The European Credit Strategist

"It's the central banks, stupid"

Credit Analysis

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Credit Strategy
Europe

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The Pied Piper

If the "Tens" (2010s) taught us one thing, it was that monetary policy is the pre-eminent driver of financial markets. And as a new decade dawns, we think it is too soon to think otherwise. Global central bank balance sheets could grow by around $600bn in 1H '20, this year has already started with China policy easing, and March tends to see the greatest share of yearly rate cuts. Thus, we look for € credit to grind tighter for now.

From hubris to humiliation…and back

Despite 2019 producing mesmerizing returns for markets, high-beta assets were "humiliated". Fine wines and classic cars were shunned despite the S&P surging, value stocks underperformed growth stocks by a historic amount, and single-Bs couldn't even muster greater returns than BBs, despite offering twice the yield. Thus, we see the ultimate "catch up" trade in 2020 being "high-beta". The winners should be BBBs in IG (note big CSPP buying likely in Q1) and single-Bs (note spread dispersion now falling).

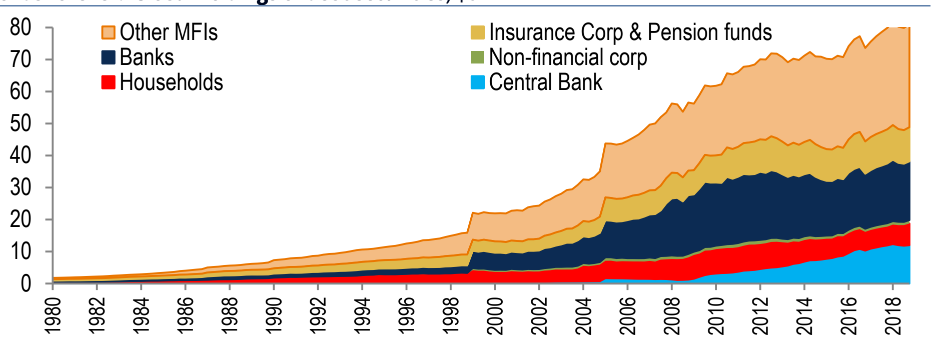
The "roaring" '20s: financial repression going wild

In 2020, we expect companies, themselves, to be big buyers of credit. Average deposit rates for non-financials have dipped into negative territory. Yet, Euro Area corporates currently sit on a record €400bn of cash (that will now be eroded). In fact, companies look to be saving *more* since QE, and signs of "animal spirits" just aren't there. French corps look the most risk averse, accounting for a third of total corporate cash. Safe to say, if part of this €400bn moves into credit, spreads will gain a material new support.

Demographics decade: trading the "Silver Generation"

The last decade threw up plenty of secular themes that were bullish for spreads: tech, globalization, capitalism, central bank largesse etc. Some of these will wax and wane in the 2020s. But one theme that still screams "buy bonds" is demographics. The world is getting older…and quickly, and the 2020s will see a jump in retirees. If this provokes consumers to transfer some of their wealth into income-bearing assets, then this can only be good news for spreads. The demographic story is particularly acute in Europe's periphery, which we see helping to underpin a bid for periphery credit this decade.

Bonds forever: Global holdings of debt securities, $tr



Source: BofA Global Research. Fed, ECB, BoJ, ONS, BoC, Riksbank. Quarterly Flow of Funds for US, EA, Japan, UK, Canada, Sweden, Norway.

Refer to important disclosures on page 11 to 13.
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"It's the central banks, stupid"

Happy New Year, and happy new decade. Let's get the bad news out of the way first: history doesn't shine brightly for credit markets as we enter the 2020s. By this, we mean that valuations could increasingly become the sticking point for corporate bonds as we look forward. History, in fact, suggests that high-grade spreads of around 90bp and high-yield spreads of around 300bp (today's levels) tend to be associated with – at best – zero excess returns over the following 12m.

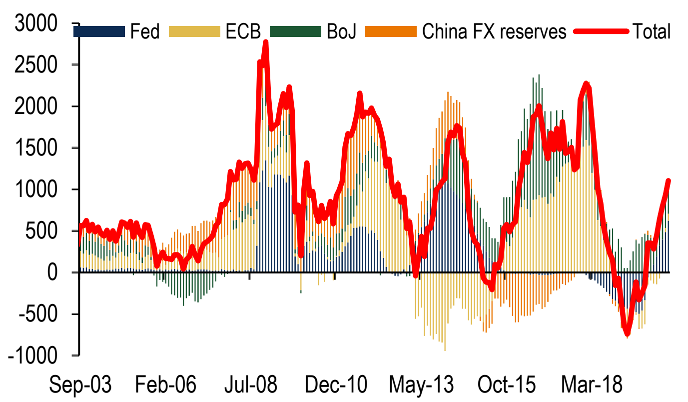
And so what's the good news? History is not all that it is cracked up to be...

The Pied Piper

If the "Tens" (2010s) taught us one thing, it was that for better or worse, central banks almost exclusively drive financial markets. Consider that 2019 provided mesmerising – and almost unfathomable – returns for many asset classes, a decade into a bull market: US high-grade total returns last year were 14%, long-end Italian government debt posted 20% returns, French equities (CAC 40 index) had their best year since '99 and the Italian stock market had its best run since '98.

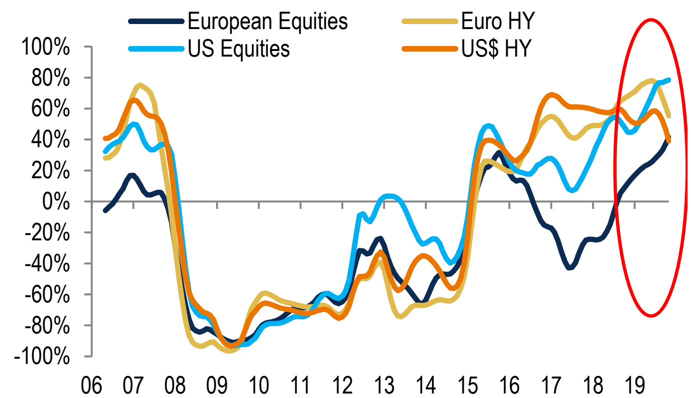
The rule of thumb in '19 turned out to be that global debt markets hummed more to the tune of central bank rate cuts...but that global stocks were more excited by central bank balance sheet growth. Charts 2 and 3 below show how the correlation of bonds and stocks to these different themes rose noticeably over the last year.

Chart 1: Tremendous central bank balance sheet expansion likely over the next 6m. We see this underpinning high-beta asset performance.



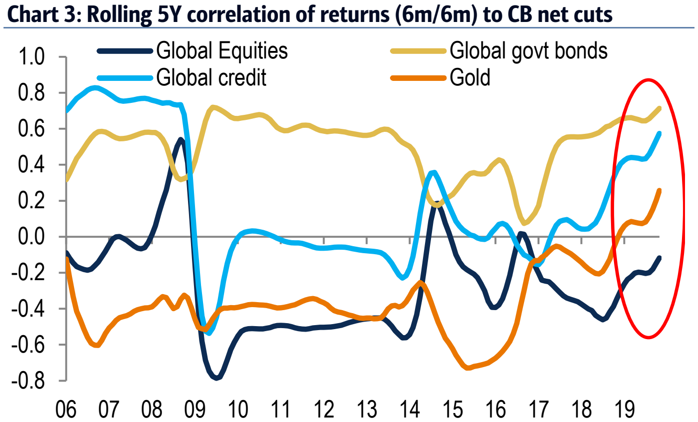
Source: BofA Global Research, Bloomberg, $bn. YoY changes in central bank balance sheets. Converting all B/S amounts into US$ equivs.

Chart 2: Rolling 3Y correlation of asset price returns (6m/6m) to global CB balance sheet growth



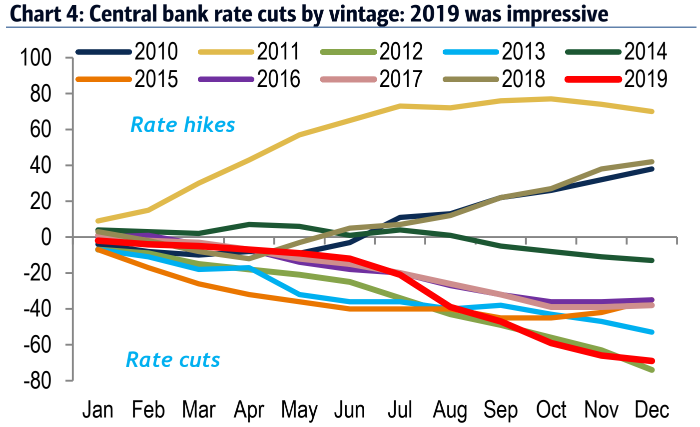
Source: BofA Global Research, ICE Data Indices LLC, Bloomberg. Positive correlation means increase in global QE results in higher asset prices.

Chart 3: Rolling 5Y correlation of returns (6m/6m) to CB net cuts



Source: BofA Global Research, Bloomberg. Positive correlation means CB net cuts result in higher asset prices.

Chart 4: Central bank rate cuts by vintage: 2019 was impressive



Source: BofA Global Research. Cumulative rate cuts/hikes by year. Large sample of global central banks.

The irony is that while investors are getting more worried about the theme of *Quantitative Failure* (or "central bank impotence"), they seem even keener to snap up financial assets at the first whiff of monetary intervention.

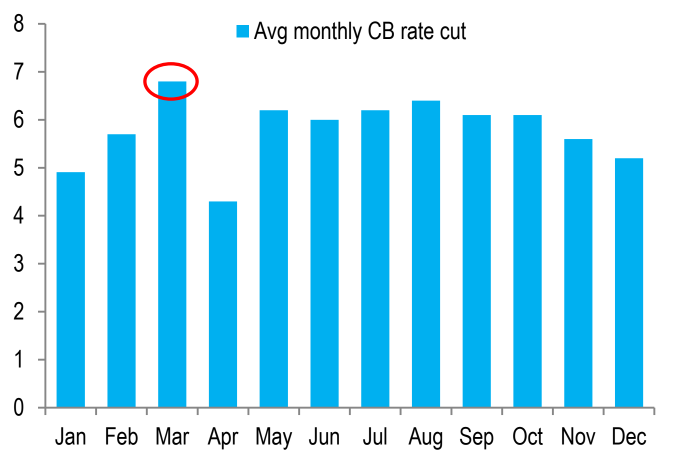
Looking into the early part of 2020, the backdrop of central bank "activism" remains supportive for financial assets and credit spreads, in our view. Perhaps no surprise then that markets have remained so resilient despite rising geopolitical tensions.

- As chart 1 shows, global central bank balance sheets could expand by a hefty $600bn in H1 this year (with Fed bill purchases and ECB debt purchases chiefly driving this).

- For credit, it's rate cuts that tend to unleash reach for yield behaviour. Chart 4 shows global central bank rate cuts by vintage. In '19, central banks cut rates a total of 92 times, the second biggest year for cuts in the last decade. And while it may feel tough to get near this in 2020, China has already cut rates before the new decade has barely started.

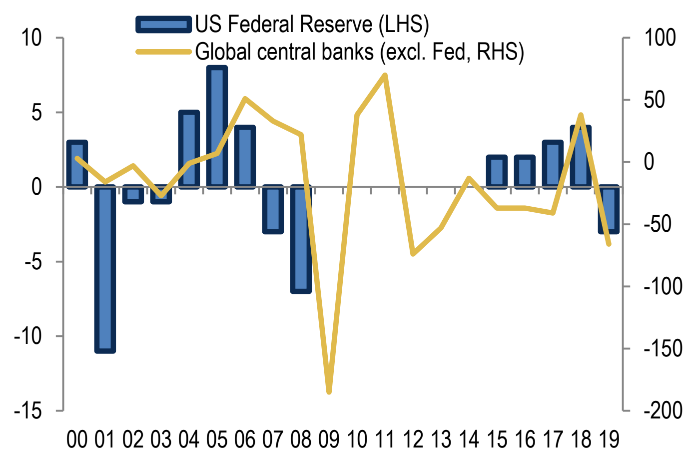
And as chart 5 shows, note that March tends to see the greatest number of central bank interest rate cuts during a year, likely supporting reach for yield behaviour again. And should the Fed contemplate easing this year in the face of geopolitics (note BofA Global Research base case is Fed on hold for '20), this could drive a follow-on response from other central banks looking to prevent undue currency appreciation (chart 6).

Chart 5: "March madness" for central banks. March historically sees the most rate cuts in a year (period of 2009-today)



Source: BofA Global Research. Average monthly rate cuts, per month, 2009-today.

Chart 6: When the Fed moves rates, other central banks tend to move too. Fed rate cuts/hikes vs. other global central banks



Source: BofA Global Research, Bloomberg. Annual number of central banks rate hikes minus cuts.

2020 outlook

Thus, with a supportive backdrop of central bank "activism" as we start 2020, we see Euro corporate bond spreads heading tighter still. We think spreads get close to the previous CSPP lows of late '17/early '18 (74bp for IG, 233bp for HY)…but not quite.

Why not? Back then, global growth was in a synchronised upswing and policy uncertainty was close to a record low. Today, growth rates are stabilizing at trend-ish levels rather than much stronger, and policy uncertainty remains close to an all-time high.

We look for the IG tights to be ~85bp this year, and the high-yield tights to be ~270bp (adjusting for the fact that markets already moved in December '19, especially high-yield).

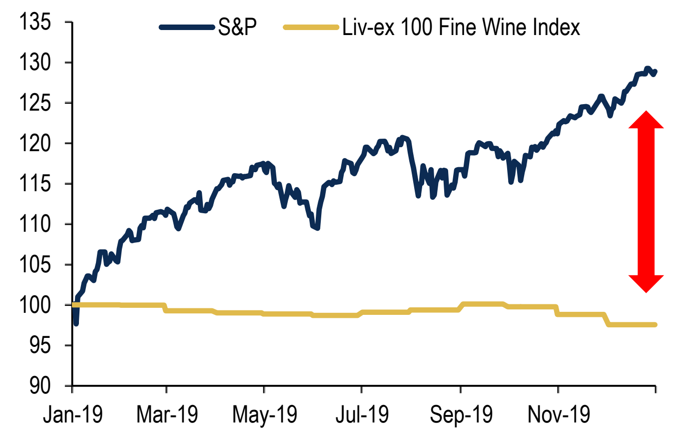
From hubris to humiliation...and back

While 2019 contained plenty of hubris, it contained its fair share of “humiliation”. The startling thing about last year was the extent to which beta trades failed to work despite the massive appreciation in markets.

For instance, while the S&P surged almost 30%, fine wines and classic cars were down for the year. And, as chart 8 shows, even though European stocks rallied an impressive 23% in ‘19, “value” stocks underperformed “growth” stocks by a conspicuous 12pp (usually, they outperform when overall market returns are 20%+).

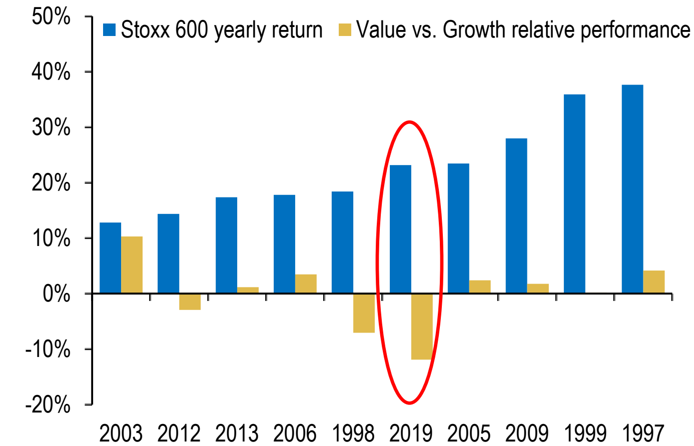
And in credit land, the same phenomenon played out. Despite European high-yield amassing total returns of over 11%, single-B total returns actually *trailed* those of BBs last year, even though single-Bs started 2019 with *double* the yields of BBs.

Chart 7: While broad markets posted tremendous returns last year, many “beta” assets couldn’t muster gains



Source: BofA Global Research. Indices rebalanced to 100 at Jan ’19.Bloomberg.

Chart 8: The underperformance of “value” vs. “growth” equities last year in Europe was conspicuous given the overall market surged

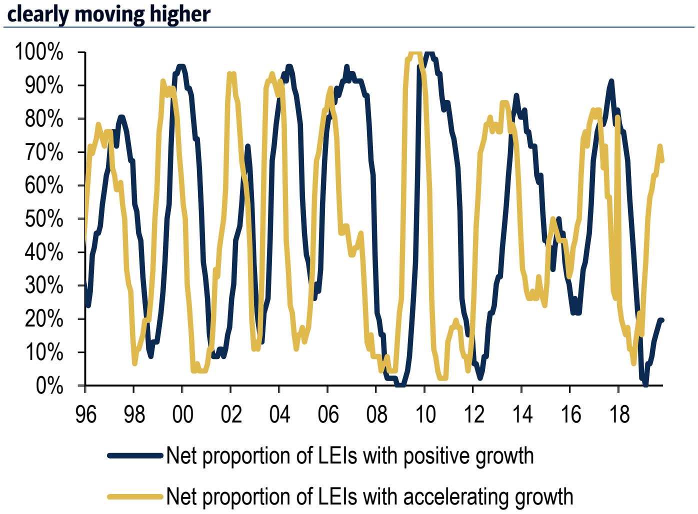


Source: BofA Global Research, Bloomberg. Using European equities as the sample set.

2019 wasn’t kind to high-beta assets because, in large part, the macro cycle wasn’t favourable. Today, however, economic data has moved into the recovery phase, something our Credit Macro Indicator has been highlighting lately.

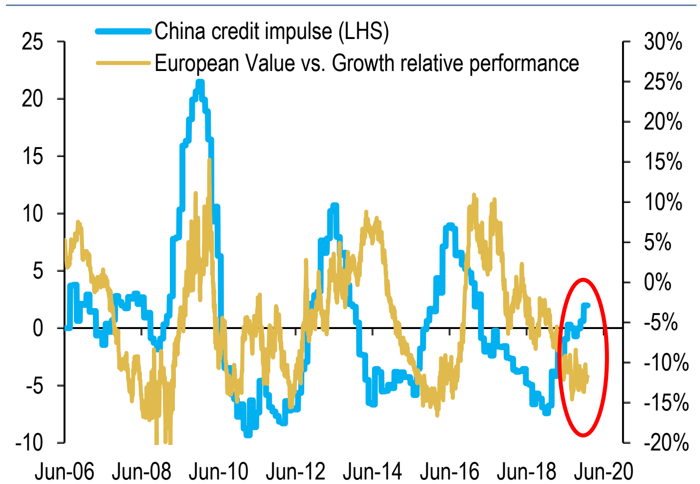
Two other charts strike us as particularly encouraging for high-beta performance looking forward though:

Chart 9: “Breadth” of global OECD Leading Economic Indicators now clearly moving higher



Source: BofA Global Research, OECD. Proportion of sample set rising or falling.

Chart 10: China stimulus is finally showing promising signs – potentially bullish for beta assets



Source: BofA Global Research, Bloomberg. China credit impulse, 12m change.

- First, the *breadth* of global economic improvement is increasing. Chart 9 shows the number of global OECD Lead Economic Indicators that are now increasing year-over-over. The trend is upwards (with Emerging Market trends particularly encouraging).
- Second, China credit impulse is showing signs of life (albeit still modest, as China is favouring monetary stimulus). Chart 10, however, suggests that in the past China credit stimulus has eventually heralded the outperformance of "value" over "growth" stocks in the European equity markets.

The FOMO trades: buy beta for 2020
In corporate bond markets, therefore, we think the best "catch up" trades will be BBBs and single-Bs for 2020:

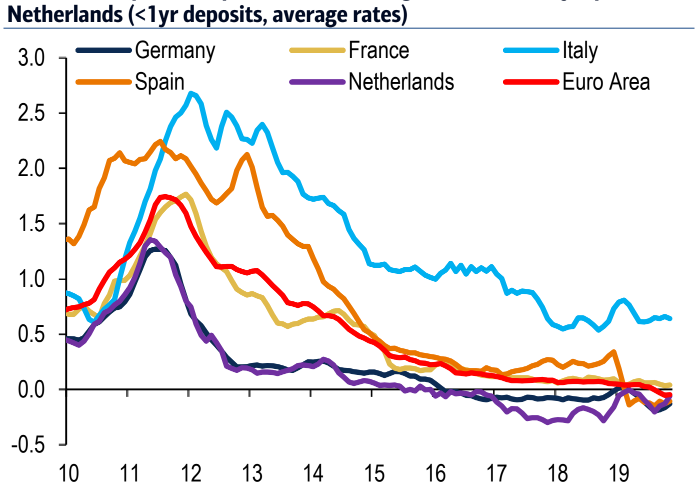
- BBBs should be further supported by the ECB's skew towards buying this part of the market (at the expense of AAs and single-As). Note the ECB bought an impressive €6bn of corporate bonds in November last year – and we expect this to be representative of their new run rate. Moreover, don't forget that CSPP reinvestments are the highest in Q1 this year (€5.2bn).
- Single-Bs should benefit from falling levels of dispersion as well, helping investor confidence return to the sector. We showed here the first signs that dispersion across single-Bs was beginning to fall.

The "roaring" '20s: financial repression going wild

We believe that companies themselves will be the big new marginal buyers of European corporate debt in 2020. What's behind this? Banks in Europe seem to have bitten the bullet recently and lowered deposit rates for non-financials even further. As chart 11 shows, banks in Europe have "crossed the rubicon": average deposit rates for non-financial corporates (<1yr) are now negative in Germany, Spain and the Netherlands. In fact, the only Eurozone region that (<1yr) corporate deposit rates still remain positive in is Italy (and marginally in France).

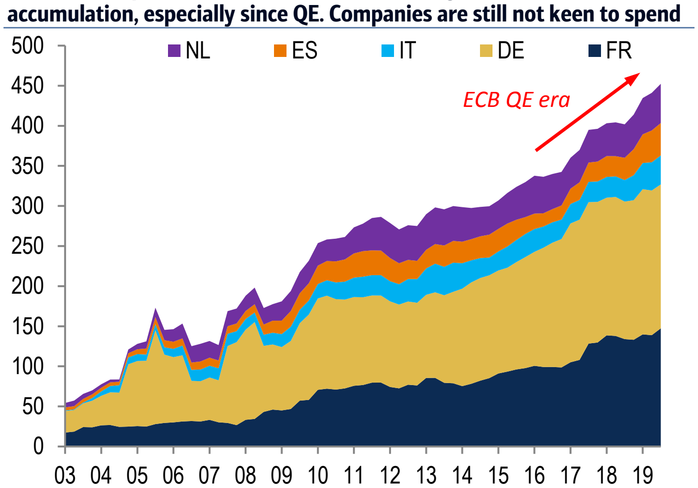
As Alastair Ryan argues here, the vast majority (~80%) of Euro Area household savings are sub-€100,000, and due to the fear of voter backlash, these deposits are unlikely to be subject to negative rates down the line. Thus, it's non-financial corporate deposits that have to bear the brunt of financial repression…

Chart 11: Corporate deposit rates: now negative in Germany, Spain and Netherlands (<1yr deposits, average rates)



Source: BofA Global Research, ECB. Interest rates on new non-financial corporations' deposits (%).

Chart 12: Corporate cash levels (Eur bn) – no signs of a slowdown in cash accumulation, especially since QE. Companies are still not keen to spend



Source: BofA Global Research, Bloomberg. Cumulative total cash for large sample of Euro IG issuers.

But Euro Area corporations sit on significant piles of cash…which are now being eroded by the backdrop of negative rates. Chart 12 shows the total cumulative "cash" holdings of Euro Area non-financials. For this, we use a large sample on non-financial high-grade issuers (members of ICE BAML's ER00 index).

Overall, we find that the number is a material €400bn. True, some of this will already be invested in "short term investments". But nonetheless, we still believe there is a ready source of new money that will be under increasing pressure to earn a greater return. And we believe that some of this money will find its way into corporate bond funds in 2020 (anecdotally, investors have told us that they are having more frequent conversations with corporate treasurers now about potentially managing some of their liquidity).

Safe to say that even a portion of this €400bn finding its way into European corporate bond funds will act as a significant new source of buying power.

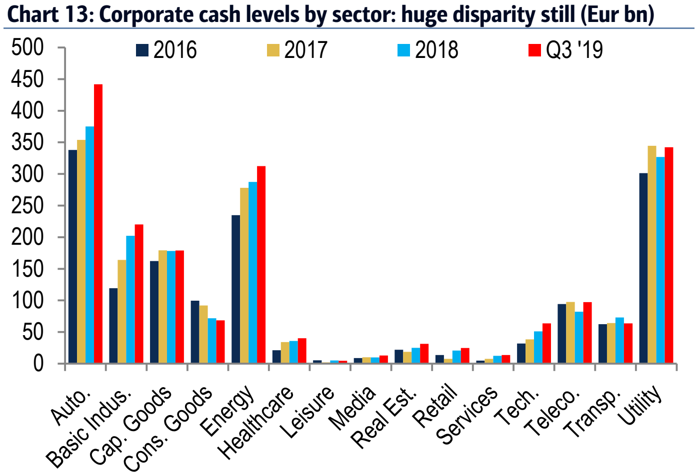
How not to spend it

There are some noteworthy facts when it comes to the distribution of corporate cash:

- **"Quantitative Failure" corporate-style**. The yearly growth rate in overall corporate cash hasn't shown any signs of tailing-off lately, even with the backdrop of trade wars, In fact, quite the opposite. Note that the growth rate in European corporate cash seems to have *accelerated* since QE started in Europe. While a lot of this will likely reflect the margin boost that corporates have received from lower interest costs, it also highlights the fact that despite the cheapest debt costs ever, companies still don't feel compelled, or confident enough, to spend the cash and transform their balance sheets (M&A, capex etc). And, this is consistent with the Japanification theme, where after 20yrs of zero rates, Japanese corporates are likewise sitting on almost record levels of cash.

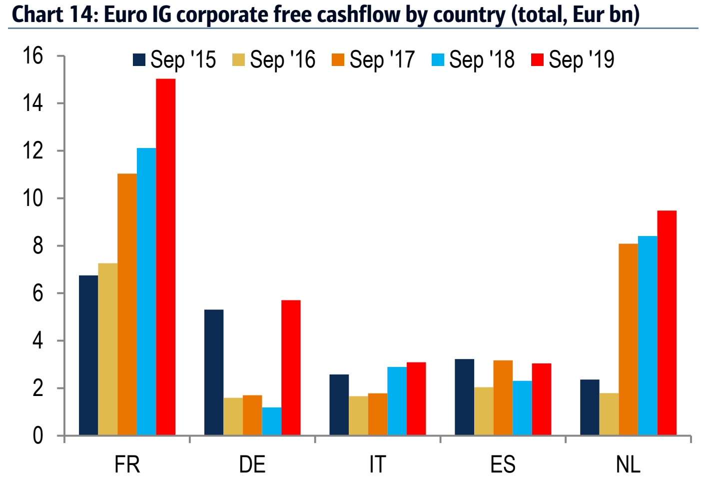
- **The French failure of "Animal Spirits"**. Interestingly, the current cash pile for French credits is €130bn, which is around a third of total European corporate cash. Yet, France is just 20% of Eurozone GDP. French issuers seem, therefore, to have a greater propensity to save (perhaps in contrast to Italian companies).

Chart 13: Corporate cash levels by sector: huge disparity still (Eur bn)



Source: BofA Global Research, ICE Data Indices LLC, Bloomberg. Eur bn. Euro IG index (ER00).

Chart 14: Euro IG corporate free cashflow by country (total, Eur bn)



Source: BofA Global Research, ICE Data Indices LLC, Bloomberg. Eur bn. Euro IG index (ER00).

- **The haves and the have nots**. Chart 13 shows that there is a wide dispersion in who has the cash and who doesn't in Europe. Utilities, Energy and Autos make up 70% of total corporate cash across Europe. Other sectors are much less cash rich.

- And looking at free cashflow trends – as an indicator of who will see their cash buffers swell in the years ahead – chart 14 shows that French and Dutch companies will likely amass more cash over the quarters ahead.

Home bias?

If Euro Area corporates allocate some of their cash into Euro-denominated corporate bonds, will there be a little bit of a "home bias" to some of their buying? We think there could be. After all, French companies will have a vested interest in helping to support the French economy etc., and a utility company will be thankful if interest costs for the sector fall further.

Thus, in conclusion, while companies themselves will help buttress demand for corporate bonds in 2020, **French** corporate bonds, as well as **utility** and **energy** bonds could get a little extra helping hand.

Trading the "Silver Generation" for the '20s

The "Tens" (2010s) threw up plenty of secular themes that promoted enormous demand for corporate bonds. The next decade will undoubtedly see some of these wax and wane in importance (can central banks always be this powerful?), but it would take a significant reversal in many of them, we think, for credit to revert back into a longer-term bear market. Thus, we think trading ranges are likely to be the norm for credit spreads over the next few years, rather than true bear markets.

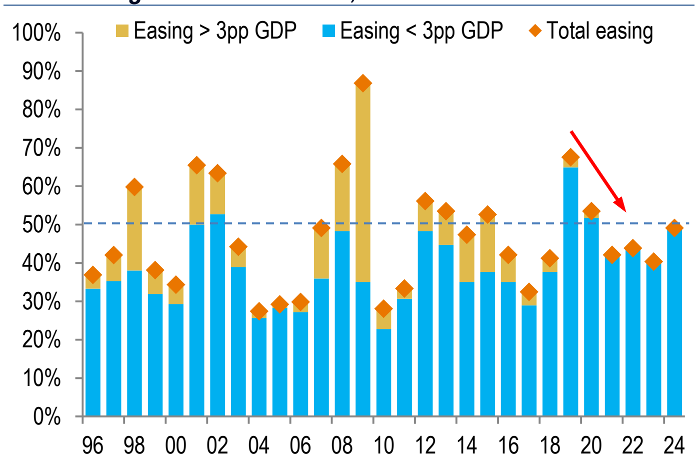
Away from central banks, what have been some of the other secular narratives since Lehman times, and will they still be as powerful over the next decade?

Fiscal *frenzy* or fiscal *fantasy*?

The 2010s generally saw European governments stick to fiscal discipline and belt-tightening rules, limiting the net supply of government debt. But central banks are now increasingly imploring European governments to take up the baton and support growth trends through fiscal stimulus. And Europe's level in investment, relative to GDP, looks conspicuously low at present.

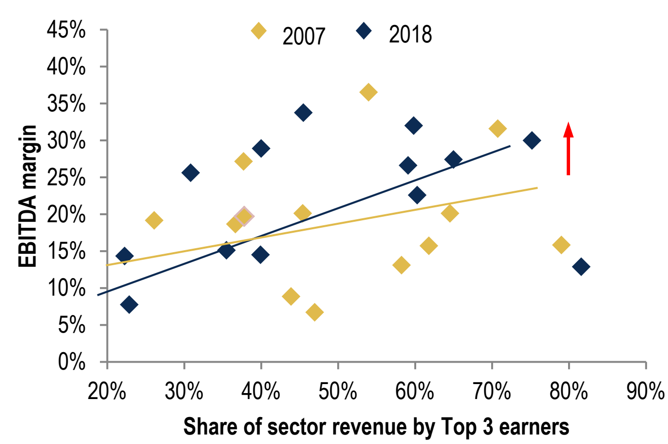
Moreover, the pressing need for economies to be carbon neutral by 2050 lends itself to potentially billions of infrastructure spend by economies around the world.

Chart 15: Fiscal *frenzy* or *fantasy*? Percentage of economies across the world running an easier fiscal stance, YoY



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 16: Globalization and tech have helped the rise of "Superfirms": companies with a disproportionately large share of their sector revenue



Source: BofA Global Research, Bloomberg.

So what's planned…and will it be a fiscal *frenzy* or fiscal *fantasy*? Chart 15 shows the number of governments across the world easing their fiscal stance, year-over-year (structural budget balance).

For now, the world doesn't seem to be embracing big fiscal spend over the next few years. In fact, there has been more fiscal loosening in 2019, relative to what's planned next year.

Nonetheless, fiscal spending "newsflow" will undoubtedly grow over the next few years. And the risk with govt. fiscal stimulus is that it crowds out the corporate bond market.

Globalization, capitalism and "superfirms"

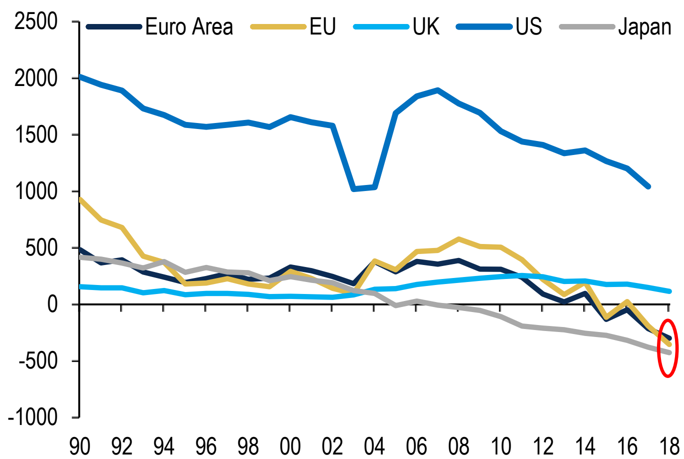
The era of globalization and capitalism have conspired to aid the rise of "Superfirms" – companies that have a disproportionately high share of their sector revenues. "Superfirms", in our view, have been able to extract more cost cutting either by holding down workers' wages or by cheaper sourcing of inputs into the supply chain…behaviour which has likely added to the lowflation backdrop. Chart 16 shows that EBITDA margins for sectors with "Superfirms" (sectors where the top 3 earners have a high percentage of sector revenue) are generally higher.

But as populism inspires deglobalization, and socialist policies become more conspicuously in favour of workers' rights (minimum wage hikes, re-unionisation etc.), this deflationary impact may start to reverse, risking higher yields and weakening the "reach for yield" trade in credit.

The "Silver Generation"

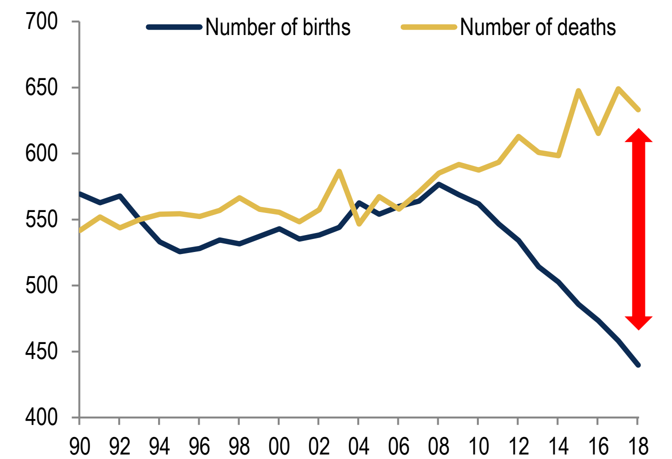
Yet, there is one secular theme we see continuing to remain supportive of the bid for corporate bonds…and that is the theme of demographics. As the charts below show, the world is getting older….and quickly.

Chart 17: Net births (per '000 people)



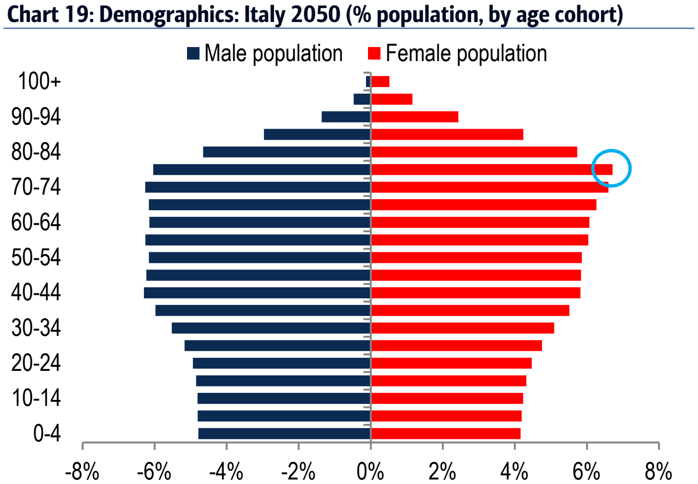
Source: BofA Global Research. UN. Number of live birth minus deaths.

Chart 18: Births vs. deaths (per '000 people): the case of Italy



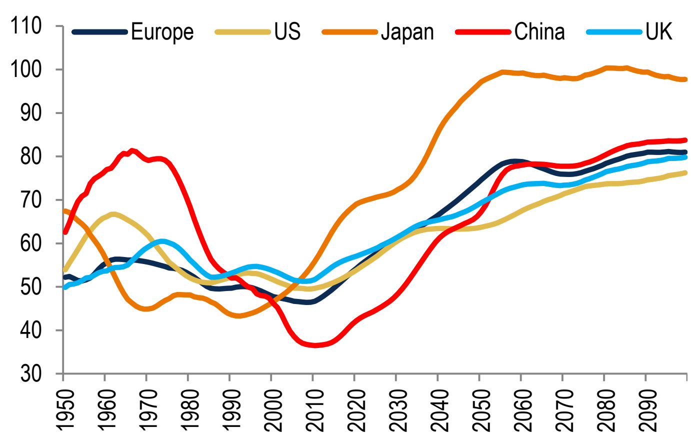
Source: BofA Global Research. UN.

Chart 19: Demographics: Italy 2050 (% population, by age cohort)



Source: BofA Global Research. UN.

Chart 20: Dependency ratio (per 100 workers)



Source: BofA Global Research. UN. Dependency ratio defined as the sum of [population aged below 14 and above 65} over the population aged between 15 and 64 (working age population).

The global population aged 65 and above is projected to rise significantly over the next 30yrs. By 2030, 11.7% of the global population will be aged 65+, and that number will rise to 16% by 2050 (according to latest UN statistics).

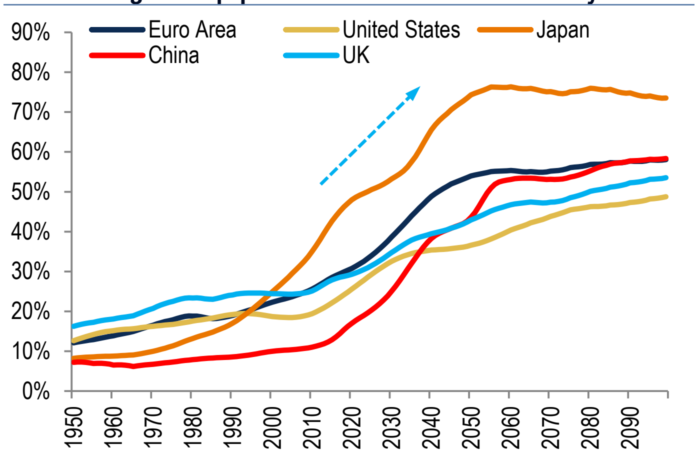
By country, Japan has some of the world's oldest population: 28% of the population are currently 65+yrs in age, and this number is projected to rise to over 31% by 2030 (again according to UN statistics). But Europe is not far behind, albeit with a lot of disparity across individual countries:

- In Germany, for instance, 26.2% of the population will be aged 65+ by 2030.
- And in Italy and Spain, the corresponding numbers are 28% and 25%.
- While Asia and Latam have "younger" populations at present, their societies are nonetheless projected to age rapidly.

What's behind the emerging "Silver Generation"? A mix of increasing longevity, and declines in the number of children being born. As chart 17 shows, the net birth rate has now dipped into negative territory for Europe and Japan.

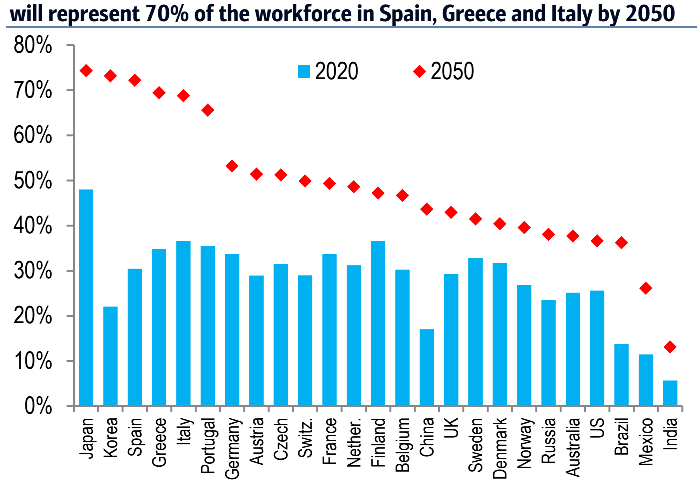
And as chart 18 shows, the picture is even more daunting for Italy, where the net birth rate has sagged of late. By 2050 (chart 19) the largest cohort of the female population in Italy will be aged between 75 and 80.

Chart 21: Retirees as a % of the workforce. All major economies will see a relative surge in the population of retirees over the next 30 years



Source: BofA Global Research. UN. Retirees are population aged 65 and over. Workforce is defined as the population aged 15 to 64.

Chart 22: Retirees as a % of the workforce. The population of retirees will represent 70% of the workforce in Spain, Greece and Italy by 2050



Source: BofA Global Research. UN. Retirees are population aged 65 and over. Workforce is defined as the population aged 15 to 64.

But as the world gets older, a constant stream of workers will be approaching retirement age.

The charts above show the evolution of retirees across the globe, looking forward. We show retirees as a percentage of the overall workforce. Across both developed and emerging markets, retirees as a percentage of the workforce are projected to rise quickly during the '2020s…but the acceleration is more pronounced for developed economies than it is for EMs.

But as workers retire, it is likely that they shift a portion of their financial wealth into income-bearing instruments, with credit likely to be a beneficiary of this demand, we think. Thus, the "Silver Generation" (the ageing population thematic) could end up being a powerful support for credit in this decade.

Note, in particular, chart 22. Periphery countries will see a big increase in retirees. Given the likely domestic bid for fixed-income and credit from these potential consumers, we think this backdrop bodes well for peripheral credit in the 2020s.

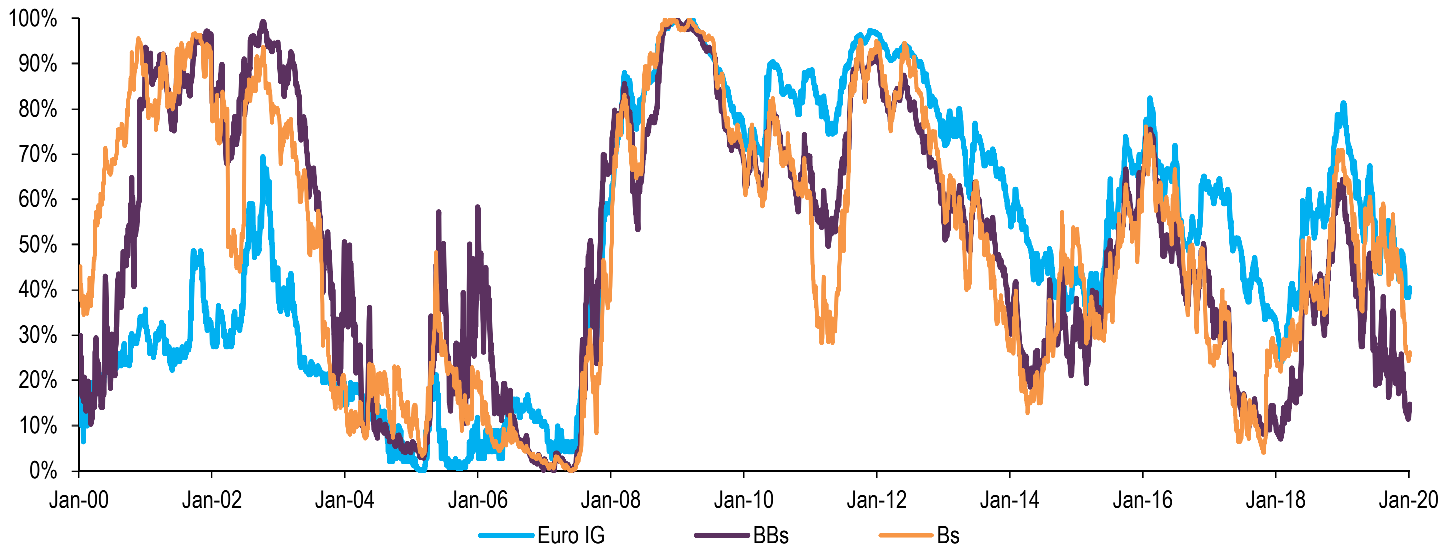
Appendix

The below chart shows the historical spread percentiles of parts of the Euro corporate bond market (higher percentiles = spreads are historically wide, lower percentiles = spreads are historically tight). We use a fixed window from 2000-today to calculate percentiles over time.

Note that BB spreads are currently screening as tight: the spread percentile is just 15%. On the other hand, single-B percentiles (26%) are a bit better, implying there is room for beta compression in the high-yield market in the early part of 2020.

However, bear in mind the significant compositional changes of European corporate bond market over the last two decades, when assessing the below.

Chart 23: Long term percentiles of Euro denominated corporate bond indices (2000-today). Lower percentiles = spreads are historically tight, and vice-versa.



Source: BofA Global Research, ICE Data Indices LLC. Using a fixed window (2000-today) for percentiles.

Disclosures

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