APR
03
2017

Around THE Curve

Is 3% Really High Yield? The Dilemma with European Credit

March was a historic month for European high yield, as average yields for euro-denominated high yield bonds fell below 3% for the first time ever. Since 2001, the European market has changed significantly. Back then, it was only a sliver of its current size, growing from €21 billion to about €360 billion today. But as the market has grown and investor demand has surged, current yields look vastly different—not even closely resembling the "high" yield European market of just over 15 years ago.

Table 1: European High Yield Changes *As of March 28, 2017*

BofA Merrill Lynch European High Yield Index	March 2001	March 2017
Market Value	€21 B	€358 B
# of Issues	138	620
Average YTW	14.80%	3.30%
OAS	1049	362
Larges Issuer in index	NTL Communications	Telecom Italia
Largest Sector	Telecom	Basic Industry

Source: Bank of America Merrill Lynch

Given the historic yield lows and corresponding price risk, coupled with central bank and geopolitical risks, European high yield credit poses a dilemma to credit investors.

The Reach for Yield Post-CSPP

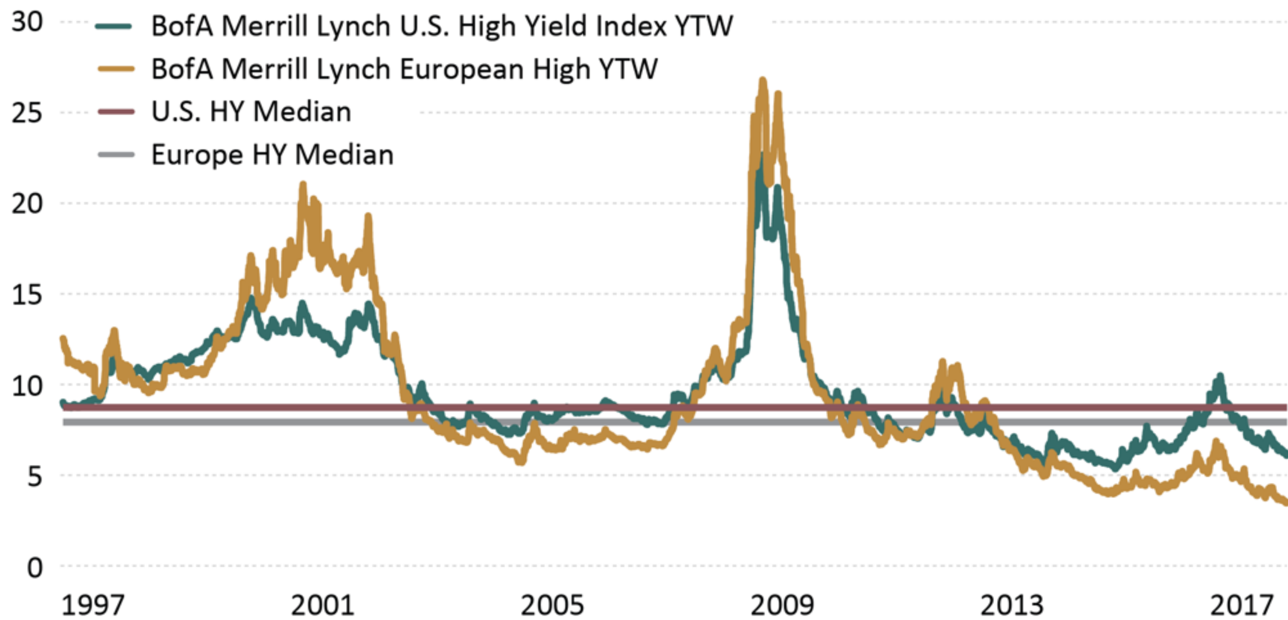
The European Central Bank's (ECB's) Corporate Sector Purchase Program (CSPP) has helped credit spreads tighten across the ratings spectrum over the past year. The ECB has bought up about 3.4% of the European corporate bond market, bringing the size of the CSPP to over €67 billion. With investors reaching for yield amid historically low global levels, the CSPP's guaranteed bond buying has helped drive both issuance and more interest in European credit. However, various economic indicators point to an increased likelihood that the central bank will start tapering its asset purchases sometime in late 2017. Across the eurozone, economic growth has picked up, the trade balance with the world is large at 3.3% of gross domestic product (GDP), and banking stresses are slowly abating. In general, CSPP tapering would be expected to create some headwinds for the European credit market. However, the impact on corporate credit could be significant if the reduction in bond purchases is disproportional across sectors. When tapering does begin, there is a risk that ECB President Draghi will scale back the central bank's corporate credit buying more substantially relative to government bond purchases in order to protect sovereign spreads in the weak peripheral eurozone countries. This uneven

tapering, if it occurs, will most likely create some weaker credit technicals.

Absolute Low Yields, Greater Duration Sensitivity

Compared to U.S. high yield, European high yield is trading at absolute low yields and is much more duration-sensitive now than in the past four years. Furthermore, yields currently have been trading in a tight range compared to long-term historic medians (see Chart 1).

Chart 1 U.S. High Yield and European High Yield *Yield to Worst, As of 2/28/2017*



Source: Bloomberg (© 2017, Bloomberg Finance LP) and BofA Merrill Lynch

Looking at bond price versus yield to worst (YTW), current levels indicate significant price risk compared to historic data points (see Chart 2).

Issuance Trends: Deterioration of Credit Quality

While default rates are expected to remain low, currently at 2.2%, certain market dynamics are sowing the seeds of trouble in the future. There has been an increase in subordinated and lower-quality issuance in the first quarter of this year, with CCC-rated bond issues up to 10.5% of total issuance compared to 2.5% for the first quarter of 2016.

Beware of Reversals

Global economic growth already has gained momentum since the middle of 2016. U.S. economic survey data remains strong, and growth has the potential to be quite robust if the new administration is able to deliver on its promises of tax cuts, financial deregulation, and infrastructure spending. While the U.S. high yield market has performed very well over the past year, a benign default outlook as well as some stability in commodity prices should provide support to this market for the remainder of 2017. On the other hand, European high yield on average is yielding at historic low ranges. We are cautious on euro-denominated high yield credit based on valuations relative to U.S. and emerging market credit, as well as the regional political risks expected throughout the year. Across our strategies, we shifted away from Europe and into U.S. and Latin American corporate credit in 2015 and 2016, which was one of the drivers of performance over the past year. With expectations of the Federal Reserve raising rates 3 - 4 times in the next 12 months, assuming the economic data continues to be positive, U.S. high yield spreads will compress tighter, offsetting the rate sell-off (see our previous blog, "Is Stronger U.S. Growth a Problem for High Yield?"). We saw this happen in the fourth quarter of last year and year to date this year. Even though U.S. Treasuries sold off, U.S. high yield performed well compared to other fixed income sectors. With credit markets in the prolonged late stages of the credit cycle, we are cautious of idiosyncratic risks and prefer asset-rich and/or cash flow-resilient companies.

Groupthink is bad, especially at investment management firms. Brandywine Global therefore takes special care

to ensure our corporate culture and investment processes support the articulation of diverse viewpoints. This blog is no different. The opinions expressed by our bloggers may sometimes challenge active positioning within one or more of our strategies. Each blogger represents one market view amongst many expressed at Brandywine Global. Although individual opinions will differ, our investment process and macro outlook will remain driven by a team approach.

©2024 Brandywine Global Investment Management, LLC. All Rights Reserved.

Social Media Guidelines

Brandywine Global Investment Management, LLC ("Brandywine Global") is an investment adviser registered with the U.S. Securities and Exchange Commission ("SEC"). Brandywine Global may use Social Media sites to convey relevant information regarding portfolio manager insights, corporate information and other content.

Any content published or views expressed by Brandywine Global on any Social Media platform are for informational purposes only and subject to change based on market and economic conditions as well as other factors. They are not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy. This information should not be considered a solicitation or an offer to provide any Brandywine Global service in any jurisdiction where it would be unlawful to do so under the laws of that jurisdiction. Additionally, any views expressed by Brandywine Global or its employees should not be construed as investment advice or a recommendation for any specific security or sector.

Brandywine Global will monitor its Social Media pages and any third-party content or comments posted on its Social Media pages. Brandywine Global reserves the right to delete any comment or post that it, in its sole discretion, deems inappropriate or prevent from posting any person who posts inappropriate or offensive content. Any opinions expressed by persons submitting comments don't necessarily represent the views of Brandywine Global. Brandywine Global is not affiliated with any of the Social Media sites it uses and is, therefore, not responsible for the content, terms of use or privacy or security policies of such sites. You are advised to review such terms and policies.