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Credit investors now have the opportunity to purchase great coupons from fundamentally solid European IG corporates

Fixed Income Boutique

Autumn Credit Outlook 2022

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The opportunity to purchase great coupons from fundamentally solid Investment Grade (IG) companies is here and available

MACRO

The last FOMC suggests the US economy can still slowdown in an orderly way, notwithstanding raising their benchmark interest rate by 75bp for the third straight time. The path to soft landing has definitely narrowed as the Fed has slashed growth estimates for this year to just +0.2%. Weakness in economic activity will be spread more broadly and with a lag, and this is also why lower employment, lower money creation and lower inflation should follow suit which represents our base case. It all works with a lag of course with inflation forecast and certain inflation measures pointing to an eventual deceleration from Q4. We are at the lower band of restrictive territory with the Fed likely to keep going until job gains start to ease materially. Powell acknowledged that weakness in jobs started materialising during his Q&A but did not sound too concerned, managing well his narrative for a higher peak rate still (4.25% as potential average). The ECB is on a similar path with the prevailing view that a neutral level for the deposit rate is likely to be 1.5%. They will of course need to move to restrictive too and one could foresee a peak rate in the region of 2.25%. The only difference with the US though is that the risk of a mild recession is higher in the Euro Area.

VALUATION

The good news though is that the market suggests that an end of the US rates cycle is in sight. Limited hikes in 2023 should bring rates stability and with it credit spread stability. European Area credit spreads are also very near recessionary levels and price in a lot of weakness.
As a matter of fact, when adjusted for very solid credit fundamentals, we wonder if credit spreads may have already reached their peaks for this cycle as credit metrics are much stronger than during the last Covid pandemic. For instance leverage is much lower today (at near 2.0X versus 3.2X during Covid) with spreads not too far away from peak Covid levels: peak fund spreads at 275 bp most recently versus c. 330 bp during Covid respectively (see slides 10 & 13). In other words, the spread for one turn of leverage is more elevated today, and this is not justified in our opinion.

SENTIMENT

Sentiment is not crumbling in our view with good things to come. We do expect PMIs to cool off over the next twelve months but we do not expect earnings to collapse and as such earnings revisions should be lighter than forecast: world PMI implied earnings growth of +3.5% over the next 12 month according to Bank of America and still in positive territory – see slide 12.
We made this our base case as US consumption, whilst likely to get squeezed, should still enjoy some support from the lower gasoline prices and considering that the employment picture there should still remain quite resilient despite being weakened by the Fed hikes – the case for soft landing in the US remains alive.
For the European area, although the higher the peak rate the ECB aims for, the greater the recession risk, the consumers' real demand for both services and goods has now flattened. As such there is good cause for rates not to move to too restrictive of a territory in the end as inflation is much more energy supply induced rather than demand driven. The risk of a wage spiral in the Euro Area is also relatively contained. In turn, a less aggressive rate path when compared to the Fed should lessen the magnitude of any downturn.
In addition, Germany, France and Spain have announced fiscal offsets to shield the consumer from the gas price burden with Italy to follow. We also see TTF gas prices staying lower after having fallen, as reserves levels are now very healthy (near 90% in Germany) and with Europeans now quite keen to jump on the energy savings bandwagon.
On the continent, we note that earnings revisions have also held up thanks amongst others to a very strong banking sector that should enjoy record net interest income in 2023 and not much higher provisions. The European banks have not fully consumed the provisions set aside during the Covid pandemic as these were not fully released back, but were rather prudently kept by management teams.
All of which should ensure that credit spreads remain quite resilient from now on and as we slowly start transitioning onto 2023. In fact we think that European corporates have not been that attractive for a very long time with higher yields and higher spreads offering great coupons for their current relative credit fundamentals.

TECHNICALS

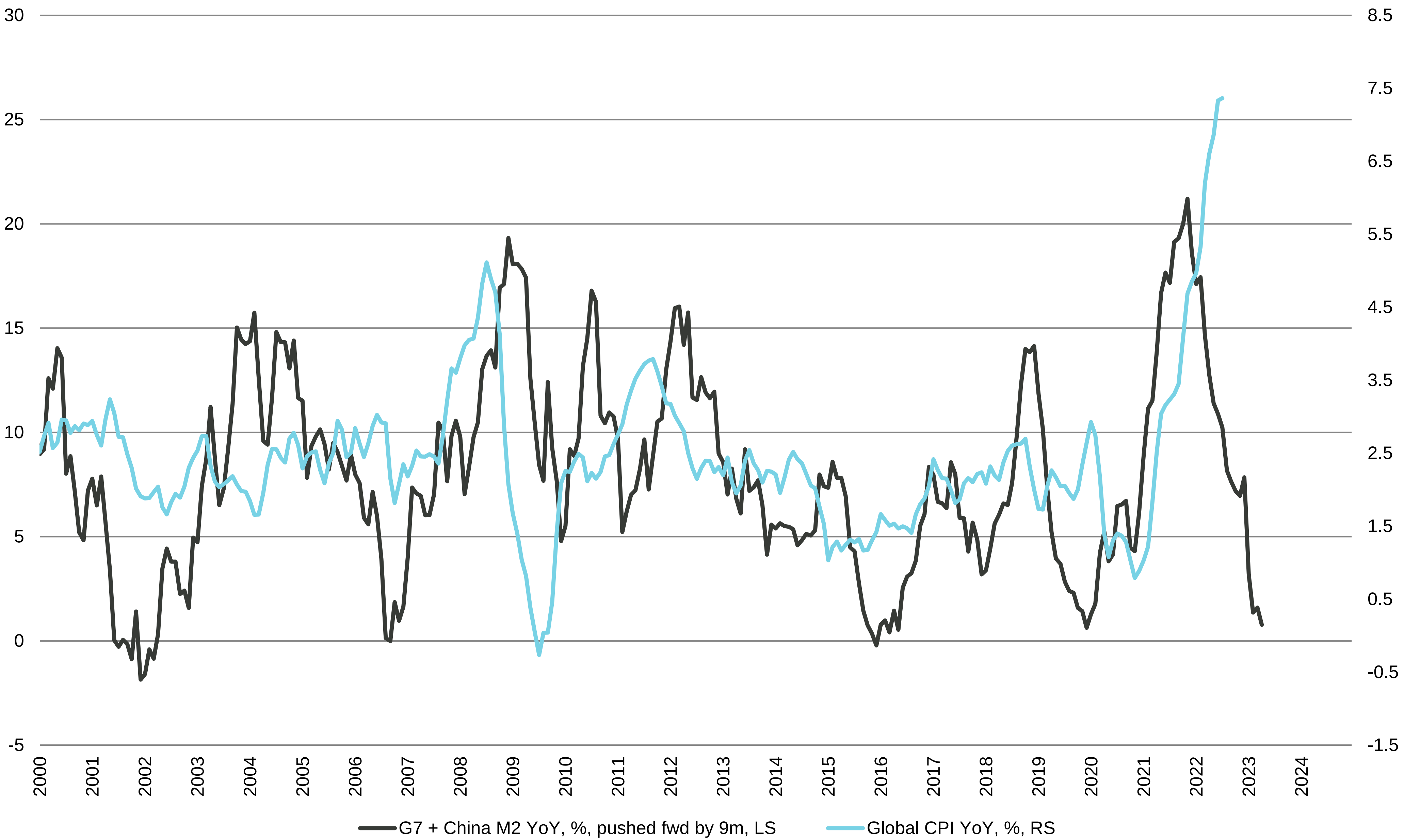
The credit markets' technical also remains supportive with the rates markets pricing in peak rates that are quite restrictive in both the US and European Area already. Better rates visibility for 2023 should bring about credit spreads stability as already mentioned too. The ECB continues to re-invest its corporate book and that is still creating good demand with about 28 bn re-investment need scheduled for next year. This should continue to support our Euro Area corporate market, at a time when corporates are not fully spending their operating cash flows given static capex spending. This means in turn that issuance levels could also well decelerate, and this was actually the trend observed for the third quarter with issuance tracking much lower compared to Q3 2021. The new issue market we believe should stay quite open, given this lower expected issuance, and given the more attractive credit yields that are on offer. In fact, IG yields have become quite enticing to investors in both absolute terms and relative to equities which should ensure the successful placement of new issues from fundamentally solid companies.

CONCLUSION

We have become more optimistic about the state of the IG market as there is still a path to soft landing in the US in our view. The near recessionary spread levels priced in in our European Area IG corporate bond segment are also very supportive given the good and current corporate credit fundamentals.

We have gradually reduced our hedge protection during the course of September to a neutral stance. We stand ready to fully remove our hedge overlay when we start seeing further weakness in the US employment picture as demand and inflation measures should naturally follow suit lower. When the slowdown in the US eventually becomes more evident in Q4, government yields should stabilise bringing along stability in credit spreads. Our developed credit markets should behave more positively in a more stable yield environment with abundant and attractive opportunities as in the European banking sector for instance. It no longer feels all gloom and doom with good things to come!

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: Citi Research, as of September 2022.

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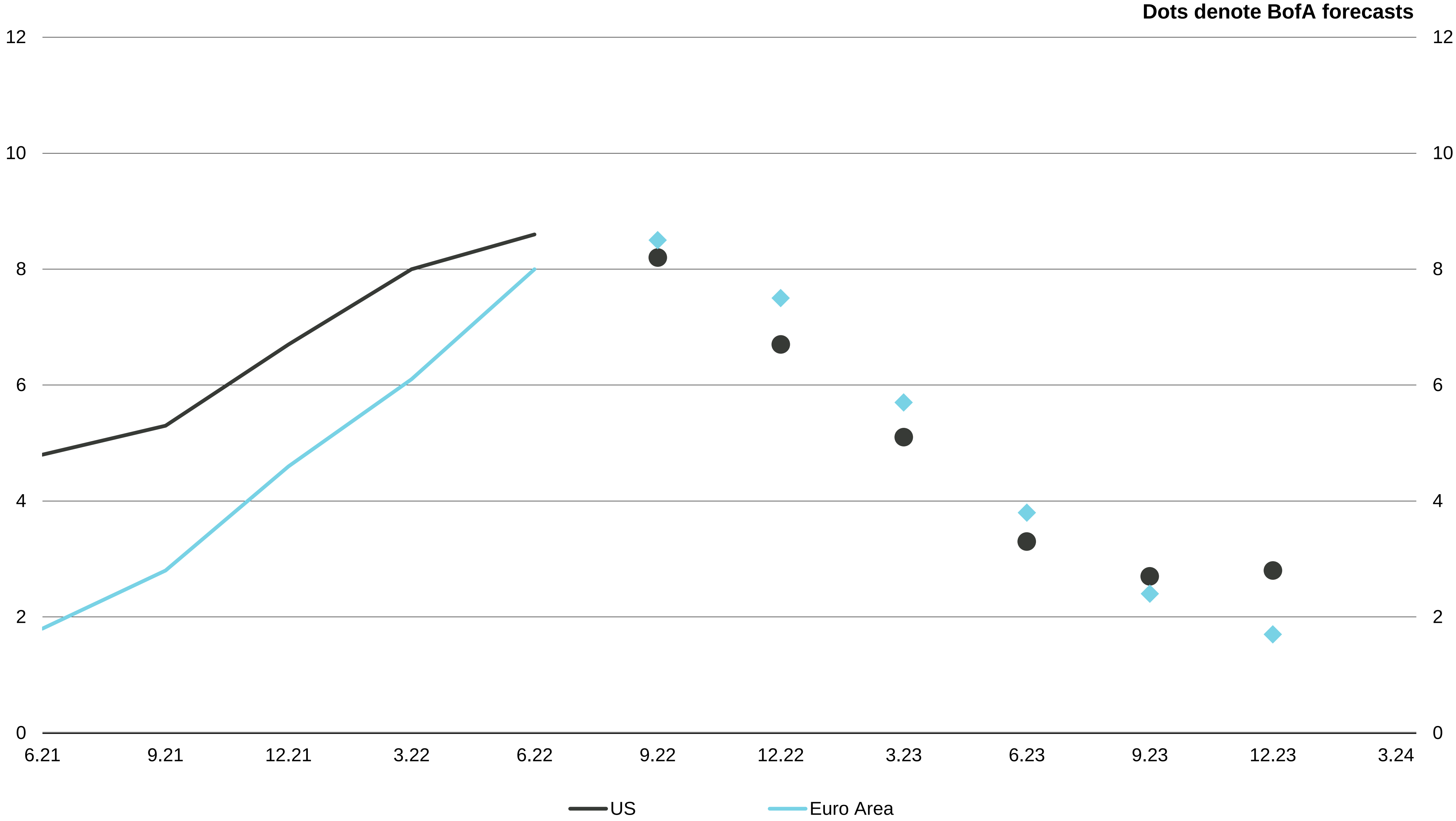
By year end, inflation should have moderated given a usual turnaround lag of 18 months after M2 money supply growth peaked in Feb 2021

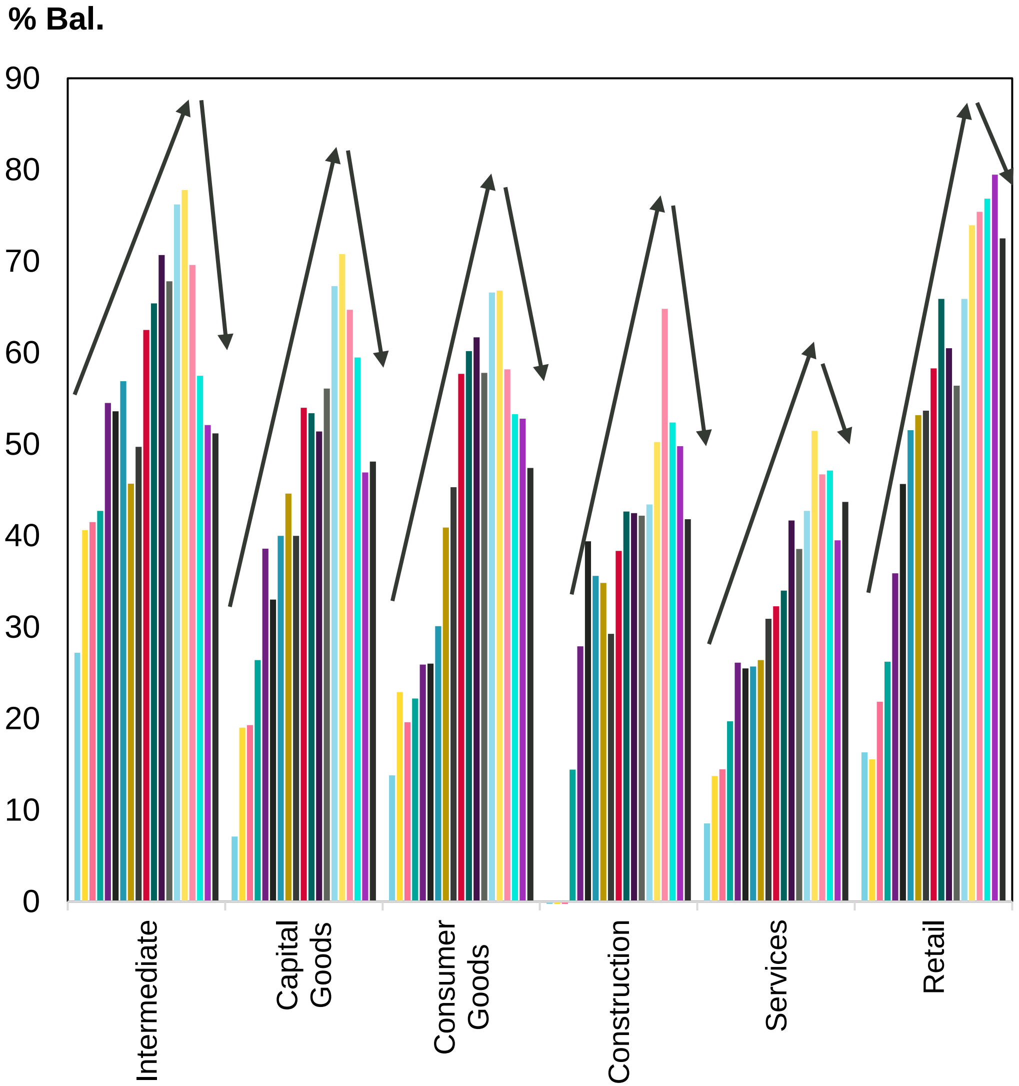
CPI YoY % (2Q21–4Q23E)



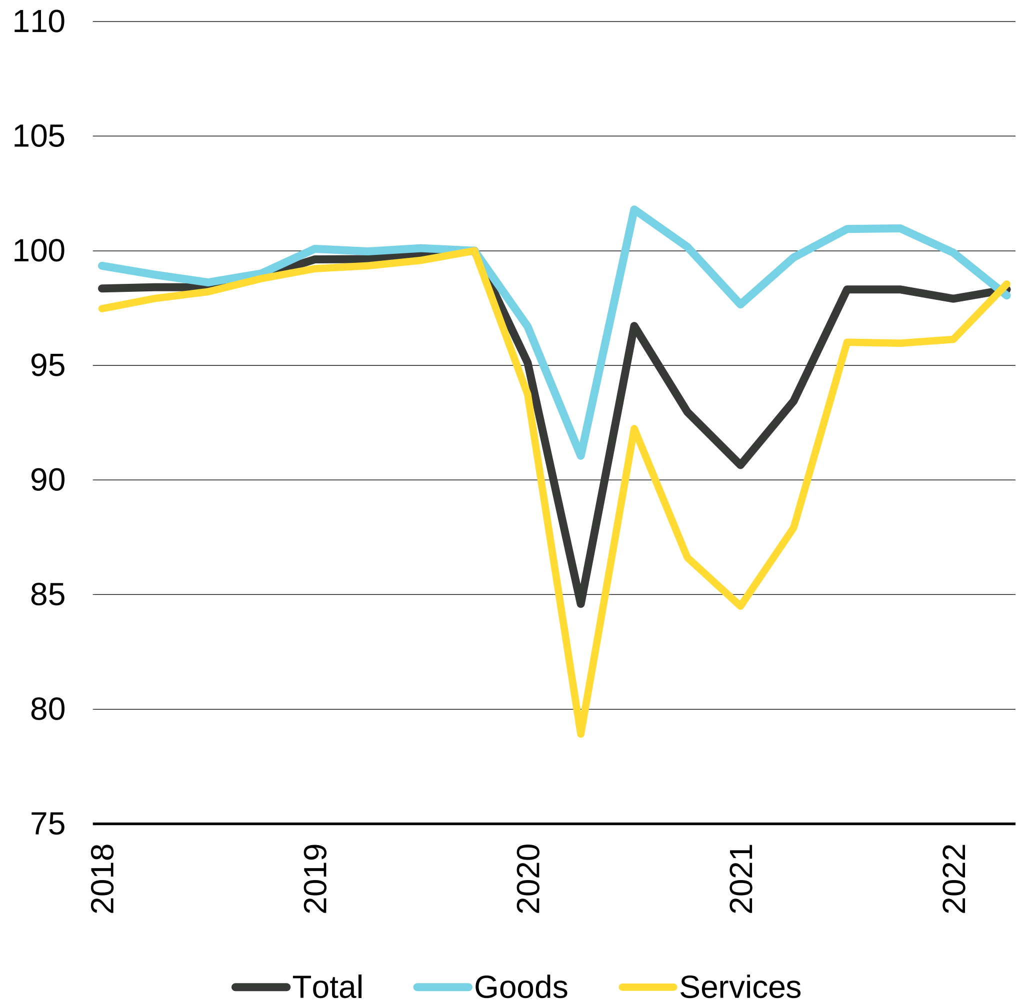
Source: BofA Research, as of September 2022.

Cost pressures in Europe should also moderate as the Euro zone is not experiencing excess demand in goods

Germany – monthly price expectations by sector: January 2021 to August 2022 (% balance)



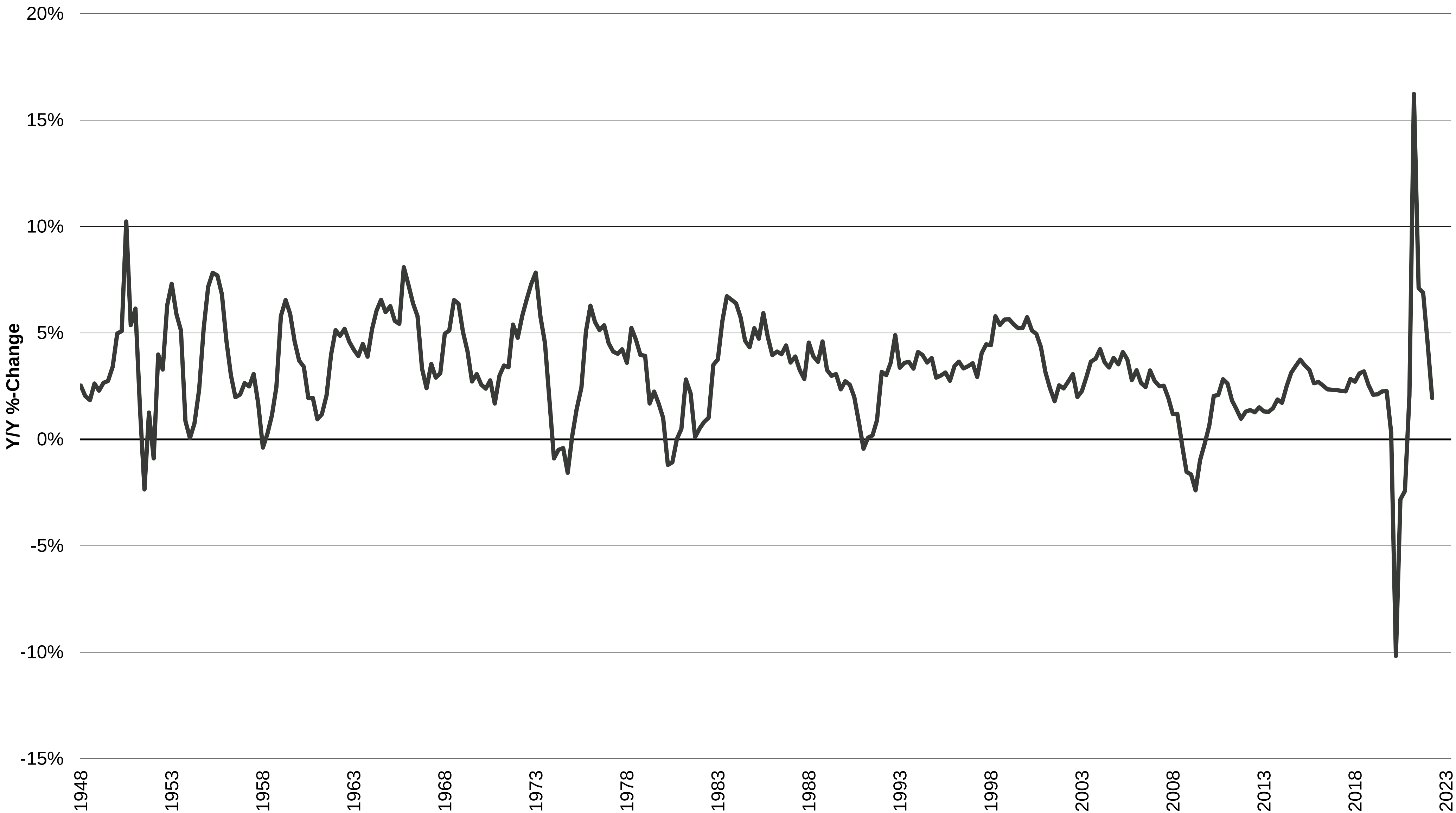
Euro area – real private consumption: Q4 2019 = 100



Source: Citi Research, as of September 2022.

US goods demand is also poised to revert to pre-Covid levels as consumers’ real disposable income gets squeezed

Real Personal Consumption Expenditures, 4 quarter %-changes annualized



Source: US Bureau of Economic Analysis, Real Personal Consumption Expenditures, Quarterly, as of September 2022.

“Core PCE Nowcasting from the Cleveland Fed is tracking the Fed’s Core PCE year end forecast of 4.5%”

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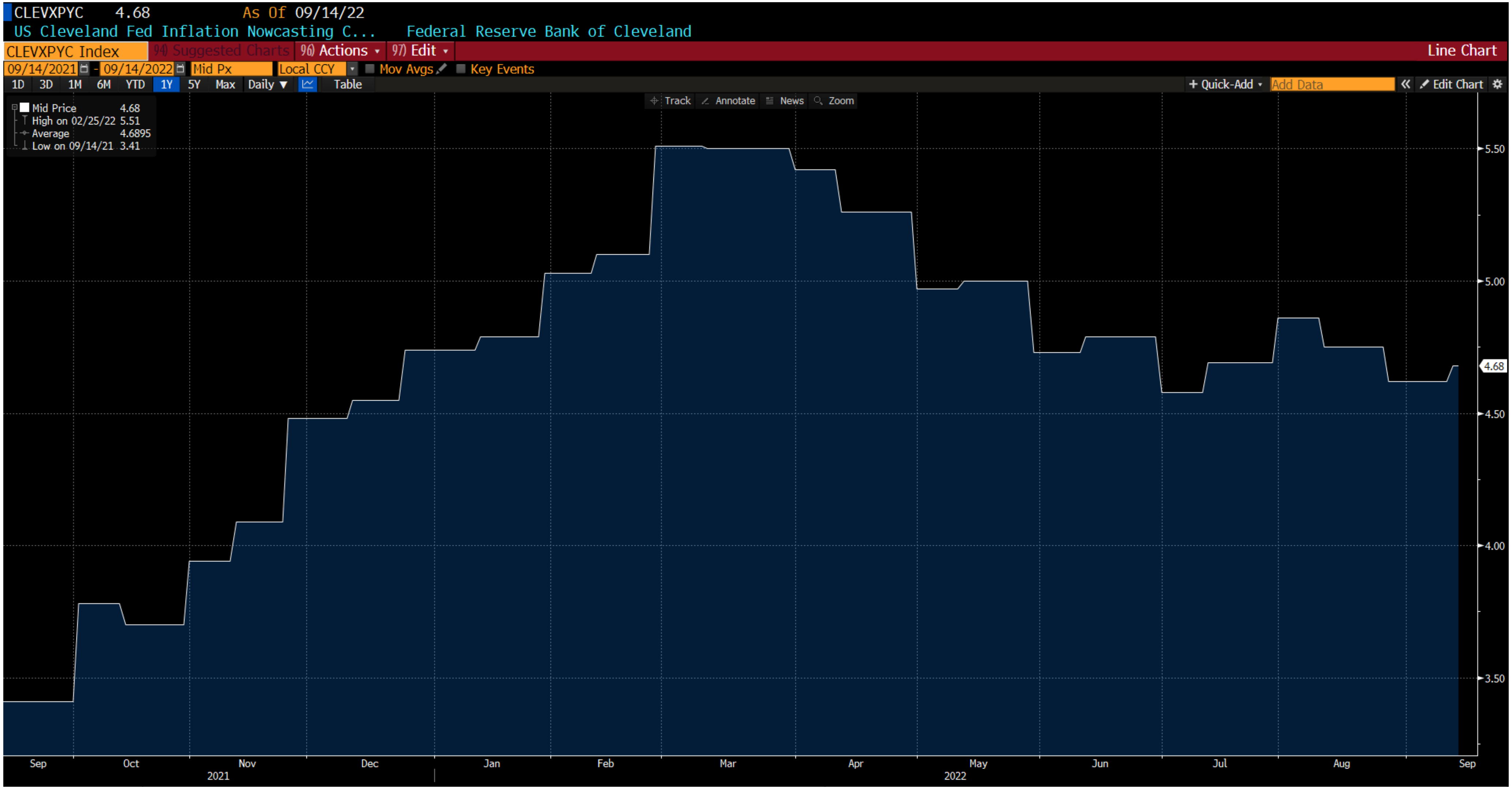
Notwithstanding the latest core CPI upside surprise, the core PCE that matters most to the Fed is still tracking their year end forecast of 4.5%



Source: US Cleveland Fed, Bloomberg, as of September 2022.

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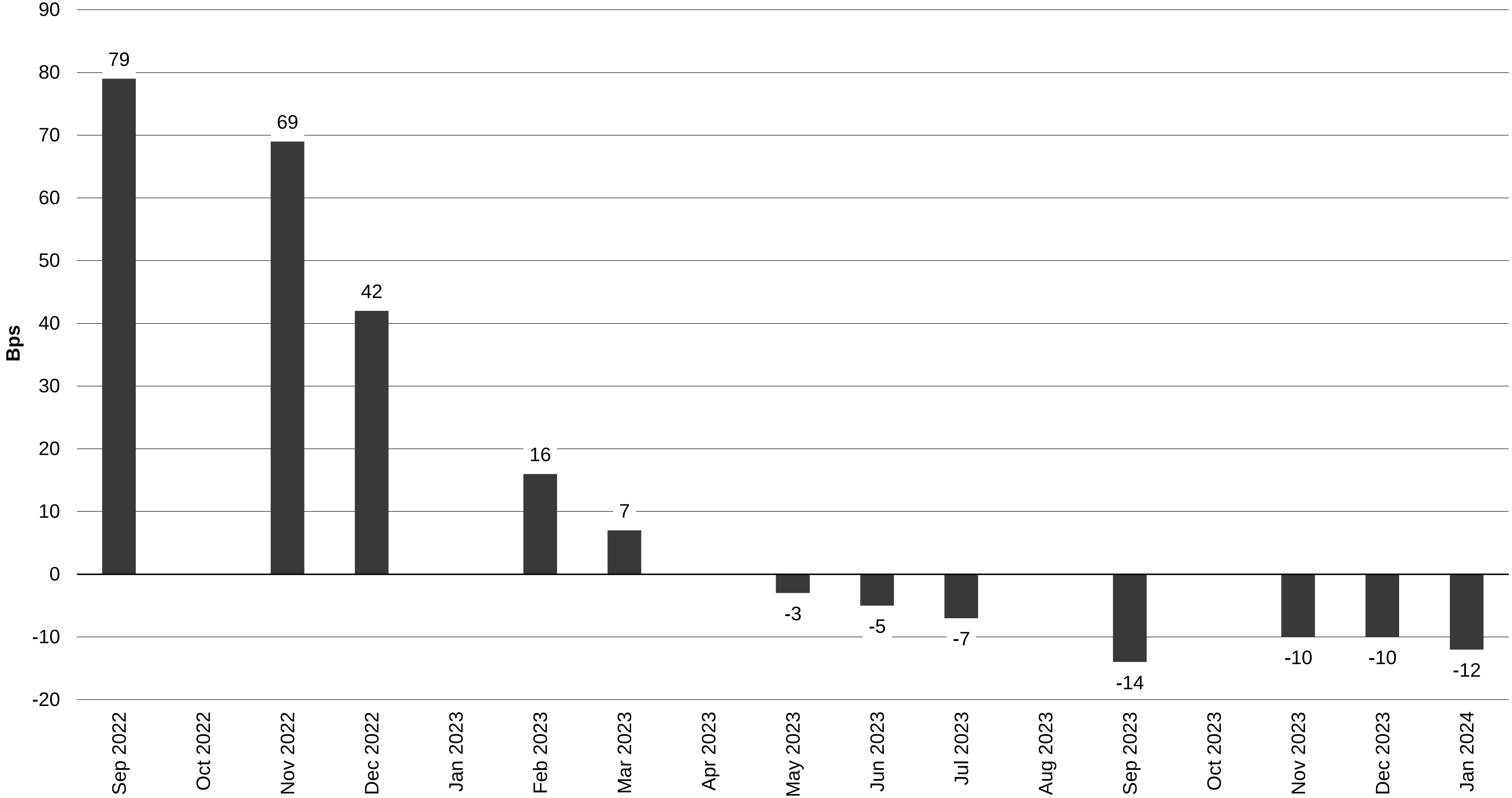
The market indicates that the end of the US rates cycle is in sight. Limited hikes in 2023 should be supportive of IG credit spreads

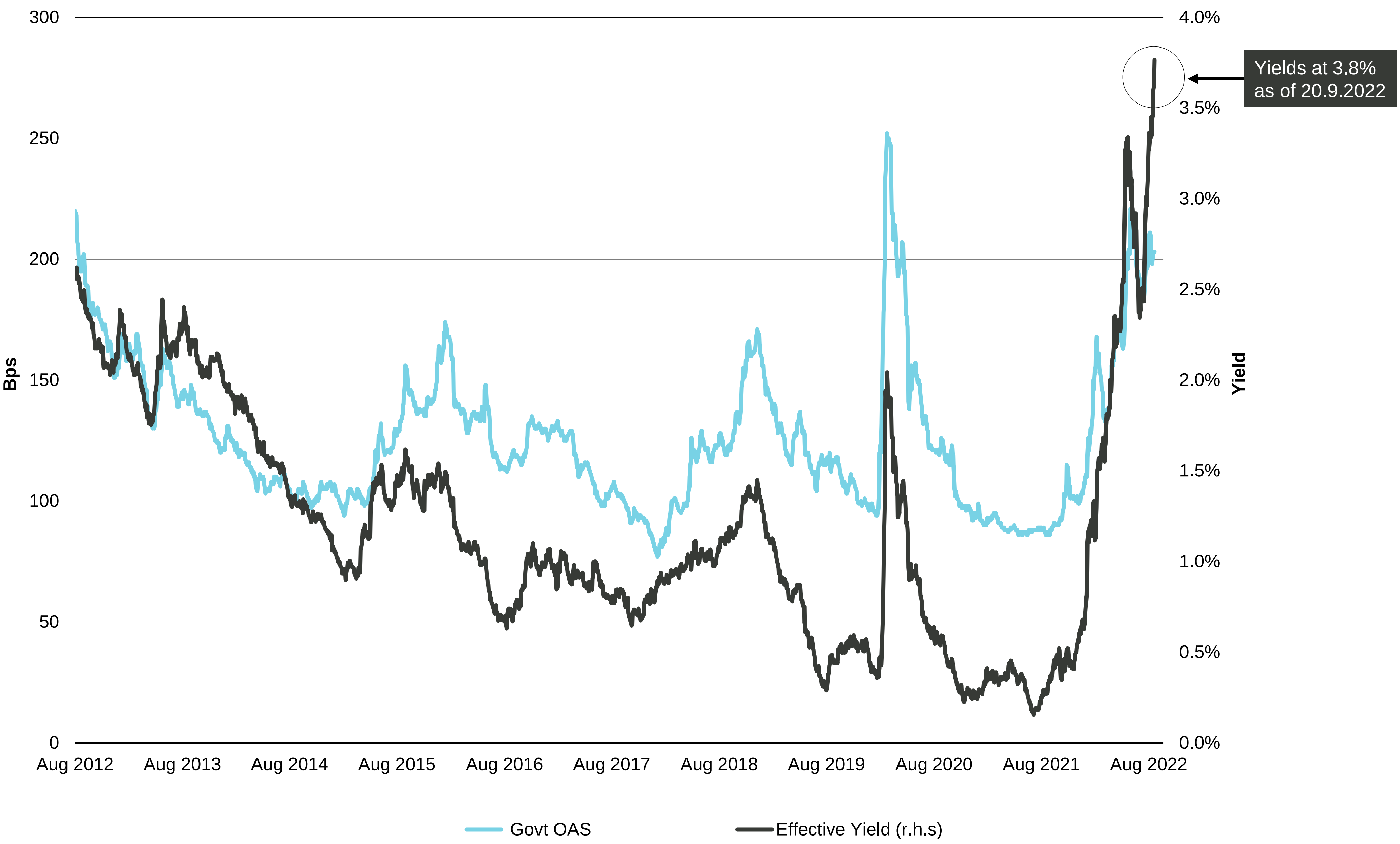
Market pricing implies the Fed hikes to around 4.25% by early 2023

MARKET-IMPLIED SIZE OF FUTURE HIKES



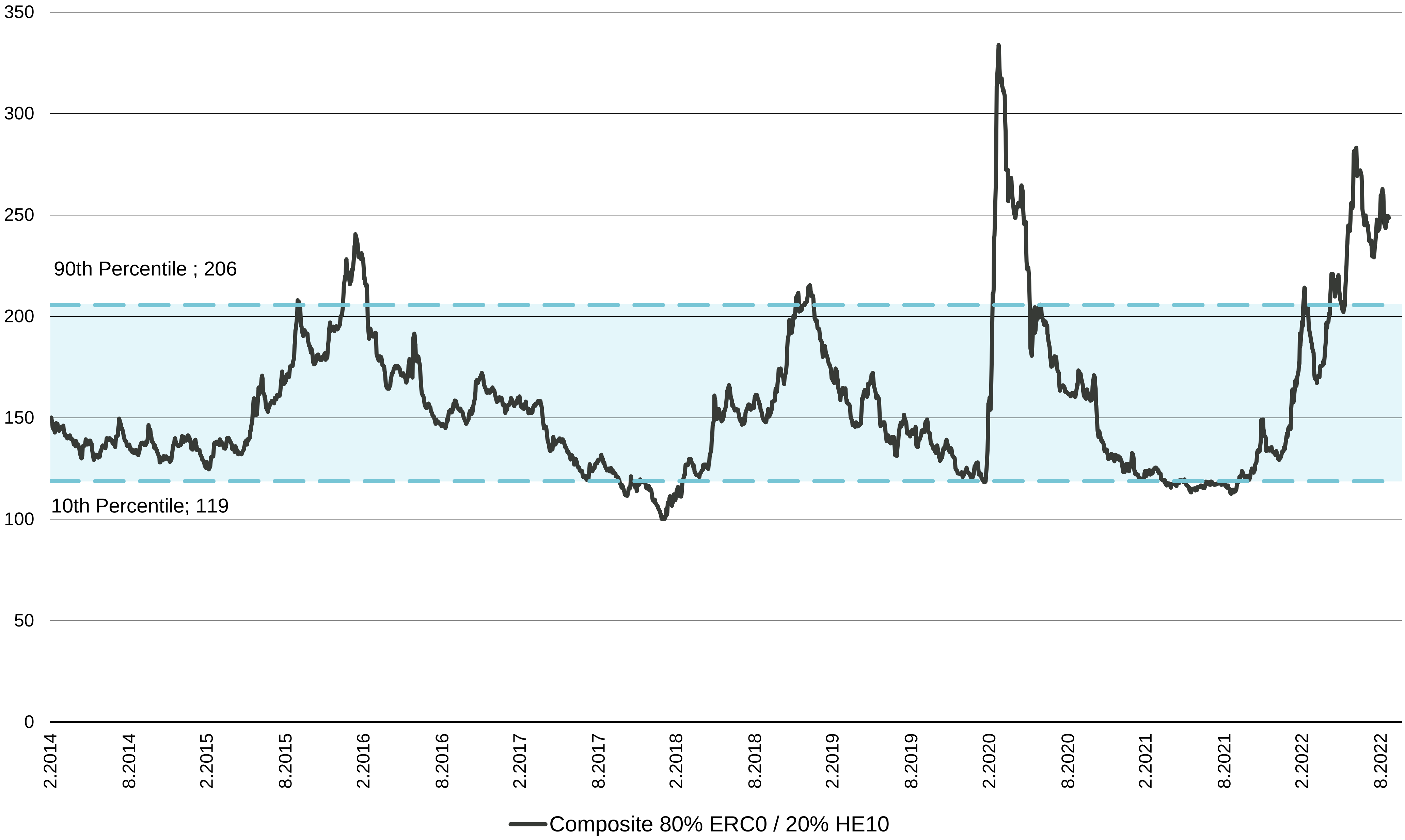
Source: MS STIR Trading, Morgan Stanley Research, as of September 2022.

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



Source: ICE BofA A-BBB Euro Corporate Index (ERC0 Index), as of September 2022.

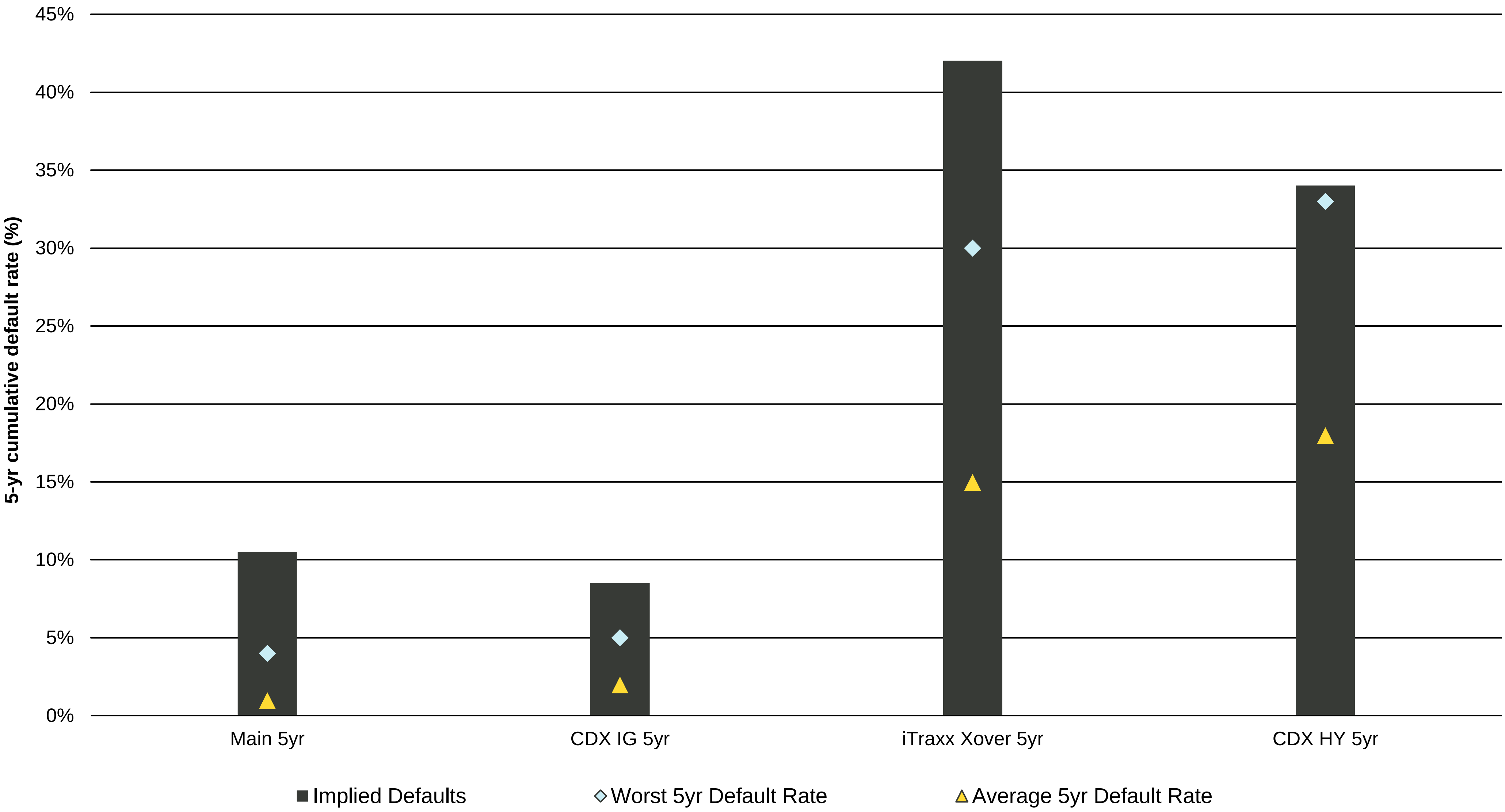
European Area Credit spreads are very near recessionary levels and price in a lot of weakness when adjusted for solid credit fundamentals



Source: ICE BofA A-BBB Euro Corporate Index (ERC0 Index), as of September 2022.

European Area Credit spreads currently price in even higher default rates than the worst 5-year point

Credit vs. historical default rates

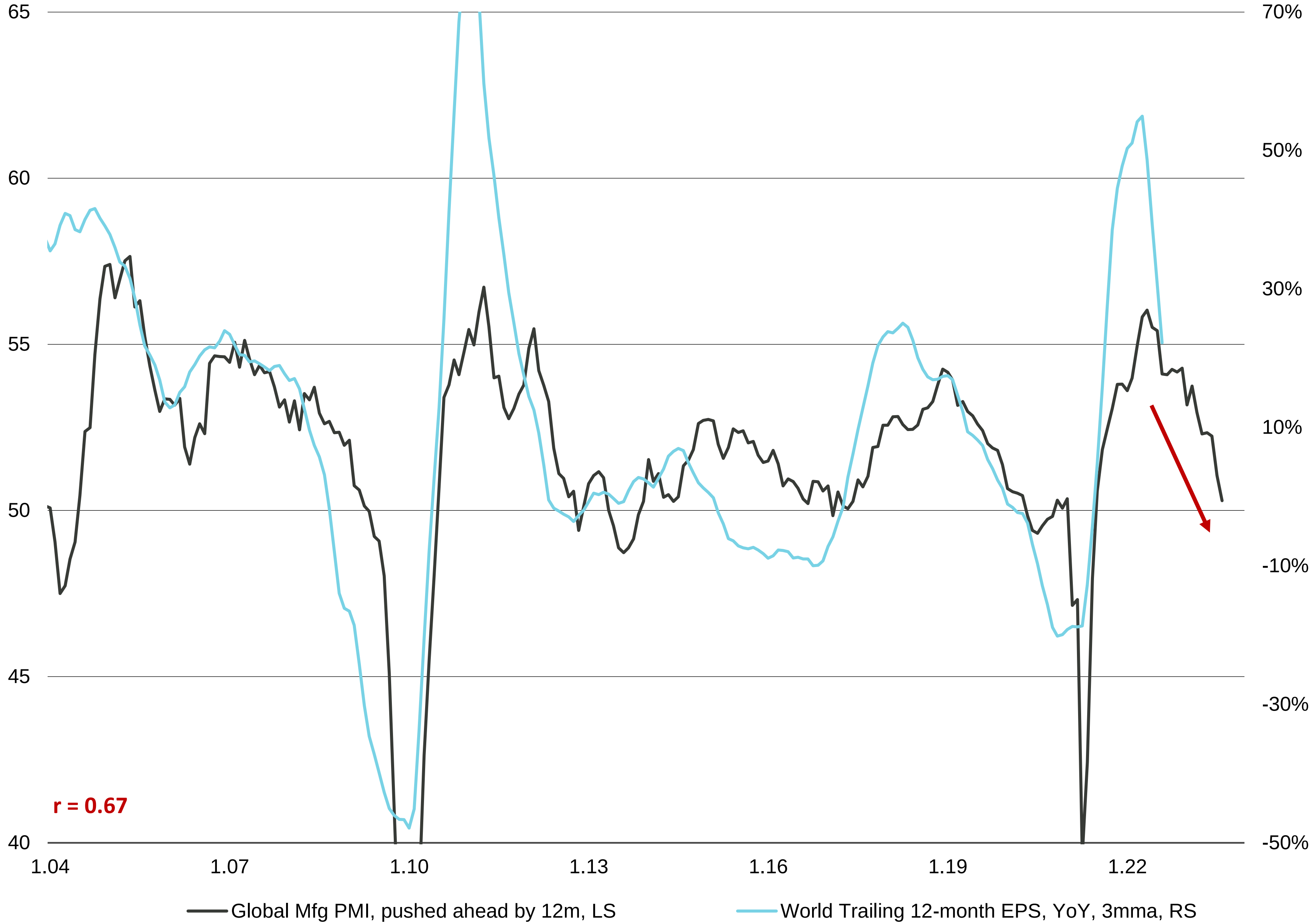


Source: Morgan Stanley Research, Bloomberg, Moody’s, Vontobel. Note: Implied defaults calculated using 35% recovery rate as of 26.9.2022. Historic defaults calculated using Moody’s default data since 1970 and current index ratings composition as of September.

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:

- PMI-implied = 3.5%
- Consensus = 7.3%



Source: BofA Research, as of September 2022.

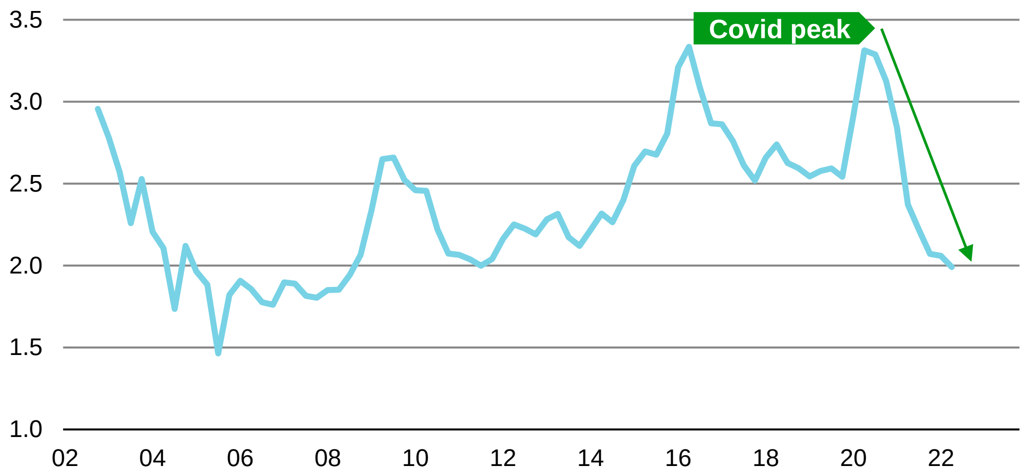
“Low issuance (corporates not spending all their cash) + Credit fundamentals much stronger than during the pandemic = spreads peaking?”

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

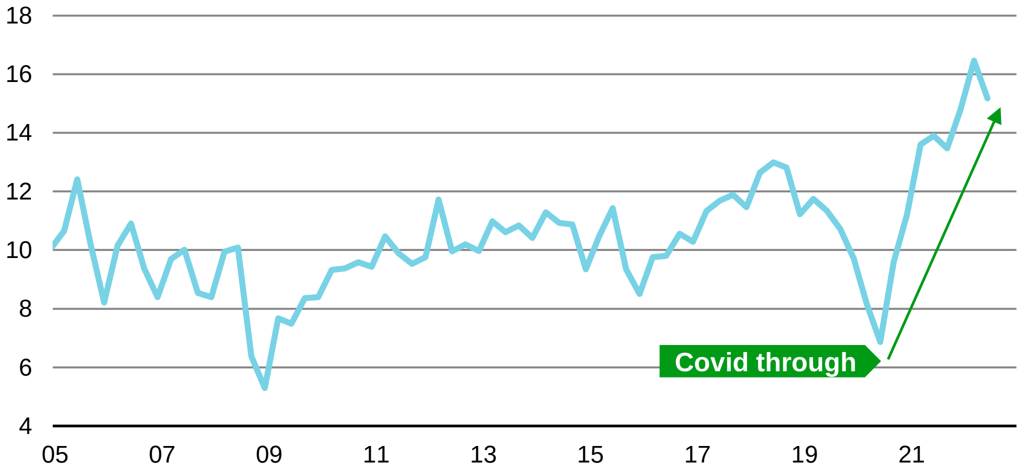
Credit metrics looking strong…

Leverage & interest coverage for sample of European corporates

LEVERAGE

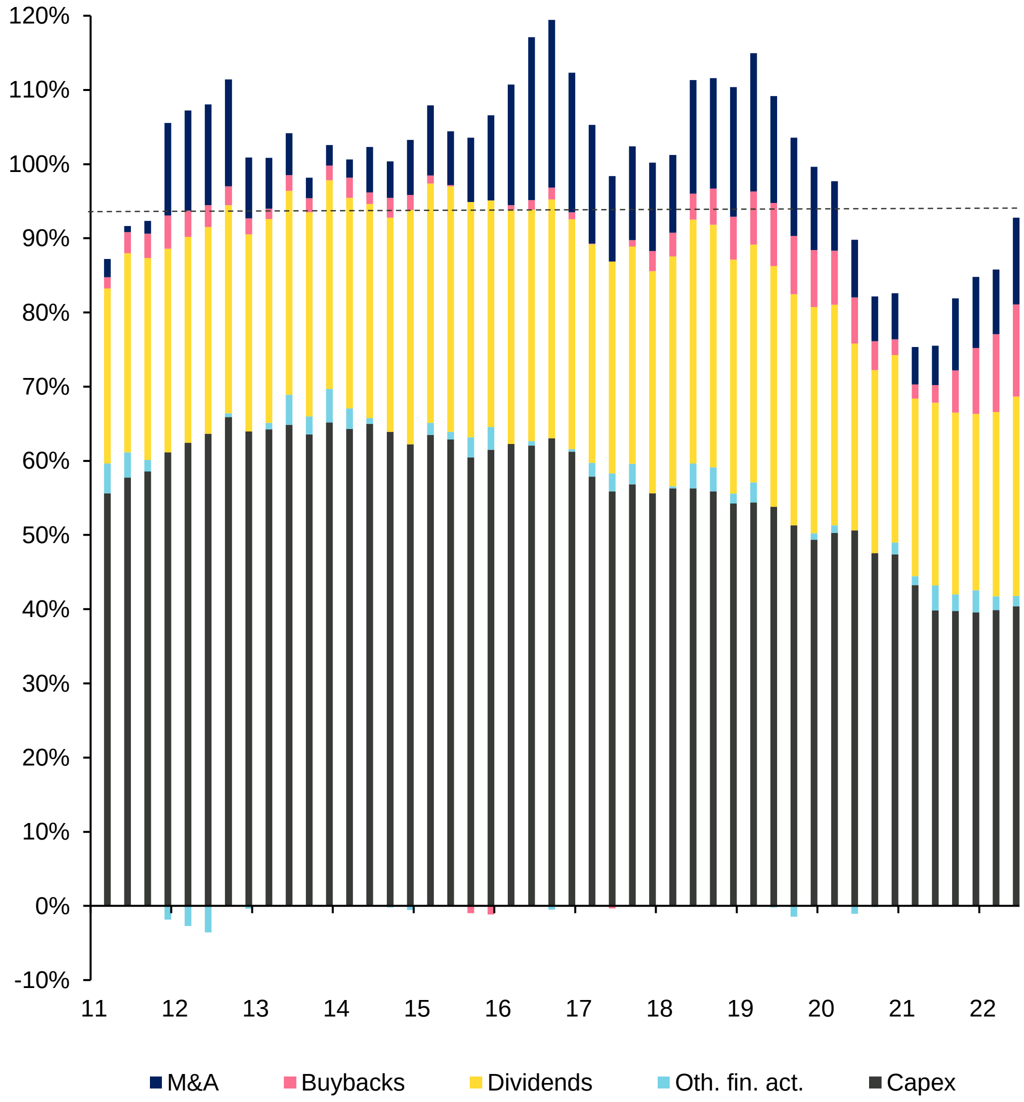


INTEREST COVERAGE



…as companies do not spend all OCFs.

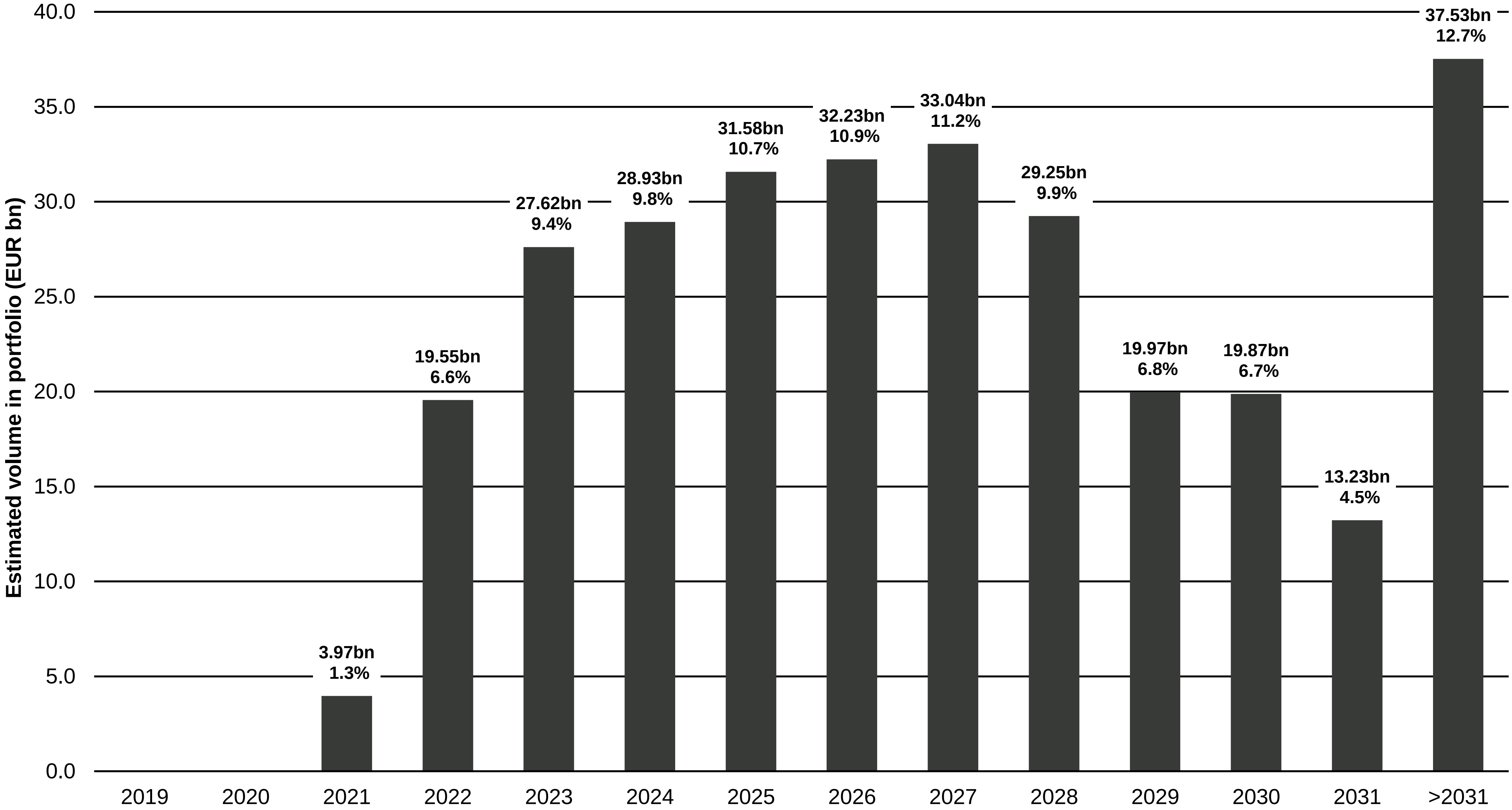
European corporate expenditures, % of operating cash flows



Source: Citi Research, Bloomberg, as of September 2022.

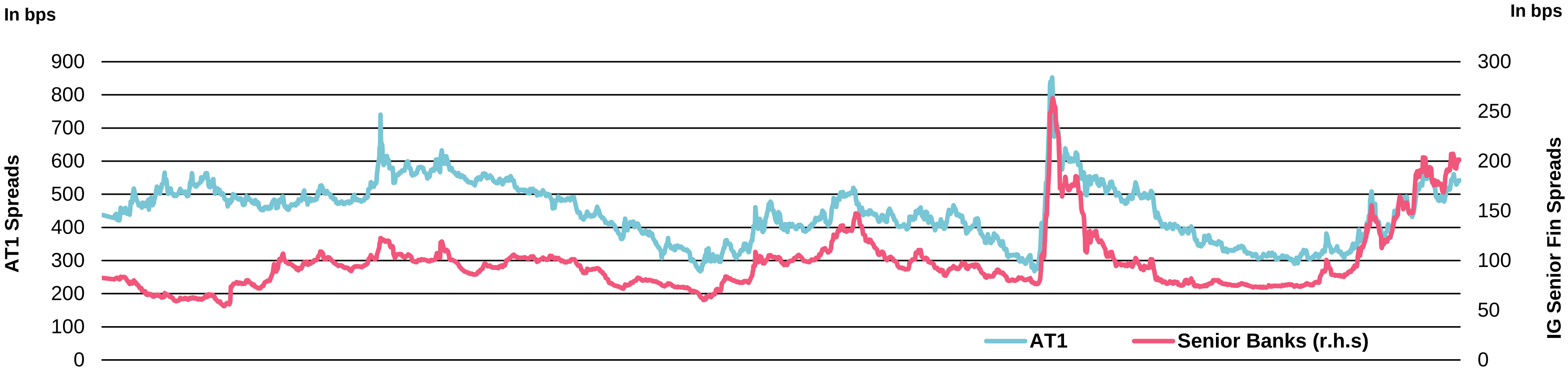
ECB required to purchase at least an average of Eur 2.0 bn of corporates per month from 2023 given their upcoming maturity profile

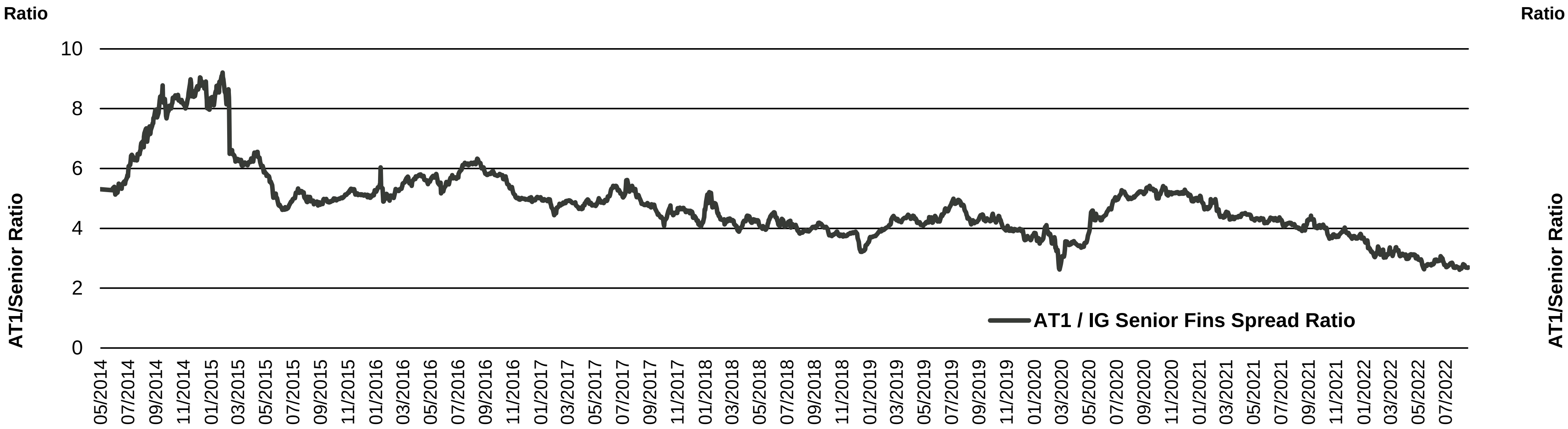
CSPP portfolio maturity profile



Source: UniCredit Research, as of September 2022.

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





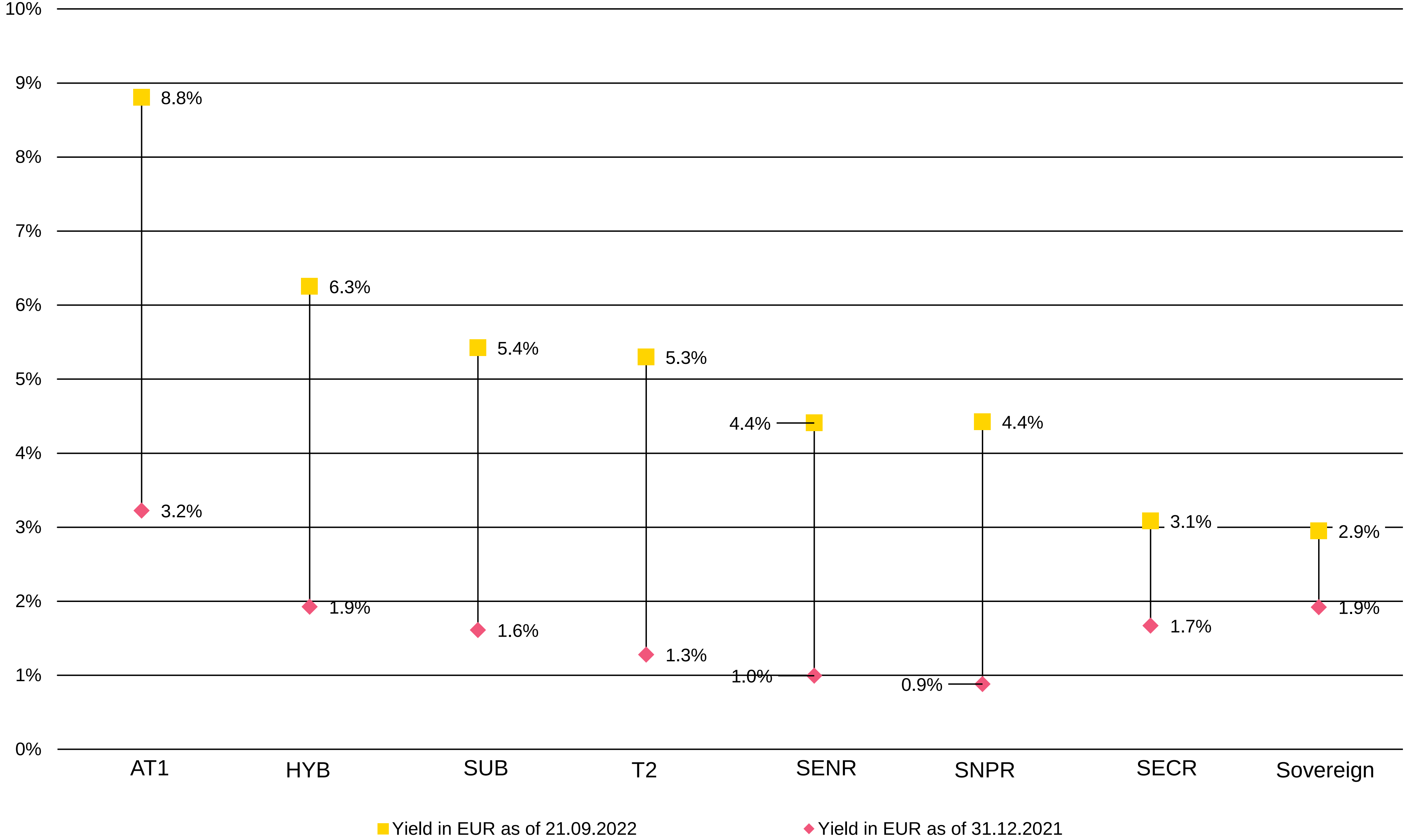
Source: Bloomberg Barclays Indices, as of 20.9.2022.

Corporate Hybrid technicals should benefit from near-zero net supply & valuations should benefit from overdone extension risk pricing

Euro Credit YTD Total Returns by Asset Type

Source: Bloomberg, ICE BofA Index, as of 21.9.2021. The ICE BofA Euro Non-Financial Subordinated Index members are IG-rated only.

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



Source: Vontobel Asset Management, BAML, as of 21.9.2022.

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

Main risks to our base case

Overtightening by central bank(s) and subsequent severe recession

Negative earnings revisions above and beyond expectations

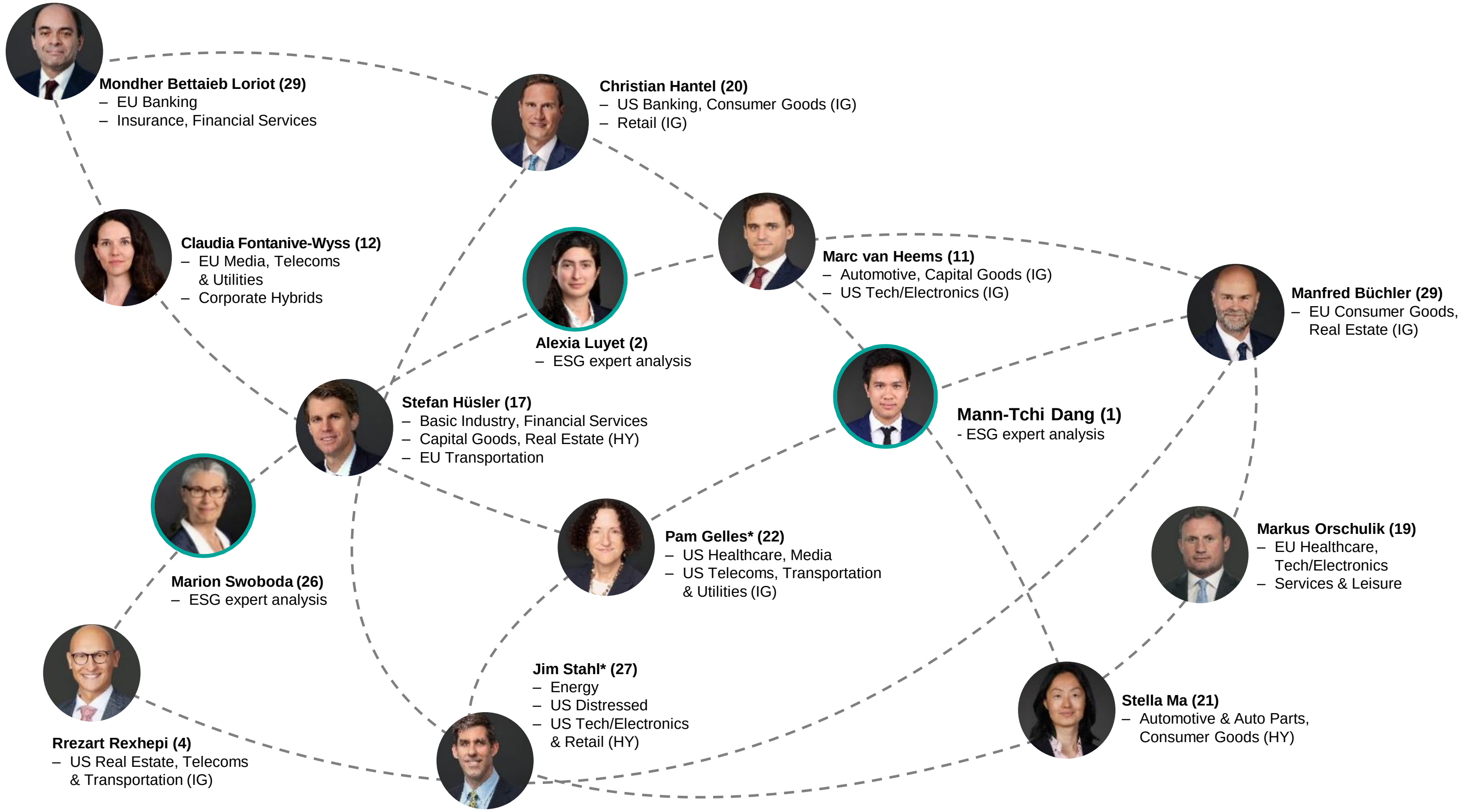
Further escalation of the Russia/Ukraine conflict

Cold winter in Europe driving energy prices even 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.

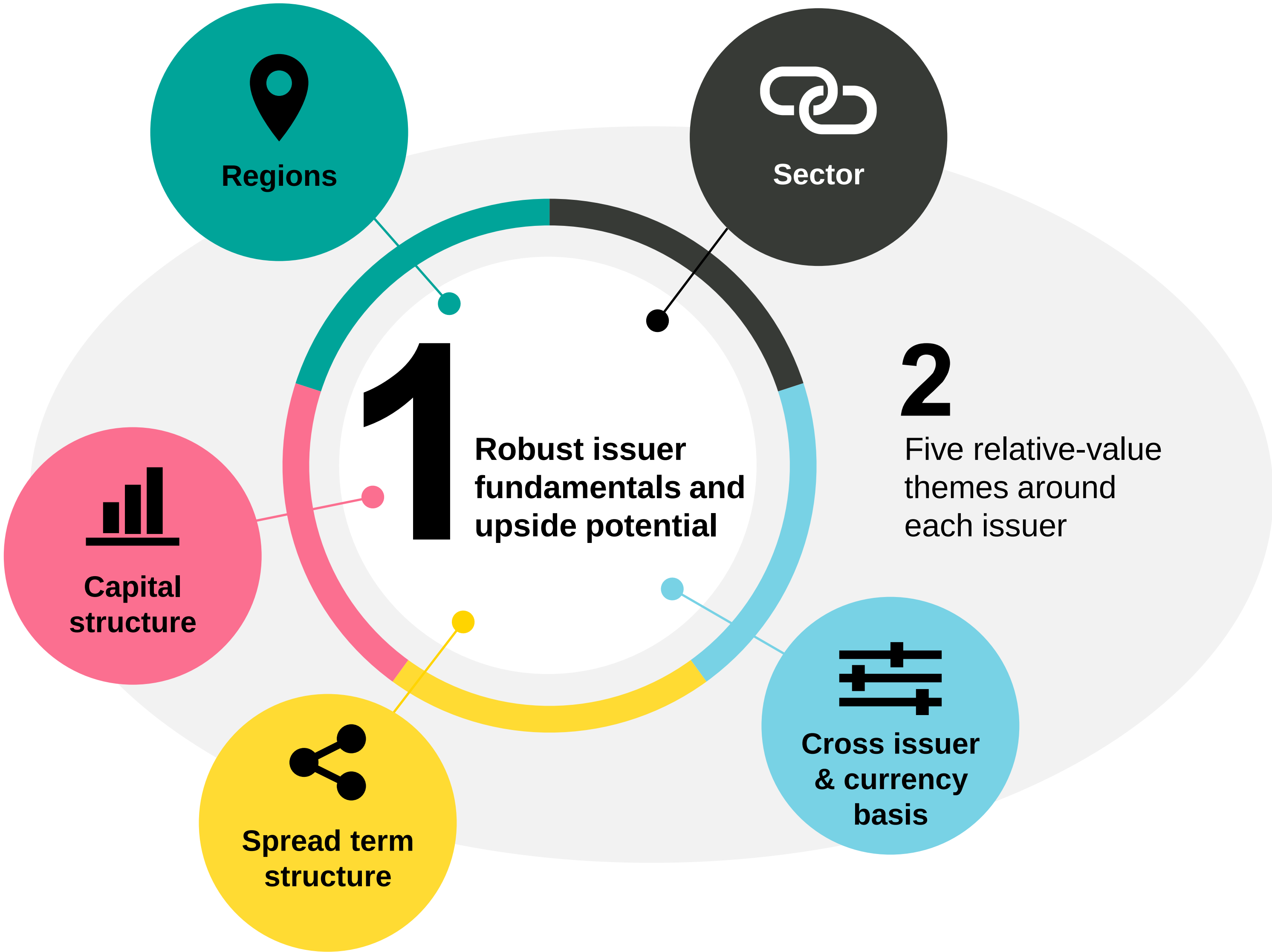


(XX) = years of experience. *Based in New York.
Global coverage across Investment Grade (IG) and High Yield (HY), unless specified.

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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