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Euro IG corporate spreads have room to tighten

Summary

- European credit spreads should eventually move tighter to echo the gradual economic recovery in the Eurozone.
- ECB’s new corporate sector purchase programme reinforces our preference for European credit versus US credit spreads.
- Since the Eurozone recovery is mainly domestically driven, we believe domestic sectors will outperform globally exposed sectors.

The global sell-off of risky assets altered corporate bonds

The start of the year was marked by elevated financial market volatility, amid a sharp decline in Chinese equity prices and oil prices. This environment led to a downward repricing of riskier financial assets, with spreads of high yield (HY) bonds increasing more than investment grade (IG) ones. While the spread between high yield and investment grade yield rose, average corporate bond yields were broadly unchanged. Credit spreads rose mainly as a result of government bond yields falling. Yields on 10yr Treasuries and Bunds both dropped by 48bps year-to-date, to 1.79% and 0.15% respectively. Thereafter, the drops in risk free rates partly reversed as oil prices rebounded, economic data in the United States showed positive surprise and expectations of further monetary policy stimulus in the Eurozone eased investors’ fears.

ECB set to buy IG Corporate Bonds

Interest rates cuts, as well as the effects of the European Central Bank’s (ECB) quantitative easing programmes - namely, targeted longer-term refinancing operations (TLTRO) and the expanded asset purchase programme (APP) - have contributed to improvements in money and credit dynamics since 2014. Between May 2014 and January 2016, the composite lending rate on loans to Eurozone non-financial corporations (NFC) fell by more than 80 basis points (bps) to 2.09%, according to the ECB. Moreover, the spread between interest rates charged on small loans and those charged on large loans (above 1 million euros) in the Eurozone has followed a downward path since the start of credit easing. Overall, this indicates that small and medium-sized enterprises (SME), which rely on banks for 80% of their financing, have benefited most from the ECB’s programmes. The reason why the ECB has first focused on SME is that they are critical to the recovery in the Eurozone as they provide two thirds of the jobs in the region and even more in peripherals countries. By including Investment Grade euro-denominated bonds issued by NFC established in the euro area in the list of assets that are eligible for regular purchases, the ECB is now enlarging its programme to also support larger firms.

This new programme along with the prospect for a greater divergence between the Fed and the ECB surely reinforces our preference for European credit spreads versus US credit spreads. The expected scarcity of EUR IG NFC bonds due to ECB’s purchases has pushed their prices higher. On the day following the announcement, European credit spreads for Investment Grade (IG) and High Yield (HY) tightened, by 13bps and 46bps respectively1. We believe there is room for spreads to tighten further as we get more details on the programme.

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1 We took the EUR iTraxx Main Index for the EUR IG bonds and the EUR iTraxx Xover as a proxy for the EUR HY bonds.

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Sector performance

The economic recovery in the euro area is continuing, albeit with signs of a moderation in growth at the beginning of the year due to a weaker external environment. In 2015, real GDP grew by 1.6%, its strongest increase since 2011. The March 2016 ECB staff macroeconomic projections forecast somewhat lower euro area real GDP growth at 1.4% in 2016 (revised down 3bps from December), at 1.7% in 2017 (revised down 2bps) and at 1.8% in 2018. The continuing improvement of the economy in the Eurozone should stimulate risk appetite and thus drive spreads tighter.

The economic recovery in the Eurozone is mainly domestically driven, thus we generally prefer domestically exposed cyclical sectors such as Consumer Staples, Consumer Discretionary and Utilities, to globally exposed sectors, such as Chemicals, Industrials and Technology.

Year to date, Materials and Mining outperformed other sectors, with their credit spreads tightening by over 100bps and 200bps respectively. But, Materials credit spreads remain wide (at 105bps) by historical standards - average Credit Default Swap (CDS) spread since 2012 stands at 81bps. Despite its ongoing transition from investment to consumption based growth, China’s demand of aluminium, copper, nickel and zinc increased in 2015, according to data from the World Bureau of Metal Statistics. In addition, oil demand was strong in 2015, but the unexpected increase of supply more than offset the upward pressures on prices. Overall, we see room for spreads’ compression in Energy, Materials and Mining.

European corporates are still deleveraging

Given the steady improvement in the Euro area growth trajectory, core European profit margins have improved and should continue to do so. The profitability of core European firms showed improvement, with retained earnings registering a double-digit annual growth rate in 3Q2015. European corporates increased their cash holdings to their historical highs and subsequently reduced their external financing.

European firms have not taken advantage of their improving credit quality and lower interest rates to issue more debt. Euro IG corporates issuance activity has remained stable since 2013, as European firms continue to deleverage their balance sheets. This trend should not reverse until firms foresee higher revenues from organic growth. As the recovery is likely to be gradual, we do not expect a supply shock in the Euro corporates credit market. Thus, we think there is more room for profits in the European credit market than in the US credit market, since US IG corporates began deleveraging in 2011.
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