No low bound for yields

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Credit Derivatives Strategy
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Ioannis Angelakis
Credit Derivatives Strategist
MLI (UK)
+44 20 7996 0059
ioannis.angelakis@baml.com

Barnaby Martin
Credit Strategist
MLI (UK)
+44 20 7995 0458
barnaby.martin@baml.com

Elyas Galou
Credit Strategist
BofASE (France)
+33 1 8770 0087
elyas.galou@baml.com

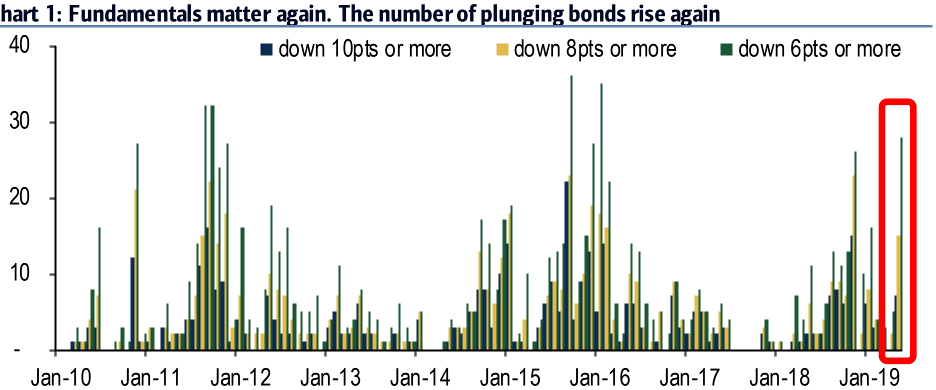
The central bank put that keeps on giving

Five years ago the ECB cut the depo rate into negative territory for the first time ever. Three years ago the ECB bought its first corporate bond under the CSPP. Fast forward to today and 10y bunds have set new all-time lows at -23bp. Fed has signalled that it's possible to see a rate cut. After years of accommodative monetary policy we think that there is still more to come. This cements our view that central banks have never left.

Alpha is finally back

A theme we have been flagging for more than a year now has finally started to play out. Alpha matters once again after years of alpha compression and beta dominance. Fundamentals have always been key for credit portfolios, but have been on the back burner during the ECB's "ETF-style" buying program. With the ECB out of the market, dispersion is – finally – back. Our work shows that dispersion is rising in the bond market especially in pockets that have benefited the most from the ECB QE.

Chart 1: Fundamentals matter again. The number of plunging bonds rise again



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

Plunging bonds rising

Bond prices fell sharply in places last month, with the number of plunging bonds increasing materially. May was one of the worst months for high-yield bonds as almost 30 bonds dropped more than six points on top of the market's underperformance. This is almost in line with the late 2015/early 2016 sell-off and the market stress seen during the European sovereign crisis. This is a testament that fundamentals do matter again.

Lower for longer - good for beta, bad for banks

Our European economics team expects no ECB hike before 2021, at least. Generous TLTROs are supportive for banks, but a potential operation twist (that would flatten the curve) and another depo cut (or at least the threat) has multiple adverse effects on the real economy and would risk damaging the banking sector.

Lower for lower yields are supportive for credit and beta (when trade wars risk abates), but damaging for banks. A disappointing TLTRO tomorrow from the ECB could help highlight the tightness of senior fins vs. Main, in our view.

Refer to important disclosures on page 10 to 12.
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Timestamp: 05 June 2019 10:28AM EDT

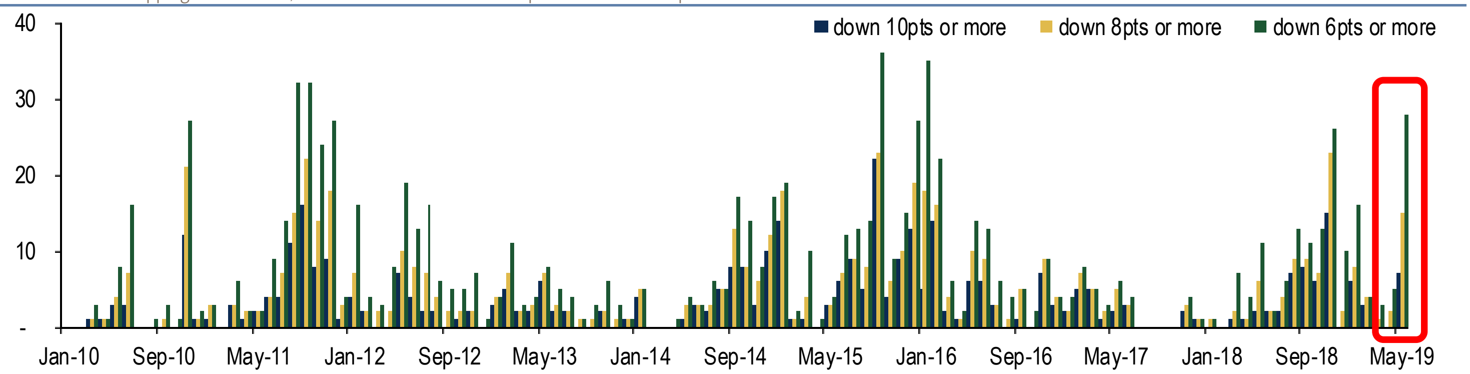
No low bound for yields

Five years ago (5th of June) the ECB cut the depo rate into negative territory for the first time ever. Three years ago (8th of June) the ECB bought its first corporate bond under the CSPP. Fast forward to the 5th of June 2019 and 10y bunds have set new all-time lows at -23bp and the Fed has signalled that it's possible to see a rate cut. After years of accommodative monetary policy we think that there is still more to come. Senior fins look "tight" too us vs. the market amid a lower for longer yield backdrop.

10y bund yields continued their descent, setting new record lows. US yields back to levels not seen since 2017. Trade wars are still far from resolved and macroeconomic data recovery is clearly showing signs of fatigue. As we have highlighted the data recovery will struggle should trade wars fail to be resolved sooner than later. But what really matters is that central banks have too much too lose if they do not support the recovery (more here).

Chart 2: Plunging bonds are rising in May

Number of bonds dropping more than 6, more than 8 or more than 10 points over market performance



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

Dispersion is finally back! A theme we have been flagging for more than a year now has finally started to play out. Alpha matters once again after years of alpha compression and beta dominance. Fundamentals have always been key for credit portfolios, but have been on the back burner during the ECB's "ETF-style" buying program. With the ECB out of the market, dispersion is – finally – back.

Life after CSPP and the return of alpha

We have been highlighting for a while the importance of forward guidance as the ECB was stepping away from the credit market. We always thought that forward guidance is a powerful policy tool that can keep credit spreads in check and prevent a meaningful widening.

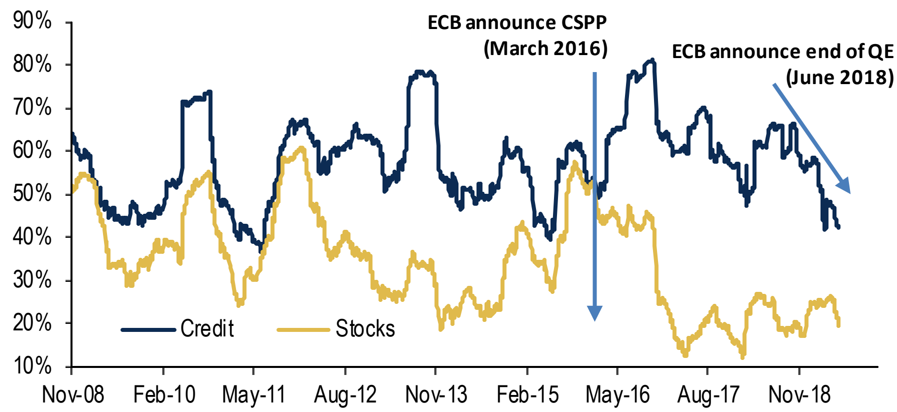
However, we have also highlighted that the end of the CSPP will instigate a significant change in European credit markets. Credit for years has been trading like a uniform asset class. The lack of dispersion and the high intra-correlation between names has been blamed for the lack of alpha.

This has clearly changed this year

Despite much lower pair-wise correlations in the equity market, credit market was characterised by high uniformity and thus low level of alpha in the years of QE. This has clearly changed since the ECB announced its intention (in mid 2018) to end QE by the end of 2018. Currently pairwise correlations are at the lowest levels since the ECB started the CSPP program and only slightly higher than the levels seen on the onset of the European sovereign crisis (chart 3).

Chart 3: The return of alpha

Presenting pairwise correlations between 5y CDS levels and equities across a large basket of different entities



Source: BofA Merrill Lynch Global Research

Assessing dispersion

CSPP started three years ago; a bond buying program that changed the dynamics of the European credit market. Spreads moved materially tighter post the announcement of the program and till the early parts of 2018, only to give back all the spread tightening in last year's second half sell-off. Currently we are at almost the same levels when the ECB bought the first corporate bond.

Chart 4: Back to where we started three years ago. Not everything though is the same

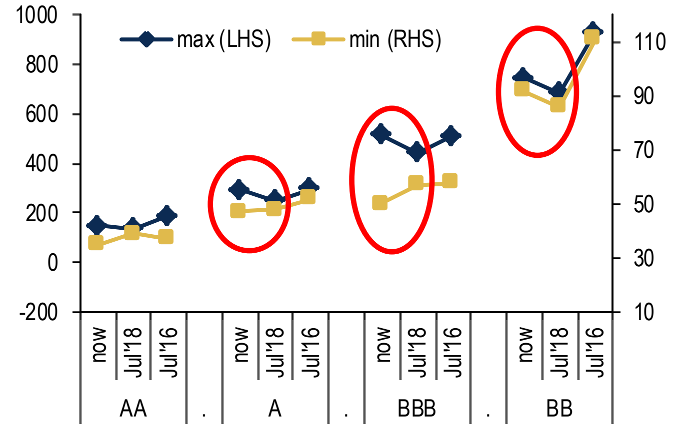
OAS spread for ENS0 index, our proxy for the eligible bond universe under the CSPP (ECB's corporate QE program)

Source: ICE Data Indices, LLC

We think there is value to assess the market structure in terms of dispersion at three key points in time: back in June 2016 (when the CSPP program started), in early Q3 2018 (before markets materially sold-off) and currently. Spread levels at these three time points were almost identical. Our work, as per our charts below, highlights that not all things have remained the same during this sell-off.

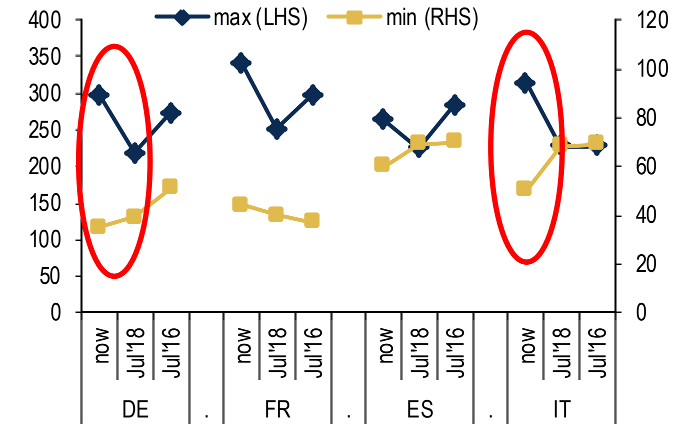
In Charts 5 to 8 we slice and dice the European IG senior non-fins credit market. We focus on **ratings**, **domiciles** and **sectors**. We present the gap between the widest and the tightest bond per bucket. We use the ENS0 corporate bond index to best proxy the "eligible" universe under the CSPP program. We also expand into BBs (when looking at ratings) by using the HE1M bond index (only senior bonds are used). We remove bonds with less than 2yr to maturity at any given point in time to reduce the roll-down effect that is more pronounced in the front-end of the curve.

Chart 5: Widest vs. tightest credit per bucket, split by ratings



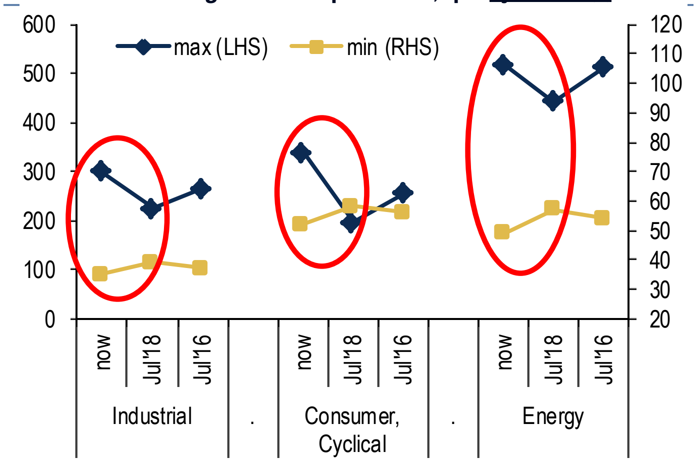
Source: ICE Data Indices, LLC, BofA Merrill Lynch Global Research; OAS

Chart 6: Widest vs. tightest credit per bucket, split by country of risk



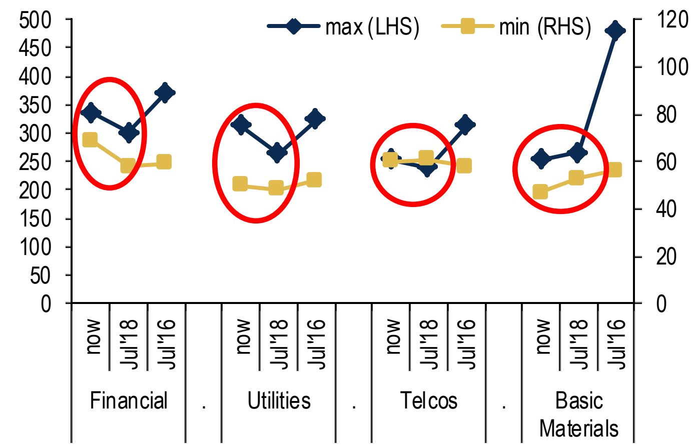
Source: ICE Data Indices, LLC, BofA Merrill Lynch Global Research; OAS

Chart 7: Widest vs. tightest credit per bucket, split by sectors (a)



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

Chart 8: Widest vs. tightest credit per bucket, split by sectors (b)



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

Our key findings can be summarised in the following points:

There is a clear increase in dispersion especially in pockets of risk that have benefited from CSPP. Focusing on **rating** buckets, BBBs have seen a significant rise in dispersion as captured by our metrics (Chart 5). Dispersion is currently at much higher levels than ever before since the start of the corporate buying program. The risk of downgrades as growth falters is now starting to put pressure on valuations for the weakest high-grade credits. We have seen a more moderate spread decoupling in single-As credits.

Note that dispersion has not risen in BBs (we use only seniors, DM non-fins) as there is lesser "upgrade" upside for names that could potentially be added into the CSPP eligible universe. The tight end of the spectrum has widened in line with the rest of the market, as there is lesser upside optionality.

- This is also the case when looking at **domiciles**. With the German economy bearing the brunt of the recent macroeconomic weakness, amid protracted US-China trade wars, we have seen that fundamentals matter again. German credits have priced-in more "fundamental" risk than ever before (Chart 6). Same story among Italian credits, amid rising political risks.

- Looking into **sectors**, CSPP has minimised the impact of fundaments in more business cycle sensitive pockets. Dispersion in industrials, cyclicals and energy has been compressed over the past years. However we find that dispersion has risen materially recently (Chart 7).

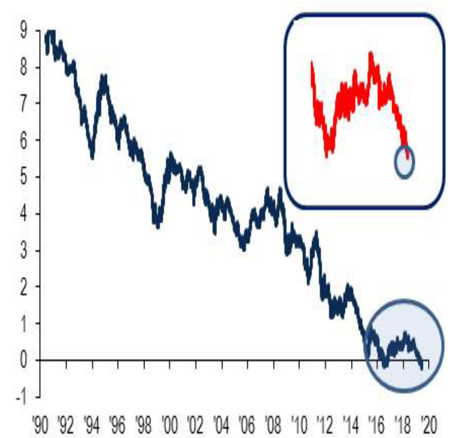
- This has been felt at a much lesser extent in non-cyclical and less business cycle sensitive sectors like utilities, communications and diversified credit (Chart 8). Same for financials as the sector is now more uniform on the back of the ECB support.

The lack of yield becomes an even bigger tailwind for IG

Inflows into high-grade funds continue despite the recent risk-off. Trade wars, geopolitical risks are ruining the party, but still high-grade funds continue to record stellar inflows as the pace has accelerated (chart 11). The lower the yield on offer in the government bond market, the higher the need for "quality" yield for fixed income investors (more here).

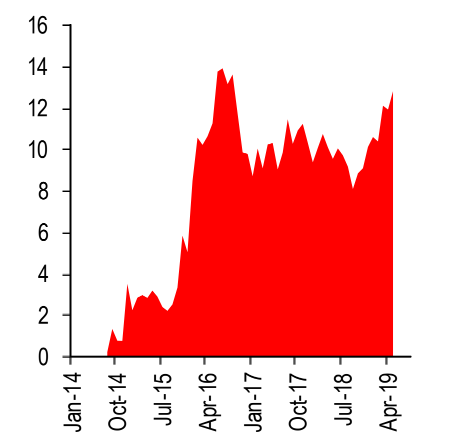
With central banks across the globe committed to support the global economic recovery, and happy to push depo rates even lower, investors are still happy to allocate into high-grade credit, we think. To the contrary the risk-off hits hardest the "growth/beta pockets" thus EM debt and high-yield funds have suffered moderate outflows lately.

Chart 9: 10y bunds setting new record lows



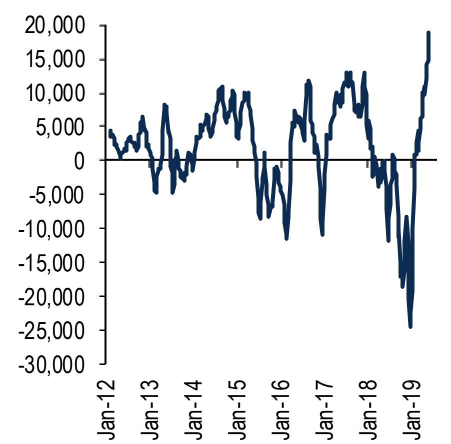
Source: Bloomberg

Chart 10: A rapidly increasing universe of negative yielding assets becomes a tailwind for positive yielding "quality" assets



Source: ICE Data Indices, LLC, BofA Merrill Lynch Global Research Using GFIM, WG7D and EMUA as a proxy of global bond market including front-end bonds (<1y)

Chart 11: Largest 5wk cumulative inflow ever for high-grade funds in Europe



Source: EPFR ; $mn

The recent streak of inflows into high-grade funds has been the strongest ever for the space as Chart 11 illustrates. This is the case as negative yielding assets across the globe continue to rise and currently rapidly approaching the $13trillion mark (Chart 10).

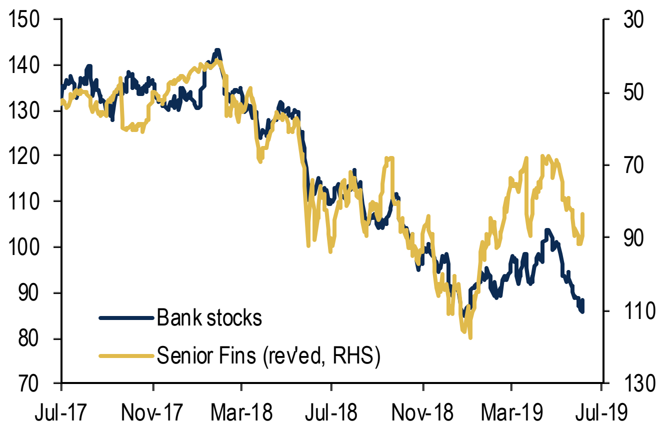
Rel Val corner – Senior Fins tight vs. iTraxx Main

Bund yields have set a new record low: 10y bund yields have rallied to levels never seen before with the benchmark hitting -23bp this morning. What are the implications? From a flows point of view, the lower the risk-free rate the more attractive the credit market looks, as we have highlighted above.

However, as dispersion rises we think that is worthwhile to look into the relative value between senior fins and iTraxx Main. We have frequently highlighted that senior fins vs. Main is strongly correlated to the level of bunds, as Chart 13 shows, and thus senior now feels "tight" to us under this metric.

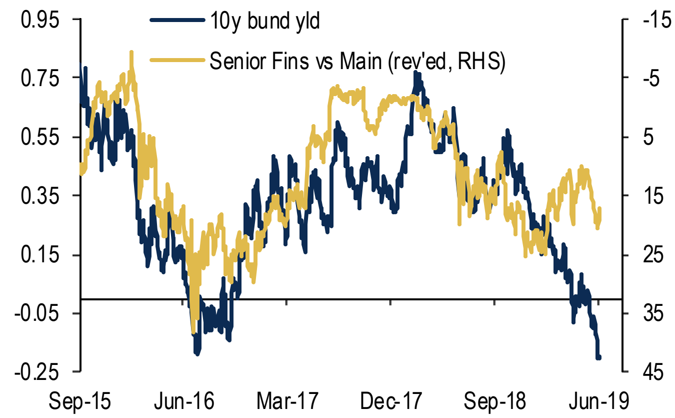
No doubt, expectations for a generous TLTRO this week from the ECB have underpinned senior bank spreads, and we agree that historically senior fins have tended to do well in the immediate aftermath of a TLTRO announcement. However, the effect is not a permanent one.

Chart 12: Credit has outperformed significantly the equity market



Source: Bloomberg

Chart 13: Senior too tight vs. Main for the level of yield in the market



Source: Bloomberg

Any disappointment this week with respect to TLTRO generosity would leave senior fins vulnerable here, in our view. In this case, the senior fins CDS index will struggle to outperform in the medium-term, amid a global pressure in yields, we think. Note that our Economic team has revised their expectations and now call for three cuts from the Fed over the following three quarters and no ECB hike before 2021, at least (more here).

Our European economics team expects no ECB hike before 2021, at least. Generous TLTROs, ultimately a long extension in forward guidance and the threat of depo cuts are part of their base case. TLTROs are supportive for banks, but a potential operation twist (that would flatten the curve) and another depo cut has multiple adverse effects on the real economy and would risk damaging the banking sector. Tiering could alleviate that risk to a certain extent, but too generous tiering would probably limit the FX effect.

Putting everything together we think that a more accommodative monetary policy stance that pushes yields lower and flattens the curve would be a structural headwind for senior fins in due course.

Macro is not that great, but not that bad either

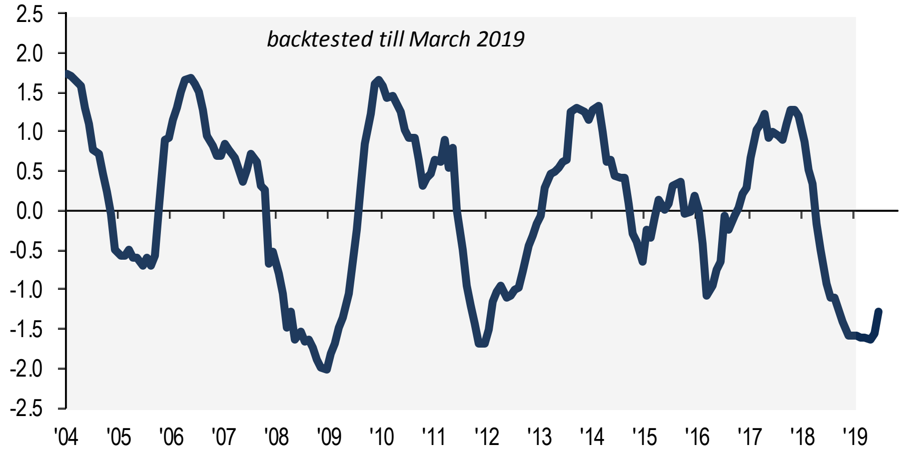
Macro has been in the front line as trade wars are posing downward pressure to sentiment and are threatening the global economic recovery. As a result the recent set of PMIs was less upbeat than expected. However macro weakness has bottomed out (more here) and we think that data are starting to stabilise, arguably at a slower pace.

We update our European Credit Macro Indicator for June (based on data available at the end of May for our 14 sub-components) and we find that it has moved another leg higher after a bounce in May. Looking into the drivers of the improvement of our indictor, we find that:

- Trends for the majority of the sub-components of our indicator have continued to improve. Twelve of the sub-components have seen their z-scores moving higher.
- Only a small subset has seen marginal deterioration (two sub-components) over the past month. One of them was a small deterioration for the trends of the Italian OECD LI.

- The key driver of the improvement has been the move higher in the OECD LI for China, the bounce in Eurozone Manufacturing PMI new export orders and the improvement for our BofAML Earnings Revision ratio for Germany.

Chart 14: The European Credit Macro Indicator moving higher in June



Source: BofA Merrill Lynch Global Research, Bloomberg, ICE Data Indices, LLC; Note that a negative (positive) reading reflects deteriorating (improving) trends. This performance is back-tested and does not represent the actual performance of any account or fund. Back-tested performance depicts the theoretical (not actual) performance of a particular strategy over the time period indicated. No representation is being made that any actual portfolio is likely to have achieved returns similar to those shown herein. The shaded area represents backtested results from January 2004 – March 2019. The un-shaded area represents actual performance since March 2019. Backtesting is hypothetical in nature and reflects application of the screen prior to its introduction; it is not intended to be indicative of future performance. The indicator identified as European Credit Macro Indicator above is intended to be an indicative metric only and may not be used for reference purposes or as a measure of performance for any financial instrument or contract, or otherwise relied upon by third parties for any other purpose, without the prior written consent of BofA Merrill Lynch Global Research. This indicator was not created to act as a benchmark.

Table 1: The vast majority of the sub-components of our Indicator have edged higher in June

Rank	Indicator sub-components	June'19	May'19	MoM chg
1	China OECD LI	-0.260	-1.095	0.836
2	EZ Manuf. PMI New Export Orders SA	-0.803	-1.506	0.703
3	BofAML Earning Revision Ratio Germany	-0.660	-1.323	0.663
4	ECB Survey Chg in Demand for Loans	-1.853	-2.488	0.636
5	DE Manuf. PMI Output SA	-0.778	-1.396	0.618
6	UK OECD LI	-1.268	-1.540	0.272
7	France OECD LI	-0.986	-1.163	0.177
8	EZ Manuf. PMI Suppliers' Delivery Times	-1.602	-1.749	0.147
9	DE Manuf. PMI Suppliers' Delivery Times	-1.665	-1.750	0.085
10	USA OECD LI	-1.647	-1.721	0.075
11	Germany OECD LI	-1.850	-1.880	0.030
12	Spain OECD LI	-1.023	-1.034	0.010
13	Italy OECD LI	-1.570	-1.429	-0.141
14	DE Manuf. PMI Employment SA	-1.948	-1.801	-0.148
	European Credit Macro Indicator	-1.279	-1.563	0.283

Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC, Bloomberg
Presenting the z-score levels of the 14 sub-components of our indicator

Chart 15: China leads Germany by 3 months on average historically

Lagging the Germany PMI data by three months vs. that of China, we find that there is the highest correlation between the two time series (using 24m rolling z-score)

Source: BofA Merrill Lynch Global Research; 24 months z-score

Where from here?

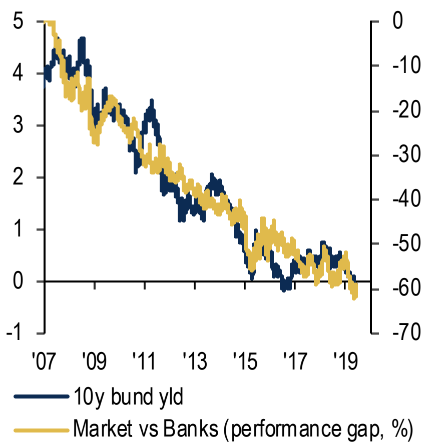
Our indicator is sending positive signals for another month, in our view. Small deviations and marginal revisions lower might arise – should trade wars continue to remain unresolved - but clearly macroeconomic data have been so poor for so long that cannot continue to deteriorate at the same/faster pace.

An even more accommodative stance from central banks across the globe is very likely to support sentiment, putting a floor on the downturn.

Chinese data have slightly weakened lately again, with Chinese new order PMIs dropping back below the 50 threshold. We think that European data (German in particular) are already reflecting this trend deterioration (lower z-score levels) and thus we will need another leg lower for Chinese data to push European metrics and our European Credit Macro Indicator even lower.

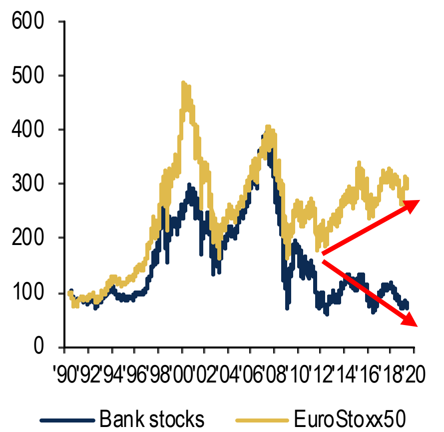
Appendix

Chart 16: One way street for European banks over the past decade



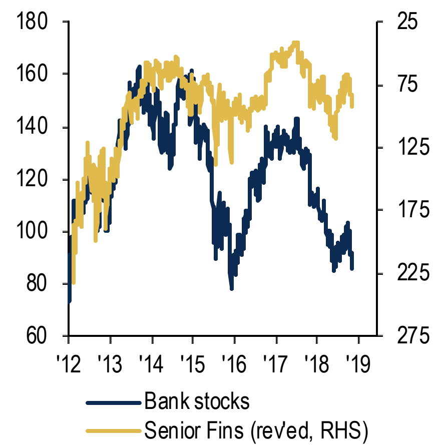
Source: Bloomberg

Chart 17: Banks stocks have clearly decoupled since the GFC. Lower yields do not bode well for bank stocks



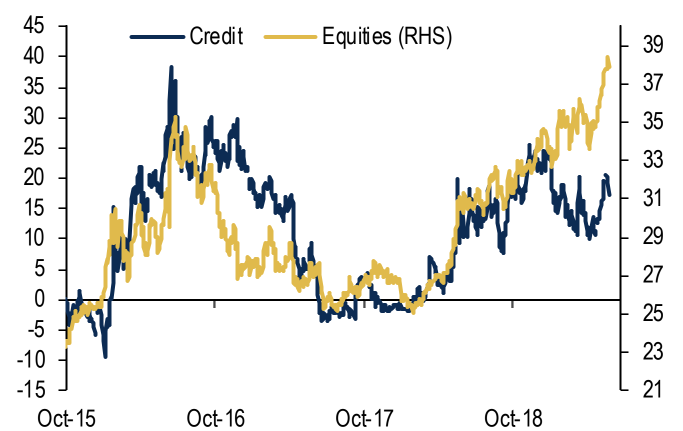
Source: Bloomberg

Chart 18: The capital structure trade – Bank stocks vs. Financials credit. Default risk vs. Earnings risk



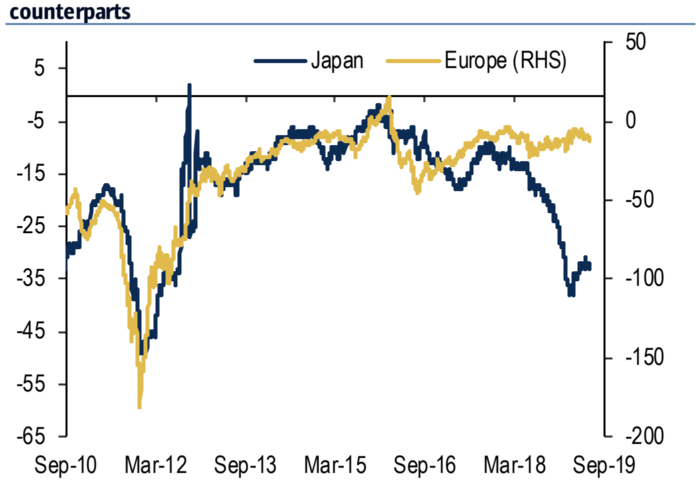
Source: Bloomberg

Chart 19: Fins have outperformed significantly in the credit market



Source: Bloomberg, Spread differential between iTraxx Senior Fins 5y CDS vs. iTraxx Main 5y. Ratio of performance between SX5E and SX7E

Chart 20: European fins have also outperformed their Japanese counterparts



Source: ICE Data Indices, LLC, OAS differential between JI00 and JF00 vs. EN00 and EB00

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