The European Credit Strategist

QE Infinity

Credit Analysis

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Credit Strategy
Europe

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To infinity and beyond

And so it begins…again. Yesterday, Draghi delivered – among many other things – open-ended QE. The pushback from the hawks appears to have been strong, with the efficacy of "more of the same" monetary policy being challenged. Yet QE can help transform sovereign debt-to-GDP ratios, as the Japan example has proved. Hence, if Thursday's ECB meeting was all about a cry for fiscal policy to take over, then we think Draghi's "QE Infinity" may be an important stepping stone in the right direction.

CSPP2.0: bullish in '16…and so bullish again

Yesterday also brought the return of an old favourite: the *Corporate Sector Purchase Programme*. By injecting another buyer into a market already brimming with demand, we can't help but see CSPP2.0 as bullish. We expect the ECB to buy €3-4bn a month of credit, but we see the risk that they buy more. Ultimately, there is only one asset class that can help deliver "QE Infinity", and that's credit. CSPP starts in November, a time when issuance will have slowed materially. This likely makes for a good old fashioned squeeze.

CSPP2.0: the trades

As we flagged last week, we see the ECB having to initially go after auto, healthcare, media and real estate bonds to "rebalance". We expect these sectors to be the strongest performers in the short-term.

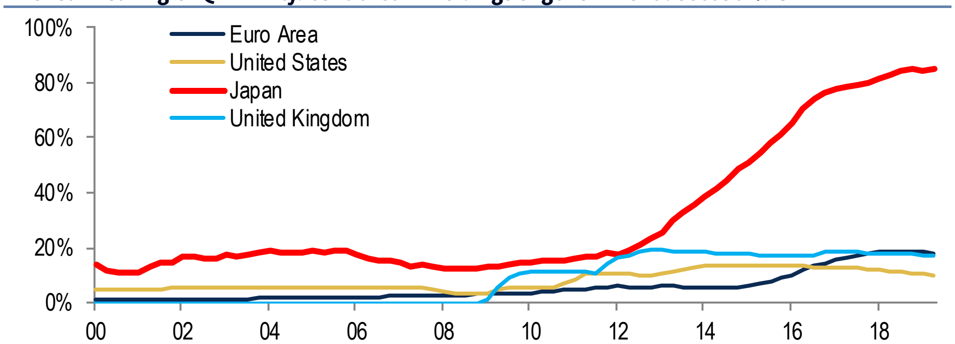
We think front-end, and negative yielding corporate bonds will also get a boost from yesterday's rule change: the ECB can now buy credit that yields below the depo rate.

Buy industrials: it's the sector with high-dispersion/fragmentation (which the ECB will want to reduce), and the percentage of CSPP-eligible names in the sector is high.

QE for the world: The ECB can buy non-Eurozone bonds if they issue from a Eurozone-domiciled finance vehicle: CSPP2.0 will be bullish for (some) Swiss and US credits.

Buy non-eligible bonds for infinity: The long-term winners of CSPP2.0 will likely be non-eligible sectors, which the market will eventually crowd into. We think AT1s and single-Bs look the most interesting here (corporate hybrids look tight now post their August outperformance). French non-eligible bonds also look wide at this juncture.

The real meaning of QE Infinity: central bank holdings of government debt as a % GDP



Source: BofA Merrill Lynch Global Research, national central bank balance sheets.

QE infinity

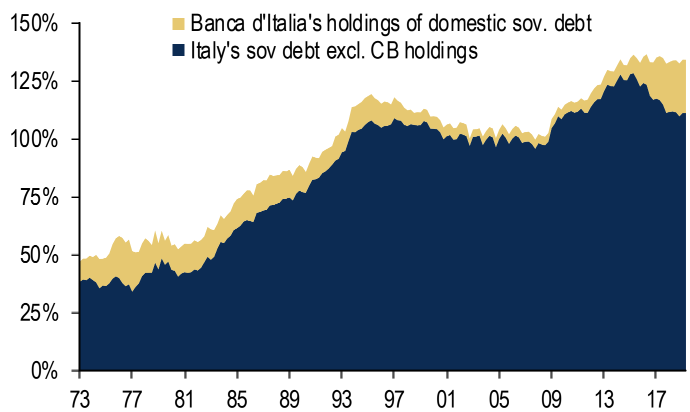
And so it begins…again. Yesterday Draghi delivered a policy package consisting of rate cuts, deposit tiering for banks, cheaper TLTROs, and – most importantly – the return of quantitative easing. From November, the ECB will purchase €20bn of assets per month for as long as necessary, targeting sovereigns, ABS, covered and corporate bonds. As so "QE Infinity" is born.

Yet, the topic of *Quantitative Failure* was front and centre of yesterday's events, with numerous questions at the press conference around the efficacy of "more of the same" monetary policy. Draghi even appears to have had one of his toughest battles to date with the ECB hawks, who reportedly pushed back strongly on the package.

What does *Quantitative Failure* reflect? The risk that as central banks go further down the "rabbit hole" of unconventional policy, the economic impacts become incrementally less…or, at worst, provoke the opposite reaction: consumers save rather than spend, companies hoard cash rather than prioritize capex, and banks tighten lending standards to enterprises as opposed to lend.

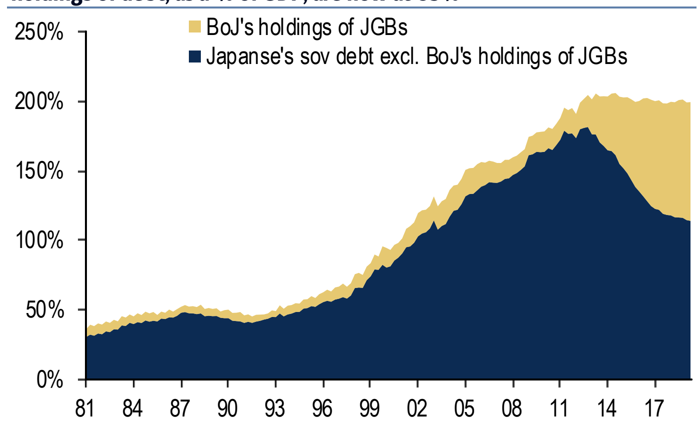
But what QE does do – and we think can often be overlooked – is to subtly "derisk" financial markets. QE "transforms" sovereign debt-to-GDP ratios by moving bonds from risk-averse investors towards more risk-tolerant central banks (buy-and-hold). And if QE is sizeable enough, the transformation in debt-to-GDP ratios can be meaningful.

Chart 1: Bank of Italy's BTP holdings have surged, helping *public* debt sustainability metrics in Italy…



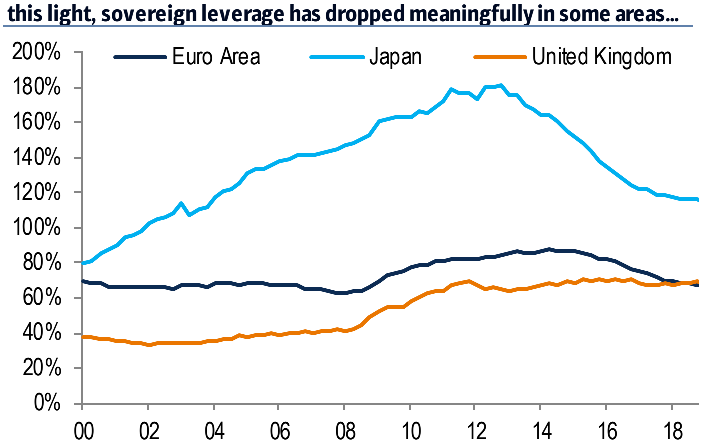
Source: BofA Merrill Lynch, Banca d'Italia, Haver. Total debt/GDP, split by CBs/Non-CBs.

Chart 2: …and on an even greater scale in Japan, where the BoJ's holdings of debt, as a % of GDP, are now at 85%



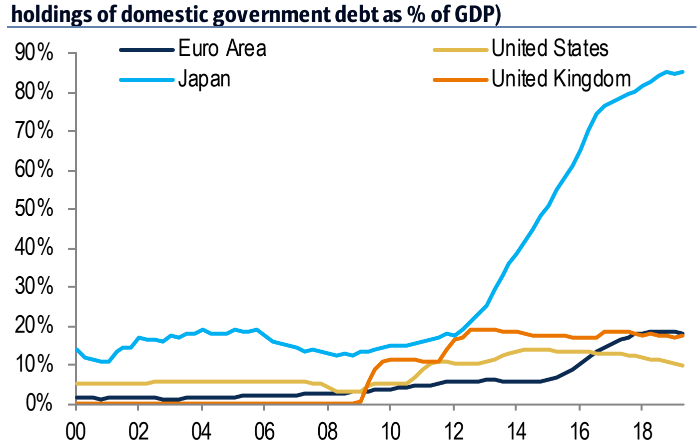
Source: BofA Merrill Lynch, BoJ, Haver. Total debt/GDP, split by CBs/Non-CBs.

Chart 3: Debt/GDP levels <u>excluding</u> domestic central bank's holdings. In this light, sovereign leverage has dropped meaningfully in some areas…



Source: BofA Merrill Lynch, Bruegel, National Central Banks, Haver

Chart 4: … depending on the aggressiveness of the central bank (CB holdings of domestic government debt as % of GDP)



Source: Merrill Lynch, Bruegel, National Central Banks, Haver.

The charts above depict this phenomenon. Chart 1, for instance, shows Italy's total debt-to-GDP ratio over time, but incorporates the growing share of debt held by the Banca d'Italia due to QE. This suggests that debt-to-GDP ratios, excluding central banks, have dipped lower since early 2015 (over this period, resident and non-resident holdings of Italian government debt have fallen, and central bank holdings have grown).

Japan, of course, is a much more meaningful example of this, as chart 2 shows. The BoJ's holdings of Japanese government bonds now represent 85% of GDP. In the same light, Japan's debt-to-GDP ratio, excluding central banks, has fallen from 180% to 110% since 2011.

Why is this risk transfer important? It may help ease the transition from monetary policy to fiscal policy. After all, fixed-income markets are less likely to be subject to tantrums as debt levels rise, if the long-term buyers of sovereign debt are (risk tolerant) central banks. Note that Japan has one of the highest government debt-GDP ratios across the globe, and yet the volatility of JGBs has been conspicuously low since 2010.

Thursday's ECB meeting was all about the need for fiscal policy to take over. In this light, Draghi's "QE Infinity" may be an important stepping stone in the right direction.

CSPP2.0 – What's new?

Yesterday brought the return of an old favourite: the ECB's *Corporate Sector Purchase Programme*. By and large, CSPP2.0 will be identical to CSPP1.0. Note that bank bonds will not be included in the new QE. High yield bonds also remain non-eligible (although a high-yield name can be eligible if it has one IG rating).

- Assuming a ~15% share of corporate bond buying, as historically has been the case, this implies that CSPP2.0 buying will probably be **€3-4bn a month**. Yet, we think the ECB could easily buy larger volumes given the abundance of supply in 2019. Recall that ECB bought €27bn of corporate bonds between Sep-Nov '16.

- If anything, we think **the risk is that that CSPP volumes are larger rather than smaller**, to help the ECB achieve the open-ended nature of QE now.

- **CSPP will likely be bullish for front-end credit and negative yielding corporate bonds**. In a technical release yesterday afternoon, the ECB clarified that it will now be able to buy corporate bonds with a negative yield below the deposit rate. This is a change from CSPP1.0.

- CSPP2.0 will begin in Nov '19. Yet, we think that primary issuance will be a lot lighter then (given so many companies have front-loaded supply over the last fortnight). The **initial squeeze effect of CSPP2.0 could therefore be quite large**, we think.

- QE and CSPP2.0 will run for as long as necessary to achieve the ECB's inflation mandate. QE will end shortly before the bank begins raising its key interest rates.

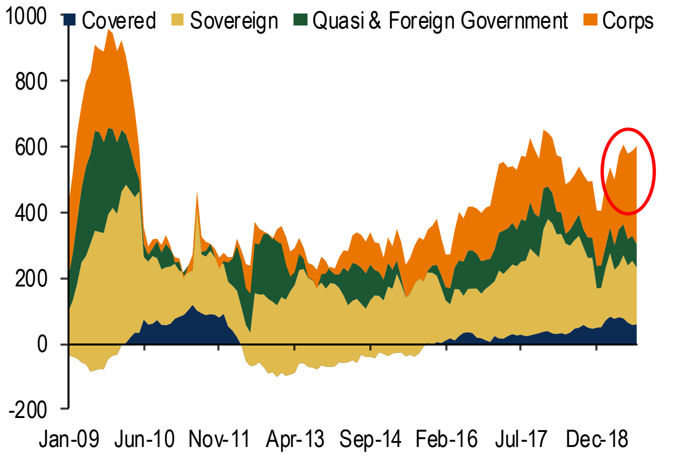
Credit is the only QE-game in town

We think the ECB has little option but to buy lots of corporate bonds for a lot longer. Credit is <u>the</u> asset class that is providing abundant new fixed-income product at present. The charts below highlights trailing 12m fixed-income net issuance in Europe (we use bond index growth as a proxy). Note the surge in net supply for credit markets of late, especially given the last few months of frantic issuance.

Over the last year, for instance, high-grade net issuance stands at almost €300bn, larger than the net supply of sovereign debt (€175bn, chart 6), due to Eurozone governments continuing to run a broadly neutral fiscal stance.

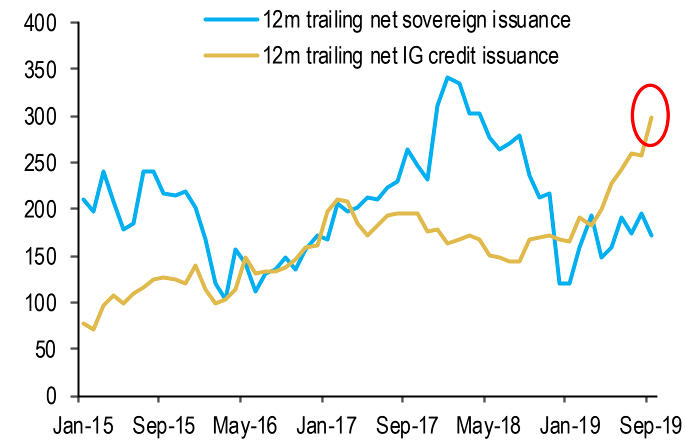
Thus for the ECB, the only QE-game in town at present, is the corporate bond market.

Chart 5: Trailing 12m fixed-income supply in Europe (€bn) –credit is the place to be for the ECB



Source: BofA Merrill Lynch, ICE data indices LLC. We incorporate provisional net supply numbers for Sep-19.

Chart 6: IG issuance has exploded higher this year vis-à-vis other bond markets in Europe – making CSPP invaluable for the ECB

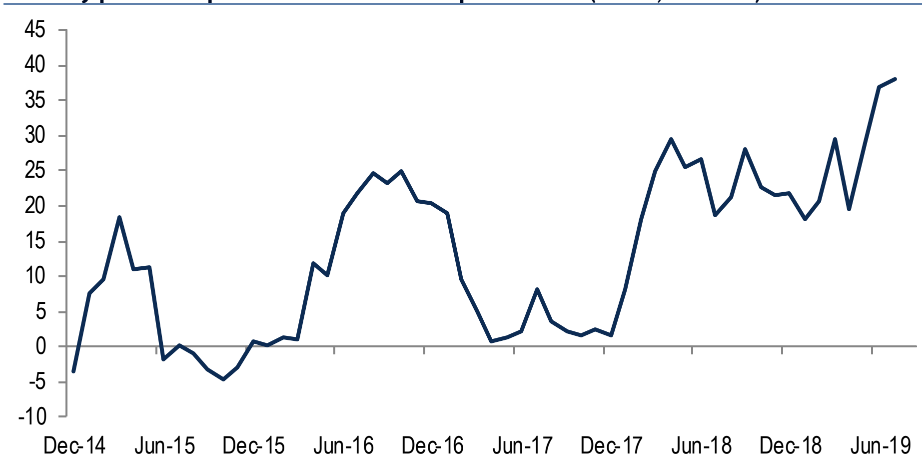


Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC. 12m trailing change in face value of Euro Broad Market Index EMU0.

Bullish in 2016…and so bullish again

We continue to think that the return of CSPP is a further bullish story for credit spreads. As we argued last week, ECB corporate bond buying will add yet another marginal buyer to a market already flush with buyers of corporate bonds. And on this point note the latest data from Japan (now including July stats) suggesting that Japanese investors are buying record volumes of Euro-denominated credit at present (chart 7).

Chart 7: Japanese net purchases of Euro Area corporate bonds (Eur bn, 12m sum)



Source: BofA Merrill Lynch, BoJ. Japanese buying proxied as the difference between Japanese net acquisition of € securities and Euro sovereign bonds, adjusted for covered bond buying.

But more broadly, the motivations of CSPP – just as Draghi described them in 2016 – read as very supportive for credit. With the Corporate Sector Purchase Programme, the ECB aims to:

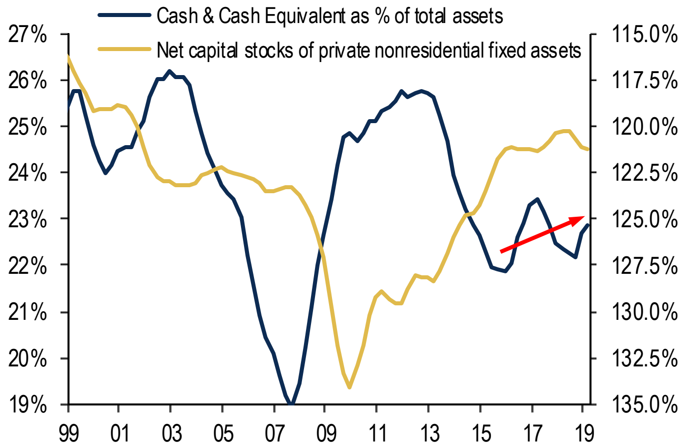
- Ease financial conditions,
- Reduce fragmentation across the corporate bond market, and
- Provide access to credit to those companies most in need.

For us, this reads simply as "tighten spreads and reduce dispersion"…and so **we expect CSPP2.0 to again be bullish for beta**.

The tougher challenge will be to ensure that CSPP drives a genuine revival in corporate "animal spirits" as opposed to cash hoarding by companies. The evidence from CSPP1.0 was disappointing, in our view. The open-ended nature of this QE will likely help to rekindle some CFOs' thirst for taking more balance sheet risk, but we still think that it will be an upwards battle.

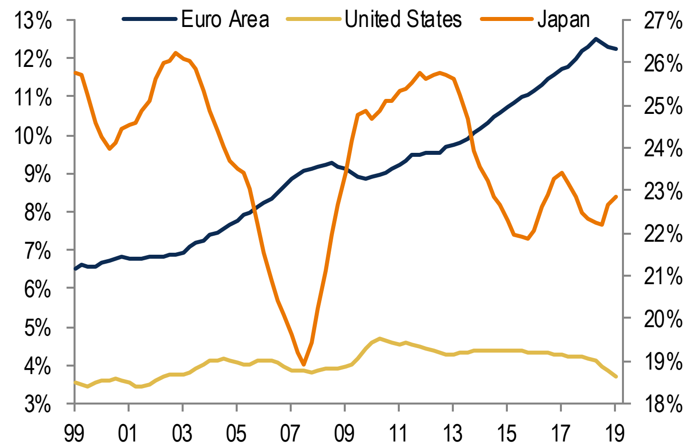
Note that Japanese corporate cash levels (as a % of total assets) stopped falling in mid-2016, around the time where the BoJ started Yield Curve Control, and Japanese corporate capex has gone sideways since.

Chart 8: Japanese non-financial corporations' holdings of cash have risen lately, holding down productive investment (RHS)



Source: BofA Merrill Lynch Global Research, Japan Cabinet Office, Haver. Net capital stocks of private non-residential fixed assets expressed as % GDP.

Chart 9: Japanese non-financial corporations' cash holdings (% total assets) are much larger than in the Euro Area (LHS) and the US (LHS)



Source: BofA Merrill Lynch, Japan Cabinet Office, Federal reserve, ECB, Haver. Cash to total assets.

The CSPP2.0 trades

In our note last week, we argued that the initial phase of corporate bond buying by the ECB would be targeted towards those sectors that have been prolific bond issuers this year. The ECB would need to "rebalance" its corporate bond portfolio to bring it back to market neutrality.

- The high-grade sectors likely to see the initial squeeze due to this are **autos**, **healthcare**, **media** and **real estate**.

Over the medium-term, though, how much of each sector is CSPP eligible is also important in driving QE sentiment. Below we show how CSPP-eligibility has changed for parts of the market since the original programme was announced in March-16.

What stands out as having changed a lot?

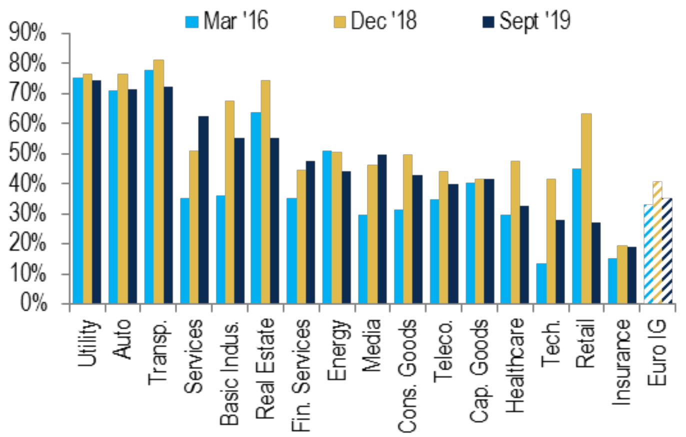
- The % **eligibility of the industrials sector has risen** since March '16 by about 10-20%. Hence CSPP2.0 feels more bullish over the medium-term for this part of the market.

- Conversely, the % **eligibility of the retail sector has fallen** by about 20%.

- In high-yield, **telecoms are less CSPP-friendly** than before, due to Telecom Italia no longer being eligible (Fitch now rate the company BB+).

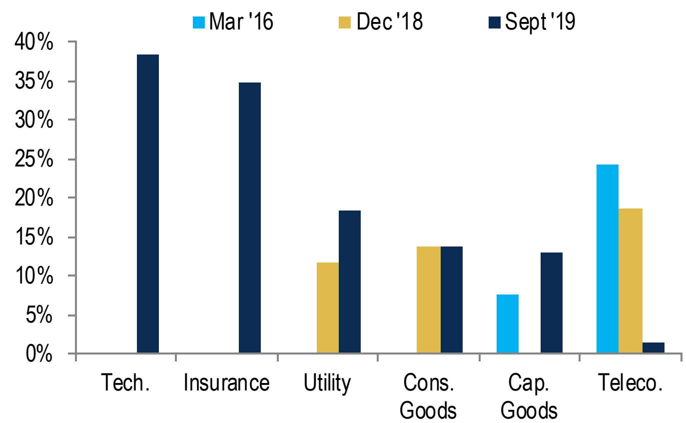
- That said, a greater number of high-yield sectors now have some eligible bonds, so positive CSPP sentiment could be a lot broader for high-yield this time.

Chart 10: CSPP eligibility: Euro IG: March '16, end '18 and today



Source: BofA Merrill Lynch Global Research, ICE Data LLC, ECB.% of a sector that is eligible.

Chart 11: CSPP eligibility: Euro HY: March '16, end '18 and today

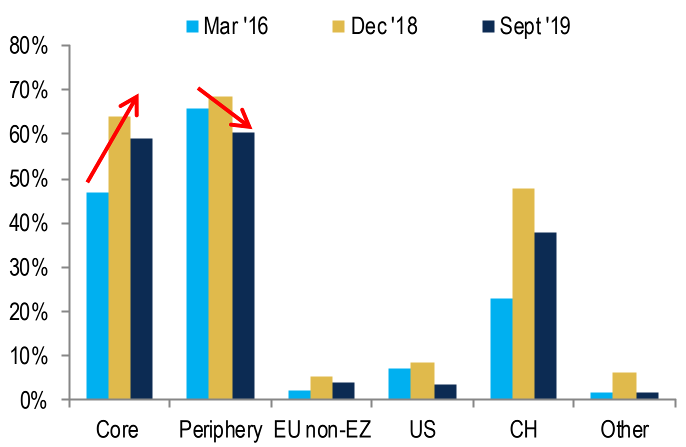


Source: BofA Merrill Lynch Global Research, ICE Data LLC, ECB. % of a sector that is eligible.

- Elsewhere, CSPP feels slightly more **bullish for core credits** than for the periphery, compared to the situation in March '16 (chart 12).

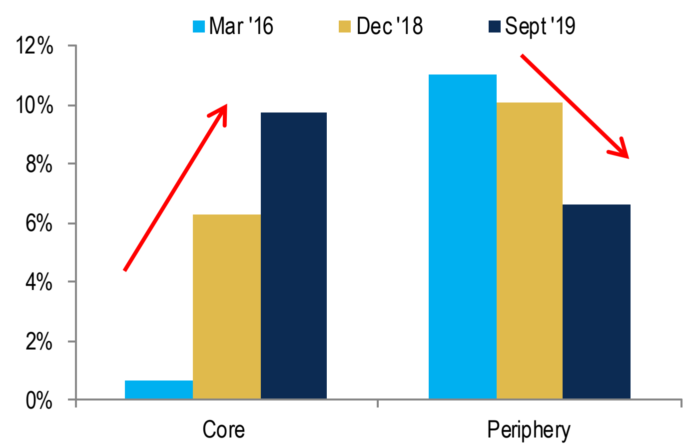
- Likewise in high-yield, which is reflective of the Telecom Italia change (chart 13).

Chart 12: CSPP sector eligibility: Euro iG, by country of risk: March '16, end '18 and today



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

Chart 13: CSPP sector eligibility: Euro HY, by country of risk: March '16, end '18 and today



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

QE for the world

As with CSPP1.0 the ECB will have flexibility to buy bonds from companies where the ultimate country of risk is outside of the Euro Area, but where the issuing entity is domiciled in the Eurozone (subject to the bonds being ECB eligible collateral).

This means that the CSPP will have ripple effects for all corporate bond markets across the globe, but especially the Swiss credit market and (to a lesser extent) the US credit market, as chart 12 shows.

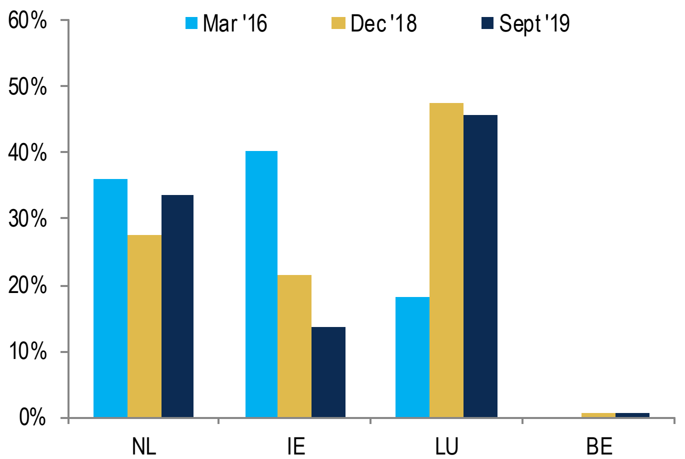
- The % proportion of CSPP eligible US names is slightly smaller today than in March-16. Note that some big recent Reverse Yankee deals such as Medtronic Global Holdings do not appear of the ECB's eligible as collateral list.

- However, the country to which CSPP feels *more* friendly towards, this time, is Switzerland. Note chart 12 shows that almost 40% of Swiss credits are CSPP eligible today compared to just 23% in March '16.

Bank of America Merrill Lynch

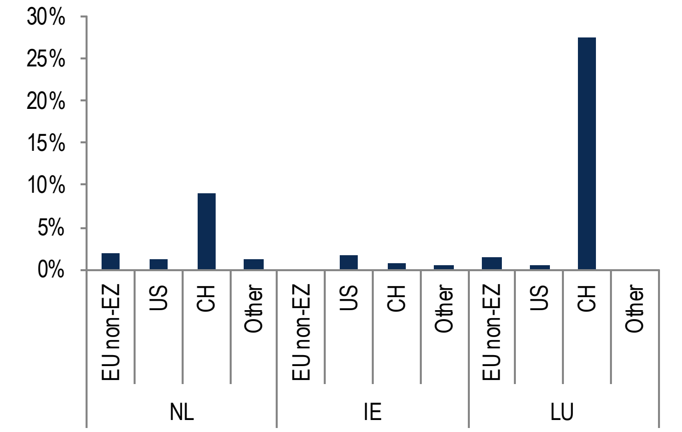
The charts below show that Dutch and Luxembourg issuing entities are the most common issuing vehicles for non-Eurozone companies at present.

Chart 14: Where is the non-Eurozone, eligible, debt issued from?



Source: BofA Merrill Lynch Global Research, ICE Data LLC, ECB. % of ER00.

Chart 15: Where do non-Eurozone firms issue their eligible bonds?



Source: BofA Merrill Lynch, ICE Data LLC, ECB. % of country outstanding debt issued in various Eurozone domiciles.

Long eligible for the short-run...

The lesson from CSPP1.0 was that the market **initially chased CSPP-eligible names** (so as to buy exactly what the central bank was buying). But as time wore on, investors then rotated out of eligible into non-eligible names to "escape the crowd" and to achieve better yields.

Chart 16 is a reminder of how this played out. Eligible spreads outperformed non-eligible spreads from the March '16 CSPP announcement until the end of July '16. Then from August '16 to November '16 non-eligible spreads kept tightening while eligible spreads drifted wider.

Chart 16: CSPP eligible and non-eligible credit spreads (OAS spreads)

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

Chart 17: Spread ratio (x) for non-eligible debt/eligible debt

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

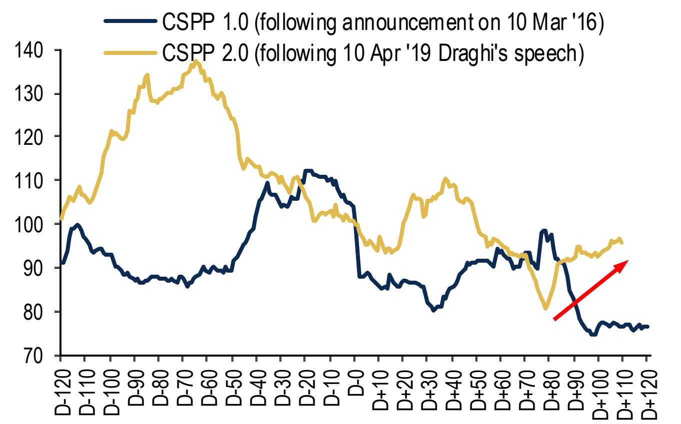
Chart 17 shows that, true to form, the market began to chase eligible names from April to August this year, as the return of QE was anticipated. Yet it looks like half of this move has reversed over the last fortnight as the market began to doubt Draghi's ability to deliver.

Hence, we see eligible bonds as having room again to outperform in the short-term.

Chart 18 below reinforces our point here. We show eligible spreads heading into the various CSPP announcements.

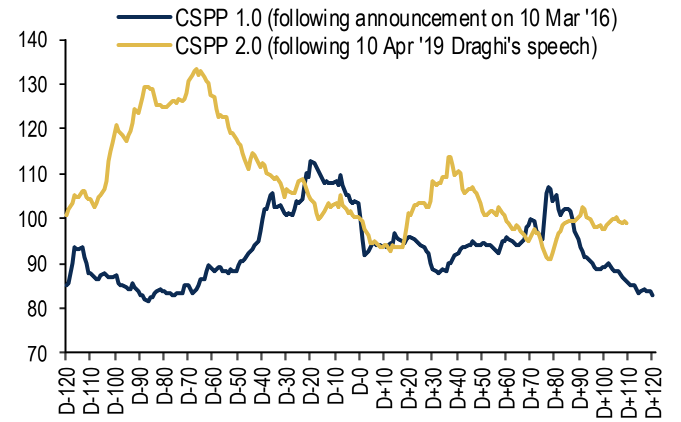
- As we highlight, eligible spreads have wobbled over the last fortnight, and in the short-term look relatively attractive again

Chart 18: How have eligible bonds performed following major policy announcements? OAS spreads



Source: BofA Merrill Lynch, ICE Data LLC. Tracking spreads days before and after CSPP announcement. Non-eligible includes AT1s and corp hybrids, but not HY.

Chart 19: How have non-eligible bonds performed following major policy announcements? OAS spreads



Source: BofA Merrill Lynch, ICE Data LLC. Tracking spreads days before and after CSPP announcement. Non-eligible includes AT1s and corp hybrids, but not HY.

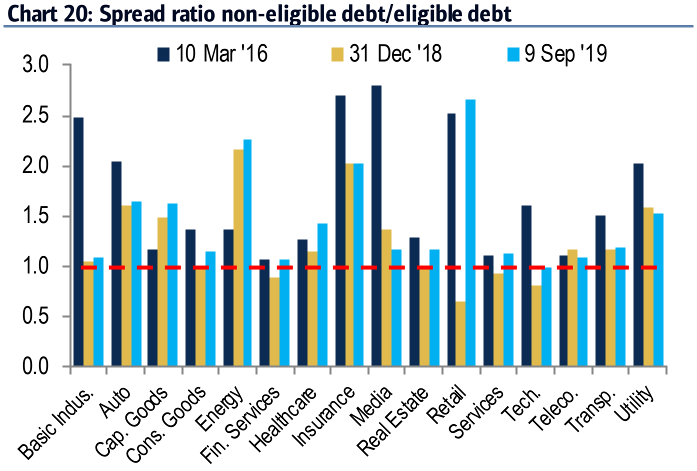
...But long non-eligible for infinity

Over the medium term, though, we think investors will again be forced to crowd into non-eligible parts of the market. Down the line, therefore, we think that this bodes well for:

- **AT1s**, which also widened a bit in August on the back on Argentina and Brexit concerns, and

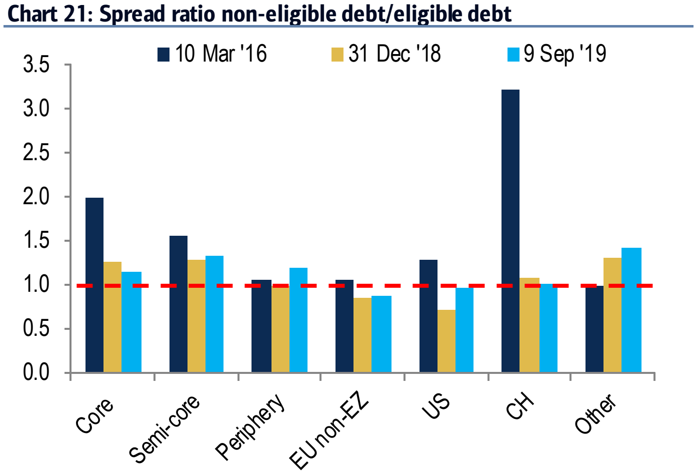
- **Single Bs**, which look very wide to BBs in Europe, albeit idiosyncratic risk is still high in single-Bs at present (note the high number of plunging bonds).

Chart 20: Spread ratio non-eligible debt/eligible debt



Source: BofA Merrill Lynch, ICE Data LLC, ECB. Non-eligible includes AT1s and corp hybrids, but not HY.

Chart 21: Spread ratio non-eligible debt/eligible debt



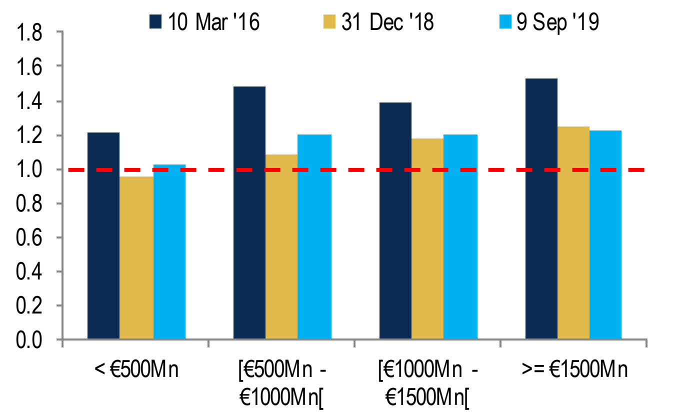
Source: BofA Merrill Lynch, ICE Data LLC, ECB. Non-eligible includes AT1s and corp hybrids, but not HY.

Where else are non-eligible spreads relatively cheap still, when looking across sector and domicile? The charts above and below show non-eligible/eligible spread ratios:

- By sector, non-eligible spreads look interesting still in **energy**, **insurance**, **retail**, **autos** and **industrials** (chart 20)

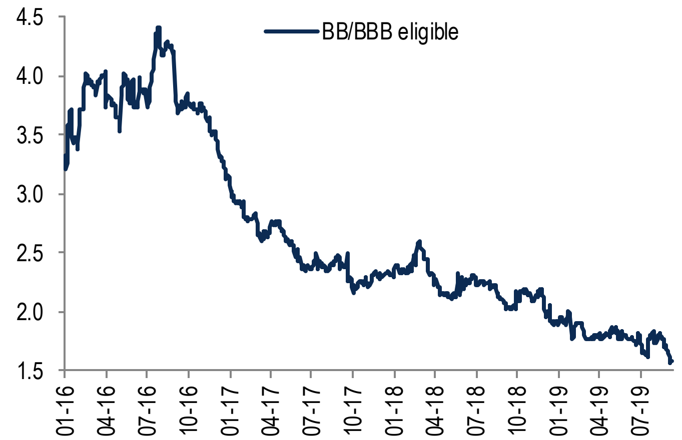
- By country, non-eligible spreads also look interesting in semi-core sectors such as **France**.
- Finally, by size of bond, there appears to be a slightly better value proposition in **larger non-eligible bonds**, rather than smaller non-eligible bonds.

Chart 22: Spread ratio non-eligible debt/eligible debt, by size of bond



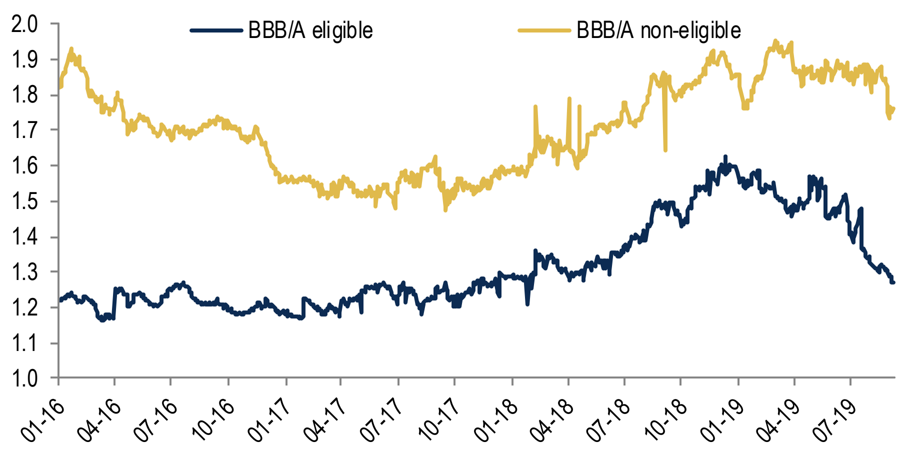
Source: BofA Merrill Lynch Global Research, ICE Data LLC, ECB.

Chart 23: BB credit looks tight at this juncture. We think the cheaper non-eligible sector in HY is single-Bs



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

Chart 24: Beta compression still has some way to go in the non-eligible universe (spread ratios).



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

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*
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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