European Investment Grade: Can the Rally Last?

Technical support for the region's bonds may diminish soon.

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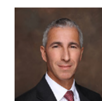

David Stanley
Portfolio Manager, Fixed Income

KEY INSIGHTS

- Government and central bank actions have inserted positive technical drivers into the European credit market, compensating for deteriorating fundamentals.
- However, some of these technical drivers may soon diminish, presenting a challenge for investors in European corporate bonds.
- Corporate fundamentals are likely to come back into focus as investors seek companies that are well placed to survive further volatility and emerge stronger.

Government and central bank actions in response to the coronavirus have inserted some very positive technical drivers into the European credit market, compensating for deteriorating fundamentals. However, some of these technical drivers may soon diminish while fundamentals continue to decline, presenting a challenge for investors in European corporate bonds.

Technical factors have dominated European credit over the past six months as the region's leaders have taken dramatic steps to counter the economic and financial fallout from the coronavirus pandemic. In March, the European Central Bank (ECB) announced a EUR 750 billion Pandemic Emergency Purchase Programme (PEPP), later expanded to EUR 1.35 trillion, through which it is buying record amounts of debt to help European Union (EU) member countries cope with extra spending. The PEPP expanded on existing schemes, including the asset purchase program and the corporate sector purchase program.

The ECB has not been the only buyer of European corporate bonds. Following initial outflows when the pandemic first hit, there have been consistent inflows into investment-grade (IG) corporate funds from investors encouraged by the central bank's bond-buying program and put off by the tiny spreads available in sovereign bonds and the possibility of defaults in high yield. Since PEPP was launched, bonds eligible for purchase under the scheme have outperformed ineligible bonds of similar quality and maturity: Euro-denominated European nonfinancial corporate bonds, which are eligible for purchase under PEPP, have delivered stronger returns than those domiciled outside the region, such as in the UK and U.S., which are ineligible.

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EU Message of Unity Has Boosted Corporate Bonds

Further support for the regional economy came in July when the EU committed to raising EUR 750 billion in capital markets to provide a coronavirus recovery fund for member countries. Some EUR 390 billion will be distributed as grants, with the remaining EUR 360 billion provided as loans, targeted at the countries most affected by the pandemic—the first time that some member states have benefited more than others from commonly borrowed funds. Although the primary impact of this stimulus has been economic, corporate bonds have additionally benefited from the message of unity given to highly indebted sovereigns and the suppression of government bond volatility.

While this has been taking place, gross supply of European IG bonds has almost halted and net supply has turned negative. This marks a sharp turnaround from the initial wave of the market sell-off in March, when issuance spiked dramatically. Although supply typically slows in the summer before picking up in the autumn, U.S. IG bond issuance has been much more robust.

The combination of surging demand and dwindling supply has helped the European IG bond sector to recover from the economic shock that obliterated markets in the spring. After selling off dramatically in early March, European IG spreads have recovered strongly, although they remain wider than pre-crisis levels. The asset class seems largely impervious to negative headlines, with spreads unaffected—so far—by reports that the global economic recovery may be stalling and that second waves of the virus are on their way.

Cash Underperforms Derivatives as Investors Seek Liquidity

Another notable coronavirus-related technical development has been the underperformance, then recovery, of cash bonds versus credit default swaps (CDSs). When the pandemic first hit and markets sold off indiscriminately, large numbers of companies were forced to issue bonds—some acting prudently but others from a position of weakness—to shore up liquidity. As they were issuing bonds in a rapidly declining market, firms had to offer significant concessions in order to sell them, accentuating the sharp spike in spreads.

The iTraxx Europe Index, which comprises the most liquid 125 CDSs referencing European investment-grade credits, was also highly volatile at the beginning of the pandemic. However, spreads on the iTraxx spiked much less than cash bond indexes as nervous investors preferred to trade in derivatives owing to their perceived greater liquidity. Before the pandemic struck, the average CDS bond basis was only slightly negative (a negative basis means the CDS spread is smaller than the cash bond spread); this widened to -120 in March, in some sectors, making it relatively more attractive to go long credit risk in cash bonds. It subsequently recovered closer to -30 basis points at the end of August.

Diminishing Technicals Could Unleash Volatility

Technical factors can have a very positive effect on corporate bond spreads and volatility and can last for significant periods of time. However, fundamental issues cannot be ignored—and they have been deteriorating, on average, while spreads have continued to tighten. This has led valuations to become stretched relative to current economic conditions and the as yet moderate pickup in corporate leverage. We believe valuations are more justified based on the 2021 outlook, assuming the economic recovery continues.

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The medium-term outlook for the European economy is uncertain, however. If a major second wave of the coronavirus is avoided and there are no further national lockdowns, growth may pick up and bond spreads will likely remain stable; if, however, there is a major second wave of the pandemic resulting in lengthy national lockdowns, as opposed to current more regional lockdowns, growth could slump again. Also of concern is what will happen when government support schemes start to be relaxed and whether this will trigger a surge in unemployment and an explosion of bankruptcies. November's U.S. election is also on the horizon, bringing policy uncertainty and, potentially, volatility.

It is against this backdrop that any reduction in the technical drivers could lead to increased volatility and possible spread widening. The ECB has shown that it is ready, willing, and able to support the eurozone's recovery. Corporate bond buying is not only set to continue, but there is scope for it to be increased if necessary. However, supply is likely to pick up again soon after slumping during the summer and become more in line with U.S. issuance, reducing one of the key technical factors supporting European IG bonds.

This does not imply that spreads, on average, are set to widen in the short term; it does, however, suggest that downside risks are growing and that volatility could rise. If this occurs, corporate fundamentals are likely to come back into focus as investors seek to identify those companies with healthy balance sheets and strong cash flows that may be well placed to survive further bouts of volatility and emerge stronger on the other side.

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