This is a shortened version of the
Euro Credit Pilot, 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 Outlook 2019"

11 2018

Contents

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Slower economic and earnings growth will weigh on European credit markets, which will likely experience more-pronounced spread widening in 2019. However, given their more-stable debt trajectory over the last few years, as well as the ECB's delayed tightening relative to the Fed, European companies are less vulnerable to credit concerns than their US peers. The anticipated decline in issuance volumes compared to previous years should offset substantially reduced demand from the CSPP, under which reinvestment volume will be low in 2019.

- **Macro Outlook:** We forecast that growth in the eurozone will be slightly above trend through most of 2019. We expect 2019 to show a small slowdown, to 1.7%, from 2.0% this year. However, GDP growth in the eurozone will likely suffer a loss of momentum in the latter part of next year, and this loss of momentum will likely intensify over the course of 2020 as the US heads towards a recession.
- **Micro Fundamentals:** As global growth concerns have increased on the back of trade tensions, spreads have experienced widening pressure in addition to the technical repricing from a fading CSPP.
- **Debt-Equity Linkage:** Equity markets will likely feel some pressure next year, as earnings expectations seem far too optimistic. In a potential risk scenario, a 20% drawdown in both Europe and the US seems realistic.
- **Credit Quality Trend:** As the average net debt of US non-financial companies has increased tremendously over the last few years, while the average net debt of European corporates has remained more stable, key indicators of credit quality have shown diverging trend; credit quality indicators for European corporates have improved, while those pertaining to US companies have deteriorated.
- **Valuation & Timing:** We expect considerable spread widening in 2019, with IG non-financials spreads widening to 90bp (from 60bp currently) and HY spreads widening to 450bp (from 360bp).
- **Sector Allocation & Recommendation Overview:** We are keeping our underweight recommendations in Technology, Chemicals and Food & Beverages. We change Automobiles & Parts to overweight from marketweight and Industrial Goods & Services to marketweight from underweight.

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Top Story

Prepare for considerable spread widening

Slower economic and earnings growth will weigh on European credit markets, which will likely experience more-pronounced spread widening in 2019. However, given their more-stable debt trajectory over the last few years, as well as the ECB's delayed tightening relative to the Fed, European companies are less vulnerable to credit concerns than their US peers. The anticipated decline in issuance volumes compared to previous years should offset substantially reduced demand from the CSPP, under which reinvestment volume will be low in 2019.

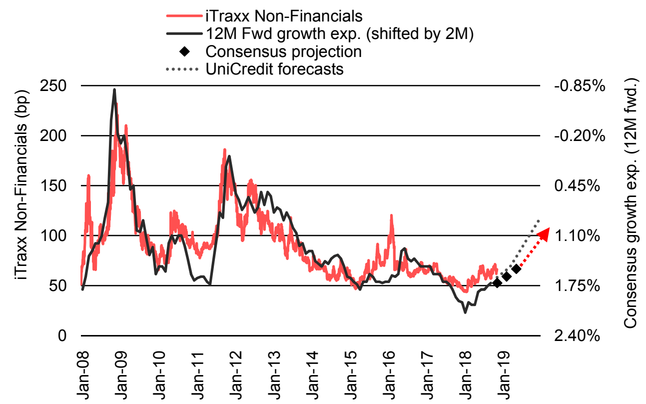
Economic slowdown will become the dominant driver of credit in 2019

As growth slows, the macroeconomic environment will become the dominant driver of credit markets over the next year. European credit spreads are likely to come under severe widening pressure. Moreover, technical tightening pressure from the ECB's CSPP will fade as the rollover of maturing bonds from the existing CSPP portfolio will have only a comparatively small impact, given that projected maturities will remain limited in 2019.

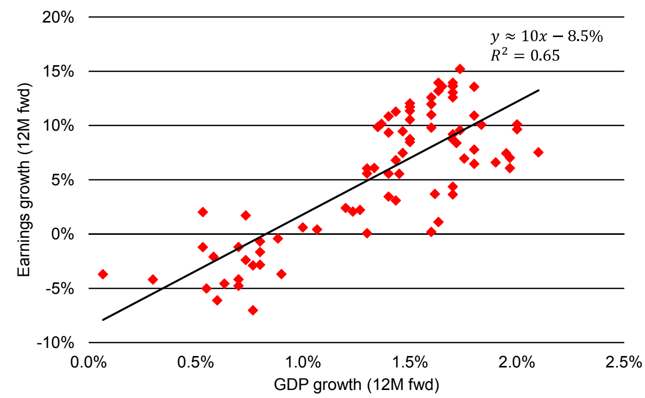
We used our macro-credit model to assess the impact of the economic slowdown ahead. Our macro-credit model is based on the quite-stable dependency between 12M forward consensus growth expectations and corporate credit spreads, as shown in the left chart below. The chart shows Bloomberg consensus growth expectations (the values having been inversed), with the y-axis adjusted according to dependency on a specific time series. Moreover, we shifted growth expectations by two months, which is approximately the lead spreads seem to have over consensus expectations. Despite spreads having led growth expectations on average, we feel comfortable deriving longer-term spread projections from growth expectations, given the fundamental relationship between growth and credit-risk premiums.

MACRO-CREDIT MODEL

Credit spreads versus 12M fwd consensus growth expectations



Dependency of GDP growth and earnings growth expectations



Source: Bloomberg, UniCredit Research

Our macro-credit model suggests material spread widening lies ahead

We added the projections of how 12M expectations would move forward based on forecasts for consensus expectations extending to 2020 (black dots) and for our own expectations (dotted line). While consensus projections show a more moderate deceleration, our own projections see a considerable slowdown towards a projected pace of expansion of below 1% (4Q20 versus 4Q19) in the eurozone. At face value, the results indicate that an average spread of 110bp in investment grade and 540bp in high yield are commensurate with such an economic environment.

Year-end 2019 spread forecast: investment grade 90bp;

high yield 450bp

However, some important technical factors will likely prevent such dramatic widening. First, credit products, particularly those that make up the safer (IG) part of the sample, will likely continue to benefit from investor demand as yields on risk-free bonds remain subdued and growth remains positive (against the backdrop of sound credit quality). Second, the supply of new bonds is likely to be only moderate next year. As a result, we expect spreads to settle slightly below our macro-credit-model results, at 90bp for IG-rated non-financials, and 450bp for high-yield bonds. In IG, the iBoxx Non-Financials Senior index, which is still being compressed by the CSPP, is currently trading at 60bp, while the iTraxx Non-Financials index is trading at nearly 70bp. In HY, the iBoxx HY is trading at 350bp, while the iTraxx Crossover, which has a different structure, is trading at 300bp. Hence, if by year-end, IG credit spreads settle around 70bp and HY spreads settle at 350bp, the year-end 2019 targets of 90bp for IG and 450bp for HY would show the same relative spread increase (about 30%), and the HY/IG ratio of 5x would also remain unchanged.

US companies are more vulnerable to credit concerns than European companies

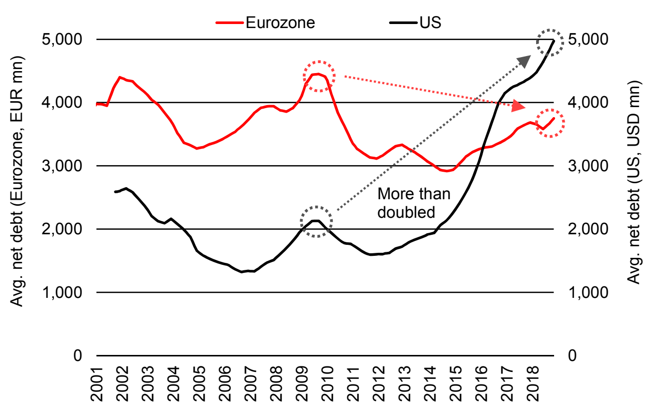
However, spread widening will not be uniformly spread across sectors and regions. Credit with more pronounced exposure to a slowdown in earnings will experience greater spread-widening pressure. On a sector-by-sector basis, this will impact cyclical industries (we will publish a more-detailed analysis, in this respect, in our upcoming *Euro Credit Pilot*). However, at the current point in time, there is a clear regional difference with respect to the stage of the credit cycle. US companies, having enjoyed years of benign economic and financial conditions, have increased indebtedness considerably over the last few years (see left chart below, which depicts the average net debt for non-financials in the Euro STOXX and the S&P 500). This has resulted in a substantial increase in leverage and is also reflected in the increase in BBB rated US corporate debt as highlighted in the US economics section, This leaves companies with higher indebtedness exposed in the event of an earnings slowdown, resulting in the necessity to quickly reduce debt.

US companies increased indebtedness as they distributed high amounts of cash to shareholders

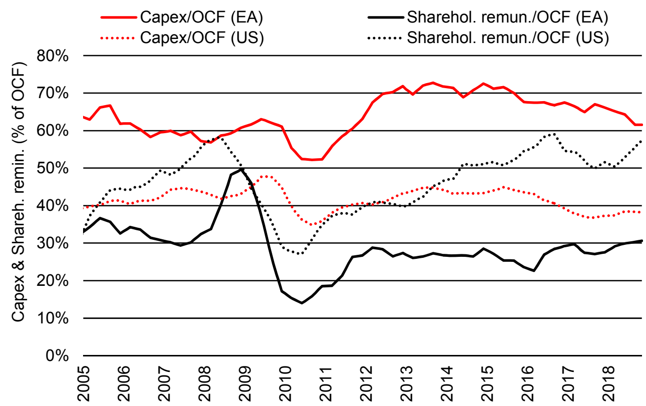
Moreover, US companies have used the cheap financing conditions over the last few years mainly to boost cash flows to shareholders. The right chart below shows capex spending and shareholder remuneration (dividend payments and share buybacks) as a percentage of cash from operations (also known as operating cash flow [OCF]) of the non-financials in the two mentioned benchmark indices. US companies distribute about 50-60% of their operating cash flow to shareholders (mainly through share buybacks) and invest only 30-40% in their business via capex. Eurozone companies, in contrast, invest 60-70% of their cash in capex and distribute only 30% to shareholders. In other words, the leveraging up of balance sheets of US companies has been accompanied by high cash payments to shareholders, with the latter driving share valuations (i.e. price/earnings ratios) to cyclical highs.

EUROZONE AND US NON-FINANCIALS IN COMPARISON

Average net debt for Eurozone and US corporates



Capex and shareholder remuneration as % of OCF



Source: UniCredit Research

The vulnerability of balance sheets with respect to a slowdown in earnings and/or rising financing costs could pressure company management to cut leverage by redirecting future funds from shareholders to debtholders. While such a development would be clearly welcome from a credit-investor perspective, it would likely impact stock prices. In any case, such a scenario would very likely be accompanied by high volatility in credit and equity.

CSPP rollover volumes will only be limited in 2019

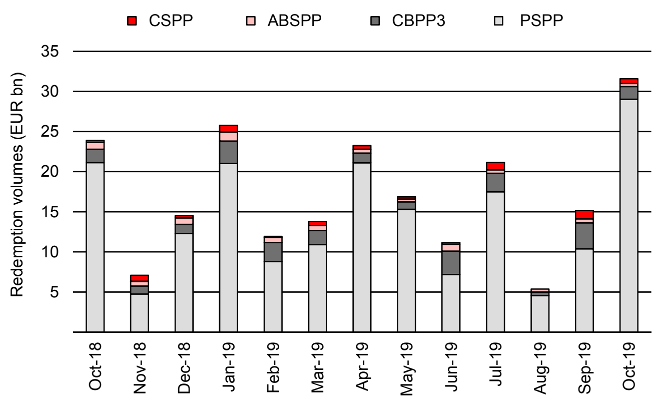
From a market-technical perspective, the dominant driver of IG-rated credit, the CSPP, will cease to be an important source of support. The ECB will continue to purchase bonds in 2019 as it plans to reinvest redemptions in the market, but corresponding volumes in the corporate sector should be low in the coming year. The left chart below shows redemption volumes in the APP over the next 12 months by asset class and as scheduled by the ECB. If the ECB reinvests these funds only in their respective programs, CSPP purchases will be quite low. At the same time, PSPP reinvestment will remain a dominant part of the market environment, and scheduled redemptions in the covered-bond and ABS universe will also remain sizable.

A slowdown in issuance will partly offset declining demand from the CSPP

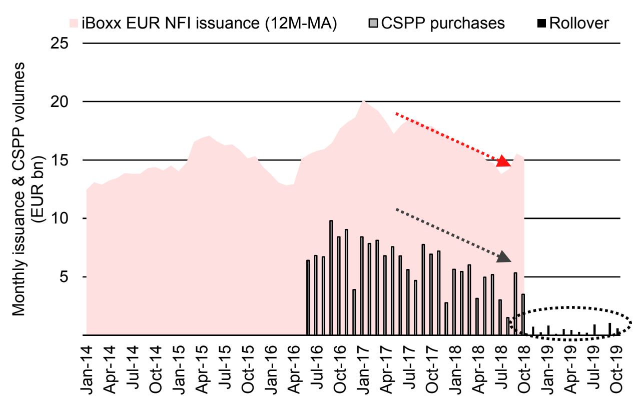
The right chart below shows how small monthly reinvestment volumes in the corporate-bond universe will be compared to volumes purchased so far. While the corresponding decline in demand will have to be taken into account, its effect will likely be offset to some extent by declining supply. The data in the right chart suggest a fairly extensive parallel decline in issuance volumes (we used rolling 12-month averages of iBoxx issuance volumes as a proxy) so far. We expect this slowdown in supply to broadly continue in 2019 given the anticipated slowdown in economic activity (which will prevent large-scale debt-financed investment and M&A activity) and the fact that companies will have used the benign financing conditions of the past to address future funding needs ahead of time as much as possible.

MARKET TECHNICAL DRIVERS

Scheduled APP reinvestment volumes by months and programs



Monthly issuance (12M-MA) versus CSPP volumes



Source: ECB , iBoxx, Bloomberg, UniCredit Research

Credit and total-return projection

From a total-return perspective, we assume spreads will have widened to 90bp by the end of 2019, from a current spread of 60bp (this figure will likely be higher at year-end 2018). Multiplying the corresponding 30bp by average duration of 5 results in a mark-to-market loss of 150bp. Adding a carry component of 60bp (for 13.5 months from the current point in time) and a spread curve roll-down of 15bp (times an average duration of 4.5 over this period) offsets about 135bp and results in a credit loss of about 15bp. For HY markets, the corresponding calculation results in a positive credit return of about 100bp, given the higher carry to start with and shorter duration in HY compared to IG. However, the more attractive credit-return projection for HY has to be weighed against the greater downside risk present in this market.

Credit Drivers

Macro: a slowdown ahead, more pronounced in 2020

Our expectations for the upcoming growth environment in the eurozone...

We forecast that growth in the eurozone will be slightly above trend through most of 2019. We expect 2019 to show a small slowdown, to 1.7%, from 2.0% this year. However, GDP growth in the eurozone will likely suffer a loss of momentum in the latter part of next year, and this loss of momentum will likely intensify over the course of 2020 as the US heads towards a recession. Hence, the window of opportunity for the ECB to normalize policy rates is likely to close fast. We think it will just manage to raise the deposit rate (in two steps, starting in September 2019) back to zero early in 2020. There is a risk that there may be even less removal of accommodation.

...the US...

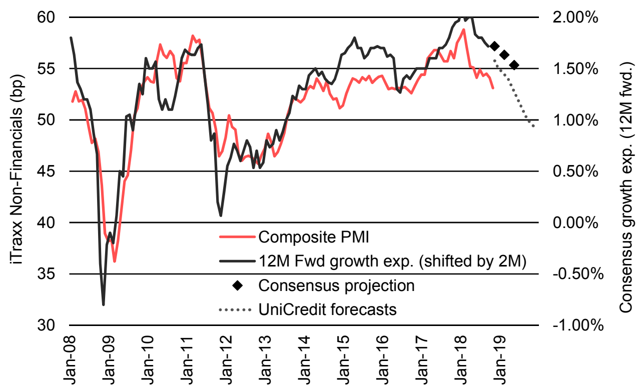
In the US, the current expansion will likely, in 2019, become the country's longest recovery on record. However, any celebrating should be muted, as we predict the economy will begin to lose momentum in 2H19 and then head towards a mild (and brief) recession around mid-2020 (probably not that dissimilar from the 2001 recession). Several factors are likely to contribute to such a slowdown, including tightening financial conditions and the petering out of fiscal stimulus at a time when wage pressure is building and corporate balance sheets are becoming stretched. In this base-case forecast, we foresee the Fed hiking rates through the second quarter of next year before first pausing and then starting to reverse course in 2020 with three rate cuts.

...and globally

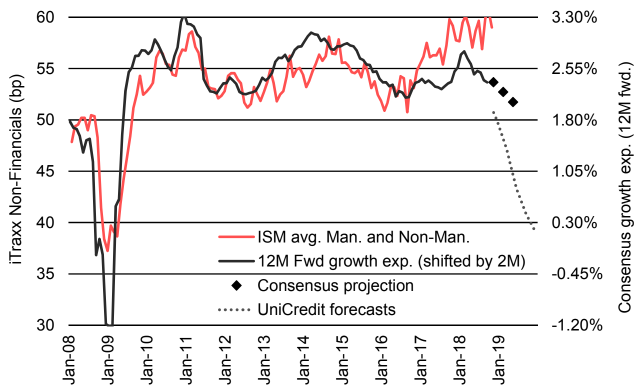
With respect to the global economic environment, we expect GDP growth to ease modestly, from 3.6% this year to about 3.4% in 2019, followed by a more-pronounced deceleration in 2020 to 2.7%. The drivers of such a slowdown are likely to include tighter financial conditions, fading US fiscal stimulus and an ongoing slowdown in China – we expect China's GDP growth to decelerate from 6.6% this year to 6.2% in 2019 and 5.9% in 2020 – as well as generally deteriorating sentiment (not least because of continuing trade tensions). Late next year and into 2020, the downturn will most likely be led by the US. We foresee emerging markets generally cooling as well as the forecast cyclical slowdown in advanced economies plays out. Importantly, we are forecasting a cyclically driven global slowdown (and a possible brief and shallow recession) but not a crisis per se. That said, the combination of slower growth and tighter financial conditions will likely spell the end of the long bull market. For more details with respect to our views regarding the macro and broader market conditions in 2019, see our *Macro & Markets Outlook 2019-20*.

12M FORWARD CONSENSUS GROWTH EXPECTATIONS VERSUS ECONOMIC SENTIMENT INDICTORS

Eurozone versus composite PMI



US growth versus ISM (avg. Manufacturing and Non-Manufacturing)



Source: Bloomberg, UniCredit Research

How our forecasts compare with consensus expectations

A comparison of our macro-economic forecasts with consensus expectations shows that our estimates are less optimistic than consensus expectations. The two charts above depict rolling 12M forward consensus growth expectations for the eurozone (left) and the US (right). We added the composite PMI index's readings for the eurozone and the average of the ISM Manufacturing and Non-Manufacturing Indices for the US. The dots in the charts show how 12M forward growth expectations are projected to evolve over the coming months, as implied by available data. At the current point in time, the 12M forward period shows a comparison of projected 4Q19 GDP growth to that of 4Q18 (expressed here as 4Q19 over 4Q18, etc.). Moreover, we also compared 2Q20 growth projections to 2Q19 growth projections (depicted by the last dot in the chart), which are the most forward-looking projections for which consensus data are available on Bloomberg. Furthermore, we also added corresponding expectations based on our own numbers (dotted lines). For the eurozone, current 12M forward consensus expectations of growth (4Q19 over 4Q18) are at 1.7%, while our projections are lower, at 1.6%. For 2Q20-over-2Q19 growth, consensus expectations project a deceleration to 1.5%, while we foresee a deceleration to 1.2%. From that period on, we expect the slowdown to become more pronounced, to a 4Q20-over-4Q19 growth rate of 0.8% (no Bloomberg consensus data for this period were available). With regard to the US, the deviations between consensus and our projections are bigger: 4Q19-over-4Q18 growth is expected to be at 2.4% by consensus and at 1.9% by us, 2Q20-over-2Q19 growth is projected to be at 2% by consensus and at 1% by us, while 4Q20-over-4Q19 growth will likely slow to 0.2% in our view.

Comparison on a country-by-country basis

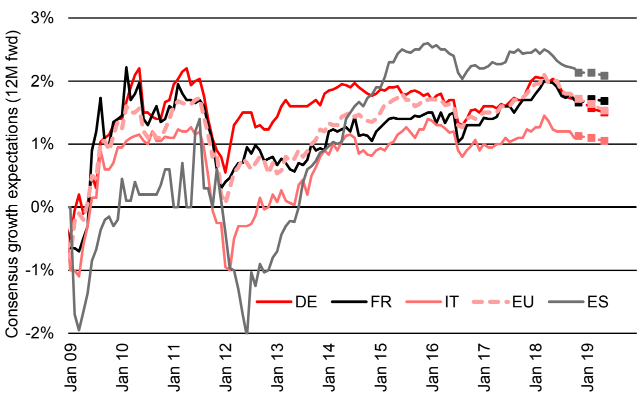
On a country-by-country basis, consensus expectations project that growth in major eurozone countries will also mildly decelerate: 4Q19-over-4Q18 GDP growth in Germany and France is expected to be about 1.7%, that for Spain is expected to be 2.1% while the same figure for Italy is projected to be at 1.1%. Our own projections with regard to 4Q19-over-4Q18 GDP growth are 1.4% for Germany, 1.2% for France, 2.0% for Spain and 0.9% for Italy. In our view, this will slow. We estimate that 4Q20-over-4Q19 growth will be 1.0% in Germany, 0.8% in France, 1.4% in Spain and 0.2% in Italy.

Revisions to consensus growth expectations

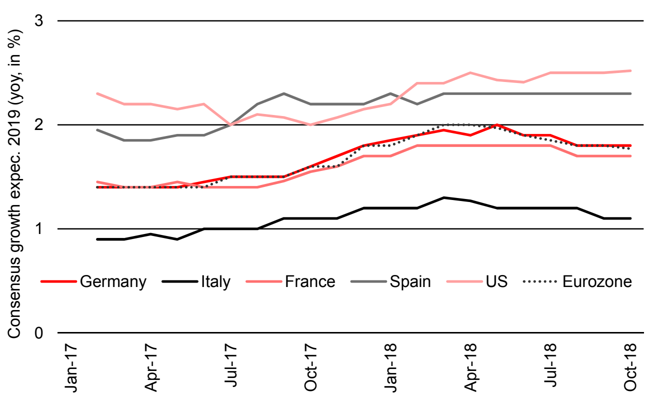
In order to quantify how consensus expectations have been revised recently, we looked at consensus expectations for full-year 2019 (see right chart below). The chart shows that, over the course of the last six months, consensus growth expectations for Germany, France and the eurozone have changed only moderately, by about 0.2pp, to roughly 1.8%. For Italy, growth expectations have also been revised down by 0.2pp, to 1.1%, while for Spain, expectations have remained unchanged, at 2.3%. For the US, expectations have remained stable, at about 2.5%.

GROWTH ENVIRONMENT IN THE EUROZONE

12M fwd consensus growth expect. for the eurozone, by country



Consensus growth expectations for 2019, by country



Source: Bloomberg, UniCredit Research

Micro: reasonable earnings growth and sound profiles

As global growth concerns have increased on the back of trade tensions, spreads have experienced widening pressure in addition to the technical repricing from the fading CSPP. Given earnings growth remains reasonable and credit profiles sound, we do not expect a dramatic widening**.**

Spread repricing due to fading technical support and growth concerns

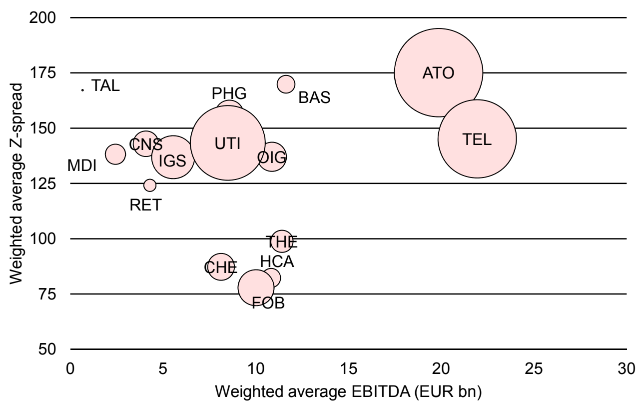
Credit spreads have moved materially wider this year, the iBoxx NFI spread has more than doubled (ASW from 35bp to 77bp, +119% YTD). A large degree of this repricing was anticipated and took place on the back of the fading effect of the ECB's CSPP, net purchases of which are set to terminate at the end of the year. For most of the year, the softening in risk premiums has been fairly uniform across sectors as the technical push wider from fading purchases has provided little need for investors to differentiate. More recently, however, increasing signs of a cooling global economy, coupled with persisting trade concerns amid ongoing political headline risks, have begun to weigh on some sectors to a larger degree. While still incremental from a historical perspective, iBoxx NFI sectors are now tentatively beginning to show diverging widening momentum. Among the sectors that widened most, Technology (+205%), Automobiles (+183%), and Construction (+172%) have been under pressure most and all widened at least 50% more than the index. At the same time, the most resilient sectors have repriced about 40% less than the iBoxx NFI. Interestingly, the traditional high-beta sector Basic Resources (+85%) is among the least affected sectors, alongside Travel & Leisure (+69%) and Telecoms (+77%). The higher stability in Basic Resources could reflect the more resilient growth outlook that persists in the eurozone, as well as the improved credit profile of the sector, which was a result of the commodity price crisis in late 2015.

Revenue and earnings growth still supportive

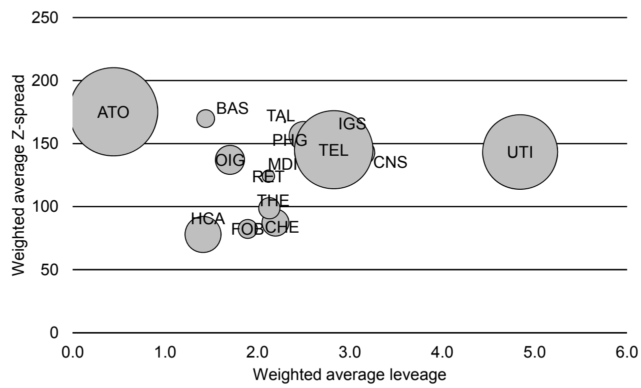
Basic Resources is also well-supported in terms of earnings growth, as it has posted the third-highest growth in net income (7.9%) among non-financials, after Oil & Gas (53.4%) and Health Care (9.1%). The strong recovery in Oil & Gas earnings is also driving up the growth in index earnings, in the Euro STOXX, income grew by 8.8% in 3Q18 compared to the previous year. Among the laggards with respect to earnings growth are Utilities (-5.1%), Consumer Goods (-7.1%) and Consumer Services (-9.9%), which are the only sectors that experienced declining income in 3Q18 compared to a year earlier. The earnings decline in Utilities came on the back of lower revenues (-3%), the only other non-financial sector for which sales fell is Telecoms (-1.1%). Across sectors, revenues have risen by 3.1% on average in the Euro STOXX, with sectors varying between 1% and 7%, except for Oil & Gas (+23.7%), which benefitted from the recovery in oil prices.

WEIGHTED AVERAGE EBITDA AND LEVERAGE ACROSS IBOXX NFI SECTORS

iBoxx NFI sector EBITDA to Z-spread



iBoxx NFI sector leverage to Z-spread



Source: Markit, UniCredit Research

12M forward sales and earnings projected to grow

Automobiles, Telecoms, and Basic Resources are the iBoxx NFI sectors with the highest average EBITDA (left chart above). Telecoms (EUR 22.9bn) and Automobiles (EUR 19.8bn) particularly stand out, while Basic Resources (EUR 11.6bn) shows slightly higher weighted average EBITDA levels than Technology (EUR 11.4bn) and Oil & Gas (EUR 10.8 bn). Both Automobiles (0.4x) and Basic Resources (1.4x) also are among sectors with the lowest leverage (right chart above), matched only by Health Care (1.4x), while Telecoms leverage is somewhat above-average at 2.8x, close to the weighted average leverage of Industrial Goods & Services (2.7x) and Media (2.6x). Construction (3.1x) and Utilities (4.8x) companies employ the highest leverage in the iBoxx NFI. Looking ahead, earnings expectations remain sound, given the decelerating, but positive growth trajectory our economist expect in the next twelve months. For the Euro STOXX, 12M forward consensus estimates currently show expected earnings growth of 12.5% (EPS) and EBITDA growth of 4.5%.

Orderly repricing of spreads, although volatility could increase further

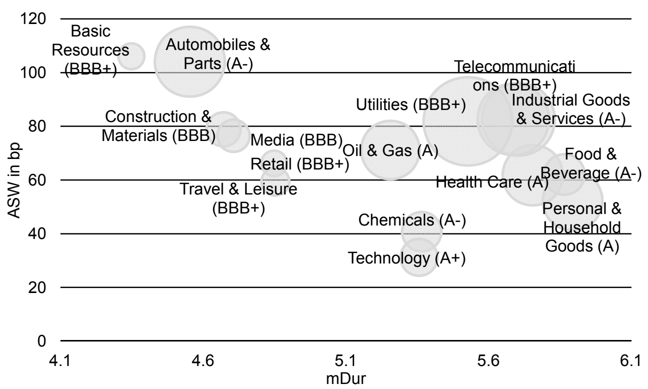
Given the fairly sound fundamentals, we are not overly concerned about significant additional spread widening pressure beyond an adjustment that is still necessary to reflect the end of CSPP and lower growth rates in the eurozone. Nevertheless, volatility may increase time and again as uncertainty over the growth trajectory becomes widespread, especially as political headline risk will likely remain elevated. With respect to the latter, the ongoing trade dispute between the US and China could exert pressure due to negative effects on global trade. In addition, the risk profile of the iBoxx NFI has shifted slightly as opportunistic issuance from US companies has increased their share to more than 20% of the index, leaving it more sensitive to a downturn in the US, in particular as the US issuers in the iBoxx NFI tend to be a combination of low spread and long duration (right chart below). Moreover, political headline risks remain within the eurozone, which contributed to significant underperformance in parts of the periphery. Italian issuers in the iBoxx NFI currently stand out with the by far the highest risk premium as a country cluster, even higher than that of CEE issuers, which are rated lower on average.

Remain constructive despite growing cautiousness

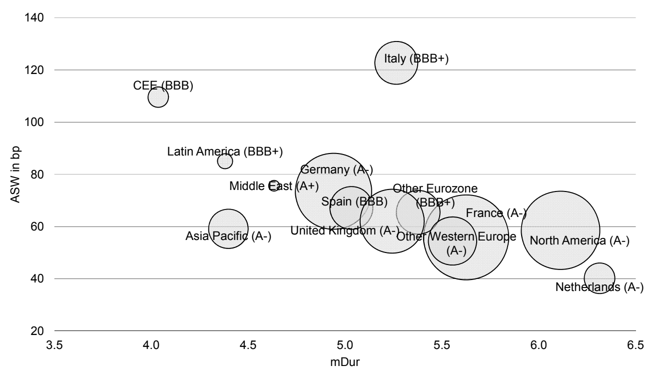
The change in growth momentum and the high uncertainty related to political headline risk will likely continue to make further adjustments to risk premiums necessary. However, at the same time it is not necessary to expect a crisis-like deterioration with a jump in the default rate. Consequently, volatility may provide opportunities amid a still credit friendly growth trajectory.

DISTRIBUTION OF IBOXX NFI SECTORS ACROSS SPREAD AND COUNTRY OF RISK

iBoxx NFI sectors by spread and duration



iBoxx HY NFI by country of risk and duration



Source: Markit, UniCredit Research

Debt-Equity Linkage: a volatile year ahead in risky assets

Equity markets will likely feel some pressure next year as earnings expectations seem far too optimistic

Like credit markets, equities will also be impacted by the slowing global growth environment, which will weigh on earnings growth. A slowing earnings environment will also leave its mark on equities, since consensus estimates still assume considerable growth in earnings. For the Euro STOXX 50, for example, consensus estimates sees earnings growth of 8% this year, 11% in 2019 and 9% in 2020. For the S&P 500, consensus estimates are 24% growth this year (driven by the tax cuts), 9% in 2019 and 10% in 2020. Given our expectations of a slowing GDP growth environment, such earnings growth rates are likely far too optimistic. UniCredit Equity Strategist Christian Stocker expects earnings growth rates in the order of 3-4% in 2019, i.e. about half of what consensus expects. In a baseline scenario, P/E valuations for the Euro STOXX 50 in the order of 12, which is also the current level, offer good support to European stock markets. If that support were to remain broadly intact, the yoy performance potential is in the order of earnings growth, i.e. 3-4%.

In a potential risk scenario, 20% drawdown in both Europe and the US seems realistic

In a potential risk scenario, with a more pronounced economic slowdown in the eurozone and the US, a P/E ratio of around 10 has to be expected for the Euro STOXX 50. Such a scenario would imply negative price potential of about 20%, corresponding with a Euro STOXX 50 level of 2700 index points. For the S&P 500, a P/E valuation of 13 has to be expected in such a risk scenario (corresponding to an index level of 2275, which is about 20% below the current index level). Experience shows that in an environment of slowing economic growth, which we expect in 2019, and political uncertainty, equity markets test the lower bounds of potential risk scenarios in any correction phase that occurs.

A volatile year ahead

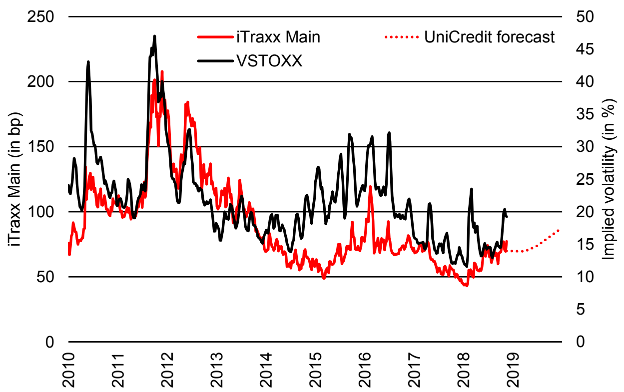
Historical evidence suggests that in an environment of slowing economic growth rates (which is, as a result, accompanied by decreasing growth of company earnings), implied volatilities in equity markets increase (see left chart). Moreover, in 2019 risks will be further fueled by political uncertainties. Against this background, we see a high probability that the low-volatility environment of 2017/18 will come to an end. Our two charts below suggest there is quite a close correlation between credit spreads, implied volatilities and equity valuations.

Stronger impact on credit spreads than on equities

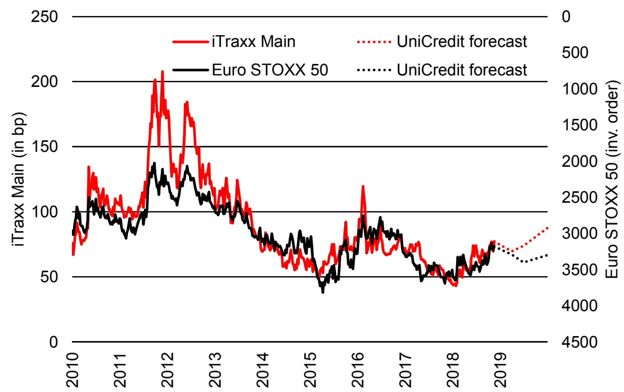
In the right chart below we have added our corresponding index forecasts (see dotted lines). We expect a relatively stronger impact on credit spreads than on equities, taking into account that credit markets tend to temporarily overreact. However, while our baseline scenario for equities is slightly less bearish than that for credit, drawdown risk in equities is material. We would not be surprised to see drawdown in the order of 20%. Such a development, however, should also feed into the risk-off cycle that typically affects credit and equities synchronously. Hence, we can probably look forward to a volatile year ahead.

DEBT-EQUITY DEPENDENCIES

Spreads versus implied volatility …



…and versus index levels (incl. UniCredit forecasts)



Source: Bloomberg, UniCredit Research

Credit Quality Trend: US companies are more vulnerable

As we highlighted above, the average net debt of US non-financial companies has increased tremendously over the last few years, while the average net debt of European corporates has remained more stable. As shown in this analysis, these different net-debt trajectories have different implications for key indicators of credit quality; those applied to European corporates have improved, while those pertaining to US companies have deteriorated.

Key credit indicators: leverage and interest-coverage ratio

We use two key credit indicators to assess the impact of rising net debt: leverage, which is defined as the ratio of net debt to EBITDA (declining leverage indicates improvement), and the interest coverage ratio, which is the proportion of EBIT to interest expenses (a rising interest-coverage ratio indicates improvement).

When applied to US companies, key credit indicators deteriorated during periods marked by a rapid rise in net debt, while these indicators, when applied to European companies, have improved as of late

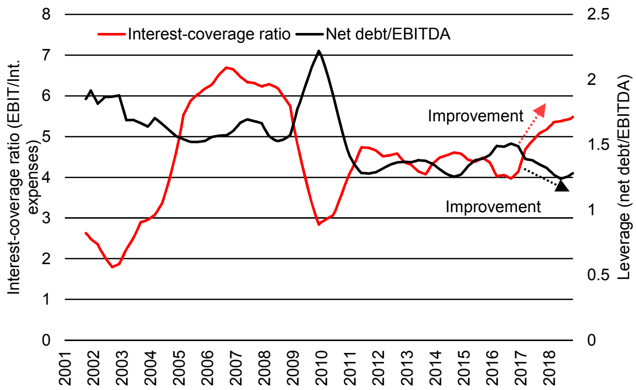
While both of these credit indicators, when applied to European non-financial companies, have improved as of late, when these indicators are applied to US non-financial firms, both show a deterioration during periods marked by a rapid increase in net debt, i.e. between 2015 and 2017. This means that the substantial increase in net debt among US non-financial firms has more than outweighed the increase in earnings generation and decline in financing costs that accompanied it. It should be noted that, although USD swap rates started to rise in 2016, average financing costs continued to decline during that period, as companies replaced outstanding higher-coupon debt with new debt with lower coupons. In the eurozone, the moderate rise in net debt has been accompanied by a decline in financing costs, and as of late, a rise in earnings has helped to improve both of the aforementioned credit indicators.

US companies appear to be more vulnerable to a slowdown in earnings and to rising financing costs compared to eurozone companies

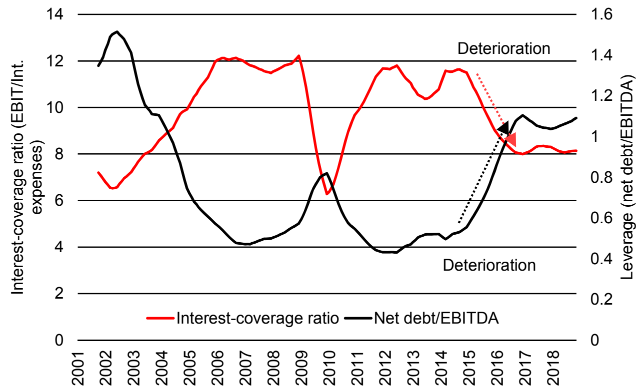
However, the two sets of companies in our eurozone and US samples vary significantly. Hence, the absolute levels of both indicators cannot be compared across the regions. In the eurozone, for example, large companies operate predominantly according to business models that involve high levels of absolute debt (such as industrials and telecoms). In the US, on the other hand, large tech companies dominate our sample. These usually do not have much debt. Many of these companies have limited debt levels. Such a structural difference affects the credit indicators cited in this analysis, as we refer to average figures across a set of companies. When median values (instead of averages) are analyzed (which involves focusing on the middle part of the data sample), leverage among US companies is higher than it is for eurozone companies. This suggests that the middle part of our US corporate sample is more highly leveraged than the corresponding segment in our eurozone sample, while among the larger companies in our samples, this is reversed. This comparison highlights the vulnerability of a large part of the US corporate sector to a moderation in earnings and rising financing costs, while European companies appear to be more resilient in this regard.

KEY CREDIT INDICATORS (LEVERAGE AND INTEREST-COVERAGE RATIO) FOR EUROPEAN AND US NON-FINANCIALS

Non-financials in Euro STOXX



Non-financials in S&P 500



Source: Bloomberg, UniCredit Research

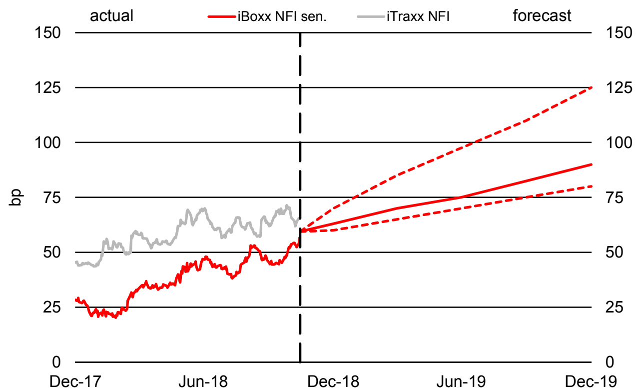
Valuation & Timing

As mentioned above, we assume there will be considerable spread widening on the back of an economic slowdown over the coming two years. Our macro-credit model, which is based on the historical dependency between credit spreads and 12M forward consensus growth expectations (which take our own forecasts into account), suggests non-financials will widen toward 110bp (and HY to 540bp). Nevertheless, we see reason to believe that the real spread trajectory will involve somewhat less widening. Among those drivers are the more-stable debt trajectory of European corporates over the last few years as well as the ECB's delayed tightening relative to the Fed – this has rendered European companies less vulnerable to credit concerns than their US peers. Moreover, the anticipated decline in issuance volumes compared to previous years should offset substantially reduced demand from the CSPP, under which there will be only low reinvestment volume in 2019. Taking these effects into account, we forecast that IG non-financials' spreads will be at 90bp (from their 60bp currently) and that HY spreads will be at 450bp (from 3,670bp) at the end of 2019. Senior financials should widen less than non-financials, to 80bp (from 65bp). For corporate hybrids, we see a widening potential to 330bp (from 255bp) and for AT1 to 640bp (from 485bp).

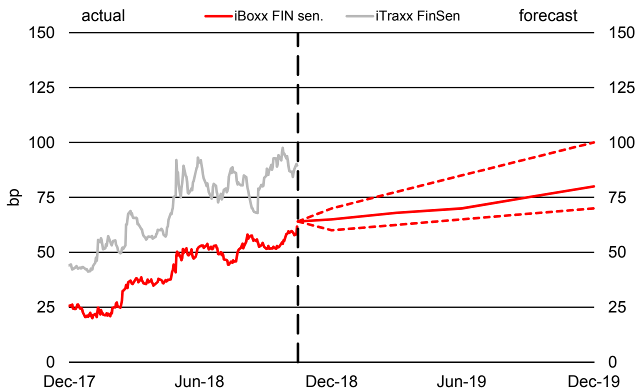
Spread forecast table

SPREAD FORECAST 2018 (BP)

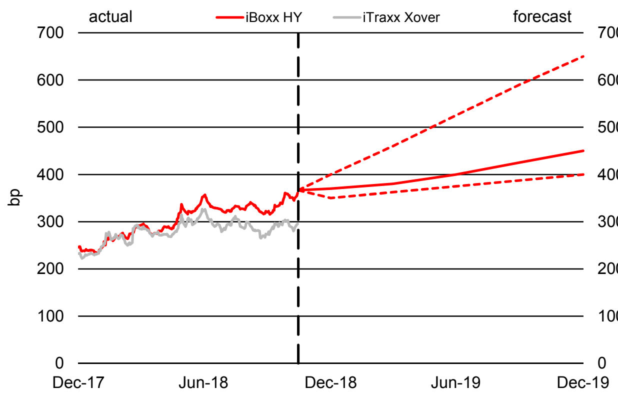
Non-financials senior



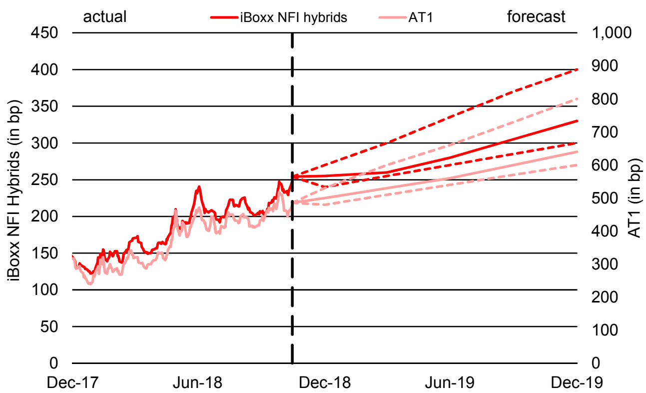
Financials senior



High yield



Corporate hybrids and bank AT1s



Source: iBoxx, Bloomberg, UniCredit Research

Sector Allocation & Recommendation Overview

While credit fundamentals have remained healthy, risk premiums have been pushed wider, driven by political headlines and ongoing growth moderation amid global trade uncertainty. Following the predominantly technical and uniform repricing that has occurred as a result of the upcoming end of the CSPP, a tentative differentiation across sectors has also started to kick in. During the summer, nine out of 15 NFI sectors traded within 10bp of the iBoxx NFI spread. This number has since shrunk to six, although the index has widened comparatively less since the summer, compared to 1H. Among the underperformers since the start of the year is Technology, which has widened materially (+205%) and still does not have much appeal, in our view. It remains tight compared to the index and entails significant US-growth exposure. Hence, we are keeping our underweight recommendation on the sector. We recommend underweighting Chemicals due to rising cyclical risk, which is not reflected in spreads as the sector remains among the tightest non-financial sectors. We also remain underweight with regard to Food & Beverage. Although this is a defensive sector, which is less sensitive to growth moderation, it appears too early to become overly defensive, especially since Food & Beverage is trading about a third of the way inside the index spread. Following the YTD underperformance by Industrial Goods & Services, we are raising our recommendation from underweight to marketweight. This sector has seen significant repricing, partly triggered by single-name stories, and although growth moderation will likely weigh on the sector, its negative momentum is likely to slow. We are changing our recommendation on Automobiles & Parts, which has underperformed significantly in recent months. Since Automobiles & Parts has a short duration profile, high average EBITDA and low average leverage, the current spread pickup warrants an overweight recommendation (from marketweight). Nevertheless, we remain slightly underweight with regard to Non-Financials and favor overweighting Financials due to the latter's gradual increase in yields and positive structural changes.

CREDIT ALLOCATION

As of 19 November 2018		Current recommendation	iBoxx weight	YTD spread change	Current spread level
Macro allocation					
Sovereigns			58.9%	+35.8	39.6
Sub-Sovereigns		MW	13.6%	+15.2	-3.2
Covered Bonds		MW	8.3%	+15.4	5.3
Financials		OW	7.8%	+59.2	101.0
Non-Financials		UW	11.5%	+41.6	76.7
Sector allocation NFI					
Telecommunications	TEL	MW	12.3%	+36.7	84.3
Media	MDI	MW	2.5%	+36.3	77.0
Technology	THE	UW	3.2%	+23.1	34.3
Automobiles & Parts	ATO	OW	11.1%	+69.4	107.4
Utilities	UTI	MW	18.7%	+42.8	83.3
Oil & Gas	OIG	MW	8.1%	+43.1	73.9
Industrial Goods & Services	IGS	MW	12.1%	+50.8	82.9
Basic Resources	BAS	MW	1.6%	+50.0	109.2
Chemicals	CHE	UW	3.6%	+23.3	42.3
Construction & Materials	CNS	MW	2.8%	+49.2	77.8
Health Care	HCA	MW	8.6%	+30.7	62.4
Personal & Household Goods	PHG	MW	3.9%	+29.2	62.2
Food & Beverage	FOB	UW	8.2%	+27.9	54.6
Travel & Leisure	TAL	MW	1.9%	+24.9	60.8
Retail	RET	MW	1.6%	+40.3	67.0
Quality allocation NFI					
AAA		UW	0.8%	+12.2	13.4
AA		UW	9.0%	+15.9	21.8
A		MW	33.1%	+30.3	51.8
BBB		MW	57.1%	+53.6	100.7

Source: iBoxx, UniCredit Research

The table below contains an aggregated 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, where 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	Volume MW	Volume UW	Volume NR	wAverage	directional
	146	563	71	289	0.10	28%
ATO	33	71	12	4	0.18	39%
BAS	6	8	2	1	0.22	50%
CHE	9	16	6	10	0.10	49%
CNS	5	20		6	0.18	18%
FOB	5	48	6	26	-0.02	19%
HCA	5	50	3	35	0.04	14%
IGS	11	39	13	75	-0.03	38%
MDI	5	12	7	3	-0.09	48%
OIG	16	53	1	11	0.21	25%
PHG	13	15	1	16	0.44	49%
RET		6	3	9	-0.30	30%
TAL		8		13	0.00	
TEL	32	80	9	8	0.19	34%
THE		13	7	16	-0.37	37%
UTI	7	124	2	56	0.04	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 some large issuers.

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RECOMMENDATIONS, RATINGS AND EVALUATION METHODOLOGY

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

Company	Date	Rec.	Company	Date	Rec.	Company	Date	Rec.
EDPPL	30/07/2018	Marketweight	OPELFN	09/02/2018	no rec.	VZ	08/02/2018	Marketweight
EDPPL	20/06/2018	Restricted	ORAFP	26/04/2018	Overweight	WBA	15/02/2018	Marketweight
EDPPL	08/02/2018	Marketweight	ORAFP	13/03/2018	Restricted	WPPLN	25/10/2018	Marketweight
ENAPHO	16/11/2018	Marketweight	PBBGR	07/03/2018	Marketweight	WPPLN	04/09/2018	Overweight
ENEASA	26/07/2018	Overweight	PBBGR	15/01/2018	Restricted	WPPLN	26/06/2018	Marketweight
ENELIM	15/06/2018	Marketweight	PFE	04/04/2018	Marketweight	WPPLN	01/03/2018	Underweight
ENELIM	14/05/2018	Restricted	PKNPW	27/04/2018	Underweight	WSTP	08/03/2018	no rec.
ENELIM	08/02/2018	Marketweight	POPSM	16/02/2018	Marketweight	WURTH	06/06/2018	Marketweight
ENELIM	09/01/2018	Restricted	PROXBB	24/07/2018	Marketweight	WURTH	15/05/2018	Restricted
ENGIFP	03/10/2018	Marketweight	RBS	12/10/2018	Marketweight	YBS	08/06/2018	no rec.
ENGIFP	15/06/2018	Restricted	RBS	28/08/2018	Restricted	ZFFNGR	04/04/2018	Overweight
ENGIFP	08/02/2018	Marketweight	RBS	04/04/2018	Underweight	ZURNVX	17/05/2018	no rec.

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