The hunt for red October

Credit Analysis

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Credit Strategy
Europe

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The end of the "invisible hand"

Despite a late rally into month-end, October 2018 still proved to be an ugly time for markets. And "crashes" are becoming more common in a world of vanishing QE support, and – importantly – rising *real* interest rates in the US. Yet, the bigger story, we think, is how few assets across the globe are now managing to post positive returns in a world ex-central banks. In fact, we find that just 23% of markets have managed to record positive total returns in '18, a number usually seen in times of either financial or debt crises, or just plain old recessions. And with so many assets failing to perform at present, we think bounces in risk appetite will probably remain shallow ones for now.

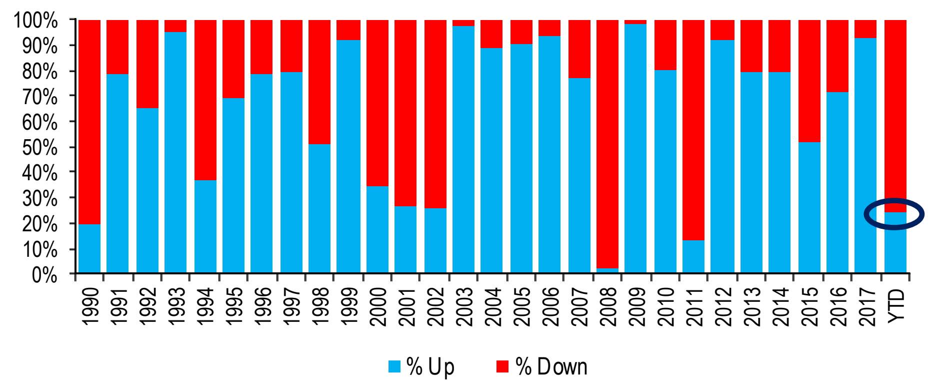
Europe – a slow motion bear market

Credit spreads widened a lot last month. Even still, we don't think they have caught up yet with the reality of weaker economic data. In fact, high-yield spreads still look tight to us relative to forward-looking measures of Eurozone growth. Hence we remain cautious on spreads. That said, we believe this is likely to be a slow motion bear market playing out. We simply don't see the overt misallocation of capital in Europe that defined the 2002 (tech) and 2008 (shadow banking) sell-offs. True, leveraged loans and "zombies" remain weak links, and have piqued the interest of central banks and regulators of late. But we believe that both are manageable in size from a systemic point of view.

The dividends for bondholders

Euro credit markets have grown profusely in the aftermath of ECB QE. Today, the size of the high-grade market in Europe is almost 22% of Eurozone GDP. But with much greater reliance on debt financing, companies are finding it tougher to manage to shareholders, at the expense of bondholders, as they once were able to do. In our view, equity investors should therefore look for the possibility of dividend cuts, asset sales or other shareholder-unfriendly actions from companies with high debt, especially as Draghi's QE draws to a close. Table 1 updates our refinancing risk screen for European issuers.

Only 23% of assets have positive total returns in 2018 – a number usually seen in financial (2008) and debt crises (2011). Percentage of assets with positive vs. negative total returns (yearly).



Source: BofA Merrill Lynch. Yearly total returns. Using sample of over 300 assets across equities, commodities, FX and credit. COB 31-Oct.

Refer to important disclosures on page 9 to 11.
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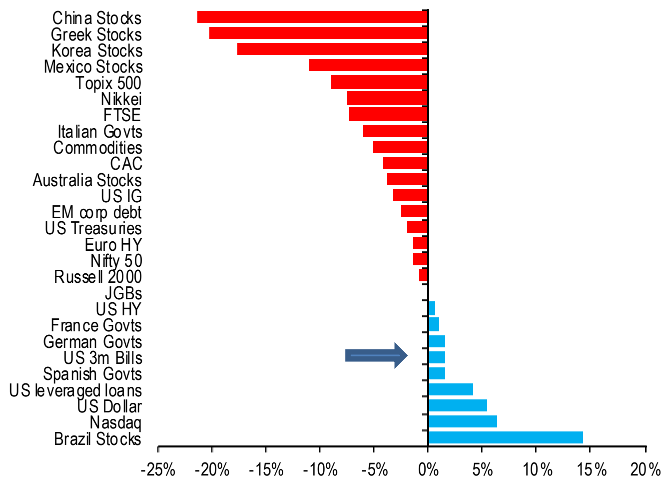
The hunt for red October

Despite a late rally into month end, October 2018 proved to be an ugly time for risk assets. US stocks, for instance, posted their third worst month for returns since the bull market began in March-09.

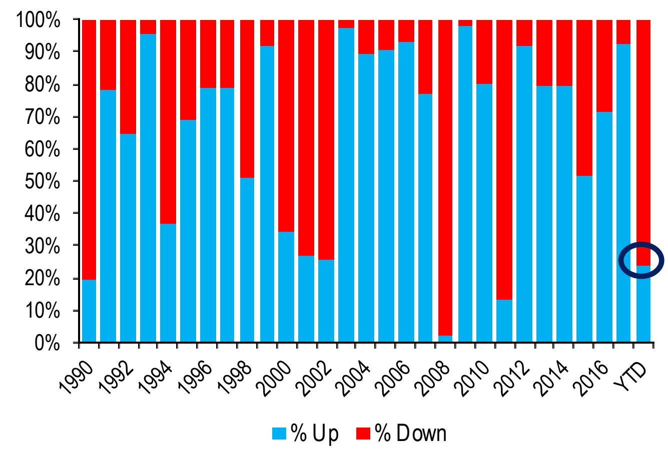
Credit markets also fared poorly across the globe, although the sell-off was tamer. High-grade spreads in Europe widened by 14bp on the month, but this was a less extreme repricing than the Italy-induced sell-off in May. Nonetheless, breadth across credit markets in October was particularly bad: only 1% of high-grade bonds in Europe saw spreads tighten. And all risk seemed to be for sale...be it cyclicals, defensives, banks, corporates and even hybrid debt.

Chart 1: The few winners...and the many losers in '18. Total returns YTD.



Source: BofA Merrill Lynch. YTD total returns. Using sample of over 300 assets across equities, commodities, FX and credit. Snapshot as of COB 31-Oct-2018.

Chart 2: Only 23% of assets have positive total returns in 2018. Percentage of assets with positive vs negative total returns (yearly).



Source: BofA Merrill Lynch. Yearly total returns. Using sample of over 300 assets across equities, commodities, FX and credit. Snapshot as of COB 31-Oct-2018.

The end of the "invisible hand"...

Last month wasn't unique, though. We think it reflects a bigger picture theme...namely that assets are now struggling to produce meaningfully positive returns in an era of less central bank liquidity. The "invisible hand" that once propped-up market prices is now significantly smaller.

Chart 1 shows that there are precious few assets that remain above water this year. In fixed-income land, US leveraged loans have produced total returns of around 4%. In Europe, many government debt markets – with the exception of Italy – are up for the year, albeit only by a modicum. But note that the biggest loser of all during the QE era, namely cash, has turned into one of the best performing assets of 2018 (1.5% total returns).

...the start of abnormal markets?

This spectrum of returns, however, is also far from normal. Chart 2 shows the historical percentage of assets with positive vs. negative returns on a yearly basis (our sample contains over 300 equity, fixed-income, commodity and FX indices).

This year, we find that only 23% of assets have produced positive total returns. As can be seen, historically this is a very low number. In fact, such a number is usually only observed in periods of financial crises (2008), debt crises (2011), or just plain old recessions. And yet despite the shocks and bumps lately, the global economy is still humming along fairly nicely in 2018.

In our view, after such a big drawdown last month, markets are likely [prepped for a rebound] in November. Yet, we caution that bounces in risk sentiment could still be shallow ones. After all, with so many assets trending lower this year, long-only investors are finding that there are much fewer ways to help them diversify and protect their portfolios.

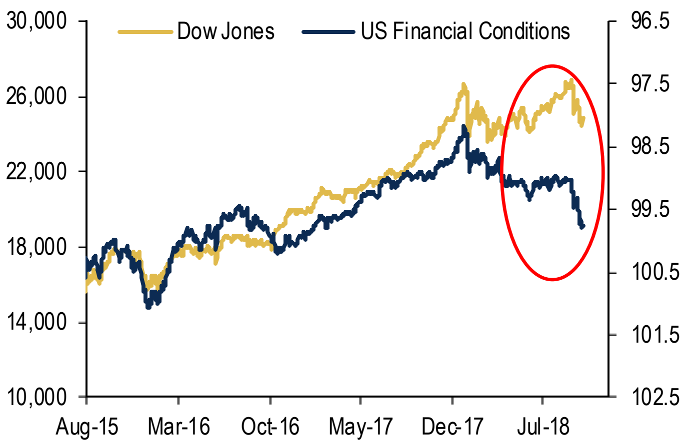
Time to get real

October contained all of the catalysts for a correction: rising geopolitics, ongoing trade concerns, some downbeat company outlooks in the US and, importantly a Fed that seems to be digging its rate hiking heels in, and looking past volatile markets.

Given a hawkish and determined Fed, US Libor has begun to climb conspicuously again, and now sits at 2.6%. As Hans Mikkelsen, our US credit strategist, points out, rising Libor is akin to tighter financial conditions (partly because Libor drives the hedging costs for foreign investors in the US fixed-income market).

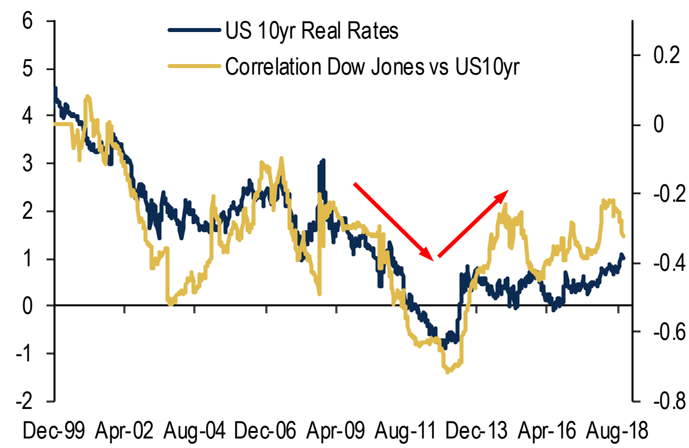
Yet, as chart 3 shows, markets had been diverging from financial conditions for much of 2018…with asset prices continuing to rise since April despite the fact that financial conditions had begun to tighten. And as the chart shows, some divergence still remains.

Chart 3: Markets (higher) have been diverging from financial conditions (tighter) for much of this year



Source: BofA Merrill Lynch Global Research, Bloomberg (GS Financial Conditions Index) .Financial conditions (RHS, higher = looser financial conditions, lower = tighter financial conditions).

Chart 4: Real rates in the US have just broken the 1% mark. Tighter financial conditions are leading to more risk-off episodes



Source: BofA Merrill Lynch. Real 10yr US rates (LHS, %). Rolling 2yr correlations of weekly equity moves and weekly yield moves (-ve means stocks and bonds move in opposite directions).

Rising real yields have often driven more "risk-off" moves in markets

Since mid-August, the rise in 10yr Treasury yields has mostly been due to an increase in *real* rates. This has been another form of tighter financial conditions for the market. As our strategists point out [here], Fed expectations have repriced higher lately, on the back of very strong US growth numbers. Moreover, the US continues to run a high budget deficit, despite a backdrop of very low unemployment. This signals a lot more treasury issuance to come next year, especially in [coupon form].

Last month, 10yr US real yields broke the 1% mark, pushing real yields to their highest levels since early 2011. Historically, we find that rising real rates seem to have been a fairly good harbinger of "risk-off" episodes for the broader market.

Chart 4 shows this by tracking the relationship between a) 10yr US real yields, and b) the correlation between stocks and treasuries. Historically, higher *real* rates tend to be associated with a less negative correlation between stocks and bonds (i.e. assets have a tendency to all sell-off together), and vice-versa.

Also note in chart 4 that 10yr US real yields have been rising since the *Taper Tantrum* episode of 2013. And over this period, the correlation between stocks and treasuries has indeed moved less negative.

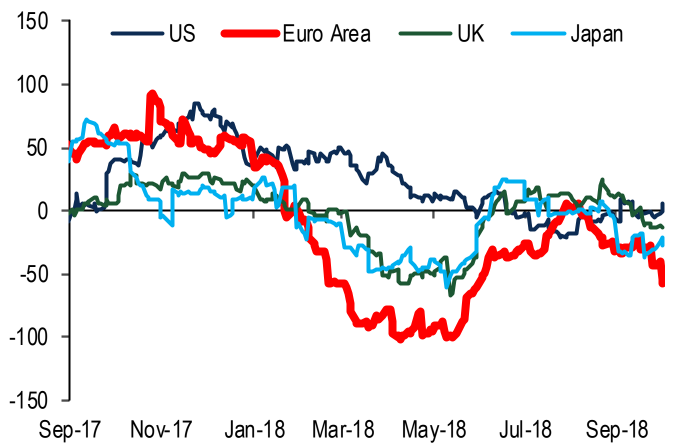
In other words, markets have become more prone to broader risk-off moves. And looking back over this year, there has almost been an event to ruffle markets every month: "Vixplosion" in February, repatriation concerns in March, Inflation worries in April, Italy stress in May, trade fears in June, tech tumult in July, EM devaluation in August and growth concerns in October.

Europe – a slow motion bear market

In Europe, high-grade spreads saw their worst month for performance since Nov 2016 (the Italian referendum) as broader risk-off sentiment took hold.

We've argued before that European credit is amid a bear market in technicals. Simply, the tantalizing rates on offer in US "cash" (6m bills etc.) create a large opportunity cost for investors who hold low-yielding European corporate bonds. The yield on 6m US bills has now climbed to 2.5% and we believe this is where retail money is heading. Sure to form, European retail fund flows remain heavily negative (and conversely note the inflows into BIL US Equity, the 1-3m T-Bill ETF).

Chart 5: European data now disappointing the most vs. peers (data surprise indices)



Source: Bloomberg, BofA Merrill Lynch Global Research

Chart 6: European HY spreads still look tight given how far the forward-looking data has declined in Europe

Source: BofA Merrill Lynch Global Research, Markit, Bloomberg. HY spreads (LHS).

Back to fundamentals

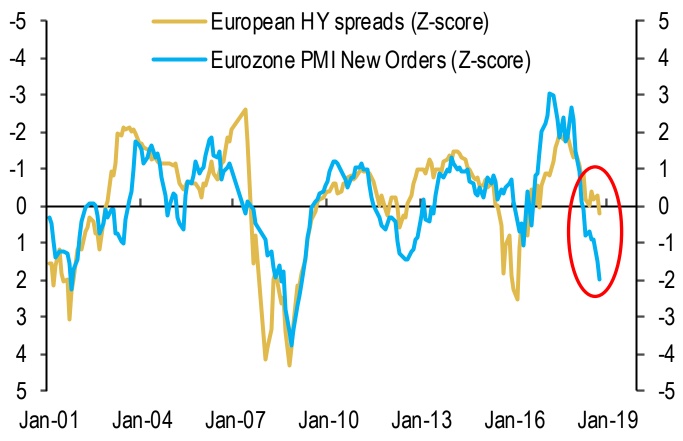
But we also think that European credit needs to grapple with the visibly slower macro cycle that's emerged. Europe's openness has hurt it amid much weaker sentiment towards global trade. And rising political uncertainty, as QE ends, hasn't helped either: note Italy's GDP stagnation in Q3. In fact, as chart 5 highlights, Europe is now seeing the most disappointing economic data prints compared to other regions across the globe.

While spreads have widened a lot this year in Europe, we still don't think they look particularly cheap vis-à-vis the slowdown in economic data. Chart 6, for instance, shows European high-yield spreads compared to the Eurozone manufacturing PMI new export orders index – an index we deem to be fairly forward looking. New export orders are back to early 2013 levels, making European high-yield spreads appear tight still (back then European high-yield spreads were 500bp, 100bp wider than today).

Chart 7 shows the same data, but in z-score format. Again, we find that the sell-off in European high-yield looks a bit mediocre relative to the move in the economic data.

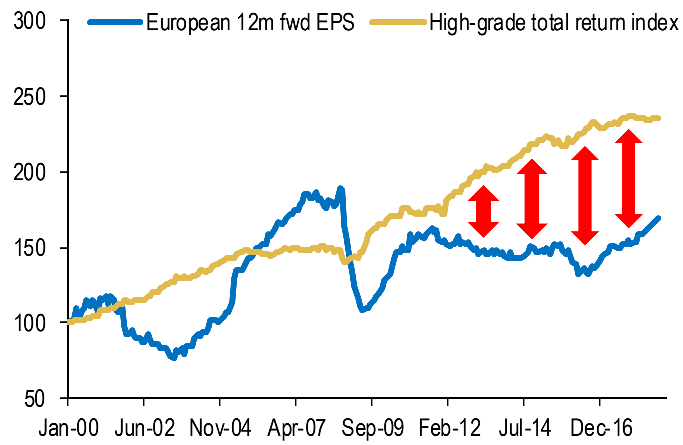
Hence, we think that spreads still need to "catch up" with the reality of the economic data in Europe (at best, capping upside in spreads should sentiment bounce). After all, corporate bonds have hugely "outperformed" European earnings growth since the ECB began intervening in 2012 (chart 8).

Chart 7: European HY spreads still look tight vs. European data (rolling 3yr Z-scores, HY spreads LHS).



Source: BofA Merrill Lynch Global Research. Rolling 3yr Z-scores. PMI RHS (negative because the reading is currently falling).

Chart 8: Credit has hugely outperformed its fundamentals since the ECB began intervening in 2012. (Credit returns and EPS rebalanced to 100)



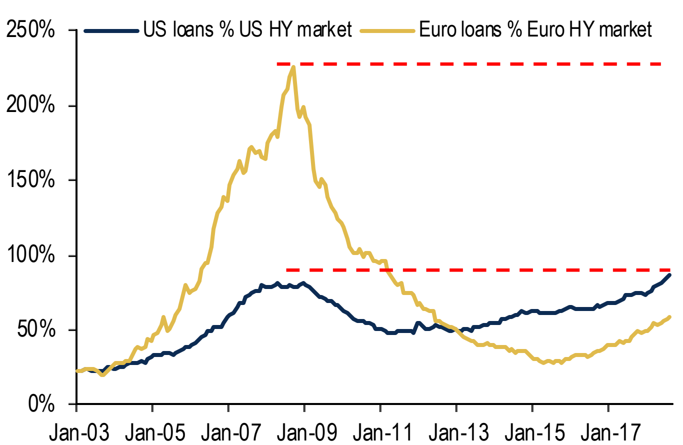
Source: BofA Merrill Lynch, ICE Data Indices LLC. European Equity Strategy Team. EPS and credit total returns rebalanced to 100 from Jan 2000. European high-grade spreads (ER00 index).

Not your father's turn in the credit cycle

The temptation when talking about turns in the credit cycle is to assume that a significant widening beacons, à la 2002 or 2008. Indeed, most credit cycles have ended because of an overt misallocation of capital in the form of corporate excesses: such as tech capital structures in 2002, and shadow banking in 2008. But we believe that this cycle lacks those classic traits, and as such, we expect this to be a fairly "slow motion" bear market for Euro credit investors.

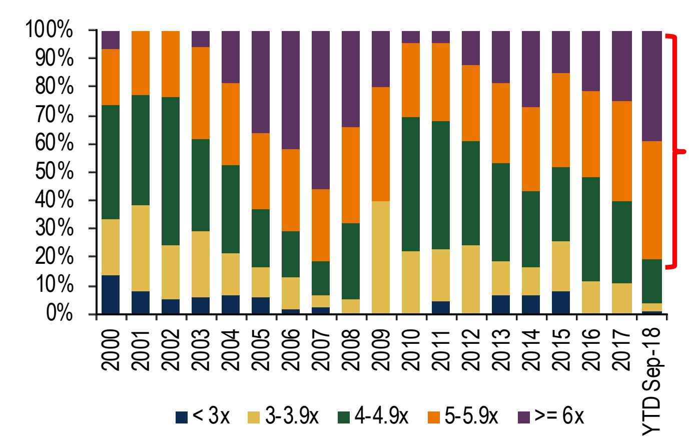
That's not to say, however, that there aren't areas of the European market where prior hubris is worth monitoring. Central banks around the globe and the BIS now seem to be zooming-in on two areas of systemic concern: namely leveraged loans and "zombie" companies. And while we agree they are "weak links", we also see some good news to help calm nerves.

Chart 9: Leveraged loan markets as a percentage of respective high-yield bond market.



Source: S&P LCD, BofA Merrill Lynch Global Research.

Chart 10: Leverage for European B-rated loans has jumped significantly in 2018 (over 80% have >5x leverage this year)



Source: S&P LCD, BofA Merrill Lynch Global Research. Based on deal count.

Loans – European market growth in perspective

On leveraged loans, growth rates in Europe have undoubtedly been strong over the last three years. The size of S&P's European leveraged loan index is currently €165bn, which represents a doubling in size since early 2015. With such a strong growth rate it's understandable why regulators and central banks are prying on the market.

And as we show here, loans in Europe are, on average, lower rated than in the US. Today, around 75% of the European loan index is B-rated, while in the US this number is closer to 50%.

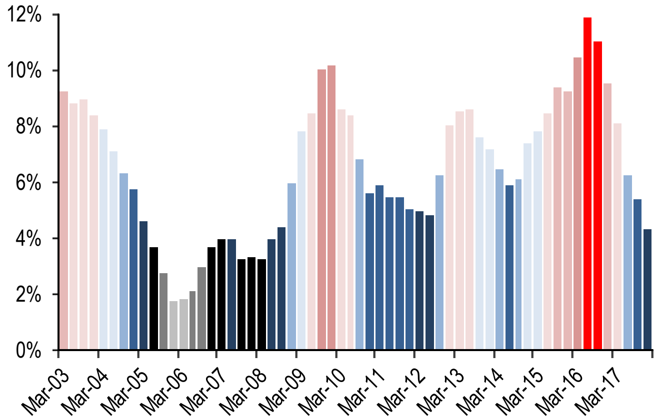
But we would argue that it's worth looking at the growth rates of leveraged loans in proportion to the size of high-yield bond markets. Chart 9 shows this for both Europe and the US. Interestingly, in this perspective, the picture looks much less daunting now in Europe than it was pre the GFC. Then, the European leveraged loan market was over twice the size of the European high-yield bond market. Today, loans are far from eclipsing high-yield bonds in Europe. But note in the US, leveraged loans have grown to now match the size of the high-yield bond market.

That said, in Europe, we would keep an eye on leverage levels for weaker loans. As chart 10 shows, over 80% of new issue B-rated loans have had leveraged levels in excess of 5x this year, surpassing the prior 2007 max.

"Zombies" – some improvement of late

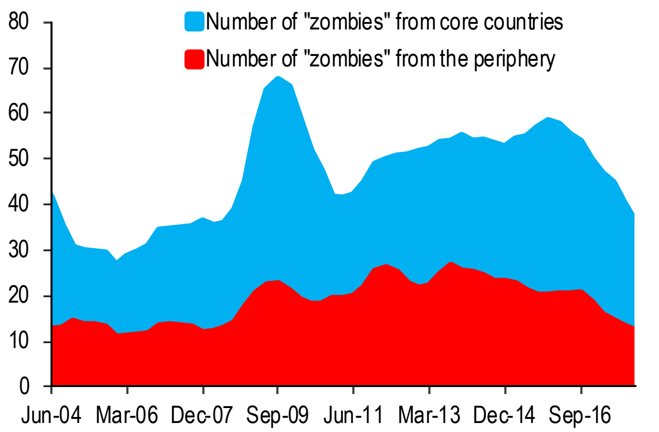
"Zombie" companies (defined those with interest coverage below 1x) have also been on the radar screen of the BIS. Chart 11 shows the progression of "Zombie" companies in Europe. Here, we track the percentage of Stoxx 600 non-financials that have an Interest Coverage ratio less than 1x.

Chart 11: There are less "Zombie" companies in Europe now due to recent refinancing (and some defaults). However, the number is still higher than the pre-GFC period....



Source: BofA Merrill Lynch Global Research. Percentage of Stoxx 600 non-financials with Interest Coverage below 1x. Market cap weighted. Rolling 4Q average.

Chart 12: ...but there has been a quicker decline over the last few years in "zombie" companies from "core" countries. The decline in "zombie" companies from the periphery has been slower (# of companies).



Source: BofA Merrill Lynch Global Research. Count of Stoxx 600 non-financials with Interest Coverage below 1x. Market cap weighted. Rolling 4Q average. Just showing those names from "core" or "periphery".

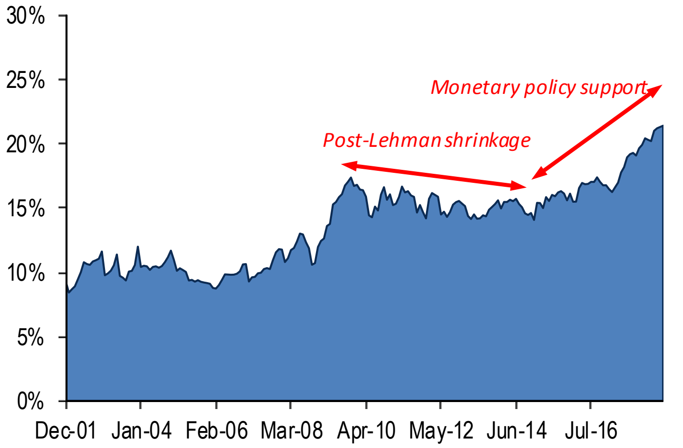
The good news is that over the last year, the percentage of Zombies has continued to decline in Europe, aided by better earnings growth, debt-market refinancing, and even some defaults. From the peak of March '16, when 13% of European non-financials companies were Zombies, the number has fallen to a much less dramatic 4.5%.

That said, the current percentage of Zombies is still higher than the pre-GFC period, when just 1.5% of European non-financials were Zombies. Moreover, as chart 12 highlights, the decline in Zombie companies has been swifter in core countries than it has been in the periphery. The latter are proving harder to shift...

The dividends for bondholders

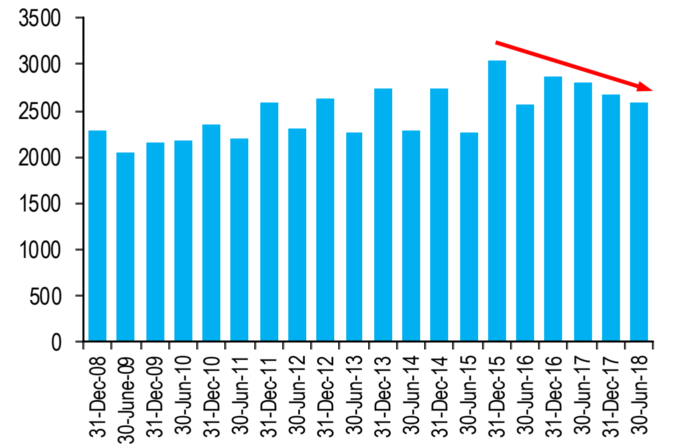
During the last few years of hefty monetary policy support in Europe, debt issuance has been abundant. But it hasn't always been like this. In fact, the Euro high-grade market spent much of the initial post-Lehman period declining in size, as chart 13 shows. Companies shrank their debt to ensure that if another freezing of the financial system took place, then they would be in much better shape to weather the storm.

Chart 13: Euro high-grade credit market size as a % of Euro Area GDP – the two stages of growth post Lehman (Eur tr.)



Source: BofA Merrill Lynch Global Research. Ice Data Indices LLC. ER00 market size as a % Eurozone GDP.

Chart 14: European Corporates' cash flow looks to be heading down now given the rise in raw material costs and heightened EM FX revenues



Source: Bloomberg. Using large sample of IG andHY credits. Average operational cashflow (Eur mn).

From 2009 to 2013, therefore, the size of the Euro IG market declined as a percentage of Eurozone GDP. But as soon as (govt.) QE was announced by Draghi, Euro IG markets began to grow again. Currently, the Euro IG market has risen to almost 22% of Euro Area output.

But with a much greater reliance on debt financing than in the past, companies are finding it tougher to manage to shareholders, at the expense of bondholders, as they once were able to do. Debt rollover concerns (as QE ends), *Fallen Angel* risk and weakening cashflow (chart 14) are starting to drive a notable uptick in pre-emptive bondholder-friendly corporate actions. Witness over the last few weeks announced dividend cuts and asset sales by companies with high levels of debt. In essence, this is a wealth transfer from shareholders back to bondholders.

We think that the stock market should care too on those names with lots of debt to rollover in the coming years. Free cashflow pressure could motive them to pursue shareholder-unfriendly actions. And as our equity strategist Manish Kabra has highlighted, the stock market is punishing bad news at the moment a lot more than before.

A simple refi screen

We finish by updating our work on refinancing risk for European companies in the table below. Other things being equal, these names might have a greater incentive to pursue shareholder-unfriendly actions (dividend cuts, asset sales, cancelling share buyback programmes) etc.

In Table 1 over the page, we screen for non-financial names where:

1) Total high-grade debt outstanding is at least €4bn,

2) High-grade debt maturities are fairly large over the next 5yrs. We sum up all 1-5yr EUR and US fixed-rate debt in this instance (using ICE Data Indices, LLC),

3) The "5yr FCF" for a company is fairly low (we define "5yr FCF" as: Cash and Cash Equivalents, plus 5yr sum of Cashflow from Operations, minus 5yr expected dividends, minus 1-5yr maturing debt.

In the columns to the right of the table, we show, in ascending order, the ratio of "5yr FCF"/1-5yr maturing debt.

In other words, we think table 1 highlights companies that we think are the most sensitive to credit market conditions becoming less favourable going forward.

In the final column we also show dividend payments as a percentage of cashflow from operations.

Table 1: A screen for debt refinancing risk in Europe. Companies with low FCF (after dividends) as a proportion of their short-term debt outstanding

Company	Country	Sector	Rating	5Y IG Debt (€bn)	Total IG Debt (€bn)	5y "FCF"	5y "FCF" to 5y IG debt	5Y dividends / 5y cashflow from operations
E.ON	DE	Utility	BBB1	2,450	4,583	-16,227	-6.6	-12%
National Grid	GB	Utility	BBB1	2,898	11,984	-5,738	-2.0	114%
Daimler	DE	Automotive	A3	31,300	47,111	-44,873	-1.4	-210%
Unibail-Rodamco	FR	Real Estate	A2	4,710	13,023	-3,207	-0.7	81%
Volkswagen	DE	Automotive	BBB1	14,712	21,312	-8,840	-0.6	-112%
Vonovia	DE	Real Estate	BBB1	5,071	12,271	-2,964	-0.6	43%
BAT	GB	Consumer Goods	BBB2	14,317	35,745	-5,757	-0.4	80%
Klépierre	FR	Real Estate	A3	2,188	5,018	-325	-0.1	68%
BMW	DE	Automotive	A1	23,375	32,303	2,764	0.1	40%
Imperial Brands	GB	Consumer Goods	BBB2	5,341	7,816	1,108	0.2	60%
Diageo	GB	Consumer Goods	A3	5,963	10,021	3,506	0.6	51%
Pernod Ricard	FR	Consumer Goods	BBB3	4,264	6,795	2,615	0.6	31%
Snam	IT	Utility	BBB1	3,982	7,186	2,467	0.6	39%
Schlumberger	CW	Energy	A1	8,651	11,521	5,641	0.7	49%
HeidelbergCement	DE	Basic Industry	BBB3	6,300	10,300	4,411	0.7	16%
Autoroutes du Sud (Vinci Group)	FR	Transportation	A3	3,895	8,945	2,967	0.8	21%
Danone	FR	Consumer Goods	BBB1	7,167	14,908	6,866	1.0	9%
Unilever	NL	Consumer Goods	A1	9,273	18,124	10,034	1.1	58%
Glencore	JE	Basic Industry	BBB2	10,918	16,332	12,581	1.2	17%
Innogy	DE	Utility	A3	3,500	8,468	4,200	1.2	50%
GlaxoSmithKline	GB	Healthcare	A2	7,778	18,218	9,669	1.2	63%
RELX	GB	Media	BBB1	2,861	5,211	4,057	1.4	39%
Siemens	DE	Capital Goods	A1	10,138	23,000	14,542	1.4	47%
Syngenta	CH	Basic Industry	BBB3	3,149	5,857	4,796	1.5	26%
Sanofi	FR	Healthcare	AA3	10,990	22,333	17,670	1.6	50%
Sky	GB	Media	BBB2	3,399	7,562	5,781	1.7	23%
Linde	DE	Basic Industry	A2	4,500	5,550	8,302	1.8	26%

Source: Bloomberg, ICE Data Indices LLC, BofA Merrill Lynch Global Research. Using Euro and US IG bond indices. Using last available full year cashflow and dividend figures.

Disclosures

Important Disclosures

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BofA Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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