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Second wave of coronavirus pandemic, value in euro corporate credit

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6 November 2020

An affiliate of: NATIXIS INVESTMENT MANAGERS

Executive Summary
Second wave of coronavirus pandemic, value in euro corporate credit

A second wave of the pandemic is currently unfolding In Europe. We expect the impact to be less dramatic than during the first wave although parts of the service sector, such as transports, entertainment or hotels, will be badly affected. Euro area GDP fell by 3.7% in 1Q and by an additional 11.8% in Q2. The second wave may knock around 5% off 4Q GDP. Longer-term consequences could be more problematic as recessions induce bankruptcies and dent output capacity. Investment spending decisions may be postponed, and consumers may turn more cautious.

Governments' fiscal stance has eased considerably to support demand via social transfers, mitigate the impact of business revenue shortfall and extend loan guarantees. The €750b European recovery plan will provide additional support. Monetary policy was eased considerably via large-scale asset purchases capping yields and spreads and long-term loans to banks at negative rates. As concerns corporate credit, the ECB has bought around half of net issuance this year. Further easing is expected at the next governing council in December.

There is no denying that the pandemic is taking a significant toll on activity and corporate balance sheets in Europe. Leverage rose from 1.8x before the pandemic to 2.5x. Big names lost their high-grade credentials in 2020. However, borrowing costs remain about record lows. Current IG non-financial yields (0.43% yield to worst) are well below March 2020 peak (2.07%). Moreover, euro area companies have pre-funded their liquidity needs, implying less refinancing pressure going forward. Ratings downgrades have started to slow.

Corporate bond markets receive support from the ECB: 55% of the securities included in major benchmark indices are eligible to the ECB purchase programs. CSPP and PEPP holdings amount to €243b and €20b. Both programs are likely to be expanded in December. Corporate bond issuance was at record levels in 1H20 and is now slowing. However, bond supply appears to be slowing.

Credit remains the most attractive within the euro aggregate complex. Average IG spreads vs. Bunds stand about 114bp (as at Nov 3). Financials command a premium over non-financials. Senior unsecured bank bonds offer spreads of 95bp vs. German Bunds. Spreads on Cyclicals hit by the crisis (autos, leisure, real estate) are widest.

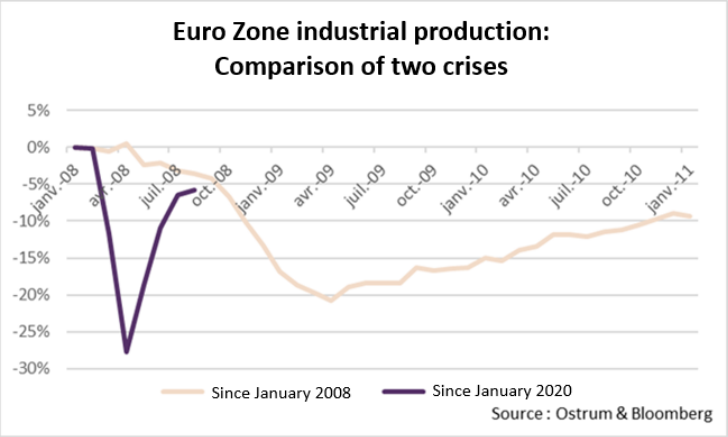
In sum, ECB support, slowing bond supply, a gradual recovery feeding into credit metrics and spread carry make euro IG credit an attractive asset class.

A second wave of Coronavirus

The second wave of the pandemic has accelerated during October to reach a level that forced governments to react. Throughout the month, not only the number of new cases has increased rapidly but the number of hospital admissions led to a worrying situation. As a result, this second wave of coronavirus has forced governments to re-establish partial lockdowns to try to curb the evolution and limit congestion in hospitals. The discovery of a vaccine, if confirmed, would thus be of a high importance as it would pave the way, eventually for an exit from the pandemic.

An impact on the economy less devastating than the first wave

Building on the lessons from the first episode, however, the lockdowns currently in place are aimed at preserving activity and minimizing the impact on the economy. Hence, we should expect the impact to be less dramatic than during the first wave. Teleworking is encouraged when possible which will limit disruption in a number of sectors, in particular for some services. Other sectors, such as construction, will benefit from a waiver so they can continue to operate. Here too the aim is to maintain activity at a minimum level. By contrast, other sectors, such as hotels and restaurants, transports or entertainment will continue to suffer heavy drop in their activity. As we saw during the recovery phase the divergence between sectors is thus likely to remain extreme.



The lockdown period is also planned to be shorter than it was during the first wave. Countries are planning a period close to a month, although this could be extended if the situation does not improve rapidly.

In terms of numbers, in Q1 this year Euro-Area GDP fell by 3.7% and by an additional 11.8% in Q2. For the reasons mentioned above that dampen the negative effects, our estimate for the impact of the second wave on the economy is roughly half of that of the first wave. We believe the GDP contraction could be close to 5%. This remains a sizeable drop for an economy that had not yet fully recovered from the first wave.

But long-lasting effects could be more pronounced

If the direct impact should be smaller this time, the long-lasting consequences could be more problematic. A second lockdown, even a less stringent one, will result in a higher level of debt for corporates which will hamper their cash flow and their ability to invest or create jobs. The number of defaults must be revised up as well which will lead to capacity destructions.

Finally, this second wave raises the probability that we could have repeated episodes in the future. This creates considerable uncertainty. It could have an impact on a number of economic decisions. Investment or job creation are long-term decisions and as such, they are heavily linked to economic prospects. The risk is thus that companies will be very prudent and underinvest or create too few jobs during this recovery. In the same vein, consumption decisions could be postponed and indeed consumers' surveys in the Euro Area show that precautionary saving is on the rise.

To that extent, the vaccine could be a game changer as it would make less likely a scenario of repeated lockdown. This would offer much more visibility to investors and consumers, with a potentially more constructive outlook for the economy at large. One can even dream of an efficient vaccine that would fully alleviate the COVID risk, in which case pent-up demand could fuel a very rapid recovery. But, this, for the time being is pure science fiction scenario.

It is thus reasonable to expect a tepid recovery. While activity bounced back and surprised most commentators during Q3 this year, it is very likely that the recovery from the second wave will be more subdued. The long-term potential growth rate could be dented as a result.

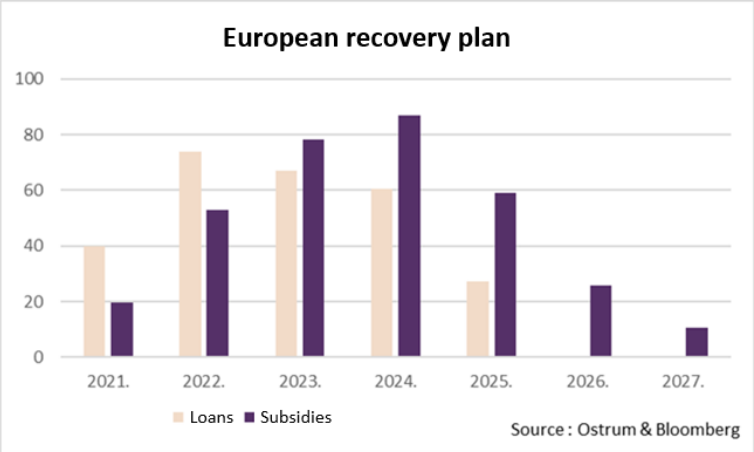
An unprecedented budgetary reaction

The policy mix reaction has been diametrically different from what it was during the great recession last decade. Following the 2009 crisis, the economy collapsed, budget deficit soared, and government implemented an ambitious fiscal consolidation to return to sustainable deficits. This year governments have implemented a much more supportive budgetary policy. Essentially this has targeted three aims:

- Support demand via social transfers. And indeed, retail sales have rebounded above their pre-crisis level in a number of countries.
- Compensate the lack of top line for companies. This has been done for instance with temporary unemployment schemes that allow corporates to transfer part of their labor costs onto the government's budget. This has reduced working capital needs. And indeed, the corporate default rate is unusually low for a recession of this magnitude.
- Allow guaranties to bank loans. This is the government behaving as "insurer of last resort" to incentivize banks to lend to corporates in need, despite the risks attached. And indeed, bank loans to corporates have soared during the lockup period.

These elements are key to keep in mind as they have played a major role in partly preserving the economy and allowing a much faster rebound than during the previous crisis.

The European recovery plan is also to be highlighted. This European solidarity and the size of the plan are again in sharp contrast with the reaction during the last crisis. It has also largely contributed to reassure markets.

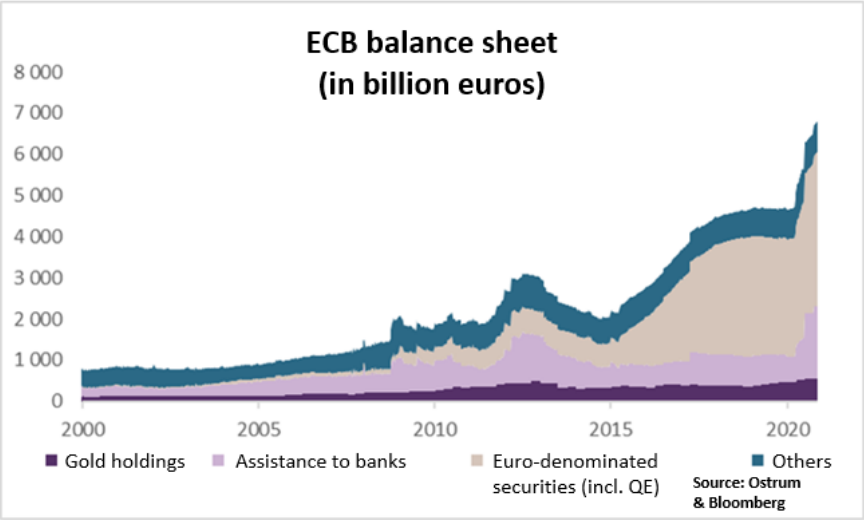


Additional measures have already been announced in the wake of the second wave, especially to support the companies most affected by the new lockdown. Further initiatives are likely in the future.

A momentous effort from the ECB

The second part of the policy mix is the monetary policy and here too the reaction has been considerably faster and larger than during the last crisis. For instance, the volume of QE implemented during the first 10 months of this year amounts to a total of 880 billion euros, a cumulated number that was reached only in February 2016, eight years after the start of the great recession.

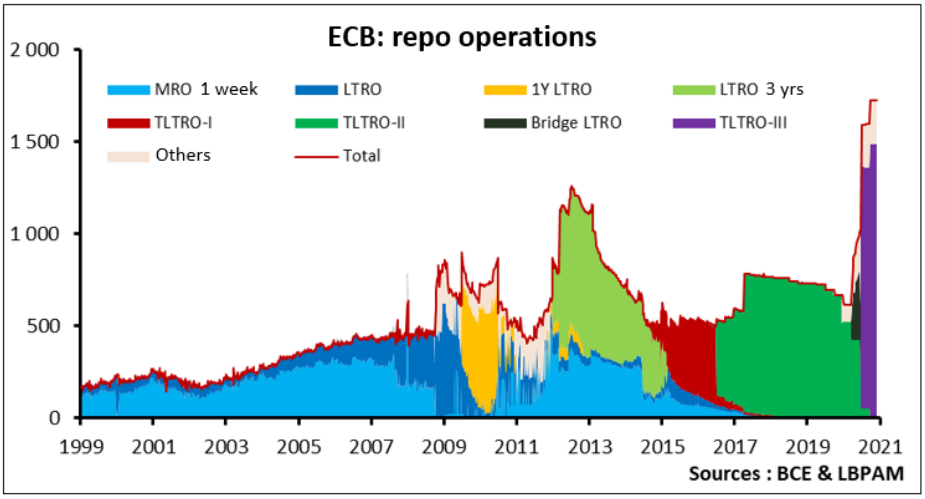
In terms of QE, the ECB is implementing a 20 billion per month program that has been supplemented by a 120 billion envelope. In addition, the ECB has also created the PEPP specifically designed for the current crisis with a 1,350 billion envelope. These numbers are likely to be increased and the program broadened at the next ECB meeting on December 10th.



The aim is to provide liquidity to the financial system but also to keep interest rates and spreads at a low level. Sovereign rates have remained very low with the German 10-year yield firmly in negative territory. Sovereign spreads have also tended to decline, here too in very sharp contrast to what happened during the last decade. Finally, it is also important to underline that, despite the considerable uncertainty, the volatility in these markets has collapsed thanks to the ECB action. As a result, governments have access to cheap but also stable funding conditions. It is a stated goal of the ECB to create these favorable conditions so that governments can implement ambitious budgetary policies.

Similarly, the reaction of credit spreads has been unusually subdued in comparison to the level of market stress and the level of uncertainty. On our number, the ECB has bought roughly half of all the net issuance on the market this year. Like in the case of the sovereign, this has played a key role in stabilizing the market and in securing cheap and stable funding for corporates.

A second aspect of the ECB efforts is the provision of liquidity to banks. The new repo operation (TLTRO III) has been successful with more than 1,300 billion of demand and an interest rate charged by the ECB at -1.0%. Conditions have also been more favorable, for instance in terms of the collateral eligible. This has provided ample liquidity to the banking system and alleviated any potential stress from funding issues. Together with the states guaranties that have reduced the credit risk associated with these new loans, this has resulted in a phase of credit easing during Q2 this year. Corporates under pressure for lack of liquidity have been able to borrow at favorable conditions.



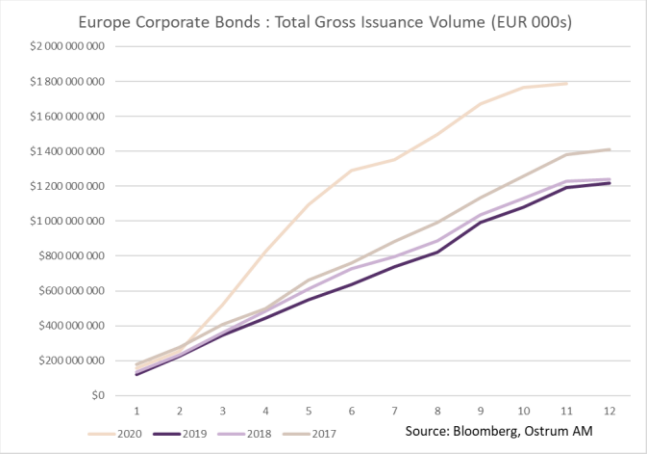
Looking forward, these measures are likely to be broadened even further at the December 10th ECB meeting. During the press conference following the last meeting on October 29th, Christine Lagarde has repeatedly stressed the need to avoid a credit crunch and the need to support banks.

In summary, the action of the ECB has been much bolder than during the previous crisis and has largely contributed to stabilize markets with yields, both in the sovereign and in the credit space, at a low and stable level.

The outlook for euro corporate credit

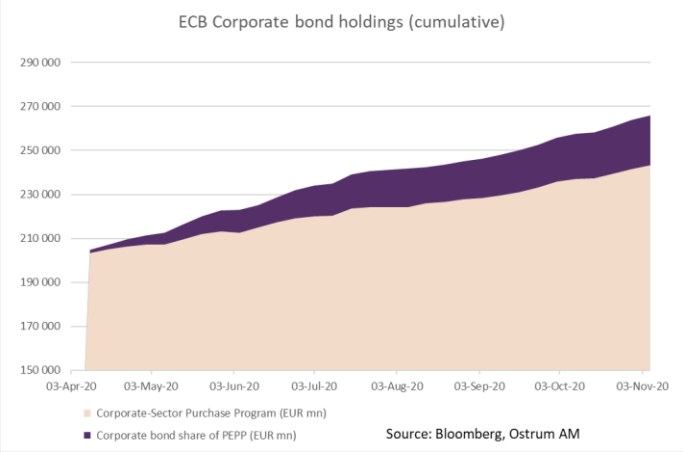
There is no denying that the pandemic is taking a significant toll on activity and corporate balance sheets in Europe. Non-financial debt ratios have worsened since hitting their bests in 1Q19, rising to decade highs on leverage and substantial virus impact on 2Q20 earnings. Leverage rose from 1.8x before the pandemic to 2.5x on average across a broad range of European corporate borrowers. Across rating categories, the positive flow of rising stars outstripping the tally of fallen angels observed since 2015 has now reversed. In 2020, fallen angels have outnumbered rising stars. Big names such as Renault, Autostrade and Kraft lost their high-grade credentials in 2020.

However, leverage need not necessarily hurt ratings, as borrowing costs remain about record lows. Current IG non-financial yields (0.43% yield to worst on Barclays Euro Aggregate Corporate Index) are now a fraction of their March 2020 peak (2.07%) which may ensure that higher leverage can be sustained. Moreover, many companies have pre-funded their liquidity needs through extensive use of corporate credit lines, implying less refinancing pressure going forward. In addition, the observed recovery in earnings in 3Q20 has already improved debt-to-EBITDA ratios. This is a key reason why rating downgrades have started to slow. The upgrade/downgrade ratios have more than doubled for the three major rating agencies vs. 2Q lows in the wake of an economic bounce. Lockdown-induced relapse in growth however bodes badly for the months ahead.



From a market perspective, European IG credit continues to receive considerable support from monetary policy. Since 2016, the European central bank purchases corporate bonds with IG ratings. The goal of the ECB is to buy a broad diversified portfolio in regular clips to preserve market liquidity. There are a number of criteria defining bond eligibility to the so-called CSPP and PEPP programs, but the European Central Bank is indeed able to buy around 55% of the securities included in the BoA ML European credit benchmark index (ER00). The central bank purchases bonds with maturities from 3 months to 20 years and the rating criterion (best of 4 agency ratings: Moody's, S&P, Fitch and DBRS) includes split-rating names. The main exclusion pertains to bank bonds due to the alleged conflict of interest between monetary policy and supervision tasks of the ECB given bail-inability of senior

unsecured bank debt. Additional ECB tools including Targeted Long-Term Refinancing Operations (TLTRO) are believed to be better suited to provide term financing to banks. It is worth noting however that eligibility criteria (sector, rating, maturity) can change if policymakers deem it appropriate.



CSPP holdings amount to €243b, about 8% of the APP. The unlimited asset purchase program may be increased in December and raised by €10b to €30b a month, which would increase corporate bond purchases to about 8b on a monthly basis. Furthermore, the temporary PEPP which includes purchases of private-sector bonds and commercial paper will likely be extended. PEPP capacity may be raised by 500b to 1850 to be deployed in the second half of 2021. So far, PEPP holdings of corporate bonds and commercial paper amount to €20b and €31b respectively as at September 2020. Net aggregate PEPP purchases for October suggest corporate bond holdings are now to about €23b. In total the ECB owns more than €260b worth of corporate bonds, which will facilitate refinancing for corporate borrowers for years to come. It is important to stress that the ECB does intervene in primary corporate bond markets competing with institutional investors. Primary market purchases have helped to rein new issuance premiums to the benefit of borrowers. In sum, CSPP and PEPP credit holdings entail a significant backstop for euro-denominated credit markets.

Corporate bond issuance was at record levels in the first half of 2020 in the fallout of the pandemic. However, bond supply appears to be slowing. Euro investment grade markets absorbed €87bn worth of new issuance in 3Q20, down by 40% on the same period in 2019. Net issuance was limited to €33bn, the lowest amount for the September quarter since 2015. Financials borrowed €33bn in gross terms (€6bn net) whilst non-financial firms issued €54bn gross (€26bn net) in 3Q20. Maturity extension has been a big theme in the past few years as ECB intervention facilitated refinancing. The average term of 3Q20 issuance is just shy of 8 years. Another eyecatcher of primary market issuance is the reduction in reverse yankee borrowing. US names have indeed borrowed €14b in 3Q20, 20% less than a year ago. Over the year ahead, we expect supply to remain in check reflecting a rebound in internal cash flow generation as economic growth improves.

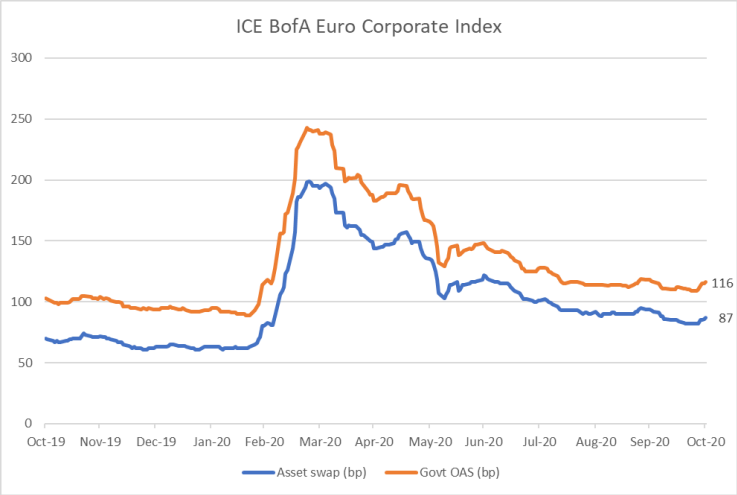
In terms of market pricing, the corporate credit asset class remains the most attractive within the euro aggregate complex. On BofA ML indices, average IG spreads vs. Bunds stand at 114bp. Market index yield-to-worst hover about 0.46% as at November 3. In aggregate, financials command a premium over non-financials names. Senior unsecured bank bonds offer spreads of 95bp vs. German Bunds with Lower Tier 2 trading around 177bp. Insurance subordinated trade wide around 220bp. In non-financial space, cyclicals have been hit hardly by the pandemic. Spreads on autos, leisure, real estate debt are amongst the widest. Conversely, technology and health care were able to maintain tighter spreads. In terms of curve positioning, the corporate credit spread curve is upward sloping with 1-3y yield in the ballpark of 0.28% and the 7-10y area around 1.28%.

In sum, continued ECB support, slowing bond supply, a gradual economic recovery feeding into improved credit metrics and spread carry makes euro IG credit an attractive asset class at this juncture.

Appendix

Total return by sectors (YTD), yield to worst (%) and spread vs. Bunds (bps) as at November 3rd.

Euro Corp Breakdown - ICE BofA ML Euro		YTD (as at Nov 3)	YTW	OAS
ER00	**ICE BofA ML Euro Corporate Index**	**1.57%**	**0.46**	**114**
EB00	**Financial Index**	**1.16%**	0.51	116
EBXS	Unsubordinated Financial Index	1.38%	0.19	98
EBSU	Subordinated Financial Index	0.39%	1.91	199
EBSL	Financial Subordinated & Lower Tier-2 Index	0.43%	1.84	197
EBSS	Financial Junior Subordinated & Tier-1 Index	-0.04%	2.90	228
EBFS	*Corporate Financial Services Index*	1.47%	0.35	110
EBIN	*Insurance Index*	0.93%	1.94	180
EB3N	Senior Insurance Index	2.29%	0.22	95
EB1N	Subordinated Insurance Index	0.40%	2.85	226
EB2N	Junior Subordinated Insurance Index	0.18%	2.90	226
EBBA	*Banking Index*	1.15%	0.28	106
EB3A	Senior Banking Index	1.30%	0.16	95
EUT2	Upper Tier 2 Index			
ELT2	Lower Tier 2 Corporate Index	0.45%	1.10	177
ET10	Tier 1 Index	-4.02%	2.97	303
EJ00	**Industrials Index**	**1.68%**	0.45	114
EJAU	*Auto Group Index*	0.81%	0.56	129
EJBS	*Basic Industry Index*	1.83%	0.38	107
EJCP	*Capital Goods Index*	1.82%	0.34	105
EJCS	*Consumer Goods Index*	2.40%	0.27	97
EJEN	*Energy Index*	0.00%	0.59	126
EJHC	*Healthcare Index*	3.11%	0.31	96
EJLE	*Leisure Index*	-9.67%	0.73	146
EJME	*Media Index*	2.17%	0.42	114
EJRE	*Real Estate Index*	0.78%	0.93	164
EJRL	*Retail Index*	2.21%	0.25	100
EJTC	*Telecommunications Index*	3.01%	0.39	105
EJTE	*Technology & Electronics Index*	1.91%	0.15	86
EJTR	*Transportation Index*	1.47%	0.51	123
EJSE	*Services Index*	0.62%	0.49	121
EK00	**Utility Index**	**2.31%**	0.35	101
			Source: Bloomberg, Ostrum AM	



Legal information

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