The European Credit Strategist

“Super Thursday” trades

Credit Analysis

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Credit Strategy
Europe

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ECB: European Central Bank
CSPP: corporate sector purchase programme

No end to the excitement

“Super Thursday” brought a big win for the Conservatives in the UK General Election (according to latest projections), a dovish Christine Lagarde (with little push-back on negative rates) and the makings of a US-China trade deal. The cacophony of news is bullish and will likely give markets enough reason to push asset prices higher into year-end.

Green is the colour of money

The ECB’s Strategic Review, as highlighted yesterday by Lagarde, will likely be far reaching, encompassing aspects such as inequality, technological developments and climate change. This means a noisy ECB for 2020, potentially also around the idea of “greening” asset purchases. Interestingly, we find that the ECB has already been keenly buying green bonds as part of CSPP. And if newsflow around this topic crops up again next year, then we think it could support spreads for utility, real estate (and bank) bonds – as well as French credits – while being less helpful for industrials and auto debt.

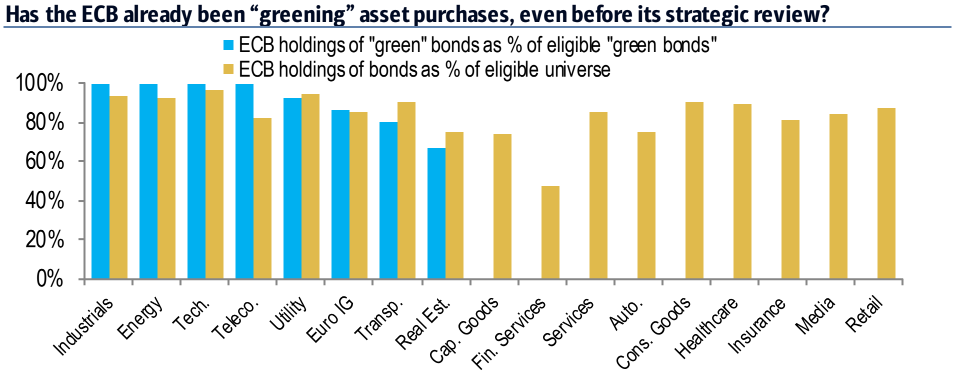
The Boris “bounce”

The Conservative party is on course for a significant majority in the UK General Election. With UK politics able to “move forward”, we expect Sterling credit spreads to tighten. But the bounce may not be as dramatic as the election result, as cross-currency relative value suggests that £ spreads are already on the tight side. However, we see better relative value in Sterling real estate, energy and auto debt.

The one chart for Q1

In the short-term, the one dynamic that we think will continue to be the backbone of the rally – and support a cyclical revival – is that of global central bank balance sheet growth, which is set to rise by a large $600bn or so over the next six months. As central banks essentially “confiscate” assets, we see this creating incremental demand for higher-beta instruments. Note the *rising* correlations of global equity market performance to central bank balance sheet growth lately.

Has the ECB already been “greening” asset purchases, even before its strategic review?



Source: BofA Global Research, ICE Data Indices LLC, Bloomberg, ECB. Proportion of bonds in ER00 which meets the “green bond” criteria as defined by Bloomberg’s field “GREEN_BOND_LOAN_INDICATOR”.

"Super Thursday" trades

Markets have been short of big events this year...until yesterday. And just like London buses, three then come along at once. Yesterday, markets were treated to a UK General Election, Christine Lagarde's first press conference as ECB President, and a US-China trade deal. "Super Thursday" has proved to be bullish in the end, we think, and will likely give markets enough reason to push asset prices higher into year-end.

The UK Conservative Party is on course for large majority according to latest projections. We expect a bounce for Sterling credit spreads now that UK politics can "move forward". As our cross-currency charts on page 6 show, relative value favours going long Sterling **real estate**, **energy** and **auto** bonds here. However, even with heightened *Fallen Angel* concerns across UK credit, Sterling BBBs still screen as tight vs. Euros, in our view, as does longer-duration £ debt.

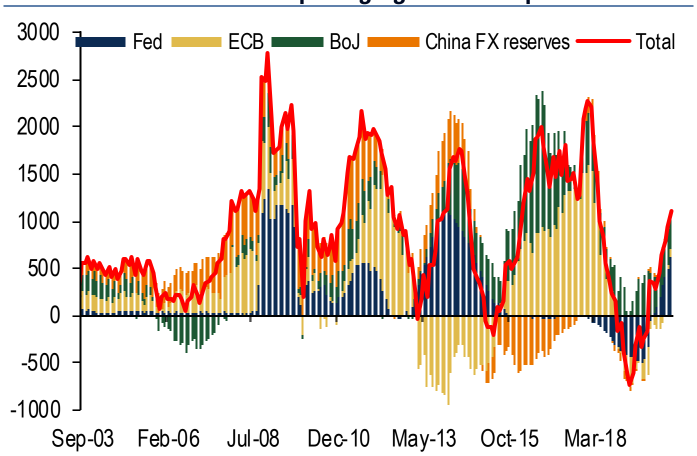
Lagarde's first outing as ECB President proved to be a relatively unspectacular affair. Rather than rocking the boat, she was less dismissive of negative interest rates and argued that monetary policy was not yet at the *Reversal Rate*. The bullish news is that all tools still remain at the ECB's disposal in the quest to revive inflation. Focus will now turn to the ECB's lengthy strategy review. We think any newsflow next year about the ECB "greening" its asset purchases could support **utility, real estate** (and **bank)** bonds, as well as **French** credit, but be negative for **industrial** and **auto** debt – based on the distribution of green bonds across the IG market.

The one chart for Q1

In the short-term, the one dynamic that we think will continue to be the backbone of the rally – and support a cyclical revival – is that of global central bank balance sheet growth.

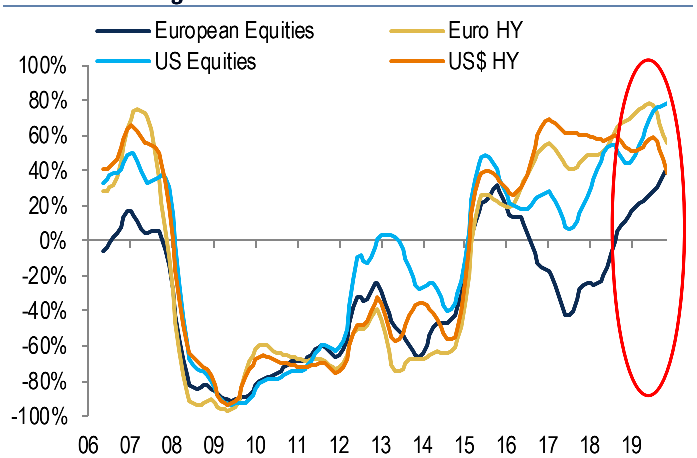
As chart 1shows, global central bank balance sheets (here we include China FX reserves) look set to rise by a large $600bn or so over the next six months. As central banks essentially "confiscate" assets, this creates incremental demand for higher-beta instruments. Note in chart 2 the *rising* correlations of equity market performance to global central bank balance sheet growth, of late.

Chart 1: Tremendous central bank balance sheet expansion likely over the next 6m. We see this underpinning high-beta asset performance.



Source: BofA Global Research, Bloomberg, $bn. YoY changes in central bank balance sheets. Converting all B/S amounts into US$ equivs.

Chart 2: Rolling 3Y correlation of asset price returns (6m/6m) to global CB balance sheet growth



Source: BofA Global Research, ICE Data Indices LLC, Bloomberg. Positive correlation means increase in global QE results in higher asset prices.

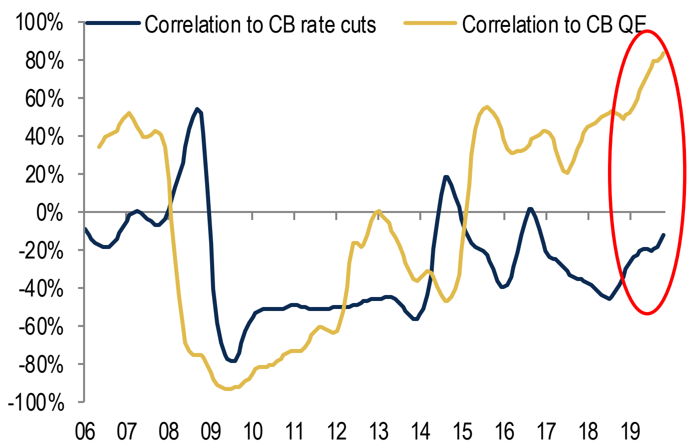
And over the page, chart 3 shows the much stronger correlation of equity market returns to central bank balance sheet growth, as opposed to interest rate cuts.

If equities are supported by global central bank policy, then we see this boding well for high-yield performance in Europe too.

Chart 4 shows another encouraging sign for credit markets. Namely that spread dispersion across the Euro single-B market is finally falling, as US-China trade tensions simmer.

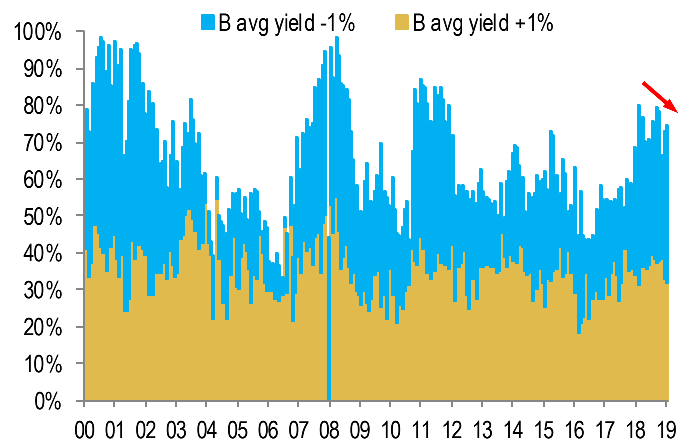
In other words, the contagion effect from "plunging bonds" – something that has plagued the Euro high-yield market a lot lately – appears to be getting less and less.

Chart 3: Rolling 3Y correlation of equity returns (6m/6m) to monetary policy tools. Equities liking the sound of QE more than rate cuts



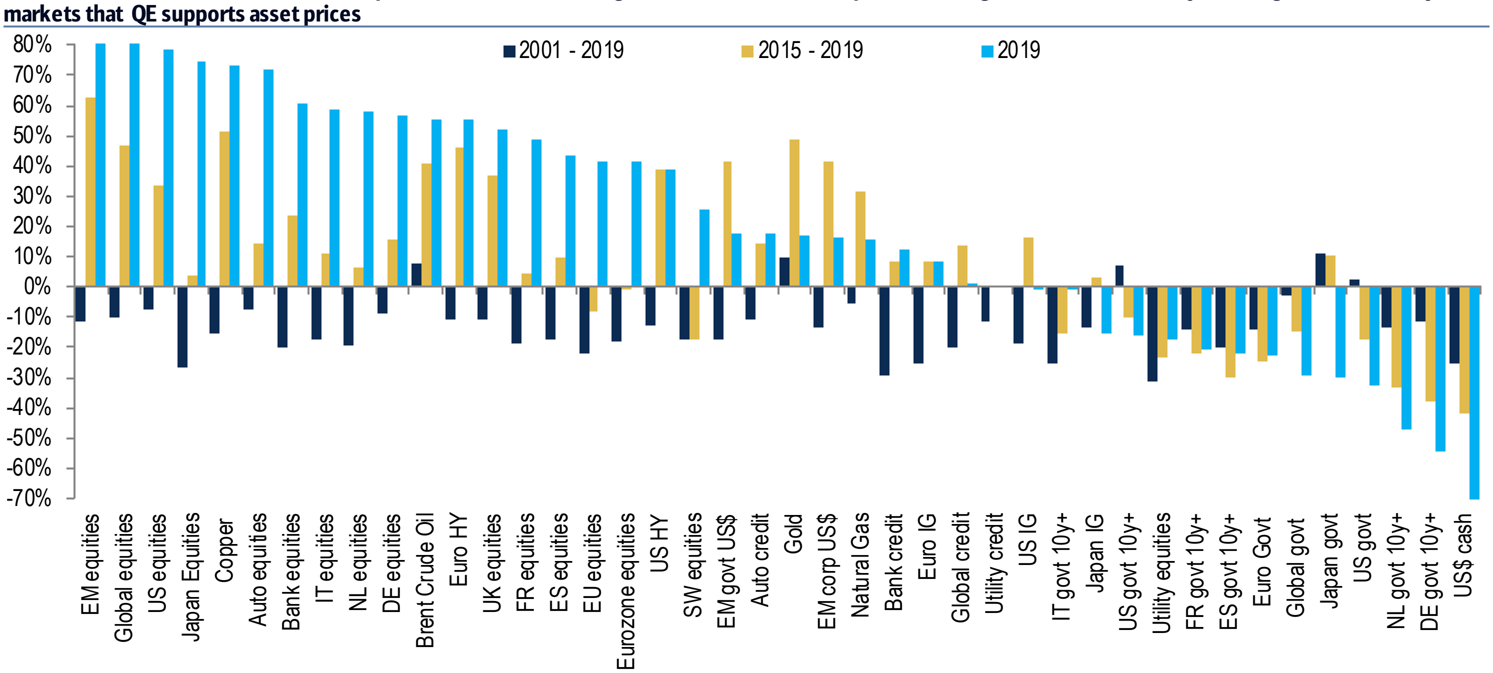
Source: BofA Global Research, Bloomberg. Positive correlation means increase in global QE/CB cuts would result in higher global share prices.

Chart 4: HY dispersion metric: % of single-B market trading more than 1% *above* and 1% *below* the overall single-B market yield



Source: BofA Global Research, ICE Data Indices. % of Euro single-B market trading +/- 1% away from index yield (HE20).

Chart 5: Historical correlations of asset price returns (6m/6m) to global central bank asset purchases. Higher correlations today reflect greater "faith" by markets that QE supports asset prices



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

Green is the colour of money

At yesterday's ECB meeting, Christine Lagarde highlighted that the ECB will undertake a strategic review, likely starting in January next year and lasting until the end of 2020. While the agenda for the review has not been set, she suggested that it would be far reaching, including other aspects such as inequality, technological developments and climate change.

On this last point, she praised the European Commission's release this week of the *European Green Deal*. The Deal provides a roadmap for actions to boost the efficient use of resources across Europe and help Europe become the first climate-neutral continent by 2050.

While little was mentioned yesterday by Lagarde in terms of making asset purchases "greener", newsflow on this has been conspicuous of late. As our European economists have been highlighting for a while, the problem with a strategic review is that the ECB will likely be a lot "noisier" in 2020…and we'd expect the topic of "greenness" of asset purchases to crop up again at some point next year.

The charts below show the extent to which the CSPP-eligible universe currently overlaps with the Euro high-grade green bond universe. To capture green bonds, we use the "use_ of_proceeds" field from Bloomberg, for each high-grade bond in the ER00 index.

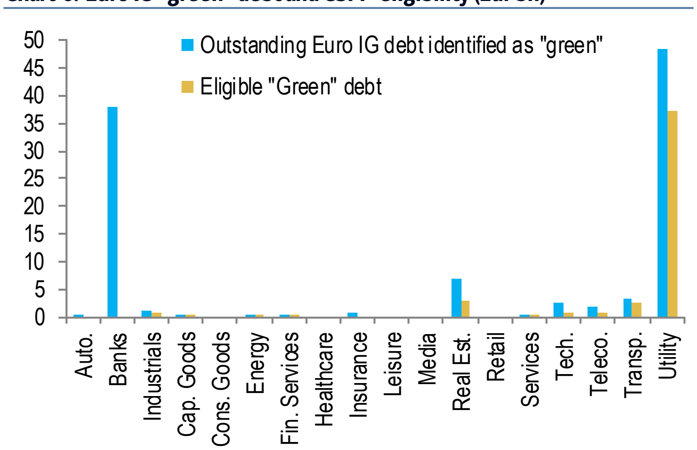
- A quick screen of the market suggests that the universe of Euro IG green bonds is currently just over €100bn, and growing fast.

Who are the big green bond issuers and sectors at present?

- Chart 6 shows that **utilities** and **banks** have a combined €90bn of green Euro-denominated bonds. Moreover, **France** is ahead of the pack in issuing green corporate bonds (chart 9).

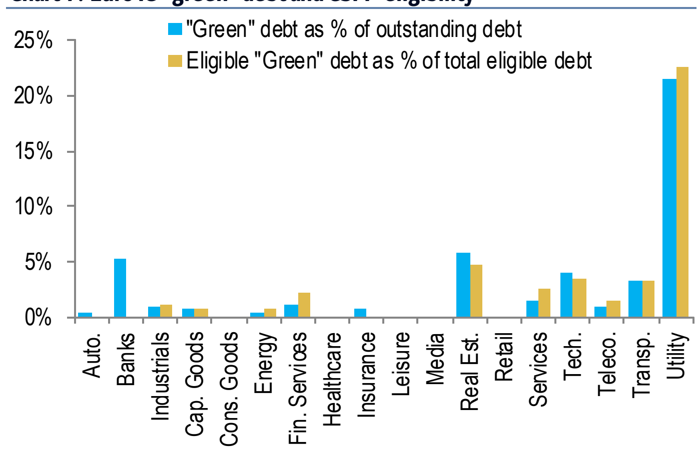
The interesting point here is that while bank debt has not been eligible under normal CSPP rules thus far, if greater emphasis were placed on green bonds in the asset purchase programme, then it could potentially encourage a rally in bank debt next year.

Chart 6: Euro IG "green" debt and CSPP-eligibility (Eur bn)



Source: BofA Global Research, ICE Data Indices LLC, Bloomberg. Proportion of outstanding debt in ER00 which meets the "green bond" criteria as defined by Bloomberg's field "GREEN_BOND_LOAN_INDICATOR".

Chart 7: Euro IG "green" debt and CSPP-eligibility



Source: BofA Global Research, ICE Data Indices LLC, Bloomberg. Proportion of outstanding debt in ER00 which meets the "green bond" criteria as defined by Bloomberg's field "GREEN_BOND_LOAN_INDICATOR". Potentially eligible debt under CSPP2.

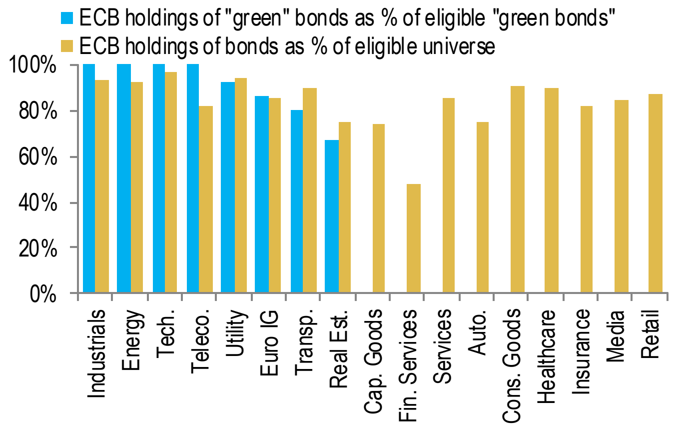
How green have ECB purchases been thus far?

- Out of the 1266 corporate bonds currently held by the ECB, only 62 are green (according to Bloomberg's classification).

- However, we find that **100% of eligible bonds in industrials, energy, telecoms** and **tech**, which are also defined as green, have been purchased by the ECB (chart 8). And **utilities** are at 93%.

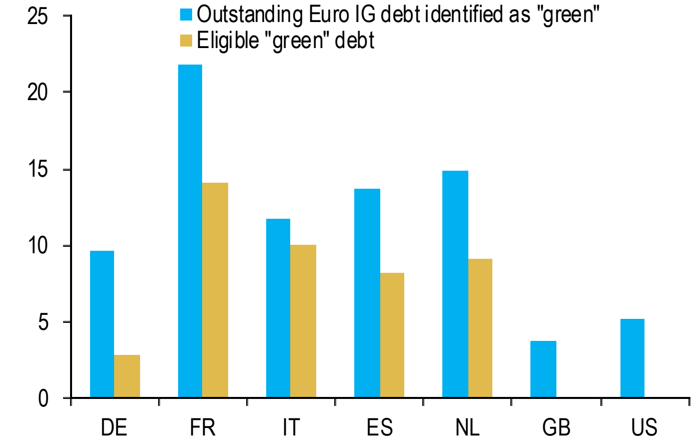
In this respect, perhaps the subtle message for markets is that the ECB has already been "greening" its asset purchases for a while now.

Chart 8: ECB has thus far bought all green bonds in the industrials, energy, telecoms and tech sectors



Source: BofA Global Research, ICE Data Indices LLC, Bloomberg, ECB. Proportion of bonds in ER00 which meets the "green bond" criteria as defined by Bloomberg's field "GREEN_BOND_LOAN_INDICATOR".

Chart 9: France leads the way on "green" corporate bonds (Eur bn)



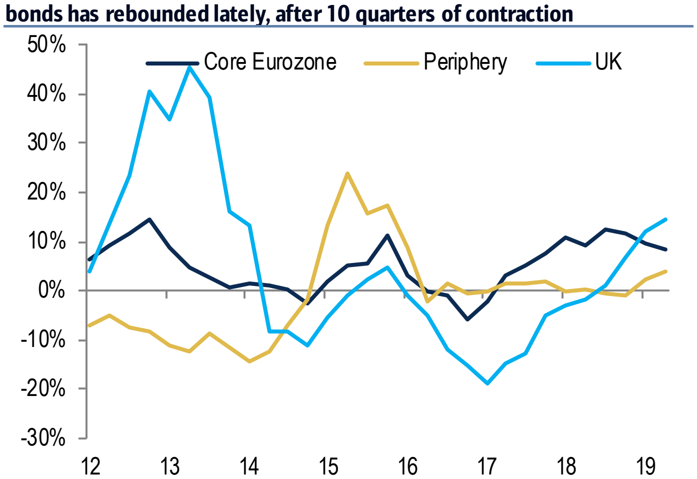
Source: BofA Global Research, ICE Data Indices LLC, Bloomberg, ECB. Proportion of outstanding debt in ER00 which meets the "green bond" criteria as defined by Bloomberg's field "GREEN_BOND_LOAN_INDICATOR".

Sterling credit, and the Boris "bounce"

The UK Conservative Party is on course for large majority according to latest projections. With UK politics able to "move forward", we expect Sterling credit spreads to tighten. As our UK economist Rob Wood highlights, a potentially large Conservative majority could even create some upside risk to UK sentiment (if PM Johnson sought a softer Brexit, for instance).

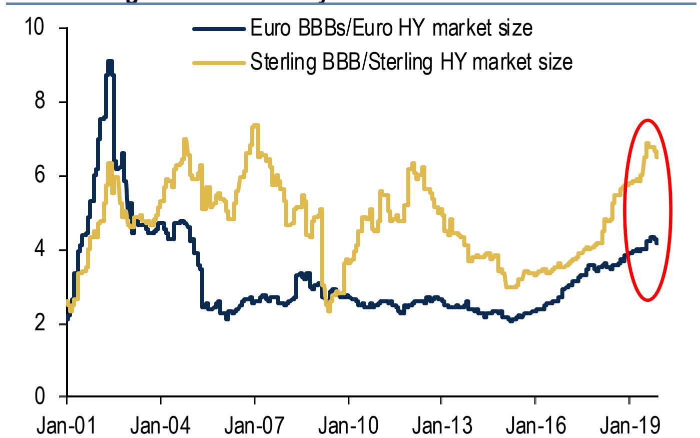
Keep an eye on UK capex as well (chart 10). After 10 quarters of contraction, recent signs are encouraging, and a large Conservative majority would aid this trend, we think.

Chart 10: Capital expenditures of UK companies with outstanding € IG bonds has rebounded lately, after 10 quarters of contraction



Source: BofA Global Research, Bloomberg. YoY change in capital expenditures of companies constituents of ER00.

Chart 11: The BBB/BB credit cliffs: bigger for Sterling, and something that has weighed on £ BBBs lately



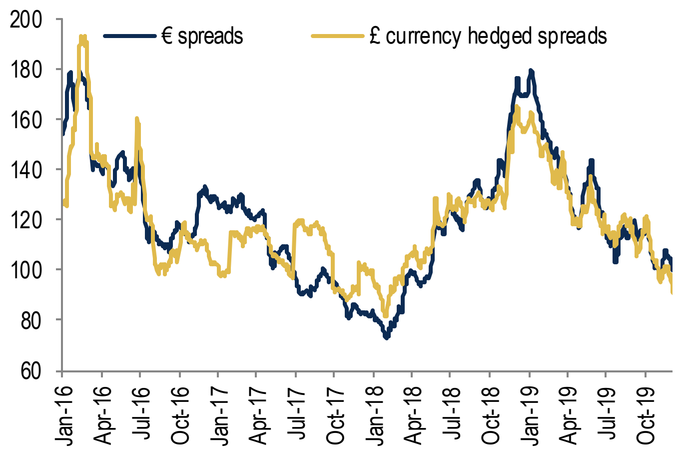
Source: BofA Global Research, ICE Data Indices LLC

Yet, one factor holding back a larger rally in Sterling credit is simply valuations, we think. In the charts over the page we compare £ spreads versus Euro spreads, taking into account the full cross currency hedge. We use our US Credit Strategy team's methodology for cross-currency relative value (see here), on a sample of nearly 100 maturity-matched £/€ bond pairs.

We find that:

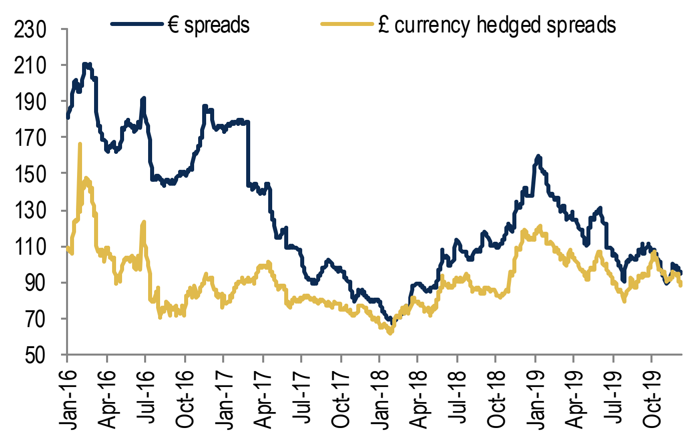
- From the perspective of a Euro investor, fully-hedged £ spreads are now marginally tighter than equivalent Euro spreads. In other words, there is no obvious Brexit premium in UK credit to be captured.
- This is the case even for 10yr BBB Sterling spreads, despite UK *Fallen Angel* fears being high lately.
- On a sector basis, £ relative value is a bit more nuanced. We find some value currently in Sterling **real estate**, **energy** and **auto** bonds (i.e. better relative value versus their Euro counterparts).

Chart 12: 5yr bonds of issuers in € and £ have historically traded very much in line



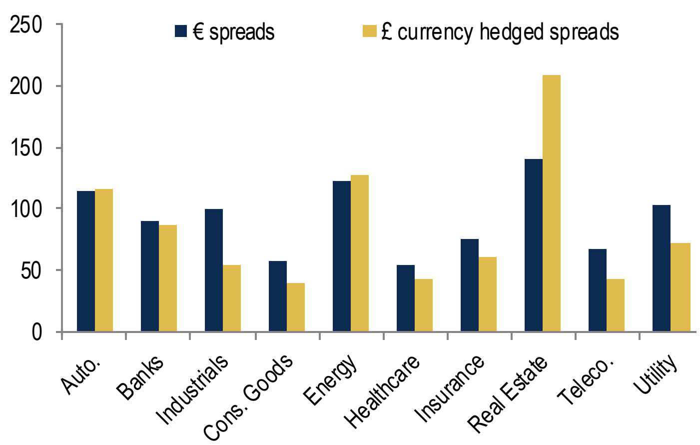
Source: BofA Global Research, ICE Data Indices LLC, Bloomberg. OAS spreads.

Chart 13: 10yr bonds of issuers in € and £ traded wider in € pre-CSPP, but the gap has since closed.



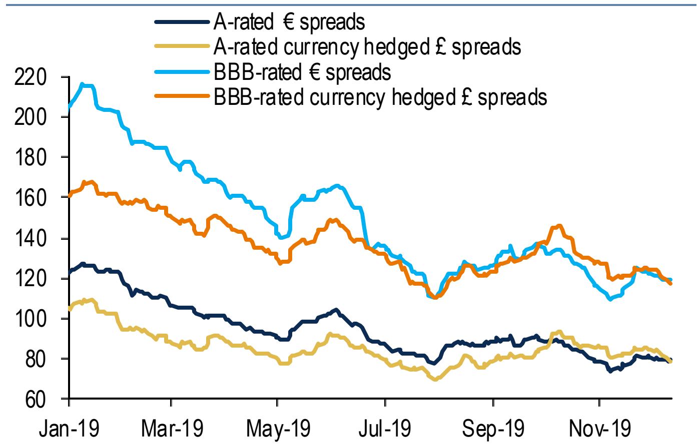
Source: BofA Global Research, ICE Data Indices LLC, Bloomberg. OAS spreads.

Chart 14: Which sectors look cheap in £ vs. Euros? We find some value in Sterling real estate, energy and auto bonds.



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

Chart 15: but £ 10yr BBBs not obviously wide, despite UK *Fallen Angel* fears.



Source: BofA Global Research, ICE Data Indices LLC, Bloomberg. Option adjusted spreads (OAS).

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

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