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Western Europe

European Credit Weekly

How would ECB QE impact credit?

- **QE in the central scenario:** Our economists have made ECB QE in Q4 their central scenario. To raise the inflation trajectory sufficiently they believe a minimum of €1tr will be necessary.
- **Supply-demand imbalance:** QE on that scale would offset the effect of Fed tapering from a global perspective. The implication is that the severe supply-demand imbalance which has lifted asset prices in recent years would likely extend into 2015.
- **The impact on credit:** Future ECB purchases would likely have less effect on generic asset prices past rounds of Fed QE. However, credit might be more directly impacted given the prospect that the ECB would also target bank bonds, if not other corporate bonds.
- **Recommendations:** Be long € versus $ credit, be long financials (and add in senior), be long Eurozone over non-Eurozone issuers, be long the periphery, and reduce the preference for short maturity credit.
- **Tighter spreads:** We are lowering our end-2014 spread target on the iBoxx € corporate index to 80bp from 90bp, and on iBoxx € HY from 290bp to 265bp.

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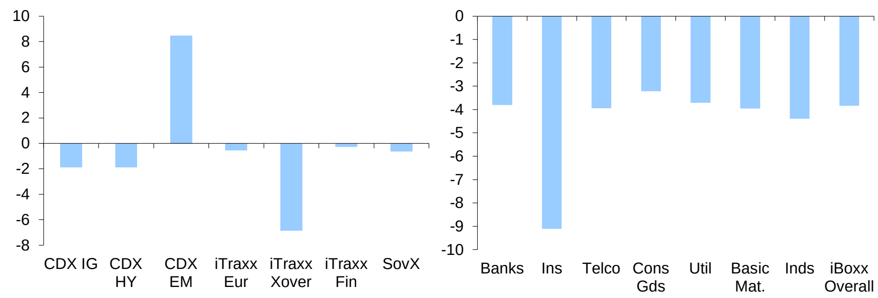
Figure 1. CDS and € iBoxx Cash Index Weekly Spread Changes, bp



Source: Markit, Citi Research.

How would ECB QE impact credit?

QE by the ECB this year is now the central scenario for our economists. On the back of the recent inflation data and the ensuing comments from Governing Council members, they see the ECB gradually laying the groundwork for QE from September or December. To lift inflation towards target they will likely have to buy €1tr or more.

We see few signs that this view is reflected in credit spreads currently, but it would have a profound impact if it comes to bear. Specifically, we reckon it means you should: be long € versus $ credit, be long financials (and add in senior), be long Eurozone over non-Eurozone issuers, be long the periphery, and reduce the preference for short maturity credit.

Below we'll take you through our thought process.

Is it already consensus? We don't think so. Anecdotally, only about 10% stuck their hand up to indicate that they expect ECB QE later this year in a straw poll at an investor presentation on the Continent this week. More persuasively, perhaps, there are no signs of European bonds outperforming other credit markets recently (if anything it's the opposite, as we discussed last week), so we see no indication that it is in the price – or rather the credit spread – at this point.

If our economists are right that it happens, and we are right that it's not consensus, then it ought to represent one of the clearest opportunities of the year.

When? Our economists believe the ECB will cut rates (and take the deposit rate negative) in June, along with an increase in liquidity and a further relaxation of collateral rules. If that fails to lift the inflation trajectory and weaken the € sufficiently, then they see a better than even probability of the ECB embarking on outright QE from September or December.

Much of the market impact might well come before that. In the two-week space between Bernanke hinting at QE3 at the Jackson Hole Symposium on 31 August 2012 and the actual announcement at the FOMC meeting on 13 September, US credit spreads rallied by 13bp and the S&P 500 rose by 4.5%. And some of the rally during July and August that year can probably also be ascribed to an anticipation effect.

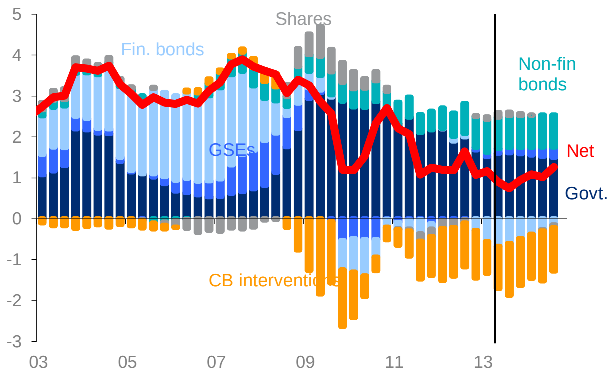
In light of the ECB's past penchant for "traffic light coding" (remember "monitor closely", "very closely", "strong vigilance"?), presumably the shift towards QE would be signalled more clearly one or two meetings ahead of the actual event. We'd expect European credit spreads to have reacted already by then.

How much? According to the Frankfurter Allgemeine Zeitung, the ECB has run simulations which suggest that €80bn of QE per month for a year would raise headline inflation by between 0.2-0.8%. On that basis, our economists reckon that €1tr of QE would be the minimum required to get the inflation trajectory back towards the ECB's medium-term objective of 'below, but close to, 2%".

What's the broader impact? Regular readers will know that we believe a huge imbalance in the supply of and demand for securities, created primarily by central bank interventions, has been the principal driver of market performance in recent years (Figure 1). The effect is most evident on the S&P 500, which continues to show a remarkably stable trending relationship with the size of the Fed's balance sheet (Figure 2). But over time, the performance of credit markets has also been strongly correlated with the size of the Fed's interventions (Figure 3).

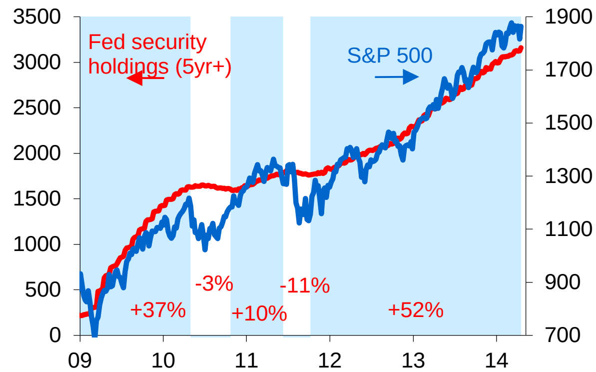
ECB QE of €80bn per month would be 30% more than the Fed did before tapering. This implies that growth in the global investible universe of securities would remain about two-thirds below its normal level even after the Fed has ended tapering going into 2015.

Figure 2. Net issuance of new securities vs. central bank* interventions, 12m rolling, $ tr (excluding ECB QE in 2014)



Source: Citi Research, Haver. * Federal Reserve, Bank of Japan, ECB.

Figure 3. S&P 500 vs Fed holdings of securities with a maturity of 5yrs or more



Source: Citi Research, Bloomberg, Haver.

Figure 4. Cum. weekly performance from 2009-14, by size of Fed interventions in $bn

	# weeks	US BIG (bp)	500 (%)	500 (pts)
>5bn	150	-289	58	700
<5bn	126	-10	20	233
<0	70	22	-6	-59

Source: Citi Research, Haver.

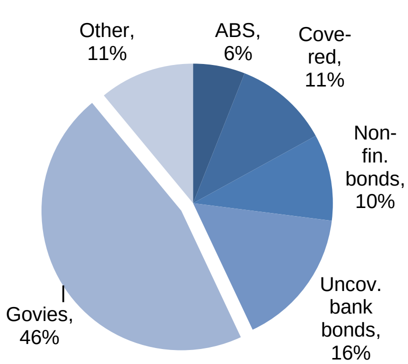
We have recently set out that the biggest risk to the medium-term outlook is a reduction in demand in response to a more hawkish Fed. But as we also argued, ECB QE increases the chance that a resulting correction would only be temporary – especially in European credit.

A diminished impact? Obviously, there are strong arguments why ECB QE might have a smaller impact on asset prices than previous rounds of QE. Economic conditions are considerably better at the starting point in both Europe and the US than they were around previous rounds. Accordingly, there are virtually no systemic risk premia in most markets to eliminate. Tight spreads make credit a less obvious destination for flows that have been crowded out from risk-free markets.

But for credit, there's one big caveat to that:

Would the ECB buy corporate bonds directly? Though it's a slightly complicated story, we suspect they might end up having to.

Figure 5. Eligible market assets in the Eurosystem, Q4-13



Source: Citi Research, ECB.

Numerous comments from Governing Council members have placed emphasis on private assets. For instance, ECB Vice President Vito Constancio recently stated that "*Private assets will be included in any decision [on QE] that may be taken*" and that "*it would make a slight difference with other policies in other central banks*".

While many ECB members clearly favour reviving SME lending and securitization markets, ABS and covered bond debt represent only 6% and 11%, respectively of the €14tr of outstanding market securities that are eligible in current ECB financing operations (Figure 4). SME ABS is only about 12% of total ABS.

Considering that much of this is already pledged to the ECB as collateral (43% of the ABS outstanding), it is hard to see how the ECB could purchase these near market levels on a sufficiently large scale to make a meaningful dent in the €1tr figure discussed above.

New securitizations could be created over time, but as we discussed recently, regulations and capital requirements currently hinder the process considerably. For

SME loans, in particular, the inherent riskiness of the exposure means that a considerable amount of overcollateralization would be necessary to leave the ECB with an acceptable level of credit risk. This in turn limits how much the ECB could bring down risk premia on the underlying loans, unless the instruments were bought far away from market levels.

Obviously, the ECB could decide to take more credit risk, but that would be rather controversial for a central bank. Considering that the ECB is only prepared to take essentially IG collateral in funding operations, where the principal risk is to the counterparty, is seems highly unlikely that the ECB would take HY or unrated risk outright. Assets purchased would almost certainly need an IG rating.

So if the ECB wanted a serious percentage of any QE programme to be made up of private assets, then it seems quite probable that that would have to extend beyond secured assets.

Unsecured bank debt would seem the most obvious candidate for them to turn to next. The rationale for lowering bank funding costs is obviously that: 1) it would facilitate further recapitalization (now that revenues from the periphery-sovereign-debt-carry trade are fading), 2) it would lower the rate at which is it efficient for banks to lend without distorting the market-based allocation of credit, and 3) that the ECB through its comprehensive assessment should have a decent insight into the quality of the collateral that it would implicitly be buying into.

Although more probable than we previously thought, we still think it is less likely that the ECB would extend any purchases to regular non-financial bonds. It might suit a political purpose, but from an economic perspective we struggle to see much merit in lowering what are already record low funding levels for the large investment-grade non-financials.

That said, even if the ECB chose not to buy them directly, by purchasing assets which fund managers hold interchangeably with non-financial bonds, the impact on non-financial spreads would be significant even at these tight levels.

And so what should you do then? As ever, we reckon the most obvious opportunities are in relative value:

- **Long € over $ credit** – Just as tighter Fed policy is negative for both $ and € credit, ECB QE is a positive for both markets, but we reckon it is more positive for € credit – especially against the prospect of direct intervention. So it strengthens our conviction in being long € credit. This applies both at a market level and to the €-denominated bonds of companies which issue also in $ and £.

- **Long Eurozone over non-Eurozone credits** – Within the € market, the ECB would presumably focus most of its purchases on Eurozone-domiciled issuers.

- **Long financials over non-financials** – It's consensus, but QE would be a powerful catalyst for further outperformance of financials, in part due to the fundamental impact but as much as anything due to the higher probability of direct purchases. We have been underweight senior unsecured bank bonds in the capital structure for a long time, but we would amend that stance if the prospect of QE hardens.

- **Long the periphery** – Again, it's a consensus position by now, but against the prospect that everything will squeeze even tighter it seems almost inevitable that more money would be forced into higher-beta IG assets, which would favour the periphery.

- **Would the ECB buy BBBs?** While the Bank of England also bought triple-B rated bonds, there is no guarantee that the ECB would not set the threshold at A- and above. Currently, there are €835bn of bonds in the iBoxx € index rated A- and above, versus €580bn of triple-B rated debt. However, the very point about helping periphery credits makes it unlikely that the ECB would exclude triple-B rated corporate assets.

- **Extend out on the maturity curve?** Spread duration has been our least favoured way of picking up carry this year. But if the ECB targeted the *"intermediate to longer part of the yield curve"* as Benoit Coeuré has indicated, then that would absolutely be the right thing to do. We would not yet deliberately overweight the long end of the curve, but we would no longer be short either.

- **Long IG over HY?** In absolute terms, we suspect that HY would outperform IG even if the ECB only bought the latter, due to the demand from funds crowded out from the IG market. However, in relative (beta-adjusted) terms you would expect IG to outperform. One way to express that view would be to revisit the Main vs. Crossover trade we discussed earlier this year.

Does it change our spread targets? Although the European corporate bond market is large, the free float is notoriously small.

The Bank of England only ever managed to buy about £3bn of CP and corporate debt at the peak of its asset purchase facility, before spreads reached a level where further interventions were deemed unnecessary.

The point that we are trying to make is that the ECB could push spread levels to almost whatever level it chooses, if it really decides to deploy its arsenal in corporate credit. We reckon it would be very difficult to buy even €50bn, let alone €100bn, of assets without causing severe distortions.

It really makes even more of a mockery of trying to set spread targets. For 2015 that may mean second-guessing the level at which the ECB would be satiated. But given that the purchases are likely to commence only towards the end of the year, the main impact on end-2014 targets is probably the anticipation effect.

Accordingly, **we are lowering our end-2014 spread target on the iBoxx € corporate index to 80bp from 90bp**, while we think the sympathy impact would lower the spread on **iBoxx € HY from 290bp to 265bp**.

The Week Ahead (Joseph Faith)

While escalating tensions in Ukraine are likely to continue to dominate the headlines next week, a busy earnings schedule in both the US and Europe and some important data releases will compete for investors' attentions.

The earnings season will remain in full swing, both for the financial sector and more broadly. With markets having been boosted by strong performance from US tech companies this week, investors will be waiting to see whether the pace can be maintained.

On the data front, the most important item out of Europe next week will be the Eurozone CPI figure, out on Wednesday. Given both increased expectations that that the ECB will launch a QE programme later this year and Draghi's comments that last month's four year low CPI figure of 0.5% was driven by temporary factors

such as lower energy and food prices and the timing of Easter, the market will be playing close attention to see whether the CPI meets its consensus forecast of 0.8% in April.

On Tuesday, the consensus expects the advance reading for UK Q1 GDP to have risen to 0.9% QoQ, compared to 0.7% in Q4 last year. Our economists expect an even more robust 1.0% expansion. Given the tide of cheap money and reduced headwinds from private deleveraging and fiscal expansion, our economists expect growth to remain high throughout this year.

There’s unlikely to be any policy surprises from the FOMC, which meets on Tuesday and Wednesday, and which will almost certainly taper by another $10bn. But in light of the growing attention being paid to shifts in the US policy cycle, which we regard as the most serious test spreads have faced in several years, investors will be watching the post-meeting statement closely.

US data releases mostly look set to paint a picture of relatively robust growth, as the economy shakes off the mostly weather-related weakness that is expected to have dragged down Q1 GDP growth, out on Wednesday, to 1.1% annualised, its slowest pace in more than a year.

The consensus expects US Consumer confidence on Tuesday, to have risen to its highest level in six years, as the job market improved and temperatures warmed. And on Thursday, both US Consumer Spending and ISM Manufacturing are expected to show healthy growth, with consumer spending boosted by a rebound in auto demand, and improving business investment likely prompting factories to have increased production.

And finally, we’ll have US Non-Farm payrolls data on Friday, with the consensus expectation for a 210k increase (the fastest pace of growth for five months) likely to confirm the relatively benign picture.

Key Economic Indicators (28 April – 2 May 2014)

Tuesday 29 April	Consensus Forecast	Last
UK GDP (QoQ, YoY)	0.9%, 3.2%	0.7%, 2.7%
Eurozone M3 Money Supply YoY	1.4%	1.3%
US Consumer Confidence	82.8	82.3
Wednesday 30 April	Consensus Forecast	Last
Eurozone CPI Estimate YoY	0.8%	0.5%
US Q1 GDP QoQ	1.1%	2.6%
Chicago PMI	56.5	55.9
FOMC Rate Decision	0.25%	0.25%
Fed QE3 Pace	$45bn	$55bn
Thursday 1 May	Consensus Forecast	Last
US Consumer Spending	0.6%	0.3%
ISM Manufacturing	54.2	53.7
Friday 2 May	Consensus Forecast	Last
US Non-Farm Payrolls	210k	192k
US Unemployment	6.6%	7.7%
Eurozone Unemployment	11.9%	11.9%

Source: Bloomberg

Earnings Releases (28 April – 2 May 2014)

Monday 28 April
Holcim, Swedbank, Bayer, GDF Suez, Bankia, Corning
Tuesday 29 April
Nordea, Pohjola, Statoil, Sanofi, Eni, Svenska Cellulosa, Fortum, Atlas Copco, Bristol-Myers Squibb, Deutsche Bank, Merck, America Movil, Enagas, Luxottica, Nokia, Santander, Goodyear, Gazprom, Marriott, eBay, BP, Itau Unibanco
Wednesday 30 April
ABB, Handelsbanken, BNP Paribas, Daimler, Iberdrola, Vale, MetLife, BBVA, SpareBank, Red Electrica, Rexel, Cemex, Banco Popular, Abengoa, Total, Yara, Nomura, Barrick Gold, Time Warner, Thomson Reuters, Vale, MetLife, Air France-KLM
Thursday 1 May
BskyB, Teva, Dong Energy, Danske Bank, Lloyds, Bombardier, ConocoPhillips, Marathon, Kellogg, Legg Mason, Western Union, Expedia, Viacom, Kraft
Friday 2 May
BASF, RBS, Chevron, Marsh & McLennan, CVS, Macquarie

Source: Bloomberg

Recent Research Publications	Author	Date
European Credit Research		
When will the credit cycle turn?: And would spread actually widen?	Hans Lorenzen	April 24, 2014
ECB and BoE on Euro ABS Recovery: Doctor is there but only some will get treated	Ratul Roy	April 14, 2014
European Credit Derivatives – Views and Trades: Index tightening overdone? What are the best carry trades?	Abel Elizalde	April 8, 2014
When will the credit cycle turn?: Long on borrowed time	Hans Lorenzen	April 2, 2014
CreditBrief: What didn't happen	Joseph Faith	April 2, 2014
Global Credit Survey: Go with the (in)flow	Joseph Faith	March 31, 2014
Where do we expect iTraxx rolls to trade?	Abel Elizalde	March 19, 2014
Beta of European Financials to US Corporates looks underpriced	Abel Elizalde	March 18, 2014
Looking for carry but afraid of adding more outright longs?	Abel Elizalde	March 11, 2014
European Credit Sector Recommendations: Walking a Tightrope	Teresa Cascino	March 11, 2014
Credit Brief: Unfazed	Joseph Faith	March 4, 2014
Global Credit Survey: Time for a Trim	Joseph Faith	February 28, 2014
European Credit Derivatives – Views and Trades: Slow grind tighter from here – what are the best carry trades?	Abel Elizalde	February 27, 2014
New 2014 CDS Definitions: What's new? What's changing? Why? When? How?	Abel Elizalde	February 26, 2014
Corporate Leverage: Should you be worried?	Hans Lorenzen	February 24, 2014
iTraxx Tranches Views & Trades: Sell equity protection and sell straddles	Abel Elizalde	February 20, 2014
Options vs. curves: playing with tail risk	Abel Elizalde	February 13, 2014
iTraxx Roll – Potential Changes	Abel Elizalde	February 10, 2014
European Credit Derivatives – Views and Trades: Time to add risk	Abel Elizalde	February 4, 2014
European Credit Sector Recommendations: "Yes" with reservations	Teresa Cascino	January 24, 2014
Sell vol in iTraxx Main to make some carry in the near term	Abel Elizalde	January 21, 2014
European Credit Outlook 2014: (Positioning & Trades)	Hans Lorenzen	January 17, 2014
European Credit Outlook 2014: The Year of the Greater Fool's Game? (Strategy)	Hans Lorenzen	January 17, 2014
European Supply Outlook 2014: Acceleration with a hybrid engine	Joseph Faith	January 15, 2014
US Credit Research		
US Credit Derivatives View: What to do now?	Anindya Basu	April 15, 2014
How To Find Value In Credit Options?Relative value across strikes and maturities	Anindya Basu	April 11, 2014

Source: Citi Research

Appendix A-1

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