the economic data, inflation expectations have fallen over the last few months. 5Y5Y inflation swaps in Europe have declined to 1.57 now (and the lows just prior to Draghi announcing QE in early 2015 were 1.48).

As we argued in our year ahead, a more uncertain inflation outlook would risk the market pivoting back to worrying about global debt levels again, especially with QE over. This would be the "Quantitative Failure" narrative.

Chart 18: Where are the debt "hotspots"? Total debt/GDP (%), across countries and categories



Source: BIS. Data as of 2Q 2018.

And with global debt levels, there are still many market fragilities after years of loose monetary policy post Lehman. In fact, as the latest BIS data shows:

- Global debt is still close to a record high, and currently stands at $179tr. (as of Q2 '18). This represents 230% of global GDP.
- US, China and Japan account for more than half of global debt today.
- Since the end of '08, however, global debt levels have risen by $62tr. (a jump of 53%). In GDP terms, the increase has been 33%.
- While advanced economies remain the most heavily indebted – with a debt-to-GDP ratio of 260% – EM debt has soared since the crisis and more than offset the modest deleveraging of advanced nations (this peaked in Q3 '09).
- Non-financial corporations have contributed significantly to global debt growth in the last decade, with the bulk concentrated among Chinese companies. Yet, since late 2017, a major shift has occurred in China where private debt growth has decelerated somewhat (on the back of the government crackdown on shadow-banking).

Chart 18 shows total non-financial sector debt by country, split by government, corporate and household debt. Interestingly, the US, Euro Area and China all have total debt/GDP bunched around the 250% mark. Nonetheless, many countries have total non-financial debt in excess of this level, and in particular a number of European countries have high debt vulnerabilities (with these vulnerabilities having emerged in the last 10yrs).

Note, for instance:

- Household debt in Denmark, Netherlands, Switzerland and Norway.
- Corporate debt in Ireland, Netherlands, Belgium, Sweden and France, and
- Government debt in Japan, Italy and Portugal.

Disclosures

Important Disclosures

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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