H1 2015 European & US Credit Outlook

IN QE WE TRUST...OR HOPE!

ABRIDGED VERSION

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YOUR PARTNER IN FINANCIAL SERVICES

Our Key Calls for H1 2015

- Expect credit to remain vulnerable and highly exposed to external shocks. We remain wary of any possible equity market corrections and heightened political risks, such as possible Grexit and Brexit (Britain and Greece exit from EU) as well as additional sanctions risk brought about by Ukraine-Russia instability.

- We expect the European economy to slowly normalize this year although risks are skewed to the downside as uncertainties and deflationary risks will remain.

- IG is less sensitive to the growth outlook than HY and is expected to benefit from QE which will push benchmark rates lower and corporate spreads tighter. Thus, we are biased towards EUR Investment Grade bonds and overweight the longer end of the curve to benefit from a Japanification of the EUR credit market. In terms of rating, we prefer BBBs.

- Hybrids remain an attractive option for spread pickup in the EUR IG market.

- Shy away from issuers/sectors highly exposed to Russia, such as the autos and luxury goods industries.

- There is scope for an outperformance of financials over non-financials in both USD and EUR IG space.

- US HY should gradually tighten following recent underperformance but this will be offset by a rise in the 1-5 year US government rates. Thus, we expect the total return to be in line with coupon rates with the 7 year bucket and the single-B rated bonds standing out as better positioned.

- US IG offers attractive spreads; taking duration risk is also advisable as the shorter government yields are likely to widen more than the long end of the curve.

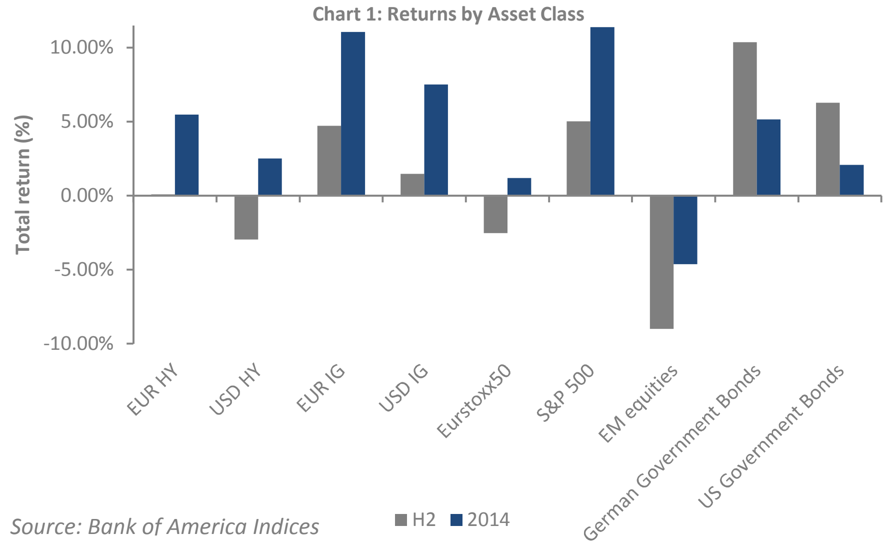
- EUR HY should see a reversal in spread decompression i.e. an over-performance of Bs compared to the BBs; thus, when looking to lower the risk profile of the portfolio we prefer combining Bs with BBBs rather than going into BBs.

- Bias towards issuers from developed countries; selective on Emerging Market names.

- Commodity related names prone to underperformance in the short term.

A glimpse of Credit markets in H2 2014

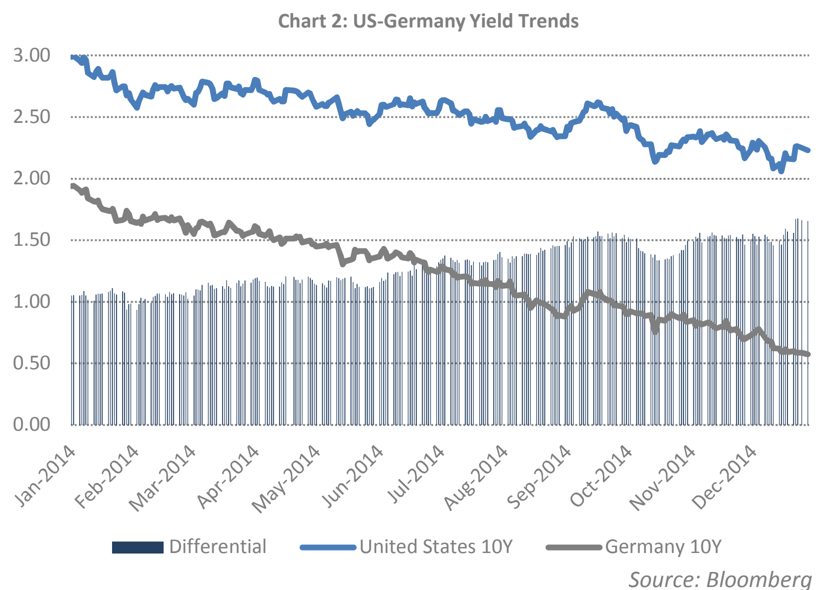
Investor complacency probably best defines the market's behaviour during H12014 but attitudes changed rapidly in H2, most notably in the Eurozone, when geopolitical concerns, idiosyncratic risk events, declining commodity prices and a re-emergence of emerging market woes, undercut the appetite for risk taking as they occurred against a backdrop of persistently deteriorating European economic data. As such, the surprise measures announced by the ECB after the September meeting - cutting three interest rates and announcing plans to buy asset-backed securities and covered bonds - had a short lived effect on high yield spreads, with momentum weakening further after the poor TLTRO pickup. It appeared that another delay in economic recovery after years of low growth increased investors' immunity to ECB guidance and its measures and the high yield market shifted its attention back to fundamentals. This led to the underperformance of high yield relative to equities (see Chart 1) as the latter found support in the greater presence of large diversified corporates and, in the case of European stocks, in the attractive valuations on offer.



Source: Bank of America Indices

Accordingly, we witnessed a sharp widening in the yield differential between B-rated and BB-rated names, a development we interpret as being indicative of scepticism on the economic outlook but appreciative of the potential positive brought about by some form of quantitative easing. The market was also affected by an unsupportive technical backdrop, with supply remaining elevated overall and many investment banks' proprietary desks unwilling to absorb bonds in periods of stress mainly due to regulatory constraints.

In the USD high yield market, performance was more resilient over most of the second semester but the abrupt fall in oil prices led to a sudden reversal as the large exposure this market has to energy names left investors uneasy and triggered mass redemptions. As a result, the weakness spread to non-energy names with the low liquidity prevalent over end-November-December, also taking a toll on valuations; the correction was sharp enough to push total returns into negative territory for a brief period of time. However, the year ended on a less dramatic tone as the stabilization of oil prices, the strong gains of the S&P500, supportive economic data and a balanced tone of the Federal Reserve's Chairwoman at the year's last meeting served to lift sentiment somewhat. Even though US economic data remained mixed, the strength in retail sales data highlighted that the positive implications of lower oil prices should not be taken lightly as it heralds a positive momentum for the cyclical sectors and hence for corporate leverage.



Source: Bloomberg

US government yields also traded lower even as the Federal Reserve completed its bond buying programme (See Chart 2). At the end of 2014, the 10 year US rate stood at 2.17% as fears of monetary policy tightening abated somewhat and US-yields started to look increasingly attractive when compared with the Euro Area ones. The general fall in commodity prices was also supportive for rates as it reduced the inflation premium by reducing global inflation woes. Shorter term US notes on the other hand had a weaker semester as the general strengthening in labour data and consumption continued to fuel expectations for a rate hike sometime in 2015.

Against this backdrop, investment grade bonds outperformed their high yield counterparts and closed the year with strong returns (11.1% and 7.5% in EUR and USD respectively, see Chart 1) with EUR names also supported by hopes that ECB will start purchasing corporate bonds.

In the emerging markets space, during Q3 the returns were shaped in the main by political developments such as the elections in India and Brazil and Russia's standoff against the West, whereas in the last few weeks of the year, commodity prices were the main driver of returns. More specifically, the weakness in iron ore prices and the plunge in oil took their toll on commodity-related issuers such as Vale, Vedanta, FMG, Chesapeake, Range Resources, Petrobras, Gazprom, Pemex, Venezuela etc.

Looking back at our H2 2014 Key Calls

In our H2 2014 Credit Outlook, we were cautiously optimistic on credit as we sought further spread tightening into year end. This appears to have been our only notable misjudgement as H2 marked a reversal in spreads, as we explained above. In contrast, our call for decreasing exposure to US credit shielded portfolios from a significant underperformance, as did our warning on carefully and limited positioning into emerging market names. We also recommended avoiding the CCC bucket, which turned out to be a well-placed call as spreads for this segment widened by circa 330 bps in the EUR space and some 206 bps in USD. With regards to our view on financials, we were right in calling for an over-performance of the sector on the back of ECB easing; indeed the Bank of America Euro Financial Index returned 3.5% over H2, while the Bank of America Non-Financial Index posted a lower 2.9% return. A selective allocation to Contingent Convertibles (CoCos) proved to be opportune as the sector was not immune to the widening in spreads. Finally, another key call in our H2 outlook was in relation to Euro hybrids where we were seeing opportunities; looking back we find that this segment posted a total return of 3.29% (Bank of America EUR Subordinated Index) and proved fairly resilient in periods of declining risk taking.

Where does this leave us?

In our opinion, the key themes going forward are expected to be fivefold:

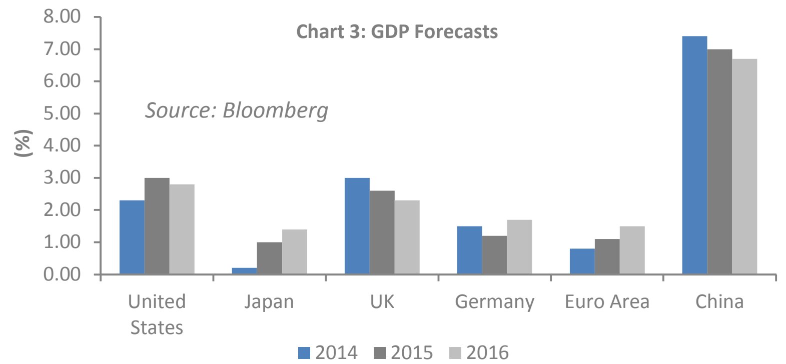
- In the Eurozone, the highly talked about Quantitative Easing programme has become pretty much a formality. However, the magnitude, timing relevance and effectiveness of this programme are going to be crucial and will determine the fate of European credit markets for 2015, both within the investment grade and high yield space, as well as that of equity markets in this region.
- Following the effective withdrawal of monetary easing measures in the US, better known as the tapering of asset purchases, it has become an almost certainty that rates (key interest rates) are set to rise in the US, in our opinion over the summer months of 2015.
- The unfolding of the Russian/Ukrainian crisis has without a doubt had devastating effects on markets ever since it broke out in February of 2014, sending both countries' economies into a recession. Furthermore, the sanctions imposed by the EU on Russia have not only had a direct effect on Russia itself but also on countries (and companies) highly exposed to Russia. This resulted in a deterioration of economic trends within the Eurozone itself, keeping both inflation and growth anchored at low levels.
- The price of oil has more than halved in a span of just 6 months, and has had adverse economic implications (in the short term so far) on the oil exporting countries and has also negatively impacted those companies and countries highly dependent on the price of oil. From a personal consumption point of view,

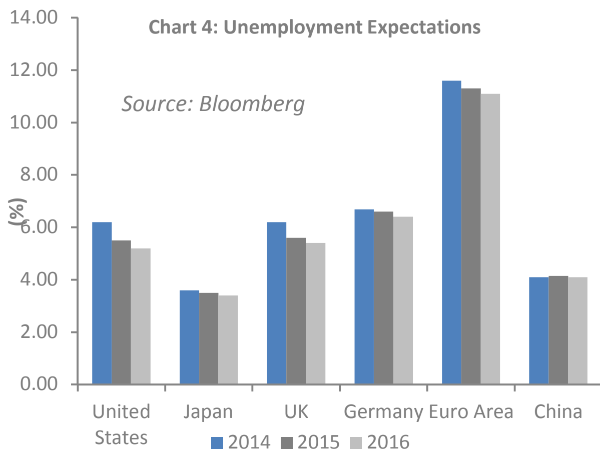
disposable income and thereby consumer purchasing power, is expected to rise as a result of this decline, but the question really remains if this additional purchasing power will translate into increased demand for global growth and result in higher overall growth. This question is yet to be answered in 2015, however, what is certain for now is, that OPEC has shown no signs of backtracking on its comments made earlier on in December to not curtail oil production, further fuelling the decline throughout most of December.

- Following a decline in economic activity (year-on-year) in China, which has had a contagion effect on neighbouring countries but also on the US and Eurozone, a pickup in economic activity in China in 2015 will benefit all aspects of credit markets, so investors should be closely watching (and scrutinising) incoming Chinese economic data.

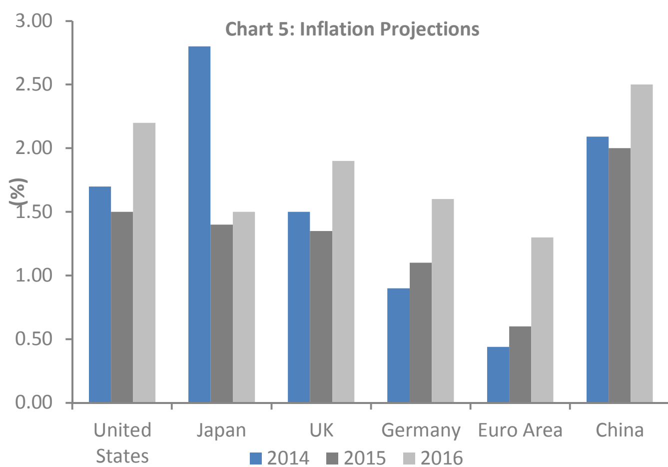
What to expect in 2015

The key theme for 2015 is expected to be the decoupling of the US from the rest of the world, as it enters a different cycle compared to its counterparts. This sets the scene for a low correlation between the US equity markets and the rest of the world, as was started to be observed in the latter part of 2014. In the Euro Area and Japan, the low interest rate environment and the use of monetary easing to propel economic activity (see Chart 3), lower unemployment data (which remains elevated in the Eurozone as Chart 4 shows) and subsequently prices going forward (see Chart 5) is expected to be at the forefront of investors' minds, as policy makers scramble to kick-start economies. The accommodative stance is expected to continue to provide support for financial assets. On the other hand, in the US, investors have already started to discount the fact that the Fed is going to raise rates, consensus being in H2 2015. As a result this is expected to have a negative effect on short term bond prices.





Exogenous risks are expected to impact the market with bouts of volatility amid an uncertain outcome. Amongst them we would include the political risk associated with elections in Greece in Q1, UK in May and Spain in December. Russia's highly uncertain economic situation and persistent tensions between Moscow and the West over the resolution of the conflict in Ukraine is expected to re-surface throughout the year. Furthermore, the continuing free-fall in the price of oil will, apart from creating uncertainty and concerns over additional deflationary pressures, also add to tensions between Russia, China, OPEC members and the West.

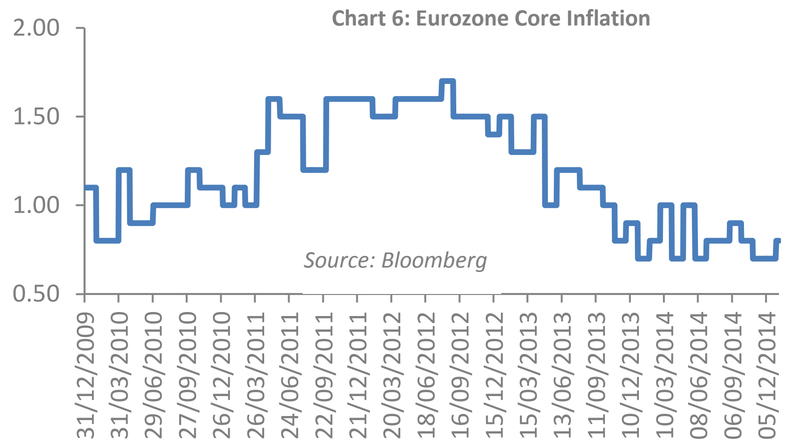


Source: Bloomberg

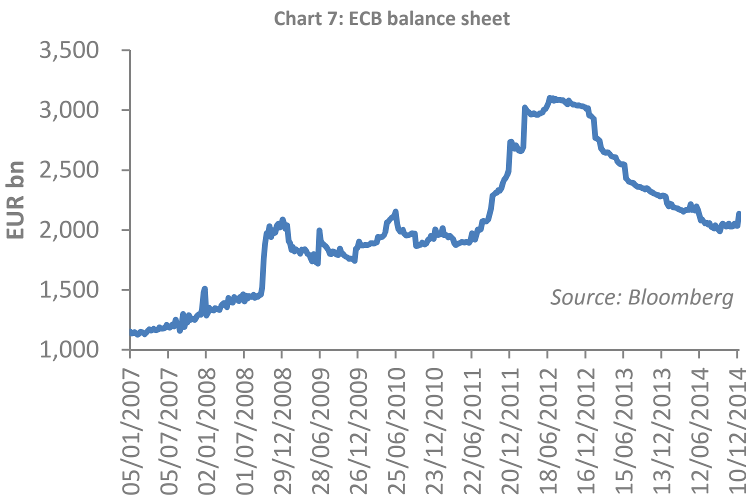
QE speculation building up in Europe

Without a doubt, as 2014 progressed, sovereign (benchmark) bond yields declined more than forecast, with end of year forecasts being constantly revised lower as the year passed by. It is cumbersome to pin point the move to one particular episode; it is merely a sequence of events, and disappointing economic data to go with it.

Rather, the major reasons behind this are a concoction of persistently lower inflation in Europe (see Chart 6) coupled with the lacklustre growth in Japan, notwithstanding the continuous easing of financial conditions in both regions. In Japan, such easing actually materialised whilst in the EU, the intention was made clear and is a foregone conclusion at this stage. In fact, oil prices exacerbated these moves, with long term inflation expectations falling sharply and breaking well below the 2% level that is consistent with a "healthy" economy and ECB's target level.



During the last six weeks of 2014, the ECB continued to provide liquidity to the markets by means of its targeted longer-term refinancing operation (TLTRO) as well as the third round of covered bond and asset-backed securities purchase programmes. **Such measures are expected to be offset by the two 3-year expiring LTROs issued in 2012 due to mature in January and February 2015.** The take up at December's TLTRO came in below expectations at €129.8b whilst the covered and asset-backed securities transaction average €4bn a week. Accordingly, the ECB balance sheet changed only marginally since June 2014 and declined year-on-year (see Chart 7).



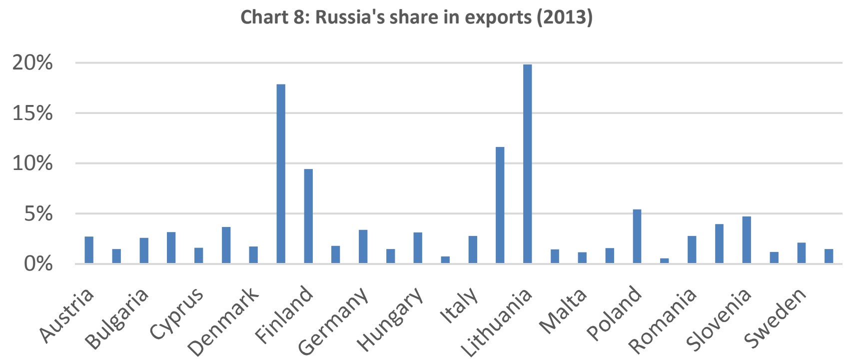
Despite this, around €250bn still needs to be repaid by February 2015, as a result of the maturing LTROs, with liquidity in European markets likely to decline in Q115. This decline in liquidity could be further exacerbated should the ECB opt to postpone QE even further, putting the rates at the front end of the curve under pressure in the short term.

But we are sceptical on its effects on growth

Recent studies have highlighted key differences in spread movements following the announcement of QE by the Bank of England, US Federal Reserve and Bank of Japan. It appears so far, that QE has had the desired effects on the UK and US economies as the announcement and subsequent implementation of QE by the respective central banks was timely, with both central banks' currently on the verge of unwinding their accommodative stance. On the other hand, the Bank of Japan took almost two years to formally announce QE after cutting its policy rate to zero. The ECB is pretty much in the same position as the Bank of Japan; laggards in taking swift action, and the direction of Bunds is expected to be similar to that of JGBs following the announcement of QE by the ECB in 2015.

However successful QE has been elsewhere, the situation may be considered to be different in Europe.

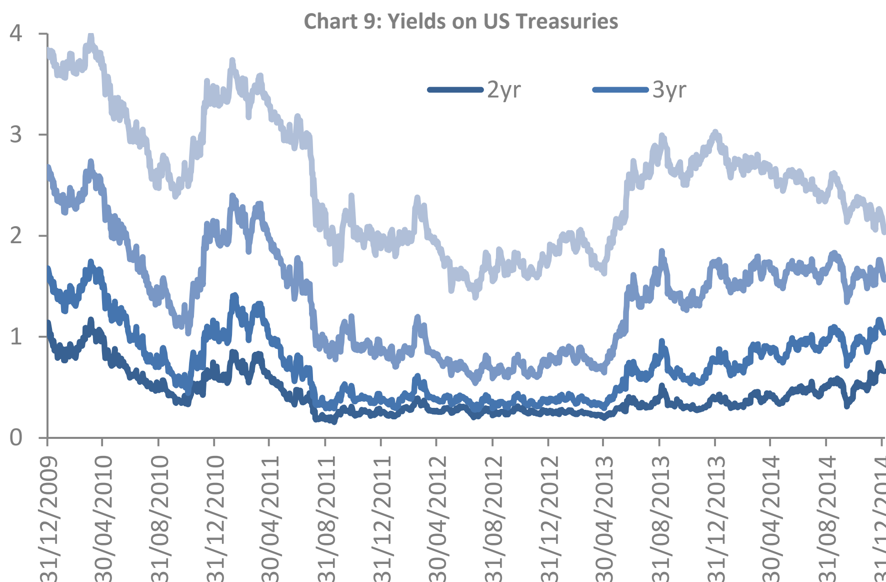
And Russia might be a drag for European growth



The abrupt depreciation of the Russian ruble is due to have a significant impact on Russian imports which have already taken a hit over 2014. Hence, Europe will also have to contend with lower demand from Russia; in terms of sectors, the European Commission data shows that EU exports to Russia are dominated by machinery, transport and equipment, which have a 47% share in total, and chemicals, which contribute another 17% (of which pharmaceuticals are 8%). The largest Russian imports come from: China, Germany, Ukraine, Belarus, Japan, the US, Italy, France, South Korea and Poland. However, of greater importance is how critical these flows are for the exporting country and from this perspective, the Baltic countries, Finland and Poland stand out as the most prone to a decline in exports (see Chart 8).

Inflation slowing down in the US

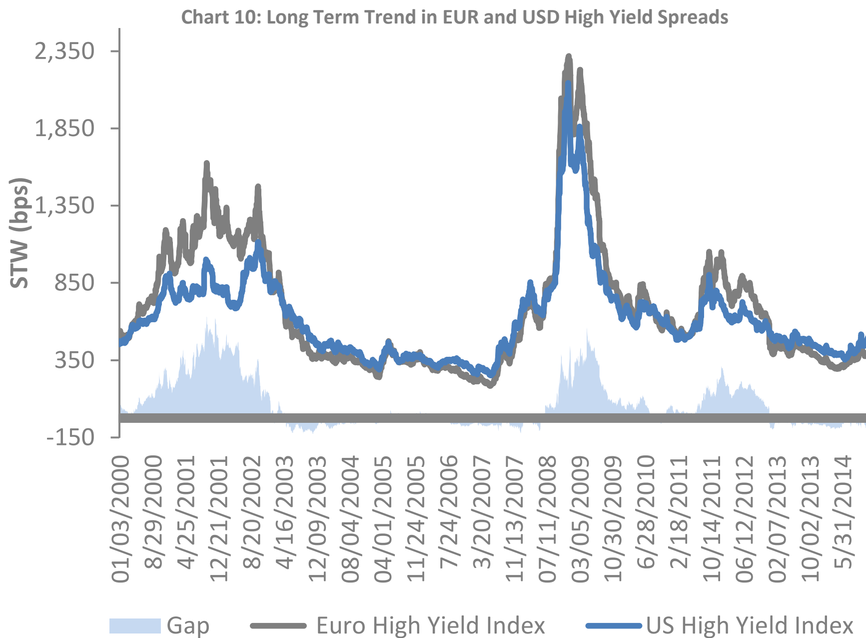
The outlook for the US economy is over-hung by the expectation that the Fed will hike interest rates. In Yellen's latest speech she appeared to take a somewhat dovish stance, stating that the US economy had to show significant improvements over multiple quarters before any action will be taken.



The expectation of a hike in interest rates has flattened the US Treasury Yield curve somewhat over the past year (see Chart 9), after yields rose at the short end of the curve. This trend is expected to continue moving into 2015 as speculation over when the Fed will proceed with the tightening of its monetary policy continues.

Meanwhile, consensus estimates for the Fed rate is to increase from the present 0.25% to 0.95% by 2015. To date, the Federal Reserve has stated that it will remain cautious on the timing of the first rate hike. Externals factors have raised some eyebrows of dampening growth in the US, coupled with slack in the labour market, seeing the Fed backtrack on its forward rate expectations during the latter part of 2014. Market consensus is for June 2015, we concur with this view generally and feel that a rate hike towards the end of summer is more plausible, as the US economy would have gathered steam by then and the labour market would be on a better footing.

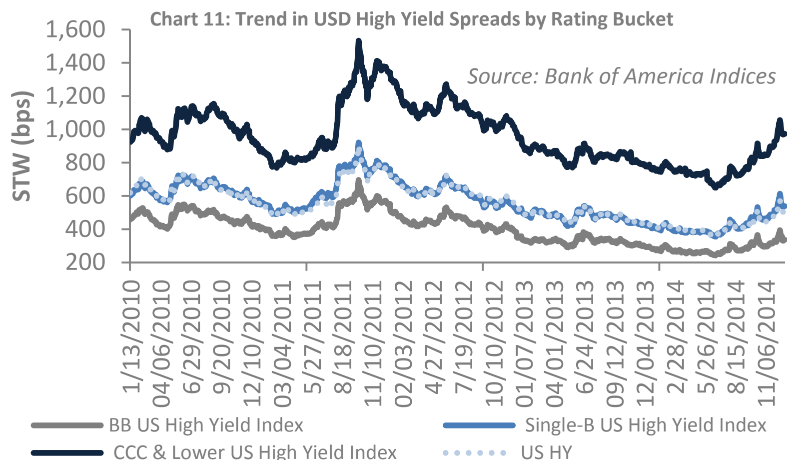
The underperformance of US High Yield looks like an opportunity



The US high yield market significantly underperformed its European counterpart over the second semester of 2014 as the larger exposure to the energy sector triggered fund outflows and uneasiness among investors. With the downfall in oil prices losing some momentum, the market subsequently recovered some of its losses although investors seem to remain hesitant and appear to lack the necessary conviction that would allow a more sustained recovery. Having said that, we find the yields on offer attractive given the relative strength of the US economy and we expect investors with longer term horizons to step in to take advantage of the emerging opportunities. Indeed, whereas US High Yield Spreads have been higher than the ones in the EUR market due to the higher duration of the US Index, the differential reached a record high in mid-December and remains close to high levels seen in 2008 (see Chart 10). USD yields look attractive not only relative to Europe but also relative to US equities. That is, whereas in Europe we find the dividend yields just 50 bps lower than the EUR HY yield, and almost 100 bps higher than the BB-rated yield, in the US market the gap is strikingly wider as the S&P 500 dividend yield is in the 2% region. However, we acknowledge that the S&P 500 earning yield is currently hovering around the 5.5% region, which remains below its 10-year mean of 6.2%. Accordingly, a stabilization of the US high yield market might bring about a gradual shift from equities to high yield towards the latter part of this semester. Some technical support might come in the form of lower issuance as the energy sector, which has accounted for some 15% of the issuance in 2014 will tap markets to a lower degree given that investors' risk aversion will fade only gradually. In addition we note that a lower number of issues now trade to next call date with the years to worst for the Bank of America US High Yield Index increasing by 0.5 years over Q4 2014; that is, the spike in risk aversion has made refinancing exercises less economical and the window of opportunity might have closed if one considers that the Federal Reserve is on track to tighten its monetary policy from this point on.

Although we do not favour all USD rating buckets equally

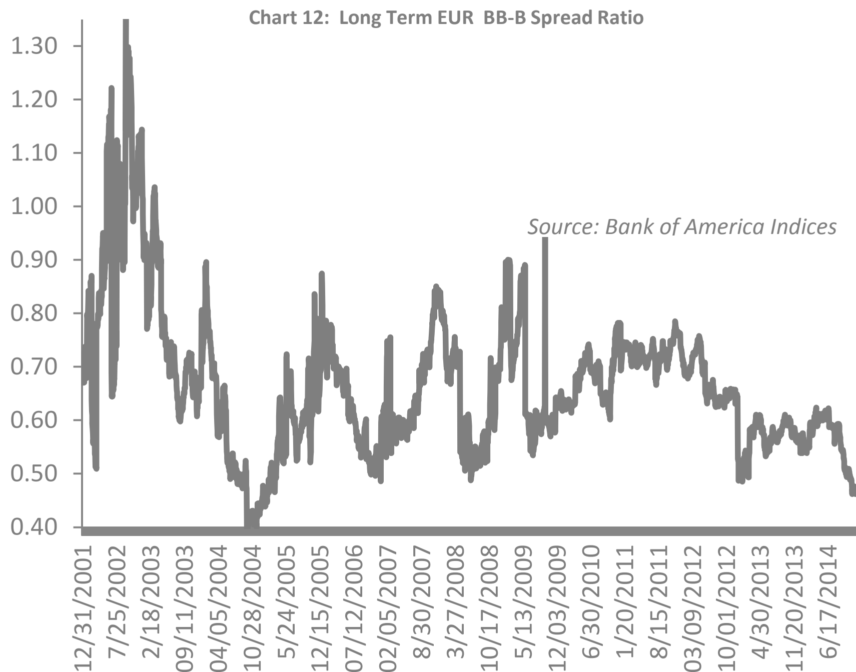
The move towards a risk-off market in the last part of 2014 was not felt equally across the board, with the B+ and lower rated names impacted by a larger degree (see Chart 11). As we will detail later, a similar and even more significant divergence occurred in the European High yield space but what surprises us is that whereas in Europe the movement is to some degree explained by renewed deflationary fears, the change in economic outlook for the US has not been as drastic. Against this backdrop we find the considerable re-



pricing of the B-rated names relative to the BB-rated universe as hard to explain from a fundamental perspective and see scope for outperformance of the former segment. Our view stems from expectations for steady economic growth which are hard to reconcile with the multiyear lows reached by the ratio between BB and B spreads and by the spread gap between these two maturity buckets.

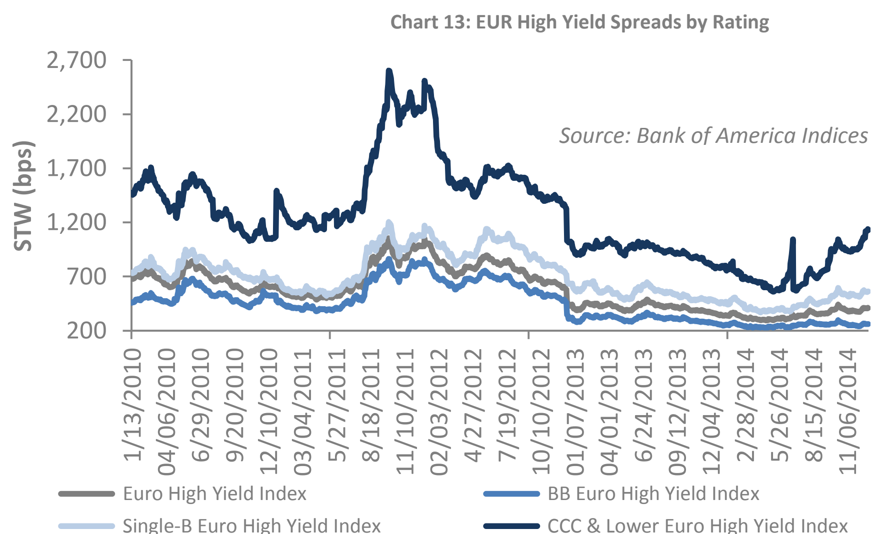
The lower end of the European High Yield market over-penalised

When it comes to the European market, we have mixed feelings, as the segment has experienced a sharp decompression between the lower rated names and the higher rated ones. Accordingly, we witnessed the spread pickup between Bs and BBs widening and the ratio between the spreads offered by the two reaching levels not seen for the last 10 years (see Chart 12). The sharp decompression is indicative of growth concerns which would impact the B segment by a larger degree given the larger incidence of cyclical names here and the inherently lower financial flexibility of these companies. Whereas we are sympathetic with the renewed growth doubts and remain sceptical about the economic outlook, we think that the markets may have overreacted, as one has to acknowledge that most high yield companies have gained some financial flexibility by lowering their funding costs and lengthening their maturities; over the last two years for instance the average coupon of the BAML European High Yield Index declined by 1 p.p.



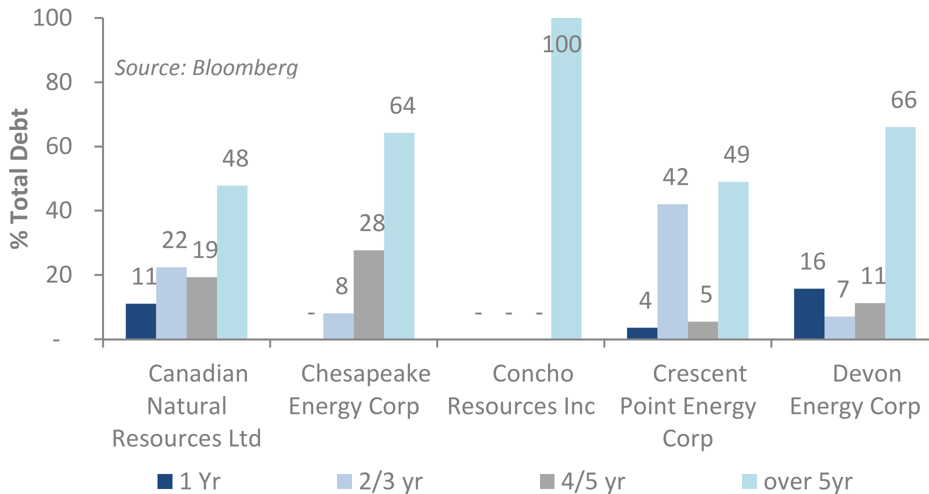
While the valuations for the EUR BB-rates look rich

European BB-rated names withstood the sell-off of the second semester very well with spreads widening by just 16 bps and closing the year marginally higher (see Chart 13). Accordingly, the lower rated Bs now look relatively cheap or, conversely, the BBs seem comparatively expensive. However, there are other indicators that suggest that the BBs are at this stage a less appealing investment alternative. We looked at how BB spreads compare with the BBB spreads and we find that notwithstanding the recent decompression, the BB to BBB spread ratio remains low by historical standards which suggests that the BB spreads are high when put against those for BBBs. This change in trend was brought about by a marginal widening in BB spreads and the concurrent tightening of the BBB names which benefited from speculations around upcoming QE and a falling yield environment which is constructive for Investment Grade.



Commodity related names prone to underperformance in the short term

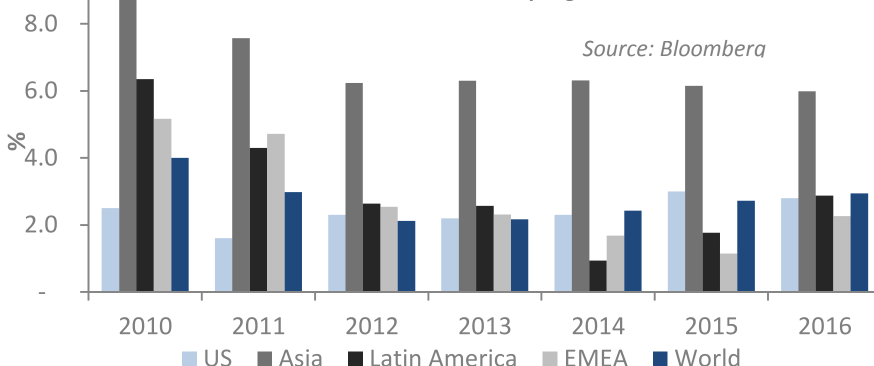
One of the key trades over the last few months in the high yield space (EUR and USD) has been the marked fall in bonds issued by commodity producers. From what we can infer, this reflects a combination of factors, most notable of which are (i) the plunge in oil prices; (ii) subdued data coming out of China and its commitment towards redefining its economy away from infrastructure-induced growth; (iii) renewed deflationary fears and (iv) iron ore's downtrend which defied analyst's expectations.



Much has been said about the sell-off in energy names and the exposure of the US high yield market to this sector in the aftermath of the shale gas boom. Indeed, the novelty of this energy segment is what complicates the assessment of the consequences of lower oil prices and concurrently increases investor uneasiness. Determining the break-even costs of each company and assessing their financial flexibility -debt payback schedule, liquidity metrics, and interest coverage ratio- is hence key at this stage; indeed, some names among which Chesapeake, Devon Energy and Concho Resources seem to benefit from more manageable debt maturity schedules (see Chart 14).

Differentiating among emerging market names will be key

Over the summer months to pretty much the end of the year (with the exceptional short term blips experienced in the interim) credit investors seem to have fallen out of love with Emerging Market. With market consensus indicating higher US rates forecasted for 2015 coupled with the persistently declining price of oil, emerging markets are in for a bumpy ride ahead. Tensions in countries such as Venezuela (highly dependent on the price of oil), Argentina (virtually on the brink of another default) and the infamous Ukraine-Russia crisis coupled with significantly lower commodity prices overall and sharp currency depreciation in EM have weakened the outlook for many EM economies. The recent (surprise) rate cut by China's central bank strongly indicated that China's growth momentum is slowing down, with the overall Asian economy set to be the likely victim in the short-medium term. Brazil too has had its fair share of negative economic data trends; it has recently been confirmed that the country posted a trade balance deficit of $3.9bn in 2014, its worst 12-month streak since the summer of 1999.



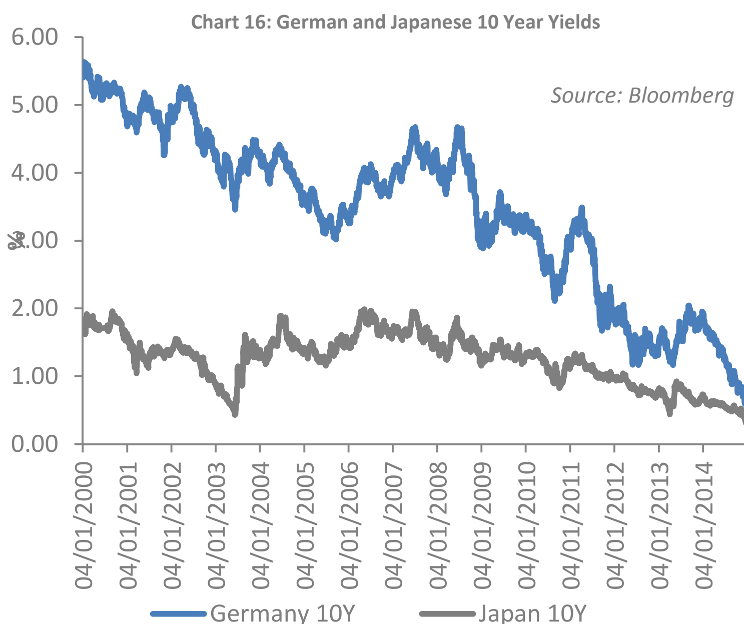
When it comes to emerging market issuers we think increasing differentiation remains essential as some of the key economies in this space look set to underperform the US, some will be challenged by the lower commodity prices while others will accrue benefits following the recent decline in oil. Starting with the latter, we note names such as Turkey, India, Thailand, Philippines, South Africa or Poland. Indeed, we believe

that most of the Asian Emerging countries should be positively impacted by the fall in oil, with one of the most notable exceptions being Malaysia. Equally encouraging, this region looks poised to be the only one for which growth will be above the world growth rate (see Chart 15, based on Bloomberg consensus). Conversely, the Latin America region is generally due to suffer from a bearish oil market, although we do find a noteworthy exception in Chile.

It is evident, the mood and tone in EM economies is slowly fading away which is why we would tend to shy away from Emerging Markets in 2015.

European Investment Grade has the potential for another year of good returns

Growth in the Eurozone remains weak whilst current valuations point towards a subdued economic recovery. The only move in credit markets which could prove to be spread supportive within the IG space is an imminent fresh wave of QE by the ECB. With spreads already at ultra-tight levels potential for more tightening may appear to be limited although not absent if one compares European and Japanese spreads (see Chart 16). Furthermore, if the benchmark Bund still has room to rally from this point forth, corporate spreads could tighten further and returns see another boost. Besides this, and following the lacklustre performance of credit markets in the second half of 2014, we do not exclude market participants will position themselves more defensively and shift out of HY into IG. We are of the opinion that IG credit will continue to outperform HY in the first half of 2015 as liquidity conditions (in terms of inventory, spreads and traders willingness to take on more risk) in IG remains more abundant than in HY. In the first half of 2014, the risk-on trade was inherited from the latter trading sessions in 2013 as global growth prospects spurred demand for risky assets (HY) while IG also enjoyed positive investor flows as investors sought to hop-on the risky band-wagon. However, as economic conditions and the Ukraine-Russia crisis progressed, risky assets turned out of favour and investors shifted their preference from HY to IG in the latter part of 2014. This resulted in IG posting remarkable full year 2014 returns, clearly standing tall of its HY counterparts.



European fundamentals supportive

Notwithstanding a declining trend in credit fundamentals, default rates remain historically low (albeit, according to a recent report from Moody's, they are expected to embark on an upward trajectory in 2015) as more rating downgrades could be on the cards in the months ahead). In the past few years, corporations around the world took advantage of favourable credit conditions, most notably the declining yield environment, to lock in additional financing at attractive rates whilst prolonging the profiles of their outstanding debt obligations.

The weakening euro is currently on a downward spiral, as economic data continues to disappoint and, more recently, talks of Greece exiting the euro, further exacerbated this move in recent trading sessions. We believe this can be supportive for European IG, as a large number of European IG issuers are multinational corporations working their trade outside of the Eurozone and are thus major beneficiaries of such a move.

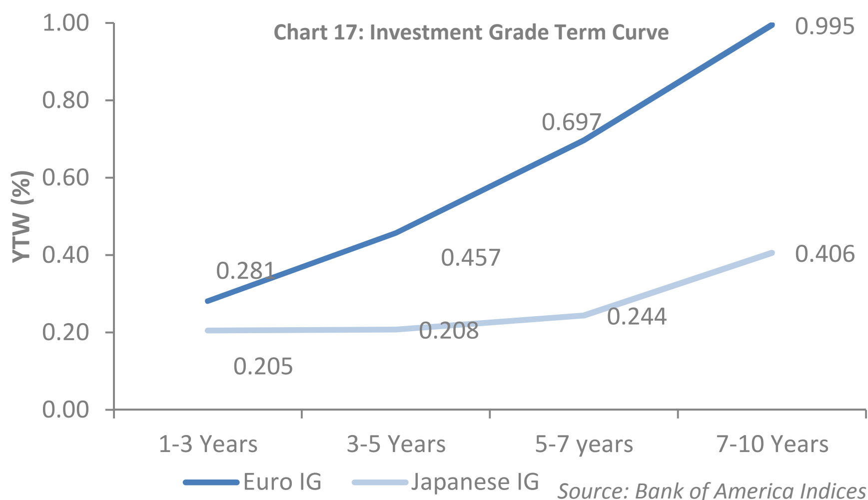
European Financials provide attractive opportunities

For Banks, the main drivers behind the increase in senior bond issuance in 2014 were the slowdown in deleveraging and to some extent LTRO repayments. However, the biggest key development within the financials space has been the increased supply in Banks Subordinated issuance as financial institutions sought to further increase their T1 capital in order to comply with the new capital ratios. Heading into 2015, even though due to forthcoming TLTROs there will be less need for Senior issuance, apart from the amount due to be issued encouraged by TLAC, banks are not expected to replace Senior issuance with TLTROs, with bank senior issuance expected to witness an increase in 2015. For several years in fact, net financials senior issuance was negative so this year we could well see a reversal in this trend. Nevertheless, looking at the spread ratio between financials and non-financials we could see further compression between the two segments.

Where do we go from here? EUR IG to tighten more

Well, stubbornly low yields coupled with persistently low levels of realised and expected growth can only be supportive for the asset class offering fixed (known) streams of cash flow. What is certain is that in 2015, credit selection within all credit rating buckets will be the key for returns, which is why we are shifting from a beta-driven market to an alpha-driven market, which is a healthy move for credit on the whole. Good credits will be singled out from bad credits and this should remain supportive for credit overall, most notably IG. In view of this, we see IG credit spreads as having an overall tightening bias in 2015. Having said this, we expect an increased spread differentiation within the different sectors, and markets as specific idiosyncratic/sectorial risks are expected to remain elevated in a scenario where the economic backdrop and the reassessment of credit risk remains benign to say the least, most notably within the HY space.

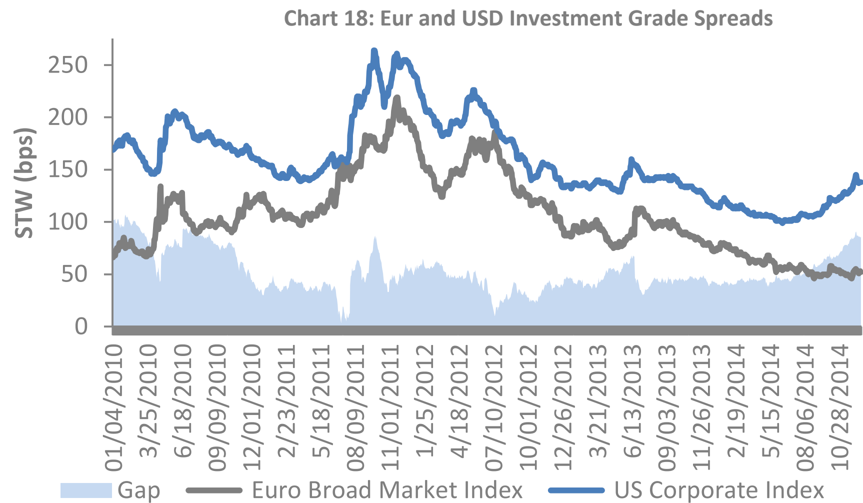
We view BBB rated bonds as being the sweet spot within the IG space as it appears to offer the right balance between safety, attractive yield and capital preservation, as they clearly underperformed in 2014. All in all, given current market conditions, we would tend to prefer opting for higher duration lower rated bonds to generate yield, as the fundamental and technical backdrop remain supportive of credit, as the so-called "Japanisation" process of European credit markets persists. In fact, the Japanification would imply further bullish flattening of the spread curve from current levels (see Chart 17). In the IG space, taking a look at the term structure of credit markets, we favour a long-to-neutral duration bias. We are aware that benchmark (sovereign) yields will eventually rise in the medium term (when this happens, the longer dated bonds will clearly bear the brunt), although it is yet unclear as to when this could possibly happen. Till then, we feel comfortable taking on additional risk by earning a higher yield through the extension of overall portfolio maturities (7-9 year maturity) within the BBB rating bucket.



The US IG market is lagging behind its EUR counterpart

Several years of strong USD issuance contributed to the underperformance of the USD IG market relative to the EUR market (which in turn benefited from negative net issuance courtesy of the abrupt deleveraging of the bank sector). In addition, the USD segment of the market was faced with higher concerns around fundamentals as a more advanced economic cycle comes with several risks for bondholders of such names (i) increased M&A activity

(ii) more emphasis on shareholders friendly measures – dividends and share buybacks- in a bid to support stock valuations and return the excess cash to investors (iii) limited scope for additional improvement in margins and (iv) larger sensitivity to monetary policy changes given the longer average maturity of this market. While the last argument likely lost its importance after the significant drop in long term rates and the increasing support that these maturities have seen from the fall in inflation expectations, the remaining factors remain relevant. Indeed, M&A, share buybacks and dividends resulted in significant cash outflows, whereas the profit margin, the Return on Assets and the Return on Equity remained broadly unchanged for the S&P 500 companies. At this stage much of the negativity could already be priced in, as the 20 bps spread widening seen over 2014, pushed the spread pick-up relative to the EUR IG to the highest in about 3 years (see Chart 18).



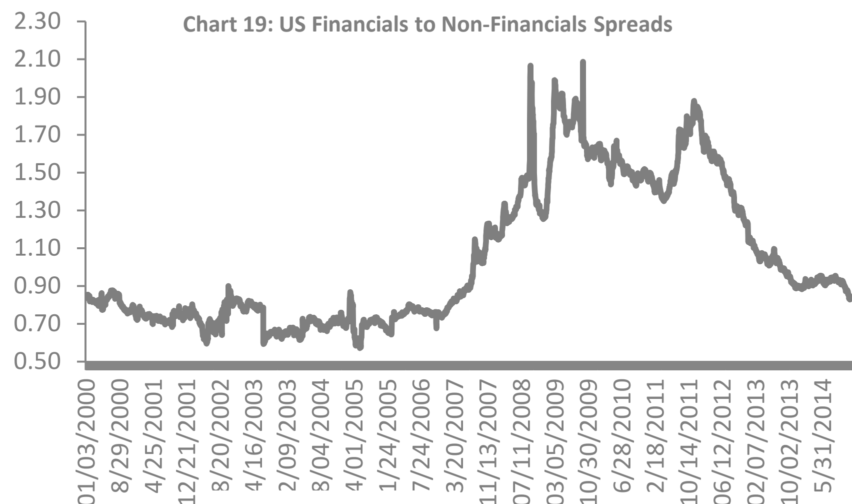
Source: Bloomberg

How to position oneself in the US IG market?

Whereas all rating buckets weakened last year, the AAA fared better, while the AA segment saw spreads increasing by 23%. As a result, putting the spreads for EUR and USD rating buckets aside, we find that the spread pickup is higher for the below AAA names and suggests that the over-performance of the AAAs should come to a halt.

However, some technical factors, such as Japanese portfolio inflows could provide impetus to the higher rated names given that the general assumption is that Asian investors are more familiar with US names than with the European issuers. Given the new and aggressive measures taken by the Japanese authorities in an attempt to tackle deflation, the country experienced large portfolio outflows (i.e. investments abroad) as the local asset managers found the local yields increasingly unattractive. BBBs stand out as carrying a spread per duration lower than in EUR as the USD bonds of such rating have a much longer duration (7 years vs 4.5 years in EUR). However, we would caution against putting too much emphasis on this metric given that duration risk is now likely to preoccupy investors less. In the same vein, we highlight that the term curve is quite steep at this moment and warrants overweighting long term bonds. Having said that, we also note that the spread gap between BBBs and BB increased and is now higher than in the EUR space, while the ratio between the spreads offered by the two rating buckets also fell dramatically, a trend which could herald a tightening of BBBs.

Finally, it probably warrants looking into how the financial sector valuations compare to non-financials and we find that there is room for further compression between the two segments (see Chart 19) although we worry that this will be deterred by supply concerns and uncertainties around how these will impact issuance; TLAC is a critical concern in this respect.



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