

Credit Outlook 2022: Don't Stop Me Now

It's one of Queen's most popular songs and more than 40 years on from its release, it's still providing us with inspiration. There was no stopping the credit market in 2021, but is it on a collision course with rising inflation? Have yourself a real good time, and read on



Key points

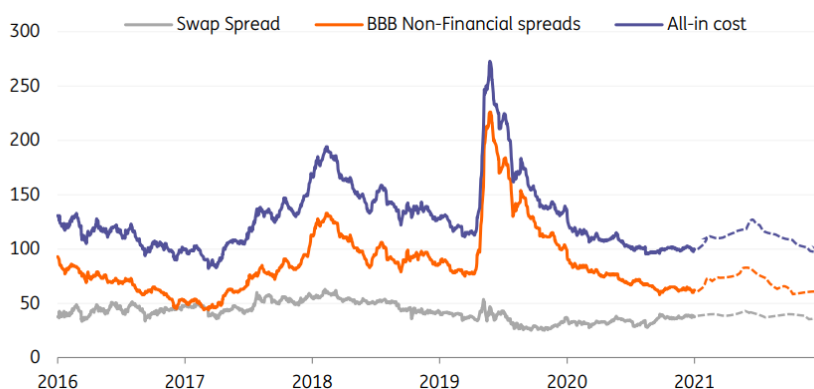
- The technical picture will still dominate in 2022 keeping spreads well supported, despite rising rates. This is helped by an expected €50bn fall in net supply.
- Inflation, rising energy / commodity prices and supply chain shortages pose the largest threat to credit in 2022. Many sectors could see earnings pressure.
- Strong cash balances will secure credit metrics and asset rotation is unlikely with only small rises in rates.
- We are cautiously optimistic for 2022 and are more tentative on sectors that are under possible pressure from inflation, energy prices and supply chain shortages. Higher coupons and lower duration product could provide some insulation against rates rising whilst spreads tread water.

This year we have taken another reference to a classic from Queen as the identifier for credit markets into 2022. **Don't stop me now** is the simple reference to predominantly QE-induced

technical strength for credit markets. But the lyrics also mention a **collision course** which could well be synonymous for inflationary risks or in a brighter world could be a reference to tapering and rising rates on the back of economic growth. The purchasing machine **ready to reload** could well be the continued determinant for more credit market strength in the near future, but as the lyrics also clearly show **the good time** seems a little too rosy at times.

Even for credit it's all about inflation, supply chains, commodity prices and subsequently rates. If ever there was a time that true credit dynamics stood at the back of the queue in determining direction it was now. With credit dominated by technicals, depending on the above factors, it's fair to say that actual credit fundamentals or credit market drivers will have little to say, or will they? After all the fact that credit market dynamics themselves should be very stable in 2022 means the asset class will be seen as a safe haven. This will show through in dependable returns for the lower beta, non-inflationary segments, as credit depends on its technicals and strong credit metrics.

Spreads will remain supported in 2022, with any widening subdued



Source: ING, Refinitiv, ICE

As shown in the chart above, we expect that EUR IG spreads will remain compressed and tight in 2022, on the back of, in particular, the strong technical picture in credit, even a slowing CSPP or slowing fund inflows will not see that change as net supply falls by another 50% in 2022. Therefore, we are cautiously positive in our outlook. Higher beta debt and lower rated debt may see some slight underperformance on the back of more pressure from rising inflation, higher commodity prices and rising rates. Furthermore, the long end of the curve will be under more pressure from rising rates, and therefore we expect a steepening of credit curves.

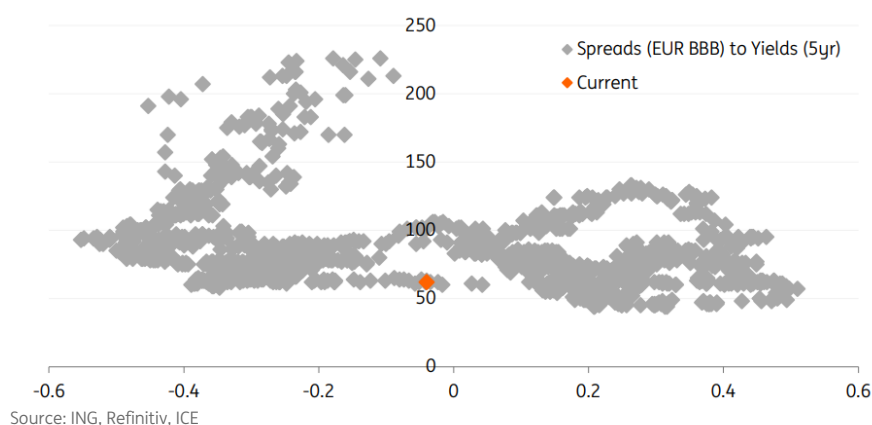
USD credit will be under more pressure from more rising rates. We expect the 10yr to move up 80bp by mid-2022 and thus total returns and inflows will be under more pressure. The 5yr is expected to rise by 50bp by the middle of next year in the US. The 3yr rates are forecast to increase by 25bp by mid-2022. With this increase in rates, returns will be lower and therefore investors may start looking elsewhere for additional return, and as such we expect to see fewer inflows into USD.

Meanwhile, the EUR 10yr rates should rise by 30-40bp by 2Q22-3Q22, respectively, The EUR 5yr will come out of negative territory and is expected to rise by 15-25bp by 2Q22- 3Q22, respectively. While the 3yr rates will not move by much, just about 10bp by mid-2022. Overall, the rates rise in

Euro will be minimal compared to USD. Already, all in cost is at very low levels as seen in the chart above. Therefore, we expect less pressure on returns and subsequently inflows relative to USD. However, as yields rise, we may see yield-hungry bargain-basement buyers come to the market when absolute yield levels temporary tick upwards.

The chart below illustrates an interesting development whereby spreads struggle to tighten any further from current levels when yields are negative. Only when yields rise is there performance potential, to the tune of a potential 10bp tightening. With the expectation of higher rates, and subsequently higher yields, we could see more tightening in spread levels. This is good for excess returns, however not for all in yield total return as yields must rise at least 20bp. Therefore, total returns will be very low, and potentially close to zero (or negative) with low coupons. This is another reason to be more conservative in 2022. Although, in saying that, we are comfortable with corporate hybrids and even lower rates BBB-/BB+ debt with higher yield and a positive return.

Regression between Yields and BBB spreads over the past 5 years

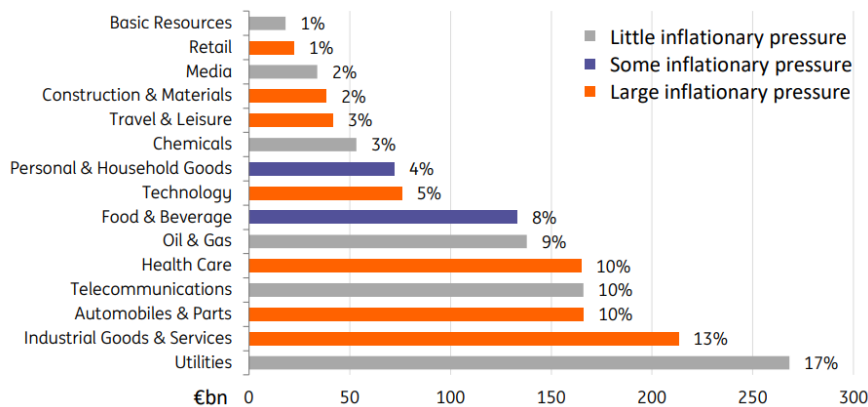


Main risks

The main risk for credit going into 2022 is rising inflation, higher commodity/energy prices and supply chain shortages. All of these factors may have a negative effect on earnings. In multiple charts below, there is a breakdown of inflationary pressure, supply chain shortages and energy usage per sector. Naturally, we would be cautious with names in sectors that could be under more pressure from these factors.

To highlight the issue for corporate credit we see that margin/earnings pressure could arise from no less than 43% of the iBoxx weighted sectors. The supersonic support for credit might just falter there and then. Adding in sectors with some pressure gets us to 55% of the total and as such a most certain situation of pressure on spreads. We believe these concerns due to higher energy prices will be a key ingredient for why we have pencilled in some weakness for credit spreads in the early part of 2022. At that time, we will also see a decent chunk of the supply hit the market. And thus, the good time had in credit could falter from both the demand and supply angle

Amount outstanding in iBoxx per sector, with expected inflationary pressure

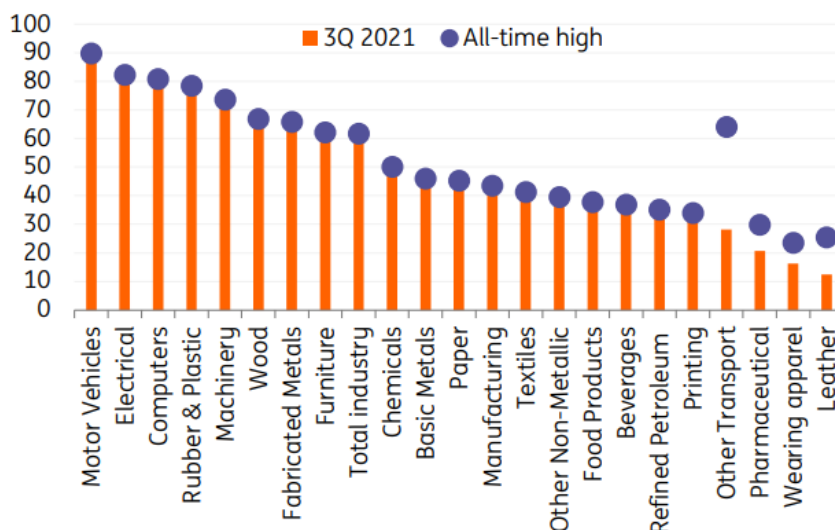


Source: ING, Markit

For many sectors supply chain shortages are at all-time highs. This is putting pressure on earnings, particularly for manufacturing and industrial sectors, and as such may result in a widening of spreads. The chart below reflects the amount of businesses reporting input shortages as a factor hindering production. The most significant declines in production have been seen in the auto sector. It is now closely followed by other sectors also dependent on computer chips. The problem is even more widespread than that though, with most manufacturing sectors now showing all-time highs in reported labour and equipment shortages hindering production.

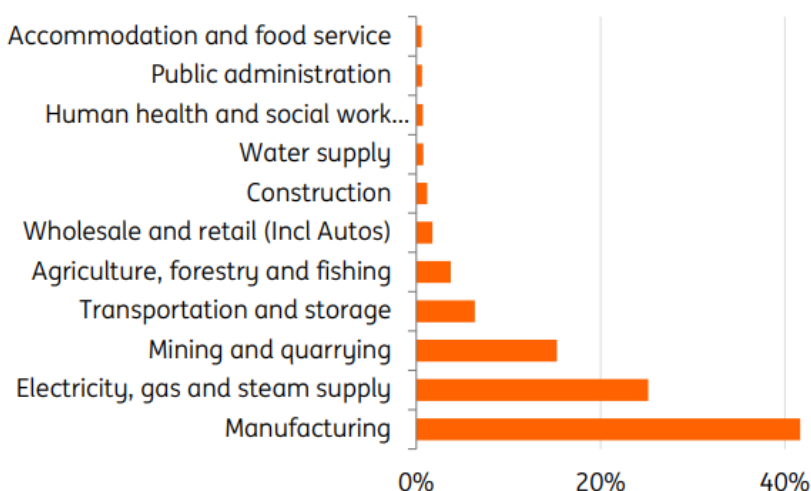
Naturally, manufacturing is also the largest user of energy at over 40% of the energy used. Now with rising and volatile energy and commodity prices, corporates with high energy usage will be under earnings pressure with this additional cost. This may further put pressure on spreads. As shown in the chart below, Manufacturing, mining, transportation and agriculture are some of the largest users of energy in Europe.

EZ Supply chain shortages per sector



Source: ING, European commission

Energy usage per sector



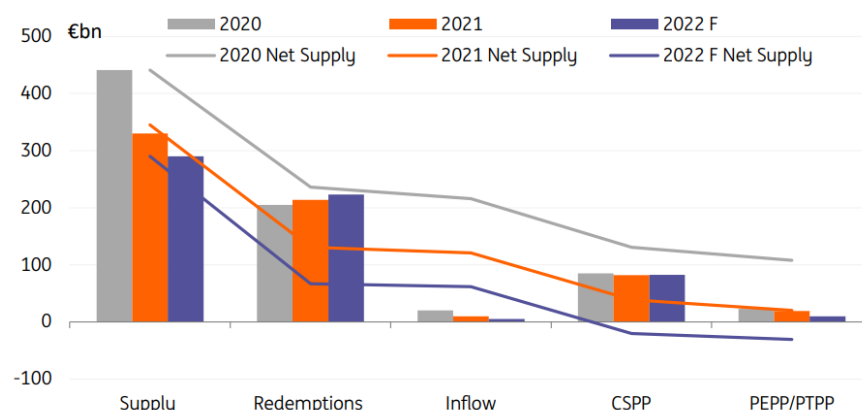
Source: ING, Eurostat

Supply to fall

However, any widening will be largely subdued, the winter energy concerns will abate and the strong technicals will dominate and keep spreads supported. The technical picture is outlined in the chart below, whereby we see EUR corporate net supply falling to below zero at around -€30bn. That is a drop of €50bn from 2021 and a significant €140bn drop from 2020. This constitutes a true positive driver for spreads in 2022.

The detail too supports that, with corporate supply expected to fall next year. We forecast supply to amount to €290bn. Meanwhile, redemptions are higher next year at €223bn. Demand consists of slightly lower but similar mutual fund inflows to this year, of about €5bn, and the ECB will continue to purchase at a speed of some of €92.5bn gross for the year.

Very strong technical picture in corporate credit for 2022

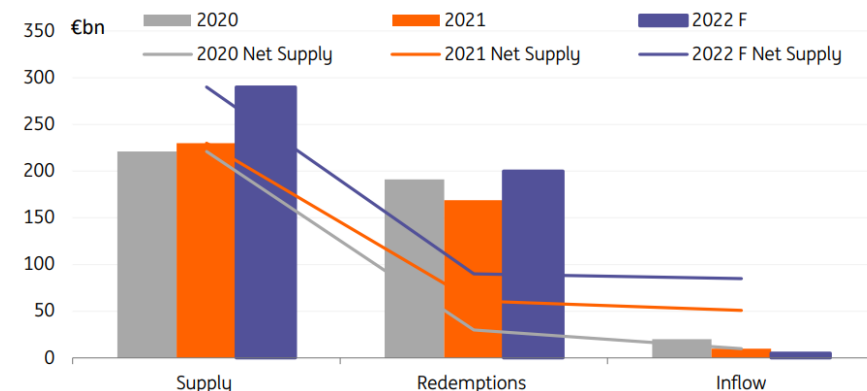


Source: ING, Dealogic, ECB, EPFR

However, the technical picture for financials is not as strong as for corporates. This is a driving reason for our preference for corporates over financials in 2022. Financials supply is expected to rise slightly next year to €290bn (excluding covered bonds), redemptions are more in line with

2020 in 2022 at €179bn, down from €205bn in 2021. Net supply, therefore, comes to €110bn. Additionally, Bank debt receives no support from the ECB's purchases. Net supply after demand comes to €100bn for financials, up on €60bn in 2021. This is less supportive for spreads.

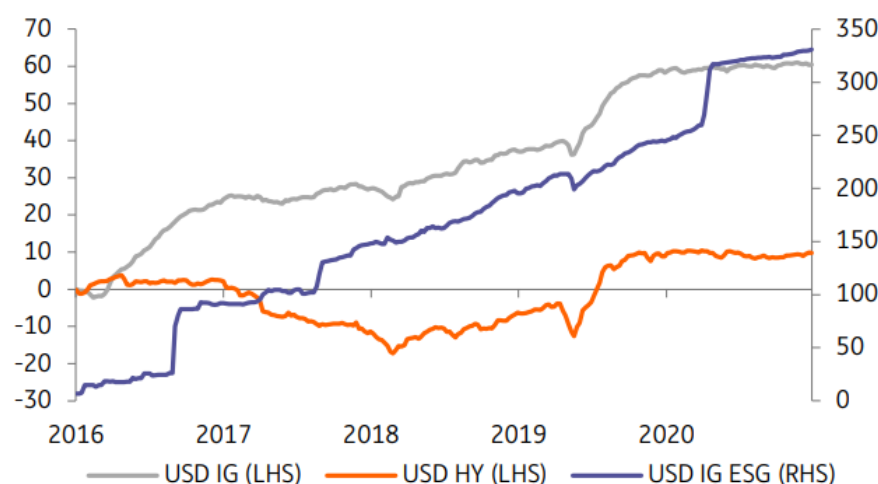
Technical picture not as strong as financial credit for 2022



Source: ING

The ECB will remain very much in the picture for corporates. We expect CSPP net purchases will continue at the average of €5.5bn per month, amounting to around €65bn by the year end. Furthermore, we calculate redemptions for the ECB to be at around €17.5bn next year, resulting in gross purchases expected at €82.5bn. In fact, even after the ECB stops APP purchases (likely in mid-2023), there is still a significant level of reinvestments for some years to come, to the tune of around €2bn per month. With PEPP set to end in March, our economists are expecting the end of the programme to be met with a transition period. This could come in the form of a new transition programme, or in the form of increased APP purchases. In any case this will be mainly for public sector purchases, and we expect corporate purchases to be low at roughly €10bn next year on top of the normal €65bn in CSPP.

ECB corporate purchases will remain high in 2022, and reinvestments are significant for years to come

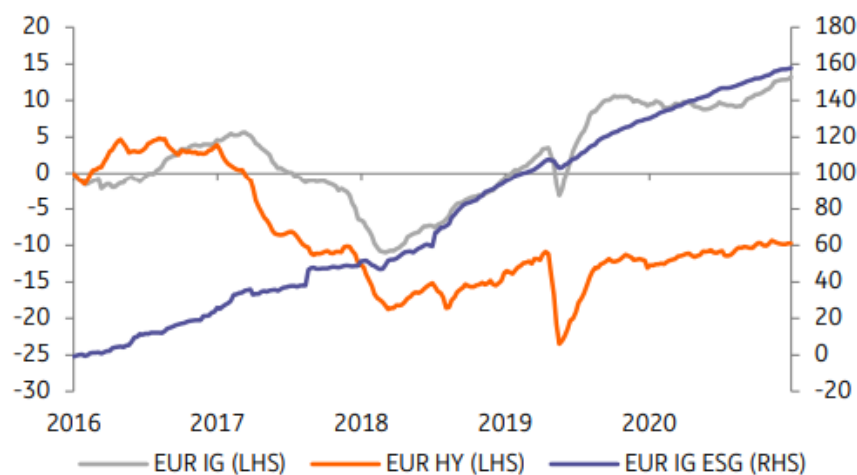


Source: ING, ECB

Mutual fund flows have been small but positive in 2021. In 2021 thus far, EUR IG inflows have amounted to 3.8% of AuM (US\$10.8bn). This is lower than the inflows seen last year of 8% of AuM (US\$18bn). EUR HY inflows have totalled 2.4% (US\$3.4bn) YTD. We expect similar but slightly smaller inflows to be seen next year, with another US\$8bn or so into EUR IG, with fewer inflows in EUR HY with another US\$2-3bn.

Overall, in both EUR and USD, fund flows have been consistently inflowing over the past five years. [ESG, however, has seen a large increase in inflows](#) over the past number of years. Demand is insatiable. In the two charts below, it is clear that grey funds are generally being replaced by ESG, particularly in times of outflows, the retracement is generally into ESG.

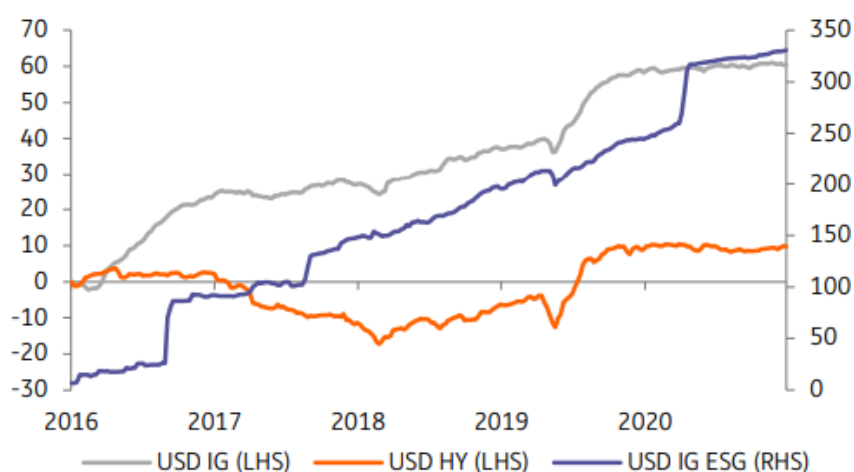
Euro Fund Flows accumulated over 5 years (%)



Source: ING, EPFR

Source: ING, EPFR

USD Fund Flows accumulated over 5 years (%)



Source: ING, EPFR

This article was first published as part of our Credit Outlook 2022. You may be able to access that on our investment research website [here](#), but MiFID and other restrictions may apply.

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