Populism and the big risk to margins

Credit Strategy
Europe

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Beyond the "lower bound"

Central banks have been forced to question the "lower bound" for interest rates over the last few weeks, as the return of inflation remains at large. We see this as leading to a further rise in the amount of negative-yielding assets across the globe, necessitating a strong ongoing bid for European corporate bonds. In fact, the "thirst for yield" is eye-watering at present: oversubscription levels for high-grade new issues in April were 5x – way in excess of anything seen during the ECB's CSPP era.

Beta blockers – go down in quality for Q2

Amid the impressive rally, we still contend that "beta" hasn't genuinely outperformed in credit as yet, as spread ratios for classic beta pairs have risen lately. But we think that high-beta will soon take over leadership of the rally, supported by the disappearance of single-A coupons, and the stabilisation of Eurozone growth. Corporate hybrids, in particular, stand out as having lagged senior (corporate) debt this year, and thus we think beta still looks cheap for investors.

Watch US Dollar strength – a fly in the ointment?

While we see an encouraging backdrop for the Euro corporate bond market at present, this doesn't mean that all risks have fallen by the wayside. Lately, a familiar foe has returned: namely that of US Dollar strength. We recall that Dollar strength was a headwind to Euro credit performance in Q2 last year, as it motivated retail investors to flee European assets and chase the allure of US T-Bills. Fast forward to today, and US cash still has the potential to "embarrass" risk assets in Europe: note that 91% of all European corporate bonds, across both high-grade and high-yield, now yield less than 6m US T-bills. Thus, a weaker Dollar from here remains key, in our view.

Populism, deglobalization and the big risk to margins

Earnings season is once again upon us and EPS beats thus far paint a fairly encouraging picture across Europe. Since 2000, margin growth has been a boon for company profits in Europe, but now more than ever, companies are expressing concern over "peak" margins. Yet, many of the risks being echoed (wage growth, weaker trade, tariffs, etc.) have their roots in the rise of populist politics. After all, corporates have been the winners, relative to workers, over the last 20yrs, thanks to globalization, corporate tax cuts, de-unionisation of labour and QE supporting the rise of "Superfirms". But the tables may be turning now: note President Macron's recent pledge to lower household taxes (and boost minimum wages) while eliminating some corporate tax breaks.

The margin winners and the future risks

For investors, therefore, the challenge will be to pick companies where profit margins are likely to be relatively stable going forward – where tech innovation or debt refinancing can still be supportive. Conversely, investors should be wary of companies where margins could negatively surprise in the near term. Who have been the margin winners of late (where things could now go in reverse)? Aside from tech and real estate, the sectors that currently have high margins relative to history are retail, consumers, industrials and (core) European utilities.

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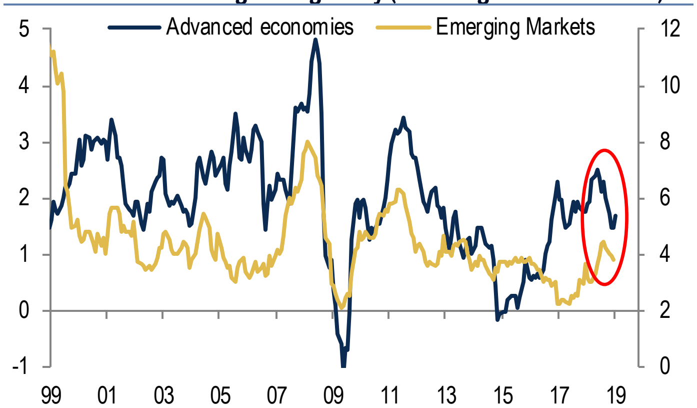
Beyond the "lower bound"

European credit feels like the gift that keeps on giving at present. Even after a strong Q1, markets had a lot more to give in April. High-grade spreads lurched 15bp tighter last month, posting their best month for performance this year, and the strongest tightening since July '16. In fact, both high-grade and high-yield spreads have rallied every month this year (the record, though, is 10 straight months of high-yield tightening in 2009).

Turbo charging spreads of late has been another big dose of the familiar: central bank dovishness. As Chart 1 shows, inflation dynamics have turned more challenging this year for both advanced and emerging economies across the globe. This has forced central banks to question the "lower bound" for interest rates. Over the last few weeks, the ECB, BoJ and SNB have all hinted that cutting rates remains an option if more stimulus is needed down the line. Cue a further jump in negative-yielding assets ... and a continuation of the "thirst for yield" supporting credit markets.

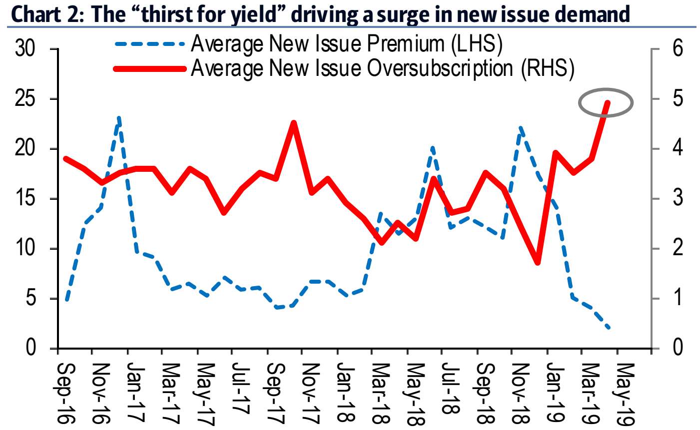
In fact, the grab for yield was eye-watering last month (Chart 2). Average new issue oversubscription for Euro-denominated IG deals reached almost 5x, a record high (and importantly higher than at any time during CSPP, when the ECB was buying in primary).

Chart 1: Inflation heading down globally (GDP-weighted YoY inflation)



Source: OECD, BofA Merrill Lynch Global Research. GDP-weighted inflation. EM (RHS), %.

Chart 2: The "thirst for yield" driving a surge in new issue demand



Source: BofA Merrill Lynch Global Research. NIPs in bps, Oversubscription in multiples. €-denominated IG new issues.

Beta blockers – go down in quality for Q2

Amid the impressive rally, we still contend that "beta" hasn't genuinely outperformed in credit as yet. Chart 3 shows the spread ratios of classic beta pairs across the European corporate bond market. In a genuine beta compression, we would expect spread ratios to decline – as they did after June '16 when the ECB began to buy corporate bonds.

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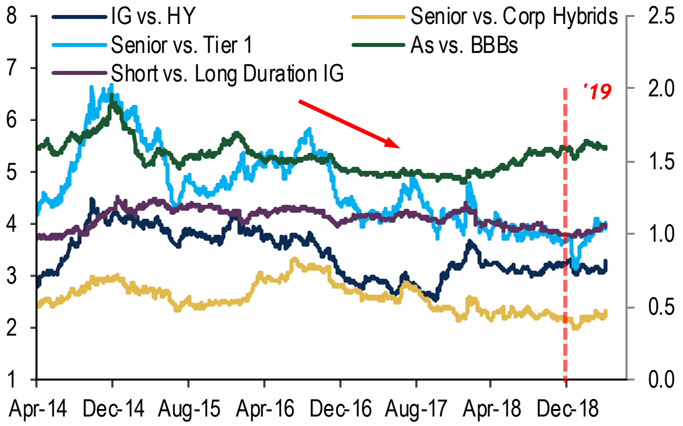
Chart 3: Credit beta has still lagged (spread ratios by classic pairs)



Source: BofA Merrill Lynch Global Research. Spread ratios LHS, apart from A/BBB and Long/Short credit (RHS)

Chart 4: Global money supply (M1) has bounced, supporting global GDP

Source: BofA Merrill Lynch Global Research.

This year, however, even though spreads for high-beta feel like they have done well, note that the spread ratios across all of our pairs have drifted higher. Thus, it's still been a defensive rally of sorts in European credit.

But we believe the stars are aligning for genuine beta compression to take place in due course. We see two important drivers of this:

- First, we think that the appetite for highly rated IG credit from European long-only investors will fade a bit given the preponderance of negative-yielding bonds (Japanese Lifers, however, are still likely to buy on a hedged basis). Note that there is now €150bn of negative-yielding single-A rated debt in Euro high-grade. In fact, 3 new issues have been able to price with 0% coupons lately (LVMH, Toyota Finance and ING). Given investors need positive coupons to compensate them for corporate event risk, we see this as driving an eventual preference for high-beta parts of the credit market in Europe.

- Second, while it's been slow going, there are nonetheless signs of growth stabilisation in Europe, as this week's GDP print hinted at. Moreover, global money supply growth (YoY M1) has inflected higher over the last few months, as Chart 4 suggests (and witness the recent bounce in Euro Area M1). As money supply trends have been a reliable lead indicator in the past to the direction of global industrial production, this bodes well for a bounce in global manufacturing in due course. We think this is another eventual catalyst for beta compression in credit.

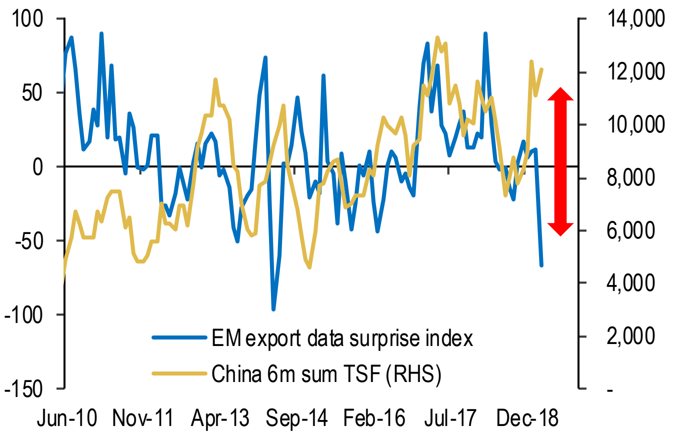
Looking at Chart 3, the corporate hybrid sector stands out has having underperformed, beta-wise, this year.

Watch US Dollar strength – a fly in the ointment?

While we see an encouraging combination of technical and fundamental support for the Euro credit market at present, that doesn't mean that all risks have fallen by the wayside. This week, we saw the return of a familiar story: namely that of US Dollar strength. Credit markets will remember that Dollar strength in Q2 last year was a catalyst for the end of retail inflows in Europe, and a period of much weaker corporate bond technicals.

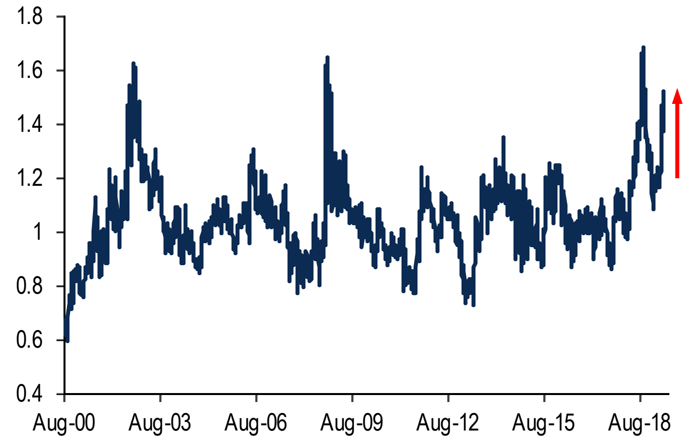
Lately, the US Dollar has likely been supported by a continuation of the global *desynchronised* growth narrative, something which will have surprised the consensus. Expectations were for a recoupling of global growth in '19, driven by a slowing of the US economy. Instead, the US economy has continued to power ahead.

Chart 5: China stimulus has been slow to boost other EM exports



Source: BofA Merrill Lynch Global Research, Bloomberg data surprise indices. 6m sum of China TSF (RHS, CNY bn).

Chart 6: US$ strength driving EM wobbles (ratio of EMFX and G7FX vol)



Source: BofA Merrill Lynch Global Research. Ratio of JPMVXYEM and JPMVXYG7 indices.

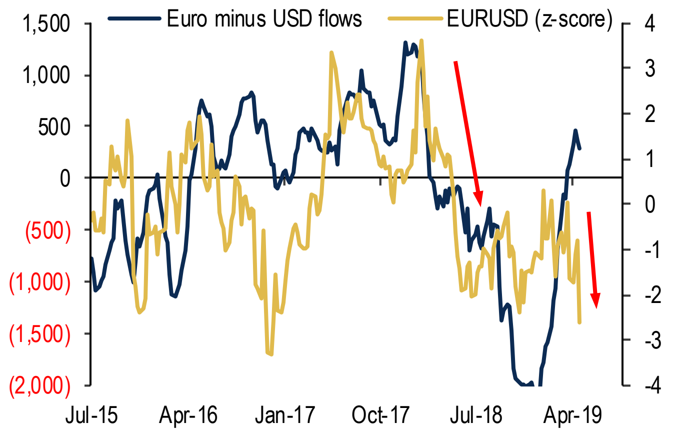
But, as Chart 5 shows, while China is doing an impressive job at stimulating (note the jump in Total Social Financing), export dataflow for other EM economies remains disappointing (South Korea and Taiwan exports are still very weak). China's stimulus may be less effective this time around (vis-à-vis '15/'16) given the rebalancing of the Chinese economy more towards domestic consumption and away from investment.

If USD strength continues, Euro credit investors should keep an eye on two important "pressure points" across the market, we think. Both played out in Q2 last year, when the USD likewise went through a period of appreciation:

- First, a return of EM volatility. EM has been a winner in 2019 amid central banks' dovish pivot. YTD inflows into global EM debt funds have amounted to an impressive $25bn (close to surpassing the pace of inflows in '17). But US Dollar strength may be a harbinger of a rise in EM FX volatility. Chart 6 shows that the ratio of EM FX vol to G7 FX vol has risen again since the end of March.

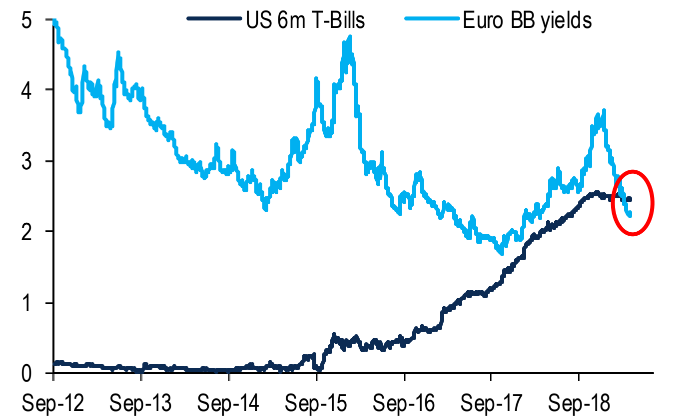
- Second, and more directly relevant to European corporate bonds, is that USD strength could precipitate a weakening of Euro credit inflows and motivate European retail investors to flock to US fixed-income – and in particular T-bills. This was a very relevant theme in Q2 last year. Back then, it wasn't just credit funds that began to experience outflows; in fact all asset classes in Europe saw withdrawals by retail investors (including money markets, equities and government debt) and there were few signs of classic haven buying. With US "cash" (in the form of T-bills) having emerged as a competitive asset class globally, European retail money was simply leaking to the front-end of the US fixed-income market unhedged. Chart 7 shows the link between USD strength and Euro credit outflows.

Chart 7: Dollar strength heralded a tougher time for Euro credit retail inflows in Q2 last year (high-grade credit flows)



Source: EPFR Global, BofA Merrill Lynch Global Research. 6m Eur-USD Z-score RHS. 10w average flows $mn.

Chart 8: US "cash" still remains very competitive. 6m US T-bills now yield more than 91% of all European corporate bonds (IG + HY)



Source: BofA Merrill Lynch Global Research, %.

US cash can still "embarrass" risk assets in Europe

Fast forward to today, and note that US "cash", in the form of 6m T-bills, has become even more competitive relative to European credit (Chart 8). **In fact, we find that 91% of European corporate bonds across both high-grade and high-yield now yield less than 6m US Bills**.

Thus, a continuation of USD strength might be enough of a motivation to push some retail investors away from risky assets in Europe and towards the relative safety of US bills (where clients can gain from the yield differential, and profit from a rising currency). Coupled with expectations of relatively high May issuance, this could become a risk to technicals.

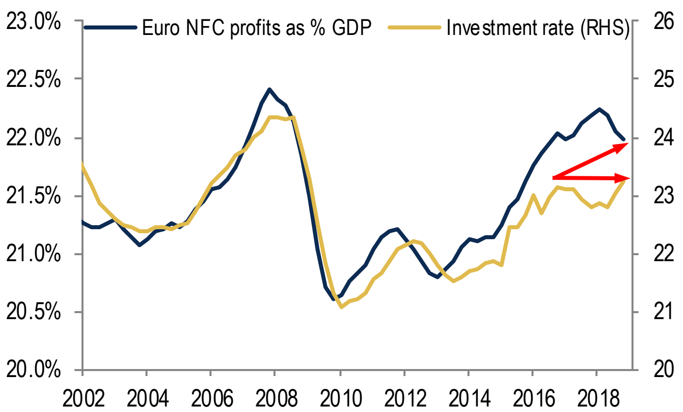
Stay tuned to the Dollar over the next few weeks.

Populism, deglobalization and the big risk to margins

Earnings season is once again upon us and EPS beats thus far (52%) paint a fairly encouraging picture across Europe. Since 2000, margin growth has been a boon for corporate profits in Europe. In recent years, margins have surged further, in part due to factors such as ECB QE (reducing debt costs), low wage growth (especially relative to worker productivity), flourishing global trade (and the decline in global corporate tax rates) and the emergence of "Superfirms".

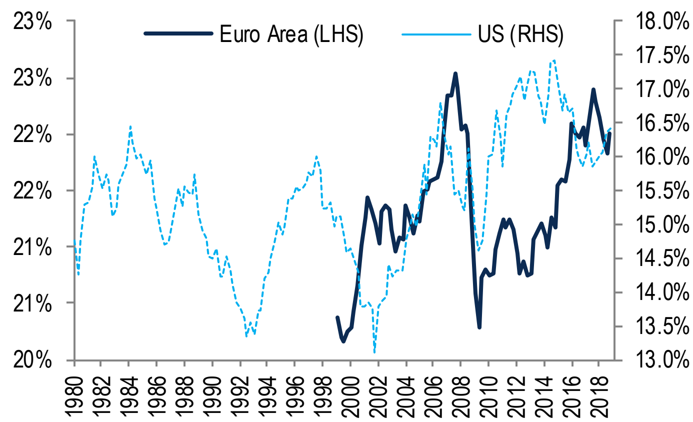
Chart 9, for instance, shows how European non-financial corporate profits have continued to rise over the last few years despite stalling investment flows. Note that prior to this, corporate profit growth tracked investment levels very closely. What explains the recent "outperformance" of corporate profits? The continued climb in margins, in our view. Accordingly, non-financial corporate profits, as a ratio of Euro Area GDP, are close to pre-Global Financial Crisis highs.

Chart 9: Non-fin corporate profits have risen since the sovereign crisis



Source: Eurostat, BofA Merrill Lynch Global Research. Investment rate, RHS.

Chart 10: Net operating profit of non-financial corporates, as % GDP

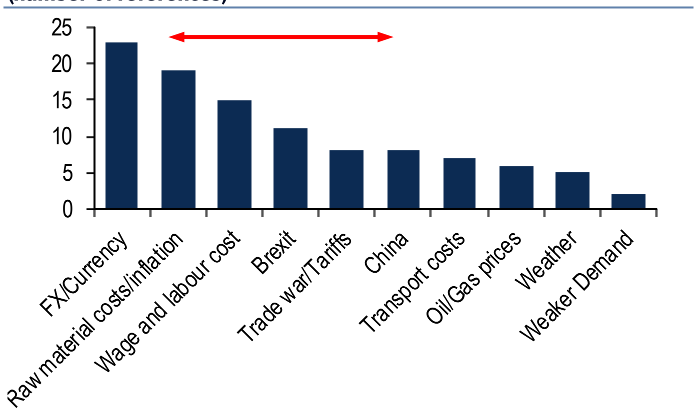


Source: BofA Merrill Lynch Global Research, DataStream.

The risk of "peak" profit margins

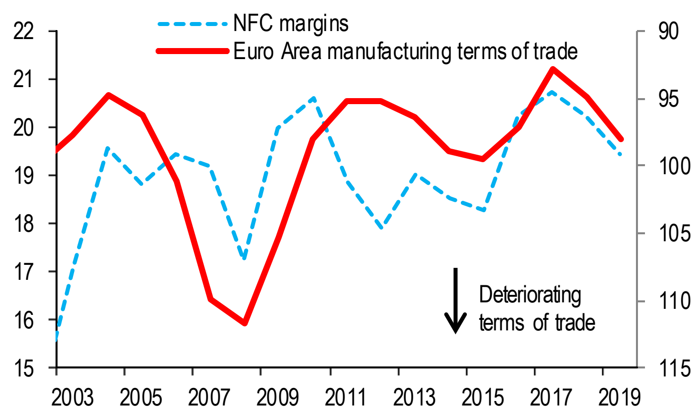
That said, Chart 9 suggests that European corporates' profit margins might have peaked. Indeed, one can see that non-financial margins have dipped slightly over the last year. Rather than a one-off, though, profit margin compression is being highlighted by more and more companies now as a future risk.

Chart 11: Stoxx 600 issuers citing negatives in Q1 '19 earnings calls (number of references)



Source: BofA Merrill Lynch European Equity & Quant Strategy, FactSet. Number of mentions.

Chart 12: Euro Area PMIs (output vs. input price indices) point to future headwinds for corporate margins



Source: BofA Merrill Lynch Global Research, Markit. "Terms of Trade" defined as the ratio of Euro Area PMI Manufacturing Output/Input prices, LHS (reversed, rebal to 100).

Chart 11, from our equity strategy team, shows the main earnings risks that European companies have cited on their results calls. Many of the above-mentioned (hitherto supportive) factors are now being viewed by issuers as a threat to future earnings: tariffs, less global trade, rising labour costs, slower China trade, etc.

Consumers over corporates for 2019

Many of these risks have their roots in the recent rise of populist politics, be it the focus on tariffs (prompting "deglobalization" and faltering world trade), minimum wage hikes and barriers to migration (requiring firms to hire more costly domestic labour) or political scrutiny of "Superfirms" (taxing big tech, etc.).

In France, for instance, President Macron has recently proposed (following the conclusion of the "*grand debat*") a round of household income tax cuts, partly paid for by the removal of special tax breaks for some French corporations. And last year, Macron announced minimum wage measures to support frustrated voters, following the *gilet jaunes* protests. Thus, populist politics seem skewed to favouring consumers over

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corporates. And with the European Parliamentary Elections pending, expect consumer-friendly, corporate-unfriendly narratives to persist across the political spectrum.

Profit margins – don't look down

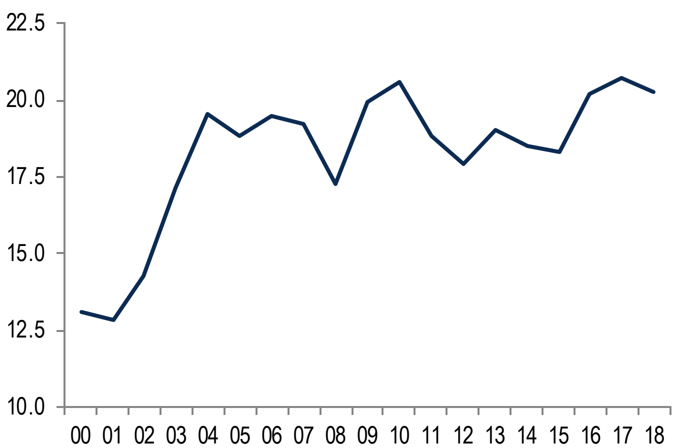
For investors, therefore, the challenge will be to pick companies where profit margins are likely to be relatively stable going forward (where tech innovation or debt refinancing can still help, for instance) and to avoid those companies where margins could negatively surprise.

And Chart 12 suggests that negative margin announcements across Europe will only rise from here. Historically, trends between the Euro Area Manufacturing PMI output price and input price indices have been a good proxy for average profit margin changes across European non-financial corporates. Note that the most recent PMI release hinted at input costs starting to rise in conjunction with weak pricing power for companies.

The margin winners and losers of late

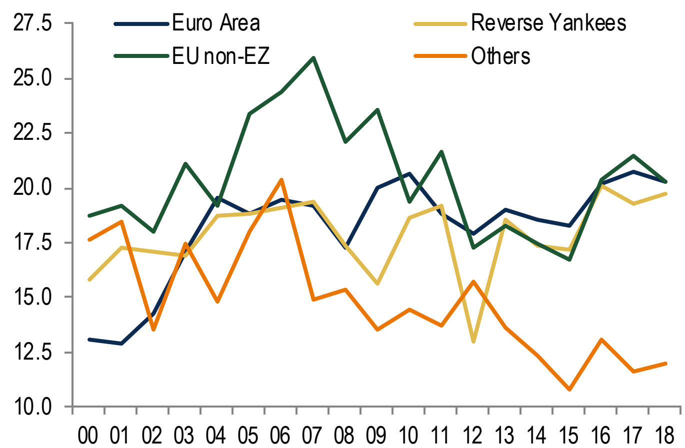
Chart 13 shows average EBITDA margins for European non-financial bond issuers. We use a large sample of € high-grade issuers, across many domiciles (Europe and ex-Europe). We find that average EBITDA margins are still around a record high. Chart 14 breaks out margins by issuer domicile: here we can see that margins are, relatively, even stronger for European-domiciled firms (we note that overall margins for Euro IG credit have been dragged down by EM-related issuers who have not fully recovered from commodity price declines).

Chart 13: EBITDA margins are close to a high for European IG issuers…



Source: BofA Merrill Lynch Global Research. Average EBITDA Margins (%). Bloomberg.

Chart 14: …but non EZ-domiciled names have seen weaker margins



Source: BofA Merrill Lynch Global Research. EBITDA Margins (%).Bloomberg.

In which sectors are current margins looking toppish (and thus these sectors may expose investors to some margin disappointment down the line?)

Chart 16 shows current sector EBITDA margins across European IG credit. We show the results in z-score terms:

- Understandably, the tech sector not only has very high EBITDA margins today, but the current margins for the sector are high versus history. For the sector, margins will always be predicated on the ability for companies to innovate, which is tough to call into question.
- The real estate sector also has very strong margins (excluded from Chart 15, but the sector's margin is close to 100%), which also have grown rapidly of late. As tenants bear the rental and maintenance costs, the sector's margins tend to be very high.

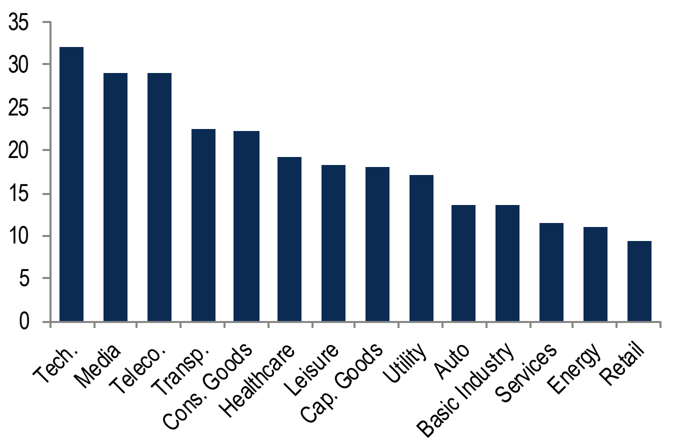
But away from these specific sectors:

- Note that the retail and consumer sectors have seen strong EBITDA margin growth lately, aided by low commodity/input prices, globalization of production, and low labour costs.

- Likewise for European industrials (capital goods, rather than metals/miners, etc.), where globalization (maximising supply chains) has helped keep production costs down.

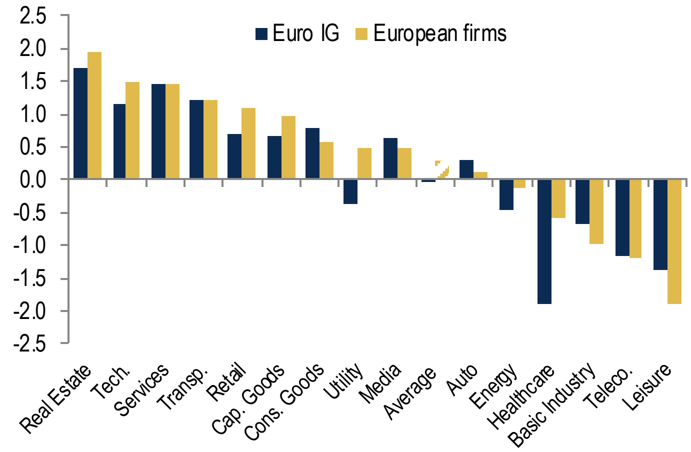
- European utilities also have EBITDA margins that are higher than history (z-score of +0.5), although less so for peripheral issuers (Italy in particular).

Chart 15: Average EBITDA margins by sector (real estate excluded)



Source: BofA Merrill Lynch Global Research. Bloomberg

Chart 16: Changes in sector EBITDA margins (z-score, from 2000-today)



Source: BofA Merrill Lynch Global Research, Bloomberg

- On the flip side, telecom EBITDA margins today are much lower than history (z-score of -1) given the rise in competitive pressures weighing on the sector.

Populism, deglobalization and "peak" margins

We think many of the recent supportive factors for European corporates' EBITDA margins are at risk of faltering, especially in a world of growing populist politics.

In particular, we think the themes of (1) deglobalization; (2) social support/fiscal spending; and (3) the scrutiny of superfirms, pose a challenge to future profit margins.

Deglobalization: the growth in world trade has supported margins

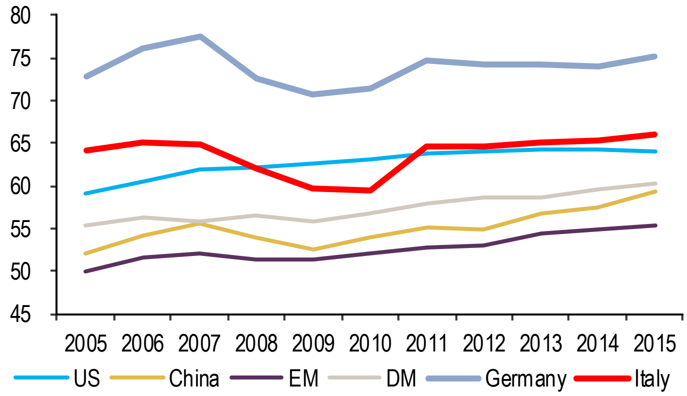
Without doubt, globalization has been a huge boon to corporate profit margins over the last decade. Companies have been able to expand production chains globally (Chart 17) to not only produce more efficiently, but also to tap into a base of low cost workers.

Moreover, by selling to new, fast-growing markets across the globe, European companies have been able to reap higher selling prices for their goods, and thus expand profit margins.

- Chart 18 shows that EBITDA margin growth has been more pronounced for European exporter credits since 2012 (post the periphery crisis). Conversely, domestically focussed European issuers have seen much less (in fact, hardly any) margin expansion over this period.

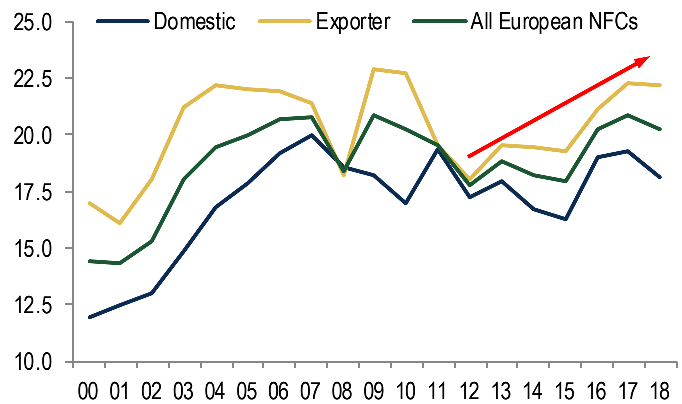
The "deglobalization" that is emerging from today's brand of populist politics (trade tariffs, "produce and buy locally", barriers to migration) puts these margin gains at risk, we think.

Chart 17: Globalization has been a great tailwind for Europe (especially the periphery). DHL's Global "connectivity" scores: rising for Europe.



Source: BofA Merrill Lynch Global Research, DHL Global Connectivity scores.

Chart 18: Euro non-financial high-grade EBITDA margins (%): exporters have seen stronger margin growth over the last decade

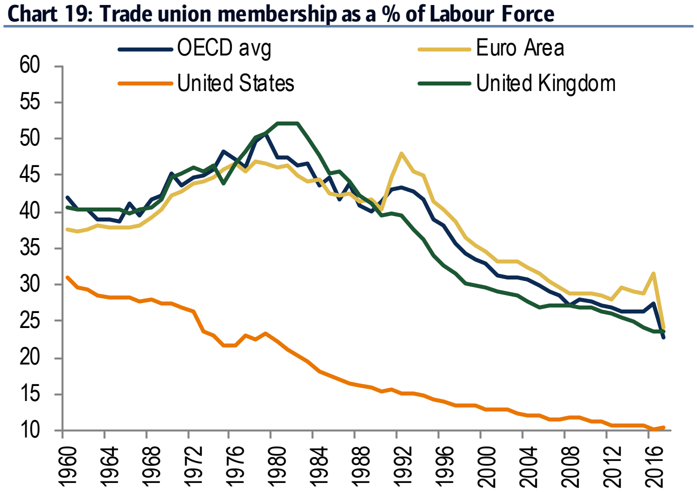


Source: BofA Merrill Lynch Global Research. Average EBITDA Margins (%). Bloomberg.

The push for greater social support, and workers > companies

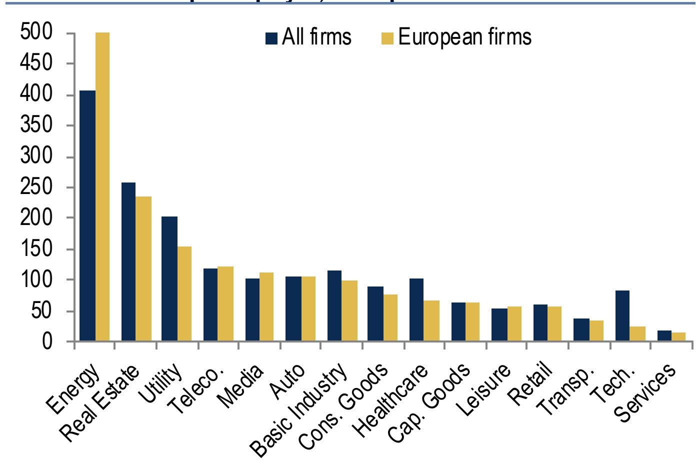
Another big contributing factor to margin expansion over the last 10-20yrs has been supressed wage growth. Workers have lost out amid the decline in trade union membership (Chart 19) and the subsequent rise in temporary (zero hours) employment.

Chart 19: Trade union membership as a % of Labour Force



Source: OECD, BofA Merrill Lynch Global Research

Chart 20: Revenue per employee, '000 € per head



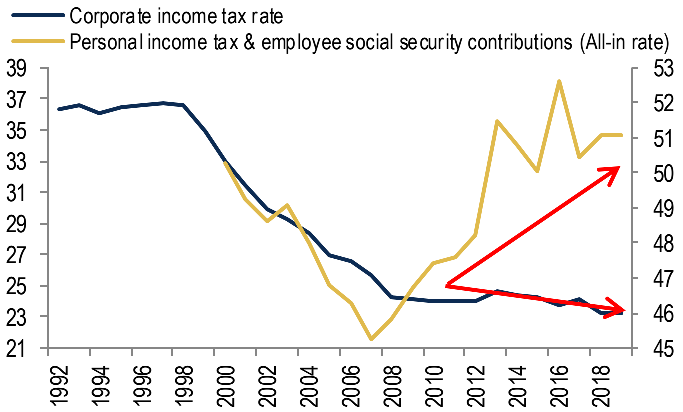
Source: BofA Merrill Lynch Global Research (Energy, all firms, is €670,000).

Yet, this has served to exacerbate poverty risk across Europe (especially for those in employment), fuelling populist support. As a result, greater focus is emerging on bolstering minimum wage levels (in France, for instance) and the concept of Citizens Income, for instance.

- Chart 20 shows Revenue per employee for European IG credit sectors. Sectors to the right have low sales/employee ratios – and investors should keep an eye on them for profit vulnerabilities down the line, if more minimum wage increases arise.

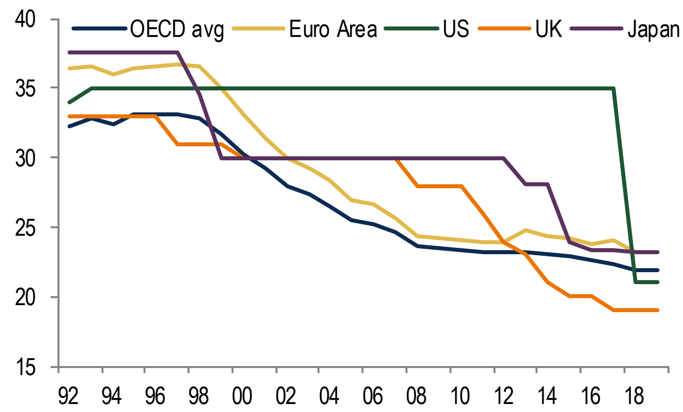
More broadly, taxation has favoured companies over workers during the last 20yrs. Corporate tax rates have been cut across the world and are now broadly harmonised (note US corporate tax reform, Chart 22). But going forward, this means less opportunity for companies to profit from tax arbitrage.

Chart 21: Corporates, rather than workers have been favoured post Global Financial Crisis (corporate rate, LHS)



Source: OECD, BofA Merrill Lynch Global Research

Chart 22: Populism to date has meant big corporate tax cuts (statutory corporate income tax rates, %)



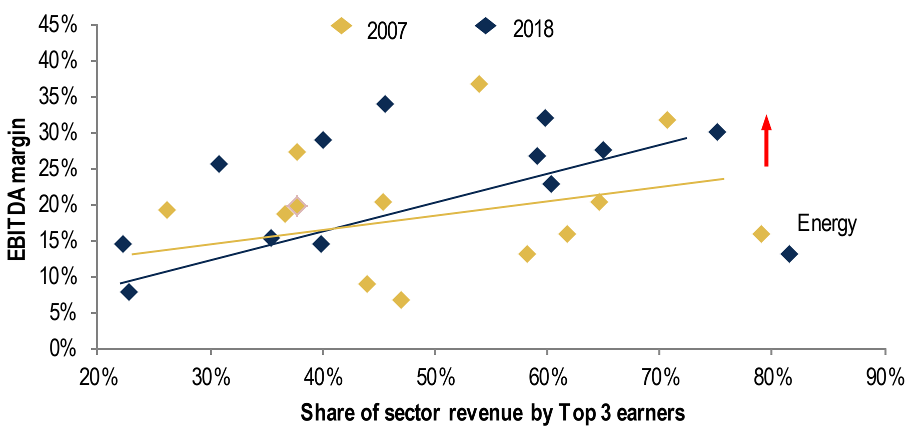
Source: OECD, BofA Merrill Lynch Global Research

If anything, some of this preferential treatment for corporates (Chart 21) may reverse. Note in France, President Macron has recently proposed (following the conclusion of the "*grand debat*") a round of household income tax cuts, partly paid for by the removal of special tax breaks for some French corporations.

The rise (and now scrutiny) of "Superfirms"

The post Global Financial Crisis era of rate cuts and QE has allowed companies to expand and thus dominate their respective sectors.

Chart 23: "Superfirms" have the ability to reap better margins in today's world. We find a stronger link today between "Superfirms" and EBITDA margins in Europe



Source: BofA Merrill Lynch Global Research

This has given rise to the modern day concept of "Superfirms": companies that have a disproportionately high share of their sector revenues, allowing them to muscle out the competition (moreover, debt-funded technological expansion has created strong barriers to entry for many of these companies).

But, in our view, "Superfirms" have been able to extract more cost cutting – either by holding down workers' wages or by cheaper sourcing of inputs into the supply chain.

Chart 23 shows the link in Europe between "Superfirms" (sectors where the top 3 earners have a high percentage of sector revenue) and EBITDA margins. We find that (1) EBITDA margins are generally higher for "Superfirms"; and (2) "Superfirms" have been able to extract greater margin gains today relative to a decade ago.

Yet, amid the populist push, European leaders are increasingly angling for greater oversight of some “Superfirms”. France, for instance, will now tax tech giants on their digital sales.

Disclosures

Important Disclosures

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Issuer Recommendations: If an issuer credit recommendation is provided, it is applicable to bonds and capital securities of the issuer except bonds and capital securities specifically referenced in the report with a different credit recommendation. Where there is no issuer credit recommendation, only individual bonds and capital securities with specific recommendations are covered. CDS and equity preferreds are rated separately and issuer recommendations do not apply to them.

BofA Merrill Lynch Global Research credit recommendations are assigned using a three-month time horizon:
Overweight: Spreads and /or excess returns are likely to outperform the relevant and comparable market over the next three months.
Marketweight: Spreads and/or excess returns are likely to perform in-line with the relevant and comparable market over the next three months.
Underweight: Spreads and/or excess returns are likely to underperform the relevant and comparable market over the next three months.

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Buy Protection: Buy CDS, therefore going short credit risk.
Neutral: No purchase or sale of CDS is recommended.
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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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