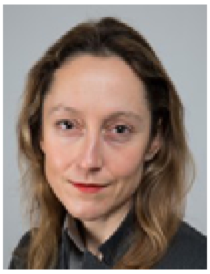
THEMATIC

An expected improvement in corporate fundamentals bodes well for bondholders



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We expect business fundamentals to improve in the coming months, especially for low-rated companies. The ratings momentum in HY, as measured by downgrade/upgrade volumes, has already turned positive.

In addition to a rebound in profits, companies should continue to benefit from historically attractive financing conditions. Demand for corporate debt is strong from yield-hunting investors. We expect low-rated issuers, in cyclical sectors in particular, to show more balance sheet discipline and to start a deleveraging cycle. M&A activity will be a key variable to monitor this year for well-rated companies.

Corporate defaults are occurring at a much lower level than initially anticipated

This crisis has been characterised by countercyclical credit conditions, thanks to the very successful coordinated action between governments and central banks. Supportive financial market conditions allowed the most fragile companies to increase their liquidity and avoid default in 2020, despite the exceptional drop in economic activity. The debt supply was massive for corporate and sovereign issuers. Many companies stored unprecedented levels of cash. Maturities have been lengthening, particularly for investment-grade companies. This heavier-than-anticipated supply has been well absorbed by investors: yields hit all-time lows on new issues. This is a big difference compared with previous crises.

As a result, default rates have remained well below initial expectations. The trailing 12-month default rate for global non-financial and financial companies stood at 6.6% at year-end 2020, compared with 10.6% projected at the onset of the pandemic. Defaults are expected to peak in Q1 2021, 12 months from the outbreak of the crisis. A downward trend is then expected to start in Q2 and the following months. Defaults should remain concentrated in specific sectors, mainly CCC companies with vulnerable business profiles, i.e., low structural capacity to generate profits.

Corporate fundamentals of low-rated issuers should improve

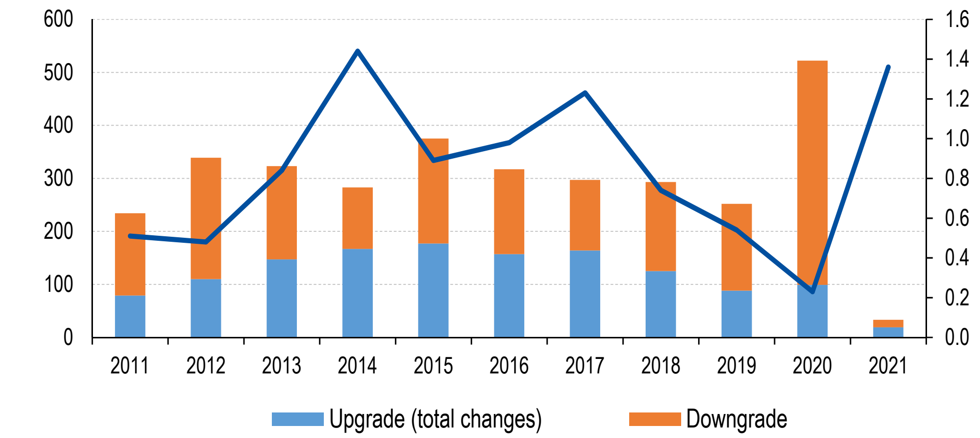
We expect corporate activity to pick up as the global economy rebounds in the second half of the year, once economies reopen and vaccines are rolled out. This rebound in growth should be supported by fiscal and monetary policies, excess household saving and manufacturing restocking. At the same time, we expect central banks to continue delivering extremely accommodative monetary policy with no pre-emptive tightening. The major central banks are likely to continue supporting economies through low rates and asset purchase programmes.

At the same time, we expect companies, especially those that are low-rated and from cyclical sectors, to show more balance sheet discipline and to start a deleveraging cycle. These issuers have accumulated debt due to the decline in economic activity and are now more leverage-constrained.

In addition, companies should continue to benefit from historically attractive financing conditions. The record low cost of funding has led to reduced interest payments on debts and improved

Ratings momentum in HY, measured by downgrade/upgrade volumes, has turned positive

1/ **Euro HY: credit ratings trends**



Source: Bloomberg, Amundi Research - Data as of 25 February 2021

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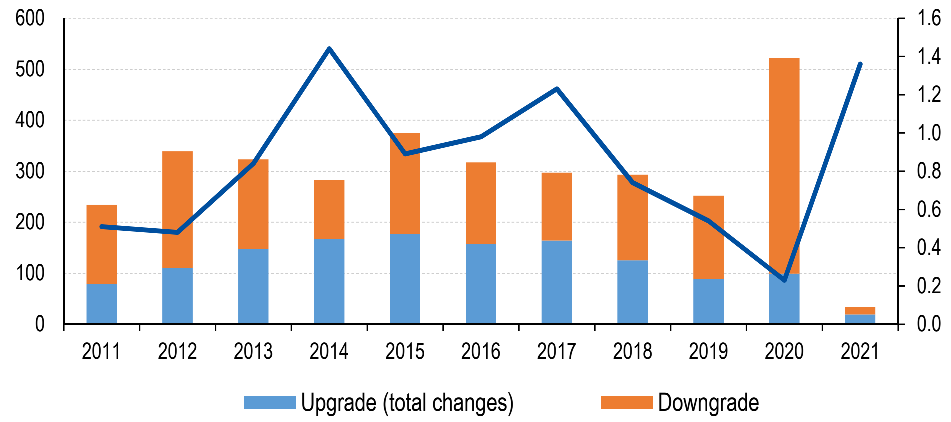
2/ **US HY: credit ratings trends**



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corporate creditworthiness. Activity on the primary market remains solid, mostly for refinancing purposes. The high level of cash on corporate balance sheets is reducing the need for additional funding in the near term.

A slow recovery would hamper the improvement in low-rated companies' credit profile. Continued access to liquidity remains crucial for companies facing impending debt maturities in order to avoid default.

Strong rebound in M&A driven by the technology sectors

Despite the crisis, M&A activity remains on track in the United States and Asia. However, it remains modest in Europe. M&A activity accelerated sharply during the second half of 2020; during this period volumes were the highest of all 2H periods since 2015.

This rebound in M&A activity was initially driven by technology, consumer non-cyclical and communication sectors. These companies have outperformed in recent years and were the big winners from the crisis. Most of them are well-rated and well-capitalised. They have an offensive strategy and pursue external growth to gain in scale and diversity (product, region, customer).

M&A activity has also resumed for those companies hardest hit by the pandemic and the economic crisis, for example companies in the energy sector. Their main motivation in this regard is to streamline costs rather than achieve external growth.

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