GENERALI INVESTMENTS

Focal Point

ECB to give new momentum to euro area credits

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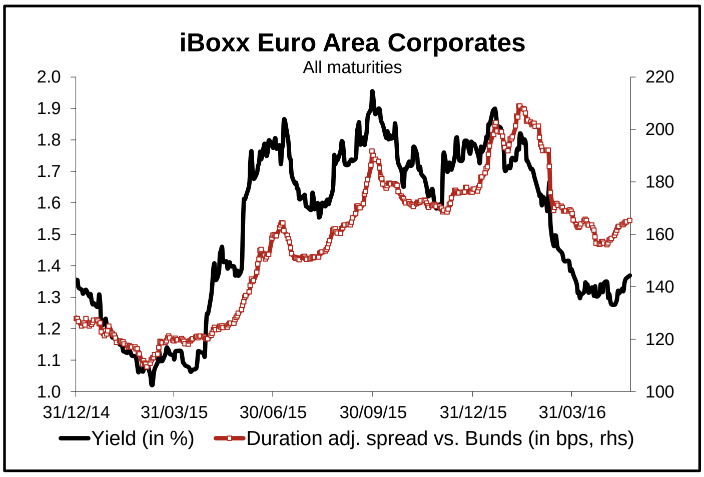
– The rally in corporates has lost steam recently. With euro area Investment Grade (IG) corporate yields close to historical lows, there are concerns that the high issuance volume (more than € 120 bn in Q2 to date) cannot be absorbed.
– We do not share this view. Given the still sound fundamental situation and the lack of attractive alternatives (e.g. 5-year EMU government yields at 0.1%), the appetite for euro area IG corporates will remain high.
– This applies all the more as from June onwards the ECB will start its Corporate Sector Purchase Program (CSPP). While the experience of other ECB programs has shown that the market functioning can be affected, the additional demand is seen to support corporates and is expected to eventually trigger tighter spreads.
– While there has been a high correlation between euro area and US corporates recently, we expect US corporates to decouple from this trend. Given the more mature cycle, US spreads are likely to move slightly upwards.

While corporates had a bad start into the year, they have rallied since mid of February. Euro area corporate spreads (duration adjusted) have tightened until the start of May by 50 bps and US spreads by more than 60 bps. Over the same period, euro area and US corporate yields fell below 1.30% and 3.10%, respectively. As the ECB's announcement to purchase IG corporate bonds in March surely had a role, the main factors were easing concerns about the world economy and higher commodity prices. On the one hand, this is clear from the strong performance of US corporates and on the other hand from the fact that the rally already began in February. But since the start of May the rally has lost momentum with spreads and yields creeping upwards. This raises the question whether the rally is over and investors should get ready for future losses.

Several stress factors burden corporate bonds

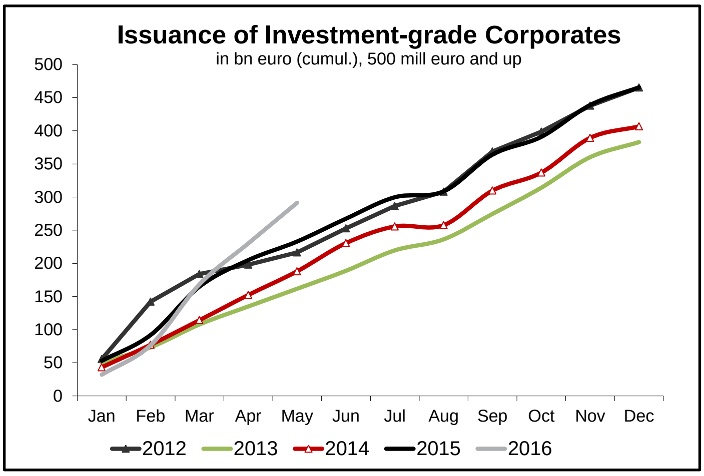
Various risks have triggered a provisional end of the rally. Beside the still lingering economic concerns, political risks – in particular the looming Brexit vote – keep investors currently on the sidelines. Moreover, primary market activity has gathered momentum since March. While the issuance activity in the first months of 2016 was below the recent years, primary markets have more than caught up in the meanwhile (see chart next page). By May, the issuance volume (restricting the analysis to corporates with a nominal amount of at least €500 m) is on the highest level ever at this time of the year. Particularly, non-financial corporates have been very busy in recent months. It is noteworthy that nearly 50% of all issuers are located outside the euro area (mainly from the US). In addition, more than 20% of new corporates have a maturity of 10+ years and around 30% have a maturity between 7 and 10 years. This is a significant increase compared to recent years and reflects both the demand for higher yields by investors and the effort to secure low funding costs for a longer time.



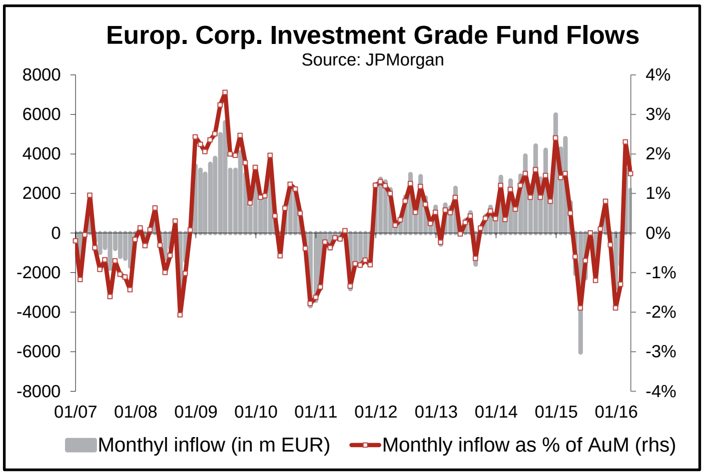
In this environment euro area IG corporate bond spreads are unlikely to tighten significantly in the short term. With corporate yields still close to the historical lows the potential for considerable price gains appears limited. Hence, at least until there will be more clarity about the exact design of the ECB's CSPP – especially the exact amount the ECB will buy – spreads are expected to remain range bound.

More constructive view in the medium term

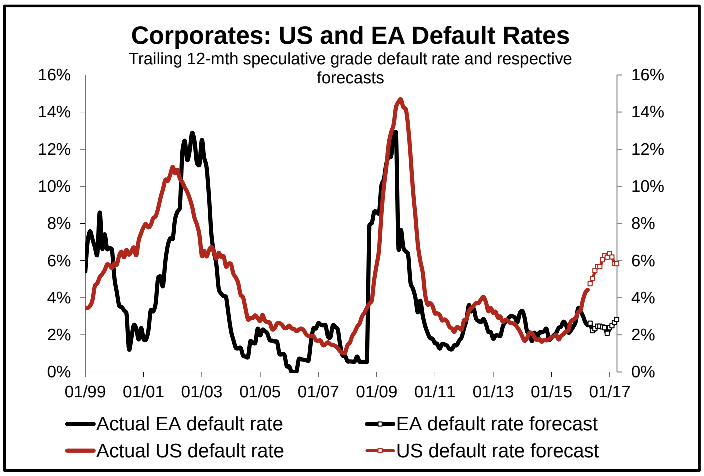
However, the outlook for euro area IG corporates further down the road remains constructive. To start with, the primary market activity is unlikely to continue unabated. The average of the last three months would imply an annual gross issuance of more than €800 bn. The previous annual record was around €500 bn in 2009. First, the TLTRO II will weigh on senior bank issuance. Second, the increasing currency hedging costs reduce the incentive for US corporates to issue € denominated bonds. Third, given the only moderate economic rebound, euro area corporates will retain their cautious stance on spending. Hence, while issuance activity is forecast to remain strong and net issuance will be higher than in the last years some slowing is likely going forward.



Moreover, the appetite for this asset class has grown in recent months again. This will help to absorb the strong supply. While between May 2015 and February 2016 there was an outflow of funds (for European IG corporate funds) of close to 1% of Assets under Management (AuM) each month on average, this has turned sharply. In the last three months, inflows in this asset class were noticeable and steady. The average inflow has come close to 2% of AuM since March. Given the strong supply, inflows are a necessary condition for corporate bonds to perform well. A negative cashflow dynamic for most of 2015 was one main reason for the disappointing spread development in 2015. Admitted the very low corporate yield level limits the total return outlook. But, given the even less attractive alternatives, we expect the positive inflows to prevail for the time being and to provide the basis for a healthy performance of euro area IG corporates. Note, however, that the total return year-to-date is already at 3.0%.



In addition, the low exposure to the commodity sector and the benign funding situation limit the default risks in the euro area. The High Yield (HY) default rate fell to 2.5% in April. This is well below the historical average and a significant increase is not on the cards. This is reflected in the 12-month rating drift as well. At 3.3% the ratio of net upgrades versus rated issuers is at a long time high.

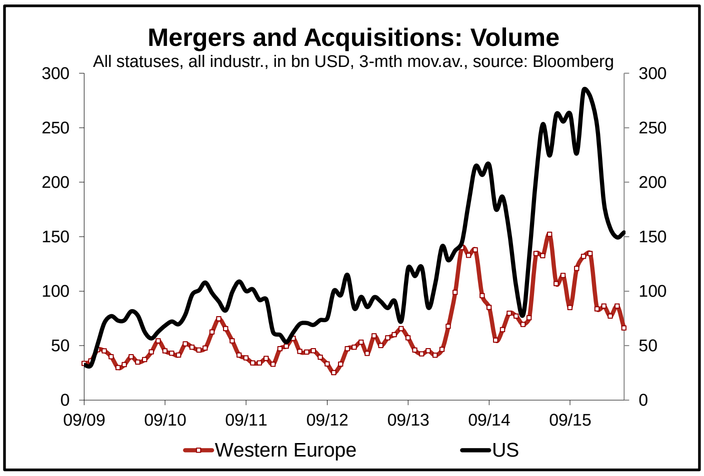


Given the still sound fundamental situation, the asset class does not appear dear and valuations are at least fair. Not least due to the low volatility compared to other asset classes, we regard euro area IG corporates as attractive. Corporate spreads are relatively wide in historical comparison. Excluding the period of the debt crisis, the current spread level of around 165 bps is still well above the historical average. While the yield level is low, it is still above other euro denominated bonds. The average yield of 5-year government bonds is currently barely positive. Hence, bond investors in search for a significant pick-up and stable current income, but limited to € denominated assets, have little choice but to purchase corporates.

ECB as a new powerful market participant

Another argument for euro area IG corporate bonds is the CSPP by the ECB. Announced to start in June, we expect the central bank to actually begin on June 6 (after the next ECB meeting). The ECB will buy euro denominated non-bank IG corporates (first-best rating must be IG) in both primary and secondary markets. The bonds must have a minimum remaining maturity of six months and a maximum maturity of less than 31 years. There is no minimum issuance volume, hence, small issuers will benefit as well. While issuers have to be located in the euro area, the issuers' parent corporation can be established outside the euro area. A negative yield is permitted as long as it is above the deposit facility rate (currently -0.40%) and the central bank announced that maturing principals will be reinvested. As employed in other ECB schemes, the maximum issue share limit is 70% of the outstanding amount.

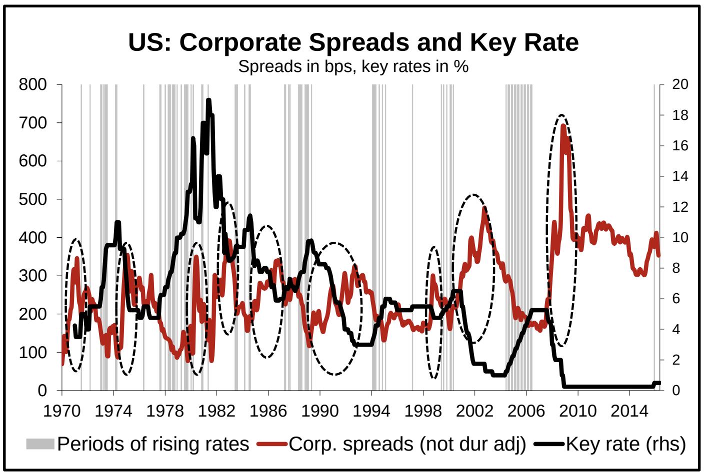
While many details of the CSPP were clarified over the last months, one crucial question remains open so far. It is ex ante not clear what the volume will be. The ECB will publish the volume ex post on a weekly basis, but the central bank has not yet committed to a determined fixed amount (and is unlikely to do so in future). Current monthly estimates are between €3 bn and €10 bn – which we regard as reasonable. Depending on the development of corporate bond markets the ECB will retain flexibility to adjust if necessary. In case the central bank starts cautiously, a setback cannot be excluded particularly as the political calendar in June is overcrowded. This applies all the more if a "buy the rumour, sell the fact" mentality prevails considering the mixed results of the latest Covered Bond Purchase Program.



However, all in, the emergence of a new buyer with potentially very deep pockets constitutes an important backstop for corporate bond markets. While the ECB purchases are expected to reduce market liquidity and will negatively impact market functioning, the ultimate consequence of the additional demand is likely to be tighter corporate spreads. What is more, there will be positive ripple effects on other spread products related to IG corporate bonds.

More cautious outlook on US corporates

Despite the high correlation between euro area and US corporate spreads in recent months, we recommend a more cautious stance for US IG corporate bonds. While the buffer for US corporates is much higher due to the higher yield level (current level around 3.2%), given the more mature credit and economic cycle in the US, we sound a note of caution. The trailing US 12-month HY default rate is already at 4.4% and is forecast to increase further. Moreover, the rating drift is in negative territory and on the lowest level since 2010 (-9.7%). In contrast to European corporates, the Mergers and Acquisitions activity is on a long-term upward trend (although in recent months some large deals have fallen victim to regulatory issues).



Though, we regard the fear of future Fed hikes as overdone. Our analysis shows that a lasting spread widening only takes place when the Fed finishes the cycle. First hikes should be rather seen as a confirmation of a stable economy and do not trigger an immediate spread widening.

Euro area corporates preferred to US ones

In this environment, we prefer an investment in euro area corporates to US ones as the high spread correlation is expected to weaken going forward. While in our forecasts euro area IG corporate spreads have leeway to tighten to 140 bps (from 165 bps currently), we expect US spreads to creep slightly upwards until the end of the year. Hence, although the bulk of the euro area corporate rally is already over and the future total return is unlikely to be above 2% until the end of 2016, it is the preferred market for the time being. This applies to institutional investors as well given the comparatively high recurrent yield and a contained risk of mark to market losses.

Imprint

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