The European Credit Strategist

To infinity and beyond

Credit Analysis

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Credit Strategy
Europe

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Credit manias (and the ultimate oxymoron)

We see signs already that the era of "financial repression" (negative yields) is fuelling a mammoth reach for yield across markets. Credit inflows are surging to the extent that the numbers are scary: by year-end, Euro IG funds could have amassed close to $200bn of new money, far in excess of anything seen before. We thus remain bullish on high-beta credit for 2H. Yet, hitherto market norms are quickly being broken…even the high-yield market is now (unfortunately) succumbing to the fad of negative yielding debt.

Is "deglobalization" unstoppable?

The G20 "truce" between China and the US was taken well by markets this week. Yet, global trade volumes remain in recessionary territory, and downbeat PMIs point to even weaker global trade ahead. We think that populism – in the form of "us first" politics – is an important contributing factor to weaker global trade. Cross-border M&A, for instance, has declined visibly in the first half of this year. Moreover, global Foreign Direct Investment – a good lead indicator for global trade – has fallen back to 2004 levels.

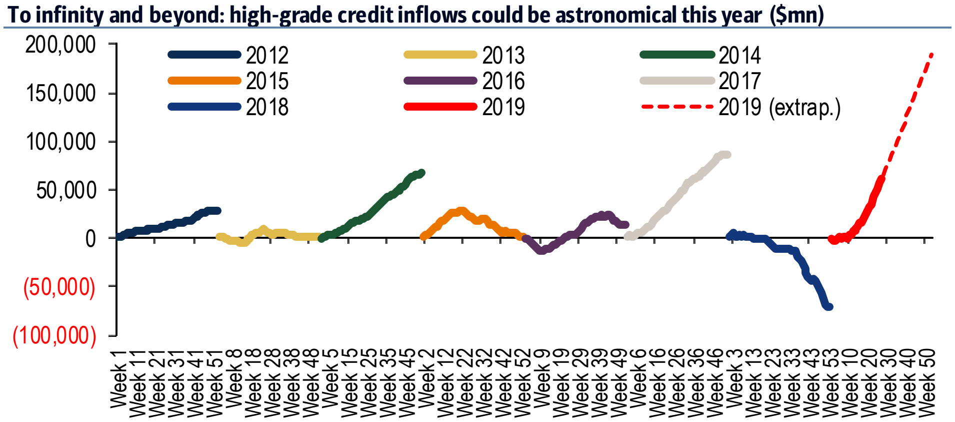
The merry-go-round: who's winning from the trade war?

But we think it would be wrong to paint all global trade with the same brush. Import substitution is likely to mean "winners" emerge from the US-China trade spat. For instance, while China is raising tariffs on US imports, they seem to be lowering them on imports from other countries. Moreover, we see signs that while US imports from China have dropped lately, they have picked up quite materially from the EU.

Trading trade wars: long US-exposed European credits

US-China trade headlines will continue to ebb and flow. Our analysis shows that the European credit sectors that have been most sensitive to these headlines in the past have been insurance, autos, banks and industrials. Relatively less affected have repeatedly been utilities, real estate and retail. Moreover, we think investors should buy US-exposed European credits here (pharma, media). Not only are trade volumes between the US and Europe looking encouraging, but our revenue exposure baskets (page 9) flag that US-exposed European names have underperformed the most since 2018.

To infinity and beyond: high-grade credit inflows could be astronomical this year ($mn)



Source: EPFR Global, BofA Merrill Lynch. Cumulative yearly inflow/outflow for Euro IG funds. '19 extrapolated from the last 6w avg flow.

Refer to important disclosures on page 11 to 13.

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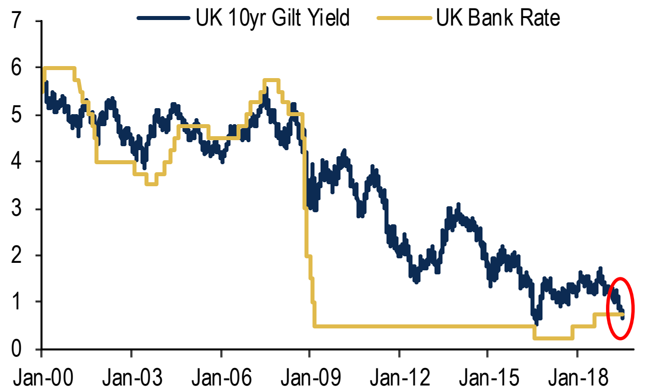
To infinity and beyond

1H is in the books…and it's been a memorable one for credit investors. Total returns for Euro IG were an eye-watering 5.4%, one of the best first halves ever seen. AT1s have provided the "best of beta" this year, with a 10.5% 1H surge, almost pipping CCCs. But long-dated bonds have been the crème de la crème…notching up close to a 13% gain. In the end the story was simple: spreads tightened and yields fell – a perfect combination for corporate bond performance.

And the catalyst for this perfect combination has been the market salivating over central bank dovishness, egged on by a combination of weak manufacturing data and less-hawkish-than-feared central bank appointments. Note that the 30yr Treasury yield has just fallen below Fed Funds (the entire Treasury curve is now "inverted"). And in the UK, 10yr Gilt yields returned the favour – falling below the BoE's Bank Rate for the first time since late 2008 (as did Bunds yesterday). Moreover, the world of negative yielding debt continues to amaze: Italy 2yr and Belgium 10yr yields joined the club this week.

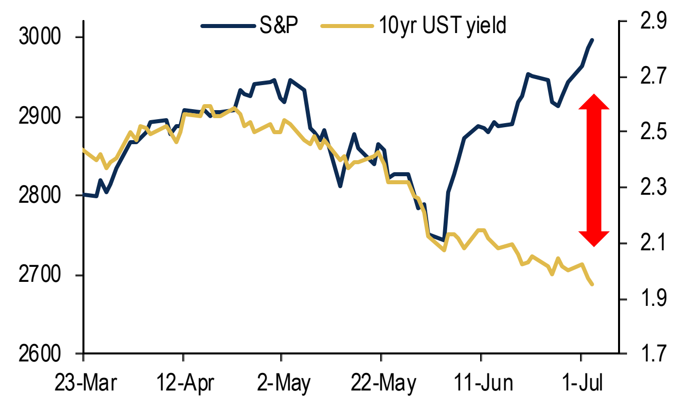
Markets have perhaps never been more expectant of central banks to follow-through on this wall of dovishness (chart 2). Yet, the higher markets go, the greater the risk, we think, that central banks end up "disappointing" somewhere down the line…

Chart 1: Duration grab in UK gilts. 10yr yields now less than Bank Rate.



Source: BofA Merrill Lynch Global Research. %.

Chart 2: The fingerprints of central bank dovishness: bonds up, stocks up

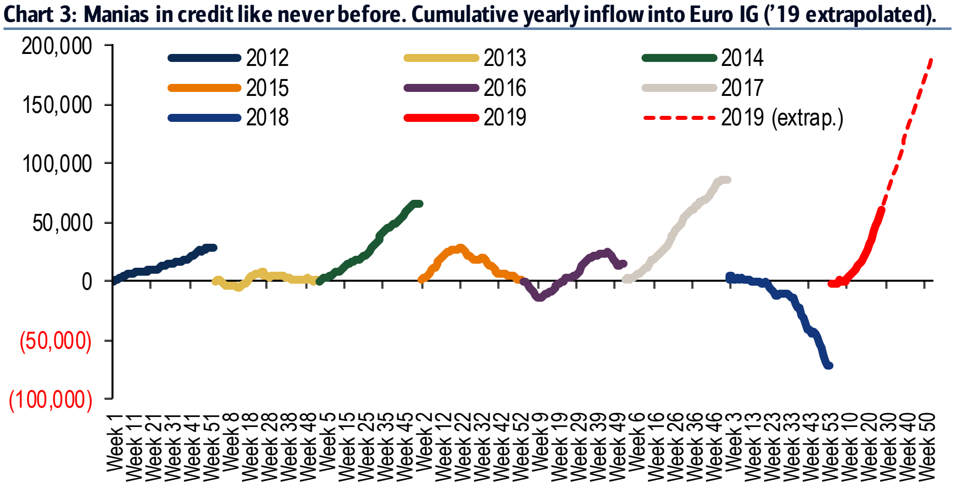


Source: BofA Merrill Lynch Global Research. UST yields (RHS, %).

Credit manias (and the ultimate oxymoron)

The backdrop of "financial repression" – in the form of $12tr. of [negative yielding] bonds – is unambiguously bullish for European credit, in our view. We see signs already that this is fuelling a mammoth reach for yield across markets.

Chart 3: Manias in credit like never before. Cumulative yearly inflow into Euro IG ('19 extrapolated).



Source: EPFR Global, BofA Merrill Lynch Global Research. $mn cumulative inflow/outflow. 2019 inflow extrapolated from last 6w average

Chart 3: Manias in credit like never before. Cumulative yearly inflow into Euro IG ('19 extrapolated).

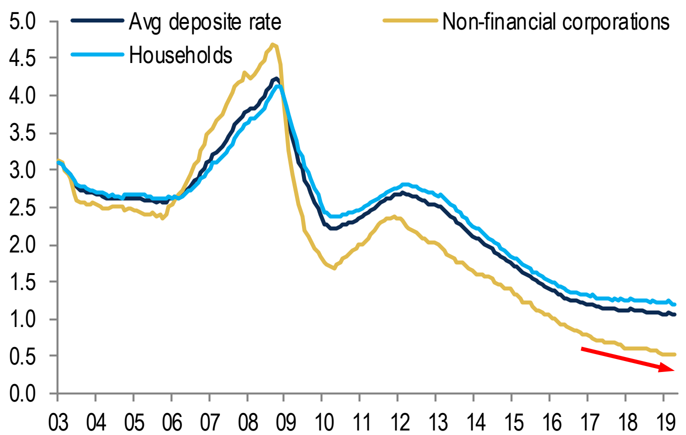
weekly flows.

Over the last 6w, for instance, inflows into Europe investment-grade credit funds have averaged almost $5bn a week, way in excess of anything we have ever seen before and far above the weekly run rate that transpired post 2016's CSPP launch (IG inflows, then, averaged around $1.5bn a week).

Chart 3 shows cumulative yearly inflows into European high-grade credit funds since 2012. Extrapolating 2019's inflow based on the last 6w suggests that by year-end, European high-grade credit funds could see staggering inflows to the tune of almost $200bn.

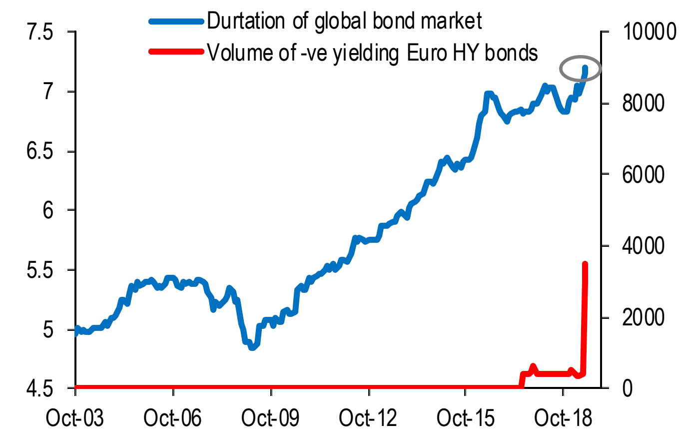
It seems safe to say that with a number of this magnitude, we see few problems for the market absorbing high-grade new issuance, despite the YoY run rate being 40% up. Net monthly IG supply (ex. coupon payments) has averaged €18bn in 2019, coverable by inflows.

Chart 4: Corporations need yield too (Average Euro Area deposit rates). We sense they are buying corporate bonds a lot more aggressively now.



Source: BofA Merrill Lynch Global Research, Datastream. Average Euro Area deposit rates (%).

Chart 5: bonds the "riskiest" ever: duration of the global bond market the highest ever...and even Euro HY bonds are starting to yield –ve.



Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC. Volume of –ve debt RHS, Eur mn.

Who's buying? Everyone...

Where is all the credit money coming from? Likely a bit of everywhere: new dedicated long-only credit mandates, more Japanese buying of Euro credit, and more cross-asset money being switched to corporate bonds (and explaining the rise in portfolio ETF trades, which further squeezes the credit market tighter).

Yet, we think companies themselves are an important buyer base for corporate bonds, as they look for higher yielding alternatives for their vast cash balances. As chart 4 shows, deposit rates for non-financial corporates continue to head lower across the Eurozone, and at a much faster pace than for household deposit rates.

High-yield: the ultimate oxymoron?

With money jumping across the bond market in search of better returns, we continue to think that this is a bullish backdrop for high beta credit performance as we begin the second half. **Corporate hybrids still stand out to us as on the cheaper side**.

That said, hitherto norms are quickly being broken in the European credit market. Note in chart 5, that we are now starting to see the emergence of negative yielding high-yield bonds...an unfortunate oxymoron. 10 Euro-denominated high-yield bonds now yield below zero, a mixture of both callables and bullets.

And while these bonds represent just 2% of the high-yield market at present, we estimate that this number would rise to 10% upon a further 35bp decline in high-yield yields (and Euro HY yields are around 1% from their late 2017 lows of 2.1%).

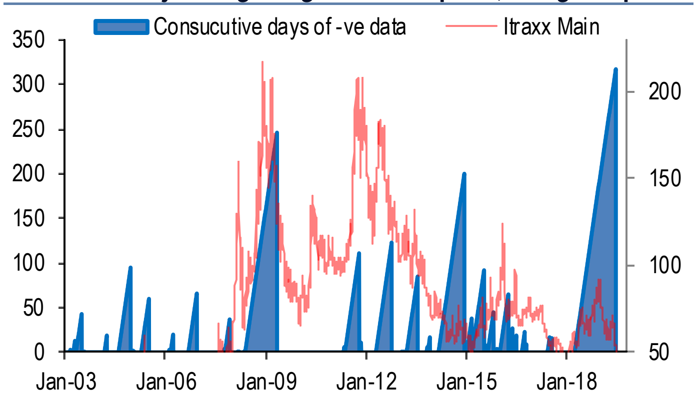
And what of fundamentals?

Amid this yield grab world, the bond markets are of course becoming a riskier place…as witnessed by the record high duration of ICE BofAML's global bond index GFIM (chart 5). While central banks are in the driving seat for risk assets now, fundamentals are taking a back seat, as has often been the case. Yet on this front, data surprise continues to be downbeat and worthy of note. Chart 6 shows that the global data surprise index has now been negative for over 300 consecutive days, the longest recorded stretch.

Given the amount of debt already in the global economy, monetary policy is likely to have to work harder this time to produce the same effects as in the past. Note the growth in China's credit impulse has been a lot slower this time around (chart 7).

For credit markets, slower/sluggish global growth feels ideal. But a more pronounced slowdown – with recession risks – would clearly not be, even if it brought ECB QE back quicker. We think it's a fine line for credit, and we keep one eye firmly on the data.

Chart 6: 300+ days of negative global data surprises, but tighter spreads



Source: BofA Merrill Lynch Global Research, Bloomberg. Itraxx RHS. Bloomberg global data surprise indices (LHS)

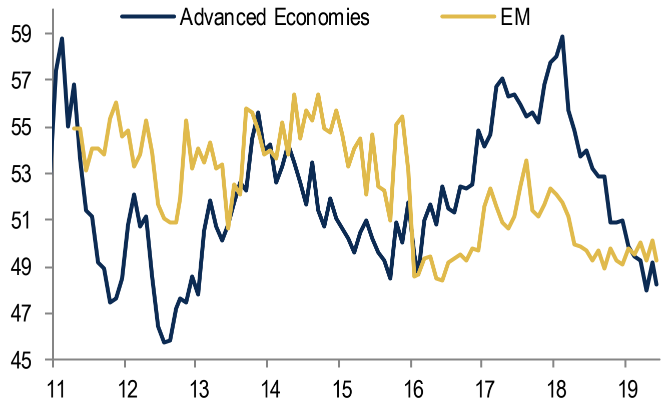
Chart 7: China's successive bouts of stimulus bearing less fruit

Source: BofA Merrill Lynch Global Research, Bloomberg. M1 growth RHS.

Is "deglobalization" unstoppable?

The G20 "truce" between China and the US was taken well by markets this week, especially those areas perceived as more global. The Dax, for instance, is now up 3% since last Thursday. Yet the weekend yielded a truce, not a rapid de-escalation of US-China tensions and a removal of the existing tariffs. We think it will take a lot more to counter the big reversal in global trade that has materialised of late. And while the US-China spat has clearly been a key driver of this, we think populism is behind a broader "deglobalization" that we observe.

Chart 8: PMI manufacturing *New Export Orders*: a significant deceleration for Advanced Economies, as opposed to EM



Source: BofA Merrill Lynch Global Research, Bloomberg, Markit. Constructed from individual PMIs from Bloomberg.

Chart 9: PMI manufacturing *New Export Orders* point to a further contraction in real export growth

Source: BofA Merrill Lynch Global Research, Bloomberg, Markit, Datastream. Export growth (RHS).

We think it's imperative that investors keep a close eye on global trade trends, as many European non-financials have spent the last decade reorientating their sales towards faster-growing external regions. Persistently weak trade would be costly for many of these companies, in our view.

Global PMI *New Export Orders* have been flagging for some time that the once-vibrant environment for external trade is now under a cloud. In fact, Global PMI *New Export Orders* have fallen for 14 consecutive months, the longest stretch of declines on record.

Chart 8 shows PMI manufacturing New Export Orders, split by DM and EM. As can be seen, the drop has been a lot more significant for advanced economies than it has been for Emerging Markets. And PMIs hint at further weakness ahead for trade (chart 9).

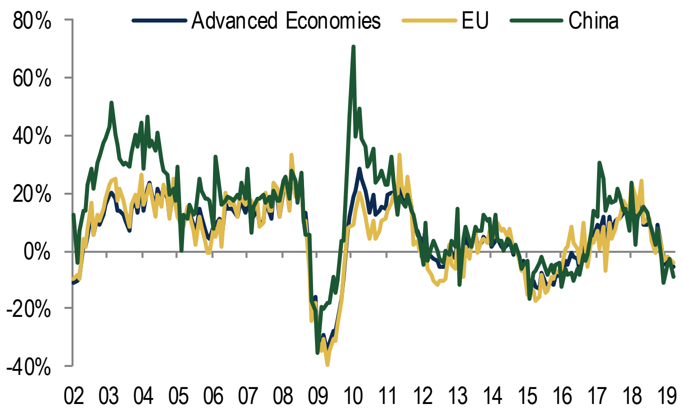
Did you know…?

But more specifically, what does the latest global trade data indicate? In chart 10 we show Advanced Economies' YoY exports, by destination (using IMF Direction of Trade statistics).

- As can be seen, YoY global trade growth has slowed and is now firmly in contractionary territory, running at levels of between -5% to -10%.
- Across regions, advanced economy exports to China are currently down a larger 9%. And drilling down within Asia, we find that world exports to Taiwan are down 9% YoY, although world exports to Japan are down only 2% YoY.

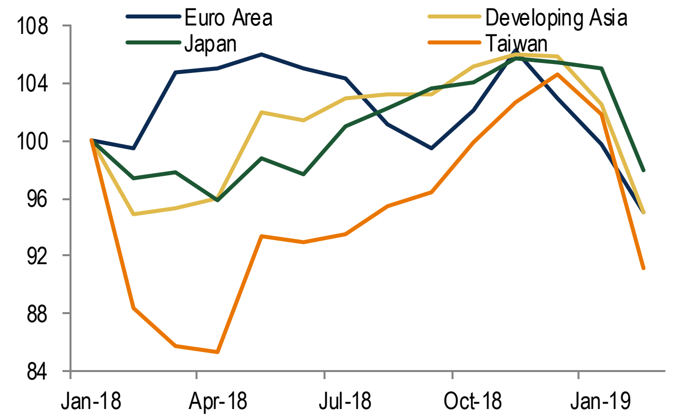
On the face of it, we find that global trade is back in a moderate recession, but one not quite as bad as in early '15 (oil price drop) and certainly nowhere near as bad as Lehman.

Chart 10: Advanced Economy exports to traditional trade bellwethers have sunk in 2019 (YoY Advanced Economy exports, YoY % change)



Source: BofA Merrill Lynch Global Research, IMF Direction of Trade Statistics. Advanced Economy exports, YoY % change.

Chart 11: World exports to Taiwan have suffered the most this year (YoY trade growth since trade tensions started)

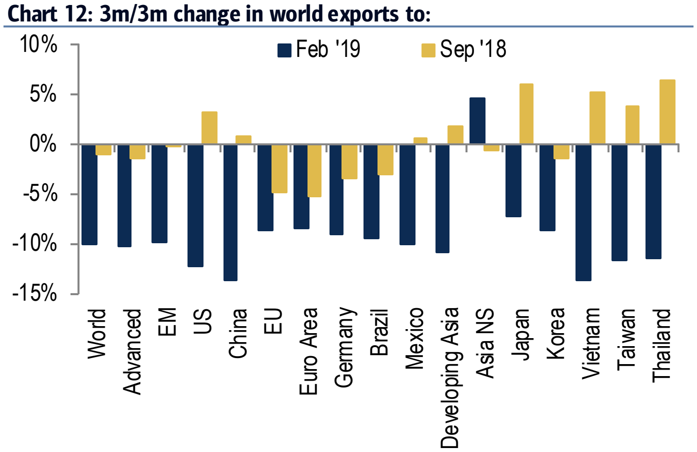


Source: BofA Merrill Lynch Global Research, IMF Direction of Trade Statistics. World Exports to Euro Area, Developing Asia, Japan and Taiwan. World exports rebased to Jan 18 levels.

Yet, there are more nuances to the global trade story when one drills down even further.

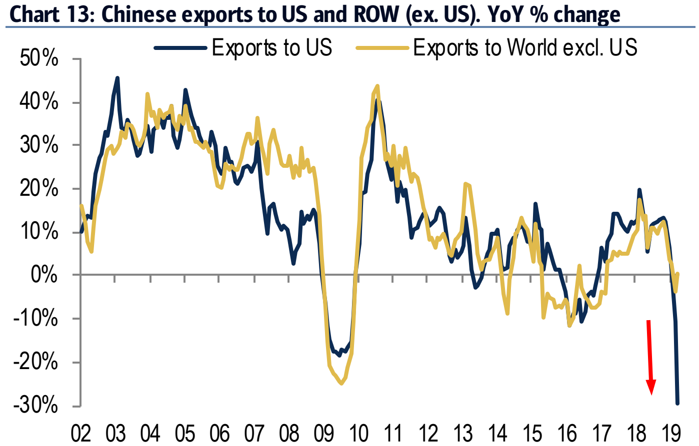
- If we look at just 3m/3m changes in world exports, the trade recession looks to have become more entrenched this year (chart 12). Almost all countries seem to be signalling less global trade now.
- One area where trade looks to be having more of a Lehman "moment" is Chinese exports. As chart 13 shows, China's exports to the US are currently heavily down YoY. While this is understandable given the current US-China trade spat, it is nonetheless a far greater drop than observed post the financial crisis.

Chart 12: 3m/3m change in world exports to:



Source: BofA Merrill Lynch Global Research, IMF Direction of Trade Statistics

Chart 13: Chinese exports to US and ROW (ex. US). YoY % change

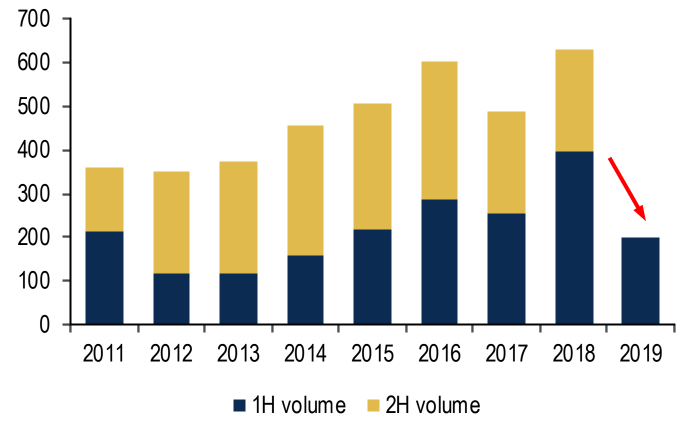


Source: BofA Merrill Lynch Global Research, IMF Direction of Trade Statistics

- On the flip side, the better news is that China's exports to the rest of the world have fallen to around zero, but as yet nothing more sinister.

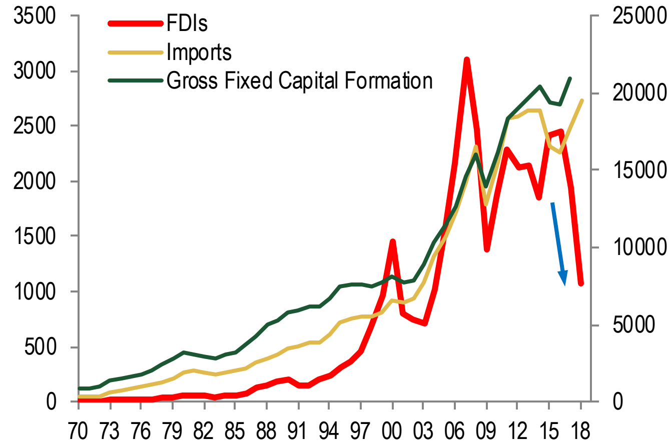
Bank of America Merrill Lynch

Chart 14: Cross-border M&A involving a US and foreign firms ($bn)



Source: Bloomberg analysis: Cross-Border dealmaking plunges as companies look inward, 3 July 2019. M&A volumes involving US firms where the buyer, target or seller if a foreign company.

Chart 15: Foreign Direct Investment tumbled last year



Source: World Bank. FDI (LHS, $bn). BofA Merrill Lynch Global Research.

We discussed here that some softening in world trade volumes was unavoidable simply given the speed at which global tariff rates had fallen over the last decade. Simply, future free trade agreements were unlikely to give the same boost the trade volumes as was seen in the past (when they were accompanied by big reductions in tariffs).

But we think that the new era of populism is greatly affecting trade volumes too. The populist narrative of "us first" is encouraging a more insular approach by companies to both producing and selling goods, as well as their future expansion strategies.

- Chart 14, for instance, shows Bloomberg's analysis of cross-border M&A trends (involving a US and a foreign company). Cross-border acquisitions involving US firms fell almost 50% in the first half of this year to $204bn, the lowest 6m volumes since 1H '14.

- Allied to this, chart 15 shows the drastic drop in Foreign Direct Investment across the globe, typically a good lead indicator of global trade volumes. Note that global FDI volumes fell to just over $1tr last year, the lowest since 2004, an ominous sign for trade in our view.

In a more populist, insular, world, companies are clearly less keen to expand overseas now.

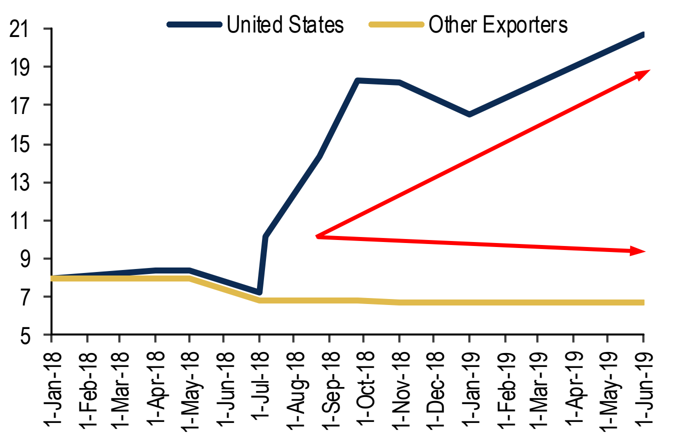
The merry-go-round: who's winning from the trade war?

It would be wrong, however, to leave the trade story there and simply paint a negative picture for all countries. While trade between some countries has slowed notably over the last year and a half, other trade channels look set to expand.

For one, trade rebalancing is a likely response by both China and the US. As the Peterson Institute points out, while China has been *increasing* its tariff rate on goods imported from the US, it has been cutting the tariff rate on imports from other regions, such as Canada, Japan and Germany (chart 16). In early 2018, note that both average tariff rates were virtually the same. Now they differ by 14 percentage points.

Understandably, this is motivating some rebalancing of global trade preferences: China's imports from the US have slowed more aggressively than they have from other countries (lower tariff rates are likely helping on this latter point).

Chart 16: China's average tariff rate is rising on US goods but falling for the rest of the world (China's trade-weighted average import tariff). %.



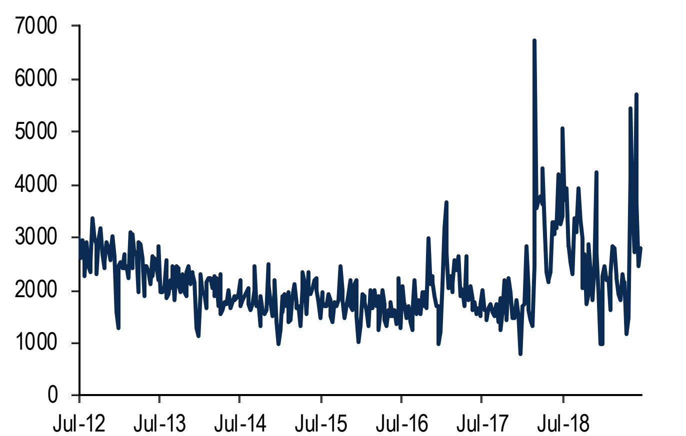
Source: Peterson Institute: "Trump has gotten China to lower its tariffs. Just toward everyone else", Bown, Jung and Zhang, June 12th 2019.

Chart 17: 3m/3m change in trade volumes

Source: BofA Merrill Lynch Global Research, IMF Direction of Trade Statistics.

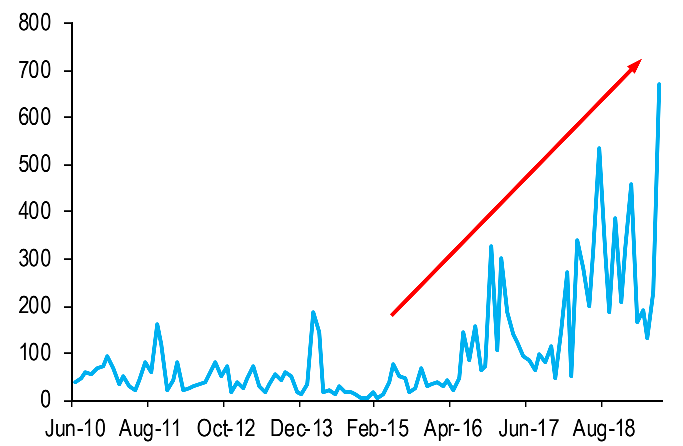
And when one looks at the US (chart 17), while import growth from China is clearly very negative on a 3m/3m basis, import growth from the EU is nonetheless the strongest it has been since 2012.

Chart 18: Weekly news story count for "trade" on Bloomberg



Source: Bloomberg, BofA Merrill Lynch Global Research

Chart 19: Global Trade Policy Uncertainty Index



Source: Bloomberg, BofA Merrill Lynch Global Research

Trading trade wars

The US-China trade spat is likely to take many more turns down the line. Understandably, news references to global trade remain conspicuously high (chart 18 shows the Bloomberg story count for "trade") and likewise for global trade policy uncertainty (the latest June reading surged to a record, chart 19).

Trade headlines will thus continue to provoke risk-on/risk-off price action across credit, in our view. But what have we learnt in credit markets thus far about which sectors and names are more (or less) susceptible to the ebb and flow of US-China trade tensions?

To answer this, we analyse credit sector performance around those periods in chart 18 when trade newsflow visibly jumps. More precisely:

- We calculate the spread beta of European credit sectors relative to the Bloomberg story count on "trade". We use a 2d window for assessing credit performance.

- For each sector, we calculate the beta relative to the overall market. This gives us an indication of which sectors relatively *underperform* and *outperform* when trade tensions rise (and conversely, the opposite when they fall).

Charts 20 and 21 show our findings. The sectors to the right in chart 20 are those that have underperformed the market, since the start of 2018, on days where trade newsflow has jumped.

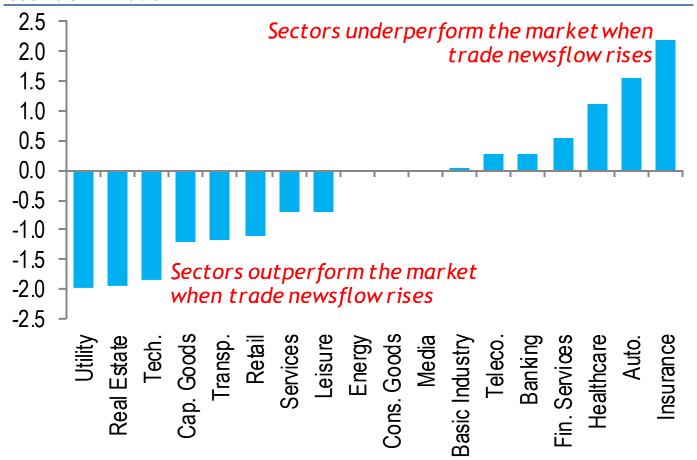
- As expected, we find autos and industrials to have underperformed the broader European credit market on days where US-China trade tensions have risen. Banks also feature, likely given their sensitivity to global GDP.

- By country (chart 21), German, UK and French credits have underperformed the broad Euro high-grade market on days where US-China trade tensions rise. Conversely, Reverse Yankees have fared better.

- Interestingly, insurance has actually been the most sensitive European credit sector to US-China trade tensions thus far.

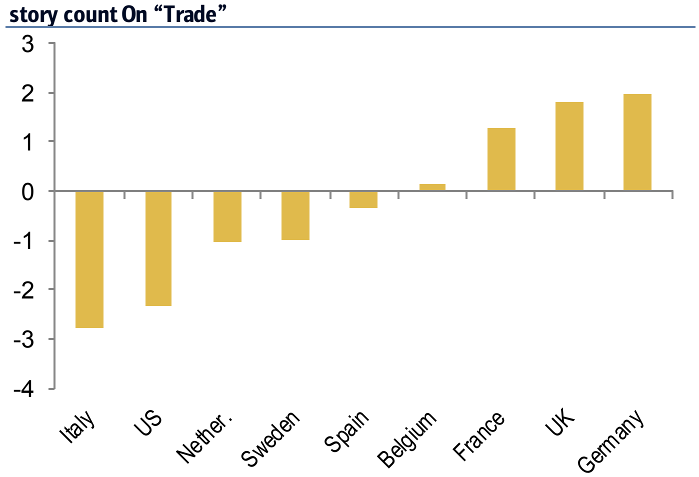
- Sectors to the left in chart 20 have attracted bids seeking lower risk assets in times of rising US-China trade stress, likely due to their domestic nature: utilities, real estate, retail etc.

Chart 20: Spread beta of European credit sectors to Bloomberg story count On "Trade"



Source: Bloomberg, BofA Merrill Lynch Global Research

Chart 21: Spread beta of European credits (by country) to Bloomberg story count On "Trade"



Source: Bloomberg, BofA Merrill Lynch Global Research

Chart 20 should therefore be seen as a playbook for trading US-China trade developments going forward:

- If US-China tensions rise again, the short-term trade would be for investors to rotate *out* of insurance, autos, industrials and financials and *into* utilities, real estate, cap goods and retail sectors.

- On the flip side, should de-escalation be on the cards, investors should rotate out of utilities, real estate, cap goods and retail sectors and *into* insurance, autos, industrials and financials.

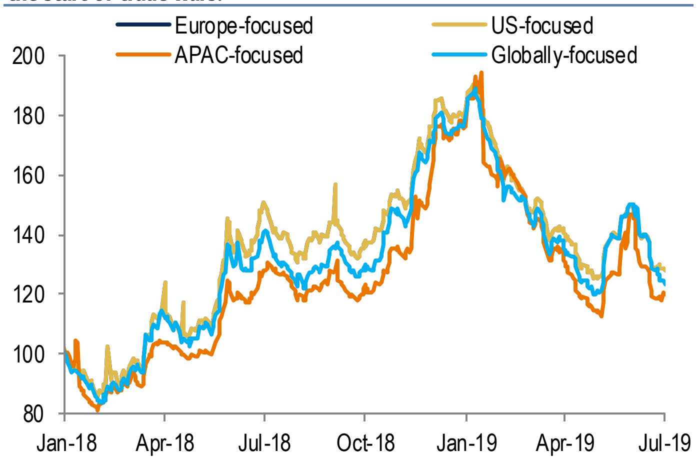
Buy US-exposed European credits

We think investors should buy European credits with meaningful sales exposure to the US. As we discussed above, while global trade volumes are suffering at present, there are nonetheless signs of substitution of imports in some countries. We showed in chart

17 that while US imports from China are significantly negative on a year-over-year basis, there appears to be signs that US imports are switching to European goods.

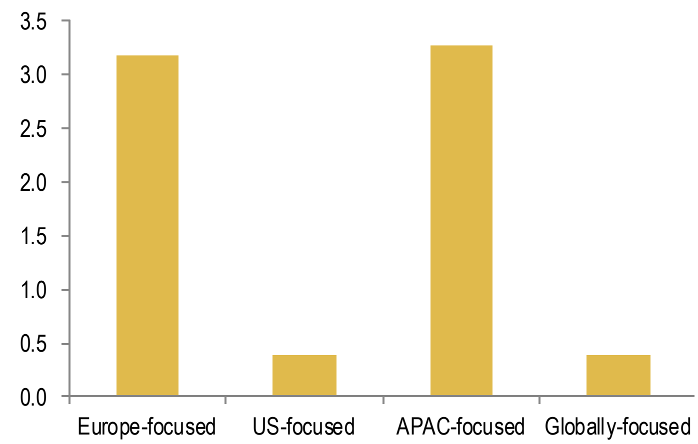
- As such, European issuers with a meaningful share of revenues from North America could stand to benefit going forward, from both better revenues and positive profit surprises in forthcoming earnings seasons.

Chart 22: Spreads of European firms with US revenues have lagged since the start of trade wars.



Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC. OAS rebased at 100 on 02/01/2018

Chart 23: Spread beta of European credit baskets to Bloomberg story count On "Trade".



Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC, Bloomberg. Revenue exposure as above.

To further support this idea, in chart 22 we create four baskets of European credits, based on their revenue exposure. We segregate names based on whether they have meaningful sales exposure (>50%) to 1) domestic Europe, 2) US, 3) APAC and 4) whether they are more global in their revenues.

We track the average bond spreads of the basket constituents, rebalancing spreads to 100 at the start of 2018 (when US-China trade tensions began).

We find that:

- Out of all four of our revenue baskets, European credits with US sales exposure have underperformed the most since the start of US-China trade tensions in 2018.

Thus, US-exposed European credits are cheap and could get a positive earnings kicker in due course from greater US-Europe trade.

Disclosures

Important Disclosures

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Issuer Recommendations: If an issuer credit recommendation is provided, it is applicable to bonds and capital securities of the issuer except bonds and capital securities specifically referenced in the report with a different credit recommendation. Where there is no issuer credit recommendation, only individual bonds and capital securities with specific recommendations are covered. CDS and equity preferreds are rated separately and issuer recommendations do not apply to them.

BofA Merrill Lynch Global Research credit recommendations are assigned using a three-month time horizon:
Overweight: Spreads and /or excess returns are likely to outperform the relevant and comparable market over the next three months.
Marketweight: Spreads and/or excess returns are likely to perform in-line with the relevant and comparable market over the next three months.
Underweight: Spreads and/or excess returns are likely to underperform the relevant and comparable market over the next three months.

BofA Merrill Lynch Global Research uses the following rating system with respect to Credit Default Swaps (CDS):
Buy Protection: Buy CDS, therefore going short credit risk.
Neutral: No purchase or sale of CDS is recommended.
Sell Protection: Sell CDS, therefore going long credit risk.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BofA Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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