AVIVA INVESTORS
HOUSE VIEW

MARKET OUTLOOK
CREDIT: TECHNICALS ARE OUT-WEIGHING FUNDAMENTALS

Q3, July 2016

AVIVA INVESTORS

CREDIT: TECHNICALS ARE OUTWEIGHING FUNDAMENTALS

– Policy makers continue to support the market

– On track for the biggest year of IG issuance on record

– Market reactions to Brexit have been muted so far

SUMMARY

The second quarter of 2016 saw the arrival of the ECB's Corporate Sector Purchasing Programme (CSPP). The CSPP has dictated much of the action in the euro credit market which drove spreads marginally tighter, offsetting much of the macro event risk around Britain voting to leave the EU and European elections. It has brought about a surge in euro issuance and significant inflows into investment grade credit funds. While spreads tighten and corporate debt accumulates, we remain conscious of the late default cycle. Defaults are picking up and there are some signs that the cycle is turning. However, we believe that the rise in default rates will be more concentrated in the energy and commodity 'problem sectors', which now represent 15% of total high-yield debt outstanding in 2015, compared to 5% in 2007. This has represented a significant compositional change of the market, reminiscent of the 'dotcom' crash in the early 2000s.

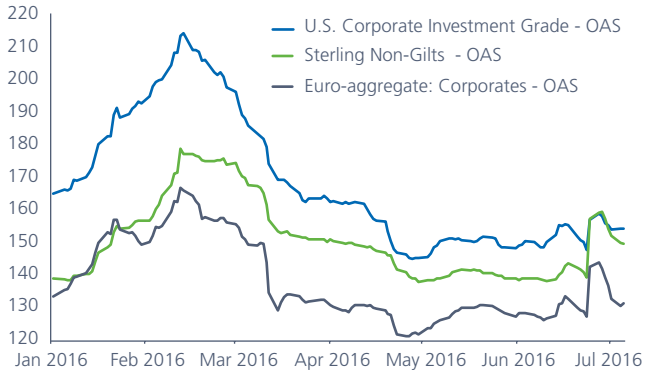
Monetary policy & maco concerns

Two opposing forces are driving European investment grade

The likelihood of further monetary support from both the ECB and the Bank Of England in the coming weeks and months will limit the extent of any major sell-offs following the Brexit vote. Meanwhile corporates are more likely to retrench their spending, limit M&A and slow down their demand for credit - all these factors should be supportive for corporate balance sheets. The concern for investors at this point is the political uncertainty, macro implications of corporate sector retrenchment and the impact on GDP, inflation, employment and general sentiment.

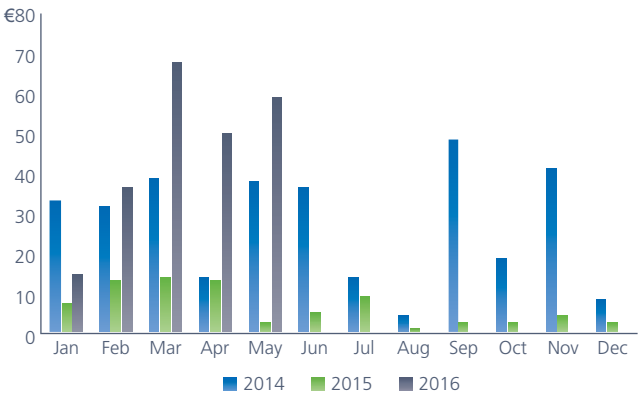
The ECB's Corporate Sector Purchasing Programme started this quarter, driving euro eligible corporate spreads tighter relative to dollar and sterling. Over June, €6.8bn of corporate bonds were purchased, equating to a monthly pace of €9bn, at the high end of what was expected. Looking forward, this should support the corporate credit market accordingly and could potentially lead to a further widening between eligible and non-eligible securities. However, while the CSPP has been a catalyst for

Figure 1: Investment Grade spreads by currency



Source: Barclays Live

Figure 2: Euro Investment Grade supply



Source: Barclays Live

spread tightening, the combination of political uncertainty, Britain voting to leave the EU and the US Federal Reserve's rate-setting agenda have weighed on prices, resulting in only a modest tightening in spreads. (Figure 1)

According to historical correlations between credit and equities, without the CSPP, euro spreads would have most likely widened over the quarter. In the past 15 years, euro credit and stocks have generally moved in the same direction. 2016 YTD has been one of only two years over that time when spreads have tightened as equities have fallen. Evidently, the CSPP has ensured that euro credit is much lower beta than it would have been given the current macro climate. However, we are alert to the fact that at their current expected run rate of purchases, the ECB probably does not have the ability to prevent spread widening if the macro environment deteriorates sharply.

Post the ECB announcement, we saw a surge in euro debt supply as issuers extended their maturity profile to the benefit of investors 'hunting for yield'. Euro investment grade issuance had its third strongest month on record in May with €58.2bn brought to market, following a record €67.8bn in March (Figure 2 and Figure 3). Euro investment grade issuance over the first five months of 2016 was €226bn, ensuring the year is on track to be the biggest IG issuance on record. However, over the first month of the CSPP, only 4% of bond purchases were made in the primary market. We believe increasingly lower yields are likely to open the floodgates to significant new supply, not only from domestic European corporates, but also from overseas, and in particular, US corporates who are facing monetary policy moving in the opposite direction.

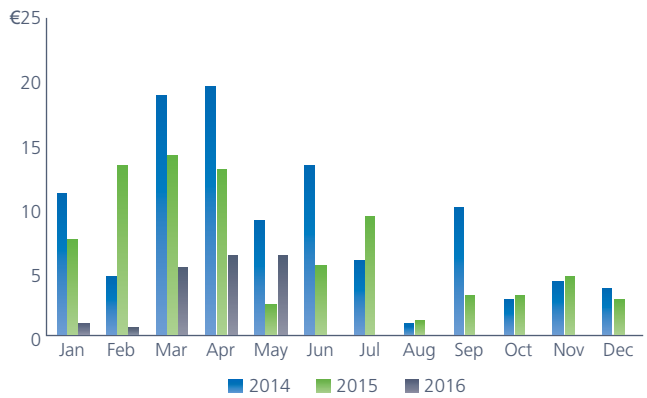
Technicals & valuations

The market reaction of Britain voting to leave the EU has been fairly muted so far. Credit spreads in sterling were around 30% wider initially but soon retraced to levels seen just before the ECB announced their intention to buy corporate bonds as part of its purchase programme in March. While gilt and bund markets reacted far more aggressively and reached new lows in yield, credit investors' neutral positioning will have played a major part in the subdued reaction.

Well-documented difficulties within commodities and industrial sectors continue to weigh on the market.. Although oil has rebounded to $50 this quarter, declining commodity and energy prices have had a profound affect on corporate bond markets and we believe that companies in the commodity sector will continue to suffer from fundamental pressures for some time.

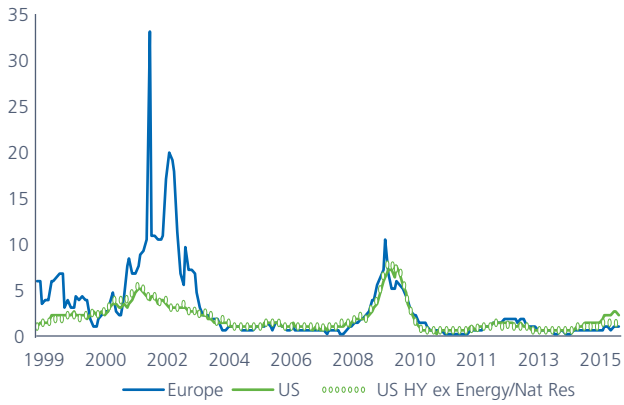
> Problems in the commodity and industrial space will continue for a while yet

Figure 3: Euro High Yield supply



Source: Barclays Live

Figure 4: Rating downgrade/upgrade ratio



Source: Barclays Live

Positive flows into both US and Euro bond funds

The last quarter saw funds flow out of European credit and into US bond funds. On a four-week average basis, this quarter has seen positive flows into both European and US funds for the first time since October last year. As expected, the turning point was at the start of March when the ECB announced the addition of the CSPP to their asset purchase programme. Since this date, there have seen positive weekly flows into both US and euro funds with the exception of the week leading up to the UK referendum vote.

Moreover, since the CSPP announcement, cumulative flows over the last twelve months into bonds have exceeded those into equities. The ECB only purchases investment grade credit, so flows have been predominantly into investment grade corporate funds.

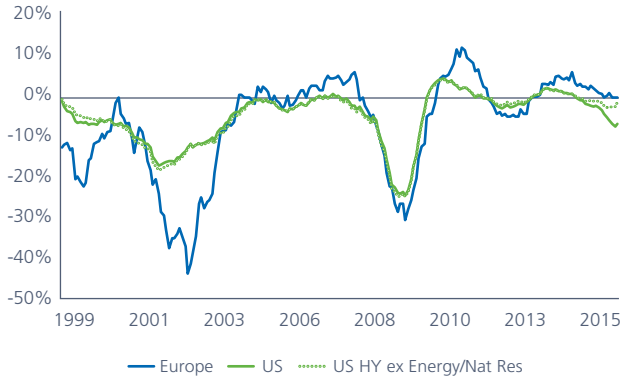
Fundamentals: The late default cycle

Are commodities the new dotcom bubble?

Late default cycle fears continue to build. Defaults are picking up and we are back around the historical average US high yield default rate of 5.4%. This signals that the cycle may be starting to turn after an accumulation of excessive debt as issuers take advantage of low market yields. Furthermore in the past twelve months we have seen 27 upgrades and 29 downgrades, the first time that downgrades have outstripped upgrades in nearly three years (Figure 4 and Figure 5). However, there is a long way to go to reach the default rate of 10 to 12% that prevailed at the end of previous cycles.

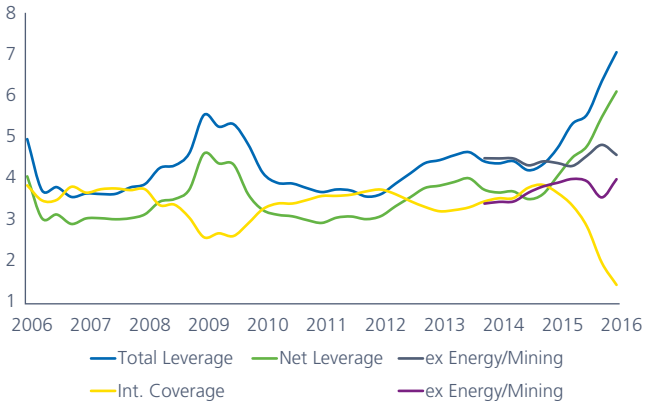
Any turn in the cycle may well be concentrated in certain areas of the market, in particular dollar high-yield credit since it is more exposed to the distressed companies in the energy and commodity sector, a sector representing 15% of total high-yield debt outstanding in 2015, compared to 5% in 2007. (Figure 6.) This has represented a significant compositional change of the market, reminiscent of the 'dotcom' crash in the early 2000s where the technology and media sectors accounted for almost 40% of the high-yield market. The picture is less clear in Europe, as active Central Bank policy continues to reduce systemic risk and support credit markets. Therefore, the default cycle in Europe will probably lag that in the US.

Figure 5: Rating drift



Source: Barclays Live

Figure 6: US leverage ratio



Source: Barclays Live

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