FOCUS

Back to Sub

Wednesday, 07/24/2019

The US Federal Reserve (Fed) has signalled a number of rate cuts in the short term, and the European Central Bank (ECB) is indicating it will use every available instrument in its toolbox, including a new corporate sector purchase programme (CSPP), to mitigate adverse conditions. This approach will compress investment grade yields and push investors into the below-investment-grade market, where we believe subordinated bonds offer the best value.

Michalis Ditsas
Investment Specialist

" Market expectations of a revitalised ECB corporate sector purchase programme are increasing. How should credit investors position themselves? By going back to sub-investment grade. "

— **Michalis Ditsas**
Investment Specialist

In the US, growth momentum has softened, the threat of trade tensions persists and the drop in ediumterm inflation expectations to the lowest level in three years is a worrying development in the context of low unemployment. As a result, the Fed turned very dovish and signalled a strong bias towards lower rates, with the market expecting two to three rate cuts over the next twelve months.

Unlike the Fed, the ECB has not had the chance to raise short-term rates in the past few years, and the deposit rate remains negative at -0.4% (see:1month in 10snapshots for details). Still, last month at Sintra, Mario Draghi emphasised further rate cuts and a resumption of asset purchases through the CSPP are viable options, given the downside risks weighing on growth and inflation.

The original CSPP was initiated in June 2016, by extending the universe of eligible assets for the purchasing programme to include investment grade euro-denominated bonds issued by non-bank corporations in the eurozone. The purpose of this was to strengthen the pass-through of asset purchases to the real economy. It resulted in the tightening of investment grade spreads, from 140bps to the lowest level ever of 74bps at the start of 2018 (chart 1).

Chart 1: Investment grade spread tightening during the CSPP implementation period

Source

Source: Bloomberg, ICE BofAML Euro Corporate Index; Data period: July 2016 – January 2018

Rate investors seem to be convinced the ECB will restart its asset purchasing via a 'CSPP 2' programme; with inflation falling and expectations indicating this will continue, the ECB will have to take action to defend its mandate. Alternatively, if the ECB does not, this could only be interpreted as Draghi's dovish stance not being supported by the Governing Council.

How should investors position for a possible CSPP 2? It will not take long for spreads in the investment grade market to tighten significantly, triggering yet another hunt for yield, with investors moving aggressively into the below-investment-grade market.

However, the European high yield market is already facing issues. Negative-yielding high yield bonds have existed for a while in the US, and they have now arrived in Europe, where currently about 2% of the universe is negative yielding. This could rise to 9% if yields drop by a further 35bps. In addition, fundamentals are deteriorating for the European high yield market, where the notional-weighted default rate stands at 1.8%, leverage is up, and recovery rates over the past year average 32% – lower than the historical average of approximately 40%.

Table 1: Total returns YTD as at 30th June 2019

	US HIGH YIELD	EURO HIGH YIELD	SUBOR-DINATED FINANCIALS	COCO
TOTAL RETURN	10.16%	7.73%	7.46%	10.47%

Source

Source: Bloomberg, ICE BofAML. USHY=US High Yield Constrained Index, Euro High Yield=Euro High Yield Index, Subordinated Financials= Euro Subordinated Financials Index, COCO= Contingent Capital Index; Data as at: 30th June 2019

We see potential in the European subordinated bond market. Year-to-date returns (table 1) are similar to those in the European high yield market, at 7.5% and 7.7% respectively – the CoCos market alone returned approximately 10.5% during the same period. As discussed in a previous analysis (detailed here), the subordinated market offers highly beneficial characteristics, namely high yield-like carry, investment grade credit quality of issuers, liquidity through a market twice the size of high yield and diversification of investments within a fixed income portfolio.

Disclaimer