THIS MONTH'S TOPIC

Corporate fundamentals are at the centre of the game

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The essential

Over the last decade, easy financial conditions encouraged an increase in sovereign and corporate debt. Indeed, the leverage of American companies has reached record high levels and US corporate debt has been used for financial risk-taking to fund corporate payments to investors, as well as for mergers and acquisitions. At the opposite, the leverage of European companies has remained at low levels as European companies have remained more cautious over this cycle. In 2019, we have evolved in a new regime: the global economy has entered a synchronised slowdown and major central banks have returned to an easing stance. What are the risks for companies in this new context? **We are following closely:**

- **The downgrade risk in the US Investment Grade universe.** Net leverage for US issuers have resumed their upward trajectory in recent months. In 2020: (1) companies to make a trade-off between maintaining share buy backs and the stability or their debt (2) the downgrade risk to increase among firms facing increase pressure on profits.
- **The default rate risk for low-quality high-yield bonds**. Sluggish earning growth poses the biggest threat for companies to pay interest on their debt despite the low cost of financing. Indeed, at this stage of the cycle, we think that interest coverage is more closely related to earnings than to its interest expense: interest coverage could be quickly eroded by a hit to earnings. A selective approach is required in the low-rated Euro and US High Yield segments.

Central bankers have been the main player in town for the last decade. They have done a great job regarding financial stability but they failed to significantly stimulate investment spending and to bring inflation back to 2%. At the same time, easy financial conditions encouraged an increase in sovereign and corporate debt. Indeed, corporate debt has risen, and has been used for financial risk-taking to fund corporate payments to investors, as well as for mergers and acquisitions, particularly in the United States. **In this note, we will assess the risk of corporate debt while we have evolved into a new regime:**

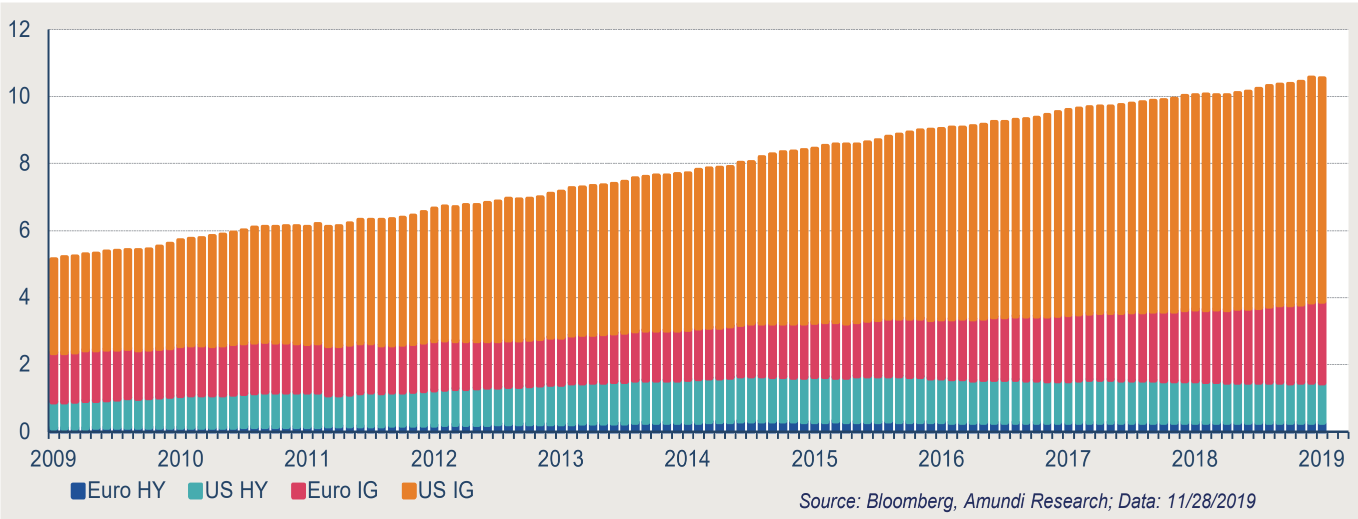
- **The global economy has entered a synchronised slowdown** after a synchronised pick-up in 2017. Momentum in manufacturing activity has weakened substantially, to levels not seen since the financial crisis, on the back of rising trade and geopolitical tensions, the slowdown of the Chinese economy and a slump in the auto industry. This year will see growth at its lowest rate since the beginning of the decade and the IMF expects slower growth in nearly 90 percent of the world.
- **The world's major central banks have returned to an easing stance this year** due to muted inflation and lower global growth expectations. Most of the major central banks have lowered borrowing costs in recent months and have restarted asset purchase programmes.
- **Political risks are expected to remain high with the upcoming US and UK elections.**

This cycle was marked by a sharp increase in corporate debt

According to McKinsey, global non-financial corporate debt, including bonds and loans, more than doubled over the past decade, growing by $37 trillion to reach $66 trillion in mid-2017. The institute also estimates that nearly 20 percent of total global corporate debt is in the form of bonds, almost double the figure in 2007. In total, over the decade, the size of the global non-financial corporate debt market increased by (source: OECD):

- 70% in advanced economies from USD 5.97 trillion in 2008 to USD 10.17 trillion in 2018. The US IG market has increased from around $2.2 trillion to $6.7 trillion.
- 395% in emerging markets, mainly driven by growth in China, to reach a total outstanding amount of USD 2.78 trillion in 2018.

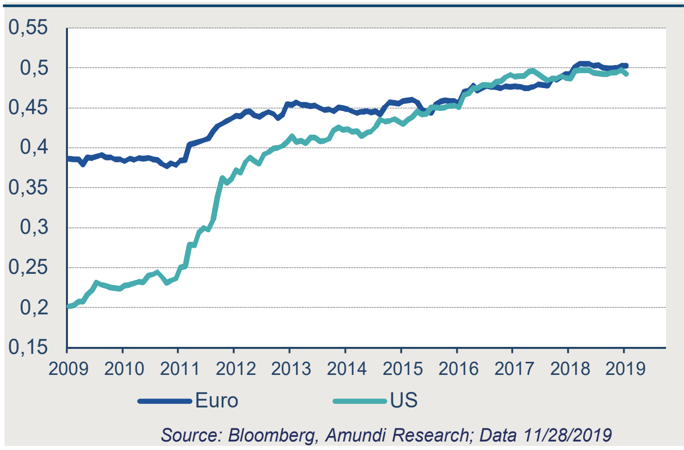
1/ The size of the corporate bond market (in trillion $, face value)



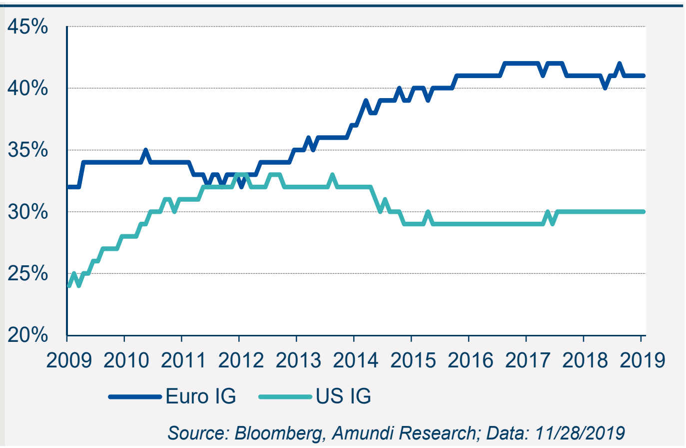
The growth in the size of the corporate debt market has been accompanied by a steady decline in overall credit quality both in Europe and the US. BBB-rated debt now accounts for around half of the whole investment grade market. However, explanatory factors between the two zones are different.

- The expansion of the BBB segment in Euro IG could be explained by a substantial increase in the number of issuers: (1) corporate bond issuance provided an alternative to deleveraging banks and (2) many US issuers tapped the euro corporate bond market.
- In the US market, the deterioration in overall credit quality could also be explained by the increase in the leverage of American non-financial companies.

2/ The share of investment Grade market rated BBB



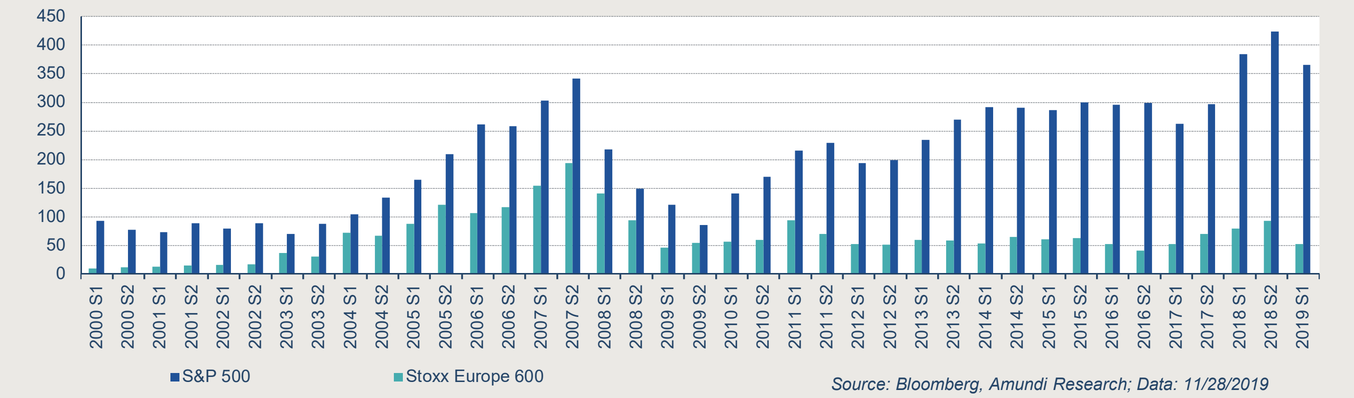
3/ The share of investment Grade market issued by foreign issuers



Indeed, the balance sheet of American and European companies has followed different trends over the past decade:

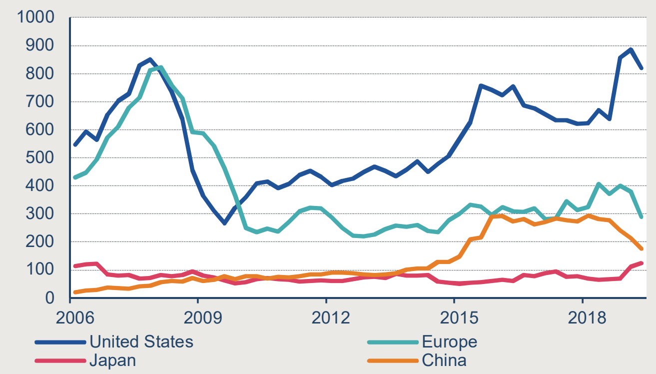
- **The leverage of American companies has reached record high levels.** American companies have raised huge amounts of cash on financial markets to fund record numbers of mergers and acquisitions and share buyback activities. Back in 2010, only 10% of the IG non-financial market had net leverage greater than 4.0x, but as of 2017, that share increased to 20%.
- **The leverage of European companies has remained at low levels, as European companies have remained in a cash preservation mode over this cycle.** Less than 12% of the IG non-financial market has net leverage greater than 4.0x and this share declines to 5% if we exclude the Utilities and Energy sectors.

4/ Share buyback activity (in $bn)



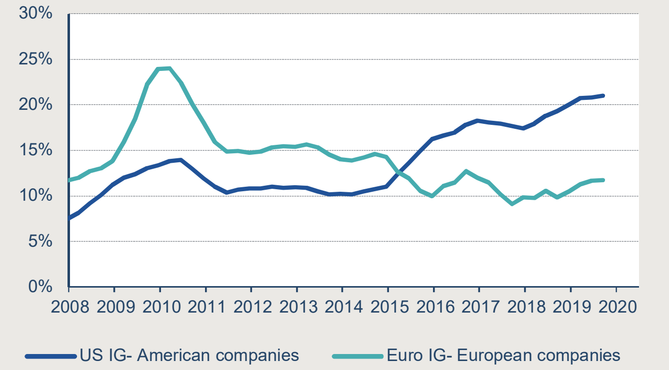
Source: Bloomberg, Amundi Research; Data: 11/28/2019

5/ Global Mergers and Acquisitions Deals (in $bn)



Source: Bloomberg, Amundi Research; Data: 11/28/2019

6/ % of issuers recording a leverage above 4 (4q ma)



Source: Bloomberg, Amundi Research; Data: 11/28/2019

What are the recent trends in corporate fundamentals and what are the risks?

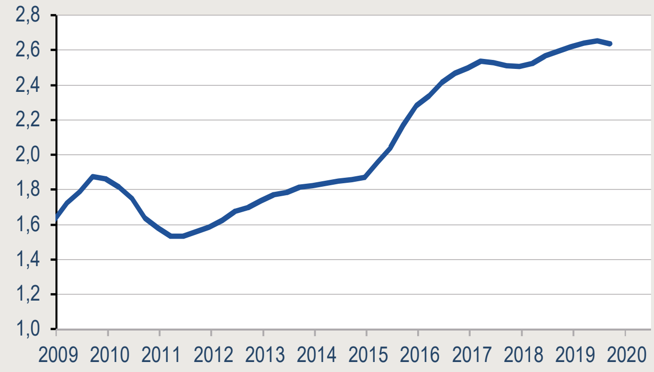
After a sharp deterioration in recent quarters, global growth is expected to come out at 3% for 2019. The weakness in growth is driven by a deterioration in manufacturing activity and global trade, with higher tariffs and prolonged trade policy uncertainty damaging investment and demand for capital goods. At corporate levels, these trends have resulted in a slowdown in sales and capex growth for a majority of issuers. Indeed, capex growth correlates closely with revenue and profitability trends. The decline was more pronounced in the energy, utilities, materials and industrial sectors. At the same time, the easing trend of most central banks has supported the search for yield and investors' appetite for credit. Euro and US Investment Grade credit experienced strong activity in the primary market and corporate borrowing remained high for most companies. Let's take a segmented look at the latest changes and challenges ahead.

1. US Investment Grade: companies were once again leveraging up in Q3

- **Net leverage: reached an all-time high in Q3** and we did not see much evidence of broad-based deleveraging across the US IG universe. Indeed, 66% of the companies in our universe even increased their leverage ratio in Q3 2019 vs. Q3 2018.
  - # Companies continued to raise debt to support M&A and share buybacks. S&P 500 companies are on track to buy back another $800bn of stock in 2019, according to JP Morgan, down slightly from around $830bn in 2018. Companies are now returning more cash to shareholders than they are generating in free cash flows.
  - # However, many US companies are moderating their capital expenditure spending. Some companies have warned that this could continue this year as US elections are likely to add uncertainty to decision-making.
- **Interest Coverage ratio: declined in recent quarters** but it remained in a bright spot thanks to the record low cost of funding.
- **Cash ratio: declined to its lowest level since 2010**. The recent decline has coincided with a sharp increase in leverage. The cash ratio declined across most sectors in recent quarters.

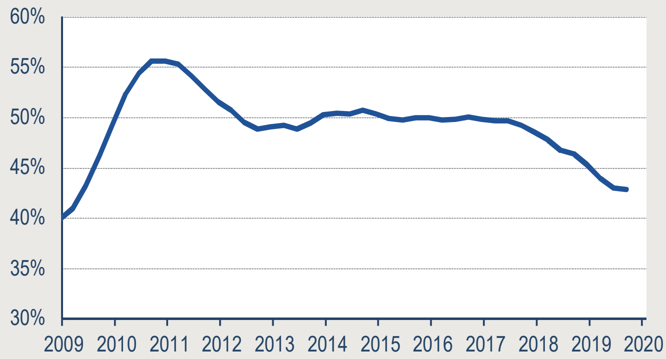
Our convictions: our greatest concern on the US IG segment is the high level of leverage. Unless earnings growth accelerates, companies will have to make a trade-off between maintaining share buybacks and the stability of their debt. Moreover, the risk at this stage of the cycle is a change in the story. During this cycle, the rise in the leverage of American companies was mainly driven by debt growth. In the future, the increase in indebtedness could also be the result of a slowdown in earnings growth.

7/ **US IG Net debt to EBITDA (4q ma)**



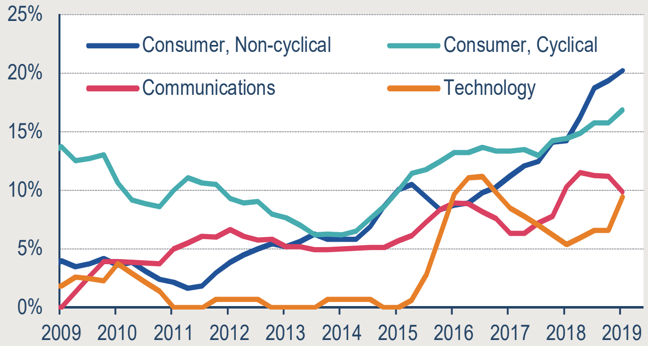
Source: Bloomberg, Amundi Research; Data: 11/28/2019

8/ **US IG Cash ratio (4q ma)**



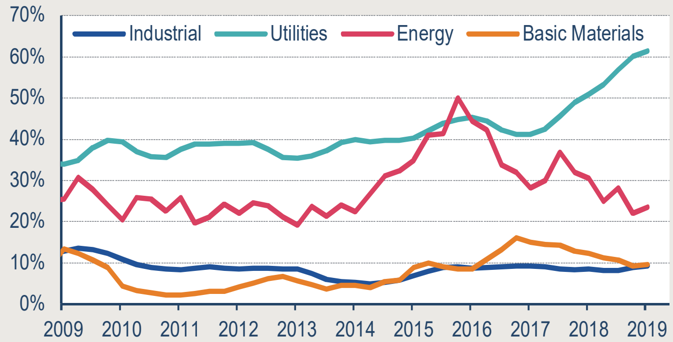
Source: Bloomberg, Amundi Research; Data: 11/28/2019

9/ **US IG % of issuers recording a leverage above 4 (4q ma)**



Source: Bloomberg, Amundi Research; Data: 11/28/2019

10/ **US IG % of issuers recording a leverage above 4 (4q ma)**



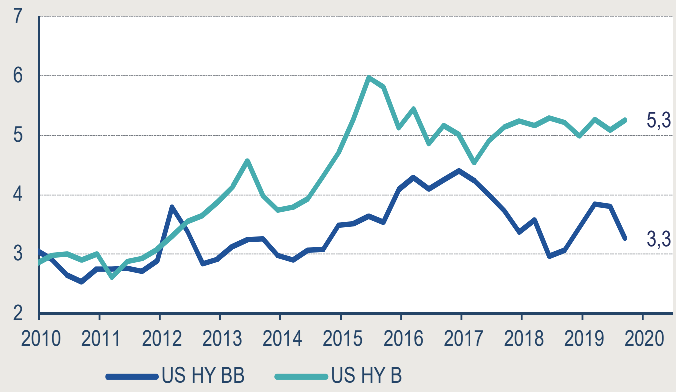
Source: Bloomberg, Amundi Research; Data: 11/28/2019

2. US High Yield: stabilisation in recent quarters but high level of vulnerability for B and C rated issuers

- **Net leverage: stabilised at high levels.** US HY issuers were focused on balance sheet improvement over the past two years and stabilised/reduced their leverage. It should be noted that the dynamics were asymmetrical between different rating classes. The fundamentals of BB-rated issuers have improved while debt levels remain particularly high for issuers rated B and C.
- **Interest coverage ratio: deteriorated over the last few quarters due to lower earnings growth**. The sharp rise in the number of challenged firms is concentrated in B and C rated bonds. Currently, 32% of High Yield firms appear unable to meet interest expenses out of earnings. The situation is more concerning for low-rated issuers (B and C). We have no serious concern on the BB segment.
- **Cash ratio: decline to its lowest level since 2010.**

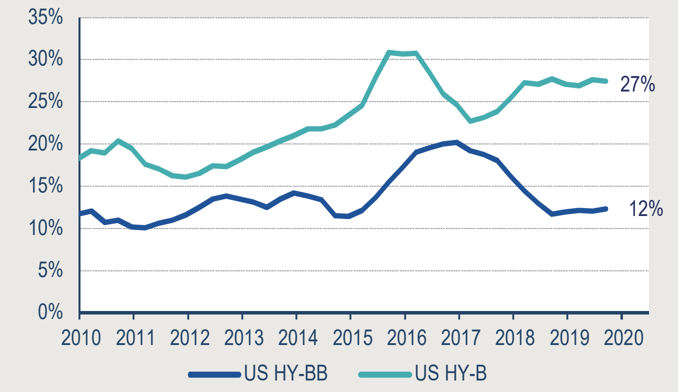
Our convictions: our biggest concern in the US HY segment is that defaults could begin to rise as firms have more difficulties to pay interest on their debt. Given how late we are in the cycle, we think that interest coverage is more closely related to earnings than it is to interest expense: interest coverage could be quickly eroded by a hit to earnings. The IMF has also warned that the number of firms with very low interest coverage ratios is already high and sees the number of firms with very low interest coverage ratios as a common signal of distress. The IMF highlights that the risk is more concentrated on small companies.

11/ US HY Net debt to EBITDA



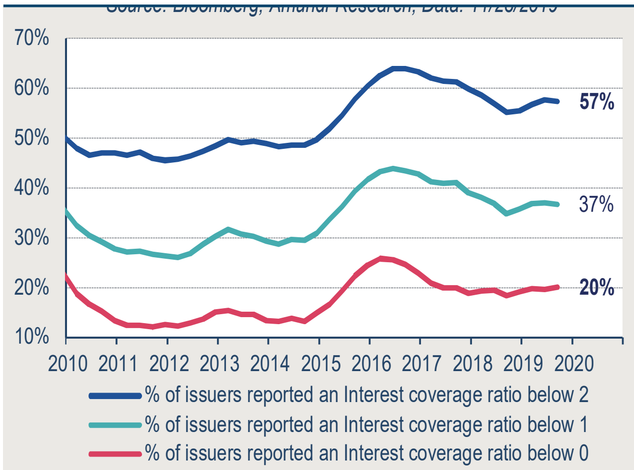
Source: Bloomberg, Amundi Research; Data: 11/28/2019

12/ US HY % of issuers reported a Leverage above 6



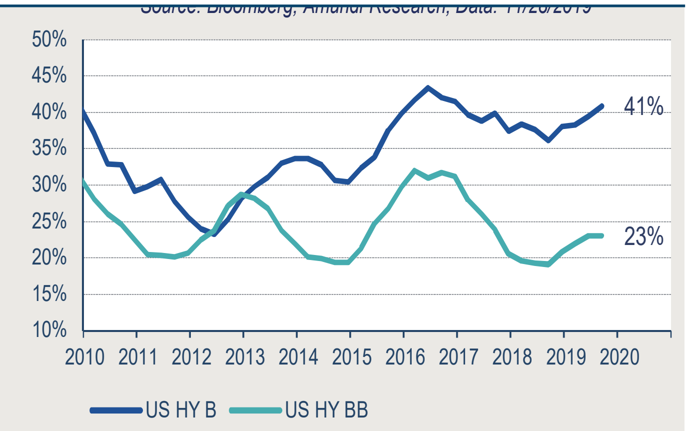
Source: Bloomberg, Amundi Research; Data: 11/28/2019

13/ US HY Interest coverage ratio



Source: Bloomberg, Amundi Research; Data: 11/28/2019

14/ US HY % of Zombie issuers*



**with an Interest Coverage ratio below 1*

Source: Bloomberg, Amundi Research; Data: 11/28/2019

3. Euro Investment Grade: slight deterioration in Q3 but fundamentals remained relatively stable

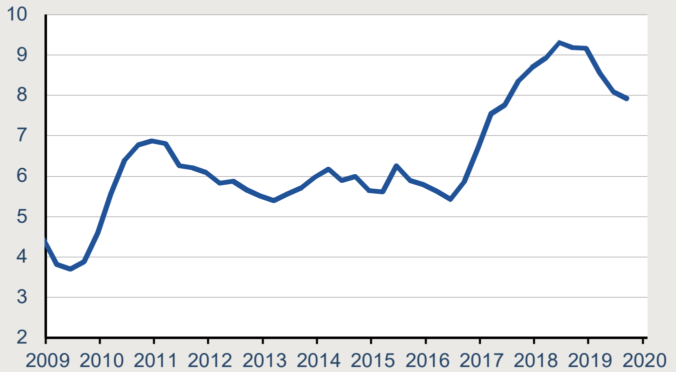
- **<u>Net leverage:</u> deteriorated slightly in Q3 but has remained relatively stable since the financial crisis**. Over the cycle, European companies have remained in a cash preservation mode. The pace of debt growth has accelerated so far this year, but from very low levels. This is in line with the stronger activity recorded on the Euro IG primary market. Capex also increased over the last few quarters, from the muted levels recorded over the cycle.
- **<u>Interest Coverage ratio</u>: fell in recent quarters but remained in a bright spot** due to the record low cost of funding and low level of debt.
- **<u>Cash ratio:</u> declined to its lowest level since 2010.** The recent decline in cash balances has coincided with a slight increase in leverage.

Our convictions: We have no major concerns about the fundamentals of European investment grade companies. There is still no evidence of broad based re-leveraging. However, at this stage of the cycle, the weak profit growth picture is a limiting factor in improving the balance sheet of European companies.

15/ **Euro IG Net debt to EBITDA (4q ma)**

Source: Bloomberg, Amundi Research; Data:11/28/2019

16/ **Euro IG Interest coverage ratio (4q ma)**



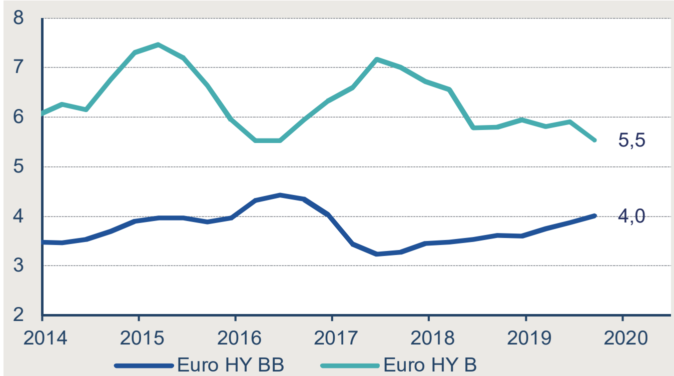
Source: Bloomberg, Amundi Research Data: 11/28/2019

4. Euro HY: stable picture for BB but higher level of vulnerability for B and C

- **Net leverage:** stabilized at high level for B. Credit metrics remained relatively solid for BB.
- **Interest coverage ratio:** slight deterioration in recent quarters especially for low rated issuers.
- **Cash ratio:** slight deterioration in recent quarters.

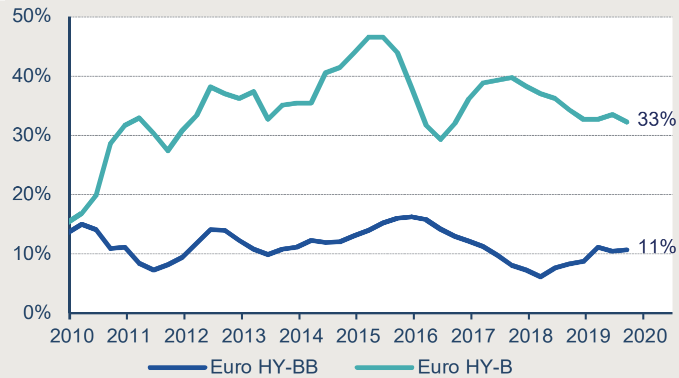
Our convictions: as for US HY, our main concern is the debt service capacity for low-rated issuers. There is no significant difference in terms of credit metrics between Euro and US HY. However, the HY structure is more defensive in Europe than in the US. BB account for 71% of Euro HY versus only 50% of US HY.

17/ **Euro HY Net debt to EBITDA**



Source: Bloomberg, Amundi Research; Data 11/28/2019

18/ **% of issuers with a Leverage above 6**



Source: Bloomberg, Amundi Research; Data 11/28/2019

Financing conditions remain favourable due to strong support from easing monetary policy

There is no maturity wall. The corporate bond market has benefited from the "hunt for yield," with rates on government debt securities at or near all-time lows – and even below zero in many places such as Europe and Japan. Strong demand for credit coupled with strong activity on the primary market enabled companies to refinance their debt and extend their maturity profile.

However, the level of refinancing needs has significantly increased in recent years. Given the size of the current outstanding stock of corporate bonds, companies, especially in the US, are facing record levels of repayment requirements in the coming years. As of December 2018, companies in the US need to pay or refinance USD 2.9 trillion within 3 years.

We maintain an up-in-quality bias. Selective pick-up in B.

The stabilisation in the macro backdrop coupled with strong technical support will likely prolong the cycle for higher quality issuers. However, risks remain skewed to the downside and the outlook for weaker credit quality remains challenging in our view. We think 2020 will continue to test the most growth-sensitive segment as earnings are unlikely to experience a strong rebound. We maintain an up-in-quality bias with a selective pick-up in B for valuation reasons. We see a sustained decline in earnings as the main risk factor.

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