Looking to European high yield

Jonathan Butler explores the five factors supporting an allocation to European high yield

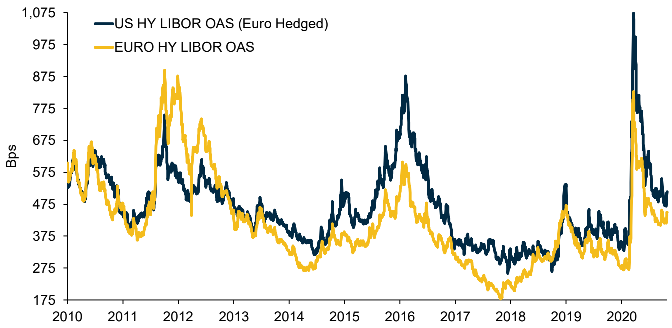
In a region inundated with negative-yielding government debt and an uncertain growth outlook, European investors face the challenge of generating positive real returns in the coming years. While European high yield credit spreads widened less than those in the US during the height of the virus-induced volatility given less stress and lower exposure to Covid-related industries, they have also lagged during the recovery since then. As such, we believe the potential for further spread compression and lower default loss expectations make European high yield particularly attractive.

The following five factors of the Euro high-yield market support the potential for attractive risk-adjusted returns for long-term investors:

1 Low default rates
2 Higher-quality high yield
3 Robust eurozone policy response
4 Less exposure to Covid-sensitive sectors
5 Rewarding environment for fundamental analysis

As one weighs these factors, consider that Figure 1 shows European high yield spreads (unhedged) recently traded slightly more than 10 per cent inside of US high yield spreads (hedged to euros).

Figure 1: Euro HY OAS Trade Just Inside U.S. HY (EUR Hedged)



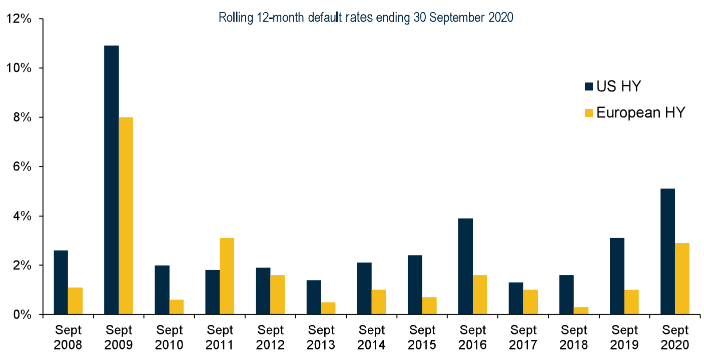
Source: ICE BofA Merrill Lynch as of 30 October 2020. Past performance is not a guarantee or a reliable indicator of future results.

1 Low default rates

European corporate bonds have historically experienced relatively low default rates, a trend we expect to continue in the coming years. Over the next 12 months, we expect default rates of 2 per cent and 6 per cent in Europe and the US respectively.[1] The stark difference is partially driven by the European market's limited exposure to highly-cyclical industries – including energy, gaming, lodging, and leisure – that account for more than 55 per cent of US high yield defaults in 2020.[2]

In addition, most issuer refinancing requirements don't increase until 2023, providing time for a euro area economic recovery to take hold. In the coming quarters, European defaults may tick higher from current levels and US defaults are likely to trend lower, yet our base case – bolstered by a recent bottom-up default analysis – is for European defaults to remain well below 3 per cent over the next 24 months.

Figure 2: European issuer default rate is historically lower than US rate



Source: PGIM Fixed Income, Credit Suisse. Past performance is not a guarantee or a reliable indicator of future results.

2 Higher-quality high yield

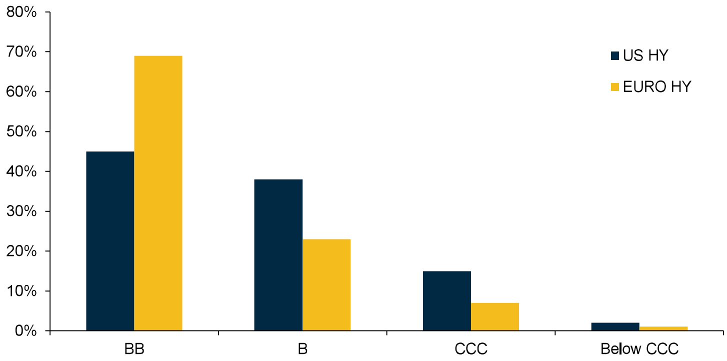
The Euro high-yield market has a greater percentage of 'higher-quality' high yield debt with 69 per cent of issuers rated BB vs. 45 per cent in the US market (Figure 3). These higher credit ratings are partly driven by stronger fundamental metrics, such as lower average leverage and higher interest coverage ratios. At the other end of the ratings spectrum, 8 per cent of the Euro high-yield market is rated CCC and below, compared to 17 per cent for US high yield.

3 Robust policy response

The European Central Bank, the European Commission, and the eurozone governments have responded to the global pandemic and ensuing recession with comprehensive, unprecedented stimulus programmes, which are directly and indirectly benefitting European high-yield companies. Importantly, state lending is ensuring liquidity to most businesses, subject to certain criteria, which will assist in keeping defaults lower than typically anticipated during a broad recession.

In many ways, these stimulus measures are greater than the US policy response. For example, the ECB's Pandemic Emergency Purchase Programme has been funded with €1.35 trillion to purchase investment-grade bonds. The programme's purchasing power is the equivalent of approximately 7 per cent of outstanding euro-denominated debt, considerably higher than the US' $750 billion programme that amounts to 2 per cent

Figure 3: Euro HY has a higher proportion of BB-rated issuers than US



Source: ICE BofA Merrill Lynch Global Research. As of 31 October 2020.

of outstanding USD denominated debt.[3] This level of support drove notable richening in ECB-eligible investment grade bonds, leading to increased interest in Euro high yield assets.

On the fiscal side, the European Commission's stimulus includes €1.29 trillion in emergency funding to help repair the economic and social damage originating from the virus. In addition to loans for small and medium enterprises, the 3 per cent limit on fiscal budget imbalances has been suspended for the next two years. This flexibility has allowed many European countries to adopt measures supportive of the broader population, including furlough schemes that fund 60-80 per cent of worker salaries for up to two years. The combination of fiscal and monetary stimulus has helped many European credit issuers weather the pandemic with limited deterioration of fundamentals thus far.

4 Less exposure to Covid-related risks

The global pandemic and subsequent lockdowns have created different economic pressures across industries. Expectations for which sectors will experience a Covid tailwind and those which will suffer a negative impact have largely been priced in, but are continually evolving particularly as virus infections have recently accelerated. For example, Euro high-yield food and beverage-related bonds were the best performing sector year to date, while restaurants have declined 11 per cent, leisure 23 per cent, and airlines 32 per cent as of 30 September 2020.[4] This type of dispersion is substantial both across and within sectors.

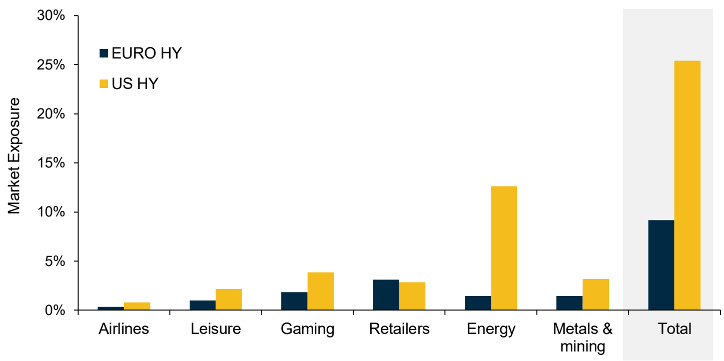
Furthermore, the European high yield market has low exposure to many of the most severely impacted industries with energy, airlines, leisure, metals, gaming and retailers accounting for 9 percent of the market, significantly less than US high yield at 25 per cent.

5 Rewarding environment for fundamental analysis

Strong credit and security selection can harness attractive opportunities across high-yield sectors and issuers, while largely avoiding deteriorating situations. Covid-related restrictions and operating requirements have stressed free cashflow and balance sheet repair across many companies. Actively managed credit selection with thorough financial analysis, scenario analysis, and stress testing can help managers identify credits that have the strength to withstand the uncertain backdrop.

European investors face challenges in terms of generating positive real returns in the coming years. Low to negative government rates amid an unclear but likely subdued economic backdrop pose hurdles. Yet, we believe the globally coordinated stimulus and promising initial results from vaccine trials will far outweigh these concerns. As such, we look for Euro high-yield spreads to compress and near-term market volatility should be viewed as a buying opportunity.

Figure 4: Market exposure to high Covid risk industries



Source: Barclays. Based on Bloomberg Barclays Pan European High Yield Index and Bloomberg Barclays U.S High Yield Index as of 30 September 2020.

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[1] *Source: PGIM Fixed Income, November 2020.*
[2] *Source: JP Morgan as of 30 September 2020.*
[3] *Source: ECB, Federal Reserve and BIS. Outstanding debt as of 31 December 2019.*
[4] *Source: Bloomberg Barclays Pan European High Yield Index. Past performance is not a guarantee or reliable indicator of future results.*