The European Credit Strategist

We need to talk about debt

Credit Analysis

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Are bubbles becoming more "bubbly" than before?

Financial "repression" was the linchpin for markets in 2019, with central banks cutting policy rates a whopping 69 times (net). Yet, the theme is resonating louder than ever in the 2020s. Year-to-date, net rate cuts already stand at 10 (103 annualised), and the average interest rate for the world has fallen to just 1.6% now, eliciting a mammoth ongoing thirst for returns. Accordingly, "parabolic" price action is becoming more common across financial assets as time goes by (chart 7).

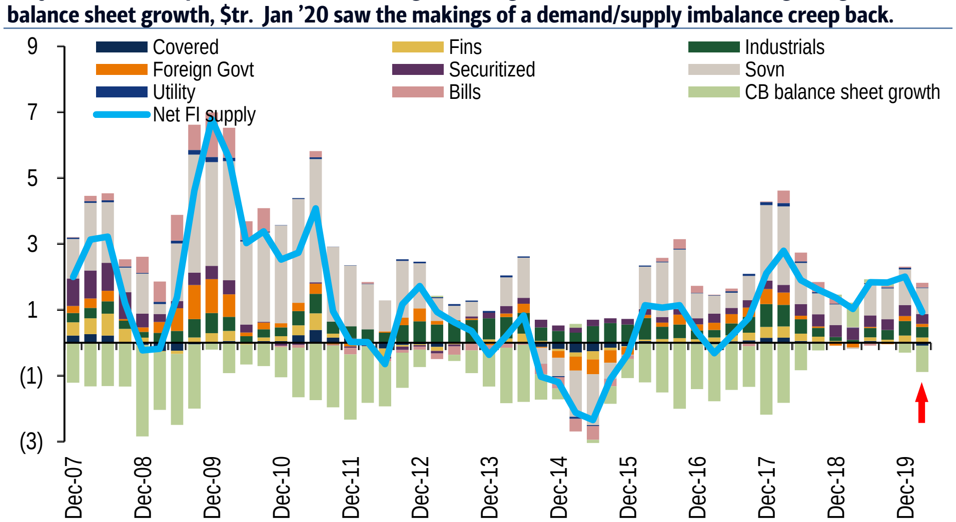
We need to talk about debt

2020 has seen the return of the event risk *cabaret*: US-Iran tensions…a deadly coronavirus outbreak…and resurfacing UK-EU tensions. Yet, asset prices are surging to new highs. "Debt" is the culprit, we think. Why? Because 2020 has started off with relatively meagre levels of global fixed-income issuance…just at a time when central bank balance sheets across the world are ballooning. Yet the world is not short of debt, far from it. In fact, the latest BIS data highlights that the budding global deleveraging trend seen in '18 has quickly reversed. Global debt is on an upwards trend again, with EMs (China) leading the way.

Just press print!

Markets are rallying despite awaiting the all clear on the coronavirus. Expectations of China stimulus are high. Nonetheless, there is a risk of some delayed profit warnings down the line from European companies that either have above-average China sales exposure, or rely on intermediate goods imports from China. Our screens on page 8 suggest that corporate bond risk/reward in **retail**, **consumer goods**, **cap goods** and **auto** sectors looks less compelling, especially if coronavirus lingers for longer.

Why are markets up? Too few bonds… YoY growth in global bond index outstandings vs. global CB balance sheet growth, $tr. Jan '20 saw the makings of a demand/supply imbalance creep back.



Source: BofA Global Research, ICE Data Indices. GFIM index, net index additions. Q1 2020 data is extrapolated from YTD number/estimates.

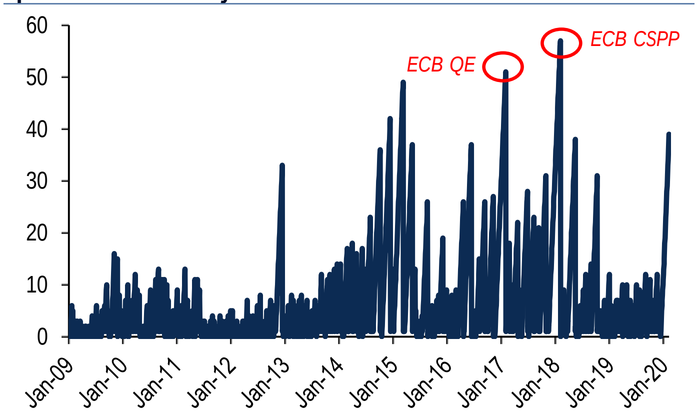
We need to talk about debt

2020 has seen the return of the event risk *cabaret*: US-Iran tensions…a deadly coronavirus outbreak…and a resurfacing UK-EU trade spat. Yet, asset prices are surging to new highs. Euro IG credit has been the ultimate “Teflon” market through all of this, widening by just a smidgen last week. In fact, Chart 1 shows that IG spreads have not moved by more than 2bp per day for almost 40 consecutive days now, even with the unsavoury macro headlines.

What’s the culprit for a world seemingly unfazed by risk?….financial “repression”. 2019 was the year where central banks “outdoved” themselves – delivering a whopping (net) 69 interest rate cuts, the second best vintage for rate cuts in the post-Lehman era. And it was big monetary easing that drove these “excess” returns for financial assets in ’19.

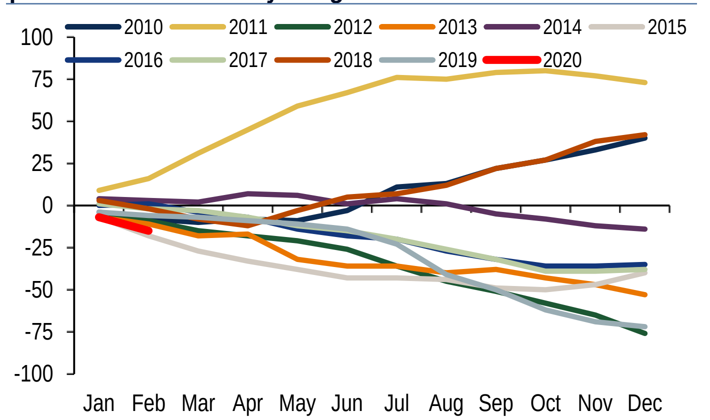
Yet in 2020, the theme of central bank largesse continues to fire on all cylinders. Chart 2 shows that global central banks have already cut interest rates a (net) total of 10 times this year – which, if annualised, implies a whopping 103 rate cuts will transpire in ‘20.

Chart 1: Consecutive days with a 2bp, or less, move in Euro IG cash bond spreads: close to 40 days now.



Source: BofA Research, ICE Data Indices LLC. Days of <3bp move in either direction. ER00 index.

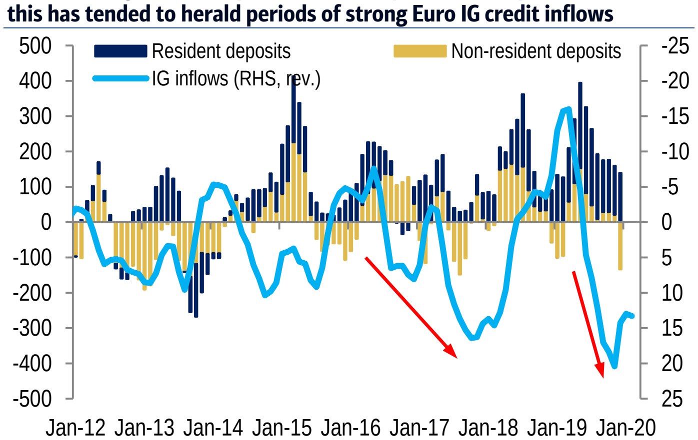
Chart 2: Global central bank net rate cuts: 10 already in 2020 – a torrid pace. Cumulative net cuts by vintage.



Source: BofA Global Research, Bloomberg. Large sample of global central banks.

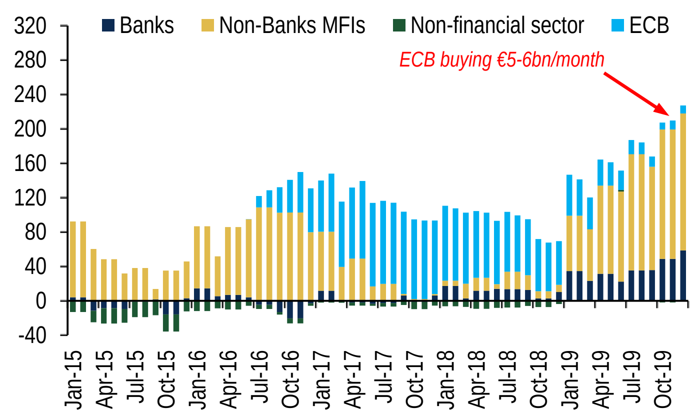
One distinguishing feature of this year’s rate cutting cycle, however, is that it is heavily EM-, rather than DM- orientated. Emerging markets central banks are easing in the face of weak inflation and growth uncertainties from the coronavirus. This should bring some relief for DM central banks, whose policies are starting to attract criticism given the financial stability implications.

Chart 3: A big recent drop in Eurozone deposits. In the post CSPP era, this has tended to herald periods of strong Euro IG credit inflows



Source: BofA Global Research, ECB. EPFR Global. Light blue line is 3m average of monthly IG inflows (Eur bn).Bars are 3m/3m change in deposits, Eur bn.

Chart 4: Eurozone demand for corporate bonds is surging as NIRP continues (purchases of corporate bonds €bn, 12m sum).



Source: BofA Global Research, ECB. Purchases by resident agents.

And while, pound-for-pound, EM rate cuts may not be perceived to be as powerful as Fed rate cuts, we still think an EM-focused easing cycle will be good news for assets with proxy EM exposure: such as European high-yield.

Real-time TINA

The longer that rate cuts keep peppering the financial landscape, the more that defensive savers are likely to "throw in the towel" and shift their investment focus into higher-yielding alternatives…the classic TINA (There Is No Alternative) effect.

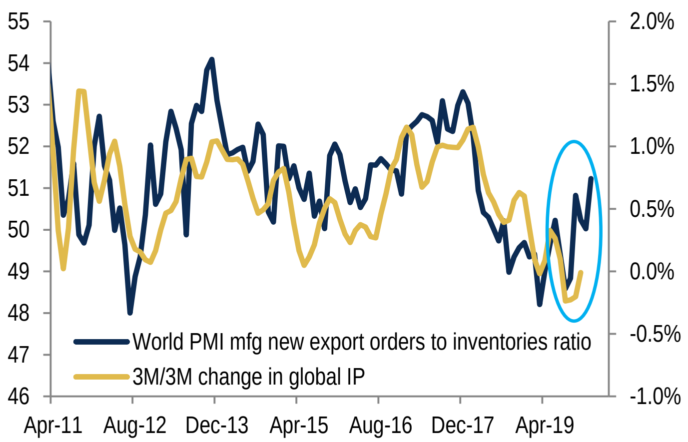
And we see evidence of this already in Europe. Note in chart 3 the conspicuous drop in Euro Area deposits of late, especially for non-residents. Since the QE era took hold in Europe, big deposit outflows have tended to be a precursor of stronger credit market inflows. Frustrated investors move money from zero return bank accounts into higher-yielding corporate bonds.

True to form, record levels of European corporate bond demand are being witnessed at present (chart 4), and these buying forces are unlikely to fade anytime soon given the above-mentioned deposit trends.

Coronavirus vs. pent-up demand

And what of the coronavirus? While a faster spread than anticipated would create downside risk for our global growth outlook in 2020 (more on this in our economics view), we take some comfort from recent encouraging dynamics in metrics such as the global new export orders/inventory ratio (chart 5). This suggests some support for global industrial production ahead.

Chart 5: The inventory cycle suggests support for PMIs ahead



Source: BofA Global Research, Dutch Bureau of Economic Research.

Chart 6: The world interest rate: falling fast

Source: BofA Global Research, IMF. GDP-weighted policy rate. Sample of 38 central banks.

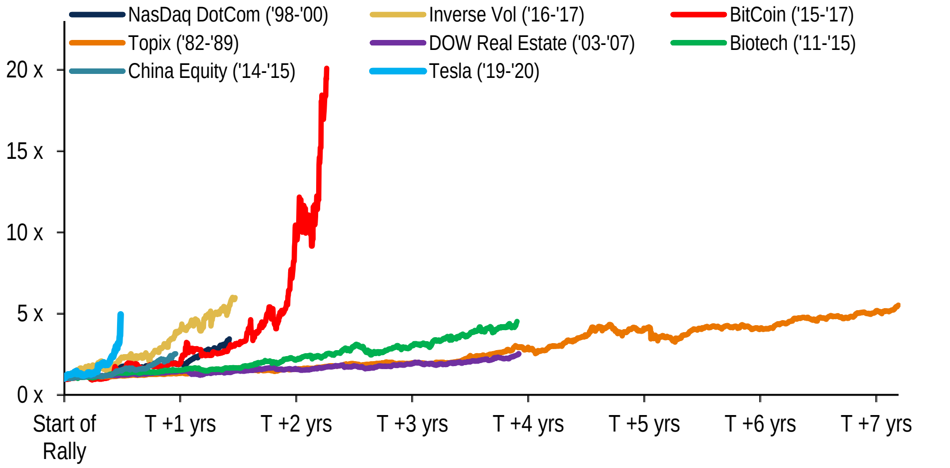
Are bubbles becoming more "bubbly" than before?

With the rate cut extravaganza, the world's interest rate is now falling fast (chart 6). In fact, the world interest rate is now at just 1.6%, only 0.5% away from the all-time low reached at the end of 2009. Ongoing financial repression is understandably eliciting a mammoth thirst for greater returns.

But it's not just credit markets that are experiencing exceptional investor demand today. As chart 7 shows, "parabolic" price action is becoming more common in a world starved of yield. Central bank largesse appears to be inducing quicker and steeper price gains in assets compared to what was often seen historically.

For instance, the increase in Japanese equities was pronounced between mid-1982 and the end of 1989, with share prices rising around 440% over the period. But since then, other in-vogue asset classes have seen their prices surge higher and quicker. Note the move in US biotech shares between 2011 and 2015, Cryptocurrencies between '15 and '17, inverse vol between '16 and '17, for instance.

Chart 7: Parabolic price action during the NIRP years (progression until peak of bull market)



Source: BofA Global Research, Bloomberg. Using TPX Index, CCMP Index, DJUSRE Index, NBI index, SHASHR Index, XIV US Equity and XBT Curncy. Data is normalized and rebalanced at 100 at the start date of the rally (lowest data point) and ends at the top of the rally (highest data point).

And already in the 2020s there have been plenty more "parabolic" price moves… the 80% YTD gain in Tesla shares being particularly noteworthy (112% at the Tuesday peak).

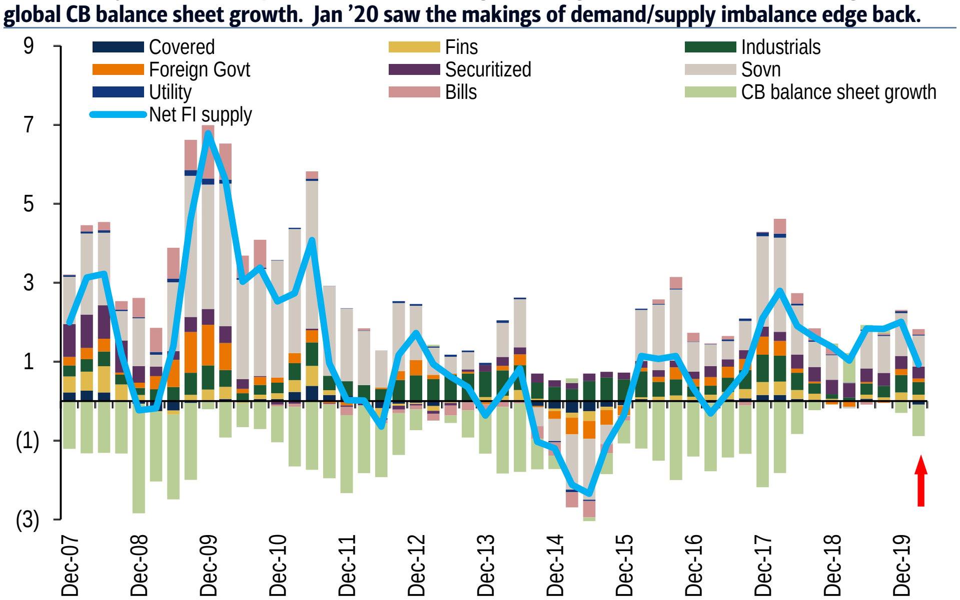
We need to talk about debt

"Debt" was one of the most polarizing topics of the 2010s. The sheer volume of it was enough to precipitate confidence crises in the early part of the decade, especially in the periphery. Yet, at other times there was a distinct lack of debt to facilitate the smooth functioning of central bank QE – and fixed-income markets rallied tremendously as a result. The 2020s feel like the same tug of war between too much, and too little debt will be here for a while longer.

Calling all bonds!

Part of why markets have been so strong in 2020, in our view, is exactly this latter point: the world actually needs *more* bonds at present. Last month saw a relatively modest amount of global fixed-income issuance…just at a time when central bank balance sheets are growing tremendously.

Chart 8: Why are markets up? Too few bonds. YoY growth in global bond index outstandings vs. global CB balance sheet growth. Jan '20 saw the makings of demand/supply imbalance edge back.



Source: BofA Research, ICE Data Indices. GFIM index, net index additions. Q1 2020 data is extrapolated from YTD numbers/estimates. $tr.

Chart 8 shows how "net" global fixed-income supply has evolved since 2008.

- For this metric, we calculate the yearly growth in the global fixed-income market, across sovereigns, covered, financials, non-financials and bills, using ICE Data Indices' GFIM index (and bill indices).
- From this, we subtract yearly global central bank balance sheet growth.
- The blue line in chart 1 ("net" fixed-income supply) thus reflects the amount of bonds that private investors have needed to absorb.

Note that the picture has evolved a lot over time:

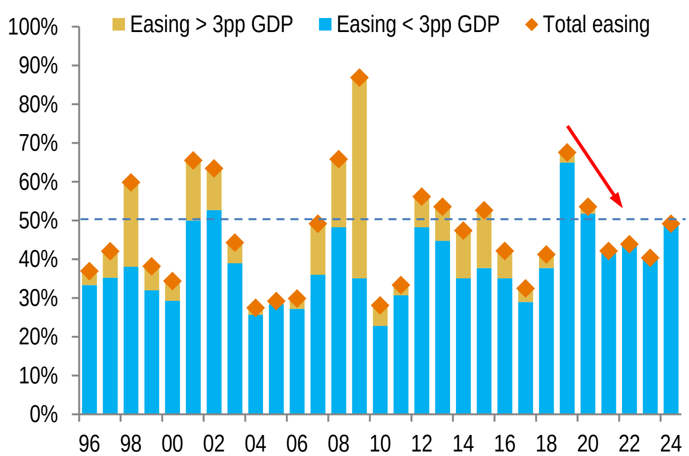
- The 2009-2011era saw big "net" supply across the globe, as fiscal deficits expanded post the GFC.
- The years the followed, however, saw "net" supply shrink materially, as austerity policies ensued and central banks fired-up QE. By mid-15 "net" supply had become hugely negative, at over $2tr (the China slowdown caused issuance of debt securities to stall).
- However, the 2016-2017 era was generally a period of low-to-negative "net" supply…and global credit returns were commensurately strong.

But note the change in the picture in the 2020s. **Last month saw relatively modest global FI index additions**. Extrapolating YTD numbers, and factoring in that global central bank balance sheets are ramping-up again, an impending demand/supply imbalance explains a large part of why markets have been so resilient year-to-date, in our view.

A fiscal please?

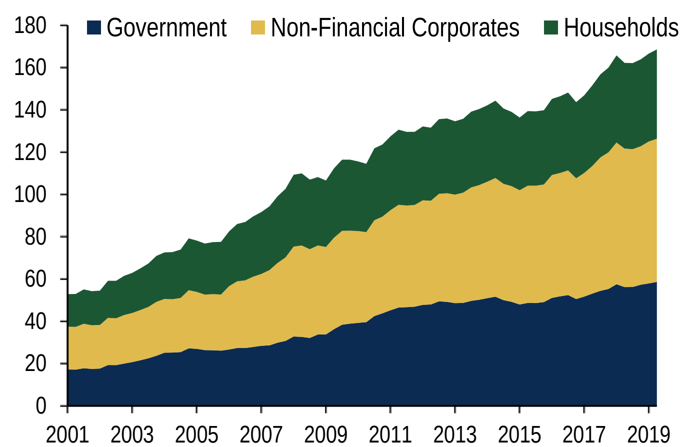
And while the "hand-off" from monetary policy to fiscal policy is likely to eventually shape this decade, our European economists continue to highlight that without more worrying signs of rising unemployment, European politicians are unlikely to feel the pressure to succumb to big fiscal stimulus at present. Allied with this, our rates team highlight that Euro Area net sovereign issuance is likely to be -€109bn this year.

Chart 9: Fiscal *frenzy* or *fantasy*? Percentage of economies across the world running an easier fiscal stance, YoY. The number is down for '20.



Source: BofA Global Research, IMF Fiscal Monitor database. Sample of around 65 economies around the world. % of economies easing/tightening structural budget balance YoY.

Chart 10: Non-financial sector debt distribution - World ($tr.)



Source: BofA Global Research, BIS.

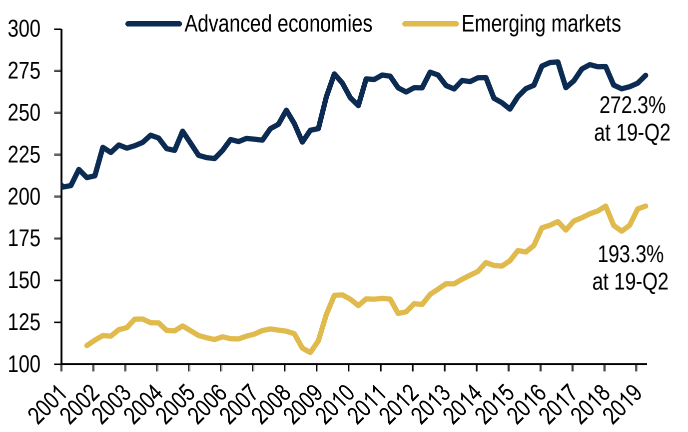
China stimulus and global debt levels

The reality, however, is that there is plenty of debt across the economy – but the growth rate is now being driven by China, and specifically non-financial debt. Chart 10 shows the latest global debt numbers from the BIS, updated to include Q2 '19.

- 2018 witnessed an encouraging drop in nominal debt levels across the globe. Yet, 2019 saw this trend reverse, as central banks resorted to a wave of interest rate cuts. Total debt levels have now risen to a record of $181tr, or 241% of global GDP, with much of the growth rate in debt, since the end of '18, coming from non-financial corporations.

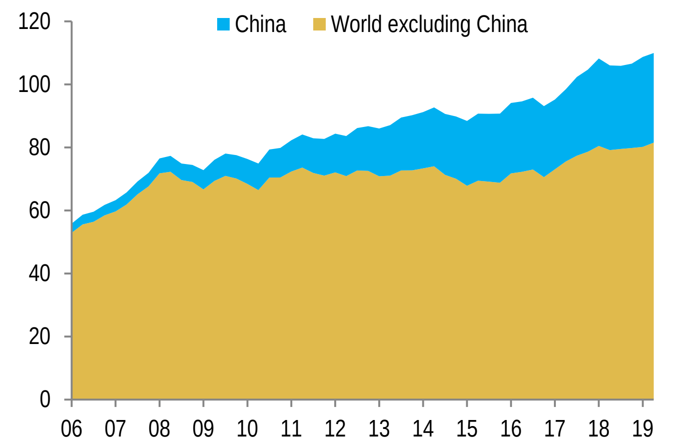
- By region, chart 11 shows that it's EM economies that have contributed the most to the recent rise in debt (here we look in debt/GDP terms). China has been responsible for a lot of the rise in EM debt, in particular non-financial private debt (chart 12).

Chart 11: Global debt-to-GDP ratios (%)



Source: BofA Global Research, BIS.

Chart 12: Private non-financial sector debt distribution – World ($ tr)

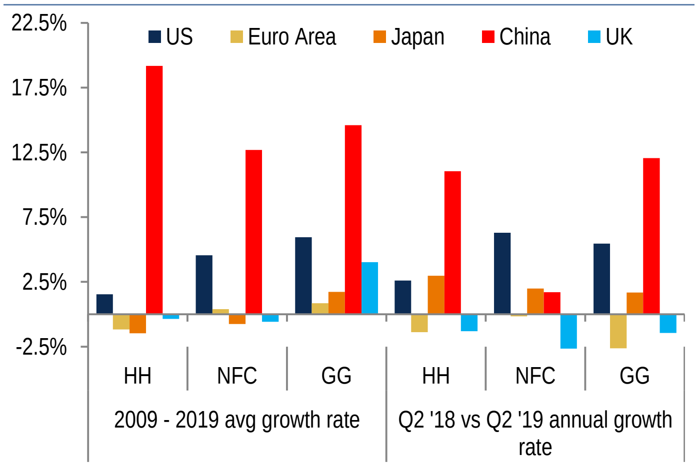


Source: BofA Global Research, BIS.

- By region, chart 13 also shows how stark the rise in debt has been over the last year (Q2 '18 vs Q2 '19) in China: note the jump in household debt and government debt, in particular.

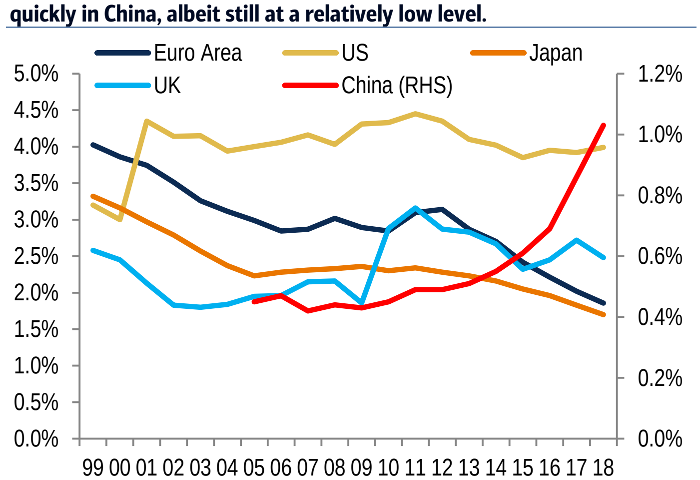
- Yet, some regions are veering towards debt reduction instead. Over the last year the Eurozone has reduced debt levels across all of households, corporates and governments. And the picture is even stronger for the UK (chart 13).

Chart 13: Debt growth dynamics by sector



Source: BofA Global Research, BIS.

Chart 14: Interest expense as a % marketable sovereign debt – rising quickly in China, albeit still at a relatively low level.



Source: BofA Global Research, BIS.

Just press print!

Markets have rallied despite awaiting the all clear on the coronavirus. Expectations for China stimulus have underpinned the strong relief rally. Our China economists expect the PBOC to continue monetary easing during Q1-Q2 this year. On the fiscal front, they argue that the government may roll-out subsidies in the form of tax waivers and extend them to transportation, catering, hotel, and micro business along with temporary subsidized funding. The frontloading of major infrastructure investment projects, in order to reboot the economy, could also be on the cards.

Nonetheless, there is a risk of some delayed profit warnings down the line from European companies that 1) have above-average China sales exposure, or 2) rely on intermediate goods imports from China.

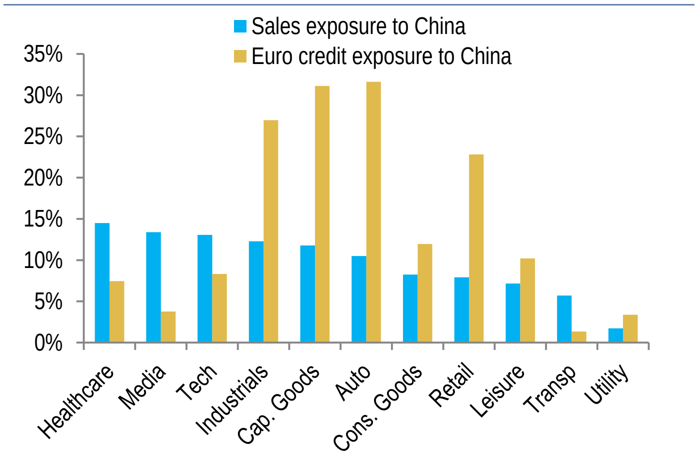
Chart 15 shows companies in ICE's ER00 index with China revenue exposure. For each sector, we compare how the average sales exposure to China (in % sales terms) compares to the percentage of debt that these companies represent in the sector:

- Note that while the average sales exposure to China for healthcare companies in the Euro IG index is almost 15%, the debt that these companies make-up just 7% of the total healthcare sector's debt.

- Conversely, companies with China revenue exposure in the industrials, capital goods, autos, consumer goods and retail sectors, account for a lot more of their respective sectors' debt.

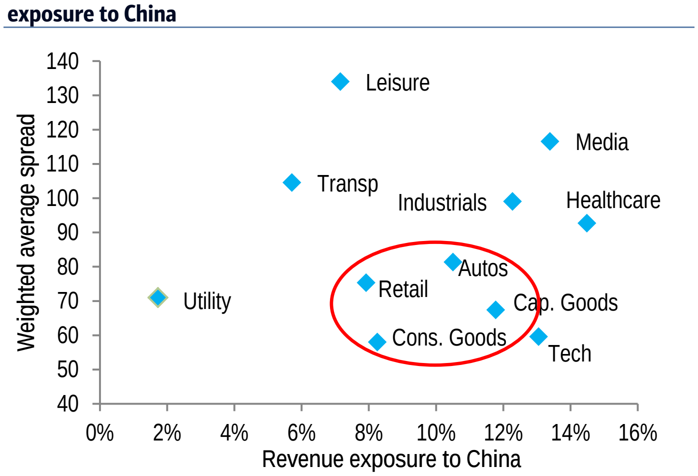
Putting it all together, chart 16 suggests that current risk/reward in **retail**, **consumer goods**, **cap goods** and **auto** sectors are much less compelling, if the coronavirus risk lingers for longer.

Chart 15: Manufacturing credit in Euro IG looks heavily exposed to the China story



Source: BofA Global Research, ICE Data Indices LLC, European Equity Quant Strategy team, Bloomberg. Sales exposure to China is defined as % of revenue generated via China business for sample of firms in Euro Stoxx 600 constituent of ER00. Euro credit exposure to China is defined as the share of €-denominated debt issued by those companies with a revenue exposure to China in total outstanding debt as given by ER00.

Chart 16: Market pricing of credit exposure to China. Retail, consumer, cap goods and auto spreads look too tight when adjusted for revenue exposure to China



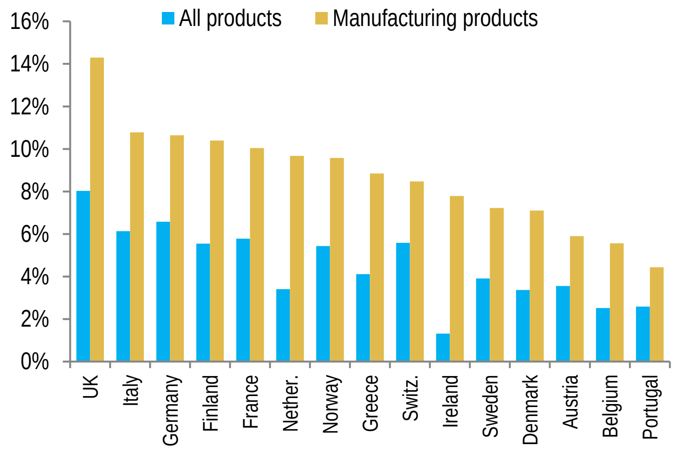
Source: BofA Global Research, ICE Data Indices LLC, European Equity Quant Strategy team, Bloomberg. Option adjusted spreads (OAS) as of 4 February 2020. Revenue exposure defined as % of revenue from China business in total revenue.

We finish with charts, over the page, that show the extent to which the Euro Area relies on intermediate product imports from China.

- As can be seen, the Eurozone relies less on China, than other regions, for intermediate manufacturing products. The underlines the importance of intra-EZ trade.

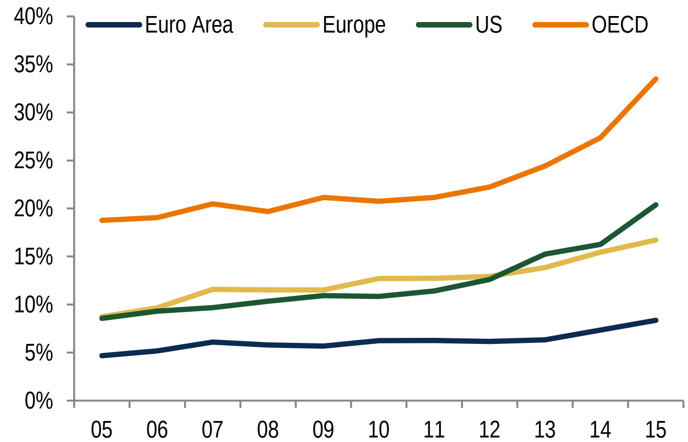
That said, if there are supply chain disruptions down the line, chart 17 suggests company warnings about this are more likely from Italian, German and French non-financials.

Chart 17: Share of imports of intermediate manufacturing products from China



Source: OECD, BofA Global Research. Data as of 2015.

Chart 18: Share of imports of intermediate products from China (%)



Source: OECD, BofA Global Research.

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