The European Credit Strategist

Are corporates safer than governments?

Credit Analysis

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Credit Strategy
Europe

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Happy 7th anniversary of "Whatever it takes" (26 July '12)

Perhaps it was no surprise that 7yrs after the infamous line from Draghi, he gave markets another dose of dovishness. The ECB left the door open for all stimulus options yesterday. We continue to think that the era of financial repression will drive beta-compression in credit, just like in '16/'17. And we think the beta trade still has legs.

Learning to live in a very strange world

Across the globe, bond markets are flush with securities yielding below zero. But it's in credit that the numbers have surged from nowhere. Today there is €825bn of negative corporate debt, and some sectors have almost half of their bonds yielding below zero. Yet demand for these securities remains strong, as they are perceived as a better "store of cash" than parking money with custodians. Negative credit could soon be the norm.

How do you say "squeeze" in high-yield?

We expect money to flow up the risk chain as high-grade becomes inundated with negative yields. But this movement of money could really squeeze some markets, given relative size differentials. For example, the volume of negative yielding bank, consumer, utility and energy paper in the IG market is over 5x the size of their respective high-yield sectors. Thus, we see spreads going a lot tighter in these high-yield pockets.

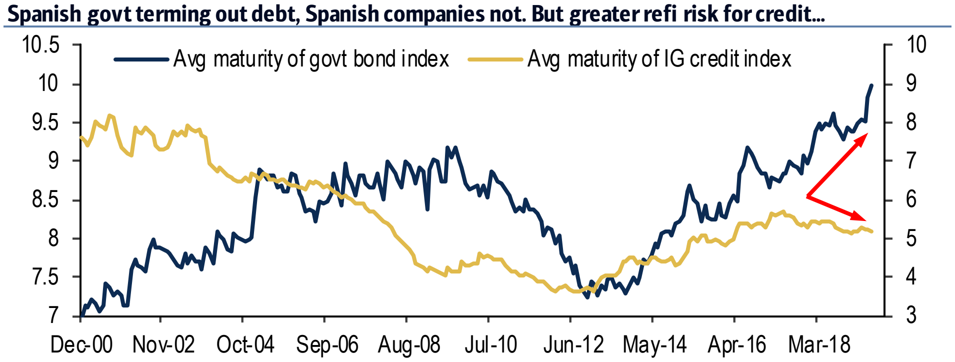
Are corporates safer than governments?

It seems only logical that amid such financial repression, companies should be terming out their debt maturities, just like governments. But they aren't, and the dichotomy is striking. Companies seem comfortable running with *more* shorter-dated (-ve yielding) debt now. While low/negative interest costs can help offset margin pressure, refi needs in credit will stay high. The irony is that this will require dovish-for-longer central banks.

The dark side of negative yielding corporate debt

We can't help but feel, however, that at some point companies will bite the bullet and issue negative debt to please shareholders. We find that corporate FCF generation has fallen markedly of late, given trade stress, and companies might think about plugging this gap via bond supply. Our screen on page 10 suggests that the industrial sector has an (unhelpful) combination of lots of negative debt and a lagging share price YTD.

Spanish govt terming out debt, Spanish companies not. But greater refi risk for credit...



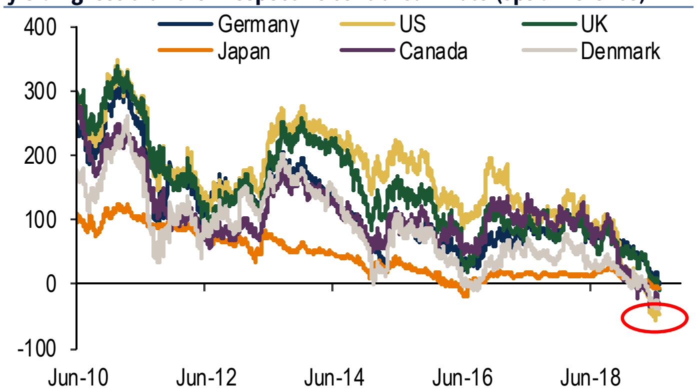
Source: BofA Merrill Lynch, ICE Data Indices LLC. Spanish names only. Spain govt avg bond index maturity (LHS, yrs). Fixed-rate indices only.

Here we go again…

Happy 7th anniversary of "Whatever it takes" (26th July '12). Perhaps it is no surprise then that Mario Draghi gave another dovish performance yesterday, leaving the door open for all stimulus options in the near-term, including a resumption of QE (albeit with nothing decided as yet). The era of financial repression lives on (note 10y government bond yields trading below respective CB rates)…driving a great thirst for yield across markets.

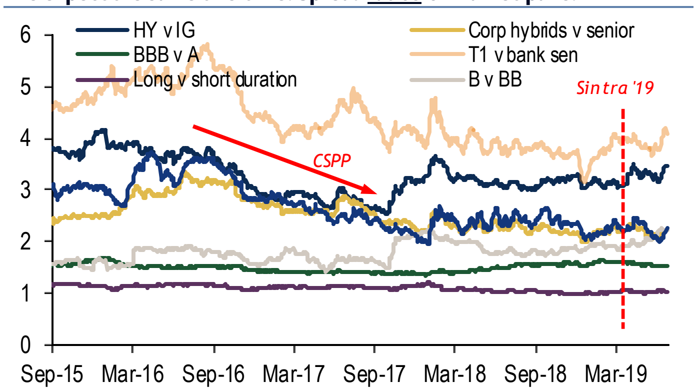
In credit, we think the ultimate end game is crowding into riskier assets, and thus beta-compression. And with €800bn+ of negative yielding high-grade credit, the movement of money up the risk chain will have very squeezy consequences (the HY market is just €280bn in size). But as chart 2 shows, beta has generally *underperformed* since Draghi's Sintra speech: most spread ratios have gone *up*, not *down* (with the lone outperformer being BBBs vs. As). Yet when CSPP1 was announced, it took around 6m before the beta trade finally worked…and then it played out for well over a year. We expect a shorter time-lag for the beta trade to ignite this time around, but remain confident that it will.

Chart 1: Great (dovish) expectations. Many 10yr govt bonds are now yielding less than their respective central bank rate (bps difference)



Source: BofA Merrill Lynch Global Research. CB interest rates minus 10yr generic govt bond yield.

Chart 2: Beta worked (eventually) in 2016 and 2017 amid a dovish ECB. We expect the same this time. Spread ratios of market pairs.

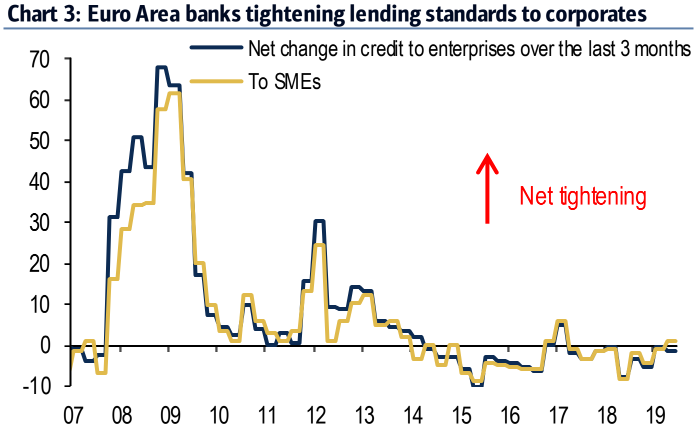


Source: BofA Merrill Lynch Global Research. Spread ratios over time.

Longer-term, as we argued last week, central banks will have to work harder – for longer – to ensure that their efforts translate into real economy progress, and not just asset price inflation. This week's Lending Survey from the ECB highlighted banks' planned tightening of credit standards to companies, an unhelpful statistic (chart 3).

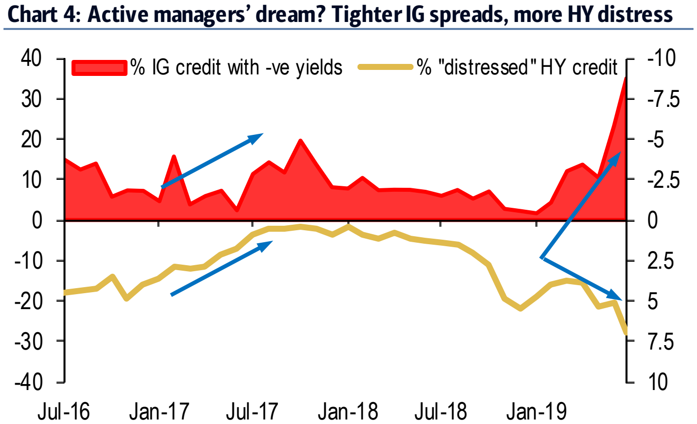
Investors may lament the return of uber dovish central banks, given the challenges of outperforming. But credit markets currently are a paradox: spreads are rallying but distress is increasing (chart 4). Today, a rising tide is not lifting all boats in the credit market, and this is good news for active managers.

Chart 3: Euro Area banks tightening lending standards to corporates



Source: BofA Merrill Lynch, ECB. Net change in credit standards to enterprises over the last 3m.

Chart 4: Active managers' dream? Tighter IG spreads, more HY distress



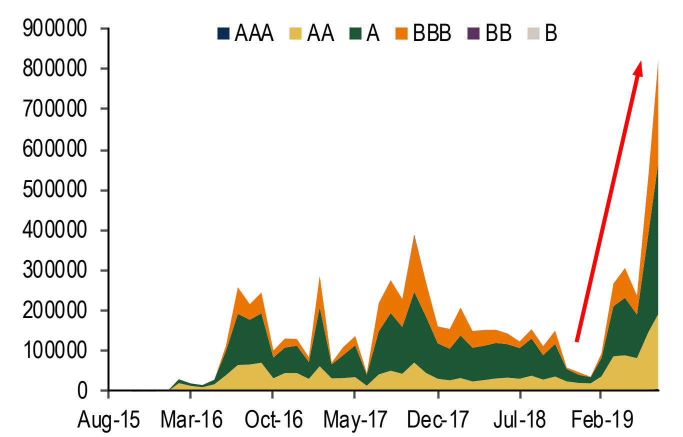
Source: BofA Merrill Lynch. % -ve yielding IG credit LHS. Distress = % HY bonds with yields >10%.

Learning to live in a very strange world

Across the globe, bond markets are now flush with securities yielding below zero. How did we get here? Central banks "pulled the rug" from under the market this year, and signalled that rates were not at the lower bound. The effect has been to kick-start expectations of a race to the bottom in interest rates. After all, currency weakness is a powerful weapon to aid the return of inflation.

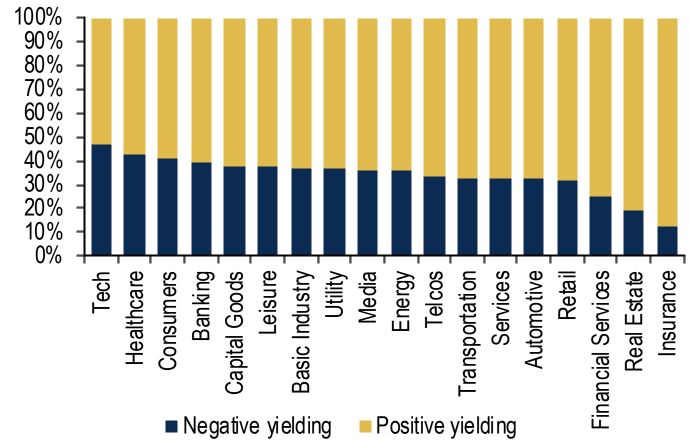
The fastest rate of growth in the negative yielding story, however, has been in the Euro corporate bond market (chart 5). At the start of the year, there were virtually no negative yielding corporate bonds. Today, €825bn of Euro-denominated credit yields below zero, a number greater than the GDP of Switzerland. In fact, close to 40% of the Euro high-grade credit market is now negative yielding.

Chart 5: From zero to hero? Negative yielding credit has surged in '19



Source: BofA Merrill Lynch, ICE Data Indices LLC . Face value of Euro credit with –ve yields, mn.

Chart 6: Percentage of IG credit sectors trading –ve/+ve yield



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

Topsy-turvy statistics: the new normal

The staggering negative yielding credit statistics keep coming, however:

- While the lion's share of negative yielding corporate debt is to be found in single-A rated bonds (46%), the phenomenon is widespread and entrenched: even some single-B rated debt now yields below zero.
- The yield on ICE BofAML's 1-3yr Euro high-grade credit index has just dipped into negative territory (-2bp), a whisker away from being a record low.
- 7 Euro IG bonds now trade below the ECB's (current) deposit rate of -40bp, which would make them unpurchaseable under QE. Thus, we think a possible return of ECB QE (and CSPP 2.0) would force credit curves flatter still.

For some sectors, negative yielding credit is close to being the *norm* rather than the *exception*. Chart 6 shows the percentage of negative/positive bonds for all high-grade sectors:

- The tech, healthcare, consumers and banking sectors now have over 40% of their bonds yielding below zero.

And by country, the predicament is similar:

- Chart 7 shows that almost 55% of Portuguese high-grade credit is negative yielding, 50% of Dutch high-grade credit is negative yielding and a third of Reverse Yankee bonds enjoy negative rates.

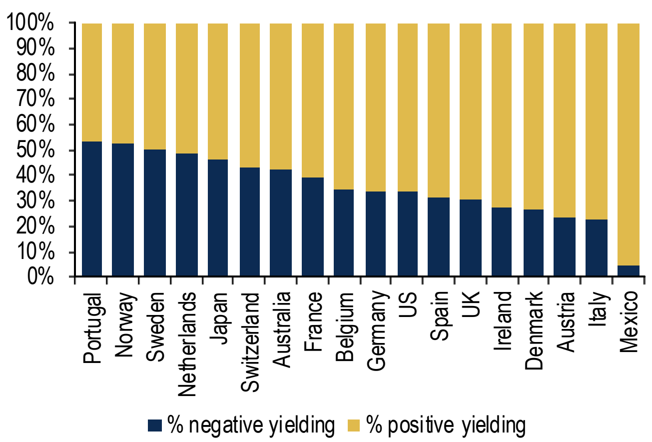
Yielding to the inevitable: next stop -60bp?

The obvious question becomes "who is buying negative yielding credit?" given the risks inherent in corporate debt – be it event risk, shareholder-friendly activity or the risk of plunging bonds. Yet, we see very robust demand for negative yielding € credit across the marketplace.

Why? Because they serve as "attractive" avenues for fund managers to park excess cash. Anecdotally, we hear from some clients that their custodian charges for cash holdings are as punitive as -60bp. In this regard, negative yielding corporate bonds can still be viewed as "cheap". Or, put another way, negative yielding credit is turning into a classic Giffen good.

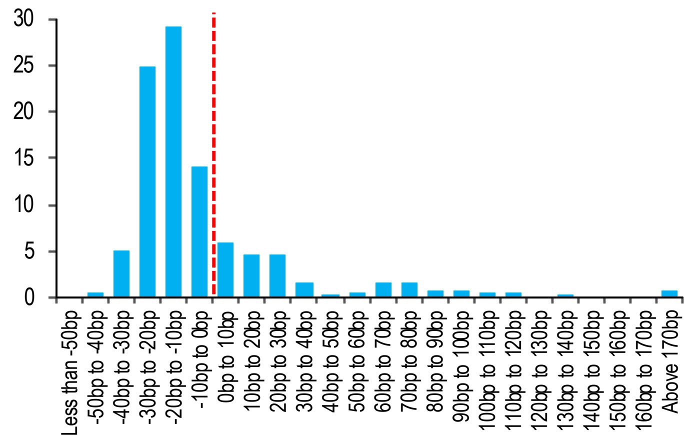
Chart 8 shows the yield distribution (in %) of 1-3yr corporate bonds in Euros. Note that most are bunched-up between the -30bp and -10bp yield range. While this is already eye-wateringly tight, the above suggests that front-end corporate bonds can still be pushed even tighter…perhaps even to the unthinkable yield of -60bp.

Chart 7: Percentage of Euro IG credit, by country, trading –ve/+ve yield



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

Chart 8: Percentage of 1-3yr € IG credit trading in various yield buckets



Source: BofA Merrill Lynch, ICE Data Indices LLC. Percentage of the market trading at various yields.

Escaping the wrath of central banks

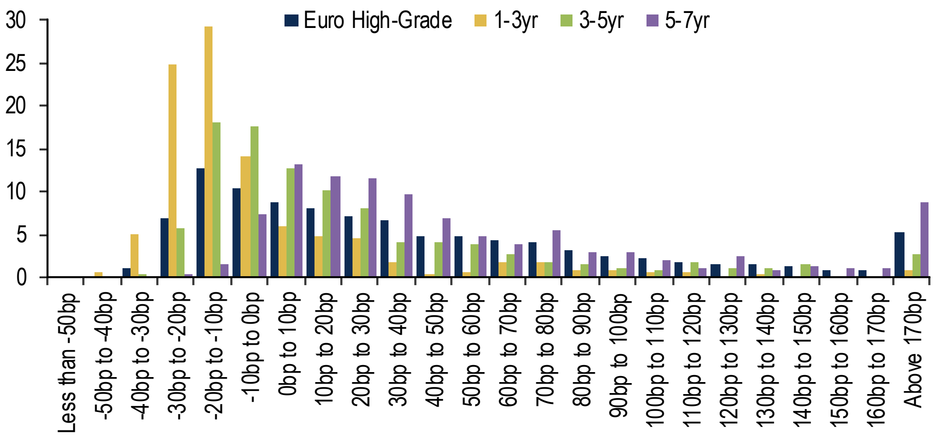
Where in high-grade can investors escape the negative yielding wrath (for now):

- By sector, we could see a more forceful bid emerging for insurance, real estate and auto bonds, in the near-term, as these sectors have less than 30% negative debt (chart 6),
- By country, Italian, UK (in Euros) and Spanish credit also has less than 30% negative debt (chart 7).
- Duration. While only 25% of 1-3yr bonds have positive yields now, 90% of 5-7yr corporate bonds and 95% of 7-10yr corporate bonds have yields above zero (chart 9).

In short, the negative debt phenomenon across the Euro credit market is a powerful catalyst for beta compression to eventually play out, in our view.

Bank of America Merrill Lynch

Chart 9: Percentage of Euro IG credit trading in various yield buckets (% of market in yield buckets)



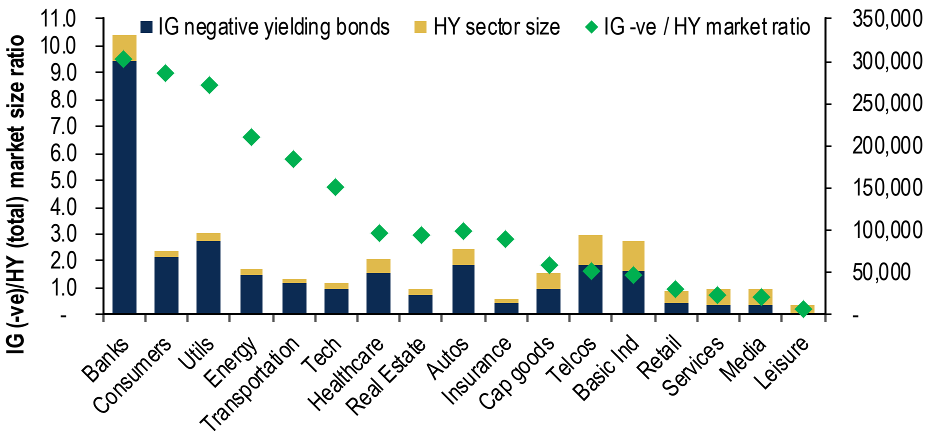
Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC

How do you say "squeeze" in high-yield?

We argued in our note here that the best template for investing in a negative yielding world was to think about how money would jump incrementally – from safer to riskier parts of the market – in search of positive yield.

For credit markets, the next logical step when high-grade sectors become overwhelmed with negative yields is to move the money into the equivalent BB sector (and eventually equities stand to see a return on inflows). But given the different sizes of the market, and recent growth rates, this movement of money could have some very bullish implications for high-yield credit. Consider that since the start of 2015, the Euro IG market has grown by €800bn (+50% growth rate), while the Euro high-yield market has shrunk by around €10bn (-5% growth rate).

Chart 10: Where could the movement of money from high-grade into high-yield be the most powerful for high-yield spreads?



Source: BofA Merrill Lynch Global Research, ICE Data Indices LLC. Market size (RHS), ratios (LHS)

Chart 10 shows the relative proportions of Euro high-grade negative yielding bonds, and the total size of Euro high-yield sectors.

What are the implications of the reach for yield?

- Those sectors to the left of chart 6 have a very big ratio of high-grade negative bonds relative to HY debt. Thus, the reach your yield could be very powerful for these high-yield sectors.

- **HY banks** stand to benefit, as do the high-yield **consumer**, **utility** and **energy** sectors. All have ratios of IG negative debt/HY total market size of 5x or greater.

Negative yielding corporate debt IS the new normal

The negative yielding bond story has often come in waves. Central bank dovishness (and hawkishness) has been the key driver of this number. Given the weak inflation outlook, and the experience of the Fed's tightening last year, we doubt that the $12.3tr. of global negative yielding assets will vanish anytime soon.

But in the Euro corporate bond market, we see other reasons why investors should prepare for the negative debt phenomenon to be the norm rather than the exception.

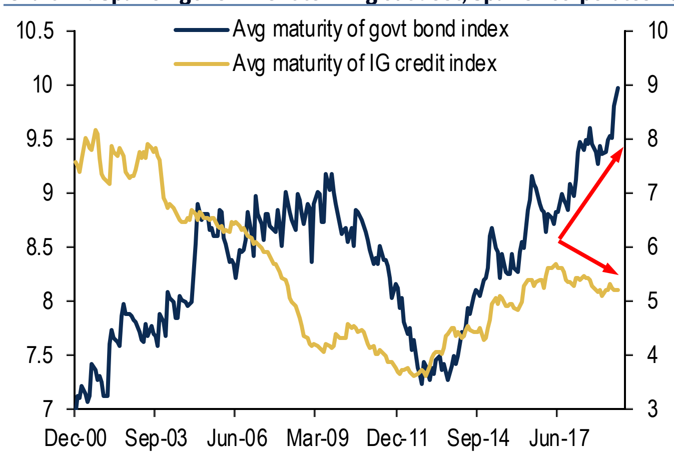
What do corporates know that governments don't (or vice-versa)?

The charts below show a striking divergence in how companies are reacting to the yield environment, versus sovereigns.

Governments are terming-out their debt, as witnessed by the rise in average maturity of Euro government bond indices (ICE BofAML indices). Yet, corporates are doing the opposite. In fact, they are choosing to let more of their debt stock become short-dated, rather than term-out debt. Note that the proportion of 1-5yr high-grade credit has *grown* from 48% of the overall market to 54%, since the start of 2018.

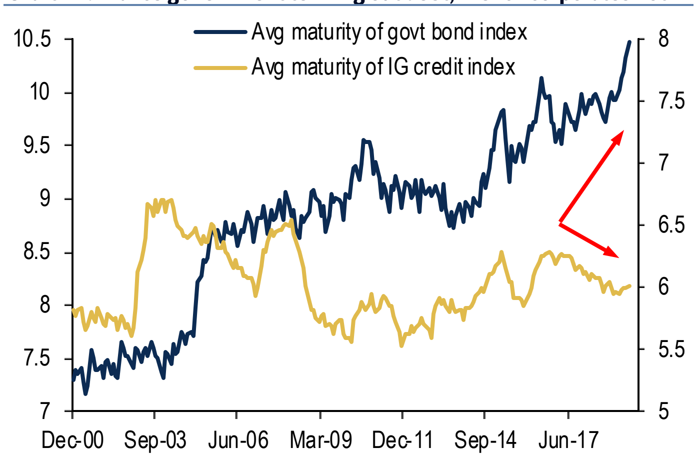
- In the case of Spain, for instance, chart 11 shows that the average maturity of Spanish high-grade credit has shrunk from 5.4yrs to 5.2yrs since the start of 2017, yet the average maturity of Spain's (fixed-rate) government debt has jumped from 8.8yrs to 9.9yrs.
- The same developments hold for France and Italy, albeit less extreme. Even Germany, has seen only a modest rise in the average maturity of its corporate debt compared to a bigger rise in the average maturity of its (fixed-rate) sovereign debt.

Chart 11: Spanish government terming out debt, Spanish corporates not



Source: BofA Merrill Lynch, ICE Data Indices LLC. Spain govt avg bond index maturity (LHS)

Chart 12: France government terming out debt, French corporates not

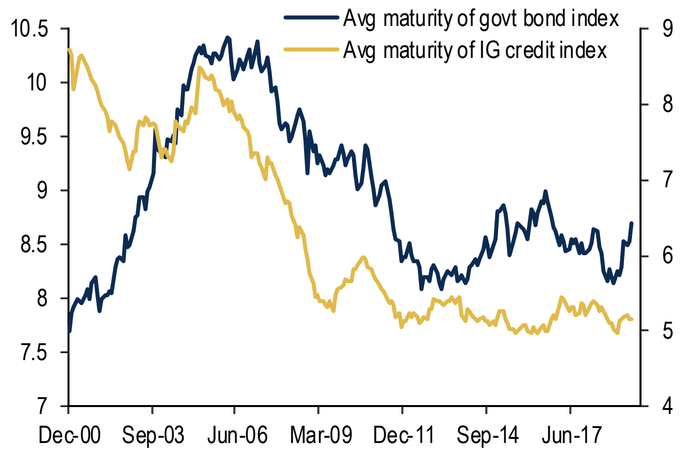


Source: BofA Merrill Lynch, ICE Data Indices LLC. France govt bond index maturity (LHS)

Sovereigns react to growing long-end demand

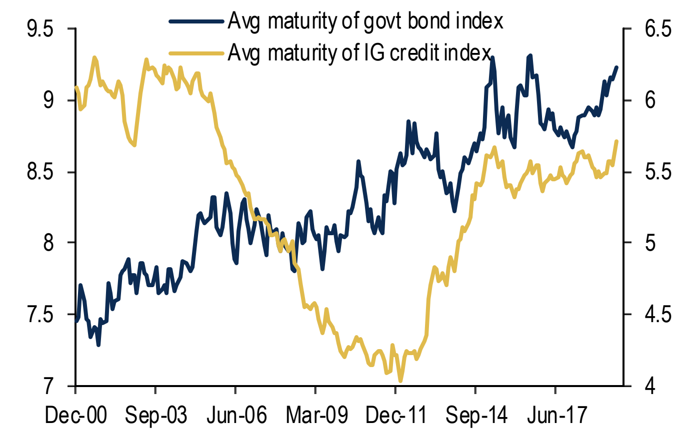
What's been behind the rise in sovereign debt average maturities over the last few years? Our rates strategist Sphia Salim argues that sovereign treasuries' mandates tend to strike a balance between lowering the cost of debt and ensuring re-financing risks are contained. The latter certainly means avoiding heavy reliance on short-term funding, as a percentage of total debt, but it also entails adapting issuance to market demand, maintaining some degree of predictability, and ensuring a high level of liquidity in secondary markets. Sovereign deviations from historical issuance patterns therefore require caution and take time to materialize.

Chart 13: Italian govts. terming out debt, Italian corporates less so



Source: BofA Merrill Lynch, ICE Data Indices LLC. Italy govt average bond index maturity (LHS).

Chart 14: German governments terming out debt, German corps less so

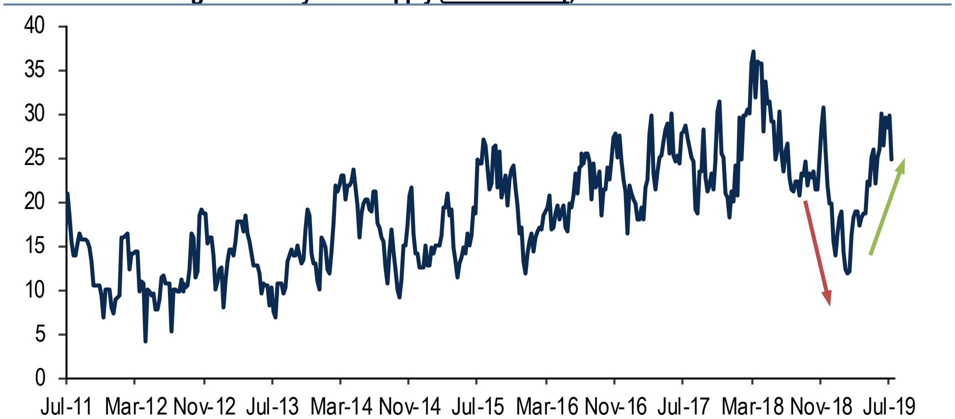


Source: BofA Merrill Lynch, ICE Data Indices LLC. German govt average bond index maturity (LHS).

The last few years have seen a continuous rise in the Weighted Average Maturity of EZ govt bond issuance, with a declining supply of short-dated bonds but also a rising amount of long-dated issues (see our analysis on the topic back in 2017 – Global Rates weekly 19-May-17). One could therefore argue that QE has helped, not only in lowering the average funding costs for EZ sovereigns, but also in allowing them to lengthen the WAM of their outstanding debt, which has for most, risen above pre-crisis levels.

Earlier this year, however, we flagged the limited EGB issuance in 15y+ auction, as a sign of reduced investor demand for long-dated bonds in Q1 (Global Rates Weekly, 3-May). Since then, the substantial decline in yields, with the pricing of ECB rate cuts, has led many investors further out the curve, especially in semi core and peripheral govies. The result was a renewed pick-up in long-end issuance – as can be seen the chart below.

Chart 13: 12w rolling sum of 15y+ EGB supply (auctions only)



Source: BofA Merrill Lynch Global Research. (*) Germany, periph and semi-core. In bn 30y equiv.

Why would corporates do the opposite to governments, though, and let their debt become shorter-dated (and incur potentially greater refi-risk down the line)? Part of it may simply be a reflection of where the investor credit demand is in Europe.

- Our Follow the Flow note has highlighted for some time that a dovish ECB has spurred retail demand for front-end corporate bond funds because of the attractive "roll down". We sense companies are simply responding to this demand by issuing more at the short-end accordingly. Note that the average maturity of IG new issues this year has been 7.5yrs, lower than 2018 (7.75yrs) and 2017 (8.25yrs).

- There is less natural investor demand for credit duration in Europe. Hedge funds, for instance, prefer to take credit risk in an environment of greater spread dispersion, rather than trade long-duration credit for the convexity.

- Another possibility is that companies may well be looking to keep interest costs as low as possible so that they can alleviate margin pressure from other areas (less global trade, rising raw material costs etc). Having more negative yielding debt would clearly be cost effective for companies.

The lesser of two evils?

But while corporate debt may be "safer" from the perspective of lower bond market duration, vis-à-vis government debt, corporates are building up a greater debt refinancing wall in the years to come.

All this points, paradoxically, to a need for the ECB to remain dovish for longer, and assure bond market conditions are smooth enough for continuous refinancing activity.

Negative credit: the dark side

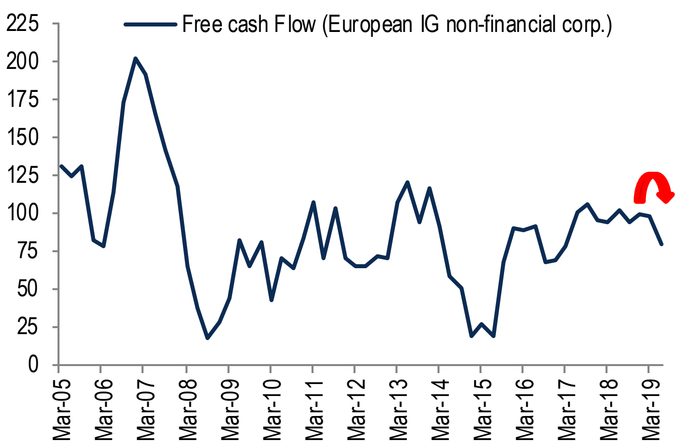
We can't help but feel, however, that at some point companies will bite the bullet and use negative debt to please shareholders. The obvious potential uses could be M&A or funding dividend payments (share buybacks have always been less prevalent in Europe), although the former likely requires political risk (Brexit, Italy) to subside first.

Another option has become more pressing we think: **the need to plug gaps in companies' free cashflow**.

- Chart 16 shows that there has been a visible drop in the total free cashflow generation of European non-financials recently. YoY, we find that it has dropped by around 15% – reflective, we think, of the effects of weaker world trade, policy uncertainty in the periphery and rising wage costs, to name a few.

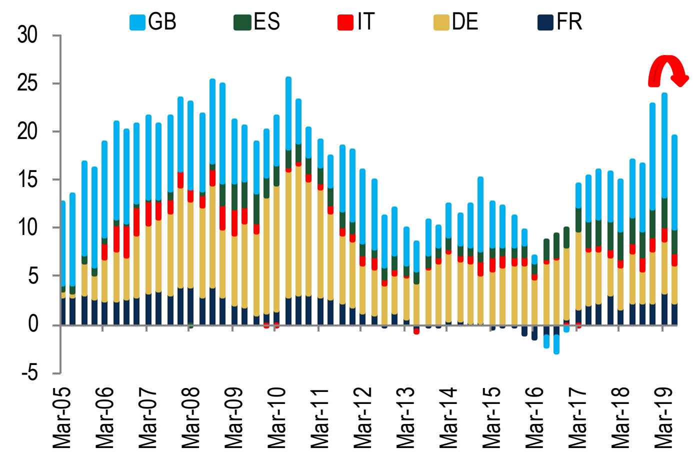
- In fact, chart 18 shows that the drop in FCF is greater for exporter companies in Europe, than it has been for domestically-orientated firms.

Chart 16: Cash generation of European companies has waned of late. Weaker global trade isn't helping (total FCF €bn)



Source: BofA Merrill Lynch Global Research. Large sample of Euro IG non-financials

Chart 17: Cash generation of European companies has waned of late (total FCF €bn, by select countries)



Source: BofA Merrill Lynch. Smaller sample of Euro IG non-financials than in chart 15.

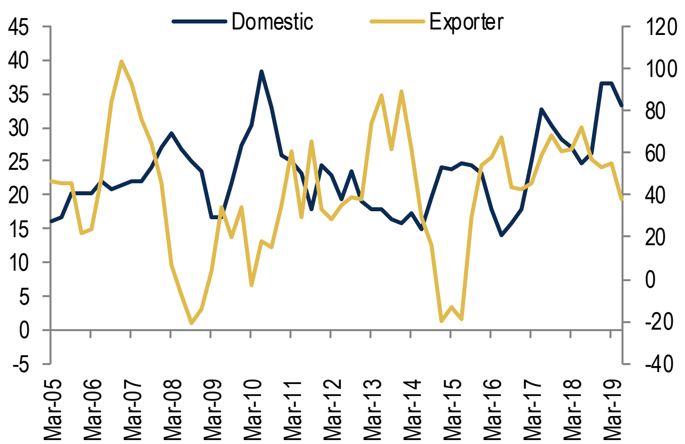
The temptation, therefore, could be for European non-financials to resort to issuing negative-yielding bonds to plug the recent decline in free cashflow. And to state the obvious, it would not cost issuers anything to raise the debt.

We think credit investors should therefore be cognizant of these sectors, given the potential supply risk.

Chart 19 finishes with a simple screen. We show credit sectors' % of negative yielding debt versus their equity market performance year-to-date (relative to the overall market). Those sectors to the top left of the chart have 1) higher amounts of negative yielding bonds, and 2) have seen their equities underperform the broad market YTD.

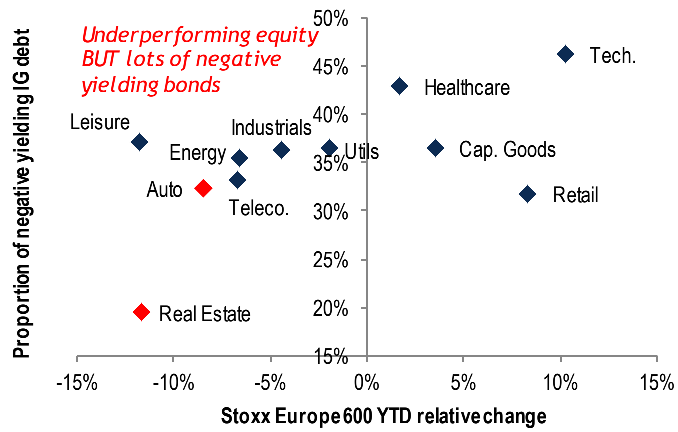
- **Industrials** continue to stand out as the sector with lots of negative yielding debt (35%+ of the sector) but with lagging equity prices YTD (because of global trade tensions). Investors should be wary of (negative yielding) supply risk here, we think.
- **Energy**, **telcos** and **autos** also feature as having lagging share prices YTD but lots of negative yielding bonds.

Chart 18: Cash generation of European companies has waned of late – a bigger impact can be seen for exporters (total FCF €bn)



Source: BofA Merrill Lynch. Large sample of Euro IG non-financials. Domestic FCF, LHS.

Chart 19: Sectors to the top left of the chart could be motivated to use negative debt to please shareholders (as equity prices have lagged YTD)



Source: BofA Merrill Lynch Global Research. Red dots indicate negative FCF.

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