MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 032 // **July 19, 2021**

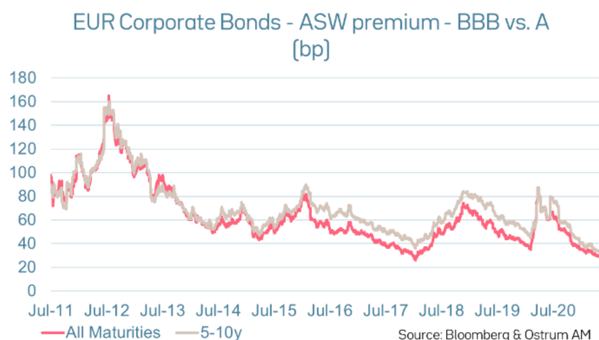
Topic of the week: QE and Credit Market Change

- **The ECB has absorbed three-quarters of the net credit offer since 2016, but more than all this year. The rates have therefore fallen and the crushing of the risk premium cannot be justified solely by the fundamentals;**
- **This policy has also allowed companies to increase their cash position and, paradoxically, improve their balance sheet;**
- **Finally, there is a structural shift in sources of financing for non-financial enterprises.**

Market review: The ignored inflation problem

- **US CPI Inflation soars to 5.4% in June**
- **Fed's Powell hammers home its dovish message**
- **Treasury note yields fall back despite inflation, poor 30y auction**
- **Equities tank as delta variant fears**

Chart of the week



Euro investment grade have fared well so far this year as aggregate index spreads have tightened to the tune of 9bp. Continued ECB purchases and modest support from rating upgrades contributed to spread narrowing.

In addition, the compression of asset-swap spreads per rating categories has continued as the premium of BBB vs. A has fallen further to just 27bp, a 2018 low.

Figure of the week

400

Despite initial opposition from UAE, the OPEC+ finally agreed to boost crude production by400k barrels per day from August.

Source : Ostrum AM

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Topic of the week

QE and Credit Market Change

ECB's QE has had a very significant impact with the absorption of a large portion of the net supply over the past 5 years. This allowed companies to get through the crisis and also reduced markets' risk premiums far beyond what the fundamentals would suggest. Finally, business financing has also evolved structurally.

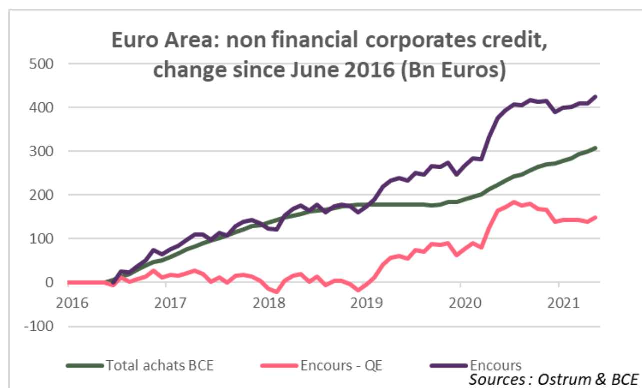
A massive impact of QE

The first point to emphasize about recent developments in the credit market is the very significant impact of the ECB's QE.

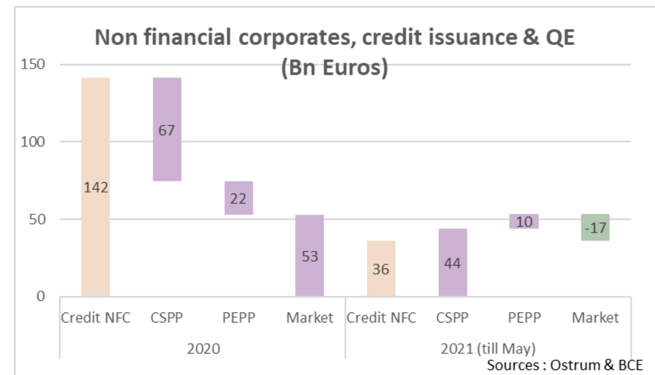
According to ECB's figures, the outstanding amount of credit issued by non-financial companies (NFC) on the European markets in May this year was 1,583.8 Bn euros. This figure has grown by 424.9 Bn euros since June 2016 when the ECB began its QE on credit. Over the same period, the ECB purchased a total of 307.5 Bn euros in credit, hence accounting for three quarters of net issues.

For investors, there is "only" €100 Bn left to invest and even less if you take into account the coupons that were paid over this period.

However, the graph below shows that the absorption by the ECB is far from linear. In the first phase of QE, between 2016 and the end of 2018, QE was very close to net issuances and therefore the outstanding amount of credit available for investors, after taking QE into account, remained almost unchanged over the period. However, with QE ending for most of 2019, the stock has started to grow again.



Last year saw record issues, a outstanding amounts rising by 142 Bn, while the ECB bought 89 Bn, or two-thirds. Since the beginning of 2021, however, the pace of issuance has slowed down considerably while ECB's purchases remain largely unscathed. The result is: a 36 Bn growth in outstanding assets compared to 54 Bn in ECB purchases. And so, a net outstanding amount, after taking into account QE, which is reduced by 17 Bn!

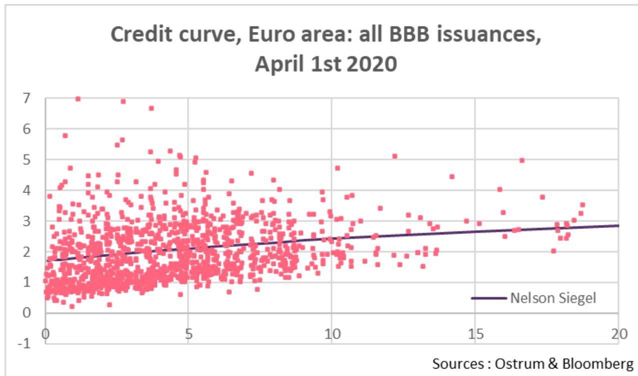


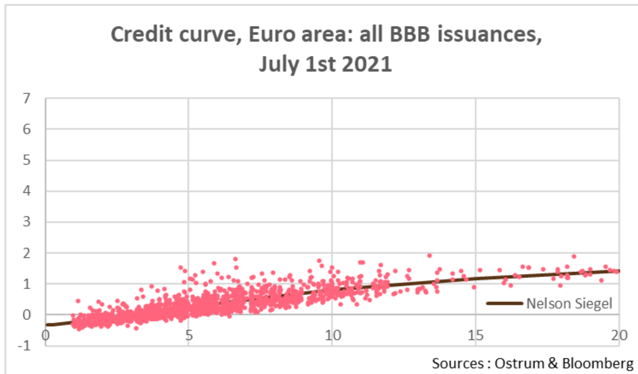
However, several details of these figures must be recalled.

- On the one hand, the outstandings given concern only non-financial corporations (NFC), and therefore exclude banks that have issued a lot. The total volume of credit in Europe is therefore more dynamic than appears on these figures.
- On the other hand, the credit that pays a coupon constitutes cash to be reinvested and therefore the shortage of paper for investors is even greater.
- Finally, the ECB's QE only applies to IG securities (to be eligible for the CSPP, the best score of the four agencies for a security must be IG, the universe therefore covers the IG and, de facto, part of the crossover), even if the outstandings figures include IG and HY. As a result, HY's outstanding amounts increased, but IG's outstanding amounts were much smaller than our figures suggest.

Much lower yields and risks

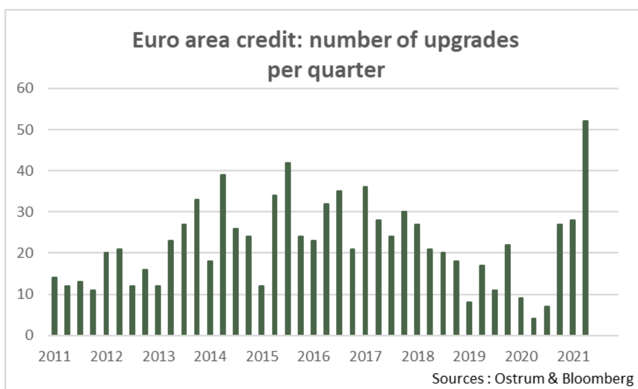
As a result of the action of the ECB, but also, of course, of the exit from the crisis, the yields on the market collapsed. The two following graphs illustrate the BBB universe in the European credit. Not only did the curve moved South enormously between April 2020 and July this year, but the very strong dispersion within the asset class also faded away.





A large portion of this flattening of the yield curve is therefore due to the compression of QE risk premiums. For an equivalent risk, investors are paid less. This is one of the goals of QE and has allowed businesses to finance themselves at relatively low cost.

However, compression is also linked to a decrease in fundamental risk. The chart below shows the number of upward revisions of ratings by S&P across the European credit universe. Clearly, the last few months have been very active in terms of upward revisions. At the time of writing, there have already been 6 upward revisions since the beginning of the quarter, which would bring us at this rate to 36, a number once again very high.



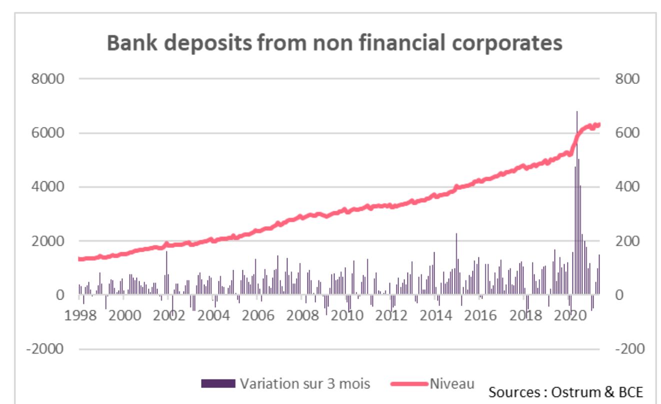
With a spread at 280 basis points on the HY index, and assuming a 40% recovery rate, this means that spreads can absorb a default rate of 1.7%. Our economic model is more pessimistic with a percentage of companies risking a default close to 4%. But companies at risk are smaller, and therefore making the assumption that, weighted by the size of the issues, the default rate will be close to 2%, does not seem outrageous.

However, the investor's remuneration remains very low: it barely offsets the risk of default even using favorable assumptions and does not offset liquidity risk at all. The reduction of the risk premium therefore seems hardly justifiable on the sole fundamental argument. The ECB has indeed had a significant impact, even on the HY, which it does not buy directly.

A comfortable cash flow level

Another consequence of QE has been the ease with which companies can issue debt and thus strengthen their cash position as a precaution during the crisis. Similarly, the ECB's extremely lax policy coupled with state guarantees for bank loans in many countries has led to an increase in bank loans and helped companies to improve their liquidity position.

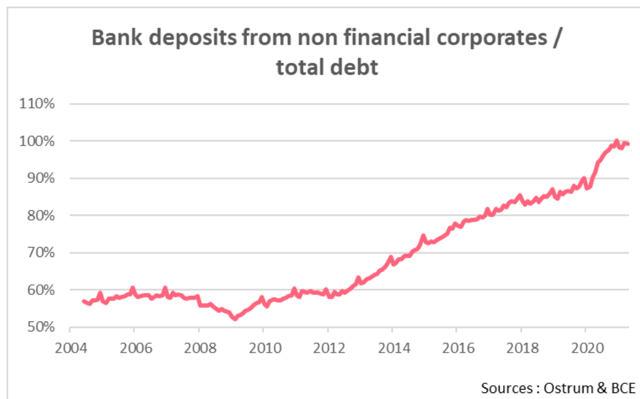
The following graph uses ECB's data on the aggregate balance sheet of banks. On the liabilities side, we use the deposit account for non-financial corporations. Over the second half of the previous decade, NFC bank deposits were growing at a fairly stable rate of 5-6% per year. They gained more than 17% (882Bn) over the first half of the year and almost 19% over the year.



It is also necessary to add a statistical precision: a sizeable part of the liquidity collected by businesses was most likely found on monetary financial instruments. Unfortunately, we do not yet have accurate and reliable figures in this area. Between 2015 and 2019, the stock of money market funds grew by 4% per year on average but gained 22% (or 115 Bn)

in 2020 alone. Though it is not possible to break down these subscriptions, part of it is necessarily the NFC. The chart thus probably significantly underestimates the cash surge over the period.

Surprisingly, the NFC balance sheet situation has thus improved. We look at the ratio between bank deposits, which is underestimating the total cash level, and the total debt level by taking bank debt plus the stock of debt issued on the markets. This ratio has improved as shown in the chart below.



Of course it would be simplistic to conclude that all European companies are coming out of this crisis healthier, but the fact remains that the fear of excessive debt must be put into perspective: it is obvious that gross debt has increased, but net debt has a much less stressful profile.

Source of funding

The last point to emphasize is the change in corporate financing structure. There has been a steady evolution for over a decade, facilitated by QE, with increasing reliance on markets.

Almost 90% of corporate debt was bank debt in 2009. Since then, the proportion of market debt has doubled, with the outstanding amount of market debt growing by 125% since 2009, while bank debt has remained virtually flat. We remain on modest levels however compared to the United States where about half of the debt of companies comes from the market. Of course, these aggregated figures are very much drawn by large companies, the SME fabric is more plethoric in the Eurozone than in the United States and partly explains the predominant share of bank loans.

The fact remains, however, that this development is beneficial in that it makes it possible to diversify the sources of financing for companies which are therefore less dependent on the health of the European banking system.

Conclusion

QE is often thought of as a transitional tool of the ECB that makes it possible to lower the borrowing rates of European companies. The consequences are more perennial, ranging from distortion of risk premiums to changing the structure of financing companies.

Stéphane Déo

Market review

The ignored inflation problem

The Fed hammers its message in the face of rising inflation, with stocks under pressure.

The acceleration in US inflation is undeniable. But the US 10-year note benefits from the unwavering support of the Federal Reserve motivated by the supposedly transitory nature of the upturn in inflation. A poor 30-year bond auction favored sellers before Jerome Powell once again hammered home his dovish message. The US 10-year yield is once again flirting with 1.30%. Amid bouts of volatility and selling pressure on Friday, stock indices remain close to their historic highs. Oil prices oscillate amid delta fears and supply uncertainty. The fall in nominal bond yields and the decline in oil prices are logically weighing on expected inflation. The July 21 meeting at the ECB will be an opportunity to present its strategic review and to consider options to extend monetary easing beyond the PEPP's scheduled deadline in March 2022. The promise of low rates keeps spreads stable. The dollar is strengthening against most currencies with the exception of the New Zealand dollar, driven by expectations of rate hikes in August.

The economic backdrop remains unchanged. Strong US growth and a recovery in the labor market seem to be leading to a persistent increase in inflation. The inflation surprise index calculated by Citi indeed stands at an all-time high. Consumer prices are up 5.4% year on year in June. The so-called core index excluding food and energy is up 4.5% from a year ago. Producer prices or the cost of imports continue to reflect ongoing pressures on global production chains. The cost of sea freight is reaching unprecedented levels. The container prices set in Shanghai exchanges has quadrupled since June 2020. These production and supply chain constraints are unlikely to subside in the short term as the reopening of economies increases the level of activity this summer. Short- and medium-term household inflation expectations also rose in June (4.8% and 2.9% respectively).

Meanwhile, retail sales advanced 0.6% in June, after a revised 1.7% dip in May. Growth driven by final consumption is expected to reach 8-10% in the second quarter of 2021. However, the Fed does not seem to want to deviate from its dovish communication. Its roadmap likely includes the announcement of tapering at the end of summer. The reduction in asset purchases to zero will then take about a year. Housing prices nevertheless deserve the attention of central bankers. Some central banks have already started to pare back monetary support. The BoC thus reduced its weekly purchases to C$ 2 billion. Likewise, the RBNZ sees the rise in inflation (1.3%q in the second quarter) as a reason to bring forward monetary tightening. An August hike is likely. The BoE is also hinting at a reduction in monetary stimulus. Conversely, the ECB meeting on July 21 will allow Christine Lagarde to present the institution's new monetary strategy. The inflation goal is now symmetrical around 2%. Ultimately, inflation will consider the cost of housing for owners. The ECB will also evoke post-PEPP monetary conditions and likely outline the contours of a sustainable asset purchase program linked to the climate crisis. The greening of the CSPP, beyond the natural increase in the stock of green bonds in the eligible universe, seems a new objective for the institution in Frankfurt. The BoJ, which turned more cautious about growth due to the resurgence of the epidemic in Asia, will also intervene in the green bond market, including in foreign currencies, given the insufficient stock of JPY bonds.

The successive surprises on the various price indices seem to add fuel to the flattening trend. The US 10-year briefly broke the 1.40% threshold in the wake of the June CPI and a poor 30-year bond auction. Jerome Powell's comments eventually capped this increase, bringing the yield on T-notes down to 1.30% at the end of the week. The 2-10 year spread narrowed by 6bp in five trading sessions, also thanks to rare tension on 2-year yields. Market break-even inflation rates seem to imply that bond investors remain rather confident in the Fed's ability to bring inflation down to the 2% target, but household surveys (CES, UofMich) do send a different message. The 10-year inflation swap is up some 5bp for the week. The German Bund follows the trend set by the T-note, as the ECB is far from considering the end of monetary support. The expiration of the PEPP will result in a new instrument being launched. The Bund fell back to the -0.35% area and the 30-year (0.14%) further accentuated this decline. Swap spreads tend to widen, especially on long maturities. However, 10-year sovereign spreads are stable around 105bp on Italian BTP and 64bp on Bonos.

Investment grade credit remains inert with spreads insensitive to data or health fears. The Euro IG spread is trading about 83bp against the risk-free benchmark, much like its US IG counterpart (85bp). High yield (297bp vs. Bund) remains driven by a decompression trade opposing BB ratings to the B group. This latest movement of 20bp since the start of the month wiped out the tightening in June.

Stocks remain close to their peaks. However, the asymmetry of market responses to corporate guidance appear to leave little room for disappointment at a time when market 2022 PE ratios hover about 15.5x. There were indeed some violent pullbacks following corporate announcements this week.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	19-Jul-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.68 %	-1	-2	+2
EUR Bunds 10y	-0.37%	-8	-17	+20
EUR Bunds 2s10s	31 bp	-7	-16	+18
USD Treasuries 2y	0.22 %	-1	-4	+10
USD Treasuries 10y	1.25 %	-12	-19	+34
USD Treasuries 2s10s	103 bp	-11	-15	+24
GBP Gilt 10y	0.6 %	-6	-16	+40
JPY JGB 10y	0.02 %	-2	-4	-1
€ Sovereign Spreads (10y)	19-Jul-21	-1wk (bp)	-1m (bp)	YTD (bp)
France	34 bp	0	-2	+11
Italy	109 bp	+5	+1	-3
Spain	66 bp	+2	+1	+4
Inflation Break-evens (10y)	19-Jul-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi (9y)	131 bp	0	+1	-
USD TIPS	232 bp	-1	+8	+34
GBP Gilt Index-Linked	346 bp	+3	+2	+46
EUR Credit Indices	19-Jul-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	83 bp	+0	+0	-9
EUR Agencies OAS	42 bp	+0	+2	+1
EUR Securitized - Covered OAS	36 bp	+2	+3	+3
EUR Pan-European High Yield OAS	298 bp	+1	+10	-60
EUR/USD CDS Indices 5y	19-Jul-21	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	49 bp	+2	+1	+1
iTraxx Crossover	243 bp	+10	+6	+2
CDX IG	50 bp	+2	+0	0
CDX High Yield	287 bp	+10	+6	-7
Emerging Markets	19-Jul-21	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	350 bp	+2	+20	-2
Currencies	19-Jul-21	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	$1.178	-0.7	-1.21	-3.68
GBP/USD	$1.371	-1.26	-1.59	+0.41
USD/JPY	¥109.82	+0.51	+0.32	-5.94
Commodity Futures	19-Jul-21	-1wk ($)	-1m ($)	YTD ($)
Crude Brent	$71.7	-$3.5	-$1.1	$20.5
Gold	$1 803.9	-$1.9	$20.6	-$90.5
Equity Market Indices	19-Jul-21	-1wk (%)	-1m (%)	YTD (%)
S&P 500	4 327	-0.97	3.86	15.20
EuroStoxx 50	3 949	-3.53	-3.30	11.15
CAC 40	6 324	-3.59	-3.74	13.91
Nikkei 225	27 653	-3.21	-4.53	0.76
Shanghai Composite	3 539	-0.25	0.40	1.90
VIX - Implied Volatility Index	20.44	26.41	-1.26	-10.15

Source: Bloomberg, Ostrum Asset Management

Additional notes

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