The European Credit Strategist

CSPP 2.0 – twice as nice?

Credit Analysis

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Monetary mania and the era of financial repression

We think the implication of last week's "dove-fest" by central banks is that the thirst for yield will become stronger. Global negative yielding assets are now well into uncharted territory, having jumped to a remarkable $11.5tr. We note some examples of the numbers in this regard: around 85% of German govt. debt yields below zero, ~80% of French covered bonds have negative yields, just under half of Spanish govt. debt is negative, and now almost a third of 7-10yr bonds feature. In our view, the negative yielding phenomenon is akin to a "tax" on risk free assets, and will likely see money surge up the "value chain" in search of better returns. We see this as clearly credit bullish.

Long German and Spanish IG, French HY, long flatteners

In some countries, there is now no alternative to buying credit, given the abundance of negative yields across the spectrum of government debt, quasis and covered bonds. Chart 5 suggests to us that the beneficiaries from this topsy-turvy yield world are likely to be: German, Spanish and Dutch IG, French HY bonds, and 7-15yr corporate debt.

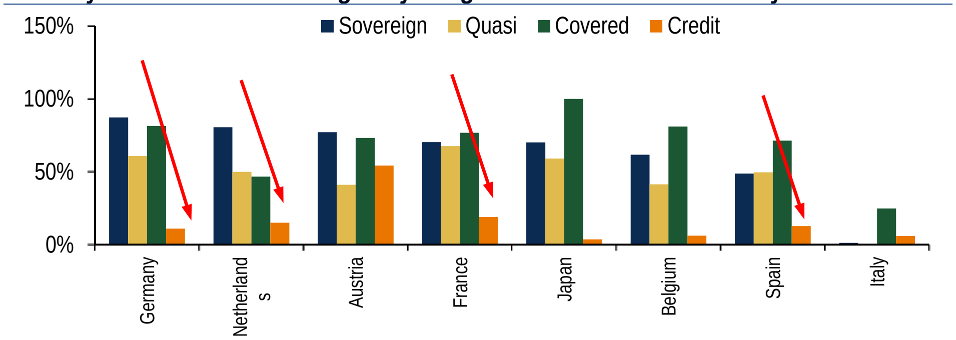
CSPP 2.0 – twice as nice?

Draghi reiterated at Sintra that all tools, including QE, were at the ECB's disposal. While we don't think we're there yet for QE2, we do expect credit to be an integral part of any future QE, given the ease with which bonds can be snapped up in primary. We expect a strong bid for non-eligible credit in anticipation: **HY**, **sub banks** and **corporate hybrids**, just as in '16. But in today's credit market, there is no shortage of buyers, unlike with QE1. Hence, if ECB QE does make a comeback, we think it could send spreads materially tighter.

Spicing it up: a more effective CSPP 2.0

Should QE restart, it's likely that the ECB would follow the same formula as before: "ETF-style" buying of eligible credit. Yet, Draghi has always emphasised other aims with credit buying: 1) reducing fragmentation, 2) unleashing corporate "animal spirits", and 3) encouraging "debut" issuers. We think the ECB's job isn't yet done here. To reduce fragmentation, the ECB might use their buying flexibility to target the **basic industry**, **insurance**, **retail** and **transport** sectors. For corporate "animal spirits", the ECB might also target **consumers** and **telcos**. And "debut" issuance has been light in **cap goods**. We think these high-grade sectors also stand to outperform in the months ahead.

Monetary mania: vast swathes of negative yielding debt across markets. Credit likely to benefit



Source: BofA Merrill Lynch, ICE Data Indices LLC. % of a sector trading negative yielding. High-grade credit only.

Refer to important disclosures on page 13 to 15. Analyst Certification on page 12. **12013059**

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Monetary mania

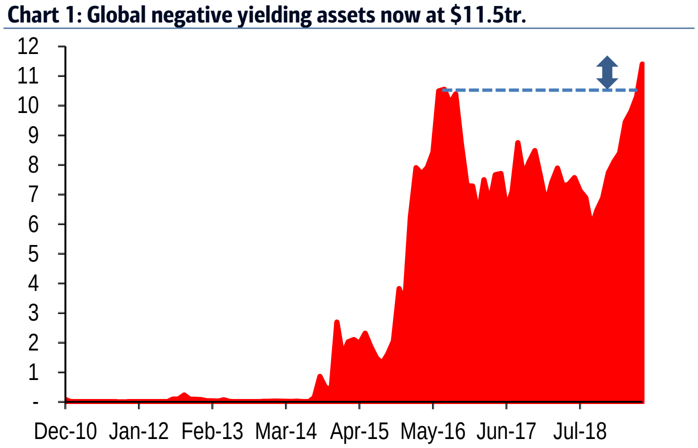
In recent years, the ECB's annual Sintra conference has become synonymous with verbal intervention from Draghi. Last week's gathering kept up the tradition. The ECB president emphasised that a continuation of the status quo – in the form of weak data and faltering global trade – would be tantamount to a materialisation of risks for the Euro Area economy, necessitating further monetary support. And on this front, Draghi reiterated that all tools remain at the ECB's disposal, including further rate cuts and a restart of net asset purchases (with, importantly, the ECB's hitherto QE limits being described as "self-imposed").

Price action last week reflected a market scrambling to prepare for all of these possibilities: front end yields collapsed (the rate cut effect), curves flattened (forward guidance effect), and peripheral spreads and corporate bonds rallied strongly (a QE effect). But not to be outdone by Draghi, Powell and Kuroda injected their own doses of dovishness on the yield curve last week, leaving global government bond yields standing at a paltry 85bp now. It was monetary mania last week...

The era of financial repression (and "tourism")

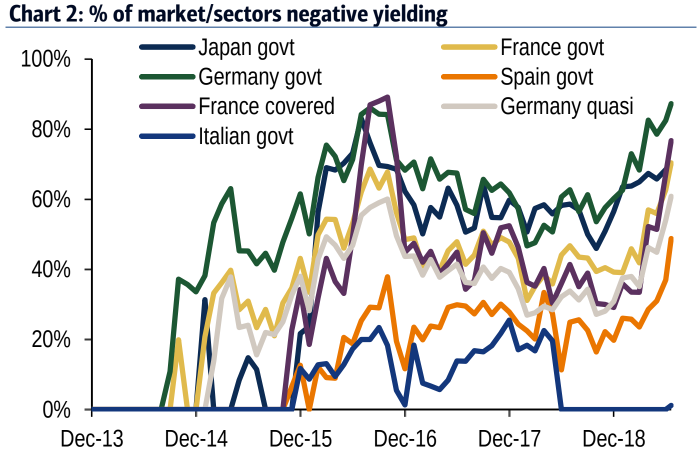
For us, though, the obvious implication of last week's "dove-fest" by central banks is that the thirst for yield across markets will become stronger. As chart 1 shows, global negative yielding assets are now well into uncharted territory, having risen to a remarkable $11.5tr. New entrants to the negative yielding club last week were Swiss 30yr government bonds and French 10yr sovereign debt.

Chart 1: Global negative yielding assets now at $11.5tr.



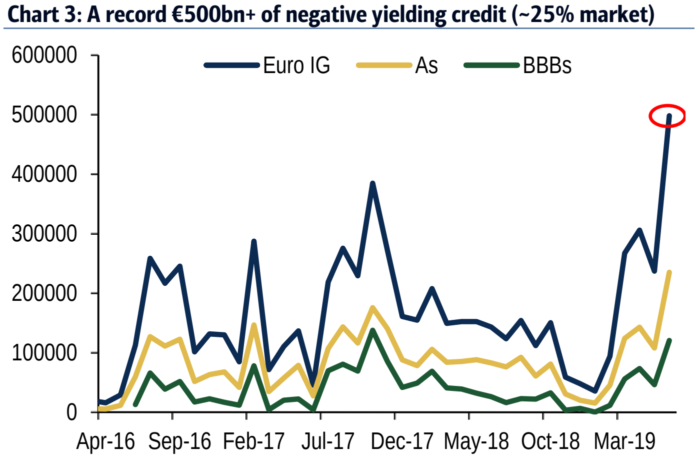
Source: BofA Merrill Lynch, ICE Data Indices LLC. Using GFIM global bond index. 1+yr bonds only.

Chart 2: % of market/sectors negative yielding



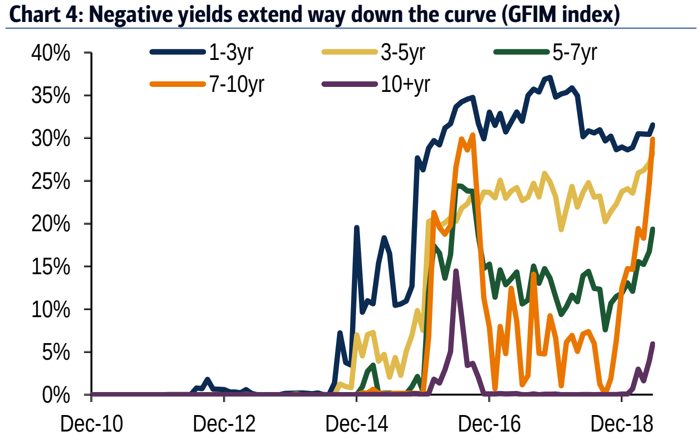
Source: BofA Merrill Lynch, ICE Data Indices LLC, $tr. % of a sector that is negative yielding.

Chart 3: A record €500bn+ of negative yielding credit (~25% market)



Source: BofA Merrill Lynch, ICE Data Indices LLC. Eur mn volume of negative yielding corp bonds.

Chart 4: Negative yields extend way down the curve (GFIM index)



Source: BofA Merrill Lynch, ICE Data Indices LLC, $tr. % of a maturity bucket that is negative yielding.

Consigning so much of the risk-free world to negative yields, however, is akin to "taxing" safe assets, in our view. The result is that money is likely to be forced up the "value chain" into higher-yielding instruments to escape this monetary tax. And accordingly "tourism" across financial markets will run rife. We expect corporate debt to be a beneficiary, though…we think it could see large retail and institutional fund inflows.

With high-grade corporate bonds still looking cheap to CDS at this juncture (Euro IG cash bonds at Libor +70bp vs. iTraxx Europe at 53bp), European credit still has a lot more room to tighten amid a thirst for yield, we think.

Mind-boggling numbers

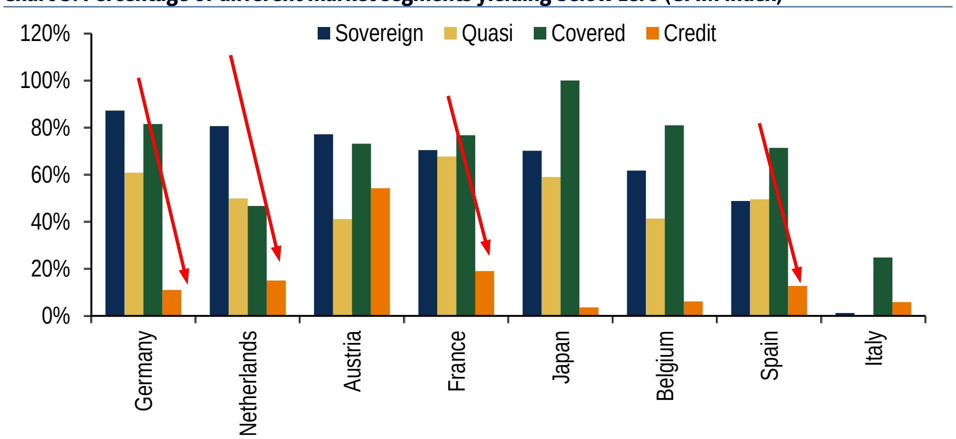
Yet the pressure on investors to move money out of negative yielding assets into positive yielding alternatives will likely be different across the overall market. As chart 2 shows, the percentage of negative yielding debt varies substantially across different pockets of the fixed-income universe (here we use ICE's Global Broad Market Index GFIM, which captures 1yr+ bonds). Consider that:

- Around 85% of German government debt now yields below zero (and ~60% of German quasi-sovereign debt is negative too),
- Close to 80% of French covered bonds now have negative yields (up from around 30% at the start of March this year),
- 70% of Japanese sovereign bonds yield below zero (emphasising why Japanese lifers have been very active this year in buying both US and Euro corporate debt),
- Just under 50% of Spanish government debt is now also negative yielding,
- Despite political tensions, Italy has seen its first govt. bond go negative last week,
- And the negative yield phenomenon is not just a story for the front-end of the market: negative debt can now be found frequently in 10+yr bonds.

Beneficiaries: long German/Dutch/Spanish IG, long French HY and long credit flatteners

How far will the money be pushed up the "value chain" therefore, in this topsy-turvy world of negative yields? If we assume that money logically flows from sovereigns to quasis, then to covered bonds, then to IG credit and then to HY bonds – as each segment of the market becomes more negative yielding – then chart 5 shows the extent to which money could be catapulted into corporate bonds very soon.

Chart 5: Percentage of different market segments yielding below zero (GFIM index)



Source: BofA Merrill Lynch, ICE Data Indices LLC. % of a sector trading negative yielding. High-grade credit only.

We also assume that as money migrates up the value chain, it stays with a domestic bias in Europe.

Based on this assumption, and the relative proportions of negative yielding debt from chart 5, we believe that:

- German high-grade credit could witness strong demand and still rally a lot from here, given such large amounts of negative yielding German sovereign, quasi and covered debt already (but only 11% of German high-grade credit is negative yielding currently). German IG bonds are currently at 123bp vs. Jan '18 tights of 77bp,

- We think the same logic holds for Dutch and Spanish high-grade credit (Spain IG bonds are also currently at 123bp vs. Jan '18 tights of 80bp),

- But within France, we would not be surprised to see more money eventually end up in French high-yield credit, given that closer to 20% of French high-grade corporate bonds are now yielding below zero.

Moreover, based on chart 4, probably the biggest shock to investors' systems lately is how quickly the volume of negative yielding 7-10yr sovereign debt has surged across the globe. As can be seen, almost a third of bonds here now yield below zero. Consider that this number was zero as recently as October last year.

- We expect some 7-10yr money to therefore move from sovereign debt into credit. And thus we think it will act as a big credit curve flattener for the Euro corporate bond market.

We find that Euro high-grade corporate bond curves (1-3yr vs. 7-10yr, and 3-5yr vs. 7-10yr) are still some way from their local tights of Feb-'18 (see appendix chart).

But are we heading for monetary overkill?

To state the obvious, another round of Draghi dovishness is a bullish tailwind for credit. Yet, the spectre of the ECB buying bonds again comes at a time when the stars have already aligned for Euro credit, in terms of super strong corporate debt demand from both domestic retail and foreign investors (Japanese, Swiss, UK etc.). This leaves us contemplating whether there really is room for another big marginal buyer – in the form of the ECB – to wade into the European corporate bond market?

And if the ECB did restart QE, we sense that the cumulative effect on credit spreads might be so much greater than we have seen before. We wonder, therefore, whether the risk in credit markets this year is actually that none of us are bullish enough…

Why QE1 and CSPP1 were relatively easy

When thinking about successive rounds of ECB stimulus on the credit market, it would be wrong to just assume "rinse and repeat" we think. The prevailing buyer base at the time is likely to play a major role in determining the overall impact on spreads. And this is where things are very different today, versus the QE1/ CSPP1 era.

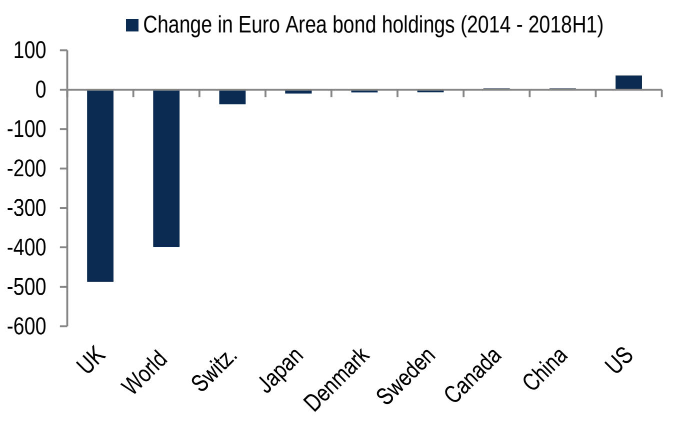
When the ECB announced its expanded Asset Purchase Programme (QE1) in January 2015, the naysayers argued that the ECB would struggle to reach their monthly purchase target, as there would not be enough willing sellers. In the end, QE1 was a fairly seamless process for Draghi.

- This is because non Euro-Area residents (non-bank financial institutions) sold large volumes of Euro Area government bonds to the ECB. As chart 6 shows, the UK was a big non-resident seller of Euro Area government bonds during QE1. Thus, there was a ready source of bonds for the ECB to mop up.

In a similar vein, when the ECB announced CSPP1 in early '16, the demand landscape for European credit was weak and fragmented. The China growth scare had left many nervous over fundamentals and domestic retail investors were withdrawing money from European credit. Likewise, foreign investors were sellers of Euro credit too, fearing rising political risk in the periphery.

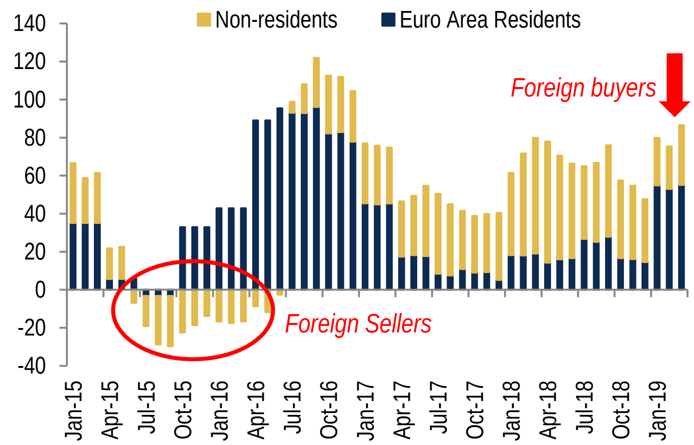
- Chart 7 shows the breakdown of Euro corporate bond demand, split between Euro Area "residents" and "non-residents". In late '15/early '16, non-residents were sellers of Euro-denominated corporate bonds, and this allowed the ECB to easily ramp up corporate bond purchases.

Chart 6: Non-residents were big sellers of Euro government debt during the ECB's APP (Eur bn)



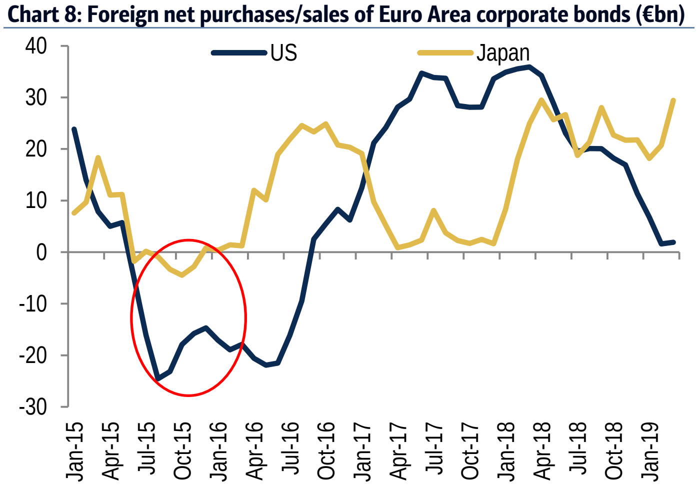
Source: ECB

Chart 7: 12m rolling sum (€bn) of Euro-denominated corporate bond purchases, split by Euro Area residents, and non-residents



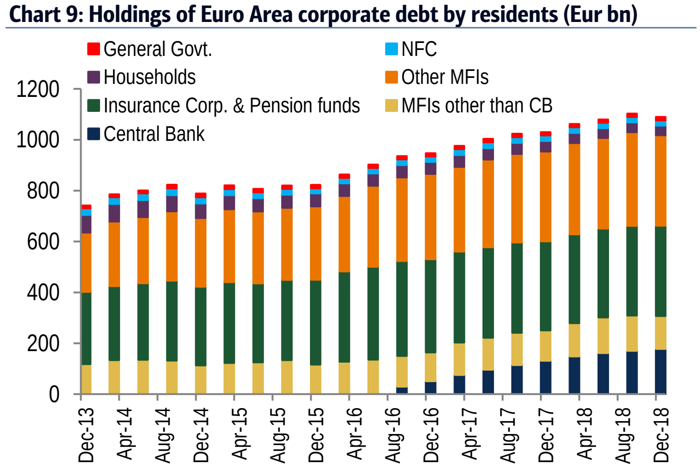
Source: ECB, BOJ, Fed, Datastream.

Chart 8: Foreign net purchases/sales of Euro Area corporate bonds (€bn)



Source: ECB, BoJ. We proxy Japanese buying of Euro credit as 12m rolling sum of non-sovereign euro-denominated bonds and apply a factor of 0.5 to this amount.

Chart 9: Holdings of Euro Area corporate debt by residents (Eur bn)



Source: ECB. Euro Area domestic agents. Outstanding amounts Eur bn. Euro denominated corps.

- Chart 8 shows that it was US real money investors who were the predominant non-resident sellers of Euro corporate bonds at that time (with Japanese investors becoming small net sellers too).

Fast forward to today, and it's already buyers galore for European corporate bonds:

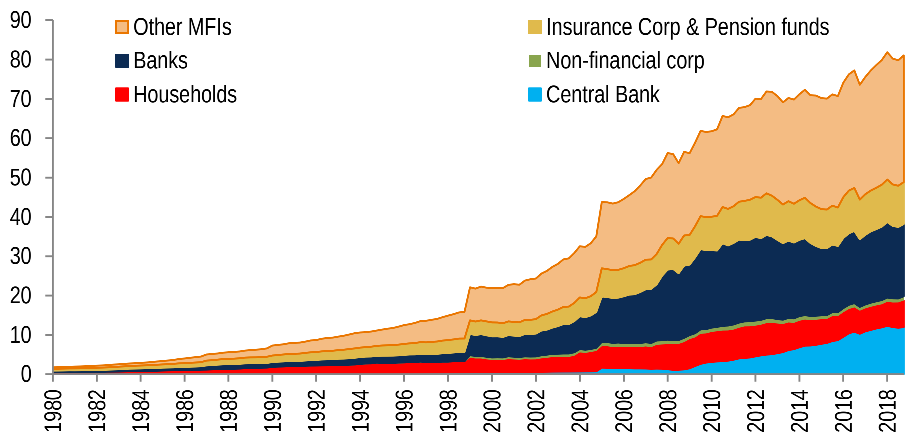
- Chart 8 shows that our proxy for Japanese buying of Euro credit is currently running at close to record high levels (the data here finishes in March '19, but over the last few months anecdotal evidence has suggested even stronger volumes of Japanese buying of Euro credit).

- Moreover, on the domestic institutional side, chart 9 shows that in the final few months of 2018 (when the ECB was tapering QE), insurance companies and pension funds had been actively buying more Euro-denominated corporate bonds. While the latest 2019 data is not available, anecdotally we believe that insurance companies and pension funds have continued to buy credit strongly this year.

More QE: too much of a good thing?

The point is that the Euro credit market today is already awash with demand from both domestic retail and institutional investors, as well as a growing presence from foreign buyers. In fact, as chart 10 shows, the global demand for debt securities continues to rise impressively – and faster than the growth in global debt (consider that the face value of ICE's Global Broad Market bond index GFIM has only grown by $10tr. since the start of 2012). And as we showed here, we believe ageing demographics is a big reason that there is strong secular demand for bonds (and note here, Italy's worrying looming demographic).

Chart 10: Global holdings of debt securities by sector, $tr.
(Global demand base, private sector, for fixed income securities)



Source: BofA Merrill Lynch Global Research. Fed, ECB, BoJ, ONS, BoC, Riksbank,, Norges Bank. Flow of Funds quarterly data by sector for the following countries: United States, Euro Area, Japan, united Kingdom, Canada, Sweden, Norway.

The bottom line is that it won't be easy for the ECB to slot themselves into the credit market as seamlessly as they did in 2016, should QE be restarted. The spread tightening Impact from more QE could be a lot more aggressive than seen before.

CSPP 2.0 – twice as nice?

At Sintra, Draghi affirmed that all tools – including restarting asset purchases – were on the table. Importantly, the hitherto QE red lines (33% limit) were declared "self-imposed". Euro corporate bond markets (marginally) beta-compressed last week, a sign, we think, that credit investors have already begun to price-in a return of ECB corporate bond buying.

But in our view, we're not there yet: a return of ECB QE first requires the ECB to admit that inflation expectations in the Eurozone are unanchored. Moreover, restarting QE is likely a decision for the next ECB President, not Draghi (see our economics view on the bar for more QE).

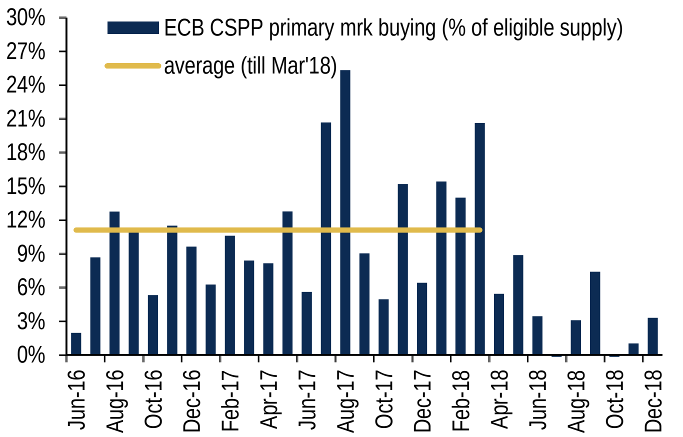
CSPP 1: simple and super bullish for non-eligible bonds

In principle, we see no reason why a CSPP 2.0 can't be part of a future ECB QE. After all, Draghi has stressed repeatedly in the past the *flexibility* of the asset buying programme, and the benefit derived from buying across a range of fixed-income products.

With QE1, for example, during months where one fixed-income market was less liquid, we frequently saw the ECB overbuy in other bond markets to ensure their monthly asset purchase target was achieved. We think the ECB would welcome the same flexibility this time around.

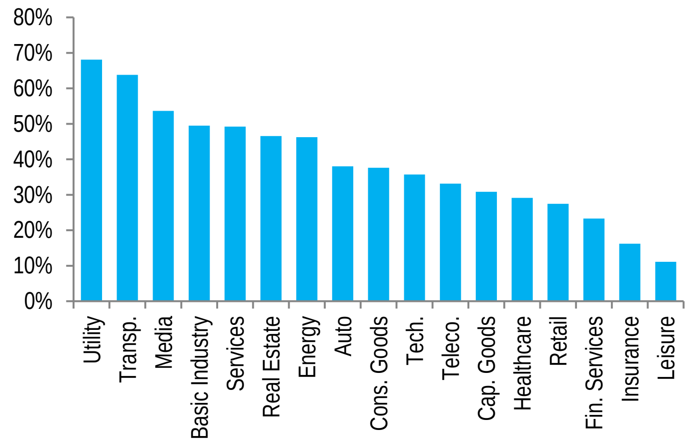
Moreover, given the jump in eligible supply in '19, the ECB own, on average, around 40% of ISINs in Euro IG credit sectors. Thus, there is plenty of scope to restart CSPP.

Chart 11: ECB primary market allocations were, on average, ~12% during CSPP1: "scarcity" is not a problem with ECB credit buying.



Source: BofA Merrill Lynch Global Research, ECB

Chart 12: % of bonds, per sector, that the ECB now own. Scope to buy more again, we think.



Source: BofA Merrill Lynch Global Research, ECB

CSPP 1 was a fairly generic affair, with the ECB buying close to neutral amounts of eligible credit – something we've likened in the past to a huge credit ETF. Looking at the ECB published holdings, we find very little deviation at the sector level, albeit a marginal overweight of 2% in autos (which may reflect the greater free float of these bonds across street trading desks, given trade war concerns).

The winner from QE1 was undoubtedly non-eligible credit, and this becomes the obvious playbook for investors now. As a reminder, from March-Dec '16:

- Euro eligible high-grade bonds tightened 34bp,
- But Euro AT1bonds tightened 121bp,
- Euro IG corporate hybrids tightened by 72bp,
- And Euro HY bonds tightened by 230bp.

CSPP 2.0 – spicing it up?

We think it's most likely that the ECB would stick to this same credit buying formula for a CSPP 2.0, given its efficiency, transparency and fairness (thus less risk of the ECB being accused of "favouritism"). **And just as with CSPP 1, we think non-eligible credits (HY, AT1s, corp. hybrids) would be the best performers**.

But that's not to say that the ECB won't employ some flexibility in any future credit buying, to achieve their monetary aims. On this front, we note that Draghi has previously looked for three things when buying credit:

1. Reduced fragmentation across corporate bonds, with a particular focus on closing the spread gap between core and periphery names,
2. Unleashing "animal spirits", and getting companies to issue more to fund investment, growth and even to acquire,
3. Provide access to credit for all, with a desire to see "debut" corporate bond issuers.

We feel that if the ECB was to try and steer CSPP 2.0 in the direction of achieving some of these aims then it would be incrementally bullish for the following sectors:

- On fragmentation, we note that the basic industry, insurance, retail and transport sectors still have relatively large gaps between their core and peripheral spreads.
- Moreover, industrials and autos are showing high spread dispersion currently vs. when CSPP1 was launched.
- On "animal spirits", the consumers and telecoms sectors currently flag as being less aggressive at this point in time. Steering some CSPP 2.0 buying towards these sectors could partly help revive this, we think.
- And on debut issuers, we think the capital goods sector has seen relatively light activity here. Again, the ECB could again steer some of CSPP 2.0 buying towards this sectors to coax more debut names into the bond market.

Below we look at each of these facets of the market in turn.

Where is fragmentation still high?

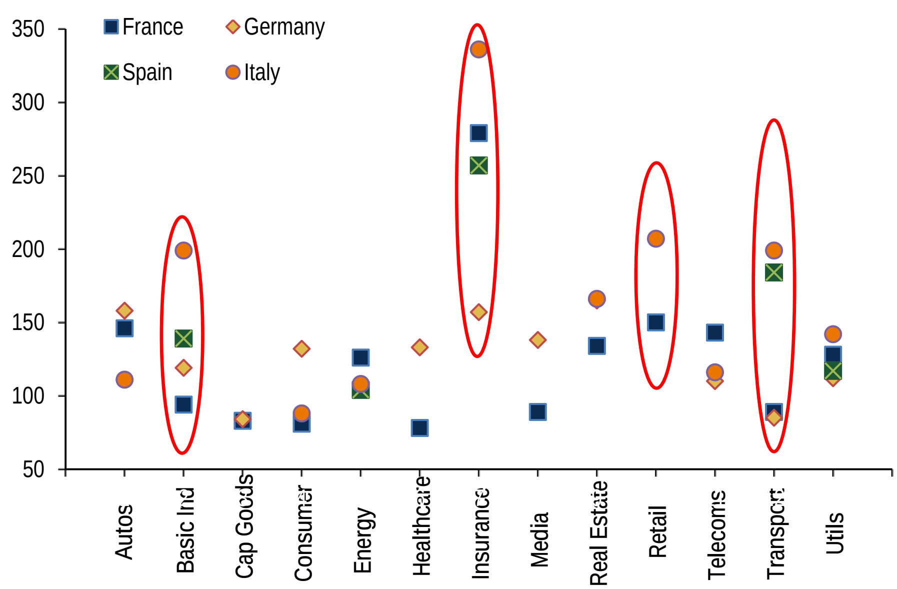
Draghi has always said that one aim of ECB bond buying was to reduce fragmentation across the Eurozone. In corporate bond markets, we can measure this in two ways:

- First, as the gap between core and periphery names, by sector, and
- Second, the min-max spreads across all bonds in each sector.

Chart 13 shows the current gap between core credit spreads (France, Germany) and periphery credit spreads, per sector. Note that while fragmentation is generally low now (and in some sectors periphery trades tighter than core), for **basic industry**, **insurance**, **retail** and **transport**, there are still big gaps.

If the ECB was to steer some CSPP purchases towards these sectors it would clearly be bullish for them (and imply beta compression within them).

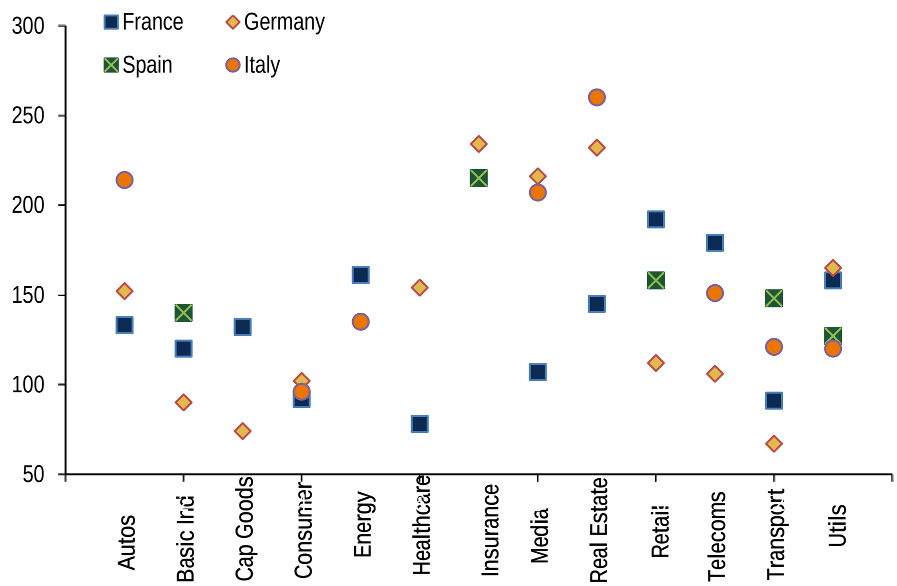
Chart 13: Core vs. Periphery fragmentation still exists in Euro IG industrials, insurance, retail and transport sectors (current sector spreads by core vs. periphery)



Source: BofA Merrill Lynch Global Research. OAS spreads.

Chart 14 shows the same analysis at the start of CSPP 1, when periphery-core fragmentation was rife.

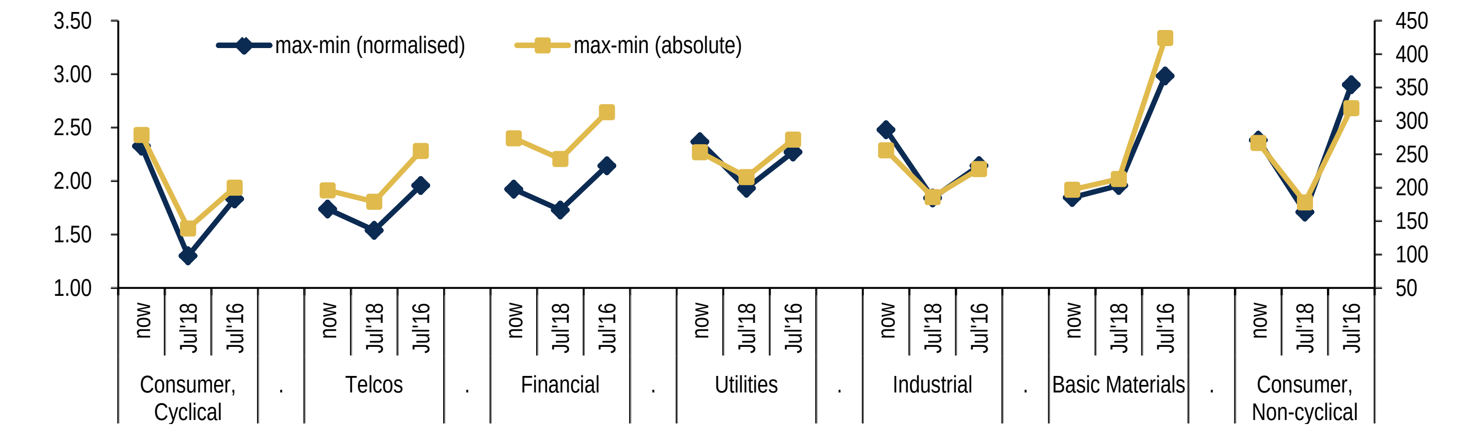
Chart 14: March'16: much more fragmentation in Euro IG credit, based on core vs. periphery dislocations



Source: BofA Merrill Lynch Global Research. OAS spreads.

Another approach in chart 15 is to look at max-min spreads within a sector over time (looking across all individual bonds). While credit sector dispersion is much lower today than at the advent of CSPP1, one can clearly see the effect on dispersion from trade wars in the auto and industrial sectors. These sectors could also be positively targeted under a CSPP 2.0.

Chart 15: Min and max credit spreads (ratios) within Euro IG credit sectors: CSPP1, mid-18, and today. Credit dispersion is generally a lot lower today, but has risen in autos and industrials because of the trade war



Source: BofA Merrill Lynch Global Research. We normalize by the average spread level across a sector. Absolute spreads RHS.

Where are "animal spirits" the weakest?

One desire of the ECB with CSPP1 was that it would motive companies to be more aggressive in using their balance sheets, even if this meant corporate leverage going up. Rather than being run for cash, the ECB were on the lookout for higher levels of capex and greater volumes of M&A.

Post CSPP1 however, the change in corporates' aggressiveness has still been rather muted:

- Chart 16 shows the YoY change in capex, M&A, employment levels and net debt for a large sample of European non-financials. The European corporate sector briefly showed some signs of life in 2015, spending more on capex and M&A (chart 17), but since then signs of corporate "animal spirits" have died down.

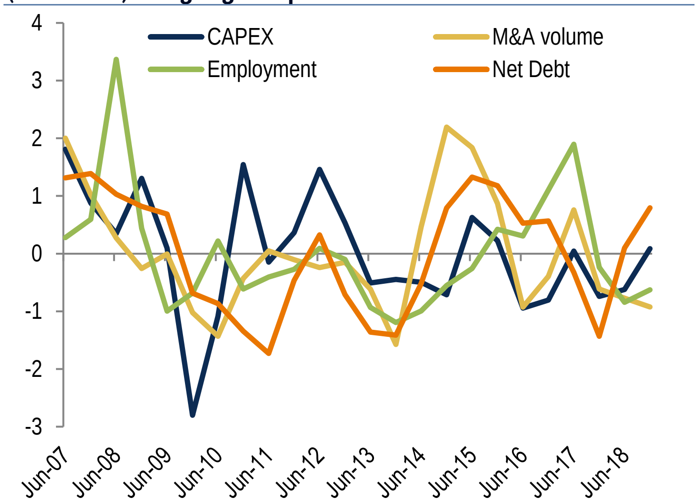
- Chart 18 shows the current level of corporate "animal spirits" (again, sum of capex, M&A, employment and net debt) versus the post-Lehman period. We show today's reading as a z-score versus 2008-2018. We find those sectors that are currently showing very few signs of being aggressive with the balance sheet or outlook are **basic industry** and **autos** (trade war related) as well as **consumers** (macro concerns) and **telecoms** (industry competitive pressures).

Again, the ECB could target these sectors in an attempt to spur greater externalities for the Euro Area.

Chart 16: "Animal Spirit" score for European non-financials in Euro IG (YoY % change in capex, M&A, net debt and employment levels).

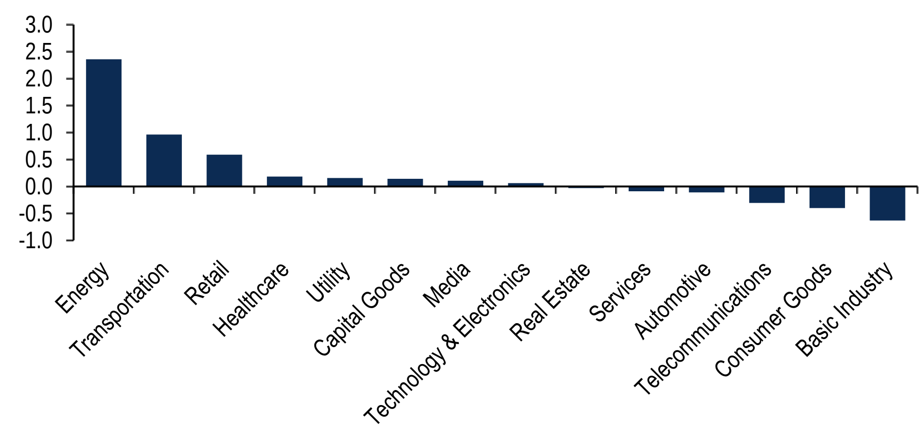
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC

Chart 17: Z-score of YoY percentage change for the following metrics (2007-2018). Using large sample of Euro IG non-financials.



Source: BofA Merrill Lynch, Bloomberg. Negative means current weak levels vs. history.

Chart 18: "Animal Spirit" z-score by sector as of year-end 2018. Basic Industry and Autos have seen a fall in their spending/balance sheet aggressiveness in 2018 (trade war impact). Consumer companies too (broader macro fears).



Source: BofA Merrill Lynch Global Research, Bloomberg. Sectors to the left are currently being more aggressive than in the past, and vice-versa for companies towards the right of chart 18.

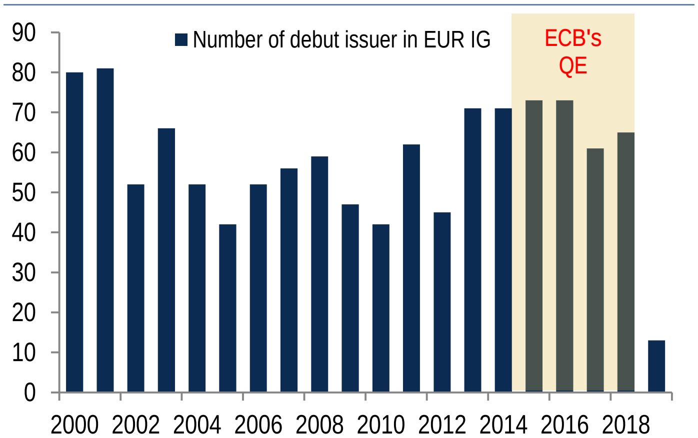
Debut issuers – who missed out?

Finally, we think "debut" issuers are also an area that the ECB has kept a close eye on during the last few years. Draghi wanted CSPP1 to give access to credit (i.e. bond issuance) for those most in need, and less so for the large, established credit issuers who had already moved away from bank financing.

CSPP1 indeed saw "debut" issuers blossom across the Euro IG market (especially from the real estate sector, for instance). But we still think that there is more work for the ECB to do in this area, coaxing first time issuers to the Eurobond market.

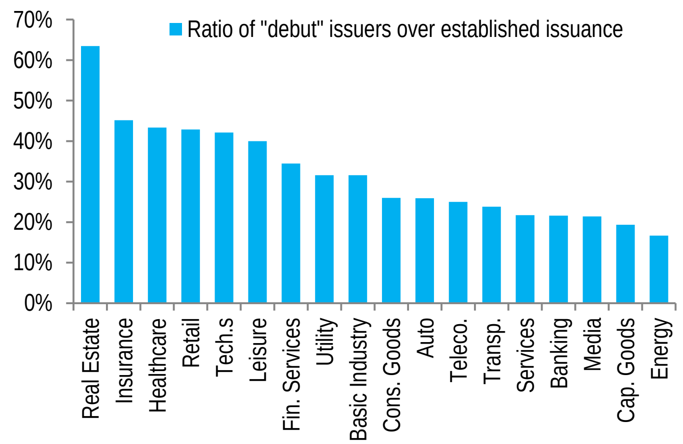
- Looking at the ratio of "debut"/established issuance in the last few years (chart 20), we sense that the capital goods, services and consumer goods sectors still have potential new issuers at hand. By targeting these sectors with any CSPP 2.0, the ECB could indeed try and coax the remaining "debut" issuers to the bond market.

Chart 19: The bulk of BBB-rated "debut" Issuers were in Real Estate and Utilities



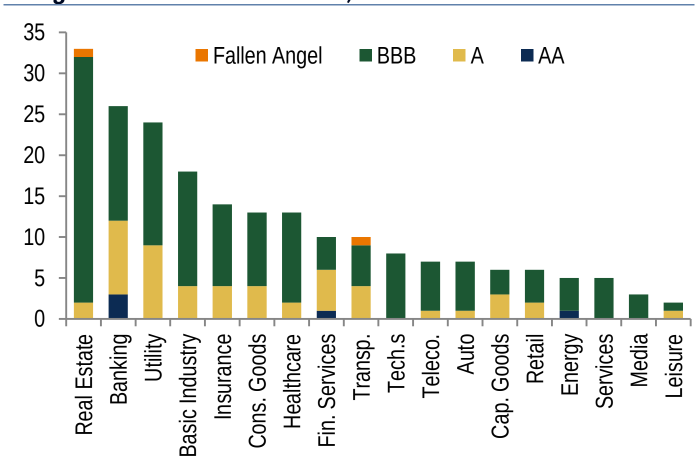
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC

Chart 20: Ratio of "debut"/established issuance as of June '19



Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC, ER00 index as of June '19.

Chart 21: Debut issuers have mostly received a BBB rating (current rating of "debut" issuers since 2015).

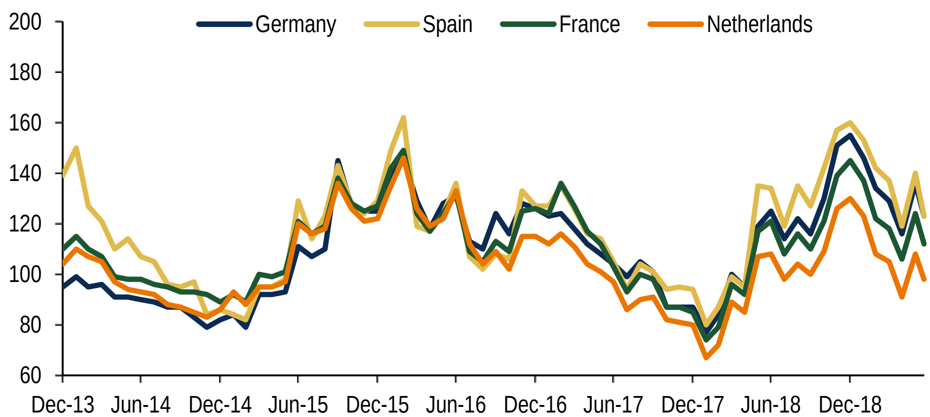


Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC. Count of issuers.

Appendix

The below chart shows Euro IG spreads by country. German credits still look on the cheap side.

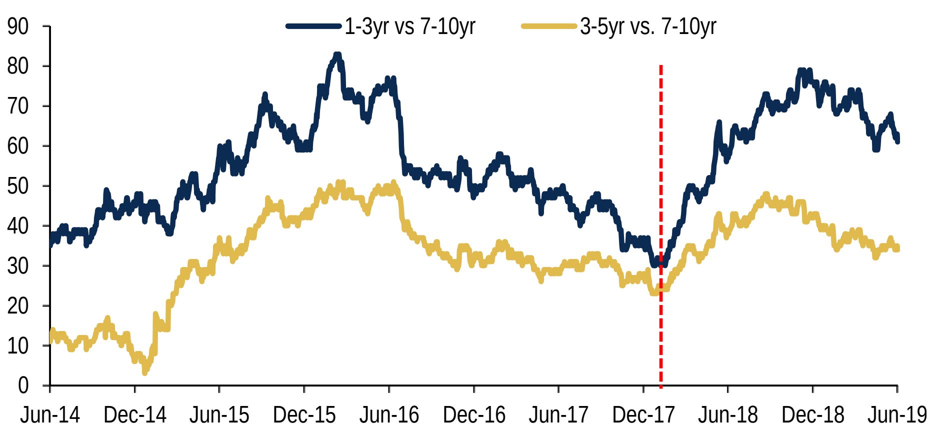
Chart 22: Euro IG credit spreads by country – Germany and Spain still look relatively cheap



Source: BofA Merrill Lynch Global Research

Credit curves are still quite steep, especially compared to the recent lows of early '18.

Chart 23: Euro IG cash bond curves still remain relatively steep in our view and could flatten from here



Source: BofA Merrill Lynch Global Research

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