This is a shortened version of the Daily Credit Briefing, which we deem to be an acceptable minor non-monetary benefit under MiFID II.

Euro Credit Pilot Strategy

Macro Research
Strategy Research
Credit Research

"Credit keeps calm and carries on … for now"

10 2018

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Corporate credit spread performance has shown some interesting divergence between synthetics and cash bonds. In synthetics, credit risk premiums have drifted wider over the last two weeks. The iTraxx Main traded at around 68bp from the time of the roll into the new series 30 until early October but has widened to around 75bp recently. For the iTraxx Crossover, widening has been more pronounced, as the index spread has increased by 30bp since the last roll to almost 300bp. Cash bond spreads, however, have remained more stable. In IG-rated non-financials, spreads even tightened somewhat as the ECB increased again its purchases of corporate bonds in September after the end of the summer break. However, Italian credit has underperformed its European peers over the last few weeks, as rising BTP yields have resulted in widening credit spreads. The spreads of Italian non-financial debt is trading at 100bp on average, compared to 35bp for the debt of German and French companies and 55bp for the debt of Spanish firms. However, while the yields of Italian financial debt have become more aligned with that of BTPs, the yield on non-financial debt has risen only gradually. Rating pressure is one of the biggest risk factors facing Italian credit. Nevertheless, substantial downgrade risk is already discounted in current spread valuations.

- **Macro Outlook:** As the end of the ECB's asset purchases approaches, and with eurozone core CPI still below 1%, the issue of inflation normalization is still relevant. One way to look at the issue is with reference to the Phillips curve.
- **Micro Fundamentals:** The average Italian rating in the IG space settled in the BBB/BBB+ area following the financial and sovereign-debt crises. Current spread valuations of Italian corporates already reflect multiple-notch downgrade risk, leaving a large portion of potential knock-on rating actions already priced in.
- **Debt-Equity Linkage:** European equity indices are stabilizing after their latest plunge. Credit indices have widened somewhat, in sympathy with equity markets, but less than historical dependency patterns would suggest. Going forward, credit-equity sensitivity will depend on the underlying economic scenario: an isolated equity correction would not be a big deal, an economic slowdown would be.
- **Credit Quality Trend:** Volatility has come and gone this year, but this has not hindered issuance from lower-rated issuers. While HY-bond issuance remains high, leveraged-loan issuance is even stronger, as investors value the floating format.
- **Market Technicals:** The surge in new bond issuance in September does not represent a new trend in primary market activity. It was conditioned by technical factors, and we expect primary market activity to be more moderate in the coming months.
- **Valuation & Timing:** Recent pronounced bond spread trends reflect technical factors, such as changes in CSPP volumes, rather than fundamentals.
- **Sector Allocation & Recommendation Overview:** We keep our sector recommendations unchanged.

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Story of the Month

Italian credit in the limelight

Corporate credit spread performance has shown some interesting divergence between synthetics and cash bonds. In synthetics, credit risk premiums have drifted wider over the last two weeks. The iTraxx Main traded around 68bp from the time of the roll into the new series 30 until early October but has widened to around 75bp recently. For the iTraxx Crossover, widening has been more pronounced, as the index spread has increased by 30bp since the last roll to almost 300bp. Cash bond spreads, however, have remained more stable. In IG-rated non-financials, spreads even tightened somewhat as the ECB increased again its purchases of corporate bonds in September after the end of the summer break. However, Italian credit has underperformed its European peers over the last few weeks, as rising BTP yields have resulted in widening credit spreads. The spreads of Italian non-financial debt is trading at 100bp on average, compared to 35bp for the debt of German and French companies and 55bp for the debt of Spanish firms. However, while the yields of Italian financial debt have become more aligned with that of BTPs, the yield on non-financial debt has risen only gradually. Rating pressure is one of the biggest risk factors facing Italian credit. Nevertheless, substantial downgrade risk is already discounted in current spread valuations.

Volatility in BTP yields is also exerting widening pressure on Italian corporate bonds

The spreads of Italian corporate bonds have come under pressure as BTP yields have widened relative to Bunds. The average asset-swap spread among the Italian constituents of the iBoxx Non-Financials Senior index has widened to roughly 100bp. At the same time, the corresponding spread among German and French companies is at 35bp and, among Spanish companies, it is at 55bp (see Chart 1). This week, the 10Y BTP yield rose temporarily to 3.70%, its widest level since 2014, according to Bloomberg. At this level, the BTP yield was about 315bp higher than the corresponding 10Y Bund yield.

However, while some pressure from BTP volatility is measurable among non-financial bonds, their yield dynamics are still profoundly different. In order to highlight this, we compared the average yield of the Italian constituents of the iBoxx Non-Financials Senior index with the corresponding reference yield for BTPs. We derived this reference yield by interpolating the BTP curve with respect to the duration of the corporate bonds. Chart 2 depicts an average of Italian corporate-bond yields in comparison to the interpolated BTP yield (both on the left y-axis) and the corresponding spread between corporate-bond and government-bond yields (on the right y-axis).

CHART 1: IBOXX NON-FINANCIALS SENIOR SPREADS BY COUNTRY

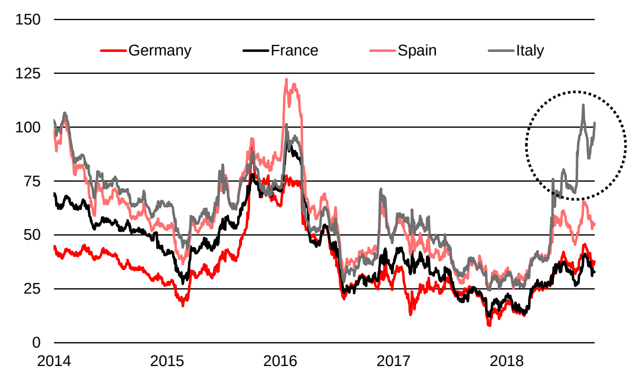
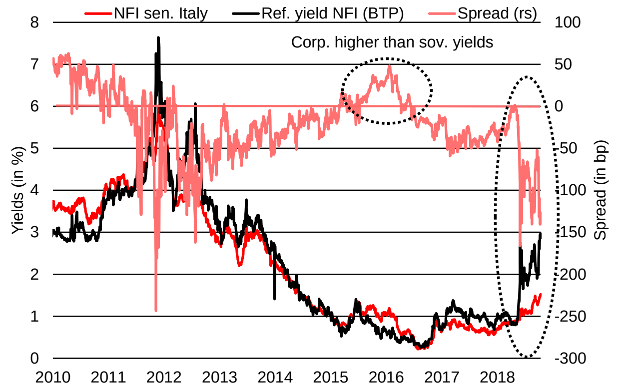


CHART 2: YIELDS OF ITALIAN NON-FINANCIAL SENIOR DEBT, BTPS AND THE CORRESPONDING SPREAD



Source: iBoxx, Bloomberg, UniCredit Research

Nevertheless, Italian non-financial-bond yields are still trading about 100bp inside corresponding BTP yields, and corporate bond yields have risen only gradually…

What can be concluded from this comparison? First, Italian corporate-bond yields developed more or less in tandem with BTP yields for most of the period depicted in Chart 2, which spans the period from 2010 to 2018. However, for a large portion of this period, corporate bonds traded at lower yields than government bonds. The only time in the recent past when corporate-bond yields were higher than BTP yields was in 2015-16. Second, the close correlation between corporate and government-bond yields broke down in May of this year, when BTP yields started to widen considerably following the formation of Italy's governing coalition. While government-bond yields have jumped higher, corporate-bond yields have risen more gradually, resulting in the formation of a significant gap between government and corporate-bond yields. At current valuations, BTPs with the same time horizon as the average duration of Italian corporate bonds (5.2Y at the moment) are trading about 100bp wider than corporate bonds.

…underlining the fact that the credit fundamentals of Italian corporates are still sound

The fact that Italian corporate-bond yields are rising slower than government-bond yields can be explained by technical, rather than fundamental, pressure. While the credit profiles of Italian companies are still sound (and the somewhat-higher costs for new funding will not change this materially), there is potential for knock-on rating pressure to develop alongside pressure from potential allocation shifts (when Italian corporate-bond yields trade too deeply inside BTP yields).

However, the spreads of Italian financials were moving more in line with BTPs.

For financials, however, the situation is different from that associated with non-financials. The credit spreads of Italian financials have widened more than those of non-financials on the back of BTP-yield increases. Charts 3 and 4 show datasets that correspond with those depicted in the previous two charts but instead refer to the iBoxx Financials Senior index. The average asset-swap spread among Italian senior financial bonds has widened to 150bp (see Chart 3). Moreover, compared to BTPs, Italian senior financial bonds are currently trading at a spread that fluctuates between zero and -50bp (see Chart 4). In a historical context, it is still unusual that financial bonds' yields are trading inside corresponding BTP yields. This underlines how unique the current circumstances are. Nevertheless, the credit spreads of Italian financials are clearly much more dependent on Italian government-bond yields than on non-financial bond yields. This is also due to the fact that the credit profiles of many Italian non-financial firms are not very sensitive to domestic growth.

CHART 3: IBOXX FINANCIALS SENIOR SPREADS BY COUNTRY

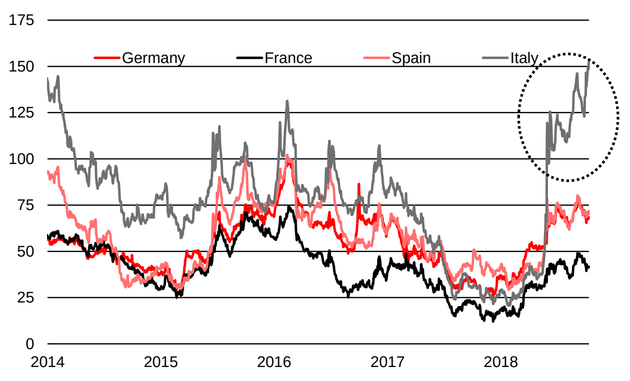
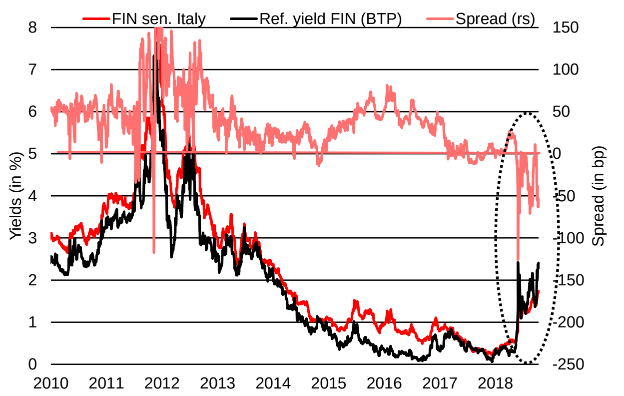


CHART 4: YIELDS OF ITALIAN FINANCIALS SENIOR, BTPS AND THE CORRESPONDING SPREAD



Source: iBoxx, Bloomberg, UniCredit Research

Rating pressure is one of the key drivers of spread widening

As highlighted above, the risk of knock-on rating pressure developing on the back of potential downgrade pressure on the sovereign rating is one of the most prevalent factors driving credit spreads wider. In particular, issuers with a rating close to the IG/HY limit might be vulnerable to spread-widening pressure due to downgrade fears.

Credit Drivers

Macro: gradual inflation normalization

As the end of the ECB's asset purchases approaches, and with eurozone core CPI still below 1%, the issue of inflation normalization is still relevant. One way to look at the issue is with reference to the Phillips curve.

A number of factors argue in favor of the restoration of the Philips curve…

The relation between wage growth and the unemployment rate was strong before 2008, as reflected in the chart on the left (black dots – high R-square). Since 2008, however, the relation has weakened (red dots – low R-square). Most recently, wages have been accelerating, so the Phillips curve relevant once again. Moving forward, however, we believe that a return of the link between wages and (core) inflation, i.e. the normalization of inflation, is probable for various reasons. The most important factor from a cyclical point of view is the high capacity utilization. Although it declined slightly last quarter, capacity utilization is still at 2007 levels, which should put pressure on prices. Most eurozone countries are facing adverse demographic backdrops, a factor that is starting to create tensions on the labor market, as in Germany, for example. As the chart on the right also shows, labor shortages in major eurozone economic sectors, such as automobile manufacturing or machinery and equipment manufacturing, are also at pre-crisis levels. The collective bargaining rounds will likely add to upside pressure on wages, as a shortage of labor typically bestows unions with additional bargaining power, and this effect can already be seen.

…but there are also risk factors

There are, however, also limiting factors. Skilled labor immigration and automation, though these will hardly ease labor shortages in short term. Further, the increasing relevance of service sectors, including low-wage sectors, in the economy constitutes another limiting factor. Finally, the vulnerable economic growth outlook, as highlighted by IMF's latest WEO *Challenges to Steady Growth,* could potentially limit inflation pressure. The Fund cut its 2018 and 2019 global growth forecasts to 3.7%, down 0.2pp from its April forecasts. Although the most pronounced growth revisions took place in emerging markets (growth forecasts cut by 0.2pp for 2018 and 0.4pp for 2019, down to 4.7% for each year), the eurozone 2018 growth forecast was also reduced by 0.2pp to 2.0% (UniCredit: 2.2%), though it was left unchanged for next year (1.9%, in line with our forecast). Although the Fund expects eurozone core inflation to rise to 1.2% in 2018 and 1.6% in 2019, and further to increase gradually to 2% by 2022, some risks should not be neglected. These risks derive particularly from the vulnerable growth outlook stemming from trade tensions between the US and China, potentially weighing via weaker confidence and financial conditions.

The bottom line

While the latter risk factor may weigh on sentiment towards risky assets, in the medium term, according to our base scenario, the above mentioned factors will push inflation higher. That, together with the end of the ECB's asset purchases by the end of the year, will undermine the attractiveness of IG credit.

CHART 1: EUROZONE'S PHILIPS CURVE

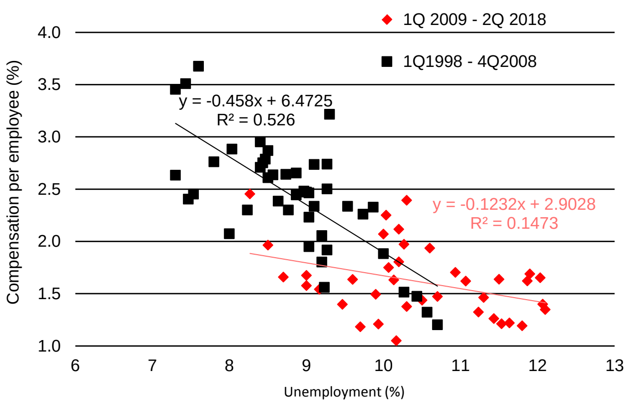
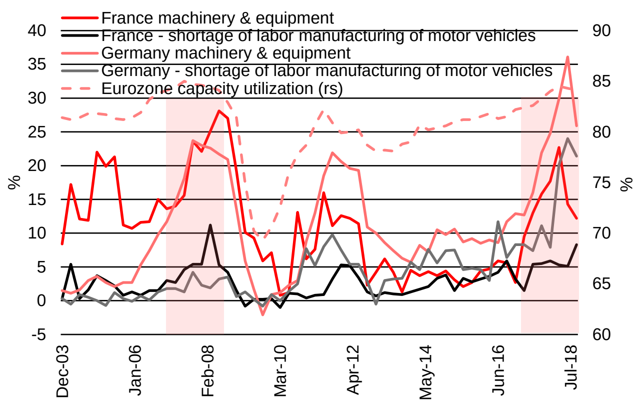


CHART 2: EUROZONE UTILIZATION CAPACITY VS. SELECTED SECTORS' LABOR SHORTAGE



Source: Feri, Bloomberg, UniCredit Research

Micro Fundamentals: downgrade risk already priced in

Average Italian rating in the IG space settled in the BBB/BBB+ area following the financial and sovereign-debt crises

S&P will publish a review of its BBB rating of the Italian sovereign on 26 October. And also Moody's will likely resolve its watch for possible downgrade of its Baa2 rating at the end of October. The corresponding risk of a sovereign downgrade including potential knock-on rating actions for private companies has been an important driver of credit spreads lately. In the following, we want to shed some light on the situation of Italian corporates in respect to potential knock-on rating actions. We start by highlighting the rating development of Italian corporates over the last 15 years. Prior to the financial crisis, Italian investment-grade corporates were on average in the single-A area (see Chart 1, depicting the average rating for IG, HY and the combined Italian universe alongside the volume share of HY). This average rating level was in line with the overall average European rating level. In the aftermath of the financial crisis and the sovereign-debt crisis, average ratings of Italian IG-rated corporates eroded to between about BBB and BBB+, a rating level that has persisted over the last five years. Only the ratings of Italian HY companies have been on a slight downward trend, pulling the overall average rating lower. However, a portion of this downward trend has been driven by lower-rated HY bonds being issued in the market due to improving investor risk appetite.

Current spread valuations of Italian corporates already reflect multiple-notch downgrade risk, leaving a large portion of potential knock-on rating actions already priced in

What about the current situation in Italian corporate bonds in respect to the impact of potential downgrades on credit spreads? In order to provide some insight, we compiled the spreads of some Italian corporate bonds and compared them with the spreads of bonds in the iBoxx index with the same rating. Chart 2 shows corporate bond spreads for a 5Y maturity (we only used those names for which a reasonable curve is available to interpolate for a five-year spread) by rating category. The shaded areas show the percentiles (in 5% steps) of the spread distribution in each rating bucket. The red-shaded areas depict the inner part of the distribution, which is comparable to the median of the distribution. The red dots designate the spread levels of the Italian companies in the sample. The analysis reveals that spreads of Italian IG-rated companies are considerably higher than the median of the distribution in the respective rating bucket. The spread of Italian corporates is below the median only in the BB bucket. Moreover, in BBB and BBB- (i.e. ratings closer to the HY area), the deviations of Italian credit from the median are larger than in the A- and BBB+ segment. This reflects the greater risk of being pushed into sub-IG. Moreover, at current spreads most Italian credit reflects at least a one or two-notch downgrade. In other words, some potential knock-on rating actions are already priced in.

CHART 1: AVERAGE RATING TREND OF ITALIAN CORPORATES BY CLASS

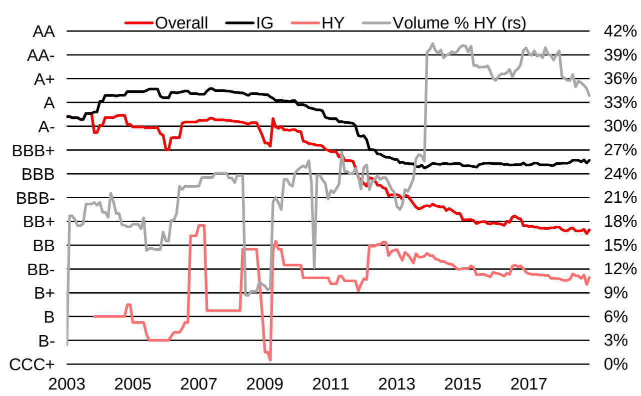
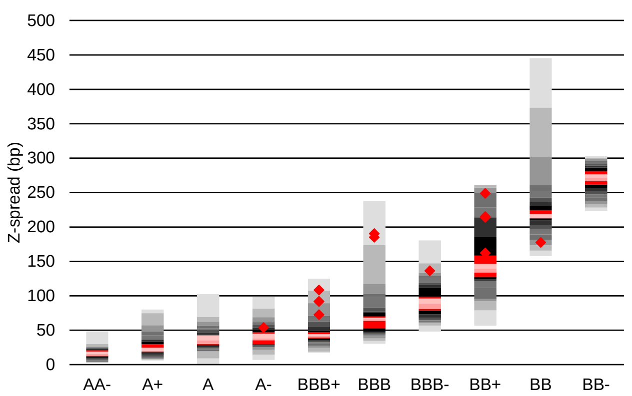


CHART 2: SPREAD BY RATING OF NON-FINANCIALS (RED DOTS: ITALIAN CORPORATES)



Source: iBoxx, Bloomberg, UniCredit Research

Debt-Equity Linkage: credit keeps calm and carries on – for now

European equity indices are stabilizing after the latest plunge

European equity indices are stabilizing after their latest plunge, which was triggered by a sell-off of US stocks. Since the beginning of October, the STOXX Europe 600 has lost 6.3%, slightly more than the S&P 500, which has lost 5.3% over the same period. The plunge has taken the European equity index to new 2018 lows. In fact, the last time the index hit such levels was in early 2017. However, European credit indices have been more resilient.

Credit indices have widened somewhat, in sympathy with equity markets, but less than historical dependency patterns would suggest

The iTraxx indices have widened somewhat, in sympathy with equity markets, but only as much as the historical dependency pattern would suggest. The two charts below show the STOXX Europe 600 equity index alongside the iTraxx Main (left chart) and the iTraxx Crossover (right chart). The iTraxx Main has moved about 7bp higher, but the historical correlation pattern would suggest a move about twice as large given the plunge in equities. The iTraxx Crossover has moved about 25bp higher, which is also only about half the spread change suggested by historical dependencies. However, while widening in the iTraxx Main moved spreads towards the upper end of this year's trading range, an important reason for this higher spread level is the iTraxx index roll on 20 September, which added about 10bp to the new series due to maturity extension and changes in the underlying pool (tight-spread names were replaced by wider-spread names). The opposite is true for the Crossover, where the roll subtracted about 10bp from the spread (as high-spread names were replaced by lower-spread names).

Going forward, credit-equity sensitivity will depend on the underlying economic scenario: an isolated equity correction would not be a big deal, an economic slowdown would be

To complete this picture, IG cash bond spreads have moved in the opposite direction recently, compressed by the ECB's CSPP buying activity. However, as the CSPP is going to end at the end of the year, this tightening is certainly only a temporary phenomenon. The more important question is thus whether the resilience of credit spreads, as compared to equities, is a lasting phenomenon. This will clearly depend on the underlying economic trajectory. If the equity sell-off remains just a technical correction driven by excessive valuations, spreads could weather the storm. If, however, the rise in equity volatility is a harbinger of a broader economic slowdown, spreads will not likely remain so resilient. Our macro-credit model suggests that at a pace of GDP growth of about 1.75-2%, a spread level of about 60bp appears to be appropriate. However, should the rate of expansion decelerate to, for example, about 1-1.25%, spreads would likely widen towards the long-term equilibrium of about 100bp.

CHART 1: STOXX EUROPE 600 VERSUS ITRAXX MAIN…

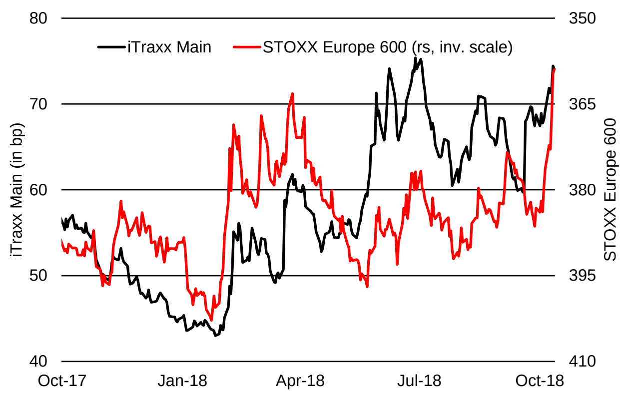
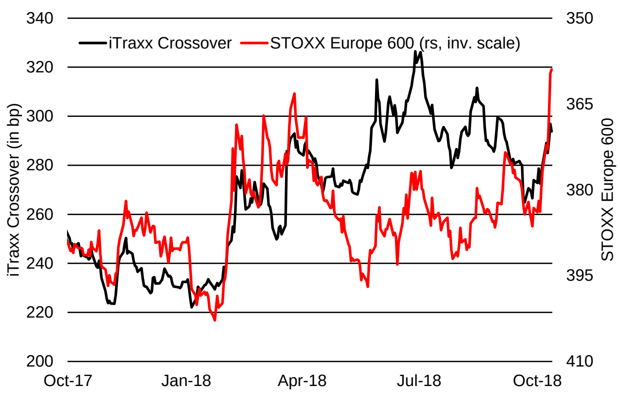


CHART 2: …AND VERSUS ITRAXX CROSSOVER



Source: Bloomberg, UniCredit Research

Credit Quality: demand for lower-rated credit remains high

Volatility has come and gone this year, but this has not hindered issuance from lower-rated issuers. While HY-bond issuance remains high, leveraged-loan issuance is even stronger, as investors value the floating format.

Issuance levels are still strong across bonds and loans

Despite yet another round of volatility this year, overall issuance conditions remain mostly attractive for both lenders and borrowers. This is reflected in high issuance levels of high-yield bonds and leveraged loans. The latter are clearly playing the bigger role again this year. Demand for loans is so high that the challenge to issuance is related to supply rather than to demand. While the European loan market just recorded its lowest quarterly issuance volume since 3Q16, it still raised almost EUR 6bn more than the bond market in that period, pushing issuance volume in leveraged loans to 46% above that of high-yield bonds YTD.

Loans continue to be in higher demand

The dominance of loans was widely expected this year, as it has followed similar patterns from previous years. This is not just because sponsors prefer loans over bonds – since loans offer greater flexibility (they may be redeemed at par at any time, repriced at any time and are cheaper than high-yield bonds. Investors also value the relative stability of prices in the secondary market and the floating format during times of anticipated gradual increases in yields. Despite the gradual repricing of high-yield bonds since the start of the year, due to the approaching end of the CSPP, the average yield differential between leveraged loans and high-yield bonds narrowed again in 3Q (to 115bp, after reaching 151bp in 2Q) to reach its narrowest point in a year, according to S&P's LCD. Yields in leveraged loans moved higher early in 3Q on the back of steady supply to the loan market, but yields came down again late in the third quarter as demand for loans increased again. The strength of the market is also reflected in relative pricing in 3Q: 69% of all deals were priced tighter than or at the tight end of initial guidance, according to LCD. This is higher than the 50% on this measure in 2Q and represents the highest quarterly share in bonds priced tighter than initial guidance this year. At the same time, the share of those deals that came in wider than or at the wide end of initial guidance was down to 7% in 3Q and is down from 13% in 2Q, the smallest quarterly share this year.

Climbing yields are unlikely to materially change the robust issuance picture in Europe in the short term. Although the yield on some of the perceived safest assets have climbed back above the zero line (left chart), lower-rated corporate debt remains unmatched for investors hunting for yield. In addition, the yield increase is still incremental from a long-term perspective: this year's issuance coupon in HY has moved back above 4% on average but is little changed compared to 2014-16 levels (denoted by the red line in chart on the right).

CHART 1: IBOXX INDICES BY YIELD-TO-WORST AND DURATION

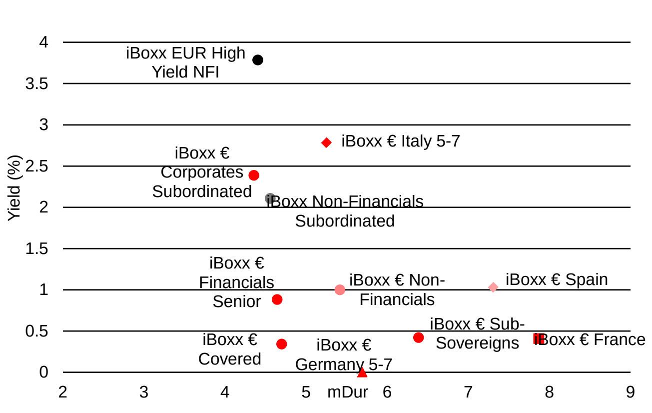
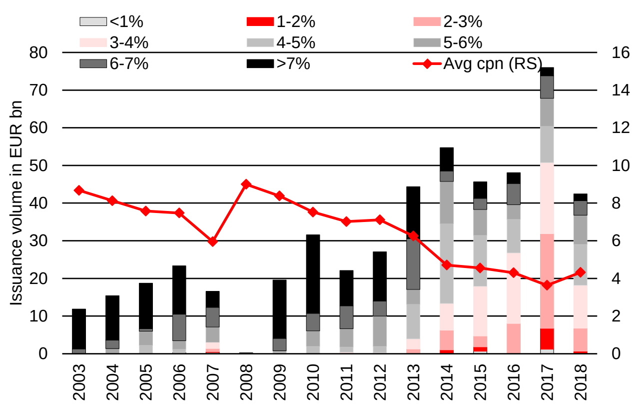


CHART 2: IBOXX HY NFI ISSUANCE BY COUPON



Source: Markit, UniCredit Research

Market Technicals: issuance to be more moderate going forward

The surge in new bond issuance in September does not represent a new trend in primary market activity. It was conditioned by technical factors, and we expect primary market activity to be more moderate in the coming months.

Fixed-coupon bonds still make sense…

September was a very strong month on the primary market – at EUR 34.8bn, the volume of senior bonds placed by non-financials was the highest since May 2016 (see Chart 1). YTD, however, iBoxx investment-grade issuance is EUR 138.7bn, a 12.5% decline compared to the same period last year. The most active sector on the primary market in September was Automobiles and Parts, where issuance rose 11.7% yoy, followed by Utilities (despite issuance in the sector declining by 20.8% yoy). The key drivers of the surge in issuance activity in September included expectations of higher credit risk premiums by the end of the year as the end of the ECB asset purchases approaches. This is expected to put more upside pressure on Bund yields and spreads in the investment-grade corporate universe. The surge in primary market activity also needs to be seen as backlog from the summer months That, together with the end of the ECB's asset purchases by the end of the year, will undermine the attractiveness of IG credit issuance stagnated at EUR 5.6bn in July and EUR 8.5bn in August. Last but not least, issuance surged ahead of the 3Q reporting season, as issuers usually remain on the sidelines around earnings releases. The bottom line is that none of these drivers suggest that we are witnessing a reversal towards stronger primary market activity going forward; the strong issuance in September does not represent any change in the issuance trend but was largely driven by technical factors. Nonetheless, although there might be lower issuance over the next few months, this technical support will not outweigh the adverse input to spread dynamics from the end of the ECB purchases, which will gradually push investment-grade corporate credit risk premiums higher in the coming weeks.

…but FRN issuance has increased this year

Last month, we highlighted three features of this year's new bond issuance: lower average duration, a higher fixed coupon and an increased share of floaters. Another important feature of this year's issuance is a relative increase in eurozone issuers and a relative decline in North American issuers. Chart 2 shows the regional distribution of issuance. At close to 70%, issuance this year has been driven by eurozone corporate issuance (primarily German and French), while issuance from North American issuers is declining. On the one hand, the regional difference in issuance volumes reflects the perceived decline in relative attractiveness of the European market for US issuers as the end of ECB asset purchases approaches and yields in the eurozone start to normalize. However, a portion of the issuance surge from US issuers in 2015-2017 was driven by an increase in M&A activity. Such activity has declined this year, likely contributing to lower issuance from US issuers.

CHART 1: MONTHLY ISSUANCE, IBOXX NON-FINANCIALS

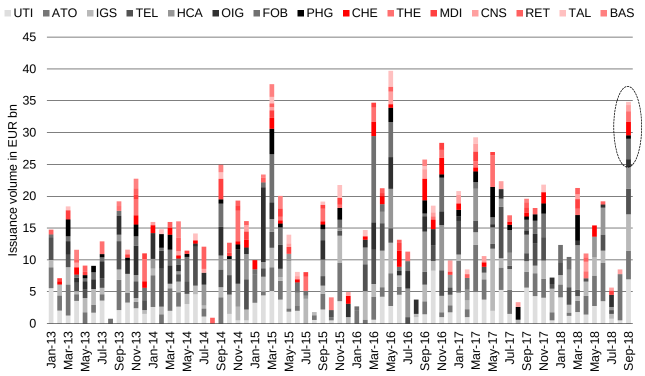
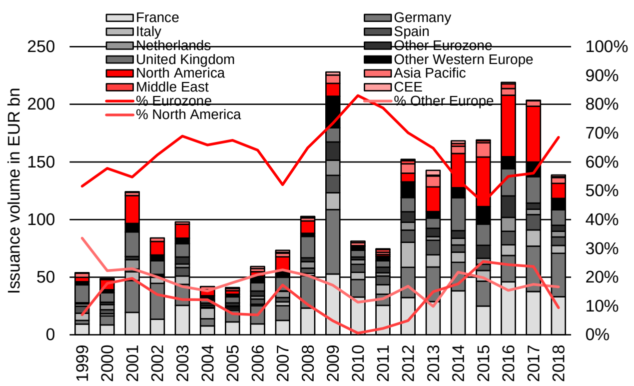


CHART 2: EUR-DENOMINATED ISSUANCE PATTERN ACCORDING TO REGION



Source: Bloomberg, Markit.com, UniCredit Research

Valuation & Timing

Recent pronounced bond spread trends reflect technical factors such as changes in CSPP volumes rather than fundamentals

There have been several consecutive pronounced spread trends in corporate credit markets over the last few months (see Chart 1). From the beginning of July to the first week of August, the iBoxx Non-Financials Senior index spread narrowed 10bp to a low of 38bp. The tightening trend ended abruptly in mid-August, when spreads turned around and started widening again, by 15bp to 53bp by early September, before reversing again and beginning to tighten once more. The bond spread index has now narrowed to 45bp and even the considerable volatility in government bond and equity markets over the last couple of weeks has only caused the spread trajectory to move sideways. Importantly, these developments do not reflect changes in risk perception – against the backdrop of high BTP yield volatility and the stock market sell-off, the latest pronounced tightening of bond spreads would be counterintuitive – but are purely a reflection of technical factors, namely the balance between new bond supply and demand from the CSPP. This is confirmed by the more stable synthetic spreads in the corresponding iTraxx universe.

Chart 2 sheds some light on short-term fluctuations in the CSPP and PSPP. In early July, the ECB purchased a comparatively high volume of corporate bonds, resulting in a squeeze on bond spreads. When ECB purchasing activity in corporates slowed down in August to new lows, spreads started to widen considerably. Finally, when the ECB restarted purchases in September, spreads went back into tightening mode.

CHART 1: TIME SERIES OF IBOXX NON-FINANCIALS SENIOR SPREADS OVER THE SUMMER MONTHS

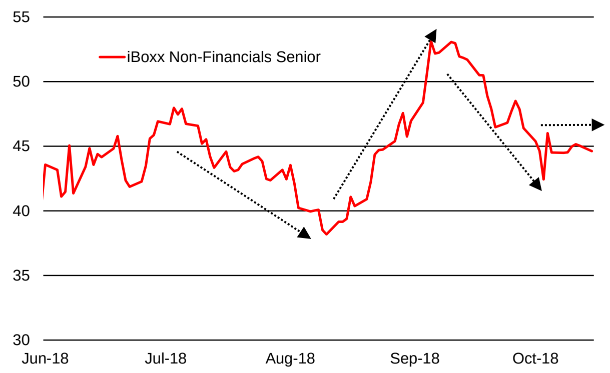
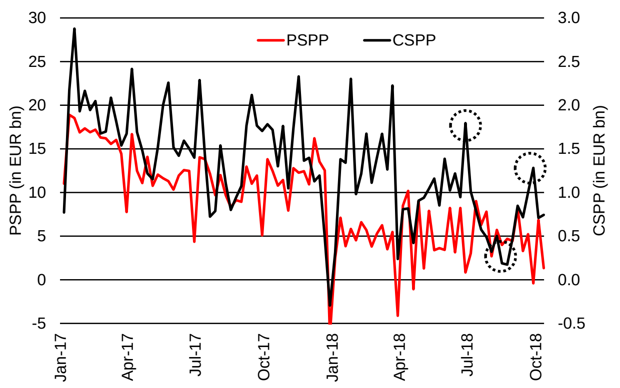


CHART 2: WEEKLY NET PURCHASING VOLUMES UNDER PSPP AND CSPP



Source: ECB, Bloomberg, UniCredit Research

However, while spreads have narrowed over the last two to three weeks as the ECB has re-increased CSPP volumes, investors should bear in mind that net monthly APP volumes have gone from EUR 30bn in 3Q to EUR 15bn in 4Q and will drop to zero next year

However, while the ECB has reported comparatively high weekly net asset purchasing volume under the CSPP recently (and a low number for the PSPP, actually slightly negative, i.e. there have been more redemptions than purchases), it is clear that CSPP purchasing volume will slow again over the coming weeks due to the imminent end of net asset purchases. Starting this month, the ECB's monthly target volume (see Chart 3) declined to EUR 15bn from EUR 30bn and the bank will stop net asset purchases completely at the end of the year. However, while the ECB will end net asset purchases, it will continue to roll over maturing debt. Nevertheless, for corporate bonds, rollover volume will remain fairly contained in 2019. Chart 4 shows the latest monthly projections by the ECB to September 2019. While the projections fluctuate considerably from month to month, mostly driven by seasonal effects in the issuance calendar, average rollover purchasing volume would amount to EUR 450mn weekly. This is only marginally higher than the lowest weekly purchasing volume over the past summer months and will clearly not be sufficient to compress spreads substantially below fair values.

CHART 3: ROLLING 4.5W SUM

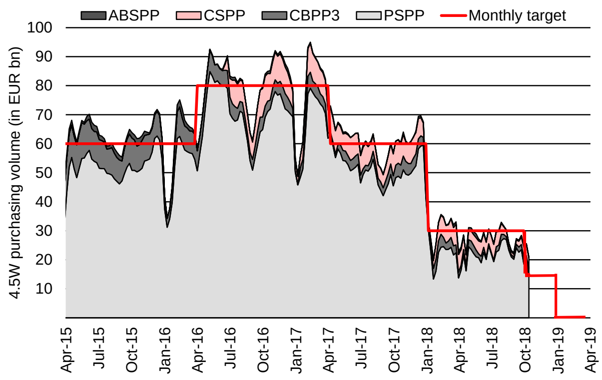
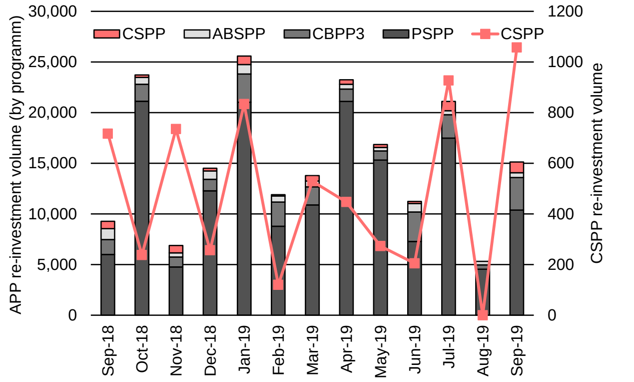


CHART 4: MONTHLY REINVESTMENT VOLUMES



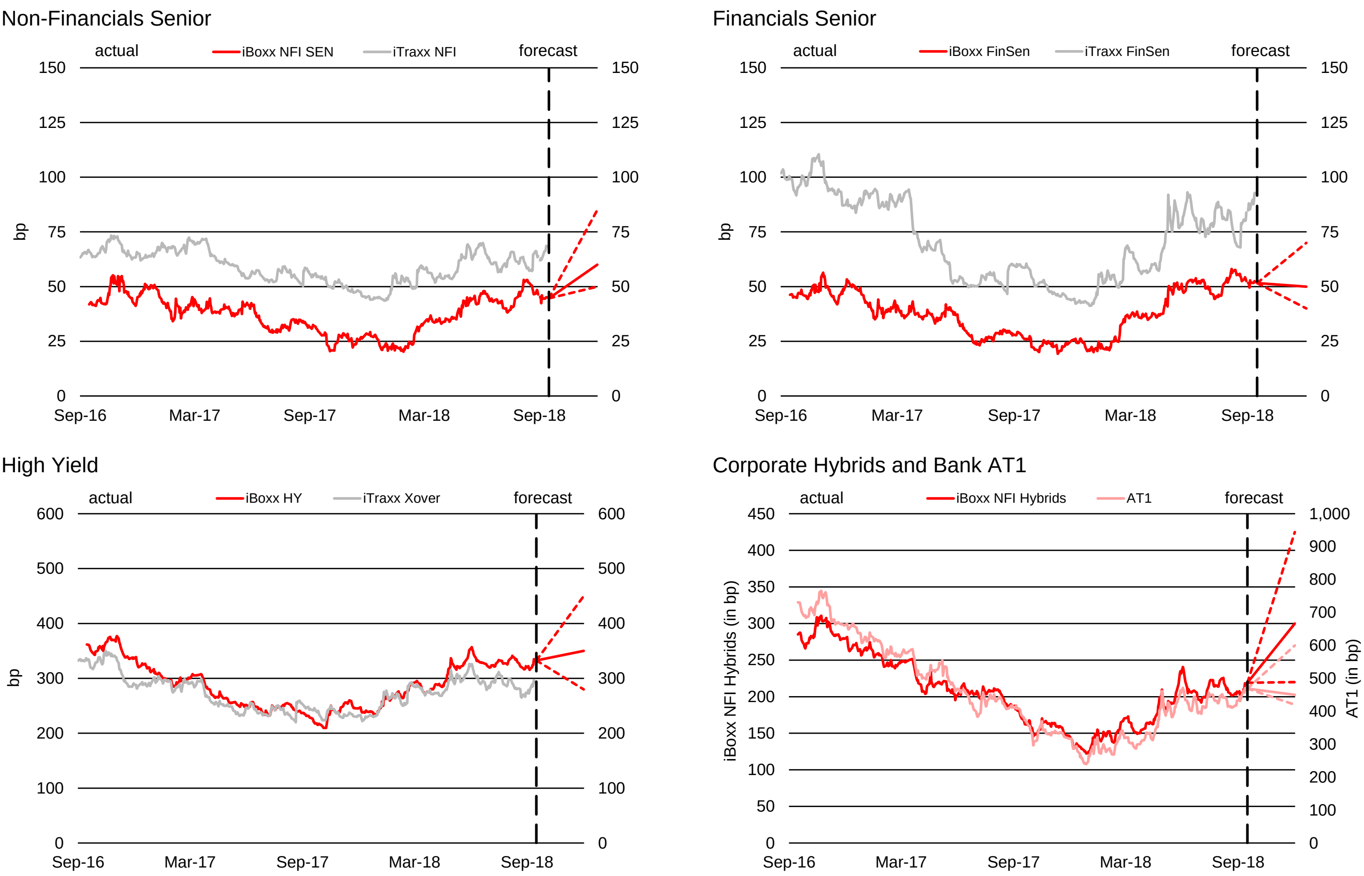
Source: ECB, Bloomberg, UniCredit Research

Investment conclusion

As technical support for bond spreads will weaken considerably with the end of net asset purchases under the ECB's asset purchasing programs (the monthly target has been reduced from EUR 30bn in the third quarter to EUR 15bn in the fourth), we think that bond spreads will widen toward fair values. Our forecast level is for about the same level as that for corresponding CDS spreads. For the iBoxx Non-Financials Senior, this is about 60bp.

Spread Forecast Table

SPREAD FORECAST 2018 (BP)



Source: iBoxx, Bloomberg, UniCredit Research

Sector Allocation & Recommendation Overview

Credit risk premiums continued widening over the past few weeks, driven primarily by technical repricing due to the termination of asset purchases by the ECB at the end of the year and the healthy fundamental backdrop in the eurozone. Notably, the selloff in global equities had a relatively limited impact on European credit. Fundamentally, we reiterate our view that the solid growth backdrop in the eurozone remains supportive for credit fundamentals, which means that we reiterate our marketweight recommendation on most non-financial sectors, and our overweight recommendation on financials. The sole exceptions within the non-financial sectors are Technology, Industrial Goods & Services, Chemicals and Food & Beverages, where we reiterate our underweight recommendation, given particularly tight spread levels.

CREDIT ALLOCATION

As of 15 October 2018		Current recommendation	iBoxx weight	YTD spread change	Current spread level
Macro allocation					
Sovereigns			58.9%	+33.8	37.5
Sub-Sovereigns		MW	13.6%	+10.5	-7.9
Covered Bonds		MW	8.2%	+10.8	0.7
Financials		OW	7.8%	+35.4	77.3
Non-Financials		UW	11.5%	+19.3	54.4
Sector allocation NFI					
Telecommunications	TEL	MW	12.4%	+12.7	60.2
Media	MDI	MW	2.3%	+17.2	57.9
Technology	THE	UW	3.2%	+5.6	16.8
Automobiles & Parts	ATO	MW	11.0%	+39.3	77.3
Utilities	UTI	MW	18.7%	+27.0	67.5
Oil & Gas	OIG	MW	8.1%	+17.6	48.4
Industrial Goods & Services	IGS	UW	12.1%	+23.8	55.9
Basic Resources	BAS	MW	1.6%	+21.6	80.8
Chemicals	CHE	UW	3.6%	+7.3	26.3
Construction & Materials	CNS	MW	3.0%	+20.3	49.0
Health Care	HCA	MW	8.7%	+8.8	40.4
Personal & Household Goods	PHG	MW	3.8%	+4.8	37.8
Food & Beverage	FOB	UW	8.1%	+11.1	37.8
Travel & Leisure	TAL	MW	1.9%	+7.4	43.3
Retail	RET	MW	1.6%	+19.2	45.8
Quality allocation NFI					
AAA		UW	0.8%	-1.5	-0.3
AA		UW	8.3%	+1.7	7.5
A		MW	34.2%	+10.6	32.0
BBB		MW	56.8%	+28.4	75.5

Source: iBoxx, UniCredit Research

The table below shows the aggregate sum of recommendations across sectors.

- **Volume OW:** nominal volume of bonds in the iBoxx NFI, where the issuer is currently OW
- **Volume MW:** nominal volume of bonds in the iBoxx NFI, where the issuer is currently MW
- **Volume UW:** nominal volume of bonds in the iBoxx NFI, where the issuer is currently UW
- **Volume NR:** nominal volume of bonds in the iBoxx NFI on which we do not provide a recommendation
- **wAverage:** (sum of nominal value of OW bonds – sum nominal value of UW bonds)/(sum of nominal values of OW, MW, UW bonds)
- **Directional:** (sum of nominal values of OW bonds + sum of nominal values of UW bonds) / sum of nominal values of OW, MW, UW bonds

AGGREGATED SINGLE NAME RECOMMENDATIONS

	Volume OW 130	Volume MW 539	Volume UW 78	Volume NR 330	wAverage 0.07	directional 28%
ATO	6	70	12	31	-0.07	20%
BAS	6	8	2	1	0.22	50%
CHE	10	15	6	10	0.11	51%
CNS	5	21		7	0.18	18%
FOB	5	60	1	26	0.07	9%
HCA	5	50	3	36	0.04	14%
IGS	11	39	13	76	-0.03	37%
MDI	8	10	7	3	0.05	60%
OIG	16	50	5	10	0.15	30%
PHG	12	15	1	15	0.41	46%
RET		6	3	9	-0.30	30%
TAL		8		13	0.00	
TEL	32	54	17	27	0.15	48%
THE	9	5	7	15	0.07	76%
UTI	6	129	2	52	0.03	6%

Source: iBoxx, UniCredit Research

The weighted averages of the sum of single-name recommendations broadly match our sector recommendations, except for the following:

- **PHG (Personal & Households Goods):** While we have a marketweight recommendation on this sector, its weighted average sum of recommendations is somewhat positive. This is due to overweight recommendations in the sector being relatively large. The tobacco sector is part of the PHG sector and we have overweight recommendations on Imperial Brands and BAT.
- **RET (Retail):** While we have a marketweight recommendation on this sector, its weighted average is slightly negative. This is due to an underweight recommendation having been assigned to one large issuer in the sector.

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RECOMMENDATIONS, RATINGS AND EVALUATION METHODOLOGY

Company	Date	Rec.	Company	Date	Rec.	Company	Date	Rec.
AALLN	19/01/2018	Underweight	ENGIFP	15/06/2018	Restricted	RCIBK	29/01/2018	Overweight
AALLN	14/11/2017	Marketweight	ENGIFP	08/02/2018	Marketweight	RCIBK	03/01/2018	Restricted
ABESM	09/03/2018	Marketweight	ENGIFP	12/01/2018	Restricted	RELLN	08/02/2018	Overweight
ABESM	19/10/2017	Underweight	ENIIM	13/08/2018	Overweight	RENAUL	28/09/2018	Marketweight
ACAFP	05/02/2018	Marketweight	ENIIM	10/07/2018	Restricted	RENAUL	20/09/2018	Restricted
ACAFP	03/01/2018	Restricted	EOANGR	14/03/2018	Marketweight	REPSM	06/11/2017	Overweight
ACEIM	05/03/2018	Marketweight	EOANGR	12/03/2018	Underweight	RIFP	29/08/2018	Overweight
ACEIM	25/01/2018	Restricted	ETLFP	01/08/2018	Marketweight	ROSW	01/02/2018	Underweight
ACEIM	30/10/2017	Marketweight	ETLFP	27/10/2017	Underweight	SANFP	18/04/2018	Marketweight
ACHMEA	05/04/2018	Marketweight	EVKGR	17/07/2018	Overweight	SANFP	14/03/2018	Restricted
AEGON	05/04/2018	Marketweight	EVKGR	08/05/2018	Marketweight	SANFP	03/11/2017	Underweight
AEMSPA	14/11/2017	Marketweight	FC	05/03/2018	Underweight	SANSCF	12/10/2018	Marketweight
AIG	17/05/2018	no rec.	FCABNK	05/06/2018	Overweight	SANSCF	25/09/2018	Restricted
AIRFP	19/01/2018	Overweight	FCABNK	19/04/2018	Restricted	SANSCF	08/03/2018	Marketweight
ALLRNV	03/04/2018	In transition	FCABNK	29/03/2018	Overweight	SANTAN	31/01/2018	Marketweight
ALOFP	16/07/2018	Underweight	FCABNK	14/02/2018	Restricted	SANTAN	09/01/2018	Restricted
ALV	12/07/2018	Overweight	FCABNK	29/01/2018	Overweight	SANUK	08/03/2018	Marketweight
AMGN	25/04/2018	Overweight	FCABNK	10/01/2018	Restricted	SAPGR	25/04/2018	Underweight
AMSSM	05/10/2018	Marketweight	FCABNK	03/11/2017	Overweight	SAPGR	07/03/2018	Restricted
AMSSM	05/09/2018	Restricted	FIREIT	03/04/2018	In transition	SCMNVX	07/06/2018	Marketweight
AMSSM	08/02/2018	Underweight	FIREIT	08/02/2018	Overweight	SCMNVX	04/04/2018	Restricted
AMXLMM	26/10/2017	Marketweight	FIREIT	24/10/2017	Restricted	SCMNVX	07/02/2018	Marketweight
ANNGR	18/07/2018	Overweight	FMEGR	24/07/2018	Marketweight	SCOR	11/12/2017	Marketweight
ANNGR	15/03/2018	Restricted	FREGR	24/07/2018	Overweight	SESGFP	27/04/2018	Marketweight
ANNGR	11/12/2017	Overweight	GFSLN	24/04/2018	Marketweight	SESGFP	27/10/2017	Underweight
ANNGR	13/11/2017	Restricted	GFSLN	09/03/2018	Underweight	SEVFP	05/09/2018	Restricted
ANZ	08/03/2018	no rec.	GMFIN	27/07/2018	Underweight	SEVFP	27/10/2017	Marketweight
ASML	08/02/2018	Marketweight	GMFIN	18/06/2018	Marketweight	SIEGR	08/10/2018	Marketweight
ATLIM	16/08/2018	Marketweight	GMFIN	25/04/2018	Underweight	SIEGR	28/08/2018	Restricted
ATLIM	07/08/2018	Overweight	GMFIN	19/03/2018	Restricted	SISIM	15/03/2018	Marketweight
ATLIM	17/05/2018	Restricted	GSK	23/07/2018	Marketweight	SISIM	22/01/2018	Restricted
AVLN	17/05/2018	no rec.	GYCGR	18/07/2018	Marketweight	SLHNVX	05/04/2018	Marketweight
AXASA	25/05/2018	Marketweight	GYCGR	18/05/2018	Overweight	SOLBBB	03/05/2018	Marketweight
AXASA	27/04/2018	Restricted	GYCGR	17/04/2018	Restricted	SRENVX	11/12/2017	Marketweight
AXASA	05/04/2018	Marketweight	HANRUE	07/05/2018	Marketweight	SRGIM	03/10/2018	Marketweight
AXASA	21/03/2018	Restricted	HANRUE	10/04/2018	Restricted	SRGIM	11/09/2018	Restricted
AZN	07/08/2018	Marketweight	HEIGR	19/01/2018	Marketweight	SRGIM	16/10/2017	Marketweight
BABLN	22/11/2017	Marketweight	IBESM	30/07/2018	Marketweight	STATK	15/02/2018	Marketweight
BAC	17/07/2018	Marketweight	IBESM	21/06/2018	Restricted	SUFP	26/07/2018	Overweight
BAC	20/04/2018	Restricted	IBESM	10/01/2018	Marketweight	SYNNVX	06/06/2018	Overweight
BACRED	09/03/2018	no rec.	IBESM	15/11/2017	Restricted	SYNNVX	05/04/2018	Restricted
BASGR	08/12/2017	Marketweight	IBM	08/02/2018	Overweight	SZUGR	21/09/2018	Underweight
BASGR	08/11/2017	Restricted	IFXGR	08/02/2018	Underweight	SZUGR	09/02/2018	Marketweight
BATSLN	22/01/2018	Overweight	IGIM	20/10/2017	Overweight	SZUGR	12/01/2018	Hold
BAYNGR	22/08/2018	Marketweight	IGYGY	14/08/2018	Marketweight	SZUGR	21/11/2017	Restricted
BAYNGR	04/06/2018	Restricted	IGYGY	22/05/2018	Restricted	SZUGR	03/11/2017	Sell
BBVASM	25/05/2018	Marketweight	IGYGY	14/03/2018	Marketweight	T	08/02/2018	Overweight
BBVASM	03/05/2018	Restricted	IGYGY	12/03/2018	Underweight	TELEFO	04/09/2018	Restricted
BMW	24/01/2018	Marketweight	INTNED	02/11/2017	Marketweight	TELEFO	27/07/2018	Overweight
BMW	03/01/2018	Restricted	IREIM	03/10/2018	Overweight	TELEFO	26/04/2018	Marketweight
BNFP	20/02/2018	Marketweight	IREIM	12/09/2018	Restricted	TELEFO	13/03/2018	Restricted
BNRGR	19/01/2018	Overweight	IREIM	15/11/2017	Overweight	TELEFO	08/02/2018	Marketweight
BNRGR	08/11/2017	Marketweight	JPM	16/07/2018	Marketweight	TELEFO	29/11/2017	Restricted
BPCEGP	08/11/2017	Marketweight	JPM	05/06/2018	Restricted	TENN	03/04/2018	In transition
BZUIM	12/09/2018	Overweight	KERFP	28/09/2018	Restricted	TKAAV	08/02/2018	Overweight
CAFP	27/07/2018	Marketweight	KERFP	23/03/2018	Marketweight	TLSAU	20/08/2018	Underweight
CAFP	05/06/2018	Restricted	KNOGR	17/09/2018	Restricted	TOYOTA	28/09/2018	Marketweight
CAPFP	08/02/2018	Underweight	KNOGR	29/06/2018	Underweight	TOYOTA	18/09/2018	Restricted
CBAAU	08/03/2018	no rec.	KNOGR	06/06/2018	Restricted	TOYOTA	05/06/2018	Marketweight
CCAMA	03/09/2018	Marketweight	LINGR	19/01/2018	Underweight	TOYOTA	08/05/2018	Restricted
CCAMA	05/04/2018	Underweight	LXSGR	19/01/2018	Marketweight	TOYOTA	08/12/2017	Underweight
CEZCP	21/03/2018	Marketweight	MAERSK	08/11/2017	Underweight	TOYOTA	14/11/2017	Restricted
CMARK	19/04/2018	Marketweight	MAPSM	05/04/2018	Marketweight	TRNIM	07/08/2018	Marketweight
CNHI	28/09/2018	Overweight	MDLZ	14/11/2017	Overweight	TRNIM	16/07/2018	Restricted
CNHI	12/09/2018	Restricted	MEOGR	23/04/2018	Hold	TTLINF	03/04/2018	In transition
CNHI	30/04/2018	Overweight	MEOGR	27/02/2018	Restricted	UBIIM	10/11/2017	Marketweight
CNHI	25/10/2017	Buy	MLFP	28/09/2018	Marketweight	UBS	01/05/2018	Marketweight
CNPFP	30/07/2018	Marketweight	MTNA	17/07/2018	Marketweight	UBS	10/04/2018	Restricted
CNPFP	14/06/2018	Restricted	MTNA	21/11/2017	Buy	UBS	14/12/2017	Marketweight
CNPFP	11/12/2017	Marketweight	NAB	08/03/2018	no rec.	ULFP	18/07/2018	Marketweight
COVEGR	26/07/2018	Marketweight	NESNVX	20/09/2018	Marketweight	ULFP	02/05/2018	Restricted
COVEGR	19/01/2018	Underweight	NESNVX	06/12/2017	Underweight	VGASDE	03/04/2018	In transition
CPIPGR	18/07/2018	Overweight	NGGLN	03/04/2018	In transition	VIEFP	02/08/2018	Marketweight
CTEFRA	11/12/2017	Marketweight	NNGRNV	11/12/2017	Marketweight	VIVFP	31/07/2018	Underweight
DAIGR	25/05/2018	Marketweight	NOVNVX	27/03/2018	Marketweight	VOD	09/05/2018	Marketweight
DAIGR	03/05/2018	Restricted	NTGYSM	29/01/2018	Marketweight	VOD	05/02/2018	Underweight
DAIGR	24/01/2018	Marketweight	NTGYSM	07/11/2017	Restricted	VW	09/10/2018	Restricted
DAIGR	04/01/2018	Restricted	NWIDE	08/06/2018	no rec.	VW	10/07/2018	Overweight
DAIGR	28/11/2017	Marketweight	ODGR	15/05/2018	Restricted	VW	20/06/2018	Restricted
DAIGR	07/11/2017	Restricted	OMVAV	08/02/2018	Underweight	VW	14/06/2018	Overweight
DAIGR	17/10/2017	Marketweight	OMVAV	07/12/2017	Restricted	VW	11/04/2018	Restricted

Company	Date	Rec.	Company	Date	Rec.	Company	Date	Rec.
DGFP	08/10/2018	Marketweight	OPELFN	04/04/2018	Marketweight	VW	13/03/2018	Overweight
DGFP	18/09/2018	Restricted	OPELFN	09/02/2018	Marketweight	VW	23/01/2018	Restricted
DLNA	05/04/2018	no rec.	OPELFN	09/02/2018	no rec.	VZ	08/02/2018	Marketweight
DPWGR	07/03/2018	Underweight	ORAFP	26/04/2018	Overweight	WBA	15/02/2018	Marketweight
DPWGR	06/12/2017	Restricted	ORAFP	13/03/2018	Restricted	WKLNA	02/11/2017	Overweight
DSM	03/01/2018	Underweight	PBBGR	07/03/2018	Marketweight	WPPLN	04/09/2018	Overweight
EDPPL	30/07/2018	Marketweight	PBBGR	15/01/2018	Restricted	WPPLN	26/06/2018	Marketweight
EDPPL	20/06/2018	Restricted	PFE	04/04/2018	Marketweight	WPPLN	01/03/2018	Underweight
EDPPL	08/02/2018	Marketweight	PKNPW	27/04/2018	Underweight	WPPLN	02/11/2017	Marketweight
EDPPL	14/11/2017	Restricted	POPSM	16/02/2018	Marketweight	WSTP	08/03/2018	no rec.
EDPPL	17/10/2017	Marketweight	PROXBB	24/07/2018	Marketweight	WURTH	06/06/2018	Marketweight
ENEASA	26/07/2018	Overweight	PSABFR	13/11/2017	Marketweight	WURTH	15/05/2018	Restricted
ENELIM	15/06/2018	Marketweight	RBS	12/10/2018	Marketweight	YBS	08/06/2018	no rec.
ENELIM	14/05/2018	Restricted	RBS	28/08/2018	Restricted	ZFFNGR	04/04/2018	Overweight
ENELIM	08/02/2018	Marketweight	RBS	04/04/2018	Underweight	ZURNVX	17/05/2018	no rec.
ENELIM	09/01/2018	Restricted	RBS	27/02/2018	Restricted			
ENGIFP	03/10/2018	Marketweight	RCIBK	30/07/2018	Marketweight			

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Overweight (OW) : We recommend having a higher portfolio exposure in the name as the respective iBoxx index. We expect that the average total return of the instruments of the issuer is greater than the total return of the index.

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Outright recommendations:

Hold (H): We recommend holding the respective instrument for investors who already have exposure. We expect that the total return of the instruments of the issuer is equal to the yield.

Buy (B): We recommend buying the respective instrument for investors who already have exposure. We expect that the total return of the instruments of the issuer is greater than the yield.

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