

I want it all: A constructive view on credit

We're mildly bullish for the credit markets in 2020, seeing technicals dominate over the impending US economic downturn threat. This article is taken from our Credit Outlook: 20 calls for 2020 which is available to MiFID professional customers [here](#)



'I want it all' was made famous by Queen

Mildly bullish for 2020; it's a beta game

- We are mildly bullish for 2020, seeing technicals dominate over the impending US economic downturn threat which could easily lead to higher defaults and a repricing of the leveraged debt space.
- Despite tight spreads and negative yields asset allocation will still favour lower beta investment-grade European credit as the Corporate Sector Purchase Programme (CSPP) and net supply support spreads and offer carry.
- For us, the Queen song title of the year is 'I want it all' as the ECB seeks more corporate debt, targets green and will be forced longer on the curve in credit.

I want it all

Once again we compare credit markets to a song title by Queen. Last year we adopted the iconic track 'The show must go on' to characterise the credit market despite the excessive widening we saw at the end of 2018. For 2020 the songs we feel have most to offer are either 'I want it all' or

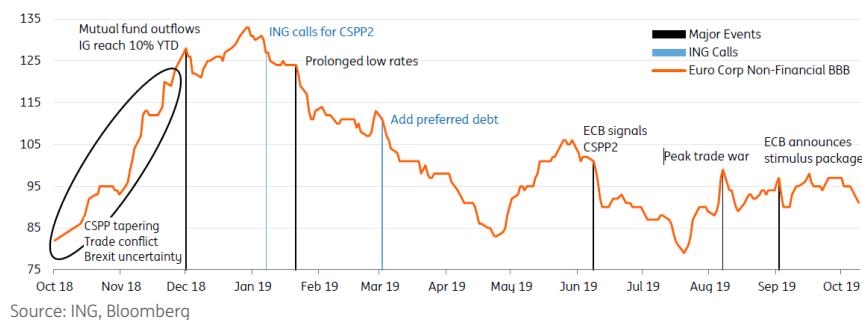
'Don't stop me now'. The 'having a good time' lyric would seem to reflect the ECB's love of CSPP and corporate bonds but better still, perhaps, the words of 'I want it all' chime to the beat of 'gotta find me a future move out of my way', encapsulating the idea that a future after CSPP2 is a long way off but nonetheless worrying; move out of my way is what the ECB will do to real money investors as they are crowded out by both negative yields and low spreads.

The 'I want it all' attitude is part and parcel of our expectation of strong credit market performance in 2020

The 'I want it all' attitude is part and parcel of our expectation of strong credit market performance in 2020 but it also reflects the more greedy nature of the ECB and the lack of true benefit of its programme. For 2020, in terms of the two main ingredients for credit, technicals improve on lower net supply and credit metrics will not put any real pressure on credit as they stand to deteriorate only marginally at worst. Having undergone little change through 2019, a move to a more leveraged phase in the US credit cycle cannot be too far off, encouraged by earnings pressure and trade concerns.

Spreads, meanwhile, look tight but are still a little above true squeezed territory and thus, despite negative yields, there is some performance potential. As highlighted by the major events highlighted in the graphic below, spreads have not even returned to pre-widening 2H18 but instead moved sideways even after CSPP2 was signalled.

Major events impacting credit since October 2018 (bp)



2020 spread behaviour

Recent weeks have seen mostly sideways movements in spreads, a disappointing earnings season but a little slowdown in supply. Heading into year-end it is becoming clear that what will determine 2020 spread behaviour is a combination of negative rates, technicals and increasing (US) economic concerns. Economic concerns have the potential to renew pressure on credit spreads at some stage during 2020.

Despite our slightly more bearish economic outlook, it is tempting to talk about a year of two halves with 2H20 starting to see more credit weakness, in terms of deteriorating credit metrics and a clear message in terms of rising default rates. The question is to what extent that will feed into Euro credit spreads that are so well supported in 2020 in terms of net supply, inflows in funds and

CSPP2 purchases.

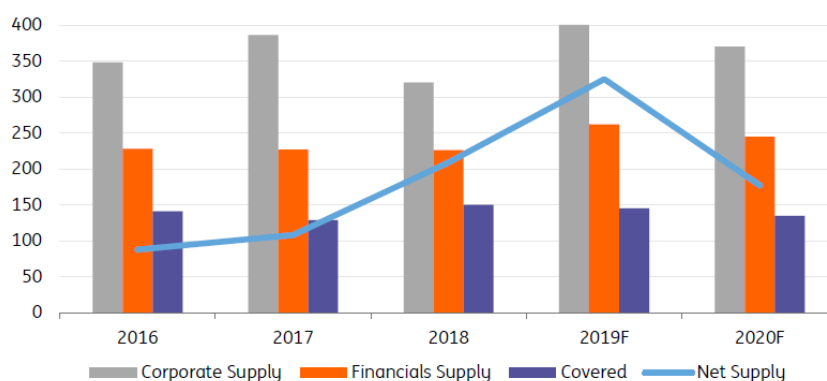
We feel that will be limited to perhaps the lower regions of the credit rating spectrum. Eligible names are certainly a strategy that we are comfortable to consider for 2020, as there is still plenty of spread tightening potential compared to CSPP1 and, given the above, the carry in these names will always work as external pressures will not be sizeable enough to increase selling flows to such a degree that eligible debt will be hit hard.

Our biggest fears, in no particular order

With that, it almost seems we see little to worry us into 2020; however, nothing could be further from the truth and in no distinct order we fear:

- Brexit; where despite the forthcoming general election, a hard Brexit is not an impossibility and newsflow could create renewed scrutiny of UK exposure and also some concerns on issues covered by English law.
- The ongoing US-China trade war is already having a major effect on corporate profitability outlooks and sector spread performance. As a consequence, spreads can underperform and as an indicator we need not look further than the auto sector at this time.
- Our US economists still expect two rate cuts in the US with yields down by up to 100bp, the economic developments in the US (talk of a recession) could severely dent the investment philosophy for credit markets in the US and in particular US leveraged markets where outflows are already identifying an area of concern.
- A rather disappointing earnings season is what defines 3Q19 as earnings growth has flipped to an earnings growth slowdown (-2.8%) only masked by earnings beating analysts' low expectations. This could well set the trend for 2020 and, as such, impact net debt to EBITDA metrics; cyclical credits consequently are also losing their shine for 2020.

Net supply falls from 2018 dizzy heights (US\$bn)



Source: ING, Dealogic

Technicals

Net supply in credit markets: Redemptions for 2020 are higher than they were in 2019 reversing

the trend of the past few years that have seen a continual fall in redemptions due to a constant decrease in banking redemptions. For 2020, total corporate and financial redemptions increase by about €60bn. Similarly positive, we do not expect supply to reach the dizzy record heights of 2019 particularly for corporates.

We predict a drop of €40bn meaning positive net supply will be just under €120bn, a drop of €75bn. On top of that, the ECB could buy up to €70bn in 2020, hence absorbing most of that. When we add financials into the mix then we have to contemplate a lack of balance sheet growth, a focus on NPS and the TLTRO meaning supply here too will drop. We believe that we will see a limited but nonetheless downward effect from this (preferred and covered debt both fall about 5%). We estimate that total financial supply falls €15bn.

Meantime redemptions rise €11bn so the total effect is €26bn more positive. Looking at corporates and financials sees net positive supply totals falling by that €35bn plus the net fall of €75bn for corporates or a total of €110bn. Plus the maximum of €70bn bought by CSPP meaning that technicals improve 180bn

What will the ECB really do with CSPP2? As we head into the new programme it is still unclear what the new parameters will be. What we do know is that private sector programmes are important to the ECB and offer room to purchase and that, looking at eligible debt, the ECB holds less than 20%. Thus plenty of room to expand purchases. Elsewhere, no real reason for the ECB to stay away from negative yielding debt but issuance will be longer to provide positive yield to yield-starved credit investors. Almost a natural operation twist for the ECB under CSPP. Then there are Lagarde's comments on the ECB's responsibility for sustainability meaning that we can expect them to be more dominant in green primary books and green secondary in the corporate market that provides plenty of green opportunities.

Crucially the start of CSPP2 has seen initial purchasing targeting the long-end of the curve and in decent size too.

Interest rates and curves

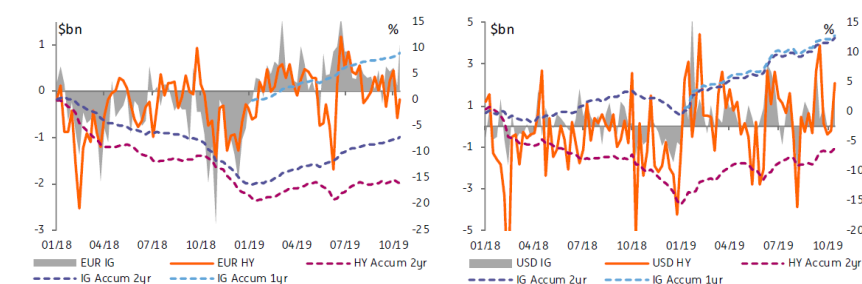
With regards to interest rate levels and curves, our economists and rates strategists forecast mildly higher rates but, from a separate perspective, little volatility is expected in either the short-end or the long-end as the ECB continues to see pressure to cut rather than anything else. Indeed, market forward levels are more negative than ours and still price in a possibility of a rate cut in 2020. All in all though, 2020 should see mildly steeper rates curves as the long-end underperforms a little. We believe these effect credit maturity selection (more positive yielding credit in long-end) but do not warrant sizeable asset allocation shifts away from credit. In the US, it is a slightly different picture with the market pricing in two rate cuts from here whilst forwards see little change to the long-end. Our ING economists though are more bearish on the US economy and certainly more bullish on rates.

Fund flows remain a key ingredient for the European credit markets and it is fair to say that 2019 indicated that there was a good deal of liquidity retracing its way back into mutual funds and ETFs aimed at European credit but more in IG than in HY. High yield flows are not that positive for the year with just 1.95% AuM flowing into funds this year whilst outflows totalled 18% of AuM last year. When looking at Euro fund flows, see below, the IG outflows define a 60% reversal of outflows for the bearish end-2018 period, the current pace of inflows in IG credit in both USD and EUR though means that we are not looking to complete the retracement of 2018 this year. At

8.7%, EUR IG inflows in 2019 stand at just over half the 2018 outflows, meaning that there is still room for plenty of inflow in 2020.

From an asset allocation perspective it is questionable, at these levels in both spread and yield, whether we see a scenario whereby EUR investment grade credit will be selected as one of the rare pockets of reasonable value as investment committees assess asset classes. From a relative perspective, excess returns will be limited in 2020, however, a comparison to lower beta interest rate markets, and the need to invest in fixed income products with some yield, improves the investment philosophy for credit.

Euro and USD fund flows



Source: ING, ICE, Bloomberg

Credit metrics

The crucial technical drivers discussed above will ensure little directional change for the European credit markets, however, it has recently become very evident that credit metrics (earnings, sector news, idiosyncratic risk) should theoretically become bigger drivers and crucial for outperformance for 2020. We are clearly not moving from beta to alpha for excess return generation in 2020 as QE and technical will dominate over earnings and credit metrics.

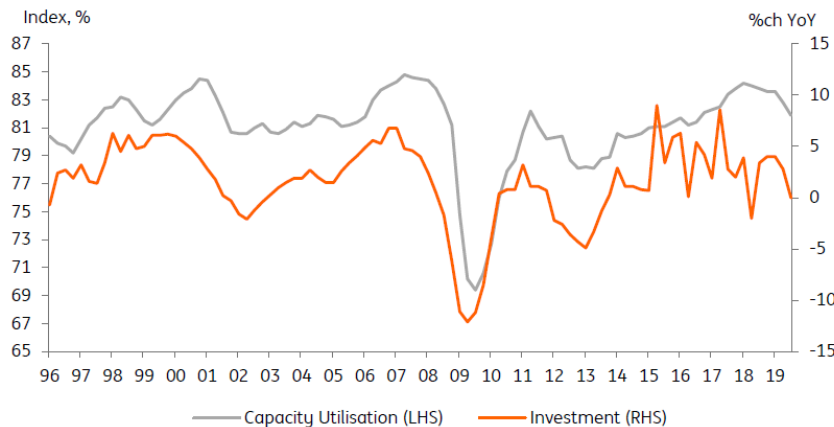
The possibility of a US recession cannot be taken off the table

Mostly due to technicals, therefore, the view on alpha and fundamentals becomes less important to a degree. The greatest caveat to this statement though is that the possibility of a US recession cannot be taken off the table; this possibility should be viewed as a great concern. The leveraged space of the US non-financial corporate environment is not capable of absorbing that hit. Debt levels and leverage have grown benefiting from low interest costs and benign credit costs. But current debt levels and coverage ratios are not sustainable in that scenario. Thus, then, expecting higher beta credit to be the first to reprice.

Back to credit metrics, in our view a key measure to look at is the development of bank lending for non-financial corporates in Europe. In the most recent report issued in October, this was up 3.7% year on year; at first blush a positive for investments. However, levels have plateaued and even fallen somewhat from the year on year figure seen last year. This data by the ECB indicating that the environment for loan growth and investment remains favourable, however, for 2019 it has not lead to greater investment levels or indeed more leverage on the balance sheet.

Capacity utilisation is our favoured indicator of future investment activity in Europe. The chart below highlights the strong correlation since 1996, but also a continued break in the strong relationship more recently with investments showing a 4% year on year increase last year to fall a little to 2% currently in the latest stats while capacity utilisation has plateaued at high levels staying above 82% for the past three years. We believe European challenges (trade, disappointing growth numbers and Brexit) have held back investment levels and will continue to do so in 2020, as such M&A and supply will also be affected. All in all, this means little to fear in terms of a supply surge or indeed from an imminent spike in the re-leveraging of the balance sheet.

Capacity utilisation points to higher investments

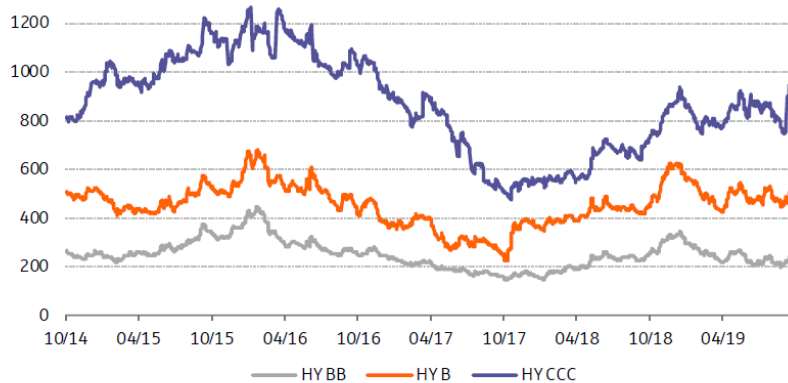


Source: Macrobond

Net debt/EBITDA levels in Europe

Elsewhere we see that net debt/EBITDA levels in Europe are in check; however from a spreads perspective Figure 8 highlights a little pressure, the higher risk more leveraged European high yield universe single B and CCC are showing bearish patterns. Similarly, net debt and coverage data for high yield and leveraged loans in Europe shows a constant but slow move to higher leverage but coverage ratios are also relatively steady giving us little cause for concern. However, looking at the chart below, we are seeing some lower rated underperformance in European high yield.

European high yield spread developments

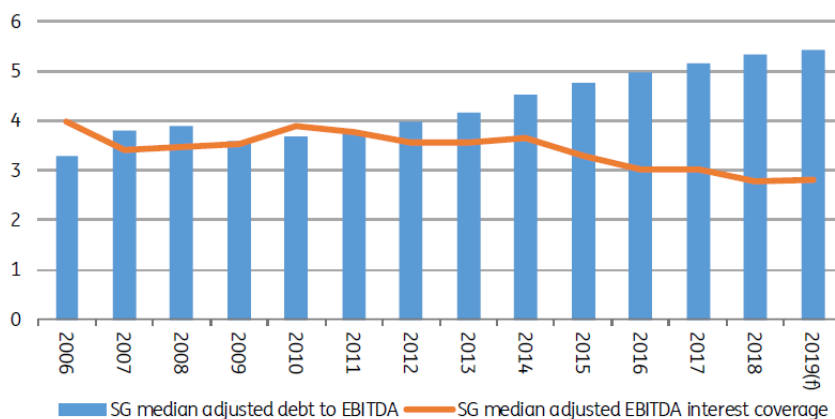


Source: S&P
Source: S&P

US leverage

However, this leverage rise is minimal compared to the US high yield/leveraged universe as identified by the following chart where debt levels are rising, but we are also seeing a significant fall in interest coverage. It's a key concern for credit into 2020. It is clear that coverage levels are not keeping pace with rising leverage and further declines will put pressure on US default rates.

US leveraged issuers; leverage rising and coverage falling (x)

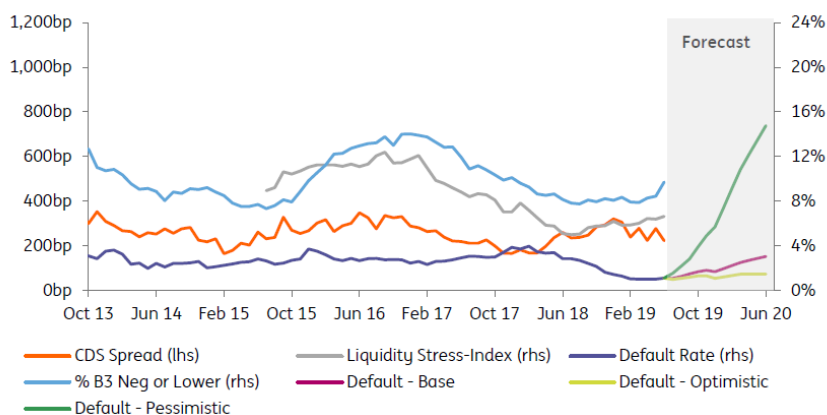


Source: S&P

Default rate expectations

Looking at default rate expectations there seems little to be concerned about. Perhaps the leveraged debt explosion risk in combination with the pessimistic default scenario is the only factor for concern. Elsewhere the numbers as forecast by Moody's offer rising default rates in all cases, including the base and optimistic scenarios. Keeping in mind that even the more pessimistic scenario is a bit more likely than previous years due to our more negative US economic view.

Default rate expectations rising- base scenario above 3% by mid-2020



Source: Moody's

Our main view

From a credit metrics perspective we remain constructive, we see that default rates (including forecasts) have plateaued at record low levels but that forecasts too show little by way of true exponential growth patterns. All in all, looking at European credit markets, in particular Investment Grade, on a standalone basis, we are resoundingly comfortable with credit spreads as technicals and credit metrics are not, unlike last year, sending us any distinct red flags.

For the time being, as long as default rates and corporate investment levels remain benign we have no reason to believe that credit should widen substantially further on the back of credit market internal drivers.

The external threats to risk markets in general are also very profound for European credit markets, with a slowing economy on both sides of the pond, Brexit and the US-China trade war all capable of killing the carry in a heartbeat. The beta power will not evaporate from European credit markets due to technical (rates, net supply and CSPP). So alpha or name discrimination is set to reduce. Favouring lower beta, non-cyclical and eligible over non-eligible debt, it is about the power of the technical whilst not forgetting the underlying economic concerns.

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