Drowning out the noise

Investors spy opportunity amid the volatitily

Politics trumps economic fundamentals in the New Year outlook, an investor survey by Crédit Agricole CIB's FI syndicate has found. But in spite of the volatility Italy and Brexit may bring, the buyside is less bearish than might be expected, with higher beta bank products and jurisdictions finding favour. *Neil Day* reports, with insights from CACIB head of FI syndicate *Vincent Hoarau*.

Politics is uppermost in investors' minds going into 2019, according to a survey conducted by Crédit Agricole CIB's FI syndicate desk. Asked about the importance of nine factors according to their near term influence on spreads, Italian politics came out on top, with 45% of respondents deeming it most important, while Brexit came in second, at 31%. Investors were asked to score the factors from 1 (very important) to 5 (least important), and 75% of respondents scored Italian politics either 1 or 2, with Brexit on 72% — both well ahead of factors such as the trajectory of interest rates (58%), global economic growth (56%), and other geopolitical tensions (54%).

This contrasts with a similar survey a year ago, when central bank meetings, interest rate hikes and economic data were seen as the key determinants of market dynamics.

Vincent Hoarau, head of FI syndicate at Crédit Agricole CIB (CACIB), says that while the move from quantitative easing (QE) to quantitative tightening (QT) might no longer be seen as the biggest risk factor looking ahead — since it has been well anticipated — it is the underlying reason why other risks are coming to the fore.

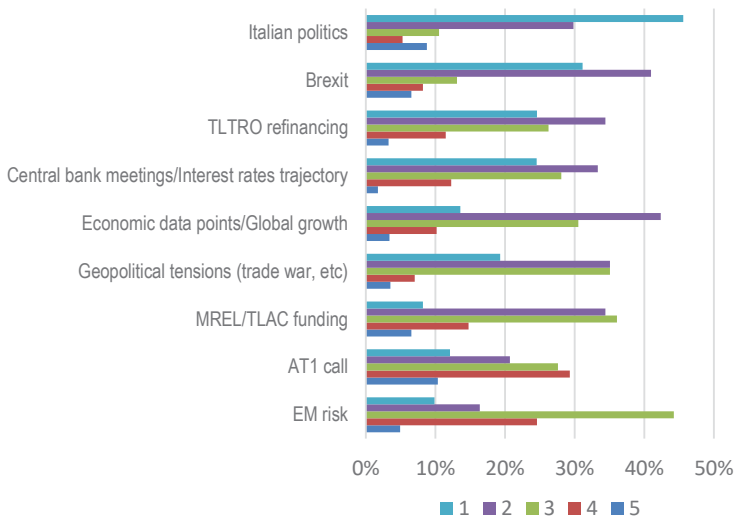
"In this transition period, idiosyncratic risks — name or country-specific — can be powerful driving forces," he says. "And everyone agrees, Italy is still at the top of the list — even if headlines have been rather constructive recently."

But while Italy is deemed a slightly more important factor than Brexit on the near term outlook, UK names are looked on less favourably than Italian assets.

"It's a very unusual situation," says Hoarau. "Even if Brexit does not question at all the risk profile and quality of the asset, investors tend to favour core European continental names unless UK borrowers reward lenders with higher NIPs. This was witnessed throughout 2018 and was justified by the multiple permutations and uncertainties Brexit implies.

"People had little incentive to get in-

Score each spread/market driver in terms of importance from 1 (very important) to 5 (least important) in the near future



Source: Crédit Agricole CIB

volved, particularly when markets were already very difficult to predict. Hopefully, the situation can be clarified on 11 December. Hopefully."

TLTRO refinancing comes out as the third-most important factor in the survey. The topic has long been on track to be a key influence on 2019 issuance, and its relevance has only been enhanced by expectations that the ECB will offer a third round of refinancing operations.

"TLTRO III? It's not a question of if, but when, and for whom," says Hoarau, "i.e. which duration modalities and at what cost. The ECB will have to step in again because liquidity is getting tighter.

"The winding down of QE and the withdrawal of liquidity will be a major theme of 2019, especially in FIs — only the availability of liquidity will matter in 2019's market."

The key drivers for next year — the outcome of "populist" movements and central banks' palliative measures — are each reactions to past developments, and naturally the events that could have the most marked influence on the market in 2019 are not yet fully anticipated. In this respect, Hoarau highlights several potential sources of trouble that investors may have to carefully navigate.

Key expectations:

- Investors to approach primary with vigilance in the early days of January
- High beta instruments to outperform. SNP/HoldCo relatively attractive
- Iberia and to some extent Italy tempting bets for early 2019
- Covered bonds set to widen further, but Eurozone to outperform non-Eurozone
- AT1 at an inflection point with first call dates around the corner
- Second half of the year likely easier to navigate vs. first half due to the extensive list of forces in place

"Countries across the board face key political turning points and those new trends will be watched carefully in 2019," he says. "In Europe, Italy and the UK are already under the spotlight, but we should not forget that Europe will vote for the European Parliament and Merkel could stand down as chancellor in 2019.

"The maturing of the global cycle will contribute to more turbulence, while the outlook in Europe will potentially be impacted by the current social situation in France, which is unique and so far rather ignored by markets. *Gilets Jaunes*, that's a ticking time bomb — France will likely breach Brussels' 3% budget deficit ceiling and this may weigh on the government curve."

The survey concluded on 30 November, just ahead of the confusing outcome of the G20 meetings in Buenos Aires, and had it concluded days afterwards, the number of investors scoring geopolitical tensions highly might have risen above 56%, if the subsequent market reaction is anything to go by.

"US-China tensions and the trade war rhetoric will continue to influence market mood in 2019," says Hoarau. "Global disagreement around trade policies has become a recurring topic in 2018. The outcome from the recent G20 and the return of volatility despite a supposed agreement between the US and China delivered further evidence of a relationship which is set to remain volatile for some time, and, with that, the global growth outlook and markets."

Despite the survey being conducted against a volatile and negative backdrop caused by the headlines already discussed, the balance of investors declaring themselves bearish versus bullish on the January 2019 outlook, at 53% versus 47%, was relatively balanced.

"There are so many risk factors to consider," says Hoarau, "but looking at the next 12 months from a fundamental standpoint, things do not look that bad. The first quarter may be a very difficult transition period with a new pricing paradigm, but once Italy and Brexit bumps are out of the way, who knows?

"By the end of March the ECB will have delivered clarity on potential new targeted refinancing operations, and we will have more visibility on the end of the cycle in the US, i.e. whether or not the next recession is close. We all see the inversion of the yield curve in the US and the capitulation of the reflation trade, but we should not read too much into it for now — it reflects the current pronounced risk aversion. And we have had enough examples in the past where this phenomenon was not the prelude to recession."

Peripheral opportunities

While Italy is seen as the most important influence on the near term direction of markets, more than half of investors (52%) consider Italian credit and subordinated debt to be either attractive or very attractive — second only to Spain on this measure — possibly helped by the aforementioned improvement in signals coming out of the country.

Italy also has strong supporters in the covered bond markets, with 10% of respondents considering OBGs very attractive — more than for any other jurisdiction — although also taking into account those deeming jurisdictions attractive as well as very attractive, Italy drops to fourth place, with core continental Europe coming out on top, with 34%. The risk aversion inherent in the covered bond market is perhaps also illustrated by the UK being deemed most attractive by just one respondent — it fares better when investors are considering credit and subordinated debt.

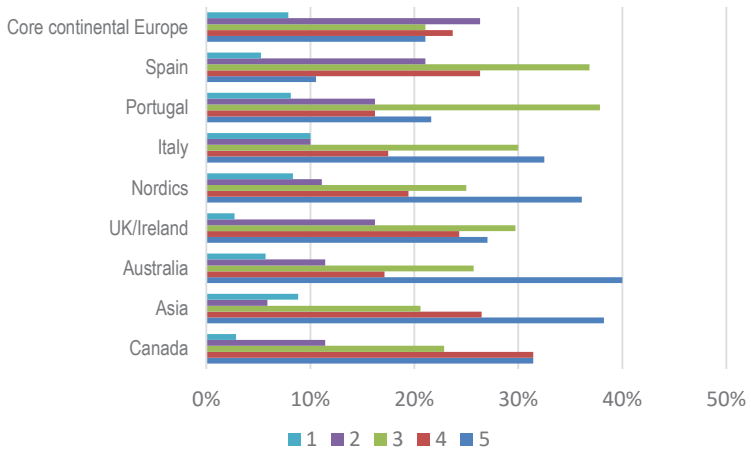
Spain is deemed attractive in covered bonds, credit and subordinated debt, coming second in covered bonds where 26% consider it attractive or very attractive, and top in credit and subordinated debt, with 56% of respondents looking favourably on the jurisdiction.

Asia, Australia and Canada are the least favoured jurisdictions in credit and subordinated debt and covered bonds. This could reflect the Eurocentric make-up of the respondents, although CACIB's Hoarau suggests that in covered bonds, at least, the repricing that has come with the end of CBPP3 could be making Eurozone issuance relatively more attractive and that non-Eurozone issuance could underperform, noting that the amount of redemptions reinvested by the Eurosystem in the secondary market will continue to provide a competitive advantage to Eurozone paper.

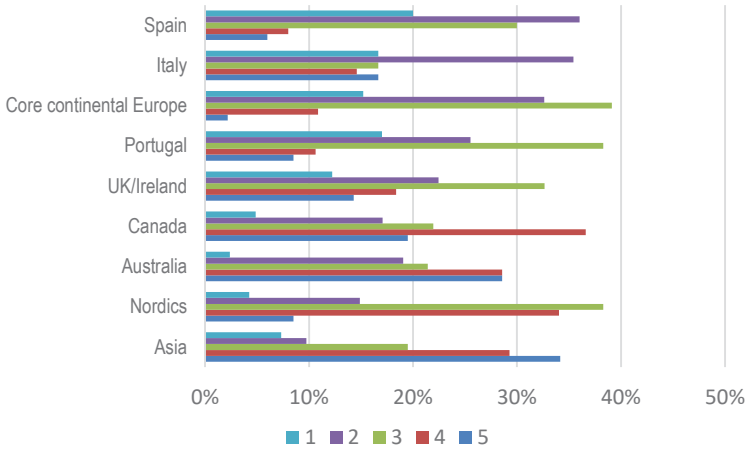
"Core continental covered bonds are not exciting, but are certainly where cash may be invested until the market finds a new pricing paradigm," he adds. "Iberia, meanwhile, seems to be where investors see value."

Despite expressing preferences for certain countries over others in credit and subordinated debt, respondents ranked jurisdiction only joint sixth out of nine factors in its importance as an Additional Tier 1 (AT1) pricing parameter *(see below for more)*.

Covered Bonds: considering the next three months, score the following regions from 1 to 5, where 1 = very attractive and 5 = not attractive



Credit & Sub Debt: considering the next three months, score the following regions from 1 to 5, where 1 = very attractive and 5 = not attractive



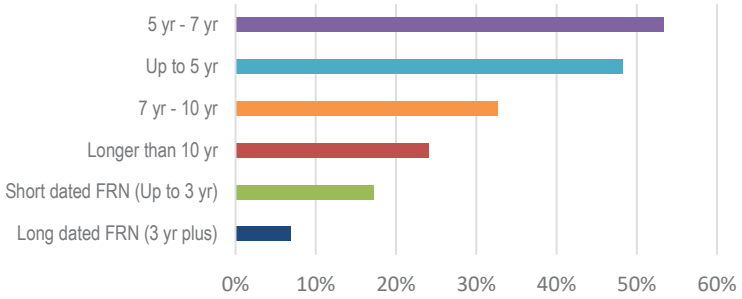
Source: Crédit Agricole CIB

Higher beta favoured in mixed spread outlook expectations

The investors surveyed demonstrated a clear preference for riskier asset classes, with Tier 2 ranking just ahead of AT1 in being considered very attractive (17% vs. 15%), while there was less enthusiasm for senior preferred/OpCo debt and covered bonds. Combining "attractive" and "very attractive" responses, Tier 2 again came out on top, but senior non-preferred/senior HoldCo debt nosed ahead of AT1.

The latter outcome comes despite

For credit, what will be your tenor of choice in January 2019? (multiple answers possible)



Source: Crédit Agricole CIB

43% of respondents expecting spreads in outstanding SNP/HoldCo debt to underperform on the back of primary market supply in existing and new jurisdictions. This was the most selected choice when investors were presented with six statements describing potential scenarios for the first quarter of 2019. 40% of investors surveyed expect greater differentiation among names in AT1 and Tier 2, while 34% expect high beta instruments to outperform low beta instruments — in line with their preferences regarding asset classes described above.

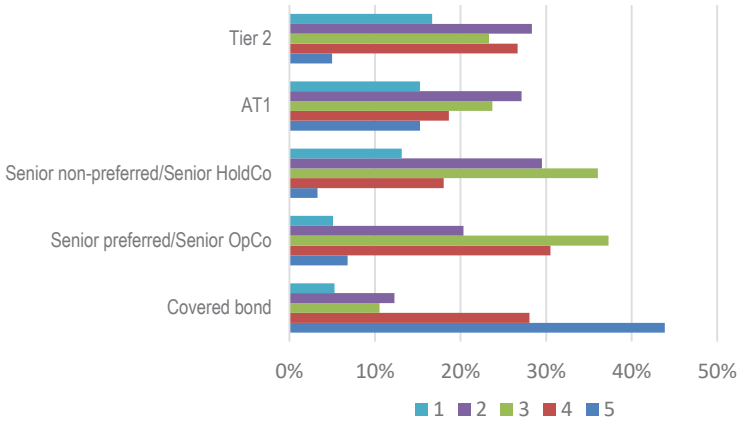
A modest 29% of respondents expect a global correction of FI spreads — although this is much higher than the number who consider technical supports to be strong and for prevailing spread levels to be maintained or tighten (12%). This matches the earlier finding of bears outnumbering bulls, while the relatively low number choosing each also fits with the difference in number of bears and bulls being lower than may have been expected.

However, sentiment is in sharp contrast to last year's survey, when 47% of respondents expected spreads to remain stable or tighten.

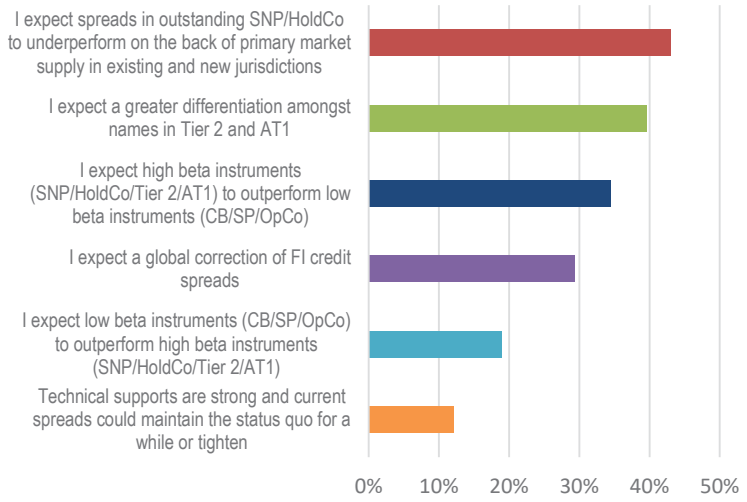
"This may imply a more defensive approach towards primary issuance in January and elevated NIPs to get things going," says Hoarau.

Investors' favoured tenors suggest relatively defensive positioning, with fixed rate bonds of up to five years and in the five to seven year bracket proving most popular, among 48% and 53% of investors, respectively.

Considering the next three months, score each of the FI sub-sectors from 1 to 5, where 1 = very attractive and 5 = not attractive



Which of the following statements seems the most appropriate to describe the potential evolution of credit spreads in FIs throughout Q1 2019?



Source: Crédit Agricole CIB

"The decade of falling interest rates is over and the majority of investors are approaching duration with a defensive bias," says Hoarau. "It nevertheless seems respondents agree on a market consensus of rates in Europe remaining low for a prolonged period of time since there is no greater interest in FRNs.

"But this doesn't mean that short dated FRNs will not continue to be the ideal instrument for parking liquidity in tough times."

AT1 sensitivity to non-calls, resets spreads, and new issue premiums

The potential for a non-call of an AT1 and the ramifications of such an event were low on investors' list of priorities when asked if it would be an important driver of the market in 2019.

However, most (55%) agreed that should an issuer not call an AT1 it would have a sustained impact and negatively affect AT1 valuations, and 25% expect that it would shut the primary market for AT1. Only 11% do not expect it to result in a significant correction, although 15% expect any correction to be short-lived and 51% of respondents said that the impact will depend on the profile of the issuer.

"A non-call of an AT1 is a market event and will have lasting consequences," says Hoarau at CACIB. "Half of investors say it depends who we are referring to, i.e. that it could be an isolated event, like Banco Popular. However, in that specific case investors were wiped; here we are talking about not reimbursing a callable instrument at the first call date.

"Among high beta names bonds with low resets have already been trading at a yield to maturity for quite some time and should a prominent issuer not call for a pure cost reason it will have a detrimental impact on the market. This means we will have to look more deeply into the set of instruments on a case by case basis, reviewing each and every call schedule, whether it is every year, five

years, or on each coupon payment."

This should play into the trend of greater differentiation but also greater due diligence, he adds, noting how "tourists" in the asset class were hit in 2018.

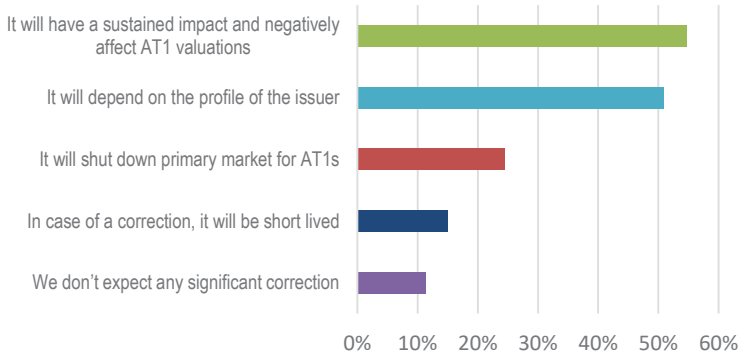
Reset spreads came out top when investors were asked to score the importance of various AT1 pricing parameters, followed by new issue premiums and then risk sentiment. Whether issues are investment grade or non-IG, and high trigger or low trigger, were deemed of the lowest importance.

"New issue premiums and reset spread analysis are key elements, together with the timing of the new issue and prevailing risk sentiment," says Hoarau. "In terms of capital metrics, MDA and distance-to-trigger are what investors look at.

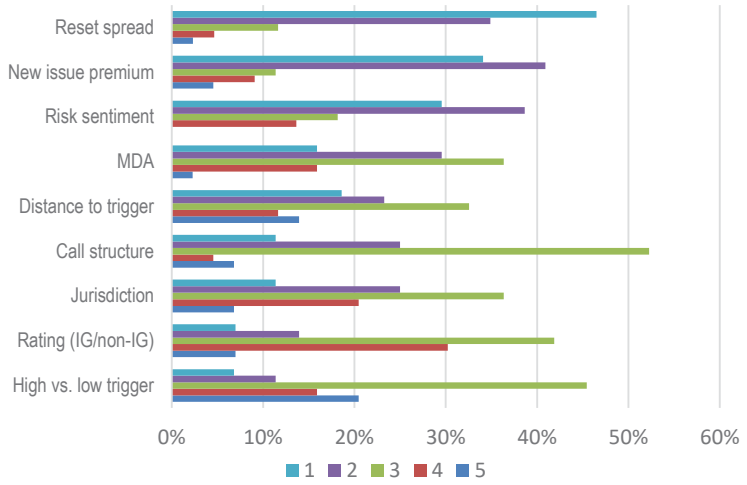
"Whether it is low trigger or high trigger, IG or non-IG is less significant. Indeed, PONV is what investors assess when looking at the probability of the trigger being hit, while most of the market is non-IG and AT1 are mostly high yield or off-benchmark investments."

Some 38% of respondents said they would buy floating rate AT1 or Tier 2, but 62% would not.

In case of an AT1 non-call event, which of the following statements seems the most appropriate (multiple answers possible)?



Score each AT1 pricing parameter in terms of importance from 1 (very important) to 5 (least important)?



Source: Crédit Agricole CIB

Green momentum

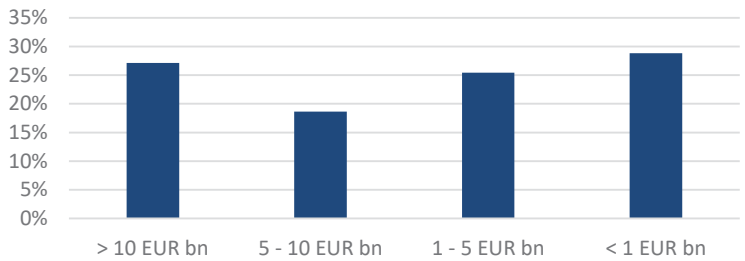
Finally, investors were asked if they intend to increase exposure to green assets in the coming year, and while 61% expect to, 39% do not.

"I would have expected the percentage in favour of the asset class to be even higher," says Hoarau. "Pressure from end-clients continues to grow and ESG factors are growing in importance in the investment process. We expect green bonds to outperform conventional bonds given the strong imbalance in the supply/demand dynamic. This is not a short-lived phenomenon."

Survey participants

The survey was conducted between 20 and 30 November. The majority of respondents (56%) were asset managers, followed by insurance companies (13%), then hedge funds and bank treasuries (8% each), with further participation from central banks and official institutions, family offices and pension funds. The vast majority of investors surveyed were European, 77% being Europe ex-UK and 16% UK-based, with a handful from elsewhere. There was a relatively even distribution of investors as measured by assets under management dedicated to financial institutions *(see chart below)*. More than three-quarters of respondents said that senior (79%) and Tier 2 (77%) financials are a focus, while 52% focus on AT1 and 38% on covered bonds. ●

What amount of your fixed income AUM is dedicated to FIs?



Source: Crédit Agricole CIB

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