

Allianz Research

Corporate credit: straddle or struggle?

21 April 2022

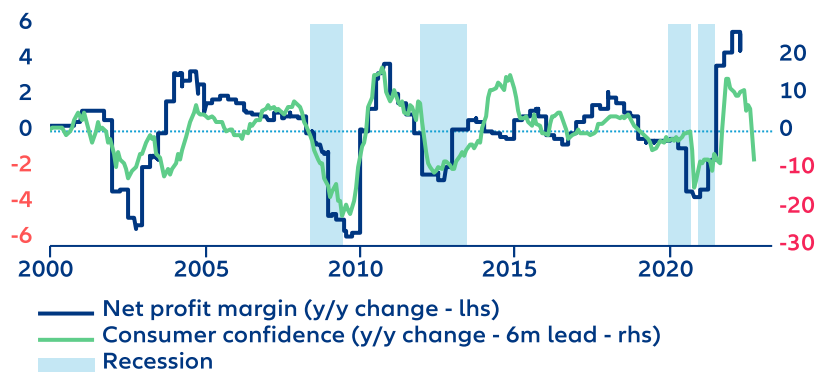
EXECUTIVE SUMMARY

- **The war in Ukraine has put pressure on European corporate margins.** The conflict has sent (energy) commodity prices soaring, amplified existing supply-chain disruptions and increased uncertainty weighing on investment. So far, high cash balances and rising profitability seem to have shielded most companies from rising input prices. However, leading indicators suggest declining earnings. Eurozone consumer confidence levels imply a -2pp y/y margin erosion within the next six months. The impact is expected to vary across sectors, with power and metals most affected by a further increase in energy prices.
- **Corporate credit spreads have de-anchored from their 2020-2021 lows due to rising - default risk amid faster-than-expected monetary tightening.** After strong policy support effectively capped insolvency risk for almost two years, the broad-based market sell-off since the onset of war in Ukraine has amplified the progressive widening of credit spreads due to tighter financing conditions. However, credit spreads, especially within the high-yield segment, have remained range-bound due to (still) relatively healthy corporate balance sheets and a protracted phase-out of policy support. Current market positioning does not suggest a broad-based credit risk deterioration over the near term, with investors anticipating a quasi-straddle payout distribution from holding corporate credit risk.
- **While corporate credit risk should remain manageable, risks to the outlook are clearly tilted to the downside.** We expect non-payment risk to increase further, given the economic slowdown, with Eurozone business insolvencies increasing by +12% this year from extremely low levels. An even more hawkish monetary stance (also driven by rapidly tightening financing conditions in the US) could precipitate credit constraints and raise default rates. However, strong fundamentals could keep credit spreads in check. We expect investment grade spreads to compress from current levels, finishing 2022 close to 115-120bps but to moderately widen to 120-125bps by end-2023. Moving down the rating scale, high-yield credit will probably finish the year close to 390-400bps before widening by 20bps in 2023.

The war in Ukraine has increased pressures on corporate margins.

The conflict has sent (energy) commodity prices soaring, amplified existing supply-chain disruptions and increased uncertainty. So far, strong cash balances as well as rising profitability and capex, seem to have shielded most companies from high input prices. However, with the real impact on companies' balance sheets yet to fully reveal itself, early earnings reports indicate a higher-than-expected though manageable impact (which is confirmed by deteriorating economic expectations, a leading indicator for corporate margins). Eurozone consumer confidence levels imply a -2pp year-over-year margin erosion within the next six months, implying a margin decline of 3.0-3.5pp from the current 8% peak to 4.0-4.5% (Figure 1)¹.

Figure 1: Europe – Corporate net profit margins vs economic confidence indicator (in y/y changes)



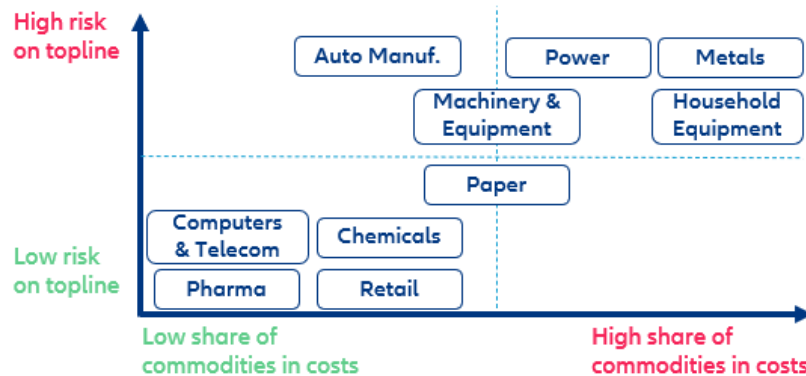
Sources: Datastream, Worldscope, Refinitiv, Allianz Research

The impact on corporate balance sheets is expected to vary across sectors. Input prices exceeded retail prices in most sectors in 2021; however, only about 40% of sectors had retail prices rising faster than wholesale prices, indicating low pricing power due to cost-push effects: oil, air transport and textiles, as well as some sub-sectors of food manufacturing. If energy prices and non-energy commodity prices remain at current levels, the metals and power sectors are most vulnerable and could lose over 20pp of their profit (EBITDA) margins (which were around 30% in 2021). This means that a further 50-70% rise in non-energy commodity prices could wipe out all profits in six out of the nine sectors under analysis (power, metals, household equipment and machinery & equipment; Figure 2). At the same time, a sharp rise in interest rates, such as a +200bps shock, equivalent to about +100bps in spreads, would (all other things being equal) mostly impact a handful of sectors, notably construction, which could see profitability losses of up to -8pp².

¹ Charts for the US equivalents can be found in the appendix.

² See our report [Who's afraid of inflation? A corporate view](#).

Figure 2: Revenue vs commodity risk mapping



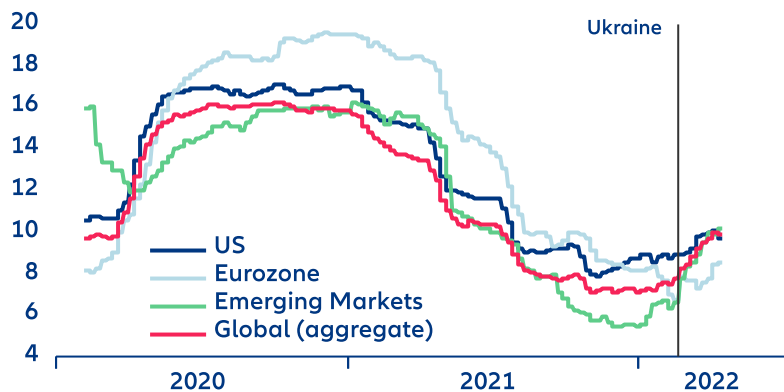
Source: Allianz Research

NB: We only consider sectors in which energy costs >5% operating expenses.

EMU6 = Germany, France, Italy, Spain, Netherlands, and Belgium. This analysis is *ceteris paribus* as we do not factor in changes in revenues, change in product mix or specifications, and cost control measures.

Earnings expectations have remained broadly resilient despite rising risks to corporate balance sheets. The remarkable earnings acceleration in 2021 (~50y/y%) has eaten into 2022 earnings expectations as markets front-run what was supposed to be two years (2021-2022) of double-digit earnings growth. As of today, markets are still pointing towards high single-digit earnings growth for 2022, with 2023 earnings expectations close to historical average levels. However, some regional differences have become prominent after the beginning of the war in Ukraine. Corporates in Europe are expected to be more affected than their peers in the rest of the world (Figure 3).

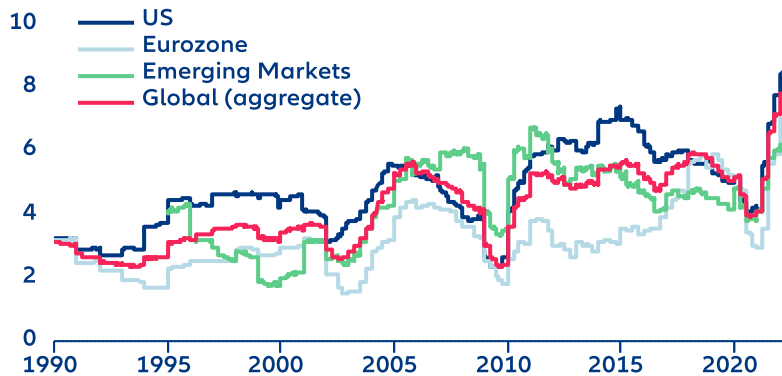
Figure 3: EPS growth expectations for 2022 (y/y%)



Sources: IBES, Refinitiv, Allianz Research

Despite the predicted margins and earnings slowdown, corporates still have a sizeable cushion to absorb short- and medium-term earnings volatility without raising debt sustainability concerns. Contrary to 2020, and after a lengthy and extensive 2020-2021 refinancing round, net leverage ratios and debt-servicing ratios are the healthiest in more than 30 years. The relatively strong balance sheets vis-a-vis short- and long-term debt commitments should allow for some market stability, making a broad-based wave of defaults highly unlikely. However, market conditions can rapidly change in periods of multiple exogenous shocks. Since corporate fundamentals were at historically high levels before each of the crises during the last two decades, a careful monitoring of the Q1 earnings season is warranted (Figure 4).

Figure 4: Interest coverage ratio (EBIT / interest expenses)



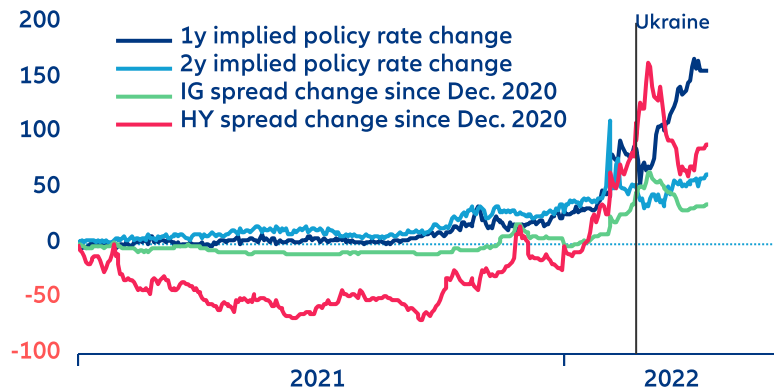
Sources: Datastream, Worldscope, Refinitiv, Allianz Research

We expect that slowing growth will raise non-payment risk, with business insolvencies in the Eurozone increasing by +12% this year. This reflects uneven trends within Europe due to diverse initial conditions, with insolvencies already rebounding in 2021 in Italy (+19 y/y%) but still at a low level in Germany and France at the start of 2022 after another drop in 2021 (-12% y/y for both countries). Insolvencies in Germany are likely to increase by +4% y/y. Should an adverse (black-out) scenario materialize, insolvencies would increase by +19% in the Eurozone and +9% in Germany. On the other side of the Atlantic, things look a bit more benign, with insolvencies expected to rise by +7% in 2022, once again hinting at the outperformance of US credit markets vis-a-vis their European counterparts.

Credit markets are still trying to price the current market uncertainty.

Corporate credit spreads have de-anchored from their 2020-2021 lows due to the anticipation of a quicker-than-expected monetary-policy normalization. Right after the initial Covid-19 widening, the combination of policy support, decreasing equity volatility and renewed economic tailwinds anchored corporate spreads close to historical lows (~90bps). Later in 2021, as market participants began to anticipate the beginning of an (inflation-led) aggressive hiking cycle spreads widened. The progressive widening was exacerbated by the broad-based market sell-off when war broke out in Ukraine, leading to an average +70bps and +150bps widening for investment grade (IG) and high-yield (HY) from 2021 lows, respectively. As of today, credit spreads, especially in the HY segment, have partially reversed the maximum widening seen in 2022 as the expectations of fiscal and monetary support (should they become necessary), paired with the relatively healthy corporate balance sheets, are capping, and even reversing, concerns about a full-fledged credit risk deterioration, especially within the IG segment (Figure 5).

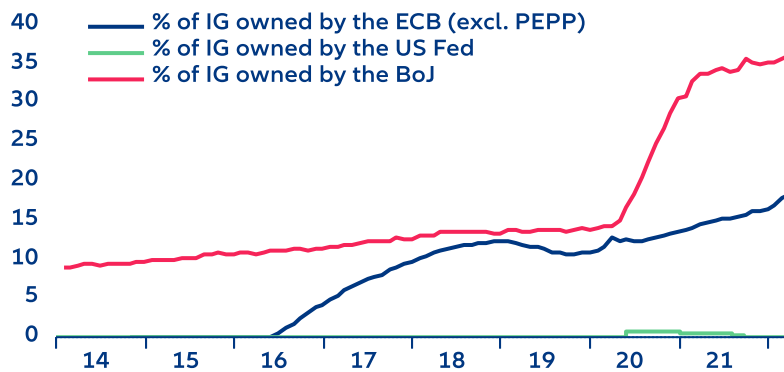
Figure 5: EUR corporate credit spreads vs ECB forward rates (bps)



Sources: BofA, Refinitiv, Allianz Research

Despite markets already anticipating an aggressive quantitative tightening and a speedy hiking cycle, the extraordinary policy support put in place since the start of the pandemic still plays a role in credit-risk-pricing dynamics. As of today, some central banks remain net withdrawers of credit-market liquidity, with their purchases adding compression pressures to spreads. Central banks' corporate credit ownership remains particularly high in the Eurozone and Japan: The ECB and the BoJ own about 18% and 36% of the investable universe, respectively. Central banks' liquidity withdrawal will remain close to current levels as they will continue to reinvest, adding permanent compression pressures on IG credit (Figure 6).

Figure 6: Central bank holdings of corporate bonds (%)*

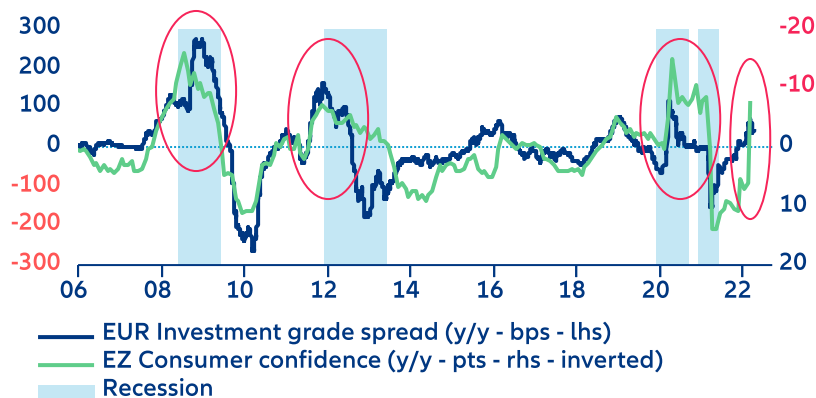


Sources: Bloomberg Barclays, Refinitiv, Allianz Research.

Note: BoJ=Bank of Japan; */ approximated based on publicly available data.

Despite the dampening effects of policy measures, credit markets tend to follow economic developments. In periods of relative market stability (i.e., outside recessionary environments), changes in economic sentiment tend to evolve in sync with credit spreads. During times of high volatility and economic uncertainty, especially in recessionary periods, spreads can detach from this long-term relationship. In such periods, spreads can compress or widen well before economic sentiment reverses. After the global financial crisis (2008), divergence between credit risk and economic sentiment have coincided with periods of policy support. Consequently, credit markets seem to anticipate that supportive policies will ultimately backstop corporate balance sheets and financing conditions, with credit spreads compressing while economic sentiment keeps deteriorating (Figure 7).

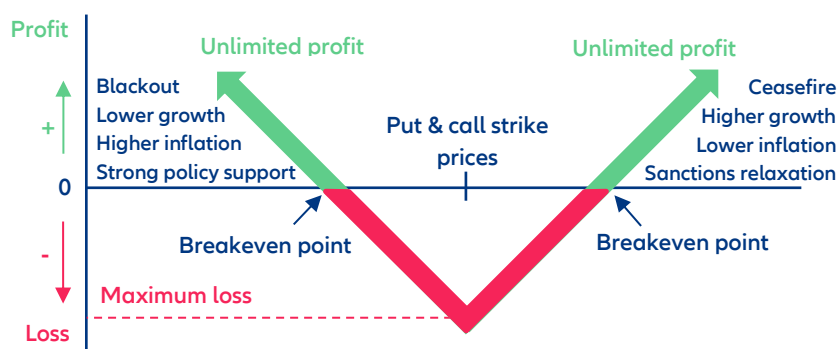
Figure 7: Investment grade corporate bond spreads vs macroeconomic conditions



Sources: BofA, Refinitiv, Allianz Research

But maybe this time is different! In a context of a faster-than-expected monetary policy normalization, it seems counterintuitive for markets to bet on extra policy support. Despite the confusing market signals, credit market participants seem to be pursuing a quasi-straddle option strategy³. In short, a long “straddle strategy” allows investors to enjoy unlimited profits if the price of the underlying asset moves very sharply while it caps the downside risk should the underlying asset remain close to current levels. Credit market participants seem to have already discounted the two extremes of the return distribution. If things rapidly deteriorate, credit markets seem to expect that policymakers will safeguard corporates’ balance sheets and overall market integrity. On the positive side of the distribution, any improvement in economic and geopolitical conditions offers market participants the upside from higher growth and lower inflation. Lastly, and in the middle of the distribution, market participants seem to be willing to onboard some short-term volatility and to pay the price for it. However, policy put-protection expectations could rapidly backfire should policymakers fail to deliver (Figure 8).

Figure 8: Stylized pay-off profile of the straddle strategy

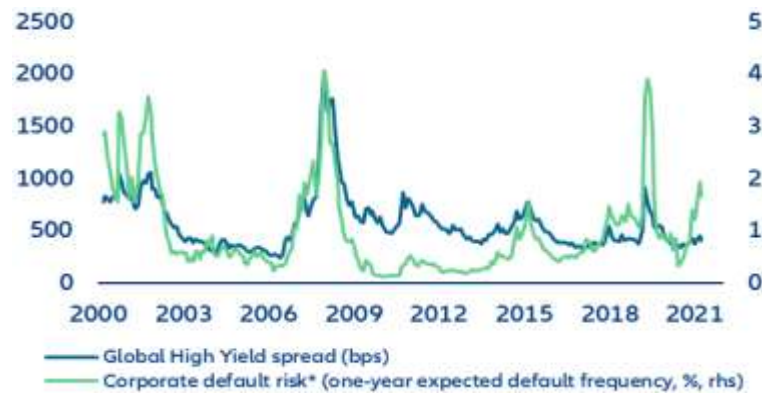


Sources: Optionsbro, Refinitiv, Allianz Research

³ A straddle is a neutral options strategy that involves simultaneously buying a put option and a call option for the underlying security with the same strike price and the same expiration date. A trader will profit from a long straddle when the price of the security rises/falls from the strike price by an amount more than the cost of the premium paid. The profit potential is virtually unlimited, so long as the price of the underlying security moves very sharply.

Is there a mispricing of credit risk? Expected default probabilities have been rising alongside the acceleration of the hiking cycle as tightening financing conditions weigh on firms' debt-servicing capacity. However, markets are not following the expected increase in defaults as they expect corporates to be resilient and policy support to step in should things go wrong (Fig 9).

Figure 9: Global high-yield corporate spread vs default risk (bps/%)



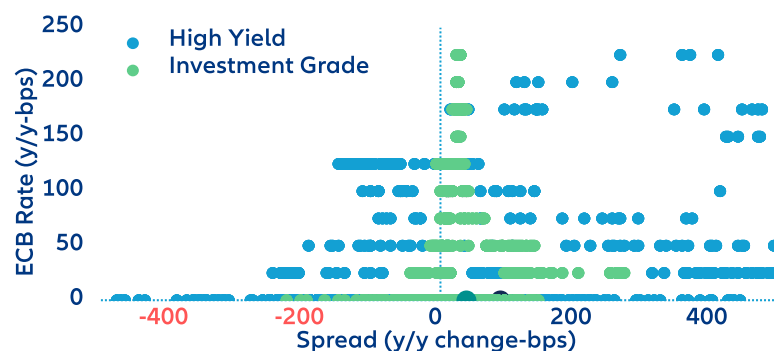
Sources: Kamakura Corp., Refinitiv, Allianz Research

Note: */ based a public firm default probability model to quantify the risk of 40,154 public companies using a multi-factor, bottom-up approach

Credit markets are heading for a bumpy road ahead.

The effect of tightening financial conditions on credit risk will be a key determinant of future performance. Central banks will be increasingly cornered if high inflation remains sticky and markets continue to price in an ever more aggressive hiking cycle. However, higher policy rates do not automatically translate into wider credit spreads. Depending on the nature of the credit cycle, higher short-term rates translate into both widening and compressing credit spreads. In the case of IG credit, higher rates tend to be associated with a widening of spreads; for HY credit, the sensitivity often varies. However, the more aggressive the tightening cycle, the wider spreads tend to be (especially for HY credit). Should markets be right about 2022 policy expectations, aggressive hikes will exert substantial widening forces on corporate spreads. To put this into figures, and isolating the short-term rate impact on spreads, our modeling suggests that an aggressive 100bps hike could lead to a 50-100bps widening of IG spreads and a 300-500bps widening of HY spreads depending on the severity of the recession ahead and the immediate impact to the economic outlook and market sentiment (Figure 10).

Figure 10: EUR spreads vs central bank rate moves (y/y)

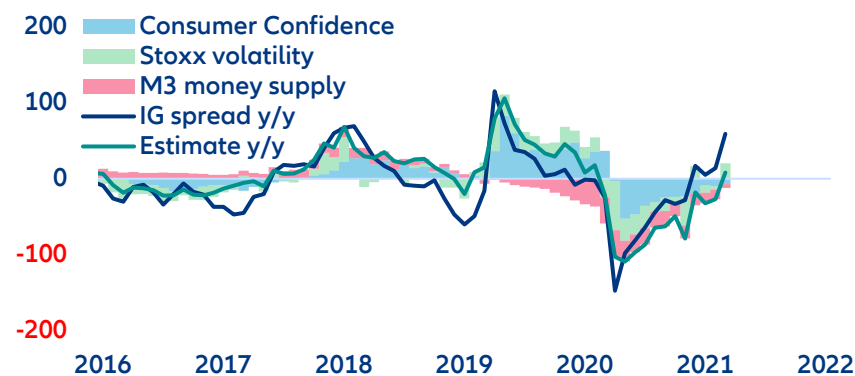


Sources: BofA, Refinitiv, Allianz Research

But inflation will also play a role! An additional proxy for corporate credit spread movements is changes in long-term inflation expectations. As in the case of equity markets, higher (but still anchored) inflation expectations tend to be relatively benign for credit performance. Following this premise, accelerating inflationary pressures have substantially compressed corporate spreads. A gradual but structural decline in inflation expectations, as expected within our baseline scenario framework, should exert extremely muted spread-widening headwinds that could be easily compensated for by a timid economic acceleration or a decline in equity volatility, thus not derailing our baseline scenario for credit spreads.

Currently, market uncertainty and deteriorating economic conditions are weighing on corporate spreads. We determine the risk drivers of credit spreads following a macroeconomic-driven valuation based on the economic outlook (consumer confidence), uncertainty (equity volatility) and policy stance (money supply). In 2021, all components aligned, adding compressing tailwinds, with the economic recovery playing the biggest part (Figure 11).

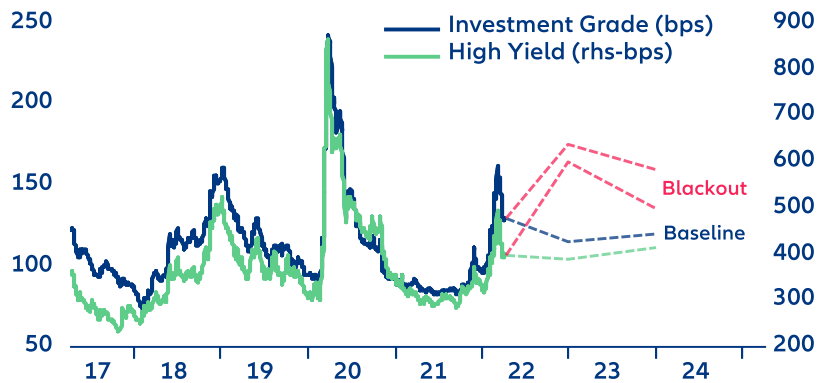
Figure 11: EUR spread decomposition framework (y/y change)



Sources: BofA, Refinitiv, Allianz Research

Overall, relatively strong fundamentals and continued policy support are likely to keep credit spreads in check over the medium term. We expect IG spreads to compress from current levels, finishing 2022 close to 115-120bps, but to moderately widen to 120-125bps by end-2023. Moving down the rating scale, we expect HY credit to finish the year close to 390-400bps and to timidly widen by 20bps in 2023. Despite the benign outlook, it is important to mention that the uncertainty surrounding the current economic and geopolitical landscape, paired with an aggressive hiking cycle, has the power to surprise corporate credit markets, leading to the beginning of a credit default wave within the HY universe. Should such a downside scenario materialize, we would expect credit spreads to come close to revisiting the maximum values experienced at the beginning of the pandemic, with IG corporate spreads remaining close to 175-180bps during 2022 and slightly compressing to 160-165bps in 2023. HY credit would reach 600bps this year before settling at 500bps next year (Figure 12).

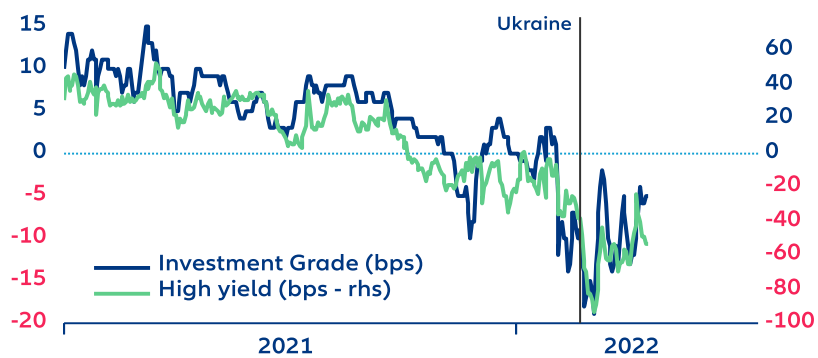
Figure 12: EUR spread forecasts



Sources: BofA, Refinitiv, Allianz Research

Lastly, the intra-year volatility is expected to be significantly different across regions, with European credit expected to be more volatile. The war in Ukraine has revealed the higher dependence of European corporate balance sheets on Russian revenues and imports compared to their transatlantic counterparts. This is in line with the expectation that the Eurozone will be significantly more economically impacted than the US. The asymmetric impact has already been priced in, with the transatlantic credit spread widening in favor of the Eurozone, which is showing higher credit risk especially within the HY bucket. The divergence is expected to persist in 2022 and 2023 (Figure 13).

Figure 13: US - EUR corporate credit transatlantic spread (bps)



Sources: BofA, Refinitiv, Allianz Research

ANNEX: Chartbook

Figure A1: US - After-tax profitability ratio

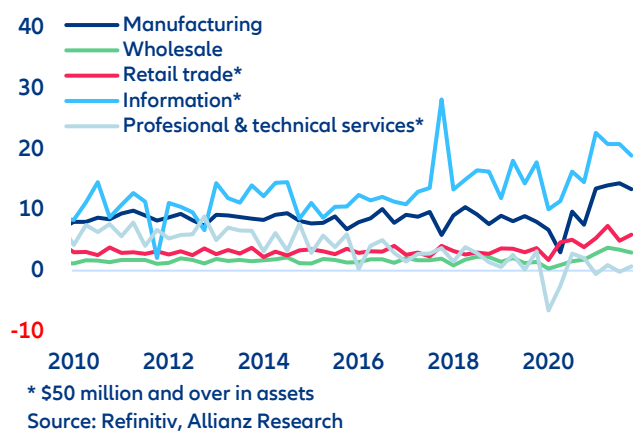


Figure A2: US - Cash (no. of days in sales)

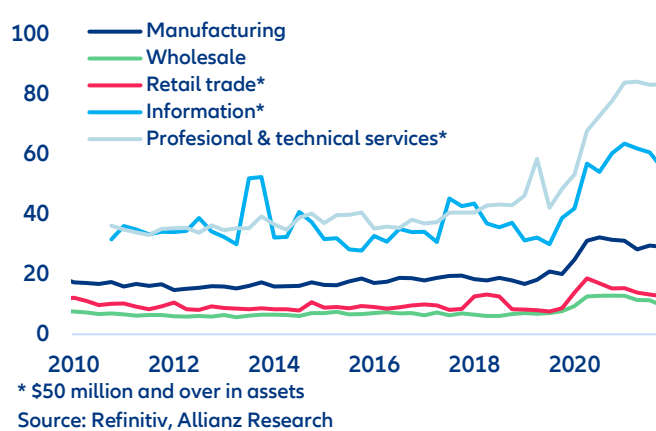


Figure A3: US - Working capital requirement (number of days in sales)

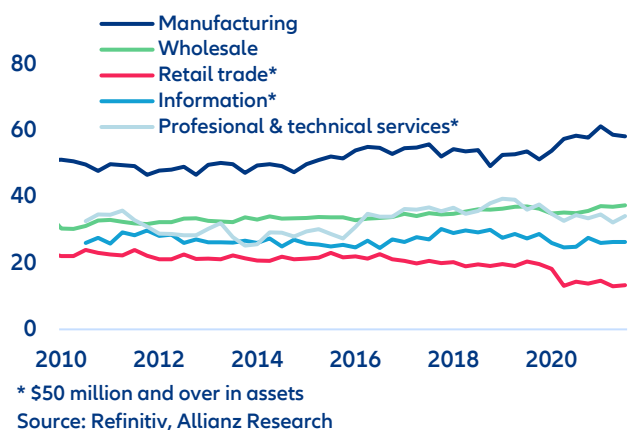


Figure A4: US - Financial debt net/total liabilities (with total cash)

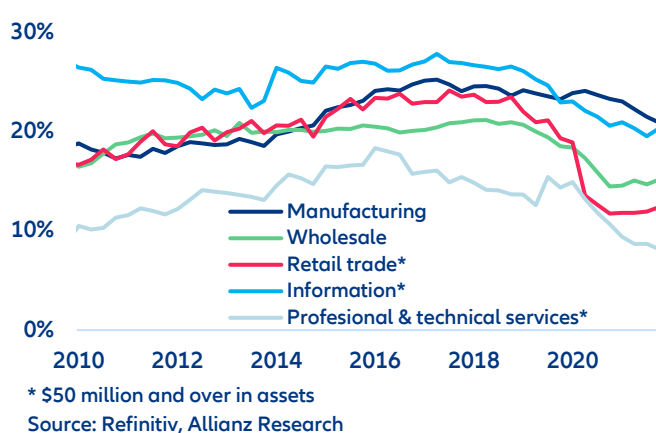


Figure A5: US - Stockholders' equity ratio

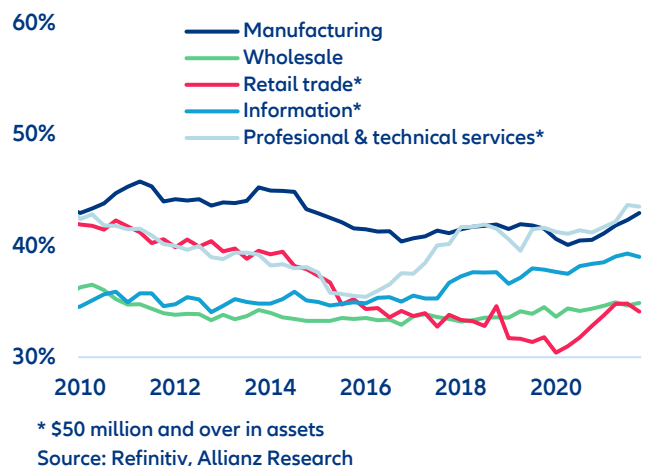


Figure A6: US - Debt service coverage ratio

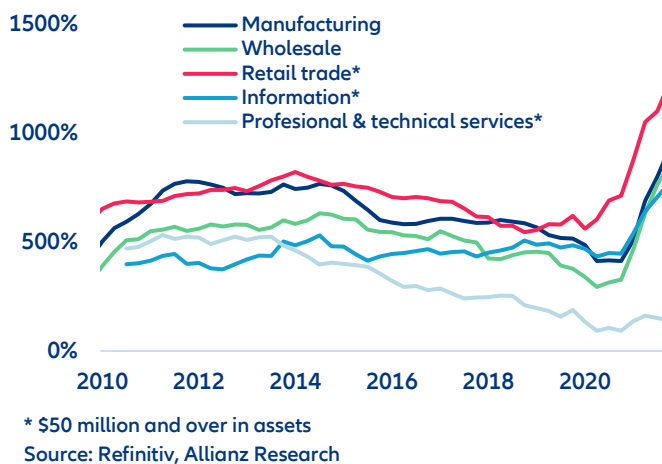


Figure A7: EUR corporate issuance

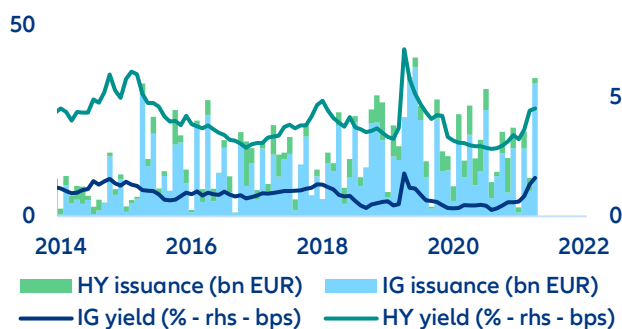


Figure A8: USD corporate issuance

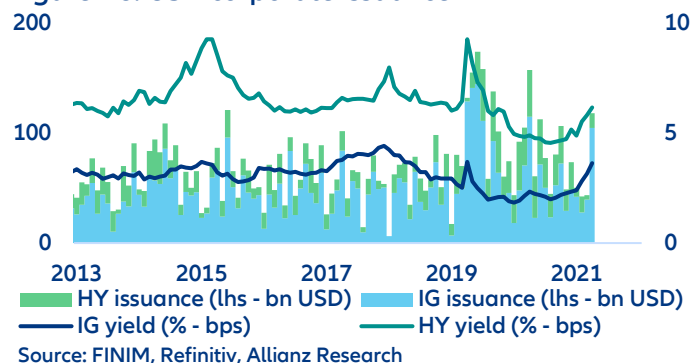


Figure A9: % of ECB-owned IG corporates

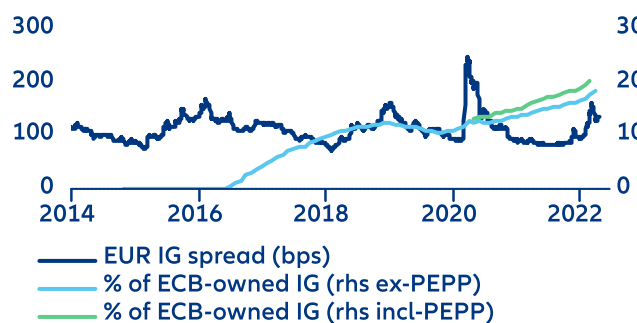


Figure A10: US Corporates vs policy (bps)

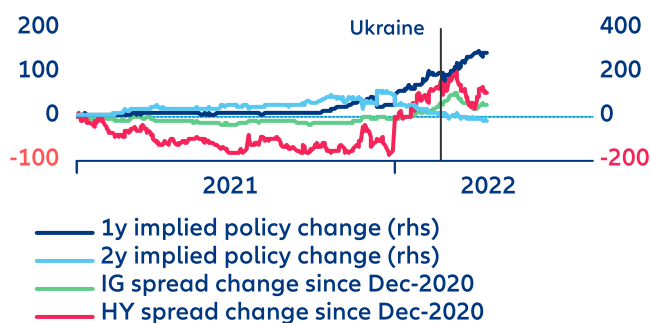


Figure A11: US Margins vs PMI

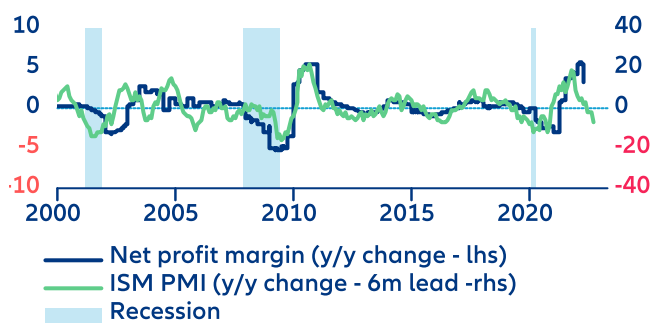


Figure A12: US IG spread vs ISM PMI

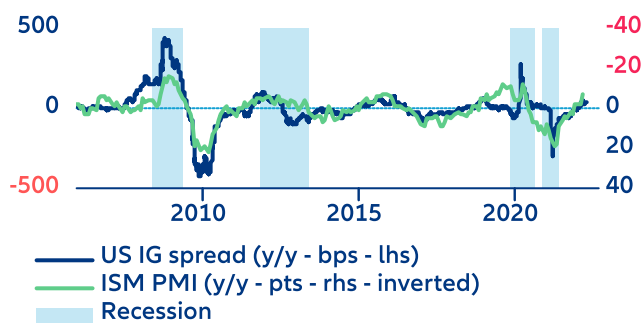
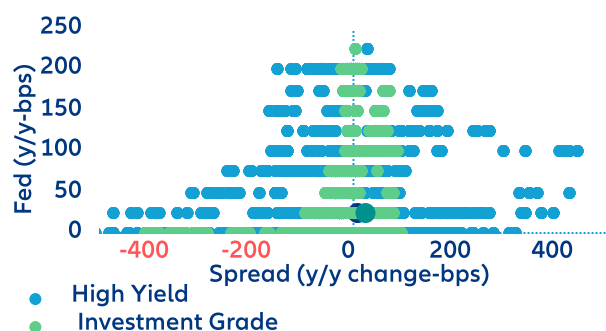
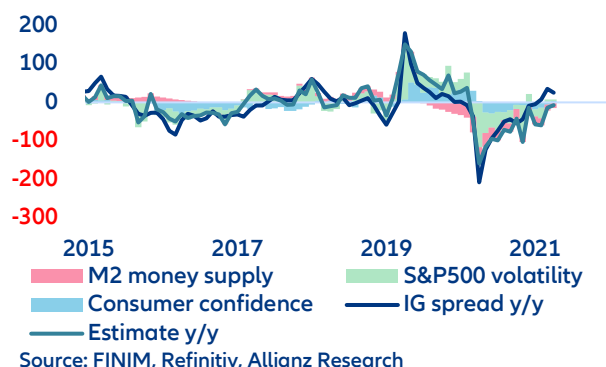


Figure A13: US IG spread vs central bank rate



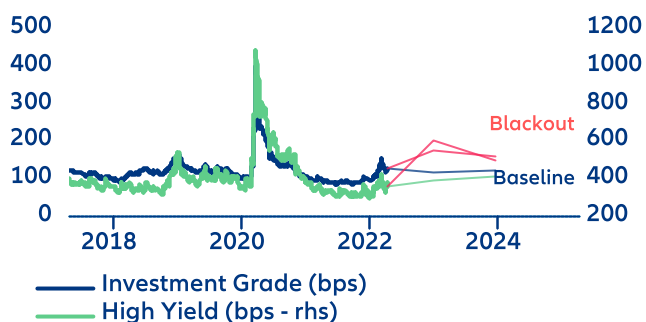
Source: Refinitiv Datastream; Allianz Research

Figure A14: US IG decomposition



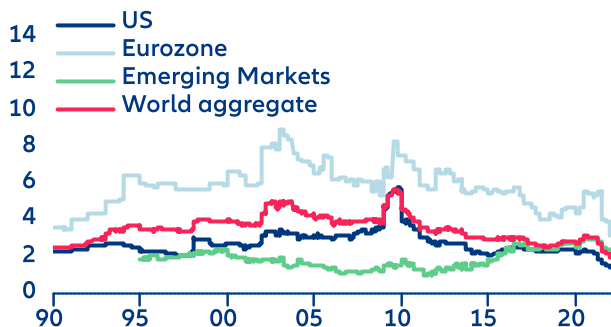
Source: FINIM, Refinitiv, Allianz Research

Figure A15: US Corporate Forecasts



Source: Refinitiv Datastream; Allianz Research

Figure A16: Net leverage ratios



Source: Refinitiv Datastream; Allianz Research

Table A1: Corporate spread forecasts
year-end figures

	Last value (08.04.2022)	Unit		Baseline	Black-out
				2021	2022f 2023f 2022f 2023f
Eurozone					
Investment grade credit spreads	130	bps 98		120 125	180 165
High-yield credit spreads	400	bps 331		400 420	650 525
US					
Investment grade credit spreads	120	bps 98		115 120	175 160
High-yield credit spreads	357	bps 310		390 415	600 500

Source: Refinitiv, Allianz Research

These assessments are, as always, subject to the disclaimer provided below.

FORWARD-LOOKING STATEMENTS

The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.

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