

Equity Quant Strategy/Credit Strategy

One final credit hurdle for stocks

Quantitative Analysis

Leverage under stress if credit shocks again

The dual shock: on investors' confidence with rising risk of pandemic and a credit blow on back of oil price collapse has led EPS downgrades from BofA analysts with 4-week BofA EPS Revision Ratio falling into range of the historical bottom decile. Over the past decade, EU stocks have seen three growth shocks which pushed EPS growth in the range of -5% to -15%, broadly a "1SD" shock. We think there's a rising potential for another one in the current backdrop. In this note we test EU companies for a growth shock to operating profits and screen for those where leverage / balance sheet could come under pressure (Exhibit 1).

Credit-sensitive stocks to re-rate when CCCs "crack"

EU stocks most sensitive to credit spreads are trading at 8.8x on Fwd PE, well below average levels and the lowest since 2012. On a relative performance to EU stocks, they are close to 2008 lows, pricing in more than the credit market stress is suggesting. The spread in EU high-grade credit is lower than levels seen during previous growth shocks, despite the largest 1-day move ever seen on Monday. Moreover, a final crack in CCCs spreads is likely needed to price in a growth shock in the credit market to be followed by a typical "V" shaped recovery. CCC spreads are currently at 1100, peak near 1800 during growth shocks and provide the catalyst to unlock the value in the credit sensitive EU stocks.

Credit growth & leverage: the dark side of monetary largesse

We think "leverage" is the theme that should resonate with equity investors the loudest at the moment. Since 2012, easy monetary policies have coaxed Euro Area companies into de-equitizing, and replacing their financing via the debt market. This has resulted in significant growth in the size – and scope – of the Euro credit market. We think investors should be cognizant of 1) those sectors that have seen the *greatest growth* in debt market reliance lately (we flag industrials and real estate) and 2) those sectors where the share of highly levered companies has been rising over the last year (we flag media and healthcare, where the share of 4x or more levered companies has risen).

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Credit catalyst for Equities

Chart 1: BofA Global EPS Revisions have dropped over past four-weeks to near cycle low

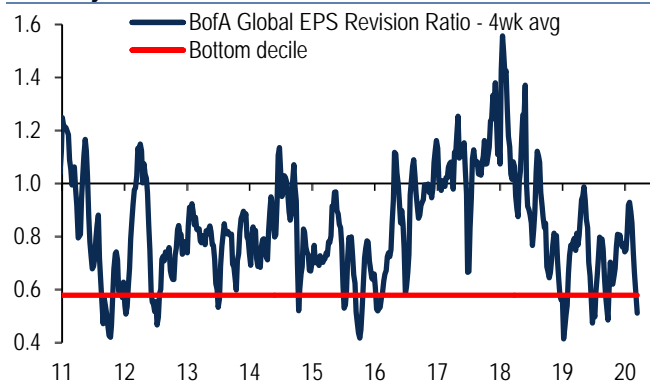


Chart 2: European EPS revisions are the worst for cyclical sectors, as one would expect from a growth shock impact

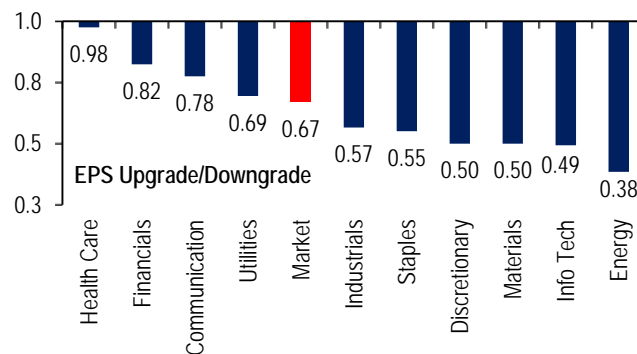


Chart 3: European EPS growth has seen 3 downgrade cycles over past decade, typically in the range of -5% to -15%

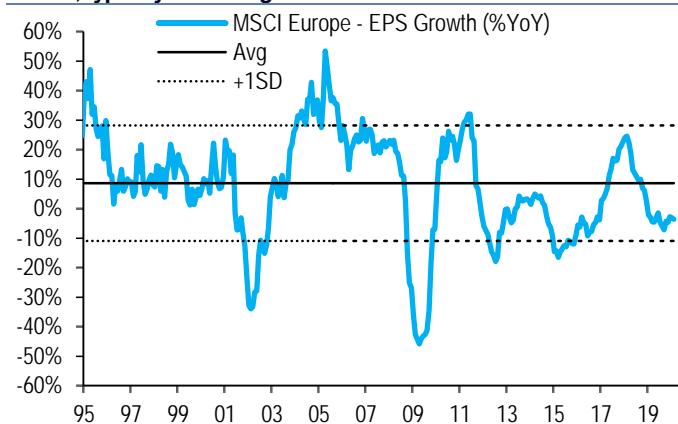


Chart 4: Euro CCC credit spreads peak near 1800 to price-in a growth shock

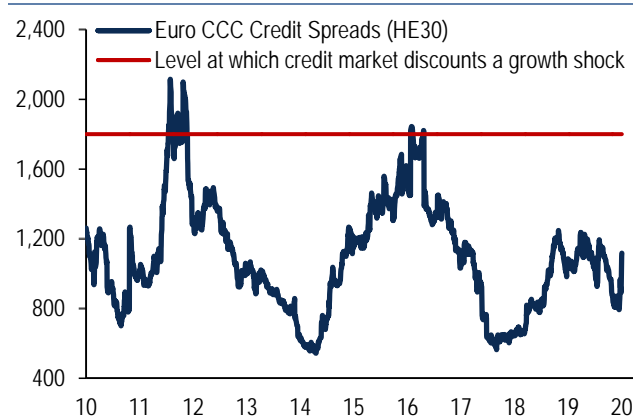


Chart 5: EU stocks most sensitive to credit spreads are trading well below average levels and lowest since 2012

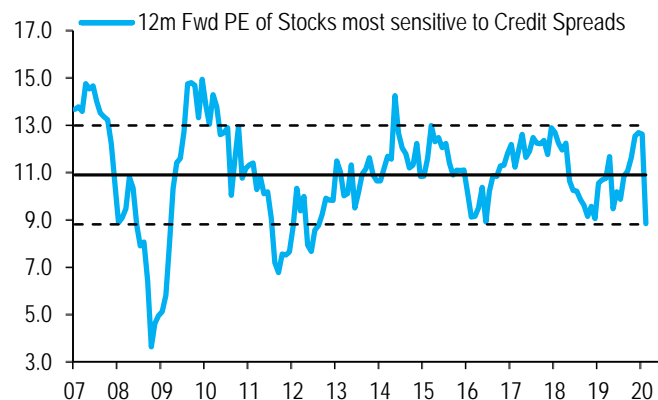
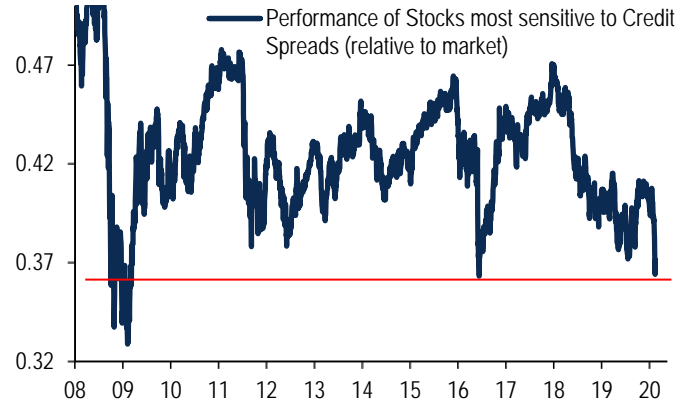


Chart 6: EU stocks most sensitive to credit spreads relative performance has dropped to 2008 lows



Leverage sensitivity to a Growth shock

We screen for companies where a potential drop in operating profits would lead to a big shift in the leverage of the company and also highlighting those companies that move from <2x levered on Net debt / EBITDA to >2x.

The growth shock is measured by applying a 1SD shock of growth seen over the past 10 years (typically meaning equity earnings drop by 10%).

The companies included in the screen are ex-financials with market cap > Eur5Bn.

Exhibit 1: EU Stocks where leverage can be stressed in a Growth shock backdrop

Sector	Mkt Cap (EUR bn)	Current Leverage (Net Debt / EBITDA)	Avg Growth Rate for last 10 years (%)	Earnings Shock (%)	New Leverage (Net Debt / EBITDA)	Impact on Leverage	
EU Stocks that move their leverage by a full "1x" in a "Growth" shock							
Ferrovial	Construction and Materials	19.4	15.25	-13.3	-38.4	24.8	9.50
Cnh Industrial	Industrial Goods and Services	10.8	6.30	-2.2	-25.5	8.5	2.16
Vivendi	Media	27.1	3.42	-7.8	-35.8	5.3	1.91
Rwe (Xet)	Utilities	19.2	3.89	-10.9	-31.6	5.7	1.80
EU Stocks that move from Net Debt / EBITA below 2x to above 2x on a "Growth" shock							
A P Moller Maersk B	Industrial Goods and Services	17.4	1.97	-5.3	-30.6	2.8	0.87
Arcelormittal	Basic Resources	11.8	1.77	1.5	-29.2	2.5	0.73
Svenska Cellulosa Aktiebolaget Sca B	Basic Resources	6.3	1.61	-2.6	-30.9	2.3	0.72
Ica Gruppen	Personal Care, Drug and Grocery Stores	7.4	1.91	5.5	-22.5	2.5	0.56
Yara International	Chemicals	8.9	1.69	6.6	-22.7	2.2	0.49
Repsol Ypf	Energy	15.0	1.73	1.7	-15.2	2.0	0.31
Telefonica Dtl. (Xet) Hldg.	Telecommunications	6.9	1.80	8.6	-14.4	2.1	0.30
Morrison(Wm)Spmkts.	Personal Care, Drug and Grocery Stores	5.1	1.98	0.3	-12.2	2.3	0.28
Umicore	Basic Resources	9.6	1.93	10.8	-11.2	2.2	0.24
Unilever (Uk)	Personal Care, Drug and Grocery Stores	130.2	1.87	6.0	-7.8	2.0	0.16
Smiths Group	Industrial Goods and Services	6.4	1.96	3.1	-5.1	2.1	0.11

Note: This screen is not a recommended list either individually or as a group of stocks. Investors should consider the fundamentals of the companies and their own individual circumstances/objectives before making any investment decisions.

Source: BofA European Equity Quant Strategy, IBES, Datastream

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