# Euro Investment Grade Corporates become the allocation of choice in 2023

Fixed Income Boutique

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**The changing trends are being substantiated as we start the New Year.**

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2023 Euro Credit Outlook

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# 5 Reasons to make Euro Investment Grade your allocation of choice in 2023

1. We had identified that Central Banks would become less aggressive with their rate hikes in 2023 and this now substantiated. The limited rate hikes this year should bring more tranquility to the rates markets and increased credit spread stability

2. Inflation continues to turn the corner on both side of the Atlantic and we note that Gas prices in Europe have resumed their decline and are now at pre-Ukraine invasion levels. Low gas prices through 2023 will be extremely supportive to the European Area (EA) economy and is a key determinant of inflation as inflation in the EA is for a large part supply/non-core i.e. Food and Energy. Gas prices in turn become a key driver to a milder ECB policy response rate, and the odds of just a brief recession have increased

3. The near recessionary spread levels priced in our EA Investment Grade corporate bond segment are very supportive to that effect, also given the solid corporate fundamentals. Our European Corporate Bond strategy starts the year with a running yield in the region of 4.5%, providing investors with a great cushion. When current running yields are that high (they have not been that attractive for sometime), one year forward-looking returns are statistically forecast to be in the high single digits and in our case in the region of 8%

4. EA Investment Grade technicals are to remain supported in 2023 even if the ECB only reinvests half of maturing corporate bonds in the their CSPP book for the year. The expected net overall bond supply of just 40 bn euros in our market is low

5. In all, spreads are seen as stabilizing and narrowing at least 20 to 30 basis points on average this year.

Source: ICE BofA A-BBB Euro Corporate Index (ERC0 Index), Vontobel, as of 1.2023. Forecasts based on internal/external analysis; not guaranteed; and actual outcomes may differ materially.

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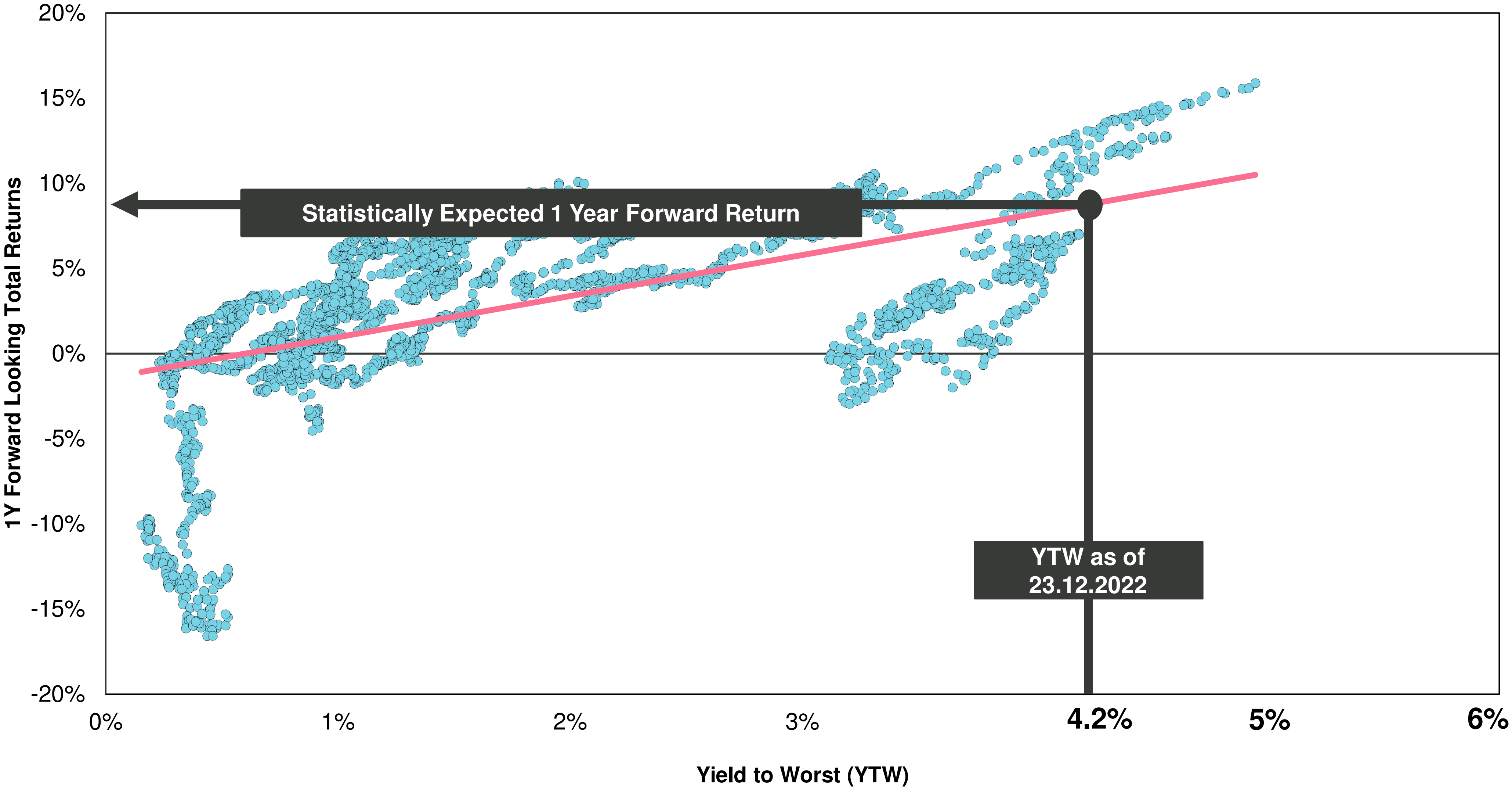
# One year forward-looking returns are statistically forecast to be high single digits as current running yields are high & have not been that attractive for sometime

## Regression of 1 Year forward-looking total returns on yield




**Past performance is not a reliable indicator of current or future performance.**

Forecasts based on internal/external analysis; not guaranteed; and actual outcomes may differ materially.

Source: ICE BofA A-BBB Euro Corporate Index (ERC0 Index), daily data range from 4.1.2010 to 30.11.2022.

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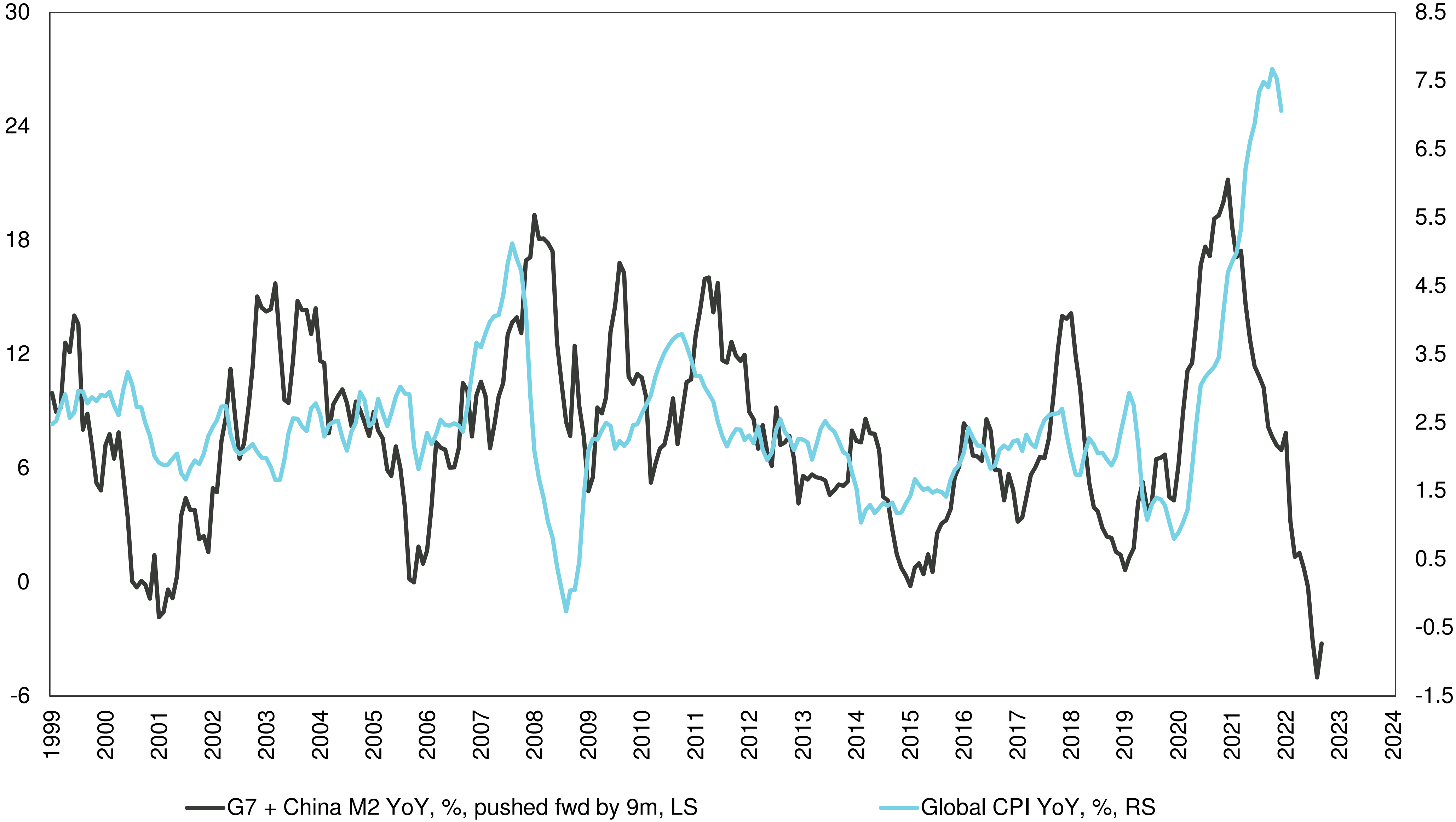
# The meteoric rise in M2 money supply since the onset of the pandemic resulted in elevated price pressures. M2 growth has since collapsed and inflation should start to fade too.




Source: BofA Research, as of 12.2022.

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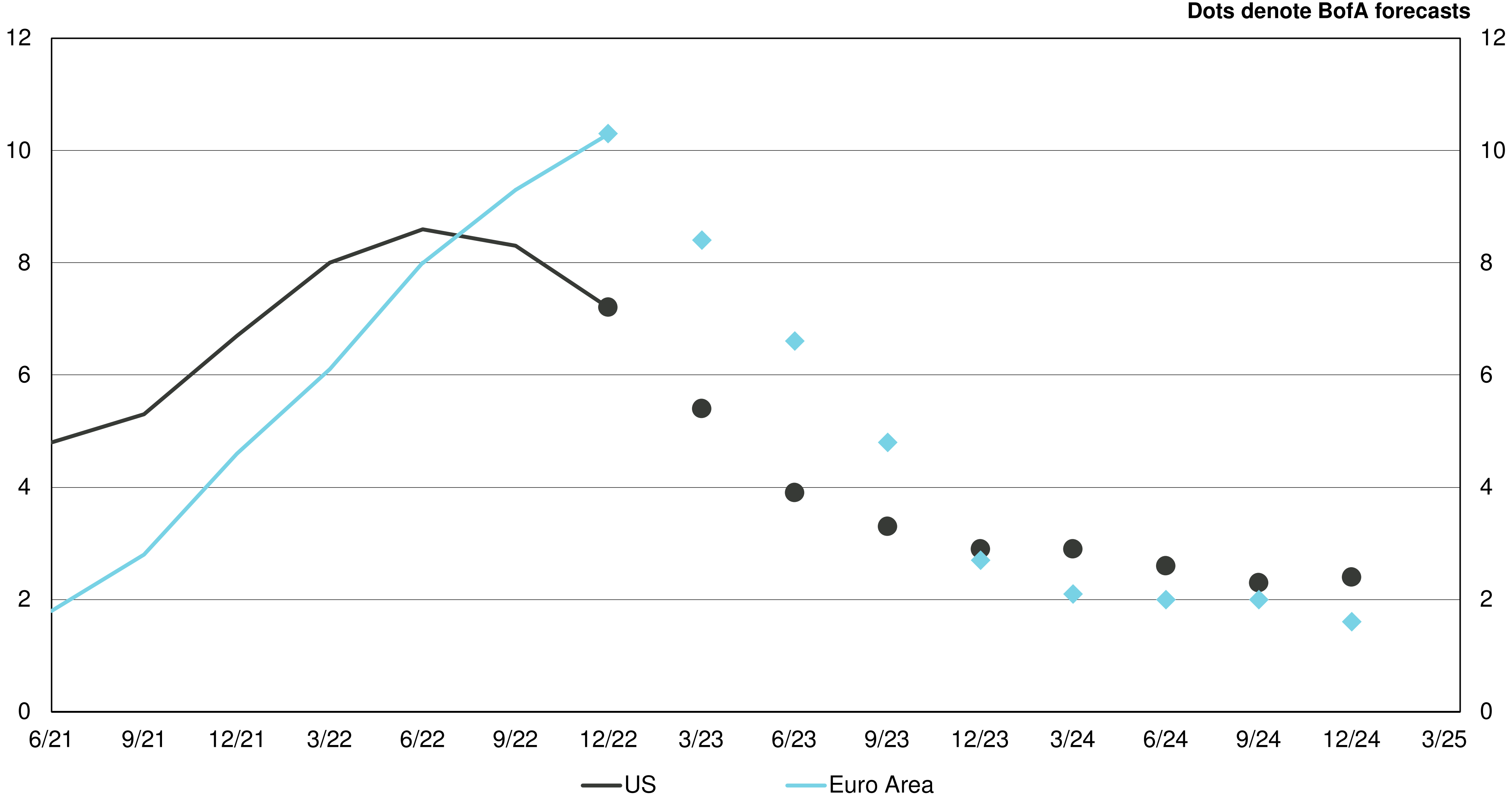
# Inflation has started moderating given a usual turnaround lag of 18 months after M2 money supply growth peaked in Feb 2021

## CPI YoY % (2Q21–4Q23E)




Source: BofA Research, as of 12.2022.
Forecasts based on internal/external analysis; not guaranteed; and actual outcomes may differ materially.

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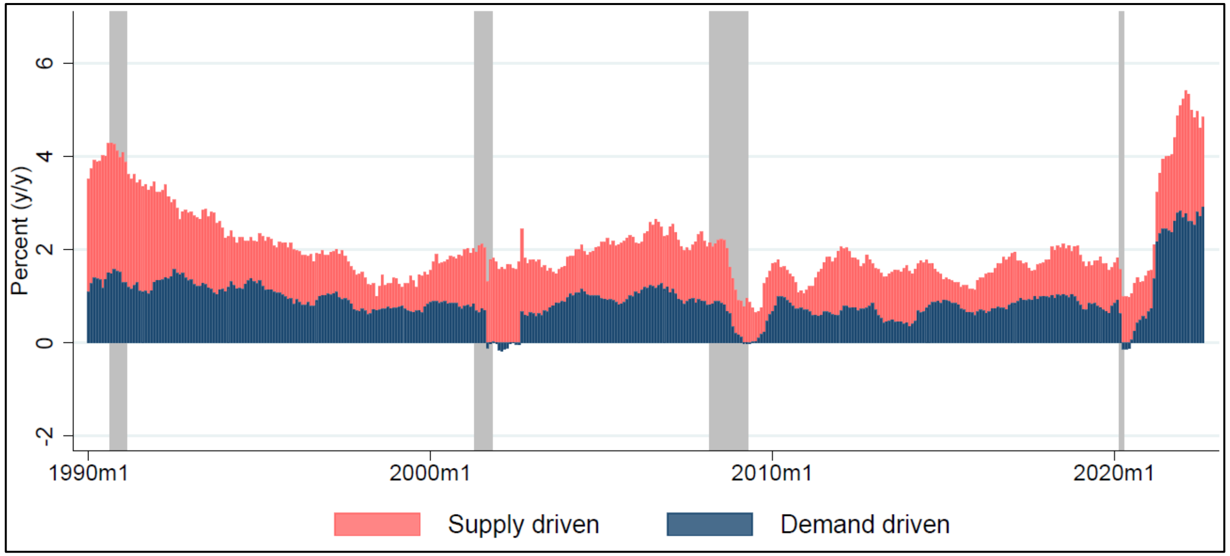
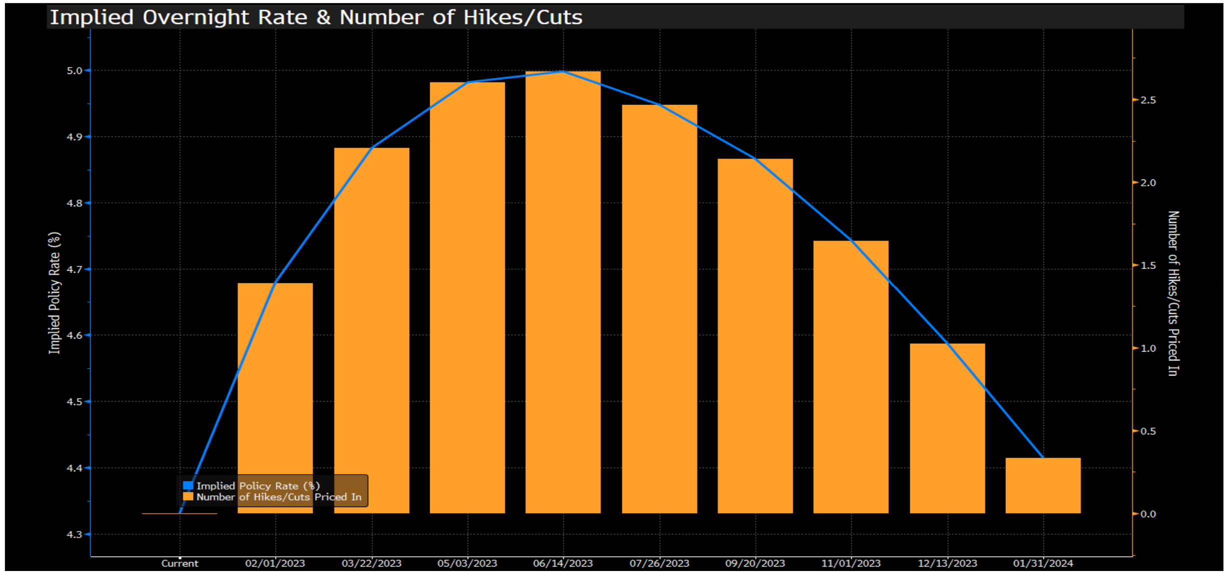
# Half of the US Core PCE is supply driven, and this contribution is receding as supply chain disruptions have eased…

The demand-driven contribution to Core PCE should also decline as the Fed Funds rate is now almost double the size of it, with Fed tightening typically impacting only this side of PCE.

Further, the Feds Fund rate is now forecast to track inflation or exceed it, with Chair Powell indicating that real borrowing rates for people are now meaningfully positive.




Source: Decomposing Supply and Demand Driven Inflation, Federal Reserve Bank of San Francisco, 10.2022. Bloomberg WIRP, as of 5.1.2023.
Forecasts based on internal/external analysis; not guaranteed; and actual outcomes may differ materially.

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# Real Borrowing Rates are meaningfully positive and restrictive as people do not borrow at the Fed Funds rates, but at much higher bank rates

## Key quotes from Chair Powell's November Q&A:

- **Nick Timiraos**

“Nick Timiraos of the Wall Street Journal. Chair Powell, core PCE inflation on a 3 or 6-month annualized basis and on a 12-month basis has been running in the high 4's, close to 5 percent. Is there any reason to think you won't have to raise rates at least above that level to be confident that you are imparting enough restraint to bring inflation down?”

- **Chair Powell**

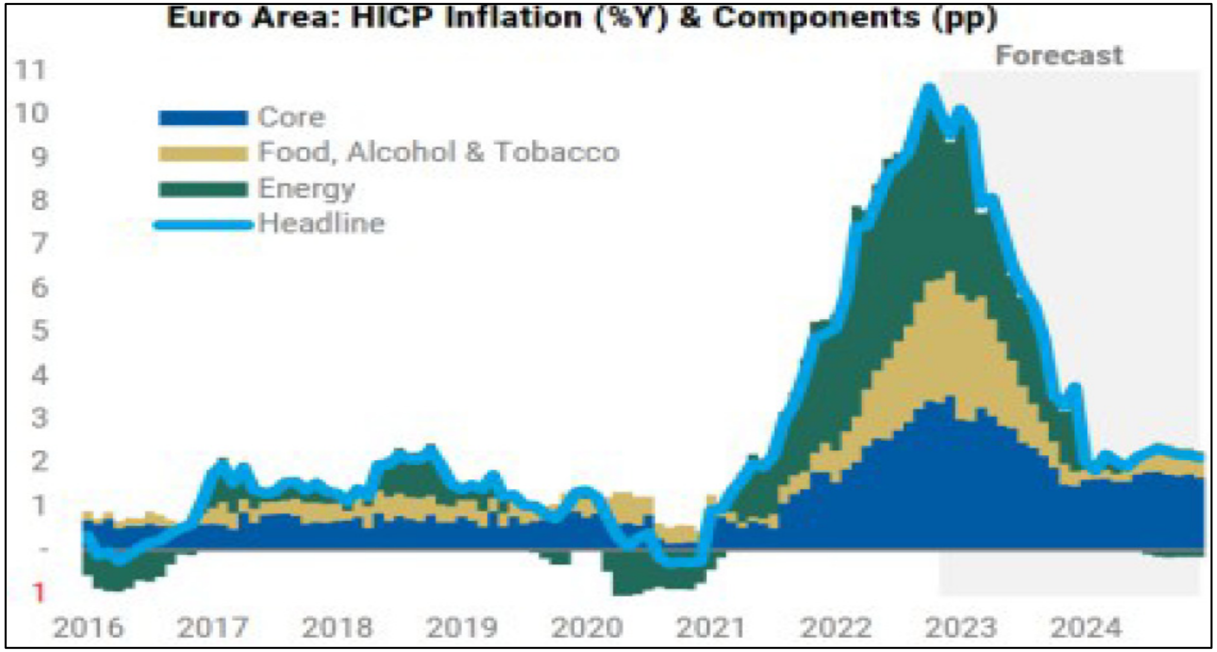
“So, this is the question of *[inaudible]* does the policy rate need to get above the inflation rate? And I would say, there are a range of view on it. That's the classic Taylor principle view. **But I would think you'd look more at a forward, a forward-looking measure of inflation to look at that**. But, I think the answer is, we'll want to get the policy rate to a level where it is, where the real interest rate is positive. We will want to do that. I do not think of it as the single and only touchstone though. I think you put some weight on that, you also put some weight on rates across the curve. **Very few people borrow at the short end, at the federal funds rate for example, so households and businesses, if they're very meaningfully positive interest rates all across the curve for them, credit spreads are larger so borrowing rates are significantly higher and I think financial conditions have tightened quite a bit.** So, I would look at that as an important feature. I'd put some weight on it but I wouldn't say it's something that is the single dominant thing to look at.”

Source: Federal Reserve Bank, as of 12.2022.
Forecasts based on internal/external analysis; not guaranteed; and actual outcomes may differ materially.

# Gas prices are a key determinant of the way forward for EA inflation, and consequently the ECB policy response rate. The one year forward curve sees much lower prices

About 70% of inflation in the EA is supply or non-core i.e. Food and Energy.

With these components easing, especially Gas prices, the ECB policy response rate should be milder and the odds of a mild recession have increased.


Source: Bloomberg Netherlands Nat Gas 1 year forward index; Morgan Stanley HICP decomposition.

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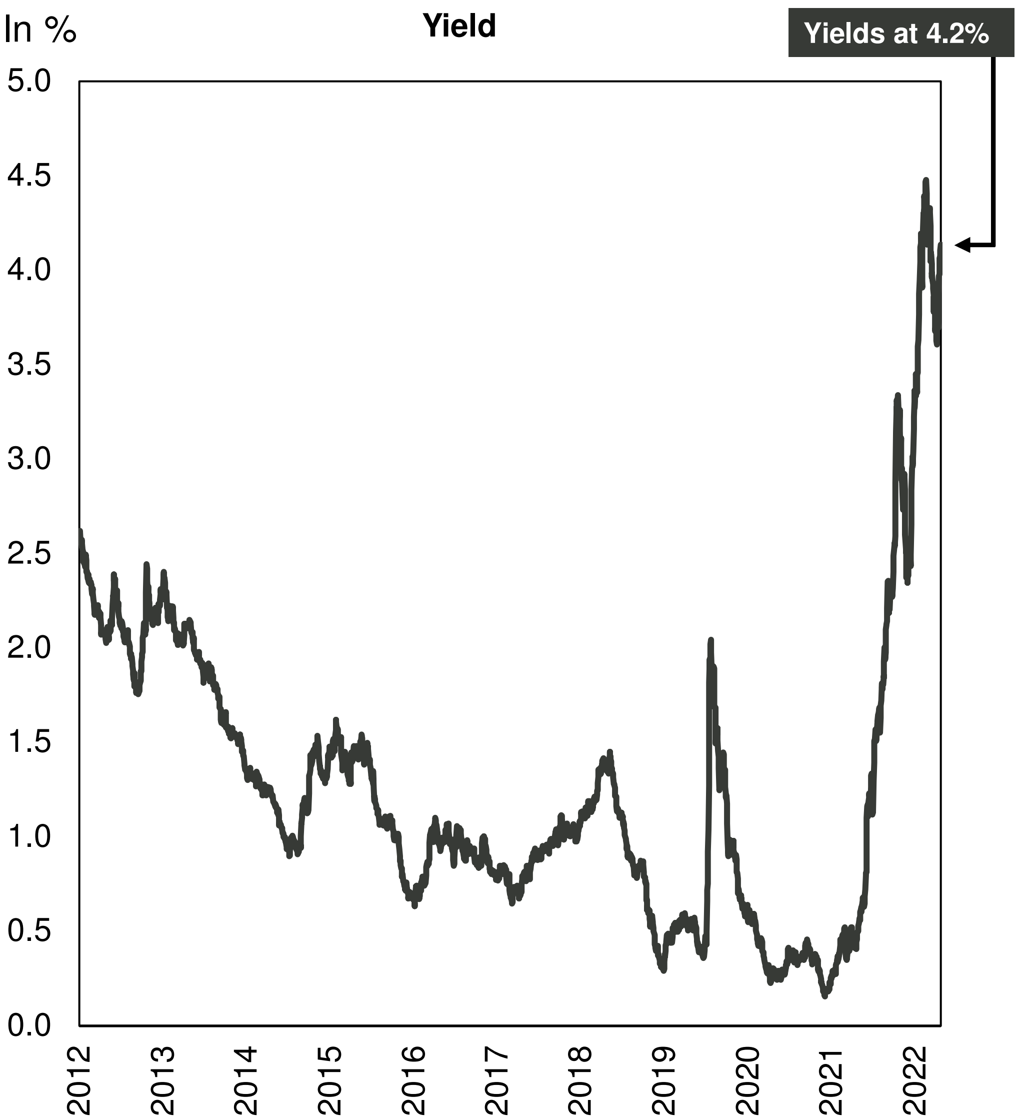
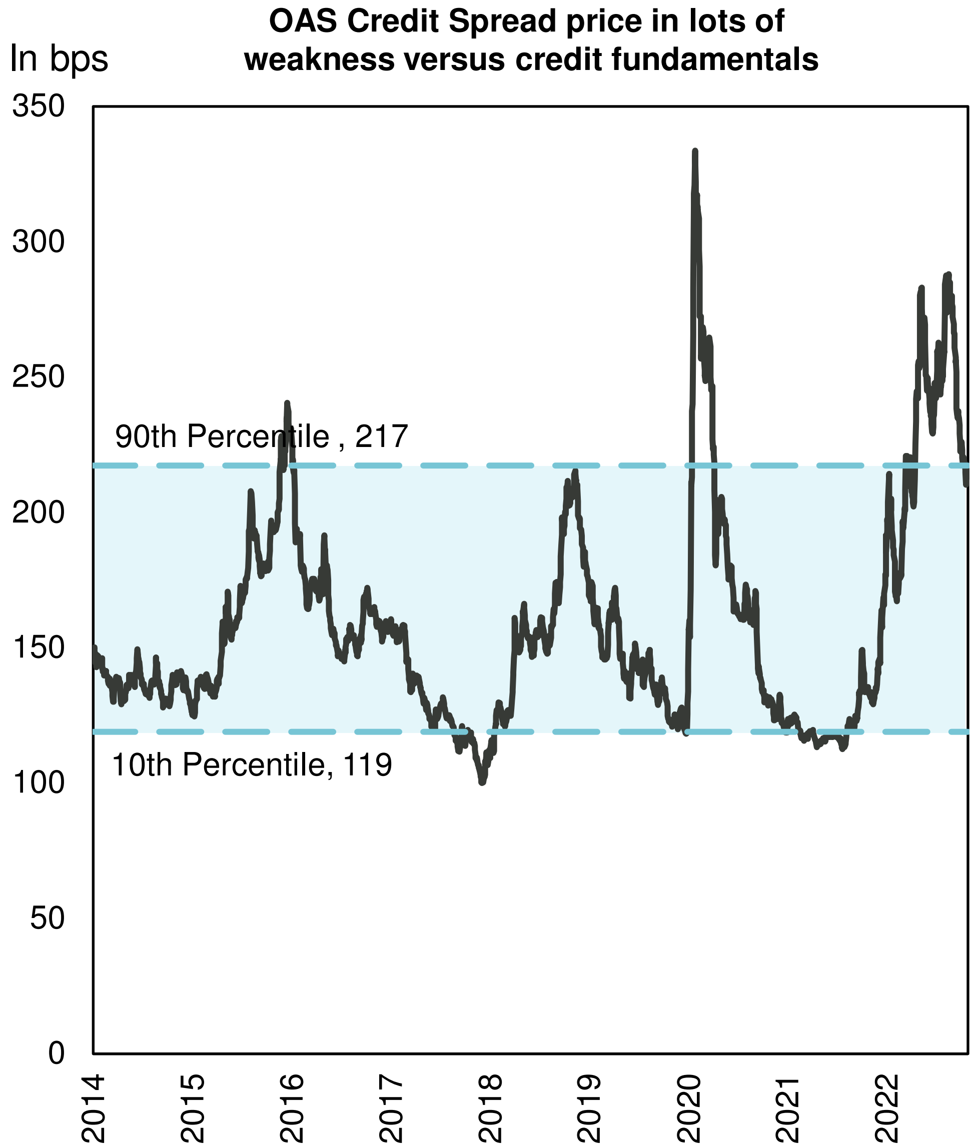
# European Corporates have not been that attractive for a very long time with higher yields and higher spreads hence offering great coupons




Source: Left chart: ICE BofA A-BBB Euro Corporate Index (ERC0 Index). Right chart: Composite 80% ERC0 Index, 20% HE10 Index. Data as of 23.12.2022.

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# European Area Credit spreads more than compensate for default risks based on a typical 40% recovery assumption

| | 5Y SPREAD | IMPLIED DEFAULT RATE* | WORST DEFAULT RATE* | AVERAGE DEFAULT RATE* |
|---|---|---|---|---|
| EUR IG | 175 | 13.5% | 2.4% | 0.4% |
| AA | 90 | 7.3% | 0.0% | 0.0% |
| A | 122 | 9.6% | 1.8% | 0.2% |
| BBB | 210 | 15.8% | 5.8% | 0.8% |

Source: Deutsche Bank, ICE BAML Indices, since inception, as of 12.2022.
*Default rates, cumulative 5 year and based on typical 40% recovery assumption.

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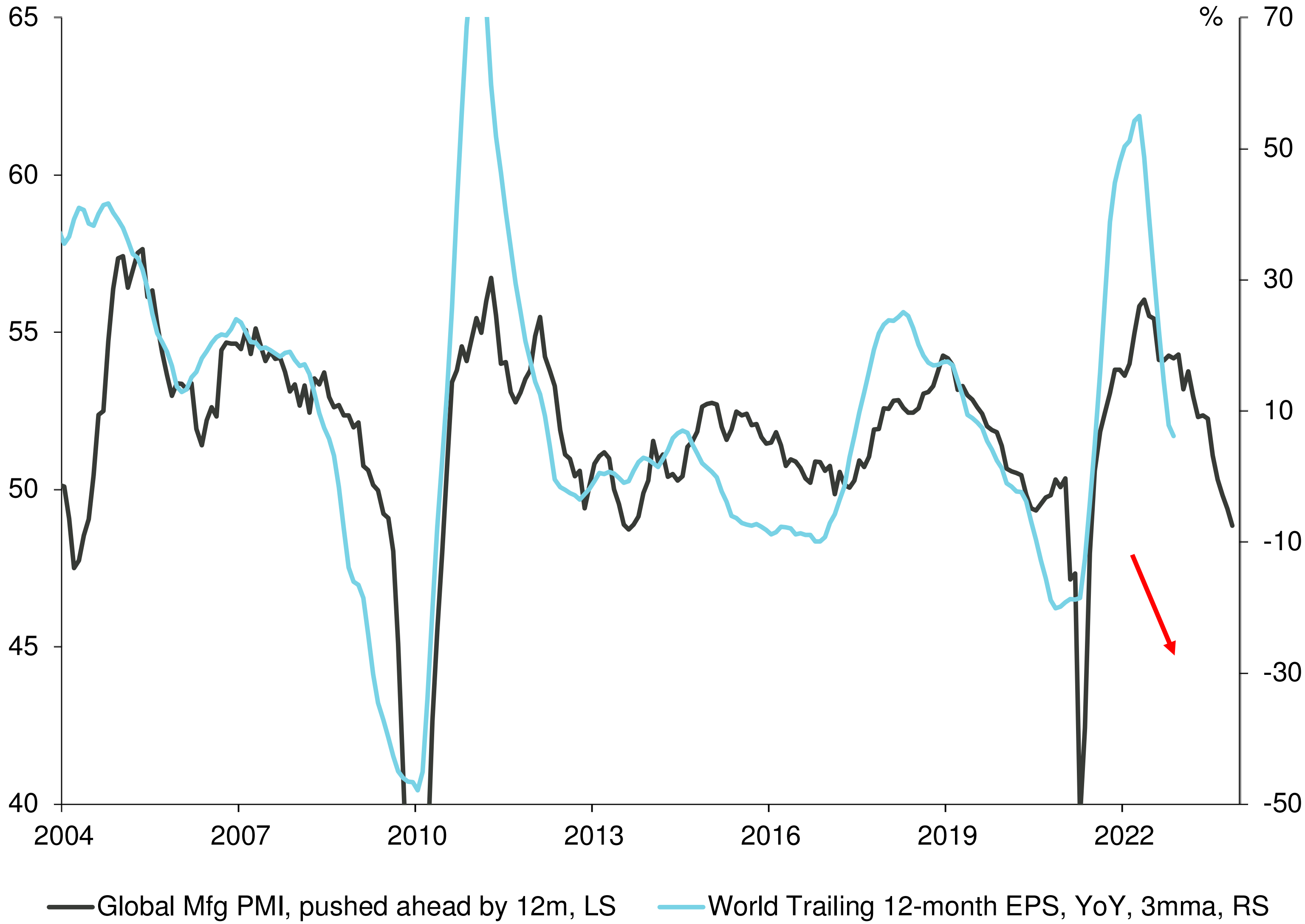
# At current levels of PMIs one year forward, earnings growth for the next 12 months should not collapse & should remain supportive of credit spreads

**Next 12-months Earnings growth:**

PMI-implied = 2.9%

Consensus = 3.1%




Source: BofA Research, as of 12.2022.

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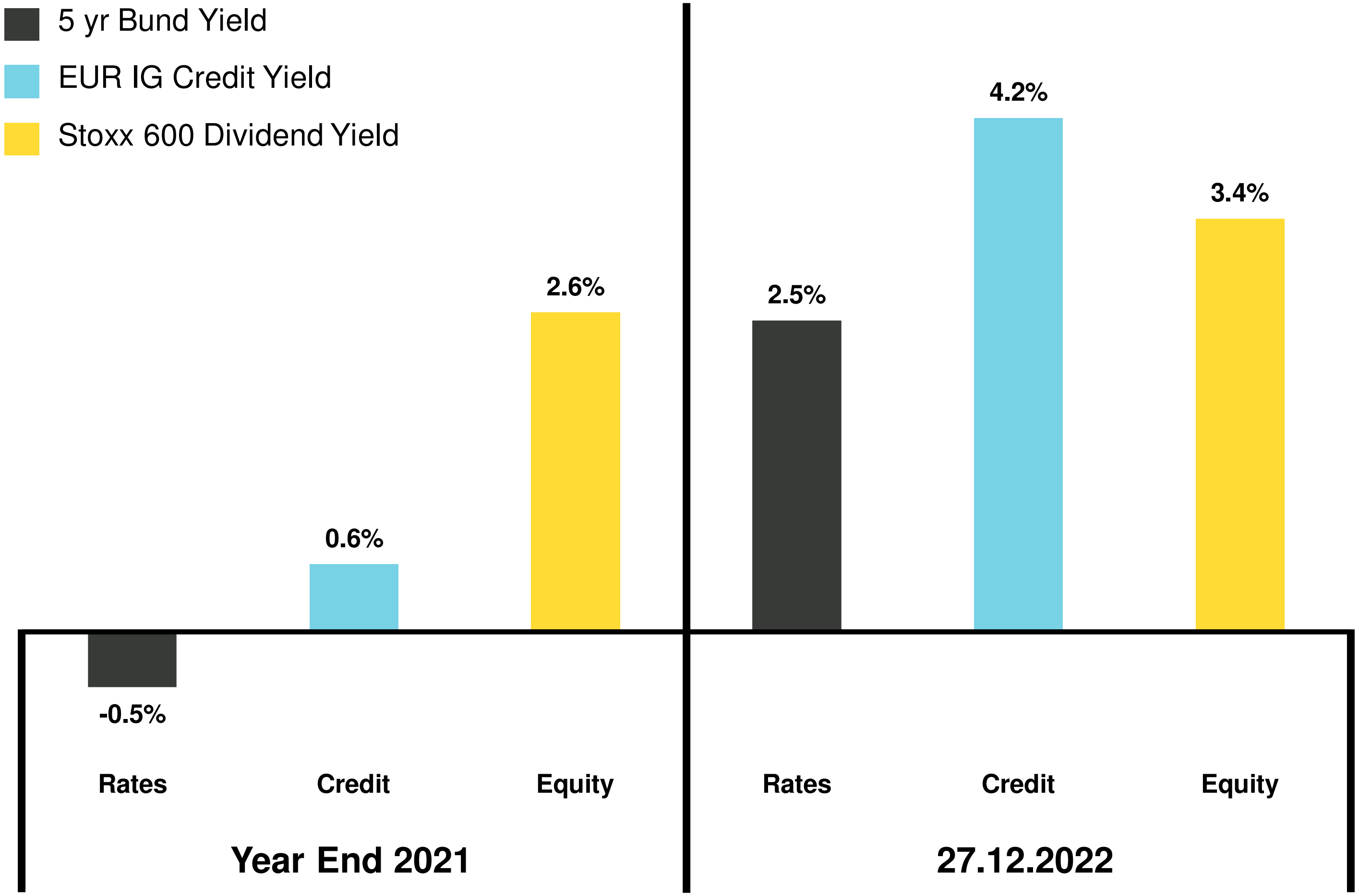
# Investors start the New Year upbeat for European IG corporate bonds




Source: Goldman Sachs, Vontobel, Bloomberg, as of 12.2022.

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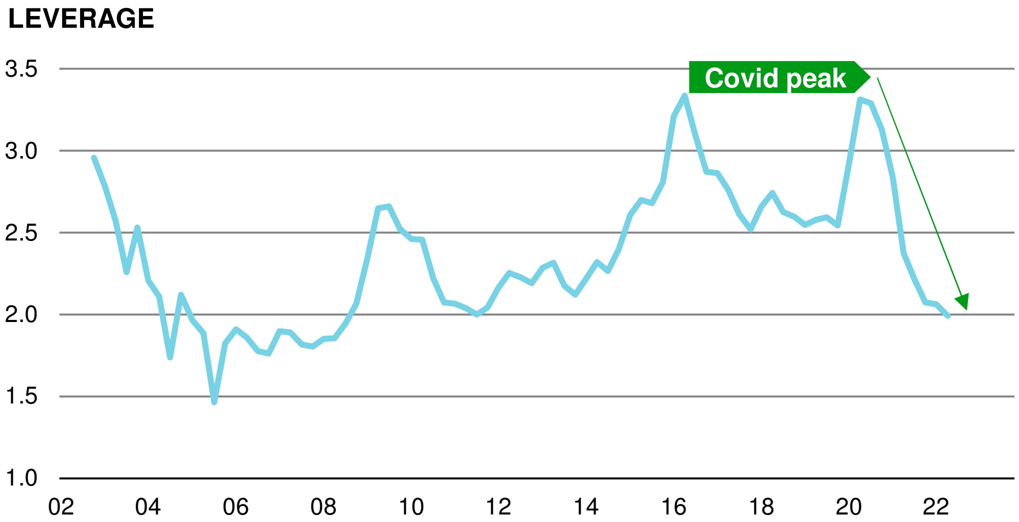
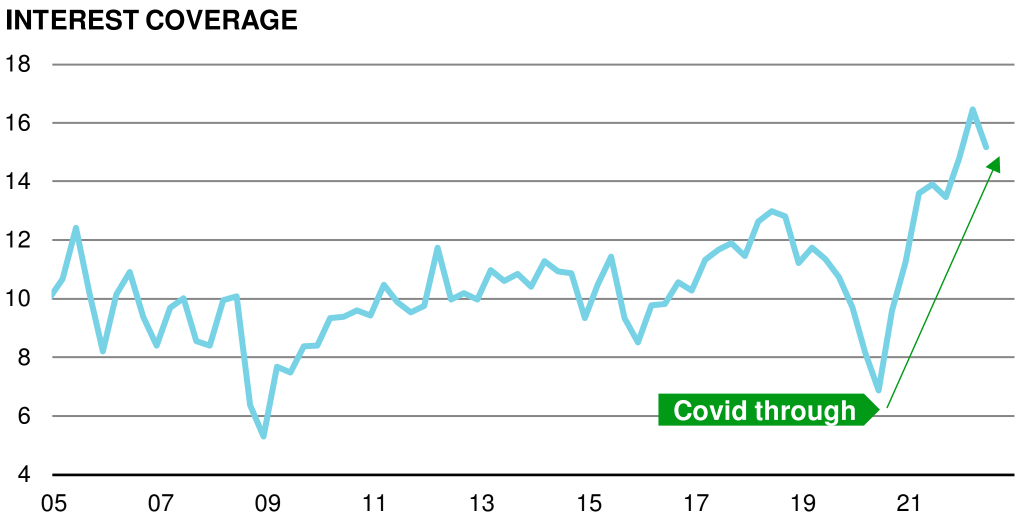
# Credit metrics are stronger than during the pandemic. Adjusted for this strength, credit spreads may well have peaked

## Credit metrics looking strong…

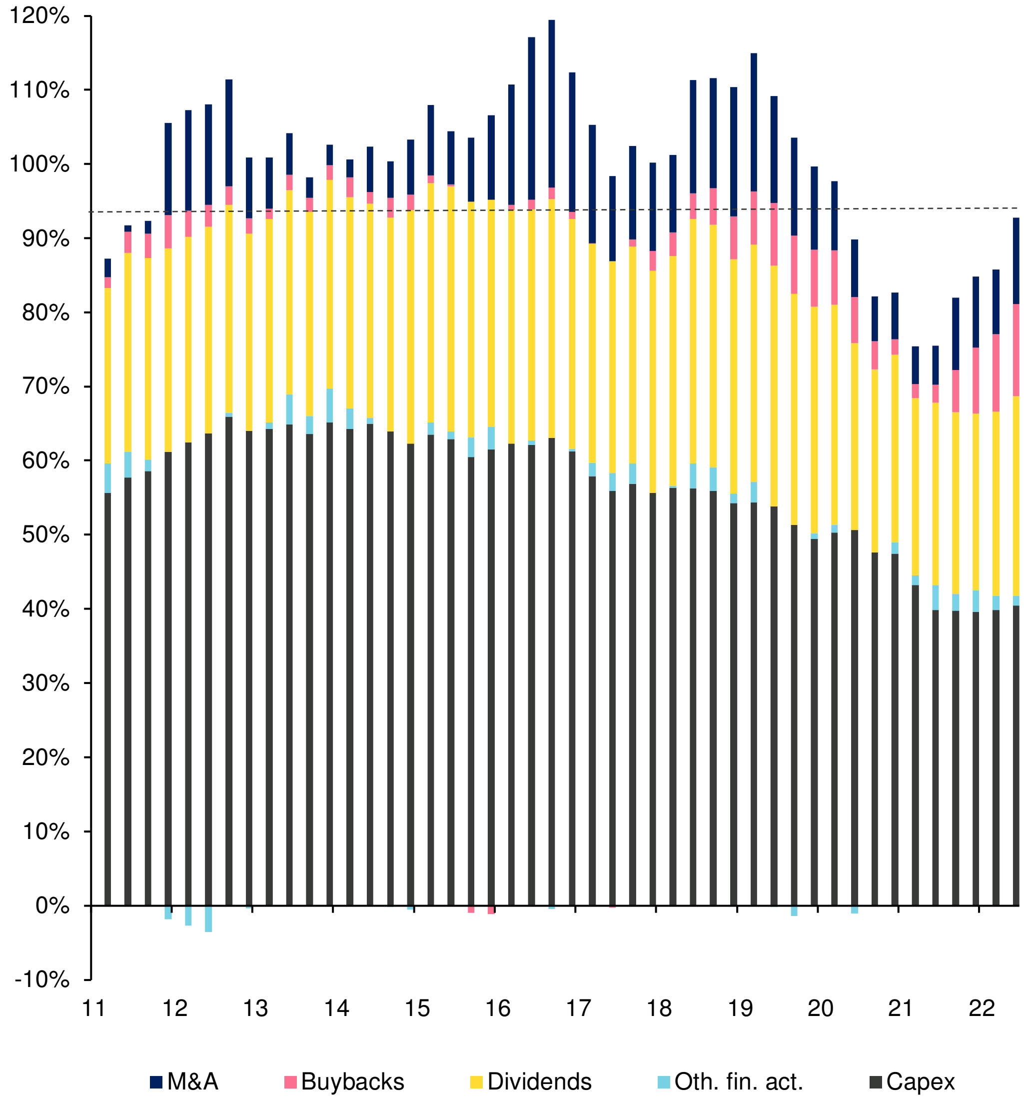
### Leverage & interest coverage for sample of European corporates




## …as companies do not spend all OCFs.

### European corporate expenditures, % of operating cash flows




Source: Citi Research, Bloomberg, as of 9.2022.

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# European Investment Grade technicals should be supportive on limited net supply

## 2023 Euro IG supply estimates, EUR B

| | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|---|---|---|---|---|
| Gross supply | 406 | 438 | 439 | 414 | 553 | 567 | 487 | 460 | **450** |
| Redemptions | 235 | 239 | 270 | 209 | 236 | 255 | 277 | 333 | **382** |
| Coupons | 47 | 43 | 41 | 40 | 40 | 39 | 37 | 37 | **41** |
| Net CSPP/PEPP | 0 | 51 | 84 | 34 | 6 | 87 | 79 | 36 | **-13** |
| **Balance** | 124 | 105 | 44 | 131 | 271 | 186 | 94 | 54 | **40** |

Source: JP Morgan, as of 12.2022.

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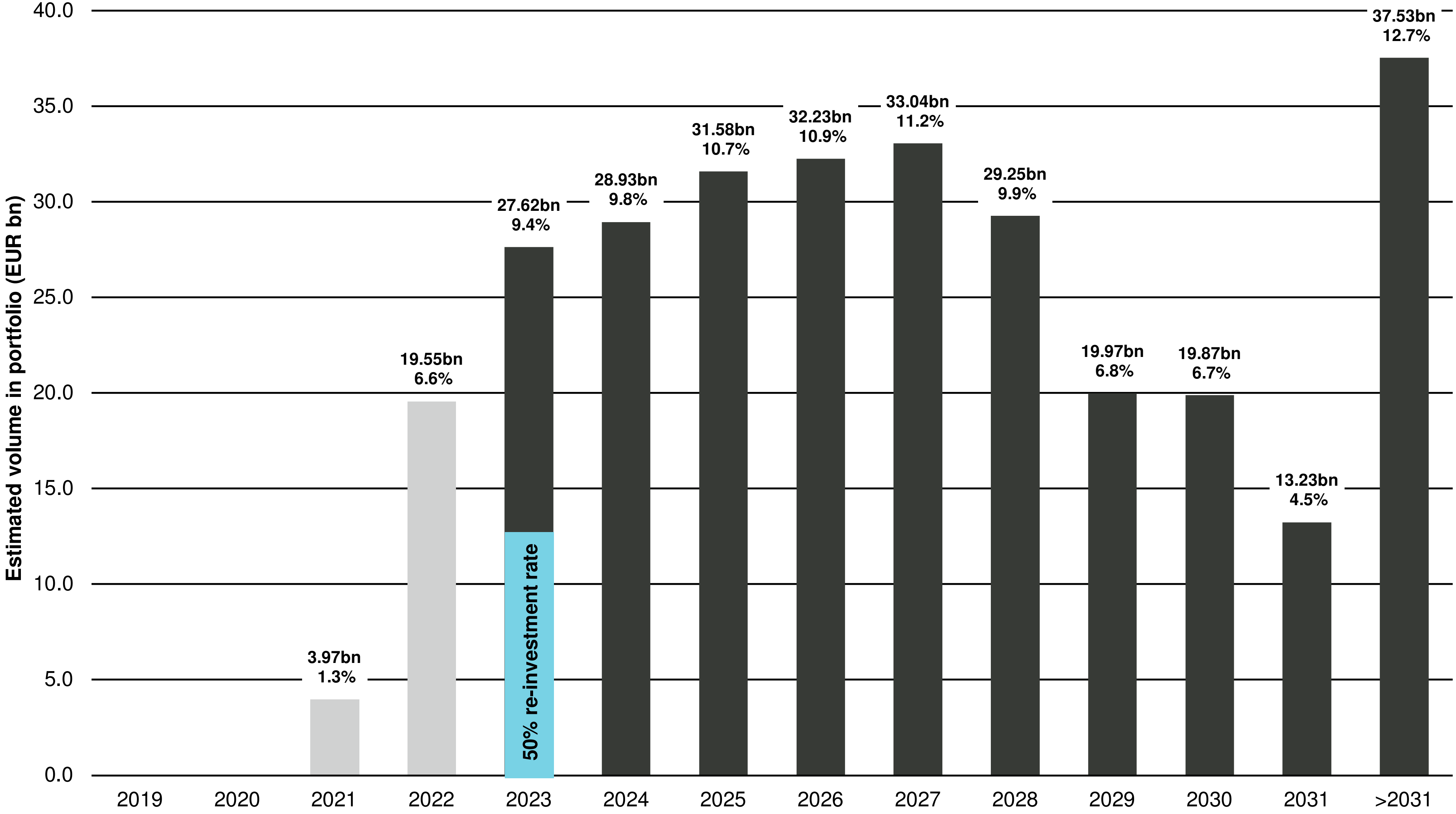
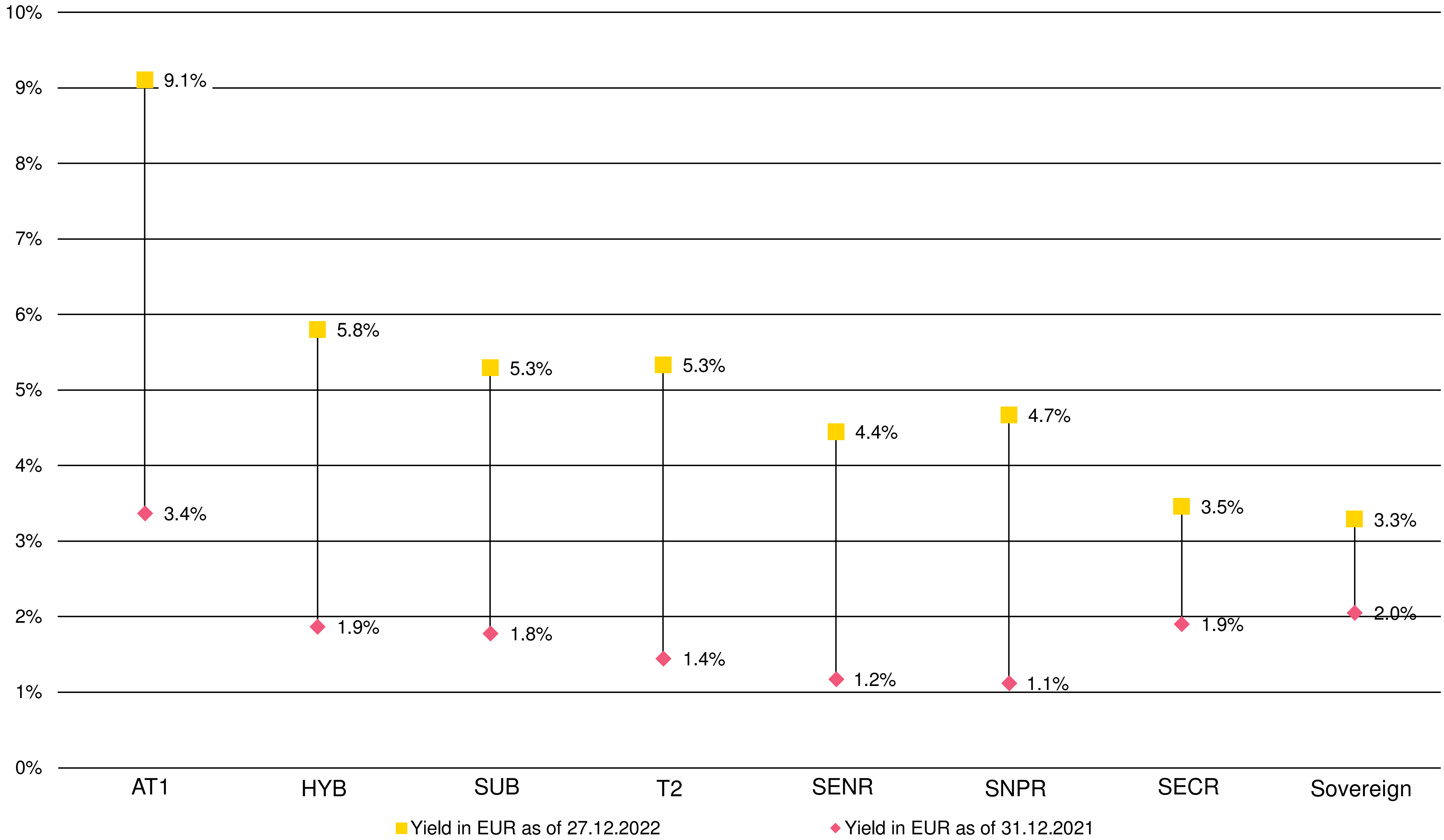
# ECB should still normally purchase an average of just over EUR 1.0 B of corporates per month in 2023 or about half its maturing bonds for the year




Source: UniCredit Research, as of 9.2022.

# How to benefit from current market conditions given solid corporate fundamentals?




Source: Vontobel Asset Management, as of 27.12.2022.

We are well aware of potential risks to our base case and stand ready to hedge/amend our current credit strategy



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# Main risks to our base case

**Overtightening by central bank(s) and subsequent severe recession**

**Negative earnings revisions above and beyond expectations**

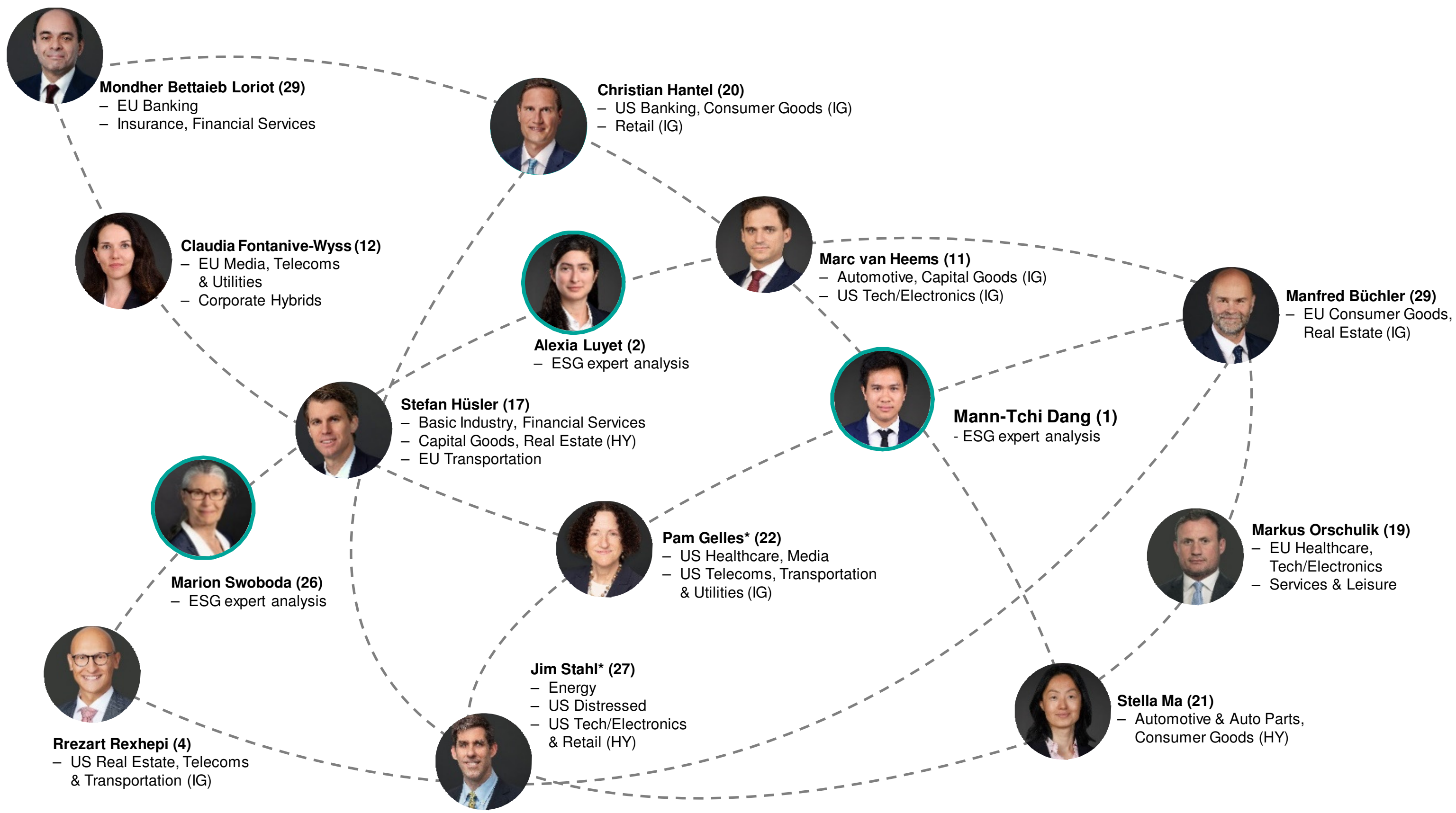
**Further escalation of the Russia/Ukraine conflict**

**Colder winter in Europe driving energy prices higher**

# Back to basics: rigorous credit selection enables swift allocation to best opportunities in our universe

## *Rigorous bond analysis and selection is key to our performance*

Experienced over multiple market cycles and with deep industry expertise, the team continually monitors the investable universe to identify the best opportunities.




(XX) = years of experience. *Based in New York.
Global coverage across Investment Grade (IG) and High Yield (HY), unless specified.

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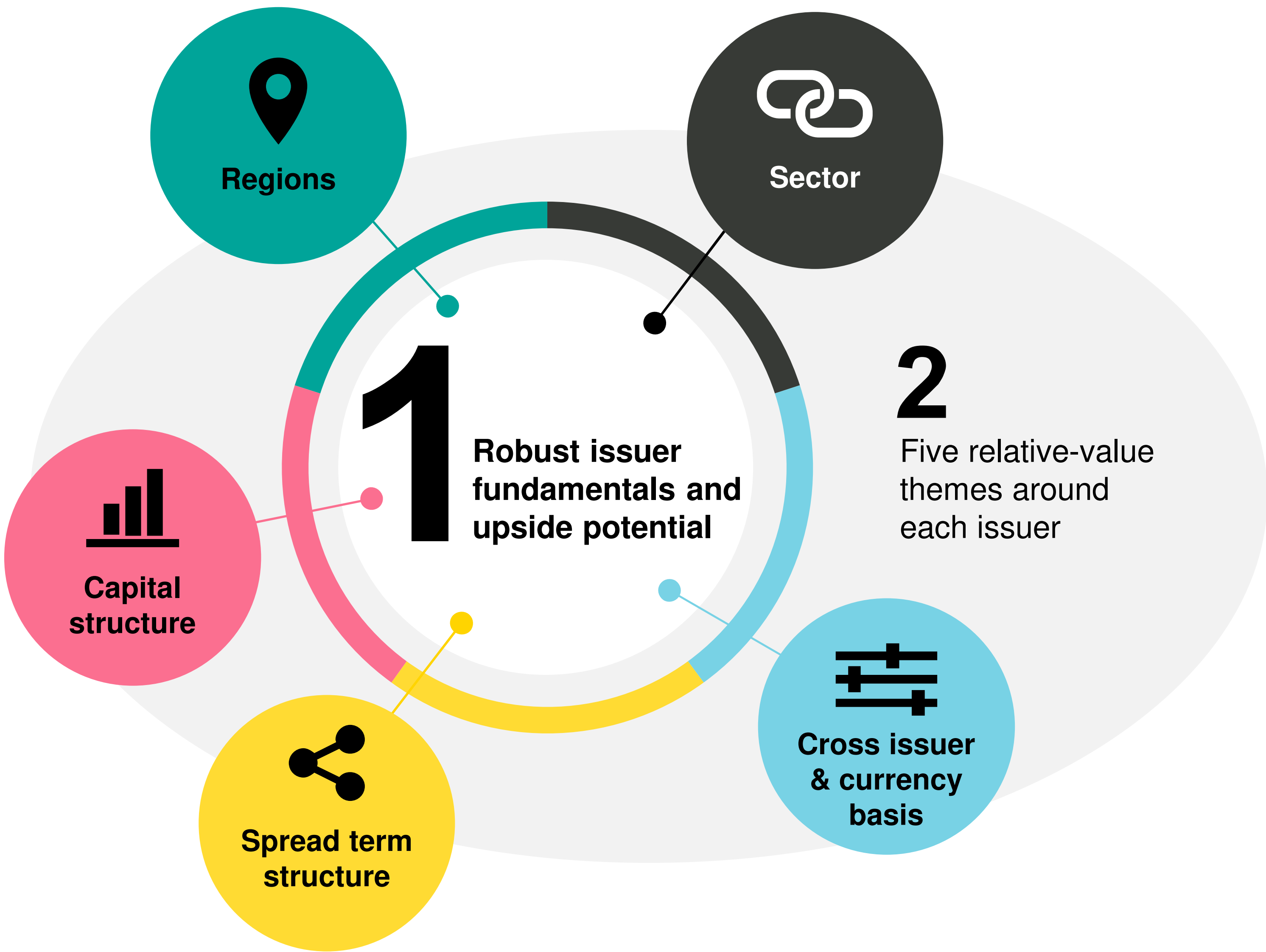
# We only invest in robust issuers

## *Two core drivers*

(1) Pure high-conviction issuer selection driven by bottom-up credit research, (2) while actively seeking to exploit relative-value themes.



# Thank you.

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# Appendix

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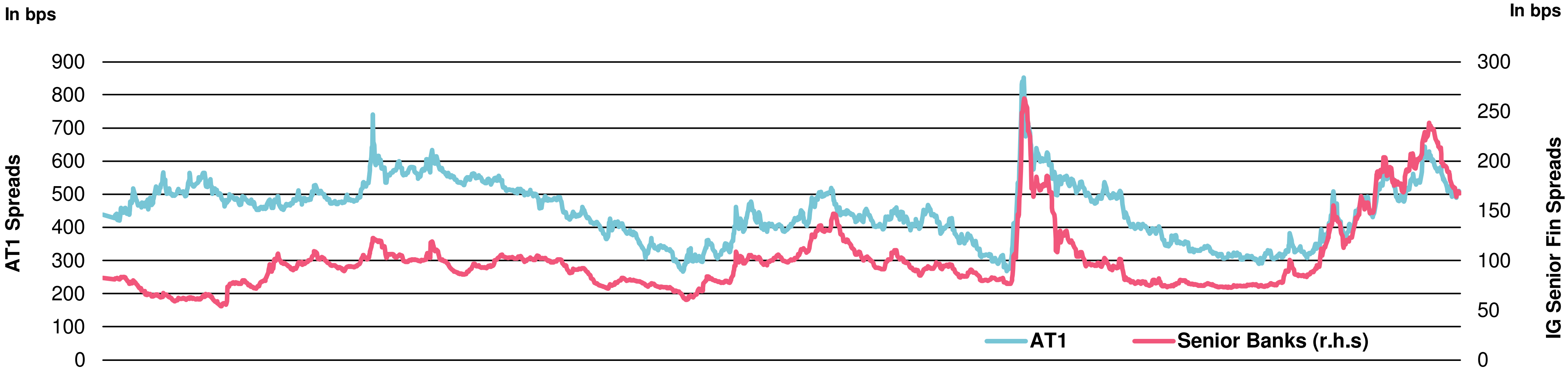
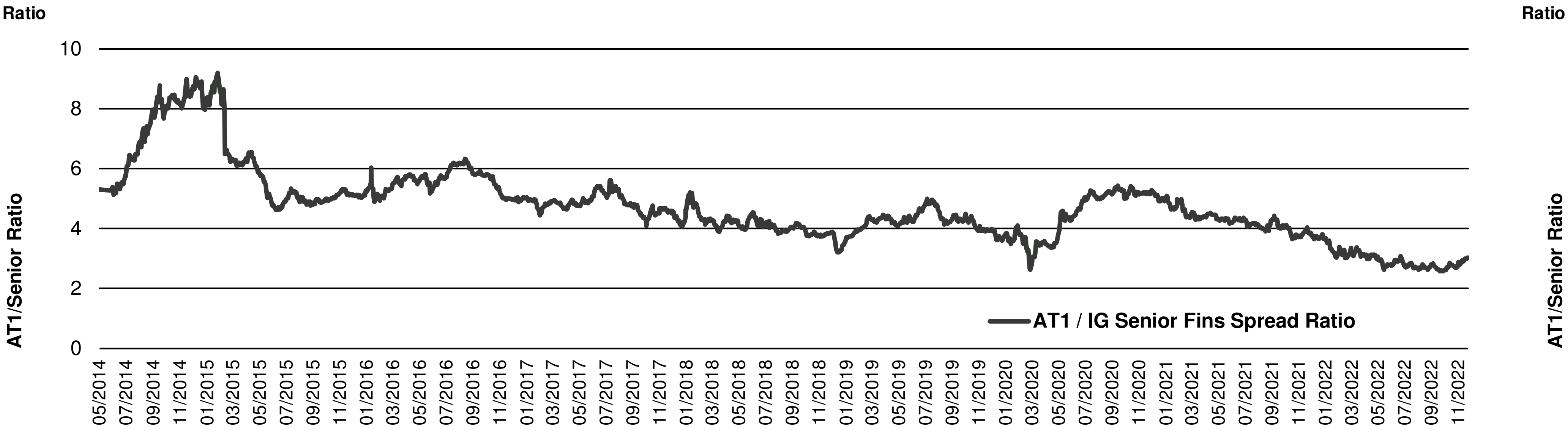
# Low risk senior non-preferreds have not been that attractive for a long time offering the opportunity of a balanced barbell strategy




Source: Bloomberg Barclays Indices, as of 23.12.2022.

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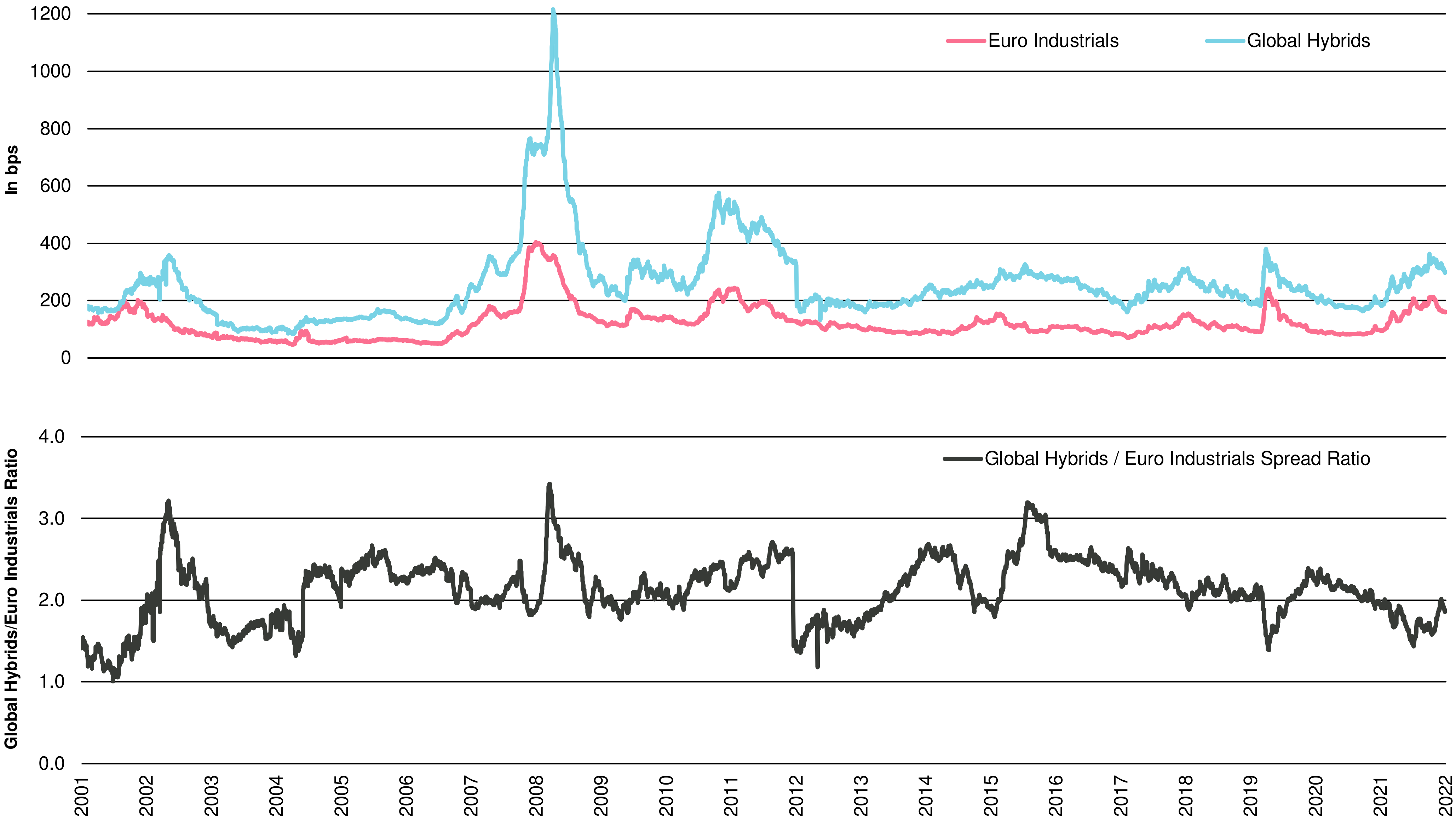
# Corporate Hybrid technicals should benefit from near-zero net supply & valuations should offer good carry




Source: Bloomberg, ICE BofA Indices (EJ00 Index, G0EC Index) as of 31.12.2022.

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# European Investment Grade technicals should be supportive on limited net supply

## Only about EUR 20 billion of net financial issuance is forecast for 2023

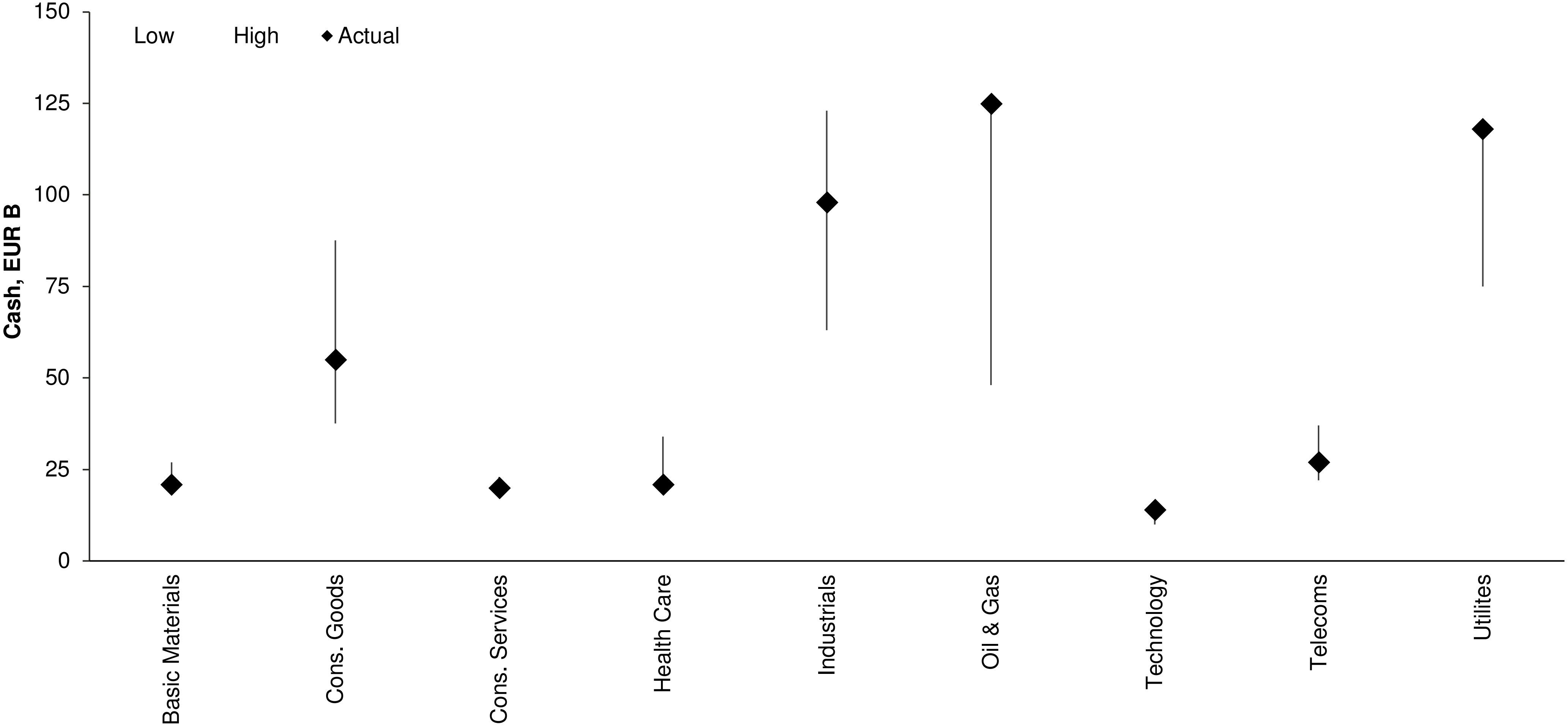
| Financials supply estimates (EUR B) | Gross Issuance (EUR B equiv) | Net Issuance (EUR B equiv) | % EUR | Gross Issuance (EUR B) | Net Issuance (EUR B) |
|---|---|---|---|---|---|
| Preferred Senior | 110 | -13 | 60% | 66 | -8 |
| Non-Preferred Senior | 130 | 18 | 45% | 59 | 8 |
| T2 | 35 | 3 | 60% | 21 | 2 |
| Insurance | 22 | 5 | 75% | 17 | 4 |
| REIT | 10 | -2 | 100% | 10 | -2 |
| Non-European/other | 30 | 15 | 100% | 30 | 15 |
| **Total** | | | | **202** | **19** |

Source: JP Morgan, as of 12.2022.

# European Investment Grade technicals should be supportive on limited net supply

## Consumer goods companies, general industrials, Oil & gas and Utility companies have high cash balances and may only require very limited issuance in 2023

### European (ex-UK) Investment Grade Cash Balance Sheet by Sector, EUR B 2012–2022 range




Source: JP Morgan, S&P Capital IQ, as of 12.2022.

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