Credit Convictions in 2020

Quantitative healing

Bank of America Merrill Lynch

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Credit Strategy
Europe
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Goldilocks buys bonds

We think 2020 is shaping up to be the "the year of Europe" – a time when perceptions of the region improve on the back of simmering trade tensions, a Eurozone economy that returns to above-trend growth and QE "Infinity" that provides the ultimate safety net for investors. We think spreads will head tighter again in this environment, to the tune of 15bp for IG. But markets are at risk of getting too bubbly, we think. A strong start could well give way to choppier conditions later in the year.

Winning in a world of QE "infinity"

Everywhere we look, we think the message is one of (spread) compression. In a CSPP (Corporate Sector Purchase Programme)-driven world, money will invariably gravitate to non-eligible parts of the market, and this bodes well for the performance and high-yield and subordinated debt. Moreover, ECB bond purchases will create a credit market split between the "haves" and the "have nots". We see this motivating companies to deleverage to stay in – or to be welcomed into – the CSPP-eligible club. Technicals might prove to be the best fundamentals in '20.

Riding the wave of financial repression

Today, central banks have upended the natural order of financial markets like never before. Although negative yields are a boon for corporate bond demand, if left unchecked they are also an instigator of hubris. We see Euro credit markets experiencing tremendous growth in the years ahead. But herein lies the risk. Investors need to be extra vigilant to the weaker quality of issuers arriving in the market today, with many the by-product of bank disintermediation. Our work shows that corporate leverage in Europe is now clearly rising when accounting for the influx of "debut" names.

Fiscal Frenzy or Quantitative Failure?

The 2020s will likely be defined by the "hand-off" from monetary policy to fiscal policy. But we think the reality is that there can be no fiscal without the still-calming effect of central banks. Coordinated poorly, and the risk is that yields surge, popping the bond bubble. Irrespective, greater fiscal noise in 2020 will be bullish for those parts of the market – such as German credit – which have a much greater share of manufacturers.

What to do for 2020?

- We think down-in-quality trades are the right ones for 2020, given an improving Eurozone growth outlook. In high-grade we think BBBs are the place to be.
- In a "QE infinity" world, we believe it will be non-eligible sectors that will be the ultimate beneficiaries.
- We favour exporters over domestic credits, as global trade volumes will likely experience a bounce. By sector, we think exporters look cheapest in autos, cap goods and retail.
- 2020 will invariably hear more noise on the "fiscal stimulus" front. This should create positive sentiment for tech, energy and telecoms sectors, in particular.

While we think that bond curves are generally flat now (and prefer CDS curve flatteners).

Refer to important disclosures on page 23 to 25. **12069716**

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European credit: quantitative healing

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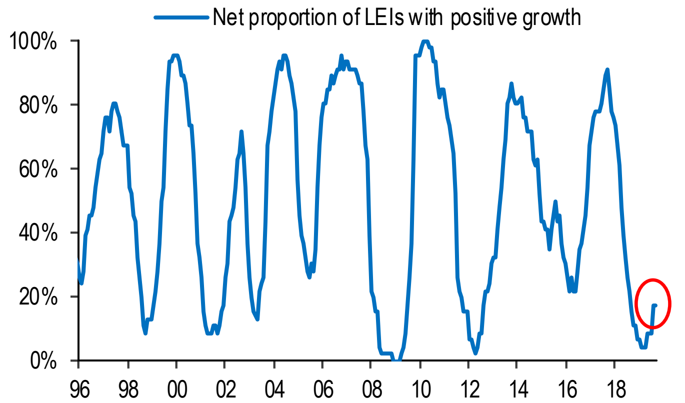
We think 2020 is shaping up to be the "the year of Europe" – a time when perceptions of the region improve on the back of simmering trade tensions, a Eurozone economy that returns to above-trend growth and QE "infinity" that provides the ultimate safety blanket for markets. We think global capital – in both equity and credit form – will buy back into Europe, pushing asset prices higher. Amid this supportive backdrop, we see credit heading tighter for another year – to the tune of 15bp for high-grade – pointing to excess returns of around 2% for IG ...still positive for a credit cycle that is now over a decade old.

In fact, conditions seem close to ideal for corporate bonds heading into the start of 2020, and we would not be surprised if spreads lurched tighter in the early months. Global cyclical data looks to be bouncing (note the encouraging signs in OECD Lead Indicator breadth, and the increase in global PMI New Export Orders), progress on US-China trade should be good news for sentiment towards open economies such as the Eurozone, and the ECB is back buying copious amounts of corporate bonds. We think spread compression should be the stand-out theme in this environment as investor flows gravitate towards non-eligible sectors (read high-yield and subordinated financials).

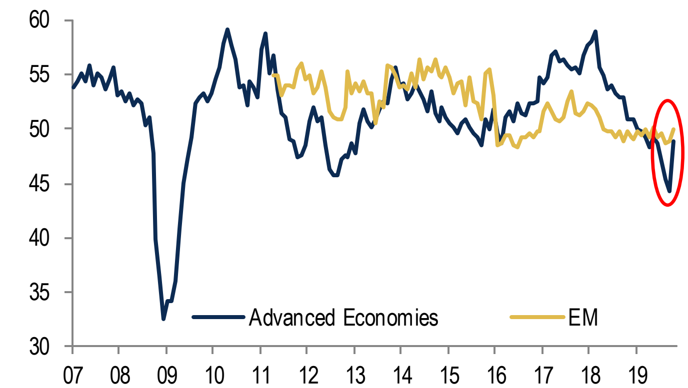
But with "goldilocks" there is always a risk...and in this case we think the risk is hubris. We see spreads prone to overshooting tighter in the early part of '20 and then remaining in a more volatile trading range until year-end as valuations lose their lustre.

Chart 1: "Breadth" of OECD Lead indicators looks to be bouncing



Source: BofA Merrill Lynch Global Research, OECD. Net % of global OECD LEI's with +ve YoY growth.

Chart 2: Global PMI New Export Orders showing signs of life

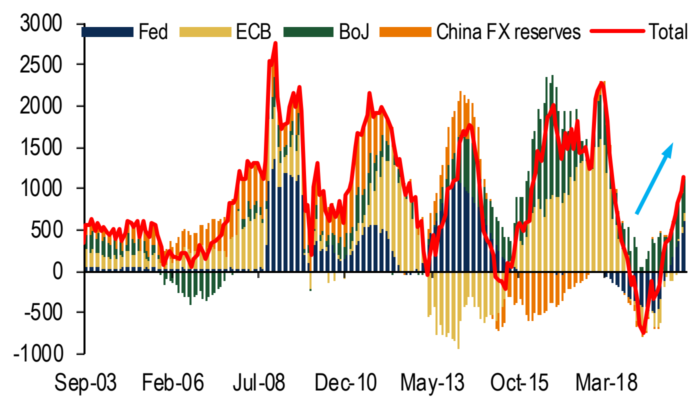


Source: BofA Merrill Lynch Global Research, Markit, Bloomberg.

Chart 3: Global M1 growth has moved higher too lately (%)

Source: BofA Merrill Lynch Global Research, Bloomberg. IP (RHS).

Chart 4: Global CB balance sheet expansion ($bn YoY growth)



Source: BofA Merrill Lynch Global Research, Bloomberg. YoY changes, converting all B/S amounts into USD equivs.

If 2019 taught markets one thing, it was that monetary policy still defines the bull market. Returns were strong across the board, and all thanks to another "whatever it takes" moment – in the form of 71 (net) rate cuts by central banks across the globe. And today, global central bank balance sheets are expanding again at a rapid pace.

Yet we are cognizant that more central banks (especially European ones) are starting to acknowledge the limitations – and side effects – of their policies. The risk next year, in our view, is that the dovish central bank message becomes a lot less pure. This year, European credit absorbed over half a trillion of issuance in its stride precisely because the central bank "put" was so dominant. But next year, a more garbled narrative from monetary authorities may leave Euro credit prone to bigger and fatter trading ranges (in contrast, 2019 was generally a year of one-way tighter spreads).

As markets ride the QE "infinity" wave, moral hazard will be rife, and investors should be ultra-vigilant to how stellar credit market growth is making the system "riskier". We find corporate bond market leverage is rising when accounting for the constant influx of debut (and foreign) issuers. Little of this should change in '20 given super-low bond funding costs in Europe, and signs that banks are becoming less willing to lend.

Our key recommendations and themes for 2020 are:

- We think **compression** ("down in quality") trades will be the big narrative next year as CSPP buying is skewed to the riskier parts of the credit market, and the economy recovers. That means BBBs should be the clear outperformers across high-grade.

- In a “QE infinity” world, we believe it will be **non-eligible** sectors that will be the ultimate beneficiaries. We expect a strong risk-adjusted outperformance of high-yield, subordinated securities and bank capital markets in Europe, next year.
- We favour **exporters** over domestic credits as global trade volumes likely bounce. By sector, we think exporters look the cheapest in **autos**, **capital goods** and **retail**.
- 2020 will invariably hear more noise on the “fiscal stimulus” front (even if just wishful thinking from central bankers). This should create positive sentiment for those parts of the credit market that have the greatest share of manufacturing companies: **German** credits should be the beneficiaries here.
- Curve wise, **front-end high-yield bonds** still look wide vis-à-vis their high-grade counterparts, which have responded quickly to the new (more bullish) rules of CSPP.

Winning in a world of QE “infinity”

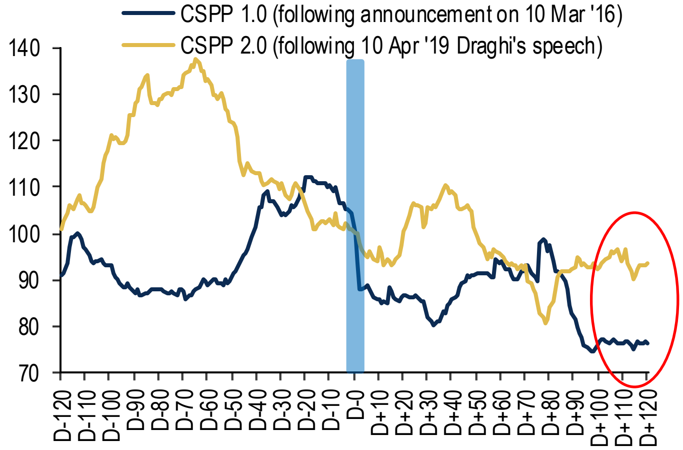
Draghi’s parting gift to the Euro credit market was a potentially infinite Quantitative Easing programme. We continue to see the Corporate Sector Purchase Programme as a bullish tailwind for the market. Just as in the past, we think that CSPP should change the “rules of engagement” for credit investing going forward:

- We believe that the Corporate Sector Purchase Programme will encourage credit markets to assess risk based simply on the “the haves” (names being eligible) and “the have nots” (names being non-eligible).
- For better or worse, the consequence is that eligible names will become less sensitive to weaker macro/fundamental newsflow (up to a point). Although it creates other risks: high-grade names should gap a lot wider than normally would be the case upon a downgrade to non-eligible status.

While it is early days, the numbers thus far suggest the ECB is buying more corporate bonds than the market had expected. Reducing the pressure on government debt buying may be one reason for this. Nonetheless, we still don’t think QE is totally in the price for Euro credit, and we think spreads can take **another leg tighter** early in 2020 as they play “catch up”.

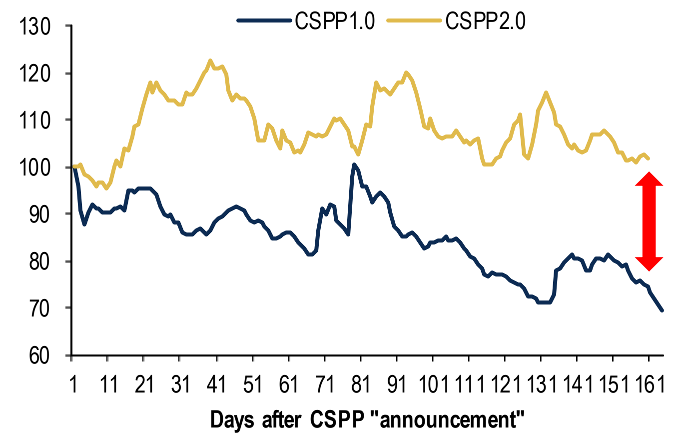
- The charts below show the progression of credit spreads this year versus CSPP1 in 2016. We overlay spreads from the time that the policies were announced (March ’16 and April ’19, respectively).
- As can be seen, back in 2016, there were two distinct episodes of spread tightening: one when CSPP was announced (March) and another when the buying began in earnest (June). Looking at how IG spreads have reacted this year, while the first leg of tightening is clear, the second leg of the rally has yet to play out.
- In particular, single-B bonds look very cheap at this juncture, when comparing the two CSPP episodes.

Chart 5: How have eligible bonds performed following CSPP 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 6: 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).

Bullish for compression

Over the medium term though, we think that there is one clear takeaway from a CSPP world – **that it is bullish for spread compression across credit markets**. We see this playing out in two ways:

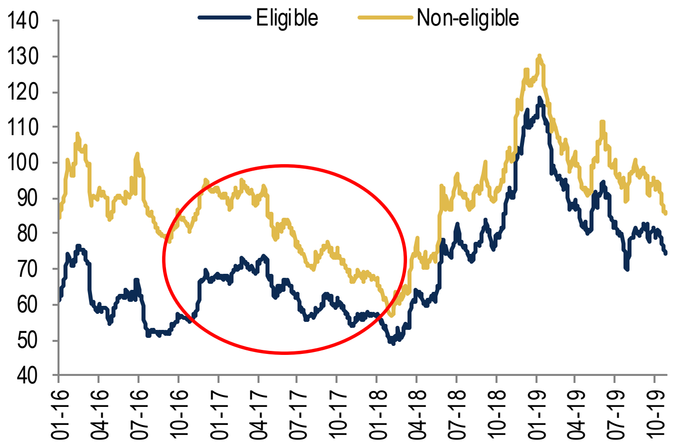
- Firstly, we believe that investors will gravitate towards buying non-eligible parts of the market (i.e., those that the ECB isn't buying). Why? To stay within sectors where spreads should better reflect fundamentals. This bodes well, over the medium term, for corporate hybrids and US IG credit, in our view.

Note the Q3 '16 to Q3 '17 pattern: high-yield (-154bp) significantly outperformed high-grade (-17bp) as investors embraced non-eligibles. We think the same investor rotation to play-out this time around.

- Secondly, the ECB have shown an inclination to try and compress spreads and reduce fragmentation across the credit market, with the aim of achieving maximum transmission of monetary policy in Europe. This will bode well for lower-rated pockets of the Euro IG market.

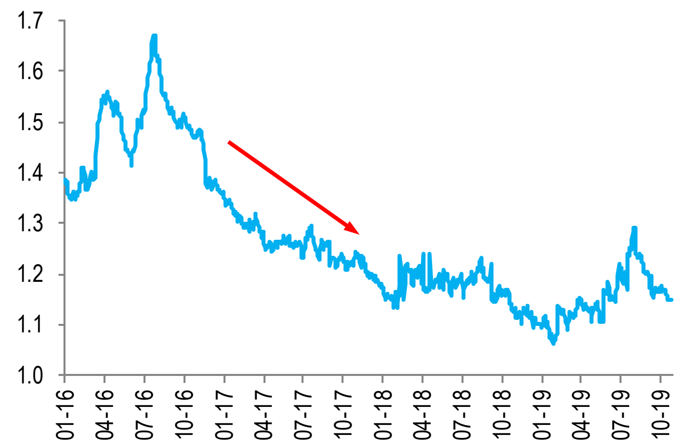
In the past, the ECB have highlighted that buying only higher-quality bonds would render CSPP ineffective. Taking "risk" with the programme is thus integral to its success, even if it leaves the ECB exposed to potential Fallen Angels down the line.

Chart 7: Non-eligibles rallied in '17: we think this is the playbook now



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

Chart 8: Eligible/non-eligible spread ratio



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

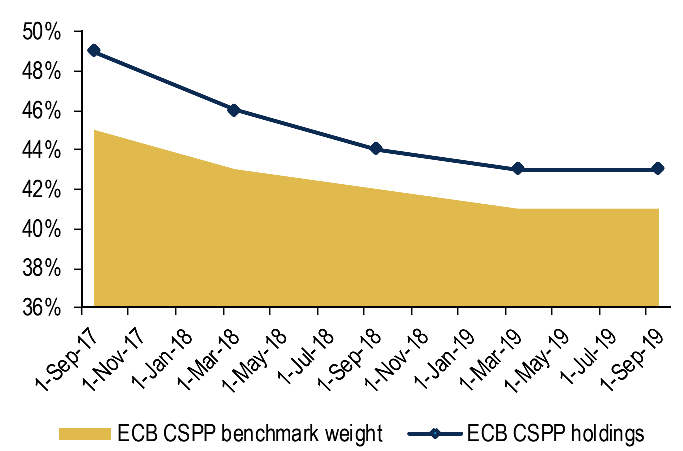
The charts below show the ECB's credit holdings in relation to their "benchmark". Note the tendency for the ECB to divert purchases towards lower-rated (i.e., riskier) pockets of the Euro corporate bond market.

- The ECB's holdings of BBBs, for instance, have always been greater than their "benchmark". And likewise for their holdings of Spanish corporate bonds.

On the other hand, the ECB have shown a tendency to underweight higher-rated (i.e., less risky) pockets of the market.

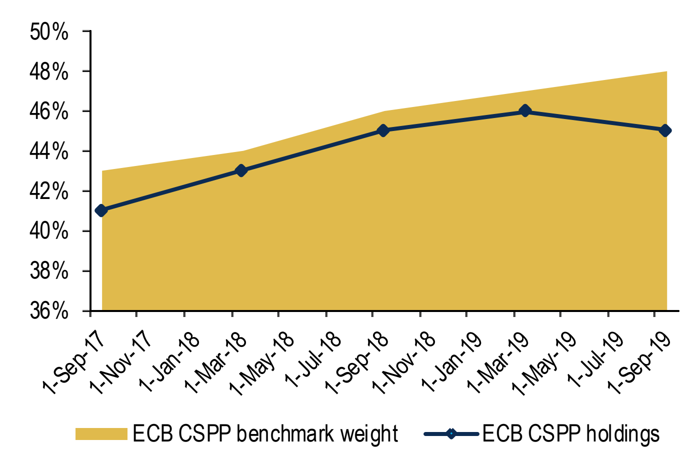
- The ECB have always been underweight single-As, and French credits, for example.

Chart 9: The ECB have consistently "overweighted" lower-rated (i.e., riskier) parts of the Euro credit market: BBB credits



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

Chart 10: Yet, the ECB have consistently "underweighted" higher-rated (i.e., less riskier) parts of the Euro credit market: A-rated credits



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

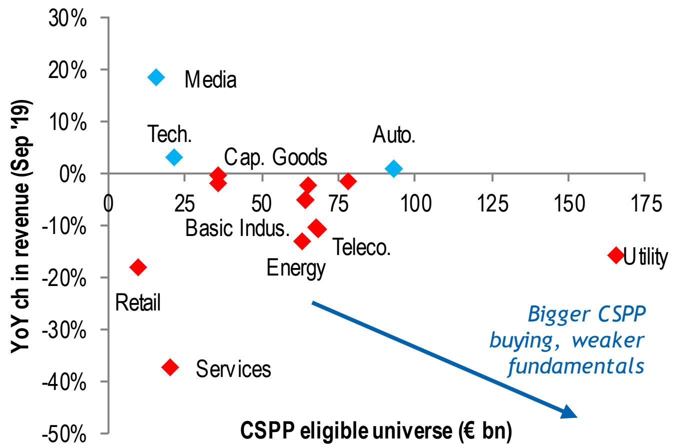
Surviving in a world of moral hazard

Despite the bullish tailwinds of CSPP, though, the uncomfortable truth is that the Euro credit market could be rife with moral hazard in 2020.

CSPP suggests that the ECB could be drawn into supporting the riskier parts of the market. We think this is even more the case with CSPP2.0 compared to CSPP1.0, because today's eligible universe is more geared towards lower-rated names given the wave of issuance from cyclical companies in '19 (autos, for instance).

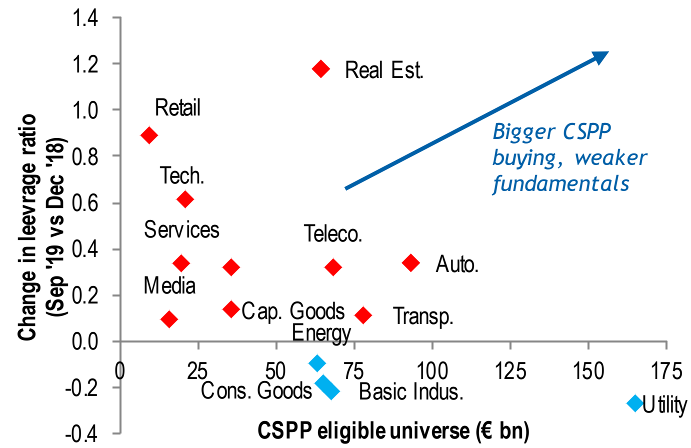
The charts below suggest that the ECB will tend to buy more of sectors (based on their size within the eligible universe) where revenue and leverage trends are on the weaker side. Thus credit spreads in '20 may do a poorer job in differentiating names based on fundamentals, and investors have to be ultra-vigilant towards this.

Chart 11: Some of the biggest CSPP sectors have seen negative revenue momentum over the last year



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

Chart 12: Some of the biggest CSPP sectors have seen leverage rise over the last year



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

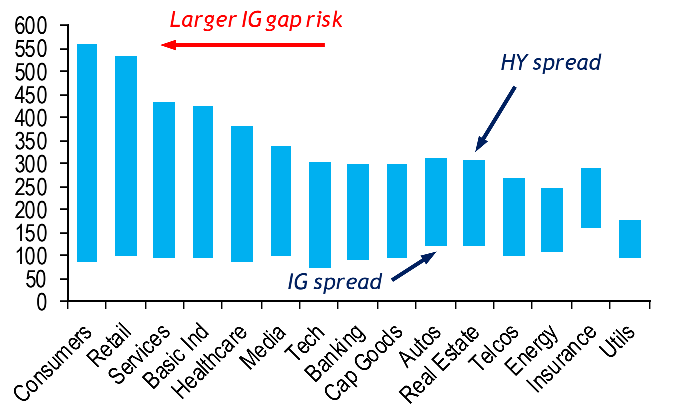
The flip side to this is that investors need to be alert to heightened "gap risk" should credits disappoint fundamentally and price-out CSPP eligibility.

- Chart 13 shows where this is most prevalent. We show the high-yield vs. high-grade spread gap for sectors. Those to the left have the largest differences between their spreads – and thus high-grade names could see big shocks wider should their IG (CSPP-eligible) status be questioned.

But history suggests that there is also a good fundamental message that emerges from a CSPP world – namely that high-yield companies will be motivated to deleverage to improve credit metrics and potentially be upgraded into the CSPP "club".

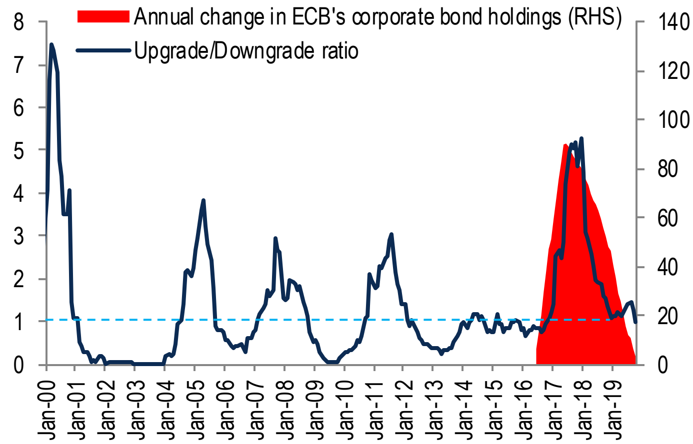
- One striking feature of the previous CSPP-cycle was that the high-yield upgrade/downgrade ratio surged to an impressive 5:1 in 2017, commensurate with the growth in the ECB's holdings of corporate bonds.

Chart 13: Where's the gap risk? Difference between high-yield and high-grade spreads (bp)



Source: BofA Merrill Lynch Global Research, Difference in sector spreads, HY vs IG.

Chart 14: A sizable rating upgrade cycle in high-yield followed the launch of CSPP in Jun '16. Technicals were the best fundamentals back then.

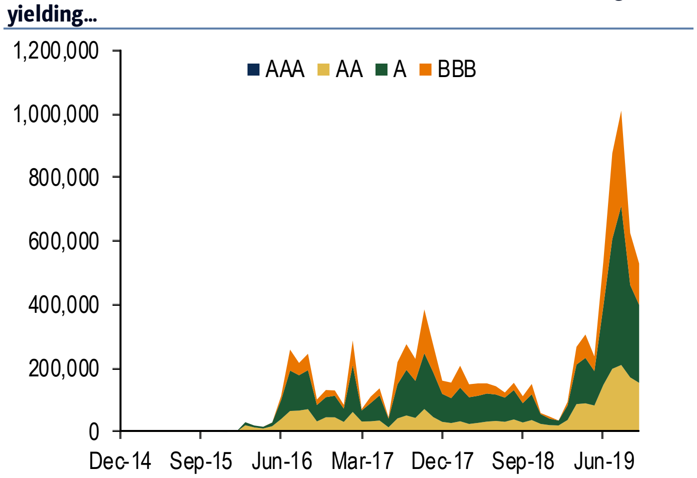


Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC. ECB holdings Euro bn. HY 12m upgrade/downgrade ratio.

Riding the wave of financial repression

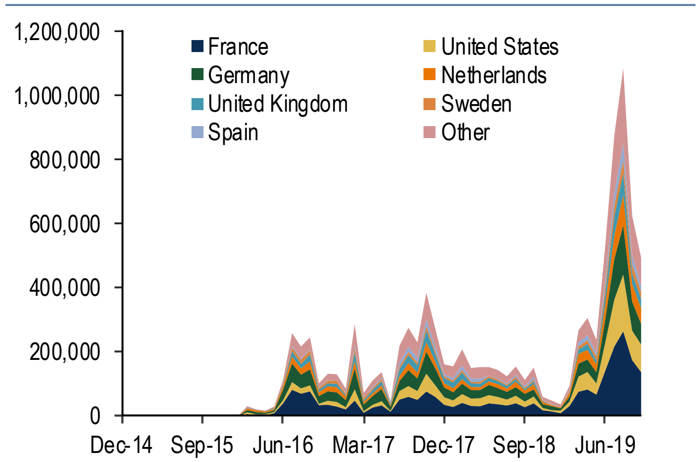
In 2019 the negative yield phenomenon went mainstream. Today, there is around half a trillion Euros of corporate bonds (around 20%-25% of the market) that are negative yielding. And it's not just European bellwether names that are enjoying this topsy-turvy world, foreign issuers contribute plenty to the backdrop: note that just under 20% of all negative-yielding Euro bonds are from US issuers, and just under 10% are from UK names. Home bias is clearly not an impediment to issuing negative debt.

Chart 15: While down, 20%-25% of the Euro IG market is still negative yielding...



Source: BofA Merrill Lynch Global Research. Eur mn.

Chart 16: Foreign issuers make up a large part of the negative yielding debt stock in Euros

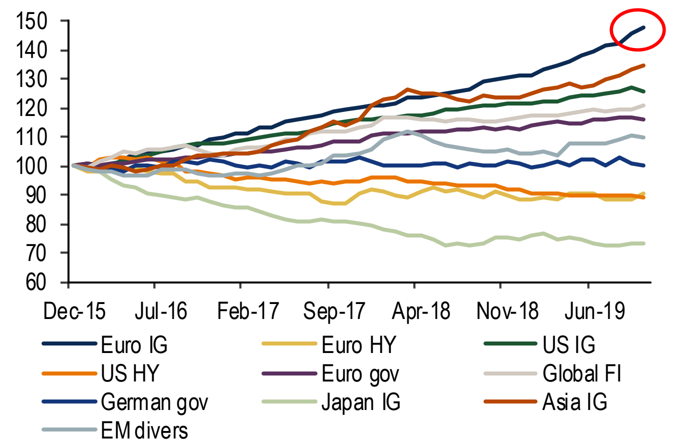


Source: BofA Merrill Lynch Global Research. Eur mn.

To infinity and beyond

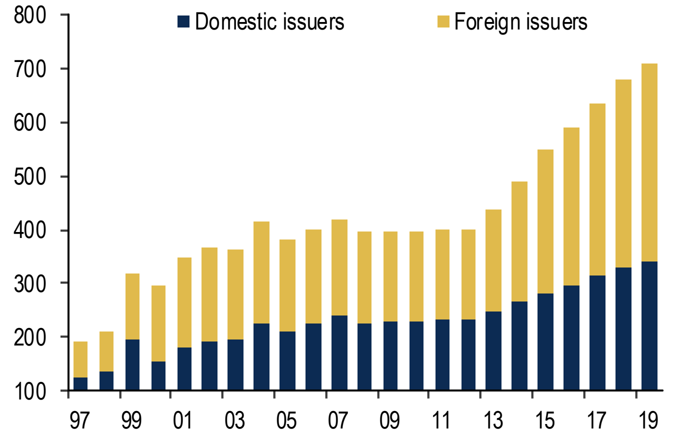
The consequence of this is that the Euro corporate bond market will continue to experience rapid growth rates over the years ahead, as negative-yielding Euro bonds will increasingly be viewed as an "asset" by companies. The Euro IG market has indeed seen one of the fastest growth rates of all bond markets over the last 12m (18%). In this respect, 2019's record €525bn of (expected) supply now feels like the norm for the Euro high-grade market, rather than the exception.

Chart 17: Negative rates have unleased tremendous growth for Euro IG (cumulative market growth rates from 2016, rebalanced to 100)



Source: BofA Merrill Lynch Global Research. Face value, rebalanced to 100. Euro IG market circled.

Chart 18: Foreign issuers increasingly coming to Euro IG in search of negative yields (number of companies, by domicile)



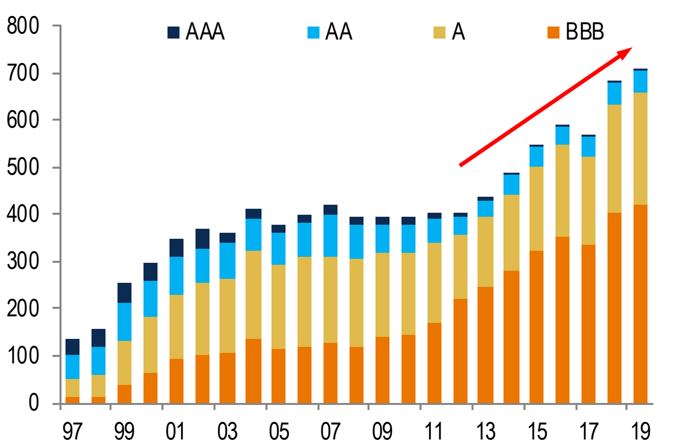
Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC.

Because of the allure of negative-yielding bond issuance, the Euro credit market is becoming more cosmopolitan than ever.

Chart 18 shows the growth in foreign issuers raising Euro debt. In fact, there are now far more non-Eurozone domiciled issuers in the Euro corporate bond market than Eurozone-domiciled issuers.

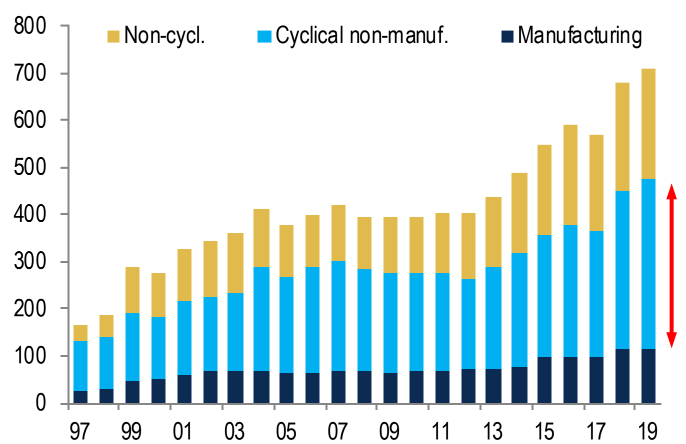
Moreover, as the charts below show, it is not just the same European issuers that are adding debt year-over-year. A large part of the growth of the Euro credit market of late has been due to "debut" names issuing, whether it be new European names or foreign companies exploiting super low funding costs in Europe (Reverse Yankees, Japanese, Chinese firms for instance). Today there are over 700 Euro high-grade issuers, up from 430 at the end of 2013 (the pre-ECB QE period).

Chart 19: Number of companies in Euro IG (ER00), by rating



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

Chart 20: Number of companies in Euro IG (ER00), by type

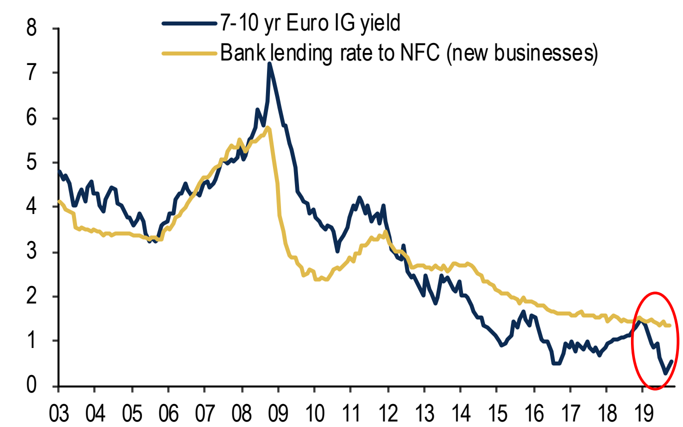


Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC. Manufacturing sectors are: autos, basic industry and capital goods.

Adding to this transformation is the Quantitative Failure theme (more on this later on). Banks are not easing credit standards to corporates in line with how quickly their bond market funding costs are falling. The upshot of this is that smaller companies – those that have traditionally been loan financed – have been motivated to repay their bank debt and move towards bond market financing…again keeping the supply of "debut" credits in Euro IG very high.

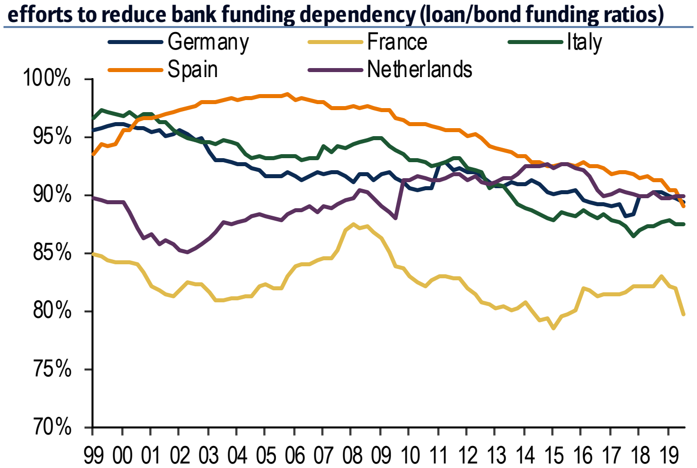
And as the chart below shows, there is plenty of wood still to chop. European companies have been quite slow in their quest to reduce loan reliance in favour of bond financing.

Chart 21: Bond market funding now looks very cheap vis-à-vis the bank market (%)



Source: BofA Merrill Lynch Global Research, Haver. Avg. interest rate on loans to NFCs.

Chart 22: Some Euro Area companies have seen slow progress in their efforts to reduce bank funding dependency (loan/bond funding ratios)



Source: BofA Merrill Lynch Global Research, Haver, ECB. It's the ratio of bank lending to NFCs over (bank lending to NFCs + outstanding amount of securities issued by NFCs)

Beauty is in the eye of the beholder

While plenty of new supply is great news for fund managers in search of diversification, investors need to be cognizant of how a rapidly changing and evolving Euro credit market is a risk unto itself.

- As Chart 20 shows, for instance, the Euro high-grade market has become more cyclical since the advent of QE in Europe and the growth of "debut" issuers. We would expect this trend to continue down the line.

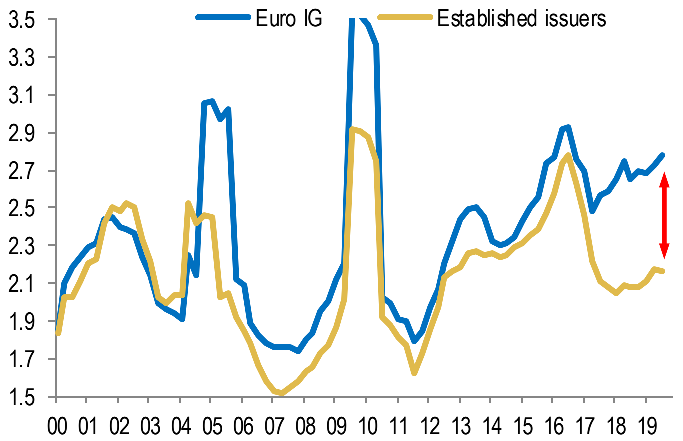
But more importantly, "debut" issuers – which are typically smaller, cyclical and less financially flexible – have added incremental leverage to the Euro high-grade market. Chart 23 makes this point. It tracks the average quarterly leverage of the overall Euro IG market, taking into account the new names that have appeared in the market as time has gone by.

- As can be seen, total high-grade leverage is now at a 3yr high of 2.6x. It has risen 0.4x since the start of ECB QE in Europe.

Yet, the chart also shows the leverage progression for a smaller subset of Euro high-grade established issuers – in this case those that have been around consistently since the early 2000s. Note here, though, that the message is somewhat different:

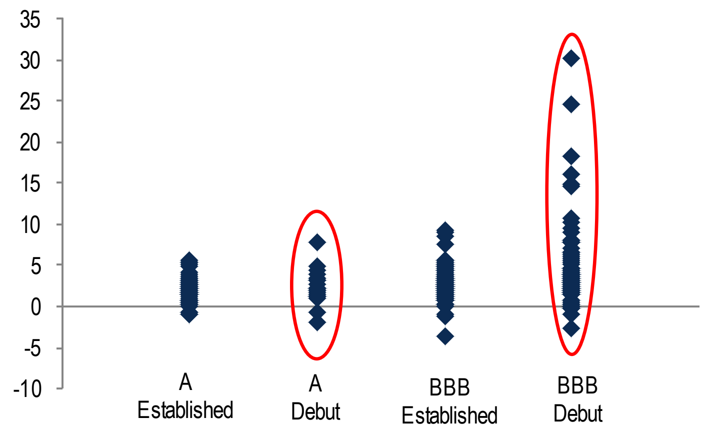
- Leverage for established issuers has been broadly stable since 2013 (despite the quick spike around the China '15 slowdown), and has been at a lower level of 2.2x.

Chart 23: Is corporate leverage what you really think it is in Europe? "Debut" issuers making Euro credit more risky (net debt/EBITDA)



Source: BofA Merrill Lynch Global Research, Bloomberg.

Chart 24: Leverage: "Established" vs. "debut" issuers. Debut names often come to the market with higher, and more dispersed, leverage



Source: BofA Merrill Lynch Global Research. 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).

Chart 24 shows the huge dispersion in fundamentals for these "debut" names, especially compared to "established" issuers. Note in particular, the leverage of "debut" BBB names can vary wildly (N.B. leverage for real estate companies tends to be very high).

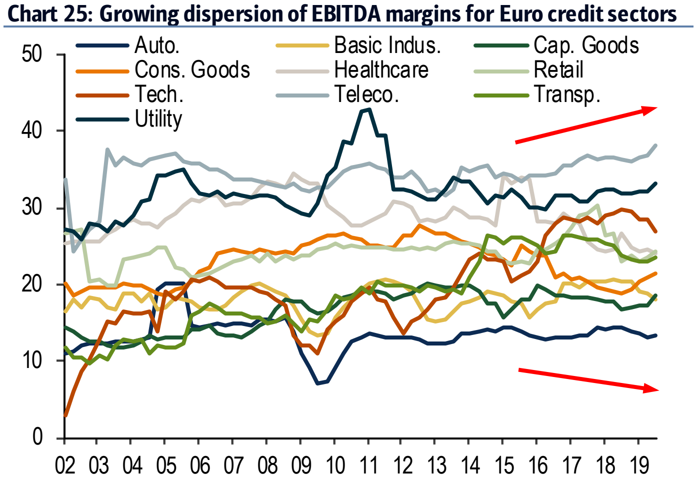
The fantastic dispersion

In 2020, credit investors need to be more attuned than ever to the potential dispersion in names arriving to the Euro credit market – and the differentiation in their fundamentals.

For instance, the charts below show the very different progression in EBITDA margins and cash on balance sheets across European credit sectors now. And the dispersion has become more apparent during the QE era in Europe.

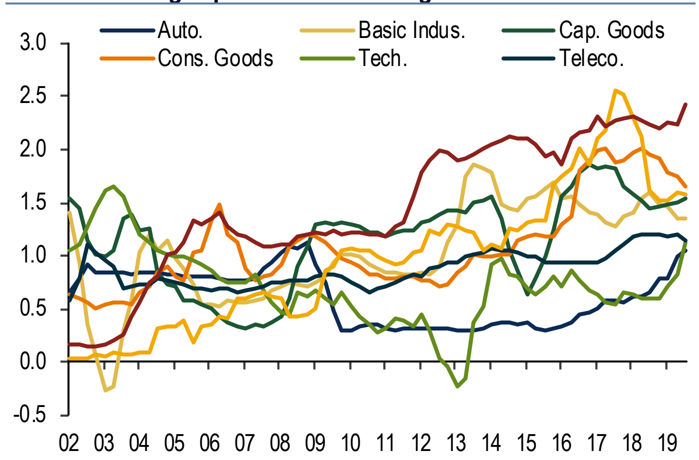
The conclusion is that while high-grade spreads may be heading for more compression, debt issuers are more varied fundamentally than perhaps they have ever been.

Chart 25: Growing dispersion of EBITDA margins for Euro credit sectors



Source: BofA Merrill Lynch Global Research, Bloomberg. EBITDA margins %.

Chart 26: Growing dispersion of cash holdings for Euro credit sectors

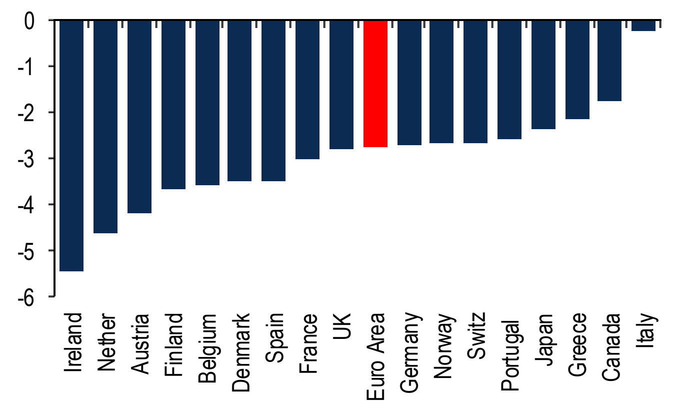


Source: BofA Merrill Lynch Global Research, Bloomberg. Standard deviation of cash holdings as % of total assets. Large sample of IG-rated non-financial corporations.

Fiscal Frenzy or Fiscal Fantasy?

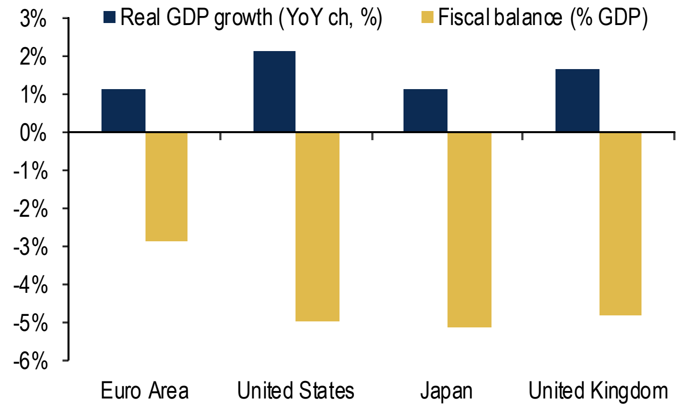
2020's catchphrase in Europe will likely be "fiscal". In fact, Mario Draghi's parting message was that European governments have to do more of the heavy lifting going forward, and take the growth burden off of monetary policy's shoulders. With interest rates so low in Europe, many countries have the space to do more fiscal spending without jeopardising their debt sustainability. And while fiscal spending can also vary in its efficacy (meaningful structural reforms vs. blunt tax cuts, for instance), Chart 28 shows that counties that have run higher fiscal deficits over the last decade have tended to have stronger rates of GDP growth.

Chart 27: "Fiscal space"? 7-10yr real rates less expected GDP growth, for a range of sovereigns



Source: BofA Merrill Lynch Global Research, ICE Data indices, LLC. Using '19 WEO forecasts. Using 7-10yr real govt. bond yields.

Chart 28: Countries with larger fiscal deficits have generally enjoyed stronger GDP growth (data over the last decade).

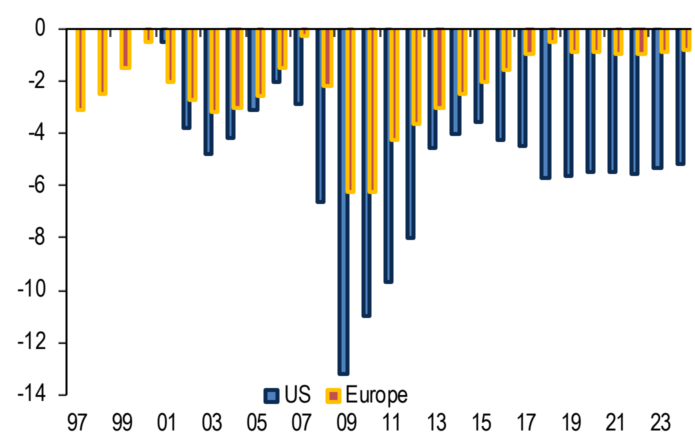


Source: BofA Merrill Lynch Global Research, Haver. Average real GDP growth YoY rates and average fiscal balance-to-GDP ratio observed between '09-Q3 and '19-Q2.

Institutions such as the OECD (Organisation for Economic Co-operation and Development) have been vocal in calling for a more optimal mix between fiscal and monetary policy going forward, especially as interest rates approach their zero lower bound in Europe.

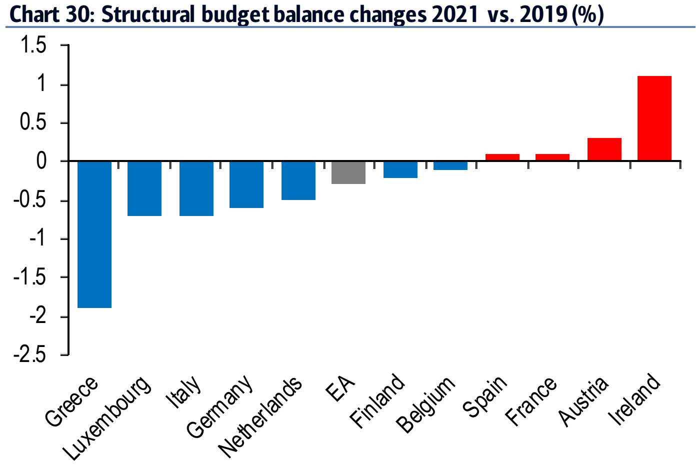
As Chart 29 shows, fiscal policy in the Euro Area has the room to become a lot more supportive. In fact, the Euro Area fiscal stance is projected to be only marginally expansionary over the next 3-4yrs, according to the latest European Commission data. Moreover, the Euro Area fiscal stance looks relatively restrictive when viewed in light of the deficits that the US is currently running (now at $1tr.)

Chart 29: Budget deficits: Eurozone fiscal policy is only a mild positive



Source: BofA Merrill Lynch Global Research, IMF Fiscal Monitor. General govt. balance (%).

Chart 30: Structural budget balance changes 2021 vs. 2019 (%)



Source: BofA Merrill Lynch Global Research, European Commission.

Modest – not big – fiscal expansion in Europe...

Is the market getting carried away with the fiscal buzzword? Chart 30 shows the European Commission's estimates for changes in the structural budget balance of major European countries (2019 vs. 2021). Fiscal loosening is forecast to be varied across countries, with some easing in Germany and the Netherlands, for instance, but almost no change in France and Spain (France eased in '19). Overall, note that the expected loosening in the structural balance for the Euro Area is forecast to be a modest ~0.3%.

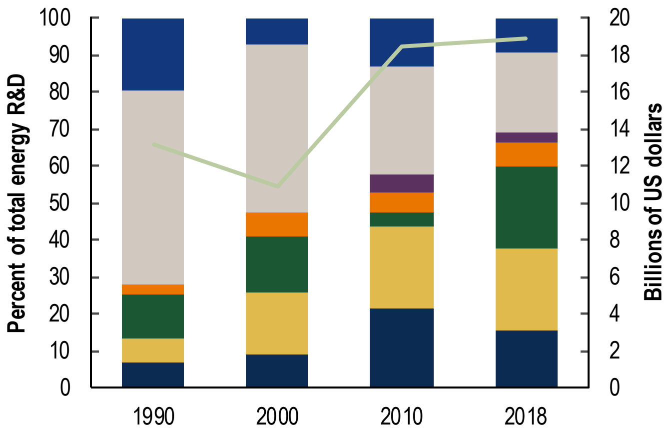
Bank of America Merrill Lynch

...but lots could still be done

That said, there are many areas where fiscal spending could be profitable for Europe, and thus the noise about fiscal policy is unlikely to die down. As we highlighted in *The European Credit Strategist*, 3 October 2019, public investment rates in some Eurozone countries (such as Germany) look woefully low in relation to other countries across the world, and have not recovered appreciably since their post-GFC (Global Financial Crisis) drop. Investment spending – when interest rates are negative – could support the economy's productive capacity, increase long-term trend growth rates and build economic resilience for the future.

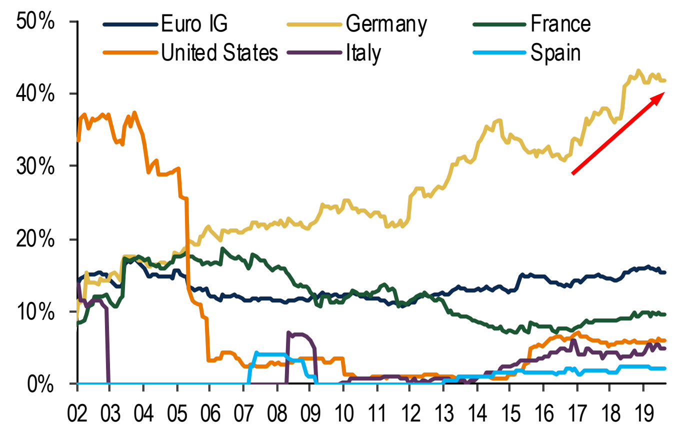
Much focus today – on the "right" types of fiscal spending – revolve around improving transport infrastructure, digital infrastructure and greater investment in health and education. Moreover, climate change is becoming a greater concern for EU citizens. And achieving carbon neutrality by 2050 will require significantly more investments.

Chart 31: Composition of Global Public Energy R&D, 1990-2018



Source: BofA Merrill Lynch Global Research, European Commission.

Chart 32: Share of high-grade credit, by country, that is "manufacturing"



Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC. % of manufacturing firms.

As the IMF recently highlighted, carbon taxes can go a long way to reducing reliance on fossil fuels and curbing the rise in greenhouse gasses...and the revenue raised can be redistributed to the poorer in society.

Moreover, the IMF has called for more Public Energy R&D spending to ensure that companies are sufficiently emboldened to invest in low-carbon technologies. Chart 31 shows that while global R&D spending is shifting from fossil fuels to renewables, energy efficiency and cross-cutting technology, in recent years, the overall level of R&D is still relatively low (just $19bn in 2018).

Trading the fiscal narrative in Europe

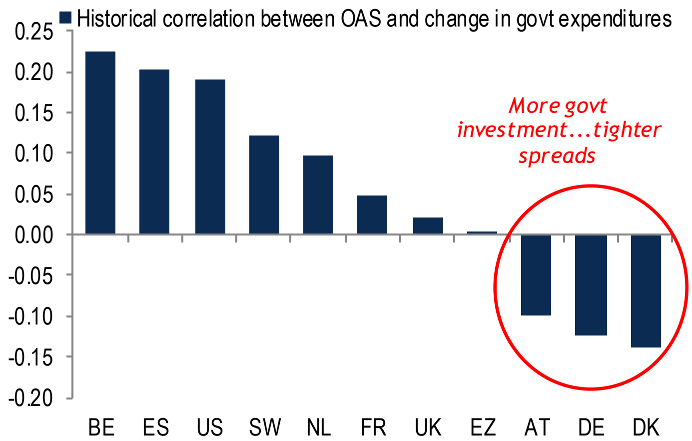
While European fiscal loosening looks on the modest side, we still expect European institutions to shout about it loudly next year (keep an eye on Lagarde and the ECB, for instance). And we expect this to drive nuanced performance across credit markets.

Who might be the fiscal "winners" in credit markets next year?

- First, greater newsflow on fiscal loosening in Europe – especially about more public investment – should support spreads for manufacturing (and construction) credits. Which countries have a greater bias to manufacturing names? The chart above shows that **Germany**, in particular, has seen its share of manufacturing firms rise materially since the start of QE in Europe.

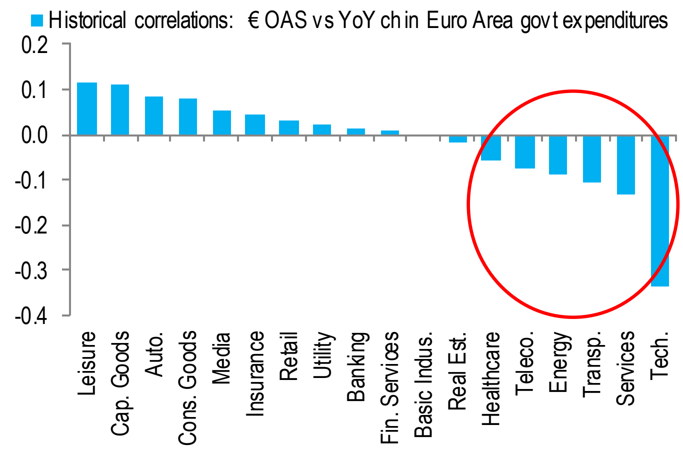
- Conversely, **France** and **Spain** have had a relatively stable share of manufacturing firms in the credit market over the last few years, and therefore may not benefit as much from rising sentiment about fiscal spending.

Chart 33: Which parts of the credit market have historically been sensitive to government investment (by issuer domicile)?



Source: BofA Merrill Lynch Global Research, Bloomberg. Correlation coefficients calculated between 2000 and 2019.

Chart 34: Which parts of the credit market have historically been sensitive to government investment (by sector)?



Source: BofA Merrill Lynch Global Research, Bloomberg, ICE Data Indices, LLC. % ER00 credits. Correlation coefficients calculated between 2000 and 2019.

And historically, which credit sectors have been most sensitive to changing government investment patterns across the Euro Area? The charts above show the correlation between government spending and credit spreads in the pre-QE period.

- By country, again **German** credit has historically tightened when the government has done more investment, and importantly vice-versa.
- By sector, **tech**, **services**, **transport**, **energy**, **telecoms** and **healthcare** should also see the greatest spread tightening upon more fiscal spending newsflow.

Trading the trade truce

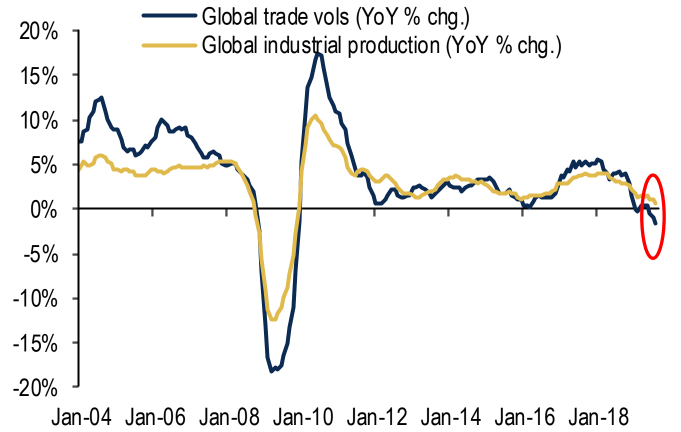
2020 is likely to start with the healthy tailwind of a de-escalation of US-China trade tensions, which should involve some rolling-back of existing tariffs. While this is short of a full-fledged trade deal, any progress will likely see global trade policy uncertainty levels decline from their record highs and the contraction in global trade volumes reverse somewhat after an almost 2yr drop.

We think this incrementally better backdrop will be good news for sentiment towards open economies such as the Euro Area. And we think that the start of 2020 will therefore be a good time to add risk in exporter credits – especially in sectors where they are still relatively wide vis-à-vis their domestically focussed peers.

Vive la France!

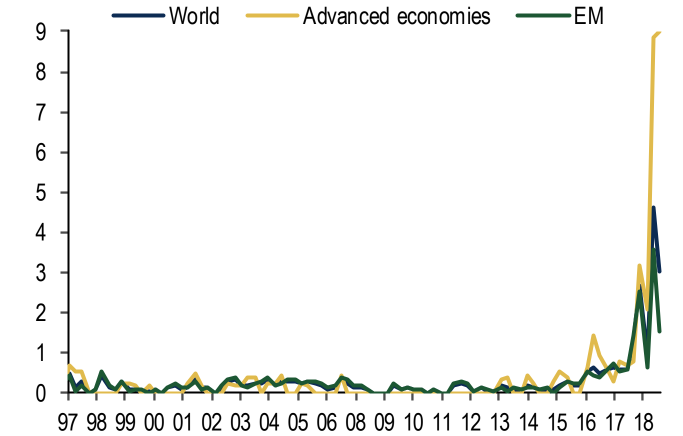
We've flagged before that there are always winners from a trade war given substitution effects. While the US and China are clearly importing less from each other respectively now, US import growth from France (3m/3m basis) is still solid (albeit slowing). This bodes well for **French exporting credits** in 2020, we think.

Chart 35: Global trade volumes have now fallen for the past 2yrs and are now well below global industrial production levels



Source: BofA Merrill Lynch Global Research, Dutch Bureau of Economic Research. Global trade volumes.

Chart 36: IMF Trade uncertainty indices: uncertainty now at an all-time high

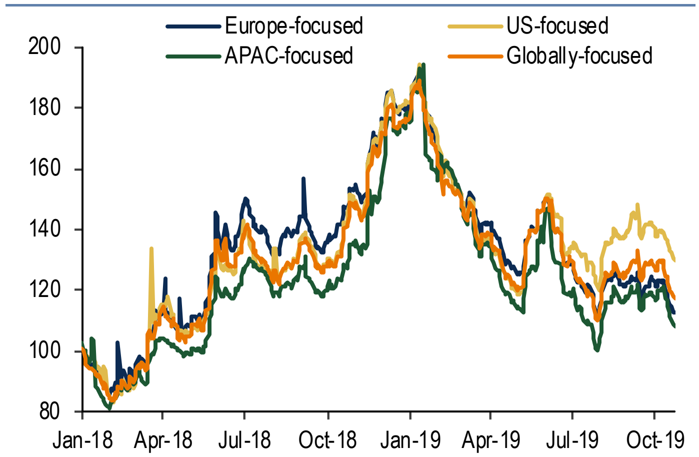


Source: BofA Merrill Lynch Global Research, IMF Trade Uncertainty Indices, equally-weighted.

Chart 37: YoY change in cross-country trade volumes. EU export growth to both the US and China has held-up better lately, while US/China cross-trade volumes have collapsed

Source: BofA Merrill Lynch Global Research, IMF Direction of Trade, Haver. YoY change, 3m moving average

Chart 38: Exposure baskets: spreads for US-focused exporting credits in Europe look relatively wide still, vis-à-vis their APAC-focused peers



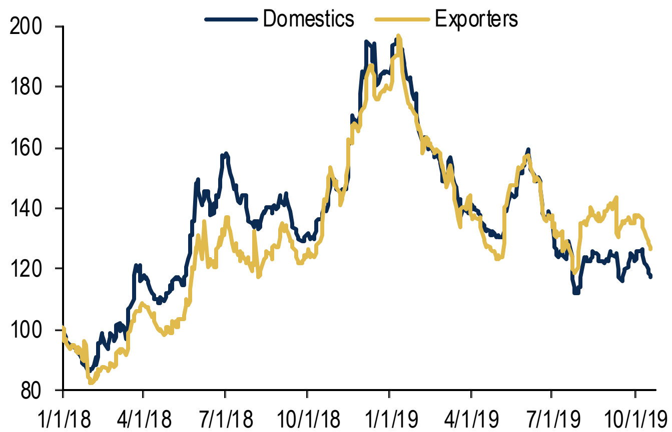
Source: BofA Merrill Lynch Global Research. Segregating exporting credits based on their end-market revenues. Index rebalanced to 100 as of Jan '18.

Moreover, as Chart 38 shows, US-focussed European exporting credits trade on the cheaper side still when compared to their globally focussed and APAC-focussed exporting peers.

By sector, where are exporter names still visibly wider than their domestic peers?

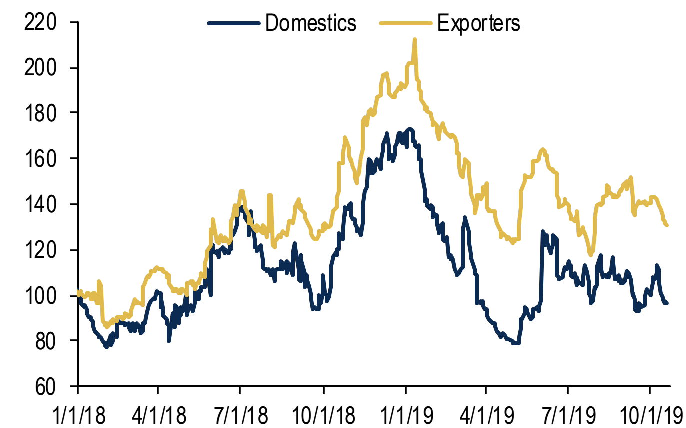
- We find that the best spread pick-ups are still to be found in the **auto**, **retail** and **capital goods** sectors,
- Conversely, investors should note that export names actually trade tighter than domestic names in the basic industry sector.

Chart 39: Exporter vs. domestic spreads: capital goods



Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC. Index rebased to 100 at 01/01/18.

Chart 40: Exporter vs. domestic spreads: autos



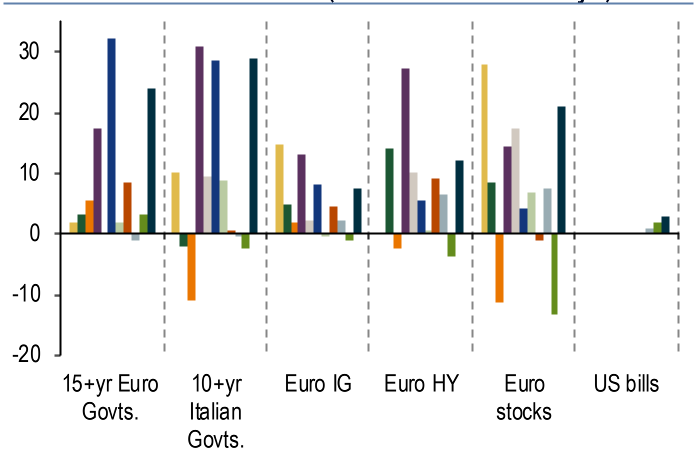
Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC. Index rebased to 100 at 01/01/18

From "Whatever It Takes" to "Whatever…"?

2019 returns were simply mesmerizing: +7% (annualised) total returns for Euro IG bonds, +11% for Euro HY…+23% for long end Euro government debt, +26% for long-dated BTPs. Even "cash" had a relatively impressive year with US T-bills posting returns of around 2.5%. All this 10yrs into a bond bull market…

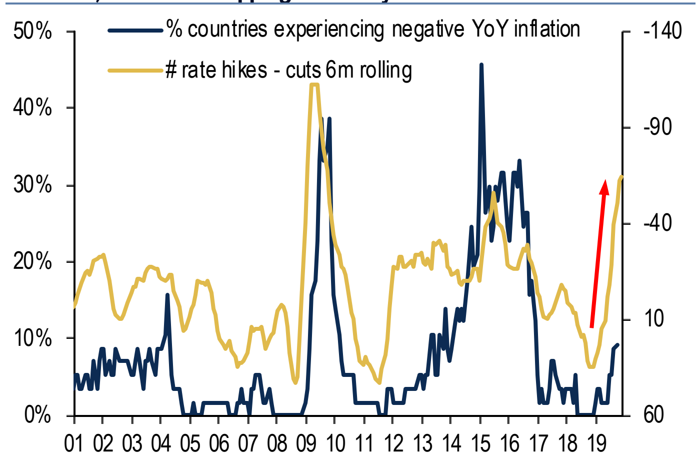
What was the big driver of 2019's strong returns? Yet again it was monetary policy largesse…this time in the form of 71 net rate cuts by central banks across the globe (a "Whatever It Takes 2" moment, if you like). Central banks were aiming for weaker currencies to help stimulate inflation (albeit the irony is that FX has barely moved given so many banks are easing in concert).

Chart 41: Many asset classes have posted returns in 2019 that were close to the best ever this decade (% returns over the last 10yrs)



Source: BofA Merrill Lynch Global Research, Bloomberg.

Chart 42: The pace of central bank easing in '19 (# net rate cuts, RHS reversed) has far outstripping the reality of the inflation data…



Source: BofA Merrill Lynch Global Research, Bloomberg, Haver.

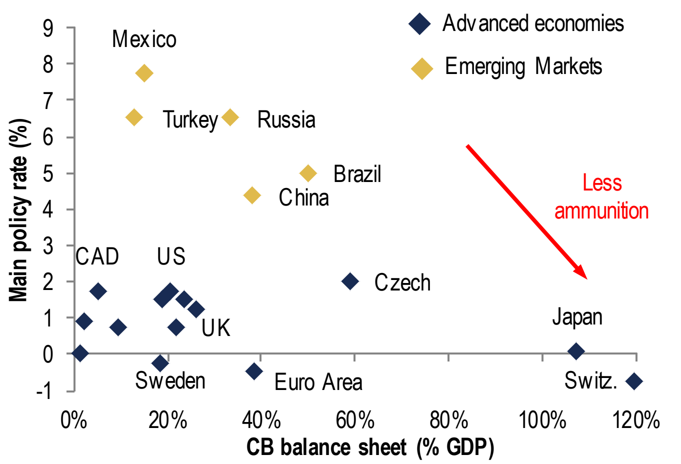
Quantitative Failure and the limits of monetary policy

While we don't doubt central banks' resolve to keep safeguarding financial stability, the challenges to repeating such a dovish message next year look far greater. Central bank ammunition is, of course, a lot lower now. But the efficacy of negative rates is increasingly being questioned by some major European central banks given rates have been below zero for many years now.

Why the doubts? We see somewhat paradoxical behaviour today, that – despite negative rates – some Eurozone households (and corporates) appear to be saving more not less, and that despite the abundance of negative rates, Eurozone economic agents appear to be repaying debt not using more of it. That said, many metrics are yet to show warning signs for central banks (note wealth and income inequality in Europe has ticked-up only modestly over the last decade).

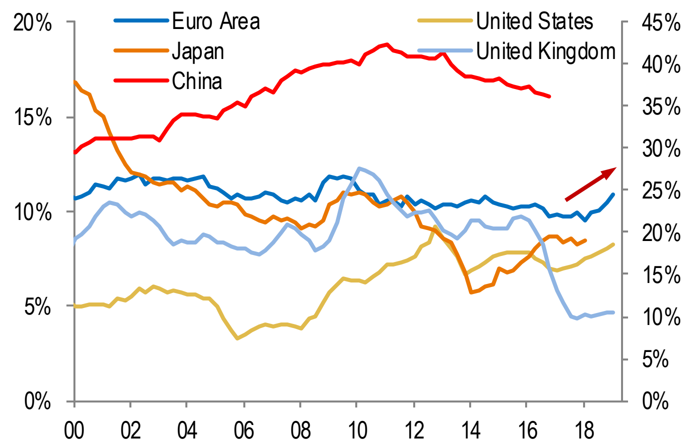
In this light, we think the recent U-turn by the Riksbank on negative rates (due to fears about domestic household debt) is important and will make the market question who might be next?

Chart 43: CB ammunition is scarcer today (although EM's still have room)



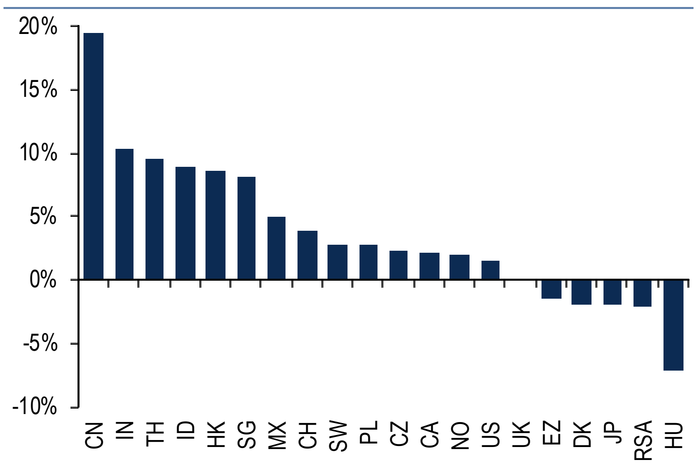
Source: BofA Merrill Lynch Global Research, DataStream, Bloomberg.

Chart 44: Household savings rates ticking higher in the Eurozone (and the trend is more pronounced for Germany and Spain)



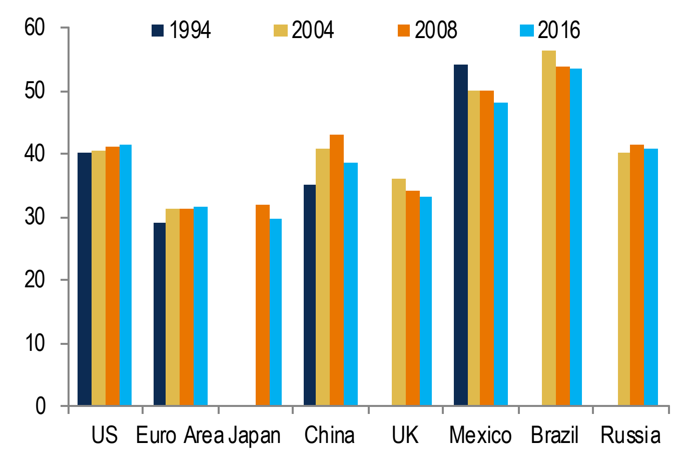
Source: BofA Merrill Lynch Global Research, Haver. China (RHS).

Chart 45: Household debt growth since 2009



Source: BofA Merrill Lynch Global Research, BIS. Compound annual growth rate 2009Q4-2019Q1.

Chart 46: Inequality changes – so far, not such a huge move during the QE era



Source: BofA Merrill Lynch, World Bank. Blended Income and Wealth GINI co-efficient.

For us, the risk next year is that the dovish central bank message becomes more muddied. And without such a powerful central bank "put" reducing risk premiums across bond markets, Euro credit spreads could see bigger and fatter trading ranges than has been the case in 2019.

We think Euro credit spreads are likely to have their strongest tightening in the early part of '20 and then widen into year-end because of a less affirmative central bank message.

Issuance: when half a trillion is the new norm

2019 has broken all issuance records for Euro IG, with supply likely to end the year at around €525bn, 45% up on 2018's levels and €80bn higher (17%) than the previous record for issuance in 2009. Almost every sector of the Euro high-grade market saw issuance volumes surge year-over-year: Telecom issuance was up over 100% (from €18bn to €38bn), healthcare issuance was up over 50% (from €23bn to €36bn), while banks and insurers were up between 20% and 30%. 2019 was thus the year that the Euro IG market truly stepped up as the funding market "for all".

Amid a backdrop of financial repression in Europe, we see no reason why supply volumes will be anything but huge in the years ahead. In 2020, we forecast Euro IG issuance between €485bn and €500bn.

Why modestly down YoY (~8%)? 2019 undoubtedly saw some corporates front-load their 2020 refinancing plans as 10yr Bund yields reached new lows of -70bp. In fact, 2019 saw corporate funding costs fall a whopping 1.2%, and historically annual Euro IG issuance has been correlated with the yearly move in funding costs. Next year, we don't see rates rallying anywhere near that drastically however (10yr Bund yields are forecast to fall just 20bp during the year), so the "refi rush" may not be as intense.

That said, there are plenty of themes keeping upward pressure on Euro IG supply, and if anything, the risk to our forecast is for more rather than less supply.

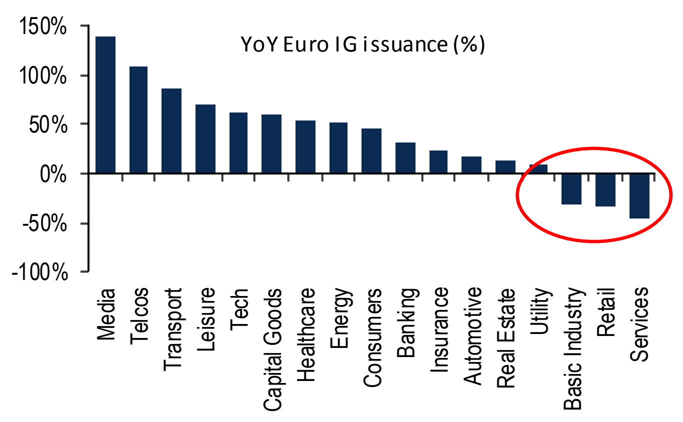
- **Maturities**. Chart 48 shows a paradox. The Euro high-grade market has become more front-loaded since '17. The proportion of 1-5yr debt has risen from 47% to 54% over this period. While the weighted average maturities of many bond markets have increased over this period given the benefit of terming-out (Euro sovereigns +0.8yrs, US IG +0.6yrs), the weighted average maturity of the Euro IG market has instead shrunk by 0.7yrs. It seems that European corporates have a penchant for issuing short – perhaps to reap the cashflow benefits of negative yields. However, this leaves issuers in constant need to roll over debt going forward: and note that there is €1tr of Euro IG bonds maturing between 2021 and 2023.

- **Negative debt**. Commensurate with the above, European IG offers negative yields aplenty. Corporate bonds are essentially "assets" for issuers now, and we believe companies will use them to placate shareholders. Amid trade tensions and the associated uncertainty, European issuers sharply cut capex spending this year. Yet our Global Fund Manager survey shows investors craving for it to return. Negative debt would be an easy funding route for this, we think.

- **Multicultural Europe**. With negative yields, foreign issuers will increasingly be drawn to Euro IG supply. As Chart 50 shows, this is more than just about Reverse Yankees now: note the rise in supply from Japanese and Australian issuers over the last 12m, for instance. We would expect the proportion of foreign supply to rise to 40% next year. Reverse Yankee issuance should again remain robust (we forecast €35bn more RY supply in 2020, vs. 2019). "Leverage neutral" transactions – where US issuers replace $ debt with € bonds – could become more prevalent.

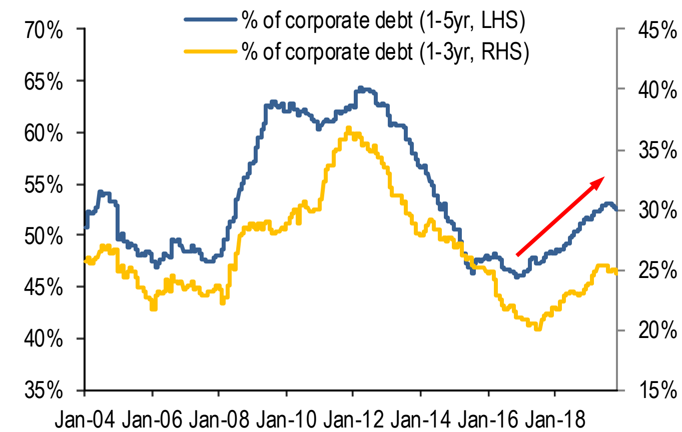
- **CSPP and the debut issuer**. ECB CSPP is again in full force, providing issuers with a big new "backstop" to their funding plans. During CSPP1.0, the presence of the ECB in the Euro primary market coaxed many issuers away from loan financing and into bonds. As Chart 51 shows, debut issuance surged. We expect this trend to restart amid CSPP2.0 (we forecast 70-80 debut issuers next year). As we flagged in the sections above, European issuers have been relatively slow in reducing their reliance on loan financing in recent years.

Chart 47: Not all sectors were up issuance-wise in 2019 (YoY IG supply), look for more industrial, retail and utility issuance in 2020



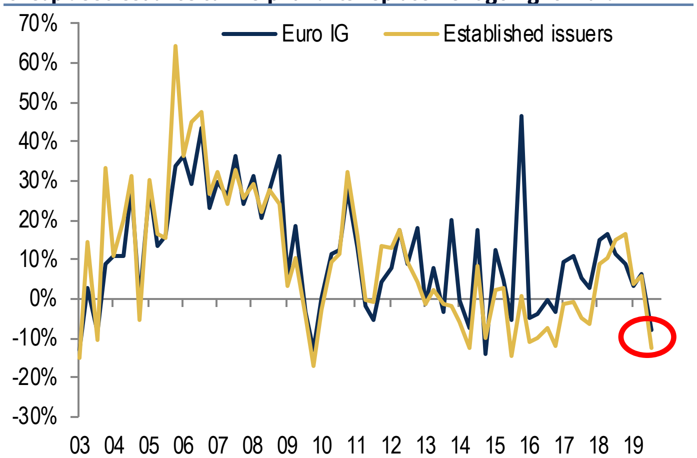
Source: BofA Merrill Lynch Global Research

Chart 48: European credit is increasingly becoming front-loaded – pointing to constant refi activity over the years ahead



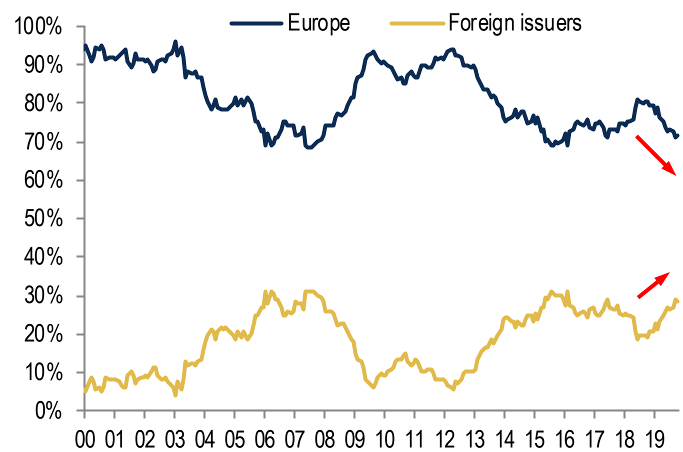
Source: BofA Merrill Lynch Global Research

Chart 49: Capex has sunk of late in Europe given trade tensions –but cheap debt issuance can help fund its replacement going forward



Source: BofA Merrill Lynch Global Research. YoY change in capex.

Chart 50: Foreign issuers being drawn to Euro IG issuance more and more (% of Euro IG supply that is domestic vs. foreign)



Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC. 12-month cumulative gross supply.

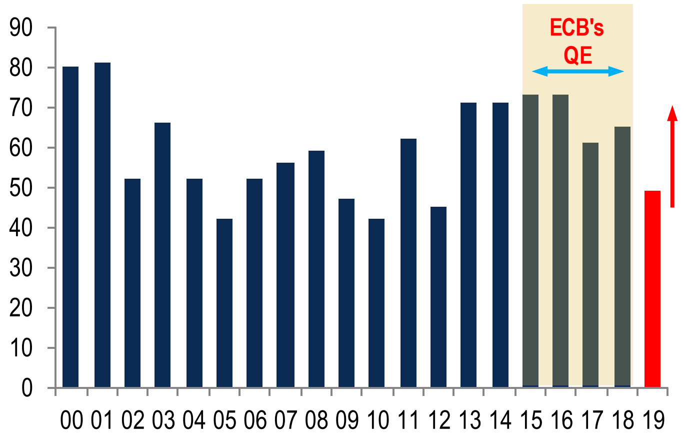
- **Pent-up issuance needs**. Away from M&A (where some sizeable transactions with bond funding needs have been announced of late) there were a number of sectors that were not able to participate in the supply splurge this year because of trade tensions or political uncertainty. Industrials, for instance, saw 30% less issuance this year compared to 2018. Likewise, retail issuance fell 35%. We would expect these sectors to bounce back and post high supply volumes next year.

Demand vs supply: almost there...

Are the sources of cash in the Euro IG market enough next year to absorb expected issuance without hiccups? Chart 52 shows the yearly difference between the sources of bond demand (maturities, coupons, ECB buying, retail inflows) and supply.

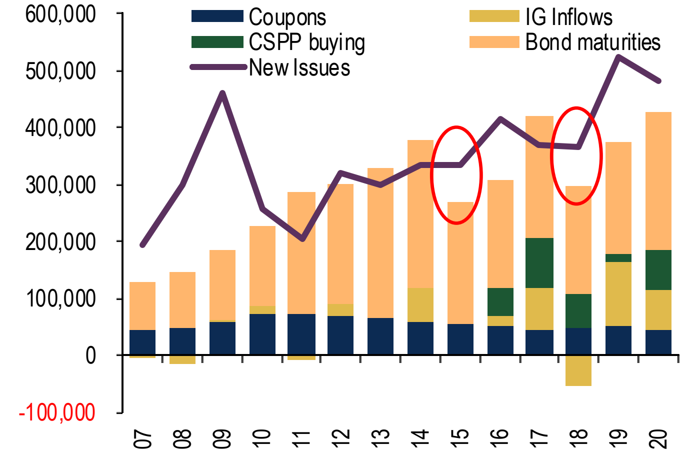
Interestingly, 2019 has seen a big demand deficit of around €120bn. In normal times, this would have widened spreads appreciably – as was the case in 2015 and 2018. Yet, the wave of central bank dovishness pushed risk premiums for corporate bonds a lot lower and was the overriding force.

Chart 51: Number of "debut" Euro IG issuers. QE1 saw a surge, and we would expect the same in 2020: we forecast 90-100 debut names in '20.



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

Chart 52: We think the Euro high-grade market will have a "demand deficit" of around €125bn next year – a high and troubling number



Source: BofA Merrill Lynch Global Research. Please see here for methodology. Assuming full year numbers for 2019. Sources of high-grade demand, versus supply (Eur mn).

For 2020, we see that:

- Given higher redemptions next year (up from €195bn to €240bn), net Euro IG supply will drop from €330bn to €260bn.

In terms of sources of cash:

- Coupon payments will fall from €50bn to €44bn;
- We forecast Euro IG inflows of around €90bn (down from €130bn expected this year), as total return potential for the asset class is lower;
- However, we forecast net CSPP buying of €70bn, up from none in 2019.

Overall this should leave a manageable demand deficit in 2020 of around €50bn (and potentially even lower if the volumes of Japanese buying increase in 2020 vs 2019).

That said, spreads could be more prone to bouts of supply indigestion next year, relative to the easier primary market conditions in 2019, especially if the central bank narrative becomes less bullish throughout the year.

2020 returns forecast – lower but positive

The table below highlights our total and excess return forecast for 2020. Across high-grade, our forecast next year is for 15bp of tightening for Euro and 20bp for Sterling markets, respectively.

The good news is that thanks to curve roll-down this should still result in:

- Excess returns next year of just under 2% for European high-grade, and

Sterling markets are likely to provide welcome returns (6% Sterling IG total returns) given the significant rally in gilt yields we forecast. We forecast 20bp of spread tightening next year, only marginally higher vis-à-vis Euro IG tightening. Note that some Brexit "clarity" next year should unleash pent-up supply needs for UK issuers.

2019 is set to be a £50bn plus year for Sterling supply. 2020 is more likely than not to surpass this figure, we think, and head closer to the £55bn-60bn mark.

Note that US and European issuers (non-UK) are becoming a larger part of the Sterling issuance landscape. With global growth likely to improve and yields still remaining at low levels, these tailwinds should support a more confident set of issuers.

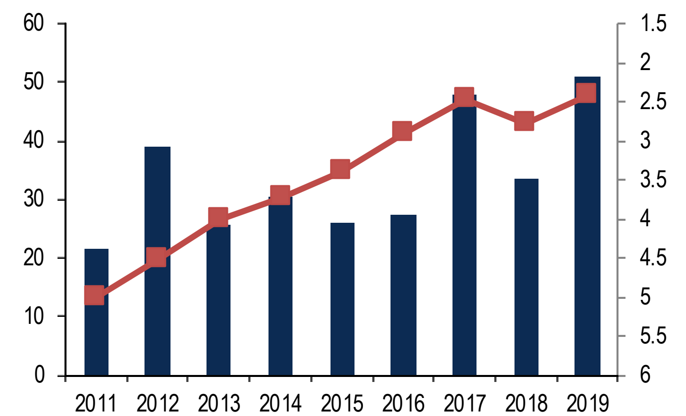
Table 1: Return forecasts for 2020

	IG (ER00)	HY (HE00)	Sterling (UN00)
Constant maturity yield change (bps)			
Treasury	-7	-7	-35
Spreads	-15	-60	-20
Curve rolldown (bps)			
Treasury	-4	-4	-2
Spreads	-7	-3	-3
'20 yield change (bps)	**-32**	**-73**	**-61**
'20 year-end duration	4.2	2.6	7.2
'20 price change (%)	**1.35**	**1.94**	**4.37**
Default Rate (40% rec)		2.5%	
Defaults loss		1.53%	
'19 year-end yield (%)	0.47	3.05	1.92
'20 total return (%)	**1.83**	**3.46**	**6.29**

	IG (ER00)	HY (HE00)	Sterling (UN00)
Constant maturity yield change (bps)			
Spreads	-15	-60	-20
Roll down			
Spreads	-7	-3	-3
'20 spread change	**-22**	**-63**	**-23**
'20 year-end duration	4.2	2.6	7.2
'20 spread return (bps)	**91**	**166**	**167**
Default Rate (40% rec)		2.5%	
Defaults loss		1.53%	
'Current spread (bps)	101	362	120
'20 Excess return (bps)	**193**	**374**	**286**

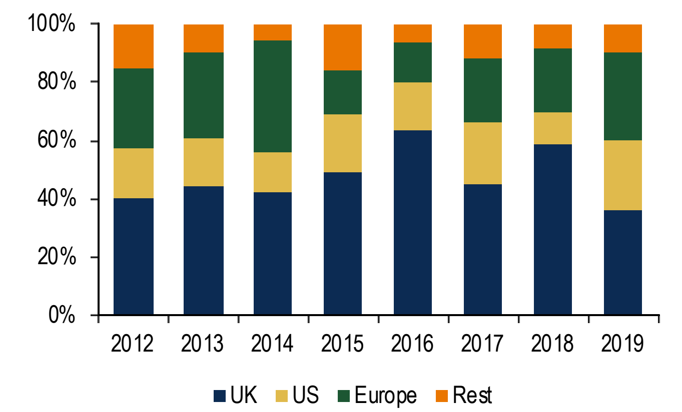
Source: BofA Merrill Lynch Global Research estimates

Chart 53: Supply in 2019 is likely to set a record for the sterling market.



Source: ICE Data Indices, LLC
LHS annual supply vs. RHS for UR00 effective yield. We assume November and December 2019 supply in line with historical averages

Chart 54: US and European issuers are increasingly tapping the sterling market (percent of contribution to annual supply figures, per region)



Source: ICE Data Indices, LLC. Sterling supply by issuer domicile.

Risk to our view

How could we be too bullish, and spreads tighten less or even widen next year? Some scenarios would be:

- The ECB follows the path of the Riksbank and hints at a "re-flooring" exercise for rates (although it would likely be accompanied by stronger forward guidance). Note the weak performance of credit markets in 2018 as QE tapering unfolded.
- Elections, yielding politicians pushing redistributive (read inflationary) fiscal agendas. Inflation expectations/surprises cause a shock higher in global government bond yields. Much greater noise on fiscal spending could also cause higher government yields, destabilizing bond total returns, and leading to credit outflows.
- Rising geopolitical stress leads to higher commodity prices and chokes off an economic rebound. Note the share of "not free" countries across the globe has risen to nearly 26% over the last decade.

- Likewise China's expected stimulus measures prove to be insufficient, and China's credit impulse, or M1 growth, fails to pick-up appreciably. Risk asset performance turns very defensive again.

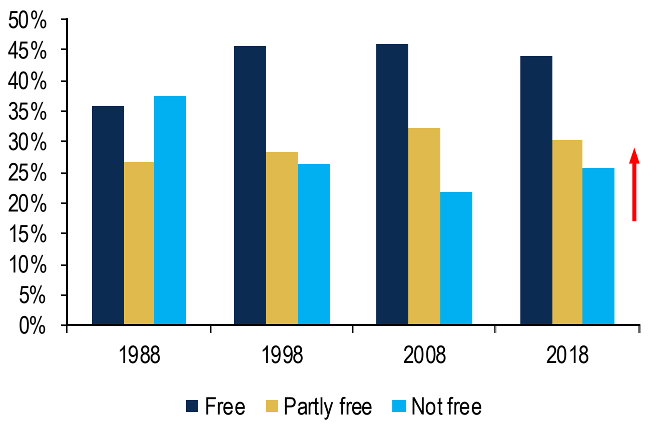
How could we be too bearish, and spreads end up tighter next year? We think some important scenarios would be:

- The ECB endorsing QE for a long time (given the market is sceptical), or slow progress on inflation raising the risk that the ECB needs to buy more assets, potentially moving into buying bank bonds. Front-end high-yield bonds look cheap, in particular, if QE is ongoing (Chart 56).

- Larger foreign buying of Euro credit given still-attractive hedge costs for Japanese lifers.

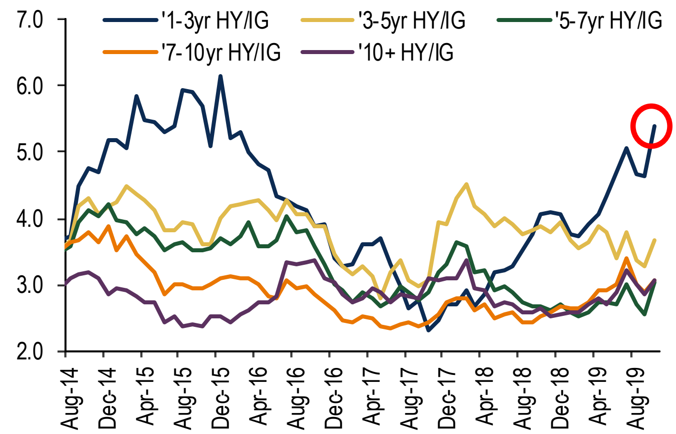
- The US administration making clear that auto tariffs are off of the table.

Chart 55: In the last decade, the share of "Not Free" countries has risen to nearly 26%. Countries based on their "freedom" score.



Source: Freedom House, BofA Merrill Lynch Global Research

Chart 56: Front-end Euro HY bonds looking cheap to IG counterparts (spread ratios of HY/IG).



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

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