Aberdeen

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EUROPEAN HIGH YIELD: NOT IN BUBBLE TERRITORY BUT SECURITY SELECTION VITAL

After five years of stellar performance since the financial crisis, there is much talk at present about a supposed bubble bursting in the European high yield market.

The BofA Merrill Lynch European High Yield Constrained index returned 165%, outperforming the stockmarket by over 40% (FTSE World Europe index). Spreads have tightened more than 1700 basis points to approximately 350 bps over the German Bund. After such a buoyant period it is hardly surprising that concerns are emerging about the future trajectory of the asset class (source: Bloomberg).

Though yields are at all-time lows and Aberdeen expects returns to be more muted, we do not adhere to the argument that the asset class is a bubble for a number of reasons.

Tight valuations are not the same as a bubble

There are fundamental reasons why spreads trade where they do. Default rates are low and expected to stay low.

The majority of issuance continues to be used to refinance debt, which has allowed companies to borrow at lower interest rates and extend maturity profiles. Failure to refinance debt when it comes due or an inability to fund interest expenses are the two most common triggers for default. Aberdeen estimates 25% of the market is pricing to call by the end of 2015, which will bring the cost of debt down meaningfully for these companies assuming no great exogenous shock occurs. Furthermore, companies are increasingly preparing for or are rumoured to be preparing an IPO later this year. This is generally a positive as it is a de-leveraging event ("equity claw" clauses in the documentation) and provides a tangible equity cushion.

Spreads nowhere near all-time lows

In 2007 spreads fell to 179 basis points at a time when the market was lower quality and a quarter of the size. With spreads where they are there is room for further tightening. Having said that this is more likely to come from rising government bond yields than capital upside as high bond prices and call options limit that. However, assuming defaults remain low there should be some ability for spreads to cushion government yield increases.

Spreads primarily compensate investors for default risk and loss given default. The good news is that since 2008 nearly half of new issuance in European high yield has been secured, which means recovery rates going forward will be higher than they have been historically. This needs to be factored in when looking at what spreads are discounting in terms of default rates. Today spreads represent no worse than fair value when analysing them in this way.

Correlation to government bonds is low

If there is a bubble it is in government bonds which have experienced a 30-year bull run and have been artificially supported by quantitative easing. However, even if this is a bubble it is unlikely to burst any time soon. Given the anaemic state of the European economy, the European Central Bank is unlikely to raise interest rates in the near term. Eurozone unemployment is not expected to fall much below 12% this year, inflationary pressure is currently non-existent and the most bullish eurozone growth forecasts are 1.5% for 2014.

Even when interest rates do start to rise, the effect on high yield will be somewhat limited compared to investment grade bonds. Average maturity in European high yield market is around four years; so relatively short-dated and minimises duration effects. The four-year bund yields 0.4% and therefore almost the entire yield is spread, which is a key reason sensitivity to government bonds is so low.

Ben Pakenham, High Yield fundmanager at Aberdeen, comments:

"While we are not anticipating a significant sell-off in European high yield, we are cautious and would view a period of consolidation or even a modest correction as healthy. In what is often a seasonally weak period for financial markets, the second quarter could offer better opportunities to top up positions in favoured holdings.

"At the same time, investors need to be watchful as lower quality companies continue to take advantage of the borrowing environment and bondholder protection from covenants erodes – investors need to do their homework. Longer term, the maturity wall and interest rate expectations suggest 2017 could be when defaults begin to tick up. Between now and then there is the opportunity for selective investors to harvest a healthy income yield."

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Notes to Editors

About Aberdeen Asset Management

Aberdeen Asset Management is a global independent asset management group. Formed out of a management buy-out in Aberdeen, Scotland, in 1983, Aberdeen is a FTSE 100 company operating on-the-ground in over 25 countries across Europe, Asia and the Americas.

The Group is defined by its pure focus on asset management, including equities, fixed income, property and multi-asset portfolios. All investment solutions are driven by its commitment to straightforward, transparent investment approaches that stress intensive, first-hand research and a long-term view.

Further information about Aberdeen can be found at www.aberdeen-asset.com