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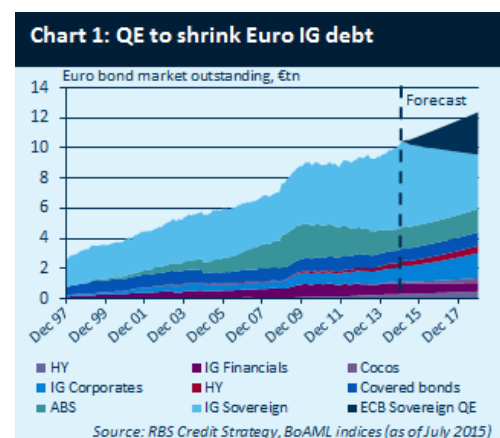
## Living up to expectations: QE and European corporate bonds

In January this year the ECB surprised markets with a larger than expected quantitative easing (QE) scheme known as the Public Sector Purchase Programme (PSPP). It has been six months since this announcement, and five since the ECB started buying. After the fanfare, what has been the impact on corporate bond markets?

At €60 billion a month, the programme is comparable to the US Federal Reserve's QE programme both as a percentage of GDP and in relation to the size of the overall bond market. Perhaps more importantly, it is larger if compared to expected net issuance, as the US government was running a higher deficit at the time compared to the Eurozone today. While the Fed's programme basically financed the additional growth of US government bonds issued to pay for the deficit, the ECB's planned purchases of government bonds, asset backed securities, covered and agency bonds will outstrip expected net issuance by 250% in these segments. This will have the added stimulatory effect of shrinking the total value of bonds outstanding in the market available to investors (see Chart 1), resulting in higher "crowding out" effects in European bonds markets than in the US. For many institutional investors in Europe one obvious consequence is a greater reallocation of assets into investment grade corporate bonds. Retail investors are also more likely to allocate towards higher yielding assets given the historical low yield on sovereign debt.

Corporate bonds were not part of the programme initially but the ECB opened a backdoor in July by adding a few southern European government-owned utilities and transportation companies to the eligible list for PSPP. We think this is not necessarily the start of broad-based buying of corporate bonds but it sends a signal to the market that the ECB is ready to increase the scope of the programme if the original objectives are missed or if the debt crisis in Greece broadens into the rest of the Eurozone.

In theory the programme should have provided a strong support for European corporate bonds. However after the initial announcement effect, euro corporate bond markets have under-performed. We think



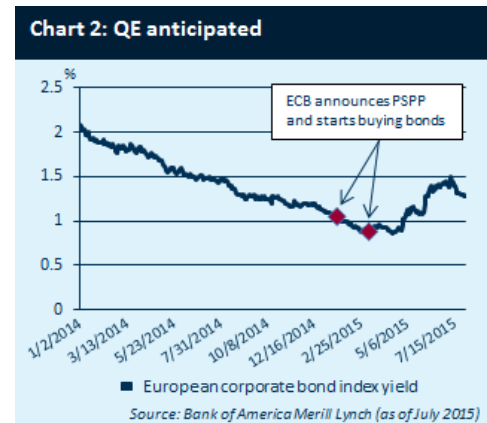
this can be explained by three main factors. Firstly, investors had been anticipating sovereign QE since the second half of 2014 and positioned themselves accordingly in the run up to it (see Chart 2). Secondly, Eurozone growth and inflation expectations have been revised upwards and are now aligned with the ECB's projections, creating some concerns about overall bond valuations despite the ECB's buying programme. Thirdly, non-Eurozone domiciled corporates and banks took advantage of the relative cheapness of the euro market and issued a record amount of new bonds leading to supply indigestion. Amongst other factors the impact of the Greek debt talks, the slowdown in China and expectations of tighter Fed policy have all impacted European corporate bonds in recent weeks.

The impact of sovereign QE on financial asset prices is undisputed but how strong is the impact on banks and corporate behaviour? Has it stimulated credit growth and investment spending? We think there are tentative signs that it has, albeit slowly. European banks have shown a small increase in lending so far in 2015 after six years of balance sheet contraction; lending surveys suggest that there is an uptick in loan demand but bank behaviour is still constrained by regulations such as Basel III. Companies in Europe meanwhile benefit from

historically low funding costs, but have only moderately increased spending given uncertainty over the growth environment. Many are benefiting from a weaker euro, which provides a boost to competitiveness and profitability for export-orientated companies such as automotive and capital goods producers. Will the next step be increased M&A in a manner similar to what we are seeing in the US? To date, this has not been the case, helping to support euro corporate credit markets. However, we remain vigilant about greater change here as it may pose a risk to strong corporate balance sheets in Europe over the medium term.

We think the credibility of the ECB's policy toolkit helped to contain the impact of the Greek debt negotiations. Compared to the sovereign debt crisis in 2011/12, the fear of a potential Greek default and exit from the Eurozone only led to a small correction in other markets. This was partly a result of market confidence in the ECB's willingness and ability to safeguard the Eurozone from potential spill overs. In this light, we view the addition of a few southern European corporate issuers to the eligible PSPP list around the climax of the Greek debt talks as an effective and well-timed signal, without having to commit the central bank's balance sheet.

Where does this leave us going forward? We think ECB stimulus will support a gradual recovery in growth and investment in the Eurozone. At present banks' lending activity remains sensitive to regulation and the outlook for default rates. Corporate profitability benefits from lower refinancing costs while exporters benefit from the weak euro, but investment decisions are ultimately driven by expected demand for their products and services. On balance, the effect on corporate bonds should be positive, as underlying yields for government bonds should remain low, meaning credit spreads should slowly compress over time. Consequently, we would expect further reallocation from sovereign bond institutional investors into investment grade credit. In terms of cross-market performance we expect euro investment grade



to outperform in the short term versus their US dollar and Sterling siblings, reflecting the very different signals these economies and their central banks are giving.

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