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Euro Investment Grade credit reacts to the ECB's bazooka: selective opportunities

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- *Covid-19 is expected to severely damage the European economy in the coming quarters. The answer at the European level to this disruption has been strong on the monetary policy side, with the implementation of the temporary Pandemic Emergency Purchase Programme of €750bn and targeted longer-term refinancing operations, and at the single country level, with targeted fiscal measures.* ***At the EU institution level, we are at a crossroads:*** *the next two weeks will be crucial to see if the political will to reinforce the Union will prevail in this emergency situation and what measures will be digestible by countries averse to any form of debt mutualisation or by worst hit countries averse to any conditionality on the emergency loans. Beyond the political debate,* ***it is unlikely we will see the issuance of corona bonds in the short term as even in case of political agreement, the devil will be in the technicalities of the implementation.*** *However, other (monetary and fiscal) tools are available in the Eurozone to address this emergency situation. A pan-European jobless reinsurance scheme now appears to be under discussion.*
- *The measures implemented so far have managed to partially calm markets. We spot* ***considerable appetite for investments in the euro fixed income market:*** *in sovereigns, which offer generous premiums on their syndication, and in the corporate market, with a flurry of primary issuance. This has been possible thanks to ECB action, and the situation is likely to improve going forward.*
- ***Some points of attention remain.*** *Liquidity is getting better, but it is not back to end of year conditions. A high level of fragmentation persists in the market: sector fragmentation (with some sectors more affected by Covid-19) and rating fragmentation. QE is directly benefiting the IG segment. With a large portion of the IG market rated BBB, we can expect some rating migration that will limit the eligibility of companies to the QE programme and therefore there could be differences in price action among different securities.* ***It is critical from a credit research perspective to identify the companies that can withstand the crisis*** *(our focus is on the liquidity of the balance sheet and the ability to operate the business to prevent or minimise negative cash flow)* ***and exploit these fragmentations. We believe that there are and will be opportunities in the Euro credit area for corporates with sound balance sheets and resilient business models.*** *The market reaction has not sufficiently differentiated high quality issuers from those more challenged issuers. We favour the short end and good quality credit ratings, where spreads have originally suffered most from the first pricing disruptions.* ***We keep a particular focus on liquidity****. This means both maintaining significant cash buckets and concentrating on high credit quality names. This remains a priority because it is the way* ***to preserve flexibility in times of uncertainty and high volatility. The move towards normality is still long, but it has started.***

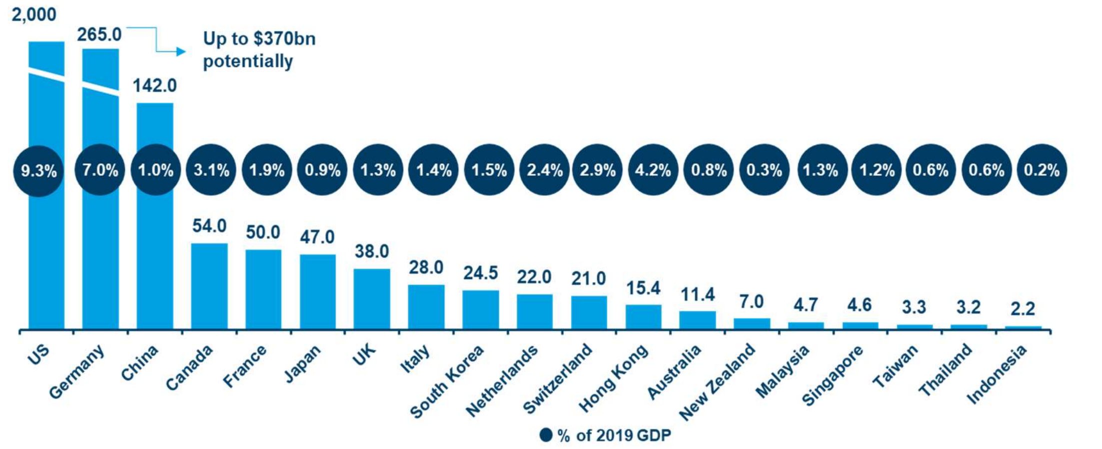
THE MACRO VIEW

The Eurozone economy is facing a severe disruption due to the Covid-19 crisis. What is your assessment of the fiscal and monetary measures announced so far?

"*Success is not final, failure is not fatal: it is the courage to continue that counts*". This is the attitude across Eurozone authorities aiming at safeguarding lives, livelihoods, incomes and businesses. The challenge is paramount. Governments are actively implementing healthcare policies to control the virus spread and human impact while working, at national level, on labour policies and incentives for companies. Strong policy responses to prevent structural damage will be key. How to pay back the cost of higher debt is still an open question.

An answer from the Eurogroup is expected in the next days. On the monetary front, the intervention has evolved in a bolder direction to preserve liquidity conditions (targeted longer-term refinancing operations – TLTRO – volumes are at multi year highs), unlimited QE is supporting liquidity in the secondary market ultimately also favouring the return of activity in investment grade primary market, and ultimately expectations regarding sovereign yields have been stabilised.

Fiscal policy support measures at the global level, USD bn



Source: Amundi on Bloomberg data, as at 23 March 2020.

"Corona bonds are a sign of a stronger political will to reinforce the Union, allow an increased fiscal capacity and a more effective interaction between fiscal and monetary policy, as is the case in the US."

On the activation of the European Stability Mechanism (ESM) with Enhanced Conditions Credit Lines (ECCL)[1], what is your view?

The discussion around a joined up fiscal response from the member states to (partially) offset the economic damages of Covid-19 remains very sanguine.

The fastest solution, in terms of implementation, is to offer enhanced credit lines (ECCL) to multiple member states. This would increase the ECB's firepower massively, as it would allow the unlocking of unlimited targeted bond purchases by the ECB, at its discretion. As Covid-19 is a global health related shock, to this extent this facility should eventually be symmetrical, applying to all members states (being aware that their fiscal spaces differ considerably within the region).

The legal architecture is already in place, as it recalls the OMT[2], but as the virus spread and its human impact as well as the public health response differ across member states, it remains politically sensitive to address the conditionality to be attached to these loans. In fact, there will be a significant political stigma if member states apply unilaterally (namely, for Italy and Spain).

Another tool recently advocated is the issuance of corona bonds. Do you see this as a concrete possibility?

Corona bonds would be a major ideological step forward in light of 'greater' fiscal union. How to design them (establishing the target: risk sharing now or post crisis reconstruction, technically sizing them, estimating the need to be covered, for example) and implement them is a very hard task. The bulk of the discussion for the time being remains political. In fact, some member states claim this tool would encourage moral hazard, dissuading some countries from maintaining the reform process they embarked on. It will be hard to win on these premises. However, there would undoubtedly be benefits, in our view, in the implementation of these instruments: it would indicate a sign of a stronger political will to reinforce the Union, support

[1] A credit line open to all euro area countries whose general economic and financial situations remain sound, but who do not comply with some of the eligibility criteria for accessing a Precautionary Conditioned Credit Line (PCCL). A country will be obliged to adopt corrective measures aimed at addressing such weaknesses and avoiding any future difficulties with respect of access to market financing.
For more info on the ESM https://www.esm.europa.eu/assistance/lending-toolkit.

[2] The Outright Monetary Transactions, announced by President Draghi in September 2012, is an ECB bond buying programme with no ex ante quantitative limits, focused on the shorter part of the yield curve, and with strict and effective conditionality for the country to which the programme applies.

increased fiscal capacity, and more effective interaction between fiscal and monetary policy, as is the case in the US.

What sort of Europe will we have after this crisis?

At this stage, it is premature try to imagine how the world will evolve and possibly re-invent itself. The speed and the effectiveness of the policy mix answer will likely be influential in reshaping the new order. Changes can take place at different levels.

First, politically. We might see a politically stronger China taking a lead global on the way out of the crisis and assuming a leading role in the new geopolitical equilibrium. At the national level, the trade-off between economic and national security objectives will find different solutions that will eventually affect the depth, the duration of the disruption, and the shape of the rebound. More nationalist waves could gain ground, in particular in those countries where fiscal space is more limited.

Second, economically. Governments' roles in targeting the safeguarding of livelihoods, incomes and business will play out in a series of bailouts eventually having a more prominent role in economies. Health care systems will likely go through a profound review, challenging the existing models (public/private, funding, and right to life for everyone). The effects of national lockdowns have yet to be seen, but there will be clearly some.

Third, socially. The great financial crisis and the asset reflation wave ultimately exacerbated income inequality. This crisis is different in nature. It involves entire populations. Health care and economic policies will impact and preserve incomes and livelihoods for a broader number of people. In this respect, this crisis, and the responses to it, can in a way reduce some income inequalities, with broader redistribution effects on populations that usually are not seeing any benefits. On the other hand, however, we envisage a more significant polarisation in the productive sector, between bigger corporations that can easily get access to credit and smaller/micro companies with less solid situations that would be hit harder.

EURO FIXED INCOME OUTLOOK

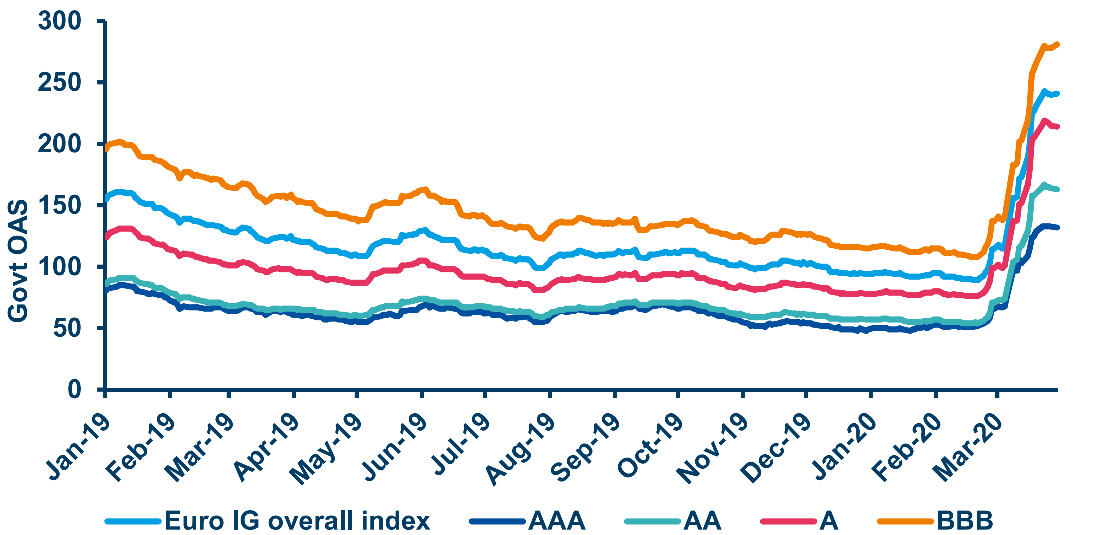
What are your main convictions on the European fixed income markets?

"We see considerable appetite for investment in the euro fixed income market: in sovereigns, offering generous premiums on their syndication, and in the corporate market, with a flurry of primary issuance".

Post announcements, we have observed that the recent spread widening has not yet been reversed by the ECB's initial actions.

Today, we see considerable appetite for investments in the euro fixed income market, especially via new issuance.

Euro IG market, OAS by rating



Source: Amundi on Bloomberg data, as at 30 March 2020.

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ASSET MANAGEMENT

Sovereigns, surprisingly, are offering generous premiums on their syndications. With the Asset Purchasing Programme operating, the liquidity of this segment is back to normal, very easily allowing arbitrage. As an example, Tuesday morning, the Kingdom of Belgium issued a seven-year bond with a 12bps premium for an initial €8bn. The book topped €57bn!
In the corporate segment, there was a flurry of primary issuances; this is the prerequisite for better liquidity in the market. The overall demand was very high, at, on average, over 10x the nominal issue. Consequently, generous premiums were tightened during the book building or by the low level of allocation at closing.

We have noted ratings agencies responding with alacrity through an acceleration in downgrades. **The impact of Covid-19 is likely to increase dispersion among sectors and issuers. This should offer a range of opportunities**, thanks to the support of strong and experienced credit research. Given these current factors, we believe this a good opportunity for investors to actively manage and operate switches selectively in portfolios.

"Most issuers in the investment grade category should have sufficient financial flexibility to weather the storm: the market reaction has not sufficiently differentiated high quality issuers from those more challenged issuers and this means opportunities for active managers".

On the credit side, how do you assess the health of the corporate and banking sector in this crisis? Will there be opportunities in the euro credit area at some stage?
In the current context, our focus is on ascertaining that companies have sufficient liquidity to survive the effects of the Covid-19 pandemic which could last for several months. In this context, the most important factors are **the liquidity of the balance sheet and the ability to operate the business to prevent or minimise negative cash flow.** We assume that companies could be shut out from the capital markets for some time and it is therefore paramount that they are able to maintain operations based on their existing liquidity (cash on hand and credit facilities). **Most issuers in the investment grade category should have sufficient financial flexibility to weather the storm.** Also, there is the issue of access to cash for small and medium sized firms that will be possible through intermediation of the banking system (TLTRO 3). The ECB will support bank lending to this segment. All policy has been structured to bridge liquidity needs based on the normalisation of the euro short-term market functioning.

"In the current crisis, banks are not the problem, they are part of the solution".

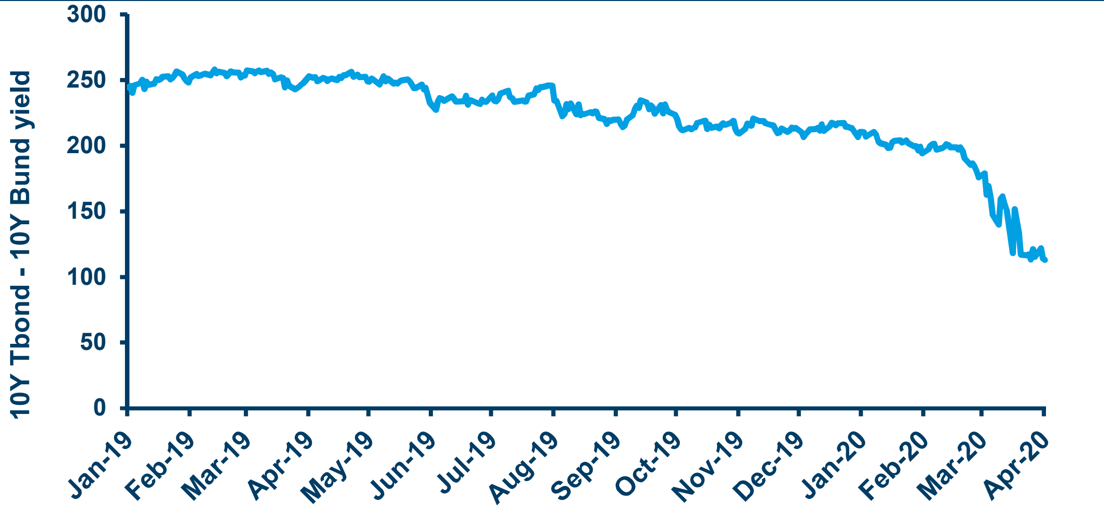
Regarding bank segment, it is important to emphasise that this is a health crisis, not a credit crunch. **Banks are not the problem, they are part of the solution**. They have highlighted their role as conduits for the government measures to support the economy. Therefore, there is joint action from governments, national regulators and central banks to sustain liquidity and solvency in the face of stress through massive monetary and regulatory initiatives. Banks will be able to maintain their own liquidity with the support of the ECB while stimulating the economy through lending to credit-worthy businesses and individuals or by transferring risk to government-related institutions.
We believe that there are and will be opportunities in the Euro credit area for corporates with sound balance sheets and resilient business models. **The market reaction has not sufficiently differentiated high quality issuers from those more challenged issuers.**
We favour the short end and good quality credit ratings, where spreads have originally suffered most from the first pricing disruptions. Our focus remains on portfolio liquidity through adequate cash management and upgrading whenever possible the quality of the credit universe.

"The US-Euro 10-year yield spread tightened by nearly 100bps YTD and by 150bps over one year and still have the potential to perform".

On a wider perspective, other central banks, not only the ECB, are also very active: how does this affect the relative value opportunities among countries?
Central bank interventions are more connected with fiscal stimulus than ever experienced in the past. After rate cuts, which have triggered a bull steepening of yield curves, yields were moving higher with the announcement of fiscal packages. To keep long-term yields under control, CBs put in place massive programmes of QE, buying government bonds, IG corporates, MBS (mortgage-back-securities) and even ETFs (Exchange-Traded fund). So, the main impact in bond markets have been flattening of yield curves and a significant over-performance of US Treasuries vs Core Euro market. The US-Euro 10-year yield spread tightened by nearly 100bps YTD and by 150bps over one year and still have the potential to perform.

The firepower of the Federal Reserve, and unlimited balance sheet action, will continue to keep pressure on long term yields (yield curve control theory in practice) in the US vs the rest of the world. In Europe, the ECB has a more challenging task to keep core rates low and play a balancing act in taming short-term volatility, as seen regarding govies spreads. Post the significant under-performance of the US credit segment, we saw opportunities in participating in new primary issues. We are surprised by the very large investor commitments seen so far (US$250bn). This is a very positive signal regarding more normalisation ahead in a very particular context as 'recession like' spreads have been observed at 400bps. This rally characterises the 'buy-in' mood of market participants in line with the recently announced Fed measures (still to be implemented) and the significant fiscal package offered by the government.

10Y Treasury and 10Y Bund – Yield differential



Source: Amundi on Bloomberg data, as at 1 April 2020.

In a few words, what is your main message to fixed income investors?

As we have seen, the current situation warrants the following observations:

- In very volatile periods, our focus is on fundamentals with regard to CB actions, fiscal measures, corporate and household balance sheets are concerned.
- The coronavirus is an exogenous shock hitting the market in all its components. This shock will eventually go away. This is very different from previous crises in which the problem was within the private sector with longer time needed to fix it.
- Policymakers are in *'whatever it takes'* mode. Market participants should not underestimate their commitment. Full implementation might require patience and persistence, but political capital and first decisions have been deployed.

"Liquidity management remains a priority because this is the way to preserve flexibility in times of uncertainty and high volatility".

That being said, it will take time to fully assess the likely outcome of current events, in both economic and financial terms. We keep a particular focus on liquidity. **This means both maintaining significant cash buckets and concentrating on high credit quality names. This remains a priority because this is the way to preserve flexibility in times of uncertainty and high volatility.**

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Definitions

- **Asset purchase programme:** A type of monetary policy wherein central banks purchase securities from the market to increase money supply and encourage lending and investment.
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Bond ratings:** (Source: Moody's and S&P). If the ratings provided by Moody's and S&P for a security differ, the higher of the two ratings is used. Bond ratings are ordered highest to lowest in a portfolio. Based on S&P measures: AAA (highest possible rating) through BBB are considered investment grade; BB or lower ratings are considered non-investment grade. Cash equivalents and some bonds may not be rated.
- **Credit spread:** Differential between the yield on a credit bond and the Treasury yield. The option-adjusted spread is a measure of the spread adjusted to take into consideration possible embedded options.
- **Curve flattening:** A flattening yield curve may be a result of long-term interest rates falling more than short-term interest rates or short-term rates increasing more than long-term rates.
- **Curve steepening:** A steepening yield curve may be a result of long-term interest rates rising more than short-term interest rates or short-term rates dropping more than long-term rates.
- **Option-adjusted spread (OAS):** the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option.
- **MBS, CMBS, ABS:** Mortgage-backed security (MBS), commercial mortgage-backed security (CMBS), asset-backed security (ABS).
- **Quantitative easing (QE):** QE is a monetary policy instrument used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **TLTRO:** The targeted longer-term refinancing operations (TLTROs) are Eurosystem operations that provide financing to credit institutions. By offering banks long-term funding at attractive conditions they preserve favourable borrowing conditions for banks and stimulate bank lending to the real economy.
- **Volatility:** A statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

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