

ECB Bond Market Contact Group

Update on the euro area corporate bond market

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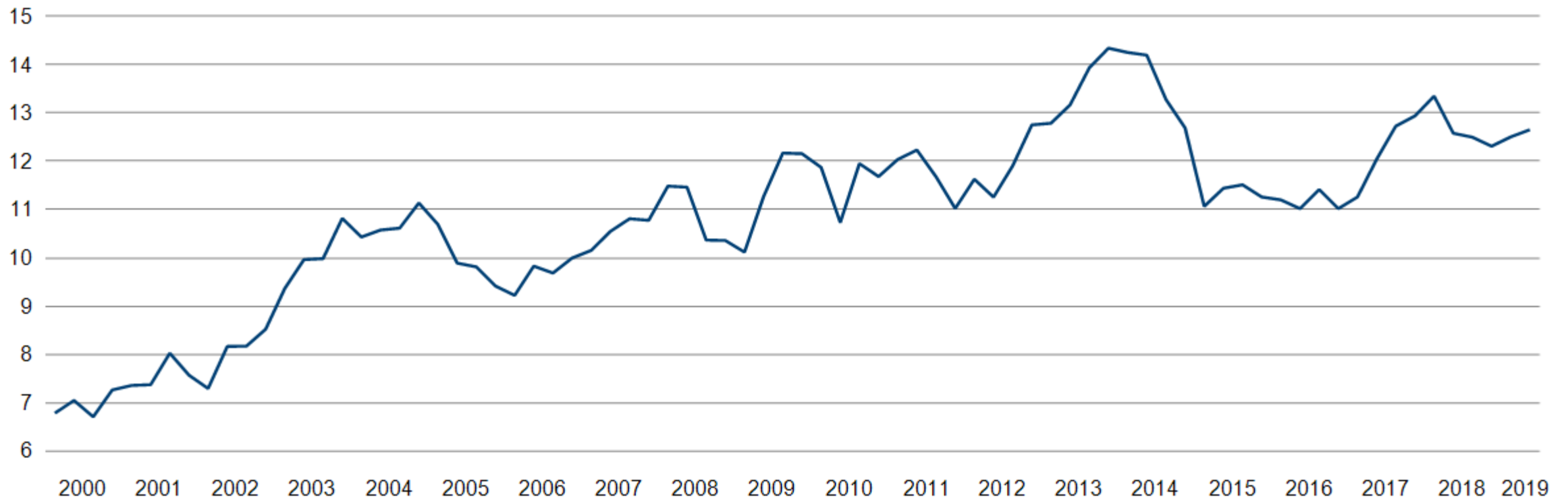
Frankfurt, 4 March 2020



Euro area non-financial corporates are increasingly reliant on bond market financing

Capital market funding to euro area non-financial corporates

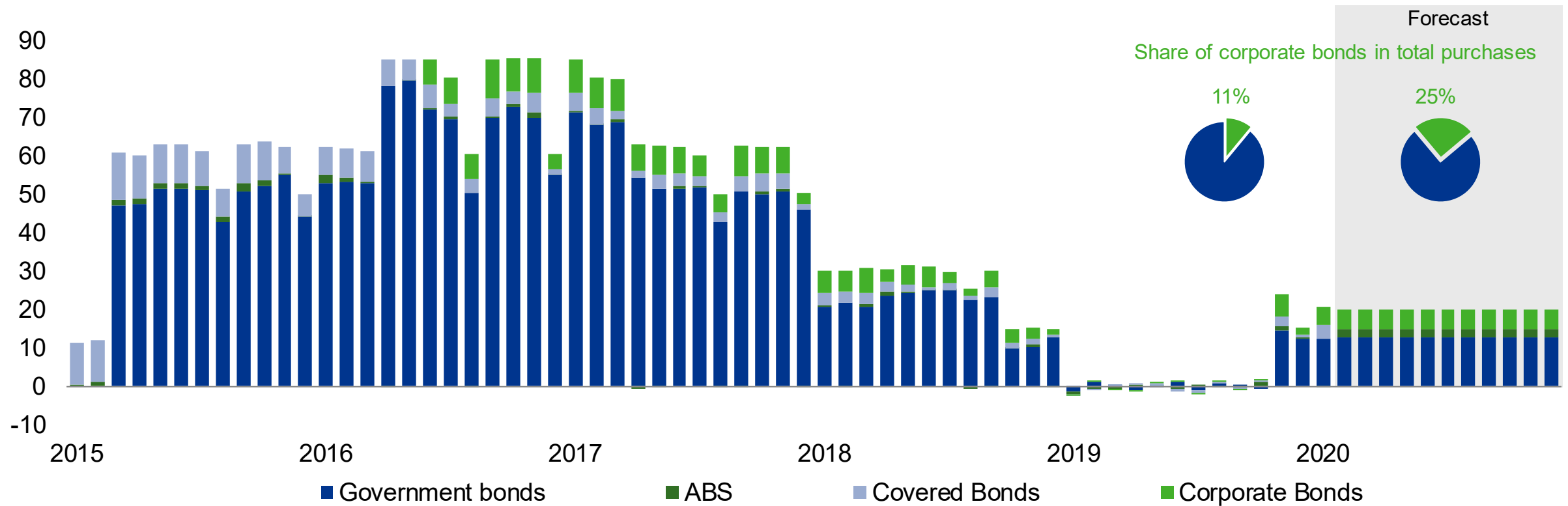
Percentage of total debt funding



Source: BIS, Union Investment

The ECB is shifting its asset purchases towards corporate bonds

Monthly net purchases under the ECB's APP
In € billion

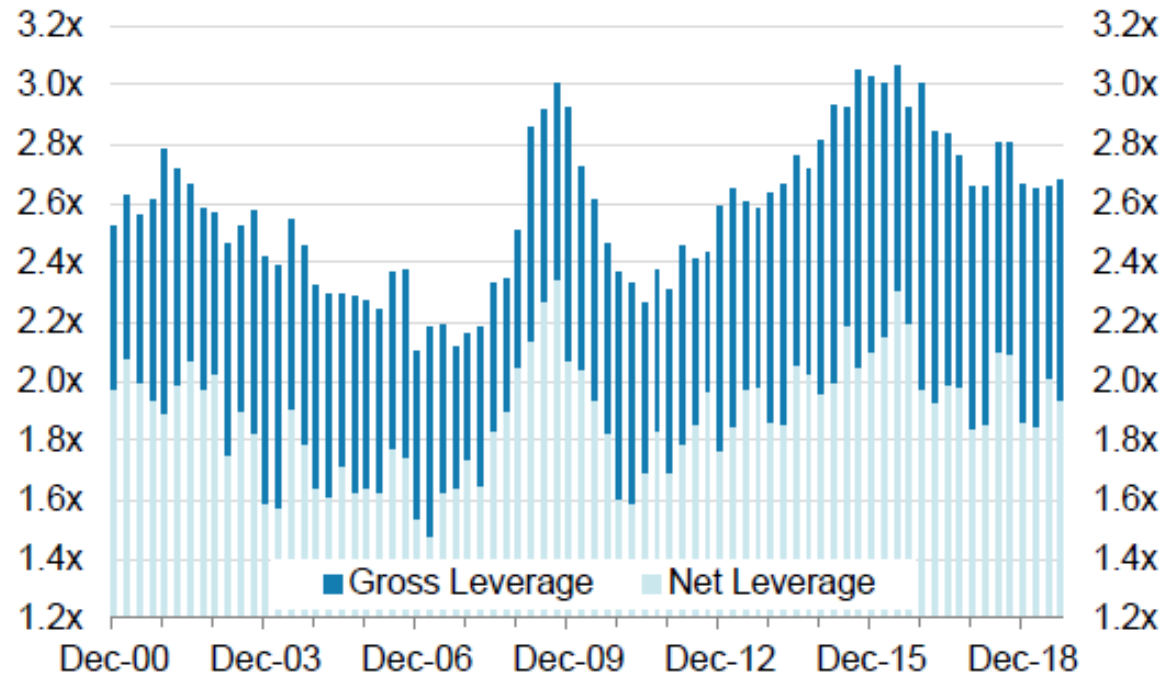


Source: ECB, Union Investment

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

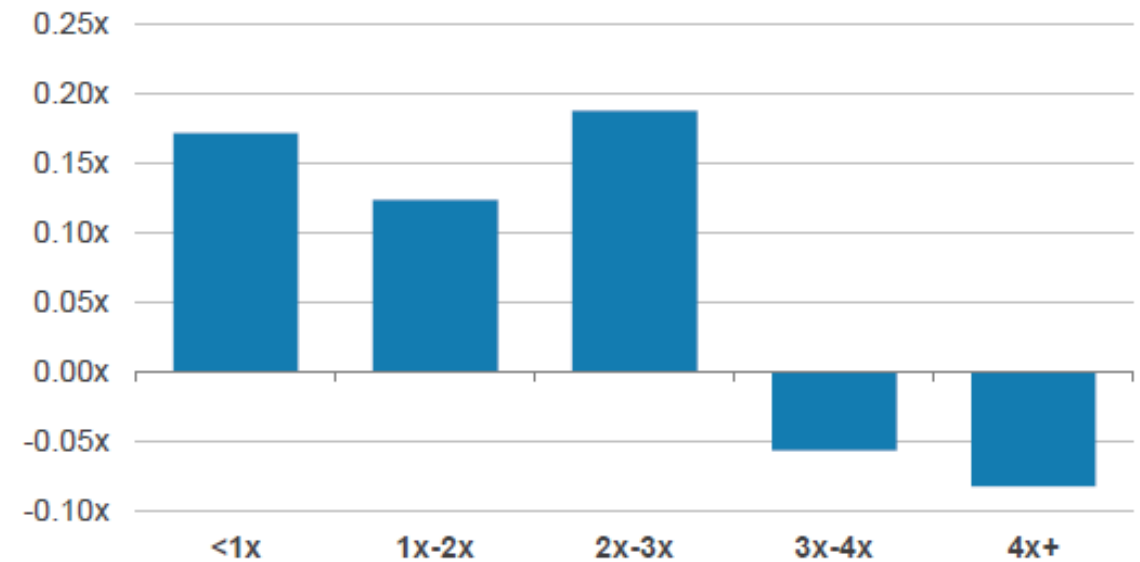
Leverage ratios are stable on aggregate

Debt/EBITDA ratio of euro-denominated investment grade corporates



Only underlevered companies increase debt gearing

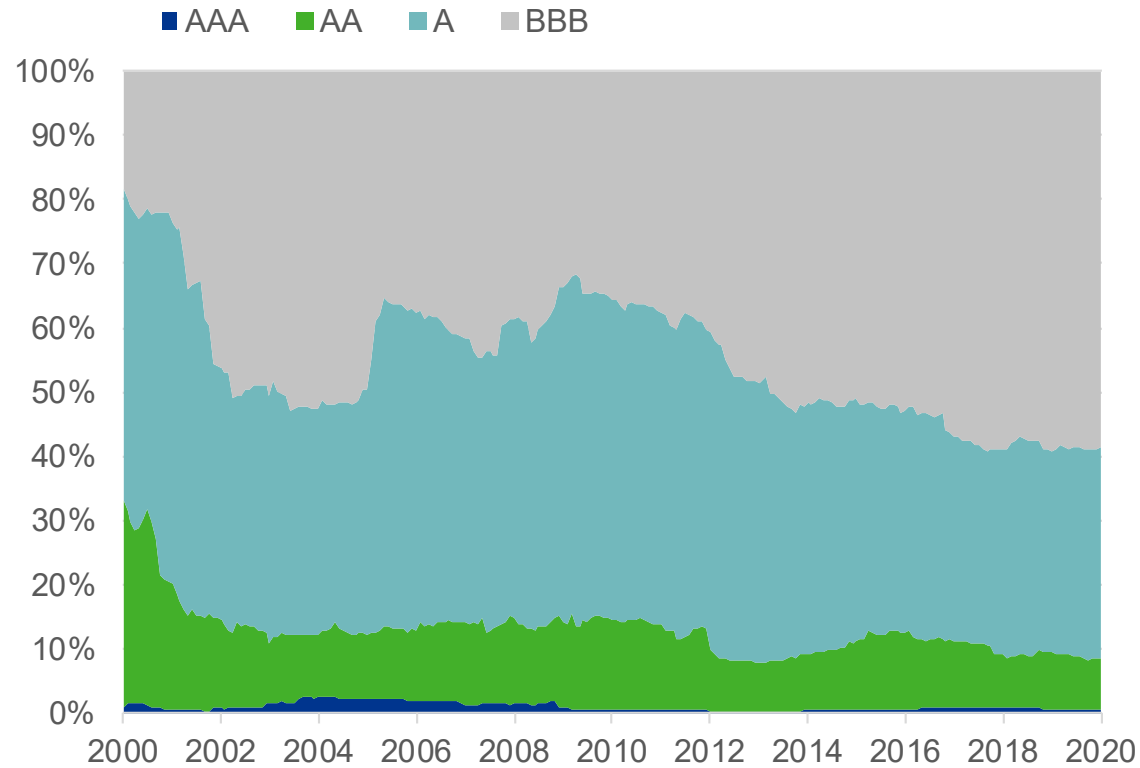
Year-on-year change in debt/EBITDA, as of 3Q2019



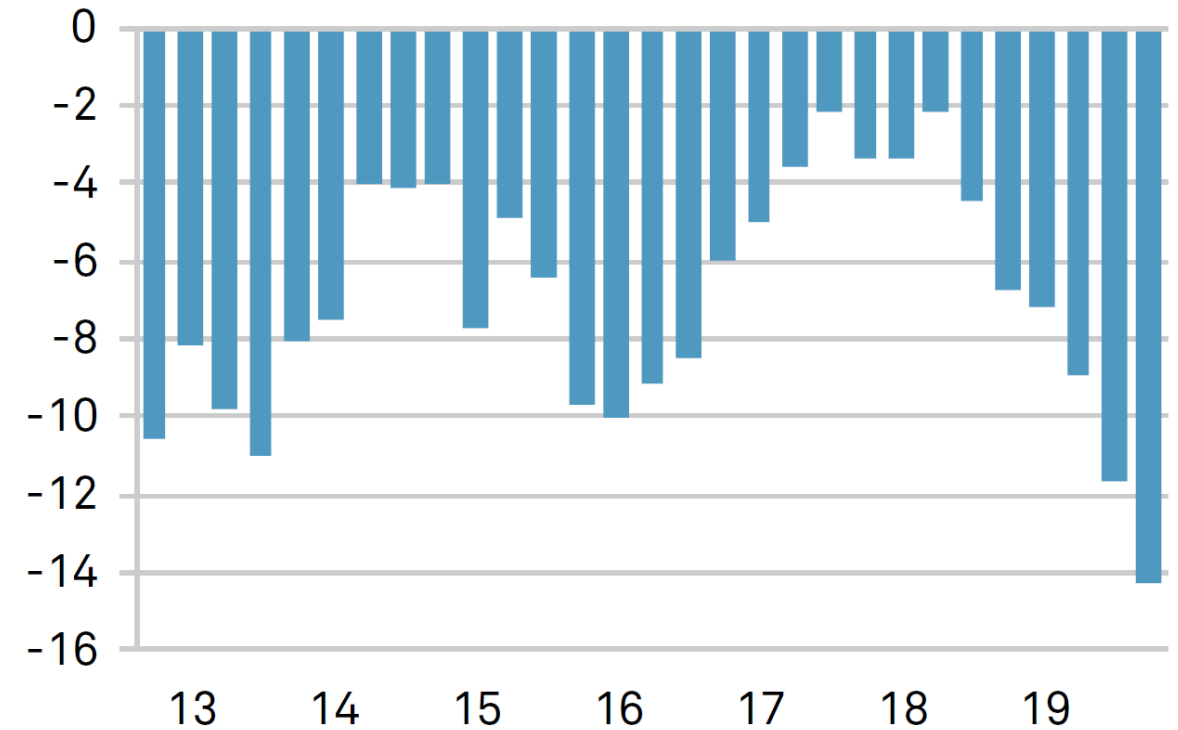
Source: Morgan Stanley. Data as of 30 September 2019

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

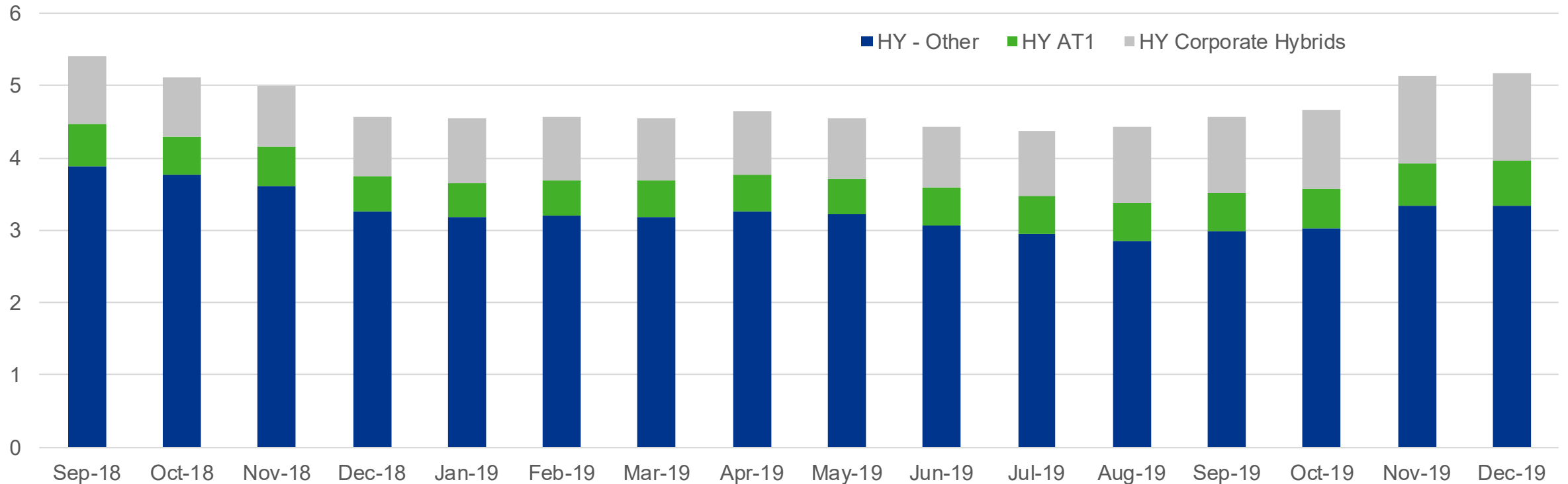


Net outlook bias = the percentage of ratings with a negative outlook less those on a positive outlook
 Sources: ICE BofA market indices, S&P Global Ratings, Union Investment. Data as of 28 February 2020

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

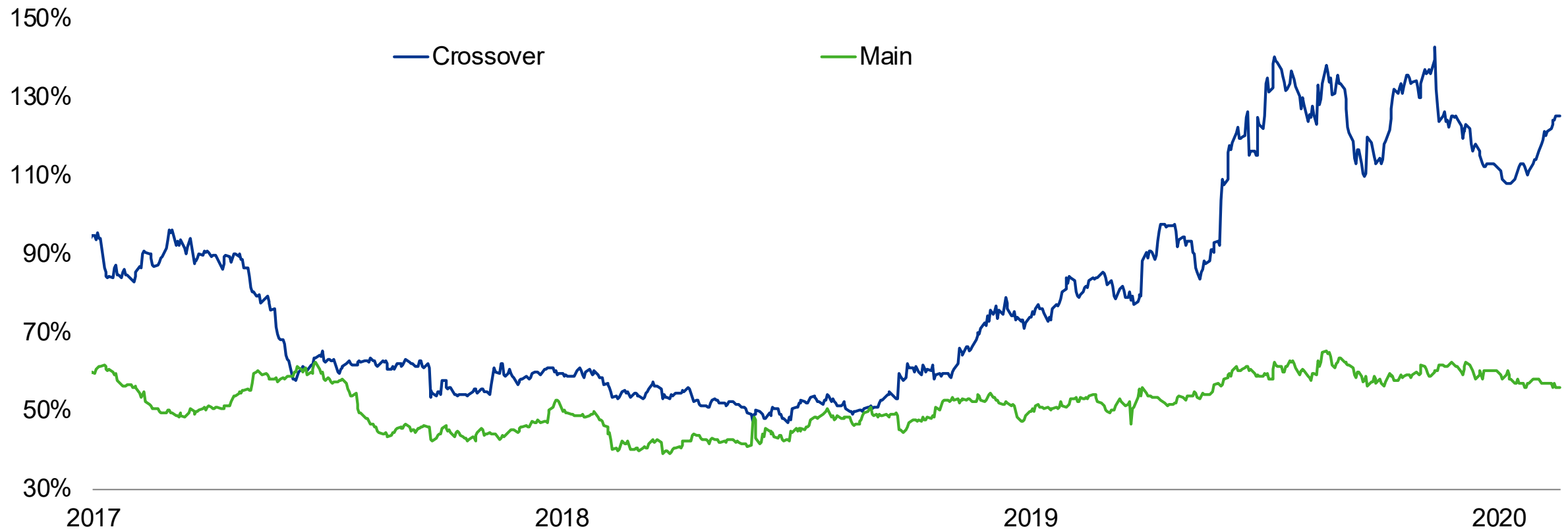


Source: JP Morgan. Data as of 31. December 2019

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)

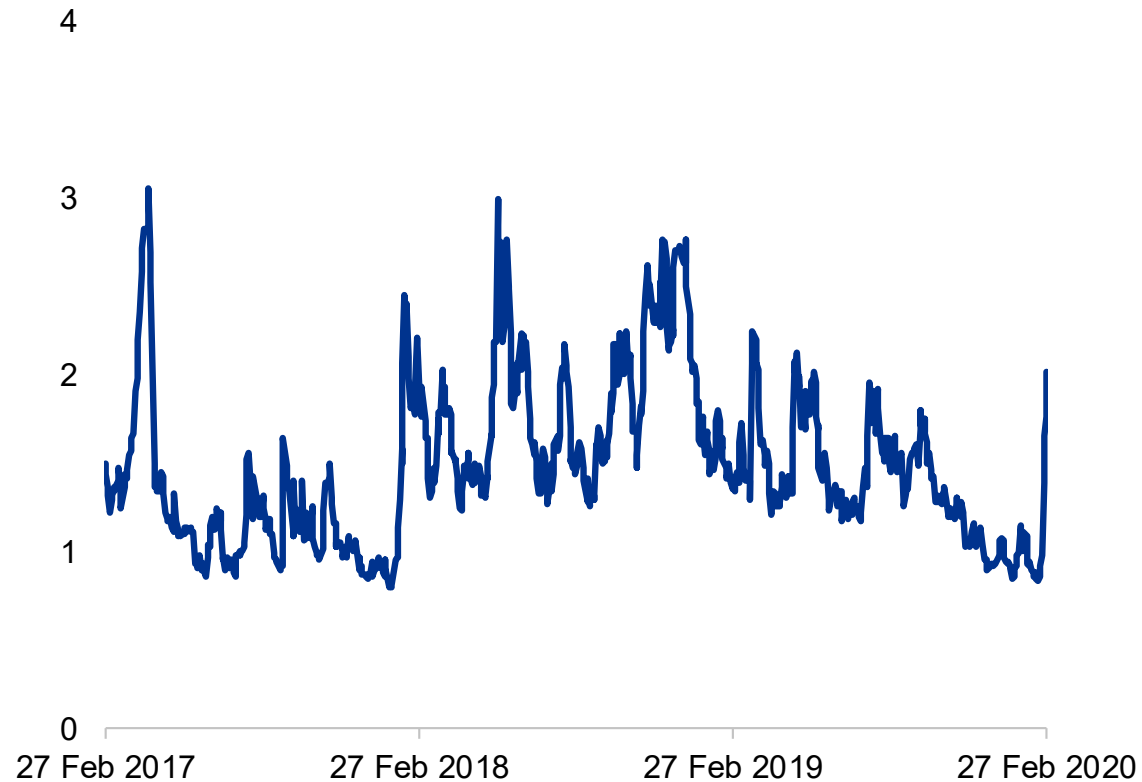


Source: Bloomberg Intelligence. Data as of 19 February 2020

Market stress following the outbreak of the COVID-19 virus threat

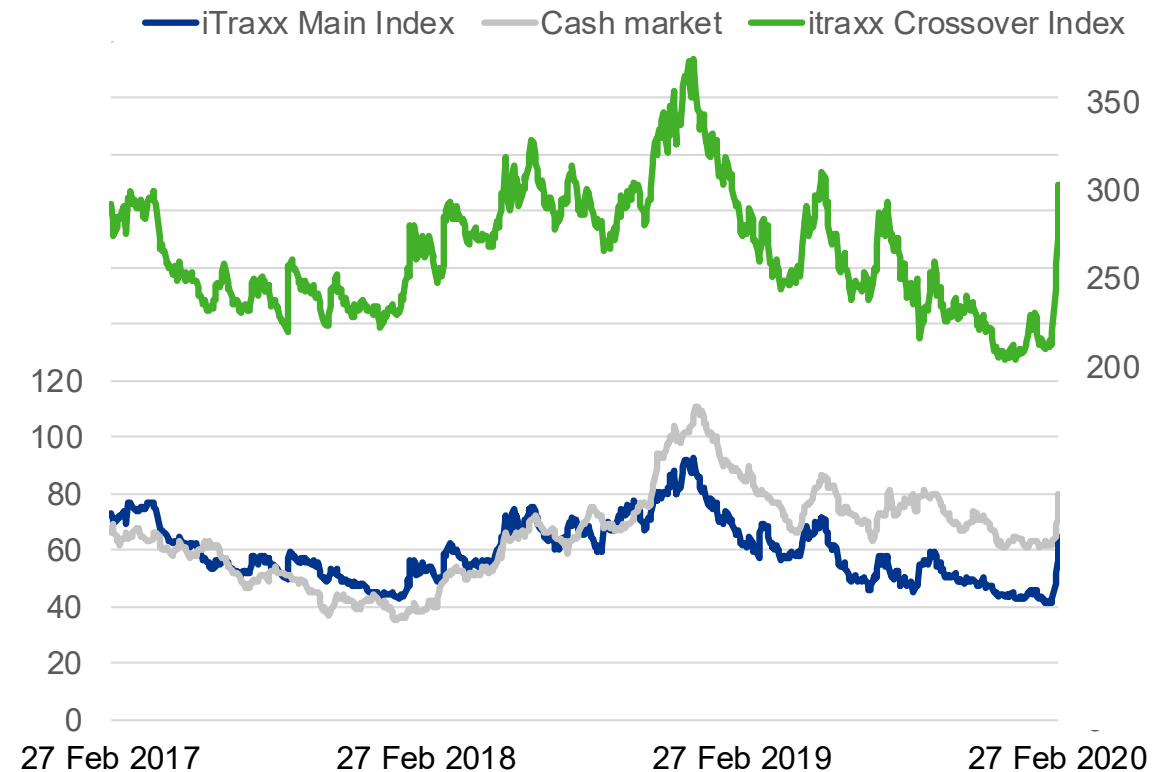
Volatility of options on euro area IG corporate bonds

Implied price volatility for 30-day options on iTraxx Main, in percent



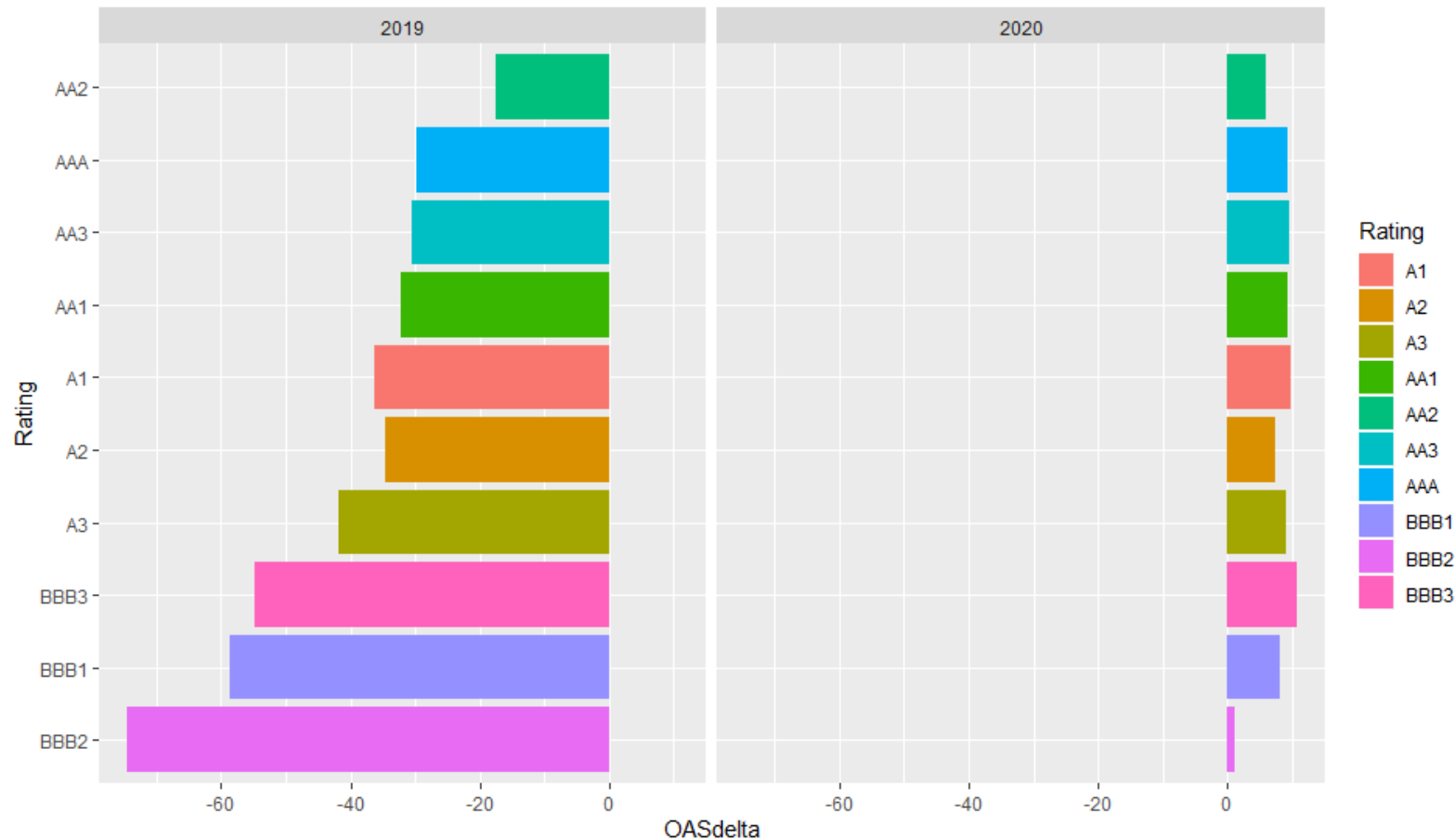
Swap spreads of euro area corporate bond indices

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

Market stress: uniform selloff across all rating classes

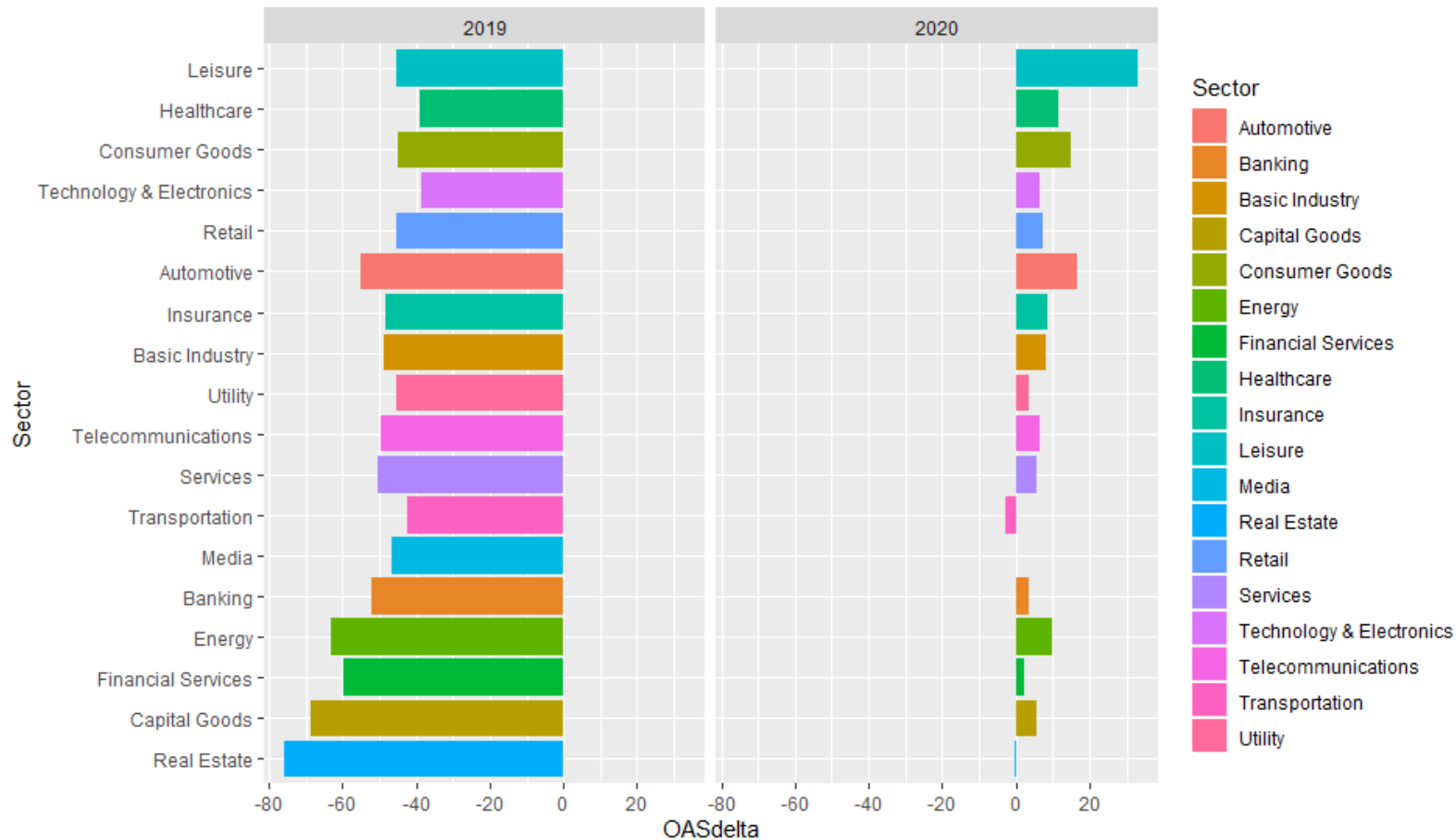


The change of the ECB's monetary policy stance contributed to a strong rally in euro area corporate bond markets during 2019, particularly in lower-rated securities.

2020 has so far been marked by a uniform selloff across all rating classes, caused by the spread of the corona virus.

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

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.

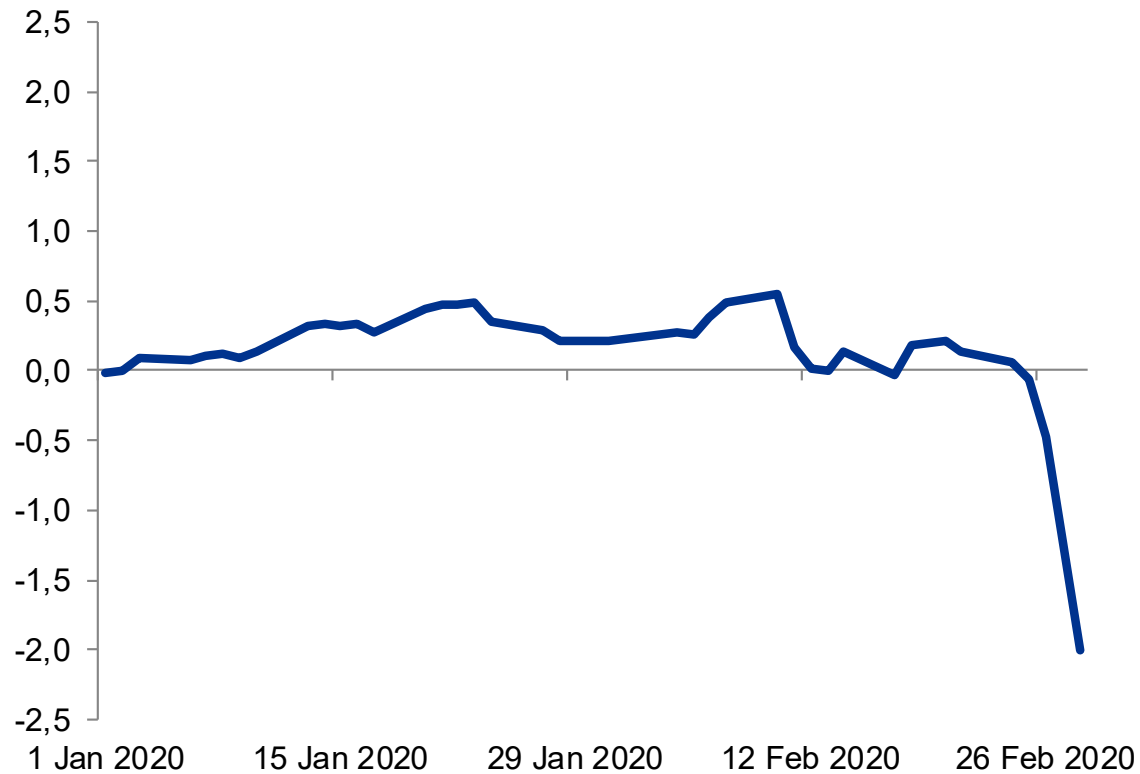
In 2020, the leisure sector (tourism, cruise ship operators) was hit particularly hard by the market selloff, along with the automotive sector, which is battling with supply chain disruptions and structural problems.

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

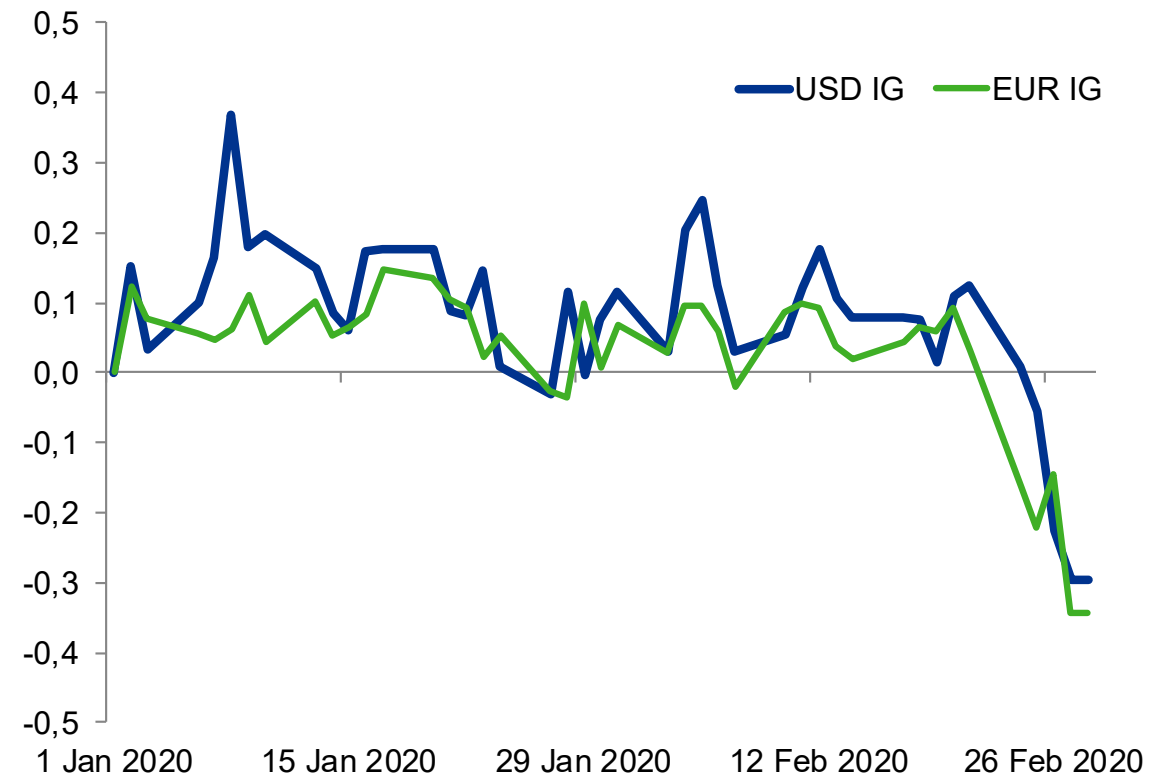
Cumulative flows into Euro IG Corporate ETFs

In € billions



ETFs are trading cheap to their intrinsic value

Average premium or discount to NAV, in percent

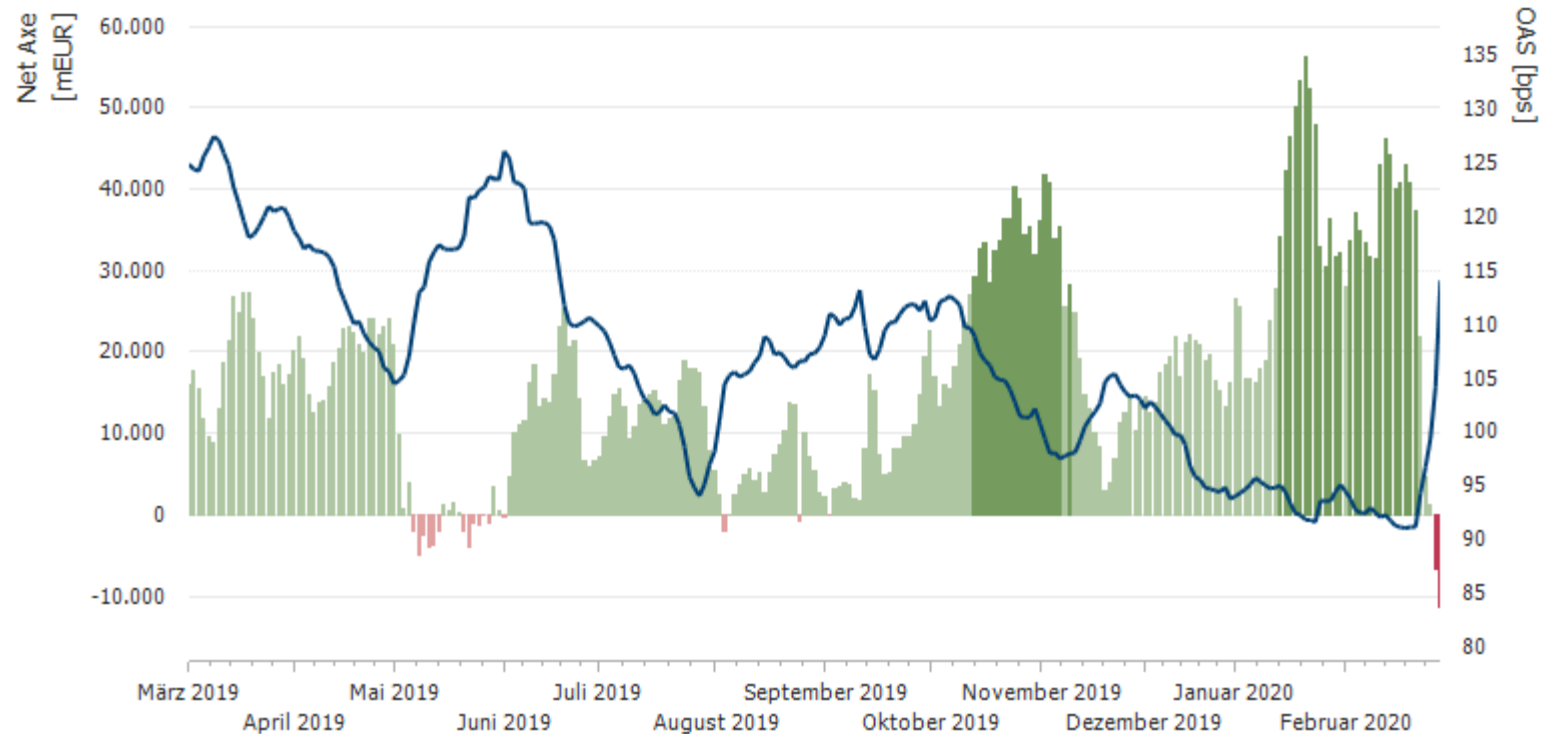


Source: Union Investment. Data as of 28 February 2020

Secondary market: the dealer bid has disappeared

Broker positioning in euro-denominated Investment Grade corporate bonds

Aggregate net broker-dealer axes in € million (lhs) vs. option-adjusted market spread (rhs)



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.

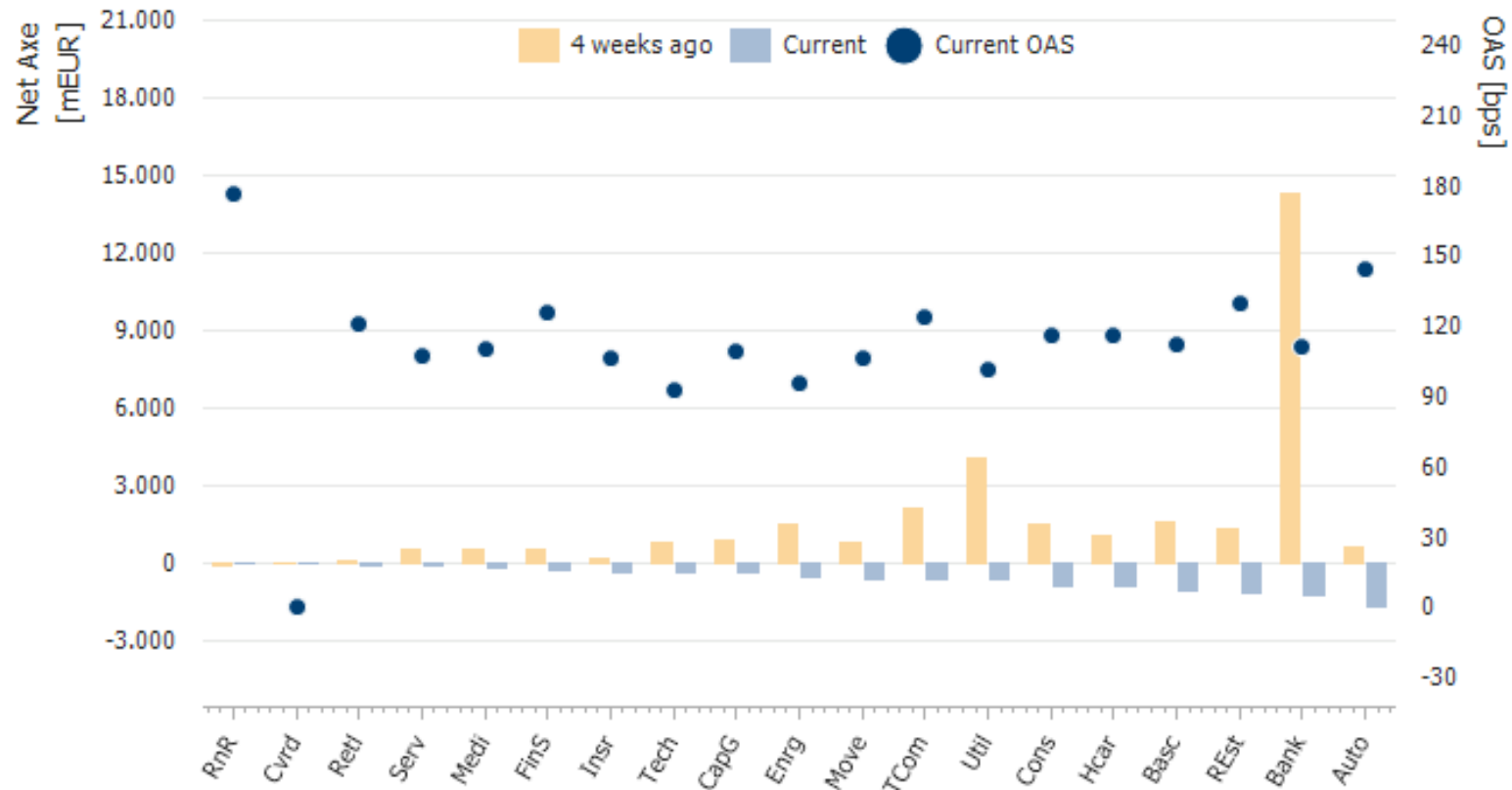
The past five trading sessions have seen a record shift in dealer demand, from net bid axes of € 37 billion to net offer axes of € 11 billion euros. The market has largely gone bid-less and has stalled.

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

Secondary market for auto and bank bonds has stalled

Broker positioning in euro-denominated Investment Grade corporate bonds

Aggregate net broker-dealer axes in € million (lhs) vs. option-adjusted market spread (rhs)



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.

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