De-equitization and the information age

Credit Analysis

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Europe

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The "wow" factor

Draghi's parting gift is potentially an infinite QE policy. But we would not overlook the "wow" effect that looms in just over a week's time when buying begins in earnest. We think spreads quickly take a leg tighter once markets realise that the ECB is buying everything. Technicals aside, though, we think cyclicals can show some leadership into year-end too, given how investor longs have been purged of late in high-yield, and the better newsflow emerging on US-China trade and Brexit deals.

De-equitization and the information age

QE "infinity" means bonds become the corporate financing tool of the future. But this suggests a continuation in the rapid pace of de-equitization. Since 2012, the number of listed EU companies has shrunk by 15%, a trend exacerbated by the era of central bank largesse, we feel. But this comes with its risks: fewer companies reporting could leave markets less equipped to assess the real-time state of the economy in the future.

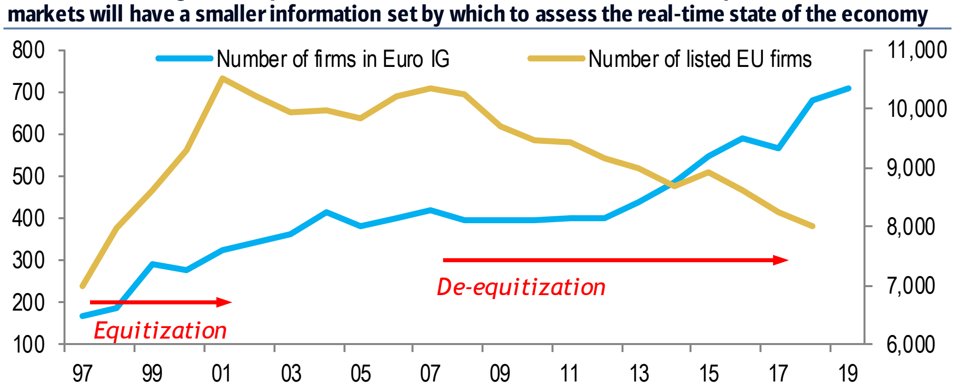
Bonds and the manic stampede

Instead it's corporate bonds that are likely to see rapid growth ahead. However, we think it's less a case of existing companies gearing-up, but more a case of new entrants raising debt, and we see bank-to-bond disintermediation being a defining feature here. In contrast to equities, the credit market has seen the number of issuers jump by over 80% since 2012, with new sectors emerging from nothing. While "debut" issuers provide diversity and spread for an opportunity-starved market, investors should be cognizant of the cyclicality and leverage that they add to the overall credit market too.

"Vive la France!"

The global trade narrative has taken a turn for the better over the last few weeks, with a "skinny" US-China deal emerging. Even still, import substitution means that the deglobalization theme is not a negative for everyone alike. French credits look interesting to us here, with spreads having underperformed over the last quarter, yet US imports from France still looking fairly rosy.

The information age: "de-equitization" meets bond mania. Fewer listed companies mean that markets will have a smaller information set by which to assess the real-time state of the economy



Source: BofA Merrill Lynch Global Investment Strategy Research team, World Federation of Exchanges, ICE data indices LLC. Number of publically listed (equity market listing). Euro IG issuers (LHS).

Timestamp: 25 October 2019 12:15AM EDT

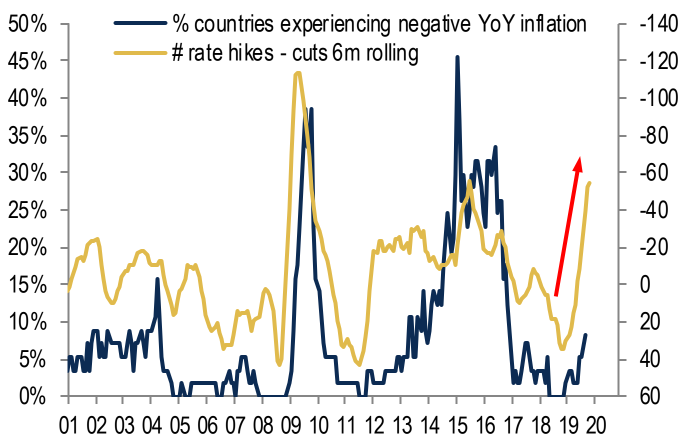
De-equitization and the bond bubble

We remain bullish on corporate bonds into year-end. We see concerns over a repeat of Q4 '18 as overblown. Back then, Fed hikes – despite being patient and predictable – drove a disorderly market unwind precisely because they translated into much higher hedging costs (read LIBOR) for foreign buyers of corporate bonds. The lesson learned was that while it's easy to cut rates, monetary normalization is *much* more difficult.

Fast forward to today, and central bank behaviour is currently worlds apart from this. In fact, central banks seem to be falling over themselves to cut rates at present (chart 1). But it's not just cuts that are the order of the day: central bank bond purchases are being resurrected. By "confiscating" assets, monetary authorities will simply exacerbate the thirst for yield across markets, in our view. Chart 2 shows how the *Quantitative Tightening* episode will soon be consigned to the history books: central bank balance sheet growth should turn sharply positive in the first half of 2020 (Fed + ECB).

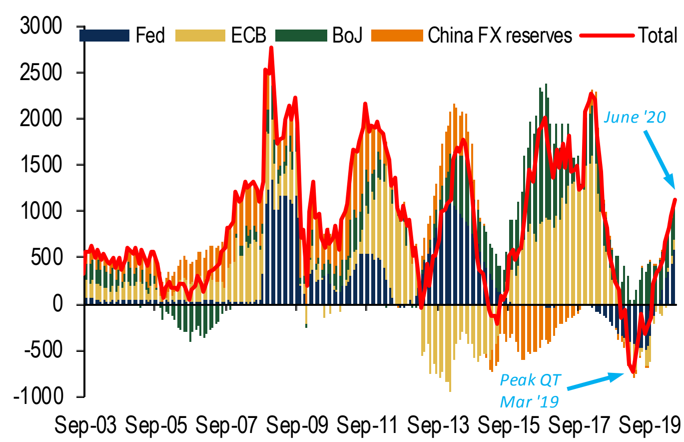
Today, therefore, financial conditions remain hugely supportive for risk assets. In fact, chart 3 shows how much Euro Area financial conditions have loosened vis-à-vis US conditions of late…all thanks to Draghi's last hurrah.

Chart 1: The pace of central bank easing (# net rate cuts, RHS reversed) is now far outstripping the reality of the inflation data



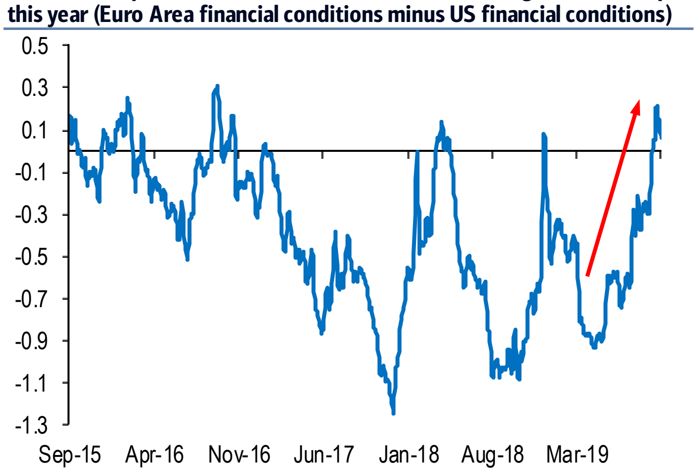
Source: BofA Merrill Lynch Global Research, Bloomberg, Haver. Using large sample of countries across the globe. Excluding Argentina. Inflation (LHS),

Chart 2: YoY changes in "Global QE", $bn (YoY CB balance sheet growth)



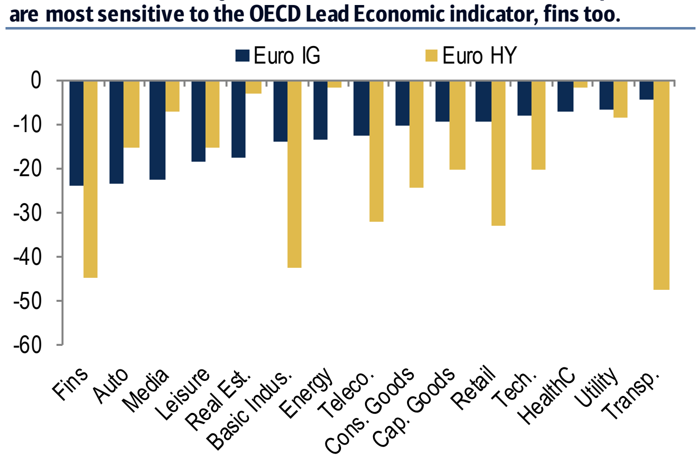
Source: BofA Merrill Lynch, Bloomberg. Note converting ECB and BoJ balance sheet numbers into USD equivalents, hence FX plays a part in driving the changes in chart 2. China FX reserves are reported in USD. Note that we do not assume recent Fed repo outstandings shrink over time.

Chart 3: European vs. US financial conditions: loosening more in Europe this year (Euro Area financial conditions minus US financial conditions)



Source: BofA Merrill Lynch Global Research, Bloomberg.

Chart 4: Where's the cyclical beta? IG Auto, media and leisure spreads are most sensitive to the OECD Lead Economic indicator, fins too.



Source: BofA Merrill Lynch, OECD. Beta of OAS to YoY change in OECD indicator (2006-2019)

Bank of America Merrill Lynch

Cyclicals into year-end

Away from impressive technicals, markets have been treated to some better newsflow on the fundamental front too – in the form of a "skinny" US-China trade deal, and a lower likelihood of a no-deal Brexit. We think this sets-up cyclical areas of the credit market to post more encouraging returns into year-end, especially given how poor sentiment seems to be here now (note the drastic reduction in high yield longs witnessed in our latest Credit Investor Survey).

Which parts of the Euro corporate bond market could show cyclical leadership for the remainder of the year? Chart 4 shows the spread beta of parts of the Euro credit market to changes in the OECD Global Lead Economic Indicator.

- Perhaps unsurprisingly, high-grade **auto**, **media**, **real estate** and **industrial** spreads have tended to show the most sensitivity to global growth perceptions in the past, and thus could enjoy a bounce into December (albeit structural weaknesses in the auto sector are now clearly shining through via daunting profit warnings).

- In high-yield, **industrials**, **transport** and **retail** spreads could see more upside on better growth perceptions.

- In financials, note the relatively *high* cyclical sensitivity of the sector as well, which could be favourable (albeit, with Credit Survey showing investors have moved longer in fins over the last few months).

The icing on the cake…

While we see enough reasons to be bullish into year-end, to top it off, in just over a week the ECB will commence QE2…a policy that will add to the squeeze in credit, in our view.

As something billed as open ended, we expect the long-run consequence of QE2 to be that investors migrate away from CSPP-eligible debt and move into non-eligible parts of the credit market**: HY, AT1s, corporate hybrids,** and of course **US high-grade**.

This was exactly the 2017 CSPP playbook and we expect it to be relevant again. Back then, it reflected investors' desire to move away from parts of the market where it was becoming questionable as to whether spreads were reflecting fundamentals.

An example? Recall that industrial spreads reached a low of just 67bp in Feb-'18…but by the start of 2019 industrial spreads where hanging out at over 150bp.

De-equitization, bond bubbles and the information age

If the future years are indeed one of constant QE from the ECB, then financial markets are likely to undergo tremendous shifts in both their make-up and in the clustering of risks. What seems a given is that credit markets will experience another bout of rapid expansion, coaxed on by the proliferation of negative yields. Since the start of 2014, for instance, Euro IG markets have grown close to 75%, and have grown over 10% this year alone (from €2.1tr. to €2.4tr).

But if bonds are the financing tool of the future…then equities can't be. After all, the gap between equity and debt costs in Europe is at a 100yr high. The consequence, therefore, is that Europe is likely to see further "de-equitization": a continued shrinkage in the number of publically listed companies.

We see this trend being exacerbated by the swathes of private capital waiting in the wings. The jump in PE activity in Europe over the last year (albeit more mid-cap, rather than large-cap focussed) highlights the discrepancy between "fatigued" public capital and more "patient" private money. At the very least, more PE interest swirling around might coax companies into traditional M&A (as protection against a potential PE bid).

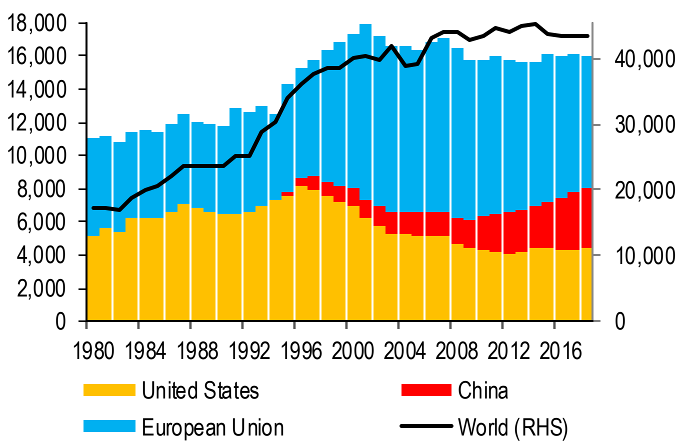
Yet, we think the long-term consequence of de-equitization is that markets will be less able to assess the real-time state of the economy. Fewer listed companies mean fewer disclosures about how earnings are faring, how business segments are performing, how geographical earnings splits are evolving… and ultimately, fewer disclosures about emerging risks.

And if there is a less reliable pulse on the economy, then this could impart more volatility to the consensus trades of the future, as markets suddenly realise that the "facts have changed".

De-equitization: now you see me…now you don't

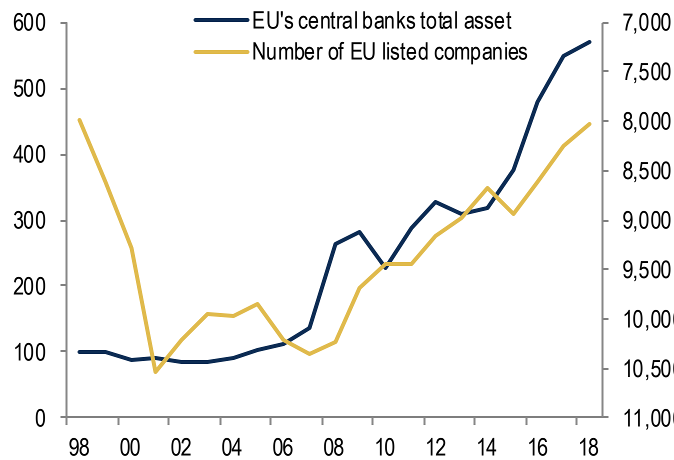
The de-equitization theme has been in full swing in Europe over the last few years. Chart 5, from our Investment Strategy colleagues highlights the change in the number of listed companies over the last 40yrs, across major regions.

Chart 5: Number of listed companies across the world: shrinkage in Europe the most profound of late



Source: World Federation of Exchanges.

Chart 6: More central bank largesse, fewer listed companies in Europe (CB total assets rebalanced to 100, as of 1999, LHS)



Source: World Federation of Exchanges, Haver. FX-adjusted.

While for the World, the number of listed companies has been broadly stable over the last decade, the regional trends have been very different:

- The most conspicuous drop in the number of listed companies has been in the EU, where listed companies have shrunk from just over 10,000 a decade ago to around 8,000 at present, a roughly 25% drop.
- The decline in the number of US listed companies has been much less severe over the last decade (~5%), albeit this likely reflects the bigger drop in publically listed companies in the decade preceding this (between '97 and '07 the number of listed companies in the US fell from ~8,000 to ~5,000).
- Instead, the big growth in listed companies has been in China, where the number of listed companies has risen 53% since 2011.

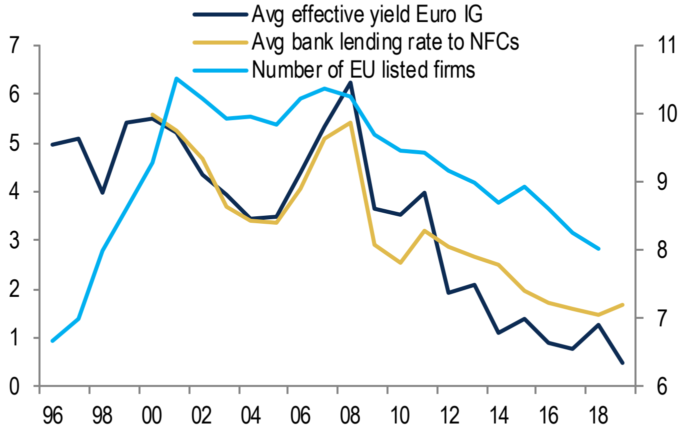
What are the optimal conditions that drive de-equitization? We think some of the following: a big gap between debt and equity costs for companies, easy bank lending conditions, contained political risk and CFO confidence in the macro environment.

Perhaps no surprise, then, that the recent uptick in de-equitization across Europe corresponds with the ECB's push into unconventional monetary policies.

- Chart 6, for instance, shows how the growth in central bank balance sheets across the EU, post the Global Financial Crisis, has corresponded with the de-equitization trend.

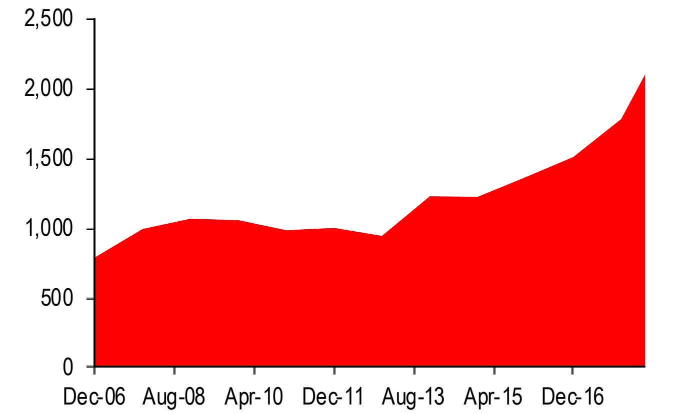
- Likewise, chart 7 shows, the drop in the number of EU listed companies versus bank lending rates, and corporate bond yields in Europe.

Chart 7: A drop in the cost of debt (LHS, %) has pushed more EU firms to exit the equity market (RHS, '000s) since '08/'09



Source: WFE, Haver, ICE Data Indices LLC. Number of listed firms in thousands (RHS).

Chart 8: Global Private Capital "dry powder" now in excess of $2tr.



Source: Prequin

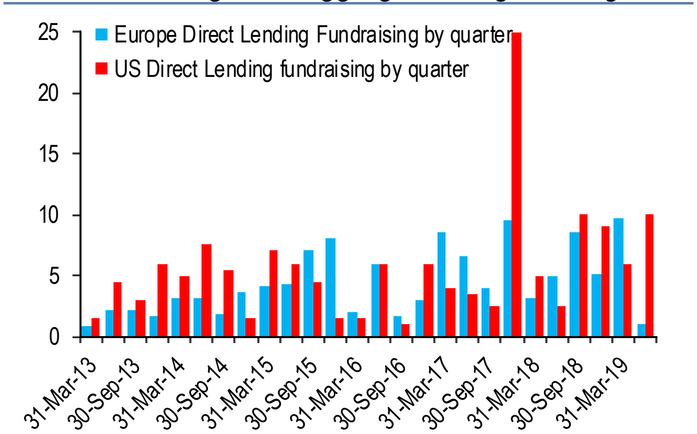
Private markets now playing their part

Another factor that will likely add to the de-equitization theme in the coming years is the amount of private capital "dry powder" waiting in the wings (a reflection, also, of how starved markets are of yield in conventional bond markets now). As chart 8 shows, private capital "dry powder" is now in excess of $2tr. according to Prequin, and Europe-focused dry powder accounts for roughly a quarter of total available capital.

Interestingly, while Private Equity accounted for a *shrinking* proportion of dry powder between 2006-2013 (as infrastructure and private debt sectors grew in prominence), PE now accounts for almost 60% of available dry powder – the *largest* proportion observed since 2012. And while dry powder is rising, the money is being spent too (witness the 20+ PE deals in Europe over the last year, albeit more mid-cap focussed). In other words, global private firepower is being put to work…and not simply stockpiled.

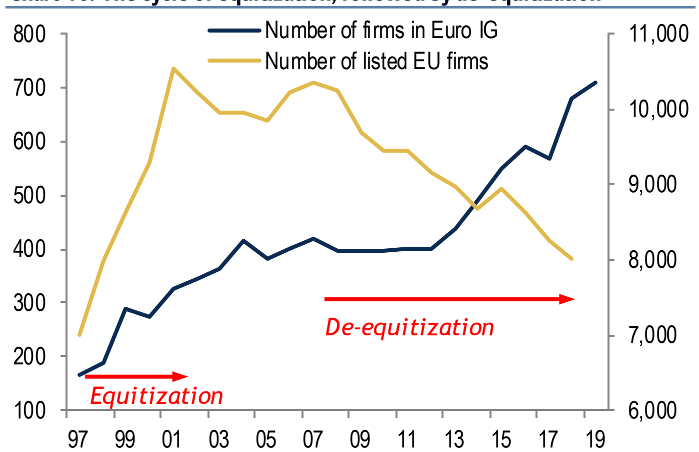
With European stocks having been stuck in a range for much of the 2017-2019 period (Stoxx Europe 600 trading between 360 and 400), public capital may well be fatigued. This opens the door to a more constructive dialogue between shareholders/management and potential PE buyers.

Chart 9: Direct lending fundraising going from strength to strength



Source: Quarterly $bn. Deloitte Direct Lending Tracker.

Chart 10: The cycle of equitization, followed by de-equitization



Source: World Federation of Exchanges.

The manic stampede

The flip side to de-equitization, however, is that credit markets are likely to experience rapid growth over the forthcoming years. But with any fast expansion comes the risk of misallocation of capital…

Chart 10 shows the equitization/de-equitization cycle in Europe over the last 20yrs. Note that as the number of (equity) listed companies in the EU has fallen, the number of credit market issuers has grown. Thus, it's the credit market that will be a better barometer for the state of the economy in future years.

The dark side of bank disintermediation

Herein lies how the risk in the European credit market has changed…and will continue to change going forward. Credit market growth is not simply about the same names leveraging up:

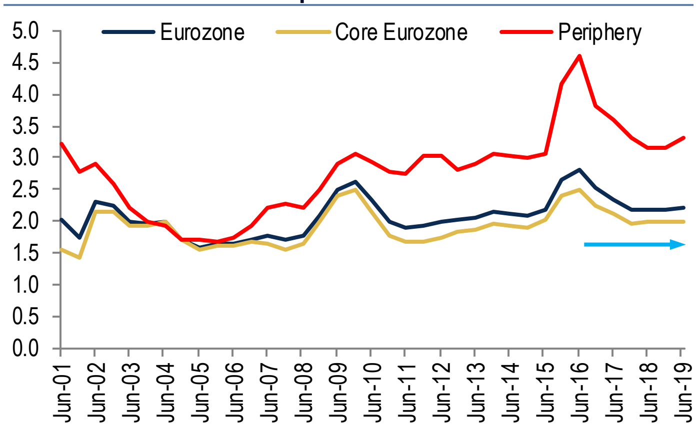
- Chart 11, below, shows how the leverage for established Euro Area high-grade issuers has, in fact, been broadly stable over the last two years, albeit more so for core than periphery (we define "established" issuers as those that have had bond debt outstanding since 2005).

Instead a key part of credit market growth in Europe has been as a consequence of "debut" issuers – companies that traditionally didn't use the corporate bond market as a funding source, as they tended to be bank financed. But we expect now, with CSPP2.0, that there will be another big wave of disintermediation: companies repaying bank loans and moving into bond financing.

And it's with this growth in debut issuers that we think greater credit risk comes. Chart 12 shows the distribution of net debt/EBITDA, by rating, for both "established" Euro Area issuers and "debut" issuers.

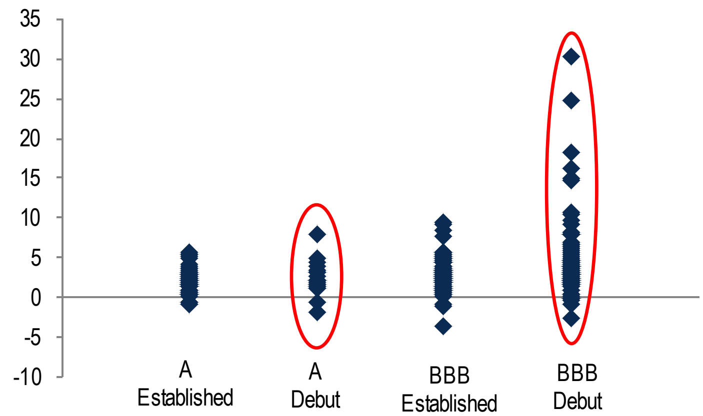
- As can be seen, for all ratings, the *average* leverage for debut names is *higher* than for established issuers.
- Moreover, the *distribution* of leverage is also greater for debut names than it is for established issuers (note real estate companies impact the picture here as their leverage tends to be very high).

Chart 11: Net debt/EBITDA of established issuers: not too pressing at the moment for core Euro Area corporates



Source: Bloomberg.

Chart 12: Leverage: "Established" vs. "debut" issuers. Debut names often come to the market with higher, and more dispersed, leverage



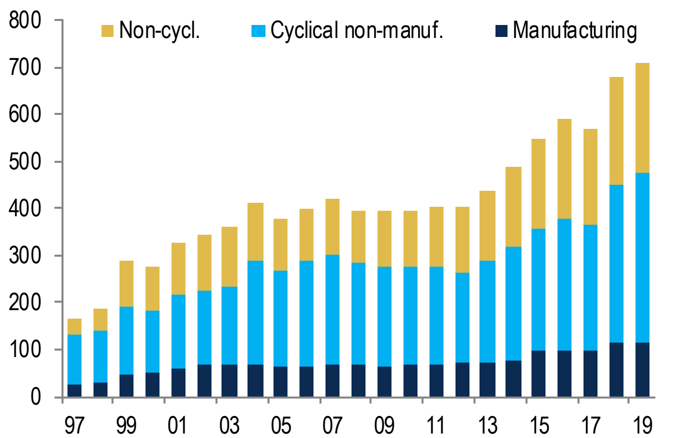
Source: BofA Merrill Lynch. Net debt/EBITDA. Each diamond represents a company in the sample. Note real estate bonds tend to have very high net debt/EBITDA metrics (and tend to be analysed instead on loan-to-value metrics).

From the ashes...

The charts below highlight the growth in the number of Euro credit market issuers over the last few years. We think it highlights that credit markets in Europe are taking on a more cyclical nature, embracing companies that might be less financially flexible in the event that the economy turns sour.

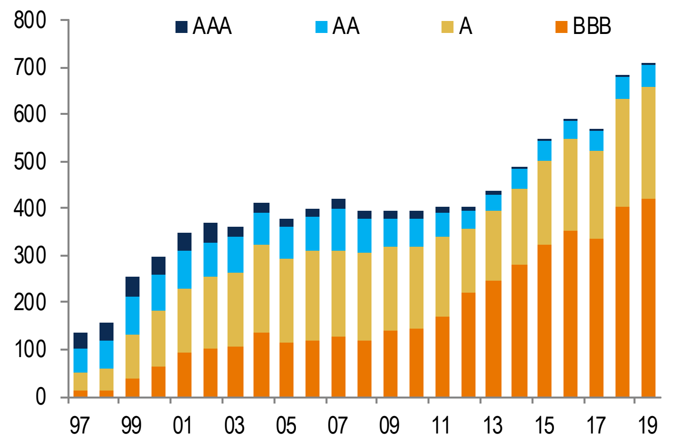
- As chart 13 highlights, the big growth in new names in the Euro high-grade market has been from cyclical sectors (albeit, the non-manufacturing parts).
- Chart 15 highlights the big growth in new names in the Euro high-grade market by sector. **Real estate** and **industrials** clearly stand out.
- And chart 16 shows that it's been less the periphery that has driven the influx of new issuers in the Euro credit market (witness Spain). Instead, the number of US and German corporate bond issuers has grown rapidly.

Chart 13: Number of companies in Euro IG (ER00), by type



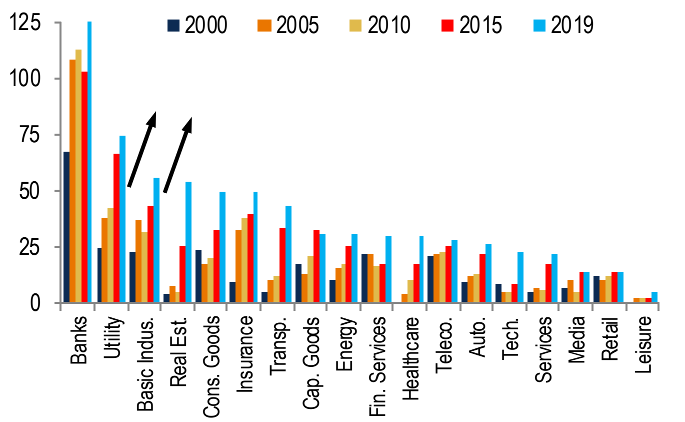
Source: ICE Data Indices LLC. Manufacturing sectors are: autos, basic industry and capital goods.

Chart 14: Number of companies in Euro IG (ER00), by rating



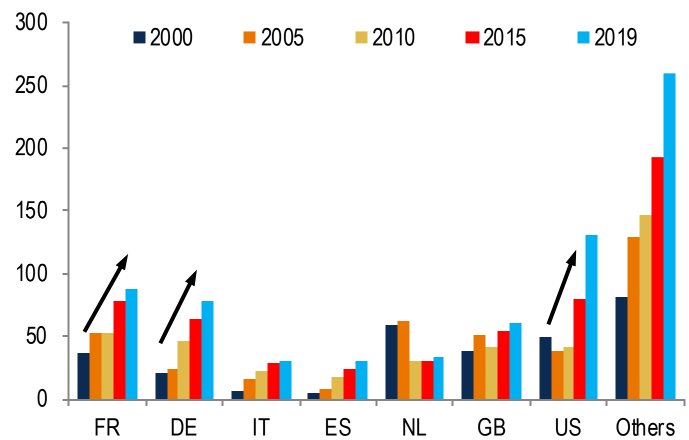
Source: ICE Data Indices LLC.

Chart 15: Number of companies in Euro IG (ER00), by sector



Source: ICE Data Indices LLC.

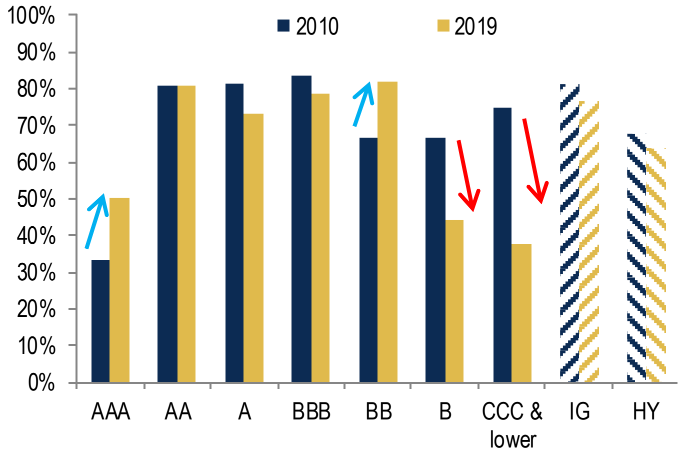
Chart 16: Number of companies in Euro IG (ER00), by country



Source: ICE Data Indices LLC.

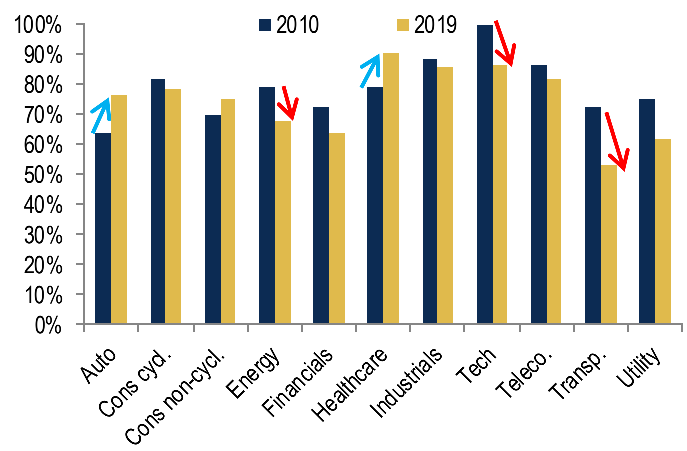
And as the credit market sees an influx of "debut" names due to bank disintermediation – names which are often smaller, cyclical and not listed – the "riskiness" of the Euro corporate bond market may increase. The charts below show a declining proportion of the Euro corporate bond market that has access to equity markets – an important source of financial flexibility for companies that struggle when the economy sours.

Chart 17: The percentage of Euro credit market issuers that are listed on the equity market is going down...



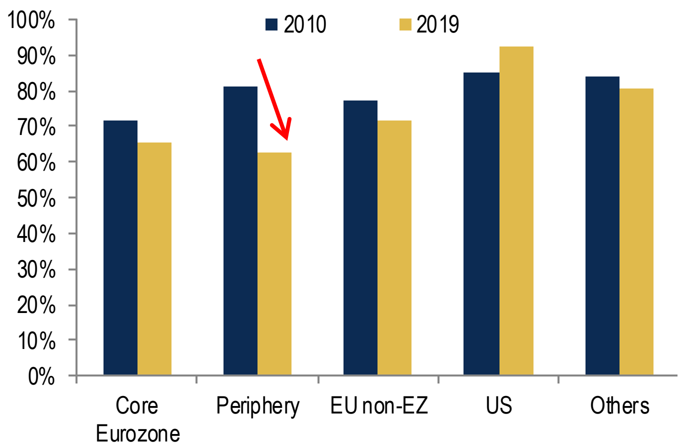
Source: ICE Data Indices LLC, Bloomberg.

Chart 18: ...especially for sectors such as energy, transport and tech (cyclical sectors)



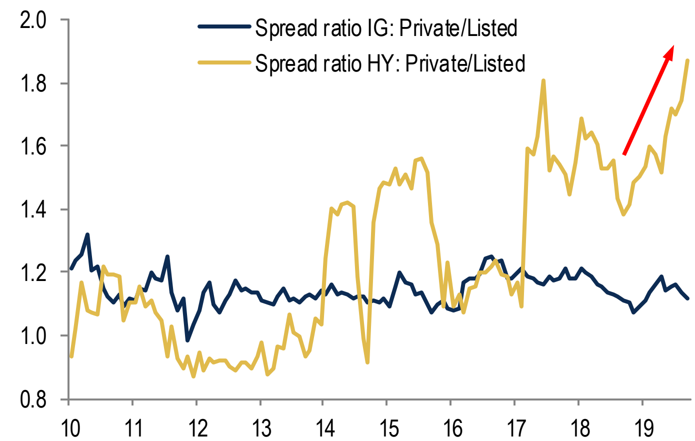
Source: ICE Data Indices LLC, Bloomberg..

Chart 19: The percentage of Euro credit market issuers that are listed on the equity market: by domicile



Source: ICE Data Indices LLC, Bloomberg

Chart 20: OAS of listed firms vs. non-listed: in HY, markets seem to be getting less comfortable with names that are not listed



Source: ICE Data Indices LLC, Bloomberg. Average of option-adjusted spreads (OAS) of companies in ER00 and HE00.

Vive la France!

The global trade narrative has taken a turn for the better over the last few weeks, with a "skinny" US-China deal emerging. Focus still remains on potential trade tensions with Europe, however, especially with the USTR due to report to President Trump on the national security threat of auto imports by mid-November.

Yet, as we have flagged in the past, the "deglobalization" theme is not a blanket negative for every exporting company/country in Europe. While the US and China are clearly importing *less* from each other respectively now, there is a "substitution" effect underway.

And we believe that French credits are the beneficiaries at this juncture:

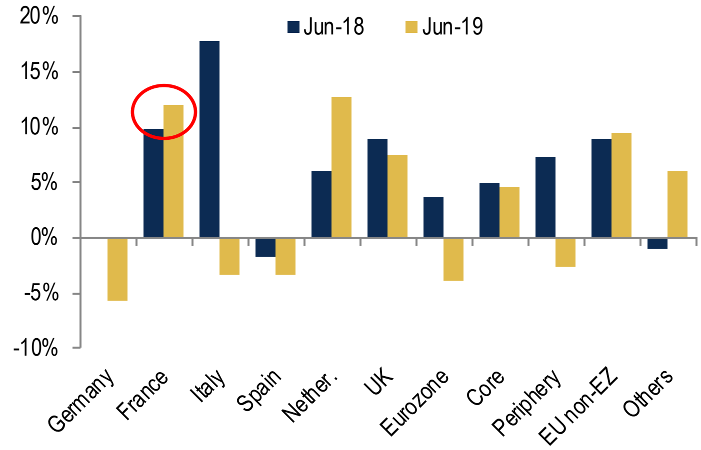
- As chart 21 shows, US imports from the EU remain at fairly healthy levels. And the latest import data shows that US's import growth from France (3m/3m basis) is still a solid 6.6%, albeit slowing.

- We think this is helping to support the fundamentals of French issuers at present. Chart 22 shows YoY EBITDA growth (%) of European credits, by country. Note that yearly EBITDA growth for French names is currently at 12% YoY, again much better than for German credits (where it is now negative).

Chart 21: YoY change in cross-country trade volumes. EU export growth to both the US and China has held-up lately while US/China cross-trade volumes have collapsed

Source: IMF Direction of Trade, Haver. YoY change, 3m moving average

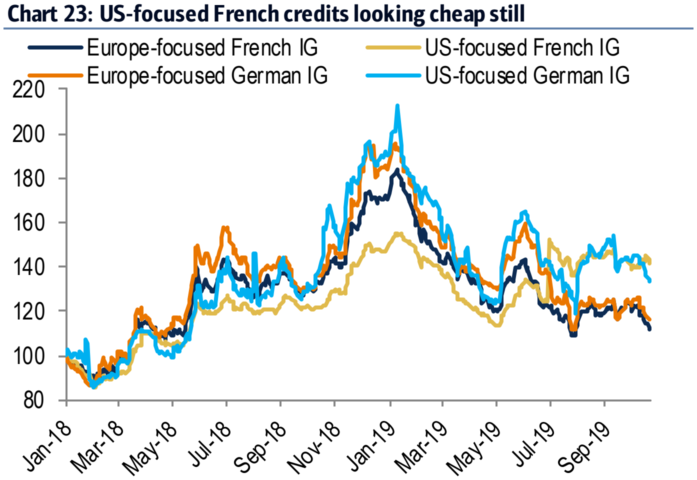
Chart 22: YoY EBITDA growth by country: still encouraging for France (sample of "established" issuers only, as defined above)



Source: ICE Data Indices LLC, Bloomberg.

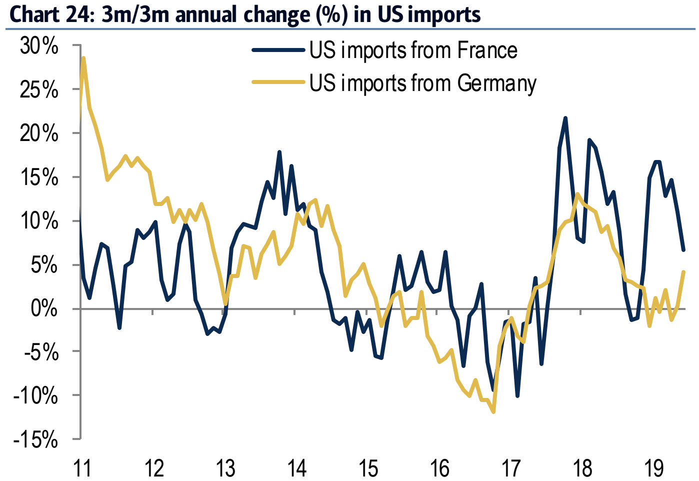
And the trade? French credits – with US revenue exposure – look on the cheap side still. Chart 23 below shows the spread of baskets of names with certain revenue exposure. As can be seen, the spread of US-exposed French credits have lagged over the last quarter, as trade war rhetoric soured.

Chart 23: US-focused French credits looking cheap still



Source: Rebalanced to 100 as of Jan '18. Spreads of credits with specific revenue exposure.

Chart 24: 3m/3m annual change (%) in US imports



Source: US Census Bureau.

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