

Credit scenarios: credit cocktail shaking up to be bearish

Numerous risks and negative factors cast a shadow over the European credit market. Inflation still poses the largest risk for credit, but the ending of the corporate sector purchase programme (CSPP) adds flame to the fire. We take a look at the three scenarios for credit for the remainder of this year



The credit market could go in one of three different directions

Goldilocks

The story of goldilocks and the three bears is fitting for the three scenarios we face for credit. The first two scenarios are rather bearish outlooks on the market, while the third is just right for credit. We break down what each means for credit:

- Inflation
- Stagflation
- Everything is just right

Remembering that the third scenario, the one involving Goldilocks and not her bears, is the one that we have basically been exposed to over the last few years and that only a miraculous return to that environment will see spreads start to tighten and funding levels become attractive. But

involving any of Goldilocks' bears would basically create a negative credit picture, in one case for both spreads and credit yields and in the other for just spreads.

1 Inflation (too hot)

As inflation remains high, and central banks continue their tapering and rate hiking, rates will continue to rise.

What does this mean for credit?

- Credit markets will see some additional widening on the back of the continued high inflationary environment.
- As illustrated in the trading range charts below, spreads could break through this current range and reach a high stress point, particularly as the European Central Bank's Corporate Sector Purchase Programme ends.
- Sector positioning depends predominately on the inflationary sensitivity of the sector and the issuers within. How elastic is the demand for products/services and to what degree can the company pass on increasing input costs?
- Curves will remain flat, the underlying yield curve compensates for maturity and the short-end is more sensitive to the hikes the central banks will undertake.
- The primary market will need to continue to offer significant new issue premium (NIP), and we also expect issuance to be possible in selective windows.
- The underlying change in yields is a massive factor for credit. For a few years, we have seen credit yields and subsequent funding at historically low levels. The rates dynamic changes that in a number of ways:
 - The possibility of finding risk-free exposure in other markets means that credit loses some of its attraction.
 - Funding rates go up drastically, particularly for the higher beta investment grade and the high yield issuers. This creates a drag on earnings as historically high debt levels will see significantly higher debt servicing costs.
 - Any issue with a call date (whether subordinated or not) needs to be judged carefully for the possibility of extension risk.
 - Cash prices tumble creating low coupon and high coupon differences (also in asset swap (ASW) considerations).

2 Stagflation (too cold)

Under this scenario we do not just discuss the pure stagflation environment but also anything getting close, basically inflation is reasonably permanent but growth slows. With little to no economic growth, rates will subsequently fall. However, corporates will be under more pressure fundamentally, and as such spreads will widen out.

What does this mean for credit?

- Credit markets will see significant additional widening as company fundamentals suffer to a greater degree than under the inflationary scenario.
- As illustrated in the trading range charts below, spreads will widen significantly towards the high 'stagflation' range, a widening of at least 40bp from here (up to 50bp).
- Default rates will increase as pressures grow for corporates.
- As such, the short-end continues to underperform, pricing in a jump to default, therefore

curves flatten further, and perhaps even invert in places (for instance in BBB rates debt).

- The primary market will need to offer an even more significant NIP, and issuance will only be possible in selective windows. Yields remain high as spreads widen, despite rates falling.
- The pressure for assets under management will actually not be as bad, as credit will have decent attraction at these levels.

3 Soft landing (everything is just right)

This scenario assumes a soft landing for markets, where the central banks' efforts bring inflation back more promptly and orderly than expected, with growth not under too much considerable pressure. Neither inflation nor stagflation remain a medium or long-term risk. Thus there is less rates volatility and spreads will presumably again be driven by the technicals in the market.

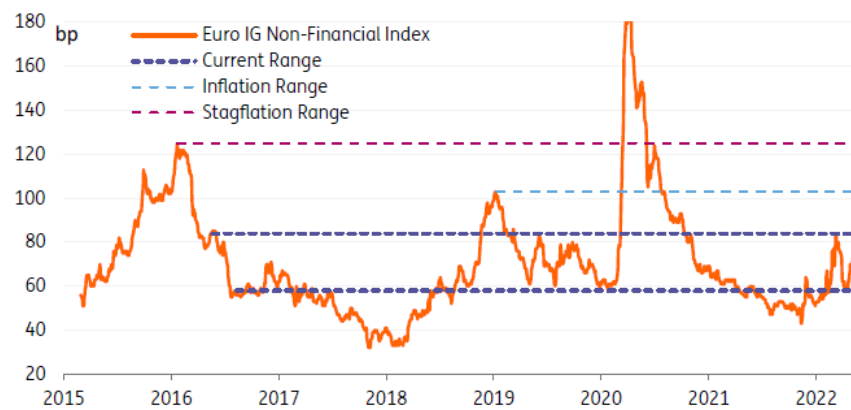
What does this mean for credit?

- A positive outcome for credit, opening up tightening potential for spreads. Significant value is then priced into credit.
- As illustrated in the trading range charts below, we will remain in this current trading range, likely tightening down towards the bottom end of the range.
- Technicals and geopolitical issues will then drive spreads. Technicals are still strong for 2022 with a notable drop in net supply forecast (supply expected at between €250-290bn, while redemptions total €223bn).
- The lack of CSPP leaves markets less supported, particularly in the primary market. But with lower net supply and a pick up in CSPP reinvestments in January 2023, credit has some tightening potential.
- Credit curves will steepen, as the short-end will outperform.
- Primary markets will likely need to still offer a smaller but decent NIP, as the large buyer (ECB) is no longer there.

Spread direction

EUR corporate spreads are once again at the high end of the current trading range. We compute the ranges for the ICE BofA EUR non-financial index (currently at 85bp) to be between 58bp and 84bp, as illustrated below. We determined the high end of the current range based on the wide levels seen in mid-2016 and mid-2019. The lower end of the range is based off the tight levels seen later in 2016 and the tight levels seen in mid-2019 until early 2020. Additionally, we also compute a higher end of the range under a high stress environment from the inflation scenario at 103bp, based off early 2019 levels, and we compute a target for spreads under the stagflation scenario at 125bp, based off the wides seen in early 2016.

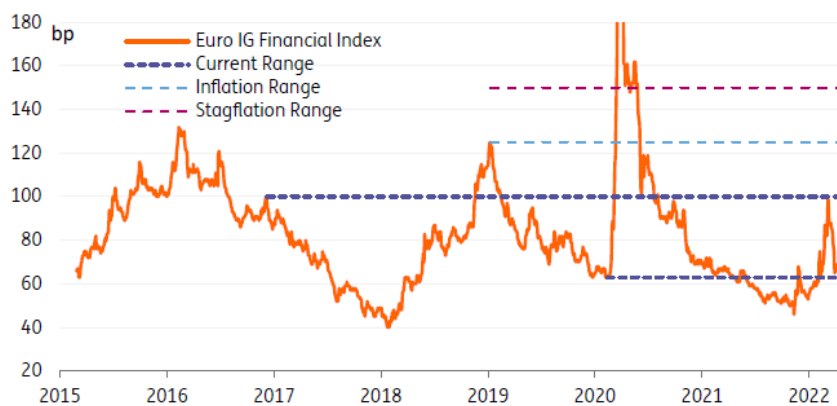
EUR IG Non-financial trading range



Source: ING, ICE

Similarly, EUR financials are also sitting at the high end of the current trading range. For the ICE BofA EUR financial index (currently at 97bp) we compute ranges between 63bp and 100bp, as illustrated in below. We determined the high end of the range from levels seen at the beginning of 2017 while the low end of the range is determined by the tight levels seen in early 2020 just prior to the Covid-19 crisis. The higher end of the range in a high stress environment from the inflation scenario at 125bp is based on the wide levels seen in early 2019. Then the target for spreads under the stagflation scenario is 25bp wider, at 150bp.

EUR IG Financial trading range



Source: ING, ICE

Over the past week, we have been testing the high end of the current trading range. For the coming weeks, we expect spreads to stay around these levels. But in the medium term, it will depend on which of our three scenarios will end up playing out.

As explained above in the three scenarios, we could see spreads widen from here under the inflation scenario, while in the case of stagflation we will see spreads widen significantly towards the highest range shown. Naturally, if we see neither, we will trade within the current range, perhaps tightening down from the high end of the range.

Primary markets

The primary markets will of course be under the most pressure as CSPP ends. Already, issuers bringing a bond to the market need to pay a significant new issue premium. In fact, due to the recent rise in rates and widening of spreads, many issuers were forced to actually pull their deals and not come to the market for the time being as volatility peaked.

Furthermore, new issues have not seen any performance after issuance, and in general, the rule of thumb is that the secondary curve is actually widening out to meet the new issue, as opposed to the new issue tightening down to the secondary curve. This is a clear indication of a bear market.

As a result, we would be cautious towards secondary market exposure to corporates that are potentially bringing new bonds to the market. We do see opportunity in new issues that are offering decent NIP, and in the widened out secondary curve.

Below, we outline a list of corporates that will see bonds maturing in the coming months and have not come to the market with the full redemptions amount, and thus may need to refinance. Given the risks in corporate credit markets and the high new issue premiums and subsequent widening to the primary levels, exposure to issuers with high refinancing needs should be minimised.

Corporates with larger refinancing needs in 2022

	European corporates (All Currency)		Foreign Corporate's EUR Debt		
	Redemptions	Net Redemptions	Redemptions	Net Redemptions	
Mercedes-Benz Group	14.5	14.5	General Electric Co	2.9	2.9
BMW	11.8	8.0	Petroleos Mexicanos -	2.9	2.9
Porsche Automobil	14.3	7.5	Verizon	2.8	2.8
Anheuser-Busch InBev	7.3	7.3	Honda Motor	2.3	2.3
BP	6.5	4.7	Takeda Pharmaceutical	2.3	2.3
Telefonica	4.5	4.4	Toyota Motor Corp	3.2	2.0
Deutsche Telekom	4.0	4.0	Coca-Cola	1.8	1.8
Shell	3.8	3.8	BooKing Holdings	1.8	1.8
Medtronic	3.8	3.8	Telstra Corp	1.8	1.8
ENGIE	3.5	3.5	State Grid Corp of China	1.7	1.7
Renault	4.0	3.2	America Movil	1.5	1.5
Glencore	3.1	3.1	AT&T	1.5	1.5
LVMH	3.0	3.0			
Vodafone Group	3.0	3.0			
Electricite de France-EDF	3.8	3.0			
Reckitt Benckiser Group	2.9	2.9			
Siemens	4.8	2.8			
Philip Morris	2.4	2.4			
Imperial Brands	2.3	2.3			
Orange	2.7	2.2			
Novartis	2.1	2.1			
Danone	1.7	1.7			
VINCI	1.7	1.7			
Veolia	1.7	1.7			
Elo SA	1.5	1.5			
Merck	1.5	1.5			
Vivendi	1.5	1.5			

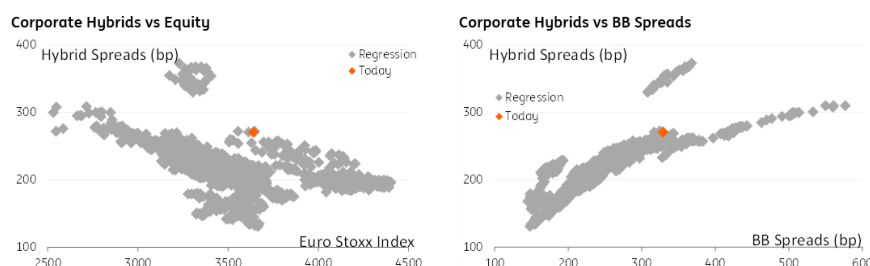
Source: ING, Dealogic

Note: Net Redemptions is the redemptions for the year minus what supply has already come to the market this year

Corporate hybrids

Corporate hybrids have been underperforming over the past months, and are now sitting 86bp wider on a year-to-date basis. We now see value priced into spreads. We see tightening potential in hybrid spreads up against equities and BB spreads. We favour hybrids from sectors such as Telecoms and Utilities.

Hybrids



With rates rising significantly and spreads widening, the all-in cost of debt has increased substantially. Many hybrids were priced at relatively lower costs, and therefore some issuers will be better off extending their hybrid bond, in order to lock in the lower rates.

In particular, under the inflationary or stagflation scenario the likelihood of the call becomes less certain. Typically, calls are structured in such a way that on the call date, the coupon is recalculated to a new 5yr mid-swap level plus the initial credit spread. Over the last couple of years, hybrid issuance has come to the market at very low coupons and this was not just the result of low underlying rates but also low hybrid spreads. Therefore, as we forecast credit spreads to rise under both scenarios it could be that senior spreads will be greater than the initial hybrid spreads paid. Therefore, it is mathematically possible to secure cheaper funding by not calling the hybrid, and the uncertainty to which issuers could contemplate doing so is a negative driver for hybrid spreads.

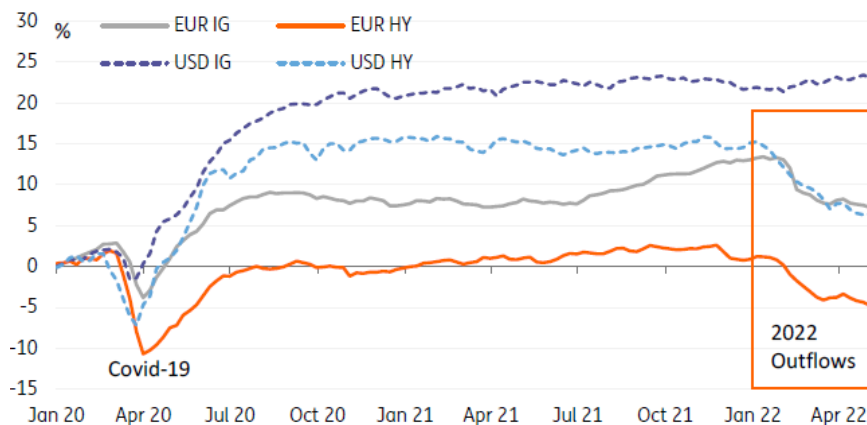
Particularly, the more infrequent hybrid issuers from more higher beta sectors or inflationary sensitive sectors seem to be most prone to this possibility, if and when they do not have significant outstanding curves (reputational risk would be detrimental to future capital funding).

Fund flows

EUR mutual funds have seen some significant outflows thus far this year. Outflows on a year-to-date basis have accumulated to 6.3% of assets under management in investment grade (IG) and 6.4% in high yield (HY). This is of course a negative factor for the technical picture. Much of the accumulated inflows since the Covid crisis have not been wiped out. HY flows have now dipped into negative territory once again in the 2.5yr accumulation. The HY market will be under relatively more pressure in the first two scenarios, particularly the stagflation scenario – in which case we will likely see more outflows from HY funds. The IG space is still positive for now, after substantial inflows over the past two years, especially in the second half of last year. With higher yields and the lack of CSPP making spreads tight, we may see inflows into the EUR IG market, as some investors were pushed into the high yield market in search of yield over the past years.

US IG flows, on the other hand, have not seen the same outflows. As illustrated in the chart below, the USD IG accumulation of flows is sitting at 23%. These fund flows are largely unaffected by the rising rates. Inflation is of course a global threat, but other geopolitical issues such as the war in Ukraine does not affect the USD market as much. USD IG credit could be seen as relatively more sticky, as inflows could remain.

EUR & USD mutual fund flows – outflows seen in 2022



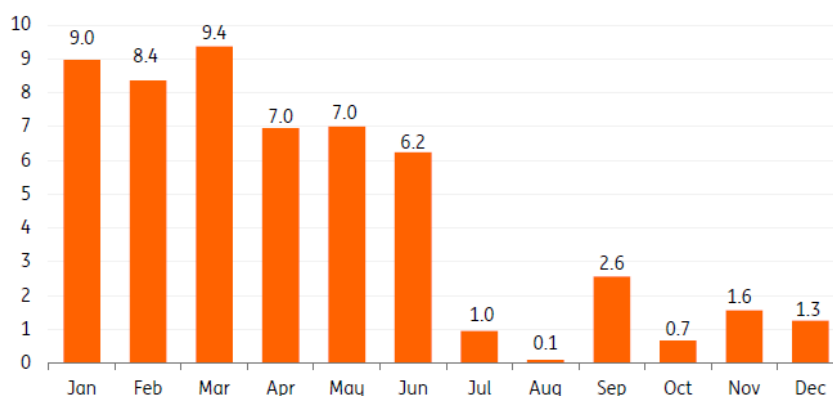
Source: ING, EPFR

CSPP

As active purchasing of corporate bonds under the CSPP will come to an end in 3Q, we take a look at the effects on credit markets. Of course, the ECB will still reinvest matured debt, but this will be particularly low in the second half of this year, therefore, purchases will **fall off a cliff edge**. This leaves the European credit market rather unsupported.

April already saw slightly lower gross purchases under CSPP than initially anticipated, as the majority of the increase into the asset purchase programme (APP) was reserved for the public sector purchase programme (PSPP). With APP/CSPP ending in either June or July, purchases will fall off a cliff as shown below. This will change the technical picture for credit come the second half of the year.

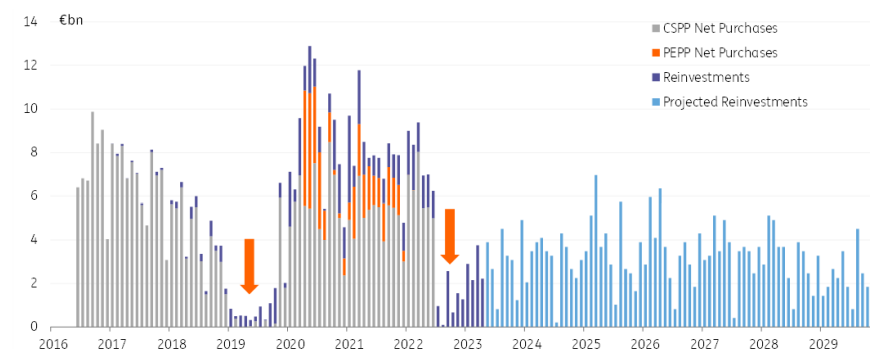
Realised and projected CSPP gross purchases for 2022 (€bn)



Source: ING, ECB

Reinvestments for the second half of this year are rather low, at an average of €1bn per month (apart from the €2.6bn in September), shown above. This leaves corporate credit very exposed in the second half of the year. Reinvestments pick up in January 2023 onwards with an average of €2-3bn per month, illustrated in the realised and projected CSPP (& PEPP) purchases and reinvestments chart below. This of course will give credit an extra bid throughout the year.

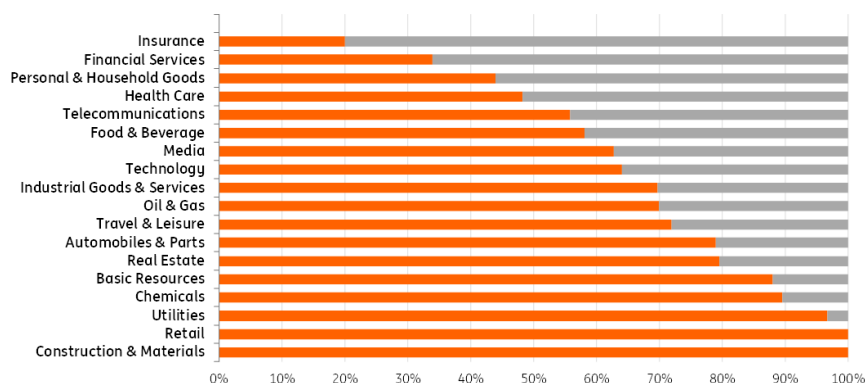
Realised and projected CSPP (& PEPP) purchases and reinvestments



Source: ING, ECB

As reinvestments are low in the second half of this year, monthly purchases will decline sharply, much like they did in 2019, as indicated with arrows in the chart above. At that time, spreads initially ballooned.

Amount of bonds held under CSPP as a percentage of the amount of bonds in iBoxx per sector

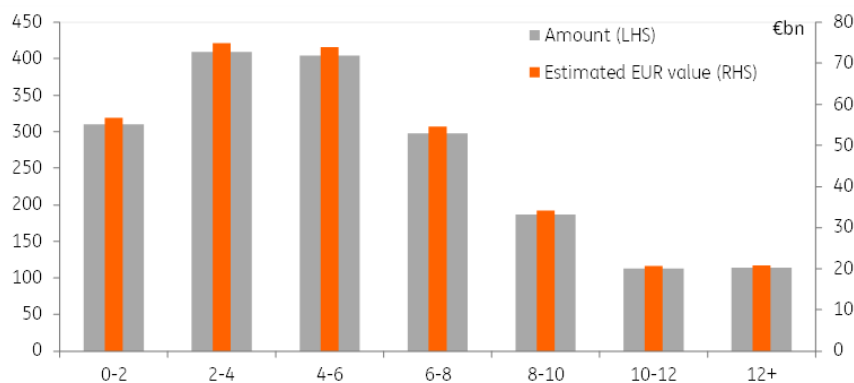


Source: ING, ECB

Higher beta sectors such as construction, retail, real estate, autos, travel, oil & gas and industrials have been favoured by the ECB. The end of CSPP will leave these sectors rather vulnerable. We expect these sectors to underperform.

The ECB is also holding a significant amount of utilities bonds. Normally this sector would be rather defensive and lower beta. However, at the moment the utilities sector has a question mark around it due to increased energy prices.

Years to maturity breakdown



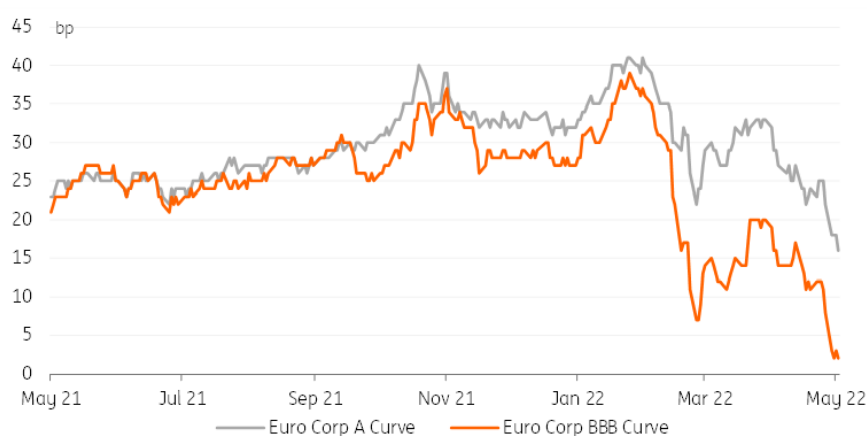
Source: ING, ECB

A significant portion of the ECB's holdings is on the shorter end of the curve. When looking at the year to maturity in the above chart, we see that most of the holdings will mature in the next eight years, with the 2-6yr area of the curve with the most amount of holdings.

Positioning in credit

We prefer the belly of the curve. The short end of the curve continues to underperform and widen more significantly, thus credit curves are flattening. Already the BBB segment's credit curves are looking very flat, as shown in the curves chart below. The long end of the curve remains more volatile and will be more negatively affected by rising rates. Thus we see the belly of the curve staying most firm in any case, and we identify the most value in the 5-7yr area of the curve.

Credit curves now looking very flat



Source: ING, ICE

We are more comfortable with defensive lower beta sectors in these uncertain times. We would be cautious when it comes to sectors that are favoured by the ECB for purchasing, as illustrated in the previous chart titled 'Amount of bonds held under CSPP as a percentage of the amount of bonds in iBoxx per sector' above. These sectors will likely underperform with the lack of a big player in the market.

We see buying opportunities in new issues that are offering a decent NIP and also see value in the widened out secondary curves when a corporate does bring a bond to the market.

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