European Credit Weekly

Is the ECB about to buy corporate bonds?

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- We assess today's suggestions in the press that the ECB is contemplating buying corporate bonds. While it is not a done deal for December, we think the probability of it actually happening continues to grow. To position for that scenario, we recommend:
- Remain long €- over $- and £-denominated bonds (though less so than previously, given how tight € bonds have become already).
- Be long funded (bonds) over unfunded instruments (CDS).
- Remain long Eurozone-domiciled issuers over non-Eurozone issuers
- Be long senior over sub and IG over HY in risk-adjusted terms, but long sub and HY (single- and double-Bs) in an absolute sense

Figure 1. Citi Credit Strategy – Key views & recommendations

	Tactical (View: Long)	Strategic (View: Long)
Cash bonds	- Long HY over long-mat. and low-β € IG - Add in 3-5yr low-BB/high-Bs - Selectively buy £ over € bonds	- Long € > $ credit - Long Financials > Non-financials - Releveraged > releveraging credits - Long T2 host CoCos - Long Eurozone > non-Eurozone credits
CDS	- iTraxx Sub / Sen Fins compression	- Long index flatteners - Main / Crossover decompression
Options & tranches		- Last squeeze to Jun-15 Series 9 Main equity - Buy SenFin, sell Crossover receivers - Sell 1m no-delta straddles - Sell S9 Super Senior 10y
Combined strategies	- Sell equity protection; sell straddles - Flatteners vs. OTM payers	-Short bond, long CDS spread duration

Source: Citi Research. Note: New recommendations/trades highlighted in bold. Closed recommendations highlighted with strikethrough text. Tactical horizon: 1-3mths. Strategic horizon: >3mths. See back pages for options disclosures

It is a couple of days early admittedly, but this note replaces the Credit Weekly we would normally publish on Friday.

Is the ECB about to buy corporate bonds?

Staying bullish on corporate credit has felt like an increasingly lonely call in recent weeks. We share many of the concerns voiced about tight valuations, weakening fundamentals, the impact of a weakening economic outlook on leveraged credits, increasing supply and a decline in incremental demand. But we have remained long on the view that the ECB will end up intervening further – in line with our economists.

In our view, the last thing the ECB needs at a time where inflation has consistently undershot its target and where Eurozone economic surprises are the most negative in 16 months is an agitated financial market pushing up risk premia and, in turn, tightening financial conditions. Market realities coupled with the restrictions the ECB has set on itself make it very unlikely TLTROs and the ABS/covered bond buying programme will bring about anything like the balance sheet expansion that Draghi indicated at the press conference after the September Governing Council meeting[1].

However, the market has been very skeptical that it would be possible to assemble the majority necessary to proceed with a broader QE program outside a more apparent tail-risk scenario.

We think today's Reuters' news story that the ECB may consider buying corporate bonds at its December meeting should be seen as a mixture of a trial balloon and a Trojan horse, likely coming from the dovish side of the Council.

Buying corporate bonds skirts the controversial issue of the prohibition on monetary financing and as such could be another interim step to full-blown QE. The fact that the headlines are unsourced still allows governing councilors to distance themselves from the quotes should the trial balloon get shot down forcefully by more hawkish members. In that regard, it is worth noting that the Bundesbank's opposition to the ABS/covered bond buying program more than anything else stems from taking on credit risk at what it perceives to be inflated values. That said, we also see it as something of a Trojan horse in the sense that it will be incrementally harder for the hawks to dismiss corporate bond buying once the market has come to expect it.

To us the key point here is that buying corporate bonds is probably one of multiple options that the ECB is mulling over. Although the story suggests discussions have already been taking place, it is not a done deal in December yet. However, with every weak data point the probability of further intervention is increasing. And today's headline increases the probability that such intervention, whether targeted or as part of a broader program, would directly involve corporate credit.

Does it really make sense to buy corporate bonds when spreads are so tight already?

It is probably the most common counterargument we hear. Indeed, it is debatable how much the ECB can improve monetary transmission through the credit channel by lowering corporate credit risk premia further. Yet it should provide an incremental benefit. And it is not as if the other assets the ECB can buy offer better alternatives in that regard. Moreover, we suspect the real purpose is the balance sheet expansion in itself, the implicit objective being to crowd out capital from Eurozone fixed income markets pushing the euro lower still.

[1] See 'Has Draghi lost his magic market touch', 26 September for a discussion.

What and how much can the ECB buy?

Given its aversion to taking credit risk it remains extremely unlikely that the ECB would intervene in HY credit directly beyond possibly some limited exceptions in sovereigns that are HY themselves.

It also seems very unlikely to us that the ECB would buy subordinated debt, even if it is investment-grade rated.

Conversely, we think it is unlikely that the ECB would exclude triple-B rated debt, because that would effectively preclude the ECB from buying anything in the periphery.

We have previously debated whether ECB purchases would stop at senior unsecured bank debt or include non-financial corporates also, but the wording in the news article suggests that both would be included.

We don't expect explicit restrictions on maturities, though we suspect the ECB would be more inclined to buy at the shorter rather than the longer end of the curve.

We think the ECB would buy both fixed and floating-rate bonds.

However, as with the ABS/covered bond buying program, we think the ECB would buy bonds issued in euros by *issuers*[2] domiciled in the Eurozone only. This a narrower set than the universe of collateral that is eligible in the ECB's funding operations, which includes debt issued in euros, sterling, dollars and yen of issuing entities based in the European Union (or Iceland, Norway and Liechtenstein).

By our estimates this implies that the universe of outstanding bonds eligible for purchases amounts to about €620bn of financial debt and €600bn of non-financial debt[3].

Whether the ECB can actually buy anything like that amount is an entirely different matter. The fact that the Bank of England barely managed to buy £1bn of corporate bonds back in 2009 and the difficulties that the ECB had in buying covered bonds two years ago highlight that sourcing the debt in large volumes at a time of general excess liquidity may be exceedingly difficult.

Is today's headline priced in already?

For CDS we suspect the answer is largely 'yes' until there is further confirmation of intervention. The 25-30bp intraday swing in Crossover is a substantial move. S21 Crossover is now 60bp inside last week's wides and only 35bp from the June tights. S21 Main is about 5bp off the September tights.

For the IG cash market we think the prospect of intervention will make it even harder for any bonds that are within the scope of possible ECB purchases to widen than it has been in recent months. We suspect that bonds will continue to squeeze, especially on any headlines which increase the probability of intervention.

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[2] So the bond of a US bank issued out of a European entity might be eligible, whereas the bonds of a European company out of a foreign entity might not be.

[3] Separately, it is also entirely possible that the ECB will consider buying IG-rated bank loans to expand the universe.

We have less conviction that the implicit backstop will also readily extend to HY (and £ credit) also – especially at the lower end. While we believe demand will trickle down into lower credit quality eventually (and therefore we remain long), much of the market is currently skeptical about that trade. So the effect may only become fully apparent when corporate bond purchases are a reality and investor targets have been reset for 2015. As such, we suspect HY cash will remain more susceptible to headlines and its own technicals.

While the effect of today's headline may fade, we expect credit spreads would still tighten substantially on the realisation of corporate bond purchases. Our target for the iBoxx € Corporate index remains at 70bp for June next year (from 94bp currently).

For comparison, Spanish RMBS tightened about 30bp (from 110bp to 80bp), when the ABS buying program was announced.

So what should you do?

To position for ECB corporate bond purchases we recommend:

- Remain long €- over $- and £-denominated bonds (though less so than previously, given how tight € bonds have become already).
- Be long funded (bonds) over unfunded instruments (CDS).
- Remain long Eurozone-domiciled issuers over non-Eurozone issuers. Even in £ (and $) credit (where the ECB is very unlikely to buy) we suspect there would be a tightening pull on spreads of Eurozone domiciled issuers.
- Be long senior over sub and IG over HY in risk-adjusted terms, but long sub and HY (single- and double-Bs) in an absolute sense (i.e. we think IG and senior will outperform in ratio terms, but sub and HY will tighten more in basis points terms)
- While today's headlines point to potential purchases in both financials and non-financials, we still think the probability of purchases are higher in the former[4] and would position accordingly.

[4] As discussed above, the ECB is probably operating with multiple options and conceivably a compromise scenario might initially see corporate purchases restricted to financials.

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Source: Citi Research

Implied vol starts the year on the expensive side (vs. spreads and vs. realised); we expect that to normalize soon and recommend selling options. Skewwise, the year starts with very flat skews on both the payer and the receiver side; bullish price action which makes us favor low cost defensive trades. “Tactical” trade ideas:

– **Sell no-delta Crossover February receivers** to tactically fade the recent index tightening, taking advantage of the high implied vol and flat short dated receiver skews.

– **Crossover delta-hedged 3m bearish risk reversal** (buying OTM payers vs. selling OTM receivers) to position for both payer and receiver skews to steepen.

– Looking for longs? Can use Senior Financials receiver spreads to take advantage of the flat skew and position for a moderate, not large, tightening.

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