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Spotlight on Euro credit

Investment grade sell-off exposes stock-specific value

M&G INVESTMENTS

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- European investment grade credit spreads have widened significantly this year as the market has sold off
- Certain stocks have reached spreads last seen pre-QE in 2016
- Having been underweight European investment grade credit for the past year, we are reducing our underweight in this area

Gaurav Chatley
Senior fund manager

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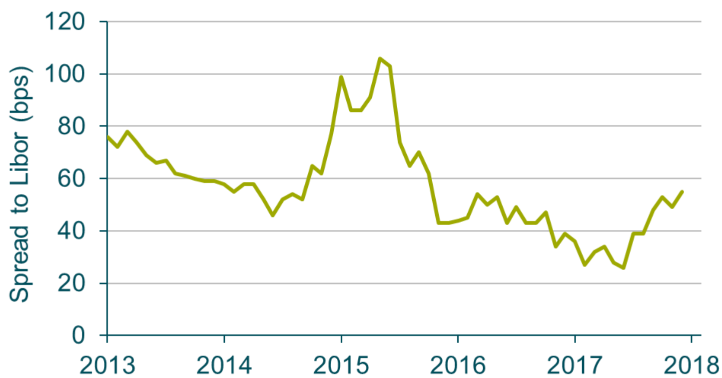
European investment grade credit has experienced a widening of credit spreads since February. It started with a risk-off event on the back of a surge in the VIX equity volatility index, and was followed by heightened concerns around Italy's political situation in May, trade war fears in June and finally the emerging market currency rout in August. As always, it is nearly impossible to predict these events with any accuracy.

However, since late 2017 we had been finding very few attractive stock-level opportunities that were not expensive. This had led us to be underweight European investment grade credit.

In particular, we were underweight the European non-financial senior credit that has been the prime beneficiary of the European Central Bank's quantitative easing programme, and in which spreads had tightened most, as Figure 1 below shows.

Figure 1: Euro non-financial senior spreads have tightened



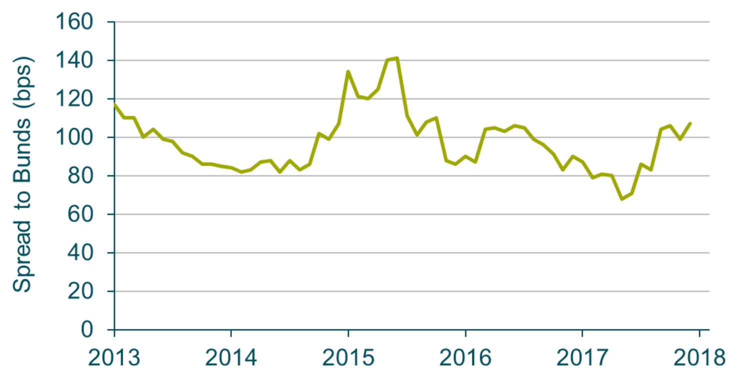
Source: M&G, Bloomberg, ICE BofAML Euro corporate index, Libor OAS, as at 26 September 2018

Even at a generic level, based on several different valuation metrics, in our view European IG credit looked expensive.

Credit spreads to government bonds show the same story, as Figure 2 shows.

We tend to favour spreads to government bonds to guide our valuation discipline about reducing underweights, since we use government bond futures to hedge our duration relative to the benchmark.

Figure 2: Euro credit spreads to government rates



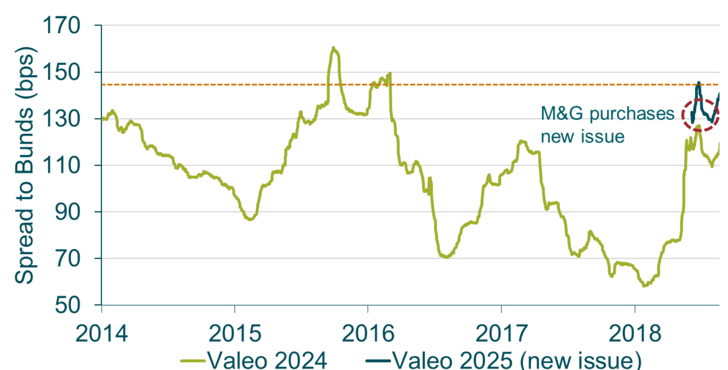
Source: M&G, Bloomberg, ICE BofAML Euro corporate index, government OAS, as at 26 September 2018

However, the sell-off this year, clearly visible in the charts, has started to create attractive stock-level opportunities where the ECB QE-led tightening of spreads has been completely unwound.

This is either due to primary market new issue premia or general risk sentiment, but we are now in some instances seeing bond spread valuations at roughly the same levels as before the start of QE, thereby completely discounting the impact of QE.

An example of this is Valeo, a French autoparts maker.

Figure 3: Spread tightening creates value in Valeo bonds



Source: M&G, Bloomberg, FRFP 3.25% 22/01/2024 and FRFP 1.5% 18/06/2025 bonds, Bloomberg mid-spread to benchmark, as at 31 August 2018

Valeo is rated BBB, and its 2024 bond experienced extreme tightening in the credit spread following the announcement of corporate bond purchases by the ECB in March 2016.

However, in April 2018, following volatility in the first quarter, Valeo issued a new seven-year bond. This priced at a spread of 147bps over Bunds – a level marked in Figure 3 by the dotted orange line.

This is roughly where the 2024 bonds were trading back in 2016, when the 2024 maturity was a longer tenor, eight-year bond.

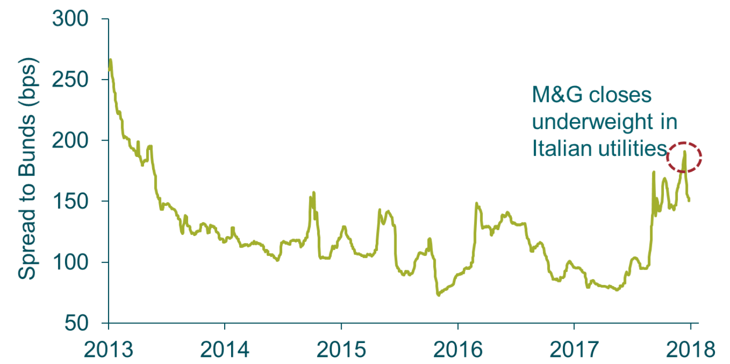
This valuation of the new bond therefore entirely discounts the effect of QE on Valeo's bonds – despite the credit quality of these bonds remaining broadly the same over the whole period.

A second example is Enel SPA, a utility company that generates 40% of its revenues in Italy. Its bonds have widened significantly this year, particularly since May, due to the Italian political situation, as Figure 4 illustrates.

Again, when viewing the credit spread of these bonds compared to government bonds it is clear the bonds have fully discounted the effect of QE and are trading roughly halfway to the wides seen in the middle of the sovereign debt crisis.

For the past year we felt that the valuations on offer on Italian bonds did not compensated for their peripheral euro area risk.

Figure 4: Italian risk is compensated in higher Enel spreads



Source: M&G, Bloomberg, Enel 5.625% bond, Bloomberg mid spread to benchmark as at 14 September 2018

Acquiring Enel bonds has enabled us to add exposure to Italian utilities at an attractive spread of 190bps over Bunds, as circled in the chart above. In our view, even if Italy's political situation does destabilise once again, Enel generates approximately 60% of its revenues outside Italy and we expect it to continue to be able to service its debts.

These examples highlight our view that, after a significant sell-off in European bond markets this year, pockets of value are beginning to appear. As always, we are working at a stock level to take advantage of some of these opportunities and reducing our underweight to European investment grade credit.

Contact

Benelux

Stefan Cornelissen
+31 (0)20 799 7680
stefan.cornelissen@mandg.co.uk

Sjoerd Hoogeveen
+31 (0)20 799 7682
sjoerd.hoogeveen@mandg.co.uk

Katya De Graaf
+31 (0)20 799 7791
katya.degraaf@mandg.co.uk

Sander van der Wel
+31 (0)20 799 7685
sander.vanderwel@mandg.co.uk

Nordics

Robert Heaney
+46 (0)8 5025 6529
robert.heaney@mandg.co.uk

Anna Louise Klintman
+44 (0)203 790 1127
anna.louise.klintman@mandg.co.uk

Switzerland

Manuele De Gennaro
+41 (0)43 443 8206
manuele.degennaro@mandg.co.uk

Mersiha Jans
+41 (0) 43 443 8217
mersiha.jans@mandg.co.uk

www.mandg.com/institutions
institutional.investors@mandg.co.uk

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