Fixed Income Strategy
April 3, 2020

European fixed income – Make yourself at home

Kris Xippolitos, Head – Global Fixed Income Strategy | +1 212 559 1277 | kris.xippolitos@citi.com
Jeffrey Sacks, Head – EMEA Investment Strategy | +44 207 508 7325 | jeffrey.ian.sacks@citi.com
Shan Gnanendran, EMEA Investment Strategy | +44 207 508 0458 | shan.gnanendran@citi.com
Joseph Kaplan, Global Fixed Income Strategy | +1 212 559 3772 | joseph.kaplan@citi.com

Summary

• Just like the rest of the world, the Covid-19 impact on economies, markets and investor sentiment has punched European fixed income markets hard. While a 1.0% year-to-date loss on the Bloomberg Barclays Euro Aggregate Index seems great relative to other regions, it still includes a 7% drop in early March (Fig. 1). Unfortunately, with the exception of sovereign bonds (most of them anyway), all European assets are now firmly in negative territory for the year.

• Central banks and governments have announced numerous monetary and fiscal programs. The European Central Bank (ECB) bond purchases are likely to offset a meaningful increase in government bond supply. Though Italy’s fundamental programs are of concern, ECB intervention is likely to keep Eurozone (EZ) rates low and spreads tight.

• As the dust settles from the recent fire sale in global bond markets, dislocations have become noticeable in corporate credit. However, we recognize risks have risen for others. Investment grade (IG) corporate spreads have not bounced back like other assets, which reflects investor angst over BBB-rated debt and potential downgrades. We favor an up in quality bias, taking advantage of wider spreads in higher rated corporate bonds. Additional Tier 1 securities offer long-term value.

Eurozone (EZ) sovereigns

10-year German Bunds have been firmly below zero for over a year now. In fact, it’s been five years since short-dated euro bonds have seen the positive yielding light of day. Over the remainder of 2020, this is unlikely to change, as the Covid-19 virus impacts both growth and inflation prospects in the region. Luckily, for bond buyers, total return incorporates the change in a bond’s price. Which is why long-dated German Bunds have managed to gain 5.8% year-to-date and 10% over the last 12 months.

The ECB continues to buy a lot of bonds. When we include the €870 billion of expected purchases under their ongoing asset purchase program (APP) and their recently announced emergency pandemic program (€750bn), the ECB’s balance sheet will eventually expand to at least 6 trillion euros (Fig. 2). These purchases will more than offset the expected significant increase in government bond supply to fund the fiscal response to Covid-19. As a result, Citi economists expect EZ government net supply to move deeper into negative territory in 2020.

Figure 1. Euro IG bonds fell sharply in March
Figure 2. ECB balance sheet will likely expand to €6T

Source: Bloomberg Barclays Indices as of April 2, 2020
Source: Haver Analytics as of April 2, 2020.

All forecasts are expressions of opinion, are subject to changes without notice and are not intended to be a guarantee of future events. For illustrative purposes only. Past performance is no guarantee of future results. Real results will vary. Indices are unmanaged. An investor cannot invest directly in an index.
Though the expanded ECB APP removed issuer limits to create greater flexibility, policymakers may not be done in their quest to keep the EZ economy afloat. It’s quite possible the central bank will need to expand their APP to include financial IG corporates or primary issuance (similar to the Federal Reserve). In our view, adjustments to the capital key should be considered. This would allowed the ECB to have a greater impact on the more problematic EZ countries, like Italy.

Though Italy will benefit from the decline in net supply, the country’s economy remains a concern. As covered in a March 26 bulletin, the Italian economy will unfortunately suffer a sharp 2Q downturn with high unemployment. Also known for being the epicenter of the Covid-19 pandemic, Italy also has one of the highest debt-to-GDP ratios in the world at 135% (Fig. 3). A larger fiscal deficit could weigh further on Italy’s debt burden, resulting in ratings pressure. If downgraded to below investment grade, yields would likely rise as forced sellers adjust allocations. We remain deeply underweight Italian sovereign bonds.

EZ rates are likely to remain low and periphery spreads tight. Despite negative yields, prices can still improve during periods of rising equity volatility. However, low yields/low coupons leaves these bond markets more exposed when interest rates rise. Along with very limited opportunities for longer-term income oriented investors, we remain deeply underweight Eurozone sovereign debt.

**Figure 3. Italy debt-to-GDP ratio has reached 135%**

<table>
<thead>
<tr>
<th>Year</th>
<th>Ratio (%)</th>
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</thead>
<tbody>
<tr>
<td>1974</td>
<td>60</td>
</tr>
<tr>
<td>1979</td>
<td>80</td>
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<tr>
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<td>2009</td>
<td>200</td>
</tr>
<tr>
<td>2014</td>
<td>220</td>
</tr>
<tr>
<td>2019</td>
<td>240</td>
</tr>
</tbody>
</table>

Source: Bloomberg as of April 2, 2020

**United Kingdom rates**

On March 27, Fitch downgraded the UK Gilt market to AA- (from AA), while leaving the country with a negative outlook. From the rating agency’s perspective, weak public financing and fiscal loosening to defend against Covid-19 is likely to cause a widening in the deficit. It is indeed possible that lower growth and debt guarantees could take deficits higher and closer to Global Financial Crisis levels. Lingering Brexit and US-UK trade relationship also contributed to Fitch’s decision. However, like most past downgrades of major economies, there wasn’t much of a reaction. Being a safe-haven asset, UK Gilt yields have fallen over concerns facing global markets. 10-year Gilts are now roughly 0.30%.

In regard to Brexit, with the political focus on Covid-19, an extension beyond the year-end deadline is becoming more likely. Despite PM Johnson’s previous stubbornness on this issue, Covid-19 is delaying the start of negotiations. More positive is the rising possibility of an eventual trade deal, given that both UK and EU economies are declining sharply. As such, it is increasingly in both their interests to agree to an amicable deal and secure a strong ongoing relationship. Though this is a bit longer out, it would be one less caveat keeping the bid for safe haven assets strong.

**European investment grade (IG) corporates**

Like most high quality bond markets, European IG corporates were indiscriminately sold as global markets were dealt a major liquidity squeeze. According to EPFR, euro IG corporate mutual fund outflows for the month of March reached €9.4 billion or 8.0% of total assets under management. ETFs (exchange-traded funds) also came under heavy selling pressure, with some funds dropping 13.5% and briefly trading up to a 6.0% discount to net asset value.

While the bleeding has seemingly stopped, euro IG hasn’t quite followed the partial recovery witnessed in other credit markets. For example, US IG corporates have improved by 7.0% since March 20, with index spreads tightening 50bp. On the other hand, euro IG benchmarks have only recovered 4.0% with spreads tightening a more modest 5bp (Fig. 4).

This can somewhat be explained by the underperformance in BBB-rated issuers. With BBB-rated bonds making up nearly half of the euro IG corporate market, recession fears and possible downgrades to high yield have left investors increasing portfolio quality. Indeed, this is reflected in the flattening of Single-A rated yield curves, while BBB curves have steepened (Fig. 5).

As we move into an uncertain period of economic weakness, we advocate keeping portfolio quality high. Many over leveraged BBB-rated issuers in cyclical-oriented sectors are likely to face revenue pressures and ratings downgrades. While some solid lower-rated IG companies can offer value, we would navigate with caution. It’s notable that 8% of the BBB-rated euro IG market is on the fringe of high yield or €80 billion.
Fortunately, spread widening in euro IG has mutually impacted highly rated securities. For example, A-rated index spreads are 210bp, its widest since 2012, and only 50bp behind BBB-rated bonds. Average yields for Single-A paper is 1.5%, a multi-year high. Euro rate differentials versus the US have narrowed tremendously, but offers some additional carry when utilizing cross-currency markets. However, investors who’ve utilized these hedges in the past may be better served in outright US dollar debt (Fig. 6).

Sterling-denominated corporate spreads are now 260bp, with index yields near 3%. The Bank of England is buying some corporates, though credit markets will likely face ongoing volatility as the country deals with the fallout from Covid-19. Waning confidence in the financial sector may also unfairly effect GBP IG benchmarks, as half the market consists of financials, mostly banks. Indeed, UK banks have scraped their dividends and share buyback programs to protect valuable capital while increasing their capacity to lend. We would stick with high quality issuers for now, until the economic impact from Covid-19 is better understood.

CPB European strategists expect 2Q GDP in the UK to drop as much as 15%.

European Additional Tier 1 (AT1) securities
European AT1 securities lost between 20-30% in March, depending on issuer and structure. Some Italian banks AT1 securities are trading at distressed levels, with yields near 15%. Even high quality banks have some bonds trading between 7-9%. Similar to other fixed income assets, forced selling in an illiquid market had created significant price dislocations.

Part of the sell-off can be fundamentally justified. Concerns around a global recession and the ability for banks to pay AT1 dividends has crept (back) into investors’ minds. Most banks have now suspended common stock dividends and share buyback programs to preserve precious capital. Moreover, European banks have both been told by regulators to use capital coffers to support the continuation of credit to households and businesses.

Fortunately, European balance sheets are starting from a position of significant strength. Post-Financial Crisis regulatory reforms (Basel III) has pushed the banking sector to raise significant amounts of capital to protect against future crisis (Fig. 7). Common Equity Tier 1 ratios for most banks are well above the required threshold. In addition, other measures of bank vulnerability like leverage ratios, liquidity coverage, and share of loans that are non-performing are all much less concerning than they were before the Global Financial Crisis.
Some eyebrows were raised over the recent dividend suspension of a Rabobank perpetual “member certificates”. These securities have some characteristics of traditional preferred stock. However, these MC’s are more like equity and subordinate to Rabobank’s AT1 securities. Therefore, the dividend suspension of their MC’s was more congruent with the dividend suspensions of other European bank common equity. To be sure, Rabobank €5 billion of AT1 securities were not affected by this news and we believe the risks surround AT1 coupon suspensions in general are low.

In our view, levels being offered in the space are historically attractive and offer long-term value. However, risks remain and weakness may continue. Liquidity has improved, but markets are far from normal. Collectively, we remain cautious. However, we think valuations should allow investors to test the waters, though incrementally. Legging into these markets is likely the best strategy.

**Figure 7. Banks have significantly increased capital buffers**

![Graph showing increased capital buffers](image)

Source: Bloomberg as of April 2, 2020

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**European high yield (HY)**

Over the first three weeks of March, euro HY bonds lost over 20%, with index spreads widening 600bp (Fig. 8). This was the fastest widening in euro HY on record, bringing index valuations to its cheapest level since 2011. Despite a 5-6% bounce over the last week of the month, the market had still lost 15% over the first quarter of 2020.

As discussed in our March 25 bulletin, it should not be too surprising that cyclical sectors took the brunt of the sell-off. Sectors which rely on the free movement of people (i.e., Restaurants, Gaming, Lodging) all lost between 25%-35%. Anything related to transportation was also greatly affected, with some issuers dropping 50%. To be clear, some large underperformers were already distressed, with the current health crisis tipping them over the edge.

As European economies sharply slow, some companies are likely to come under pressure to meet debt obligations. HY bond default rates currently at 2.5% are likely to rise over the coming 12-months (Fig. 9). S&P projects euro default rates could rise to 8% over the coming year. Indeed, downgrades have already outpaced upgrades 3 to 1 over the first quarter.

**Figure 8. Euro HY spreads have widened to 2011 levels**

![Graph showing euro HY spreads widening](image)

Source: Bloomberg as of April 2, 2020

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**Figure 9. European HY default rates are likely to rise**

![Graph showing euro speculative grade default rates](image)

Source: Bloomberg as of April 2, 2020

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European bank loans have also struggled, as less liquid assets were severely punished from indiscriminate selling. With the market dropping nearly 20% over the first 3 weeks of March, average loans prices briefly fell below €80 before settling in around €83. Similar to HY bonds, the loan space will likely struggle over the immediate near term. However, when markets recover, we’d expect loan prices to move higher. However, based on past post-crisis recoveries, HY bonds tend to be the better performing HY asset.

Mean reversion in HY bonds tends to be quick, however, low quality has a historical tendency to lag higher quality assets in a recovery. At the same time, dispersion across sectors is expected to rise. Dislocations provide an opportunity to slowly add exposure, but we don’t feel rushed. In our view, value will likely be around for a while. An active, selective approach is imperative in this environment. Though government policies already put in place have been impressive, more may be needed. Still, government support may not help companies already over leveraged. If you must buy HY, stay defensive.

**Sector views**
The recent sell-off in both IG and HY has created large dispersion across sectors (Fig. 10). We remain cautious on energy, with energy IG and HY down 7% and 15% respectively YTD. Yields around 7.7% are tempting, but default risks (or profitability issues at the very least) are likely to rise given weakness in oil prices. We note that HY energy represents a small weighting in European HY markets overall, representing only 1.4% of market (vs. 15% in US HY). Transportation and consumer-cyclical sectors have been the worst performers year (in HY both down over 20%), and are likely stay under pressure as businesses and manufacturing businesses remain closed in the near term.

Within financials, opportunities in the aforementioned subordinated bank debt market exist. However, we take a more defensive approach in non-financials. Consumer non-cyclical sub-sectors have relatively outperformed, and we expect areas like healthcare, pharma and supermarkets to be better protected in the current environment. Communications have also held up, with areas like media-entertainment and cable & satellite benefitting with a large proportion of the population working from home. Utilities continue to exude its traditional defensive characteristics, though spreads are also significantly tighter than the index. Utilities have outperformed IG and HY indices by 4.9% and 6.5% respectively, though still posting negative performance in absolute terms. If volatility persists, we would expect utilities to remain a relative safe haven in credit markets.

**Figure 10. Euro IG & HY sector performance, last 3 months**

Source: Bloomberg as of April 2, 2020
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