EIFFEL INVESTMENT GROUP

Benchmarking and impact analysis of the ECB QE – A big fish in a smaller pond

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With €60bn of monthly asset purchases to be completed between March 2105 and September 2016, the ECB is about to embark on an unprecedented program. On one hand, our guts tell us that its impact can only be profound and long-lasting, but on the other hand, we have to reckon that we are entering unchartered territory. Consequently, as we always do for any complex and multifaceted situations at Eiffel, we put on our analyst caps, we dig into relevant data and information, and we used our knowledge and experience of European credit markets to form a view that will shape the Fund's portfolio positioning. This time was no different and given the high-profile nature of the ECB's announcements for European credit markets, we have decided to write for our readers the most important conclusions of our analysis.

1. We estimate that the total size of the ECB program will amount to €1.14tn, i.e. ca. 80% of the amount of assets purchased by the Fed during its QE3 program. On a monthly basis, that is the equivalent of 0.6% of the Eurozone GDP vs. 0.5% for the Fed at the peak of QE3.

2. We consider that ca. 70% of the ECB purchases will be in Eurozone govies, with the balance spread between covered bonds (ca. 15%), agencies & supranationals (ca. 12%), and ABS. This implies that the ECB will likely buy 14% of the Eurozone govies outstanding over the current term of the program and that in 2015 alone, the ECB purchases may represent ca. 130% of the net issuance of Eurozone governments.

3. Taking into account both eligible and non-eligible (i.e. financial senior and subordinated + corporate IG and HY) bonds, we estimate the current size of the Eurozone fixed income market at around €10tn. Putting the ECB QE in perspective means that an equivalent of 11% of the total fixed income market will be bought by the ECB over the life of the program. This is more than twice as much as what the Fed achieved from September 2012 to October 2014 as it bought the equivalent amount of ca. 5% of the US fixed income markets – bearing in mind that the size of the Eurozone fixed income markets is about 38% of that of the US.

4. Looking at the net issuance of those markets, the figures are even more staggering. For 2015 alone, the amount of securities to be purchased by the ECB will be 2.5x-to-3x greater than the total expected bond issuance (including both eligible and non-eligible securities). That is 4x larger in proportion of the net issuance of all US fixed income markets than what the Fed bought in 2013 – 2013 was the peak year of QE3.

5. In the next step of our analysis, we tried to gauge the amount of excess liquidity that the ECB QE program could generate on a full-year basis. For that purpose, we broke down the amount of expected ECB purchases and of net issuance for each type of Eurozone fixed income asset. In total, we believe that more than €400bn of excess liquidity might be reallocated annually by investors into non-eligible assets – such as Eurozone corporate or financial bonds, or non-Eurozone or non-euro-denominated European govies, agencies and supranationals, ABS, corporate or financial bonds, among others – as a result of the ECB's actions.

6. To put this huge €400bn in perspective, we chose to broaden the scope of "investable" assets for crowded-out investors beyond the pure Eurozone assets. We therefore included all corporate bonds – financial senior and subordinated, as well as IG and HY corporate – issued by a European borrower – non-Eurozone borrowers included – in all currencies, as we thought such assets could constitute relevant substitutes for asset allocators. Relative to those buckets of the market, we estimate that marginal buyers for ca. 11% of the market outstanding and for more than 2.6x of net issuance could come annually.

7. Last, we reassessed how our compression thesis could play out in 2015 and beyond, on the back of the ECB announcements. To do so, we looked at where B and CCC credit spreads traded before the inception of the Fed QE3 and at the end of it; B credit spreads tightened by ca. 33% to 400bps from 600bps, while CCC credit spreads tightened by ca. 36% to 700bps from 1,100bps. Interestingly, both B and CCC European credit spreads currently trade at similar levels as where their US equivalent did before the Fed QE3, i.e. 600bps and 1,250bps, respectively. It is too early to know whether such massive price action will be replicated in Europe during the period of the ECB QE program, but it is hard not to argue that the ECB QE program offers a highly favorable backdrop to credit investing in Europe for the many quarters to come.

Our judgment is that European credit – in particular B and CCC corporates, as well as bank hybrid capital instruments – may well end up being the asset class to benefit most from the upcoming ECB QE program. Importantly, the fact that the region's economic outlook has been improving over the past few months will support corporate and bank credit fundamentals and contribute to a very favorable backdrop for credit investing. On the risk side, watch for the rotten business models, overleveraged balance sheets and flawed capital structures that populate our credit markets; there will be more defaults and credit accidents in 2015 and avoiding them will be key to deliver performance and capital protection.

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