BERENBERG *Markets*

FOCUS

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Within ***Focus*** we comment on extraordinary market events and analyse capital market related special topics.

Corporate bonds still offer opportunities in 2021

COVID-19 induced lockdowns, massive revenue losses, zombie companies and an impending wave of insolvencies – a flood of horror news kept the corporate bond market on tenterhooks in 2020. Nevertheless, after a correction of unprecedented speed and magnitude, many segments closed in positive territory, with risk premiums close to the levels at the beginning of the year (see Fig. 1). Can one continue to invest in corporate bonds with a clear conscience or is 2021 in for a rude awakening in view of valuations that are no longer favourable?

European corporate bonds – only hesitant adjustment so far

Credit ratios of European companies have deteriorated in 2020

According to two of the most important credit ratios, the leverage and interest coverage ratios, deteriorations are visible for European companies, especially for the high-yield segment, i.e. low-quality bonds. For these, net debt rose over the year to c4.5x operating income and the interest coverage ratio fell towards 1 – a value below this means that the companies' operating income is not sufficient to service the interest on loans and bonds.

Credit rating downgrades dominate

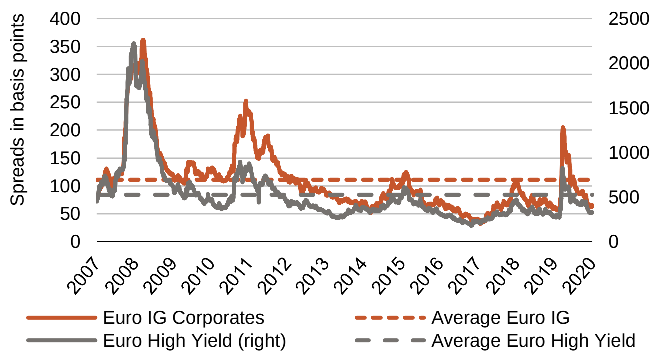
Credit rating downgrades therefore did not come as surprises (see Fig. 2). According to the rating agency Moody's, in 2020, 60 upgrades in the high-yield segment were offset by 364 downgrades. The volume of downgraded investment grade companies, so-called "fallen angels", was even higher in 2020 than after the financial crisis in 2008. However, the volume of outstanding corporate bonds has also more than doubled since 2008. In relative terms, the ratio of downgraded companies to the total is thus lower today at c1.9% than the peak value of 2.4% during the great financial crisis of 2008-9.

Rating agencies record rising insolvencies

However, it did not just stop at rating downgrades. Compared to previous years, the number of defaults among European high-yield issuers increased significantly. Moody's and Standard & Poor's expect defaults to rise to 6% and 8% respectively,

Fig. 1: Corporate bonds no longer cheap versus history

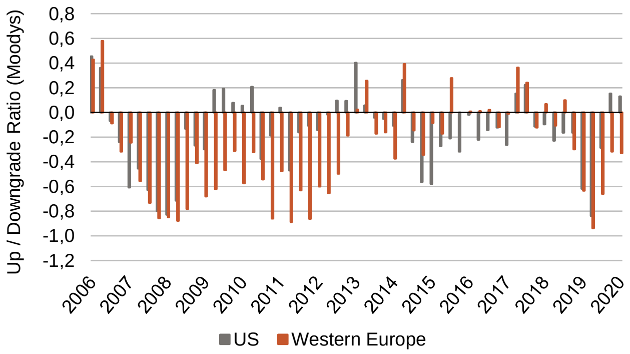
Credit spreads of euro investment grade and euro high yield bonds in basis points compared to the historical mean



Period: 12/31/2007 -12/31/2020, daily data
Source: ICE, Bloomberg, own calculations

Fig. 2: Glimmer of hope - slower rating downgrades?

Rating trend for western Europe and the US based on upgrades and downgrades by the Moody's (-1 = 100% downgrades; +1= 100% upgrades).



Period: Dec. 31, 2007-Dec. 31, 2020, quarterly data
Source: Commerzbank, Bloomberg own calculations

with a peak in the first quarter. However, it is interesting to note that not a single investment grade company in the euro area defaulted in 2020. Comparing the default rates of Europe with those in the US, we have recorded significantly fewer defaults in Europe since the summer. Apart from the lower interest rate environment and fiscal support measures for companies, this development also results from changed insolvency laws in countries such as Germany or France. Legal relaxations and longer transition periods delay insolvencies or may enable companies to achieve a turnaround through a longer "grace period", thus avoiding insolvency. Since default rates also depend significantly on the availability of fresh liquidity, companies with access to the capital markets are at an advantage. However, micro-enterprises and parts of the SME sector are at a relative disadvantage, as they could suffer from stricter credit requirements being imposed by their lenders.

Lower interest rates and regulatory changes cause defaults in Europe to rise more slowly than in the US

The fundamental way out of the above described misery is called "balance sheet repair". Cutting costs, deferring investments and suspending dividend payments reduce liquidity outflows and improve companies' ability to survive. However, with the credit markets recovering, financing costs becoming cheaper again and the expected economic upswing in 2021, there is a risk that companies leave the balance sheet repair phase prematurely without having cleaned up their balance sheet ratios. Instead, companies may fast-track on pent-up investments and try to participate disproportionately in the recovery through further expansion. Exuberant takeover campaigns and the resumption of dividend payments could penalise creditors and put renewed strain on still shaky balance sheets. The temptation is great, as there is immense investor demand for corporate bonds thanks to the negative interest rate environment and sustained ECB purchases.

Balance sheet repair phase threatens to end prematurely

A clean-up of balance sheets has thus only taken place to a limited extent so far, and it remains to be seen whether the economic recovery will bring about a truly sustainable improvement in average credit quality and ratings. The moderate improvement in the ratio of rating upgrades to downgrades in the fourth quarter of 2020 provides some hope (see Fig. 2). JP Morgan analysts already lowered their default expectations for high-yield bonds for 2021 from 3% to 2% in December 2020, arguing that the economic recovery in the third and fourth quarters, as well as comfortable liquidity in the capital markets, had improved the balance sheet quality of many companies. This would suggest that the wave of insolvencies will be smaller than initially feared – a necessary condition, in our view, to fundamentally justify the current valuations of corporate bonds. As a way out of insolvencies, progressive consolidation, mergers and acquisitions are also to be expected in some sectors.

Demand overhang dominates and supports

Technical factors cause excess demand for corporate bonds

While the threat of defaults and questions around the future creditworthiness of companies continue to cause uncertainty, the ECB's purchases of corporate bonds are a clear support factor for the markets. Monthly purchases of up to €8bn are likely to continue. Euro investment grade corporate bonds available on the open market are already sought after: by the end of 2020, more than 37% of the outstanding volume will have a negative yield (see Fig. 3). Moreover, after recording new issues in 2020, many analysts expect a significant decline in issuance activity, which is likely to further exacerbate the demand overhang. This is because asset inflows for corporate bonds are also expected from the investor side in 2021. Institutional investors will have to shift into corporate bonds if large parts of European government bonds yield negatively and an increase in equity quota is not possible at the same time.

These technical factors should support corporate bond markets and dampen potential volatility. We expect corporate bonds to continue to rise in price for the time being thanks to this excess demand despite battered balance sheets and the threat of defaults. Fundamentally, however, the potential is limited as the prevailing risk factors for corporate bonds still exist. Even high-yield bonds are only 50bp cheaper than they were at the beginning of 2020. Positive news on vaccine development and economic recovery seem largely priced in.

Corporate bonds likely to rise further in price thanks to excess demand

Opportunities in bank bonds – worth a closer look

One sector that has been unfairly singled out is the European banking sector. Strengthened by ECB liquidity measures, relaxed capital requirements and suspended dividend payments, many financial institutions have been able to bolster their equity despite the COVID-19 crisis and increased loan loss provisions. In addition, many banks surprised with better earnings and lower loan losses in the past two quarters. Despite negative interest rates and still expected loan defaults, many institutions are in a much sounder position compared to the 2008 financial crisis: they have more comfortable capital buffers, reduced their problem loans and balance sheet contractions have improved the health of European banks in recent years.

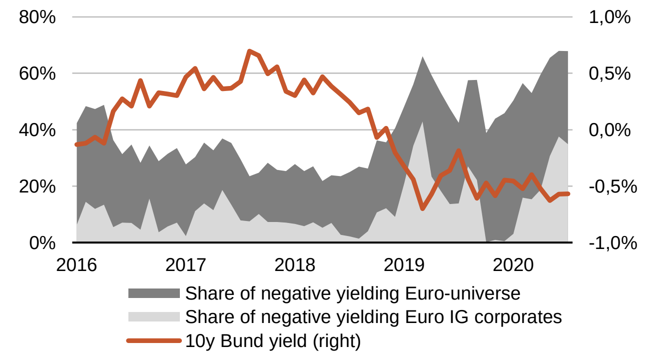
European financial institutions are better than their reputation, or rather, the valuations of financial rivals are too favourable when considering balance sheet quality

The lowest subordinated bonds of European banks (contingent convertibles (CoCos)) still offer an attractive yield. Interestingly, as Figure 4 shows, the risk premiums of European CoCos are still c50% higher than the lows of February, while other market segments such as Euro high yield, with poorer credit quality of the issuers, have already mostly priced out the COVID-19 crisis. The reason for this was, among other things, the fear that regulators could also restrict the coupon payment on these instruments after the dividend bans. However, since limited dividend payments are already being released again for 2021, this concern should be successively priced out.

Contingent convertibles (CoCos) with higher risk premiums and better credit quality than Euro high yield bonds

Fig. 3: A considerable part of the euro universe yields negatively

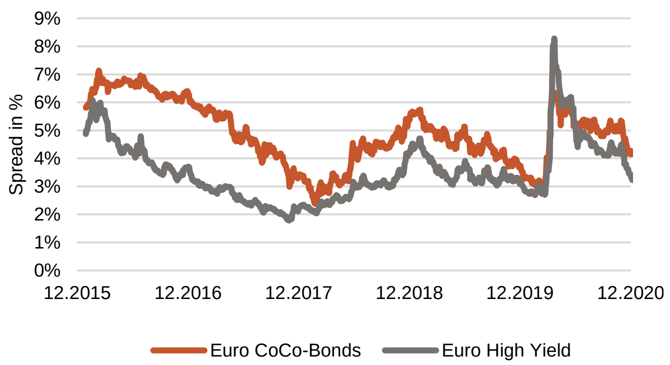
Share of the broad euro universe, as well as investment grade corporate bonds with negative yield



Period: 06/30/2016-12/31/2020, monthly data
Source: ICE, Bloomberg, own calculations

Fig. 4: Still attractive valuation in CoCo bonds

Risk premiums of European CoCo bonds compared with risk premiums of the Euro high yield segment (in %)



Period: Dec. 31, 2015-Dec. 31, 2020, daily data
Source: JP Morgan, ICE, Bloomberg, own calculations

Legacy securities from banks offer interesting opportunities in corporate bonds

Another opportunity is represented by the so-called "legacy securities" of banks. These are old subordinated bonds that will lose their eligibility for equity capital under the new banking regulations at the end of 2021. Features such as issuance from subsidiaries, issuance under non-European law or lack of intervention in coupon payments will no longer be accepted by the European Banking Authority (EBA) in the future. As recently as October, the EBA once again called on institutions to buy back, cancel or contractually amend these securities. An investment seems interesting here, especially against the background that many securities are still trading at well below 100% and a buyback or termination can mean double-digit returns for investors. Further advantages of these securities are the comparatively good creditworthiness of the debtors, a low interest rate sensitivity and a diversifying character for the overall portfolio.

In our opinion, both segments are very attractive in the current market environment. Minimum investment volumes, an intensive analysis effort of the securities prospectus and a sufficient diversification of individual securities are only a few reasons why an investment via an active and flexible fund concept is the most sensible form of investment in these segments.

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IMPORTANT NOTICES

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