

Why credit's better outside the €

In credit, at least, the £-€ spread gap for many issuers is too wide

- The traditional cheapness of the £ credit market has now reached record levels.
- This cheapness is not just due to differences in index composition or maturity, nor to lower liquidity.
- In numerous cases, switching from € to £ provides a 45bp pickup, even after adjusting for cross-currency swaps.
- The difference, in our view, seems to be driven more by the expensiveness of national champion issuers in € than by concerns about £ as a currency.
- We recommend investors with global mandates overweight these names in £, and those with € mandates investigate buying in £ and swapping back to €.

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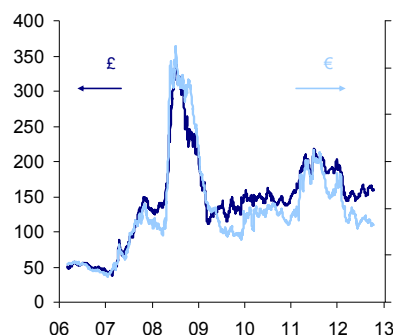
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Sell euros, buy sterling (in credit at least)

In a market in which monetary policy is increasingly making all things expensive, some are nevertheless more expensive than others. To our minds the cheapness of £ credit vs € has, at this point, gone too far.

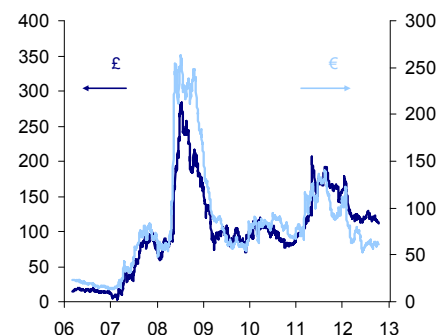
Admittedly, £ investors have traditionally demanded a higher spread than € investors, and been more skeptical of structures like hybrids as well. But the differential between the two is, in many cases, now very high relative to history. You only need to plot similarly-rated sub-sectors of the € and £ iBoxx corporate indices to see the recent breakdown in the long-term trend (Figure 1).

Figure 1. iBoxx A Overall Non-Fins, £ vs €
Bp, Spread to Libor



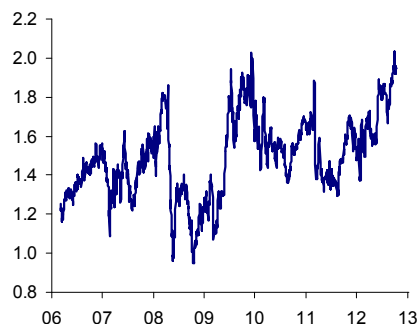
Source: Citi Research, Markit

Figure 2. iBoxx A 3-5yr Non-Fins, £ vs €
Bp, Spread to Libor



Source: Citi Research, Markit

Figure 3. Ratio of A-rated spreads in £ iBoxx to A-rated spreads in € iBoxx



Source: Citi Research, Markit

Nor is this gap simply due to the longer maturity of the £ market, and the current steepness of credit curves: it persists even when we look at an individual maturity bucket like A-rated 3-5years (Figure 2). The same pattern applies across other rating- and maturity-matched buckets, too. Rather, it reflects a broad spread divergence for bonds with similar characteristics in the two currencies, which holds all the way down to the single issuer level.

You can see just how extreme this divergence is relative to history using the ratio of £ single A-rated spreads in the iBoxx to their counterparts in €, which is near record highs (Figure 3). The current tightness of spreads helps to make the ratio look large, but it is still far higher than back 2006-7, for example. Especially when spreads are this tight, we think such a pick-up is extremely appealing.

What is more, the charts suggest the difference has at least as much to do with the € market becoming more expensive than it has with any flight from £. The latter may continue; the former seems unlikely to. We suspect much is because the largest European corporates have a captive audience of retail buyers who are prepared to buy new €-denominated issues at extremely tight levels, whilst this logic is less relevant for these same names when they issue in £, which is a much more institutional-dominated market.

In addition, whilst many sterling mandates can buy €-denominated bonds, the reverse is generally not the case. The smaller potential investor universe in the currency shifts the balance in favour of those buying bonds rather than those issuing them.

The sell-off in £ as a currency may also have contributed, but we think it is a lesser factor. The prospect of a deteriorating currency (and associated higher inflation) may be deterring a few investors, but the vast majority of bond investors currency

hedge their exposures. Besides, Figure 2 shows clearly that it is not that £ spreads have sold off; rather, they have simply rallied less than €.

How to position

While we are happy to recommend overweighting the £ credit market as a whole relative to €, a much purer way to take advantage of this differential is at the individual issuer level. The easiest way to spot anomalies is on the pages for the various issuers of our [CreditUniverse](#) analytics report.

In many cases, the spread pick-up easily outweighs the cost of bid-offer and any potential liquidity give-up. The table below depicts those for which similar bonds in £ (on the left) trade more than 45bp wide to their roughly maturity-matched € equivalents (Figure 4). We have tried to ensure there are no differences in legal entity or subordination here either.

Figure 4. Sell €, buy £, increase spread by about a third

Issuer	£			€		
	Bond	Spread to € swaps	Spread to £ swaps	Bond	Spread to € swaps	Spread to £ swaps
EDF	Dec-22	171	177	Sep-24	106	108
Unicredit	Feb-16	413	436	Feb-16	335	357
Lafarge	May-17	347	369	Nov-17	261	283
RWE	Apr-21	162	170	Aug-21	90	98
Telecom Italia	Jun-19	403	420	Jan-20	303	316
GDF	Feb-21	149	157	Jul-22	75	79
Enel	Jun-19	318	334	Jun-18	236	252

Source: Citi Research

What is striking is that most of these names are 'national champions'. These seem likely to have benefited from a strong investor base of domestic retail buyers for their €-denominated issues. Their £ issues on the other hand, are mostly purchased by £-asset managers with fewer incentives to purchase these companies' bonds. To the extent that explains the spread difference, to our minds it makes the switch all the more attractive.

Investors with global mandates can easily take advantage of this simply by overweighting the issuer in £ relative to €, and then applying their portfolio-wide currency and interest rate hedges as usual.

€-based investors are more likely to want to buy the £ bonds and then explicitly use a cross-currency swap over the bond's lifetime to hedge them into €. As the table shows, swapping back to Euribor does remove around 15bp or so from the spread, but still leaves a pick-up of more than 45bp. Eagle-eyed investors may also note that if there is a default prior to maturity, there may also be costs associated with unwinding the cross-currency hedge – but for investment grade names like these (and given the likelihood of unwinding the entire trade prior to maturity) we do not think this is a major consideration. For hedge funds needing to fund both the long and short legs, repo costs will eat further into the spread difference, but still seem unlikely to eliminate it entirely.

For example, the TITIM £ Jun19 trades at 420bp to £ swaps¹, which is equivalent to 403bp over 3m Euribor. Yet this is still fully 100bp wide to the TITIM € Jan20 at 303bp over 3m Euribor. In such cases, at least, we reckon credit investors are better off outside the € than in.

¹ Note also that £ asset swaps are conventional quoted vs 6m Libor, in contrast with the 3m rates on the € side.

Appendix A-1

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