

August Supply Update

Junk-y Supply Keeping Issuance High

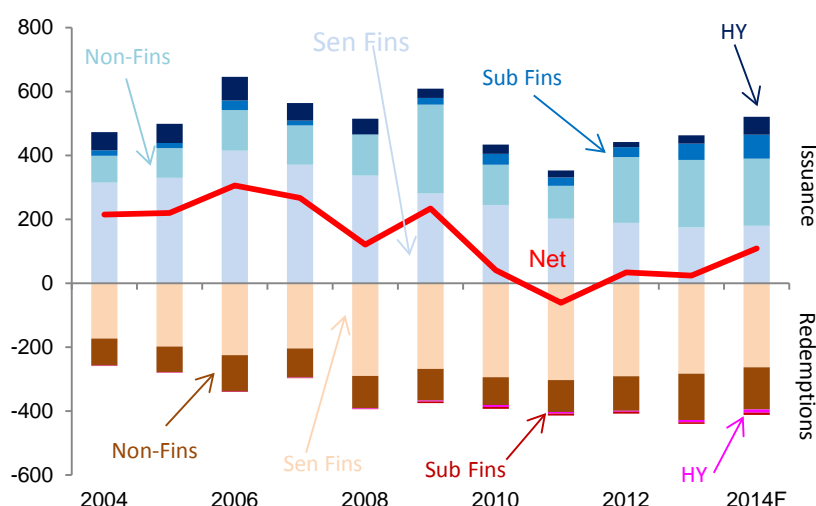
- € corporate supply, at €353bn YTD, is the highest total for the period since 2009, with record issuance from the riskiest parts of the credit spectrum: HY and hybrids.
- The key trends we highlighted in [January](#) are playing out: senior bank issuance has remained relatively subdued and low funding costs in € relative to \$ and £ have led to a massive increase in € supply from issuers outside the Eurozone.
- But with much of this year's refinancing done already, a slowing maturity schedule and the issuance climate less favourable than it was, primary activity over the rest of the year is unlikely to reach H1 levels, in our view.
- Besides HY, where our new €75bn FY target is €20bn above our previous one, we've slightly reduced all the rest of our 2014 forecasts. We now expect €521bn of gross issuance across IG and HY in 2014, down €26bn from our January estimates. This implies €109bn of net issuance this year – €85bn more than in 2013.
- At €11bn/month, the net issuance we expect over the rest of 2014 is slightly ahead of the €8bn of monthly net issuance we've seen to date. Although this small increase is unlikely to have a significant impact on spreads, it does raise the probability of another supply-driven wobble, like we saw in June, if the volumes end up uneven.

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Figure 1. €-Denominated Corporate and Financial Supply, Fixed and Floating, € bn



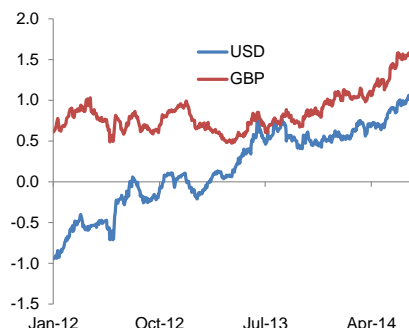
Source: Citi Research, Dealogic

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Figure 2. Yield Differential vs €, iBoxx A 3-5yr Bucket, %



Source: Citi Research, Markit

The €353bn of €-denominated corporate bonds issued so far in 2014 represents the highest total for the period since 2009 and is 30% more than was issued during the equivalent period last year. As we predicted in our January supply outlook, much of the increase is attributable to the riskiest market segments: HY and sub debt. Yet with the run-rate over the rest of the year unlikely to meet H1 levels, we've revised most of our full-year forecasts down slightly. We now expect €521bn of gross issuance across IG and HY this year, which is €109bn in net terms. This would be roughly double the €53bn of net issuance we've had year-to-date and €85bn more than last year.

The trends we highlighted in [January](#) have been playing out. Despite the relatively subdued fundamental backdrop, issuance conditions in the Eurozone have mostly been favourable. The decline in the relative cost of issuing in euros versus other currencies (Figure 2) has led to increased issuance from non-Eurozone issuers, particularly in non-financials.

Volumes are up in corporate hybrids, which have now become an established part of many companies' funding kits. Bank sub debt issuance has ballooned, with clarity on the new regulatory regime assisting banks as they strive to meet Basel III capital requirements. And conventional High Yield issuance has seen a structural shift, with a record number of first time issuers coming to market as bond markets opened up to low- and un-rated borrowers while bank lending in this segment has remained constricted.

Figure 3. Fixed & Floating Corporate Supply, 2014 FY Projections, Local Currency, bn

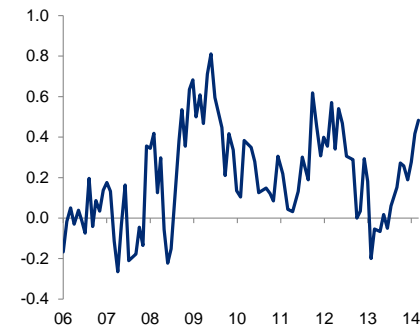
		--- Gross issuance ---				Redemptions		Net iss.
		2013	YTD	Jan Forecast*	Updated Forecast	Chg	2014	2014F
Euros	Corporates	211	142	234	210	-24	132	78
	Senior Fins	175	124	193	180	-13	263	-83
	Tier II	24	27	45	40	-5	7	33
	Tier I	3	9	20	16	-4	-	-
	HY*	51	51	55	75	+20	10	65
Sterling	Corporates	17	12	20	18	-2	11	7
	Senior Fins	10	6	12	10	-2	9	1
	HY**	11	7	13	13	-	1	12

Source: Citi Research, Dealogic, *Adjusted for database changes, **Non-Financials only

Although we expect issuance volumes to pick up again after the summer lull, we reckon that the busiest periods of primary activity in 2014 are behind us. Financial issuance in particular is likely to slow in the run-up to the release of the AQR and stress tests results. Non-financials too have seen much of this year's refinancing done already. And though the jump in M&A volumes and an increased pace of buybacks should generate some issuance too, we suspect this will be insufficient to fully offset the decline in refinancing.

Recent weeks have seen a deterioration in the backdrop for spreads, particularly due to the prospect of reduced central bank support going forward. And with the riskiest segments of the market responsible for the overwhelming majority of the expansion in net issuance this year, it's here that the decline in risk appetite is likely to have its most significant impact in terms of restraining primary activity. Yet with inflows resilient (Figure 5), and yields nearing record lows, reasonably-priced new issues should continue to find ready buyers over the rest of the year.

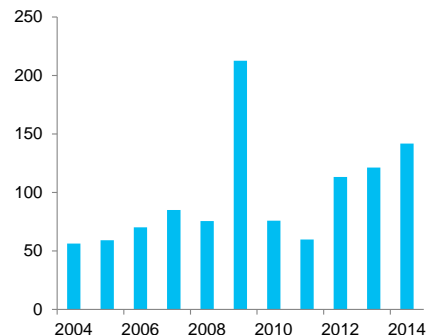
Figure 4. Reported Real Money Inflows, €
Real Money Accounts (Index, +2 Large
Inflows, -2 Large Outflows)



Source: Citi Research

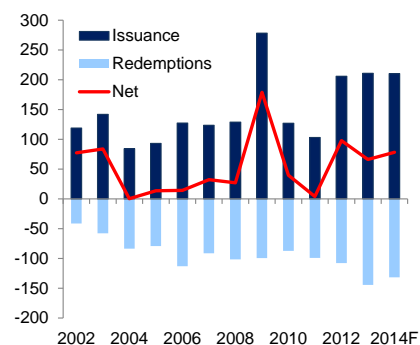
Non-Financials

Figure 5. € IG Non-Fin Issuance YTD in All
Years, bn



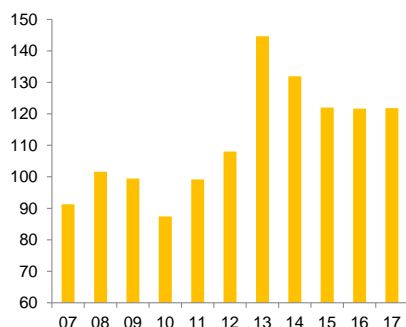
Source: Citi Research, Dealogic

Figure 6. € IG Non-Fin Issuance, bn



Source: Dealogic, Citi Research forecasts

Figure 7. € IG Non-Fin Redemptions, €bn



Source: Citi Research, Dealogic

The €142bn of non-financial issuance we've had year-to-date is 17% above what we saw over the equivalent period last year. The trend in sterling has been similar, with the £12bn issued to date, 35% more than over the equivalent period in 2013. Much of the issuance we've seen has been driven by refinancing, with 2014 the year when many of the bonds issued in record-breaking volumes in 2009 are coming due (Figure 8). The healthy pace of Eurozone corporate issuance means that much of the considerable amount of debt coming due this year has been refinanced already, and this is likely to result in a diminished pace of primary activity going forward, and we've revised down our full-year issuance forecast as a result.

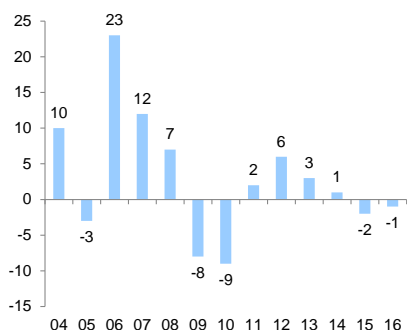
There's been a striking increase in FRN issuance this year, with the €12bn YTD total the highest we've seen over the period since 2007. This is partially a function of the gradually improving economic backdrop as investors seek to protect themselves against the prospect of rising rates in the years ahead. One key buyer of FRNs has been bank treasury desks, whose increased risk appetite this year has led them to venture beyond lower-return CP. That said, with European rates now looking like they will remain "lower for longer", especially if the ECB moves towards further easing, we expect demand for FRNs to moderate slightly over the rest of the year, and we remain comfortable with our original FY forecast of €19bn for the product.

There's been a notable increase in the average maturity in bonds issued relative to recent years. 46% of the non-financial bonds issued so far this year have a maturity of 10 years or more, compared to an average of 29% over the last decade. Issuers have been keen to lock in the low-rates currently on offer for as long as possible and yield-hungry investors have displayed a strong appetite for moving further along the maturity curve.

As opposed to HY, where disintermediation has played a large role in driving up primary volumes to record levels (see below), this process has had a far smaller impact on the IG market so far this year, as we predicted in our [January Supply Outlook](#). Most of the larger Eurozone corporates are at or near their desired ratio of bank-to-bond funding, and there's been relatively little supply from first time European issuers.

Capex growth has made only a small contribution to issuance so far this year. While S&P expects a growth rate of 1% in capex this year relative to 2013 (Figure 9), this overall figure conceals some marked differences between sectors, with Energy in

Figure 8. Projected Non-Fin Capex Growth in W. Europe, YoY%



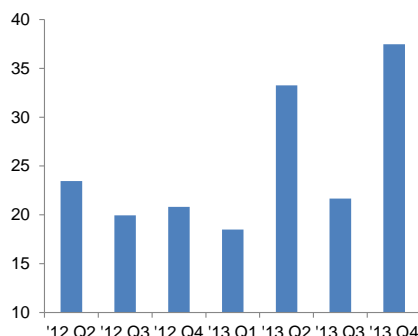
Source: S&P Capital IQ

particular seeing a decline in capex, while spending in Autos and Telecoms is increasing.

We've already seen a rise in primary activity in the latter two sectors relative to 2013, and we expect this to remain the case over the rest of the year. Given expectations for capex shrinkage next year, the risks of our revised forecasts being materially exceeded due to a wave of issuance to finance increased fixed investment are limited, in our view.

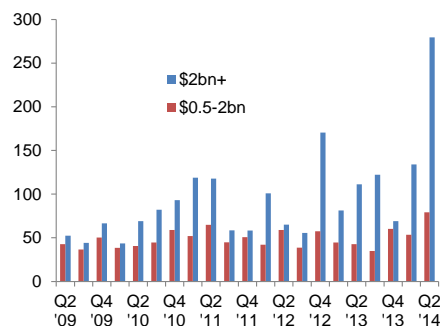
The pace of share buybacks has increased in recent quarters (Figure 10), and this has contributed to issuance volumes too. We see scope for this accelerating further in H2. Buyback volumes have been negatively impacted by corporates' caution over the potential impact on their rating profiles. We don't expect this caution to dissipate entirely, and we doubt buybacks will approach the record levels seen recently in the US. That said, we reckon companies will increasingly favour shareholder-friendly activities to support equity prices, particularly given the uncertain earnings outlook, and this should prove supportive for issuance going forward.

Figure 9. Buyback Volumes by Quarter, Stoxx 600, € bn



Source: Citi Research, Bloomberg

Figure 10. European M&A Volumes, \$bn



Source: Citi Research, Bloomberg

M&A has surged in Europe this year (Figure 11), with the Telecoms sector leading the way, as we forecast at the beginning of the year. Conditions for financing large deals look set to remain mostly favourable, so volumes are likely to increase further. While there's been only a slight increase in smaller \$500mn-\$2bn deals, for which transaction volumes in Europe have increased only slightly from last year, the volume of \$2bn+ "mega deals" has grown dramatically.

Yet many of these have been stock-funded as companies have taken advantage of higher equity prices to fund acquisitions. So the increase in M&A-driven issuance in the IG space has been smaller than the deal volumes would suggest. Given both the trend to fund deals with stock and considerable uncertainty as to how many of them will actually be executed over the coming months, we think the upside risk that M&A-driven issuance poses to our IG forecast is relatively low.

Only €7bn (31%) of the increase in supply relative to last year is attributable to Eurozone corporates. The fact that so many foreign names have opted to issue in euros this year is a reflection of the low cost of swapping euros into dollars, as reflected in the evolution of the basis swap over the last few months. To our minds, a potential acceleration of this trend poses the key upside risk for our FY forecasts.

It's not just US and UK corps who have been issuing more in euros – there's been an 80% increase in euro-denominated EM supply too. Besides the relatively lower

cost of issuing in euros, these corporates have benefitted from the improved EM climate, as illustrated by the massive rally in EM corporate spreads over the first half of the year (Figure 12). Despite the recent increase in geopolitical risks, we reckon that the ability to issue of EM corporates not based in domiciles subject to western sanctions is unlikely to be significantly impinged.

Corporate Hybrids

As we forecast in our outlook, corporate hybrids have been a key engine of growth for supply this year. The €17bn of issuance year to date is the highest figure on record, and 43% higher than over the equivalent period last year. Hybrids are being used by issuers in a broader range of industries: only 55% of hybrid issuance YTD has come from the Telecoms and Utilities sectors, while they accounted for 84% of supply of the product over the equivalent period in 2013. Hybrids have become increasingly accepted as a regular part of corporates' funding toolkits, as templates have standardised and rating agencies' attitude towards the product has become more predictable.

Hybrid issuance has also benefitted from the increase in M&A volumes. Issuers have been attracted by the instrument's 50% equity credit, which helps protect credit metrics, with Bayer's debut hybrid issued to fund the purchase of Merck's consumer care business a recent example. As we argued in a recent [weekly](#), investors' demand for the product is likely to remain strong over the rest of the year, especially given how much spreads have lagged the rally in subordinated financial debt.

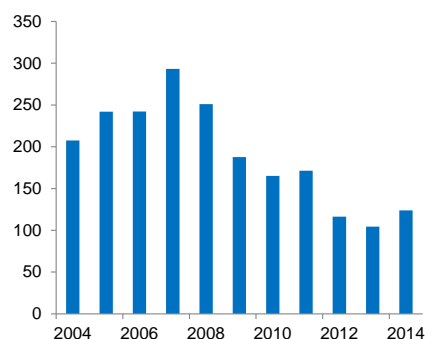
Senior Financials

Figure 11. CEMBI Spreads to Bchmrk, bp



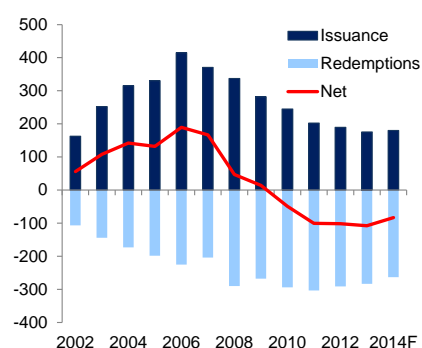
Source: Citi Research, Bloomberg

Figure 12. € IG Senior Fin Issuance YTD in All Years, bn



Source: Citi Research, Dealogic

Figure 13. € IG Senior Fin Issuance, bn



Source: Citi Research, Dealogic

Although the €124bn of senior financial supply YTD represents a 21% increase in gross terms relative to last year, net issuance so far this year remains deeply in negative territory (-€68bn), as banks continue to deleverage and focus on building up capital ahead of the onset of the Basel III regime. Gross supply volumes have been slightly below the run-rate we expected for this year and we've revised our full-year forecast down to €180bn, from €193bn, as a result. The trend in sterling is similar. With £6bn of senior supply so far this year, we've revised our original £12bn full-year forecast down to £10bn.

Yet, while sterling senior supply is roughly in line with last year's levels, UK banks have dramatically increased their euro senior issuance, as the relative

attractiveness of issuing in the currency has increased. The €17bn they have issued YTD is more than double the amount over the equivalent period last year.

FRN supply, at €52bn, is roughly commensurate with our original expectations for €70bn of supply for the year as a whole. As for non-financials, we expect new FRN issuance to moderate over the rest of the year due to decreasing concerns about rising rates in Europe.

Despite the increase in issuance YTD relative to the equivalent period last year, we see little evidence that banks' need for senior funding per se has increased: there's been a continuation of the shrinkage in Eurozone bank lending, and deleveraging has continued albeit at a slower pace than in previous years, with banks reducing their assets by €66bn in the first four months of the year, according to the ECB. Instead, to our minds it was the benign conditions prevalent over most of H1 which encouraged issuers to bring forward some of their H2 financing needs.

With issuance for refinancing purposes to slow going forward as result and many banks likely to take up the ECB's offer of cheap TLTRO-funding, we expect senior supply to remain below the €20bn/mth average seen in H1 even after once issuance resumes after the summer. In particular, we can expect primary activity to slow in the run-up to the AQR and stress tests. However, given the leniency of the stress tests' "stressed scenarios" there's likely to be little in the results to increase investors' perception of risks to senior unsecured bank debt, and consequently we still think senior issuance is likely to pick up from its summer lows in the final third of the year.

The €23bn of issuance from periphery financials YTD is almost double the amount we had over the equivalent period last year. The massive rally in periphery spreads over 2013 meant that more mid-tier periphery institutions have been able to access the market than previously. Yet, as we've argued [elsewhere](#), given how much they've rallied in the last couple of years, periphery bank spreads are likely to struggle tightening through their levels of a couple of months ago, even if they do retrace their recent widening, as we think likely.

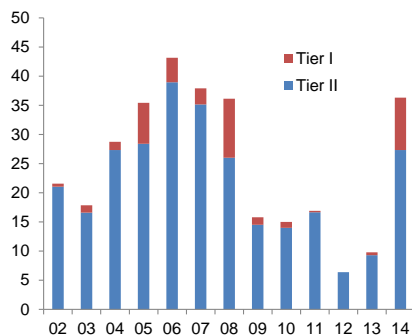
As with non-financials, the receptive investor base and low cost of swapping euros into dollars (Figure 15) have led to a marked increase in senior issuance from non-Eurozone issuers, which, at €48bn, is 60% more than the €30bn seen over the equivalent period last year. If anything, we think the pace of non-Eurozone issuance has scope to increase further: both the US and UK are on a rising rates trajectory, while our rates strategists expect Eurozone yields to remain near their current lows for the rest of the year.

Figure 14. EUR-USD 5yr Basis Swap,bp



Source: Citi Research, Bloomberg

Figure 15. € Sub Fin Issuance YTD, bn



Source: Citi Research, Dealogic

Subordinated Financials

At €36bn year-to-date, Euro sub financial issuance is at its highest level since 2007. Sterling has seen a similar increase, with the £7bn of new bonds launched more than triple the amount issued over the equivalent period last year. Bank capital issuance had stalled over the previous couple of years, despite the onset of increased capital requirements under Basel III, due to a highly uncertain regulatory environment. The passing of CRD IV in June of last year helped clear up this uncertainty, and issuance has shot up since.

Yet the issuance environment has been highly dependent on sentiment, and the BES story, among other negative headlines, catalyzed an earlier-than-expected start to the summer lull in sub debt issuance. Consequently, the €27bn of euro Tier

II issuance YTD is slightly below the run-rate we originally expected, and we've revised our FY forecast down as a result. Demand for new Tier II paper has been strong, as illustrated by the relatively consistent contraction in yields year to date. In periods of comparative calm demand for the product should remain steady, especially due to the large number of investors who are bound by their mandates to stick with "must pay" coupons, with insurance companies in particular acting as a key buyer base.

As discussed above, it's unlikely that the stress tests will lead to much senior bank debt being bailed-in this year, and this gives banks in Europe less impetus to issue Tier II debt to increase the buffer for their senior bondholders. That said, they still have a considerable way to go to meet capital requirements under Basel III, and this should mean that the pace of Tier II primary activity remains relatively strong in the latter part of the year.

It's in the most junior capital instruments that the jump in issuance has been most evident. We saw quite a few new-style AT1 instruments being launched at the tail-end of last year, although only a couple were in euros, but it's in 2014 that supply of the product has really taken off. European banks have issued €20bn of AT1 bonds across currencies, of which €9bn has been in euros, with most of the rest in dollars.

The investor base for these instruments has also broadened considerably since last year. While a small proportion of AT1 deals are still being sold to Asian retail investors, European investors have accounted for over 80% of the buyers for most of the recent euro-denominated AT1 deals. Many European real money mandates have been expanded to accommodate the risk of equity conversion or write-down.

While at first AT1 issuance was dominated by "national champion" banks from the core, we've since seen more deals being launched by mid-tier, peripheral institutions. Although the BES saga has thrown peripheral AT1 issuance off course for now, we expect issuance to resume later this year, particularly once the stress tests and AQR are concluded.

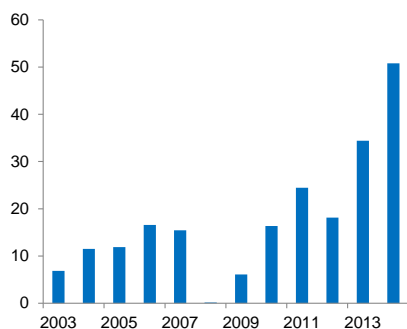
It was only in April that the German finance ministry confirmed the tax-deductibility of AT1 instruments, and the Netherlands has yet to do so; there are still many banks in the core which have yet to begin their AT1 issuance programmes, and we expect to see more supply from them too. We've recently seen an increase in AT1 from UK banks. In particular, Barclays' successfully executed AT1 exchange in June is likely to encourage others to follow suit.

AT1 issuance is, however, still vulnerable to bouts of regulatory-driven uncertainty. Indications that other jurisdictions are tempted to follow the UK's example in considering setting limitations on usage of AT1 in the leverage ratio would likely slow the pace of supply.

High Yield

The €51bn of HY issuance we've seen so far already amounts to over 90% of our previous full-year forecast. The benign funding conditions that have spurred elevated IG issuance have had an even greater impact in HY, and unrated issuers, previously a niche segment, have become an established part of the HY market as a result. Demand for the product has been high over most of this year: according to Lipper, HY average monthly fund flows in the first five months of the year were almost triple what they were a year earlier.

Figure 16. € Non-Fin HY Issuance YTD in All Years, bn



Source: Citi Research, Dealogic

With record low yields on offer in the IG space, issuers were able to capitalise on a broad-base of return-hungry investors, and issuance expanded accordingly. That said, the recent underperformance of HY spreads relative to their IG counterparts indicates that investors' assessment of the product has tempered somewhat. We attribute this, at least in part, to growing concerns about HY valuations, particularly given the loosening in borrowing terms witnessed in recent months. But none of this should prevent HY issuance volumes from rising again after the summer, and as a consequence we're raising our FY forecast to €75bn.

With many HY corps, in particular those based in the European periphery, still finding funding more attractive in bond than loan markets, disintermediation for this market segment has been given an additional push. This has led to a record number of first-time issuers entering the market, who are typically far smaller than their more established counterparts. While only around 5% of dollar HY issuance so far this year has come from first-time issuers, for euros the figure is around 35%.

But the difficulty in accessing bank funding is not the full story: even many corporates with easy access to bank funding are choosing to issue HY bonds, which are typically longer-dated, offer more flexible covenants and are quicker to organise than a syndicated bank facility. Furthermore, corporates that issued expensive debt at the height of the crisis took advantage of the diminished cost of issuing in HY to refinance bonds that have in many cases passed their non-call periods.

HY has been particularly impacted by M&A. The bonds issued by Numericable and Altice to help fund the former's acquisition of SFR from Vivendi represent a full 9% of all euro-denominated HY bonds issued so far this year. Admittedly, we doubt a deal of this magnitude will be repeated this year, but this deal should be regarded as a landmark in terms of the ability to execute large-scale financing for M&A, and this underpins our expectation for relatively elevated HY issuance in the latter part of the year.

Conclusion

The early start to the summer issuance lull, together with the resilience we've seen in inflows to € credit accounts, should mean that investors will have plenty of cash to deploy once supply volumes pick up again in September. And with many issuers having already completed their refinancing programmes for this year, there should be less pressure on primary markets during any periods of softness. Yet we suspect that the issuance climate is unlikely to be as benign over the rest of the year as it was in the first half.

The high total returns on € credit YTD have meant that many investors are nearing their end-of-year targets already. With risk-reward having declined of late, we expect investors to prefer to stay closer to home over the coming months, and that primary appetite is likely to suffer as a result. That said, barring a dramatic upset, the primary environment should mostly remain relatively accommodative for most issuers.

We may not see the same levels of over-subscription as we saw on new deals earlier this year, and some of the more optimistic rhetoric about mid-tier periphery banks issuing AT1 paper with a 4-handle in 2014 already sounds overblown. But the decline in investor risk appetite is likely to be met with a possibly more pronounced decline in gross issuance. And, with many investors still seeing participation in primary markets as an important means of alpha generation (although we reckon

this has been [less true recently](#)), we think it will take more than a batch of negative headlines to blow issuance off course.

As we argued [a few weeks ago](#), credit is very supply-sensitive at present and consequently the divergence in net issuance we expect between market segments is likely to have important implications for spread performance. Senior financial spreads will continue to be supported by negative net issuance, while conversely, the technical underpinning HY is likely to be far less strong as net issuance of the product remains highly positive. This contributes to the divergence in relative performance [we expect](#) between them over the rest of the year.

At the aggregate level, the €11bn a month of net issuance we foresee over the rest of the year is slightly higher than the €8bn we've seen on average in the first seven months of the year. While the increase in itself is unlikely to have a significant impact on spreads, it does raise the probability of another supply-driven wobble, like we saw in June, if the volumes end up uneven.

Appendix A-1

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