The European Credit Strategist

Let it QE

Credit Analysis

05 September 2019

Credit Strategy
Europe

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The moment of truth

Since the Global Financial Crisis, the central bank "put" has been the credit market's best friend. Next Thursday we expect Draghi to again embolden markets with rate cuts and QE, albeit the ECB "hawks" are making this decision a lot trickier. We see a return of CSPP as further bullishness for spreads, even if the QE size appears small. Contrary to March '16, today's credit market is already flush with marginal buyers. Adding another will simply make excess demand conditions in Euro credit even more favourable.

CSPP2.0 and the race to rebalance

2019 has seen a historically high volume of supply, changing the makeup of the Euro credit market. We think this means that the ECB's existing credit portfolio is "offside" today, requiring them to rebalance. Where might their purchase focus be first? Likely, we think, on those sectors that have seen the biggest market growth his year. Thus, we think CSPP buying could initially favour **autos**, **healthcare** and **media** bonds. **Real estate** could also be bought given relatively impressive issuance YTD. Conversely, the more meagre supply from **utilities** in '19 has driven its market share lower, and thus we think the ECB would be in less of a hurry to purchase here.

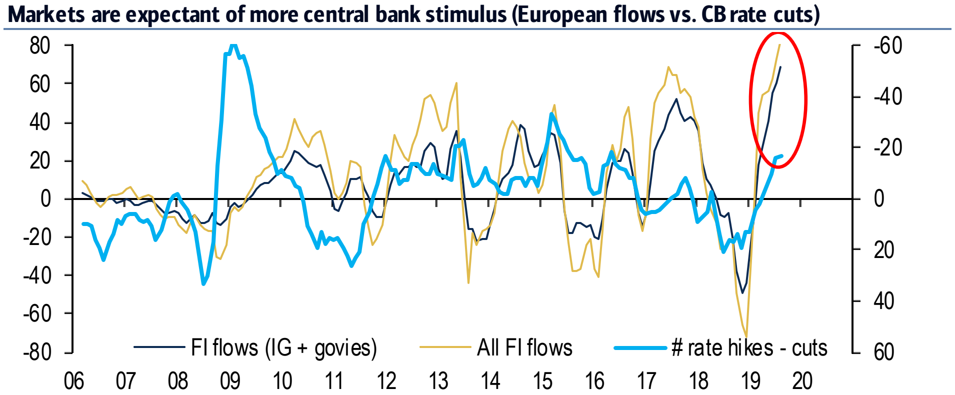
The let-down trades? Non-eligible at risk this time

If next Thursday is a "let-down" and even results in no QE at all, then we would expect spreads to correct, as the market has been pricing-in the return of ECB asset purchases. But we don't see this as ending the bull market, as the strength of inflows remains a potent force on its own. Where are markets more vulnerable? Interestingly, we think investors have been much quicker to embrace non-eligible sectors this time, versus the slower take-up in '16. We think **high yield** and **IG corp hybrids** are more at risk.

Brexit and the "wanted"

The spectre of a No Deal Brexit raises the possibility of the BoE restarting QE as well. But given that credit markets are more cosmopolitan now, the ECB and BoE would be after some of the same names, with very bullish consequences for these spreads. Chart 18 shows 24 names that could be wanted by both central banks.

Markets are expectant of more central bank stimulus (European flows vs. CB rate cuts)



Source: BofA Merrill Lynch Global Research, Bloomberg, EPFR Global. # of CB rate hikes minus cuts, RHS, 3m average. 3m flows into Euro FI funds, $bn.

Refer to important disclosures on page 11 to 13.
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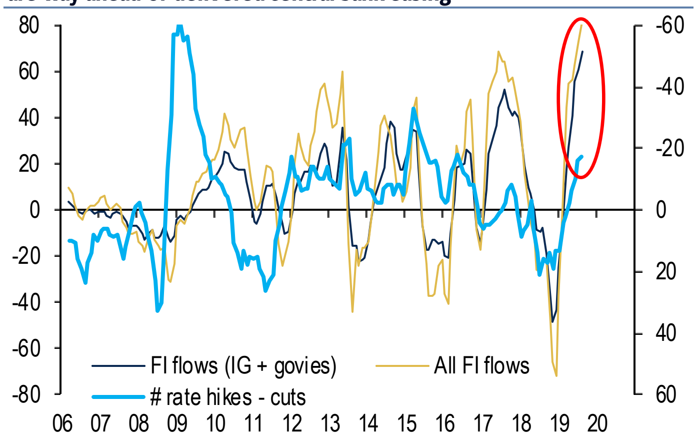
Let it QE

Since the Global Financial Crisis, the central bank "put" has been the credit market's best friend. Next Thursday will be yet another chance for the ECB to embolden financial markets. We expect Draghi to announce a policy package that includes rate cuts and the return of QE – a policy that tightened credit spreads last time and one we expect will do the same going forward.

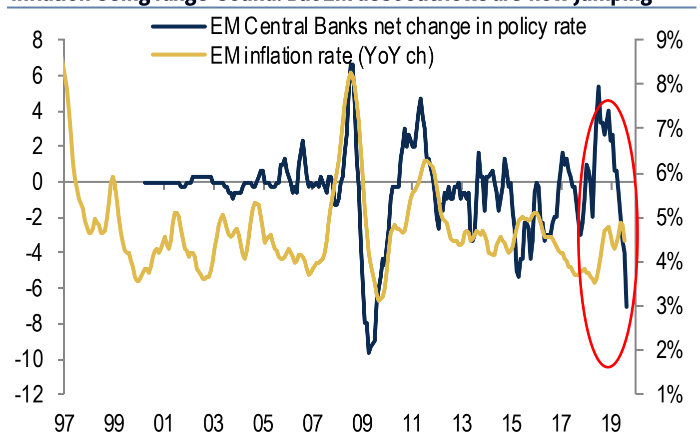
Yet with a week to go, things still appear up in the air at the central banks. The ECB "hawks" have been out in force pushing back on the need for more bold policy measures. What's clear is that markets are priced for a good outcome – note that inflows into fixed income are running way ahead of the amount of central bank easing to date (Chart 1). If next week proves to be underwhelming, then markets are vulnerable to correction. So as always, the onus will be on Draghi to convince the disbelievers…

Chart 1: Markets have run ahead of central banks: fixed-income inflows are way ahead of delivered central bank easing



Source: BofA Merrill Lynch Global Research, Bloomberg, EPFR Global. # of global CB rate hikes minus cuts, RHS, 3m average. 3m cumulative flows into Euro fixed income funds, $bn.

Chart 2: EM central banks are cutting furiously at present despite inflation being range-bound. But EM debt outflows are now jumping



Source: EPFR Global, Haver. Cumulative EM central bank hikes minus cuts (LHS), 3m average. Excluding Argentina.

Quantitative Failure…in real time

Could it be that in the spirit of *Quantitative Failure*, even central bankers are witnessing, in real time the limits to how far monetary policy can go? A "race to the bottom" in rates has collateral damage on the way down. As Chart 2 shows, EM central banks are now cutting rates at the most aggressive pace since the Global Financial Crisis – even though EM inflation remains respectable. The consequence? EM currencies have weakened and EM debt outflows have been conspicuous over the last month (even though other bond market inflows have surged).

Bonds forever?

Central banks are likely debating the *reversal rate* – the point at which rate cuts end up driving counterproductive behaviour across the economy … be it precautionary savings by households, rather than "animal spirits", or banks tightening lending standards rather than engaging in their bread and butter business of providing credit to the economy.

And on this latter point, the ECB's Q2 bank lending survey showed banks were *tightening* loan margins to corporates, despite the world living amid a record $15tr. of negative-yielding assets. While the lessons from Japan are far from perfect, especially for the Eurozone, they do highlight the challenges to having a vibrant bank lending cycle when interest rates are persistently low.

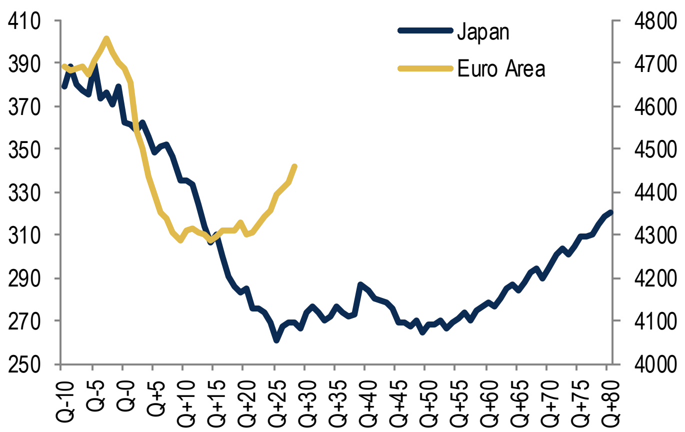
Chart 3 shows how long it has taken for Japanese bank lending to revive, and it is still at half the level when the BoJ first cut rates to zero. Japanese banks have instead often been attracted to the higher yields on offer by investing in foreign fixed income.

And Italian bank lending seems to be eerily following the path of Japan bank lending.

This puts the emphasis on corporate bond markets to provide the bulk of financing for companies going forward – and the healthy supply this month in Euros indeed reflects a number of companies repaying bank debt with bonds.

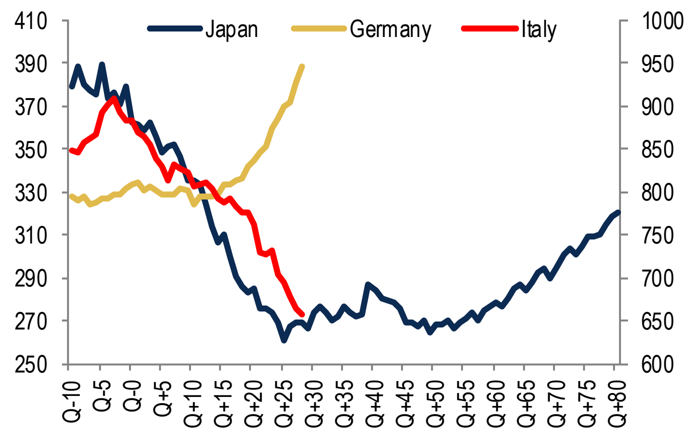
We reiterate our theme that credit markets in Europe will continue to experience strong growth in the years ahead amid an era of financial repression. There should be plenty of new issues for investors to mull over...

Chart 3: Banks' lending to non-financial corporates: Euro Area vs. Japan. Progression from the point at which both CB rates were cut to zero.



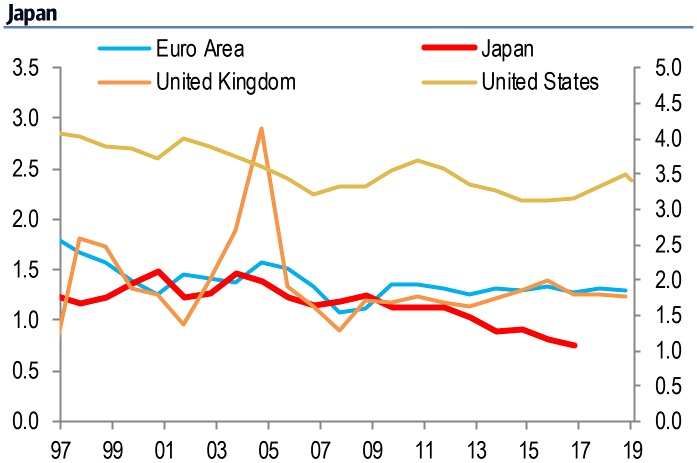
Source: BofA Merrill Lynch Global Research, ECB, BoJ. BoJ overnight rates reached zero in early 1999. Euro Area, RHS, Eur bn, Japan LHS (Yen tr.). Quarterly flows. Showing timeline in quarters from when rates = zero.

Chart 4: Banks' lending to non-financial corporates: Italy appears to be mimicking the Japan scenario.



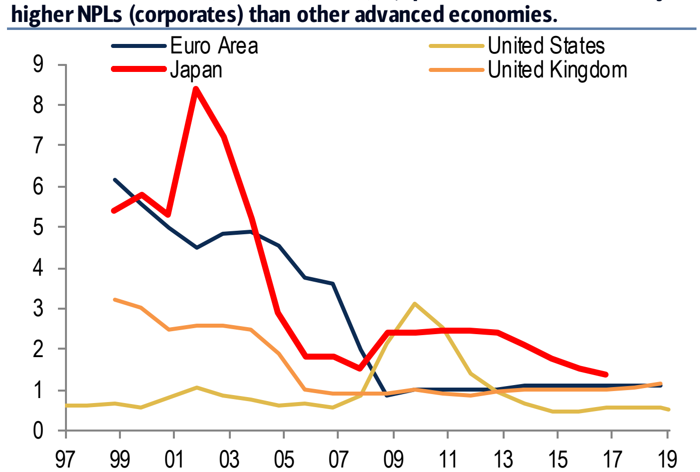
Source: BofA Merrill Lynch Global Research, ECB, BoJ. BoJ overnight rates went to zero in early 1999. Euro Area RHS Euro bn, Japan LHS (Yen tr.). Quarterly flows. Showing timeline in quarters from when rates = zero.

Chart 5: Banks' net interest margin (%) – over a decade of decline for Japan



Source: BofA Merrill Lynch Global Research, ECB, Fed, BoJ. Domestic banks only. US (RHS).

Chart 6: Banks' NPLs (as % of all loans) – Japan banks have had visibly higher NPLs (corporates) than other advanced economies.



Source: BofA Merrill Lynch Global Research, ECB, Fed, BoJ. Domestic banks only.

The season of QE

The final innings of the year are shaping up to be the "season of QE". Our economists expect the ECB to launch a stimulus package next Thursday consisting of a depo rate cut (20bp), tiering for banks and the restarting of QE (€30bn per month, for 9-12m, across the same asset classes as before). And if Brexit takes a disorderly *No Deal* turn over the next few months, then the Bank of England may be kicked into action too, restarting QE and their *Corporate Bond Purchase Scheme*.

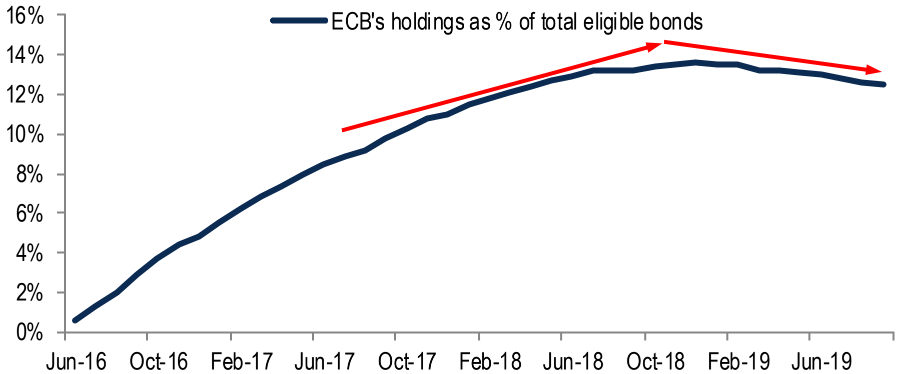
Just as in the past, we think corporate bond buying by central banks will act to tighten spreads (that, after all, is the aim). Yet, with a week to go until Draghi, it's clear that the situation remains fluid. The ECB "hawks" have been out in force over the last few weeks expressing their discomfort with adding more unconventional stimulus. There is, thus, a growing risk of disappointment next week.

CSPP2.0: easy to "rinse and repeat"

If ECB asset purchases are resumed, though, we expect CSPP to again be part of it. At the very least, having another asset class to purchase provides the ECB with flexibility: whenever government debt becomes scarce in a month, the ECB can purchase more credit to compensate. This was a familiar pattern in the 2016-2018 QE. And given the Euro-denominated new issue market should remain vibrant for some time, we would expect the ECB to feel compelled to buy credit for the flexibility.

Note that this year's impressive supply provides fresh impetus for the ECB to reload on corporate bond buying. Chart 7 shows that the ECB's credit holdings as a % of the eligible universe peaked at 14% in Dec-18, but we estimate that it has now declined to just 12.5%. Hence, there is room for the ECB to restart purchases ...

Chart 7: Room to reload on CSPP: thanks to vibrant new issuance, the ECB's credit holdings, as a % of the eligible universe, have fallen from 14% to 12.5%.



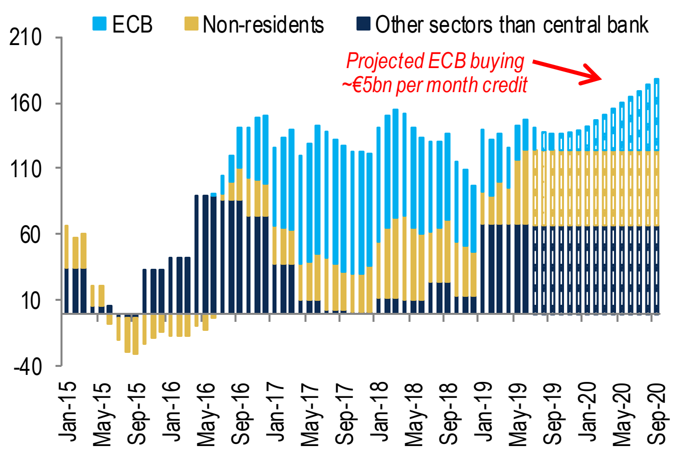
Source: ECB, BofA Merrill Lynch Global Research, ICE Data Indices, LLC. Using the ENS0 bond index as a proxy for CSPP-eligible universe.

We would expect CSPP2.0 to be bullish for spreads even if our economists' €30bn per month overall QE forecast appears relatively small.

- As the charts below show, there are already abundant marginal buyers of Euro-denominated corporate bonds. In fact, there is healthy buying from both Euro Area residents (retail investors) and foreigners (Japanese lifers, for example).

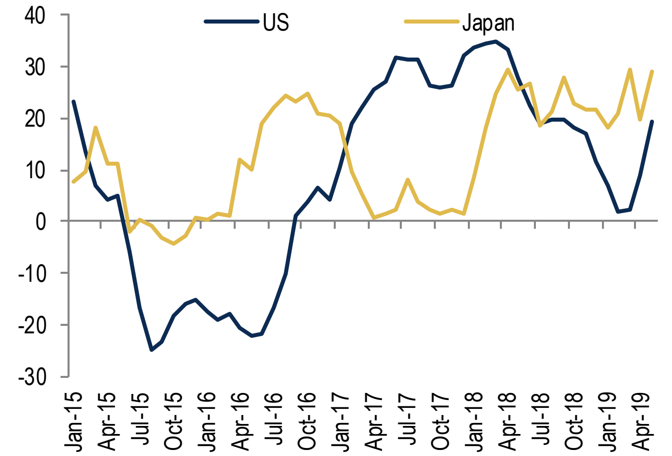
- In particular, note that our proxy for Japanese buying of Euro credit has begun to increase of late (Chart 9).

Chart 8: Net purchase of Euro Area corporate bonds by residents/non-residents (€bn ,12m rolling sum), and now including ECB buying



Source: BofA Merrill Lynch Global Research, ECB, Fed, BoJ, DataStream.

Chart 9: Pick-up in foreign buying of € credit lately. Foreign net purchases of Euro Area corporate bonds (Eur bn, 12m sum).



Source: BofA Merrill Lynch Global Research, Fed, BoJ. Japanese buying proxied as the difference between Japanese net acquisition of € securities and Euro sovereign bonds, adjusted for covered bond buying.

- As Chart 8 shows, adding the ECB as an additional buyer of credit (buying potentially €40-€50bn over the next year, assuming the ECB dedicates 10-15% of buying towards credit) will make excess demand conditions for Euro credit even more favourable.

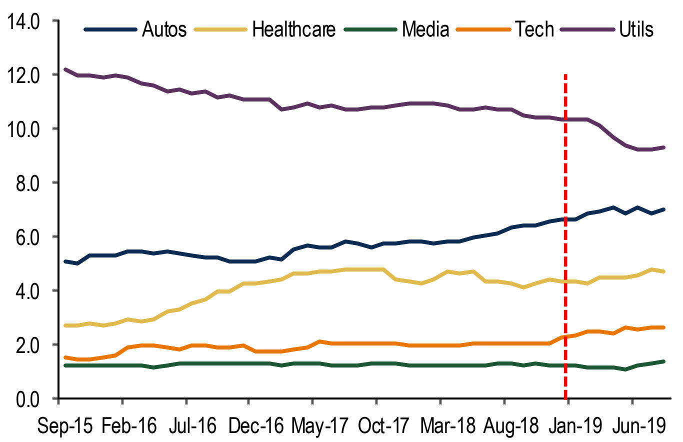
Back in 2016 when the first CSPP was announced, note that the demand situation for Euro credit was quite tame. Foreigners were sellers and domestic retail investors were only buying small amounts of credit, given the Eurozone economy was grappling with deflation risks.

The race to rebalance: What's the ECB's "priority" list?

Given this year's surge in supply, there are plenty of new bonds for the ECB purchase quickly. We think this subset could see the first wave of CSPP buying – and subsequent squeeze in spreads – because liquidity will likely be better here.

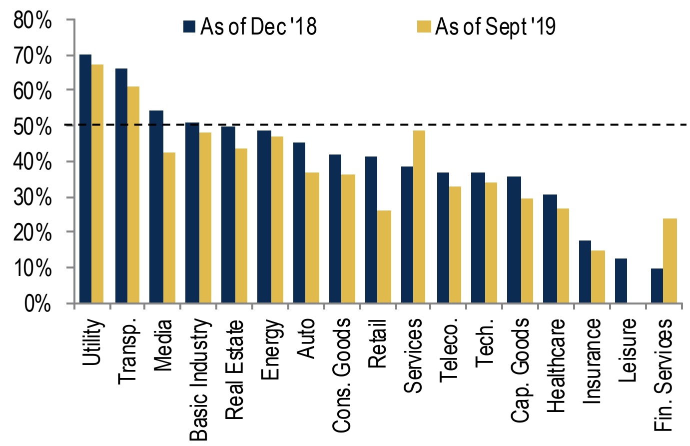
Moreover, given the ECB has tended to run CSPP in a market-neutral fashion, the ECB will need to quickly "rebalance" its corporate bond portfolio to make it more representative of today's market.

Chart 10: How credit market sector weightings have changed this year given the surge in supply (ER00 index, % weight by sector)



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

Chart 11: Proportion of bonds in ER00 held by the ECB (%). CSPP space has grown in retail, leisure, media, autos and real estate



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

On this point, the charts above show how heavy corporate bond supply in 2019 has changed the structure of the Euro credit market. Chart 10 shows the sectors that have seen the greatest market share changes this year, because of issuance:

- Note that **autos**, **healthcare** and **media** are the sectors that have seen their market share grow this year due to supply. Auto issuance in '19, for instance, stands at an impressive €34bn (trade wars have motivated the sector to issue). This is almost 25% growth in the face value of the auto index this year.

Other things being equal, we would expect a greater focus from the ECB on buying these sectors first.

- Conversely, relatively sparse issuance from the **utility** sector has seen its weight within the ER00 index fall by over 1 percentage point in '19. Accordingly, we would expect less emphasis from the ECB on buying here (and the ECB also appears to be "underweight" the utility sector, based on their disclosed sector holdings).

Chart 11 shows how the *percentage* of ER00 index ISINs held by the ECB has changed this year (the ECB do not disclose the notional value of bonds held, simply whether they hold a particular bond or not).

- Again, one can also see the drop in the % of ISINs that the ECB own in the autos and media sector.

- But under this metric, the ECB's **real estate** holdings look a little light too, we think, and this sector could also see some initial buying from the ECB, squeezing spreads.

Charts 21-23 in the Appendix show the proportion of CSPP-eligible issuance this year that has been bought by the ECB as part of their reinvestment.

- Again, for the autos and real estate sectors, the proportion of new supply purchased by the ECB has been relatively low.

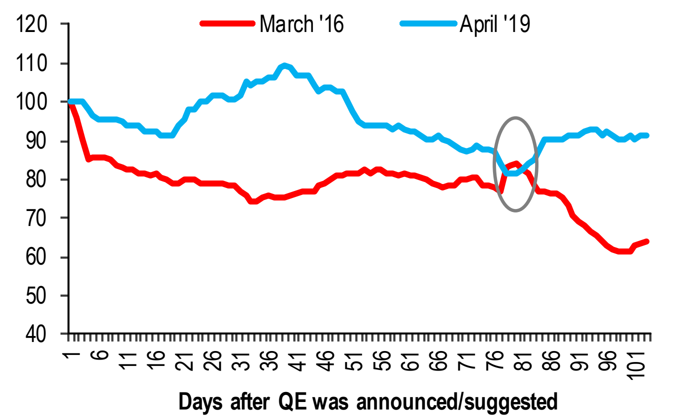
And if it's a let-down ... who's exposed?

Given all the messages by ECB "hawks" of late, there are risks that next week sees an underwhelming policy response from the ECB (with potentially no new asset purchases).

If there were no QE announcement (and a feeling that neither was one imminent), then we would expect some spread widening upon the disappointment. While strong credit inflows would continue to be a supportive factor, limiting the sell-off, we think the market has moved some way to pricing-in ECB QE lately, and thus spreads would be vulnerable in places.

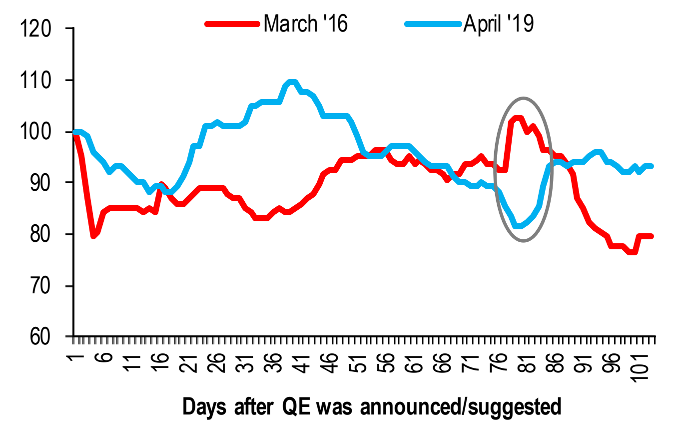
To highlight this, Charts 12-14 compare the progression of credit spreads after (1) the April '19 ECB meeting – when Draghi hinted that QE could make a return; and (2) after March '16, when the ECB first announced CSPP. We rebalance spreads to 100 at the start date and show how spreads evolved thereafter.

Chart 12: Utility spreads: then and now (rebalanced to 100)



Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC. Rebalanced to 100 at the start of CSPP announcement.

Chart 13: Consumer spreads: then and now (rebalanced to 100)



Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC. Rebalanced to 100 at the start of CSPP announcement.

As the charts show, at the start of August this year, Euro credit spreads had performed *better*, relative to the situation after the 2016 CSPP announcement.

- For instance, high-grade consumer spreads tightened almost 20% from the April-'19 ECB meeting until the start of August this year. This was a much stronger performance than the equivalent period after the March '16 CSPP announcement.

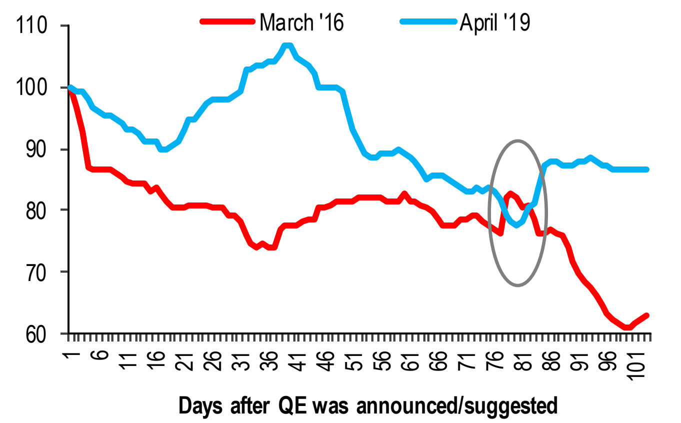
Broadly, however, we think it's been the non-eligible parts of the market that investors have been quicker to embrace during this QE anticipation period, and thus we would expect them to be more vulnerable should the ECB disappoint on QE.

- Chart 15, for instance, compares the spread ratio of single-Bs (*non-eligible*) to IG *eligible* spreads over time. Note that the market has been quicker to embrace non-eligible parts of the market this time relative to '16 (the spread ratio is falling quicker this time).

- Likewise for the performance of corporate hybrids (*non-eligible*) relative to telco (*eligible*) spreads. The market has been quicker to embrace non-eligible parts of the market now relative to '16 (the spread ratio is falling quicker this time).

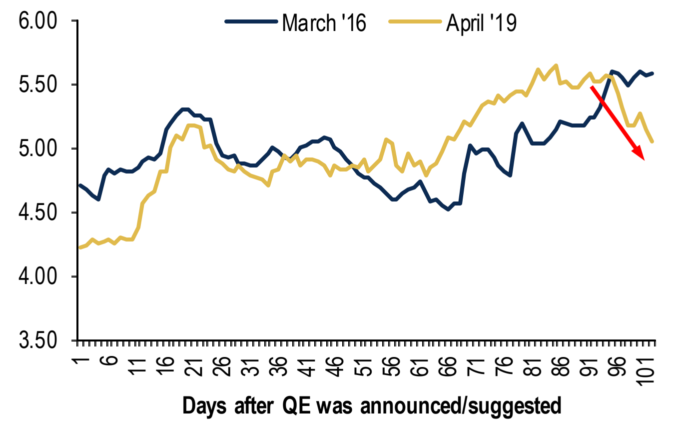
- AT1s appear a bit less vulnerable at this juncture because Brexit and Argentina woes caused the sector to widen in August.

Chart 14: Real estate spreads: then and now (rebalanced to 100)



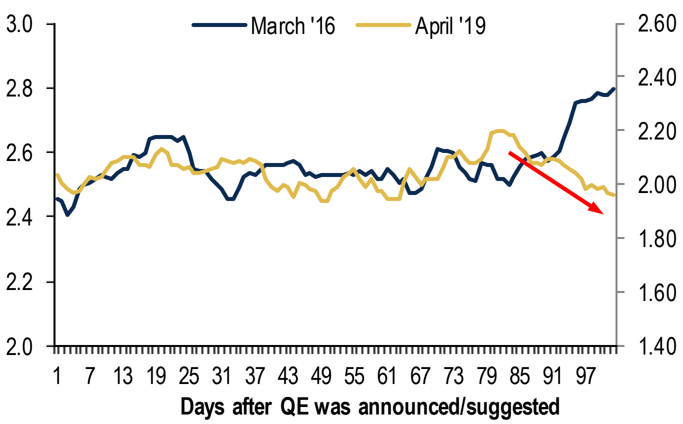
Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC. Rebalanced to 100 at the start of CSPP announcement.

Chart 15: Single-Bs (*non-eligible*) vs. IG telco spread ratios: markets reaching for non-eligible sectors sooner this time, versus 2016's CSPP



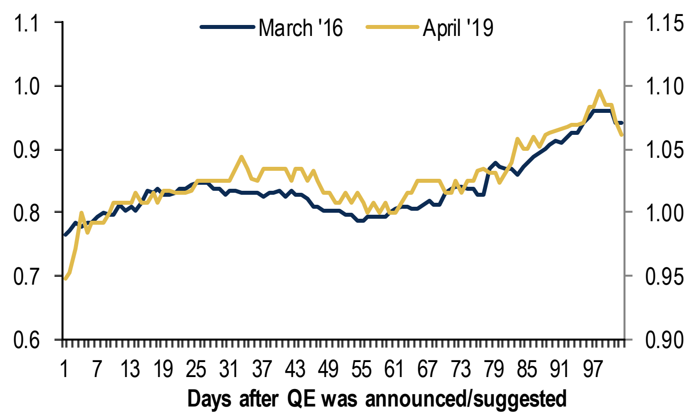
Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC. Rebalanced to 100 at the start of CSPP announcement.

Chart 16: Corporate hybrids (*non-eligible*) vs. IG telco spread ratios: likewise markets reaching for non-eligible sectors sooner this time



Source: BofA Merrill Lynch Global Research. Rebalanced to 100 at the start of CSPP announcement.

Chart 17: Senior banks vs. telecom spread ratios



Source: BofA Merrill Lynch Global Research. Rebalanced to 100 at the start of CSPP announcement

Brexit and the "wanted"

The UK has not been far out of the limelight of late given the Brexit debates. As our economists have highlighted, No Deal risk continues to rise. In our view, a disorderly No Deal outcome could be the trigger for the BoE also restarting QE, and in particular the *Corporate Bond Purchase Scheme*.

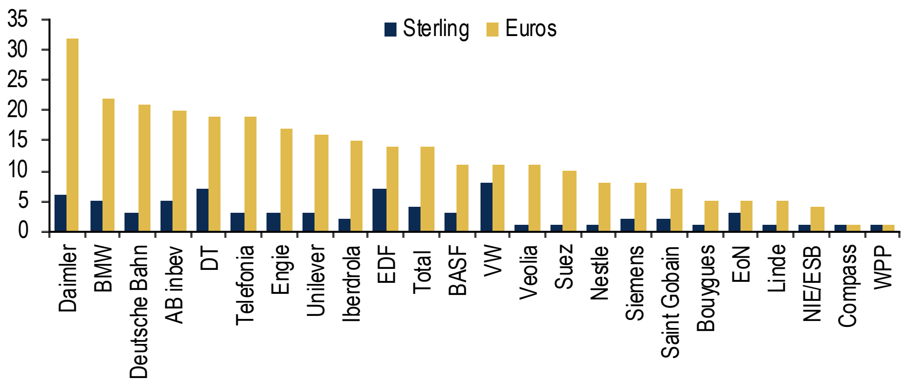
Recall that between late September '16 and the end of April '17, the BoE bought £10bn of sterling-denominated corporate bonds, yet this was an accelerated purchase pace from what was originally envisaged.

Unlike ECB CSPP – which has rigid rules – the BoE has tended to purchase bonds from companies that "make a material contribution to the UK economy" – which means that Eurozone-domiciled (and even US) names would be bought by the BoE.

We can envisage a scenario then, towards the end of the year, where both the ECB and BoE are buying corporate debt. But there would be some names that would be captured by both QEs … meaning their spreads would be given a much bigger boost.

Who are these "wanted" names? Chart 18 shows that there are currently 24 names that have eligible bonds in both Euros and Sterling. We think these names would outperform strongly if both ECB and BoE corporate QE went live.

Chart 18: The "wanted"? 24 names that potentially could be bought under ECB and BoE QEs (we show the # ISINs on the BoE's current eligible list, and #ISINs currently held by the ECB)



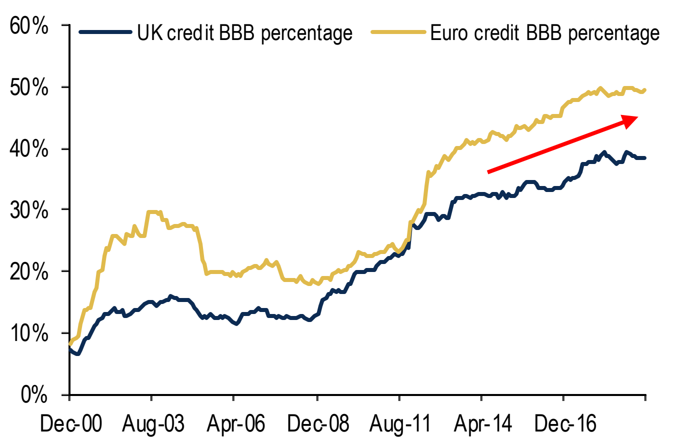
Source: BofA Merrill Lynch Global Research, ECB, BoE. Using the BoE's latest eligible list for the Corporate Bond Purchase Scheme.

Brexit and the BBB/BB cliff

To get a return of BoE QE, however, we think the No Deal scenario would need to be very disruptive for the UK economy (see here for our broader Brexit views and credit). This in itself would mean heightened probability of rating downgrades of UK issuers (especially those that are domestically focussed).

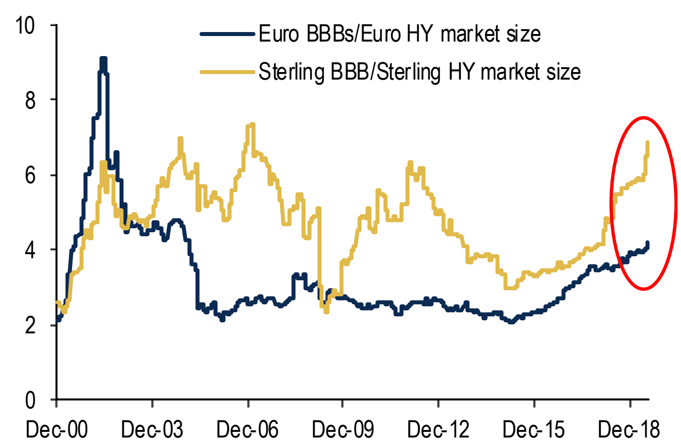
As the charts below show, the BBB/BB crossover could be back in focus for the UK credit market under this scenario. Note in Chart 19 that just shy of 40% of the Sterling credit market in now rated BBB, up from 28% at the end of 2012. While the percentage is not quite as high as it is for the Euro-denominated credit market (~50%), it is nonetheless still meaningful.

Chart 19: BBB percentage of high-grade markets over time



Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC. Proportion of BBB-rated bonds in ER00 and HL00.

Chart 20: Sterling BBBs are almost 7x the size of the £ high-yield market



Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC. Ratio of market size (BBB/HY).

Fallen Angels would be problematic for the UK high-yield market simply given imbalances in market size. Chart 20 shows that the £-denominated BBB market is now almost 7x the size of the Sterling HY market, and the number has surged higher of late (much more than for the Euro market).

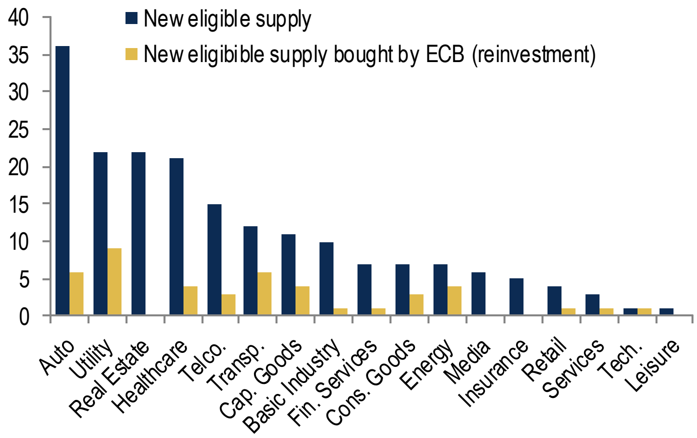
It is safe to say that indigestion risk on the back of Sterling *Fallen Angels* would be meaningful – and would mean £ BB underperformance as the Brexit saga deteriorates.

Appendix

The following charts show the number of new eligible ISINs issued in the Euro-denominated credit market in '19 vs. the number of purchased by the ECB due to CSPP reinvestment.

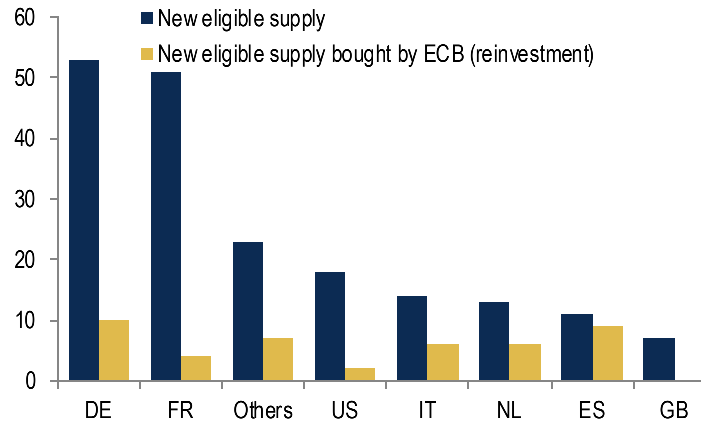
In the sectors to the left, there is an immediate source of liquid bonds that the ECB can quickly purchase. Thus, spreads here should tighten if CSPP2.0 is announced next week.

Chart 21: New eligible bonds issued in 2019, by sector, and how many of them the ECB has purchased (number of ISINs)



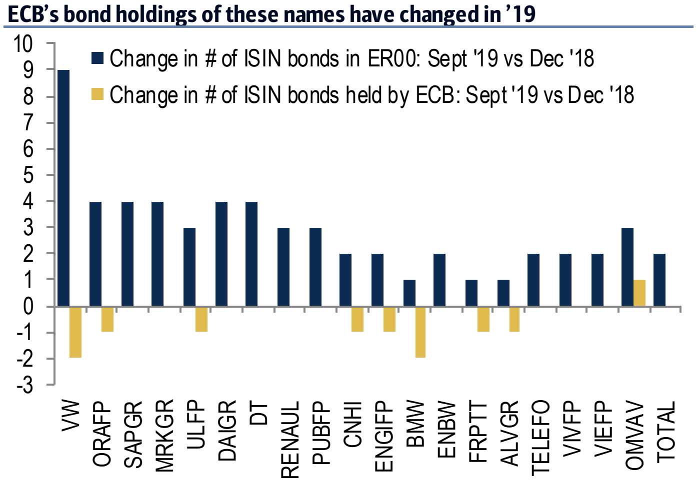
Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC, ECB.

Chart 22: New eligible bonds issued in 2019, by country, and how many of them the ECB has purchased (number of ISINs)



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

Chart 23: The top eligible bond issues this year (# ISINs) and how the ECB's bond holdings of these names have changed in '19



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

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