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Focal Point

EA Corporate Bonds: Tougher times ahead

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- For almost two years euro area Investment Grade (IG) corporate bond spreads have been tightening, triggering a strong absolute total return (2016: 4.8% and 2017 ytd: 1.8%) and outperforming most other government bond markets. Meanwhile, supported by decreasing underlying yields, the corporate yield level is close to a historical low.
- At current spread levels, the scope for a further tightening appears limited. This applies all the more as adjusting for the lower rating composition corporate spreads are closer to their historical tights than headline figures suggest.
- Taking into account the ambitious valuation, the forthcoming scaling back of ECB purchases in combination with an ongoing large supply of new corporate bonds is expected to induce higher spreads in 2018.
- Hence, coupled with higher government bond yields, IG corporates will struggle to render positive total returns. Given the low compensation for taking risks, low-rated and long-dated corporates do not appear appealing any longer.

For almost two years euro area (EA) Investment Grade (IG) corporate bonds have been in a goldilock environment. Since the peak in mid-February 2016, spreads have tightened markedly, while government bond yields have moved sideways. This has not only resulted in a high absolute total return, but EA corporate bonds have performed better than EA government bonds (with the exception of Greek and Portuguese ones) and covered bonds.

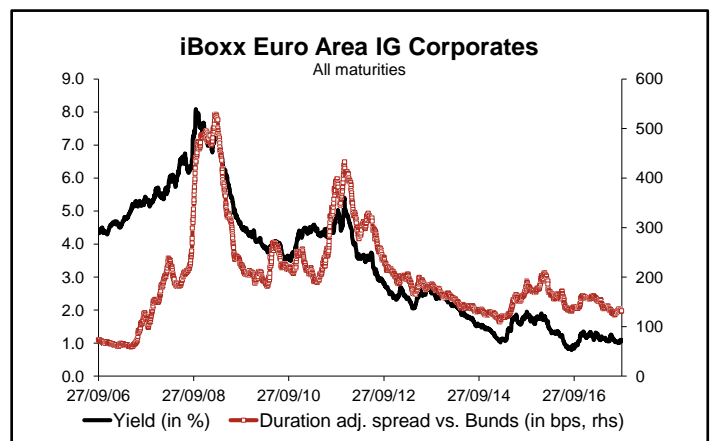
However, the best times for IG corporate bonds are likely over and they are facing more difficult times ahead. Although the fundamental situation of corporates is and will remain benign going forward, the current low yield level of only slightly above 1% limits future returns. The scaling back of the ECB's QE programme next year and a high net issuance volume is expected to trigger wider spreads. In an expected bearish bond market environment, particularly the compensation of low-rated and long-dated corporate bonds looks no longer adequate.

Spreads tighter than headline figures suggest

The current IG corporate yield level is close to the all-time low of 0.8% in September 2016. While this is mainly due to the low government bond yield environment, spreads have tightened significantly, too. Although the current (duration-adjusted) spread of around 130 bps is still above the historical trough of 60 bps marked in spring 2007, it is well below the long-term average of 210 bps. This limits future returns significantly.

What is more, the current spread level is closer to the historical tights than headline figures suggest at first glance. The composition of the iBoxx EA IG Corporate Bond Index

has changed since the start of the financial crisis. The index quality deteriorated significantly. While in spring 2007 only about 25% of the value-weighted iBoxx universe had a BBB rating, this share has increased to almost 50% now. At the same time, the share of AAA or AA-rated bonds fell from 30% to around 10%. Should the previous rating mix be considered, the current spread level would be only 115 bps. While this is still above the historical trough, it provides further evidence for the limited scope for a further spread tightening.

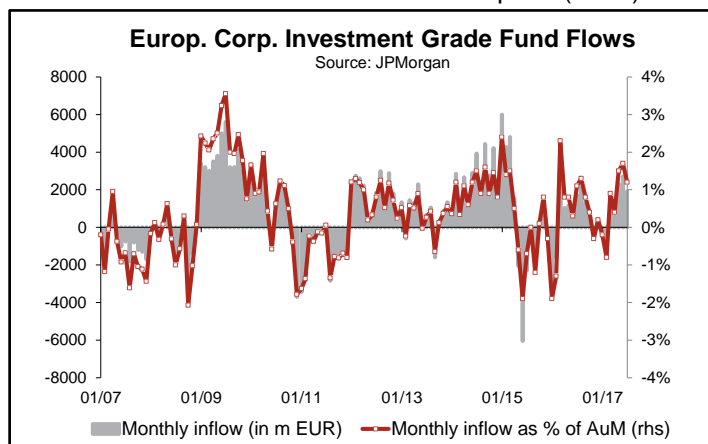


In addition, the search for a yield pickup and the demand for an adequate current income have allowed HY issuers in the past years to issue corporates with limited financial maintenance covenants. All in, it can be seen that the average quality of the outstanding corporate bonds deteriorated significantly.

rated over the last years and, therefore, investors receive a lower compensation for the risks they take.

Little to worry about in the short term, but...

Yet, this does not mean that a strong spread widening is imminent. There are still several factors which will continue to support the EA IG corporate bond market. To start with, the trailing 12-month speculative grade default rate is at 2.6% and is – not least due to the ongoing economic expansion – seen to fall below 2% in the course of next year. This is reflected in the trailing 12-month rating drift (balance of upgrades vs. downgrades in % of issuers) which has been in positive territory for nine months. At a level of 7.1% it is still close to a historical peak (8.5%).



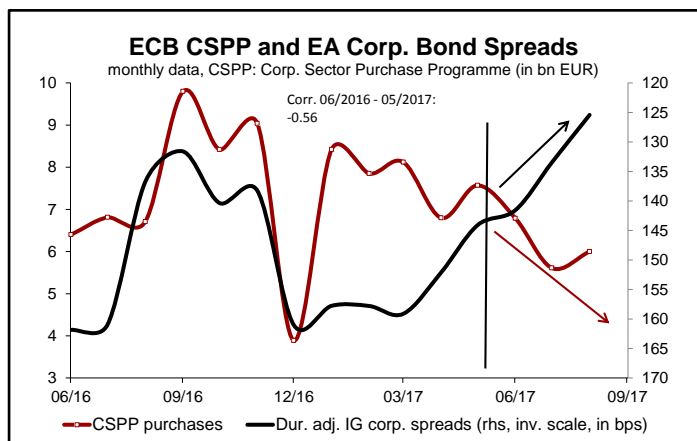
What is more, the ECB's Corporate Sector Purchase Programme (CSPP) continues to foster the corporate bond market. Since the start of the programme in June 2016 the ECB has accumulated corporates worth more than €110 bn. Although the overall amount of the QE programme was scaled down in April 2017, the CSPP is less affected and its share in the overall amount has risen slightly (from 9.6% to 10.6%). Until the end of the year the ECB will extend its programme taking down at least €6 bn/month. The strong return in the past drew in a sufficient fund inflow as well. Given the meagre returns in the government bond market, investors are likely to continue to shift funds into this asset class in the next months. Accordingly, EA corporate bond spreads are forecast to trend basically sideways in the weeks to come.

... hurdles in the way in the medium term

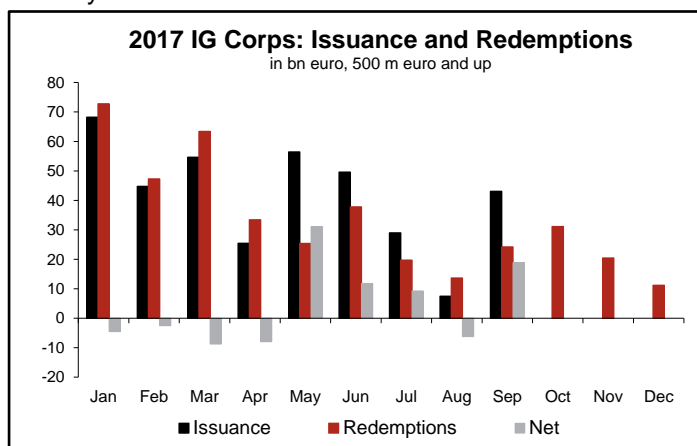
Further down the road, however, spreads are set to widen from the current low levels. The most immediate concern is the looming ECB tapering. Most likely, the ECB will announce its exit plans in October. Although the central bank is expected to handle the issue flexibly and to even increase the CSPP's share in the overall programme in light of the scarcity of government bonds, the absolute volume will decline going forward. Assuming the QE programme will be phased out by September 2018, we calculate that the ECB will purchase corporate bonds worth less than €40 bn in 2018, compared to roughly €85 bn in the current year.

Although the impact of the ECB on the corporate bond market has been more limited than on the government bond market, its declining support should not be underestimated. Since the start of the CSPP, the purchase volume and corporate spreads showed a significant negative correlation. We consider the breakdown of this correlation since early summer – temporary. The respective season-

al and political factors are likely to vanish going forward. According to our models, the monthly purchases under the CSPP are keeping the equilibrium level for EA IG corporate bond spreads lower by 10-15 bps. We anticipate this "flow effect" to fade along with the QE tapering in 2018. That said, while the overall downward distortion on spreads induced by the CSPP is likely to be much larger – we calculated an overall impact of 60 bps – we expect the "stock effect" (currently estimated at around 45 bps) to remain significant as the ECB will not trim its corporate bond portfolio, reinvesting maturing securities over the foreseeable future.



The reduction in demand by the ECB will come at a time when supply increases. The (net) issuance activity in 2018 will likely rise from current levels. Although the cash balance of European corporates is comfortably high, the issuance activity is unlikely to slow considerably in 2018. It appears that the cheap financing and the solid balance sheets support buybacks and the payments of dividends. What is more, the still relatively weak M&A activity in Europe is likely to pick up going forward. Therefore, as redemptions will decrease by around €85 bn compared to 2017 (particularly the volume of financial corporates will come down), the net issuance of corporates will rise noticeably in 2018.



Credit will increasingly compete with other asset classes given the phasing out of the extraordinary monetary policy measures. Given the ambitious valuation and taking into account the low yield level, the meagre return outlook do not indicate that inflows will increase from current levels. Rather, there is a risk that credits will struggle to maintain the level. This applies all the more as the relative attractiveness of IG corporates has come down as e.g. the yield

advantage versus 5-year sovereign bonds has declined by around 50 bps to less than 100 bps since the start of 2016.

Not a sell-off, but more testing times ahead

With only a few short interruptions, IG corporate bond spreads have been narrowing since the end of 2011. Not coincidentally, this concurred with the trend towards lower government bond yields (the only noticeable interruption was the period from Q2/2015 to Q4/2015 when yields rose and spreads widened). However, in light of the robust EA economic outlook, the slowly increasing inflation pressure and the (cautious) QE exit by the ECB, the way is paved towards higher government yields. This implies that the search for a pickup is becoming less pressing for investors. Against this background, the long-lasting trend towards tighter spreads will likely come to an end.

Although the risk/reward profile is rather unattractive, the sound fundamental situation will likely prevent a strong sell-off. In our base scenario (probability 65%), we expect IG corporate bond spreads to widen from 132 bps to 145 bps on a 12-month horizon. The expected increase in underlying yields of around 25 bps contributes to a forecast rise in the corporate yield level to more than 1.45% (the highest level since March 2016). This means that the total return on a 1-year horizon would be negative at -0.9%. For a non-negative total return, the increase in government yields would have to be capped at 8 bps or corporate spreads would have to tighten another 4 bps. Both scenarios are rather unlikely. Hence, investors should prepare for a negative total return on a 1-year horizon.

Different scenarios (12-month horizon)	Current spread (dur.-adj., in bps)	Change IG corp. spread (in bps)	Spread forecast (dur.-adj., in bps)	Change underl. yield (in bps)	Total return
Base scenario (prob. 65%)	132	13	145	25	-0.9%
Breakeven (1)	132	13	145	8	0.0%
Breakeven (2)	132	-4	128	25	0.0%
Downside scenario (prob. 25%)	132	28	160	50	-3.0%

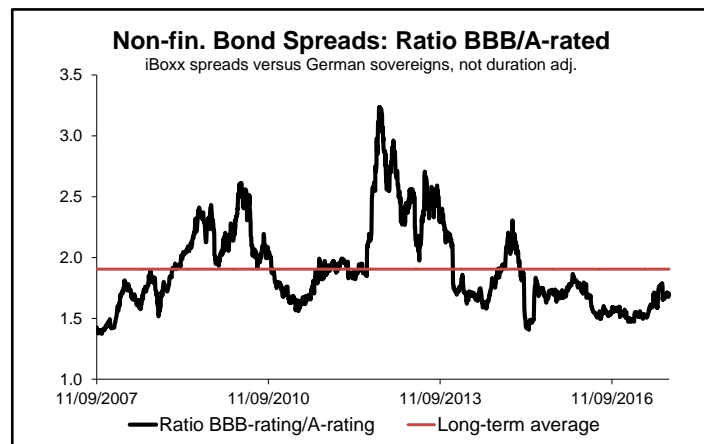
In a downside scenario the prospects could be even more gloomy (probability 25%). Triggered for example by a more rapid unwinding of extraordinary monetary policies on both sides of the Atlantic, government bond yields would increase more strongly. The corresponding deterioration of funding conditions would bring about a more considerable spread widening as well. In this case a total return of around -3% appears not unlikely.

Primarily low quality corporates unappealing

This rather unappealing outlook raises the question how to position going forward. Particularly non-financials will be affected as this segment was the main beneficiary of the CSPP in the past and they are seen to underperform financials on a one-year horizon. Generally, with the asymmetric risks and the upside potential clearly surpassed by the downside risks, it does not pay off to go long risk. Indeed, non-financial corporate bond spreads adjusted by volatility are low and even close to the historical trough. The compensation investors get for taking risks is particularly low in the case of low-rated non-financials. While the historical average of volatility-adjusted BBB-rated non-financial spreads is 1.7, currently spreads are only at 0.8.

What is more, in a difficult market environment with widening spreads, low-rated corporates generally underperform. As the current ratio of BBB-rated and A-rated non-

financials is at 1.7 (historical average is at 1.9), there is scope for an increase at least towards the average, implying a relative underperformance of BBB-rated non-financials. Furthermore, as underlying yields are forecast to rise, long-dated non-financials should be avoided to limit potential losses. All in, although losses might not be completely avoided, we recommend reducing risks and overweight high-rated and short-dated non-financials versus low-rated and long-dated ones.



A similar argument applies also to Financials, especially when looking at the capital structure. Subordinated bonds have significantly outperformed Senior ones year-to-date (+6.07% vs +1.33%) on recovering banks' profitability and reduced systemic risk, especially after Mr. Macron's victory in the French presidential election. However, valuations of Subordinated bonds look stretched at these levels. Indeed, the spread ratio between Subordinated and Senior Financials is at the low-end of the range seen since the outbreak of the Great Financial Crisis (at 1.93 vs the average of 2.36). While the improved outlook for European banks and rising yields can keep supporting Subordinated bonds for a while, a balanced stance between Senior and Subordinated bonds looks more appropriate at this point.

Imprint

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