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Europe Credit Research
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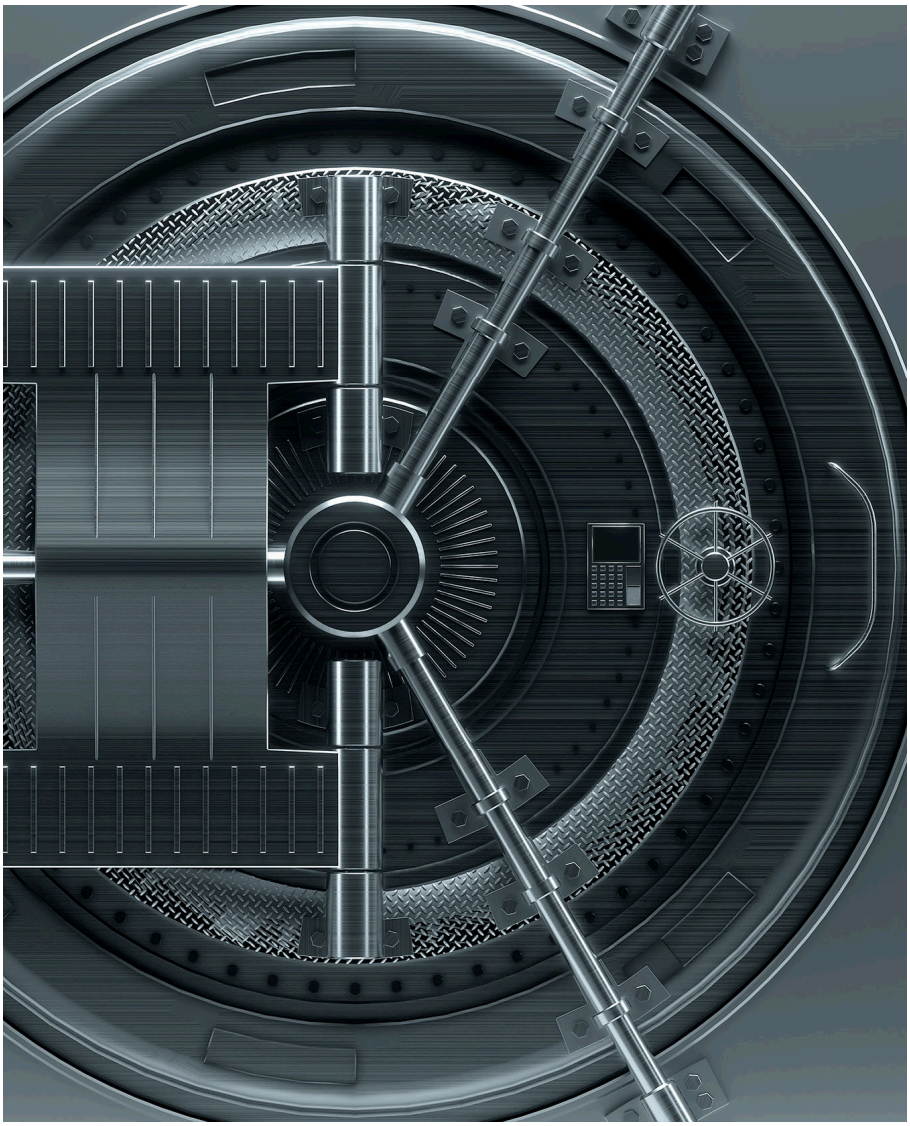
European Credit Outlook & Strategy 2023

Safe Carry



European Credit Strategy

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Executive Summary

- **Safe Carry:** Next year, we expect the market focus to shift away from monetary policy and systemic risk and toward single-name fundamentals. On the upside, we believe that global central banks are approaching their terminal rates as inflation peaks, the risk of energy rationing in the Euro Area over this winter is fading, and policy makers still appear to be very sensitive to financial stability risks. In our view, this will drive a continued rally in investment grade paper, where we believe that valuations have become extremely compelling. However, while the tail risks are diminishing, we are still anticipating a mild recession in our region over the next two quarters, which could put some pressure on issuers with weaker balance sheets and drive a shallow default cycle. Consequently, we think there could be some renewed weakness in high yield, especially in the single-B space. Additionally, there are still overhangs from the global economic cycle, with the potential downside risk of a US recession in late 2023 or 2024 likely to put a limit on performance.

- **Euro Investment Grade**: In our view, the bottom is in for euro investment grade credit. We are forecasting 30bp of spread tightening to 180bp next year, as: i) valuations are too cheap to ignore; ii) sovereign bond stability could be a tailwind as central banks approach their terminal policy rates; iii) we anticipate limited supply of just €450bn gross / €70bn net, with bank loans partly replacing capital markets as a source of funding; and iv) swap spread narrowing could improve global relative value. Our top trade recommendations are: i) OW banks vs corporates; ii) buying reverse Yankees; and iii) positioning for higher dispersion, including BBB / A decompression.

- **Corporate Hybrids:** Concern over extension risk pushed hybrid spreads to very wide levels during 2022, but we continue to see the path of least resistance being a 'call and replace' strategy for corporates. At the same time, we expect negative net supply once again due to the cost of issuing hybrids relative to the imputed cost of equity. Relief over calls being exercised and supportive supply-side technicals should enable the product to perform well in 2023.

- **Euro High Yield**: High yield has outperformed this year due its short duration and low delivered defaults. Next year we see the focus shifting from rates to fundamentals, as Europe goes through an energy-induced recession and the cumulative effect of rate hikes becomes evident. We look for a shallow default cycle, with default rates of 3% in FY23, but think spreads need to price in a greater risk premium until a US 'hard landing' can be ruled out. We look for 75bp of widening to 625bp driven by lower-rated bonds, giving a credit return of 3.5% and total return of 7.5%. Loans are more vulnerable to further decompression, and we expect them to underperform with a 5% total return.

- **Sterling High Grade**: There's no denying that the economic outlook for the UK makes for a sobering read with an expectation of two further quarters of negative GDP growth followed by an anaemic recovery as austerity sets in. Weakening fundamentals, however, are likely to be balanced out by stronger technicals as issuance drops, driven by a slowdown from Financials and lower overall refinancing needs, and demand stabilizes as attractive valuations draw investors back in and the pension risk transfer process comes back into focus. All said, we expect spreads to tighten c.20bp to 190bp next year.

Macro Overview: Safe Carry

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In our view, we are already past the worst for euro credit spreads and returns this cycle, although the road from here could still be bumpy and uneven over the next year. Only a few months ago, the popular narrative was that surging energy prices and disruption to natural gas supplies would cause a deep recession in Europe over the upcoming winter, while in the US the Fed would be forced to engineer a 'hard landing' to tame runaway inflation. To make things worse, it looked like China's economy would continue to be held back by a strict Zero-Covid policy and a snowballing crisis in the real estate market.

These concerns have slowly been chipped away at, although by no means removed completely. First, Europe has successfully managed to fill its gas storage capacity by substituting toward LNG imports – and early indications are that the weather could be milder than average over the next few months – thereby likely **avoiding disruptive rationing over the winter heating period**. In our view, coupled with some targeted government support for households, it's therefore possible that the nascent Euro area recession will be milder than initially feared. Additionally, last week's US CPI miss has **opened the door to a slower pace of tightening**, with the implication being that the Fed stands a better chance of 'threading the needle' and avoiding recession in 2H23. Finally, China has made tentative steps toward both easing COVID protocols and rescuing the troubled property developer sector.

As a result, while we are still anticipating a moderate recession in Europe, we think that both tail risk and macro uncertainty have declined. **Consequently, we are recommending that investors marginally add risk to their portfolios, but with a preference for 'safe carry' from higher quality paper**. We expect excess returns to be positive across all segments of euro credit, but think that the risk-return is better further up the credit rating spectrum.

Unusually, we are simultaneously forecasting spreads to be tighter in investment grade and wider in high yield, although still below the peak from this year. In our view, the market **focus will shift away from central bank policy and systemic risk and toward single-name fundamentals**, which should drive weakness in lower-rated paper. Further, we believe there is little reason for investors to stretch down the rating spectrum to meet their 'hurdle-rate-of-returns' when high grade paper offers a yield of 4.2%, and, on top of this, the current high yield / investment grade spread ratio looks extremely stretched in historical terms at 2.7x (Figure 1). **Overall, our year end targets look for investment grade to tighten by 30bp to 180bp, while high yield widens 75bp to 625bp.** These forecasts would see the spread ratio move out to 3.5x, closer to the long-term average.

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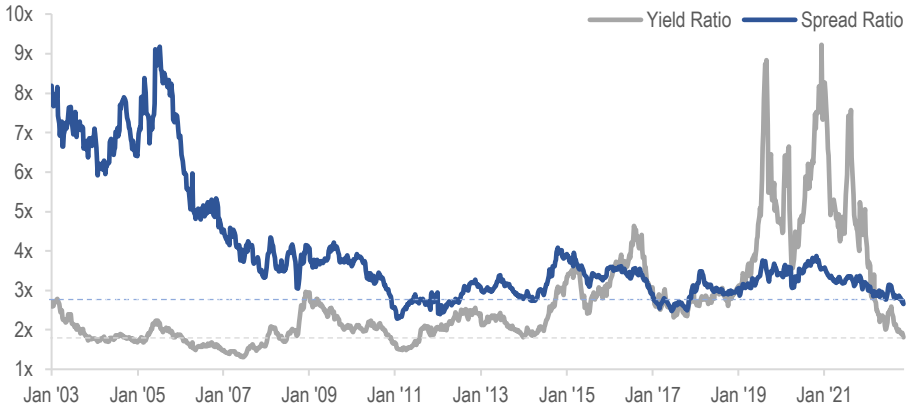
Figure 1: EUR HY / EUR IG Yield and Spread Ratios, x



Source: J.P. Morgan, Markit Group. Dotted lines show current yield and spread ratios of 1.82x and 2.66x.

In terms of other themes, we expect the technicals to be relatively strong in both markets. In investment grade, we anticipate very limited net supply of just €70bn as the quantitative easing-fuelled expansion in capital markets comes to an end, with a greater proportion of funding shifting toward bank loans. Additionally, we do not think ECB QT will be a gamechanger for the balance between supply and demand, estimating that the CSPP portfolio will only shrink by €13bn next year. In high yield, we are looking for refinancing volumes to pick up as issuers feel compelled to term out bonds, but also almost no net supply.

We do, however, expect a modest deterioration in the fundamentals over the next few years. We recently raised our default target for next year to 3.0%, and set a preliminary FY24 target of 2.5%. Similarly, we anticipate a tick up in fallen angel volumes to €20bn, or 0.8% of investment grade notional, although we still expect this to be surpassed by €25bn of rising stars. Within both investment grade and high yield, we expect net ratings migration to turn negative.

Finally, we expect a 20bp tightening in sterling credit to 190bp, implying a c.5bp underperformance versus euros from current levels – in our view, while there is room for GBP-EUR compression at the shorter end of the curve, we expect underperformance in the longer maturity buckets (which have a larger impact on duration-weighted index spreads), where the gap between the two asset classes is currently at stretched levels.

Table 1: 2023 Spread and Return Targets

Asset	Index (Metric)	Current Spread, bp	YE Forecast, bp	Change, bp	Excess Return	Total Return
Investment Grade Bonds (EUR)	iBoxx EUR Corp (Govt)	207	180	-27	3.6%	
Investment Grade Bonds (GBP)	iBoxx GBP Corp (Govt)	214	190	-24	3.6%	
High Yield Bonds (EUR)	iBoxx HY Non-Fin (Govt)	550	625	+75	3.5%	7.5%
Leveraged Loans (EUR)	JPM ELLI					5.0%

Source: J.P. Morgan, Markit Group.

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Trades and positioning

- OW IG Banks vs UW IG Corporates
- OW IG Reverse Yankees
- OW A vs UW BBB
- OW IG vs UW HY
- OW HY vs UW Loans
- OW BB vs UW B
- OW Select Short-Dated Callable High Yield Bonds
- 'Safe Carry' and 'Beta' Corporate Hybrid Baskets
- OW Short Duration Sterling IG
- OW IG Bank Bail-in, IG Bank Preferred, IG Corporate Hybrids, HY Gaming, HY Healthcare, IG/HY Metals & Mining, IG Oil & Gas, IG Real Estate, and IG/HY Telecoms.
- UW IG Autos, HY Bank Subordinated, IG/HY Chemicals, IG Media, HY Retail, HY Services, and IG/HY Transport.

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Economic Outlook

Economic & Policy Research

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Euro area: Going slow to disinflate

- **A mild recession to be followed by a modest recovery**
- **ECB tightening, weaker external growth and a small net fiscal tightening to weigh on the economy**
- **Side-effect is that unemployment will nudge higher, doing some of the ECB's job on inflation**
- **Larger ECB hikes are possible, but our base case has a pause at around 2.25%-2.5% and QT starting in 2Q23**

Having spent a decade trying to escape low inflation, the Euro area got much more than it asked for in 2022. Headline inflation surged to double-digits in October and, at 5%oya, core inflation also far exceeded the ECB's 2% target. This not only prompted a big shift in the monetary policy outlook, but also weighed on growth and hence dampened the pandemic-related bounce in activity. Nevertheless, solid fundamentals provided resilience to the huge energy shock and hence helped the economy recover quite solidly through mid-year, pushing unemployment down to record lows.

As we turn towards 2023, the uncertainties remain very high. A mild recession still looks likely over the winter as the economy adjusts to a much high level of gas and electricity prices. But, as the intensity of this adjustment abates in the spring, uncertainty over the external backdrop is likely to increase with US growth slowing throughout 2023 and the UK largely stalling. Growth risks are skewed downwards from mid-year onwards due to the risk that the Fed's attempt to manage the US unemployment rate higher results in a recession rather than low growth. Underlying this is real uncertainty over the global inflation outlook with transitory factors likely to fade but the landing zone over the medium-term much harder to gauge. This makes it difficult for central banks to know how much restriction is needed. From the perspective of managing slack and the medium-term inflation outlook, the best we may be able to hope for is a period of below-potential growth.

For the Euro area, our judgment is that inflation can still settle back at the 2% target even if the ECB does not become very restrictive. This reflects a few judgments. First, that a recession this winter and faster tightening by some other DM central banks do some of the ECB's job in cooling the labor market. Second, that Euro area inflation is to a significant extent driven by temporary factors and by supply shocks that weigh on the economy and that wage growth has picked up more modestly so far. Third, that a likely move to quantitative tightening may have a larger effect on longer-term interest rates than elsewhere. For these reasons, the ECB may lift its deposit rate to only around 2.25%-2.5%, which would be mildly restrictive. The risk however is that the ECB hikes more aggressively in the near-term if the recession is very mild if the inflation data do not turn lower quickly enough or if wage growth picks up significantly further.

From COVID crisis to gas crisis

While the Omicron wave delayed the rebound, the lifting of restrictive measures in domestic leisure/hospitality in 2Q22 and tourism in 3Q22 generated a strong bounce in contact-intensive parts of the economy in the spring and summer. Euro area GDP

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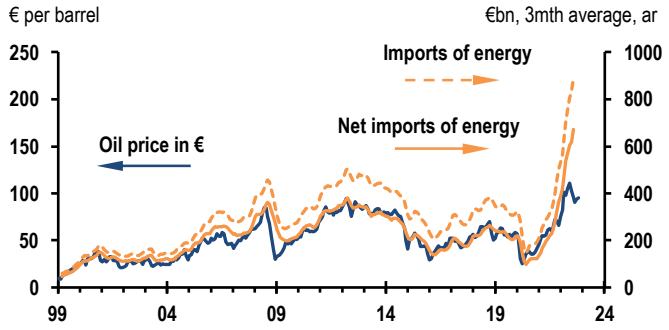
grew at a 3%ar pace in 1H22, but the bounce would have been much larger without the intensification of the energy shock triggered by the outbreak of war in Ukraine. In 1H22, Euro area inflation was already rising at over a 10%ar and energy imports surged to an annual rate of almost €900bn in the three months to August (Figure 2). Compared to 2019, this is an increase of over 5% of GDP (and around 4% if higher energy exports are deducted). This represents a large transfer of income abroad, with domestic spending and activity forced to adjust to this hit.

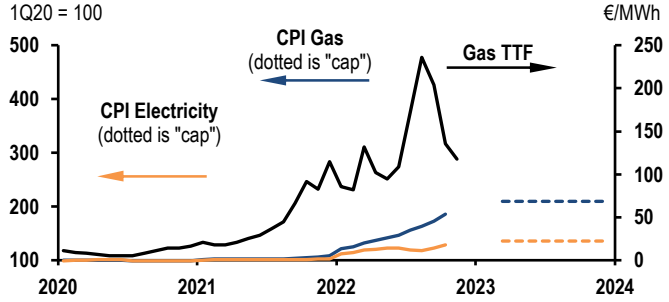
Figure 2: Euro area imports of energy products



Source: ECB, Eurostat, J.P. Morgan

While this large transfer of income abroad is causing domestic spending and output to adjust downwards, initial predictions of a very deep recession look overly pessimistic. First, gas storage levels were filled rapidly as the high price of gas attracted global LNG into Western Europe, admittedly helped by weak demand from China and by mild weather. The result is that gas rationing is no longer seen as necessary to get through this winter. Second, the high price of gas has encouraged industry to reduce its demand for gas with limited impact on industrial production so far outside of a few energy-intensive product categories. Third, governments have stepped in with direct income supports to vulnerable groups and with direct price interventions to limit the increases in household gas and electricity bills. Some support for businesses has also been provided. For example, on our calculations, gas and electricity bills for German households may not even double due to the price brakes (Figure 3). And, importantly, this intervention is being structured in a way that leaves in place an incentive to save gas and electricity.

Figure 3: German CPI gas and electricity



Source: Destatis, Bloomberg Finance L.P., J.P. Morgan

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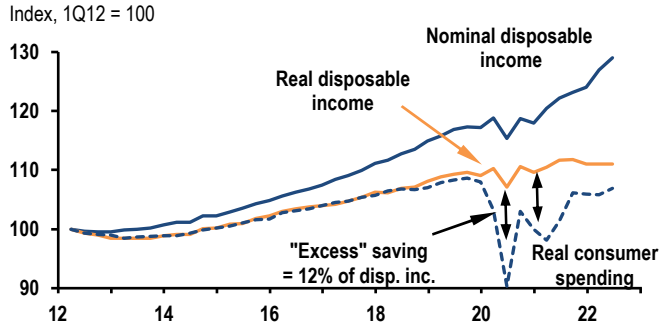
It has also helped that the rebound from the pandemic has generated strong gains in incomes. On the household side, a sharp pickup in nominal disposable income has meant that real income has only stagnated through mid-2022 in aggregate despite the surge in inflation (Figure 4). In addition, households have yet to dip into the accumulated excess saving of 12% of their gross disposable income, built up during the pandemic. The incomes of corporates have also grown solidly, helped by significant pricing power that allowed them to pass on many energy-related costs. This is visible in the Euro area GDP deflator, which was up 4.2%oya in 2Q22.

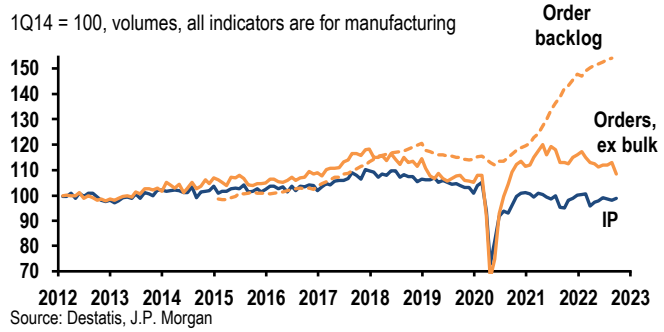
Figure 4: Euro area household spending and income



Source: Eurostat, J.P. Morgan

There is also still scope for industrial production to improve as older supply bottlenecks and supply chain problems are worked through. In Germany, order backlogs have increased dramatically as the level of production has persistently fallen short of the level of industrial orders (Figure 5). This creates the possibility that output will hold up well relative to orders even as the latter is pushed lower by the energy shock and low sentiment.

Figure 5: German Industrial indicators



Source: Destatis, J.P. Morgan

Inflation: far too high and far too unclear

While it is clear that Euro area inflation is currently far too high, the forward-looking implications are much harder to assess. With headline inflation at 10.7%oya in October and core inflation at 5.0%oya, more than half of the pressures related to energy and food prices. Energy inflation is likely to fall rapidly during 2023 unless market-based oil, gas and electricity prices surge again. While these prices will remain elevated, the inflation rate captures the changes in prices from one year to the next, which should rapidly drop back towards zero. Food inflation could prove stickier but should move towards more normal levels for the same reason.

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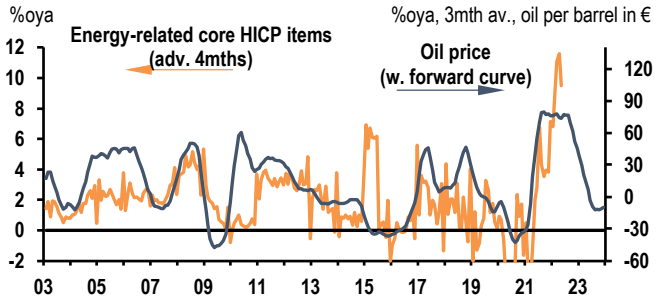
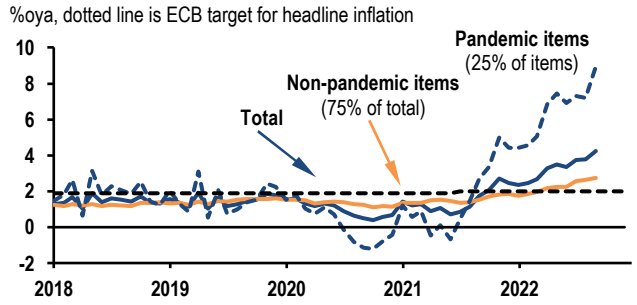
The outlook for core inflation is more central to the outlook. At face value, its pickup looks very broad-based with core goods inflation at 6.0%oya and services inflation at 4.4%oya in October. Many measures of underlying inflation, such as trimmed mean, supercore and persistence-weighted measures have also picked up strongly. However, such measures were not designed to deal with the context of the pandemic and energy crisis, and therefore we would still argue that many of the core inflation pressures reflect transitory factors. First, core goods inflation is likely still affected by supply bottlenecks and the large shifts in demand towards goods during the pandemic. Second, core inflation overall is likely impacted by the surge in energy prices as some core items are energy-intensive (Figure 6). The clearest example is airfares, which become more expensive when oil prices increase. Third, services inflation remains very skewed towards items that have been impacted by the pandemic, such as some leisure, transport and tourism items (Figure 7). Excluding these items, services inflation was running at around 2.7%oya in September. While that is above the ECB's 2% target, services inflation has needed to be above target in the past to offset lower core goods inflation.

Figure 6: Euro area core inflation and oil prices



Source: Eurostat, J.P. Morgan

Figure 7: Euro area services inflation



Source: Eurostat, J.P. Morgan

Another reason for suspecting that underlying inflation pressures are more modest than the reported core inflation rate is that wage growth has not yet picked up very strongly. Negotiated pay has improved from 1.5%oya during the pandemic to 3.0%oya in 3Q22, but higher wage growth is needed for the region to sustainably transition away from the 1% inflation regime it was stuck in before the pandemic (Figure 8). Admittedly, effective pay is firmer than negotiated pay, but even this has only increased at a 3.4%ar in 1H22. Some of the upward pressure also relates to

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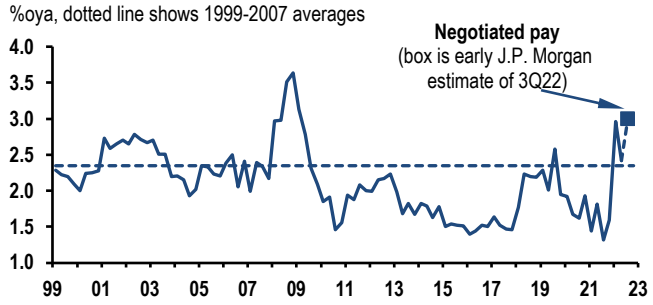
adjustments to national minimum wages and to wage indexation clauses in a small number of Euro area countries (e.g. Belgium).

Figure 8: Euro area negotiated pay growth



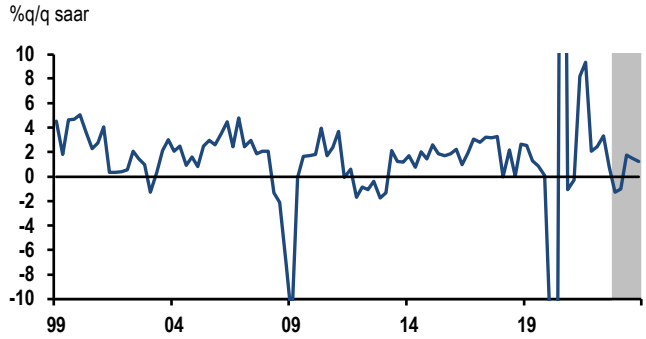
Source: ECB, Eurostat, J.P. Morgan

Lackluster growth in 2023

Against this backdrop, our forecast for 2023 has a number of key features.

- **A mild energy recession this winter.** Relative to the size of the income shock, the recession we expect this winter is very mild with GDP declining only 0.6% peak-to-trough. This reflects the progress the region has made in building its gas storage, the adjustments made by the private sector and the targeted fiscal supports. Despite this, we expect GDP to contract 1.25%q/q saar in 4Q22 and 1%q/q saar in 1Q23.

Figure 9: Euro area real GDP



Source: Eurostat, J.P. Morgan

- **A modest mid-year bounce.** As we expect gas prices to remain high, averaging €155/MWh, the bounce in activity in 2Q23 will mainly reflect the fading drag from rising energy prices rather than an outright boost that would result if energy prices were to fall outright. The region will also face a challenge in rebuilding its gas storage for the following winter in absence of any Russian gas flows through NS1. In fact, there is also a risk that Russian flows through other routes are cut and that the region faces stronger competition for global LNG. Hence, some uncertainty is likely to persist next year, dampening economic sentiment. Overall, we expect growth to rebound only 1.75%q/q saar in 2Q23.

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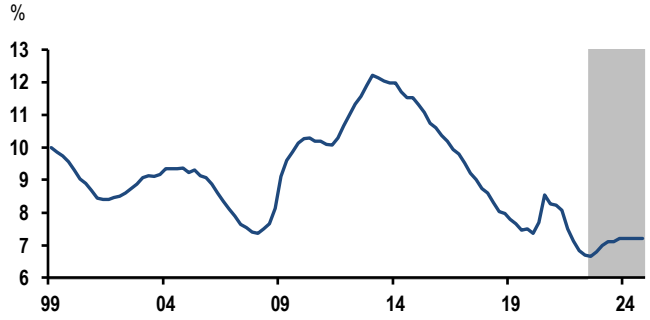
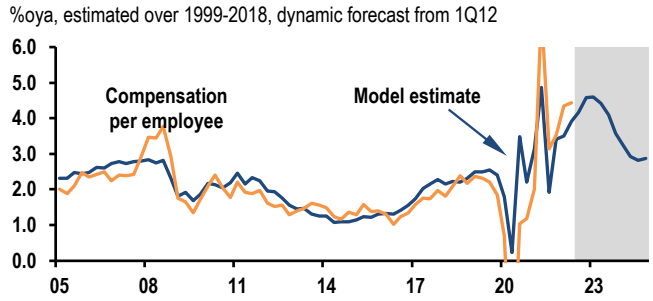
- **Building drags weigh on 2H23.** As we move past mid-year, the impact of faster monetary tightening in the US (and UK) will weaken the external backdrop. This adds to a shift in domestic financing conditions and fiscal policy that is modestly more restrictive overall (even if it continues to target parts of the economy particularly impacted by persistently high energy prices). The slowing profile on external demand in 2H23 in particular will weigh on Euro area growth, causing a slowing to 1.5%q/q saar in 3Q23 and 1.25%q/q saar in 4Q23.
- **Taking a bit of steam out of the labor market.** The incomplete recovery from this winter's energy-related recession and the slowing growth into end-2023 suggest that Euro area unemployment will not reverse the likely increases this winter. Hence, the labor market is likely to become a bit less tight (Figure 10). This requires that productivity per employment picks up to a more normal level as a continuation of the very job-rich growth seen recently could push unemployment even lower. It also requires some further growth in the labor force. On the productivity side, the recent pickup in wage growth and high levels of labor shortages could encourage firms to focus more on the intensity with which they use labor, leading to slower jobs growth. If correct, the increase in unemployment would help to move wage growth lower again to levels consistent with unit labor costs growing around 2% (Figure 11). Reinforcing this would be the fall in inflation and a fading of special factors (e.g. large minimum wage increases, non-negotiated pay components).

Figure 10: Euro area unemployment rate



Source: Eurostat, J.P. Morgan

Figure 11: Euro area wage growth



Source: Eurostat, J.P. Morgan

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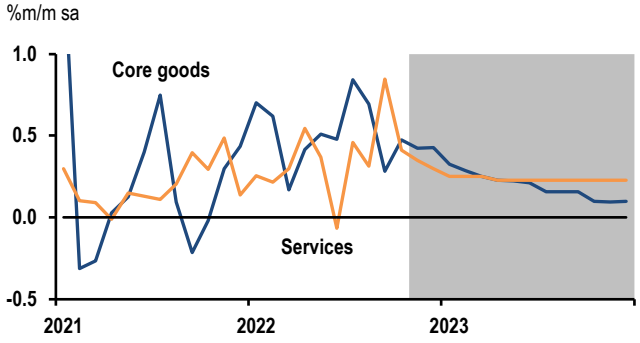
ECB faces a difficult balancing act

The ECB faces a difficult task in navigating through the huge crosscurrents likely to affect the Euro area economy and the lack of clarity about where inflation is likely to settle over the medium-term. As a result, it is not difficult to see the ECB erring on the side of hiking more rather than less in the near-term. A few issues are likely to guide its decisions.

- **Going to normal.** Irrespective of how the inflation surge is interpreted, it makes little sense at present to have an accommodative policy stance. This suggests that the ECB will almost certainly want to raise rates back to neutral, which we continue to put at 2%. This journey is likely to be complete in December.
- **A peak in inflation concerns.** How far the ECB goes into restrictive territory will depend important on how soon there is a peak in its level of concern about inflation. Preconditions for a slowing and eventual pause in the rate hiking cycle are an absence of second round effects and clear signs of a turn in the inflation data. The first two of these are still being met as longer-term inflation expectations remain anchored overall and as wage growth has not picked up to worrying levels. What is still missing however is a turn in the incoming inflation data. There may be some hints of moderation in core goods inflation on a seasonally adjusted basis (Figure 12), while a repeat of last month's downside surprise in US core inflation could have some signaling value for the ECB as well. Overall, a peak in inflation concerns is unlikely until 1Q23, which raises the risk of larger rate hikes in the very near-term.

Figure 12: Euro area core inflation



Source: ECB, J.P. Morgan

- **Recognizing the external "help".** While an absence of second round effects and a turn in the inflation data would likely reduce some of the ECB's inflation concerns, an easing in labor market conditions would give much greater confidence that the landing zone for inflation in the medium-term will be at the target. In this context, the energy recession this winter and the larger tightening already delivered by the Fed, which is expected to significantly slow US growth, will impact labor market conditions in the Euro area. This will do some of the job the ECB would otherwise have to do with monetary policy. While an energy recession in the region looks imminent, the timing of US growth concerns is more uncertain. It would however likely play a key role in convincing the ECB that a renewed tightening in labor market conditions is unlikely after this winter.
- **Watching the passthrough.** The ECB looks set to not only raise its policy rates further but, having already tightened the TLTRO conditions to encourage earlier

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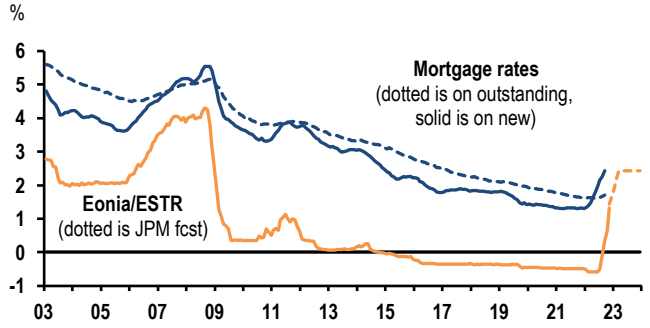
repayments, it also looks set to begin some quantitative tightening next year. The impact of this on bank lending conditions and sovereign yields/spreads will be crucial. Through to September, the increase in actual new bank lending rates has looked relatively normal. However, the passthrough to outstanding mortgage rates may be slower than normal due to a lengthening in recent years of the rate fixation periods (Figure 13). There are also no clear overextensions in the economy, which gives some resilience to higher borrowing rates. However, accidents in financial stability cannot be ruled out and sovereign spreads could at some point see larger upward pressures even if the ECB's new TPI looks effective at reducing the risk of this.

Figure 13: Euro area interest rates on mortgages



Source: ECB, J.P. Morgan

Overall, our forecast has the ECB rising rates further by 50bp in December, 25bp in February and possibly by another 25bp in March. This would take the deposit rate to 2.25-2.5%. If the ECB's tightening and signs of a US slowing are sufficiently strong by that time, then the ECB could pause. The risk remains skewed to faster hikes in the very near-term, with 75bp in December likely to be on the table. A lot will depend on the next HICP report and the new ECB staff forecasts.

It is also possible that the ECB will accelerate a decision on quantitative tightening. At present, only the broad principles look set to be decided in December, but an actual decision is possible. Nevertheless, our base case is that the ECB will delay a final decision until February or March, with a start in April. We expect only APP to be affected, with PEPP reinvestments continuing in full until "at least the end of 2024", and we also do not expect any active selling. As the ECB's forecast of redemptions for the next twelve months amount to around 10% of its APP holdings, a scaling back of the reinvestments will likely suffice to shrink the portfolio quickly enough. At first, the ECB may halve the reinvestments across all parts of the APP (i.e. government bonds, corporate bonds, covered bank bonds and ABS) and then cease all reinvestments at a later date (e.g. 4Q23) if the initial phase did not cause an overly adverse market reaction. At that point, flexibility in PEPP reinvestments would remain available to manage any unwarranted fragmentation, while TPI could also be activated if fragmentation were to become very problematic.

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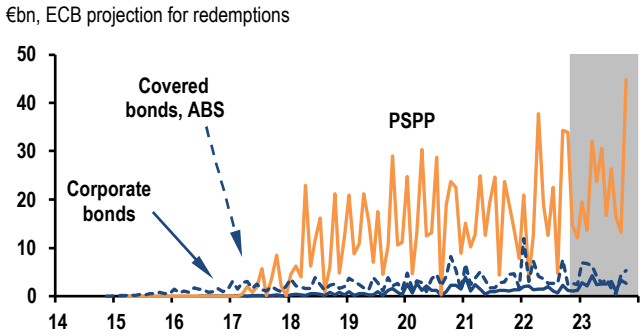
Figure 14: APP redemptions



Source: ECB, J.P. Morgan

Further institution building

Even though the Euro area has been affected by broader populist forces, it has managed to strengthen its institutional architecture. Building on PEPP and NGEU, 2022 saw the launch of the ECB's Transmission Protection Instrument, which allows unwarranted fragmentation to be addressed during a rate hiking cycle and against acceptable conditionality. As we move into 2023, the region is likely to strengthen its strategic resilience (e.g. in energy security). But, importantly, it will also debate important reforms of the fiscal rules. The European Commission has already published proposals that adjust the existing rules in a sensible way to take into account the wide range in government debt levels. This debate will likely result in an agreement next year.

The ongoing institution building continues to have a positive impact on national politics as well. In Northern European countries, recent supports (e.g. NGEU, TPI) have come with sufficient conditionality. In the South, the conditionality has come with sufficient levels of support. Hence, concerns of both sides have been taken into account. One result is that the cost of reneging on fiscal and reform commitments is high for countries in the South as they would lose access to various supports. This acts as a disciplining mechanism on domestic politics, most visible at present in the prudent statements made by the new right-wing government in Italy.

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Euro Investment Grade: In the Sweet Spot

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- **Altogether, we are forecasting 30bp of spread tightening to 180bp next year, as: i) valuations are too cheap to ignore; ii) rates stability could be a tailwind; iii) we expect very limited net supply; and iv) swap spread narrowing could improve global relative value.**
- **We recommend: i) OW Banks vs Corporates; ii) buying reverse Yankees; and iii) positioning for higher dispersion, including BBB / A decompression.**
- **Our full year 2022 supply forecasts are €450bn gross / €70bn net, split into €250bn gross / €50bn net from Non-Financials and €200bn gross / €20bn net from Financials.**
- **With the Euro Area economy likely having entered recession this quarter, we expect fallen angel volumes to tick up slightly to €20bn, or 0.8% of investment grade notional.**

In our view, the bottom is in for euro investment grade. After an incredibly difficult twelve months full of war, inflation and recession, we think the outlook is finally looking brighter for credit investors. Our economists expect an economic recovery in the Euro Area to begin in the second quarter, supported by a steady decline in core inflation towards the central bank mandate by the end of the year as passthrough effects from energy and the weaker currency fade. We expect ECB policy rates to reach their terminal level by early next year, at a below market consensus 2.25-2.5%. At the same time, valuations have become too cheap to ignore, and the cost of being under-invested is too punitive at these higher yields, which is already encouraging investors to deploy their cash on the sidelines. Further, we expect the technicals to be strong, with only limited net supply as the quantitative easing fueled growth in the total size of capital markets comes to an end.

Overall, **we are forecasting 30bp of spread tightening to 180bp**, translating into an excess return of ~3.6% (Figure 15). This would only take us to levels from the early summer, and still above the historical median. Investment grade only traded above 180bp for twenty months and sixteen months respectively in the 2008/9 and 2011/2 recessions, and this time around we have already been above that threshold for six months. By the end of next year, we would therefore already be matching the length of the previous worst case stress episodes at nineteen months.

Figure 15: EUR IG Benchmark Spreads, bp

Source: J.P. Morgan, Markit Group. Annotations are time spent above 200bp.

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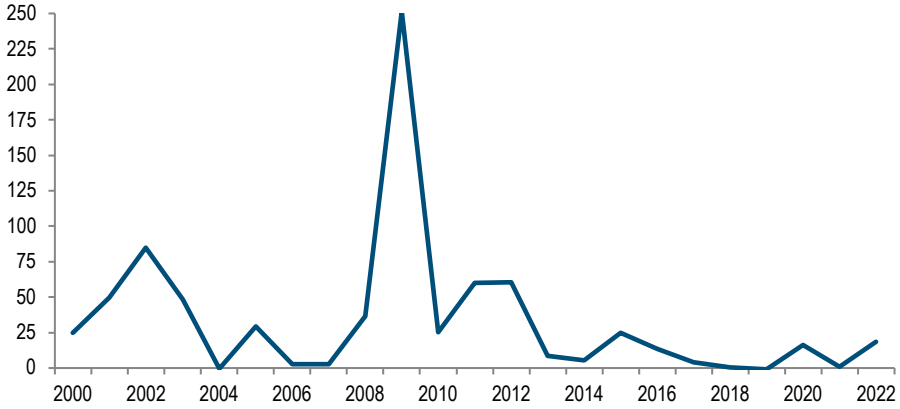
Why are we not looking for an even bigger rally? There are several concerns which keep us from turning more aggressively bullish. Primarily, there is risk of an economic "double-dip" in Europe driven by a desynchronized global cycle, with a potential risk that the US economy only enters recession in late 2023 or 2024. In our view, it will be challenging to see a more significant tightening until this hurdle has been cleared. Additionally, unlike in previous recessions, we are less likely to see a full pivot in central bank policy with a shift towards stimulus. On the contrary, next year our market may have to contend with Quantitative Tightening for the first time as the ECB shrinks its APP portfolio. As a result, the rally could be slower and bumpier than in previous recoveries. Nonetheless, this should not detract from the key message of stronger markets next year.

Value is hard to ignore

In our view, investors are currently being compensated for close to a worst-case scenario for credit risk on a hold-to-maturity basis. Estimating realized credit losses on investment grade is not simple, as actual defaults tend to be very rare, but we typically think that the negative impact of fallen angels on high grade portfolio returns is the best measure. Using our usual methodology of assuming that investors buy investment grade at the new issue price and are forced sellers on the day fallen angels leave the benchmark – adjusting for rates moves in the interim – we estimate that the worst single year for losses was 252c in 2009, still only just above current spread levels of 210bp even after the latest rally (Figure 16).

Further, the current spread does not only compensate for risk over the next year, but is earned over the full life of a portfolio, which is currently around five years on average. Over the cycle, the average credit loss from fallen angels has been just 34c per year. As a result, in our view, we would need to see an unprecedented environment over the next half decade for excess returns to be negative on a hold-to-maturity-or-downgrade basis going forward.

Figure 16: Portfolio Credit Losses from Fallen Angels, c



Source: J.P. Morgan, Markit Group, Bloomberg Finance L.P.

Rates stability could set the groundwork for a better year

As inflation begins to roll over, our economists believe that global central banks are approaching terminal policy rates. In Europe, we are only looking for a 50bp hike in December, followed by another 25bp in February and potentially one final 25bp hike in March next year depending on the data, taking the deposit rate to 2.25-2.5%. Similarly, in the US, we are also looking for the Federal Reserve to hike by a further

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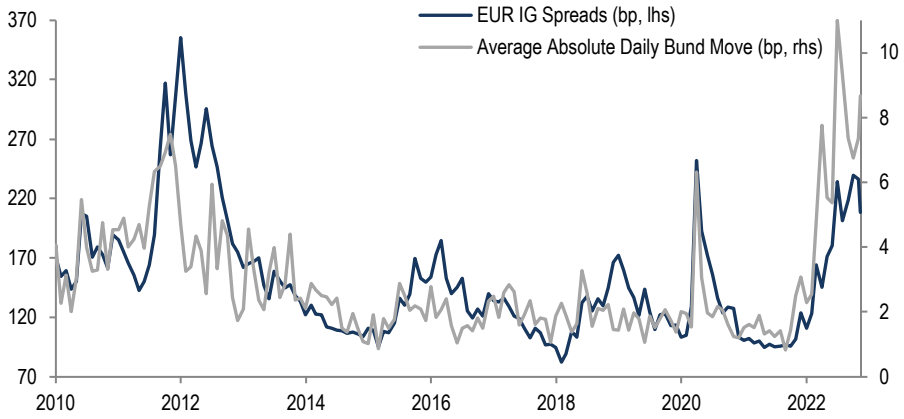
75bp by the end of 1Q23 before pausing to assess the impact of their already delivered tightening on the economy.

As a consequence, we think that rates volatility could decline substantially from the record levels set this year, when 5y Bund yields have moved by an astonishingly high 6.9bp per day on average (Figure 17). To put this in context, the average move over 2008-9 was only 5.2bp. Historically, investment grade spreads have correlated very closely to rates volatility, and so, in our view, this could be a significant tailwind to valuations next year.

Figure 17: EUR IG Benchmark Spreads vs Rates Volatility



Source: J.P. Morgan, Markit Group.

Limited supply is more important than ECB QT for the technicals

In December, our economists are expecting the ECB to announce their plans for balance sheet normalization. We expect them to gradually ramp up Quantitative Tightening over the second and third quarters, before ending APP reinvestments completely by the start of the fourth quarter. This would shrink their balance sheet by ~€160bn over 2023 in total, hitting peak pace of ~€30bn/month.

In our view, this will have a meaningful indirect impact on investment grade, both by signaling tighter monetary policy and reducing the overall liquidity in euro fixed income markets. However, the actual direct impact is fairly negligible. We are expecting ECB CSPP holdings to fall by €13bn in total over the year, which is very small in the context of a €2.5tn market.

Instead, we think the biggest theme in the technicals next year will be a continued slowdown in primary markets. We are expecting little to no net issuance, as: i) corporates maintain conservative capital allocations given weak business sentiment and more expensive funding; ii) bank loans begin to displace capital markets as a source of financing, with the quantitative easing fueled growth in bond markets coming to an end; and iii) SLAC issuance reaches a steady state. Altogether, we are forecasting issuance of just €450bn gross / €70bn net.

As a result, we expect technical conditions to be very solid. After redemptions, coupon reinvestments and negative net CSPP purchases, we estimate that investors will only have to take up around €40bn of new paper next year, the lowest since at least 2015. In our view, this will be easily absorbed by regular inflows into the market from insurance premiums and pension contributions.

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Table 2: Supply - Demand Balance, €bn

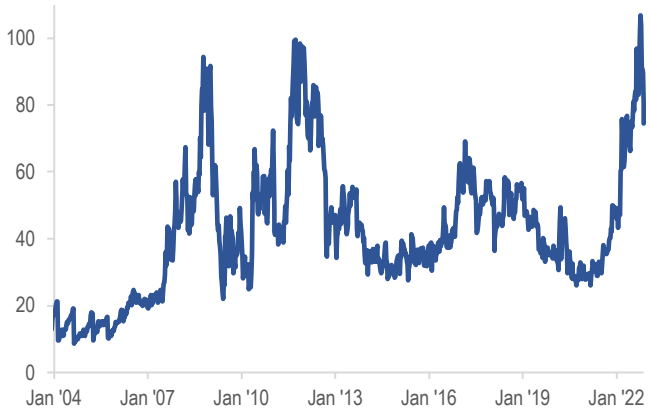
	2015	2016	2017	2018	2019	2020	2021	2022	2023
Gross supply	406	438	439	414	553	567	487	460	450
Redemptions	235	239	270	209	236	255	277	333	382
Coupons	47	43	41	40	40	39	37	37	41
Net CSPP/PEPP	0	51	84	34	6	87	79	36	-13
Balance	**124**	**105**	**44**	**131**	**271**	**186**	**94**	**54**	**40**

Source: J.P. Morgan, ECB. 2022 and 2023 are forecasts.

Just what are we forecasting, anyway?

Outside of credit, one of the most significant trends in euro fixed income this year has been a widening in swap spreads. In mid-October, the 5y swap spread temporarily reached levels even higher than the financial crisis at 109bp, driven both by a scarcity of bund collateral and systemic stress from pension fund LDI liquidations (Figure 18). In our market, this has caused a huge divergence between government spreads, which we track and currently look cheap, and Z-spreads, which are closer to the middle of the range in historical terms (Figure 19).

Figure 18: EUR 5y Swap Spreads, bp



Source: J.P. Morgan, Bloomberg Finance L.P.

Figure 19: EUR IG Benchmark and Z-Spreads, bp

Source: J.P. Morgan, Markit Group.

There is a risk that we could see a continued reconvergence between these two metrics next year as Quantitative Tightening and early TLTRO repayments add collateral into the market. If we see swap spread narrowing next year, it is possible that we could simultaneously see tighter G-spreads and flat Z-spreads; for example, if swap rates fall, credit yields follow the move, and Bund yields remain stable. Which measure is most relevant will depend on the rates hedging strategy of each investor.

However, if this does occur, we would note that it should be supportive for international demand for euro credit. Elevated swap spreads have left euro credit looking unattractive relative to dollars on a fully swapped basis for most of this year, despite the worse economic environment in our region, although, as we discuss below, it does already look very good on a 3m/12m FX hedged basis (Figure 20). If euro Z-spreads lag in the midst of a broader risk rally, we think it could make the global relative value case for euros more compelling.

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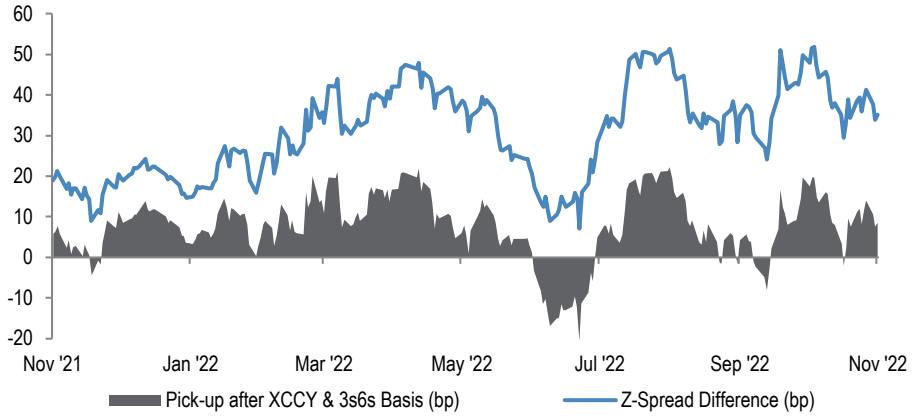
Figure 20: USD - EUR Spreads, bp after duration matched xccy hedges



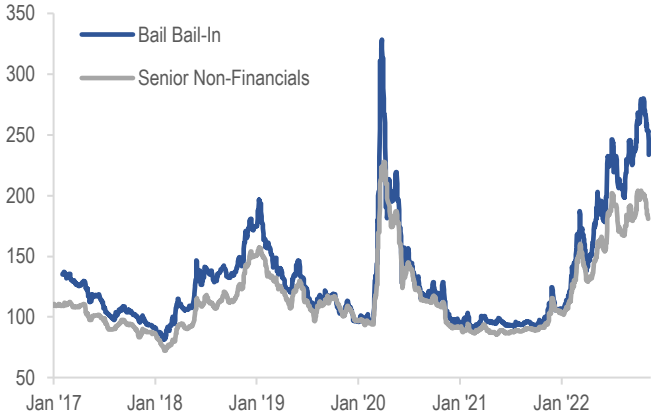
Source: J.P. Morgan.

Top trades

OW Banks vs Corps

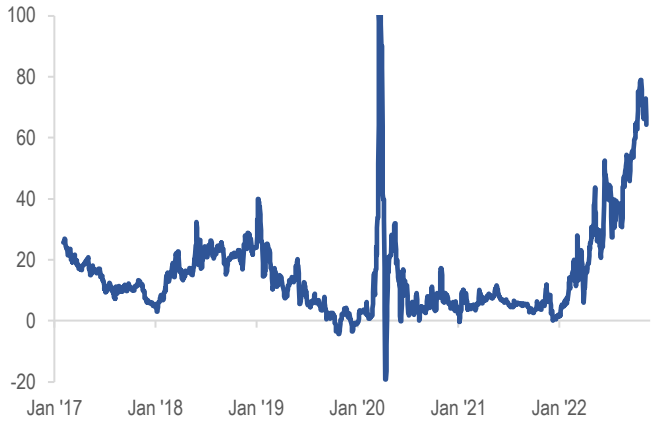
In our view, it is attractive to buy senior financials. This year, the bank sector has been one of the biggest underperformers, with the differential between senior bail-in and senior Non-Financials widening to 64bp (Figure 21 and Figure 22). These levels were only seen for a few days during the pandemic, and quickly reversed once overall spreads began to move tighter.

Figure 21: Financials and Non-Financials Benchmark Spreads, bp



Source: J.P. Morgan, Markit Group.

Figure 22: Financials - Non-Financials Differential, bp



Source: J.P. Morgan, Markit Group.

In our view, Financials are pricing in significant systemic risk, which we do not think is justified as: i) banks are almost as well capitalized now as at any point over the past few decades with average CET1 levels of 15.2% (Figure 23); ii) policy makers are highly focused on both preventing and responding to stability risks, as shown both by the precautionary announcement of the TPI by the ECB and the rapid BoE response to the UK LDI stress; iii) much of the leverage in euro markets has shifted out of the banking system and into areas such as private credit; and iv) European banks stand to benefit from the higher rates environment in the long-run, with wider margins driving higher pre-provisioning profits.

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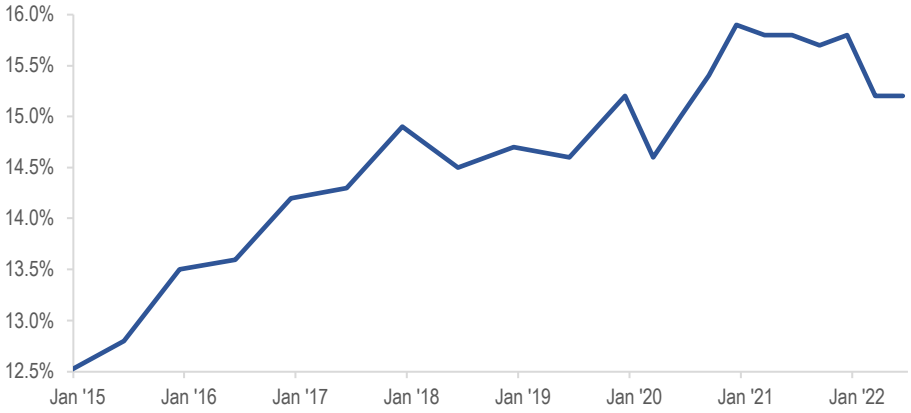
Figure 23: European Bank Average CET1 Ratio, %

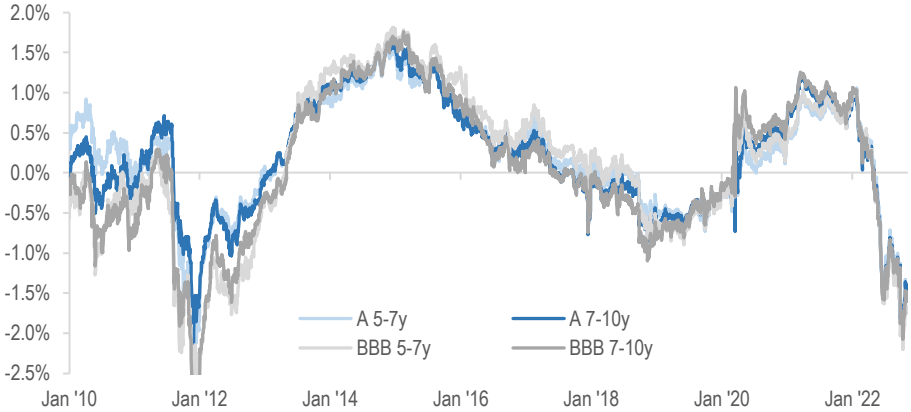


Source: J.P. Morgan, EBA.

Reverse Yankees

In our view, euros currently look extremely attractive relative to dollars on a 3m or 12m FX hedged basis. Due to euro benchmark spread underperformance and the divergence between Federal Reserve and ECB policy rates, the differential between the two currencies has increased to ~1.5% across all rating buckets, the widest since the peak of the Eurozone crisis in 2011/2 (Figure 24).

Figure 24: USD - EUR Yields, % 3m FX hedged



Source: J.P. Morgan, Markit Group, Bloomberg Finance L.P. Data as of 9-Nov-22.

Anecdotally, however, we have only seen very limited buying of euro assets by US and Asian investors so far. Up until now, our understanding is they have been dissuaded by the energy crisis, together with concerns that we could see a renewed bout of periphery sovereign stress. However, as both of these issues move out of the spotlight – with energy storage levels likely to be adequate for the winter, and a market friendly Italian budget this month – we expect an increase in cross-border flows into our currency.

In our view, the most comfortable place for foreign investors to add is likely to be reverse Yankees, which we think could outperform due to this demand technical. In Table 3, we show a list of top opportunities to add yield through euros hedged with a 12m FX forward paying 2.58%.

Table 3: Top Reverse Yankee Opportunities

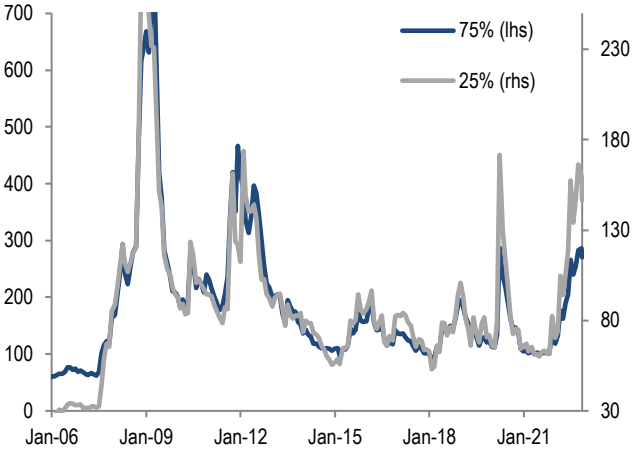
Ticker	EUR ISIN	Coupon	Maturity	EUR yield	EUR Yield + 12m FX hedge	*USD ISIN*	*USD Yield*
WPC	XS2306082293	0.95	01/06/2030	5.96	**8.54**	*US92936UAG40*	*5.87*
BCRED	XS2403519601	1.75	30/11/2026	6.91	**9.49**	*US09261HAD98*	*6.93*
DLR	XS2063495811	1.125	09/04/2028	5.34	**7.92**	*US25389JAV89*	*5.76*
SPG	XS1412281534	1.25	13/05/2025	4.26	**6.84**	*US828807CV75*	*4.95*
BRK	XS1200679071	1.125	16/03/2027	3.57	**6.15**	*US084664CZ24*	*4.30*
PM	XS1066312395	2.875	14/05/2029	4.76	**7.34**	*US718172CJ63*	*5.49*
CE	XS2497520887	5.337	19/01/2029	6.67	**9.25**	*US15089QAN43*	*7.41*
PSA	XS2384697830	0.5	09/09/2030	4.31	**6.89**	*US74460WAE75*	*5.10*
CB	XS2012102914	1.4	15/06/2031	4.16	**6.74**	*US171239AG12*	*5.00*
PM	XS1040105980	2.875	03/03/2026	4.11	**6.69**	*US718172CR89*	*4.95*

Source: J.P. Morgan. Pricing as of 1pm 10-Nov. 12 month FX hedge at 2.58%.

Dispersion is set to rise

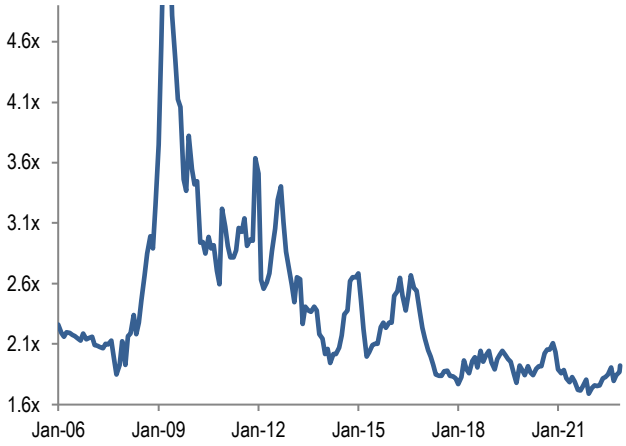
In our view, higher quality bonds have room to outperform in the rally. The weakness over the past year has primarily been focused on the monetary policy tightening cycle, which has disproportionately impacted the upper end of the rating spectrum. The swap spread widening has also impacted spreads-to-Bunds on everything in tandem. As a result, our favourite measure of dispersion – the ratio between the 75th and 25th percentile of bonds by spread in the index – has barely budged from the lows (Figure 25 and Figure 26).

Figure 25: EUR IG 75th and 25th Percentile Benchmark Spreads, bp



Source: J.P. Morgan, Markit Group.

Figure 26: 75 / 25 Percentile Spread Ratio, x



Source: J.P. Morgan, Markit Group.

In our view, dispersion is set to rise as we enter recession. We expect the market focus to turn to corporate fundamentals as 4Q22 and 1Q23 earnings are released, and away from central banks as they approach terminal rates. As a result, while we expect everything to rally, we expect higher-quality paper to outperform in spread ratio terms. In particular, we think we could see further decompression between BBB / A, with the ratio remaining near historical lows (Figure 27).

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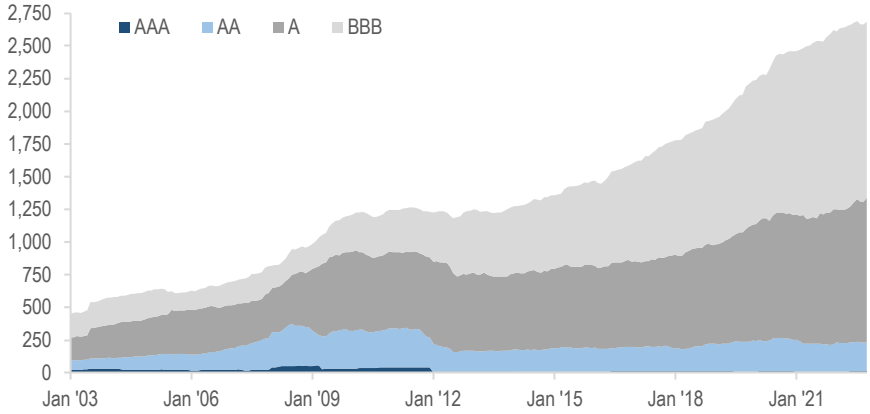
Figure 27: BBB / A Benchmark Spread Ratio, x

Source: J.P. Morgan, Markit Group.

Supply: Entering the post-growth era for capital markets

Altogether, next year, we are forecasting investment grade supply of €450bn gross / €70bn net. In our view, the rapid expansion in the total size of the market fueled by quantitative easing over the past six years is over, with only low single-digit growth rates in notional outstanding likely from here (Figure 28). In part, we expect corporates to be more conservative as funding becomes more expensive, and we also expect bank loans to displace capital market borrowing. Further, we think that the financial sector is approaching a steady state on MREL requirements, leading to lower bail-in senior issuance volumes.

Figure 28: EUR IG Notional Outstanding, €bn



Source: J.P. Morgan, Markit Group.

Redemption volumes

The starting point for our supply forecasts is always refinancing needs. According to our estimates, these will increase sharply next year to €380bn, up by 15% YoY (Table 4). This has been rising steadily over recent years, and, in our view, this trend is set to continue over the next cycle as redemption volumes gradually catch up with the growth in the overall size of the market. To provide some context, annual issuance volumes over the past five years have averaged just over €500bn, with most of these bonds maturing over 2024 - 2029.

Table 4: Redemption Profile by Sector, €bn

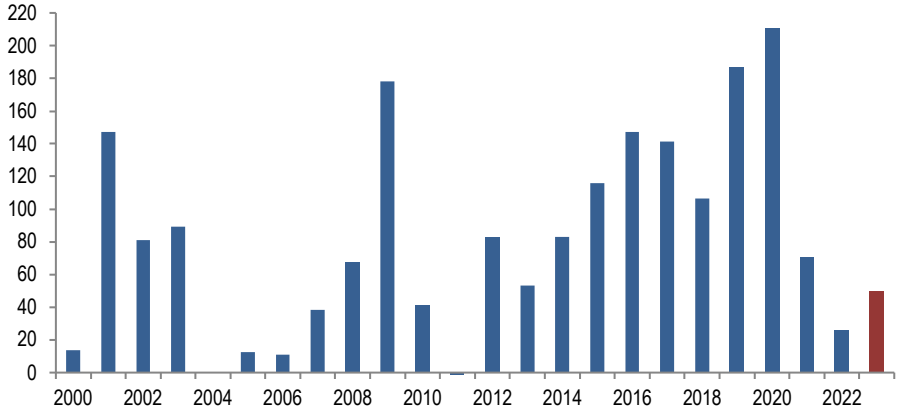
	Basic Materials	Consumer, Cyc	Consumer, Non-cyc	Energy	Industrial	Technology	Telecoms	Utilities	Non-Financials	Financials (ex-REIT)	Real Estate	Total
Jan	0.0	3.8	2.0	0.0	0.7	1.8	1.3	1.0	10.4	15.4	0.2	**26.0**
Feb	0.0	5.6	3.7	2.6	3.2	1.0	0.0	4.0	20.2	9.5	0.0	**29.6**
Mar	1.5	4.1	8.3	0.8	1.9	0.0	3.0	2.4	21.9	26.3	0.7	**49.0**
Apr	1.9	4.8	0.9	0.8	2.6	0.0	1.8	2.7	15.5	14.3	2.4	**32.2**
May	2.3	4.6	3.3	1.0	3.5	3.5	0.3	0.2	18.6	17.1	0.2	**35.9**
Jun	2.3	2.4	9.7	2.3	2.6	1.5	0.8	1.6	23.0	12.3	1.0	**36.2**
Jul	0.0	4.5	1.2	2.3	0.5	1.5	1.5	2.8	14.2	16.6	0.5	**31.3**
Aug	0.0	2.8	2.4	0.0	0.0	0.0	1.8	1.3	8.2	7.9	0.0	**16.0**
Sep	1.8	5.3	3.9	0.9	4.7	0.8	6.0	4.9	28.2	16.3	3.5	**48.0**
Oct	0.0	5.9	3.9	0.0	2.1	0.0	1.7	2.3	15.8	17.1	1.0	**33.9**
Nov	0.0	4.8	8.7	1.0	2.2	0.0	3.2	0.6	20.5	12.9	0.9	**34.3**
Dec	0.2	0.0	1.2	0.5	1.2	0.0	0.3	0.8	4.1	4.3	1.0	**9.3**
2023	**9.9**	**48.4**	**49.0**	**12.0**	**25.2**	**10.0**	**21.6**	**24.5**	**200.5**	**169.9**	**11.4**	**381.8**
2022	*10.3*	*34.2*	*29.1*	*11.6*	*12.8*	*7.8*	*20.1*	*29.8*	*155.7*	*168.7*	*8.4*	*332.8*

Source: J.P. Morgan, Markit Group.

Non-Financials net issuance

In our view, next year will once again see very light net issuance from the corporate sector, although potentially still a small increase from the very low base this year. On the one hand, we expect management teams to be in cost cutting mode, with limited appetite to add to leverage multiples, and we also think that bank loans could partly displace capital market borrowing. On the other hand, however, some sectors are running low on liquidity after delaying deals due to the volatility this year, and so we could see some catch up. **We are forecasting €250bn gross / €50bn net of Non-Financials issuance in 2023 (Figure 29).**

Figure 29: Non-Financials Net Issuance, €bn



Source: J.P. Morgan. 2022 is ytd, and 2023 is forecast.

CFOs are playing defence

In our view, corporates are likely to become increasingly conservative with their capital allocation next year. Business sentiment has rolled over in recent months, both due to a squeeze on margins from rising energy and labour costs, and in anticipation of a broader downturn in the economy (Figure 30). Consequently, we expect only limited appetite for new capital expenditures and bolt-on acquisitions, which should reduce net issuance requirements next year.

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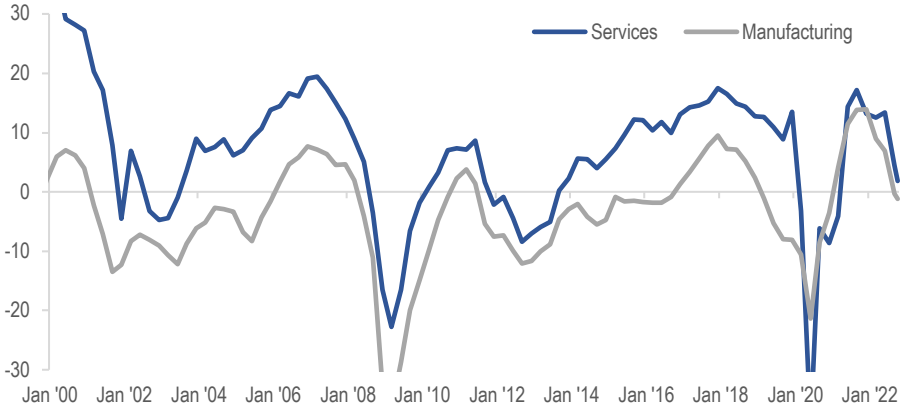
Figure 30: Business Sentiment Indicators

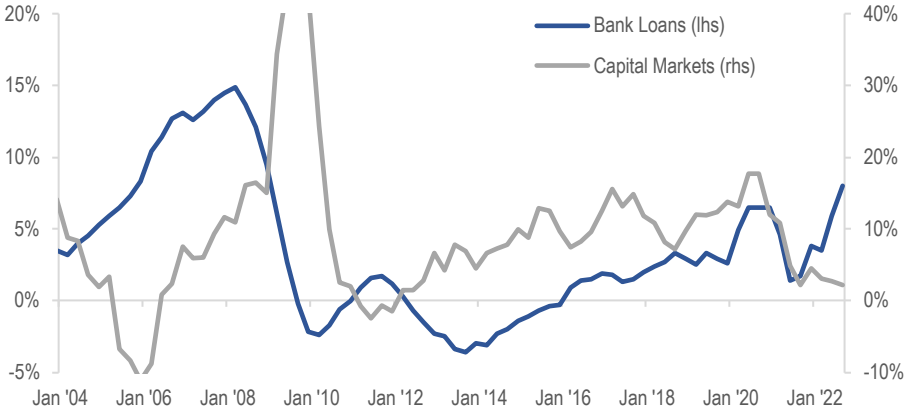


Source: J.P. Morgan, European Commission.

'Bank dis-intermediation' is over

Additionally, we think we could see some 'bank re-intermediation', after more than a decade of the opposite trend (Figure 31). Capital markets are becoming a less attractive source of funding in the absence of central bank purchases, and, in our view, the financial sector could step in to fill the gap. The European banking system currently has ample excess capital and cheap funding from deposits, which means that expanding the loan book could be profitable at these current higher yields. This could particularly impact sectors which are suffering from weak investor sentiment but have unencumbered assets to pledge against bank loans.

Figure 31: Growth in bank loans and EUR IG notional outstanding, %yoy

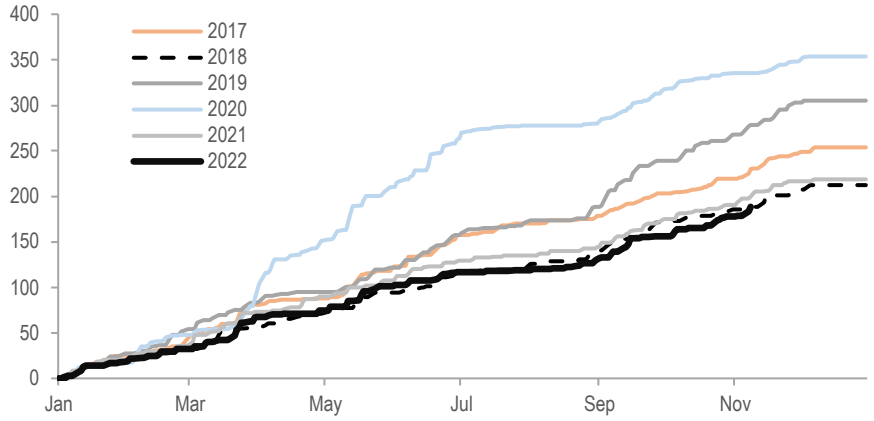


Source: J.P. Morgan, ECB, Markit Group, Bloomberg Finance L.P. ECB Euro Area MFI loans to Non-Financials.

Corporates have less cash on balance sheet

Over much of the past two and a half years, corporate primary markets have been very sluggish. Non-Financial supply is running at just €188bn year-to-date, the slowest pace since 2014 (Figure 32). In our view, issuers were initially just winding down the 'war chests' of liquidity which they built up over the pandemic. More recently, however, we think they have been largely waiting on the sidelines in anticipation of better market conditions, as we have rapidly bounced from the Russia/Ukraine war to the end of ECB CSPP purchases, to the energy crisis, and most recently to the UK LDI liquidation stress.

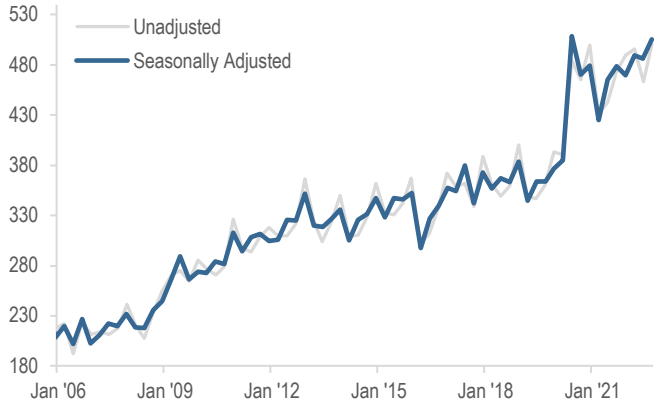
Figure 32: EUR IG Non-Financial Cumulative Supply, €bn



Source: J.P. Morgan.

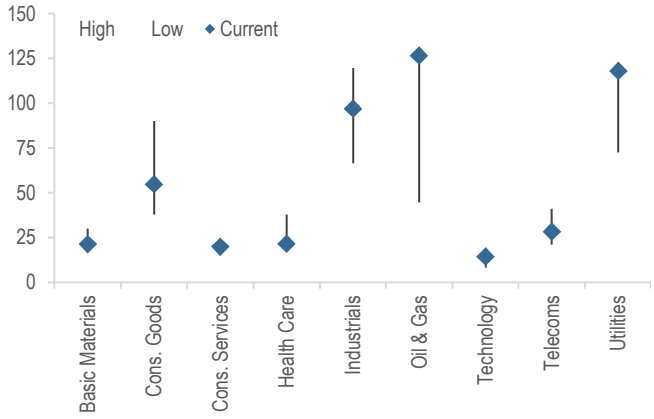
Consequently, cash balances have started to dwindle across many sectors, falling back towards the middle or even bottom end of their historical range from the past decade (Figure 33 and Figure 35). While cash on balance sheet remains near the highs on aggregate, this has been distorted by cash build in the Oil & Gas sector, where record profits are being retained on balance sheet to finance the green transition, and because it would be politically unpopular to raise shareholder payouts substantially in the middle of an energy crisis. In our view, this could put some upward pressure on issuance volumes next year.

Figure 33: European (ex-UK) Investment Grade Cash on Balance Sheet, €bn



Source: J.P. Morgan, S&P Capital IQ.

Figure 34: European (ex-UK) Investment Grade Cash on Balance Sheet by Sector, €bn 2012 - 2022 range



Source: J.P. Morgan, S&P Capital IQ.

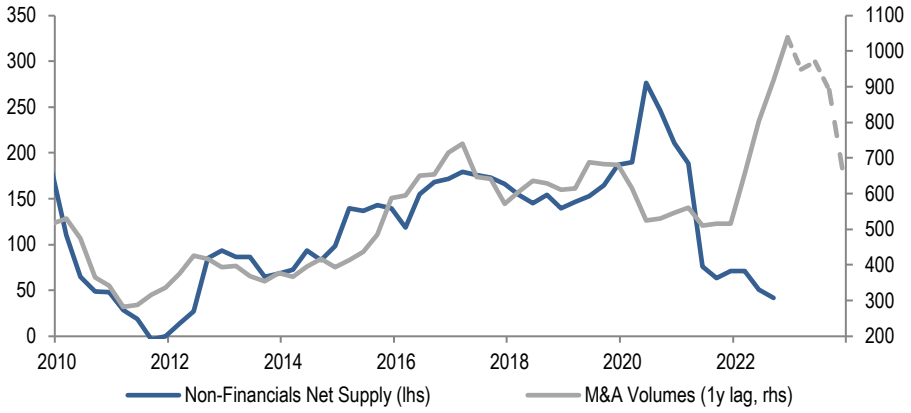
M&A is becoming less of a guide to supply

Over the past cycle, the single best predictor of future supply has been 12-month trailing M&A volumes. However, this relationship has broken down since the pandemic, with very light issuance despite the highest acquisition volumes in over a decade last year and still very elevated levels this year (Figure 35).

In our view, there are several reasons for this. First, up until recently corporates have been running down the heavy cash balances which they raised during the pandemic. Additionally, some of the larger pending deals in our figures this year have either been the purchase of a European asset by a foreign acquirer (such as Swedish Match

/ Philip Morris), private equity buyouts, or even nationalizations (Uniper). Finally, it is possible that there has been a shift towards organic cashflow or equity financing of deals as the cost of debt has risen. In our view, this latter point could become more relevant over the next cycle.

Figure 35: EUR IG Non-Fin Net Supply vs M&A volumes, LTM €bn



Source: J.P. Morgan, Bloomberg Finance L.P.

Financials net issuance

In Table 5 below, we provide a breakdown of our Financials supply forecasts by sector and asset class. Overall, we expect net issuance to be only just positive at €20bn, the lowest in five years. Primarily, our banks analysts think that banks are approaching steady state on MREL issuance, where we are looking for just €60bn of euro-denominated supply. Instead, where banks need funding, we expect them to go to covered bond markets at lower yields. Additionally, we expect another year of very limited REITs issuance, with investors hesitant to add to their positions after an extremely challenging year. Instead, we believe this sector will lean on secured bank financing given low asset encumbrance ratios.

Altogether, including insurance, REITs, and non-European banks, we expect Financials supply of €200bn gross / €20bn net.

Table 5: Financials Supply Estimates, €bn

	Gross Issuance (€bn-equiv)	Net Issuance (€bn-equiv)	% €	Gross Issuance (€bn)	Net Issuance (€bn)
Preferred Senior	110	-13	60%	66	-8
Non-Preferred Senior	130	18	45%	59	8
T2	35	3	60%	21	2
Insurance	22	5	75%	17	4
REIT	10	-2	100%	10	-2
Non-European/other	30	15	100%	30	15
Total				**202**	**19**

Source: J.P. Morgan.

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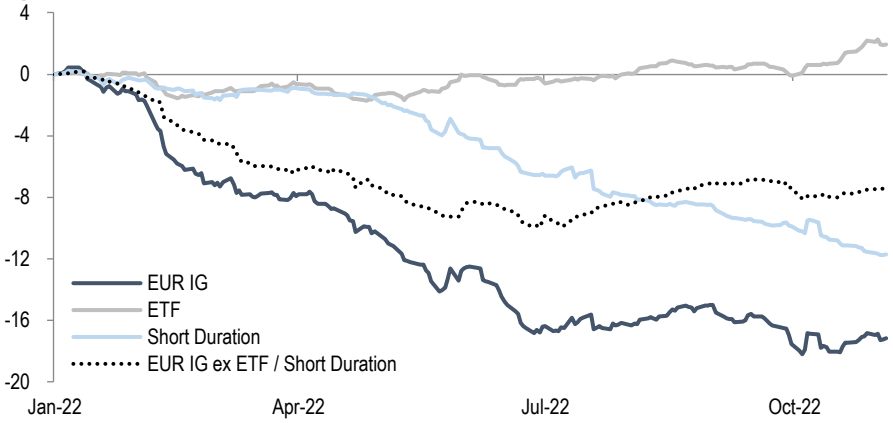
Demand: Bouncing back

Retail fund flows could show some improvement

It has been a very challenging year for investment grade retail funds. In total, they have seen outflows of €17.3bn (7.5% of AUM), the largest redemption since the period of Italian political turmoil and Federal Reserve Quantitative Tightening in 2018 (Figure 36). The vast majority of this occurred over the first half of the year in response to both the Russia-Ukraine war and the end of ECB CSPP purchases, although there was still a very small drawdown over the second half. Overall, the outflow was roughly evenly split between traditional 'mutual-style' funds and short-duration funds. ETFs were an exception, actually seeing a meaningful inflow of €2bn (10.5% of AUM) on the year.

Looking forward, we expect retail demand to show some improvement, but likely only modest. In our experience, fund flows are often a lagging function of market performance, and – as long as rates can hit a peak and begin to stabilize – we think that both total and excess returns are likely to positive next year due to better carry at these higher yields. However, there are opportunities in every segment of risk markets after the broad-based weakness this year, and so corporate bonds are unlikely to be a priority for investors.

Figure 36: EUR IG Cumulative Retail Fund Flows, €bn



Source: J.P. Morgan, Bloomberg Finance L.P.

ECB CSPP reinvestments will be good while they last

Over the first quarter of next year, we expect an acceleration in ECB CSPP reinvestments to €3.1bn/month, up from an average of €1.5bn/month in 2022 (Figure 37). In our view, this will be a modest positive technical, although the impact is much smaller than net purchases.

However, from the second quarter onwards, we expect reinvestments to slow and eventually stop. Assuming that they reinvest approximately half of their redemptions in 2Q/3Q23 and zero in 4Q, this will cause their portfolio to shrink by €13bn over the full year. This is a significant change in policy, although given the small figures we think the impact is very manageable for the market.

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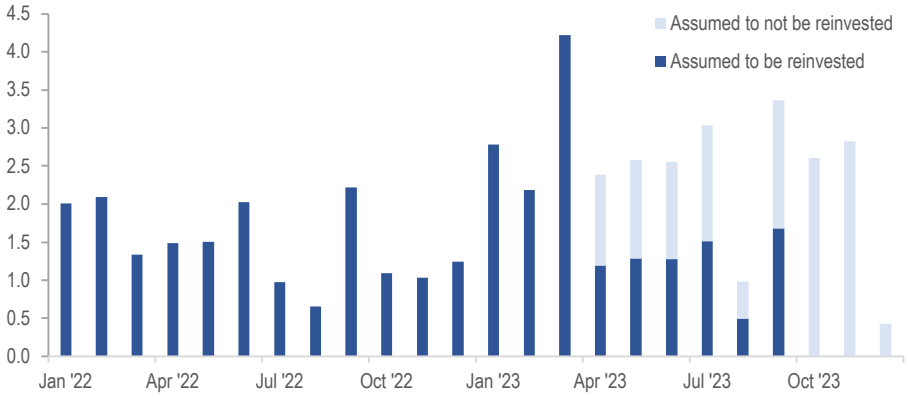
Figure 37: ECB CSPP Redemption Profile, €bn



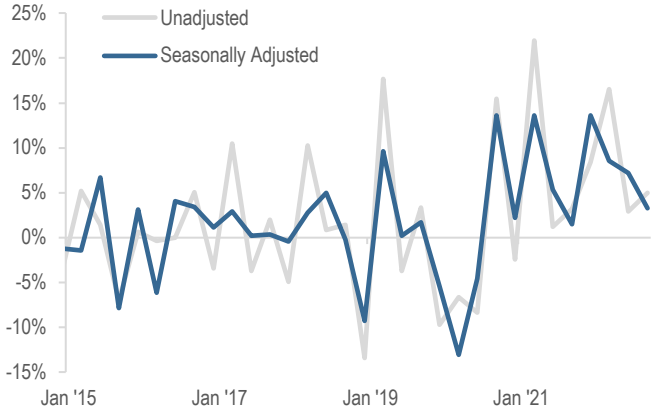
Source: J.P. Morgan, ECB.

Fundamentals: Recession impact is yet to come

Credit fundamentals are holding up for now

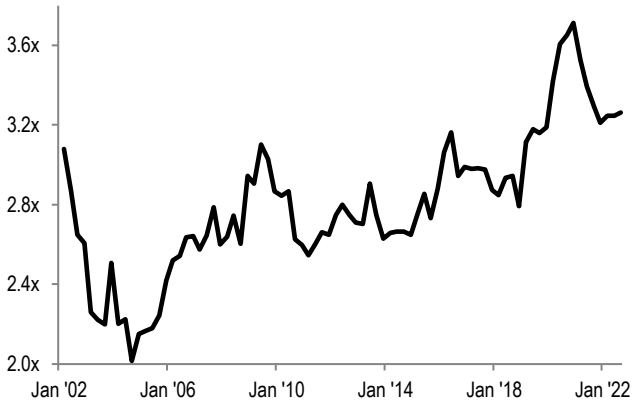
With just under half of our sample of ~200 European (ex-UK) investment grade corporates having reported for the third quarter, there is little sign of weakness in the fundamentals so far. EBITDA grew by 3.3% q/q sa, which, while down from some of the very elevated figures over the past few years of recovery from the pandemic, is still strong in historical terms (Figure 38). Further, it was broad based across sectors, with Oil & Gas, which has driven a lot of the strength in recent quarters, essentially growing in line with the average. This translated into flat net leverage on the quarter at 3.3x (Figure 39).

Figure 38: European (ex-UK) IG EBITDA Growth, % QoQ



Source: J.P. Morgan, S&P Capital IQ.

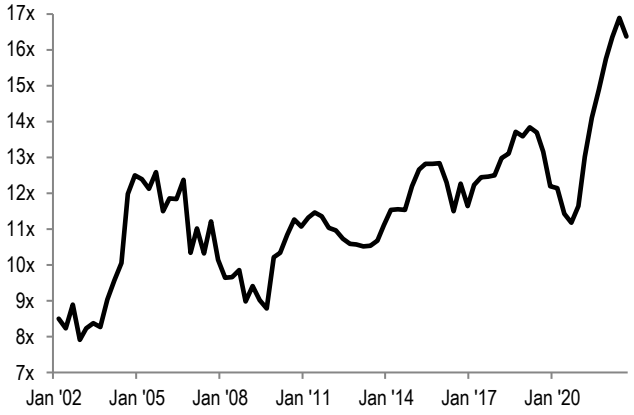
Figure 39: European (ex-UK) IG Net Leverage, x



Source: J.P. Morgan, S&P Capital IQ.

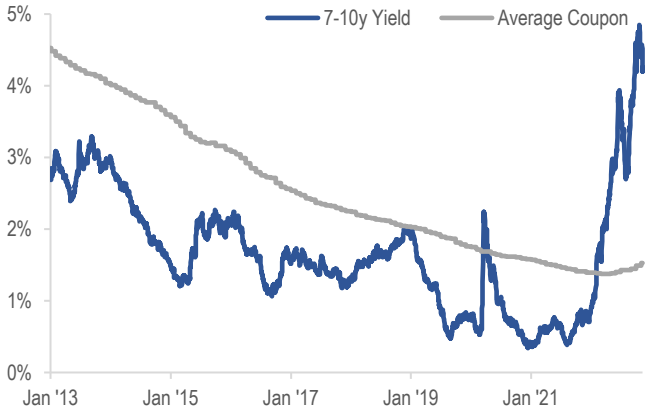
The only real sign of weakness came from interest coverage, which declined by 0.5x on the quarter to 16.4x (Figure 40). Looking forward, interest costs are set to rise further as low coupon bonds are refinanced at higher yields, with the 7-10y yield on the benchmark of 4.26%, which is indicative of new issue levels, now at almost triple the average coupon of 1.53% (Figure 41).

Figure 40: European (ex-UK) IG Interest Coverage, x



Source: J.P. Morgan, S&P Capital IQ.

Figure 41: EUR IG 7-10y Yield vs Average Coupon, %

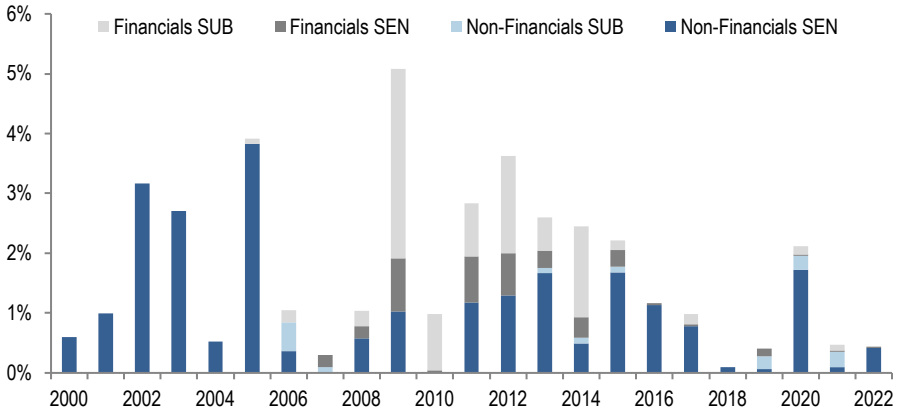


Source: J.P. Morgan, Markit Group.

Fallen angel rates remain near the lows

Euro investment grade has only seen €11.5bn of fallen angels to date, or 0.4% of notional (Figure 42). The entirety of this has been from senior Non-Financials, with the bulk made up of sanctioned Russian credits (GAZPRU/NLMKRU) or issuers directly impacted by reductions in gas flows from the country (ENAPHO).

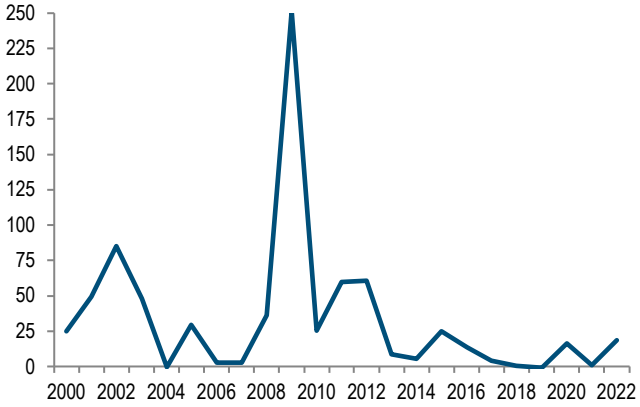
Figure 42: EUR IG Fallen Angel Rate, % of notional with contribution by category



Source: J.P. Morgan, Markit Group.

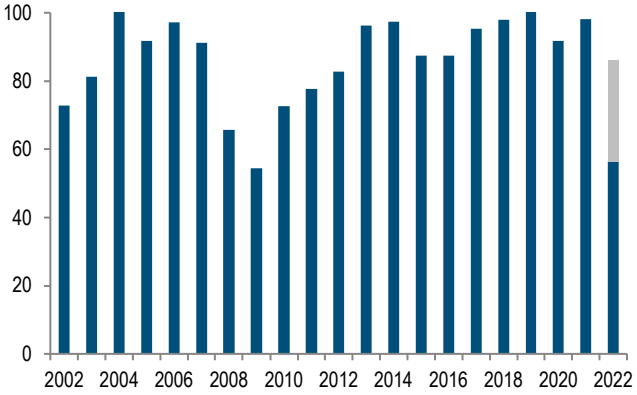
The impact on performance has been somewhat larger than might have been expected from the low headline downgrade rate. Using our usual methodology of assuming that investors buy at new issue and are forced sellers on the day fallen angels leave the benchmark – adjusting for rates moves in the interim – we estimate that downgrades have subtracted 18c from credit returns for a typical portfolio this year, slightly more than in 2020 (Figure 43). This reflects both large losses on sanctioned bonds, and a more sustained high spread environment this year compared with the rapid gap wider and snap back during the pandemic. Even excluding sanctioned names, the average fallen angel has lost 14pts from spread widening this year, compared with just 2pts last year (Figure 43).

Figure 43: Portfolio Credit Loss from Fallen Angels, c



Source: J.P. Morgan, Markit Group, Bloomberg Finance L.P.

Figure 44: Average Fallen Angel Exit Price Adjusting for Rates, pts



Source: J.P. Morgan, Markit Group. Grey bar excludes sanctioned issuers.

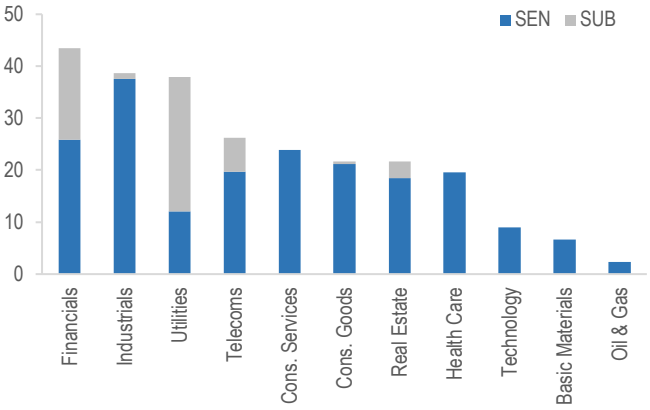
We set a fallen angel forecast of €20bn

As the economy moves into recession this quarter, it seems likely that we are due for an uptick in fallen angel volumes. There is currently €250bn of BBB- rated paper outstanding, or just under 10% of the investment grade benchmark (Figure 45 and Figure 46). This is down slightly from the recent peak, due to a wave of downgrades during the pandemic, but is still a large pool of at-risk paper.

Figure 45: BBB- Notional Outstanding, €bn

Source: J.P. Morgan, Markit Group, Bloomberg Finance L.P.

Figure 46: BBB- Notional by Sector, €bn



Source: J.P. Morgan, Markit Group, Bloomberg Finance L.P.

With that said, however, when we actually look at this bucket from a bottom-up perspective, there are only a handful of names that our sector analysts see as real fallen angel candidates (Table 6).

We see elevated risks of downgrade for: i) **Wizz Air** following the move to negative watch at Fitch considering the company's significant exposure to Eastern Europe, ambitious growth plans and mostly-unhedged fuel position; ii) **Celanese** due to elevated net leverage and cyclical end market; iii) **Metro AG** as the company is BBB-/Neg at S&P, with the rating agency expecting leverage to remain close to the downgrade threshold and potentially downgrading on an exit from Russia; iv**) Nissan Motor** as higher financing rates affect auto demand and weaker financial cushion due to possible electric vehicle investment in Renault; v) **Adecco hybrids** as weaker business sentiment impacts demand for temporary workers; vi) **JCDecaux** as advertising spending falls with firms moving into cost saving mode; and vii) hybrids

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from **Aroundtown, Grand City** and **Unibail-Rodamco**, all of which are already trading at very wide levels.

This is €11bn of paper in total, or roughly on par with the volume of fallen angels from last year. However, from a top-down perspective we think this is potentially an underestimate given the macroeconomic environment, with some single-name surprises along the way, and so we set a 2023 forecast of €20bn of fallen angels, or 0.8% of euro investment grade notional.

Table 6: 2023 Fallen Angel Candidates

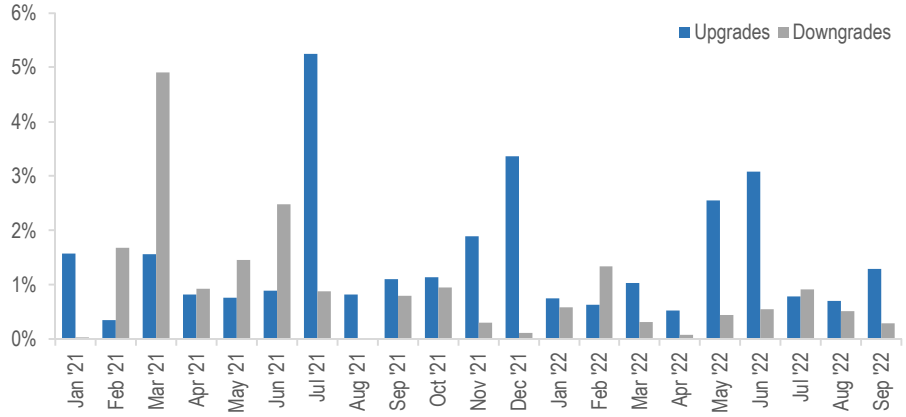
Analyst	Issuer	Sector	Rating*	Index Notional (€bn)
Danielle Ward	Wizz Air	Transport	Baa3/BBB-	1.0
Ben Defay	Celanese	Chemicals	BBB/Baa3/BBB-	2.5
Neill Keaney	Metro AG	Retail	BBB-	0.6
Jemma Permalloo	Nissan Motor	Autos	BBB-/Baa3	1.5
Jemma Permalloo	Adecco (sub)	Services	BBB-/Baa3	0.5
Andrew Webb	JCDecaux	Media	BBB-/Baa3	1.7
Roberto Henriques	Aroundtown (sub)	REITs	BBB-	1.7
Roberto Henriques	Grand City (sub)	REITs	Baa3	0.7
Roberto Henriques	Unibail-Rodamco (sub)	REITs	BBB-/Ba1/BBB-	0.8
			Total	**11.0**

Source: J.P. Morgan, Markit Group, Bloomberg Finance L.P. *S&P/Moody's/Fitch.

Ratings are moving sideways

Over the third quarter, we saw a slight upward trend in credit ratings for investment grade issuers: 2.8% of bonds in the index were upgraded by at least one notch by at least one agency and 1.7% were downgraded (Figure 47). However, the pace of upgrades did slow notably from the previous quarter.

Figure 47: Euro Investment Grade Rating Upgrades and Downgrades, % of bonds



Source: J.P. Morgan, Markit Group, Bloomberg Finance L.P.

There was little change in the average rating of the index, which remains roughly halfway between A- and BBB+ (Figure 48 and Figure 49). Over both the past year and past three months, the average numerical rating has been almost entirely stable between 7.37-7.39 (7 = A- / 8 = BBB+).

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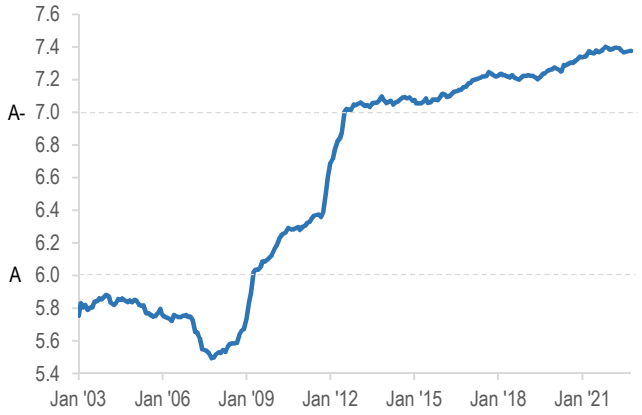
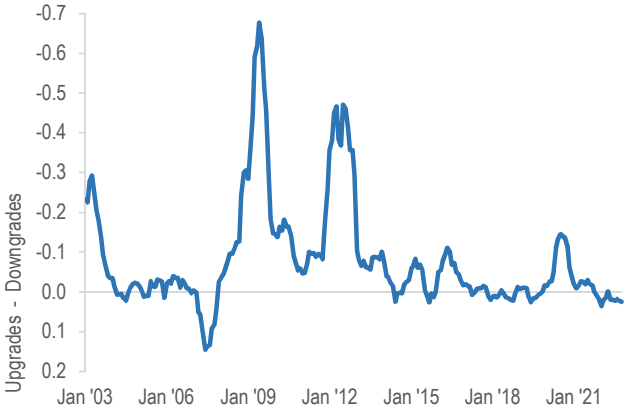
Figure 48: EUR IG Average Rating, converted to number



Source: J.P. Morgan, Markit Group, Bloomberg Finance L.P. AAA =1 / AA+ = 2 / AA = 3 etc.

Figure 49: EUR IG Change in Rating, LTM



Source: J.P. Morgan, Markit Group, Bloomberg Finance L.P. AAA =1 / AA+ = 2 / AA = 3 etc.

Looking forward, in our view, we are likely to see net downgrades as higher energy costs begin to impact margins for third and fourth quarter earnings. Historically, there has been a very strong correlation between net ratings migration and the level of the composite PMI, which has already begun to roll over and could fall further in coming months as our region enters recession (Figure 50).

Figure 50: EUR IG Net Ratings Drift (upgrades - downgrades) vs Euro Area Composite PMI

Source: J.P. Morgan, Markit Group, Bloomberg Finance L.P. Monthly frequency data

Corporate Hybrids: Crunch Time

Overpriced extension risk and low supply a support in 2023

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Next year will see the biggest test of the corporate hybrids market since the financial crisis, in our view. It will be the first time that a large cohort of instruments reach their call dates at a time of market stress, where new hybrids would cost substantially more than the bonds they replace.

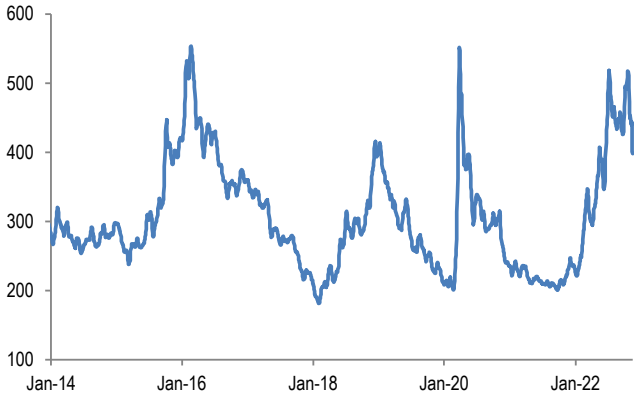
Concern over extension risk pushed spreads to very wide levels during the course of 2022, although this has started to correct in all but a few names. We continue to see **the path of least resistance for most corporates being a 'call and replace' strategy**, even if it means paying a higher coupon than before. Simply put, it's the price for retaining equity credit on the entire hybrid stack, and in many cases the incremental expense will be small in relation to the size of the capital structure.

The cost can also be partly defrayed by repurchasing up to 10% of outstanding hybrids with the agreement of S&P, something we think issuers should consider in any case. Some issuers with only a small amount of hybrid capital might decide that it's no longer worth retaining these in their capital structure, and simply redeem at the call date without replacement, as Naturgy did recently.

While it generally makes sense for existing issuers to roll over hybrid securities at the call date due to rating agency constraints, the case for *net* new hybrid supply is weak at present. Convergence between hybrid yields and the imputed cost of common equity means **that for an equivalent amount of rating agency equity credit, hybrids are more expensive**, even accounting for tax deductibility of coupons (Figure 52). In our view this means **net supply will be negative again next year**.

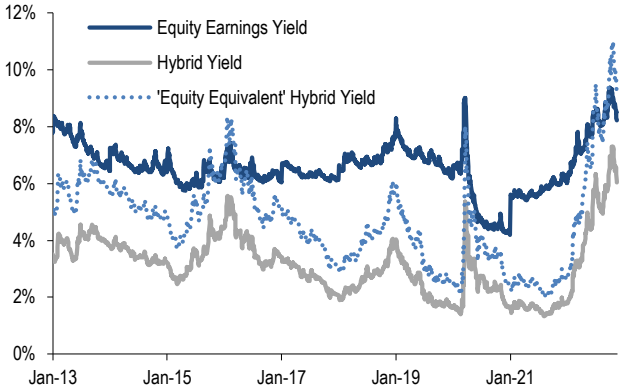
Assuming we're right, **relief over hybrid calls being exercised and supportive supply-side technicals should enable the product to perform well in 2023**, hence our upgrade to an Overweight in the latest *Sector Review*. We think a limited number of idiosyncratic extensions (e.g. within Real Estate) would not invalidate this view.

Figure 51: Euro High Grade Corporate Hybrid Spreads, bp



Source: J.P. Morgan, MARKIT Group.

Figure 52: Comparing Yields on Equity and Corporate Hybrids



Source: J.P. Morgan, MARKIT Group, Bloomberg Finance LP. 'Equity equivalent' hybrid yield based on 50% equity credit and 25% tax rate. Equity earnings yield uses 12m forward earnings estimates compiled by Bloomberg.

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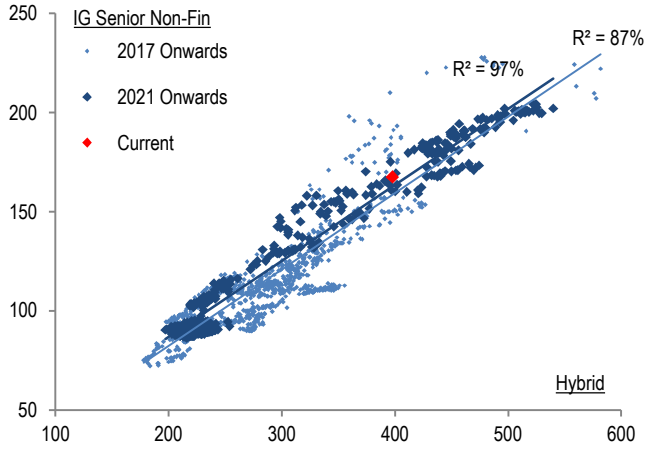
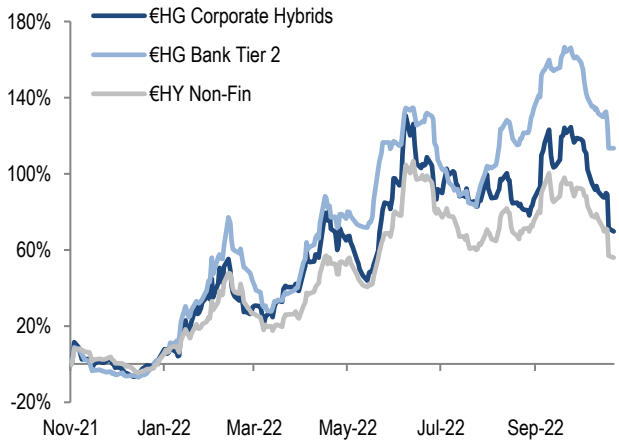
In terms of relative value within the euro credit market, hybrids don't stand out at present. They trade broadly in line with their short- and medium-term relationships versus senior debt (Figure 53). Among high beta credit segments, hybrids have outperformed Tier 2 but lagged high yield over the past 12 months (Figure 54). However, this is consistent with the general outperformance of corporates versus financials across both senior and subordinated paper.

Figure 53: High Grade Corporate Hybrid vs Senior Spreads, bp



Source: J.P. Morgan, MARKIT Group.

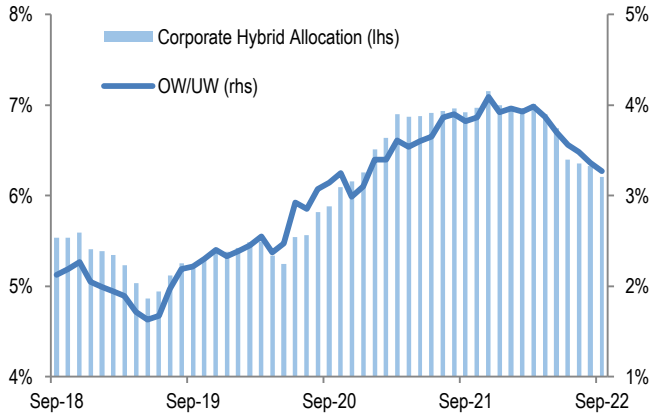
Figure 54: 'High Beta' Credit 1Y Spread Changes Rebased



Source: J.P. Morgan, MARKIT Group.

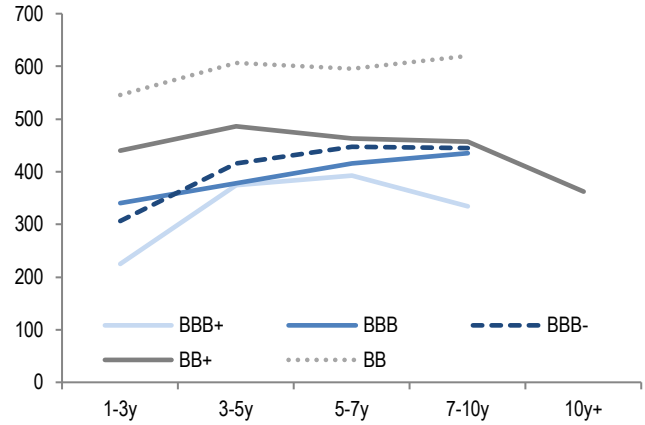
One of the overhangs for the hybrid market is that benchmarked high grade investors are already heavily exposed to the segment, limiting their capacity to add more exposure. Our latest figures show that hybrid allocations have steadily moderated in recent months, and the Overweight is down by 0.8%-points since last year's peak to 3.3% in September. In our view investors will slow their rebalancing away from hybrid debt once fears of extension fade, and with the credit market showing more resilience next year.

Figure 55: Euro High Grade Fund Allocation to Corporate Hybrids



Source: J.P. Morgan, IPREO.

Figure 56: Hybrid Spread Curves by Rating (ex Real Estate), bp



Source: J.P. Morgan.

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Something for everyone

Wide spreads and flat curves present a 'something for everyone' offer to investors. Fears of extension risk, which we think in most cases are overblown, offer attractive 'safe carry' in short-call hybrids from strong issuers, particularly those with large capital structures that have a history of replacing hybrid instruments. Our analyst team has compiled a basket along this theme in Table 7.

Table 7: Corporate Hybrids 'Safe Carry' Basket

ISIN	Hybrid	Rating	Price	Z-Spread, bp	Yield	Reset Spread, bp
XS0968913342	VW EUR 5.125% Sep-23	Baa2/BBB-	101.00	115	3.8%	335
XS2011260531	MRKGR EUR 1.625% Sep-24	Baa2/BBB+	96.16	93	3.8%	195
XS1309436910	BHP EUR 5.625% Oct-24	Baa1/BBB	103.26	94	3.8%	480
XS1720192696	ORSTED EUR 2.25% Aug-24	Baa3/BB+	95.76	159	4.5%	190
XS1974787480	TTEFP EUR 1.75% Apr-24	A3/A-	96.25	173	4.6%	177
XS1795406575	TELEFO EUR 3% Sep-23	Ba2/BB	98.38	183	4.6%	245
XS1713462403	OMVAV EUR 2.875% Mar-24	Baa2/	97.13	189	4.8%	234
XS1713466495	HOLNSW EUR 3% Apr-24	Baa3/BBB-	97.23	190	4.8%	307
XS1888179477	VOD EUR 3.1% Oct-23	Ba1/BB+	98.55	212	4.8%	267
XS1757377400	ALLRNV EUR 1.625% Mar-25	A3/A-	92.25	199	4.8%	95
XS2056730323	IFXGR EUR 2.875% Jan-25	/BB+	95.25	217	5.0%	339
XS2069101868	KPN EUR 2% Nov-24	Ba2/BB+	92.88	260	5.5%	234
XS1933828433	TELEFO EUR 4.375% Dec-24	Ba2/BB	97.00	291	5.8%	411
XS2010044977	NGGLN EUR 1.625% Sep-24	Ba1/BBB-	92.88	302	5.9%	214
XS0903532090	NGGLN GBP 5.625% Jun-25	Ba1/BBB-	94.57	380	7.9%	348

Source: J.P. Morgan, Bloomberg Finance LP.

For investors with a more bullish outlook, moving down the maturity curve gives an opportunity to lock in for several years yields that were unthinkable just a year ago, adding beta to benefit in the event the market tightens further. The team's 'beta' basket is shown in Table 8.

After the rally of the past few weeks **our current preference is to stick a bit shorter on the curve, with a view to adding duration via primary in new hybrids that in the current environment will offer healthy reset spreads**.

Table 8: Corporate Hybrids 'Beta' Basket

ISIN	Hybrid	Rating	Price	Z-Spread, bp	Yield	Reset Spread, bp
XS2486270858	KPN EUR 6% Sep-27	NR/BB+	101.00	299	5.8%	377
XS1888179550	VOD EUR 4.2% Jul-28	Ba1/BB+	92.25	308	5.9%	343
XS2056730679	IFXGR EUR 3.625% Jan-28	/BB+	89.50	318	6.0%	400
XS1795406658	TELEFO EUR 3.875% Jun-26	Ba2/BB	92.25	340	6.2%	297
XS2342732562	VW EUR 3.748% Dec-27	Baa2/BBB-	89.25	349	6.3%	292
XS2187689380	VW EUR 3.875% Jun-29	Baa2/BBB-	86.13	375	6.5%	396
XS2010045511	NGGLN EUR 2.125% Jun-27	Ba1/BBB-	82.38	397	6.8%	253
XS2342732646	VW EUR 4.375% Mar-31	Baa2/BBB-	85.13	396	6.8%	336
DE000A3E5WW4	EVKGR EUR 1.375% Sep-26	Ba1/BBB-	81.46	433	7.1%	184
PTEDPYOM0020	EDPPL EUR 1.875% Jun-29	Ba2/BB+	71.88	446	7.2%	208
XS2286041517	WNTRDE EUR 2.4985% Apr-26	Ba1/	84.38	471	7.5%	292
XS2035564629	ENBW EUR 1.625% May-27	Baa3/BBB-	78.00	484	7.6%	173
XS2381272207	ENBW EUR 1.375% May-28	Baa3/BBB-	72.13	498	7.8%	165

Source: J.P. Morgan, Bloomberg Finance LP.

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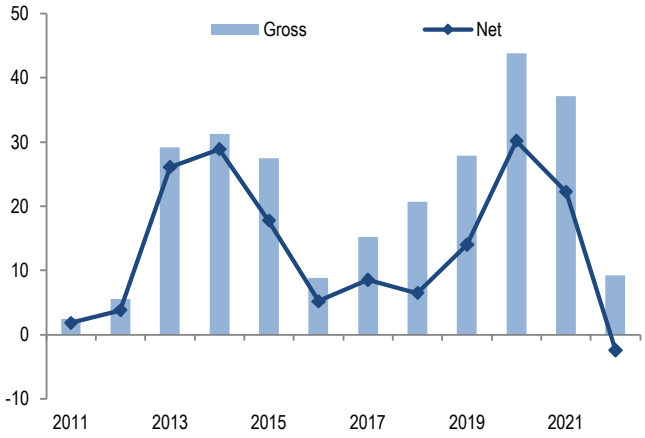
Another light supply year

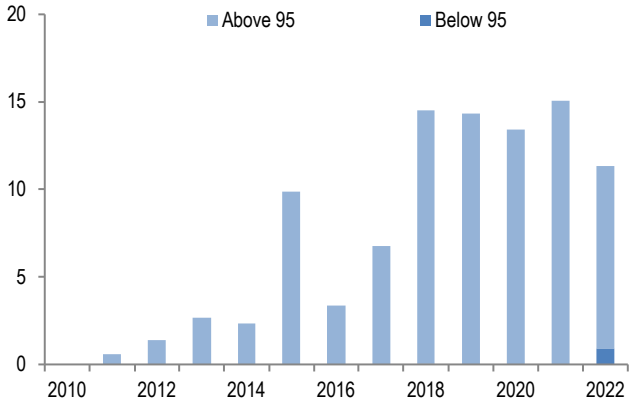
Only €9bn of corporate hybrid supply printed through October this year, a steep fall from the prior two years which saw closer to €40bn in annual issuance. Net supply was marginally negative -€2bn, with most new issue activity used for refinancing existing hybrid securities, and issuers also tendering for bonds. Most of these tenders were for short-call instruments rather than to opportunistically take advantage of low cash prices. Only €1bn of notional was repurchased for a price below 95.

Figure 57: European Corporate Hybrid Issuance, €bn



Source: J.P. Morgan.

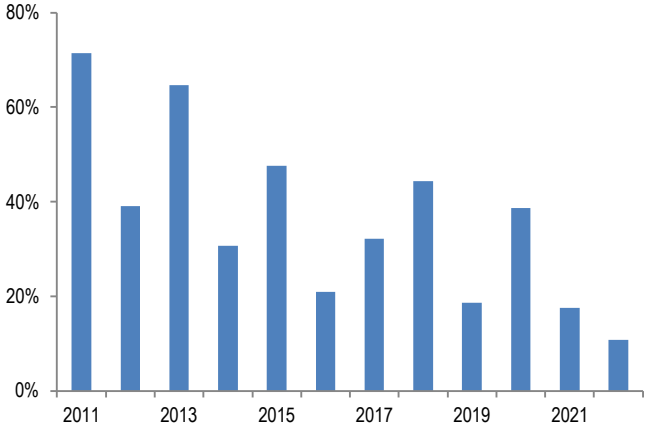
Figure 58: European Corporate Hybrids Call Schedule, €bn



Source: J.P. Morgan.

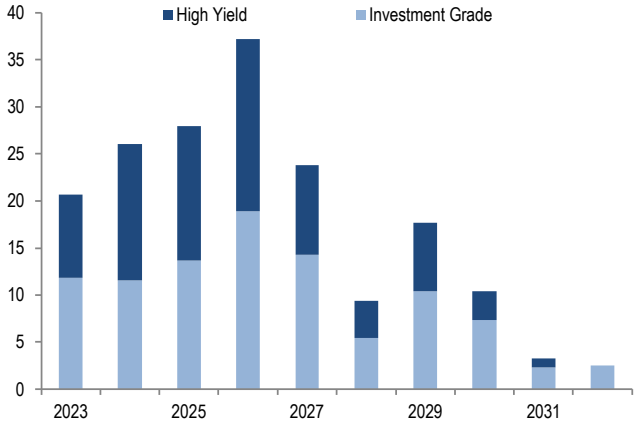
As we mentioned earlier, we expect a similar story for next year: refinancing of upcoming calls, but overall negative net supply with few first-time hybrid issuers and some existing issuers looking downsize their hybrid stacks. We look for €20bn of gross issuance and -€5bn net of redemptions. While it's hard to see much downside to the gross supply target given next year's call schedule, if market conditions improve we could see upside to these figures as issuers also start to tackle 2024 calls.

Figure 59: Proportion of Hybrid Issuance form First-Time Issuers



Source: J.P. Morgan.

Figure 60: European Corporate Hybrids Call Schedule, €bn



Source: J.P. Morgan.

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Table 9: Corporate Hybrids Call Schedule and Estimated Repurchase Capacity

		Amount			Issuer Hybrid Notional		Issuer Hybrid Supply over the past 12m		
ISIN	Instrument	(€ eq)	Price	Reset	Total	10%	Gross	Net	Net + 10%
XS1721410725	ATSAV 4.75 Nov-22 *	41	99.92	955	391	39	350	216	256
XS1629658755	VW 2.7 Dec-22	1,500	100.03	254	15,400	1,540	2,250	1,150	2,690
FR0013310505	ENGIFP 1.375 Jan-23	30	100.00	115	3,423	342	0	-344	-2
XS1508392625	ARNDTN 3.75 Jan-23	369	74.88	438	3,551	355	0	0	355
XS1491364953	GYCGR 2.75 Jan-23	200	77.00	389	1,250	125	0	0	125
USF2893TAF33	EDF 5.25 Jan-23	2,043	95.80	370	13,141	1,314	0	-267	1,047
XS1716927766	FERSM 2.124 Feb-23	500	86.70	213	500	50	0	0	50
XS1721244371	IBESM 1.875 Feb-23	1,000	99.51	159	8,250	825	0	0	825
XS1731823255	TELEFO 2.625 Mar-23 **	676	99.97	233	7,550	755	750	0	755
XS1677911825	BALDER 3 Mar-23	321	86.12	290	765	77	0	-85	-9
XS1150695192	VLVY 4.85 Mar-23	600	100.05	435	600	60	0	0	60
FR0013292828	BNFP 1.75 Mar-23	750	98.81	143	1,250	125	0	0	125
USN4297BBC74	KPN 7 Mar-23	142	99.81	496	1,142	114	500	47	161
XS1115502988	ORAFP 5.75 Apr-23	487	99.80	335	5,437	544	0	0	544
XS1590787799	TELIAS 3 Apr-23	100	99.82	265	1,700	170	1,100	-319	-149
XS1222591023	BERTEL 3 Apr-23	650	98.88	264	1,250	125	0	0	125
XS1224953882	ERFFP 4.875 Apr-23 *	183	99.38	701	583	58	0	-417	-359
XS1501167164	TTEFP 2.708 May-23	1,000	99.48	275	12,250	1,225	1,750	0	1,225
FI4000441860	FOY 10.25 Jun-23 *	200	89.79	1,525	200	20	0	0	20
XS1405763019	LXSGR 4.5 Jun-23	500	98.31	451	500	50	0	0	50
XS0943370543	ORSTED 6.25 Jun-23	350	100.91	450	2,436	244	0	0	244
XS1788973573	AKFAST 3.875 Jul-23	315	96.51	349	650	65	0	-350	-285
XS1634523754	ARNDTN 5.25 Jul-23	625	63.48	355	3,551	355	0	0	355
XS1811181566	GYCGR 2.5 Jul-23	350	73.51	243	1,250	125	0	0	125
FR0013330529	ULFP 2.125 Jul-23	1,250	86.68	168	2,000	200	0	0	200
XS1713463716	ENELIM 2.5 Aug-23	750	97.01	210	6,765	676	0	0	676
XS0968913342	VW 5.125 Sep-23	750	100.63	335	15,400	1,540	2,250	1,150	2,690
XS1795406575	TELEFO 3 Sep-23 **	824	98.16	245	7,550	755	750	0	755
BE0002597756	ELIASO 2.75 Sep-23	700	97.30	242	700	70	0	0	70
US29265WAA62	ENELIM 8.75 Sep-23	1,218	100.22	663	6,765	676	0	0	676
XS1888179477	VOD 3.1 Oct-23	2,000	97.82	267	10,672	1,067	0	0	1,067
XS0992293901	SOLBBB 5.425 Nov-23	500	100.14	370	1,800	180	0	0	180
XS1322373017	VATFAL 6.1 Nov-23	390	96.92	406	1,954	195	0	-303	-107
BE6309987400	SOLBBB 4.25 Dec-23	300	98.49	392	1,800	180	0	0	180
CH0398633724	HOLNSW 3.5 Dec-23	203	99.16	361	703	70	0	0	70
XS1797138960	IBESM 2.625 Dec-23	700	97.25	206	8,250	825	0	0	825
XS1752984440	ARNDTN 2.125 Jan-24	400	55.00	200	3,551	355	0	0	355
FR0013252061	VIEFP 2.875 Jan-24 *	600	97.50	250	3,600	360	0	-500	-140
USF2893TAM83	EDF 5.625 Jan-24	1,461	89.77	304	13,141	1,314	0	-267	1,047
XS1405765659	SESGFP 5.625 Jan-24 *	550	99.46	588	1,175	118	0	0	118
FR0013399177	ACFP 4.375 Jan-24	500	92.82	456	1,000	100	0	0	100
PTEDPKOM0034	EDPPL 4.496 Jan-24	1,000	99.27	429	3,750	375	0	0	375
XS1028599287	ORAFP 5.25 Feb-24	1,000	101.18	367	5,437	544	0	0	544
XS1591694481	TENN 2.995 Mar-24	1,100	97.38	253	1,100	110	0	0	110
FR0014003YZ5	KORIFP 4.125 Mar-24 *	229	76.81	908	229	23	0	0	23
XS1713462403	OMVAV 2.875 Mar-24 *	500	96.72	234	2,500	250	0	-750	-500
XS1050461034	TELEFO 5.875 Mar-24	1,000	100.62	430	7,550	755	750	0	755
XS1974787480	TTEFP 1.75 Apr-24	1,500	95.70	177	12,250	1,225	1,750	0	1,225
XS1713466495	HOLNSW 3 Apr-24	500	96.17	307	703	70	0	0	70
XS1224710399	NTGYSM 3.375 Apr-24	500	98.28	308	1,500	150	500	0	150
XS2000504444	LIBMUT 3.625 May-24	500	86.41	370	500	50	0	0	50
FR0011942283	ENGIFP 3.875 Jun-24	338	99.67	265	3,423	342	0	-344	-2
XS1323897725	SOLBBB 5.869 Jun-24	500	100.76	522	1,800	180	0	0	180
FR0013425170	AKEFP 2.75 Jun-24	400	93.72	287	700	70	0	0	70
XS2017788592	ARNDTN 4.75 Jun-24	457	53.96	438	3,551	355	0	0	355

Source: J.P. Morgan. All amounts in euro mm equivalent. * Denotes unrated by S&P. ** Prior to recent new issue and tender offer.

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Euro High Yield: More Interest

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Executive summary

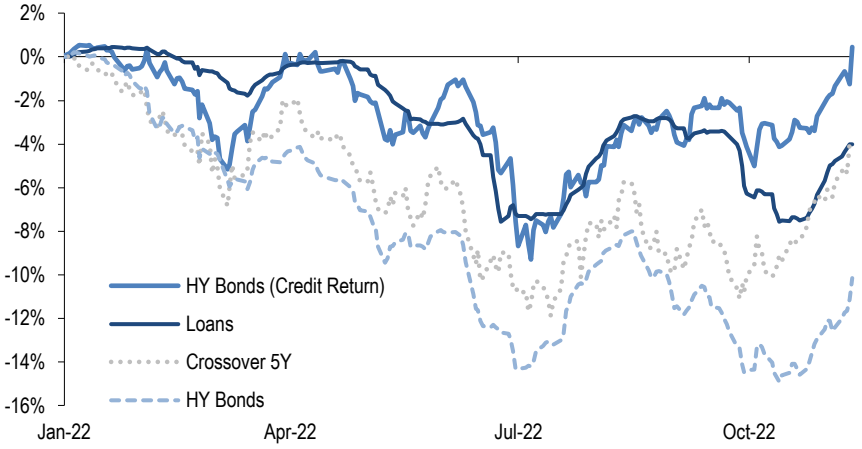
It has been a tough year for European high yield investors, with YTD total returns of -10% on track for the worst full-year outcome since 2008. However, in the context of the broader investible universe of mainstream financial assets, performance has not been so bad, beating longer-duration sovereign and investment grade debt, alongside equities.

Leaving aside the contribution from rates, ***credit* returns have been surprisingly resilient, up 0.5% in bonds but down 4% in loans**. Spreads may have widened substantially, but duration is short and default losses have so far not materialised – the trailing default rate is just 0.4%.

The European high yield market is ending the year with positive momentum. A worst-case outcome of severe energy rationing leading to a deep recession has not materialised, and the end of central bank rate hiking cycles is in sight, thanks to the recent step-down in US inflation. Added to this are signs of policy easing in China.

The technical backdrop has also stabilised, we believe, even though fund outflows are not yet showing signs of moderating after a heavy spell of withdrawals which saw €13bn (16% of AUM) redeemed YTD. **Supply has been sporadic** as issuers delay terming out debt at higher coupons, and banks offloaded bridge risk to alternative lenders. A small contraction in the high yield market size due to net upgrades has helped too. Positioning has also turned more defensive - our measure of high yield **fund betas has been stuck at 'neutral'** for some time now, indicating that there's scope to add exposure. Finally, investment grade funds have **reduced their off-benchmark exposure to 7%**, from a peak of 8.1% at the end of last year.

Figure 61: European Leveraged Finance YTD Returns



Source: J.P. Morgan, MARKIT Group. High yield credit return is total return minus 5y govt return.

While these factors point to some further performance near-term, we think the environment will remain challenging in 2023, as investor **focus shifts away from central banks and towards fundamentals**, with the impact of cumulative rate hikes on the global economy becoming clearer.

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Assuming our base case for a shallow cycle, with default rates lifting to 3% in FY23, **spreads at 550bp today offer a risk premium of just 50bp above the long-term median**. In our opinion therefore, valuations imply a mild and short-lived contraction in Europe and a 'soft landing' in the US. Even if this ends up being true, **we think this view will be tested over the first half of next year**, and expect spreads to remain elevated until a US recession can be ruled out.

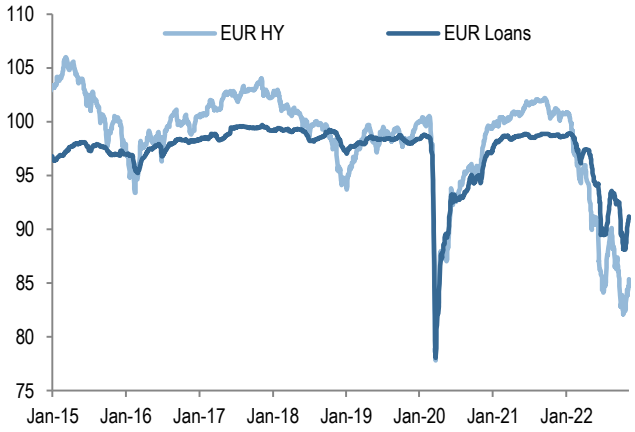
The other sizeable challenge will be when the primary market reopens, as we feel it must soon in order to process the refinancing wall that steps up from 2024 onwards. We pencil in a 40% rise in **leveraged finance origination to €80bn, split €50bn bonds and €30bn loans. This still leaves supply substantially lower** than in previous years.

All told, **we look for spreads to resume widening next year as the global growth slowdown takes hold**. However, we're no longer as bearish as we were for most of H2 given the progress made on European energy supplies, our outlook for defaults to remain contained, plus the wider starting point for spreads and what it means in terms of breakevens. We're also prepared for the fact that we will need to turn more bullish if and when the US macro data rules out a hard landing later in the year.

We set a **target for spreads of 625bp, 75bp wide of current levels**. After accounting for default losses that amounts to a **credit return of 3.5%**. Total returns should be better still, with our economists expecting that the ECB will under-deliver versus market expectations on policy rate increases. **We forecast a total return of 7.5%** over the year, and expect BBs to outperform as rate volatility subsides.

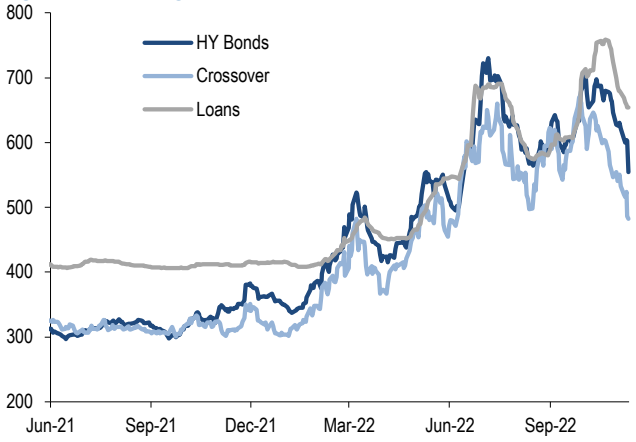
The loan market offers a higher entry point in terms of yields and spreads, but we think this is warranted due to the lower credit quality and swifter pass-through of rising rates into interest expense. We see **the risk-reward profile as more favourable in the high yield bond market:** in the event of a deep recession, bonds offer better protection due to lower spread duration, better rating, lower cash prices, and will benefit if rates rally. **We look for a 5% total return in the loan market**.

Figure 62: Euro High Yield Bond and Leveraged Loan Average Price



Source: J.P. Morgan.

Figure 63: Euro High Yield and Loan Spreads, bp



Source: J.P. Morgan, MARKIT Group. Bond spread over gov, loans over swaps.

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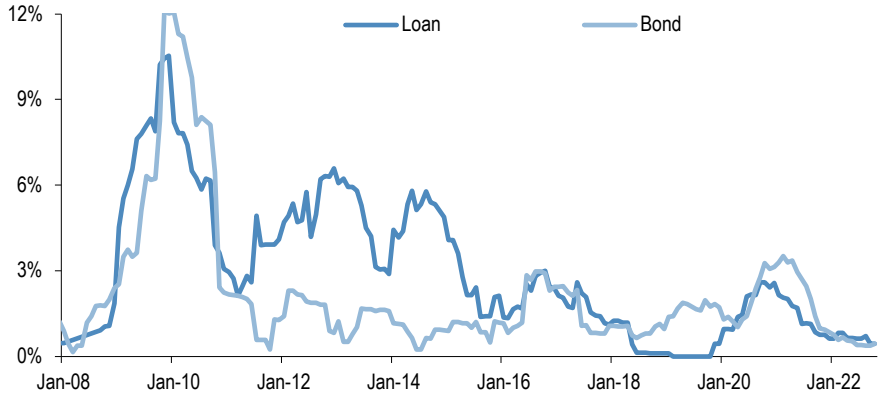
Our base case is a shallow default cycle

The economic spill-over from elevated inflation and tighter central bank policy has so far taken time to translate into corporate delinquencies. The 12m trailing default rate drifted lower over the second and third quarters, and at 0.4% is set to slightly undershoot our FY22 target of 1%, despite a few near-term debt restructuring processes kicking-off recently.

Looking into next year our core view is still that **this default cycle will be shallow, but with default rates remaining above the average over the last decade for a prolonged time**, as high yield balance sheets adjust to the new interest rate regime after years of negative rates. However, with funding conditions still tight, and a couple of large idiosyncratic distressed situations having emerged, **we recently decided to raise our high yield default forecast for 2023 to 3.0%** from 2.5% previously, and set a preliminary FY24 target of 2.5%.

We don't produce loan default forecasts, but expect the rate will at least match that in the bond market, due to the loan market's greater exposure to lower-rated credits, and the swifter pass-through of rising rates. Below is a summary of the considerations that feed into our default rate prediction.

Figure 64: European High Yield Bond and Loan Default Rates

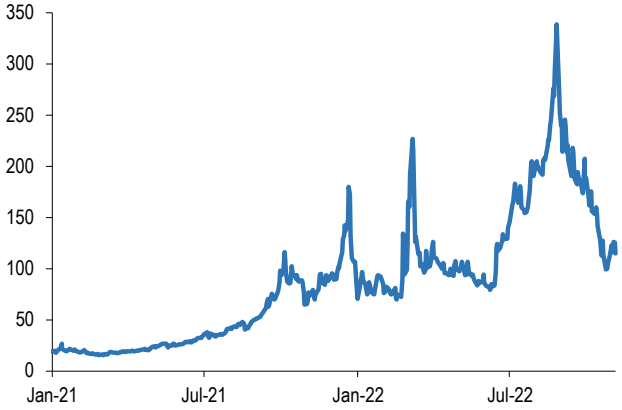


Source: J.P. Morgan, PitchBook LCD. Weighted by notional.

Recession has begun, but a severe winter energy shock has been averted

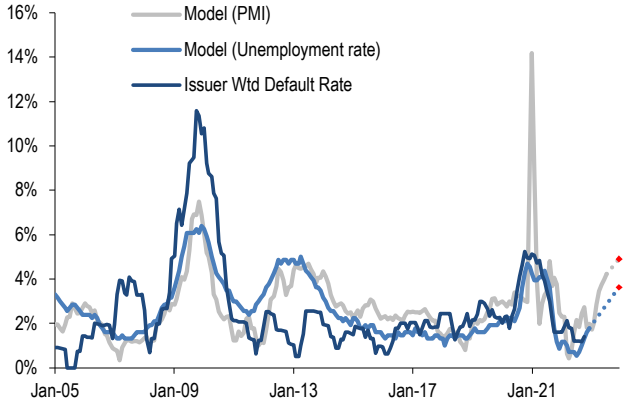
Over the summer it looked as though parts of Europe could be facing severe rationing of natural gas over the winter, as utilities scrambled to replace supplies that had been contracted from Russia but were not being delivered. However, the region is entering peak heating season in much better shape, with gas storage facilities nearly full and natural gas futures prices at c.€110-120/MWh through next year, well below the peak of more than €300/MWh, although still elevated compared with the average of €50/MWh in 2021. It's worth noting also that part of the rebalancing of supply and demand for natural gas has come through **lower levels of activity in energy intensive industries**, particularly in the Chemicals sector.

Figure 65: Dutch Natural Gas Front Contract, €/MWh



Source: Bloomberg Finance L.P..

Figure 66: Euro High Yield Default Rate Models in a Mild Recession



Source: J.P. Morgan. One-factor model for default rates under a mild recession. Assumes Composite PMI of 45 / 12m rise of 0.5%-point in the unemployment rate.

While there are still challenges ahead, including the need to refill reserves after the end of winter, the likelihood of a severe near-term collapse in output has receded, in our view. **The latest survey data are consistent with the mild recession that our economists forecast for 4Q22/1Q23**, although we've yet to see the full effect of central bank tightening cycles. An added source of uncertainty is what happens in the US, where growth is set to slow over the middle of next year just as Europe should start expanding again. A deeper US downturn therefore poses risks of a more protracted slump in Europe.

The distressed ratio is consistent with a 2.5% default rate over the coming year

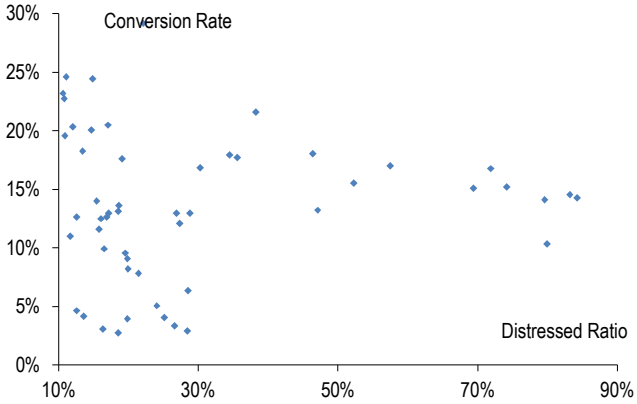
Unfortunately translating a particular economic outturn into a default rate estimate is a challenge. Any model needs to be calibrated on previous cycles, and there are few observations in the European high yield market's short history. Moreover, each downturn tends to have unique characteristics – for example, extraordinary levels of stimulus kept default rates suppressed during the pandemic despite a sharp collapse in GDP.

For what it's worth, **simple one-factor regressions put default rates at 3-5% in a mild recession**, based on a 0.5%-point 12m increase in unemployment or the Euro area Composite PMI falling to 45, but the model fit is poor and we don't want to rely too much on this approach (Figure 66).

Although it's somewhat circular to use market pricing to infer default rates and then reapply this to value spreads, we can't escape the fact that the quantity of distressed debt has historically been one of the better indicators of future restructuring activity.

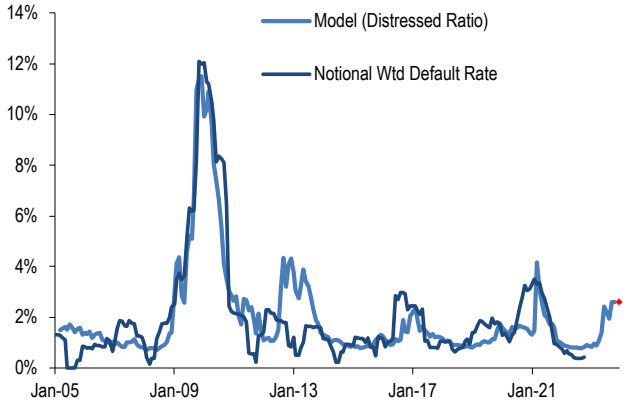
Once the distressed ratio exceeds 10%, the proportion of bonds going on to default within 12 months – which we dub the 'Conversion Rate' – is typically between 5% and 20% (Figure 67). This is consistent with a range for default rates over the coming year of 1-3%. Alternatively, using a one-factor regression suggests a 2.5% rate (Figure 68).

Figure 67: Proportion of Distressed Debt that Defaults over 12M



Source: J.P. Morgan.

Figure 68: Modelling Default Rates with Distressed Debt



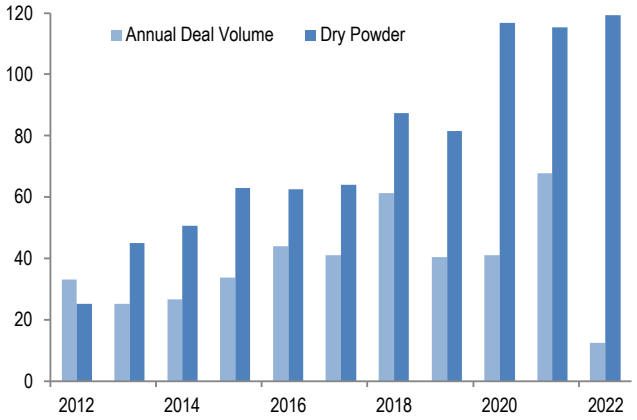
Source: J.P. Morgan.

New capital is harder to source than in 2020

During the pandemic, there were various channels for companies that needed to raise liquidity. Away from public capital markets, loans were also available in many jurisdictions from state-backed lenders, or banks with a government guarantee. Private lenders offered another alternative, and shareholders were generally also supportive when fresh equity was required, in order to retain an option on an economic recovery.

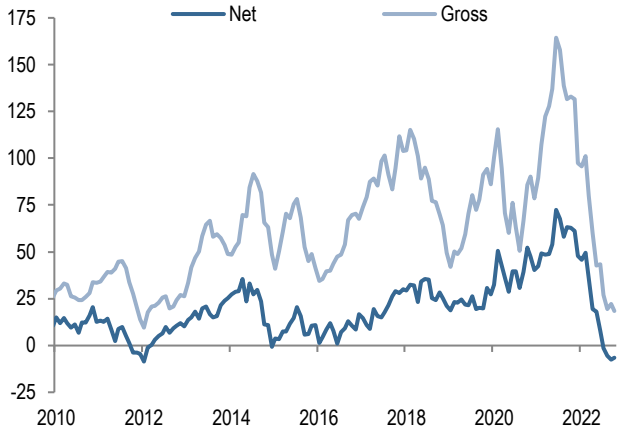
Today these avenues are either unavailable, such as government loans, or expensive to access. Despite yields more than trebling in the past year, the European high yield bond market has struggled to attract capital according to our fund flow data. Even private lenders have been less active this year **despite access to $120bn of committed 'dry powder'. Deal flow has fallen from $68bn in 2021 to just $13bn YTD**, pointing to a tightening in lending conditions. The case for shareholder-led recapitalisations is also more nuanced than in 2020, in our view, since there is no clear sign of an end to the economic malaise.

Figure 69: European Private Credit Deal Volume and Dry Powder, $bn



Source: J.P. Morgan, Preqin Ltd. 2022 deal volume through October.

Figure 70: 6M Rolling HY Bond and Institutional Loan Supply, €bn



Source: J.P. Morgan, PitchBook LCD.

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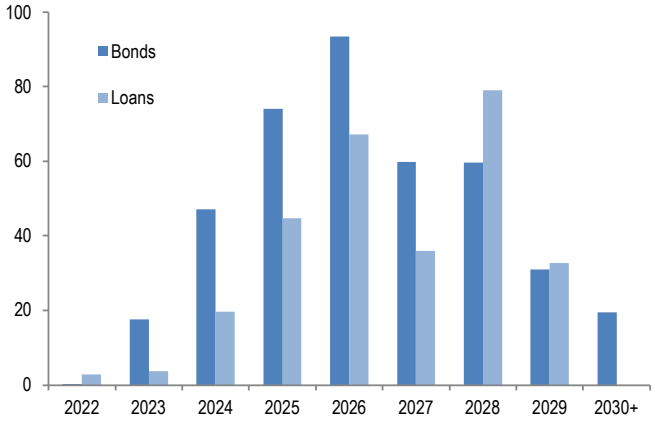
Few near-term maturities, but some 'mild' defaults from reprofiling trades
With only €18bn coming due in 2023, high yield maturities are unlikely to be the sole cause of a meaningful default cycle, in our view. However, as we've discussed in previous notes (here and here,) in reality many issuers will need to start tackling their liabilities before they become 'current' a year ahead of maturity. This means that the **€47bn in 2024 maturities are more relevant in terms of thinking about potential issuance needs**.

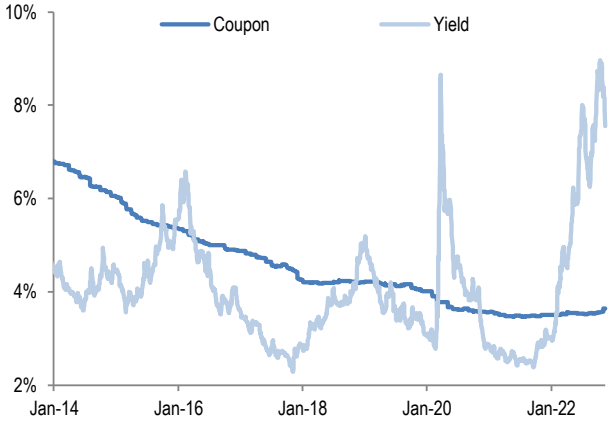
Given the challenging primary market backdrop, we expect to see more use of liability management exercises (LMEs) to push back maturities where a straight refinancing is not viable. **Depending on the nature of these LMEs, we may classify them as** defaults if we deem it is detrimental for investors that choose not to participate, although recoveries tend to be quite high in these reprofiling transactions, as they typically require little if any principal impairment.

Figure 71: European Currency HY Bond and Loan Maturity Profile, €bn



Source: J.P. Morgan, MARKIT Group. Excludes hybrids

Figure 72: Average Euro High Yield Bond Coupon vs Yield

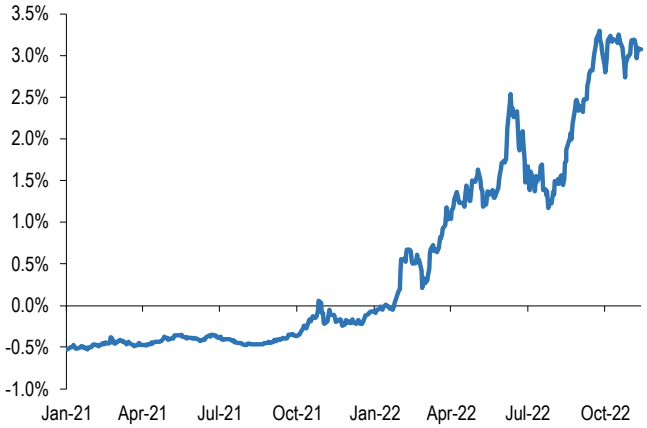


Source: J.P. Morgan.

Interest rate shock not a concern for most in FY23, with loans the exception
Issuers coming to refinance existing high yield bonds today would likely see their coupons double, based on current market pricing and observed new issue premiums. However, this drag on cash flow will only take effect over several years, as companies term-out their liabilities.

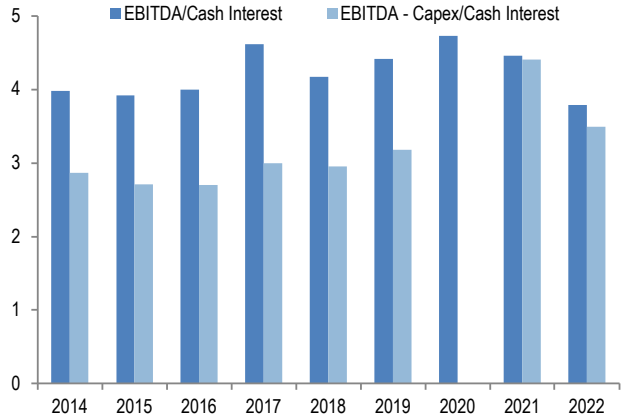
The exception is issuers with unhedged floating rate debt, which is being re-priced alongside central bank rate hikes. This naturally is most impactful for leveraged loan borrowers, where the rate component is projected to rise to 3% by Jun-23 from zero a year earlier, putting downward pressure on interest cover ratios.

Figure 73: Jun-23 3m Euribor Rate Implied by Futures



Source: J.P. Morgan, Bloomberg Finance L.P..

Figure 74: Average Pro Forma Interest Cover for Leveraged Loans



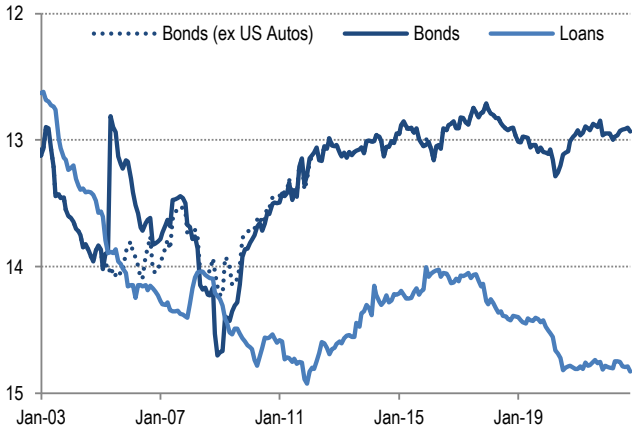
Source: PitchBook LCD. Newly originated loans where financials were made available. Not enough observations in 2020 to show EBITDA – Capex/ Cash Interest.

Strong HY ratings heading into the downturn, but loans are more vulnerable

Another mitigating factor against a substantial rise in the default rate is the high yield market's strong average rating of slightly above BB-, with just 12% of bonds rated B- or below, close to a record low (Figure 75 and Figure 76). This means that there is not a long tail of weak issuers that could need to restructure in a mild downturn.

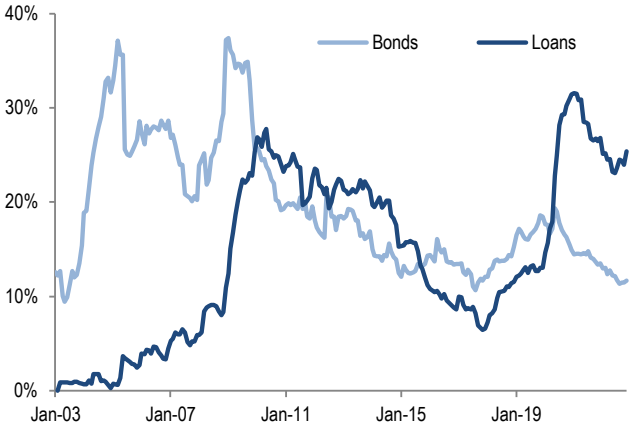
The situation is different in the European leveraged loan market, which has typically been dominated by single-Bs. Here the average rating is close to a historical low, two notches weaker than in the bond market, **while a quarter of facilities are B- or lower, twice the proportion of bonds**. The amount of lower-rated loans is a concern to us, since it is well above pre-pandemic levels, indicating that there is less resilience to a downturn than was the case heading into 2020.

Figure 75: Euro High Yield Bond and Loan Average Rating



Source: J.P. Morgan, rating agencies, PitchBook LCD. 12 = BB, 13 = BB-, 14 = B+, 15 = B.

Figure 76: Proportion of HY Bonds & Loans Rated B- or Lower



Source: J.P. Morgan, rating agencies, PitchBook LCD.

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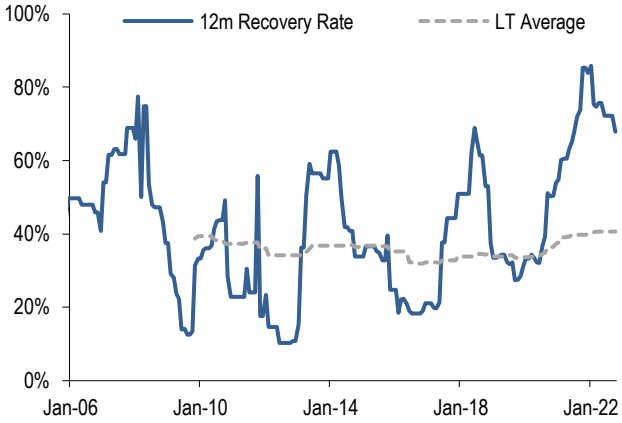
Recovery rates are set to moderate

Recovery rates for defaulting bonds were exceptionally high during the pandemic, as the swift rebound in equity valuations meant that asset coverage was generally improving during the course of creditor negotiations. Capital markets also re-opened swiftly after the initial shock of 1Q20, which combined with government support meant that liquidity was broadly available.

The situation is very different today. Leveraged companies' access to capital is constrained, and very expensive for those that have needed it. Meanwhile, government support is lighter, and more targeted at helping consumers with their energy costs rather than providing subsidised corporate loans.

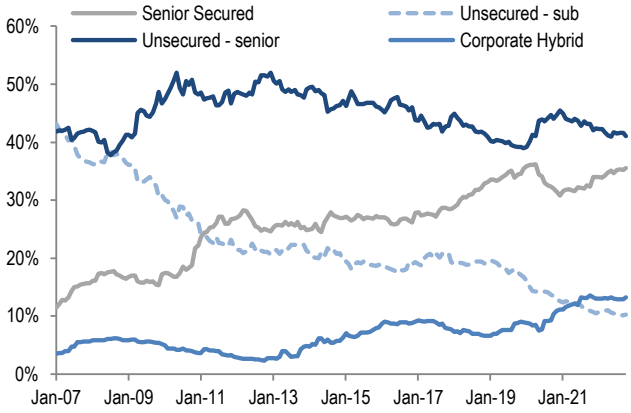
In our view **recovery rates are set to normalise into a 40-50% range. This is slightly above the long-run average of 38%**, reflecting (i) the potential for high recovery LMEs, and (ii) the growing share of secured debt within the high yield market, and shrinking amount of (non-hybrid) subordinated bonds – 36% and 10% respectively (Figure 78).

Figure 77: European High Yield Bond Recovery Rates



Source: J.P. Morgan.

Figure 78: European High Yield Market Composition by Seniority



Source: J.P. Morgan, MARKIT Group.

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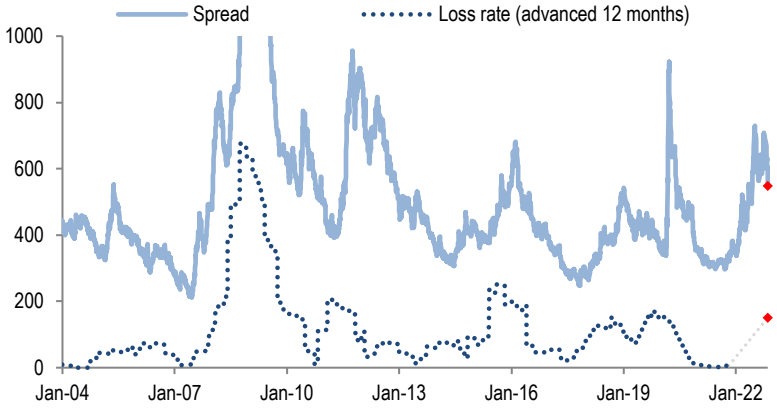
Is enough in the price already?

Excess spreads imply a mild recession in Europe and soft landing in the US

If we're correct with our default and recovery views, then credit losses over the coming year will amount to roughly 150bp. With spreads at 550bp, this means that **the asset class already contains a 400bp risk premium, and over time should deliver healthy returns**, unless default rates rise dramatically beyond our target. However, as we see in Figure 79 it's usually the case that spreads overcompensate for defaults, and excess spreads today only exceed the long-run median by 50bp (Figure 80).

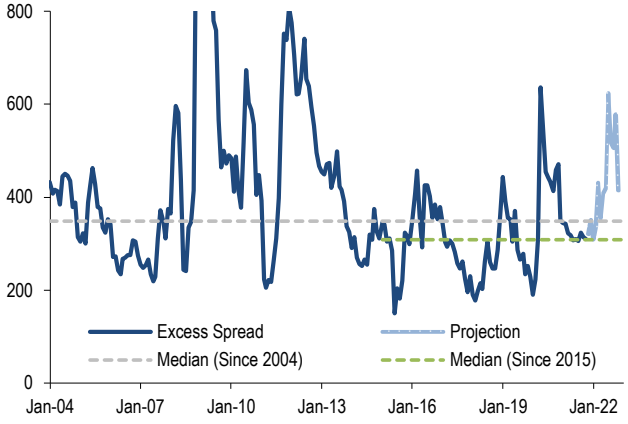
Figure 79: Euro High Yield Spreads versus 12m Forward Credit Losses, bp



Source: J.P. Morgan, MARKIT Group.

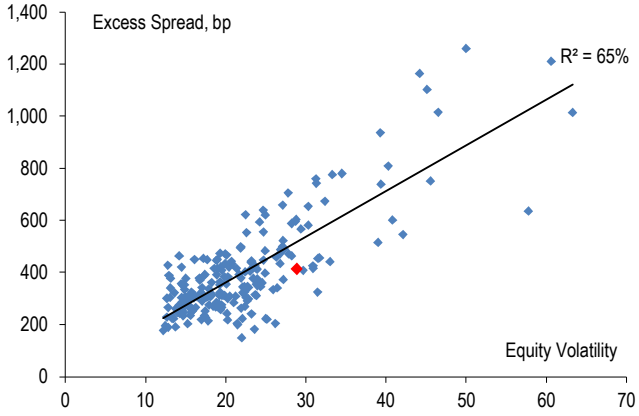
Looking into next year, is there enough of a buffer built into high yield spreads to compensate for the challenging economic backdrop? Historically the excess spread has exhibited a reasonably close connection to equity volatility (Figure 81). Under this relationship, VSTOXX at 20 equates to an excess spread of roughly 350bp, and each extra 5 points is worth 100bp of additional spread. This means that **spreads today are broadly consistent with equity volatility settling in the low 20% area**, towards the low end typically seen in an economic slowdown (Figure 82).

Figure 80: Euro High Yield Excess Spread, bp



Source: J.P. Morgan. Projection based on expected default losses over the coming 12m.

Figure 81: Euro High Yield Excess Spreads versus Equity Volatility



Source: J.P. Morgan. Equity volatility used is the average VSTOXX over the prior month.

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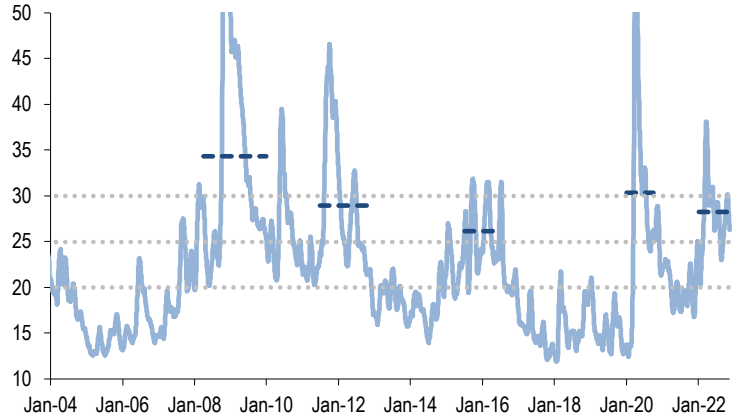
In our view, valuations are discounting a mild and short-lived recession in Europe, followed by a return to growth in the middle of 2023. Implicitly this also means a soft landing in the US as rate hikes take effect. While this may end up being true, we think this view will be tested next year.

We look for spreads to resume widening next year as the global growth slowdown takes hold. However, we're no longer as bearish as we were for most of H2 given the progress made on European energy supplies, and our outlook for defaults to remain contained. We set a forecast for **euro high yield to reach 625bp, 75bp above current levels, with the excess spread rising to 475bp**.

Figure 82: Trailing 1 Month Average VSTOXX



Source: J.P. Morgan, Bloomberg Finance LP. Dashed lines are averages over the respective periods.

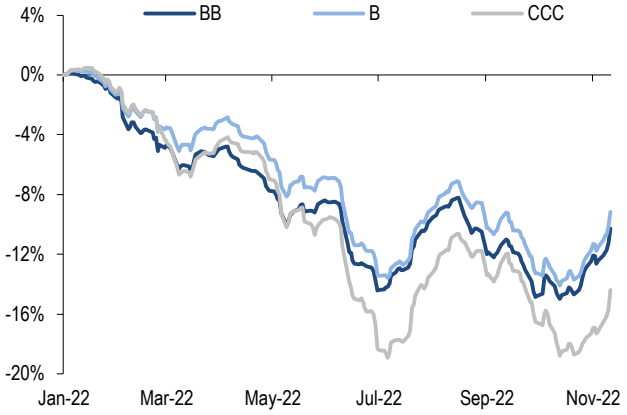
Trading themes

Position for a steeper ratings curve

The past year has seen 'bearish compression', as rising rates and elevated systemic risk have caused higher quality (and by extension high duration) assets to underperform. We've been looking for decompression in recent months and have to admit to being too early on this trade.

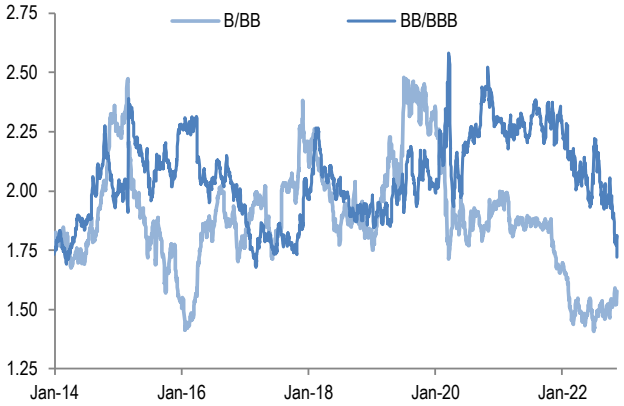
Nevertheless, as the narrative shifts from terminal policy rates towards default risk, we expect to see quality outperform. Figure 84 shows that the B/BB and BB/BBB spread ratios are at historically compressed levels, and we expect these to rise. Some of this compression arguably is the result of elevated swap spreads, which have recently started to normalise. Finally, **although we see much better value in BBs than the rest of the high yield market, if our low default rate forecast is correct, the degree of outperformance versus lower-rated bonds will not be that large**.

Figure 83: Euro High Yield Total Returns by Rating



Source: J.P. Morgan, MARKIT Group.

Figure 84: Euro Credit B/BB and BB/BBB Spread Ratios



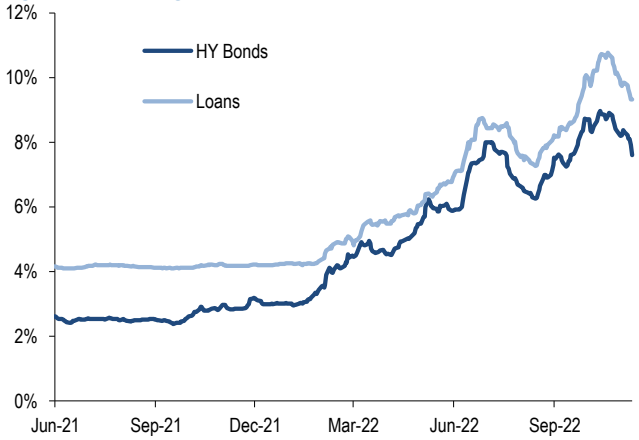
Source: J.P. Morgan, MARKIT Group.

Bonds offer a better risk-adjusted return than loans

As we showed upfront, this year's outperformance in the leveraged loan markets is entirely due to the interest rate headwind that hit fixed rate bonds. Credit returns were actually worse for loans, and based on the current rates curve, **loans now offer a higher yield and wider spread**, which we think is entirely appropriate given the extra challenges that we discussed above (Figure 85 and Figure 86).

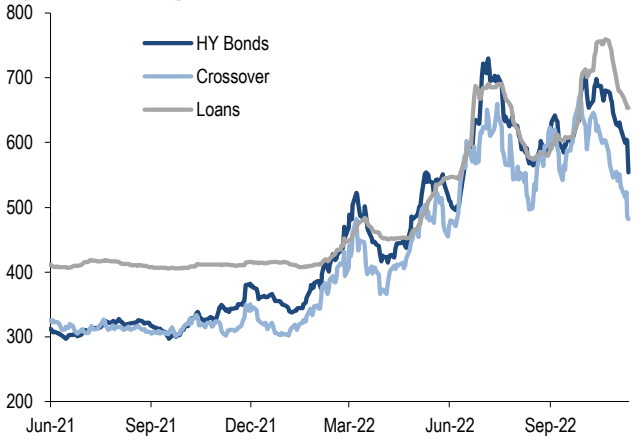
Despite the superior yield in loans, we think **the risk-reward profile is more favourable in the high yield bond market** at present. In the event of a deep recession, bonds offer better protection due to lower spread duration, better rating, lower cash prices, and will benefit if rates rally. We also believe that the loan market has become increasingly reliant on new CLO formation, which has become challenged over the past year, and may remain so with high quality alternatives such as investment grade bonds trading at attractive yields. We set a **5% total return forecast for loan next year, equivalent to a 1-point price decline** on an average coupon of c.6% over the year, caused by a rise in distressed paper.

Figure 85: Euro High Yield Bond and Loan Yields



Source: J.P. Morgan, MARKIT Group. Loan yield based on the forward rates curve.

Figure 86: Euro High Yield and Loan Spreads, bp



Source: J.P. Morgan, MARKIT Group. Bond spread over gov, loans over swaps.

Upside from 'jump-to-call'

We recently turned positive on longer-duration bonds, based on the view that central bank tightening cycles are close to an end, and that rate curves have already reset substantially higher this year. At the same time, we still see select **opportunities in low-coupon short-dated callable bonds** that offer substantial returns if they are refinanced early. In August we recommended a basket of bonds along this theme (see *Better call spreads*), which has since outperformed the broader market by 2.8%. We refresh this now, showing for each bond the yield to a workout date 12 months ahead of maturity.

Table 10: Select Callable European High Yield Bonds

							Yield to		Spread to		12m Change in	
ISIN	Ticker	Coupon	Maturity	Amt	Rating	Price	Maturity	Mat - 12m	Maturity	Mat - 12m	Yield	Spread
XS2110799751	SFRFP	2.125	Feb-25	500	B	**89.7**	7.3%	11.5%	513	918	**4.2%**	404
XS1690644668	SAZGR	3.5	Sep-24	479	B	**93.9**	7.2%	11.3%	497	909	**4.2%**	412
XS2054539627	SFRFP	2.5	Jan-25	550	B	**90.8**	7.3%	11.4%	513	913	**4.2%**	400
XS2110768525	STENA	3.75	Feb-25	315	B	**91.1**	8.4%	12.2%	626	991	**3.8%**	365
XS1699848914	DUFNSW	2.5	Oct-24	800	B	**96.7**	4.4%	6.4%	218	409	**2.0%**	191
XS1785467751	EOFP	2.625	Jun-25	1000	BB	**92.6**	5.8%	7.8%	371	555	**2.0%**	184
XS1496337236	CAR	4.125	Nov-24	300	B	**96.4**	6.1%	8.1%	396	574	**1.9%**	178
XS1605600532	ATALIA *	4	May-24	625	B	**98.7**	5.0%	6.8%	272	500	**1.9%**	227
XS2247614063	DRXLN	2.625	Nov-25	250	BB	**90.6**	6.2%	8.0%	418	586	**1.8%**	168
XS2031870921	LOXAM	3.25	Jan-25	700	BB	**96.0**	5.3%	7.0%	316	474	**1.7%**	157
XS1990952779	LHMCFI	4.75	May-25	390	B	**95.4**	6.9%	8.2%	475	595	**1.3%**	120
DE000A2G8WA3	PROGRP	3	Mar-26	600	BB	**90.6**	6.2%	7.5%	415	541	**1.3%**	126
XS2010038904	SAZKAG	4.125	Nov-24	300	BB	**97.5**	5.5%	6.8%	335	449	**1.3%**	115
XS2102493389	ALTICE	3	Jan-28	1100	B	**81.8**	7.4%	8.4%	536	635	**1.0%**	98
XS2272845798	ZIGGO	2.875	Jan-29	700	B	**77.3**	7.7%	8.6%	563	648	**0.9%**	85
XS2112335752	BANIJA	6.5	Mar-26	400	CCC	**95.4**	8.3%	9.0%	622	681	**0.7%**	60

Source: J.P. Morgan. Pricing as of EOD 14 November 2022. * Bonds expected to be called on closing of takeover.

Sector recommendations

In our recent *Sector Review* we made changes to our industry recommendations, based around the themes of (i) greater dispersion along fundamental lines, (ii) underweight sectors with heavy exposure to consumer discretionary spending, and (iii) positioning for an increase in demand for longer-duration paper.

Our current recommendations are shown in Table 11 with pricing from the time of latest rebalancing. The key sector picks are as follows:

- **OW Metals & Mining** and **Oil & Gas** given low leverage and healthy free cash flow vs **UW Services** and **Chemicals** which have too much leverage for this point in the cycle.
- **UW Transports** and **Retail** due to the squeeze on consumer incomes and normalisation of supply chain disruption.
- **OW Telecoms** and **Healthcare** with longer-than-average duration.

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Table 11: High Yield Sector Performance and Recommendations

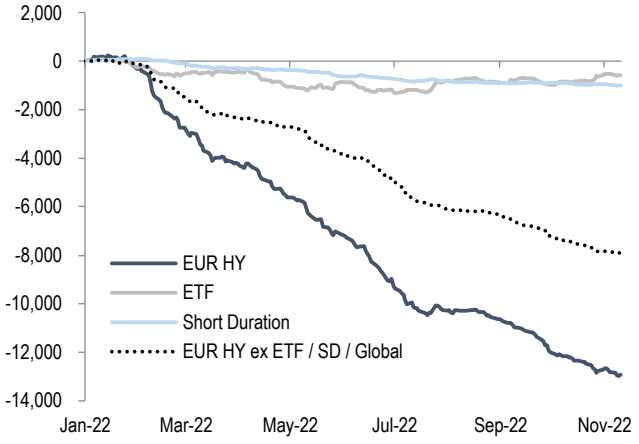
Sector	Sector Weight	Spread, bp	Spread, bp (18-May-22)	Change, bp	Duration	Credit Return	Rank	Recommendation Prior	Recommendation New
iBoxx EUR HY		629	521	108	3.2	-1.0%			
Paper & Packaging	1%	545	535	9	3.4	+2.2%	1	OW	N
Autos	11%	522	504	18	2.9	+1.8%	2	N	N
Gaming	2%	615	577	38	2.8	+1.7%	3	N	OW
Metals & Mining	2%	479	451	28	2.6	+1.4%	4	OW	OW
Healthcare	7%	538	494	44	3.7	+0.7%	5	OW	OW
Oil & Gas	2%	608	552	57	3.4	+0.6%	6	OW	OW
Services	8%	666	583	83	2.9	+0.3%	7	N	UW
Media	1%	654	578	76	3.3	+0.1%	8	UW	N
Transport	7%	465	405	59	3.4	-0.2%	9	UW	UW
Telecoms	19%	567	504	63	3.9	-0.2%	10	N	OW
Insurance	2%	423	352	71	3.4	-0.8%	11	N	N
Bank Senior	4%	494	381	113	2.4	-1.0%	12	N	N
Bank Subordinated	9%	630	483	147	2.7	-1.7%	13	N	UW
Chemicals	5%	642	504	138	3.0	-1.8%	14	UW	UW
Utilities	6%	583	441	142	3.2	-2.5%	15	N	N
Food & Consumer Products	3%	765	602	163	3.7	-3.3%	16	N	N
Retail	6%	903	672	231	2.9	-3.5%	17	UW	UW
Real Estate	4%	1688	854	834	2.7	-19.4%	18	N	N

Source: J.P. Morgan, MARKIT Group. Pricing as of COB 06-Nov-22. Some ratings changed between sector review publications.

A tentative improvement in technicals

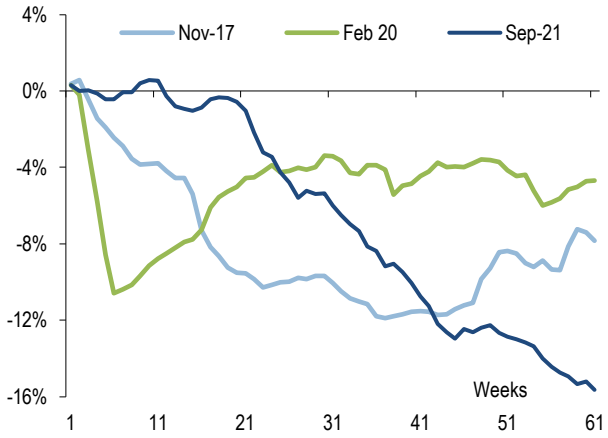
It has been a relentless year for European high yield fund managers. Withdrawals from retail funds accelerated after Russia's invasion of Ukraine, and have persisted ever since, absent a brief pause during the summer. In total, **our fund universe has posted €12.7bn of redemptions, equivalent to 15.6% of assets under management** at the start of the year (Figure 87).

Figure 87: YTD European High Yield Retail Fund Flows, €mm



Source: J.P. Morgan, Bloomberg Finance LP.

Figure 88: Recent Euro High Yield Fund Outflow Cycles, % AUM



Source: J.P. Morgan, Bloomberg Finance LP.

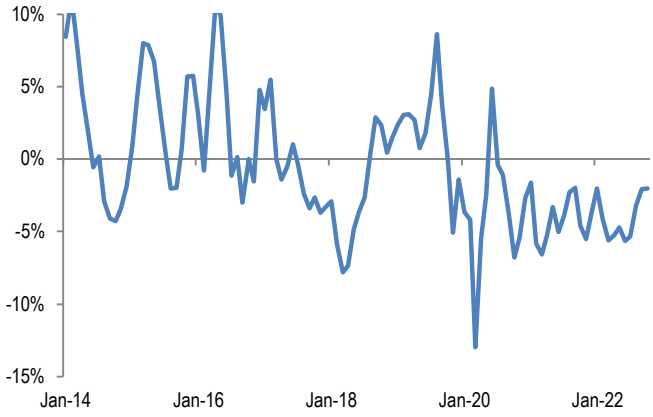
Cumulatively this **is a larger drawdown than funds suffered in the two previous outflow cycles**, and although the pace of withdrawals has slowed since the second quarter, we don't yet see conclusive signs that an end is in sight.

There are however some mitigating factors that can offer some support into next year. Firstly, **supply volumes have collapsed** as issuers balk at paying far higher yields than were the norm last year. Although we think gross volumes will have to pick up next year, as we discuss later, *net* issuance is likely to stay subdued.

Our Technicals Index – which measures the balance between demand and supply – has been negative all year but is at the upper end of its recent range, helped by some issuer debt buybacks (Figure 89). We also think that valuations reached a level in the past few months that will have attracted **capital from opportunistic investors** but is not captured in our fund flow figures.

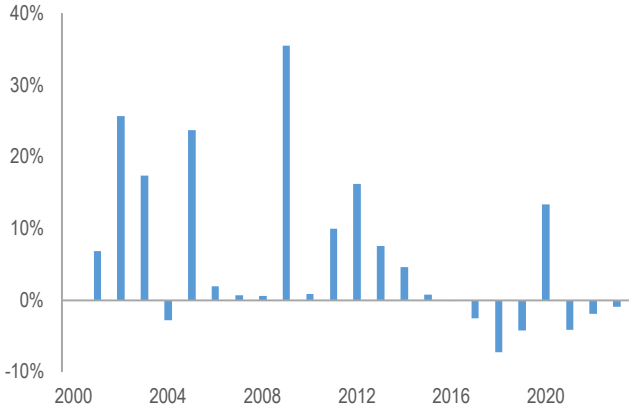
Secondly, **we're not predicting a large wave of fallen angel downgrades next year, despite the economic slowdown**. Many of the weak-BBB cyclical credits were downgraded to high yield during the pandemic, leaving a shorter list of candidates this time around. We forecast €20bn of fallen angels in 2023, offset by €25bn of rising stars (see *European Credit Ratings Watch*). This year has also seen a small net upgrade of €10bn.

Figure 89: European High Yield Technicals Index, 3M Rolling



Source: J.P. Morgan. Demand (fund inflows as % of AUM) minus net supply (as % of index).

Figure 90: Growth in Euro High Yield Market from Net Up/Downgrades

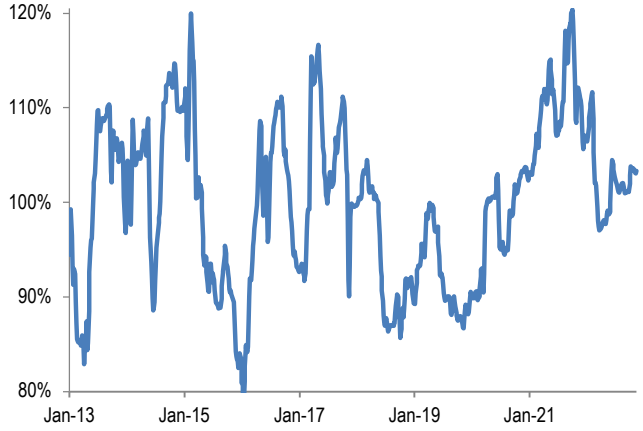


Source: J.P. Morgan. 2022 and 2023 figures are estimates.

Third, our positioning metrics show that **retail funds have already de-risked, running with a collective beta that is close to neutral** (Figure 91). At the margin this gives some room for portfolio managers to add exposure.

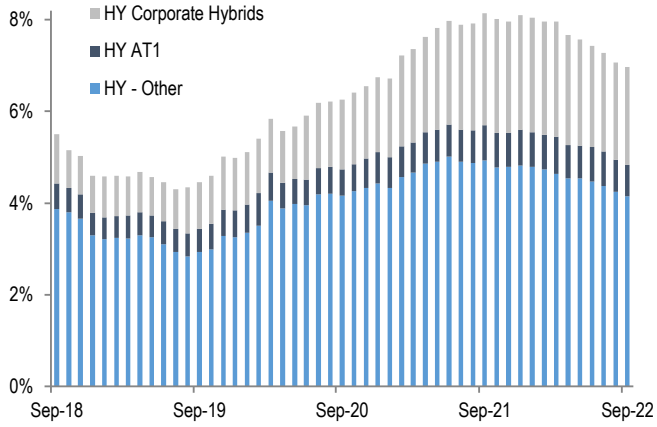
The overhang from non-traditional investors has also reduced according to our latest figures. The size of **off-benchmark holdings within investment grade funds fell to 7% at the end of September**, down from a high of 8.1% at the end of last year. However, based on the allocations to high yield that these funds held in 2019, there may still be some further reductions to come (Figure 92).

Figure 91: Average European High Yield Retail Fund Beta



Source: J.P. Morgan, Bloomberg Finance LP.

Figure 92: Euro High Grade Retail Fund Off-Benchmark Allocations

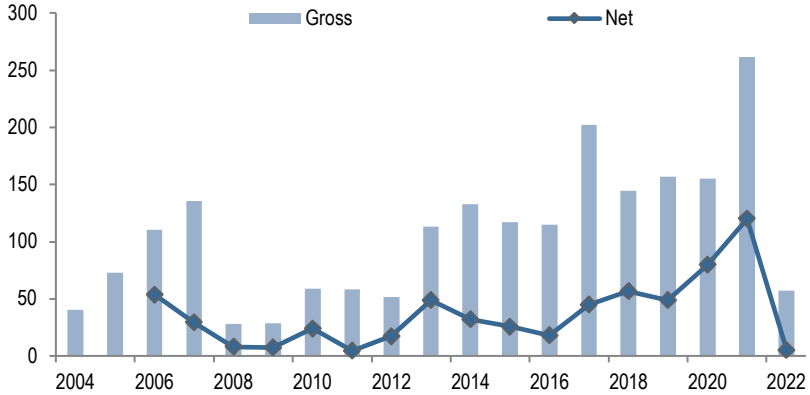


Source: J.P. Morgan, IPREO.

Issuance – time to get moving

European leveraged finance origination has been in quasi-hibernation for most of this year, with most issuers unwilling to lock-in the rates required to access funding as yields repriced higher. What few deals did come to market were largely out of necessity: to replace M&A bridges, or refinance the few short-dated bonds coming due. Combined bond and broadly syndicated loan volume was just €57bn through October, down 75% from a year earlier and 65% versus the five year average, and is set for the lowest annual total since 2012. Net origination stands at €5bn compared with €120bn in FY21.

Figure 93: European Institutional Leveraged Finance Origination, €bn

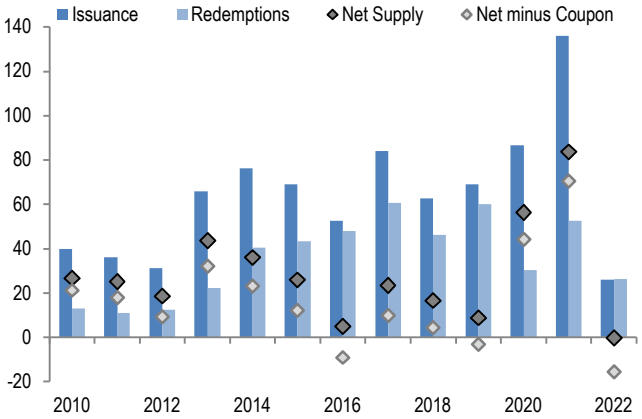


Source: J.P. Morgan, PitchBook LCD. 2022 figures through October.

How late can you leave it?

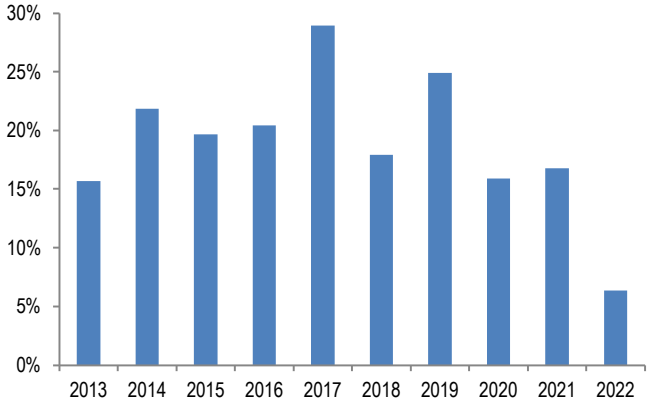
Even if primary market conditions remain tight, more companies will eventually have to bring deals next year, in our view. From 2014-19, on average 22% of bonds were redeemed each year; this fell to 16-17% in 2020/21 and 6% YTD (Figure 95). As a result, the **average life across the index has shortened by half a year in 2022 to 4.1 years, and is at the lowest level in the past decade** (Figure 96). Delays to the refinancing process mean that **75% of callable bonds will be in their call window next year, equivalent to €170bn notional** (Figure 97).

Figure 94: European Currency High Yield Issuance Jan-Oct, €bn



Source: J.P. Morgan.

Figure 95: Proportion of Euro High Yield Bonds Redeemed Annually

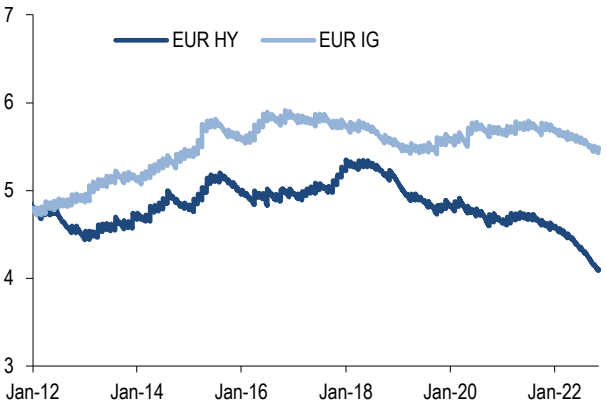


Source: J.P. Morgan.

Although individually it makes sense to wait as long as possible to refinance, and enjoy existing (low) coupons, collectively this may not be possible. To term-out all of the high yield bonds maturing by Dec-25 before YE24 – which assumes debt needs to remain 'current' – requires €60bn of supply annually, rising to €65bn if nothing is issued until January, or €90bn if the process starts next June.

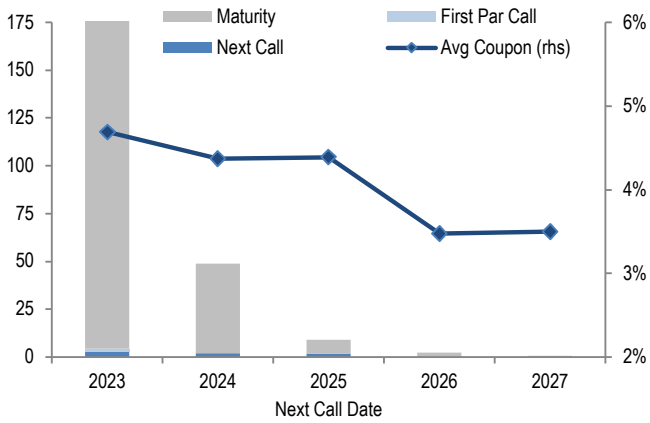
While these figures might be mitigated by some companies having cash on balance sheet already, or using alternative sources of financing, we think it's also likely that some issuers will have additional funding needs due to the deteriorating economy. There's also €24bn of corporate hybrids that will become callable over that horizon that need to be rolled in order to retain intermediate equity credit at S&P.

Figure 96: Average Index Time to Maturity, Years



Source: J.P. Morgan, MARKIT Group. Indices do not contain bonds with <1y to maturity.

Figure 97: Workout Dates for Euro High Yield Callable Bonds, €bn



Source: J.P. Morgan.

Average annual gross supply in the five years prior to the pandemic was €78bn, meaning that the numbers we're talking about are achievable, though it's a stretch unless funding conditions normalise. The loan market could potentially help with the terming-out process, since maturities there are back-loaded, with only €25bn maturing in the next two years. This itself depends, however, on the conditions for CLO formation improving.

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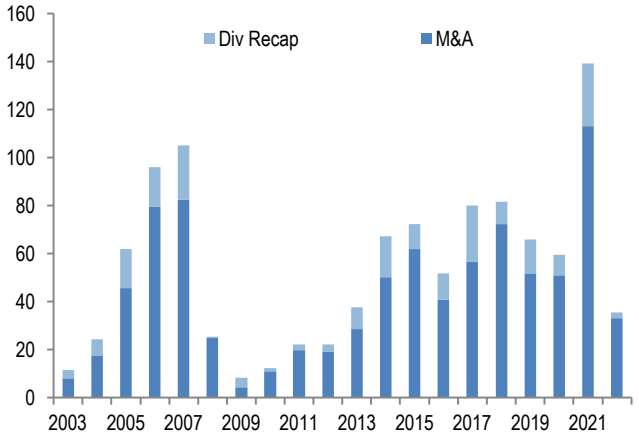
Subdued M&A volumes as the pipeline clears

M&A financing represented a larger share of supply than usual this year, particularly in the bond market where 'credit negative' issuance accounted for 51% of total deal flow, the highest figure since 2015. However, at €33bn to-date, volumes are not that large in absolute terms. Moreover, these transactions came from a pipeline of acquisitions that were signed before market conditions deteriorated. Now that the pipeline has been substantially cleared, M&A volumes will likely fall even further over 2023, in our view.

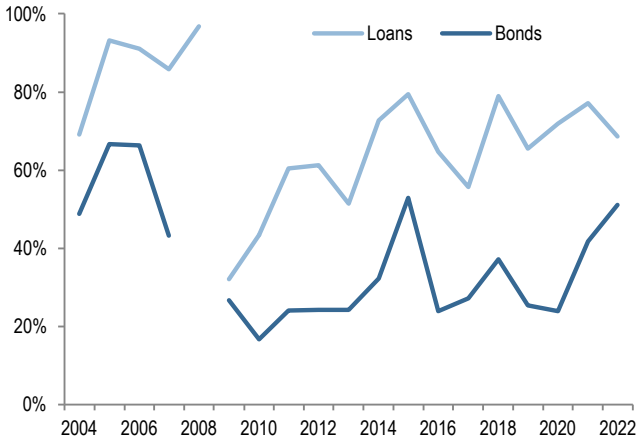
To the extent that sponsors proceed with new LBOs, we expect capital structures will contain a large equity component – the five year average is just shy of 50% according to LCD – and low leverage, with a view to recapitalising the business in future if funding conditions ease. We think private lenders are well positioned to compete for this business, with banks remaining conservative on bridge underwriting.

Figure 98: European Leveraged Finance Credit Negative Supply, €bn



Source: J.P. Morgan, PitchBook LCD.

Figure 99: Proportion of 'Credit Negative'



Source: J.P. Morgan, PitchBook LCD.

We look for some normalisation in origination volumes

Forecasting supply has been a challenge this year, and even after cutting our forecasts mid-year we overestimated the pace at which activity would resume. Our working assumption for next year is that more issuers will finally feel compelled to bring deals, primarily to term-out bonds, as so volumes will begin to normalise.

The shift away from funding LBOs and towards refinancing favours a pick-up in bond volumes relative to loans, in our view. However, some sponsors may prefer to replace bonds with loans – assuming capacity exists in the loan market – in order to retain the flexibility to reprice their liabilities tighter in a future rally.

With these considerations in mind, we estimate FY23 supply at €50bn gross / €5bn net for high yield bonds, and €30bn gross / €5bn net in loans. This equates to a 40% increase on YTD issuance, but would still be a large decline versus prior years (Table 12)

Table 12: European Leveraged Finance Origination, €bn

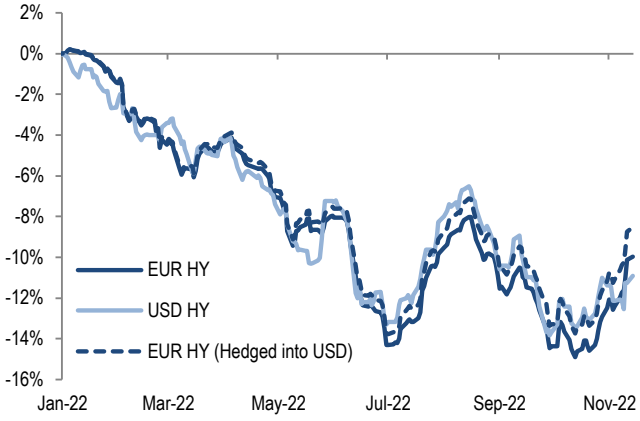
	2017	2018	2019	2020	2021	2022 (YTD)	2023 (F)
Gross							
HY Bond	101	65	87	103	150	26	50
Lev Loan	101	79	69	52	112	31	30
Total Institutional	**202**	**144**	**156**	**155**	**262**	**57**	**80**
Net							
HY Bond	20	15	17	58	86	0	5
Lev Loan	25	42	32	22	34	6	5
Total Institutional	**45**	**57**	**49**	**80**	**120**	**5**	**10**

Source: J.P. Morgan, PitchBook LCD.

Euro credit is not as cheap as it appears relative to dollars

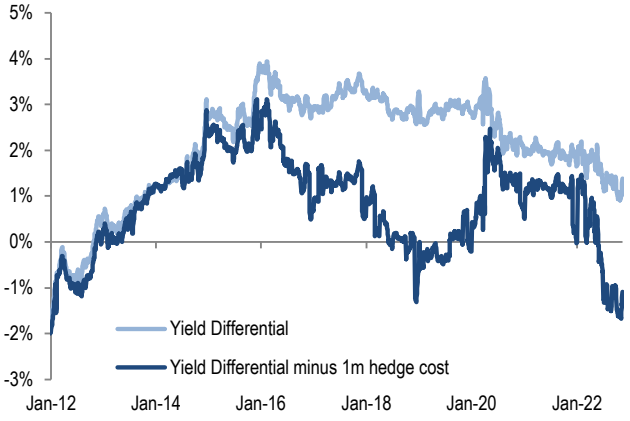
Euro and dollar high yield returns have tracked each other closely this year, and despite the perception that euro credit had underperformed, on a currency-hedged basis total returns for euro bonds are 2.5% better than for dollars. This is because the euro market was supported by a shorter duration, lower CCC-exposure, and c.2% benefit from hedging, which offset the extra spread widening (Figure 100 and Figure 101).

Figure 100: EUR vs USD High Yield YTD Returns



Source: J.P. Morgan, MARKIT Group.

Figure 101: Dollar – Euro HY Bond Yield Differential

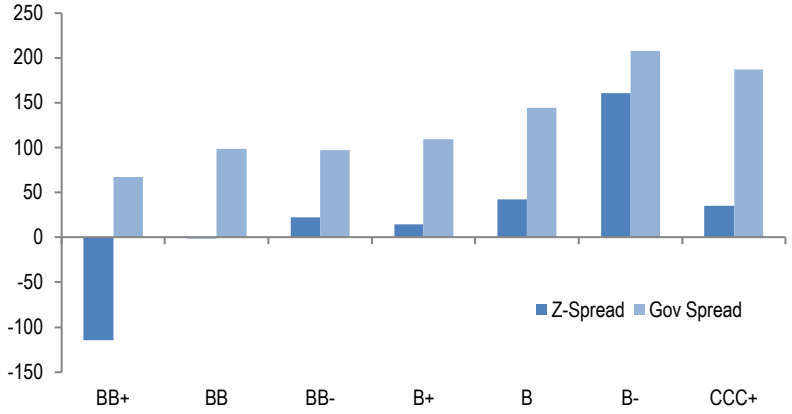


Source: J.P. Morgan.

The debate about relative valuations is somewhat complex. While euros trade considerably wide to dollars on a gov spread basis, this is largely attributable to a sizeable widening in euro swap spreads, which we believe is due to scarcity of Bunds resulting from QE. Focus instead on the spread over swaps, and the gap between the two currencies is actually far closer (Figure 102).

Most high yield investors buying in a foreign currency don't swap bonds to maturity but instead hedge the currency using short-dated forwards. This means that the easiest way to compare the different markets is to think about the yield differential and hedge cost.

Figure 102: EUR – USD High Yield Spread Differential by Rating, bp



Source: J.P. Morgan, Bloomberg Finance LP. Z-Spread differential adjusted for cross-currency basis.

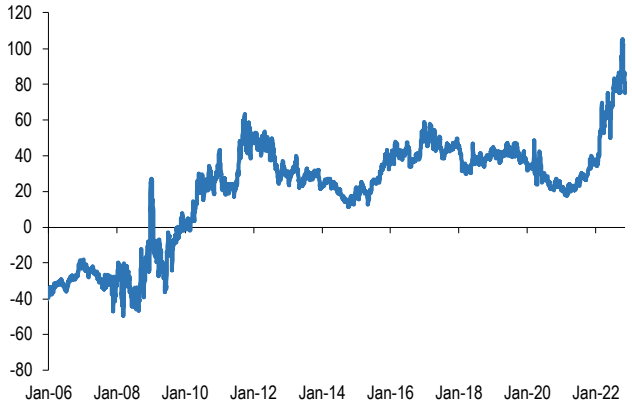
As it stands, buying dollar high yield offers 1.4% incremental yield pick-up over euros, but costs around 2.5% to hedge the currency exposure for a euro-funded investor. This means that in order to offset the hedge expense, the dollar index would have to return at least 1.1% more in local currency terms than the euro index, i.e. the yield gap to narrow by ~30bp given the duration.

We think this is unlikely to happen, based on the forecasts from our Rates colleagues, which sees the Bund-Treasury gap increasing next year as the ECB under-delivers on market expectations. If they are correct**, euro high yield returns should exceed dollar high yield on a hedged basis**, unless dollar spreads outperform substantially from here. Our US Credit Strategy colleagues have yet to publish their own 2023 forecasts.

Figure 103: Euro and Dollar High Yield Govt Spreads, bp

Source: J.P. Morgan, MARKIT Group.

Figure 104: EUR – USD 5Y Swap Spreads, bp



Source: J.P. Morgan. Based on LIBOR/EURIBOR swaps.

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Sterling High Grade: Pick yourself up, dust yourself off

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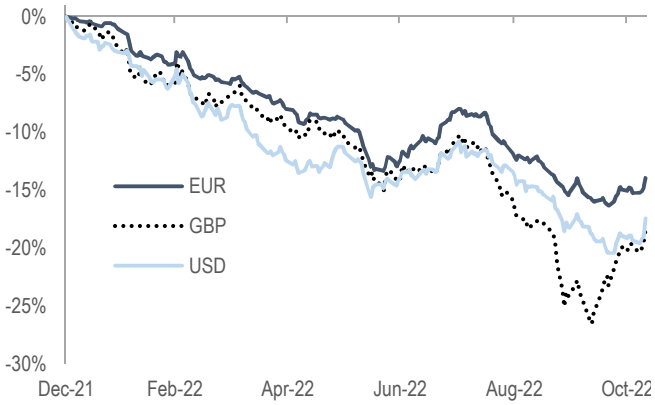
- **While there's no debating the worsening economic outlook, we think technicals are likely to be more supportive on the back of lower supply and more attractive valuations. We forecast a 20bp tightening from current levels to 190bp.**
- **Major trading themes: (a) UW GBP vs EUR, driven by long duration underperformance, (b) OW financials vs corporates, (c) OW short duration bonds on valuations, (d) UW domestic vs foreign issuers in sterling index.**
- **We forecast £35bn gross / £10bn net supply in 2023, driven by a fall in expected Financials issuance as well as lower refinancing needs.**

To say that 2022 was a challenging year for our asset class is almost comically underselling reality, bookended by the BoE's surprise announcement of corporate quantitative tightening back in February on one end and the LDI deleveraging cycle in September and October triggered by the UK government's since-retracted 'mini-budget' on the other, and interspersed with war, supply chain disruptions, the energy crisis, and frequent domestic political upheaval (Figure 105).

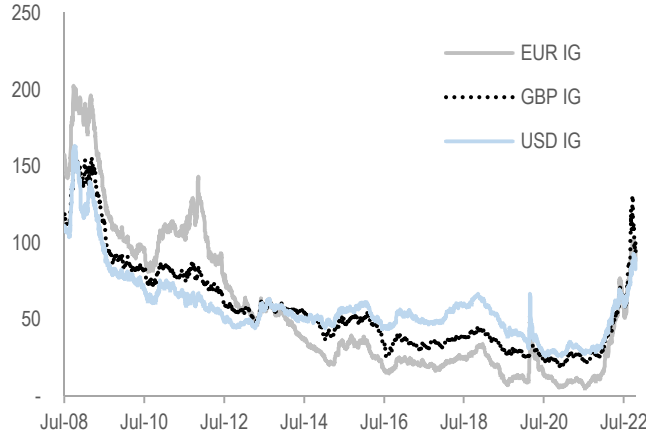
We also go into setting our 2023 targets aware that this could very well have the shortest shelf-life in the history of Outlooks, with Chancellor Hunt expected to publish his Autumn Statement on 17th November alongside the OBR's independent review. Our current expectation is for significant fiscal tightening to be factored in, but to be back-loaded in the five-year projection window, dampening the impact on near term growth.

Figure 105: Global Investment Grade Corporates YTD Total Returns, %



Source: J.P.Morgan, Markit Group

Figure 106: Global Investment Grade Yield Breakevens, bp



Source: J.P.Morgan, Markit Group

While the perceived credibility of these plans could very well guide near-term price action, and leave us at a significantly changed starting point, we think the underlying factors guiding the markets next year will remain unchanged. There is no arguing that the **economic backdrop for the UK makes for a sobering read** – with contraction having already set in in the third quarter, our economists forecast a further two quarters of negative GDP growth through 4Q22 [-2.2% QoQ saar] and

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1Q23 [-0.8% QoQ saar] followed by a sustained period of anaemic growth as austerity sets in.

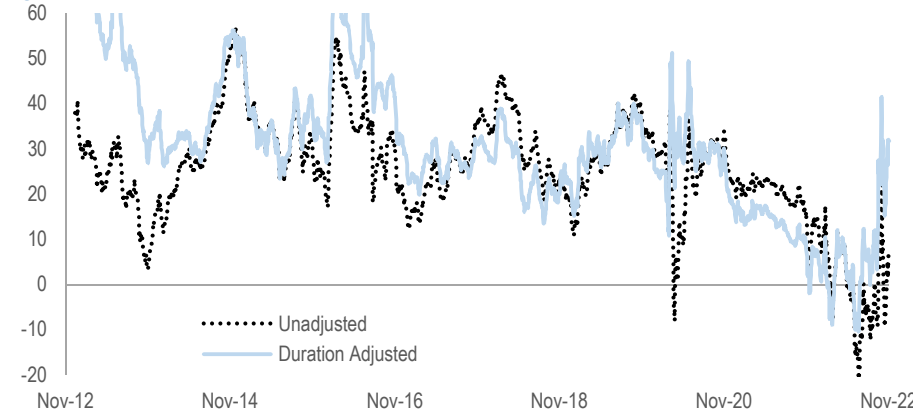
Weakening fundamentals however, are likely **to take the pressure off on the monetary policy** front, with the BoE expected to reach its 4.25% terminal rate next year with the central bank's projections already showing a drop in inflation to well below the 2% mandate by the end of its forecast horizon. In addition to this, we think **technicals are likely to be fairly strong next year**, on account of a slowdown in Financials supply and a resurgence in demand driven by renewed focus on the portfolio rebalancing and the pension risk transfer process from defined benefit schemes, a trend that has historically bolstered inflows into the asset class.

Finally, and perhaps most importantly, we think **valuations at current levels are too attractive to ignore**, with yield breakevens for sterling markets at 90bp, a level not seen since the 2008-09 GFC and higher than seen during the Eurozone Crisis when 10y gilt yields were last at their current levels of c.3.5% (Figure 106). All-in, we expect spreads to tighten 20bp to 190bp this year, a slight underperformance versus euros with the gap between the two set to increase to 10bp, albeit still well shy of the 22bp average seen historically.

EUR vs GBP: strap on for a bumpy ride

Despite the sharp underperformance that sterling markets saw versus euros in the third quarter, index level spread differentials currently still hover around the 5bp mark, well shy of the 22bp average that we've seen since 2017. We think the asset class will likely continue to underperform euros into next year, with the latter also typically gaining an edge in a rallying market (Figure 107). That being said, in our view, there are two factors here worth keeping in mind that could keep a lid on the extent of underperformance:

Figure 107: GBP – EUR Spread Differentials

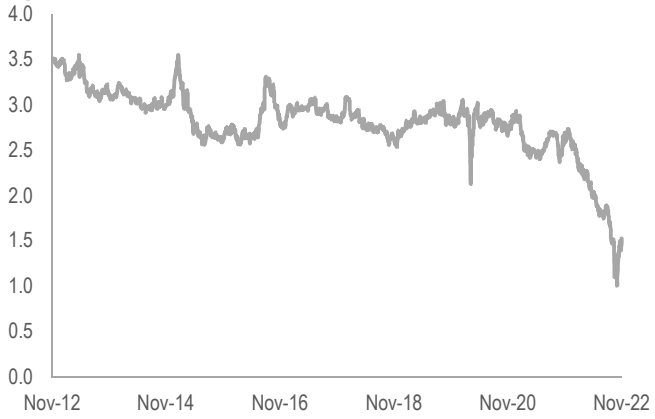


Source: J.P.Morgan, Markit Group

What is the spread gap compensating investors for?
We've typically tried to break down the gap between the two indices using three factors: **duration, historical losses, and illiquidity**. On at least two of those counts, we think the premium warranted has now reduced: one, with the yield moves this year, the difference in duration between sterling and euros has fallen from the c.3y level it's maintained over the past decade to half that currently (Figure 108).

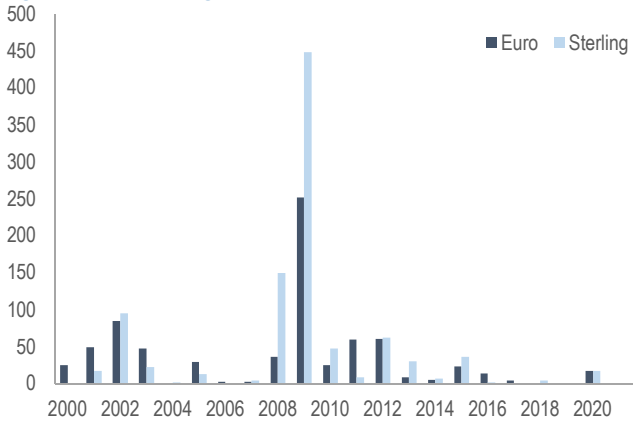
Fallen angel losses, barring the GFC period (when sterling markets had a significantly higher concentration of subordinated financials), have also moved in lockstep with one another in the period since – here, we think sterling may be even safer than their European counterparts heading into the coming recession, with the heavily defensive composition of the BBB market leaving few candidates for downgrade into high yield (Figure 109).

Figure 108: GBP – EUR Duration Difference



Source: J.P.Morgan, Markit Group

Figure 109: Fallen Angel Losses, bp



Source: J.P.Morgan, Markit Group.

This rally is different: the lack of ECB support and the importance of fundamentals
Finally, there's no questioning, of course, that the smaller size and the buy-to-hold nature of a large portion of investors continue to leave sterling the more illiquid of the two – that being said, the potential for the ECB to slowly withdraw from the euro corporate bond markets could leave the illiquidity premium lower than seen over the past decade of easy monetary policy.

A central bank free world is also likely to drive increased dispersion based on underlying company fundamentals and here, the more defensive tilt in the sterling index composition, particularly as we head into a growth slowdown, combined with a lower beta to any further fallout from the energy storage and supply situation should also support a smaller gap between the two indices.

So….what's the conclusion
We think there's still some room for GBP performance here at the shorter end of the curve: once you adjust for duration, the gap between euros and sterling spikes up to 32bp, around 5bp above the long term average. Drilling down into the maturity buckets, the gap between the EUR and GBP 1-5y indices reflect this dynamic, currently at 52bp versus the average 30bp seen since 2015 (Figure 110)

In contrast, the longer end of the curve (which has a larger impact on the duration-weighted index spreads) leaves less room for further compression here with the gap at -1bp (versus a 11bp average historically), driving our call for an index-level sterling underperformance. We pencil in a 5bp gap widening from current levels, leaving the index level differential at 10bp in 2023.

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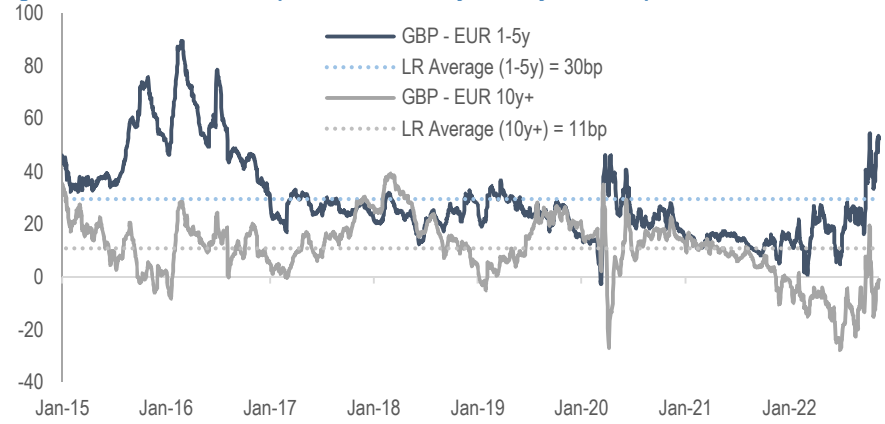
Figure 110: GBP-EUR Index Spread Differential by Maturity Bucket, bp



Source: J.P.Morgan, Markit Group

Trading Themes

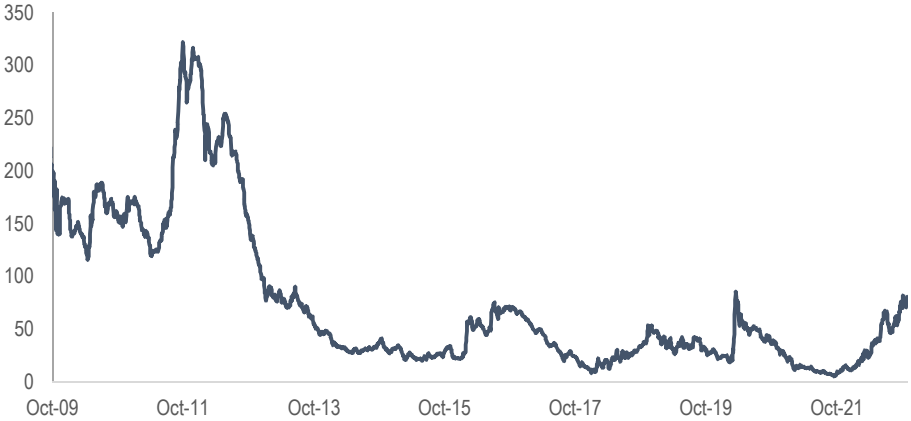
Overweight Financials versus Corporates

As we detailed in our note a few weeks ago (here), we expect **Financials to outperform Corporates**. While the gap between the two indices has tightened marginally from the 82bp high seen back in mid-October, at its current level of 76bp it still offers a spread pick-up that measures in at the wider end of the range seen since in the post-Eurozone Crisis years (Figure 111).

In our view, the sector benefits from a technical perspective, with lower issuance requirements looking into 2023 as well as no selling pressure from the Bank of England as they wind down their corporate bond portfolio. From a fundamentals standpoint, we think Banks are stepping into the upcoming growth slowdown with better capitalization levels, lower leverage, and adequate liquidity.

Further, in our view, the market is likely to be positively surprised on fears over loan loss provisioning, with our calculations showing a worst-case charge to the three large UK Banks combined at £3bn, well shy of 1H 2020 levels. Further, while event risk remains around the 17th November autumn budget on the likelihood of a higher than expected surcharge on Bank tax rates, recent headlines have indicated that this will likely not go through, removing an additional risk factor to performance.

Figure 111: GBP IG Financials vs Corporates Spread Differential, bp



Source: J.P. Morgan, Markit Group

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Inverted curves and index composition support short duration outperformance

In our view, the volatility episode following the mini-budget and consequent LDI deleveraging has left the **front end of the sterling credit curve looking cheap at current valuations**. We think shorter duration performance is likely to benefit from:

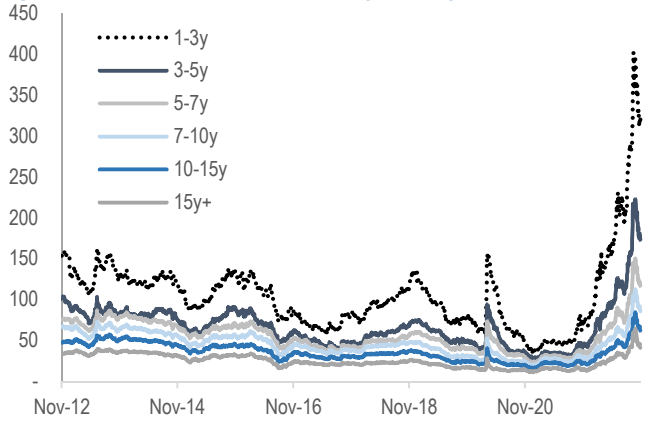
(a) a ratings composition perspective, tilting more towards higher quality paper (surprisingly), with 48% in AAA-A paper versus 38% in 7y+ paper.

(b) a sectoral perspective, with a roughly two-thirds weight towards sectors where we hold a more constructive view, primarily driven by a nearly 50% allocation to Banks.

(c) a reduction in the level of central-bank driven front end rates volatility as the monetary policy tightening cycle moves reaches some form of steady state

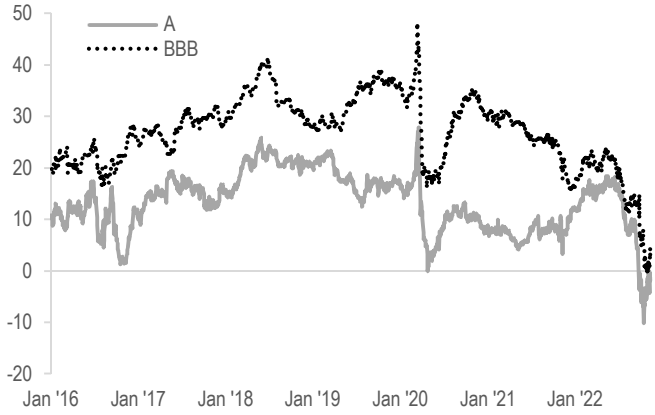
Value is also hard to ignore here - at the index level, yield breakevens for sub-5Y paper are currently running at nearly 3x their long run average levels (Figure 112), and an issuer by issuer analysis of 5s10s steepness in curves portrays much the same view, currently measuring at an average 2.5bp for BBBs (versus a 27bp average since 2016), and even inverted at -1.4bp for single-As (versus 13.3bp, Figure 113).

Figure 112: GBP IG Yield Breakevens by maturity bucket



Source: J.P.Morgan, Markit Group

Figure 113: GBP IG 5s10s breakdown by rating, bp

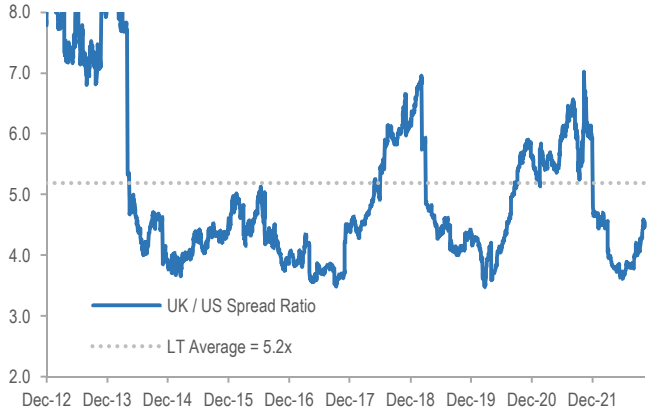


Source: J.P.Morgan, Markit Group. Issuer curve-based benchmark spread differential

Domestic names could underperform

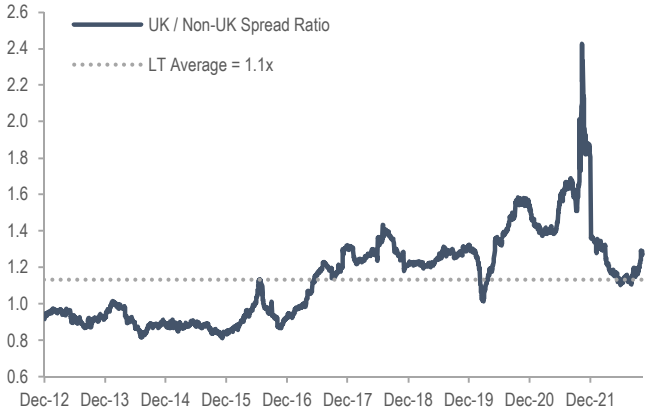
With the UK's growth prospects lagging behind both the US and the Euro Area looking ahead into next year, we think domestic names could underperform in the expected rally. The ratio between UK and US issuers in the sterling index is (almost surprisingly) well shy of the historical wides reached during previous eras of growth slowdowns in 2020, 2018, and looking back to the post-Eurozone crisis years, and the long-term average of 5.2x (Figure 114).

Figure 114: UK vs US Spread Ratio



Source: J.P.Morgan. Using 5Y Asset Swap Spread Issuer Curves

Figure 115: UK vs Foreign Spread Ratio



Source: J.P.Morgan. Using 5Y Asset Swap Spread Issuer Curves

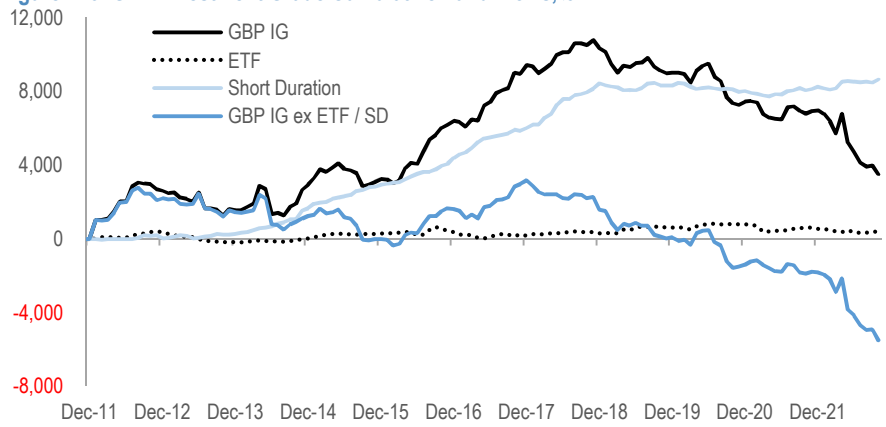
Demand: buying that dip

Retail funds try and turn a corner

It's fair to say that sterling high grade funds have struggled to build any kind of inflow momentum over the past decade, with repeated disruptions over the period, with the Scottish referendum in 2014, the 2015 election, the 2016 EU referendum, the deal-or-no-deal tug of war in the aftermath of the vote, COVID in 2020, and the 2022 omnishambles that managed to combine frequent government upheavals, war, a potential collapse in the pension fund industry and policy tightening all in one short year.

Indeed, once you strip out ETFs and short duration funds from the composition, **traditional 'benchmarked' funds have lost nearly 20% of their assets to outflows or £5.5bn between 2012 and 2022** (Figure 116). In our view, the upcoming year is likely to provide an opportunity for a turnaround but with geopolitical risk factors that could keep a lid on the extent of the recovery.

Figure 116: GBP Investment Grade Cumulative Fund Flows, £mm



Source: J.P.Morgan, Bloomberg Finance L.P.

On the one hand, our constructive view on credit combined with our Rates colleagues' expectation for sovereign yields to trek lower over the coming year should support total returns in the asset class in the coming year, a trend that has typically driven inflows into credit from momentum-following retail investors.

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On the other, the UK's economic and political outlook (with a protracted growth slowdown coinciding with fiscal austerity, even as the country gears up for yet another election cycle in 2024) could keep investors wary of stepping back into the market in size.

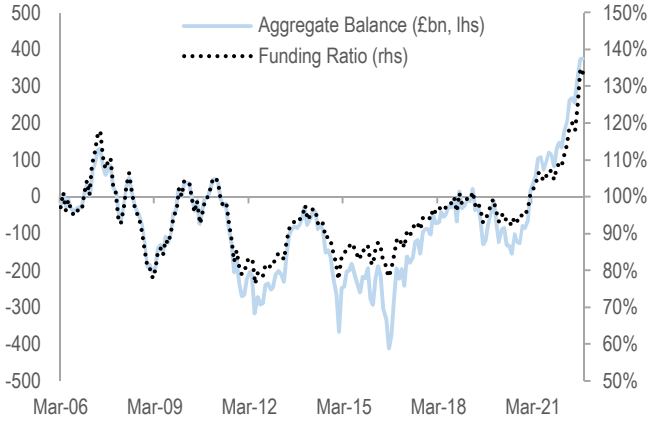
Institutional demand should steady the boat

With the worst of the LDI deleveraging cycle hopefully in the rear-view mirror, we think the pension fund landscape in its aftermath is likely to be supportive for fixed income assets in the coming months.

The steep increase in gilt yields, while being the very cause of the collateral crisis seen through September and October, also served to continue improving the asset-liability balance for pension funds with **funding ratios currently at a fresh record 135%**, while the proportion of surplus schemes also touched a new high at 86% (Figure 117 & Figure 118). Why is this positive for sterling credit?

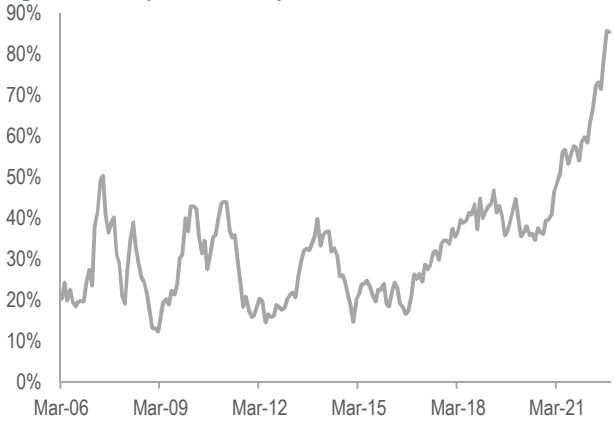
One, this sharply improved funding status, against a backdrop of concerns over the growth-driven strategies employed through the low yield environment over the past decade, could **drive pension funds to rebalance towards a more conservative allocation with a rotation out of equities and into fixed income** (typically longer duration gilts and higher quality corporate bonds) as they lock in profits from their funded status.

Figure 117: PPF7800 Funding Ratios



Source: J.P.Morgan, Pension Protection Fund

Figure 118: Proportion of Surplus Schemes



Source: J.P.Morgan, Pension Protection Fund

And two, we think the focus will be back on the pension risk transfer process, with an increasing demand for insurer buyouts of defined benefit schemes, a trend that has historically been a source of steady demand for sterling credit (Figure 119).

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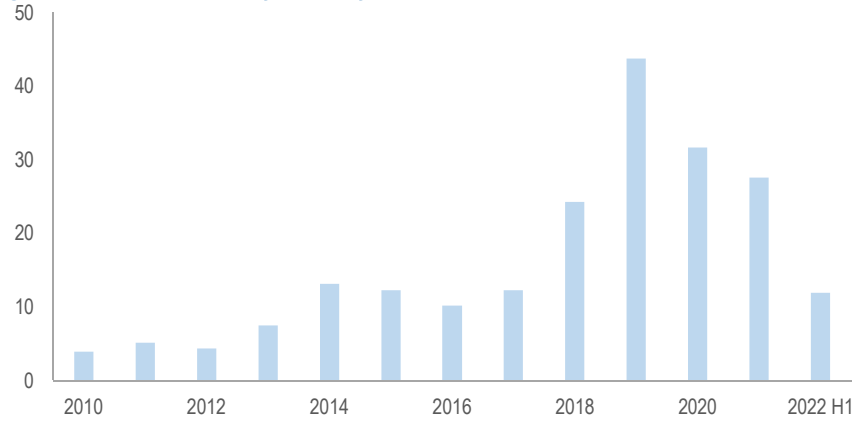
Figure 119: Pension Fund Buyouts / Buy-Ins, £bn



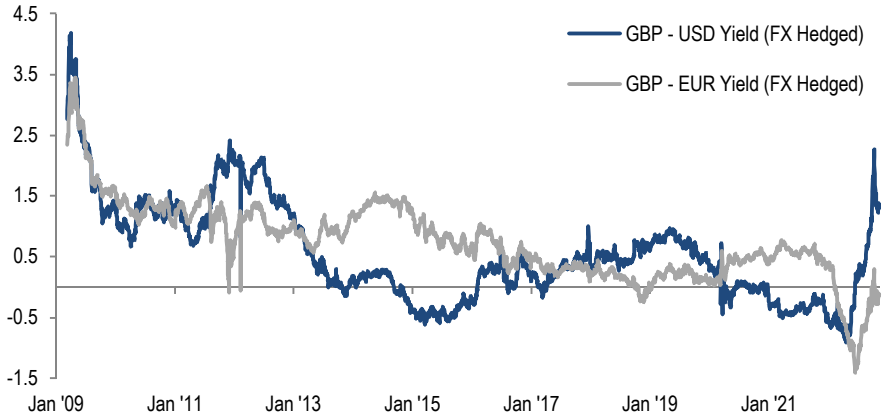
Source: J.P.Morgan, Insurance Company Data, LCP

Foreign demand could pick back up

We think 2023 could also see some revival in the extent of foreign investor flows coming into the asset class, although a lot would hinge on the upcoming budget calming markets on fears over UK's debt sustainability and restore the country's credibility in international markets.

While there's little to choose between euros and sterling at the moment, the same cannot be said of the yield pick-up offered versus dollars, with the differential currently measuring in at 1.3%, levels last seen during the Eurozone Crisis and well above the long run average of 0.5% going back to 2009 (Figure 120)

Figure 120: 3m FX Hedged Cross Currency Yield Differentials, %



Source: J.P.Morgan, Bloomberg Finance L.P., Markit Group

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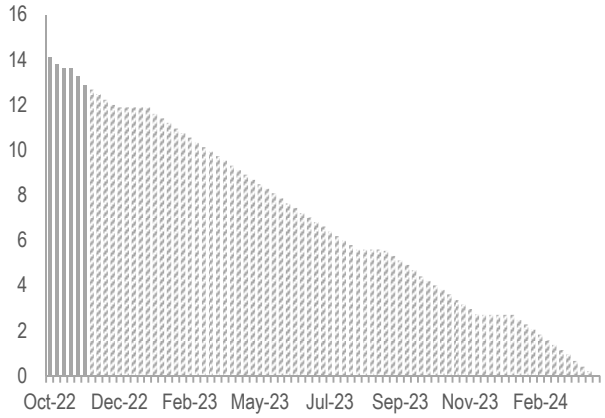
On track for the BoE's corporate bond sales

One of the primary challenges to the more constructive view we've laid out so far could come from the Bank of England's wind down of their corporate bond holdings, with a complete exit from the portfolio likely to be reached by March-April 2024 at the Bank's stated goal of £200mm / week of selling after accounting for an estimate of maturing bonds over that period and pauses over the usual holiday months, August & December (Figure 121).

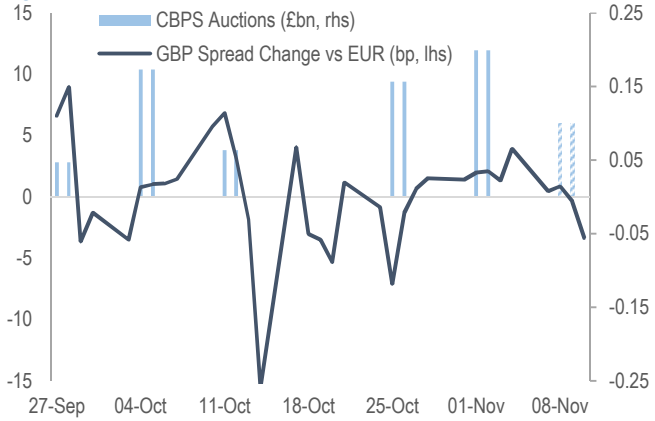
In the auctions held so far, our estimates have the Bank's pace of sales at slightly above the expected average £200mm/week, having compensated for the slower pace in the first week (held on September 27th & 28th during the mini-budget driven sell-off) and the mid-October hiatus (during the peak of the LDI crisis), by ramping up sales in the following weeks. All things considered, the **sales seem to have been relatively well absorbed**, with sterling credit markets barely underperforming euros over the auction days through the last three weeks under more 'normal' market conditions (Figure 122).

Figure 121: CBPS wind-down profile estimate



Source: J.P.Morgan, Bank of England

Figure 122: CBPS Auctions & Spread Performance



Source: J.P.Morgan, Bank of England, Bloomberg Finance L.P. Patterned bars for 8th & 9th November –BoE figures available only next Thu, average £200mm/week used.

In our view, we think the spread impact of CBPS sales will remain relatively benign in the coming year, as valuations bring investors back into the market, even as a slowdown in the pace of supply (see below) could free up cash to be deployed into the program.

Digging further into the Bank's holdings throw up a couple of concerns, although we do not think this is a game changer for the broader outlook:

(a) the portfolio is **heavily weighted towards lower-rated BBB credits** – that being said, this is at least partially countered by the sector composition of the segment which leans towards the more defensive sectors (Figure 123)

(b) **non-ESG friendly issuers** could still give investors pause, most notably with the Tobacco names, although these account for less than 5% of the overall amount outstanding in the CBPS ISIN list.

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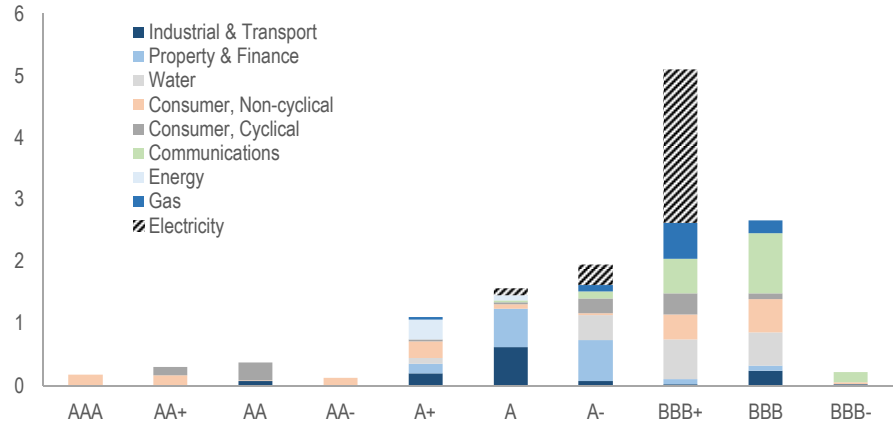
Figure 123: CBPS Portfolio breakdown by sector & rating



Source: J.P.Morgan, Bank of England, Bloomberg Finance L.P.

Supply shifts to a lower gear

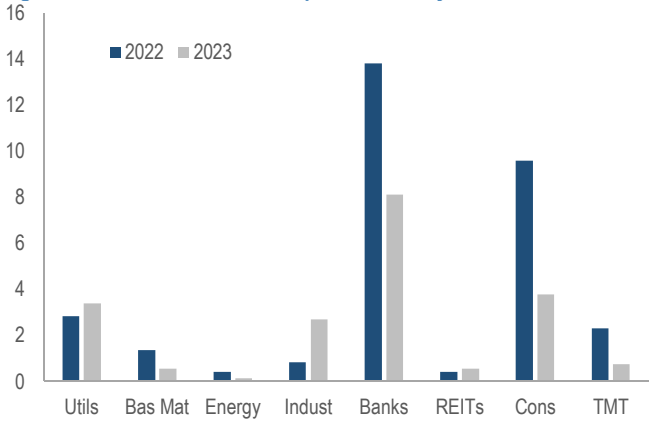
While the CBPS wind-down drives 'net' supply into the market, we think there is likely to be a step down in broader issuance activity in 2023, supported by a slowdown from Financials (which has tended to drive volumes in sterling in recent years), and a significant reduction in the overall amount of refinancing required versus the 2022 maturity wall.

Further, in our view, the economic backdrop (as the UK struggles through a protracted growth slowdown and reckons with the fallout from Brexit) is unlikely to support a surge in business investment, tamping down the likelihood of an uptick in domestic issuance to support capital expenditure. This dynamic is also likely to be mirrored across global markets, consequently impacting the volume of foreign supply coming to sterling credit. **We pencil in £35bn gross / £10bn net for 2023.**

Consumer & Financials drive redemptions lower
With the bouts of geopolitical and central bank volatility keeping funding costs high and opportunistic financing windows short in 2022, re-fi requirements proved particularly useful in predicting gross issuance activity over the year - the three sectors that accounted for the lion's share of debt coming due (Financials, Consumer, and Utilities) drove nearly all the £40bn of supply that we've seen so far year-to-date (Figure 124 & Figure 125).

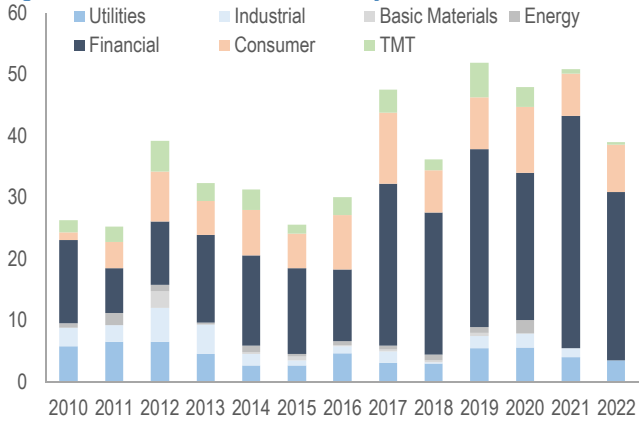
In this aspect and in contrast to their euro counterparts, **next year's maturity wall should throw up few challenges for the sterling markets**, with a total of just over £20bn coming due, a distinct reduction from the refinancing needs seen through 2022. Critically, both the Consumer sector and Financials, which have together accounted for an average of nearly 80% of annual gross supply since 2015 show a sharp drop of in redemptions from close to £24bn in 2022 to just above half that in the coming year.

Figure 124: 2022 vs 2023 Redemption Profile by Sector, £bn



Source: J.P.Morgan, Markit Group.

Figure 125: GBP Issuance breakdown by sector, £bn

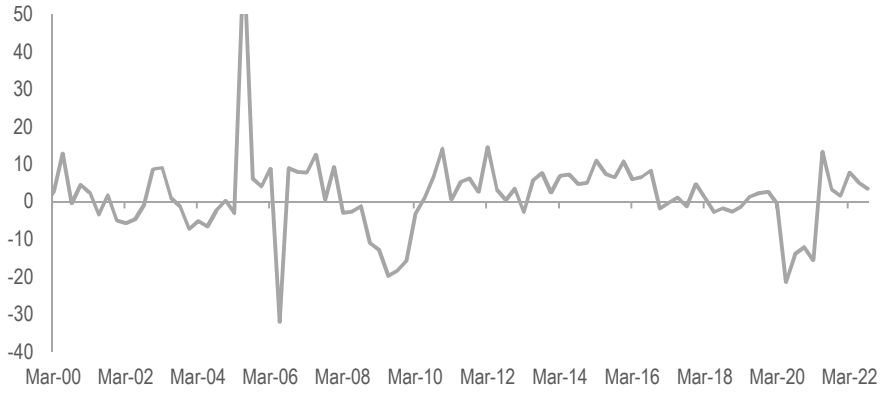


Source: J.P.Morgan

Domestic issuers face economic slowdown, foreign supply hinges on valuations

In our view, the UK's economic outlook for 2023 does not really provide the ideal backdrop for a revival in animal spirits amongst domestic corporates to drive higher capital expenditure and investment-driven supply. The upcoming growth drag from fiscal tightening is likely to dampen business confidence and, consequently, growth in investment which has already seen periodic interruptions since the Brexit vote back in 2016 (Figure 126).

Figure 126: UK Business Investment Chained YoY SA



Source: J.P.Morgan, ONS, Bloomberg Finance LP.

While investment may dwindle, however, we do note that, after a rush to come to market in the direct aftermath of the first COVID-19 sell-off and the Bank of England's CBPS announcement, supply from domestic corporates has progressively slowed over the past two years, accounting for a record low 30% of total issuance in 2022 (Figure 127). Facing compression in profit margins as the 'cost of living crisis' bites and supply chain disruptions continue in post-Brexit Britain, issuers may choose to opportunistically come to market in order to shore up cash holdings heading into recession.

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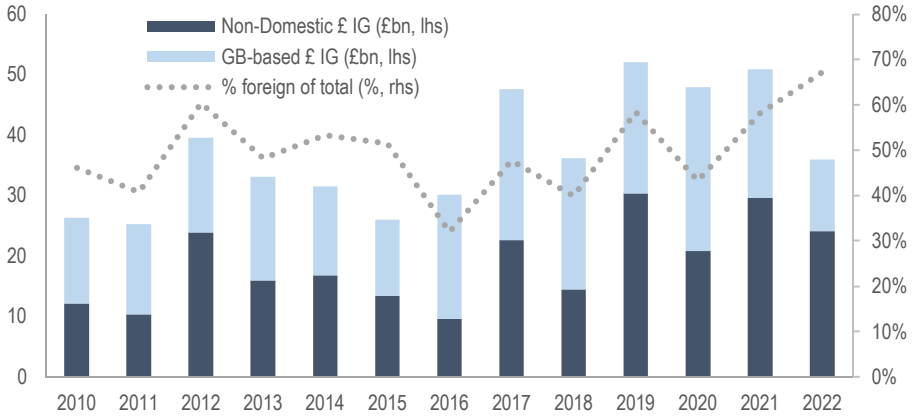
Figure 127: Domestic vs Foreign Supply

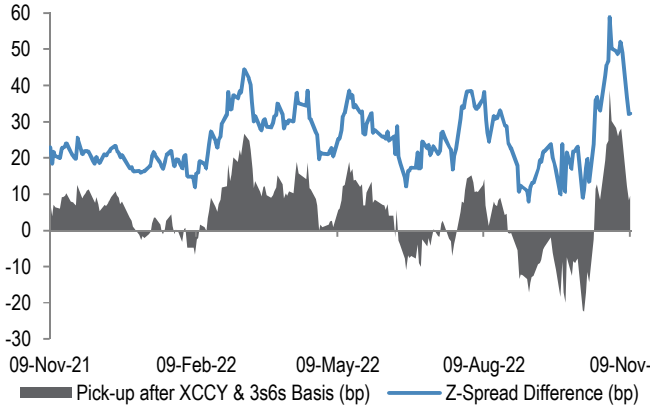


Source: J.P.Morgan, Bloomberg Finance L.P.

The other side of this equation is the paper coming through from foreign issuers, where we also expect a slowdown primarily on account of a downshift in funding requirements for Banks - both in Europe, where our colleagues anticipate lower net funding needs as the sector has reached its Jan 2024 MREL requirements, and in the US, where supply is set to shift away from the GSIBs and towards more regional banks.

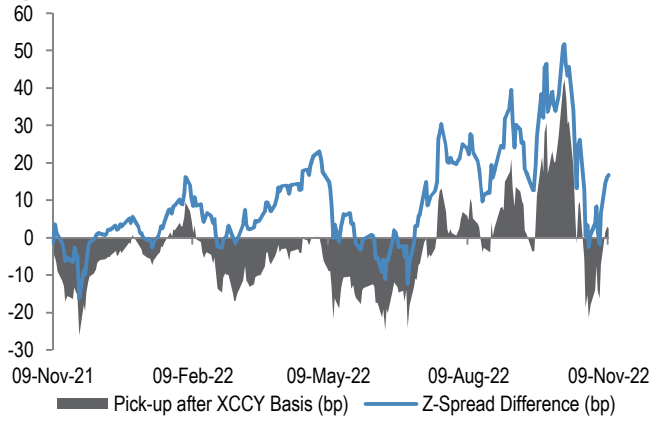
The wildcard, as ever though, is in the cross-currency dynamics - sterling screened cheaper for issuers to tap versus both euros and dollars through much of the early half of 2022 which has also proved to be a key support for the higher amounts of foreign issuance coming into the market this year. That being said, the gap proved its mean reverting nature, having tightened in recent weeks with sterling now trading only 10bp inside USD on XCCY-hedged basis and 3bp wide of EUR (Figure 128 & Figure 129).

Figure 128: USD – GBP Spread Differential, bp



Source: J.P.Morgan

Figure 129: GBP – EUR Spread Differential, bp



Source: J.P.Morgan.

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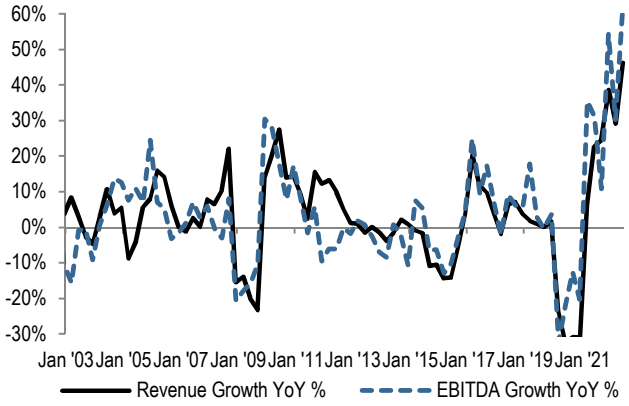
Fundamentals: a dark cloud on the horizon

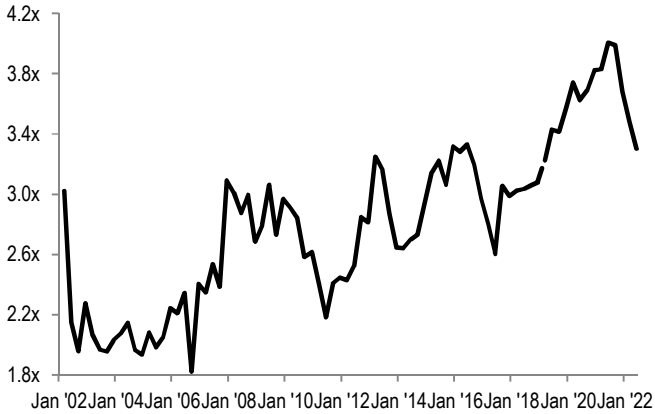
With a significant portion of the sterling universe only reporting semi-annually, corporate fundamentals data has always been one step further backward looking than most other markets. Updated data for Q2 2022 show both EBITDA and Revenue growth at fresh record highs of 63.7% and 46.2% respectively, impacted both by the sharp improvement earnings amongst the Oil & Gas and Basic Materials names in our dataset, as well as base effects (with the denominator impacted by the alpha and delta waves in mid-2021). Net leverage, consequently, fell sharply to pre-pandemic levels, coming in at 3.3x in Q2 2022, the lowest the first quarter of 2019 (Figure 131).

Figure 130: EBITDA and Revenue Growth, % yoy



Source: J.P.Morgan, S&P Capital IQ

Figure 131: Net Leverage, x

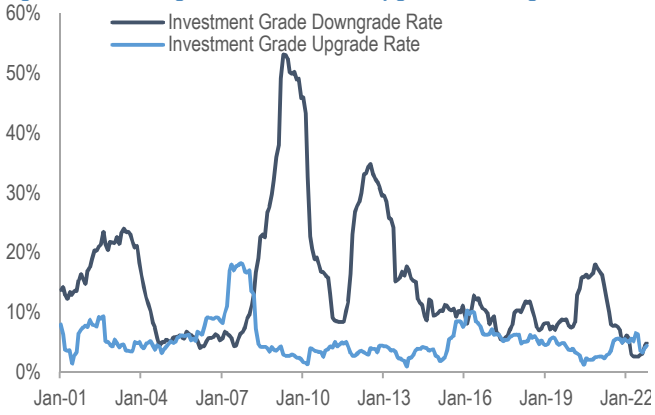


Source: J.P.Morgan, , S&P Capital IQ

Looking ahead, we think there are two factors to consider here: one, the composition of UK companies includes a large number of multi-national corporates with significant foreign earnings, meaning the steep fall in the currency through the second half of this year could serve to bolster balance sheets reported in sterling. That being said, in our view, there is no debating the worsening economic outlook next year, with the 'cost of living crisis' likely to dampen company pricing power even as supply chain disruptions and Brexit keep input costs and margin pressures high.

Ratings migration trends have already started to reflect a worsening backdrop, seeing a steady decline from July onward both on account of a fall in the LTM upgrade proportion as well as a tick up in the number of bonds seeing at least a one notch downgrade (Figure 132). The net rate, consequently, shifted back into negative territory after briefly showing upward momentum in May & June this year (Figure 133) – in our view, migration rates are likely to fall further from this point onward as the growth rates and company fundamentals deteriorate.

Figure 132: Sterling Investment Grade, Upgrade & Downgrade %



Source: J.P.Morgan, Markit, ICE-BAML. Measured as the % of bonds seeing a one notch upgrade / downgrade on an LTM basis

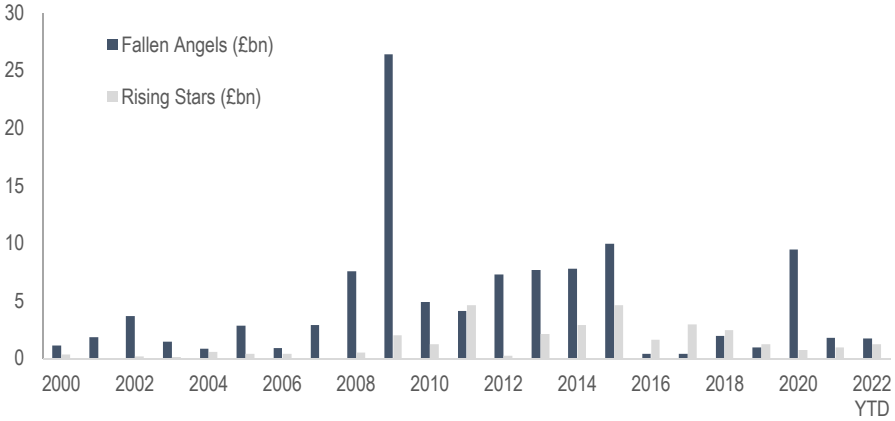
Figure 133: Net Ratings Migration, %

Source: J.P.Morgan, Markit, ICE-BAML

We don't think this necessarily translates to a significant pick-up in fallen angel activity however – the BBB space currently is overwhelmingly weighted towards the more defensive sectors with TMT and Utilities together accounting for nearly 40% of the amount outstanding, and Banks, which should benefit from the higher rate environment, forming another 20%.

Further, 2020's fallen angel cycle has already seen the weaker cyclical names being downgraded in the market, with sterling not really participating in the rising star wave seen through the last couple of years, leaving candidates few and far between (Figure 134).

Figure 134: Sterling Fallen Angel and Rising Star Volumes, £bn



Source: J.P.Morgan, Bloomberg Finance L.P., Markit, ICE-BAML.

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