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European Debt.
RETURNS FORECAST TO BE MODERATE AMID MIXED ECONOMIC TRENDS.



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EXECUTIVE SUMMARY

European debt markets are set for another year of moderate returns in 2016, with interesting opportunities continuing to arise in the investment-grade and high yield credit markets.

- European debt markets are set for another year of moderate returns in 2016 as slowly improving fundamentals are offset by external headwinds.
- Slowing growth in China and other emerging markets is weighing heavily on eurozone exports, and there is no indication that the slack in global demand will be taken up anytime soon by the slowly growing US economy.
- Eurozone sovereign spreads are likely to remain narrow as the ECB maintains its monthly bond purchases and the European economy continues to grow.
- Investment-grade corporate yields are historically low, but they look reasonable compared with sovereigns; the European high yield market looks set to remain attractive relative to the US high yield market for most of 2016 and possibly beyond.

European debt markets are set for another year of moderate returns in 2016 as slowly improving fundamentals are offset by external headwinds. While concerns in Europe this year have been primarily about internal issues—the possibility of a ”Grexit” chief among them—the main challenges next year will come from outside the Continent, namely the slowdown in emerging markets and the weaker-than-expected recovery of the US economy. The actions of the Federal Reserve and the European Central Bank (ECB) in response to their respective domestic issues will also play an important role in determining bond market performance.

Slowing growth in China and other emerging markets is weighing heavily on eurozone exports, and there is no indication that the slack in global demand will be taken up anytime soon by the slowly growing US economy. Given that growth in Europe itself

looks set to remain tepid at best, and there remains much excess capacity in the eurozone, it is highly likely that inflation will remain below the ECB's target of 2% for at least the next two to three years and possibly longer.

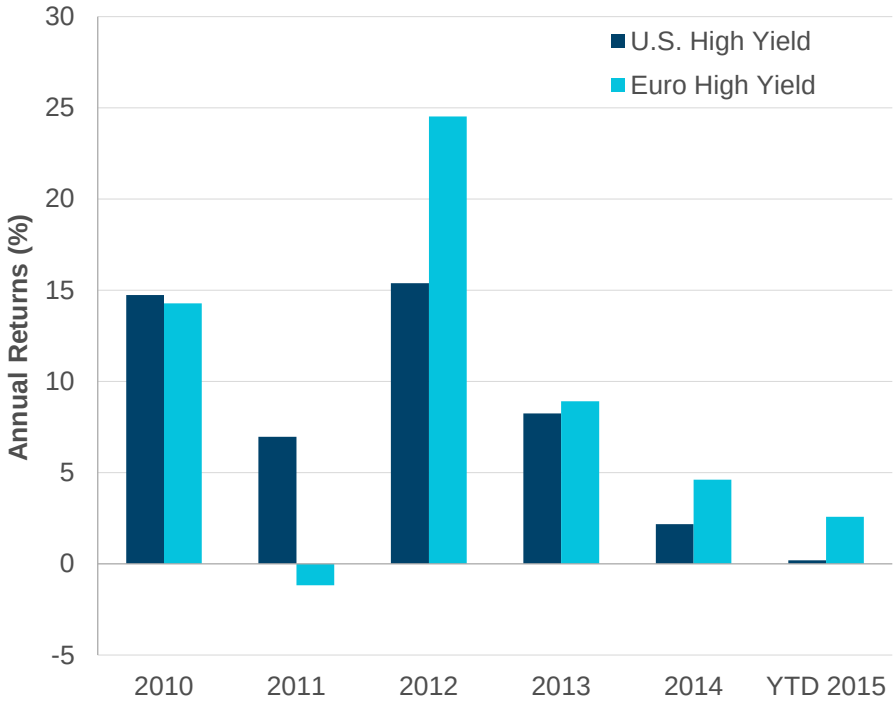
ECB TO PLAY DECISIVE ROLE

How the ECB responds to the inflation shortfall will play an important role in influencing asset prices in Europe during 2016 and beyond. In early December, the bank announced a number of measures, including a 10-basis-point cut to the deposit rate of 0.3%, an extension of the QE timeline until at least March 2017, and an expansion of the range of assets eligible for purchase under the program to include local and regional government debt. Any further measures will need to be finely calibrated, taking into consideration the strength of the eurozone recovery and how any actions will affect the region's money markets and banks.

Eurozone sovereign spreads are likely to remain narrow as the ECB maintains its monthly bond purchases and the European economy continues to grow, meaning that opportunities will be largely confined to carry trades between so-called core and peripheral sovereign bonds. More attractive sovereign opportunities exist in Eastern Europe, where widespread disinflation means that interest rate cuts are possible in places such as Romania, Russia, and Serbia, sending local bond prices higher. We are approaching this theme with caution, however, as the disinflationary trend may reverse next year in some Eastern European countries, leading to dispersion within the bloc.

Figure 1: Euro High Yield Outperformed US High Yield Since 2012

As of 31 October 2015



Past performance is not a reliable indicator of future performance.

Sources: J.P. Morgan Domestic HY Index and BofA Merrill Lynch European Currency High Yield Constrained Excluding Subordinated Financials Index hedged to the euro.

FAVOURABLE CREDIT CYCLE CREATING OPPORTUNITIES

Credit looks more interesting. Investment-grade corporates saw spread widening in mid-2015 as external factors led to generic widening in spread sectors. Over recent months, however, widening and volatility have resulted from an increase in idiosyncratic factors, including a pickup in merger and acquisition and the Volkswagen emissions scandal. Relative underperformance from industrial sectors is leading to attractive stock selection opportunities.

Unlike in the US, the credit cycle in Europe is still improving. Economic recovery is expected to feed through into corporate earnings, yet, given the still fragile nature of the recovery, companies are, on balance, still maintaining relatively conservative balance sheets. Although future spread tightening is likely to remain modest, the asset class remains relatively well supported by the ECB's accommodative policy.

Investment-grade corporate yields are historically low, but they look reasonable compared with European sovereign markets.

In high yield, Europe continues to look attractive compared with the US (Figure 1). A key factor here is that a fifth of outstanding US high yield debt has been lent to the highly vulnerable oil and gas industry, whereas few energy companies have issued in the European high yield market. Defaults among US energy companies appear likely as companies that borrowed when they could sell oil for more than US$100 a barrel struggle to adjust to prices below US$50. As of 2015 according to JP Morgan, some 62% of the European high yield market is composed of BB rated companies, including many ”fallen angels” that were previously rated investment grade. In the US, ratings are distributed further down the spectrum toward the CCC segment, with less than 50% rated BB.

CENTRAL BANK DIVERGENCE TO PERSIST FOR MEDIUM TERM

The relative attractiveness of the European credit market over the US market should persist through most of 2016 and possibly beyond, depending on how aggressively the Fed hikes interest rates and the precise nature of any further easing from the ECB. Higher target rates set by the Fed will send US bond yields higher and prices lower, making it more expensive for US companies to borrow. By contrast, an extension to quantitative easing from the ECB will keep yields at very low levels for the foreseeable future, maintaining highly favourable conditions for European issuers. Eventually, further rate rises in the US will attract investors seeking higher yields and the European credit cycle will mature, but this a longer-term scenario.

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