ECB Bond Market Contact Group

Update on the euro area corporate bond market

Christian Kopf, Head of Fixed Income

Frankfurt, 4 March 2020
Euro area non-financial corporates are increasingly reliant on bond market financing

Capital market funding to euro area non-financial corporates
Percentage of total debt funding

Source: BIS, Union Investment
The ECB is shifting its asset purchases towards corporate bonds

Monthly net purchases under the ECB’s APP

In € billion

Source: ECB, Union Investment

Share of corporate bonds in total purchases

Forecast

11%
25%
Low market rates have contributed to rising corporate bond issuance, but not to a widespread rise in corporate leverage.

Leverage ratios are stable on aggregate
Debt/EBITDA ratio of euro-denominated investment grade corporates

Only underlevered companies increase debt gearing
Year-on-year change in debt/EBITDA, as of 3Q2019

Source: Morgan Stanley. Data as of 30 September 2019
Risk of orphaned assets: The share of euro area corporate bonds that could losing eligibility for ECB purchases has never been greater

Rising market share of lower-rated corporate bonds
Rating distribution of euro-denominated non-financial IG corporates

Rising probability of rating downgrades
S&P’s net outlook bias for European non-financial corporates, in percent

Net outlook bias = the percentage of ratings with a negative outlook less those on a positive outlook
Sources: ICE BofA market indices, S&P Global Ratings, Union Investment. Data as of 28 February 2020
Risk of orphaned assets: European corporate bond funds could shed off-benchmark allocations to high yield issuers

Off-benchmark allocations in European Investment Grade credit funds

In percent of NAV

Little differentiation amongst investment grade corporates in early 2020

Spread dispersion in the synthetic market for euro area corporate debt
Standard deviation of index constituent spreads, in percent of index derivative spread (Series 32)

Source: Bloomberg Intelligence. Data as of 19 February 2020
Market stress following the outbreak of the COVID-19 virus threat

Volatility of options on euro area IG corporate bonds
Implied price volatility for 30-day options on iTraxx Main, in percent

Swap spreads of euro area corporate bond indices
In basis points

Vol market = JP Morgan VTRAC-X; cash market = ICE BofA Euro Corporate Index (ER00).
Source: JP Morgan, ICE BofA, Bloomberg, Union Investment. Data as of 28 February 2020
The change of the ECB’s monetary policy stance contributed to a strong rally in euro area corporate bond markets during 2019, particularly in lower-rated securities.

2020 has so far been marked by a uniform selloff across all rating classes, caused by the spread of the corona virus.
Market stress: pressure on leisure and automotive industries

2019 was marked by an outperformance of the real estate sector which is particularly sensitive to changes in interest rates.

In 2020, the leisure sector (tourism, cruise ship operators) was hit particularly hard by the market selloff, along with the automotive sector, which is batting with supply chain disruptions and structural problems.

Euro High Grade Corporate bonds, excluding Tier 1, Upper Tier 2 and Junior Subordinated bonds. Source: ICE BofA, Union Investment. Data as of 27 February 2020
Stress in the market for ETFs on euro area corporate bonds

Cumulative flows into Euro IG Corporate ETFs
In € billions

ETFs are trading cheap to their intrinsic value
Average premium or discount to NAV, in percent

Source: Union Investment. Data as of 28 February 2020
Secondary market: the dealer bid has disappeared

On a daily basis, Union Investment screens and filters around 600,000 broker quotes across all credit markets from various trading platforms and messaging systems.

On a given day, bids for individual euro-denominated corporate bonds have exceeded offers by around €15 billion on average over the past twelve months. This is different from the US corporate bond market, which shows a greater balance between net bid and net ask axes over time, and is likely explained by the ECB’s market presence. Dealers are generally willing to take on euro paper, since they are able to offload it into the central bank’s asset purchase programme.

The past five trading sessions have seen a record shift in dealer demand, from net bid axes of €37 billion to net offer axes of €11 billion euros. The market has largely gone bid-less and has stalled.

Secondary market for auto and bank bonds has stalled

Union Investment’s proprietary data show that the strongest adjustment in dealer behaviour occurred in the market for bank bonds, which are not eligible for ECB purchases.

The lack of dealer bids is most pronounced in the automotive sector. Since Thursday, 27 February 2020, dealers have largely stopped quoting bids for euro-denominated bonds issued by Daimler, Ford, Peugeot, Renault and VW. The market for BMW and Toyota bonds remains somewhat more balanced at the time of writing.

Source: Union Investment. Data as of close of business on 28 February 2020
Main points

• The euro area corporate bond market has become increasingly relevant for the funding of non-financial corporates in recent years. Corporate leverage ratios have remained stable in aggregate, but an increasing number of lower-rated corporates with higher leverage have gained market access.

• Many non-financial corporates with weak investment grade rating are facing the risk of a discrete rise in borrowing costs if their bonds no longer qualify for ECB purchases.

• In normal times, large-scale asset purchases by the ECB suppress volatility and credit spreads in the euro area corporate bond market, contribute to a crowding out of private sector investors from investment grade corporate bonds and distort dealer positioning. In times of stress, the impact of steady central bank purchases on price discovery disappears. The heightened market volatility in reaction to the outbreak of the COVID-19 virus threat is thus an (unintended) consequence of an earlier volatility suppression by the ECB.

• The magnitude of the rise in euro area corporate bond spreads cannot be explained by an increase in expected credit impairments and thus points to a market that has become dysfunctional.

• It appears highly unlikely that a cut in the ECB’s deposit rate would counter the sudden tightening of euro area financial conditions that has been brought about by rising credit spreads and declining equity markets. On the other hand, direct market intervention in credit or stock markets – or the threat of it – could act as a circuit breaker.
Disclaimer

This presentation is only intended for professional clients as described in section 31a, paragraph 2 of the German Securities Trading Act (WpHG). The present document has been prepared and issued by Union Investment Institutional GmbH. The document does not constitute a binding offer. Union Investment does not assume any obligation or liability for this document. The document is no substitute for the individual advice by Union Investment Institutional GmbH. Union Investment Institutional GmbH is not responsible for disadvantages that may arise directly or indirectly from the distribution of this document or its contents. For extensive product-specific information and details of the opportunities and risks presented by the respective fund, please refer to the latest sales prospectus, the Bank’s terms and conditions or the annual and half-yearly reports that can be obtained free of charge from Union Investment Institutional GmbH, Weissfrauenstrasse 7, 60311 Frankfurt am Main, Germany, telephone +49 69 2567-7652. These documents constitute the sole legally binding basis for the purchase of fund units. Unless otherwise noted, all information, illustrations and explanations are as at 2 March, 2020.

Origins of Data:
Despite our effort and care no liability or guarantee can be assumed for the timeliness, accuracy or completeness of the data provided. Where data has been obtained from external sources, this is explicitly stated. We consider data obtained from external or publicly available sources to be reliable. Data obtained from external sources or contained in our own calculations may be incorrect.

We assume no liability for any errors that may occur when data is passed on, recorded or entered or when calculations are made using this data.

Historical performance:
Performance data shown is historical. Past performances can not be taken as a reliable guide for future investments. The BVI method (time-weighted return) is used for these calculations. Where the gross method has been used for such calculations (adjusted for management fees and depositary fees), this is explicitly stated. Data calculated and presented using either the BVI method or the gross method does not include any front-end fees or product-specific costs (fees, commissions and other charges).

Compliance with Global Investment Performance Standards (GIPS®) and the BVI-Rules of Conduct:
Union Investment claims of compliance with GIPS® has undergone the verification process and has been verified by an independent third-party „verifier“. The Composite-Performance calculation and presentation comply with the GIPS® guidelines. The composite allocation of individual funds. or all Composites complying with GIPS® are available upon request. Union Investment Institutional GmbH has committed to comply with BVI’s code of conduct. In consequence, Union Investment Institutional GmbH employs the code’s standards for performance illustrations. Cases of deviation will be individually indicated.

Future assessment:
Any opinion expressed in this document (including estimates and forecasts) is solely for information purposes and does not constitute an individual offer or a guarantee for future performance. Any opinion contained herein was given at the date of publication and may be subject to change without notice.

Use of Union Investment’s country ratings:
The country ratings devised by Union Investment are merely the outcome of its assessment of the creditworthiness of sovereign issuers for internal purposes, and they are intended to be used purely as quality appraisals of a certain selection of sovereign issuers. The ratings represent Union Investment Institutional GmbH’s own assessment and do not constitute a recommendation to take a particular course of action.