Insights

Global versus US high yield

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A global high yield bond portfolio can offer investors diversification benefits and exposure to different parts of the credit cycle

Taking European high yield (HY) as a silo, we believe a confluence of factors is combining to make the outlook for the asset class appear healthy. In our view the US and European HY markets are at divergent points in their credit cycles and policy is supportive of sector fundamentals.

Positive credit fundamentals

Ignoring monetary policy, HY credit fundamentals of European issuers appear positive. With approximately half of European HY issuers having reported fourth quarter 2015 earnings, EBITDA on average grew at 10% year-on-year in 2015 on revenue growth of 5.5% year-on-year. Although net leverage remained static throughout the year, it is important to note that the affordability of this debt has increased significantly; using interest coverage as a metric, the ability to service this debt is at the highest level since 2011 (and has climbed from 3.9x to 4.8x throughout the course of the past year).

By way of comparison, US HY is at a somewhat different stage of the cycle. EBITDA of US HY issuers (ex-energy) grew by only 3% year-on-year in the last quarter with leverage levels trending higher (net leverage at just over 3.8x is approaching an historic high according to recent Morgan Stanley data). As per Europe, interest coverage in the US is still at comfortably elevated levels, it is however beginning to fall from its peak and is now back to a similar level as that seen in the fourth quarter of 2014.

Supportive monetary policy

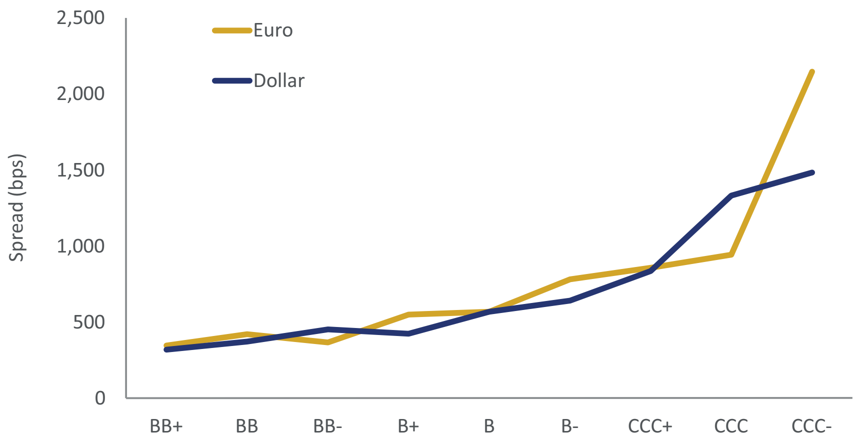
Given that Europe is generally recognised as being in the earlier stages of its business cycle (certainly in comparison to the US) and policy conditions look set to remain conducive for the foreseeable future, it would seem reasonable to suggest European corporates are well placed to continue growing earnings and benefit from the lower cost of borrowing.

In terms of policy, the recent rhetoric and action from the European Central Bank (ECB) has significant ramifications for European credit as a whole. Although European HY bonds are not captured by the ECB corporate bond repurchase programme (bonds need an investment grade rating from at least one agency to qualify), it seems likely to us (as we have witnessed to some degree already) that European HY bonds may well benefit from a second order effect from the ECB's actions. As investment grade yields compress, investors will essentially be pushed or 'crowded', in a search for yield, into parts of the European corporate market that are not explicitly covered by the ECB programme. European HY bonds would appear to be a key beneficiary of this effect and indeed we have seen evidence of this taking place already with HY almost keeping pace with the rally seen in European investment grade corporates.

In addition to the supportive policy backdrop, the European high yield market appears to us to be structurally well placed to perform during 2016. As has been well-publicised, Europe has a significantly lower exposure to the resources sector. So far this year this has resulted in lower realised default rates and a less volatile return profile than that experienced by the more heavily-resource-correlated US HY market.

With regard to relative value, comparing European and US HY on a like-for-like basis (stripping out commodity exposed credits and interest differentials) Europe actually trades on top of/cheap to US HY across most rating categories.

Fig. 1 Euro and US dollar spread to worst (STW)(ex-resources) by rating



Source: JPMorgan, as at March 21 2016

Increasing your allocation?

In summary, Europe and the US are at very different stages of their respective businesses cycles. Further, it would seem there is significant policy support to underpin sector fundamentals, demand and valuations over the near-to-medium term. With this backdrop in mind, we believe a global, rather than a US-only approach to investing in HY which, (based on the Bank of America Global High Yield Constrained Index) facilitates considering a larger allocation to Europe would, in our opinion, seem prudent at this stage in the cycle.