Macro Keys

Can European credit weather the US HY storm?

Economics & Macro Strategy

Global

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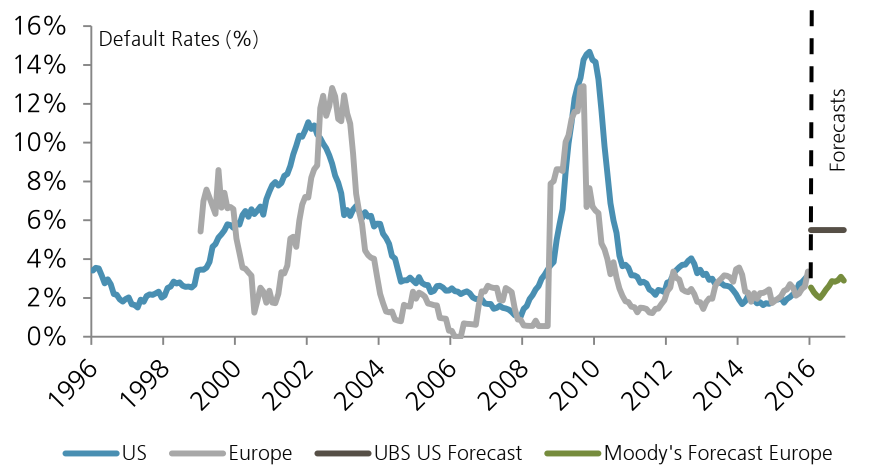
European and US credit fundamentals are diverging

Historically, European and US credit have been highly correlated both in terms of spread movements and total returns. However, several indicators show an improvement in conditions in Europe relative to the US. Firstly, the ECB credit lending survey shows steady and easy lending conditions whereas on the basis of non-financial indicators we expect the SLO survey in the US to show lending standards growing more restrictive. Secondly, the credit quality of European HY has much less B and CCC exposure than US HY. Thirdly, European credit is seeing more rating upgrades than downgrades since the middle of last year while the US is seeing the opposite. And finally, total returns are starting to show beta falling between European IG and HY and US HY suggesting a de-coupling is already underway.

Flows and foreign demand

There is a stark contrast between US and European flows in credit. US HY outflows over the last two years have erased all inflows post-crisis. EUR HY inflows have stalled as volatility has resurfaced, but has not switched to outflows. Breaking down the source of flows geographically, non-US demand for US HY has crumbled along with the price of oil, and is now focussed only on high grade credit. In contrast European HY has benefitted from both robust domestic and foreign demand.

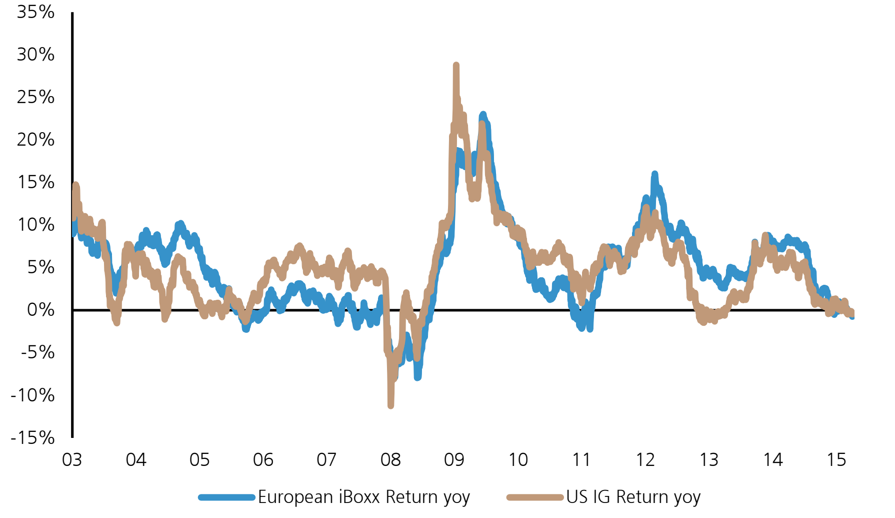
Figure 1: Divergence in default rates. Trailing 12-Month Issuer-Weighted Speculative Grade Default Rate in Europe and the US.



Source: Moody's, UBS

The effect of the fall in oil prices last year caused a selloff in the US HY market which has a large sectoral exposure in energy. However other macroeconomic factors, such as the strength of the US dollar, and slower and less commodity intensive growth in China have caused a more widespread problem in the lower quality segments of US High Yield (see "Non-Bank Liquidity Chilled by Macro Shocks", link). European credit spreads seldom escape unscathed if there is a widening in the US market, and this time has not been different (Figure 2). Put another way, in the 146 months since 2003 US IG has had a negative total return just 34% of the time, but in those months European credit had a negative total return 78% of the time.

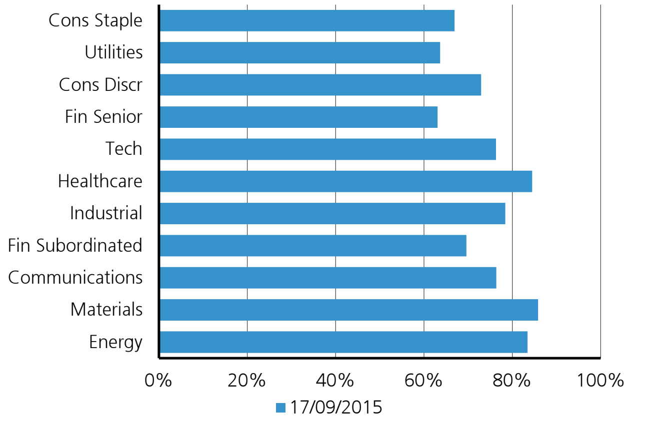
Figure 2: US investment grade (NBBITR Index) and European iBoxx corporate (QW5A Index) year-on-year returns in local currency.



Source: Bloomberg, UBS

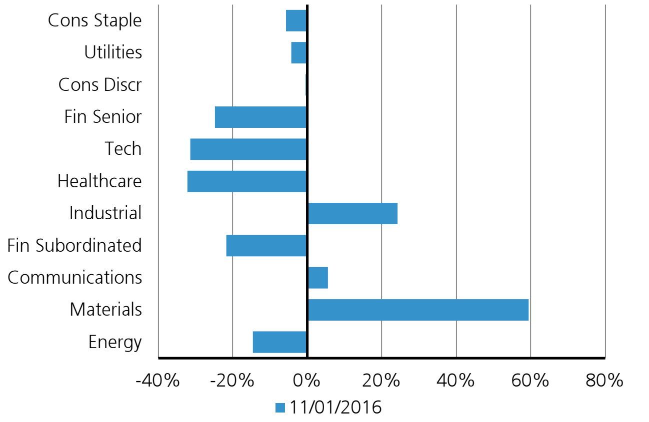
If we drill into the correlation of European credit spreads in IG and HY to US HY overall credit spread, it is clear that during the end of last year the correlation of all IG sectors to US HY spiked as European credit sold off in tandem (Figure 2). Since then all sectors, except Materials and to a lesser extent Industrials have de-correlated (Figure 4).

Figure 3: European IG sector correlation to US HY OAS spread over 90 day period ending Sept 17, 2015.



Source: Bloomberg, UBS

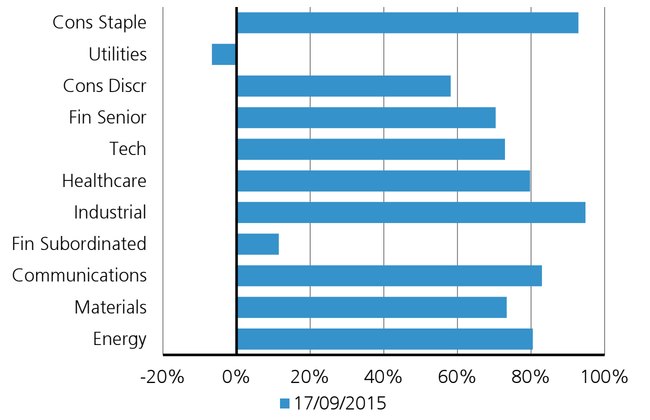
Figure 4: European IG sector correlation to US HY OAS spread over the last 90 days.



Source: Bloomberg, UBS

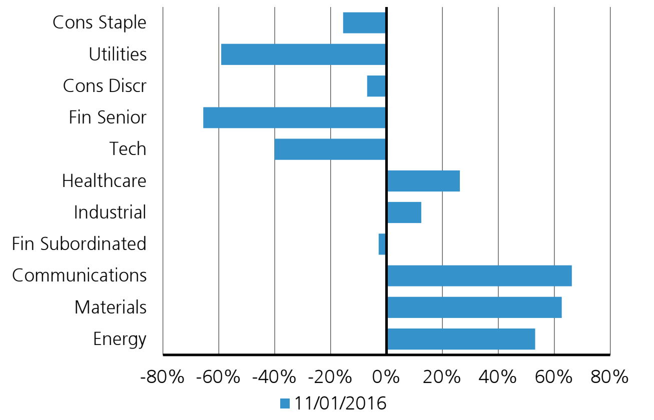
High yield tells a similar story with a twist. While all sectors sold off with US HY, the European Utilities and Subordinated Financials sectors were affected much less (Figure 5). Also in HY more sectors remain correlated with US HY, the obvious ones being Energy and Materials but also Communications.

Figure 5: European HY sector correlation to US HY OAS spread over 90 day period ending Sept 17, 2015.



Source: Bloomberg, UBS

Figure 6: European HY sector correlation to US HY OAS spread over the last 90 days.



Source: Bloomberg, UBS

Fundamental divergence

Given these high correlations it is easy to forget that many of the drivers of the US credit selloff are not shared, or are shared to a much lesser degree, by the European credit market. For example the exposure of the European credit indices to Energy is relatively small (5.7% for iBoxx IG, 8.3% for iBoxx Euro HY crossover) vs c16% for US HY (par weighted 12.6% Energy and 3.2% Metals & Mining) and c13% for US IG (par weighted 10.7% for Energy and 1.8% Metals & Mining). While dollar strength has been eroding the top line of US income statements the trade weighted euro has been weak and has boosted income for exporters. Furthermore overall credit quality in European HY is better than US HY: comparing ratings we see that US HY contains three times the amount of CCC, and one and a half times the amount of BB (Figure 7). Finally, policy remains accommodative in Europe while the Fed has begun its tightening cycle.

Figure 7: Comparison of US and European IG and HY (data as of Jan 11th).

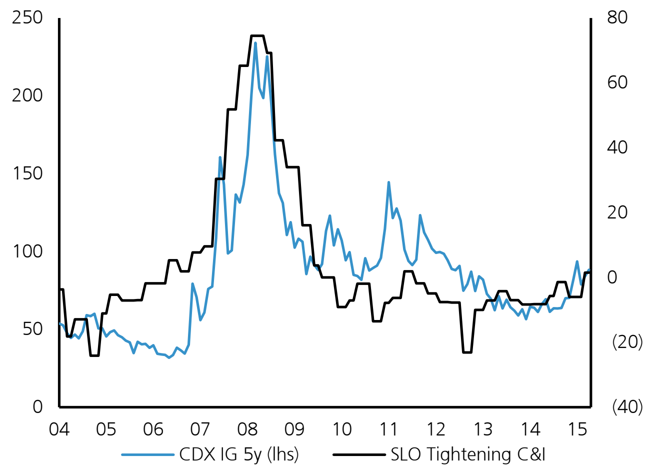
	US IG	EU IG	US HY	EU HY
Duration	6.9	4.9	4.5	3.4
Spread	171	161	763	548
Yield (carry)	3.55%	1.79%	8.77%	5.46%
Rating		Weight in index		
AAA	1.6%	0.5%		
AA	12.6%	12.7%		
A	36.8%	42.9%		
BBB	49.0%	43.9%		
BB			51.6%	72.0%
B			37.6%	24.8%
CCC			10.7%	3.0%

Source: Yieldbook, Markit iBoxx indices, UBS

In building our models for US credit spreads we found that the principal leading indicator was the C&I component of the Senior Loan Officers survey (SLDETGTS Index, see Figure 7). For Europe a comparable measure based on the ECB lending survey, which is the average of enterprise credit standards and expectation for enterprise credit standards, is also strongly linked to credit spreads in Europe (Figure 9) and at the moment clearly indicates easy and stable credit conditions. For the US however we have found that non-financial credit indicators suggest that credit conditions will tighten further (see "Credit Cycle Turning? Non-Bank Liquidity Hits Multi-Year Lows", Caprio and Mish, October 7th 2015). The proxy we use for non-financial lending is based on B-rated and lower bond market issuance as a percentage of AUM and trade credit standards (financing of inventories and receivables).

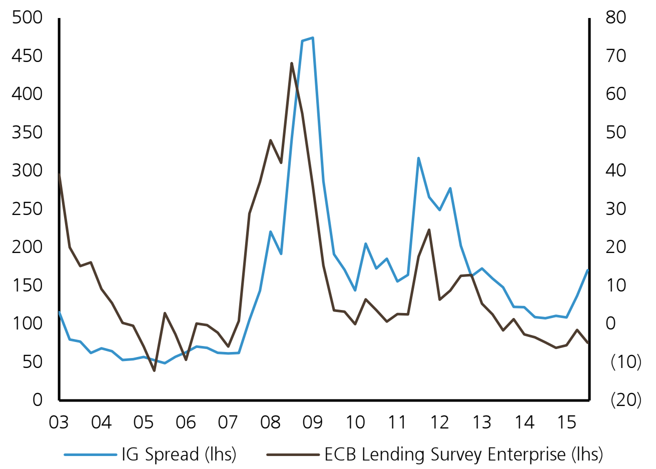
Easy credit standards in Europe, tightening in the US

Figure 8: US CDX HY spread vs SLO survey tightening C&I loans for small firms



Source: Datastream, Bloomberg, UBS

Figure 9: European IG cash spread vs ECB bank lending survey[1]



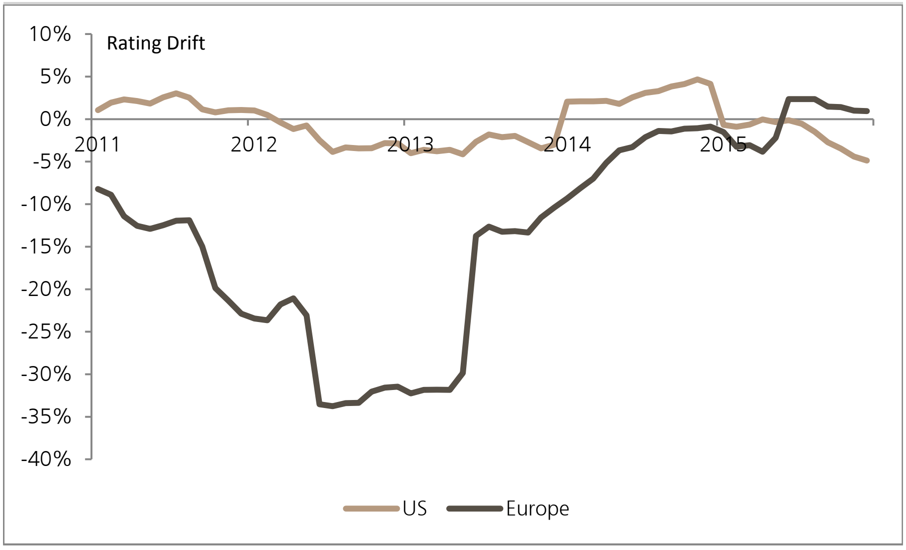
Source: Datastream, Bloomberg, UBS

If we want to get a handle on relative improvement in credit fundamentals between the US and Europe then we can compare the relative number of credit upgrades and downgrades over time by region. Ratings drift, which is the number of upgrades minus downgrades divided by the number of rated issuers, is shown in Figure 10. During the sovereign crisis Europe clearly suffered a spill-over effect of sovereign credit risk but this reversed sharply in mid-2013. Since the middle of last year the ratings drift has been positive in Europe whereas the US started to get downward drift at the same time.

Europe ratings drifting upwards, US drifting downwards

[1] Average of Enterprise credit standards and Enterprise credit standards expectations from the European Central Bank Lending Survey.

Figure 10: Issuer rating drift for US vs. Europe (number of upgrades minus downgrades over rated issuers over 12m period).

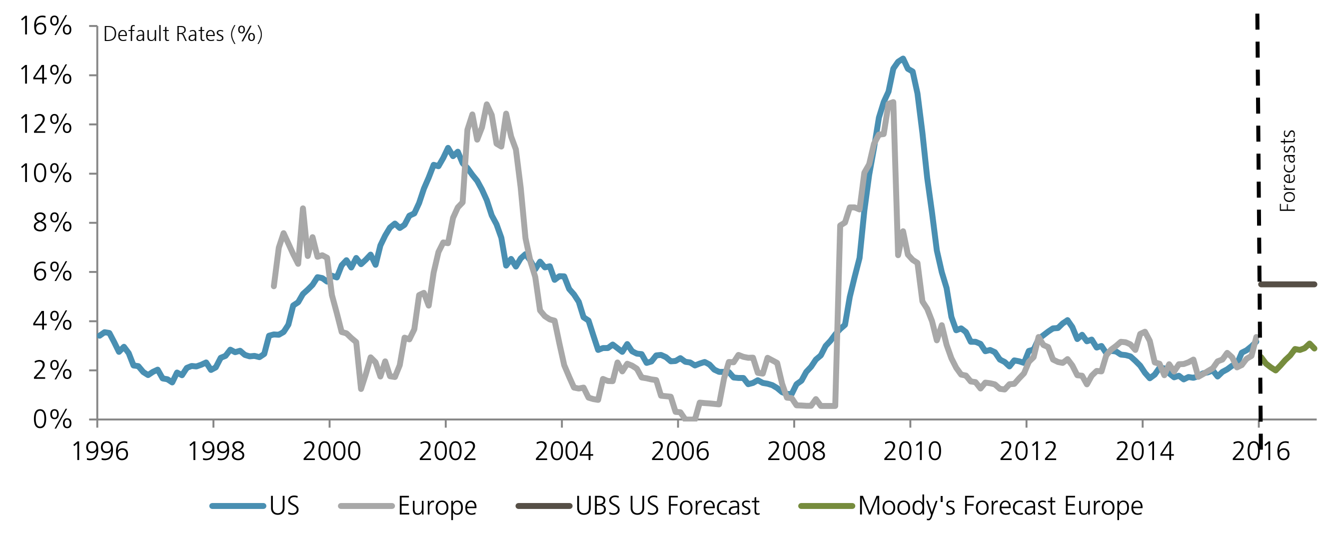


Source: Moody's, UBS

Moody's forecasts a divergence in HY default rates

Another comparison that is useful for exploring the link between US and European credit is realized and forecast default rates. For speculative grade credit the past two cycles have been tightly coupled with one another (Figure 11). We also show Moody's central case forecast for speculative default rates until the end of 2016 and this is where the two regions diverge sharply. We forecast that US default rate is forecast to reach 4%-5% by the end of this year whereas European default rates are forecast to reach 2.9% by Moody's.

Figure 11: Trailing 12-Month Issuer-Weighted Speculative Grade Default Rate in Europe and the US.



Source: Moody's, UBS

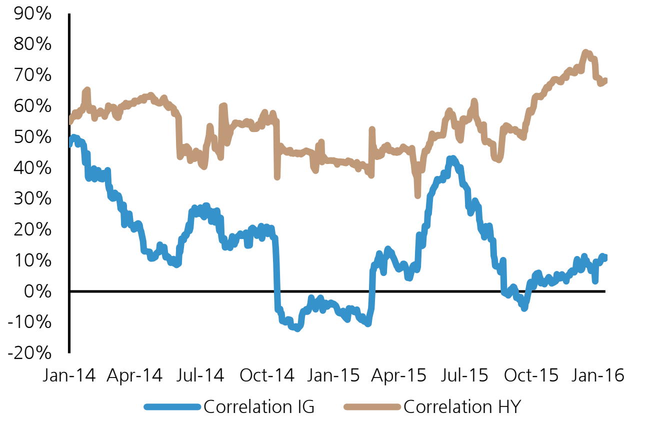
Beta of European credit to US HY credit is falling

If it is true that fundamentals are diverging then we might expect to see this reflected in market pricing. While the correlation of total returns[2] between European IG and HY to US HY are high (between 65% and 70%) and show little signs of falling, this is not true of beta. This has been steadily falling, even during

[2] US HY (NBBHTR Index), Europe IG (QW5A Index), Europe HY (EHYTCQRQ Index)

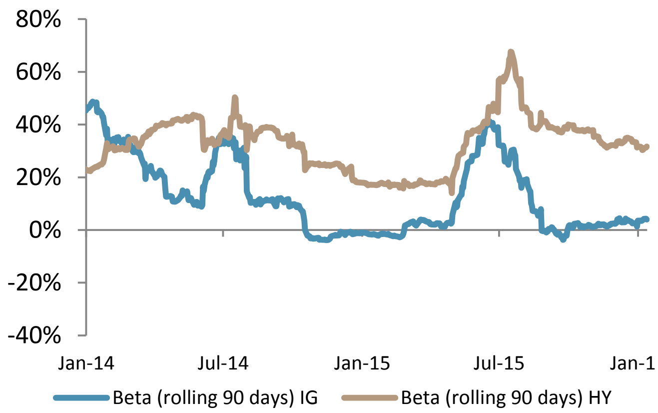
the large selloffs in US HY in Q4 last year. For European IG beta is close to zero and for HY it is now below 40%. This suggests that there are at least some signs that a de-coupling is starting to take place between the US and European credit markets.

Figure 12: Rolling 90 day correlation between US HY and European IG and HY (daily total returns).



Source: Bloomberg, UBS

Figure 13: Rolling 90 day beta of European IG and HY to US HY (daily total returns).



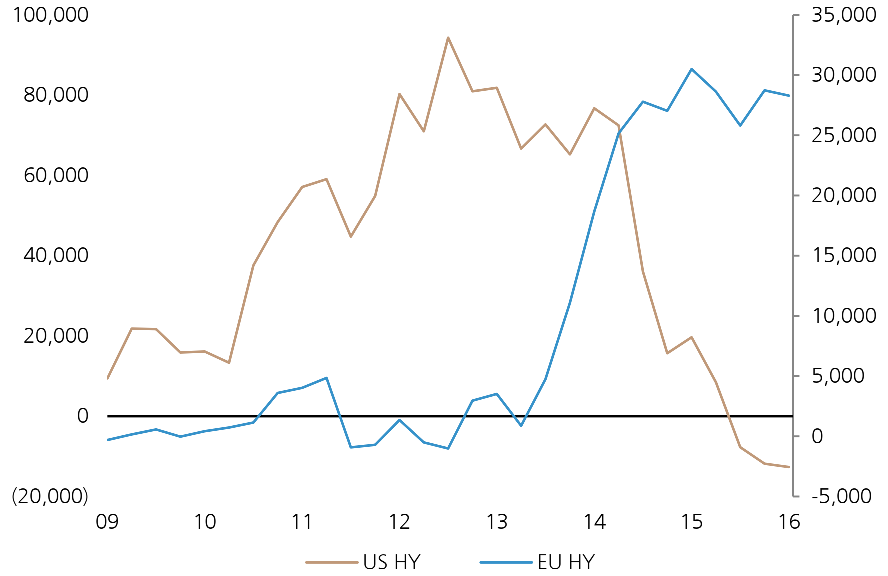
Source: Bloomberg, UBS

Flows

Flows are another area where the divergence between US & European credit is quite real and under-appreciated. The general story of US HY retail outflows is well-documented. However, are institutional US HY flows also receding? And are European funds seeing outflows of similar magnitude? We address the problem by looking at data on both retail flows (similar to Lipper/Morningstar for US/Europe, respectively) and institutional flows (managed via third-party mutual funds and separate accounts).

Figure 14 below shows cumulative flows into US & European credit since Jan 2009. The US-European divergence is stark. US HY outflows over the past 2 years have completely erased all of the inflows post-crisis. Since March 2014, US HY has experienced $80bn of outflows vs. $9.6bn of inflows into EUR HY. To be clear, inflows into EUR HY have stalled as volatility has resurfaced, but they have not systematically moved to outflows.

Figure 14: Cumulative Flows* into HY credit

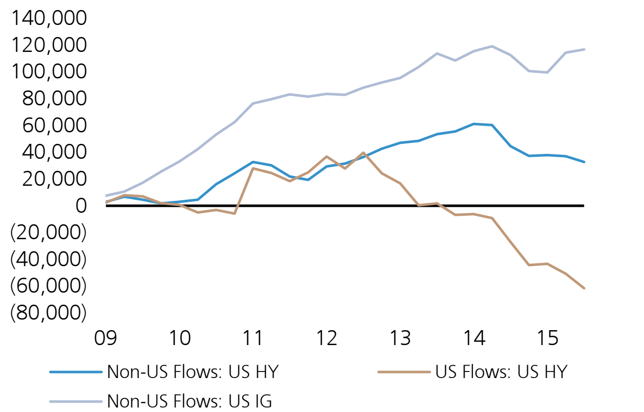


Source: UBS, eVestment, *Flows include both institutional and retail accounts

The slump in US HY is being aggravated by both domestic and foreign demand. The figures below look at flow per investor domicile (though only through Q3'15 due to data reporting lags). US investors have fled US HY, to the point where we estimate cumulative outflows may be -$60bn since January 2009.

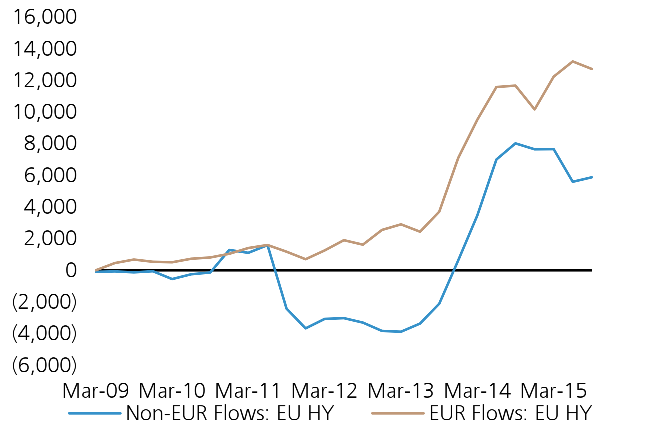
Foreign demand for US HY had been stronger, but has been cracking ever since oil started falling (cumulative flows have been halved since March 2014). For comparison, one can see foreign-domiciled flows into US high-grade corporates have been robust (Figure 15). The foreign bid for US credit is an investment grade story only. European HY on the other hand is benefitting from the presence of both healthy domestic and foreign demand that has been more resilient during the latest selloff (Figure 16).

Figure 15: Cumulative Flows* into US credit by domicile



Source: UBS, eVestment, *Flows include both institutional and retail accounts

Figure 16: Cumulative Flows* into EUR credit by domicile



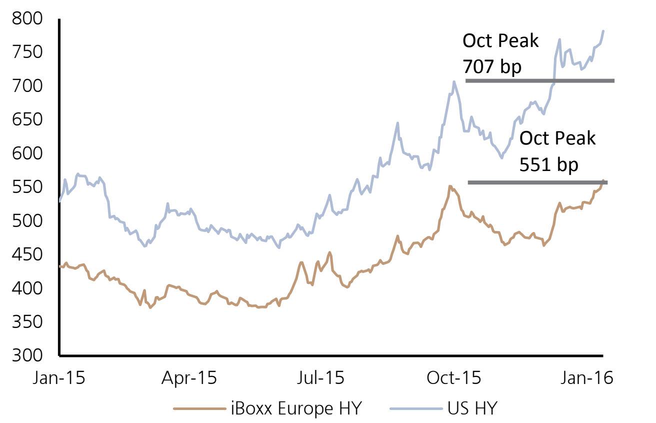
Source: UBS, eVestment, *Flows include both institutional and retail accounts

Conclusion

As we have described above several fundamental drivers of credit are moving in favour of European credit over US credit. But history shows that if oil stays at

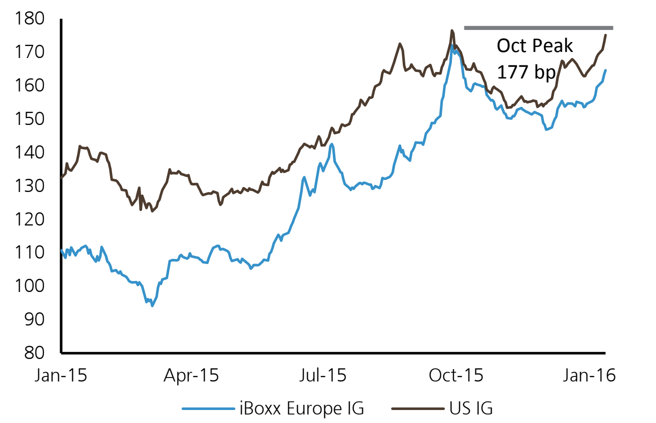
$31/bbl or lower and if the US continues to widen, then it is unlikely Europe will not follow suit. So it pays to look at what is priced in. Looking at cash spreads in IG and HY since the October selloff it is surprising how well European spreads have held their ground in HY. HY European spreads are only now widening to their October peak whereas US HY spread crashed through its peak in mid-December (Figure 17). For IG it is not so clear that the improvement in fundamentals is priced in (Figure 18). Both Europe and US IG peaked at around 180bp. Recently the US has almost reached its October peak and Europe is now widening rapidly in line with the US and so there is less evidence of decoupling that we would expect given our analysis. So in European HY we think the improvement in fundamentals is priced but for IG less so, and there will therefore be room for European IG to outperform US IG as a result.

Figure 17: European and US HY cash spreads.



Source: Reuters, Yieldbook, UBS

Figure 18: European and US IG cash spreads.



Source: Reuters, Yieldbook, UBS

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