The European Credit Strategist

Here we go again

Credit Analysis

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Credit Strategy
Europe

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Life is a circle

Today sees the return of Quantitative Easing from the ECB, a policy that was ended less than a year ago on the basis that it was "job done". Yet today it is back, and this time billed as an "infinite" programme. Just as in the past, we see it creating something of a brave new world for corporate bonds. It will encourage credit markets to assess risk based on "the haves" (eligible) and "the have nots" (non-eligible). It will – for better or worse – make names less sensitive to weaker macro/fundamental news (up to a point). And in the long-term, it should drive reallocation of money within credit, as investors gravitate towards sectors more distanced from the ECB's influence. In the very short-term, though, we expect a leg tighter in spreads – as per the '16 playbook – and note November tends to be a bigger QE purchase month due to front-loading (chart 1).

The world according to the ECB

Much has changed in corporate bond land since QE was last in effect. The growth of credit markets in '19 means that today's CSPP *Eligible Universe* now stands at €855bn – giving the ECB plenty of runway to buy credit for years (chart 9). Moreover, today's *Eligible Universe* looks quite different in places from the one that markets knew during CSPP1.0. Utilities are by far the largest sector now (€160bn, 19%), which should mean a constant bid for its bonds by central banks. Conversely retail has become a tiny CSPP sector, despite it being an economically-sensitive one (i.e. arguably in need of some QE).

"QEternity" trades

In the short-term, we anticipate the ECB needing to buy sectors that have been prolific issuers this year, so as to help get its credit portfolio back to neutral. Thus, we continue to think that this will benefit autos, real estate and healthcare. Another aim of QE is to reduce fragmentation across bond markets. While the periphery/core split is hardly noticeable in many sectors today, it is still conspicuous in insurance and transport (and spread dispersion is high in industrials due to trade tensions). Thus, the ECB could buy here too. Eventually, we see markets gravitating towards non-eligibles as per '17. The long-term "home" for investors will increasingly be HY, sub fins and US IG, we feel.

History says…it's not over yet

CSPP leadership in 2016 was eventually in single-Bs as markets concluded that asset purchases would be growth-stimulative. Today, leveraged credit is significantly lagging the '16 episode (chart 20). But even eligible names are lagging the historic experience thus far (chart 19). In short, while the return of ECB QE has been well flagged for weeks, we don't think it is, as yet, all in the price.

Zombies at dawn

Open-ended monetary support means that markets need to be extra vigilant of rapid credit growth, and its consequences, in future years. In Europe, we see signs that "zombie" companies are on the rise again (chart 22). Yet "creative destruction" has not been completely abandoned: the number of distressed bonds across European high-yield is rising *despite* trillions of negative yielding assets causing a thirst for returns. We don't think QE2 will bail-out weak companies to the extent that QE1 did, and this, we think, is good news for the investibility (longs vs. shorts) of European credit in the future years.

Refer to important disclosures on page 7 to 9.

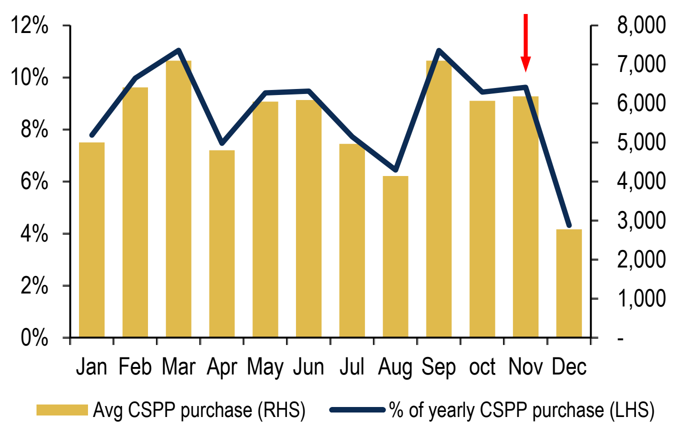
CSPP charts that matter

Below we include the most relevant charts for investors as QE begins again. We include screens on the CSPP-eligible universe, ECB holdings versus the market, eligible vs. non-eligible spreads, QE buying seasonality and signs of prior "misallocation of capital" coming back to bite.

CSPP seasonality and eligible issuance

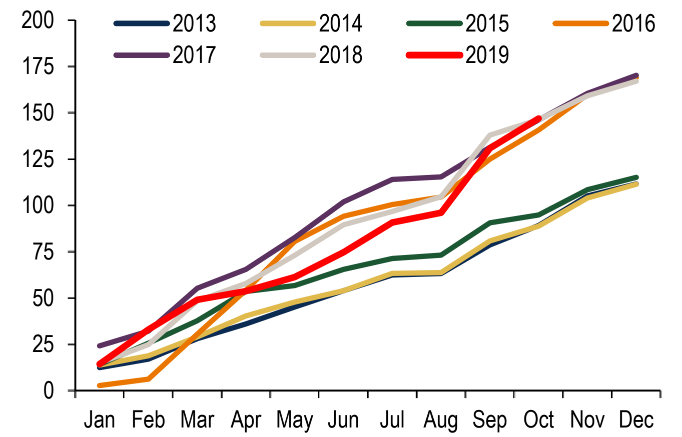
- November CSPP purchases have historically been on the higher side (just under 10% of total yearly purchases) given the December slowdown.
- Autos have issued the most eligible debt this year, but so far relatively few ISINs have been purchased by the ECB.

Chart 1: November CSPP buying tends to be strong given front-loading (average monthly CSPP buying)



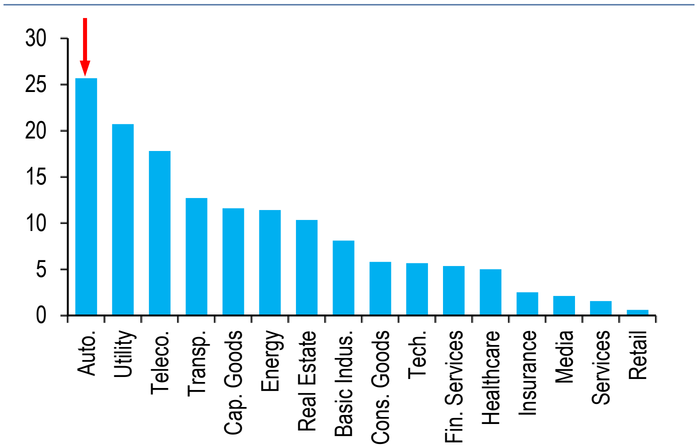
Source: BofA Merrill Lynch Global Research, ECB. Eur mn (RHS).

Chart 2: CSPP-eligible supply: '19 has been a strong year for eligible supply, but not record setting because of wave of foreign issuance



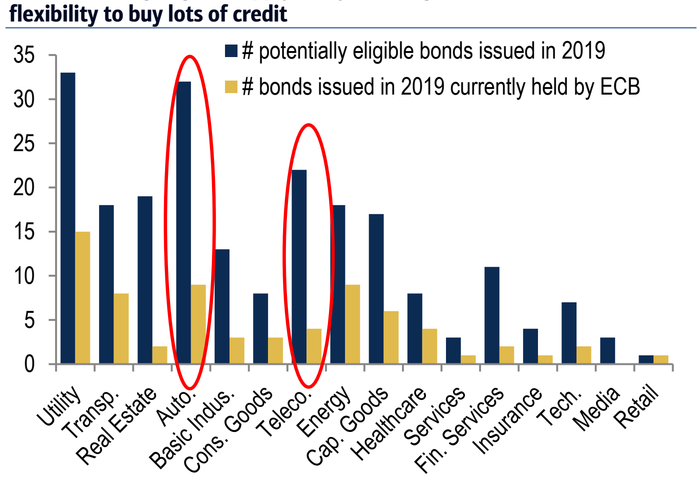
Source: BofA Merrill Lynch Global Research. Eur bn, cumulative.

Chart 3: YTD eligible supply by sector (€ bn): autos leading the pack in 2019



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

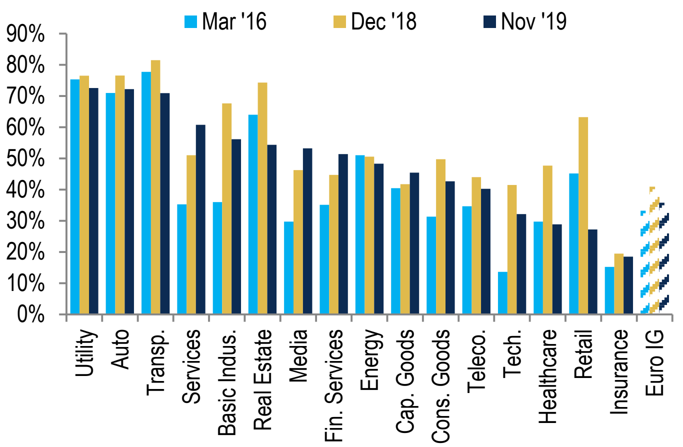
Chart 4: Strong eligible supply this year has given the ECB more flexibility to buy lots of credit



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

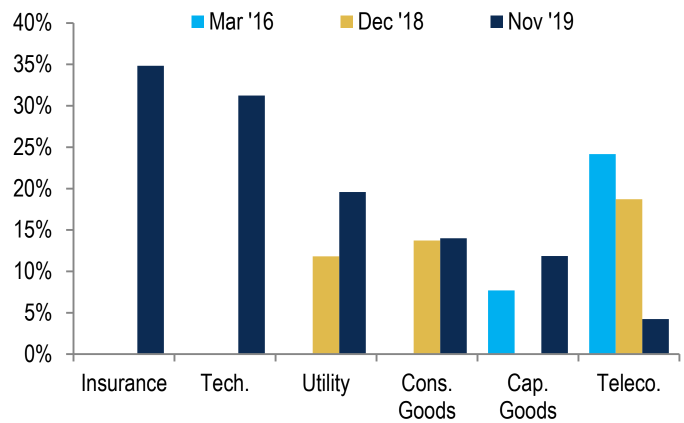
- Utilities are by far the largest eligible sector today (€160bn). Autos are second at €90bn. In total, the CSPP-eligible universe is €855bn (including October's supply).
- HY eligibility is much more geared towards core than periphery today (Telecom Italia is no longer eligible, for instance).

Chart 5: CSPP Eligible universe, % of overall sector: Euro IG



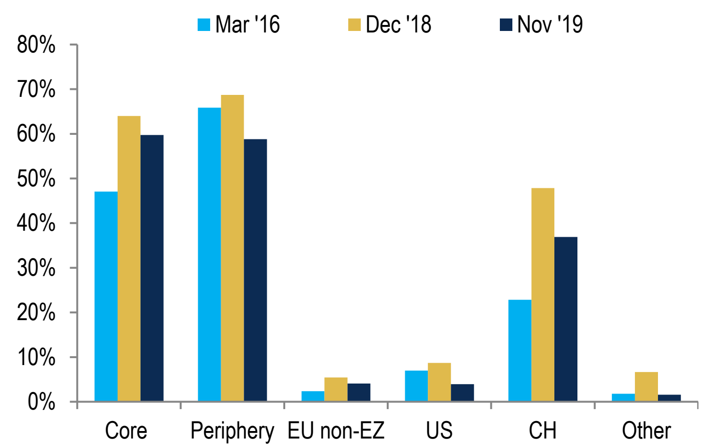
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC. Estimate of eligible universe as % of outstanding €-denominated debt by sector in ER00.

Chart 6: CSPP Eligible universe, % of overall sector: Euro HY



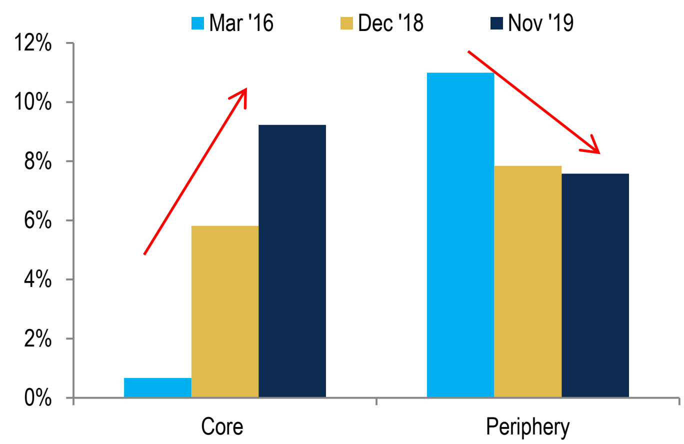
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC. Estimate of eligible universe as % of outstanding €-denominated debt by sector in HE00.

Chart 7: CSPP Eligible universe, by region: Euro IG



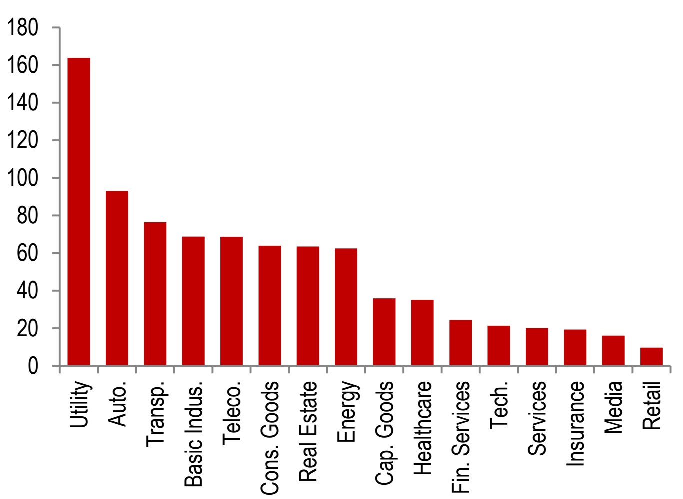
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC. Estimate of eligible universe as % of outstanding €-denominated debt by economic region in ER00.

Chart 8: CSPP Eligible universe, by region: Euro HY



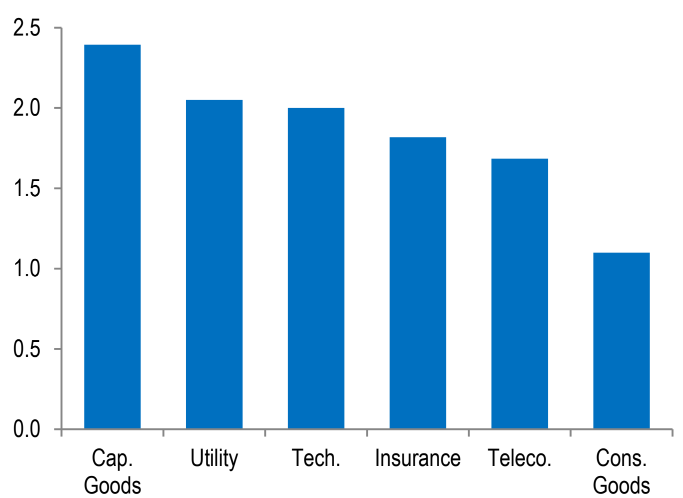
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC. Estimate of eligible universe as % of outstanding €-denominated debt by economic region in ER00.

Chart 9: Current CSPP-eligible total universe , by sector (Eur bn.)



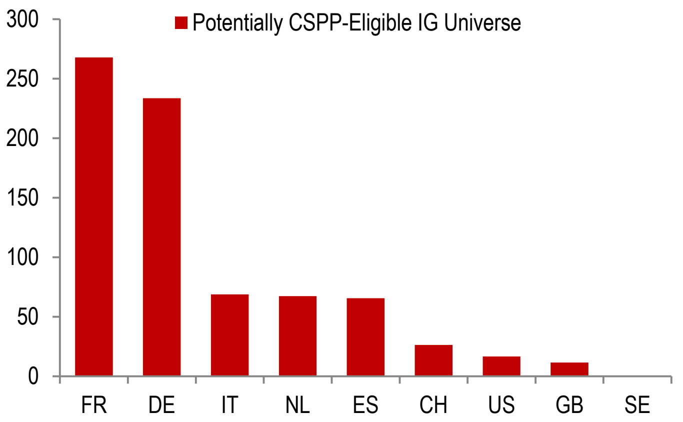
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC. € bn

Chart 10: Current CSPP-eligible HY universe, by sector (Eur bn.)



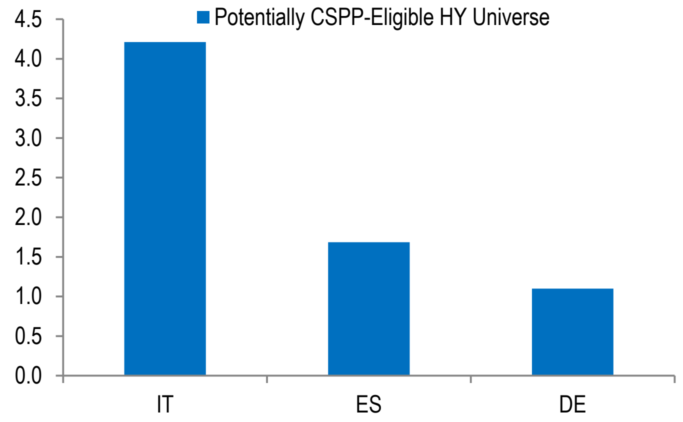
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC. € bn

Chart 11: Current CSPP-eligible total universe , by country (Eur bn.)



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

Chart 12: Current CSPP-eligible HY universe, by country (Eur bn.)

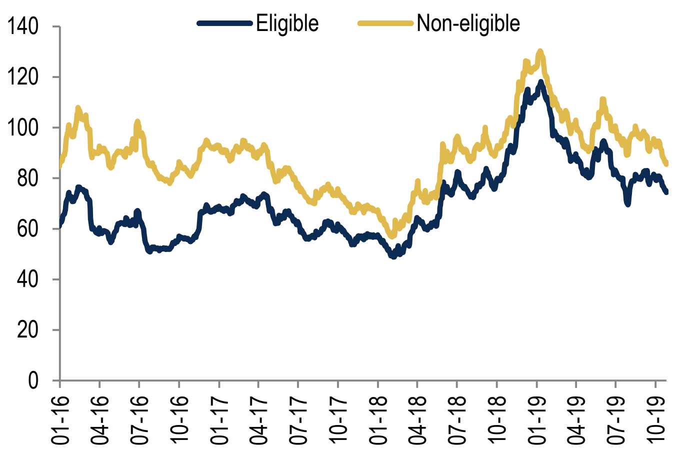


Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC. € bn

Eligible vs. non-eligible credit spreads

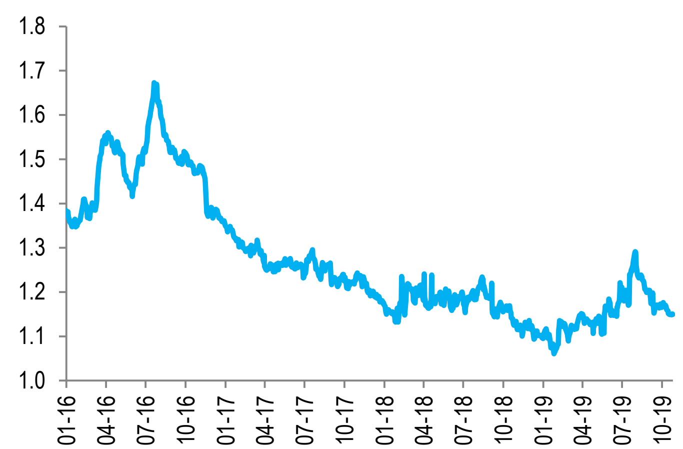
- Eligible spreads have not rallied that much thus far, but non-eligible spreads have been quicker to get a bid.
- But non-eligibles still look wide in autos, cap goods and consumers, we think.

Chart 13: CSPP eligible and non-eligible credit spreads (OAS spreads)



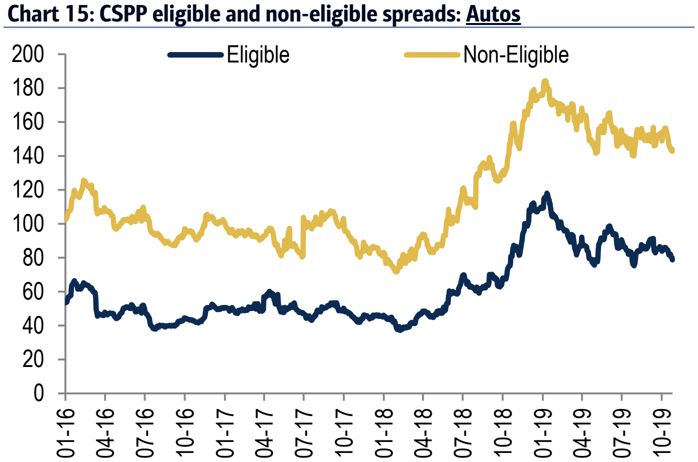
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC, ECB. Weighted average OAS. Non-eligible bonds include AT1s and corp hybrids, but not HY.

Chart 14: Spread ratio (x) for non-eligible/eligible debt



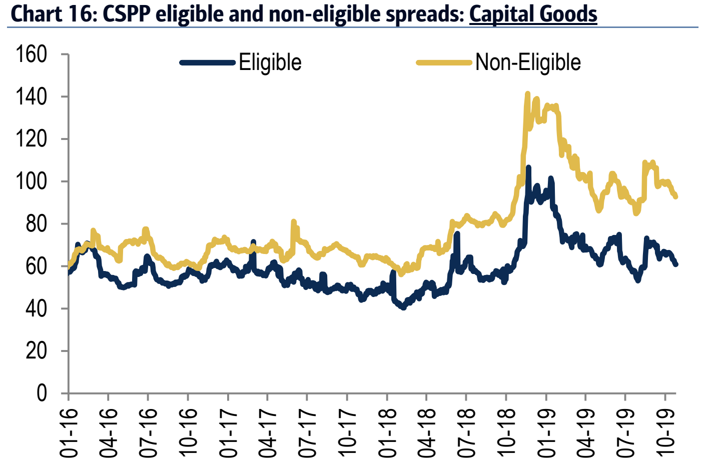
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC, ECB. Ratio of weighted average OAS. Non-eligible bonds include AT1s and corp hybrids but not HY.

Chart 15: CSPP eligible and non-eligible spreads: Autos



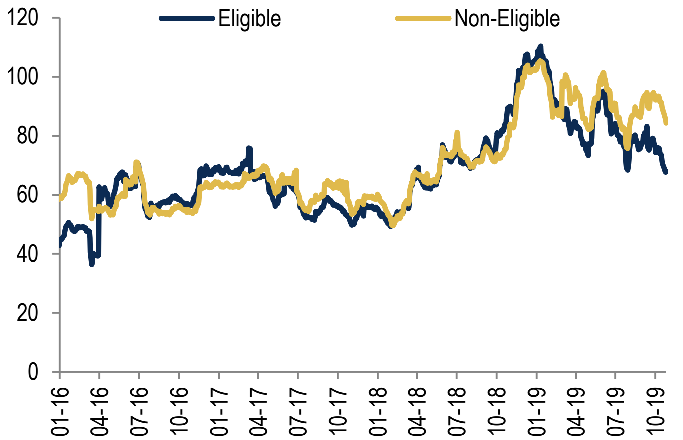
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC, ECB.

Chart 16: CSPP eligible and non-eligible spreads: Capital Goods



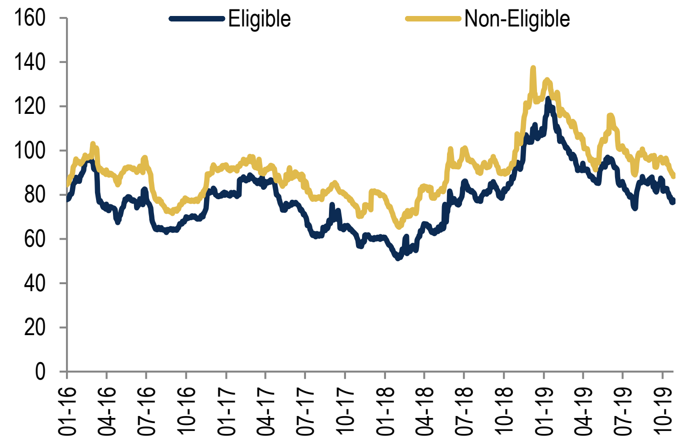
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC, ECB.

Chart 17: CSPP eligible and non-eligible spreads: Consumer Goods



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

Chart 18: CSPP eligible and non-eligible spreads: Telcos

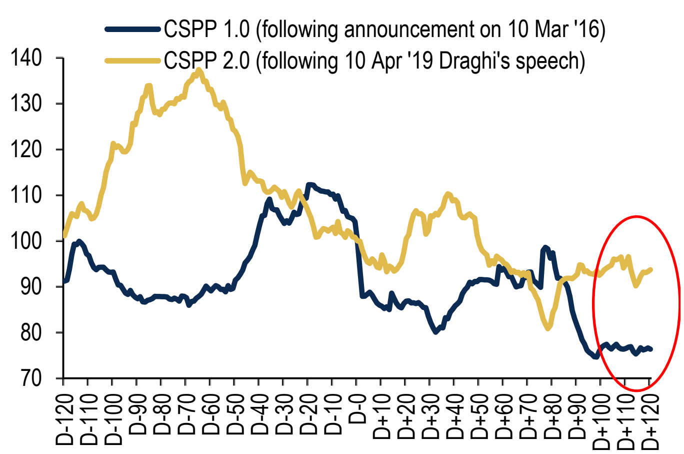


Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC, ECB.

CSPP1.0 vs. CSPP2.0

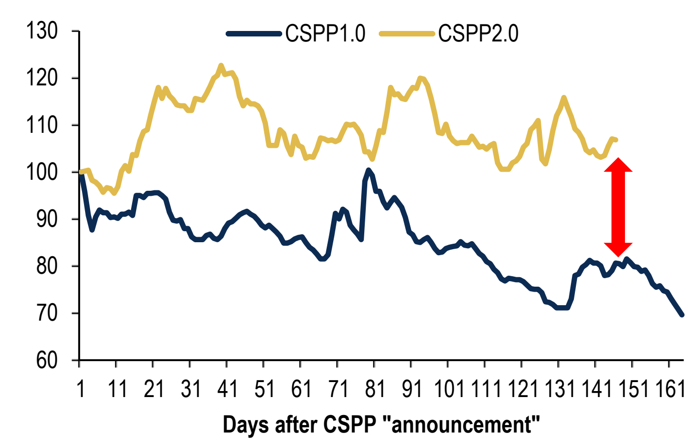
- When comparing CSPP1.0 to CSPP2.0 (from the time at which both policies were "announced" or hinted at), we see that eligible spreads are lagging under CSPP2.0
- For leveraged credit, single-Bs are significantly lagging this time versus the CSPP1.0 experience. Markets are sceptical as to whether QE today will have a tangible economic benefit.

Chart 19: How have eligible bonds performed following major policy announcements? This time, eligibles look to have room still to rally



Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC, ECB. Spreads rebalanced to 100 at "announcement" date (Mar '16 and ECB meeting of Apr '19).

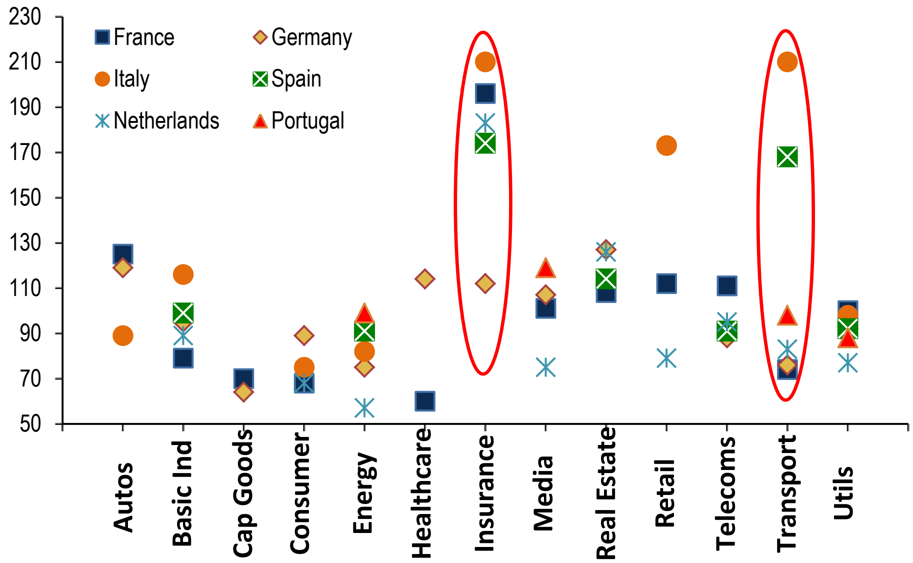
Chart 20: Single Bs: CSPP2.0 vs CSPP1.0: Leveraged credit, however, not rallying anywhere near as much today compared to CSPP1.0



Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC, ECB. Spreads rebalanced to 100 at "announcement" date (Mar '16 and ECB meeting of Apr '19).

- Chart 21 over the page shows where credit markets are still "fragmented" in places, an aspect that Draghi has, in the past, said QE aims to address.
- In 2015/16, fragmentation was assessed as the difference between core and periphery spreads. Chart 21 shows that while these gaps are now very low across the credit market, they are still conspicuous in the insurance, transport (and retail) sectors. Thus, the ECB may look to buy these sectors to reduce fragmentation.
- Elsewhere, as our *Credit Derivatives Strategist* research note highlighted this week, credit dispersion is still high in the industrials sectors, because of trade tensions.

Chart 21: Core vs. Periphery fragmentation still exists in Euro IG insurance and transport sectors (and retail too). Current sector spreads by core vs. periphery (OAS spreads)

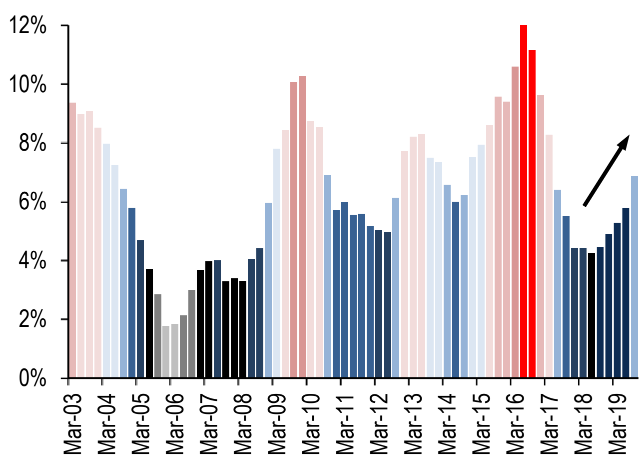


Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC.

The long-term? Risks and opportunities

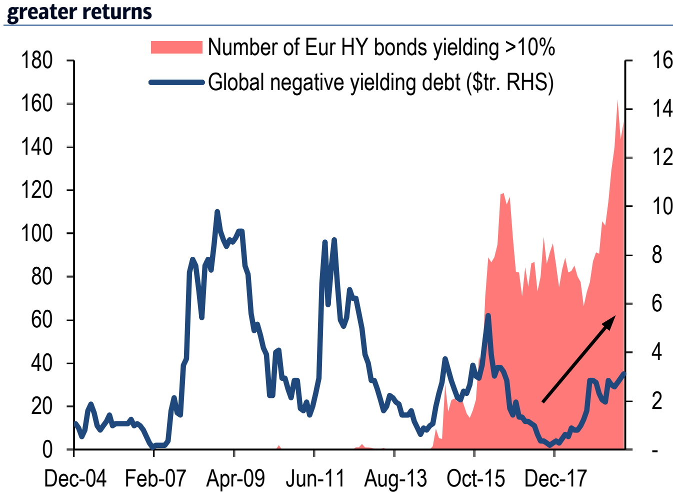
- Chart 22 shows that "zombie" companies in Europe are heading higher again, after hitting a local low in mid '18. The risk with persistently easy monetary policy is that less profitable companies can refinance and give themselves time to keep going.
- But, that doesn't mean that the classic "Creative Destruction" has been supressed. The irony in today's world is that despite trillions of negative yielding bonds globally, the distressed ratio in European HY keeps heading higher.
- Chart 23 shows the number of HY bonds yielding above 10% is at the highest since mid '16.

Chart 22: Zombie companies in Europe rising again as easy money helps less profitable issuers refinance. European companies with interest coverage ratio below 1x (% of Euro Stoxx 600 market cap)



Source: Source: BofA Merrill Lynch Global Research, Bloomberg. Market-cap weighted results. 4Q moving avg. Using a large sample of Stoxx 600 non-financials. Zombie company defined as

Chart 23: The number of distressed bonds in €HY is rising, despite trillions of negative yielding bonds across the globe, forcing a thirst for greater returns



Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC. Distress defined as bonds yielding above 10%.

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