Credit Market Outlook

February 2023

Growth: Activity resistance persists

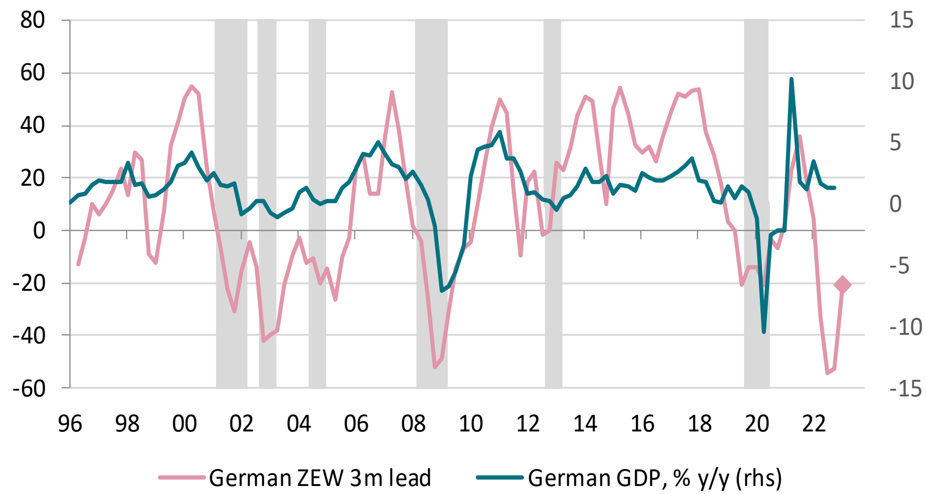
Not looking bright though

Activity resistance persists

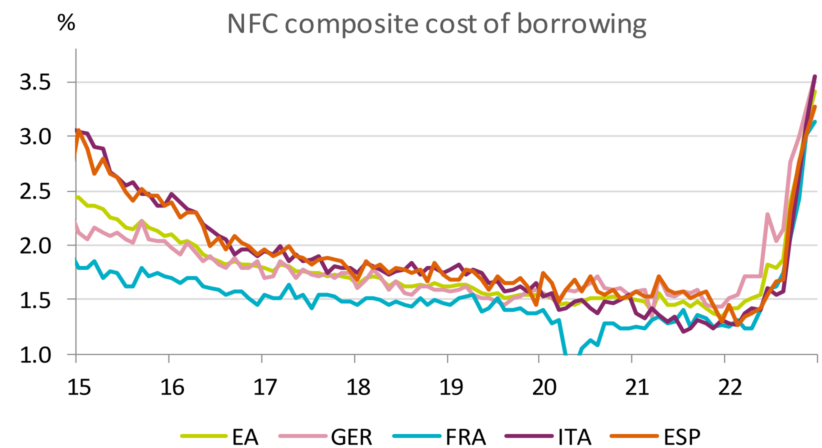
- Forward looking indicators point to only a shallow recession if at all, implying marked upside risks to our projected cumulative 1.0% Q4 22- Q1 23 euro area GDP contraction, likely mainly owing to mild winter temperatures, energy efficiency gains, supply bottlenecks abating, lower energy prices. MT outlook still underpinned by weak growth.

Tightening of the Financials conditions

- However, growth is unlikely to be spectacular. Progressively tightening fiscal and further tightened monetary policy likely to prevent growth to be above potential in line with our baseline forecasts.



Source: Refinitiv, AXA IM Research. Diamond is for Q2 23



Source: ECB, AXA IM Research, February 2023

Inflation Outlook - focusing on Core

Lower inflation in 2023, pushed down by energy (5.9%); core still robust (upside risk)

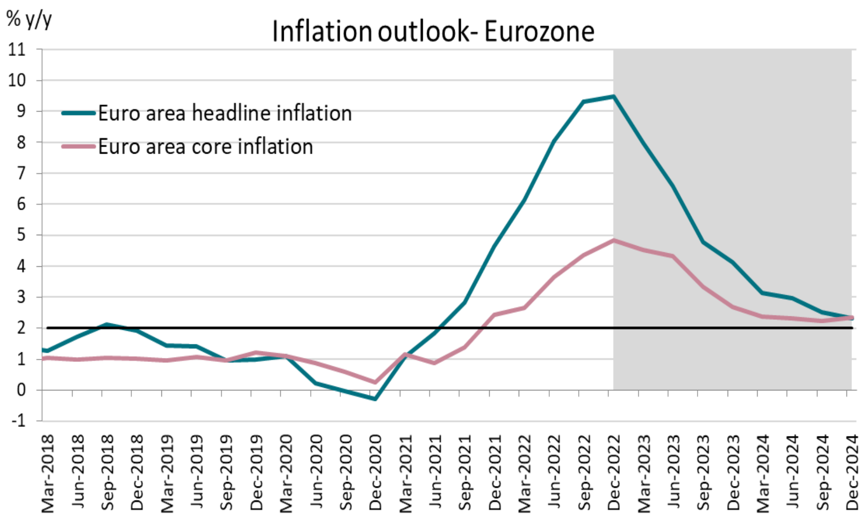
Deceleration of headline inflation should continue

- If wholesale energy prices remain low, base effect should grow through 2023, lowering headline inflation by c. 5p between now and the end of 2023

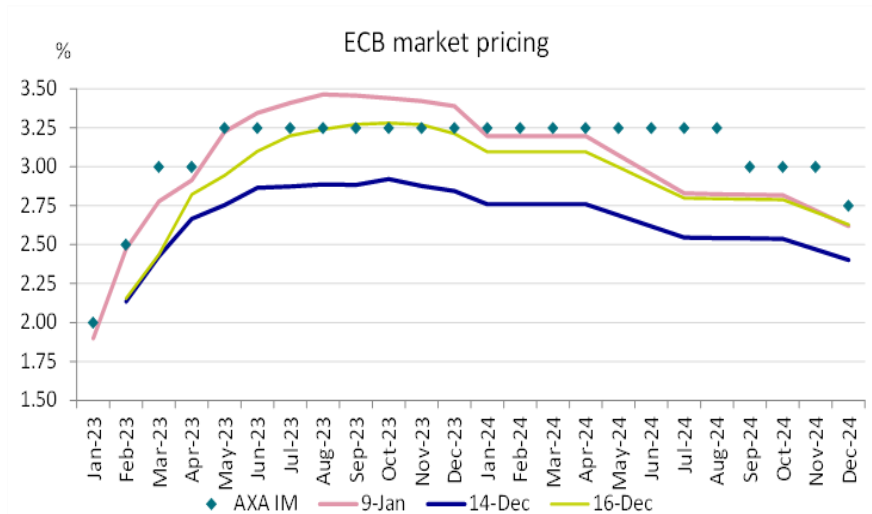
Deceleration of core inflation will take time

- We believe core reached a peak at around 5.2% but our forecasts remain sticky and elevated in Q1 (5.1%) and Q2 (4.5%).
- Resilient demand and generous fiscal support are creating higher risk for endogenous inflation (inflation generated by higher wages/constant level of margins), which could complicate ECB policy

Our 2024 inflation forecast would remain above 2% in 2024 (2.8%)



Source: Eurostat, AXA IM Research, December 2022



Source: Bloomberg, AXA IM Research, as of 9 January 2023

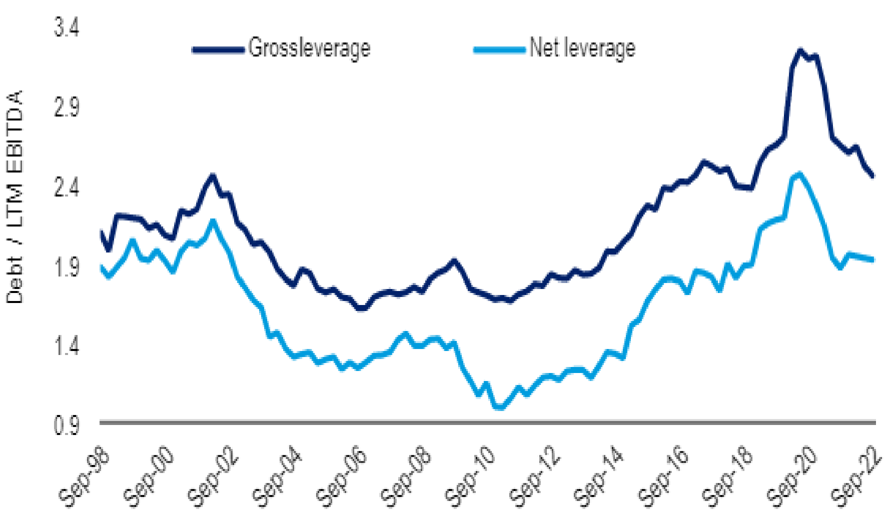
Source : AXA IM, Decembre 2022

Corporates

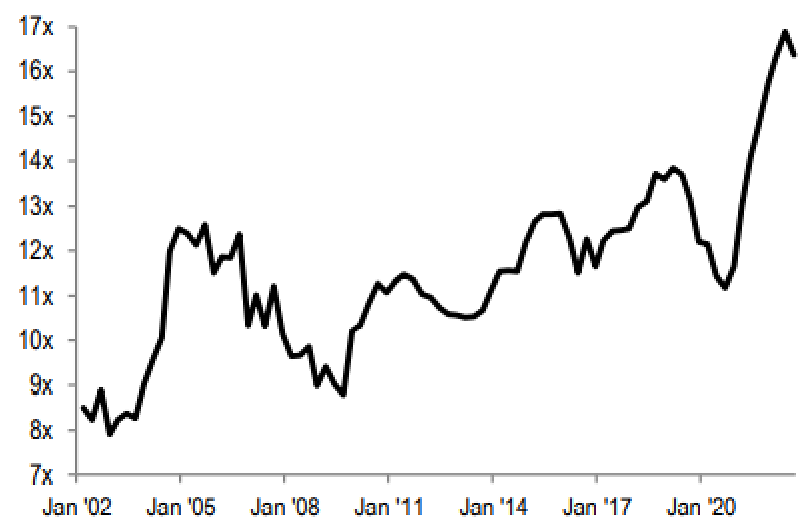
Q3’2022: still sound credit metrics

- Q3’22 preliminary estimate shows that credit metrics improved for non-financial Investment-Grade issuers thanks to lower gross debt, positive revenues growth and still positive Ebitda growth. As such, gross leverage was down by 0.1x to 2.45x, while net leverage was almost flat as companies continued to use their cash (capex notably).
- By ratings, gross leverage declined by a similar margin for both single-A and BBB-rated issuers, but net leverage was higher in 3Q for high quality issuers and lower for BBBs.
- Interest coverage ratio was ticked slightly down but remained at high levels (>16x)

Net debt to Ebitda ratio has ticked down modestly



Median coverage ratio down but still at elevated levels



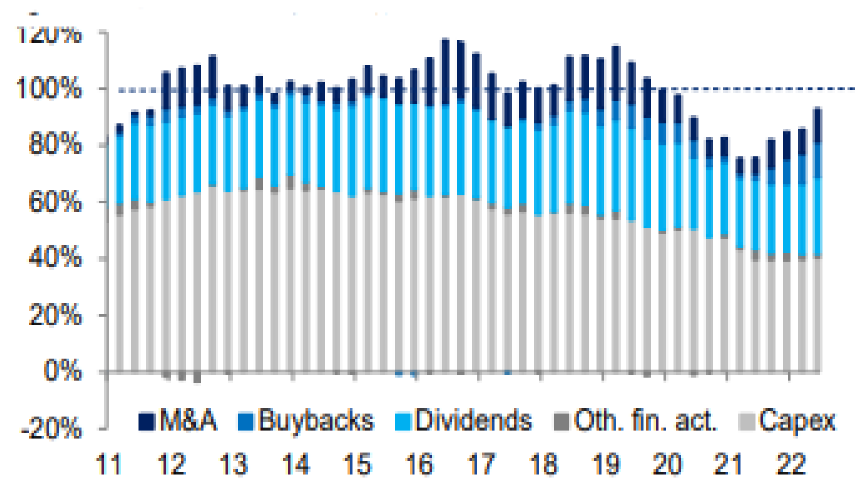
Source: BofA Merrill Lynch US Research, JP Morgan Euro Credit , November 2022

Corporates

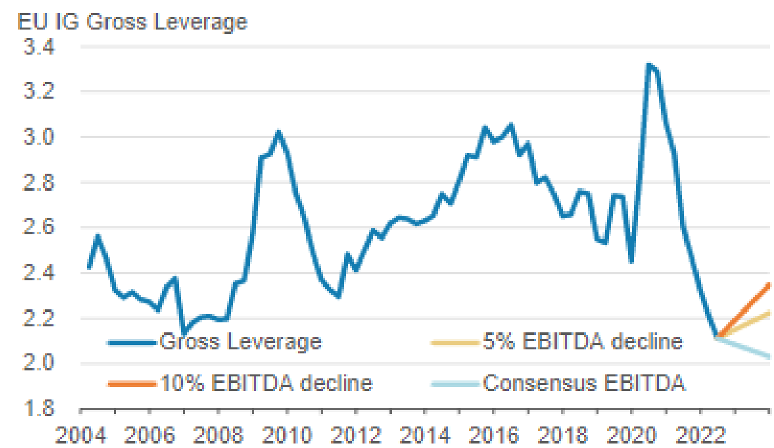
Q3’2022: still sound credit metrics

- The uncertainty about energy prices and the associated economic uncertainty will have prompted may companies to keep running their expenditures below their operating cash flows.
- Assuming unchanged total debt, a 10% shock to in-place last 12M EBITDA suggested that median IG gross leverage could rise by 0.2x (0.5x for HY). The starting point for other key metrics such as interest coverage ratios and cash to debt compares favorably versus long-run averages

Companies are still spending less



Leverage is expected to increase next year but modestly



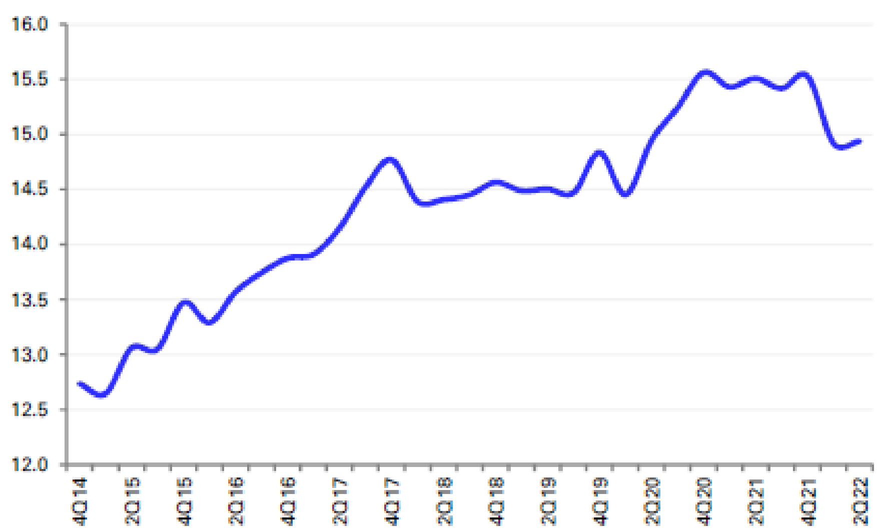
Source: Citi, Morgan Stanley Credit Research, November 2022

Banks

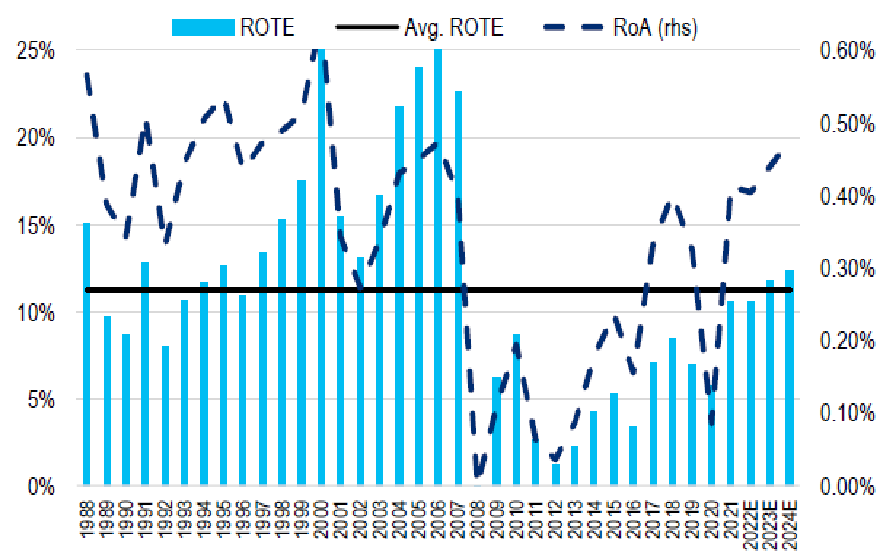
Above-consensus Q3’22 results

- Q3’22 results were overwhelmingly above consensus thanks to higher revenues and lower impairments than expected, with pre-tax profit often defying expectation. Net Interest Income grew at an accelerating pace at banks with exposures to Central Eastern Europe (CEE), Latin America, the UK and Norway, while positive impact from rising euro rates started to emerge at Italian/Spanish banks. Furthermore, overall NII outlook is strong/strengthening. Banks are also focused on cost optimization to cope with inflationary pressure.
- Over the last decade, European banks have been focused on improving balance sheets and solvency levels. Indeed, CET1 ratio was solid at ~15% as September 2022, but we believe a plateau is reached in terms of capitalisation. Capital ratios are hence expected to weaken, due to cash return to shareholders, but from a strong level.

European Banks – Average CET1 Ratio



Return On Equity of Major European Banks



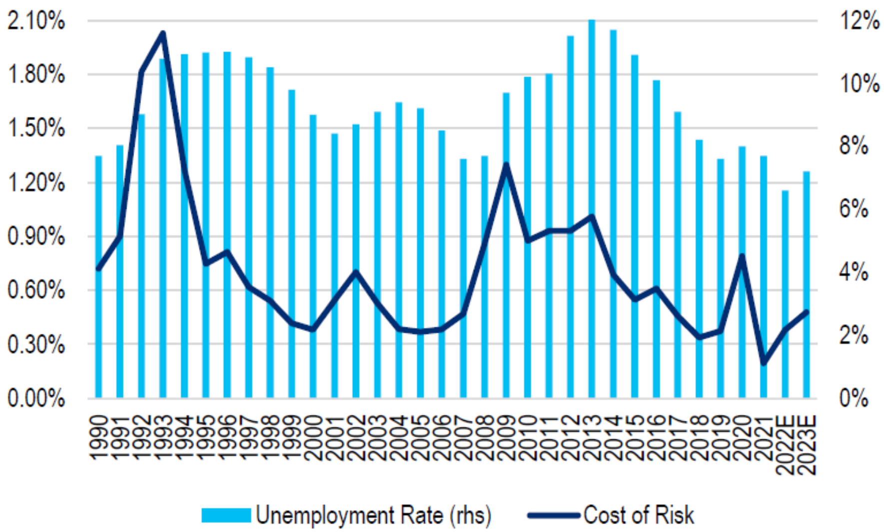
Source: Citi Credit Research, DB, Citi, December 2022

Banks

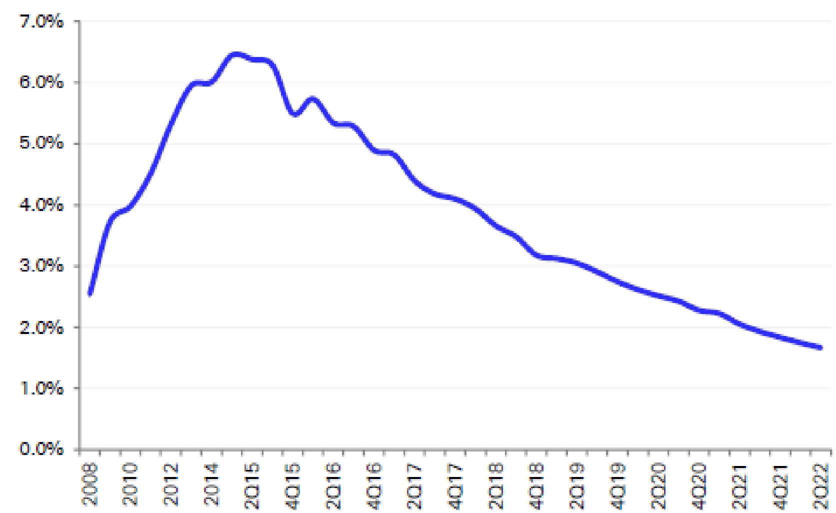
Above-consensus Q3'22 results

- Asset quality showed no sign of deterioration yet and banks conveyed a surprisingly confident outlook, while acknowledging uncertain as much as challenging times ahead. Cost of risk has increased vs. 2021 but still modest from an absolute level.
- Non-performing loans continued to decelerate benefiting from LLP reversals post Covid.

European Banks – Cost of Risk slightly higher



Bad loans as % total loans

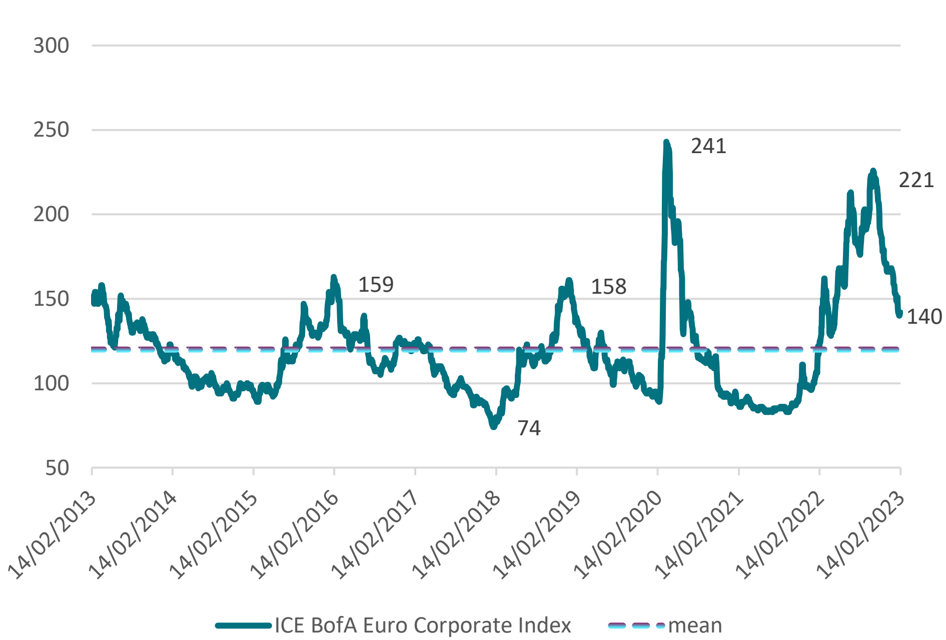


Source: Citi, EBA, DB , December 2022

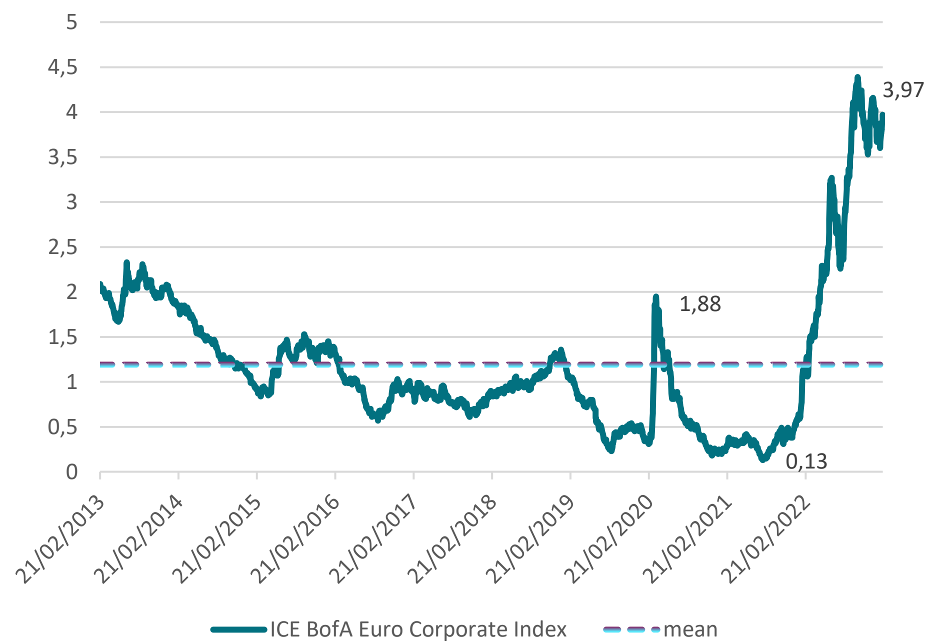
Investment-Grade Euro Credit Market valuation

- The tide of central bank liquidity that supported the asset class through a significant portion of the past decade is over. With the move from ultra-low interest rate to a more “normal” rate levels, credit premium has moved markedly year-to-date.
- This had led to a repricing of the credit asset class offering a good opportunity from a historical perspective.

Euro Investment Grade Market in Spread(OAS)



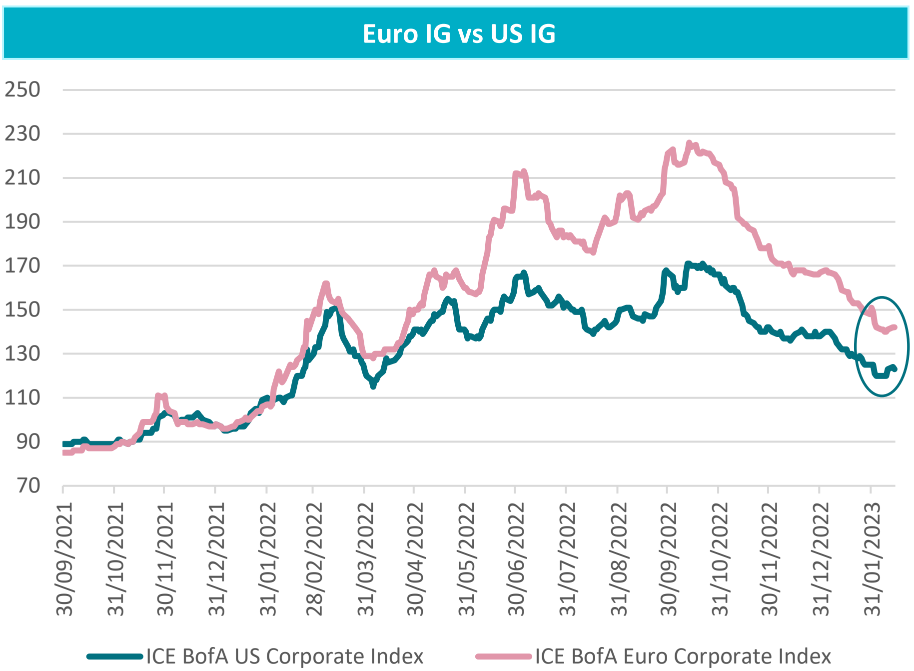
Euro Investment Grade Market in Yield (%)

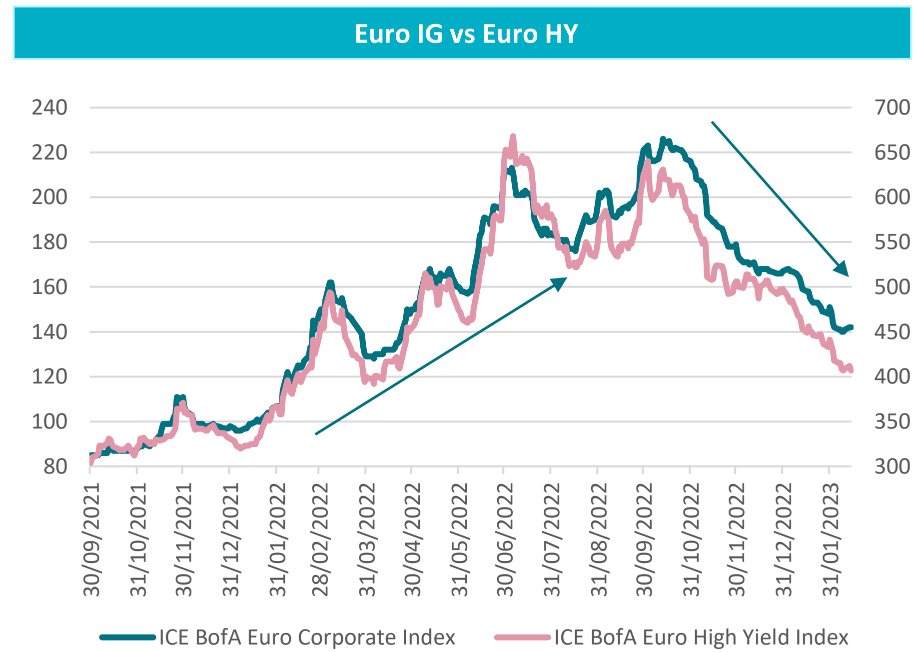


Source : AXA IM, Bloomberg as of 14/02/2022

Credit Valuations : Go Euro !

- Euro credit IG has underperformed the US credit IG
- European HY has perfectly followed the move on the IG this year.





Source : AXA IM, Bloomberg as of 14/02/2023

Investment-Grade Euro Credit Market valuation

Focus on the Short-Term part of the curve

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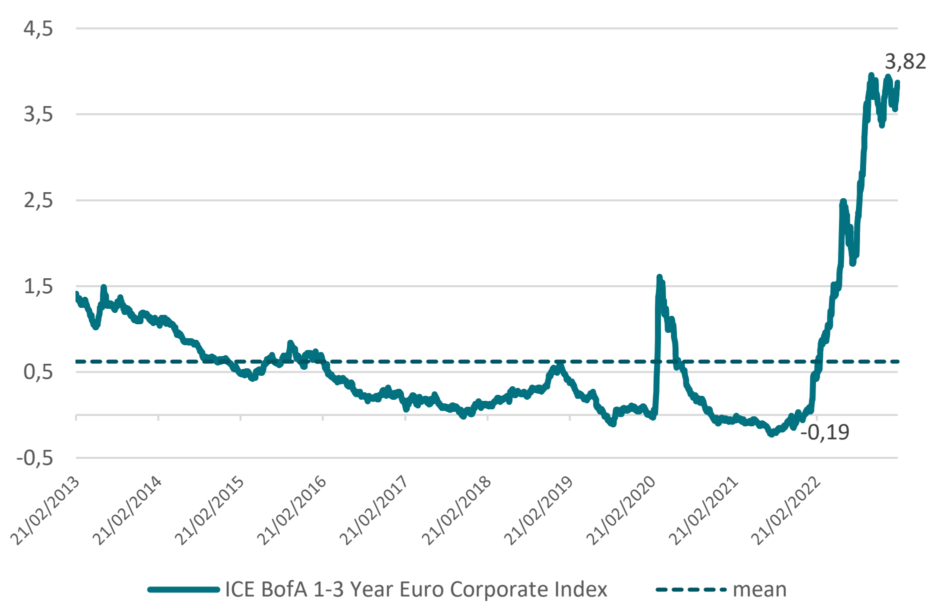
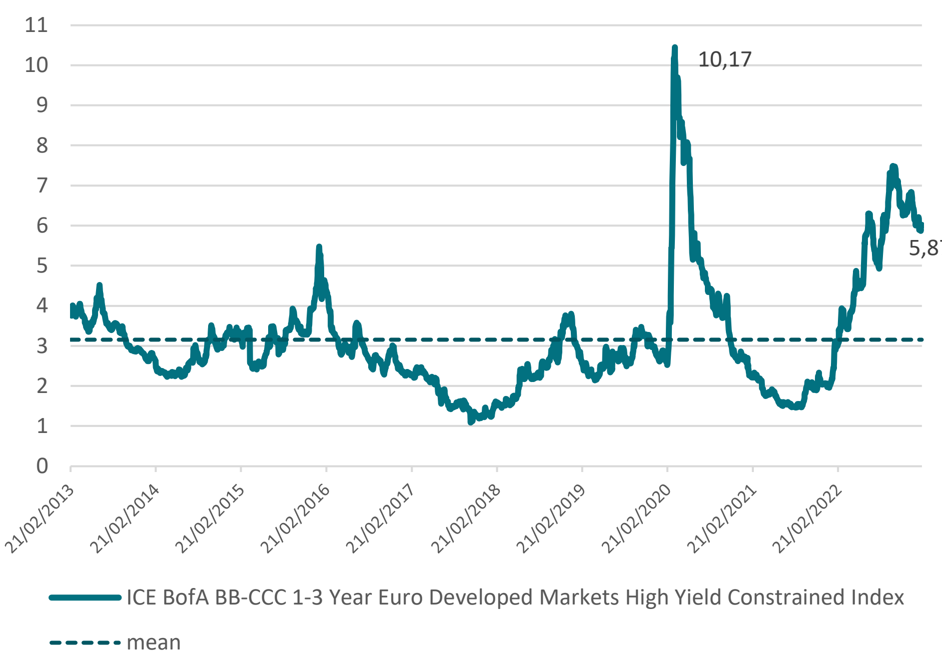
Euro IG 1-3 Year in Yield



Euro HY 1-3 Year in Yield



Source : AXA IM, Bloomberg as of 14/02/2022

Investment Managers

Investment-Grade Euro Credit Market valuation

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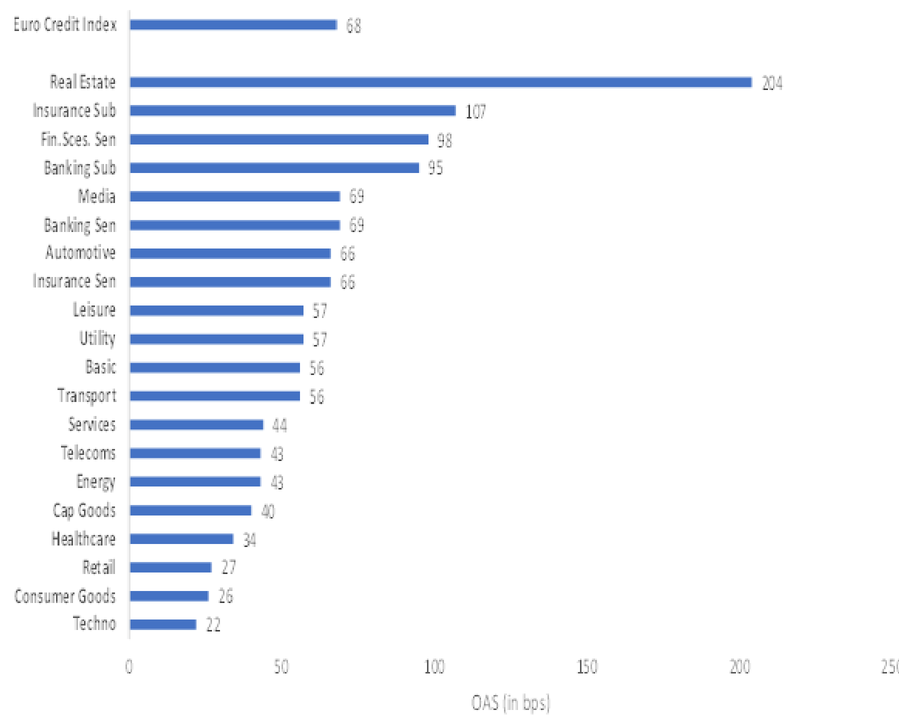
- This had led to a repricing of the credit asset class offering a good opportunity from a historical perspective. By sector, Real Estate and Subordinated debt were the main underperformers while defensive sectors held well.

Real Estate Overshoot

Euro Investment Grade by Sector (OAS variation YTD)



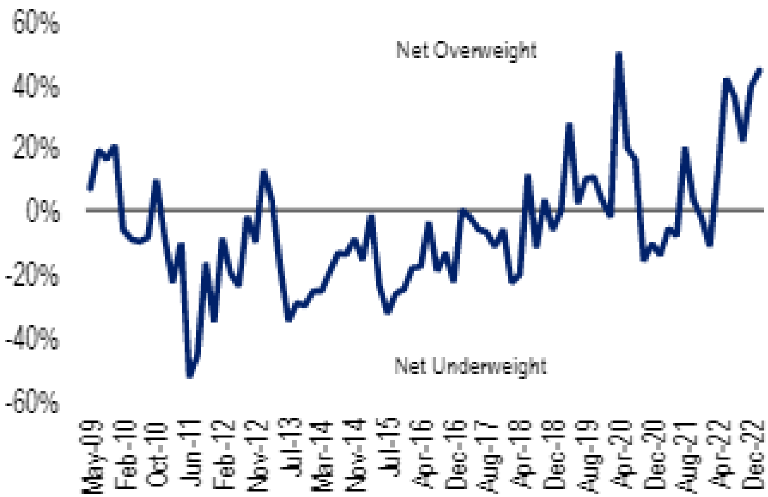
Source : AXA IM, Bloomberg as of 14/02/2023

Strong consensus on Banks

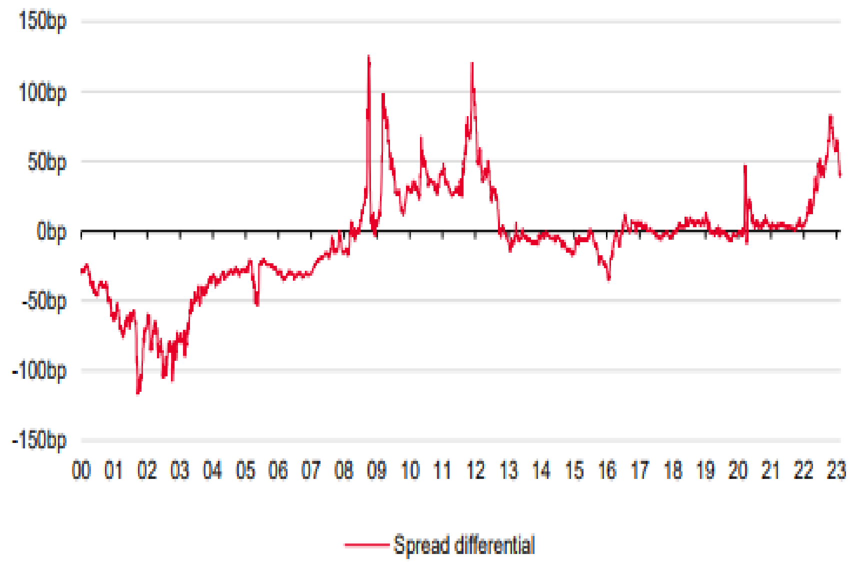
- In 2022, the banking sector was the second underperformer after the Real Estate whilst it exhibited from good fundamentals, notably on the back of the new rates environment and well controlled cost of risk.

- The sector was particularly impacted by the supply, which was massive in 2022, notably on the MREL eligible capital, leading to an above average differential of premium compared with the rest of the market. This has led to a massive repositioning of the investors, which looks very consensual.

Senior Banks positionning



Spread differential between Senior Banks vs Senior Corporates



Source : AXA IM, Bofa ML and SG, February 2022

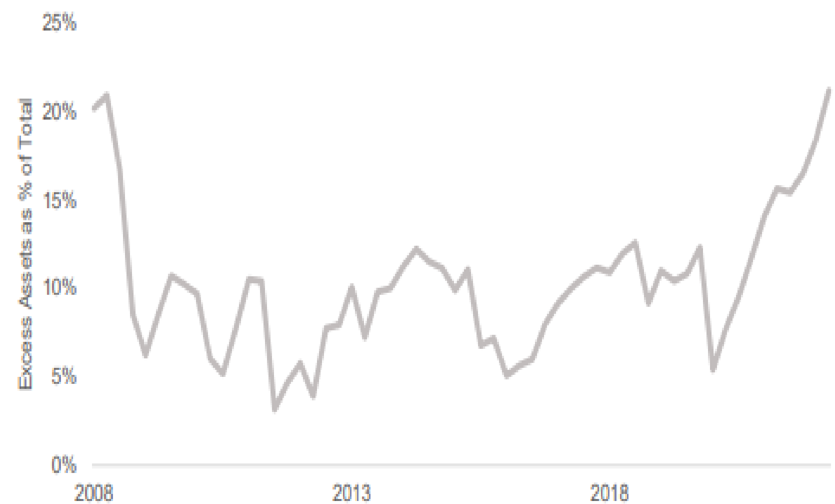
Technicals

Demand should be supported by yield buyers

- Between 2002 and 2010, bonds yielded, on average, 1.6% more than equity. Between 2010 and 2021, equity yielded, on average, 1.7% more than bonds. Now the yield advantage has moved back to bonds, and even with the recent spread rally and yield decline, Euro IG still yields 35bp more than stocks.
- Thanks to the rise in yield which has cut the net present value of liabilities, the excess assets of the whole European pension fund industry are at their highest level since 2008.

Credit Yield vs Dividend Yield

Excess assets for pension funds ALM



Source: SG, December 2022

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