European HY Credit Strategy

The art of freaking out

Credit Analysis

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High Yield Credit Strategy
Europe

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When tariff tantrums met QE "infinity"

Draghi's message couldn't have been clearer yesterday: "all tools are at our disposal, *including* QE again". We find it hard, therefore, not to be constructive on high-yield given that during the '16-'17 CSPP era, leveraged credit was the pre-eminent outperformer in bond land. Last month's sell-off due to US-China stress also looks a bit excessive for us, especially compared to other trade "tantrums" in '18. And we have to finally thank the Fed for being dovish: US T-bills are no longer making Euro high-yield look so uncompelling. Accordingly, we think Euro high-yield can rally to 375-400bp by year-end.

Distress is becoming distressing

Once again it's been raining bonds, with 10pt price drops back with a vengeance in May. But we think the market's inclination to drop bonds at the first sign of trouble is also a function of the extreme yield erosion witnessed in European corporate debt. Credit losses from the top 20 "plunging bonds" last month amounted to almost 2 months of high-yield income. Mistakes simply can't be made up down the line by clipping coupon. Part of the problem is that "debut" (read: higher yielding) issuers are flocking to the loan market given the ability to push the envelope on leverage levels. "Plunging bonds", will thus remain a consistent part of the European high-yield landscape, we think.

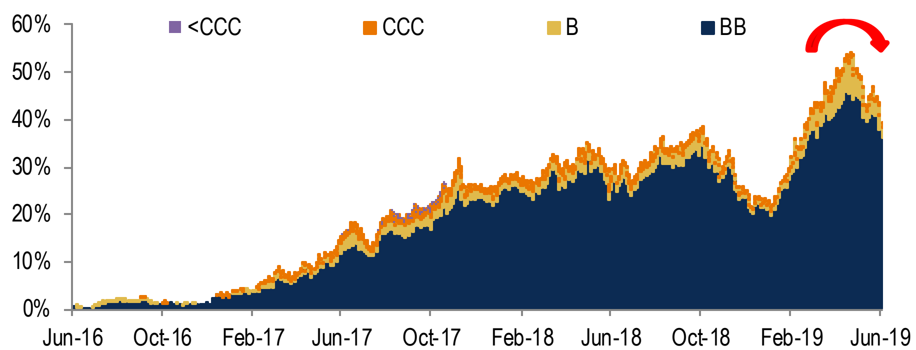
BBeware the overvalued

BBs look tight now, we think, with the problem being that both BBBs and single-Bs have become relatively cheaper in the last month. We think investors should be extra careful in the BB space as the BB-BBB spread is close to a 3yr low for sectors such as insurance, retail, capital goods, energy, real estate and tech. Conversely, BBs look less vulnerable, we think, in telcos, fins and services.

A topsy turvy world of relative value

May's sell-off has caused many inconsistencies: cyclicals have outperformed defensives, and domestics have underperformed global names. These moves feel wrong amid heightened trade tensions, and we would take the other side. We find that the high-yield sectors most sensitive to global growth are retail, transport, basic industry, tech and autos. We would be cautious in the near-term here.

Percentage of Euro HY bonds yielding less than 6m US T-bills (contribution by rating)



Source: BofA Merrill Lynch Global Research

The art of freaking out

The harder they come the harder they fall, as the expression goes. This has been no more apparent of late than in the European high-yield bond market. Last month's tariff "tantrum" eradicated most of the Feb-April spread rally, handing investors total return losses of 1.5%. Spreads now stand at 430bp in Europe, albeit slightly above their post sovereign crisis average of 400bp. Year-to-date total returns have dropped to 5.5% now.

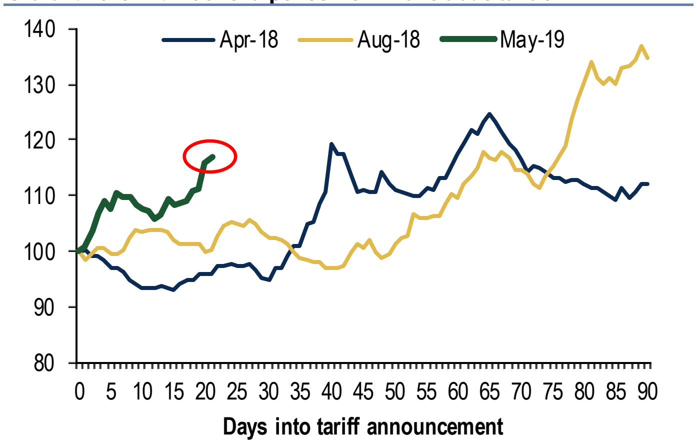
Tariff "tantrums" – this one was big

Our feeling is that last month's sell-off was a bit too exaggerated, however. After all, this was the first major wobble for the European credit market in a world without ECB corporate bond QE. We think dealers will have been more anxious than ever about credit market liquidity during this period, exacerbating the repricing wider.

That's not to underplay the significance of trade uncertainties, though. As an open economy, the Eurozone stands to lose a lot from potentially weaker global growth – and less vibrant world trade – if tariff escalations aren't resolved soon. And the European high-yield market has become more "global" over the last few years, as witnessed by the relative growth in outstandings from sectors such as basic industries and tech etc.

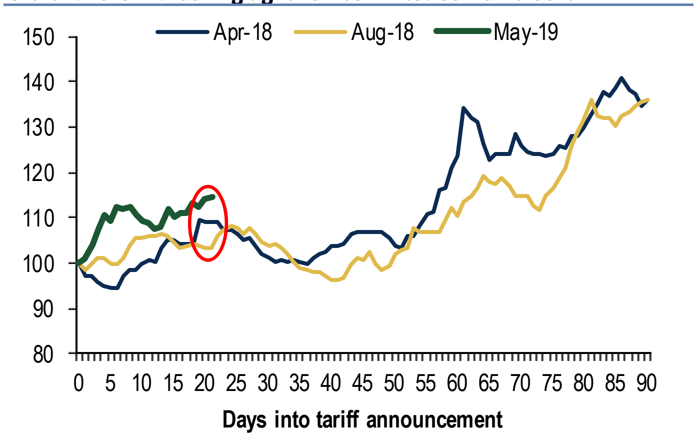
Yet, as the below charts show, last month's tariff "tantrum" has been much more severe for high-yield spreads than some of the previous trade-driven sell-offs. To see this, we show the progression of spreads during the 3m after a US tariff hike on China imports.

Chart 1: Euro HY: much sharper sell-off in this trade tantrum



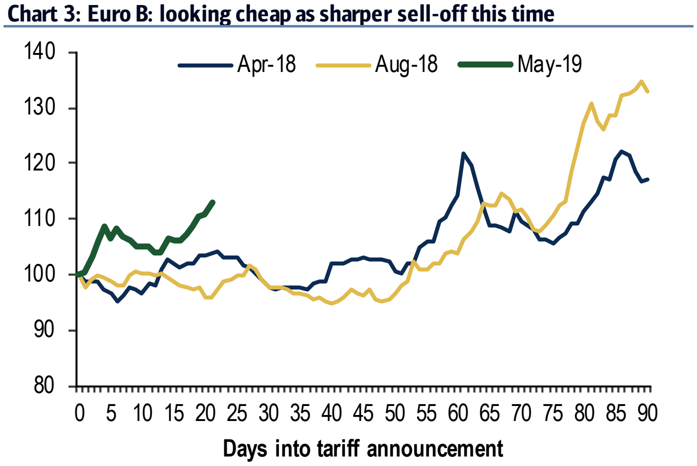
Source: BofA Merrill Lynch Global Research. Spreads rebalanced to 100 at start of tariff episode.

Chart 2: Euro BB: looking tight now as limited sell-off thus far



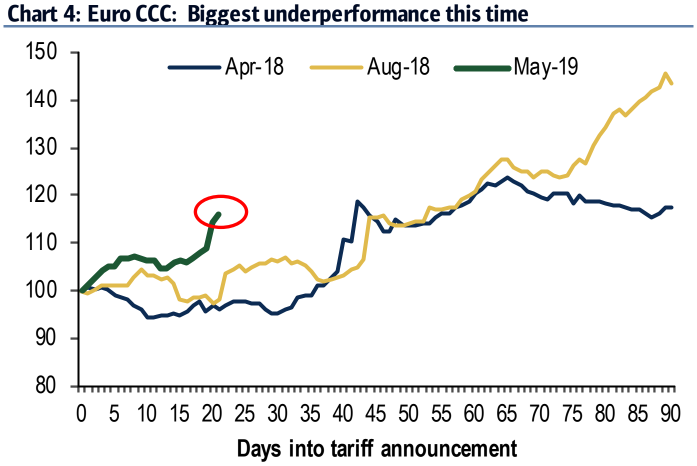
Source: BofA Merrill Lynch Global Research. Spreads rebalanced to 100 at start of tariff episode.

Chart 3: Euro B: looking cheap as sharper sell-off this time



Source: BofA Merrill Lynch Global Research. Spreads rebalanced to 100 at start of tariff episode.

Chart 4: Euro CCC: Biggest underperformance this time



Source: BofA Merrill Lynch Global Research. Spreads rebalanced to 100 at start of tariff episode.

- As can be seen, spreads for the overall market have sold-off a lot more in this current trade episode than in the past (such as the Apr-18 tariff announcement, and Aug-18 one). For instance, Euro high-yield spreads are already around 15% wider in this tariff episode. Conversely, high-yield spreads were still roughly unchanged at this point during the Apr-18 and Aug-18 tariff episodes.

- In terms of underperformance in this tariff episode, drilling-down we find that this is particularly the case for single-B and CCC spreads.

- Yet, BBs have performed roughly in-line with previous trade driven sell-offs, and we would view them as looking relatively unappealing at this juncture (and we also show later in the note that the BBB-BB spread ratio is now particularly tight for many sectors as a consequence of this).

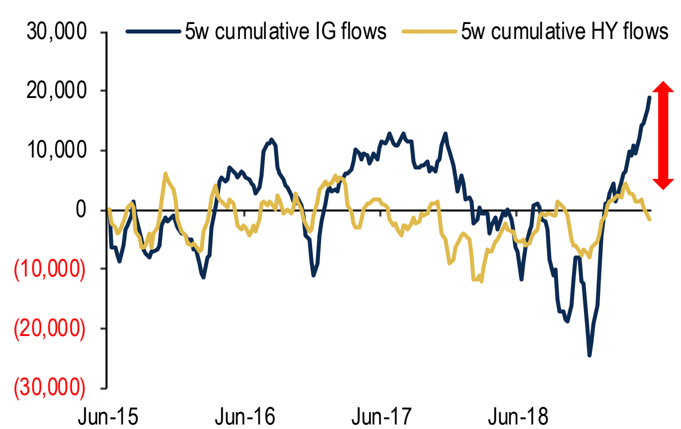
And a thank you to the Fed

We think the Fed's dovish spin this week goes a long way to alleviating one consistent worry we have had of late with respect to European high-yield bonds: namely the competition from simple "cash" in the US, in the form of T-bills.

We had been highlighting for some time that European BB yields had become very uncompetitive relative to US 6m bills…and with the USD appreciating, European investors might eventually be tempted to leave European assets and buy the latter. As chart 5 shows, we think some element of this has been underway lately: note that Euro high-yield inflows have begun to stall. And chart 6 shows that at start of last month a record 55% of European high-yield bonds yielded less than US 6m T-bills.

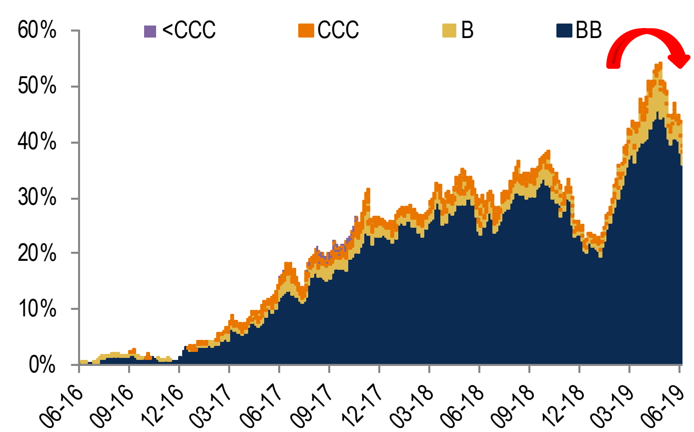
Yet, the good news is that a dovish Fed chorus this week has pushed yields at the front-end of the US treasury market a lot lower. The result is that chart 6 has finally rolled-over, in favour of European high-yield bonds. Now "only" 35% of European HY bonds yield less than T-bills. We expect this number to continue to decline and in due course we think this should coax some inflows back into the Euro high-yield bond market.

Chart 5: HY flows have faded of late in Europe (5w cumulative flows)



Source: BofA Merrill Lynch, EPFR Global. $mn cumulative flows IG vs HY.

Chart 6: Percentage of HY bonds yielding less than 6m US T-bills



Source: BofA Merrill Lynch Global Research. Contribution by rating.

We forecast tighter high-yield spreads by year-end

From here, our base case is a resolution to the US-China trade spat fairly soon, rather than an all-out, protracted, trade war. As such, current trade tensions should pose only minor damage to the global economy, and certainly keep at bay concerns over economic recession: reassuring news for a leveraged asset class such as high-yield.

But inflation remains conspicuous by its absence across major economies, meaning a continuation of uber-dovish global central banks for a lot longer. And with global negative yielding assets surging, we can't stray far from thinking that all of this points to a continuation of the thirst for yield in Europe, supporting credit (and high-yield).

We look for Euro high-yield spreads to end the year at around 375bp-400bp (and IG at 105bp-110bp). One fly in the ointment for high-yield, though, is that slower Eurozone growth has already pushed up leverage levels across the European high-yield market, leaving spread-per-turn of leverage looking quite tight at the end of Q1 this year (see the fundamentals section at the end). This is why our year-end spread tightening forecast is more modest for high-yield, vis-à-vis high-grade.

Topsy-turvy high-yield opportunities in the short-term
In terms of opportunities and trades, we think the May sell-off has created many opportunities for investors, we highlight these in the rest of this note:

- Some things look very inconsistent to us, namely: cyclicals *outperforming* defensives and global names *outperforming* domestics over the last month. We would take the other side here (buying defensive sectors and buying domestic HY credits).

- BBs look unattractive now, given much wider single-B and BBB spreads lately. In particular, investors should bear in mind that the BBB-BB spread is now at a multi-year *low* for the insurance, retail, capital goods, energy, real estate and tech sectors.

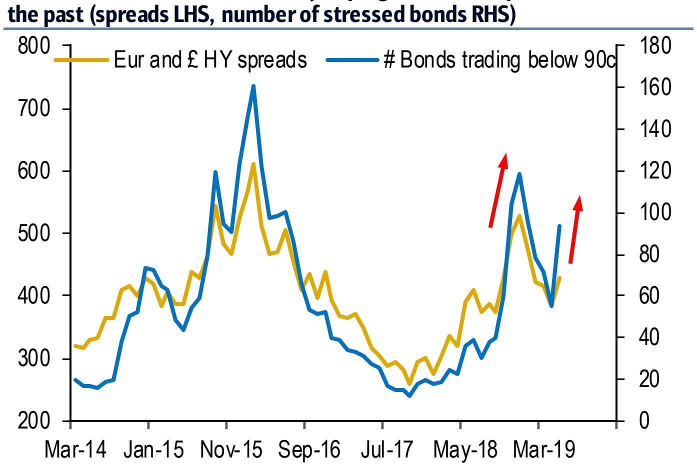
- Yesterday's TLTROs from Draghi, albeit less generous than in the past, is a welcome support to credit markets. Historically, we see a very dispersed performance across European high-yield sectors post TLTRO announcements. HY fins tend to do slightly better than HY corporates though, post a TLTRO, we find.

Distress is becoming distressing

Last month saw a return of the "plunging bonds" syndrome across high-yield. Numerous bonds suffered 10pt drops or more in May (Aldesa, Diversey, Thomas Cook, Teva, CMA, Atalia, Douglas), a phenomenon last seen in November '18. Understandably, the flare-up in US-China tariff tensions was a sentiment breaker, and caused investors to adopt an extra-cautious tone towards anything highly levered. Names that disappointed on the earnings front last month, were understandably kicked-out of portfolios quickly.

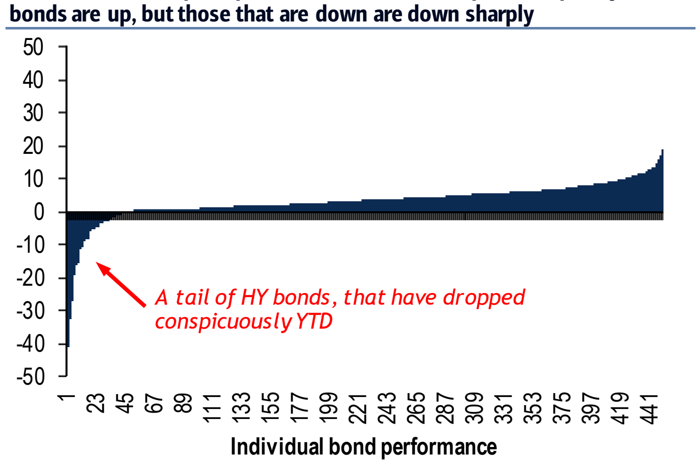
Yet, we continue to think that "plunging bonds" are becoming a more permanent feature of the European high-yield landscape, and investors should be prepared for more of this going forward. Chart 7 shows the relationship over time between Euro high-yield spreads and the number of stressed bonds (those trading below 90c).

Chart 7: More bonds seem to be jumping to distress quicker now than in the past (spreads LHS, number of stressed bonds RHS)



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

Chart 8: YTD bond price performance across European HY: plenty of bonds are up, but those that are down are down sharply



Source: BofA Merrill Lynch, ICE data indices LLC. YTD price change for each bond in HE00 index.

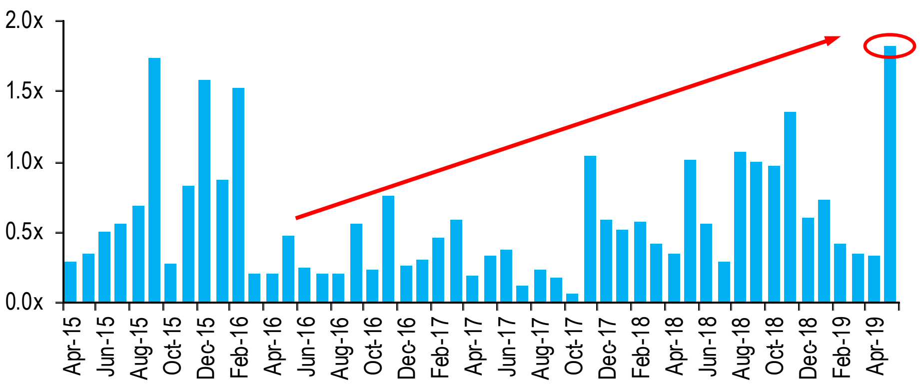
- Notice that lately, the number of stressed bonds has jumped a lot quicker than spread widening would normally imply. In May for instance, (combined £ and Eur) high-yield spreads widened 50bp, but the number of stressed bonds jumped from just over 50 to 85.

Bank of America Merrill Lynch

Disappearing yield: the dark side of monetary hubris

We think a big contributing factor to the rise of plunging bonds is simply that coupon income across the European high-yield market continues to be eroded on a monthly basis. As such, investors' "cushion" against single-name event risk is being continually weakened…creating an incentive for investors to dump bonds at the first sign of trouble. Note that the par-weighted coupon for the European high-yield market is just 4.15% now, and has been rapidly falling since 2016 (the start of ECB CSPP).

Chart 9: Multiple of monthly Euro HY coupon payment wiped-out by the top 20 "plunging bonds". Distress caused European high-yield investors almost twice their monthly coupon in May '19.



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

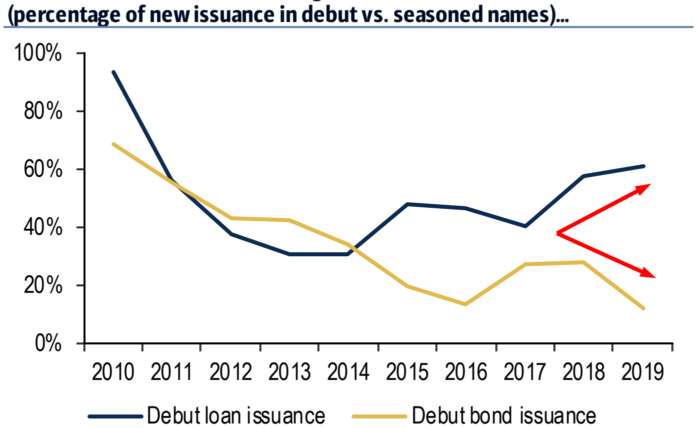
One way to visualise the consequence of this is to look at how much of monthly coupon payments are being eaten-up by credit losses from "plunging bonds". Chart 9 shows credit losses from the top 20 plunging bonds each month, as a multiple of monthly Euro HY coupon income (our US high-yield team look in a similar fashion at this here):

- Note the general trend higher in this metric since 2016, commensurate with the start of CSPP and the huge fall in European corporate bond yields (i.e. coupons)
- Moreover, last month's top 20 plunging bonds resulted in cumulative credit losses of €1.7bn (some big cap structures, such as Teva were impacted). But this was almost twice the month Euro HY coupon payment, a record high (chart 9).

Calling the debut issuers

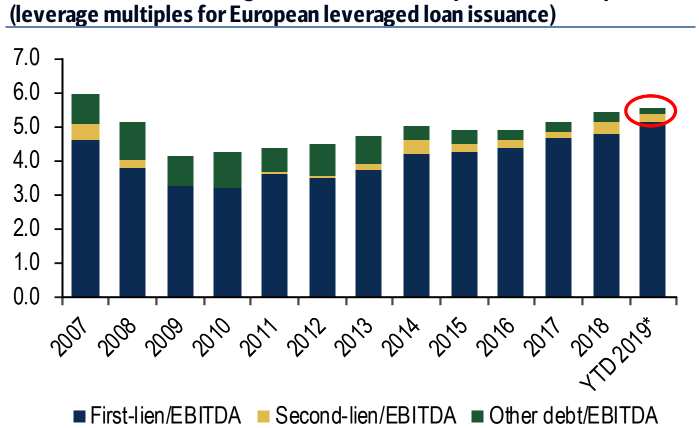
Away from central bank dovishness, we think another important driver of the disappearing yield in European high-yield credit is that "debut" issuers (read: those with interesting yields) are now overwhelmingly favouring loans as opposed to bonds.

Chart 10: "Debut" names heading to the loan market more and more (percentage of new issuance in debut vs. seasoned names)…



Source: S&P LCD, BofA Merrill Lynch Global Research. 2019 YTD.

Chart 11: …where leverage levels continue to "push the envelope" (leverage multiples for European leveraged loan issuance)



Source: S&P LCD

Chart 10 shows, over the last 2yrs, the huge jump in debut issuers in the loan market, and the corresponding drop in debut issuers in the bond market. Year-to-date, 61% of loans issuers have been debut, versus just 12.5% in the bond market.

And the attraction of the loan market for debut leveraged finance names? The ability to still "push the envelope" on leverage levels. Chart 11 shows that total debt/EBITDA for European leveraged loan issuance has crossed the 5x mark this year, a higher multiple than in 2008.

Thus, a vast majority of European high-yield bond issuance has been for refinancing purposes lately, with the effect of eroding the market's coupon income.

In conclusion, European high-yield bond investors should buckle up for more frequent bouts of "plunging bonds", we think.

Sick cyclicals? Defensive names looking cheap

Although May saw a sharp sell-off across European high-yield, the "internals" of the market look very confusing to us.

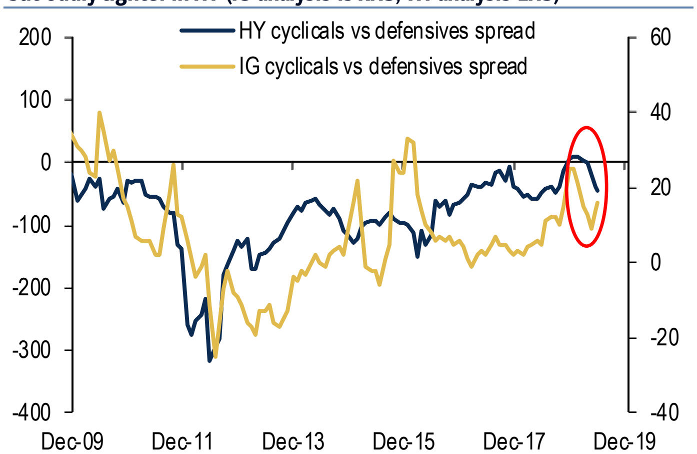
Given the global growth implications of tariff tensions, we would have expected cyclical credits to underperform their defensive peers. While this has been apparent in the high-grade market, we find the, strangely, the opposite has played out in the high-yield space.

Chart 12 shows spreads for cyclical vs. defensive buckets in both credit markets.

- In high-grade, the cyclical/defensive spread widened 6bp last month,
- But across European high-yield, the cyclical/defensive spread tightened almost 20bp.

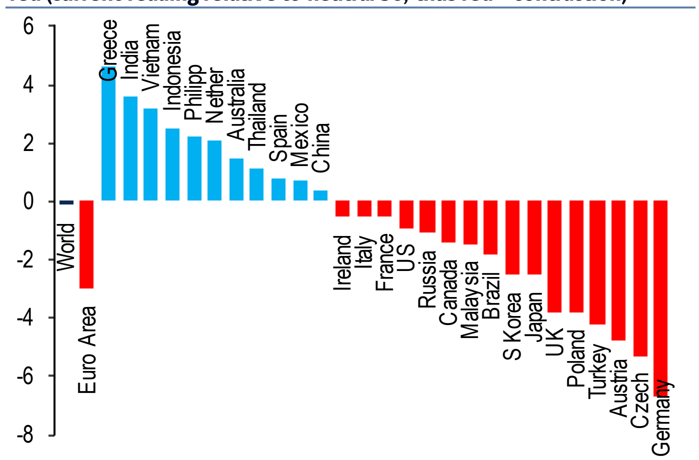
Again, amid what was probably broader liquidity worries for the market, investors likely sold some big large-cap names first (and some of these names would reside in defensive sectors like TMT, for instance).

Chart 12: Cyclical vs. defensive spread: wider in IG over the last month but oddly tighter in HY (IG analysis is RHS, HY analysis LHS)



Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC. HY spreads (LHS), IG spread (RHS). Grouping non-financial sectors only.

Chart 13: Global manufacturing *New Export Orders* – still mostly a sea of red (current reading relative to neutral 50, thus red = contraction)



Source: Bloomberg, BofA Merrill Lynch, Markit. Current reading relative to neutral 50 reading. Thus blue = expansion, red = contraction.

On balance, though, these moves in high-yield feel wrong to us, given that tariff tensions will undoubtedly slow the "green shoots" economic growth narrative for a bit. As chart 13 shows, the latest PMI *New Export Order* numbers from across the globe still contain many sub-50 readings.

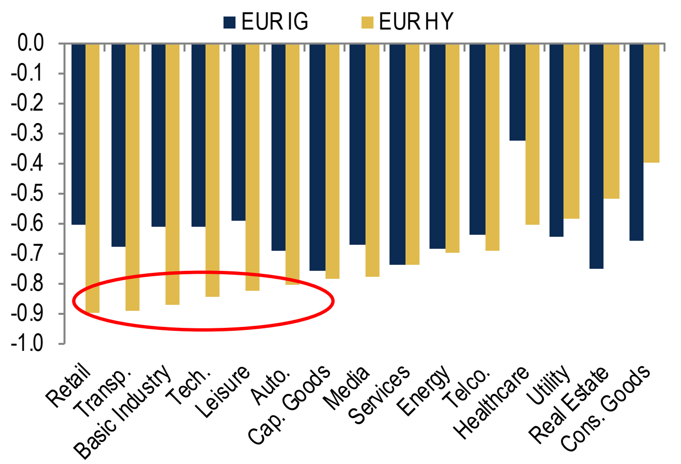
- In the short-term, therefore, we feel much more cautious towards European high-yield cyclical sectors. We think they are still vulnerable to repricing wider over the weeks ahead (and, at best, lagging in a recovery).

What sectors have displayed the greatest cyclicality in European high-yield of late? Chart 14 shows correlations between the OECD global leading indicator and Euro high-yield sector spreads. We do this for both high-grade and high-yield (calculating 3yr historical correlations).

- In Europe, the high-yield sectors most sensitive to global growth have been **retail**, **transport**, **basic industry**, **tech** and **autos**. And note that these sectors appear much more growth-sensitive in high-yield than in high-grade (where correlations are lower).

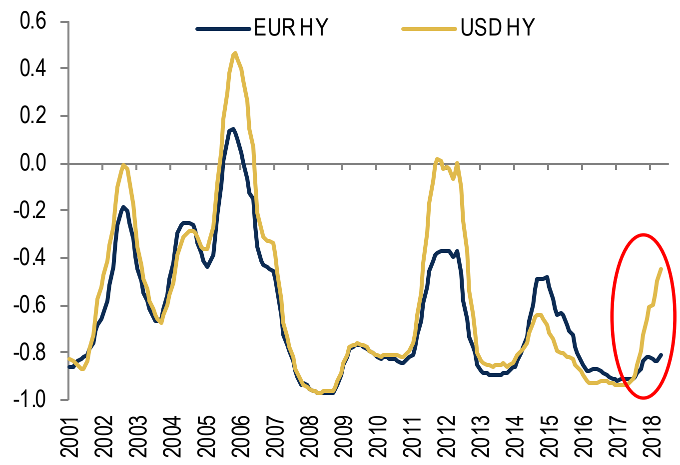
- Conversely, **consumer goods**, **real estate**, **utilities**, **healthcare** and **telecoms** have displayed more defensive characteristics across the European high-yield market.

Chart 14: 3yr correlations between OECD Global Leading Indicator and sector credit spreads (both IG and HY).



Source: BofA Merrill Lynch, OECD. Negative correlation means weaker OECD LEI = wider spreads.

Chart 15: 3yr correlations between OECD Global Leading Indicator and global HY credit markets. The cyclicality of European HY credit still remains high, while it has dropped for US HY (tax reform driven)



Source: BofA Merrill Lynch, OECD. Negative correlation means weaker OECD LEI = wider spreads.

Note the same analysis in chart 15 for the overall European and US high-yield credit markets. The cyclicality of European high-yield credit still remains high, while it has dropped lately for US high-yield (which likely reflects the tax reform impact on fundamentals).

BBeware the overvalued

We think investors should also be much more discerning in the BB space in the near-term. We think the sector looks tight now from multiple angles:

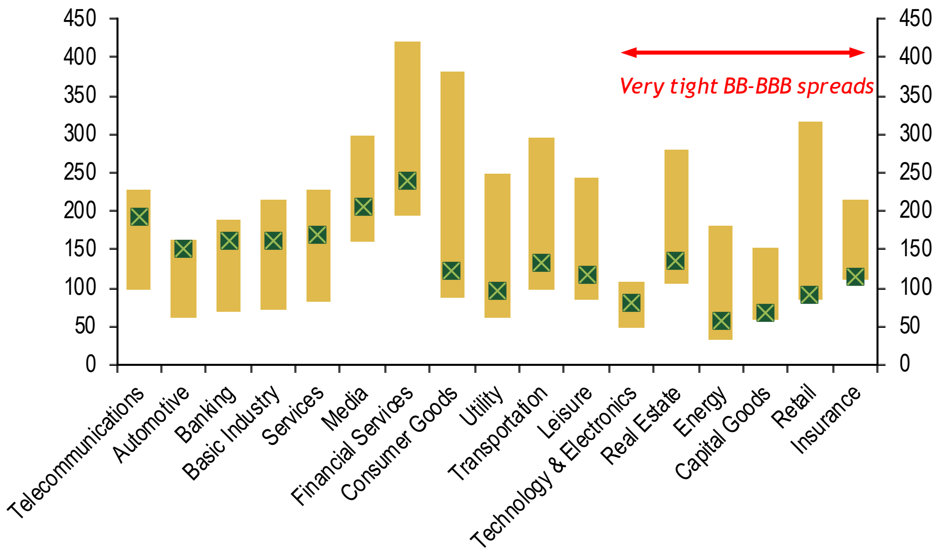
- Firstly, as single-B spreads have widened a lot more in May and now look much more interesting relative to BBs,

- But secondly as BBBs have widened a lot too. We flagged this as a risk recently given the rise of "debut issuers" in this segment of the market, and the subsequent deterioration of their leverage metrics lately.

Drilling-down, we find that the BB-BBB spread gap for some sectors is now at a 3yr low, boding poorly for the performance of BBs here in the near-term.

Chart 16 shows the current BB-BBB spread gap across European high-yield sectors, compared to the 3yr min and max levels in this number.

Chart 16: BB-BBB spread. Some sectors are at a 3yr min in this relationship (yellow bar charts reflect 3yr min-max range, green square is current BB-BBB spread differential).



Source: BofA Merrill Lynch Global Research.

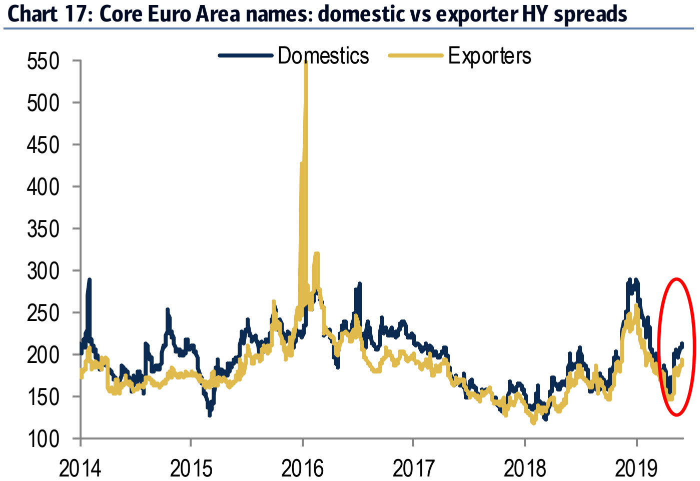
- Under this metric, the tightest (i.e. vulnerable) BB sectors currently are: insurance, retail, capital goods, energy, real estate and tech.
- Those that still look on the cheaper side are: telcos, autos, fins, industrials and services.

"Domestics" continue to look cheap amid trade tensions

We've been highlighting for some time that populism is synonymous with "deglobalization", and this is starting to play out in the form of much lower global trade volumes.

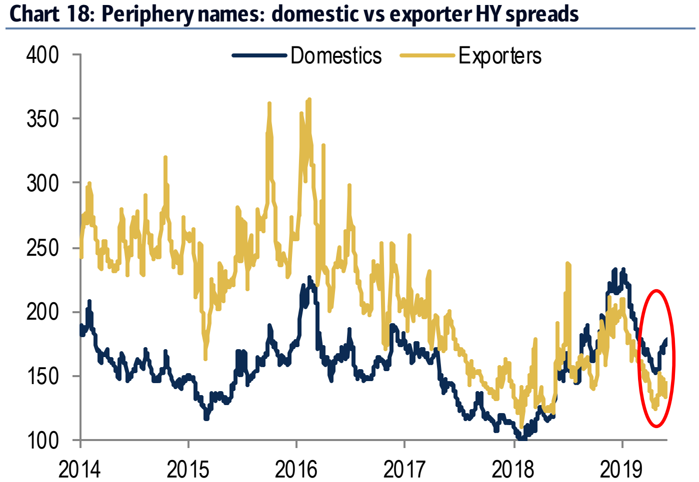
May's performance across high-yield was also strange in that "domestic" credits (those with their revenues more in Europe) visibly *underperformed* exporter names. This held true for both core and peripheral issuers in Europe, as the charts below show. But a jump in tariff tensions should have clearly seen the opposite play out.

Chart 17: Core Euro Area names: domestic vs exporter HY spreads



Source: BofA Merrill Lynch Global Research.

Chart 18: Periphery names: domestic vs exporter HY spreads



Source: BofA Merrill Lynch Global Research.

Again, we would take the other side in June: "domestic" issuers in the high-yield market look cheap to us now.

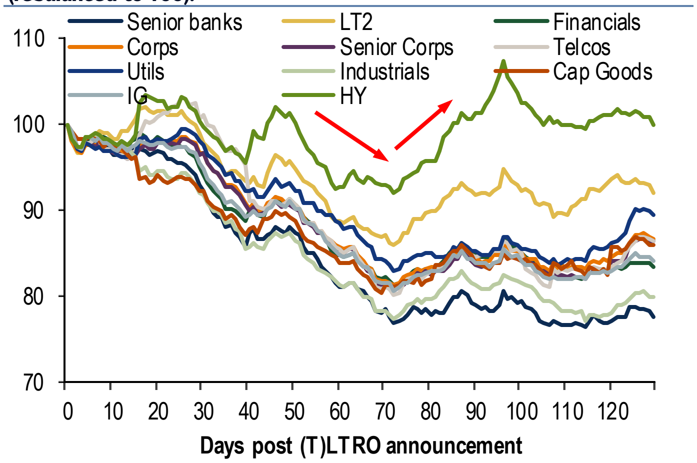
Know your TLTROs

As is often the case, Draghi delivered another dose of dovishness yesterday. Forward guidance was extended by another 6m until mid-2020, and the terms of TLTROIII were announced. TLTROIII rates were set at depo+10bp for banks exceeding their lending benchmarks, although this was not as generous as the last TLTRO round.

In our recent note, we highlighted the performance of the corporate bond market around the 3 previous (T)LTRO episodes (chart 19).

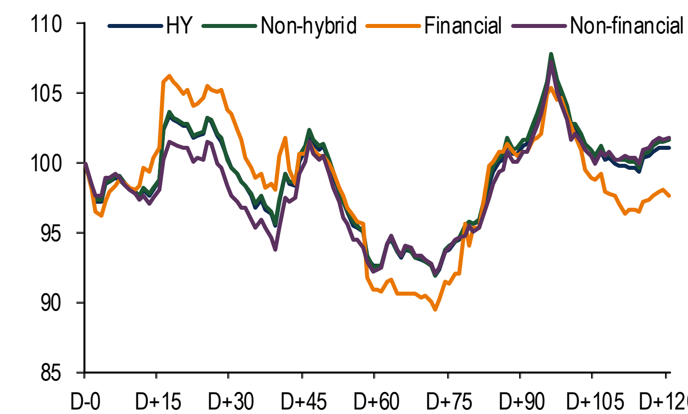
- We found that in high-grade, industrial and senior bank bonds do the best 6m after a TLTRO announcement (~20% spread tightening),
- High-yield does well to begin with (~10% tightening of spreads up to 3m) given the initial risk-on feeling, but then tends to give a bit back over the following 3m (the latter sell-off presumably reflecting the weaker growth environment).

Chart 19: Average spread changes across the 3 previous (T)LTRO episodes: historically, senior banks do the best, high-yield the worst (rebalanced to 100).



Source: BofA Merrill Lynch Global Research

Chart 20: Average spread changes across the 3 previous (T)LTRO episodes for Euro HY segments (HY fins, non-fins and non-hybrids). HY fins also appear to do a little better.



Source: BofA Merrill Lynch Global Research

In some ways, yesterday's less generous TLTRO pricing likely reflects an ECB that is a bit more optimistic on the Eurozone recovery.

In this sense, we could expect high-yield spreads to do a bit better over the coming 3m than chart 19 implies, supportive of our more constructive view on the market.

HY fundamentals update

We update our European HY fundamental data, looking at the progression of fundamental metrics. This edition includes data up until Q1'19 and includes adjustments to the history to take into consideration the change in composition and rating.

Of note in this edition:

- Overall European high-yield leverage increased **0.5x** QoQ.

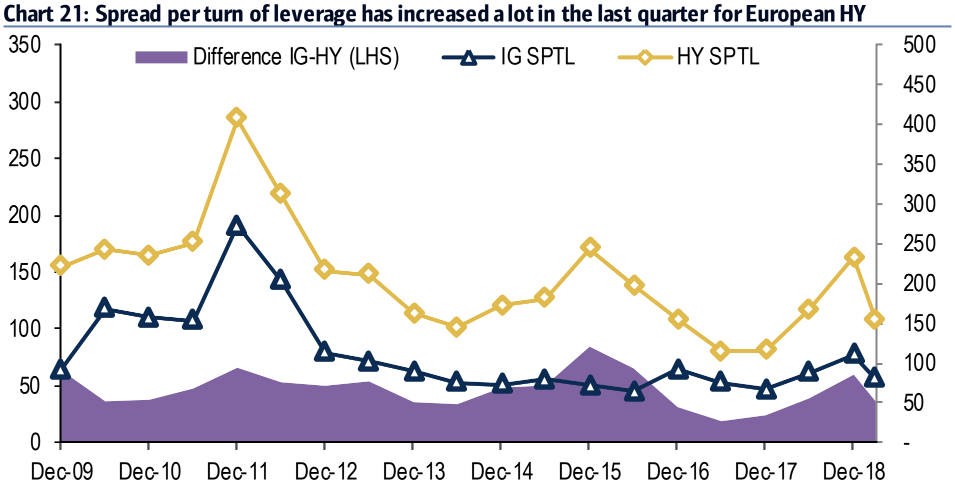
- We find that BB leverage has ticked up **0.4x** QoQ on the back of a net debt growing at a much stronger pace than earnings. This is the largest increase since Q4 '16. Note the BB leverage ratio has been steadily rising since Sep-15.

- Single B leverage in Q1 '19 was **flat** QoQ but remains at a level (4.6x) higher than its post GFC average of 3.3x.

Chart 21 shows that spread-per-turn-leverage for European high-yield fell materially between the end of last year and the end of Q1 this year.

At just over 100bp, it's now looking on the tighter side, in our view, and partly justifies why we have a more moderate tightening for Euro high-yield spreads into year-end as opposed to high-grade.

Chart 21: Spread per turn of leverage has increased a lot in the last quarter for European HY

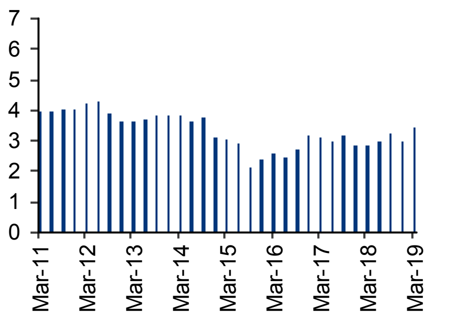


Source: ICE Data Indices, LLC. Basis points.

HY fundamentals update

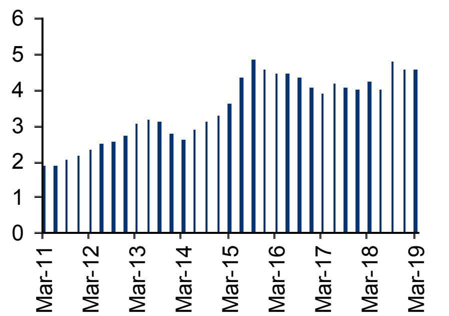
Below we show European high-yield leverage, coverage, EBITDA, cash and debt metrics for a broad sample of BB and single-B names.

Chart 21: Leverage ratio for BB



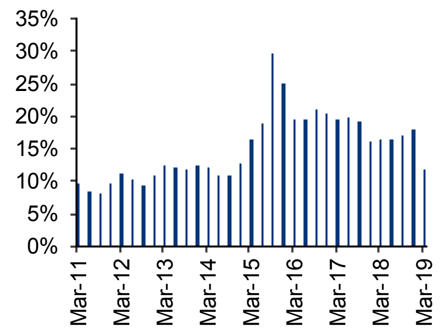
Source: BofA Merrill Lynch Global Research.

Chart 22: Leverage ratio for B



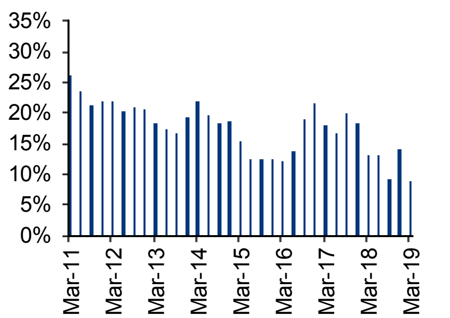
Source: BofA Merrill Lynch Global Research.

Chart 23: Cash to debt ratio for BB



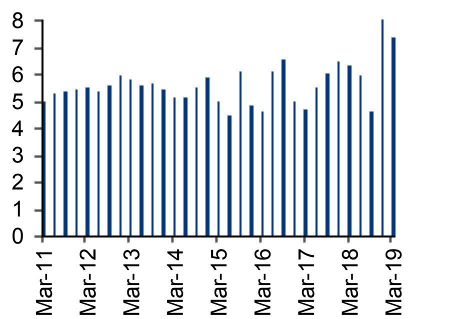
Source: BofA Merrill Lynch Global Research.

Chart 24: Cash to debt ratio for B



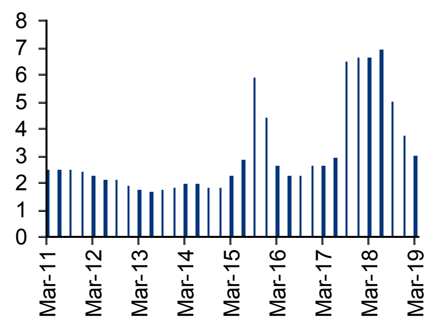
Source: BofA Merrill Lynch Global Research

Chart 25: Coverage ratio for BB



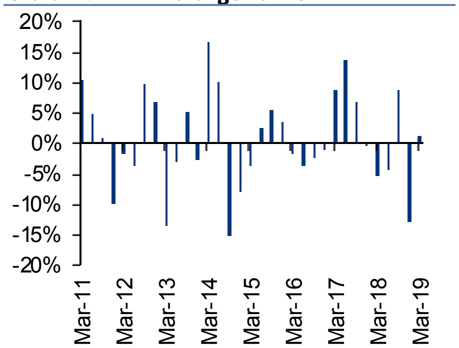
Source: BofA Merrill Lynch Global Research

Chart 26: Coverage ratio for B



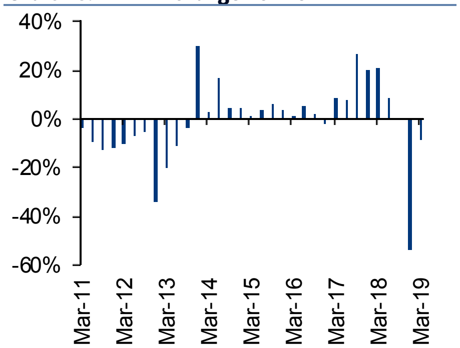
Source: BofA Merrill Lynch Global Research

Chart 27: EBITDA change YoY for BB



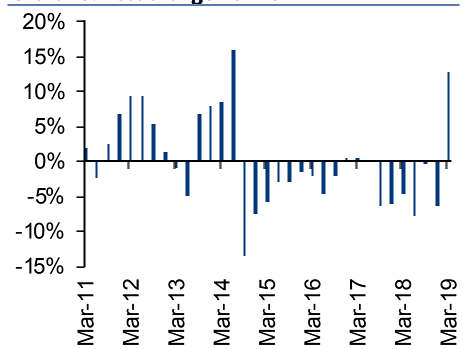
Source: BofA Merrill Lynch Global Research

Chart 28: EBITDA change YoY for B



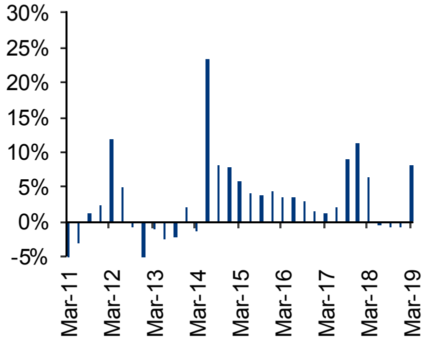
Source: BofA Merrill Lynch Global Research

Chart 29: Debt change YoY for BB



Source: BofA Merrill Lynch Global Research

Chart 30: Debt change YoY for B

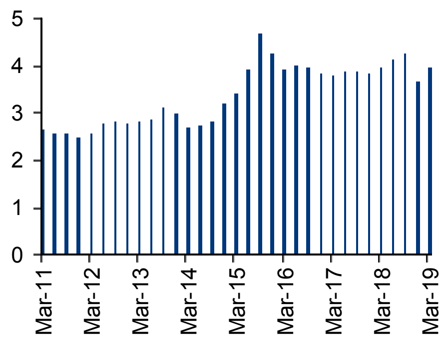


Source: BofA Merrill Lynch Global Research

HY Chartbook – by Domicile

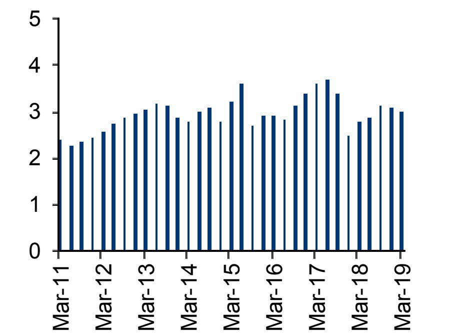
- European corporates' leverage remains lower than their non-Eurozone peers.
- Leverage ratios have been steady for European HY corporates in Q1 '19, with earnings growth matching debt growth on a quarterly basis.
- Leverage has been roughly stable for peripheral corporates in Q1 '19 (+0x QoQ) whilst it has slightly decreased for core Euro Area companies (-0.1x QoQ).

Chart 31: Leverage ratio in non-Eurozone



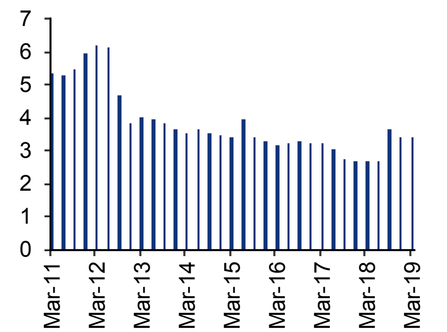
Source: BofA Merrill Lynch Global Research.

Chart 32: Leverage ratio in Core



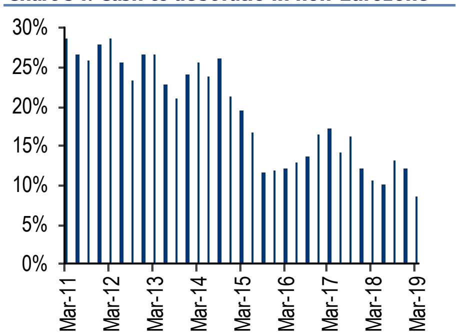
Source: BofA Merrill Lynch Global Research.

Chart 33: Leverage ratio in Periphery



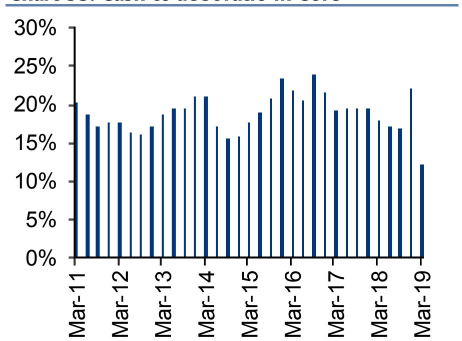
Source: BofA Merrill Lynch Global Research.

Chart 34: Cash to debt ratio in non-Eurozone



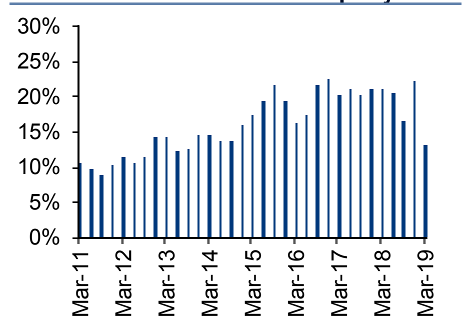
Source: BofA Merrill Lynch Global Research

Chart 35: Cash to debt ratio in Core



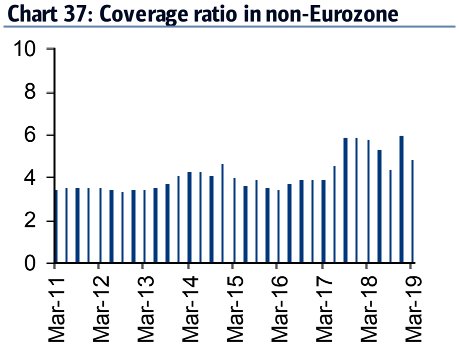
Source: BofA Merrill Lynch Global Research

Chart 36: Cash to debt ratio in Periphery



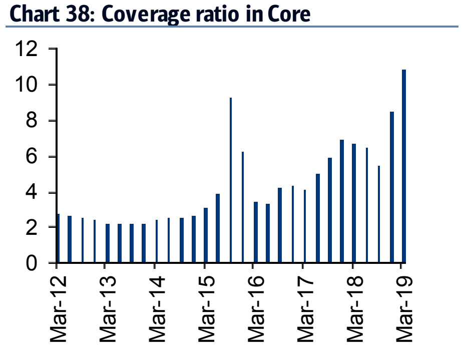
Source: BofA Merrill Lynch Global Research

Chart 37: Coverage ratio in non-Eurozone



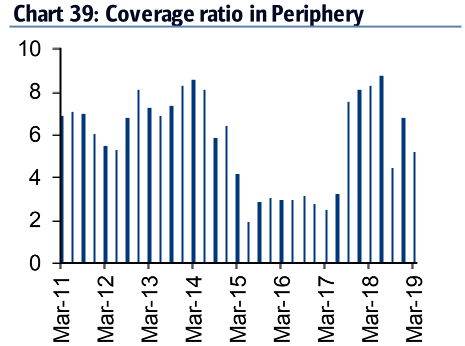
Source: BofA Merrill Lynch Global Research

Chart 38: Coverage ratio in Core



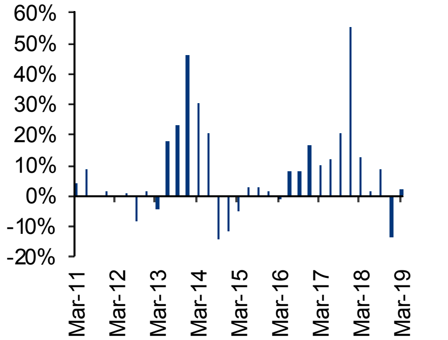
Source: BofA Merrill Lynch Global Research

Chart 39: Coverage ratio in Periphery



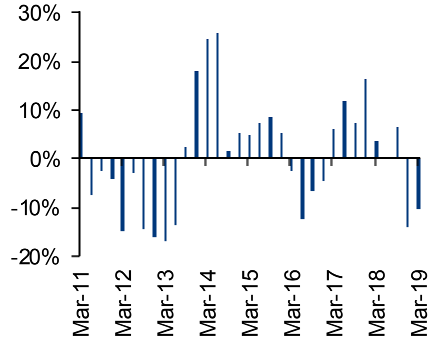
Source: BofA Merrill Lynch Global Research

Chart 40: EBITDA YoY in non-Eurozone



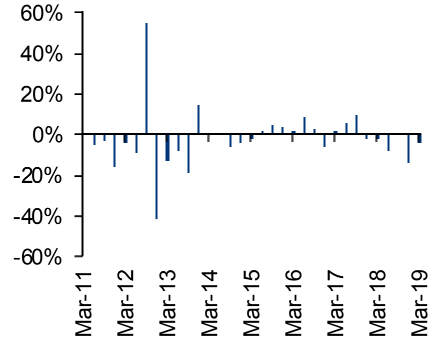
Source: BofA Merrill Lynch Global Research

Chart 41: EBITDA YoY in Core



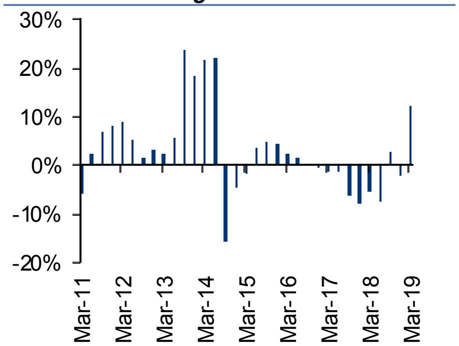
Source: BofA Merrill Lynch Global Research

Chart 42: EBITDA YoY in Periphery



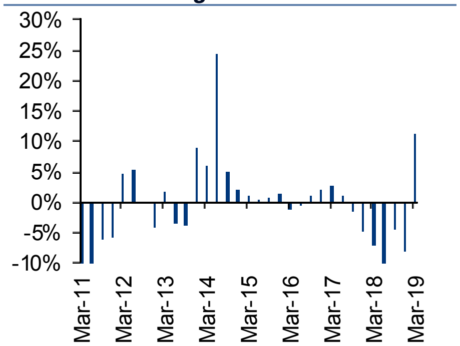
Source: BofA Merrill Lynch Global Research

Chart 43: Debt change YoY in non-Eurozone



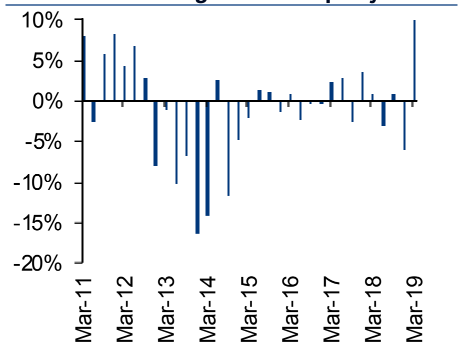
Source: BofA Merrill Lynch Global Research

Chart 44: Debt change YoY in Core



Source: BofA Merrill Lynch Global Research

Chart 45: Debt change YoY in Periphery



Source: BofA Merrill Lynch Global Research

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