

European high yield: Time to take notice?

European high yield (HY) has been a much-overlooked asset class recently but is it time for investors to pay attention?

The reach for yield from other quarters pushed European HY bond valuations, in many cases, to uncomfortably tight levels. In our view, this led to a fair reappraisal of relative value, and consequently, to a period of persistent retail outflows from the asset class.

However, spreads in the European HY universe have widened significantly over the past year. The heavy skew toward Italian issuers within the asset class has provided plenty of volatility and the trials and tribulations of Italian politics offer another reason for investors to shy away. Meanwhile, the loan market has been in the ascendency with increasingly flexible structures (from an issuer's perspective) and a floating rate arrangement providing seemingly insatiable demand (and in turn reducing the need for the HY bond market in Europe to provide financing options).

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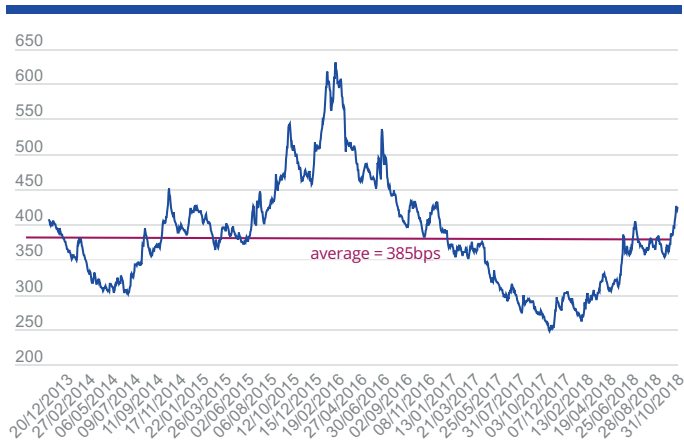
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The spread on the ICE BofAML Euro High Yield Index is at 425bps (31 October), 165bps wide of the lows achieved in 2017, and importantly 40bps above the average spread that the market has displayed over the past five years (Chart 1).

CHART 1 EUROPEAN HY SPREADS(BPS) ARE NOW ABOVE THE FIVE YEAR ROLLING AVERAGE



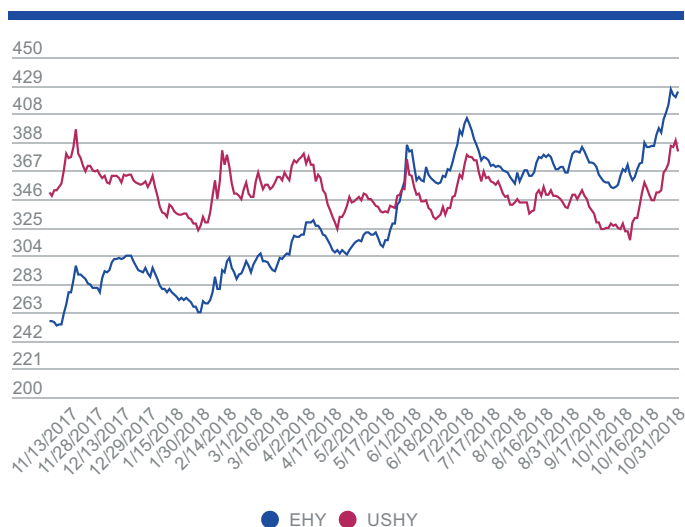
Source: Bloomberg as at 31 October 2018; ICE BofAML Euro High Yield Index

Europe vs the US

The fact that European HY spreads have significantly underperformed their US HY peers puts the recent market pricing into context.

As Chart 2 illustrates, the ‘normal’ relationship between US and Europe is for European HY to trade tighter than US HY. From a ratings perspective, this intuitively makes sense as the European HY universe is of much higher quality and is made up of approximately 70% of BB-rated assets while the US market, by comparison, is of lower rating quality with only 45% of that universe rated BB.

CHART 2 US VS EUROPEAN HY SPREADS (BPS)



Source: Bloomberg as at 31 October 2018; ICE BofAML Euro High Yield Index; ICE BofAML US High Yield Index

One year ago, European HY was trading 100bps inside US HY as we have come to expect. Today, that relationship has reversed with European HY some 40bps cheap to US HY. This inverted relationship (where Europe is cheap to the US) is something typically only prevalent during periods of extreme stress such as the sovereign or banking crisis.

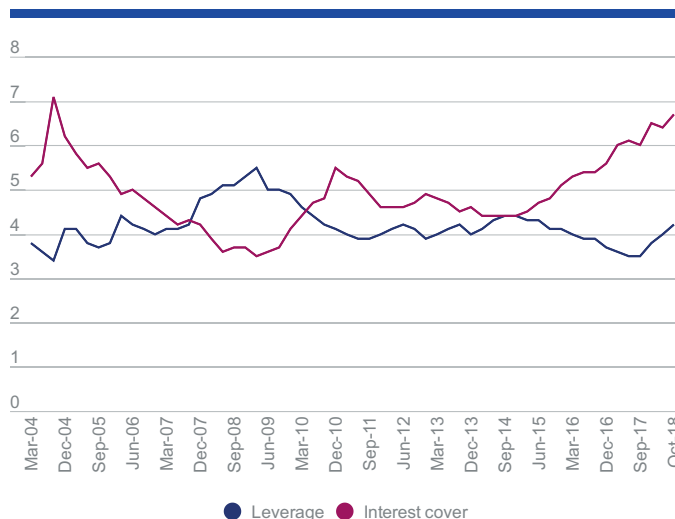
Although there is currently a dichotomy in growth between the regions with both economic data and individual corporate revenue and earnings growth far more favourable in the US (added to a very supportive technical backdrop with surprisingly limited primary market supply in the US market), we don't think this necessarily warrants the extreme reversal in fortunes experienced this year.

Margin of safety

While we certainly wouldn't contend the fact that European growth is lagging the buoyant tax reform fuelled conditions of the US HY market, we don't believe it's time to sound widespread alarm bells around the health of the European HY market - although there are some recent trends worth considering.

Leverage has increased in the European HY market of late. Data from JP Morgan suggests headline leverage has increased up to 4.2 times (increasing by around 0.4 times over the past year). This is, however, to be expected and is consistent with a return of slightly more aggressive/lower rated issuance (to finance M&A/LBO for instance), while last year this was skewed much more heavily towards refinancing. However, significant work done by the broader universe in terming out debt at attractive funding levels over the previous 18 months means that the cost of debt has fallen and as a result debt affordability is at elevated levels and is increasing. Expressed as earnings/interest cost (interest coverage ratio) the latest reading of 6.7 times is the highest we have ever seen (Chart 3).

CHART 3. EUROPEAN HY LEVERAGE INTEREST COVER (RATIO)



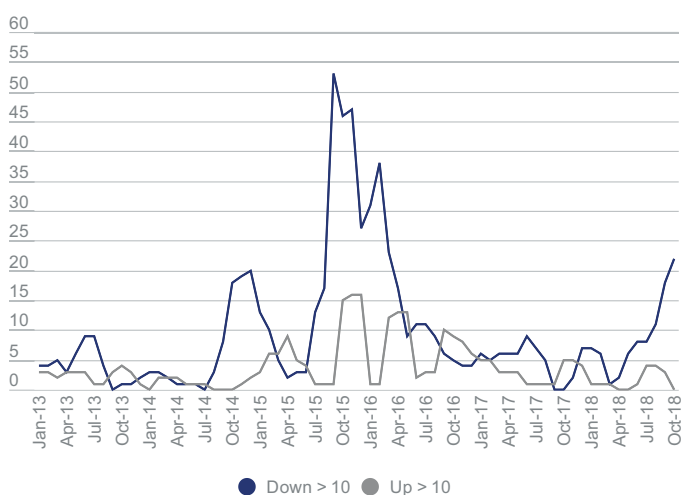
Source: J.P. Morgan, Bloomberg as of October 2018

Despite the improved interest coverage ratio, there has been a small rise in defaults in Europe over the past six months with the last twelve month rate moving up to a little over 1% from a mid-year low of 0.6%, with the retail sector dominating. While levels have risen, they remain low and outside of the retail sector we don't foresee any other systemic risks over the short to medium-term which are likely to outweigh the supportive debt affordability levels noted above (and the very manageable HY maturity schedule over the coming two years).

Rise in dispersion

More interesting to us beyond defaults is the rise in single name volatility – the portion of bonds moving more than ten points per month (to the downside) has risen dramatically over recent months according to data from JP Morgan (Chart 4).

CHART 4 NUMBER OF EUROPEAN HY BONDS MOVING +/- 10 POINTS PER MONTH



Source: J.P. Morgan 28 September 2018 (3-month rolling total of rated euro and sterling HY bonds)

Much of this is attributable to previous tight spreads which offered little to no downside protection against trading blips or hiccups. With limited protection/compensation offered by low coupons, bonds have nowhere to go but meaningfully lower when they experience an issue.

As strange as it may sound, we are quite pleased to see this volatility return. It serves as a timely reminder that we are operating in the high yield market and one must be compensated for lending to 'riskier' companies. Additionally, as an active manager focused on bottom-up credit selection, we believe this presents a compelling opportunity to generate alpha but also to price new risk coming to the market more appropriately.

To expand on this latter point, one of the outcomes of this increase in volatility is the greater risk premium demanded for new issues coming to the market and the ability for managers such as BlueBay to influence terms, conditions and structures for those new crop of issuers. The balance of power has notably shifted back towards the investor and it is increasingly a buyers-market. Looking forward, this can only be a good thing – in our view, higher coupons and better structures inevitably can lead to better returns over the long term.

With this in mind, we do think the European HY market has become more interesting here and it is time to take notice of a somewhat forgotten asset class.

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