29 May 2020

Credit Strategy

Fallen angels and beyond

ECB likely to add fallen angels in support of HY

We expect fallen angels to be added by the ECB to their purchase programmes.

On top of that, our economists expect the ECB to increase the size of PEPP by €500bn next week. The ECB is behind the curve relative to the Fed in terms of support being offered to speculative grade.

The Fed is busy purchasing high yield debt offering support and financing needs, by utilising purchases through high yield ETFs, purchasing fallen angels and their main street financing facility. This has, in turn, opened up the primary market for junk bond issuance in USD. Meanwhile, the ECB is limited to investment grade when utilising their corporate purchasing programmes (CSPP & PEPP). Euro high yield primary market issuance remains low for now, and the segment seems more exposed. This leads us to beg the question; what will the ECB do?

- **Add Fallen Angels.** Fallen angels have already been made collateral eligible, it would seem only a small step to now add these to purchasing programmes. Buying these fallen angels from investment grade to high yield will add much needed support to the high yield market.
- **Add High Yield ETFs & Entire BB.** Although as it stands it is unlikely that the ECB will follow in the Fed's footsteps and add high yield ETFs, nor is it likely they will add the entire BB universe. The European high yield ETF market is relatively small compared to the US. Additionally, after just adding fallen angels to their collateral eligible list, they chose not make other amendments to the eligibility criteria and for now at least are not likely to re-visit.
- **Add Senior Preferred.** During the last meeting, the ECB chose to add more support to banks by easing TLTRO terms and the introduction of PELTROs. However, we feel it is unlikely the ECB will take the next step and add senior preferred banking debt, despite it already being collateral eligible. If they had the intention to, why were previous opportunities not exploited, and additionally, the ECB have an oversight supervisory role, meaning there would be a conflict of interest.

We expect fallen angels to be added. We forecast up to 10% of the BBB universe to be downgraded to high yield in the next 12-18 months, accounting for 45 bonds totalling nearly €70bn. This is based on our expectation of European speculative grade default rates reaching up to 10%. As a result, there will be a substantial fallen angel eligible universe for the ECB to purchase. Of course, if downgrades exceed our expectations and rating migration and defaults grow substantially, then we believe the likelihood of fallen

Jeroen van den Broek
Global Head of Credit Research and Strateg
Amsterdam +31 20 563 8959
jeroen.van.den.broek@ing.com

Timothy Rahill
Credit Strategist
Amsterdam +31 20 563 8170
timothy.rahill@ing.com

Lagarde has expressed that PEPP was set as such that it can be flexible as needed, and the ECB is willing to expand the amount under the programme as well as adjusting the composition of the programme. It is likely that, if any, changes will be in PEPP and not the APP, mainly by adding fallen angels to CSPP for PEPP purchase purposes. As stated, our economists believe there will be a €500bn increase in PEPP next week.

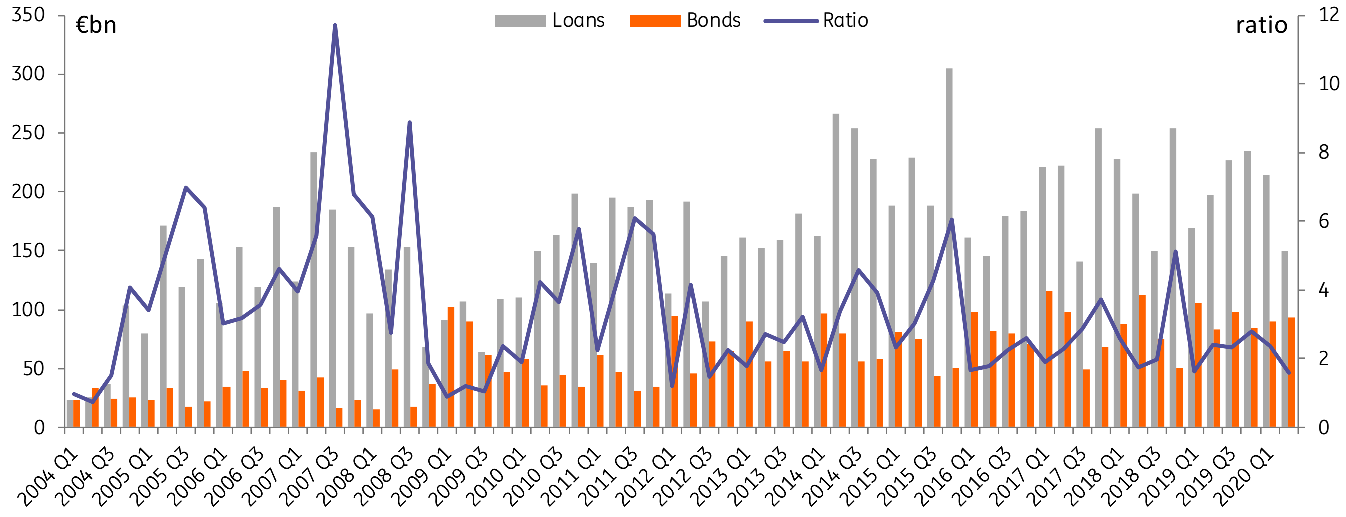
"Very unlikely ECB will add ETFs"

The Fed opted to purchase not just fallen angels but also high yield ETFs, in addition to its main street programme for financing non-financial corporates. Their actions reflect that the US credit market is composed differently to the European market. The sector composition (for instance Energy in the US is significant), the size of the high yield markets (whereby the USD HY space is considerably larger), the size of the ETF market , and the different level of disintermediation (Europe still trails the US by some margin). This last point highlights the greater dependence of US non-financial corporates on bond issuance and as such creates the need for greater central bank support.

As illustrated in Figure 1, loans are a much more dominant source of financing relative to bonds, the bond to loan ratio is consistently above 2 times, meaning quarterly volume of loans is twice as high as bonds from European companies. As a result, the ECB decided to utilise this in supporting corporates indirectly through the banks.

The ECB's heavy support for banks through various programmes facilitate them in turn to offer lending support to corporates. Former ECB VP Vitor Constâncio, mentioned the possibility of bank loans to be made available for purchasing if the ECB was to expand PEPP. He also went on to say that adding bank bonds (i.e. preferred senior) is unlikely and unnecessary. Despite preferred senior banking debt being collateral eligible, we believe the ECB has had many opportunities in the past to add to purchases. Not to mention, banks are more than capable of financing themselves already.

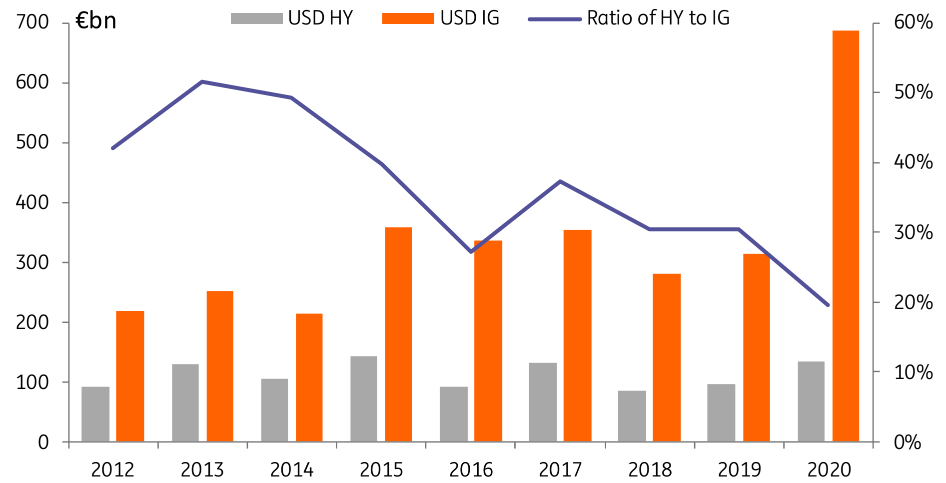
Fig 1 Euro Bond vs Loan Supply



Source: ING

As seen in Figure 2, the outcome of the Fed's support for high yield debt in the US is clearly shown through the level of financing volumes. The USD high yield bond supply has been considerable (€130bn). It levels with the full year figure in 2018, and is indeed soaring up in terms of YTD figures. And this is a necessary development as the US non-financial funding market is more dependent on bond issuance relative to loans. Euro high yield bond supply, on the other hand, has been lower YTD at just €20bn, highlighting lower ECB support and a (subsequent) greater dependence on loan markets.

Fig 2 USD High Yield and Investment grade supply



Source: ING, Dealogic

However, it is evident the Fed has actually not been overly active in its programmes. Instead, the signalling effect has been working considerably well thus far. With USD spreads tightening across the board and an enormous quantity of bond supply in both investment grade and high yield, there has been little need for the Fed to put an extensive amount to work.

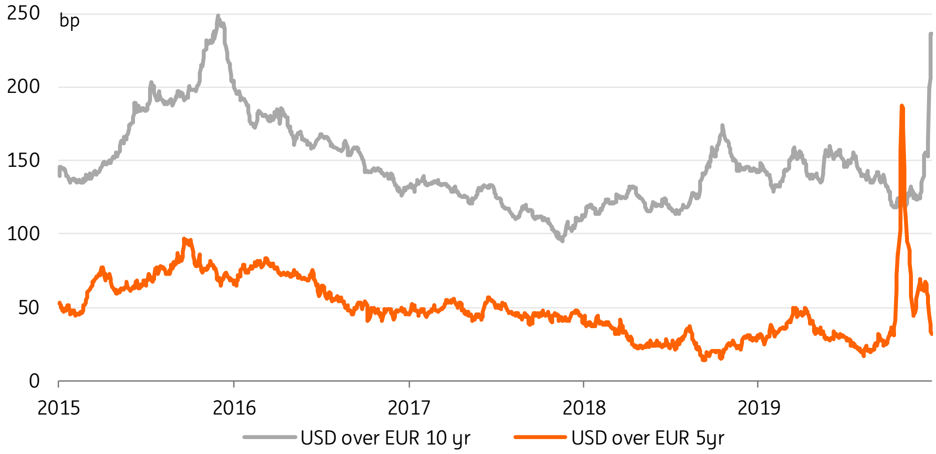
The fact that the Fed is willing and able to support has opened up the high yield market. This may be the case in Europe too if fallen angles are added. Whereby simply adding them to the eligibility may be suffice, without needing to do any considerable purchasing. Thus far the weekly Fed purchases of corporate credit through ETF purchases remain in the range of US$1-2bn. Therefore, the annualised amount that may be put to work is only around the US$35bn area. This is very modest relative to the possible utilisation of up to US$750bn.

"ECB more supportive across the curve, the Fed limited to short end"

The ECB is certainly more supportive when it comes to the maturity spectrum of its investment grade purchasing. Unlike the Fed, the ECB is not limited when it comes to purchasing across the curve. The Fed is constrained to the short end of the curve, with their primary market and secondary market purchasing facilities limited to 4yrs and less, and 5yrs and less, respectively. This has caused a substantial steepening on the USD credit curves. Which means the USD EUR spread differential has tightened on the short end but has widened considerably on the long end, as illustrated in Figure 3.

This offers an attractive opportunity for US corporates to issue a reverse yankee bond in Euro in longer tenors. However, the percentage of reverse yankee issuance is set to fall in 2020, with large scale issuance in USD and only long tenors available in Europe besides these issues are not eligible for the Fed nor the ECB and US corporate facilities.

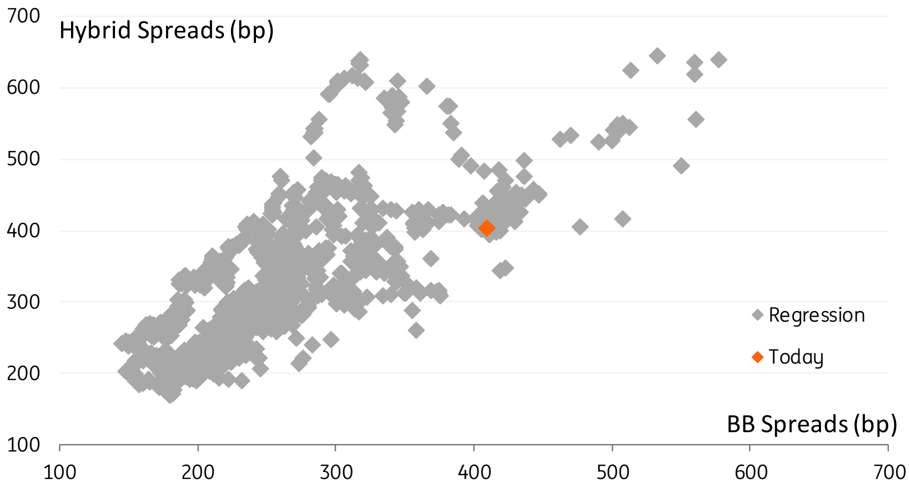
Fig 3 USD EUR Spread differential



Source: ING

If fallen angels are not added then the already richly priced BB universe will struggle even more, we already see hybrids performing better in that space and that would only strengthen that hybrid performance over BB spreads. If the ECB comes through though we would expect some initial BB outperformance and weaker (troubled COVID) BBB names to catch a bid.

Fig 4 Euro spread levels of Hybrid vs BB debt



Source: ING

So, whilst we believe the ECB will add only fallen angels there is an extreme line of thinking that they could simply change the criteria on collateral eligibility and say that all that has been added already is also eligible for CSPP and PEPP. And that, yes, that would mean that preferred banking debt could also be absorbed. However, we still believe this is less likely than simply adding fallen angels.

Disclaimer