Powerful Technicals Support European Corporate Bonds

We favor the eurozone ahead of a possible ECB bond-buying restart.

July 2019

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KEY INSIGHTS

- We currently see opportunities in eurozone corporate debt as the European Central Bank (ECB) could restart corporate bond purchases.
- Plummeting yields in the eurozone are another supportive factor for the eurozone investment-grade corporate market.
- We think the positive technical conditions generated by the ECB's potential return to the market more than offset the negative drag from weak fundamentals.

With the U.S. credit cycle in its later stages and escalating U.S. trade conflicts dampening corporate sentiment and fundamentals, we are applying a broader lens to develop portfolio positioning in our investment-grade corporate bond strategies. An international allocation can provide valuable exposure to credit cycles that are not as synchronized with the U.S. or to markets with unique supply/demand situations. In the latter category, we currently see opportunities in eurozone corporate debt as the European Central Bank (ECB) could restart quantitative easing involving corporate bond purchases.

At the central bank's annual conference in Sintra, Portugal, in June, ECB President Mario Draghi said that the ECB could cut rates and implement another round of bond purchases if the eurozone's economic outlook does not improve. Under the ECB's corporate sector purchase program (CSPP), which ran from June 2016 through the end of 2018, the central bank bought EUR 5 billion to EUR 6 billion of investment-grade corporate bonds every month. While we think that eurozone growth data would need to continue to deteriorate and inflation would need to remain low to trigger a new round of quantitative easing, the market consensus currently expects the ECB to restart its CSPP, possibly before the end of 2019.

Search For Yield In Eurozone Supports Investment-Grade Corporates

Plummeting yields in the eurozone are another supportive factor for the eurozone investment-grade corporate market. Yields on higher-risk Italian government bonds have tumbled recently as fiscal tensions with the European Union have eased. With the safe-haven 10-year German sovereign note yielding -0.25% in mid-July, investors have been reaching into

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sectors offering slightly positive—or less negative—yields.

At the end of June, about one-third of the European investment-grade corporate market had a negative yield, and even some subinvestment-grade "high yield" bonds now trade with negative yields. We expect this reach for yield to continue even without the ECB resuming purchases of corporate debt.

Powerful Technical Support Overwhelms Weak Fundamentals

Although it is not yet clear that the ECB will restart its CSPP, the possibility of a large, regular, price-insensitive buyer of eurozone corporate bonds reentering the market has created opportunities to take advantage of potential compression in credit spreads[1] in European corporates. We anticipate that this compression will be most pronounced in the lower-rated segments of the investment-grade universe. The fundamentals of many eurozone corporate issuers are deteriorating as the region's economy struggles to grow. However, the positive technical conditions generated by the ECB's potential return to the market more than offset the negative drag from weak fundamentals.

Within the eurozone investment-grade corporate segment, we are finding opportunities in higher-beta[2] sectors. This includes financials, an area that had particularly fallen out of favor with investors amid sagging eurozone growth and expectations for even lower interest rates. The financials sector is a prime example of a segment where renewed ECB purchases would create powerful technical support that overwhelms weak fundamentals. Although the ECB has not directly purchased debt issued by banks, the spillover effects from its broad buying in other segments under the CSPP caused meaningful credit spread compression in financials. We are also increasingly comfortable adding longer-duration[3] positions in European corporates as yields on short-duration, higher-quality bonds become more negative.

Favor Short Duration In U.S.

In U.S. investment-grade corporates, however, we still favor short-duration positions for the simple reason that this positioning limits exposure to credit risk if there is a meaningful downturn in the U.S. economy. While we do not currently expect a recession in the next 12 months, we believe that this posture is a prudent hedge against credit downside. In addition, some short-maturity investment-grade corporate bonds provide an attractive risk/return trade-off by providing attractive yield with relatively low expected price volatility.

However, our team of credit analysts has been finding select opportunities to add longer-duration U.S. corporates priced at levels that are dislocated from their fundamentals. These positions are scattered across segments and issuers but tend to be focused in the health care and technology sectors.

Monitoring Liquidity In Shifting Market Environment

We also closely monitor the liquidity of our positions throughout the investment-grade corporate market. Bond dealers have sharply reduced their inventories of tradable debt since the global financial crisis, so limited liquidity is not a new risk. However, with the market environment shifting as the Fed and other major global central banks transition to policy easing, the ability to quickly buy and sell individual securities at reasonable prices is even more important.

[1] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.
[2] Beta measures the volatility of an individual security in relation to the volatility of the broad market.
[3] Duration measures a bond's sensitivity to changes in interest rates.

WHAT WE'RE WATCHING NEXT

U.S. corporate earnings growth is set to slow further in the second half of 2019 as the benefits of the 2018 tax cut and topline growth fade. The question is how much more earnings growth will decelerate given the escalation of the U.S. trade war with China and other countries. Slowing earnings growth will further weigh on capital expenditures (capex) even as many companies prioritize share buybacks and dividend increases over capex.

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ID0002472 (07/2019)
201907-906521