Keeping Calm

- **We remain positive on European IG Credit** expecting tighter spreads. The risk premium is high, credit conditions are benign and global flows should become supportive.
- **Cyclical risks have increased...**the global manufacturing slump has deepened since December across China, the Eurozone and now also the US. Coupled with a weak commodity trend, this makes the trend similar to 2015-16.
- **…but a policy response is slowly emerging.** Like 2016, a policy response is emerging, but unlike then this is still far more tentatively. A trade deal, even if only partial, would be an important catalyst, given that the global weakness is centred on the Manufacturing sector.
- **We favour (1) Italian credit, and (2) Hybrids.** The Italian Senior bank credit risk premium has compressed meaningfully and we are moderating our bullish view, but political and financial risks are lower, a TLTRO would be positive, and investors remain underexposed. Hybrids are less cyclical than BBs, have less extension risk than AT1s, and low supply risk in a market where New Issue premiums are high.

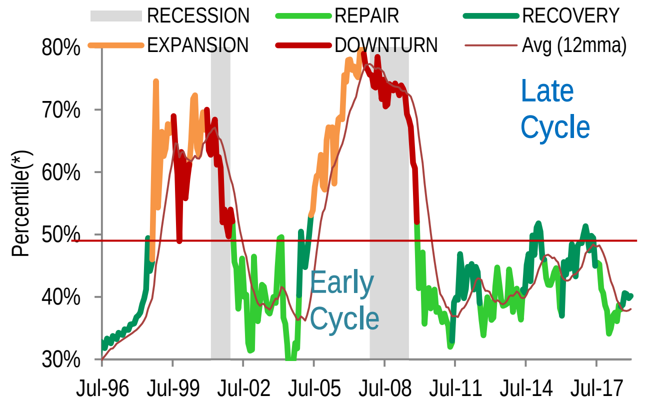
1. Why be bullish on European IG

We maintain our positive view on € IG credit (see *European Credit Outlook 2019: Keep Calm, Carry On*, *10* December, 2018). The market has moved against that view since mid-December but we continue to see € IG spreads tighter in 2019 with a spread target of +135bp on the Bloomberg Barclays EuroAgg Corporate index.

To recap, there are three key arguments for a positive view:

1. **The risk premium is high** with spreads, Cash-CDS, equity-credit risk premiums all as wide as when the ECB announced CSPP. The cyclical risk premium is as high as in late-2015, the last meaningful global slowdown. Finally, € IG funds have lost all inflows that took place since the CSPP launch, leaving positioning much cleaner.
2. **Credit conditions remain easy** in Europe as evidenced by the BNP Credit Conditions index and the Credit Cycle is too early to be consistent with a prolonged credit downturn (Charts 1-2 and Table 1). In fact, credit conditions may actually be too easy, enough to pose a risk that corporates view debt as too cheap as to not borrow more, with the risk of ever higher New Issue premiums.
3. **Global flows will increasingly benefit European Credit.** The FX-hedged yield of € IG and € HY has improved materially vs. US$ IG and US$ HY respectively, suggesting that the persistent outflows from € Fixed Income since the ECB launched QE may now reverse and European funds start to repatriate flows, while European supply leans on the Yankee market.

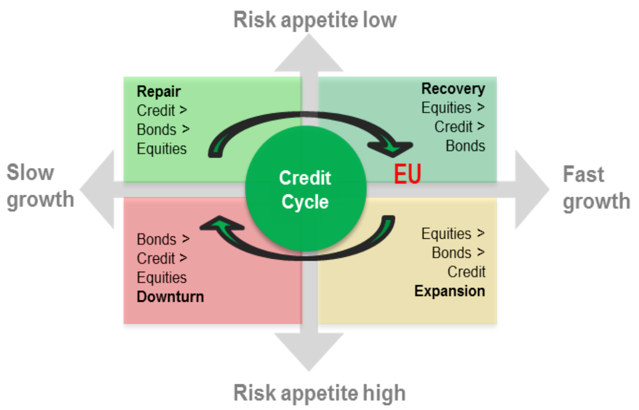
Chart 1: **BNPP Credit Cycle Indicator-Europe. still early**



Source: Bloomberg, CapitalIQ, BNP Paribas

(*) Indicator constructed as follows: average percentiles of the five selected variables. The cyclical stage is determined by position vis-a-vis: 1) the 50% threshold and 2) the trend vs. the 12mma.

Chart 2: **European Credit Cycle: still early**



Source: BNP Paribas

Table 1**: Factors defining the Credit Cycle Indicator**

Factors	Perc*	Desciption
LEVERAGE		
Debt/EBITDA	92%	Leverage is high but has moderated since a peak in 2017.
yoy (Gross Lev.)	73%	
Debt/GDP (Non Fin)	81%	
CREDIT CONDITIONS		
BNPP CrCond Index – EU	15%	Still extremely easy, although likely peaked.
RISK APPETITE		
M&A	68%	On an uptrend but far from aggressive.
Loan-GDP growth	34%	
POLICY		
Rates-GDP growth	39%	Early-cycle environment with rates close to the bottom
Real Rates (adj CPI)	2%	
ECONOMY		
Output gap	32%	Slowing and in line with potential GDP

Source: Bloomberg, CapitalIQ, BNP Paribas

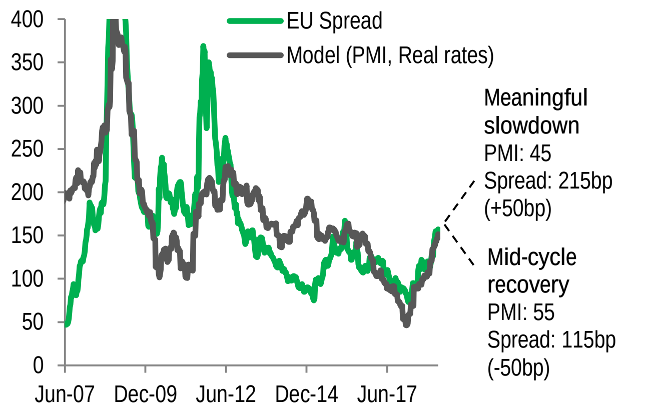
(*) High values indicate a late stage of the cycle. Data since 1999.

What's changed: cyclical risks are increasing…

What's changed since mid-December is that the evidence of a global manufacturing slowdown is now unambiguous. The China PMI(s) are below 50 for the first time since early 2016. German manufacturing order growth at -4.3% yoy is the weakest since the 2012 recession. The biggest shift, however, has been in the US with the more than 5pt drop in the manufacturing ISM. That's the single biggest drop since 2008 and, while coming from elevated levels, suggests that the US is *catching down* with the rest of the world and is no longer a unique growth engine. The non-manufacturing sector is doing better and employment growth is strong, but these are often lagging indicators: inflection points in US payroll growth have typically lagged ISM inflections by 12 months or more.

€ IG credit is well priced for the current *slowdown*. Spreads are consistent with a PMI at 50 using a model based on PMI and real rates (Chart 3). The cyclical risk premium (vs. non-cyclical risk) is at similar levels to 2015. The market is not priced for a *downturn*: PMI manufacturing at 45 – where it got to in both 2012 and 2003, would require IG spreads wider than 200bp (see Chart 3).

Chart 3**: European Credit spread fairly priced vs. model**



Source: Bloomberg, Markit, BNP Paribas

**Cyclical Euro-credit model: €-IG spreads = f(Eurozone manuf PMI, 2Y implied real rate).*

The breadth of the global manufacturing slowdown, the softness in commodities, a Fed intent on hiking rates and a high cyclical risk-premium in Credit markets – these factors all resemble late-2015/early-2016. That sell-off was ultimately reversed by a powerful combination of policy measures from the ECB (CSPP), BOJ (QQE), Fed (pause) and the Chinese government (credit boost and capital controls).

2. ….but the policy cycle is responding, albeit gradually.

Now a policy response is again emerging, although it remains a gradual one with much less determination than in 2016.

- **The Fed is moving towards a pause.** The December hike was not the dovish hike the market had hoped for, but Mr Powell's statement last week softened the view in two important respects: (1) it specifically referenced 'markets' as a source of risk, suggesting a Powell-put at some yet-undefined strike price, and (2) it nuanced the view on balance sheet reduction and that it may not be on 'autopilot' and could be reviewed if conditions deteriorate. This explicit recognition of the tightening caused by quantitative tightening is particularly relevant for Credit markets.
- **China is easing** in two ways. First, policymakers are aiming to improve credit availability for the private sector, partly by cutting RRR (most visibly) but also leaning on banks to target SME lending specifically (more importantly). Second, fiscal support will increase, through tax cuts (Auto sector) and infrastructure spending. BNP Economists for now view these measures as cushioning downside more than creating upside.
- **The ECB is lagging** having just concluded its bond purchase program and still only seeing risks "shifting" to the downside. To support Credit markets, the ECB would need to explicitly acknowledge the downside risk – risks "are" to the downside – which would open up the prospect of policy support (the ECB has a chance to do this on 24 January). We think the hurdle for another TLTRO is low, albeit with less favourable conditions. Beyond that, the hurdle for restarting CSPP is higher but possibly lower than more government bond purchases.

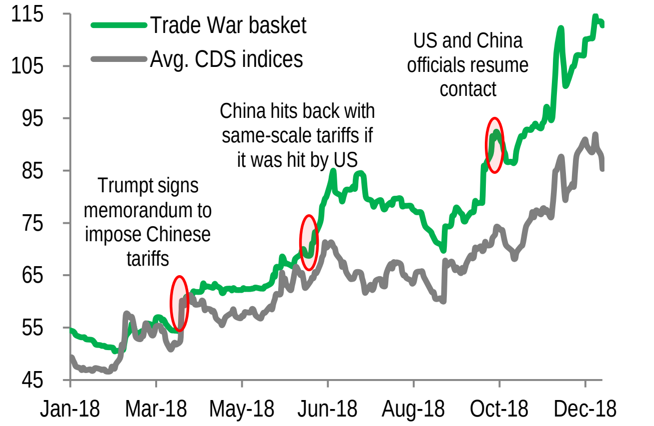
3. Trade – a critical catalyst now

The global slowdown is driven by the Manufacturing sector and manufacturing has been hit by the uncertainty, costs and logistical issues caused by the global trade conflict. Therefore, a trade deal between the US and China would be a very positive catalyst. The clock is ticking - the 90-day truce expires late-February - and the starting positions have been far apart. But the hurdle for a credit-friendly market outcome may still be quite low for two reasons:

1. **The market only needs certainty and low tariffs** for trade and the Manufacturing sector to perform. Far reaching market access to China is a political goal for the US administration, not something that was important to earnings or the Credit market.
2. **The incentives to make a deal have improved** as a consequence of the slowdown across both US and China. Neither side has much room to dig in for a prolonged trade war.

Credit markets are pricing in material risks related to trade. Chart 4 below shows the performance of a Trade-basket consisting of European and Asian trade-sensitive credits, vis-à-vis a blended global credit index.

Chart 4: **Trade war risk well reflected in sensitive basket**



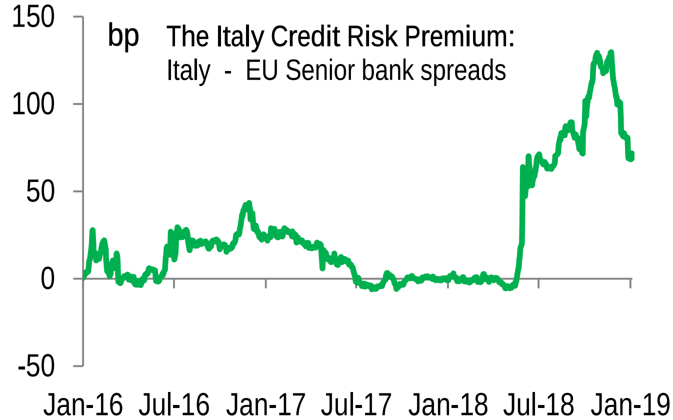
Source: BNP Paribas

4. Our key investment views: Buy Italy, Buy Hybrids.

We continue to favour two higher-risk/higher-reward assets.

1. **Italian credit,** specifically Italian Senior banks (vs. European Senior banks). We are moderating our existing bullish view here (see *Why we are bullish on Italian credit*, *4* October, 2018): the Italian risk premium vs EU assets has compressed meaningfully since the Italy-EU budget deal in early December and in Financials is now back to the range prevailing last summer (Chart 5 below). The upside is now more limited, but the asset class is safer: it remains the only asset class in Europe with some crisis-risk premium built in, the political risks have decreased, the proactive addressing of Carige's issues is encouraging, a TLTRO2 would be very supportive and investors remain significantly underexposed. The biggest downside risk is the economy – Italy manufacturing PMI at 49 is flirting with recession.

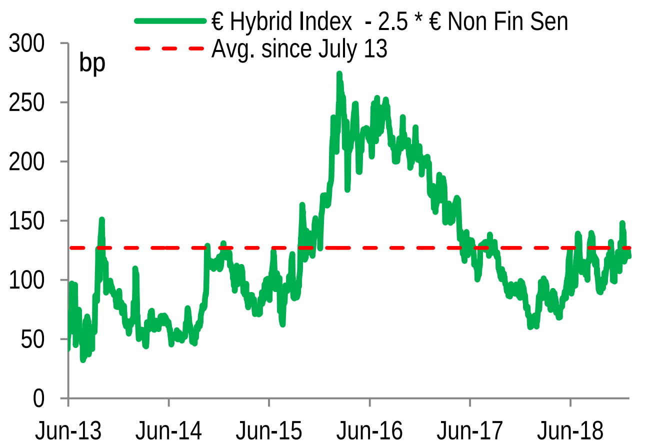
Chart 5: **The Italy risk premium has compressed, still high**



Source: Financial Stability Report – June 2018, BNP Paribas

2. **Long Hybrids** which we prefer over AT1s or BB High Yield. Hybrids underperformed Senior credit during the sell-off last year and has now settled back into its long-term range (Chart 6). With cyclical risks still elevated we view Hybrids as defensive leverage. 80% of the outstanding universe is in non-cyclical sectors making it an attractive alternative to BBs or cyclical-IG such as Autos. Supply will be limited for as long as M&A remains muted, making it a safer haven from high New Issue premiums. Extension risk is limited, given the loss of Equity Credit in the event deals are not called at first call date, which makes it an attractive alternative to AT1s, at least in the short term.

Chart 6: **Hybrids in long-term range, after underperformance**



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