The European Credit Strategist

# Bonds for equities

Credit Analysis

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Credit Strategy
Europe

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## Animal spirits and the "hidden" rotation

The 2020s are already feeling like a turbo-charged version of the last decade. Crunch time will be when central banks feel compelled to normalize policy on concerns of asset bubbles and market stability. But in Europe, households have been busy accumulating financial assets again and rotating from bonds to stocks. This makes eventual monetary normalization an even trickier feat for the ECB, just as it was for the Fed in '18.

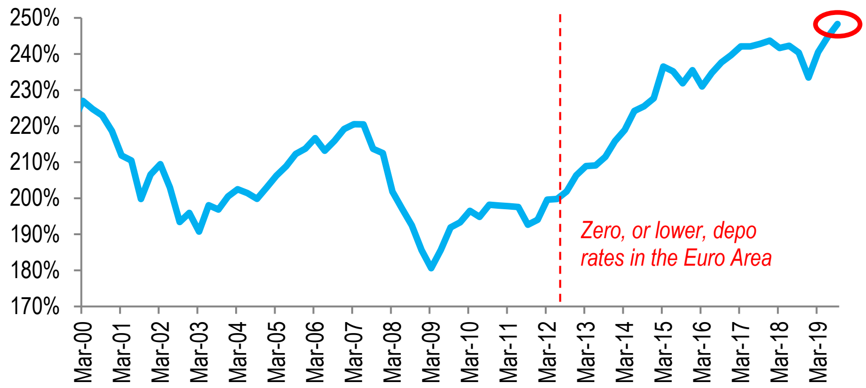
## "Equities" are booming in credit land

While high-beta stocks are struggling in Europe, "synthetic" equity is booming across the credit market. Corporate hybrid yields are not only at a record low of 1.5%, but hybrid capital costs have significantly diverged from equity costs in the last 6m. If the credit market is giving challenged companies in Europe another route to fix themselves, then this has to be bullish for a bigger risk-on trade in stocks...and supports our equity strategy call for "value" to outperform "growth". Moreover, we think hybrid-funded share-buybacks will emerge, supporting the de-equitization theme in Europe.

## The colour of money

The ECB is continuing to foster a "money for all" environment in Europe. This month would likely see more than half of Euro IG issuance come from foreign companies, a rare occurrence historically. And 55 corporate bonds in Europe now have zero coupons. Strong credit market growth over the next few years is very likely, we think. But "debut" issuers continue to arrive with higher leverage, making the credit market fundamentally riskier over time. Cyclicals stand out to us as having a particularly large gap between the leverage of "established" and "debut" companies.

**Euro Area households' net wealth (% disposable income) has risen sharply over the last year. Households are embracing equities again...making the job of ECB normalization trickier.**




Source: BofA Global Research, ECB, Federal Reserve.

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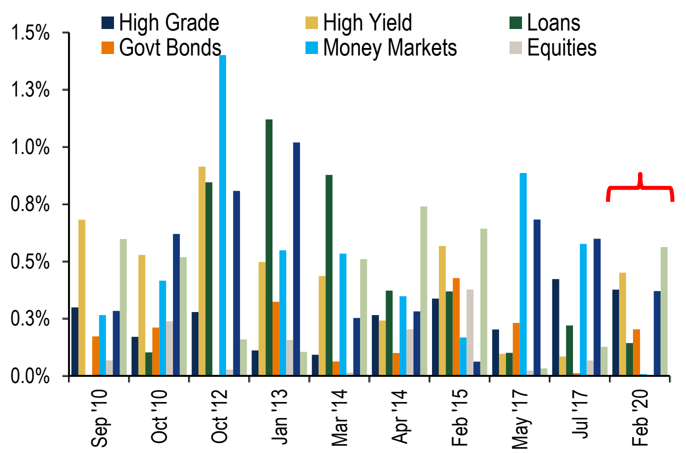
# Bonds for equities

The 2020s are already feeling like a turbo-charged version of the last decade: 13 (net) rate cuts by central banks year-to-date, a world interest rate of now just 1.58%, Euro IG issuance annualizing €800bn, 1-3yr corporate bonds yielding below zero…and investors seemingly buying everything. Last week saw retail inflows into every European asset class – only the 10th time in history that markets have gone "all in" (chart 1).

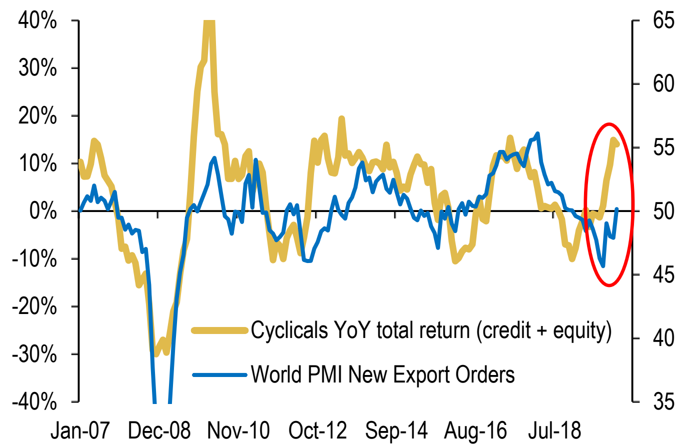
Monetary largesse continues to incite an unprecedented thirst for yield. "Punishing" the most sacrosanct of assets (cash) has elicited a monumental behaviour change across financial markets, and asset prices are, accordingly, running well ahead of the economic data (chart 2). What gives? Crunch time will be when central banks feel compelled to normalise policy on concerns of asset bubbles and financial stability (note the growth in lending to non-bank financial institutions, chart 3). And last week's contradictory newsflow from the ECB shows that some central banks are already starting to grapple with the many dimensions of their mandate.

**Chart 1: Weekly net inflows across all asset classes in Europe last week, only the 10th time in history.**



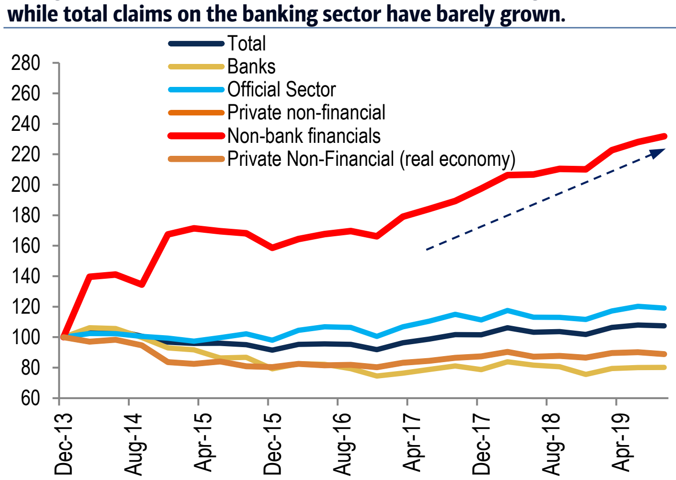

Source: BofA Global Research, EPFR Global. Weekly flow as % of assets under management.

**Chart 2: Markets are well ahead of the data already. YoY total returns of European cyclicals (bonds + stocks) vs. World PMI New Export Orders**



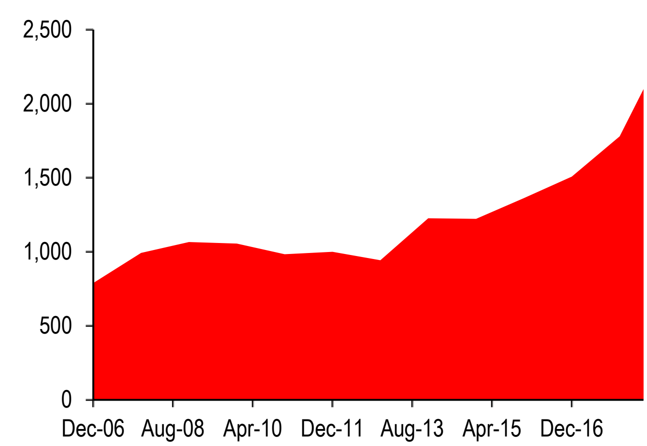

Source: BofA Global Research, ICE Data Indices LLC, Markit, Bloomberg. "Cyclicals" total return (LHS). "Cyclicals" are 50% SCYC index and 50% ICE's EJ00 index returns.

**Chart 3: Evolving pockets of risk in a low yield world: Global banks' foreign claims to the non-bank financial sector have surged since 2013, while total claims on the banking sector have barely grown.**




Source: BofA Global Research, BIS. Amounts rebased to 100 as of Q4 '13. Global cross-border bank claims.

**Chart 4: Alternatives in a low yield world: Global Private Capital "dry powder" now in excess of $2tr.**




Source: Prequin, BofA Global Research.

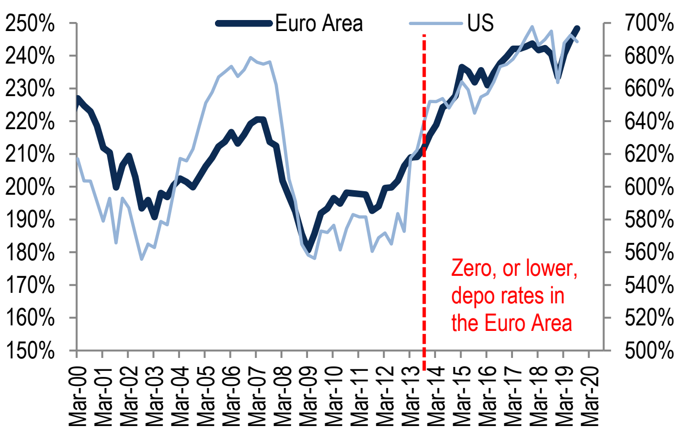
## "Animal spirits" and the hidden rotation

If there is one lesson that markets have learnt over the last few years, it is that normalizing monetary policy has become significantly challenging. Years of low rates have pushed consumers into holding more financial assets. But this amplifies the negative wealth effect on the economy if rate hikes tip markets into the red. The sensitivity of consumer spending to asset prices has likely increased, therefore. Michael Hartnett highlights the Fed's "liquidity trap": that US private sector financial assets, as a share of US GDP, have currently grown to a record 5.5x.

But in Europe, households also seem to have been accumulating more financial assets of late – and in particular equities. **The upshot is that the ECB will likewise have to tread carefully when the time comes to begin monetary normalization.**

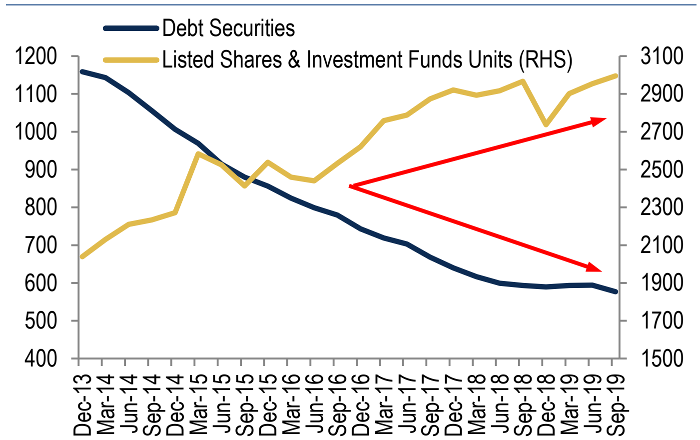
- Chart 5 shows that Euro Area households' net wealth, as a % of disposable income, has jumped to a record 250%. While this is lower than the outright levels in the US (using the same definition), the metric for Euro Area households rose more in 2019, implying that consumers are becoming more sensitive to financial markets.

**Chart 5: Euro Area households' net wealth (as % disposable income) has risen sharply during the last few years**




Source: BofA Global Research, ECB, Federal Reserve. Euro Area household wealth (LHS).

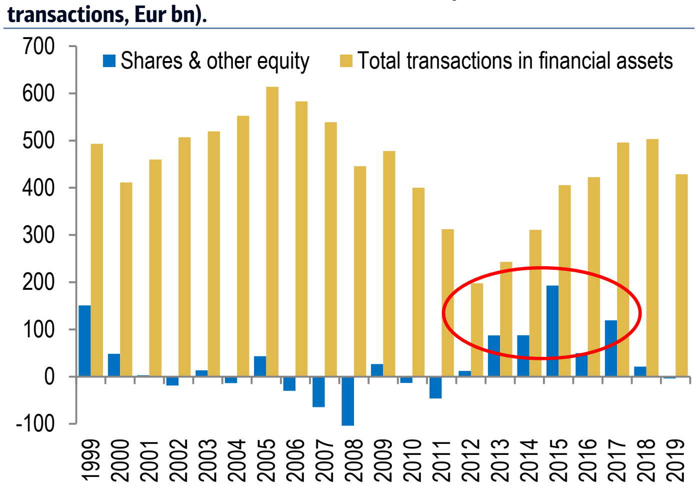
**Chart 6: Euro Area households' holdings of securities (Eur bn.)**




Source: BofA Global Research, ECB. Debt securities LHS.

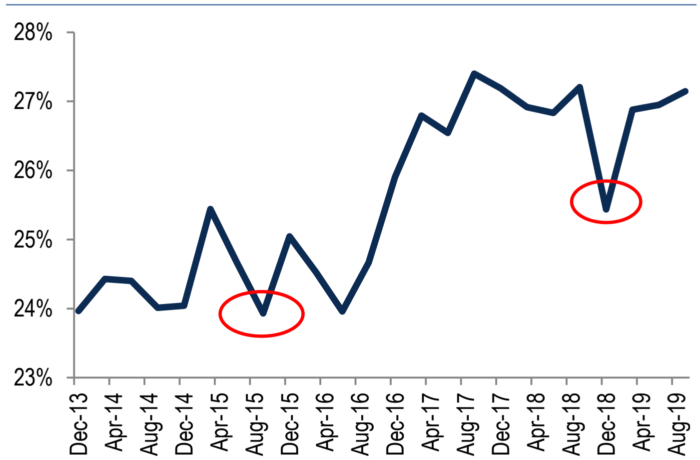
Interestingly, we see signs of a "rotation" by Euro Area consumers over the last 3yrs: holdings of debt securities have declined, while holdings of "equities" look to have risen.

**Chart 7: Transactions in financial assets of European households (annual transactions, Eur bn).**




Source: BofA Global Research, ECB

**Chart 8: Holdings of shares as a % of Euro Area Households' holdings of securities**



Source: BofA Global Research, ECB.

- Chart 6 shows that household holdings of "equities" have grown by €500bn since mid-2016. While for debt securities, there has been a drop of over €200bn during this time (although, we know from our weekly flow reports that European retail investors have been big buyers of corporate bonds during this period).

Chart 7 also reflects Euro Area households' newfound appetite for equities in Europe – something that looks to have taken hold in the post-QE era.

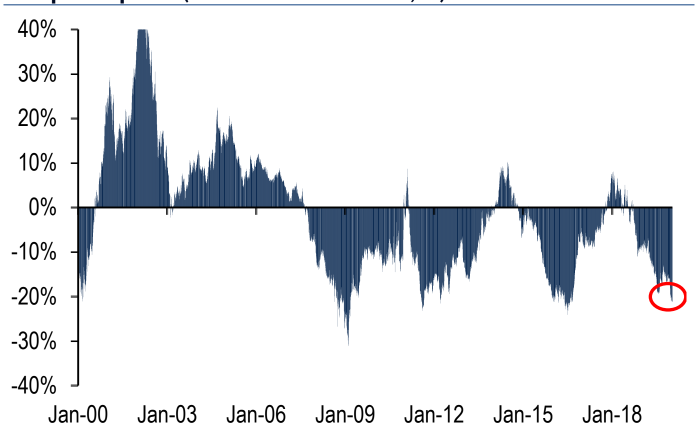
Finally, chart 8 suggests that Euro Area households are becoming more responsive to market gyrations. Even though the market sell-off of late '18 was not monumental by historical standards, Euro Area households were much quicker to reduce their exposure to equity markets. Contrast this with 2015 (China concerns), where Euro Area households reduced their equity holdings by a lot less.

## The colour of money

Despite the surge in asset prices over the last year, the equity market refuses to embrace beta in Europe with the same vigour (chart 9). Manish Kabra, our Quant Equity strategist points out that high-risk equities are now trading at a 50% discount to the market on a forward P/E basis – a gap last witnessed in 2008. "Value" stocks have flatly refused to outperform "growth" stocks thus far in the 2020s.

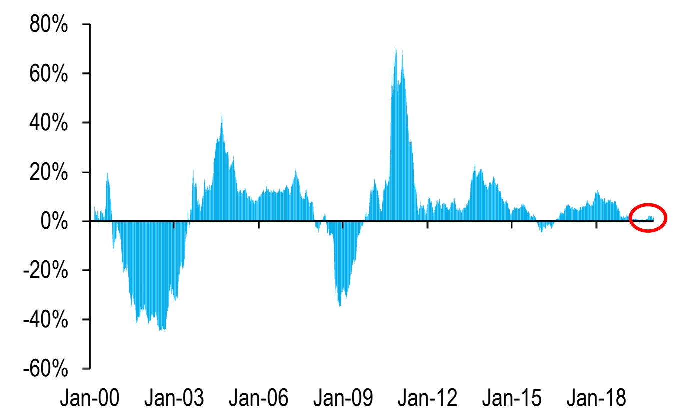
The mood in credit though, has been a lot more full-on since the US-China phase 1 deal. In particular, high-yield (-62bp) has significantly outperformed high-grade (-11bp) since last November. Accordingly, chart 10 shows that the high-beta/low-beta pattern in corporate bonds looks very different to equities (see more here on how to think about "value" vs. "growth" factors in the European credit market).

**Chart 9: 2yr rolling performance of "Value" vs. "Growth" stocks in European equities (total return differential, %)**




Source: BofA Global Research.

**Chart 10: 2yr rolling performance of HY vs. IG credit in Europe (total return differential, %)**




Source: BofA Global Research, ICE Data Indices LLC. HE00 vs. ER00

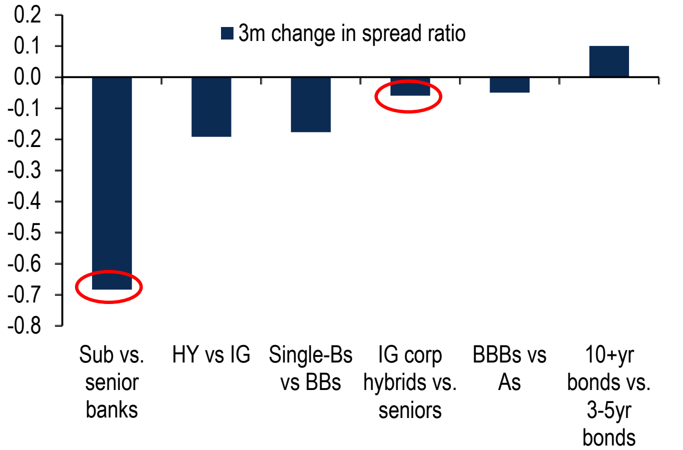
In fact, the "value" outperformance in credit has been much broader than just HY vs IG. Chart 11 shows how the credit spread ratios of six classic sector pairs have evolved over the last 3m. With the exception of duration – which has clearly been shunned, but now looks interesting from a contrarian aspect – all other spread ratios are lower over the last 3m....and materially so for financials where sub banks have been on a tear.

What's behind the happy times in credit? The ECB continues to rubber stamp the rally by helping to create a "money for all" environment for corporate issuers globally...and the concept of *interest cost* is starting to become a thing of the past.

- Note, in chart 12, that this month is on track to see more than half of IG issuance come from non-Euro Area corporations – a rare occurrence historically (the 2006-today average is 35%). And it's not just the Reverse Yankee trend....Swiss, Japanese, UK, and Australian issuers are now flocking to the Euro IG market.

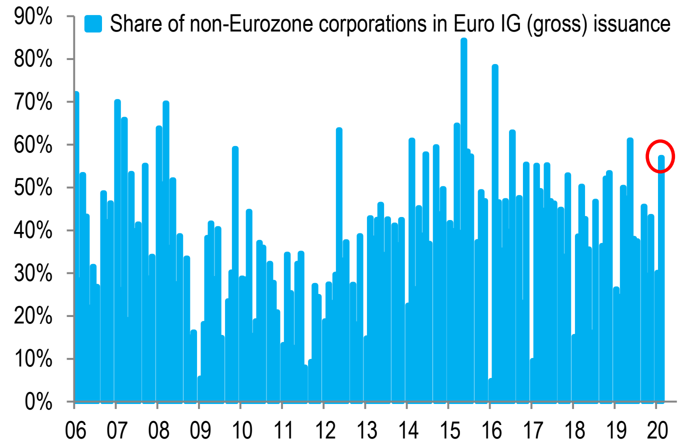
- The possibility of achieving free debt is also driving this. Chart 13 shows the jump in the growth of zero-coupon € corporate bonds: there are now 55 in existence and the number is rising fast.

**Chart 11: "High risk" factors have generally done well in € credit lately. 3m change in spread ratio of selected high-beta/low-beta credit pairs.**



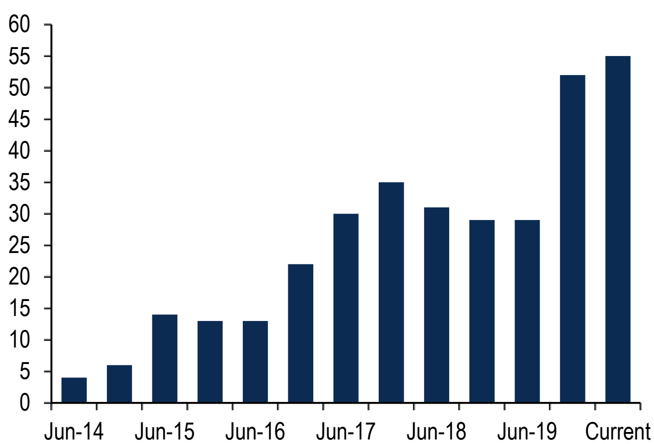

Source: BofA Global Research. ICE Data Indices LLC. Change in spread ratio (x).

**Chart 12: Money for all? The percentage of non-Eurozone issuers in monthly Euro-denominated corporate bond issuance is jumping**



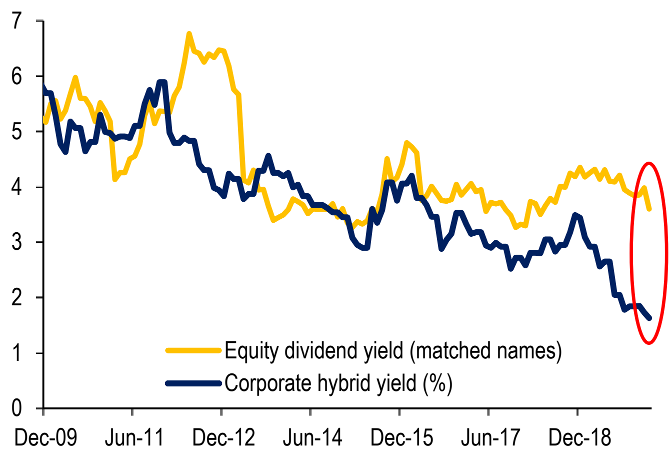

Source: BofA Global Research. ICE Data Indices LLC

**Chart 13: Number of Eur high-grade bonds with zero coupons**




Source: BofA Global Research. ICE Data Indices LLC

**Chart 14: Corporate hybrid yields have plummeted vis-à-vis equity dividend yields lately…**




Source: BofA Global Research. ICE Data Indices, Bloomberg. Using GNEC and HNEC indices.

## But "equities" are booming in the credit market

A "credit for all" jamboree has to be good news, though, for "value" stocks in Europe…if only because more challenged companies still have a chance to roll-over debt and live another day.

More directly, however, the credit market's equivalent of equity – hybrid securities – are currently witnessing an incredibly strong performance. Chart 7 shows that AT1s have had a stunning start to the year, and corporate hybrids have nudged tighter too. In fact, yields for both products have plummeted to new lows (3.35% and 1.5%, respectively).

**But this has left "synthetic" equity costing much less for companies in Europe than real equity, now**. Chart 10 shows that corporate hybrid yields have materially decoupled from equity dividend yields (the latter being thought of as the running cost of equity). Yet, for much of the post-Lehman decade, the two measures traded in-line.

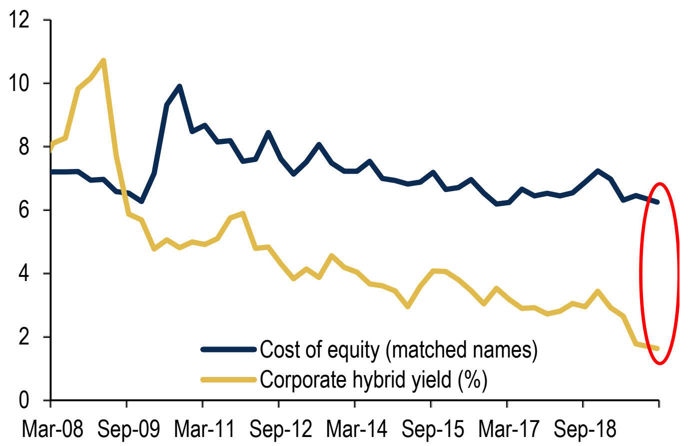
**We feel this has to be very good news for Value stocks in Europe, supporting our strategists' call for Value stocks to outperform Growth stocks by 9%.**

We see very cheap "synthetic" equity being good news for stock markets in two ways:

- First, challenged companies have an even greater incentive to raise hybrid debt (which is given partial equity treatment by the rating agencies) as opposed to raising stock (and diluting shareholders), cutting equity dividends or selling assets.

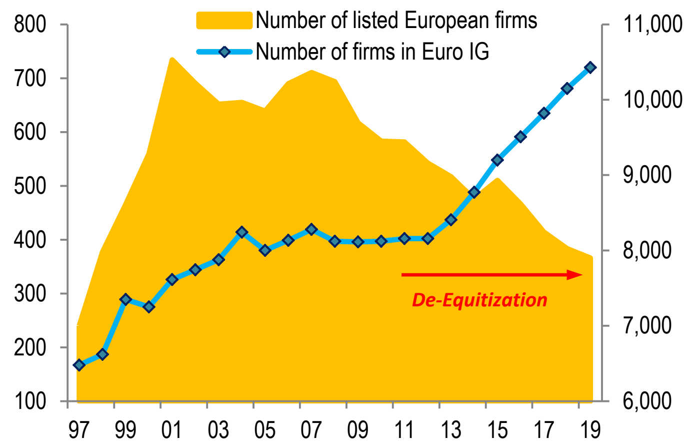
- Second, hybrid-funded share buyback activity should start to increase, we feel, and this should extend the de-equitization theme in Europe (good for stock markets). Note in chart 16 that there are now just 7900 publically listed companies in EMEA – with the rate of decline picking-up speed since the ECB QE era (and, commensurately, the number of bond issuers in the Euro credit market growing).

**Chart 15: ...and likewise for corporate hybrid yields vs. cost of equity (%)**




Source: BofA Global Research. ICE Data Indices LLC, Bloomberg. Using "WACC_COST_EQUITY" from Bloomberg.

**Chart 16: The cycle of equitization, followed by de-equitization**




Source: BofA Global Research. ICE Data Indices LLC, World Federation of Exchanges. Listed companies (RHS). Number of Euro IG firms (LHS).

And while there are rating agency imposed limits of the amount of hybrid capital that companies can have in their capital structures, we feel that the product is being underutilized by companies in this cycle. For instance, only 11% of Euro IG non-financial issuers have hybrid bonds outstanding.

We believe the product is set to see a second wave of issuance emerge, given the current cost of capital arbitrage for companies.

- Last week BT issued a €500m hybrid (1.874% coupon) following on from Moody's rating adjustment to outlook negative on their Baa2 rating. Nick Macdonald, our TMT credit analyst, highlighted after Q3 '19/'20 results that credit ratings were precariously placed, but that compensating measures were possible.

- Moreover, the market has just seen its first Reverse Yankee entrant – with a €2.875% pref issue from ATT last week. As we have seen with the Reverse Yankee cycle before (in Euro IG), its emergence helps galvanise greater interest in the sector, and supports market growth.

## The problem with "money for all"

IG issuance is running at about 50% above last year's run rate. Such ferocious market growth warrants heightened scrutiny of corporate fundamentals in Europe, despite spreads heading tighter and tighter.

We continue to believe that it is not established European companies that are overtly gearing-up – their leverage appears relatively stable, in our view. But it is the trend of "debut" issuers that is clouding the picture. Here, leverage is conspicuously higher but is also much more dispersed, warranting a closer examination.

Chart 17 shows that, true to form, ECB QE2 is driving a resurgence in "debut" bond issuers. After a lull last year, 2020 is on course to see 60-70 debut names emerge in the Euro IG primary market this year.

What does this mean for overall credit market fundamentals? Chart 19 highlights the point made above: that net debt/EBITDA for established issuers has generally been stable since 2017. **Yet, when incorporating the influx of debut names, we find that overall IG leverage is about 0.5x higher.**

However, we find a lot of sector disparity to this theme:

- The biggest gap between established and debut leverage can be found in cyclical sectors outside of industrials. Here the gap in net debt/EBITDA is closer to 1x.
- Conversely, we find very little gap in the leverage of established and debut issuers when looking at just manufacturing sectors (industrials, cap goods and autos).
- For non-cyclicals, note that the leverage gap between established and debut issuers is now declining.

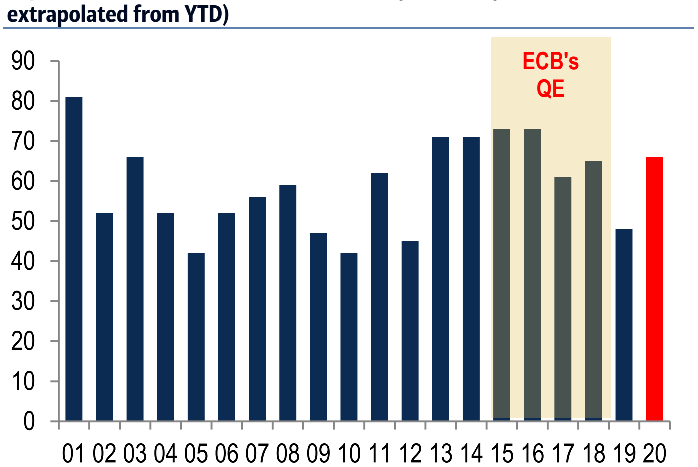
Chart 21 summarises the leverage gap between established and debut issuers across all sectors.

We think the focus on the debut issuers theme is warranted because these companies tend to be smaller, more domestic, cyclical and are thus more prone to suffering in a period of economic malaise, we think.

Chart 22 highlights this point. Again, when focussing just on established issuers, we find that EBITDA margins have held up relatively well amid the trade tensions of the last few years. But, when looking at the full market – and thus incorporating debut issuers – we witness a far more dramatic decline in EBITDA margins, which we think reflects the vulnerability of debut names.

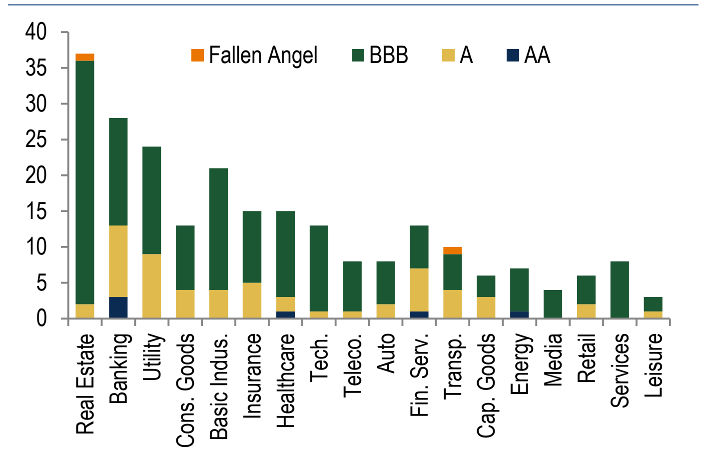
We find that it is the non-manufacturing cyclical sectors that seem to have the most vulnerable debut issuers.

**Chart 17: The number of *debut issuers* surged during ECB QE1.0. We expect another wave of *debut issuers* this year ( full year '20 extrapolated from YTD)**



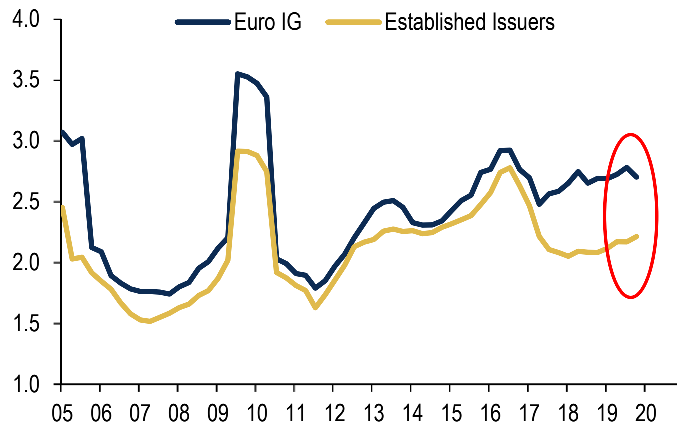

Source: BofA Global Research. ICE Data Indices LLC.

**Chart 18: Almost 75% of "debut" issuers are BBB-rated (debut issuers since March '16).**



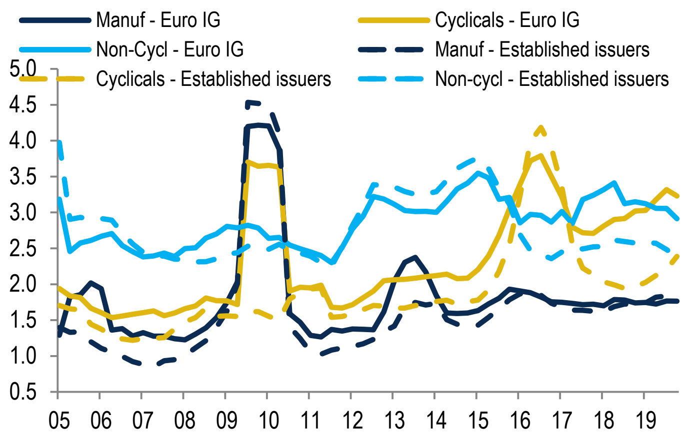

Source: BofA Global Research. ICE Data Indices LLC.

**Chart 19: Leverage (net debt/EBITDA) of established issuers has remained roughly stable since '17, yet it has increased for the overall € IG market, showing the riskier nature of debut issuers.**



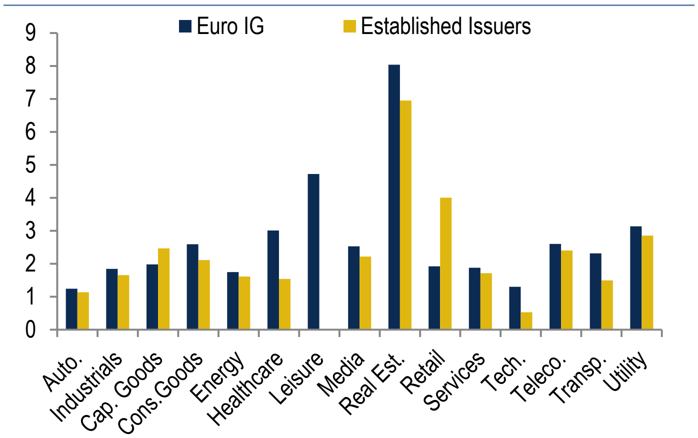

Source: BofA Global Research. ICE Data Indices LLC, Bloomberg. Net debt over EBITDA (x).

**Chart 20: Leverage ratio gap dynamics. The gap in leverage between established and debut issuers has widened for cyclical sectors, but shrunk for non-cyclicals.**



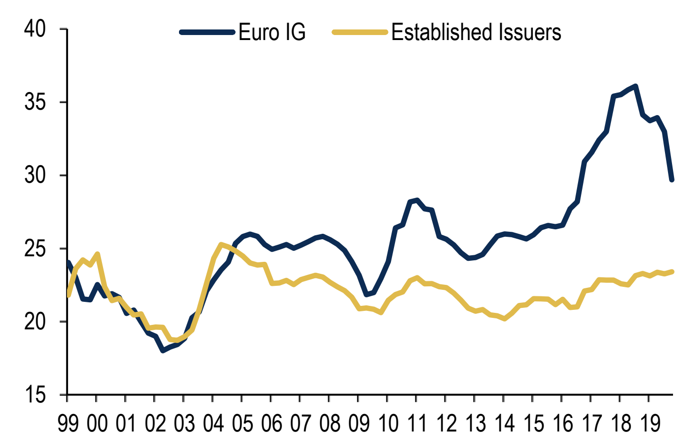

Source: BofA Global Research. ICE Data Indices LLC, Bloomberg. Manufacturing sectors include autos, industrials and capital goods.

**Chart 21: Leverage ratio gap by sector (net debt/EBITDA).**




Source: BofA Global Research. ICE Data Indices LLC, Bloomberg

**Chart 22: EBITDA margins: debut issuers clearly more vulnerable to a downturn in the economic environment**




Source: BofA Global Research. ICE Data Indices LLC, Bloomberg. EBITDA as % of revenue.

# Disclosures

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| Neutral | ≥ 0% | ≤ 30% |
| Underperform | N/A | ≥ 20% |

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

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