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Value across the global credit curve

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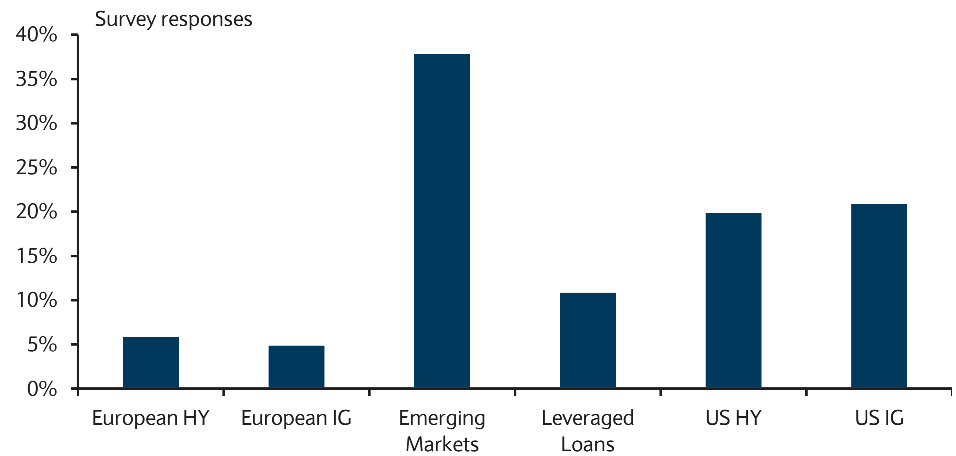
- **Credit spreads are broadly unchanged since our *2018 Global Outlook* was published last December, but performance within the asset class has been differentiated. We are now less negative on $-IG given recent underperformance, specifically versus €-IG and US high yield. A further rise in USD Libor is a risk to that view, if continued rises in hedging and funding costs result in a further unwind of $-IG cash longs.**
- **Assessing relative value across the global credit curve is complicated by the range of attitudes investors hold towards FX risk in corporate bond portfolios. Just under half of all credit investors in our recent Global Macro Survey said they have no FX risk in their portfolios, while 14% take unhedged FX risk. This leaves more than a third of credit investors who implicitly view relative value through the lens of FX hedging costs, with the majority (30pp) using FX forwards to hedge.**
- **The majority of our survey respondents see best value in EM and USD markets; this is at odds with our views. In investment grade, we like $-IG below 3y, €-IG in the 5-10y area, and £-IG at the long end. In high yield, we partition value by ratings: preferring double-Bs in the US and single-Bs in Europe. In emerging markets, we see some value in €-EM versus $-EM and €-HY, but note that EM-DM spreads are compressed, as is EUR versus USD relative value within EM.**

Based on our recent Global Macro Survey,[1] there is a strong divergence between where we see risks and rewards in the credit asset class and the views of survey respondents. For example, 38% of survey participants highlighted emerging markets as the most attractive segment of credit and there was a strong preference for the US over Europe (Figure 1). This compares with our view that EM spreads, particularly corporate spreads, are historically tight versus developed markets, while threats to our benign base case for flows into EM have risen. Equally, we see relative value as more balanced between Europe and the US when FX hedge costs are considered. Given the tightness of credit spreads in all markets, even after recent weakness, we believe that global credit valuations need to be considered in a nuanced way.

FIGURE 1

Investors see best value in EM and USD markets; we believe the answer is more nuanced



Source: Barclays Research

[1] The Barclays Macro Survey invites clients to give their views on how markets are likely to develop over the short and long term. The Q1 2018 survey, which was open between March 12 and March 19, 2018, captured the views of 74-88 clients who responded to the Credit section in the questionnaire on Barclays Live. The respondents comprised a broad range of institutional investors, including hedge funds, money managers, proprietary trading, and corporate trading desks.

Reassessing relative value

Like other asset classes, credit has endured a tumultuous quarter. After a fast and furious rally in January, the market has given back most of its prior gains, with $-IG worst hit. Retracement has been quick in the case of CDS, but slower on the cash side with secondary markets only re-pricing in earnest once supply accelerated (Figure 2). Several factors have driven this reversal in performance: issuance has moved from very low levels in January to above-average levels for March; equity volatility has picked up and stock prices have lost their upward momentum; and global economic data are softening just as rhetoric from the Fed and the BoE is hardening and the ECB is preparing to end net asset purchases.

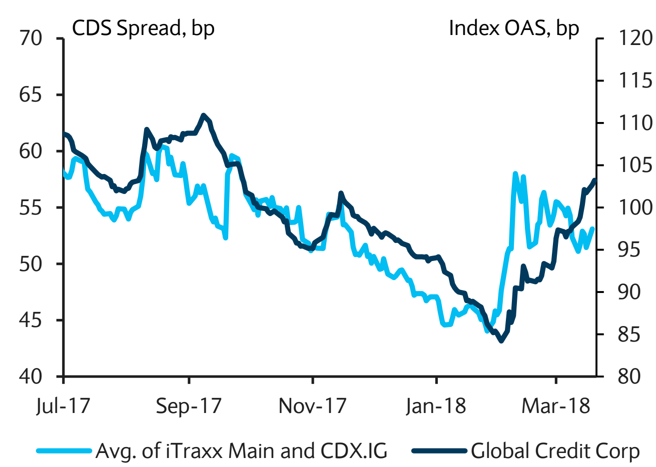
There have also been headwinds in the form of outflows from credit mutual funds and ETFs. The largest outflows have been in US high yield (-$12bn, -5.0% AUM) and European high yield (-$6bn, -6.4% AUM), while the flows out of US investment grade (-$2bn, -1.3% AUM) and European investment grade (-$4bn, -2.0%) were manageable before supply picked up. As primary volumes have grown, particularly on the investment grade side, the lack of matching inflows to the asset class has resulted in fund managers selling in secondary valuations to fund new deals, pressuring spreads wider.

The combined headwinds that emerged in February and March have not only unwound the January spread rally, but also rearranged relative value in credit. Despite having the worst outflows, US high yield has had the best spread performance since our outlook (-13hp), as the asset class's beta to rising Treasury yields led to spread compression. Most other areas of credit are a little further away from our year-end spread targets than where they started. Interestingly, however, if we look at how various credit markets have moved relative to each other (by re-basing spreads versus our $-IG forecast), it is notable that €-IG and $-HY have largely absorbed our expectations relative to $-IG. As a result, our previous preferences for Europe over US (in investment grade) and high yield over investment grade (in USD) look less justified, and we are more constructive on $-IG relative to these parts of credit.

The overhang to improved $-IG valuations is if the drivers of its recent underperformance, namely ongoing rises in USD Libor that inflate FX hedging costs and leveraged funding costs, extend further. It is not clear how big leveraged positions in $-IG are or how they may react to rising funding costs; however, we do not view the widening of Libor-OIS as indicating specific stress on US banks (*LOIS outlook: known Unknowns*, 22 March 2018). One way to side-step this potential risk would be to rotate longs into CDS over cash.

FIGURE 2

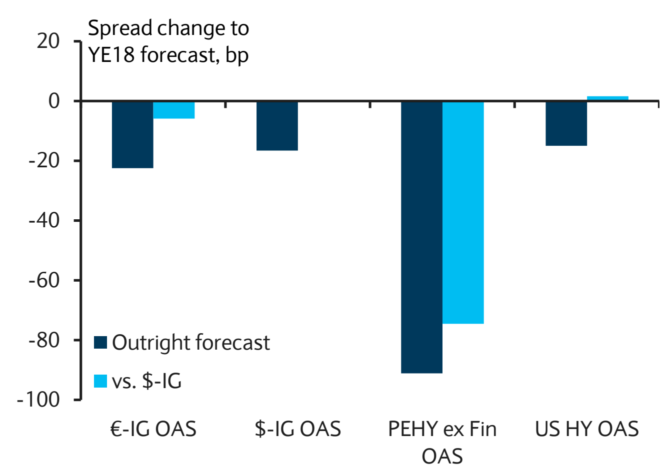
CDS led the widening in February, but supply has pushed the balance of weakness into corporate bonds



Source: Bloomberg, Barclays Research

FIGURE 3

No progress toward our year-end targets, but relative value versus $-IG is now closer to our expectations



Source: Bloomberg, Barclays Research

Different perspectives make a market

Recent performance and our year-end targets are just two ways of contextualizing relative value. Another, and one of our key themes this year, is identifying value across all credit markets with an understanding of how hedging costs frame this conversation. In particular, while outright levels of spreads (and, even more so, yields) have long flattered the USD market, the rising cost of hedging has had a material effect on where the marginal demand for credit has fallen in recent quarters, as the wedge between the sticker price (unhedged yields) and all-in returns has grown. This has been exaggerated by the downtrend in the US Dollar Index (DXY), which has hurt non-US investors who took unhedged USD exposure.

In this sense, value in credit markets is a matter of perspective and changes dramatically for investors who hedge compared with those who do not. As shown in Figure 4, the hierarchy of value changes materially when hedged into a single currency (eg, euro). This creates a variety of perspectives on where to find value in credit.

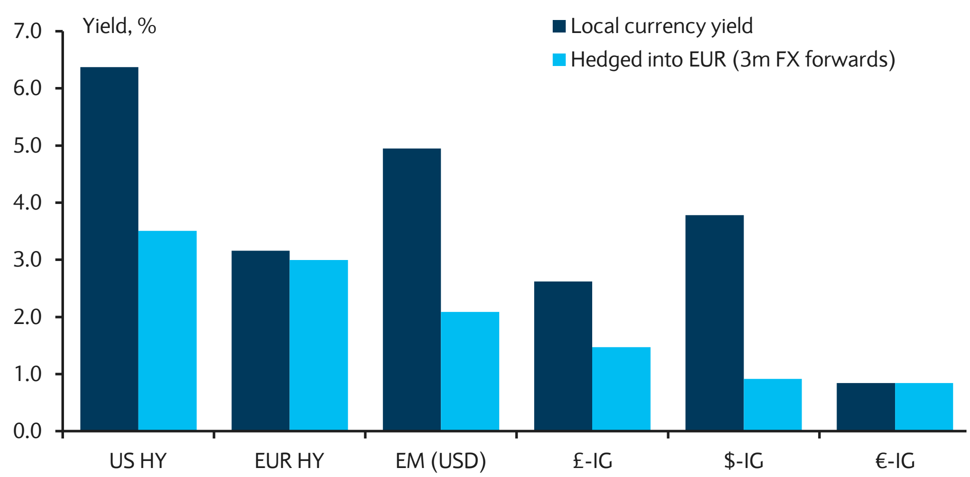
Sizing the cross-border flow potential

To size the relative importance of cross-border flows for global credit markets, we asked a series of questions in our most recent Global Macro Survey. As seen in Figure 5, roughly half of the credit investors surveyed are single-currency specialists; hence, investment decisions are made with a focus on relative value within the credit asset class. Even there, we would argue that these investors have indirect exposure to relative value across currencies, as it will affect the inflows and outflows of their funds if their end investors are sensitive to currency risk. For the other half of credit investors, however, cross-currency considerations are a first-order concern and only a relative minority (7pp of HY/EM managers, 7pp of IG managers) are willing to invest across markets without hedging their FX exposures.

This leaves 39% of credit investors for whom cross-currency relative value matters and, because they actively hedge the FX exposure in their corporate bond portfolios, for whom all-in return *after the cost of hedging* is the most relevant metric. Notably, as suggested in our European investment grade supply outlook (*Low yields shape demand,* 10 November 2017), the majority of investors hedge this risk using FX forwards (usually a combination of 1-3m forwards). Anecdotally, we believe that this behavior is most prevalent within the investment grade community, while we think that high yield managers are less likely to invest across multiple currencies. Hence, particularly in IG, there is a large block of discretionary money being allocated across markets on an FX-hedged basis.

FIGURE 4

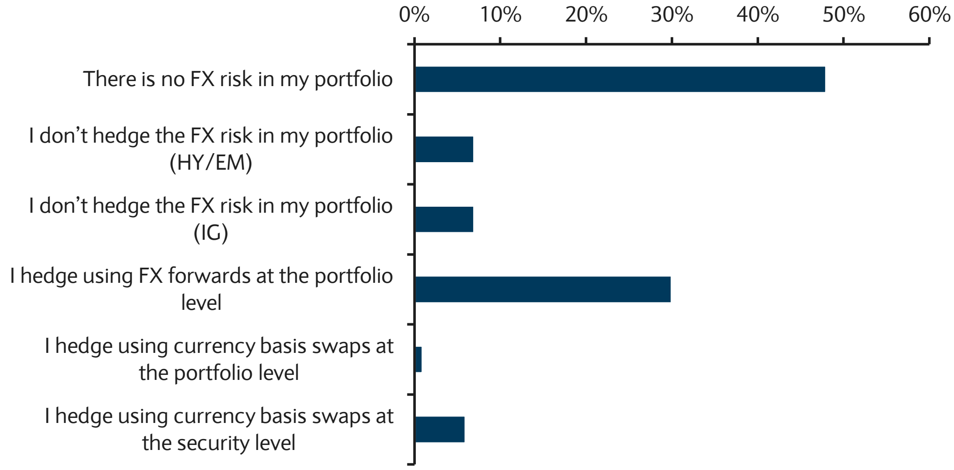
US credit offers a yield pickup over Europe, but only for investors who take FX exposure



Benchmark index yields, not name or tenor adjusted. Source: Bloomberg, Barclays Research

FIGURE 5

Relatively few credit investors are willing to accept FX risk in their portfolios



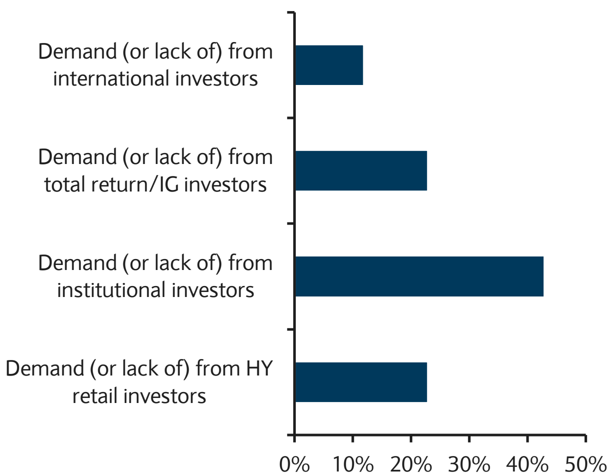
Source: Barclays Research

Further support for our views comes from the answers to our questions regarding the marginal investor in each segment of credit (Figures 6 and 7). In high yield, the key investor bases are (domestic) institutional investors (43% of votes), followed by retail investors (23% of votes). Only 12% of replies identified cross-border investors as the marginal demand for high yield. In contrast, 55% of those surveyed cited overseas (European plus Asian) demand as the key demand dynamic in $-IG credit, well ahead of the 37% who consider US institutional investors to be the most important investors. Interestingly, the €-IG market is seen as much less international, with US and Asian investors receiving only 26% of the votes in our survey, versus 39% for European institutional investors and 30% of votes going to the corporate sector purchase program (CSPP). In broad terms, these results agree with our *a priori* assumptions: FX hedged valuations drive flows between $-IG and €-IG at the margin, while outright valuations matter more for high yield.

Finally, a small minority (6pp) of investors manage FX risk by asset- and cross-currency basis-swapping individual securities. This is the domain of life insurers, given that currency-swapping a security effectively creates an illiquid structured credit product, and we expect this demand to be constrained to highly rated bonds for that reason.

FIGURE 6

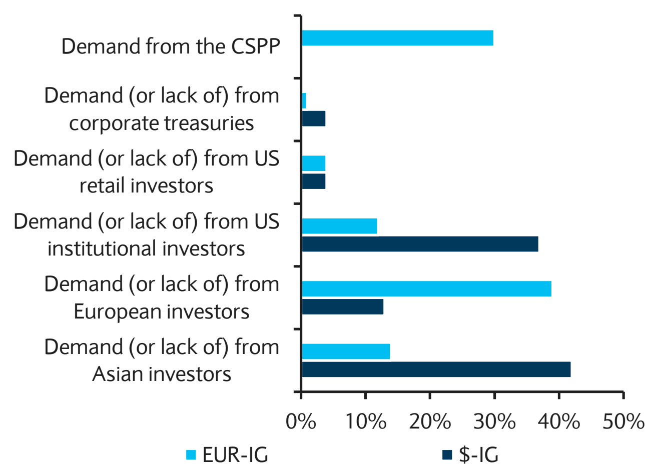
High yield investors attribute less importance to cross-border flows…



Source: Barclays Research

FIGURE 7

… while investment grade markets are more responsive to cross-border demand



Source: Barclays Research

Investment grade: Dollars to the front, sterling to the back, euro in between

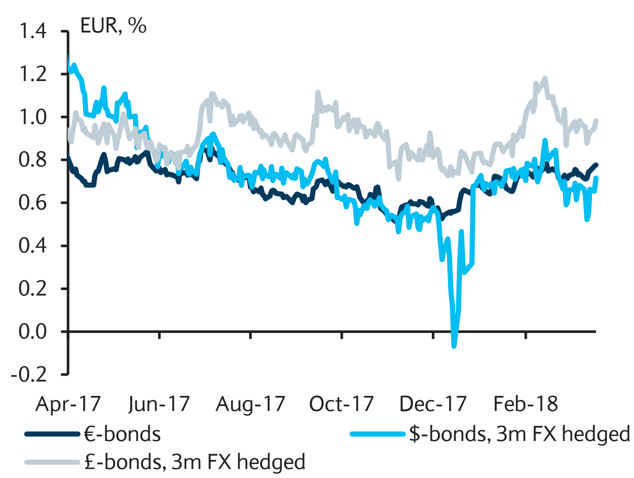
As noted above, FX-hedged yields are an important relative value perspective for investment grade credit, and €-IG bonds have become competitive with $-IG bonds when viewed after hedging costs. An important feature of FX hedging with 3m forwards is that the tenor of the hedge is not matched to the tenor of the bond; as a result, the FX hedging cost is fixed across the curve. But the yield pickup is not the same at all tenors: the 2s10s yield curve is nearly 50bp flatter in $-IG than in €-IG, giving the (hedged) relative value between a distinct term structure (Figure 9). Specifically, $-IG offers more yield below the 5y tenor, particularly in the 1-3y bucket, while the value in €-IG emerges at the 5-10y tenors. This analysis is based on name- and tenor-matched baskets of corporate bonds, so yield differentials between currencies are not driven by differences in market structure.

This analysis aligns with our view on the front end of the $-IG spread curve. Short-dated $-IG spreads underperformed during the February volatility, reflecting a lack of buying from US corporate treasury desks whose corporate bond holdings are largely funded by offshore cash. Given the deemed repatriation of overseas earnings (part of recent US tax changes), we believe that these holdings are unlikely to grow and could indeed decline meaningfully. While the pressure on front-end $-IG spreads is unlikely to reverse, underperformance in February stretched relative value to the point where certain issuer curves offered less than 10bp of pickup between 2y and 5y bonds (*Front-end Flattening is Flattering for a Few*, 23 February 2018), which looks overdone. Underperformance is also apparent relative to 1-3y credit in other currencies; 1-3y $-IG spent most of 2017 trading in line with €-IG, whereas in 2018, it has usually traded in-line with cheaper £-IG bonds (Figure 10).

The short end of European fixed income markets tends to be dominated by investors who are often currency constrained; hence, the relative cheapness of $-IG is unlikely to result in significant flows out of €-IG and into $-IG, despite the clear return pickup. Because of this, we view the attractiveness of €-IG over $-IG in 5-10y bonds the more relevant measure of the relative value between the two markets and, at these tenors, hedged yields look better in Europe than in the US (Figure 11). This suggests that demand for €-IG paper from global investors should be strongest beyond the 5y area, which should keep the €-IG spread curve flat even though it already trades at the rich end of historical valuations (*A small decompression*, 16 February 2018).

FIGURE 8

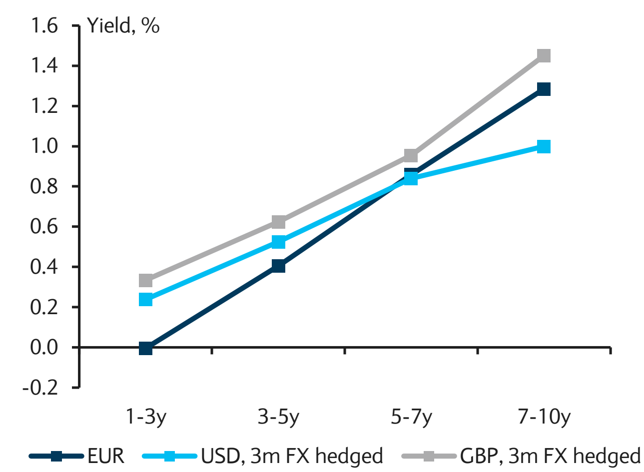
$-IG yields look unattractive on a hedged basis, but…



Tenor and name matched baskets. Source: Bloomberg, Barclays Research

FIGURE 9

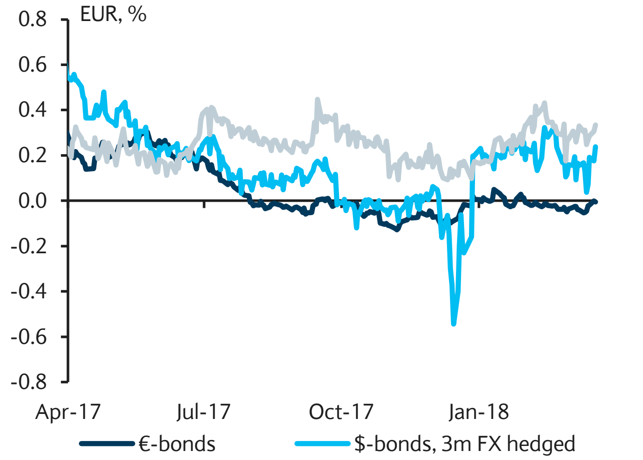
…this is driven by yields at longer (5y+) tenors



Tenor and name matched baskets. Source: Bloomberg, Barclays Research

FIGURE 10

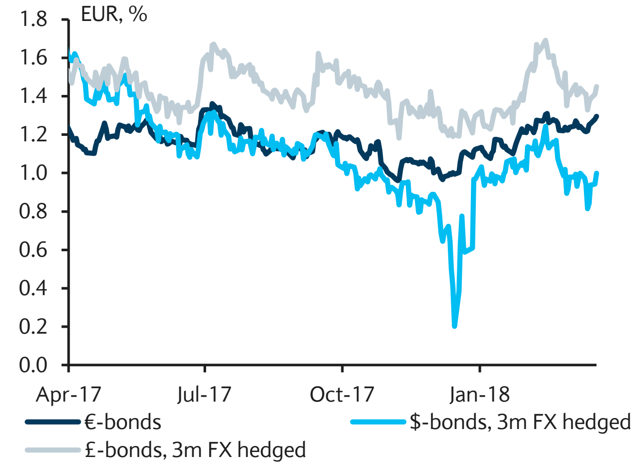
1-3y investment grade yields: $- and £-IG still offer a hedged yield pickup



Tenor and name matched baskets. Source: Bloomberg, Barclays Research

FIGURE 11

7-10y investment grade yields: €-IG yields 25bp more than $-IG on average



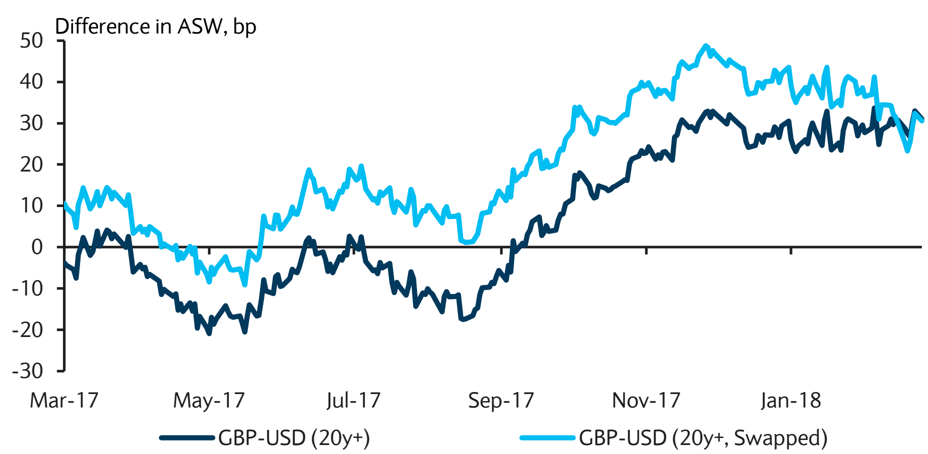
Tenor and name matched baskets. Source: Bloomberg, Barclays Research

On the other hand, particularly for investors with a more bearish outlook, the case for the front end of $-IG as a relative "safe haven" within investment grade credit is becoming increasingly strong, given that it offers a yield pickup (even FX hedged) and that, in a downside scenario, policy easing by the Fed would help compress front-end yields even if spread curves were to flatten in a sharp move wider (eg, if the US entered a significant economic slowdown).

Thus far, our discussion has focused on €-IG versus $-IG, but £-IG has also received increased attention from multi-currency investors over the past quarter, in line with the thoughts from our sterling investment grade outlook (*Cheap as Chips*, 1 December 2017). As shown in many of the preceding figures, sterling valuations look compelling across the curve, as the market offers yields that are higher than in the €-IG market, but hedging costs are lower than in $-IG. Indeed, since December we have seen interest from US life insurers in the long end of £-IG, driven by the sharp rally in 30y $-IG spreads that has left £-IG spreads looking cheap (Figure 12). We note that this buying has likely been cross-currency basis swapped: hedging costs have moved from negative (US investors were paid to hedge £-IG) to flat which we attribute to hedging flows. However, £-IG still looks cheap outright.

FIGURE 12

Long-end £-IG underperformed from September and remains cheap despite the rising cost of basis-swapping from USD to GBP (the pickup for US investors has fallen)



Source: Bloomberg, Barclays Research

High yield: BBs in the US, single-Bs in Europe

Despite negative year-to-date returns, high yield performance is more typical of a rallying market, with higher beta and lower quality leading the way and CCCs outperforming BBs in year-to-date total return terms by 2.2% and 2.4% in the US and Europe, respectively. However, looking back over the past year, single-B sub-indices have lagged the spread moves of their BB and CCC peers, particularly in Europe (Figure 13). That underperformance relative to historical beta-implied spread changes has been particularly stark in the European market. This observation naturally leads to the question of what has contributed to that outcome and if we see the ingredients for that underperformance staying in place.

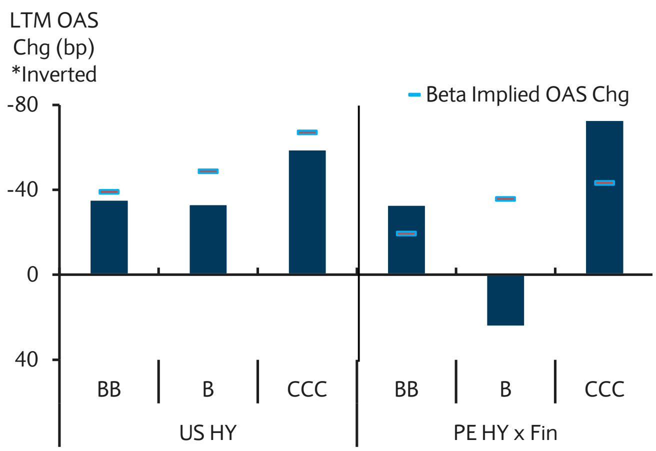
Over time, there have been many sources of underperformance for single-B total returns. Call constraints, a shorter duration than the broader high yield market (in a rallying rate environment), adverse sector disparities, and fallen angels that actually benefit the BB segment of the market (see *A Walk down Sub-Carry Memory Lane*, 5 January 2018) have all contributed. Figure 14 provides more details on the underperformance in both markets over the past year. In Europe, the Communication, Transportation, and Consumer non-cyclical sectors (along with Other) have largely lagged their sector peers in the single-B category.

In contrast, the lagging performance of single-Bs in the US has been driven almost entirely by weakness in the Communications sector (+10bp, Figure 14), which consists of Wirelines, Wireless and Cable/Media. Simply put, the underperformance of Pan-European (PE) single-Bs has been broader than the more concentrated sector drivers in the US high yield market over the past year.

Adding further perspective on the emergence of single-B underperformance, Figure 15 tracks the spread ratios of the PE high yield single-B ex-financials index (both with and without Communications) to the broader PE high yield ex-financials index. While depressed by the recent stretch of weakness in Wireless/Cable-Satellite, single-Bs were a persistent laggard within PE high yield for most of 2017, with the spread ratio sitting at the recent highs of the range, even after excluding Communications. Meanwhile, a look at the same measure of US high yield single-Bs relative to the broader market in Figure 16 shows a large wedge between the index-level ratio, which is currently near multi-year highs, and the ratio recalculated excluding the communications sector. The difference between the two series is, itself, at a multi-year wide.

FIGURE 13

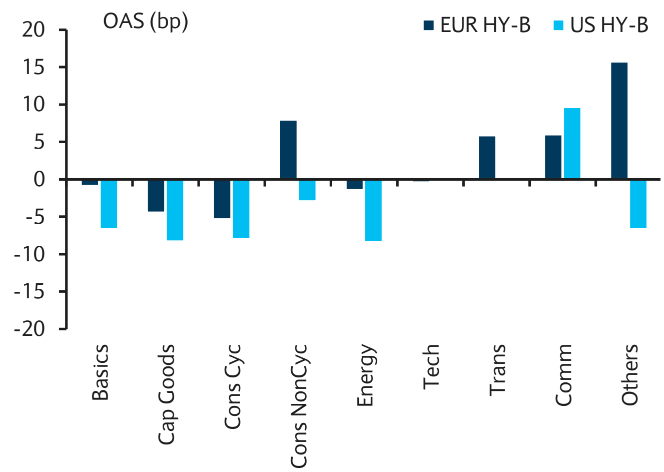
US high yield and PE high yield ex-financials LTM spread changes



Note: Betas calculated by regressing weekly spread changes over the past five years for each ratings bucket to the index. Lower and not-rated HY not shown.
Source: Bloomberg Barclays Indices

FIGURE 14

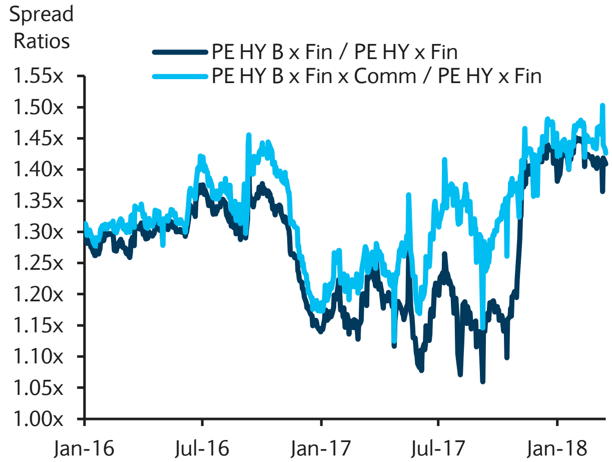
LTM sector spread contribution to EUR and US single-B high yield indices' changes



Source: Bloomberg Barclays Indices

FIGURE 15

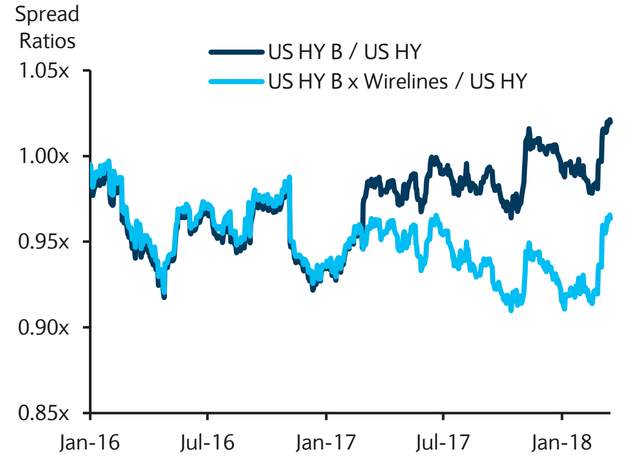
Ratios of PE high yield single-B spreads to the PE high yield e-financials index



Source: Bloomberg Barclays Indices

FIGURE 16

Ratios of US high yield single-B spreads to the US High Yield Index



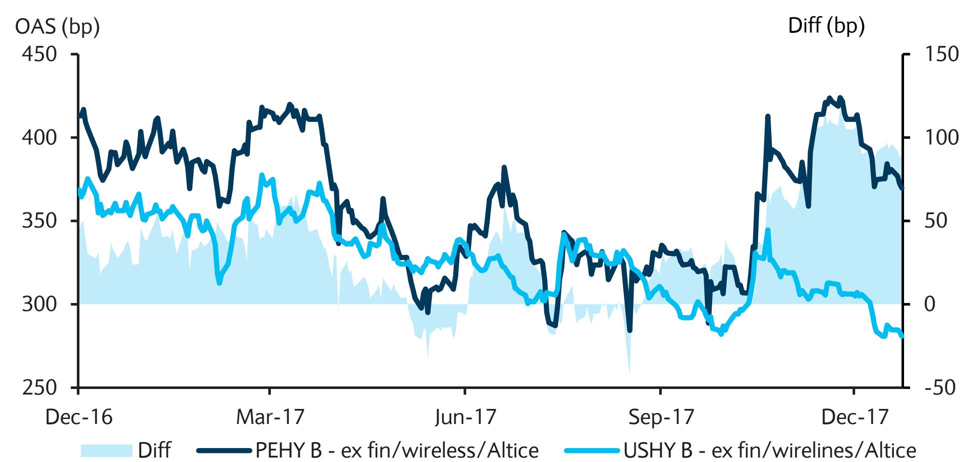
Source: Bloomberg Barclays Indices

We believe that weakness in PE single-Bs is overdone and see the broad-based widening as an opportunity to reiterate our preference for lower quality in Europe (see *European High Yield: Measured optimism for the year,* 4 January 2018). Meanwhile, in the US, we believe that the benefits of changes in the tax code should be greater for higher-quality issuers, helping offset weakness due to rising interest rates. This, coupled with the tight trading of single-Bs outside of Wirelines relative to the US High Yield Index, leads us to favor BBs over Bs in the US, in contrast to our view in European high yield.

The divergent views for Pan-Europe and the US are summarized in Figure 17, which shows PE single-Bs trading approximately 90bp cheaper than US single-Bs, from trading almost flat in mid-November 2017 (excluding the Financial, Energy, and Communication subsectors, mainly wireless in EUR and wirelines in the US). Also taking into account the additional pickup available to US investors buying EUR-denominated bonds with a currency hedge, switching from US single-Bs to PE single-Bs is compelling, in our view.

FIGURE 17

EUR high yield Bs offer meaningful premium over US high yield Bs (excluding communications subsectors)



Note: The cross-currency swap basis has remained largely range-bound over the past 12 months and does not materially affect cross-border relative value. Source: Bloomberg Barclays Indices

AT1s CoCos: Dude, where's my TR?

This section is an excerpt from AT1 CoCos: Dude, where's my TR?, 16 March 2018.

The total return (TR) of $-AT1s for unhedged non-US investors has been negatively affected by USD depreciation over the past year. We think this has caused private wealth managers to reduce their $-AT1 positions, leading to underperformance versus €-AT1s. We expect a reversal when USD and US Treasuries stabilize and recommend switches from €-AT1s to $-AT1s. We also view $-AT1s as more attractive than US bank preferreds.

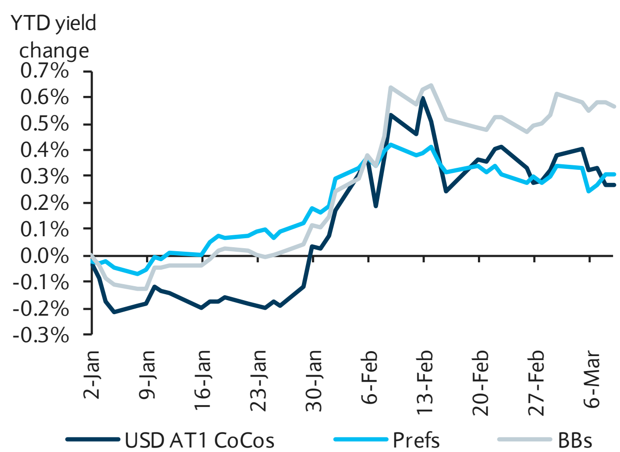
USD bank capital has generally been weighed down by the risk-off move triggered by the sell-off in US Treasuries. So far this year, the 10-year UST yield has increased by c.40bp, which has translated into an increase of c.30bp for both $-AT1 and US bank preferred yields (Figure 18). Notably, the move higher in USD bank capital yields largely mirrored the sell-off in US BBs until early February, but the latter has underperformed significantly since. While $-AT1s outperformed the US high yield market in the recent sell-off, their performance versus €-AT1s has been less impressive. Year-to-date, $-AT1s have underperformed €-AT1s by c.60pp in yield terms, which, although in line with our view that €-AT1s should outperform $-AT1s, appears a bit overdone (see *Steady at the top*, 1 December 2017). This continues the trend from last year, as the yield difference between the two has now increased by 1.7pp, to 2.1%, since June (Figure 19); this is not just rates driven, as $-AT1s have underperformed €-AT1s by 80bp in yield terms even after hedging out the currency risk with a rolling 3m forward.

We note that $-AT1s have underperformed €-AT1s in a rallying market, suggesting that demand for $-AT1s has fallen short relative to €-AT1s. Relatively strong demand for €-AT1s has also been reflected in their continued outperformance versus Pan-European high yield (ex-financials) single-Bs, where the basis has compressed from c.-15bp in late November to c.-95bp today, although the basis has been mostly unchanged since February.

Following the year-to-date outperformance of bank capital, broadly speaking, the value in the sector has become less compelling relative to the high yield market. This is especially the case for US bank preferreds, which now yield c.40bp less than US BBs. Still, we continue to see better value in $-AT1s than in US high yield and US bank preferreds. Specifically, $-AT1s now appear attractive after having underperformed €-AT1s – a trend that we believe could reverse, as discussed below.

FIGURE 18

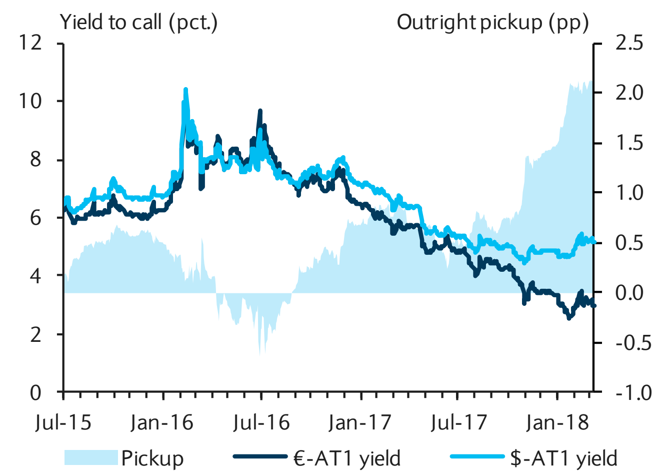
$-AT1s and US bank preferreds have outperformed US high yield BBs so far this year



Source: Barclays Research

FIGURE 19

The yield pickup for $-AT1s over €-AT1s has increased by 1.7pp, to 2.1%, since June 2017



Source: Barclays Research

There has been no apparent fundamental driver behind the move in relative value, and we suspect that the \$-AT1 underperformance relative to €-AT1s has been driven partly by diverging demand technicals. On one hand, it appears that €-AT1s have benefited from a more stable investor base: while there is little data available on overall AT1 CoCo ownership, this trend has been visible in the mutual fund segment, which accounts for about a third of the market (see *Mutual fund demand for hybrids*, 10 November 2017). A more stable investor base for €-AT1s would be supportive of their valuations, in line with their outperformance.

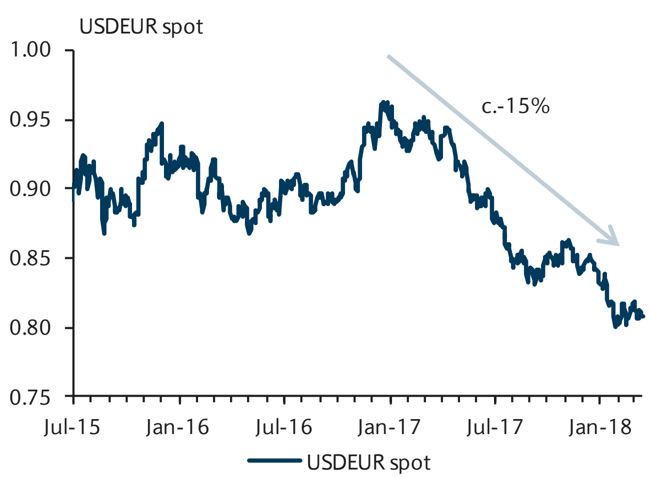
Historically, \$-AT1s have had a more stable investor base than €-AT1s, leading the former to trade richer than the latter. We do not think that the \$-AT1 investor base has changed materially; rather, the market moves suggest to us that the \$-AT1 investor base has faced temporary headwinds. Domestically, US high yield funds have been significant owners of \$-AT1s, while private wealth managers have owned material holdings overseas, particularly in Asia. The private wealth investor base tends to invest on an unhedged basis and, given that the outright yield for \$-AT1s has historically been attractive relative to €-AT1s (Figure 19), they have primarily been buyers of \$-AT1s. Bearing the FX risk worked well until late 2016; since then, however, USD weakness has been a drag on unhedged \$-AT1s.

For example, the US dollar has depreciated by c.15% against the euro since January 2017 (Figure 20), eliminating most of the otherwise strong total returns of \$-AT1s for unhedged EUR investors (in local currency terms). Consequently, EUR investors holding \$-AT1s since January 2017 without having hedged the USD exposure would have seen USD returns of nearly 15% reduced to a small loss (Figure 21). Although the above example considers unhedged EUR investors, the same calculation applies for investors in other currencies that have appreciated relative to the USD, including major Asian currencies such as TWD, JPY, CNH, and KRW.

We know from previous studies of retail demand (in the context of fund flows) that retail investors tend to reduce their ownership of asset classes that have underperformed recently – a finding that we have found to hold across €-IG funds, US and Pan-European high yield funds, and EM hard currency funds (for instance, see *US High Yield: Stumble and a Trip over Treasuries*, 2 February 2018). We see no reason that this would not also be the case for private wealth investors holding \$-AT1s. Moreover, under normal circumstances, US high yield funds would be natural buyers of \$-AT1s in this scenario given that they would not have been affected by US dollar depreciation. However, the large outflows from US high yield funds since October have likely dampened their appetite for \$-AT1s.

FIGURE 20

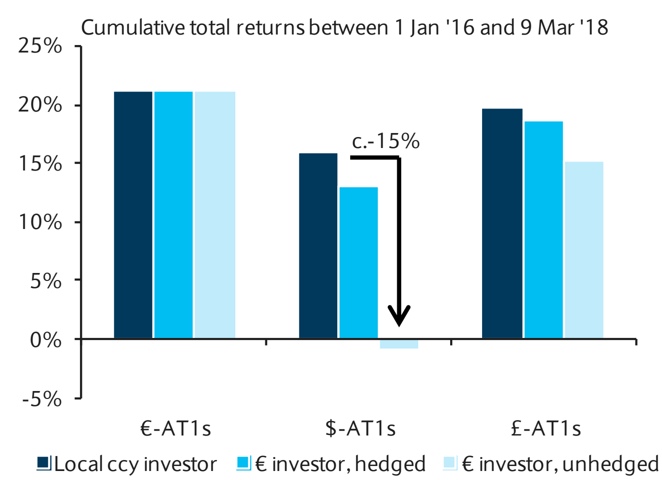
The dollar has depreciated c.15% against the euro since January 2017…



Source: Barclays Research

FIGURE 21

… and for unhedged euro investors, the depreciation has flipped a c.15% total return for \$-AT1s into a small loss



Source: Barclays Research

Reversal scenarios – All about rates and FX

While we see no reason for a reversal of the stabilization of the €-AT1 investor base, we do view a reversal of the weakness in retail demand for $-AT1s as likely, which in turn should support $-AT1 valuations. Specifically, we expect the adverse retail demand technical for $-AT1s to reverse if:

1. **The downtrend in the USD pauses.** In this scenario, the FX-induced underperformance for unhedged non-US investors would come to an end, alleviating the selling pressure from this segment of the investor base.

2. **US high yield fund outflows abate.** The outflows from US high yield funds have been driven in large part by the rise in US Treasury yields, in our view; hence, a slowdown in outflows depends on a stabilization of UST yields. In a scenario where rates and, in turn, outflows stabilize, we would expect $-AT1 demand from US high yield funds to pick up.

Both of these conditions depend on a stabilization of the broader US macro picture – FX and rates – rather than the credit market. In this context, our colleagues in FX and rates research expect a stabilization of the EURUSD, as well as a small decrease in the 10y US yield. We think that $-AT1s offer value at current levels given that the weakness in retail demand is likely to be transitory.

$-AT1s still more attractive than preferreds

The year-to-date outperformance of USD bank capital means that the basis versus US high yield has continued to compress. This is particularly the case for US bank preferreds, which now yield nearly 40bp less than US BBs. While a strong bank fundamental backdrop in the US and more attractive tax-adjusted yields should be supportive of preferred valuations, the preferred-BB basis appears tight, and we expect preferreds to underperform BBs in the near term. While $-AT1 yields have also compressed versus US high yield, the basis versus preferreds has remained largely stable this year, with $-AT1s still trading c.70bp wide. This should drive outperformance of AT1s, which should also be supported by robust European bank fundamentals and a still-wide AT1-LT2 basis (see *Global hybrid capital: Steady at the top*, 1 December 2017, for a more detailed discussion).

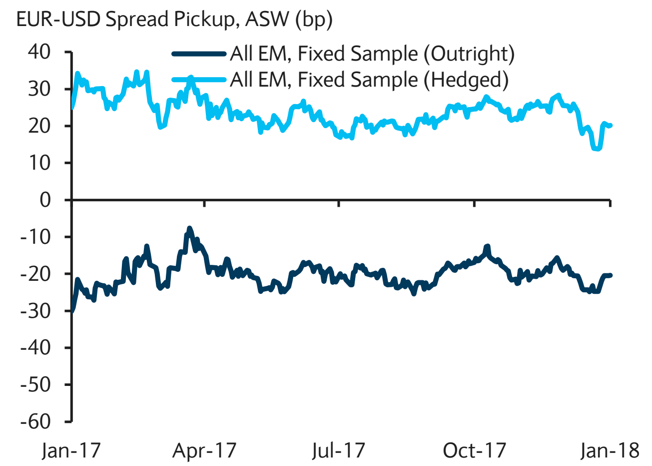
Emerging markets: Screening for cross-currency opportunities

Emerging market USD credit started 2018 strongly, tightening nearly 10bp before widening in sympathy with the broader sell-off in risk assets. Despite this, $-EM spreads remain near multi-year tights, especially for EM corporates. Given rich valuations, one option for spread-starved EM investors could be to swap into EUR-denominated bonds of EM issuers. Indeed, although EUR bonds trade tight of maturity-matched USD securities on an absolute spread basis, on average (within the same issuer), emerging market credit remains one of the few asset classes in which EUR securities offer a substantial *currency-hedged* pickup to USD (using the USD/EUR cross-currency basis as an indicative measure for hedging costs).

Figures 22 and 23 highlight the average move in EUR securities versus USD equivalents for both emerging and developed markets over the past year. In our sample of EUR/USD EM pairs – consisting of all pairs of USD and EUR securities from the same issuer that are roughly the same maturity and with at least one year of spread history – the median outright EUR-USD differential has increased slightly while the hedged difference has declined modestly (Figure 22). That said, €-EM bonds continue to trade with a substantial spread pickup over USD securities of the same issuer after hedging the currency and rates differential (20-25bp on average). This contrasts with developed markets, where the hedged difference tends to hover close to zero, currently averaging about a 5-10bp hedged pickup for USD securities (Figure 23).

FIGURE 22

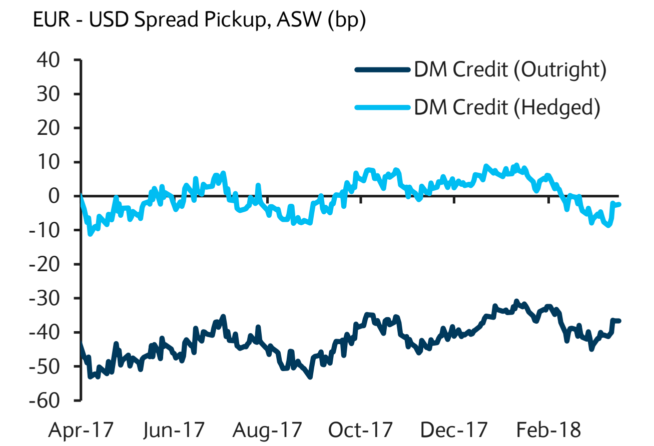
EM EUR bonds have persistently traded wide of EM USD on a hedged basis over the past 12 months…



Note: 121 pairs of issuer- and maturity-matched USD/EUR pairs with at least one year of data. Asset swap spread. Source: Bloomberg, Barclays Research

FIGURE 23

…unlike in developed markets, where EUR and USD bonds have tended to trade within 10bp of each other

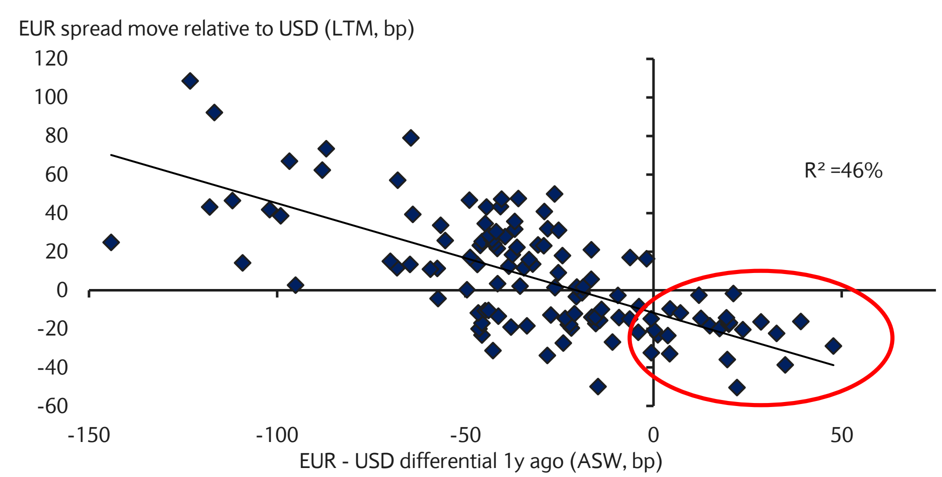


Note: 121 pairs of issuer- and maturity-matched USD/EUR pairs with at least one year of data. Asset swap spread. Source: Bloomberg, Barclays Research

While there is a large natural buyer base for emerging market USD bonds, the dedicated investor base for EUR EM is much smaller, contributing to the structurally wider EUR EM spreads (relative to DM). Indeed, given this unique structural feature of EUR EM, it is worth delving into the LTM drivers of EUR versus USD performance in an environment where macro conditions and flows have been highly supportive of EM assets. It appears that EUR performance versus USD has largely mirrored the beta compression that characterized markets in 2017; when EUR spreads have been wide (tight) to USD on an outright basis, the EUR bond has tended to outperform (underperform). Figure 24 shows this relationship, comparing the YE2016 EUR-USD differential for our 121 pairs with the subsequent 12-month EUR spread move relative to the USD bond in the pair: the bottom right quadrant (circled) shows that in almost every case in which the EUR security was wide to USD on an absolute basis (for example, in IVYCST, ARGENT, or INDON), it has tightened sharply versus the dollar pair.

FIGURE 24

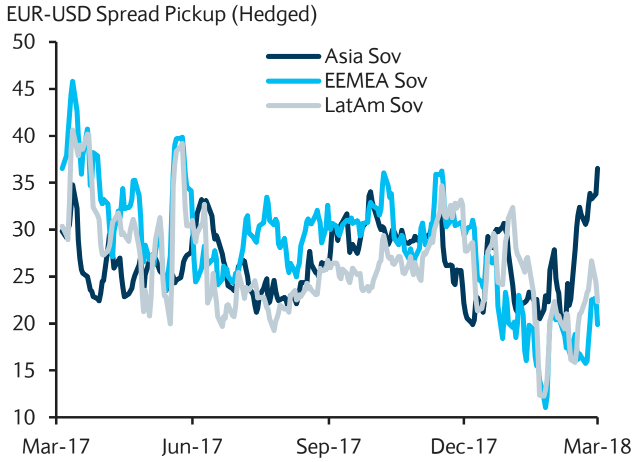
Absolute EUR versus USD spread performance has largely been a function of the starting differential



Note: 121 pairs of issuer- and maturity-matched USD/EUR pairs with at least one year of data. Asset swap spread. Source: Bloomberg, Barclays Research

FIGURE 25

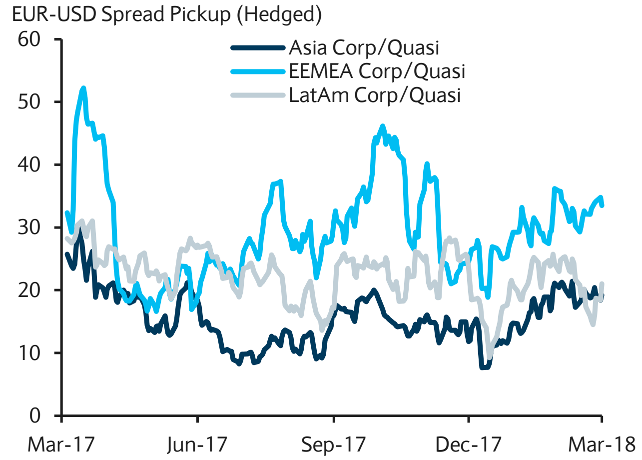
Sovereign EUR bonds have tightened substantially relative to USD bonds, particularly in EEMEA, LTM…



Note: 52 pairs of issuer- and maturity-matched USD/EUR pairs with at least one year of data. Asset swap spread. Source: Bloomberg, Barclays Research

FIGURE 26

…Corp/quasi EUR performance relative to USD has been flatter LTM, even widening in Q1 2018 across all regions



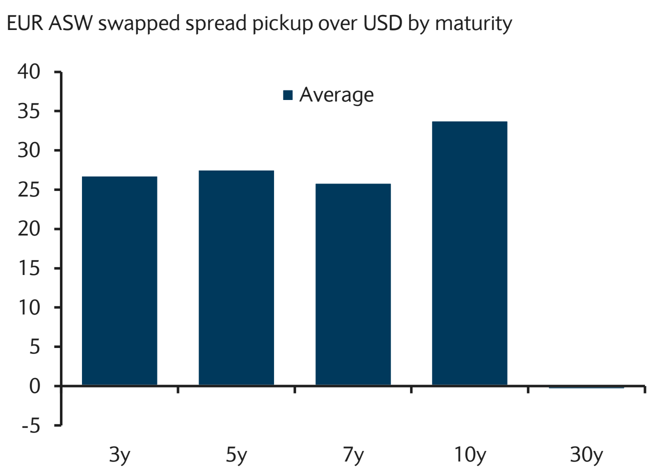
Note: 69 pairs of issuer- and maturity-matched USD/EUR pairs with at least one year of data. Asset swap spread. Source: Bloomberg, Barclays Research

On a more granular basis, the EUR-USD differential appears to have compressed more in sovereigns than in corporates/quasis, given that the EURs tend to trade wider, on average, relative to USD pairs in the former than the latter. Despite this LTM compression, the current EUR-USD swapped differential remains higher in sovereigns (c.25bp on average) than in corps/quasis (c.20bp), on average. Figure 25 highlights that EEMEA sovereigns have experienced the most pronounced decline; conversely, corps/quasis across all regions saw the EUR-USD pickup actually increase since December 2017 (Figure 26).

Despite the LTM tightening of EUR relative to USD (hedged), EUR securities continue to offer a healthy spread premium on a swapped basis. Figures 27 and 28 show the swapped EUR-USD spread differential across different ratings and spread buckets. The pickup is highest in the 10y part of the credit curve (and least attractive in the long end); moreover, Bs appear to offer the highest pickup, on average, across the ratings spectrum.

FIGURE 27

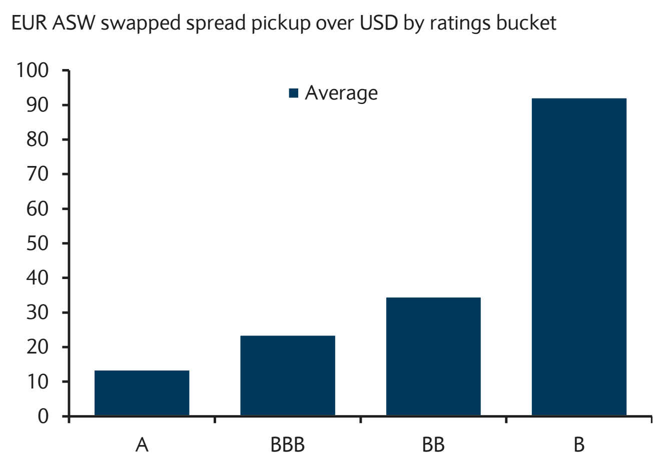
7-10y bucket has the widest-trading EUR bonds relative to USD on a cross-currency-swapped basis



Note: 185 pairs of issuer- and maturity-matched USD/EUR pairs. Asset swap spread. Source: Bloomberg, Barclays Research

FIGURE 28

Lower-quality buckets have the widest-trading EUR bonds relative to USD on a cross-currency-swapped basis



Note: 185 pairs of issuer- and maturity-matched USD/EUR pairs. Asset swap spread. Source: Bloomberg, Barclays Research

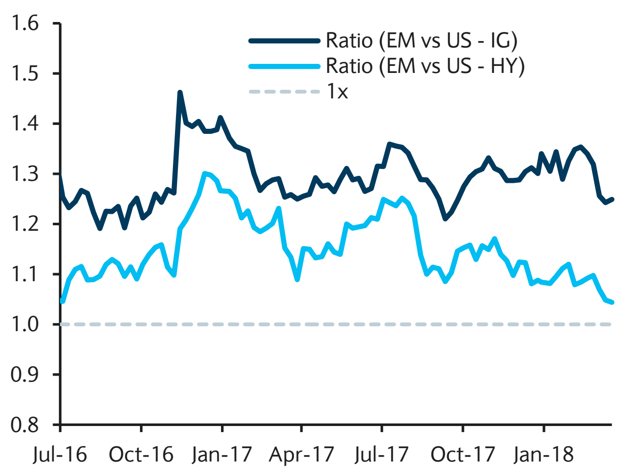
EM-DM relative value has become less compelling in €-HY

Figures 29 and 30 highlight the performance of emerging market spreads relative to developed market credit over the past two years, broken down by currency, on a maturity- and ratings-adjusted basis. Clearly, in a spread-tightening environment and given that EM trades with a premium to ratings- and maturity-matched developed market credits, EM excess returns have been higher than DM. Moreover, in both USD and EUR credit, EM high yield spread ratios relative to developed markets have declined markedly, particularly since the middle of 2017.

We believe that EM USD high yield corporate valuations relative to US high yield, especially in Latin America, look somewhat stretched by historical standards. Similarly, we think that aggregate EM EUR high yield value relative to developed markets is not quite as compelling as it was a year ago, given the approximately 1x average spread ratio in high yield and the recent tightening of spreads (Figure 30). There are still, however, several pockets of opportunities for EUR high yield investors to pick up spread, particularly in the BB bucket. Moreover, the EUR high yield market has grown larger and deeper recently, making it a better alternative to EUR developed markets than it was three or four years ago.

FIGURE 29

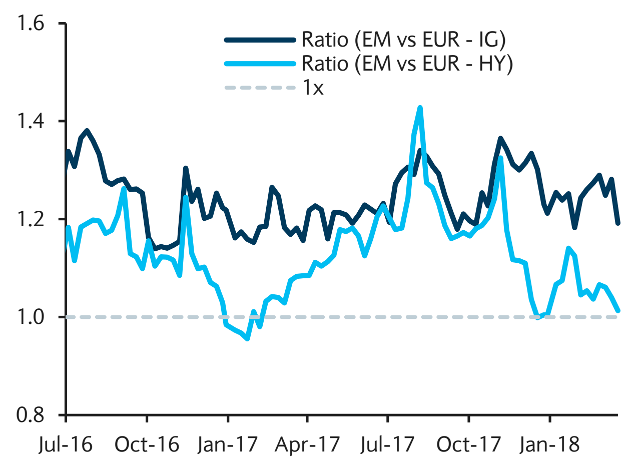
Over the past year-and-a-half, EM USD HY credit has tightened to US HY, and EM USD IG has been relatively stable



Note: We match the average maturity and rating of developed market credit to our EM indices and then calculate the spread ratio. Excluding Venezuela.
Source: Barclays Research

FIGURE 30

Similarly, EM EUR HY has tightened to developed market EUR credit, trading at a spread ratio just above 1x



Note: We match the average maturity and rating of developed market credit to our EM indices and then calculate the spread ratio. Excluding Venezuela.
Source: Barclays Research

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