GENERALI INVESTMENTS

Focal Point

Credit: Searching for value after recent market woes

February 22, 2016

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- Corporate bond spreads widened markedly year-to-date due to China's turmoil, lower oil prices and concerns over banks' profitability. High Yield (HY) spreads rose by 100 bps in the euro area and by almost 200 bps in the US.
- The mature credit cycle will keep weighing on US spreads, with negative spillovers likely also on EUR-denominated credit. HY spreads will widen more and even the Investment Grade (IG) sector is likely to suffer in the short-term.
- However, corporates will benefit from a more supportive ECB stance and the avoidance of a global recession further down the road. While we continue recommending a cautious stance regarding US corporate bonds, we see leeway for tighter euro area IG spreads.
- Thus, euro area IG corporates are attractive from a medium-term perspective – particularly relative to negative yielding government bonds. While encountering moderate risk, a total return of 2% appears feasible on a 1-year horizon.

Corporate bonds had a bad start into the year. EUR-denominated High Yield (HY) spread over government yields widened by as much as 104 bps since year-end and the US HY spread hit a peak at 887 bps, only a few basis point below the highs reached in October 2011. In particular, plunging oil prices drove the spread of US HY Energy index up to almost 2000 bps, even above the highs reached during the Great Financial Crisis in 2008/09.

Even the less risky Investment Grade (IG) segment performed poorly. The total return was barely positive both in the US and in the euro area, but only thanks to the large drop in the underlying government yield. Finally, the concerns over banks' profitability amid more and more negative government yields hit EUR IG Subordinated Financials bonds. They fell by 1.8% in total return terms, thus reversing the gains recorded in 2015 (+1.6%), when it was the best segment in the corporate credit asset class.

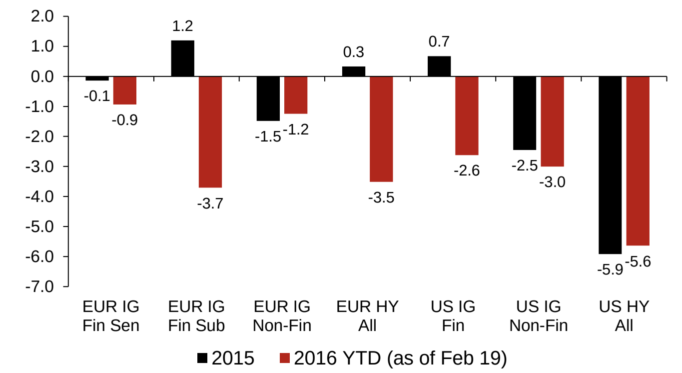
Many headwinds at work simultaneously

There were several drivers behind the poor performance of corporate bonds year-to-date. First, the concerns over the slowdown in China and the implications for commodity prices and emerging markets weighed on Non-Financials.

A second key factor was the drop in oil prices, with WTI down to as low as $26/barrel, the lowest level since 2003. The concerns over a wave of defaults in the US shale oil sector drove the US HY Energy index down by a whopping 15.2% since the end of 2015, and the Option Adjusted spread (OAS) widened by 412 bps to 1827 bps as of February 19.

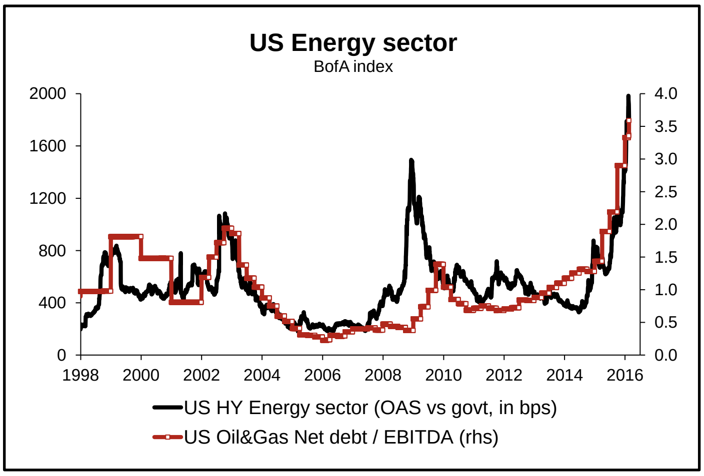
Corporate Bonds: Excess return vs govies

BofA indexes, in %



The outlook for central bank policies and its implication for the financial sector also weighed on the performance. The reassessment of Fed's future policy path led to lower yields across the Treasury curve. The negative correlation between Treasury yields and corporate spreads inevitably impacted the relative performance.

The linkage between the ECB and EUR IG corporate bonds is less obvious. President Draghi hinted to new stimulus measures as soon as at the next meeting (March 10), something that in the past supported risky assets. More recently, however, investors have become more and more concerned about the implications of negative rates on banks' profitability. Moreover, several major banks (e.g. Deutsche Bank, Credit Suisse, Société Générale) disappointed in the current reporting season. Subordinated



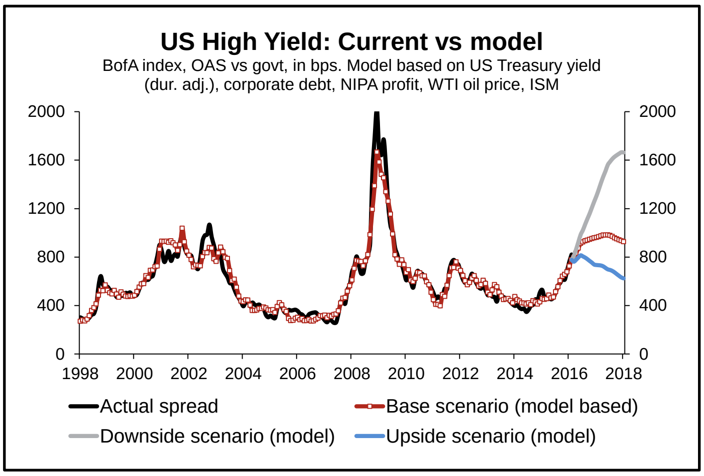
bonds suffered heavy losses, also due to the punitive resolution regime (bail-in rules) now in place in the euro area.

A final rationale for the underperformance of EUR credit was the widening of peripheral and semi-core spreads versus German Bunds, driven both by country-specific political issues (Portugal and Spain) and higher systemic risk amid fears of deteriorating growth momentum and lack of an effective European governance more in general.

More downside for the High Yield on the horizon

The rapidity of the market correction and the already high levels reached by credit spreads support the argument for some relief in the short-term. The recent stabilization in oil prices and the reassuring comments by central banks, in particular by ECB's Draghi on monetary stimulus and on the adequacy of banks' capital, have helped market sentiment and contributed to a partial rebound in risky assets, and consequently to somewhat lower corporate spreads.

Looking down the road, however, we expect the most risky segments of the credit space to remain under pressure. Also in a scenario of slightly rising oil prices, energy companies will face mounting cash flow pressures over the coming quarters. Moreover, the weakness in US HY is not just about energy. US corporates face a mature credit cycle (as confirmed by the progressive tightening in credit standards shown by the Fed's Senior Loan Officer Opinion Survey) and have re-leveraged substantially after the debt decline registered following the Great Financial Crisis. The debt-to-GDP ratio of marketable debt of non-financial corporates was 70.9% in Q3 2015, just below the peak hit in late 2008. Weak sales growth (also due to the strong dollar) and deteriorating margins amid accelerating wage pressures pose additional hurdles to corporates.

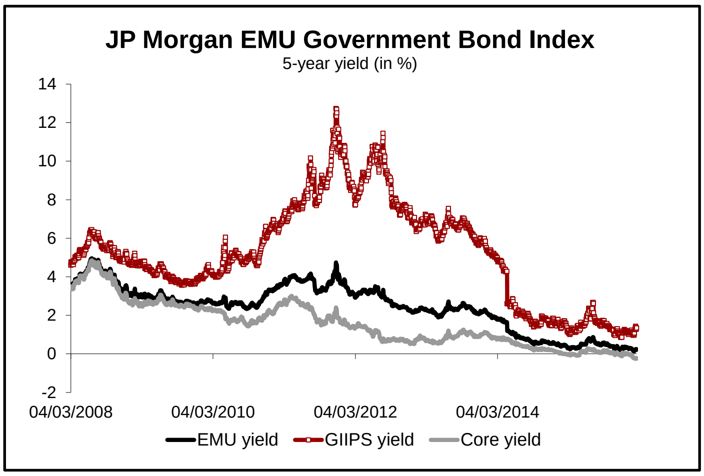


Our models suggest that the US HY spread can rise to 950 bps by year-end (from 823 bps now) even in a scenario of no significant deterioration of the US economy and marginally rising oil prices. Moreover, the downside risk seems ample. Should oil prices average $25/barrel and US real GDP growth slowed between 0% and 1%, the HY spread could rise to 1250 bps by end-2016 and continue to widen in 2017. Given the very high correlation between the US and the EUR HY markets, the latter would inevitably suffer. We expect EUR HY spread to rise to 720 bps by year-end (from 605 bps now).

Some relief further out

While the HY segment remains unpalatable for the time being, we see several reasons to be more constructive on Investment Grade in the medium and longer term. To start with, current concerns regarding the global economy appear exaggerated. Notwithstanding some slowdown, a lasting recession is unlikely as China has the ability to buffer the downtrend and resilient services sectors in the developed economies are forecast to keep growth afloat. Moreover, the downtrend in the oil market appears to have run out. Signals for a coordinated action by the oil producing countries have increased recently and the oil price bounced back to levels well above $30 USD/barrel.

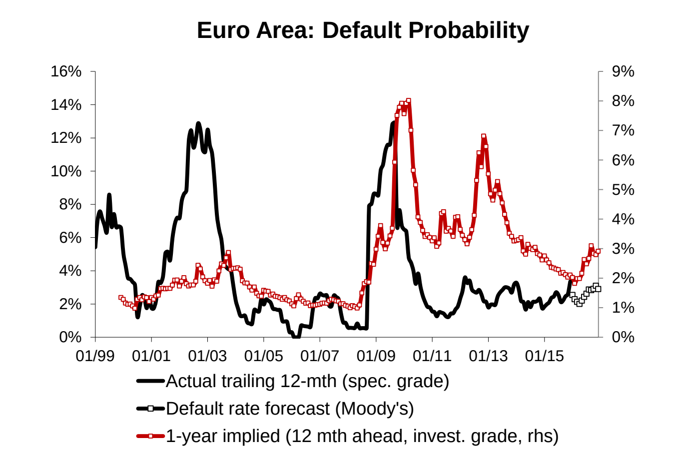
In addition, central banks are becoming more dovish. Not only the Fed is forecast to remain on hold for the time being, but also other central banks have shifted to a more generous policy. Most importantly, the ECB signaled its readiness to become more accommodative as well given the turmoil on financial markets. Even the possibility that corporates will be included in the ECB purchase universe cannot be ruled out any longer. In any case, the dovish stance of central banks increases the opportunity costs of holding money and will keep government yields on a low level for longer. This reduces investors' desire to keep building up deposits and, hence, they will be pressured to put money to work. Since February 2015 the spread between euro area corporate yields and the overnight rate rose by more than 100 bps to well above 200 bps – a long-term high.



What is more, corporates offer a significant yield advantage versus euro area government bonds. While the capital weighted 5-year EMU government bond yield is only slightly in positive territory, even 5-year peripheral yields are well below the corporate yield level. Hence, in a search for yield environment, this is an important supportive factor for corporates.

Solid fundamentals of euro area IG corporates

On top of that, we regard the fundamental situation of euro area corporates as still solid. The 12-month trailing default rate of euro area HY fell to 3.3% in January (down from 3.5% in December). In the months to come, this rate is expected to drop below 3% and to rise back to the current level on a one-year horizon. This would still be below the long-term average of close to 4%. The priced default probability of IG corporates on a one-year horizon is around 3%, well above the historical default probability of euro area IG corporates of below 0.2%. This highlights that valuations have become very attractive.



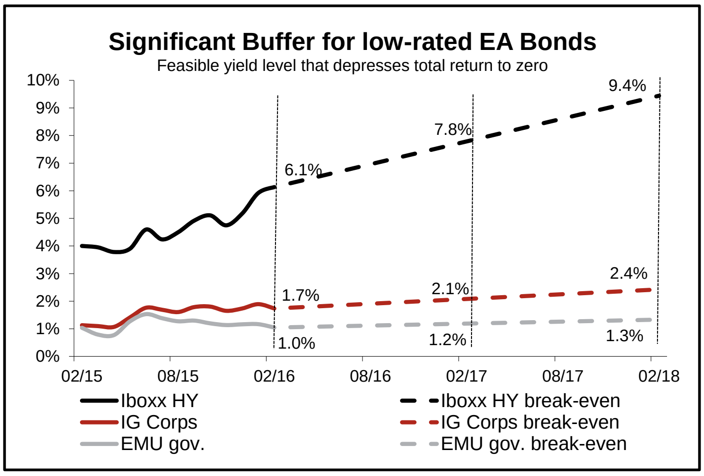
Besides, this distinguishes euro area corporates from US ones. The funding conditions are better and the lower exposure to the commodity sector reduces the risks. Beyond that, euro area corporates are more cautious with respect to M&A and the economic cycle in the euro area is less matured. Finally, US corporates act in an environment of (slightly) rising key rates while the ECB is on the brink of easing more. Consequently, the US trailing 12-month HY default rate is forecast to rise to 4.7% (from 3.1%) on a one-year horizon. This divergence is also shown in the rating trend. While the 12-month rating drift fell to -5.4% in the US in January, it increased to +1.3% in Europe. Therefore, we see leeway for US corporate spreads to widen slightly, but expect euro area IG spreads to tighten once the situation on financial markets has eased.

Considering risk, euro area corporates attractive

Consequently, abstracting from short-term volatility, euro area IG corporates are a defensive, but attractive asset class as they can achieve positive total returns even in turbulent times. Going forward, given the expected continuation of the low yield environment, the spread level is decisive as it determines the carry and potential capital gains. The highest spread level for more than three years is a good precondition for the medium term prospect.

A moderate spread tightening to 145 bps (from 158 bps currently) in combination with a stable underlying yield results in a total return of more than 2% on a one-year horizon. What is more, if market stress rises again, the attractive spread level in combination with a drop in underlying yields is expected to secure capital preservation. The corporate yield level has to increase by around 0.4 pp before the total return becomes negative.

This is particularly appealing in comparison to other fixed income assets. Although euro area HY have a buffer of nearly 1.7 pp before the total return turns negative, they are characterized by a significantly higher risk. What is more, as outlined above even in our base scenario we expect HY spreads to widen considerably. The buffer of EMU government bond yields amounts to only 0.15 pp. While an increase in government bond yields is not on the cards in the near term, the spring 2015 sell-off indicated that even assets deemed as most safe are not without risk.



All in all, abstracting from volatility in the short term, the high spread level of euro area IG corporate bonds offers an attractive entry level for investors. On a medium term perspective, they are expected to achieve a higher total return than most other fixed income assets (including negative yielding government bonds). Hence, euro area IG corporate bonds are an option to improve the current yield – while encountering a moderate risk.

Imprint

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