

## European Credit Outlook for H2 2018 : Time to Buy ?

Friday, 07/27/2018

After more than one and a half year trending up, Euro credit markets have been under pressure during the first half of 2018. Several factors have played a role, ranging from shifts in monetary policy expectations to rising political risks on top of tight valuations and slowing economic pace.

We believe most of these factors have either disappeared, faded out or weakened over the last six months offering a chance to look once again with interest to Euro denominated corporate and financials bonds.



**Antonio Ruggeri**

European Credit Expert

*“Clearer and supportive monetary policy from the ECB, stable economic growth, solid fundamentals and improved valuations all suggest credit is poised for a positive second half this year.”*

- Normalized valuations have sharply reduced the risk of disordered market reaction.
- Leading indicators support the view that Eurozone will grow above its structural long term pace.
- Political shocks tend to adjust in the medium term as long as fears fade out and investors become more selective.
- Macro and micro conditions appear today much different than in 2010-11, pointing to a much lower, if any, contagion risk.

### Monetary policy and valuations : clearer rates path and normalization

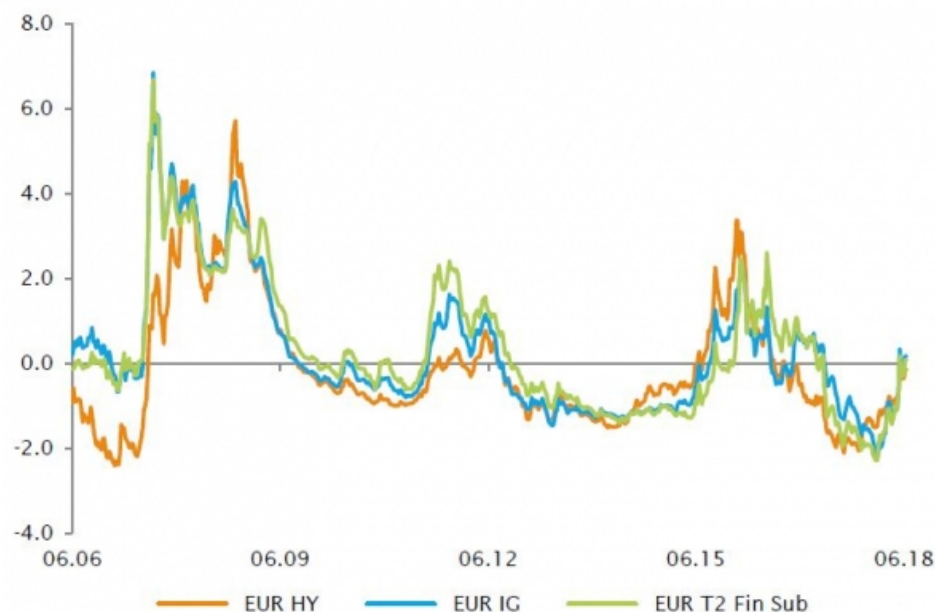
After an impressive start of the year, with spreads reaching multi-years lows on all market segments, credit markets have been impacted by a shift in monetary policy expectations. Indeed, strong economic performances led markets to expect tighter monetary policies from both the Fed and the ECB. The rise in rates impacted all risky assets, but the tight valuations of the credit markets accelerated sales on the asset class, especially on high beta segments like High Yield and Subordinated instruments.

As of today the risk of unexpected hawkish shocks is very low, as the Fed hiking cycle is already priced in and Draghi's led ECB reaffirmed its very cautious and supportive stance. Risk free rates may rise, but this should just be a reversal of the flight to quality experienced so far, and with limited impact on risky assets valuations. Indeed, both spreads level and short-term volatility are now above their three years averages and compared with the past, the magnitude of this year widening is in line with post-2008 episodes of market corrections. We believe that valuations have certainly improved, even though not yet on cheap territory, and the risk of a disordered market reaction has dramatically diminished which creates a more attractive European credit market environment.

### Business cycle and fundamentals : no economic recession nor overheating fundamentals

After a rebound between mid-February and March, credit spreads started to widen again led by lower than expected economic data: Eurozone leading indicators started to decelerate since December last year and Economic surprise indicators turned negative. This trend continued till May this year, and drove the decoupling between EUR and USD spreads, as the latter barely moved. More recent data are signalling that growth is stabilizing in expansion territory, with surprise indicators rebounding sharply. This supports our view that the Eurozone will grow above its structural long term pace in the second half of this year. This is also confirmed by corporate fundamentals, as European companies Q1 results continue to show an aggregate improvement in margins, leverage and coverage ratios. Corporations have stopped piling up in debt last year while at the same time extending liability maturities at lower interest rates.

## EUR IG, HY & Sub Credit Valuations – 3 years z-scores



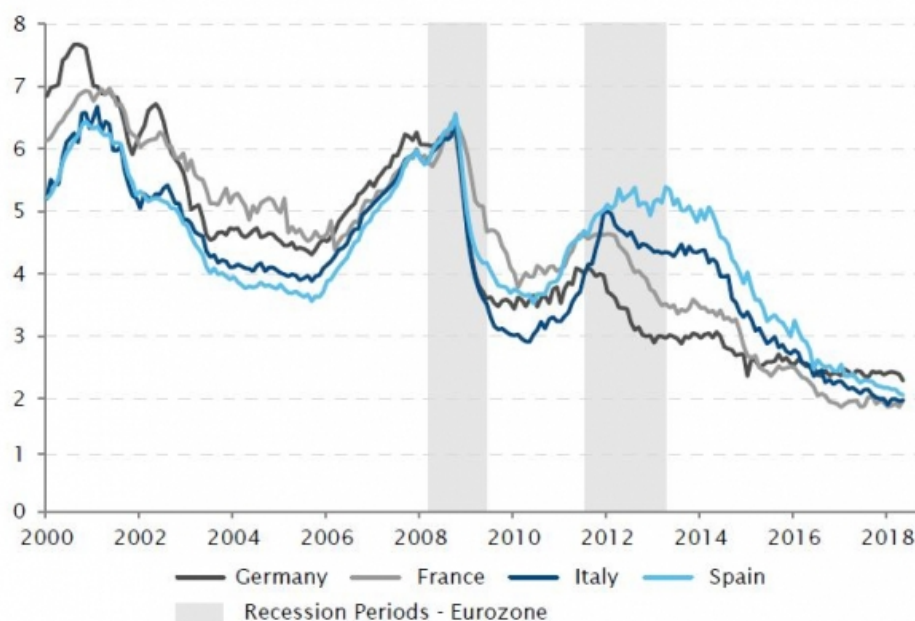
Source

ICE indices, SYZ Asset Management. Data as at: 30 June 2018

### Political risks : Italy and trade war fears fading but not disappearing

The final and most compelling shock to credit markets came from the political front, especially within the Eurozone due to a leaked draft of the forming new government program in Italy. The draft reignited fears on the Euro, evoking contagion risk scenarios last seen in 2015, at the time of the Greek referendum. Sovereign spreads jumped in Italy, but also Spain and Portugal, mostly affecting financials' paper, not only in the periphery. Such shocks tend to adjust in the medium term as long as fears fade out or investors become more selective. This is what we are observing now. First of all, the spike has been much lower than the one observed in 2011, when High Yield and subordinated bonds jumped more than 500 basis points versus 150 this year. The market may have priced in some risk, but not a Euro break-up or similar scenario. This is also evident when looking at Spain and Portugal, whose sovereign spreads are still tighter today than in December last year.

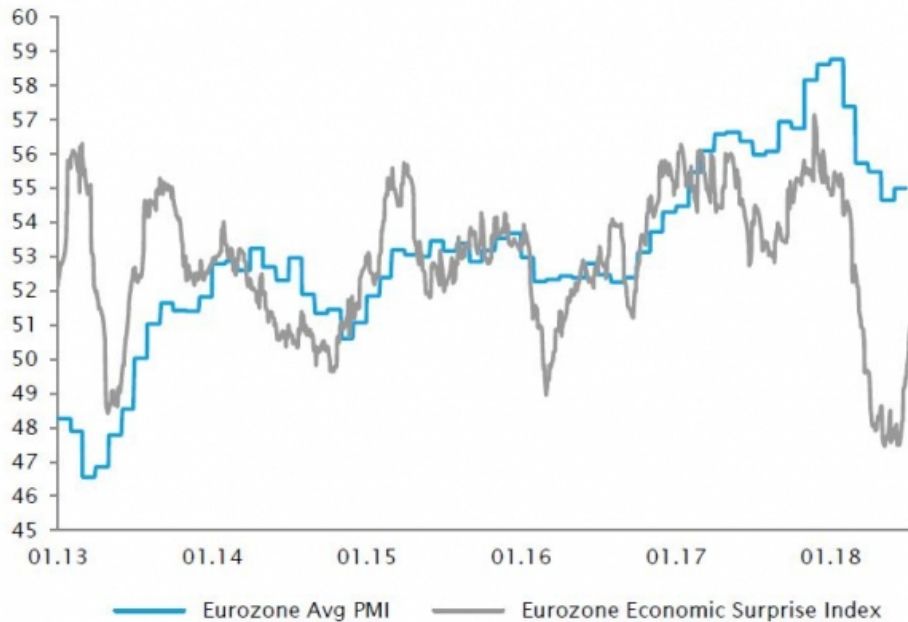
## Eurozone-average rate for loans to non-financial Corporate up to 1mil Euro



Source

FactSet Research Systems, SYZ Asset Management. Data as at: 31 May 2018

## Eurozone Average PMI and Citi Economic Surprise

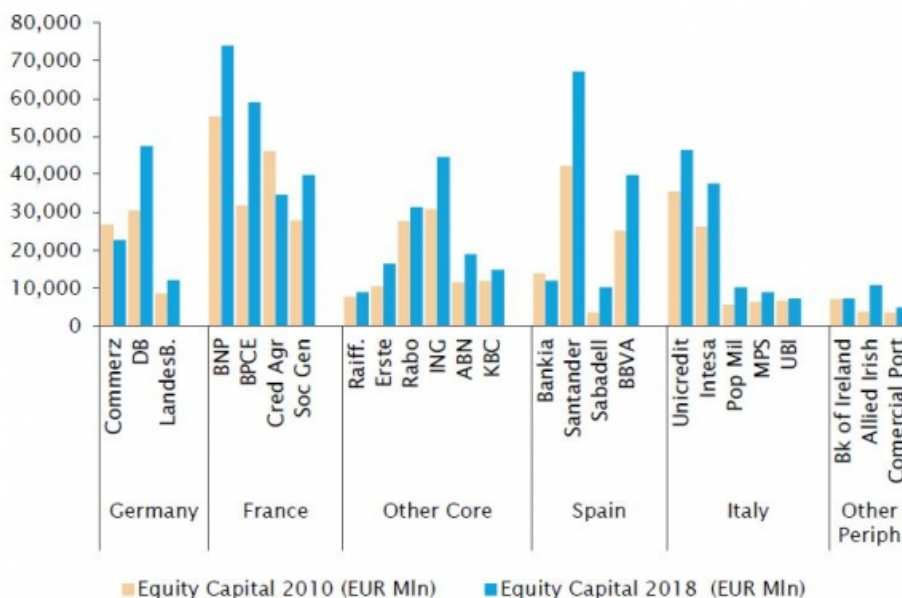


Source

Markit, Citigroup, SYZ Asset Management. Data as at : 31 May 2018

Only Italy remains wider as uncertainties on fiscal policies still hold, but BTPs are far from recent peaks. We expect volatility to continue to surround Italian names, only partially spreading to other countries, until the budget draft will be submitted to the EU in early fall. According to the Finance Minister, we can expect a slightly wider deficit than programmed last year but not a full deficit spending manoeuvre. More than political gauges (away from political concerns?) we are comforted by macro and micro conditions that appear today much different than in 2010-11, pointing to a much lower, if any, contagion risk. On the macro side we have growth rates never seen in the past decade, especially in Spain and Portugal, coupled with the easiest corporate credit conditions in a while. Loan rates to non-financial corporates are at historical lows with low dispersion among countries; the opposite was true in 2010. Additionally the Eurozone has today tools like the ESM, the OMT and the ECB purchase program that were not available 8 years ago. Finally, the financial system continued its balance sheet strengthening with higher levels of equity capital and improved asset quality. Eurozone banking institutions (\*see note) have piled billion of fresh equity capital since the end of 2010, at the same time reducing their bad loan exposure from 2015 peaks to the current Non-performing Loan ratio of 4.9%. All in all we see the Eurozone today much better equipped to face a potential, albeit low-probability, scenario of another financial shock.

## Main Eurozone Banks – Equity Capital 2010 vs. 2018



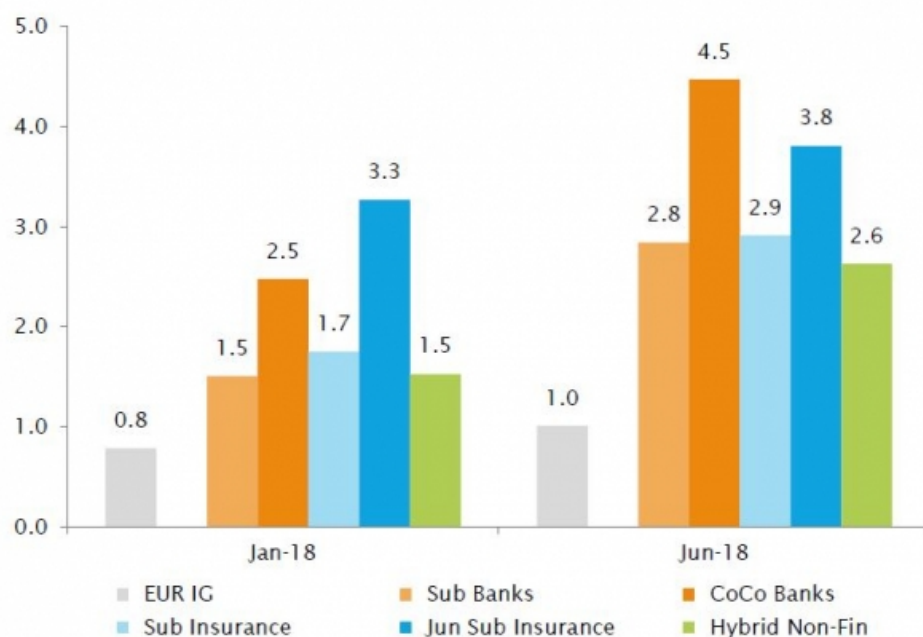
Source

EBA Risk Dashboard & ECB Supervisory Banking Stats, SYZ Asset Management. Data as at : 31 December 2017

## Market themes : Identifying opportunities in credit markets

From a top down perspective, we consider Investment Grade credit a structural component of fixed income portfolios, as in the medium term it shows lower volatility and better returns than sovereign bonds. The current one year low in rates and one year peak in spreads suggests that is a good time to add exposure. Maybe the most compelling segment are subordinated bonds: the asset class posted the worst performance among EUR credit, with core countries insurance names surprisingly affected as much as bank peripherals. Insurance bonds' and Contingent Convertibles' (banking hybrid instruments) most conservative yield measure (Yield to worst) jumped from 2.5 to 3.5 and 4.5% respectively since January lows. Finally, Single B's may be worth a look among Euro High Yields given the decoupling versus USD corresponding instruments: the average spread of Euro B rated stands now above 500 basis points vs. less than 400 for USD. Industries such as transportation and retailers were significantly impacted by slowing economic growth and trade war fears and currently offer premia above 800 bps. While still volatile, investors are certainly better compensated today for such risk compared to January.

### European Investment Grade vs. Subordinated bonds yields



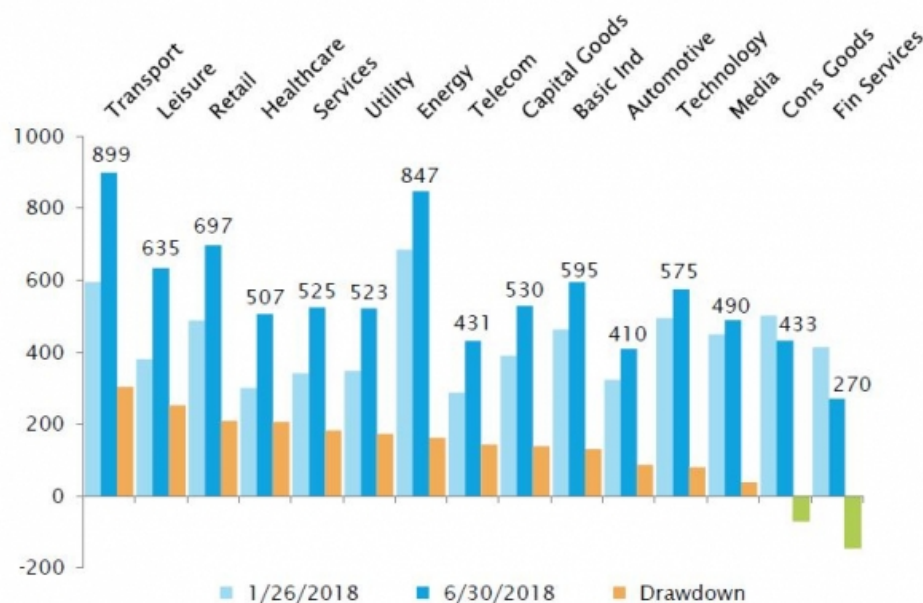
Source

Bloomberg, SYZ Asset Management. Data as at : 30 June 2018

## Conclusion: time to (re)buy

Political uncertainty will continue to influence markets, but volatility should remain moderate as the probability of tail risks has decreased. Clearer and supportive monetary policy from the ECB, solid economic growth and fundamentals and improved valuations all suggest credit is poised for a positive second half this year.

## European High Yield, single B's Spread



Source

Bloomberg, SYZ Asset Management. Data as at: 30 June 2018

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