ETF Securities Fixed Income Research:
European domestic and infrastructure-related sectors likely to outperform

Summary

- Infrastructure-related corporate bond sectors likely to benefit the most from the ECB’s Corporate Sector Purchase Programme (CSPP).
- The CSPP will also be particularly supportive for corporate bonds issues from the euro area core.
- The ECB’s support for larger firms will likely have a positive impact on growth and employment figures.

ECB’s programme and EU challenges

As widely expected, the ECB left policy rates and the amount of monthly purchases (EUR80bn) unchanged at its June meeting. The Corporate Sector Purchase Programme (CSPP), which started on June 8, is part of the broader EUR80bn monthly purchase. It will include corporate bonds with a maturity from 6 months to 30 years and with a minimum rating of BBB- (i.e. Investment Grade). The national central banks will buy on behalf of the ECB, with the ability to purchase up to 70% of any individual bond.

ECB president, Mr Draghi, has also stressed the need for countries to focus on rising productivity and improving business environment, by enhancing public infrastructure and reducing differences in financing conditions between member states as per Juncker’s “Investment Plan for Europe” announced in November 2014. We believe the CSPP is genuine way to deepen and integrate capital markets in the euro area. Moreover, by including Investment Grade (IG) euro-denominated bonds issued by non-financial corporates (NFCs) to its programme, the ECB is now enlarging its support to larger firms with potential larger impact on growth and employment figures. In this regard, the CSPP is likely to remain in place at least until 2018 or beyond but we don’t expect the ECB to disclose the time frame.

Fundamentals

The economic recovery in the euro area is continuing, albeit with signs of a moderation in growth due to a weaker external environment. In June, the ECB staff revised upward real GDP growth forecast for the euro area to 1.6% in 2016 (up from 1.4% forecast in March), and the annual inflation to 0.2% from 0.1% in March, reflecting the recent oil price rebound.

The fundamentals of European non-financial IG corporates have improved significantly since the beginning of the year, showing a rebound in profitability as well as a downward trend in leverage ratio (from 3x in 2015 to 2.5x in average). The continuing improvement of the economy in the Eurozone should stimulate risk appetite and thus drive European spreads tighter.

Market performance

Our estimate of the amount of eligible CSPP Eurozone corporate bonds outstanding is approximately EUR757.5bn, of which 13% are yielding below zero. In our opinion, the ECB could buy between EUR5bn to EUR10bn monthly, leading the ECB to own between 4.5 - 9% of the current supply by the end of the year.

Euro denominated corporate bonds have outperformed dollar and sterling denominated counterparts so far this year. We expect bonds issued from the core – namely Germany, France and Netherlands – to outperform bonds issued from peripheral countries in the near term since the core countries represent about 70% of the bonds eligible for the CSPP. Since the start of the CSPP, OAS credit spreads on Peripherals IG have widened 4.3bps, while the spread on European HY widened 10.3bps. But as the programme intensifies, investors will rotate more aggressively from Core European IG to Peripherals IG and HY.
in search for yield. Accordingly, it could be a good entry point into peripheral and HY European corporates.

**Sector performance**

Since the announcement of the CSPP on March 10, European non-financial corporate bonds (within the BBB rating bracket) tightened by 48bps on average. We believe the CSPP will likely be most beneficial for European Utilities and infrastructure-related sectors. These sectors represent the largest proportion of the bonds eligible for the CSPP (32%), according to our estimates.

**CSPP eligible bonds - sectors breakdown**

The aforementioned sectors have seen a significant improvement of their profitability since the beginning of the year. The profitability of European Utilities and Consumer non-cyclicals sectors has rebounded significantly year-to-date.

**Profitability of Eur non-fin IG issuers**

In contrast, Energy and Financial corporates experienced declining profitability. Energy sector still remains under pressure due to volatile oil prices. Insurance companies – which are eligible to the CSPP - face asset/liability mismatches as European populations are rapidly aging while the prolonged low yield environment significantly reduced investment income and squeeze margins. Additionally, banks’ net interest income and loan margins are declining as a result of the ECB’s negative deposit facility, and they are excluded from the CSPP. Accordingly, we believe Financial corporates will underperform in the medium term.

Despite improving fundamentals, spreads widened in May and subsequently tightened following the ECB meeting on June 3. The recent tightening more than offset the widening in May for most sectors, with the exception of Utilities, Consumer Staples and Consumer Discretionary where we believe opportunities still remain. Since the Eurozone recovery is mainly domestically driven, we believe domestically focussed sectors such as Consumer Staples, Consumer Discretionary and infrastructure-related will outperform the globally exposed sectors (Energy and industrials). Furthermore, infrastructure-related sectors appear to be the sectors targeted to increase the growth potential in the euro area.

**Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA)**

Moreover, we believe the bulk of opportunities remains in long dated IG European corporate bonds, which have outperformed the short dated bonds so far in 2016. The potential market knock on effect should be a gradual shift in market issuance to longer dated bonds since the programme will likely reduce the cost of funding, together with higher duration risk. However, the ongoing deleveraging of the European corporates’ balance sheet should prevent an unexpected spike in primary market activity.

**Conclusion**

We believe the CSPP is likely to remain in place until 2018 and the monthly purchases could be increased later this year or early 2017. Thus, we believe opportunities remain in core European BBB credit market, especially in domestic and infrastructure-related sectors as well as in long dated bonds.
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