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MONETARY POLICY NORMALISATION: HOW WILL THE PRIMARY FIG BOND MARKET BE IMPACTED IN 2023?

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Monetary policy normalisation: How will the primary FIG bond market be impacted in 2023?

With the new year approaching, Crédit Agricole CIB invited French investors to a roundtable in Paris on 1 December to discuss how 2022 played out and what they expect for the primary FIG market in 2023. What monetary policies can be anticipated and how will they affect market dynamics? How will they position themselves vis-à-vis banks and different parts of the capital stack? And how do they expect green, social and sustainable bonds to develop in light of regulatory developments?

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Julien de Saussure, Senior Credit Portfolio Manager, Edmond de Rothschild Asset Management (EDRAM)

Louis Harreau, Head of Developed Markets Macro & Strategy, Crédit Agricole CIB

Vincent Hoarau, Head of FIG Syndicate, Crédit Agricole CIB, and moderator

Gwenaëlle Lereste, Senior Bank Analyst, Crédit Agricole CIB

Marjolaine Marzouk, Head of Credit Sales France Belgium Luxembourg Switzerland, Crédit Agricole CIB

Vincent Hoarau, Crédit Agricole CIB: What are the origins of the new interest rate and inflation regimes, and are they lasting?

Louis Harreau, Crédit Agricole CIB: We can distinguish three main waves in the historically high inflation rates that we are seeing today. Firstly, there are the persistent effects of the pandemic; production chains have not improved, while consumers continue to massively spend savings accumulated during the pandemic. This imbalance between limited supply and strong demand has led to an upward adjustment in prices that is still ongoing. This first factor is expected to fade in 2023, as production chain constraints ease and consumption should slow.

Then there is clearly the energy crisis, mainly linked to the Russian invasion, but accentuated by other factors, such as the maintenance of nuclear power plants in France and the OPEC strategy. The increase in energy prices has led to an increase in inflation not only directly, on the prices paid by households, but also indirectly, insofar as everything that is produced and sold requires energy and therefore its price is reflected in the increase in costs. Although we do not expect a substantial improvement in energy prices in 2023, the contribution to inflation is expected to decrease slightly, since most of the increase was incurred in 2022.

Finally, there are more structural factors, whose influence on inflation is limited now but could have lasting or even perennial effects. Thus, the consideration of climate change in production processes should irreparably lead to increases in production costs and, therefore, general and permanent price increases. Similarly, the increase in international risks — pandemic and geopolitical risks — could halt the massive process of globalisation that has been observed since the 1990s. Globalisation has had very significant disinflationary effects, so the reversal of this phenomenon could lead to inflationary pressure in the long term.

To conclude on this issue, I would say that part of the inflation we have today is temporary — so that inflation will not remain close to 10% over the long term. It

‘It is unlikely that inflation will return by itself to the levels seen in the 2010s’

Louis Harreau, Crédit Agricole CIB

is expected to fall sharply in 2023. But at the same time, it is undeniable that, since 2020, new sources of structural inflation have emerged; therefore, it is unlikely that inflation will return by itself to the levels seen in the 2010s, i.e. below 2%.

Hoarau, Crédit Agricole CIB: We have been fighting disinflation for a long time, so even if inflation is more persistent now, if it falls back to levels above the 2% target, that would not necessarily be a bad thing.

Harreau, Crédit Agricole CIB: This is precisely the challenge central banks face, with a consensus that inflation will naturally fall back to around 2%. The current phenomena cannot be only solved by central bank rate actions, particularly the impact of energy on inflation. However, it can be contained by a more restrictive and coherent fiscal policy in view of excess savings, which are still too large. The unemployment rate is particularly low and consumption is too high, creating an overheating of the economy and inflationary pressures.

Marjolaine Marzouk, Crédit Agricole CIB: Moreover, Jerome Powell very much insists on the wealth effect’s link to the rises in equity and real estate markets, in which much of US savings are still invested, in conjunction with forced savings during the pandemic, and its impact on the labour market notably through limiting the return to work of older people, which is an inflationary factor for wages.

Harreau, Crédit Agricole CIB: This is one of the post-pandemic phenomena in the US that is accelerating early retirement, given the wealth accumulated by pension funds and very comfortable retirement. As a result, the US labour force has been shrinking, which is an additional factor in reducing the unemployment rate and wage pressures for the remaining active workforce.

Philippe Berthelot, Ostrum Asset Management: On top of inflation and its impact on markets, I would indeed highlight the phenomenon of forced savings accumulation. The figures mentioned are huge, at around $3.5 trillion. It’s what also explains, in my view, the relative resilience of economies, and which has led to a market reaction that is not as dramatic as one might have expected. In terms of the future level of inflation, can we really see it returning to 2%-2.5%? That’s not our scenario, in any case not before 2024 at best. Won’t we return to a world that is slightly or much more inflationary than before? Certainly. After that, we will clearly not continue to see figures of more than 10% over the long term.

Hoarau, Crédit Agricole CIB: In this context, what monetary policy actions can be anticipated for 2023?

Harreau, Crédit Agricole CIB: On interest rates, the two central banks have already gone most of the way: the Fed has already raised its rates by 375bp and the ECB by 200bp. But there is still a long road ahead, which is why we expect both central banks to increase their rates further, by around 100bp by the end of the first quarter of 2023.

> **'We have returned to an environment that should rather benefit banks'**
> **Philippe Berthelot, Ostrum**

The question of quantitative tightening should then become central: the Fed has already begun — very gradually — the reduction of its balance sheet since mid-2022, while the ECB has only just started, with the first TLTRO repayments, and has already announced that it will discuss the terms of its QT at its December meeting.

In conclusion, until the first quarter of 2023, central banks will continue their rapid tightening through rate hikes. Thereafter, monetary tightening will take place mainly through balance sheet reductions.

Hervé Boiral, Amundi: Can the ECB really continue to raise interest rates when we are in a recession? Can we imagine that central banks, particularly in Europe, be guided not only by their inflation mandate but also by the growth rate, as is the case in the US? I understand that from a political perspective, it is complicated.

Harreau, Crédit Agricole CIB: It's all in the posture. For some central bankers, including Powell and Isabel Schnabel, recession is necessary. There is a real desire to break the economy in order to reduce wage pressures. But it is clear that it is easier to say this when you are not yet in a recession. However, there is a real risk of monetary policy mistakes, particularly in Europe, since we should enter a recession when the ECB will have probably raised its rates to the maximum, with a real risk of having gone too far.

At the end of Q1, rates will therefore be at their maximum, banks will be less willing to provide liquidity — we will have reduced the excess liquidity by a trillion — and TLTROs will reach maturity. So we will have a significant tightening in liquidity. Also bear in mind that the ECB will discuss its QT in December. In summary, we would return to a recession when the ECB has tightened all the levers of its monetary policy.

Boiral, Amundi: And fiscal and budgetary policies in this context?

Harreau, Crédit Agricole CIB: Indeed, we are also at a time when monetary and fiscal policies are not coordinated. This is one of the first times in recent economic history where central banks are pushing the emergency brakes while fiscal policies are ultra-expansive, seeking to protect the consumer. This may lead central banks to be even more aggressive.

Hoarau, Crédit Agricole CIB: The rise in rates in 2022 had a very violent impact on credit. At Ostrum, what was your positioning on the banking sector in 2022?

Berthelot, Ostrum: We were very constructive on the banking sector, certainly overweighting banks a little too soon. Credit spreads are not really behind portfolios' underperformance in terms of total return. It was above all the rise in rates that hit us hard. We anticipated the end of the CSPP, but we all underestimated the widening of swap spreads, which punished financials more than corporates. However, we have returned to an environment that should rather benefit banks, with an anticipated narrowing of swap spreads and the further rise in interest rates.

Boiral, Amundi: I agree, and I would again emphasise that what did the damage was the widening of swap spreads, from 40bp at the start of the year to 110bp in mid-September, which was very painful. This affected all asset classes and no one had protected against such a widening.

Marzouk, Crédit Agricole CIB: Given the level of rate volatility and repricing, 2022 has been a challenging year to navigate with clients. Portfolio performance has in some cases been historically disappointing. We have witnessed outflows, but they have been more limited than what we could have feared. This is due to the lack of alternatives in other risky asset classes, such as equities, real estate, emerging markets or private equities, also depressed by the start of the quantitative tightening. Very often, the repricing in credit offered interesting entry points on the back of inflows in favour of fixed income instruments.

What was notable this year were some clear yet cautious and opportunistic approaches reflecting the fragmentation of the credit market, marked by trends towards quality and liquidity in the primary and secondary markets. Very often we observed differentiation based on jurisdictions, issuers and their frequency of issuance. We saw more and more stock-picking and relative value games on the curve, while investors are looking to generate alpha to achieve performance. Expertise and experience often made the difference again in such markets.

Julien de Saussure, EDRAM: On the swap spread, we must thank Louis for the quality of his analyses, which had raised the prospect of reverse tiering and its impact on swap spread widening. He was the first to put his finger on this and one of the few to mention technical solutions that would not lead to swap spread widening. Moreover, his analyses coincided with the timing of the tightening of swap spreads, even though his proposed solutions were not chosen. I think there was a little bit of misunderstanding in the market about this.

Berthelot, Ostrum: The lack of high quality collateral was the catalyst for the major widening of swap spreads.

'The balance of power between issuers and investors is more even'
Vincent Hoarau, Crédit Agricole CIB

Hoarau, Crédit Agricole CIB: Julien, at EDRAM, in view of the positioning of your bank funds, what was the nature of the shocks?

De Saussure, EDRAM: Our managers reduced all exposure to financials in February, mainly due to extension risk considerations. They reduced subordinated financials, corporate hybrid perpetual debt, etc on the basis of spread widening that would lead to extension risk and therefore a negative total return. Afterwards, we tried to cushion the rise in rates by limiting duration and being tactically or structurally protected in terms of duration. Now we are arriving at a moment when we can say that we have made significant progress and we want to be more neutral or even hold long dated positions. However, we can see that there is a predominance of tactics over strategy in this market, and that views change rapidly.

Christophe Auvity, BNP Paribas Asset Management: For us, things have been similar. This is what we call a consensus position. The same problems were clearly seen with the end of the CSPP, which was meant to hit corporates more than financials, particularly with the risks to growth, and ultimately we saw that it was the swap spread that was underestimated this year and which punished financials more.

To come back to what Julien said, we also underestimated the strength of the beta elements in financials due in particular to our positioning on the capital structure. As a result, with subordinated securities giving beta to the asset class, in a negative market performances were poor.

Boiral, Amundi: Paradoxically, if we look at spread widening on a percentage basis, AT1 subordinated securities held up very well. By holding good subordinated debt, AT1s, and a lot of cash, you did much better than the others.

Hoarau, Crédit Agricole CIB: We recently had very encouraging inflation figures in the US and a very strong rally on credit. Is the worst behind us on credit?

Auvity, BNPP AM: Before we answer the question, I would like to remind you that we find ourselves in exactly the same configuration as in the summer of 2022, and we then had Jackson Hole, which cooled things down in the autumn, so be careful. Looking at spreads, we find ourselves at the same level as the lows we reached in mid-August.

Hoarau, Crédit Agricole CIB: We are nevertheless much further along in the rate hike cycle.

Auvity, BNPP AM: Yes. And inflation is now less strong, it is more structural and, because of the base effect, a mechanical effect is removing a lot of pressure. Recession is coming, and it will have to be navigated. Yes, that's what changed from last time. This summer, the market was far too optimistic on the pivot, but we can see that this is a very strong theme and a major driver on credit and credit valuation.

Yes, from this perspective, I am much more optimistic. But then my optimism is tempered by the rapidity of the rally. The question is then rather, is the bulk of the repricing behind us? I am constructive. 2023 will be a very good year compared to 2022. Certainly a year of carry more than performance in terms of credit spread.

De Saussure, EDRAM: I have a similar view here. To paraphrase Beckett: "Waiting for Pivot." I think the summer episode has been painful for many investors. Now secondary levels have tightened, but NIPs did not really move in November. We are currently seeing that supply on the primary market is increasing even if premium levels remaining relatively high. In July and August, the premium that appeared vanished rapidly. This doesn't say anything about the direction of spreads, but issuers are a bit more cautious now. This is a positive change. Which makes me say that this rally is perhaps a little more virtuous. US CPI levels released in December are going to be instrumental. They will give much insight into the state of the rate cycle and valuation prospects for 2023. They should set the market on a good course over the cycle of rate hikes and therefore valuations for 2023. But there is so much hedging and gamma in the market that if there is disappointment, it could have a negative effect. We were burnt once, so we are approaching the moment with great caution.

Hoarau, Crédit Agricole CIB: To expand on Julien's remark on the level of new issue premiums, I think we are in a market where the balance of power between issuers and investors is more even and I hope it is more virtuous. Volatility will remain high in the coming months and a lasting consensus can be established on the primary market after a decade where the issuer has almost always had control.

Berthelot, Ostrum: After an annus horribilis, we will have an annus mirabilis. We expect 2023 to be a good year for fixed income, including credit. But be careful when it comes to entry points. 2023 will not be a straight line. In the US, this is marked and we are coming to the end of the Fed's hiking cycle, with

Q1 marking the end. In Europe, with the ECB, that's where we will have more questions. Will it stop at 2.5% or go up to 3%? The end of the cycle will be in Q2 2023, this is our projection. Will the ECB achieve this in view of the economic outlook? In any case, the deciphering of Q1 2023 in Europe will be exciting. We can be amazed by the resilience of European economies, particularly in Italy, Spain and Germany. We expected Q3 2022 to be down and it was revised upwards. In terms of credit, we do not see the default rate exploding. This reassures us, in contrast to what many strategists say. Now to explain what has just happened and confirm what Christophe said, the catalyst for the rally is objectively the recent US CPI prints, for which everyone feels that we have come close to the peak. This had already started this summer, but core CPI continued to rise. Today, this seems to be less the case. Europe is the same, then, with a certain lag. Now there are many unknown quantities. The short base on the crossover was monstrous. Is it the neutralisation of short covering for year-end where everyone wants to be neutral and no longer have very strong active positions? Are we in a bear market rally? This was the question of the summer. This is currently a real internal debate within our teams. Has the rally not been too fast, too strong? However, we also think there will be carry in 2023 and some capital gains. But be careful when it comes to entry points. We want to emphasise that because it will be chaotic. However, on US IG we can afford to put our foot down a little, but I am not sure that being immediately overweight Euro IG credit at the beginning of the year is the best thing to do. There is still this rate sensitivity, which is very high. At Ostrum, we will be underweight in euro credit IG until we see the end of the rate hike cycle in Europe. And for the moment, we're far from it. For me, the visibility on the US market is quite high. On the European market, this will be a bit more complicated.

Boiral, Amundi: I am not concerned about credit. What scares me is the primary market supply and the potential avalanche of new issues. €200bn in government debt in 2022. This number is expected to rise to €400bn in 2023. I am very afraid of potential indigestion. If at some point we see that there are difficulties in government debt, there will be a communicating vessels effect and everything will spill over through other asset classes. The big question is, therefore, whether the market can absorb €600bn-€700bn in SSA issues over two years, 2022-2023.

De Saussure, EDRAM: Moreover, in the government debt market, we had a test in the Gilt market. What Louis said about the opposition between monetary and fiscal policies was illustrated in the UK. It is easy for Germany to counteract from a budgetary perspective; it is not as easy for other countries.

Berthelot, Ostrum: I agree with Hervé. The risk of indigestion due to this amplification of sovereign debt issues will in any case have an impact on credit.

Marzouk, Crédit Agricole CIB: I quite agree, and we have already seen this reweighting in favour of rates and against credit on the part of some aggregate funds and insurers. So, given this rather short positioning on credit versus rates, we could expect a repositioning in favour of credit, even if that's more in the medium than the short term — the market will remain volatile and it's surely still too early to be overweight credit.

Boiral, Amundi: Captain Obvious: It's no use putting on carry trades in credit if rates are meanwhile increasing another 100bp or 200bp.

> **'What scares me is the primary market supply and the potential avalanche of new issues'**
>
> **Hervé Boiral, Amundi**

Hoarau, Crédit Agricole CIB: The excess supply on the primary market can be a negative factor and contribute to spread widening. What are our forecasts for new issue volumes for financials in 2023?

Cécile Bidet, Crédit Agricole CIB: For 2023, we estimate that volumes issued by European banks will be relatively stable compared to 2022, with different trends depending on the instrument.

Covered bond volumes have already doubled in 2022, with France and Germany at record levels above €40bn, partly due to the repayment of the TLTRO but also because loan production was very high in 2022. Canadian banks were also very active in replacing their central bank funding, but this also followed a review of deposit flow models (in anticipation of a decline in deposits). In 2023, some countries such as Spain and Italy will be more present (Italy as soon as banks are able to issue technically, probably at the end of Q1). With the significant repayment of the TLTRO, the covered bond will once again become the cheapest financing tool for banks, which will keep issuance at around €200bn in 2023.

On senior non-preferred, issuance is expected to be basically stable in 2023. All the major banks are already well positioned on TLAC and MREL levels, so it will be about refinancing upcoming maturities. Some medium-sized banks are not yet at their MREL requirements, but the amounts remaining to be issued are marginal on a global scale and a number of banks that do not have subordinated MREL requirements will be able to issue senior preferred.

AT1/Tier 2 subordinated debt volumes will fall significantly. Banks are relatively well optimised in terms of capital structure, so there is no deficit to be filled, and the amount of instruments reaching their first call date is low (around €15bn in the next 18 months). For Tier 2, we will move from €35bn equivalent issued in 2022 (USD, GBP and EUR) to less than €30bn in 2022. Uncertainty over the evolution of risk-weighted assets remains. For now, credit deterioration is low. If it were to increase, it could lead to an increase in risk-weighted assets, but this would be moderated by a decline in loan production and banks' activity. Non-calls are not expected to have a major impact on issuance volumes, with Sabadell remaining anecdotal from a market perspective.

Finally, senior preferred will be the adjustment variable and its volumes should increase by 10% in 2023. Volumes will depend on the speed of deposit reduction. For example, in France, the Livret A will necessarily impact the level of deposits with the expected revaluation. In the other "core European" countries, we see only the beginnings of this. We are seeing fierce competition between banks to keep deposits with high levels of remuneration, particularly in Italy, where the dependence on TLTRO remains high.

Gwenaëlle Lereste, Crédit Agricole CIB: We see the risk of refinancing TLTRO into senior preferred bonds as limited in 2023 — with the biggest repayment in June 2023, banks used it for arbitrage, as shown by the amount deposited at the ECB. Most European banks have already anticipated the TLTRO impact in their 2022 funding needs. The partial replacement of TLTRO with market-based funding is gradual, firstly through covered bonds.

Bidet, Crédit Agricole CIB: Diversification will be another characteristic, as some issuers are conscious of reaching saturation levels among some investors and are looking to diversify into different currencies. They are also thinking more about private placements to reach different pockets of investors. There is a very strong diversification effort.

'We see the risk of refinancing TLTRO into senior preferred bonds as limited in 2023'
Gwenaëlle Lereste, Crédit Agricole CIB

Hoarau, Crédit Agricole CIB: How do the dynamics of the ECB purchase programmes impact valuations on the different asset classes?

Harreau, Crédit Agricole CIB: We will know more about this in December, but the ECB will have to fine-tune its QT. I think that the ECB's aim now is to tighten swap spreads and free up safe and high quality securities. So non-reinvestments in the public sector will be a priority over the course of 2023. This could create a shock to the fixed income market, because it is the first time since 2014 that the ECB will not buy more sovereign debt than what is issued in net terms. For the first time, you will have an ECB that divests and will buy as little German sovereign debt as possible. The ECB's attitude towards private assets will be even more interesting. We are seeing an ECB that has been greening its CSPP since October 2022. If it stops reinvesting CSPP from March 2023, this means that the major greening policy of its balance sheet lasted six months and represented only around €20bn. So I think that for reasons of credibility and image, the ECB cannot stop its CSPP, because it wants to green its balance sheet. So in this respect, I think reinvestments in corporates will continue during 2023. On covered bonds — if I were the ECB — I think I would keep a small pocket to potentially reinvest in covered bonds. In 2014, the ECB reduced the incentive for banks to issue large amounts of covered bonds by offering the TLTROs, while at the same time buying covered bonds on the primary and secondary markets and reducing the free float. In 2023, it will be the reverse effect: the ECB is stopping TLTROs, encouraging banks to issue covered bonds, and at the same time, it is making net negative purchases of covered bonds. So for me, this is really the challenge of the ECB meeting in December: how to tighten monetary policy without suffering the collateral effects of the widening of corporate spreads, the end of the greening of the ECB's monetary policy, and the destruction of the refinancing capacity of the banking sector? Reducing its QE by sovereign bonds and keeping some room for manoeuvre to invest in corporate bonds and covered bonds is my bet regarding the ECB's attitude in the coming months.

Hoarau, Crédit Agricole CIB: The normalisation of monetary policies is synonymous with a reduction in liquidity. What is the buyside approach?

Berthelot, Ostrum: At Ostrum, we have long been following the "Liquidity Cost Scores" from Barclays' quant analysts, which is an independent means of measuring liquidity on the euro IG, high yield, emerging and convertible bond markets. This measure of average bid-ask spreads has only increased since the beginning of the year, it has almost doubled, with the worst level reached just before the announcement of the US CPI in mid-October. The indicator showed almost crisis levels. This has been much better in the last five weeks. However, we are still at relatively tight levels of liquidity. We are still challenging the salespeople at our preferred dealers on bid-ask spreads,

'Many banks have already seized the November 2022 window to pre-fund themselves'
Cécile Bidet, Crédit Agricole CIB

and I think that the maintenance of inventories at low levels was due to it being hazardous for them to correctly hedge their books when rates volatility was so high. The credit market is the market that was the most volatile in the past year — in contrast to the equity market, which was strangely banal.

Will this be better next year? Good question. For the highest beta buckets, we tended to raise the level of liquidity to face potential outflows or capture opportunities in the primary market. It is true that liquidity is not what we would expect. We can have great active management ideas, but if we can't implement these on the secondary market — the primary market is necessary, but not sufficient — that will lead to less generation of alpha. For me, the issue of secondary liquidity is critical.

Hoarau, Crédit Agricole CIB: Cécile, how will issuers adjust regarding their funding plans in 2023?

Bidet, Crédit Agricole CIB: In addition to currency diversification, banks will have a particular sequencing in 2023. Many have already seized the November 2022 window to pre-fund themselves, anticipating significant activity in January and uncertain conditions. As a result, it is likely that banks with lower needs will realise less than 60%-70% of their funding plans by the end of June. They are anticipating that it will be easier to meet a portion of their financing in H2, where visibility is expected to be better. We can also see that months like November are entirely actionable, as evidenced by the volumes issued during that month this year.

Hoarau, Crédit Agricole CIB: Julien, where do you see value on the capital structure in 2023?

De Saussure, EDRAM: I manage a subordinated bank fund, so I have a rather natural tropism for subordinated bank debt — I can be anywhere across the capital structure, but doing senior debt is extremely dilutive for us. The rise in rates and spreads as well as the maintenance of the NIP are now changing the game a little. We also now have more of a bias towards second tier banks than towards national champions. Then we must pay attention because the level of progress in MREL programmes is not the same everywhere. There are many senior issues aimed at fulfilling MREL targets because these banks do not have high subordinated MREL targets, and there, we consider there to be value. This tropism for subordination means that we focus more on spreads than on rates. We have the impression that rates will be favourable next year, but we are not certain, so I find these instruments that are practically only spread with a very short duration very interesting. We'd had a 0% bucket in senior debt, so we increased it to 3%-4% on opportunities that give us either very short term high yield or more rates, with the impression that the product is more sensitive to interest rates, not like a Tier 2 or Tier 1. I am looking very closely at the senior portion. We were talking about covered bonds a little earlier. It is true that the senior preferred tranche is both an adjustment variable in terms of volumes and also more efficient in NSFR than covered bonds in the funding plan. Ultimately, the instrument can be used to tick an MREL box for quite a few issuers. So the preferred senior ticks a lot of boxes in this case. Issuers use it extensively and we see a lot of preferred senior private placements in structured format. The marginal attractiveness can be a cushion on the widening that would be expected of covered spreads because you have other transmission channels.

The AT1 segment for yield reasons still seems attractive, also because of having suffered from the rise in rates, while spreads held up well. It is also important to see whether we look at the instruments on their first call date or to perpetuity. In fact, the bulk of the losses on AT1s is a function of repricing to perpetuity, and we are currently reflated, with AT1s with high coupons and spreads. Indeed, there is a pool of positive convexity in AT1s, which is extremely interesting because there are many instruments that are priced to perpetuity. For me, this does not mean that the instrument will not be redeemed. This means that we would not need much spread tightening to make the reverse movement, repricing to the first call date. And we have seen that in recent weeks. We have no natural appetite for low reset instruments, but I know that in line with market practice these instruments will perform the most if spreads tighten — except that we consider these instruments to be mispriced at the outset. In concrete terms, credit curves are not really readjusted. Most people work on the assumption of a linearity between the back-end differential and the yield to call. In fact, this function is not at all linear. 100bp of back-end is not the same when the option is in the money as when it is out of the money. So we consider that low resets are badly priced, but we still play them because we know that it is this segment that can perform well. So I just put a little nuance on what the market calls convexity because prices are low. There are instruments with low cash prices and I bet you they are not going to be called through

a cycle. The aim for us is rather to take advantage of the directionality of the market. I think that spreads will tighten, so I want instruments that can benefit from this gamma and at the same time we want instruments that are correctly priced. This is why our preferences tend to move towards instruments that are slightly out of the money and can adjust more easily. That is it for AT1s.

Regarding Tier 2 call policies, we believe that this is where the market suffered the biggest disappointment, as the assumption regarding Tier 2 was that the instrument would be redeemed at call date because there is a regulatory amortisation mechanism. This is exactly the same principle as for Deutsche Bank's step-up Tier 2 in 2008. The existence of a step-up means that when the instrument is issued, the call option is already in the money. This turned into a call expectation, but we saw very well that that's not how it works. So we make the true mathematical calculation and we continue to believe that many issuers with a lot of Tier 2 and many points on the curve will adopt an attitude through the cycle and will still reimburse in advance. Then there are smaller issuers that have only one point on the curve and poorly refinancing their Tier 2s could have a significant impact on their profitability. Unfortunately, the game is a bit more uncertain: the world is divided into two categories, there are good and bad issuers, but I can't tell you where the border is. It is true that we tend to have a constructive attitude on callable Tier 2 for low beta issuers. For smaller issuers, you have to do the maths. All of this also has an impact on issuance volumes: if there are no refinancing needs, there are no new issues, hence an impact on issuance forecasts. In Tier 1, primary offering means refinancing needs. In Tier 2, it is less obvious, because there is this amortisation mechanism and therefore this intrinsic need to come back to primary. We have the example of Eurobank. They offset the loss in amortisation of Tier 2 held by the government. So they need to issue again. And we have also seen it in the IFIS and possibly BCP exchange offers. There is a need to reissue to offset this loss related

'At the moment, we like the extremes'

Christophe Auvity, BNP Paribas Asset Management

to depreciation. On high beta Tier 2, we really need to link the considerations to the credit history. Pricing for a low beta Tier 2 is a consideration of market beta. It was issued at a time when the market was tight. Spreads widened and the instrument is no longer in the money. For a high beta Tier 2, if you believe in the history and business plan of the bank, potentially the call will be in the money simply because the bank has delivered on its business plan. This was also our conviction on Greek banks, but we were caught up by the market.

Hoarau, Crédit Agricole CIB: Christophe, from senior preferred to AT1, where do you see the most value?

Auvity, BNPP AM: For us, investing involves a balanced portfolio that meets specific objectives or themes. What are the reasons we buy? For example, before 2022 we didn't give much consideration to covered bonds. Now there is a real swap spread theme; we buy covered bonds and it's a good positioning. Of course, we are going to look at who we buy, what issuance is expected, etc, but there is a major theme that consists of capturing the value of swap spreads and the instrument corresponds to this need. If I look at extremes and Tier 1s, on the other side, this asset class is not at the core of our investment universe. It's off-benchmark, it's high yield, many investors don't want this equity/bond relationship. AT1 is therefore a very specific animal. We look at AT1s as a niche product. But we will look at it in relative value terms in the market compared to corporate high yield, so there are many things to consider, above all at the extremes. And then there is more the core of our investments, I mean SNP and Tier 2, even if we have a rating issue with Tier 2, particularly for those that are non-IG and therefore cost us much more in terms of risk. In summary, at the moment, we like the extremes, covered bonds due to swap spreads, and AT1 for reasons of absolute return but also beta with an attractive valuation versus pure high yield.

Berthelot, Ostrum: I share this view. AT1 was 10% at the beginning of the year on our HY funds, nothing before the summer, and we now have 20% in this bucket even though many people think that the AT1 has no place in HY buckets. We think that it does and we accelerated investments there when we passed above 9% in coupon terms. Now we will have to be very vigilant and wait to see what is happening, because here, too, the performance has been very strong in recent weeks. In terms of topics, non-call is not a systemic risk — the market is mature, so I don't worry. Covered bonds are interesting in taking advantage of swap spreads. After this is the topic of SNP versus Tier 2, particularly for low beta issuers. However, Tier 2s have been on the rise this year. In short, there is interest in the entire capital structure. We look at our regulatory constraints, covered bonds versus senior preferred, SNP versus Tier 2. I like SNP. The AT1 will remain limited in our universe given that it belongs to the HY class and therefore is subject to our limitations in terms of rating and investment guidelines.

Boiral, Amundi: Very clearly, I see interest in the primary market on Tier 2. There is a lot of value on 10NC5s given absolute spread levels, which remain historically high despite the recent decline. The probability that the instruments will be redeemed at first call date is extremely high overall. If this also allows us to exit some Tier 2s with extremely low resets, I see a lot of interest there. I need Tier 2 with reset levels adapted to the current market situation. On the other hand, we will not follow syndicate managers on back-end adjustments and new primary issues adjusted to reset differentials. In any case, not in Tier 2. Some investors are complacent about this; we are not.

Hoarau, Crédit Agricole CIB: Over the past few years, we have seen significant enthusiasm for ESG issuance formats. The underlying trend is very powerful. How are investment strategies and programmes evolving?

Berthelot, Ostrum: The momentum is huge, with a target for 90% of our funds to be SRI-labelled. A quarter of 2022 corporate new issues have been green, which is huge. The topic of the "greenium" is becoming less prominent given the change in its relative value compared to changes in rates and spreads in absolute terms. The greenium is becoming marginal, and as I always say: virtue can come at a cost. We do not have enough social bonds in corporates — we have a lot of them in agencies — so there is still a strong need. The greening of our financial market is imperative because of climate issues, and I like that. Stopping financing fossil fuels is the done thing. We discuss this with our clients and are intellectually honest in saying that the restriction of the investment universe can lead to lower returns. Not doing oil and gas this year was costly, for example — I'm afraid to say that it was one of the best performing sectors. We assume this cost us a few bps — but that's how it is. Virtue comes at a cost, but it is a trend whose momentum will only grow. We are learning to have this ethos in finance.

I would also like to add that there is a lack of a European label. Then, our preferences within sub-asset classes could be based on whether the instrument is positioned as SRI-labelled or not (i.e. versus SFDR Article 8). As long as the work is done well — and I would like to remind you that it's self-certified, Article 8 or 9 — everything is all right with us. We have dedicated teams. It is necessary to have technical skills and expertise, and we have people who are specialised in ESG strategies. We want to be able to demonstrate at all times that the extra-financial score of the labelled portfolio (and/or Article 8) is higher than that of the investment universe. Indicators such as carbon density and sustainable investments are particularly important even if there is not yet a common definition on a large scale.

As I always say: virtue can come at a cost

What issuers must be reminded of is not to lie. Put a price on it, but not too much, because we also have targets for returns and alpha that must be respected for our clients. It is good to be green, but we cannot forget this element linked to financial performance. I personally believe that many large institutional clients will be more driven by extra-financial performance in the next three to five years than with the purely financial aspect. This dimension is extremely important and green issues are always welcome as long as they fit within a coherent framework. It is the use-of-proceeds that investors and their analysts will look at very closely.

'I have no marginal interest in buying green bonds; it is only the issuer's rating that counts'

Julien de Saussure, EDRAM

Bidet, Crédit Agricole CIB: Banks are starting to publish sector targets, which will make analysts' work easier.

De Saussure, EDRAM: I have a slightly different view. I also manage an SRI-labelled fund that is cross-asset credit, but which works by exclusion, with the methodology that was validated with certificate 1. In this context, I have no marginal interest in buying green bonds; it is only the issuer's rating that counts. And for me, it's an aberration to force exclusion in a bond portfolio. My equity colleagues have portfolios with 30 names. Applying exclusion when we have 200 lines in a bond portfolio becomes very complicated. As long as we are unable to force the creation of a marginal profit in buying a green bond format, SLB or whatever it may be, in my opinion we will not move forward.

But generally I like green Tier 2s, because ex-post I see that they are instruments that are always performing better. They capture a particular demand, and I can always understand the adjusted risk.

Berthelot, Ostrum: If I can be semantic, bear in mind that, to date, the French SRI label does not give any benefit for having sustainable bonds, but note that from 1 January 2023, with the PAI reporting required in relation to funds, what you have in terms of carbon footprint, in green, social, SLB, etc will be visible. You will have clients who will ask you for

'We are strengthening our presence on the secondary credit market'
Marjolaine Marzouk, Crédit Agricole CIB

a minimum of x percent of your fund, and even if the label has not required it so far, its evolution and the SFDR level 2 will lead to a growing alignment to being even more virtuous.

De Saussure, EDRAM: OK, but there is also a debate between use-of-proceeds and KPIs. While the ECB's objective is to green the economy, there are many sectors that will not be able to do use-of-proceeds, many service companies, for example. In concrete terms, property companies, banks and utilities have a competitive advantage. Then if we go on SLB-type structures, this still has consequences for the tranches of capital, because for me SLB is not compatible with capital because of the step-up issues, and we have already had quite similar lengthy debates on green AT1s. So we create a huge competitive advantage for banks. Finally, there is another element: the greenium is based on an element of scarcity, and there is a marginal buyer, which is the ECB. Now if we have EU NG arriving in green format, perhaps we are solving the problem, but in the other direction!

Hoarau, Crédit Agricole CIB: It's only a matter of time!

Boiral, Amundi: I think that the current development is rather that of a market that is segmenting. We have green themes with green funds that invest in green bonds, these are clearly and perfectly identified, the client knows what they are buying and what they can do without. For the rest, we have ESG funds that are often created based on our own methods and in which we can put green, SLB, basically what we want according to our dedicated methods. Both are completely different, but investors know what they are buying.

De Saussure, EDRAM: Just to finish on ESG issues, I would like to talk about insurers as investors, which I think is also a topic. On the asset side, this type of investor is not ready to pay a greenium — big insurers can source green assets elsewhere. But smaller insurers that don't have the scope to source green real assets will try to reach their target by buying green bonds.

Hoarau, Crédit Agricole CIB: It is also important to bear in mind when considering the valuation of green issues versus conventional issues that on the secondary market, market-makers will always have less inclination to short green bonds. As a result, green curves are generally tighter and less volatile.

Cécile, on the regulatory side, what are the main challenges for 2023?

Bidet, Crédit Agricole CIB: I see four major regulatory areas that will impact 2023.

The finalisation of Basel 3, in Europe CRR III/CRD VI, with divergent views between the European Council and the European Parliament (level of application of the output floor, transition period, ESG risks and their inclusion in risk-weighted assets). This will have an upward impact on capital requirements and may change the business models of certain banks.

The macro-prudential review of the regulatory framework for additional buffers (the possibility of a neutral counter-cyclical at a positive level of 2%, review of G-SII and O-SII buffers). Capital requirements could increase but are likely to remain modest, with some measures counterbalancing others.

The review of CMDI (Crisis Management & Deposit Insurance). The main objective is to find a solution to the resolution of medium-sized banks and make the contribution of the Deposit Guarantee Scheme (DGS) easier. The introduction of a European preference for deposits (which would become senior to senior preferred) and the contribution from DGS to make up for the difference with TLOF's 8%.

Finally, the treatment of ESG risks in the prudential framework. The ECB already takes into account certain ESG risks in the calibration of 2R and 2G pillars, but the European Parliament's proposal that would apply a weighting of 1250% for new exposures to fossil resources could have a material impact on banks' activity.

Hoarau, Crédit Agricole CIB: What are the challenges and objectives for CACIB sales in 2023?

Marzouk, Crédit Agricole CIB: Proactively marketing our primary market transactions. Putting at issuers' disposal our distribution platform to facilitate market access. Roadshows, speed-dating and conference in partnership with our DCM and syndicate colleagues. We are strengthening our presence on the secondary credit market. This is also a strategic focus to serve better our investor clients. The alignment of the primary and secondary market franchise is essential for the further development of our commercial offering. We continue to join forces with research analysts and sustainable bankers, as well organising similar events as the one today. In sum, further demonstrating the full alignment of our credit chain is a top priority. ●

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