European High Yield

Fund Manager Interview
March 2016

Steve Logan
Head of European High Yield

Ben Pakenham
Senior Investment Manager

Key points:

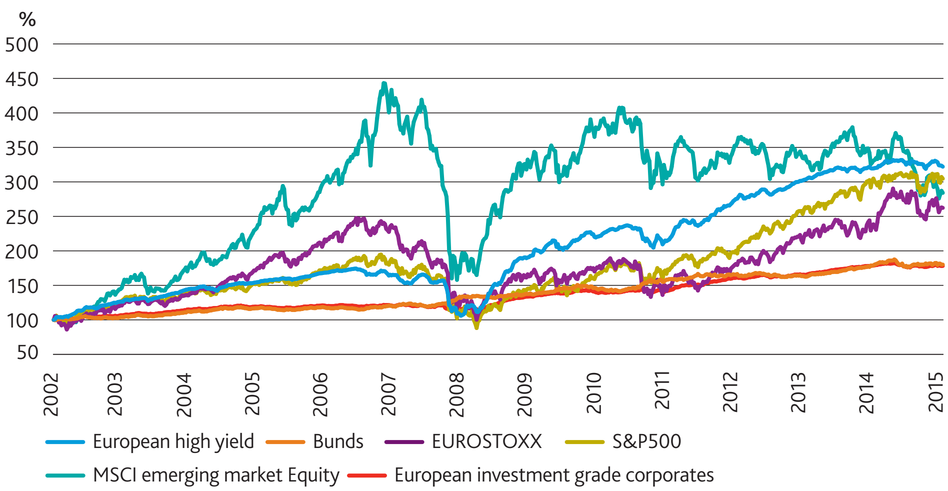
- European high yield has held up relatively well amid intense market volatility
- US high yield underperforms European high yield
- The weaker euro should benefit European high yield
- The default rate remains low

There's been a lot of market turmoil recently. How has European high yield dealt with the volatility?

With the recent interest rate rise by the US Federal Reserve (Fed) still fresh in investors' minds and the added issue of slowing global growth, financial markets are more volatile. Most major equity indices posted returns of -10% at the beginning of the year. However European high yield indices held up relatively well with returns of -2%. The Eurozone is no exception to the volatility but growth is still good enough for the bulk of high yield companies to continue to be able to service their debt obligations, and at a level that encourages conservative behaviour from management teams. European high yield also has minimal exposure to emerging markets, oil, energy and commodity sectors – meaning that lower commodity prices are beneficial to profit margins in the region. Furthermore, minimal maturities and a cash-rich investor base, lends technical support in a market where new issue supply has disappointed.

In such uncertain conditions, preparation is key and investors should ensure their portfolios are properly diversified. European high yield cannot escape the short-term global volatility but the power of the high coupon asset class is weathering the storm better than most so far, making it a strong diversifier for fixed income portfolios.

Attractive long-term total returns compared to other asset classes



Past performance is not a guide to future results.
Source: Bloomberg, RIMES; Returns in local currency to 31 December 2015.

Aberdeen
Simply asset management.

High yield is a low duration asset class, that is, it has slow sensitivity to interest rates – what are the benefits of this in the current market environment.

Interestingly, worries about duration have faded a little. That was a topic that was a big discussion in the first half of 2015, particularly in Europe where we saw a big back-up in government bond yields. Stubbornly low inflation, not helped by continuously falling commodity prices, is also part of the equation. Longer term, though, we continue to favour a shorter duration strategy (2.6 years versus 3.5 years for the market) because we find it hard to believe government yields can remain this low in Europe forever. If quantitative easing (QE) is ultimately successful in driving inflation higher then you want to avoid being too exposed to government bond risk.

Should we be worried about 'Third Avenue?'

Some commentators fear that the failure of the Third Avenue US High Yield Bond fund is indicative of further problems for high yield credit. We don't believe this is so. This fund was heavily invested in illiquid positions and was not representative of the broader high yield market. Looking forward, we see a number of positives for the asset class. For example, the lower oil price, weaker euro and further stimulus from the European Central Bank (ECB) should continue to provide a boost to economic activity. Growth is therefore set to accelerate over the next two years, but not to levels that are likely to cause overheating, inflation or aggressive corporate activity – all in all, a decent backdrop for credit.

What advantage does European high yield have over US high yield?

European high yield is a very distinct asset class. It's quite easy to group high yield in one basket, but actually today, more than ever, we have seen correlations between the two diverge. Over the last three years European high yield has broken away from the US and global high yield markets.

Today, European high yield is lower yielding than its US counterpart, but with that also comes lower risk. Specific tailwinds that don't necessarily apply to the US market, such as currency depreciation, have been helpful for several of the companies that we invest in, particularly those with external revenue streams. For large commodity importers, falling prices have been helpful both for corporate margins but also for consumer disposable incomes. Finally in Europe, there exists a very accommodative central bank, which again, is quite different to the US market.

The yield difference between the two markets is significant but there are good reasons for that. The US has fewer banks but they have a lot more oil and gas exposure (roughly 15-20%), particularly on the exploration and production side. This is one of the key reasons the US has struggled for the last two years.

The other point to make is that the average duration of US high yield bonds is about a year longer than in Europe, making US high yield more sensitive to Government bond movements.

Finally, Europe and the US are at very different points in the monetary policy cycle. The US has finished QE and is now tightening monetary policy whereas the ECB have taken rates into negative territory and have now extended their bond buying programme (and are likely to extend further).

The relative tightening of monetary conditions, along with increased pressure in the energy sector, should cause default rates to tick up in the US before they do in Europe.

What does the decline in the value of the euro mean for European high yield?

A weaker euro should be perceived as a benefit for the majority of European high yield companies. For those companies that export, it makes their goods and services cheaper for overseas customers. For domestic consumers, a weaker euro currency means the products of domestic producers are more competitive. Furthermore, a weaker euro encourages tourism and inward investment, all benefiting activity levels in the economy.

Long-term asset class return correlations

	EUR high yield %	USD high yield %	Investment grade corporates %	10Y Bund %	Euro Stoxx %	Emerging Markets Bond Index, Global %	S&P 500 %
EUR high yield							
USD high yield	91						
Investment grade corporates	54	59					
10Y Bund	(28)	(24)	39				
Euro Stoxx	72	71	35	(33)			
Emerging Market Bond Index, Global	70	77	76	8	56		
S&P 500	69	74	33	(34)	86	60	

Source: Merrill Lynch, Iboxx, JP Morgan, RIMES 31 December 2015. Correlations of monthly returns since 2005.

Does European high yield correlate with equities?

The extended period of low interest rates has driven appetite for riskier assets such as high yield and equities. Recently, performance between the asset classes has diverged significantly.

Why should investors include European high yield as part of their portfolio?

European high yield can benefit a wider portfolio by providing:

Attractive income potential – in the current low yield environment European high yield bonds still provide a more attractive risk return profile than the wider bond spectrum. Bond coupons are contractual obligations, unlike the payment of dividends which can be easily cut.

Lower volatility than equities – high yield bond returns have been similar to equities over the past 25 years. The "pull to par" effect and a high, stable coupon means that the volatility of high yield bond returns has been meaningfully lower than that of equities, providing more attractive risk adjusted return characteristics.

Return potential in a low growth environment – while low global growth is a concern, high yield companies do not need robust growth to perform well. If anything, low but consistent growth helps to promote cautious corporate behaviour, which can support the value of high yield bonds.

Downside protection – sub-investment grade bonds have a comparatively higher coupon component and shorter maturity profile than other fixed income instruments. This helps to lower the bonds 'duration' or the sensitivity of the bonds price to a change in interest rates, providing an element of downside protection. All is not lost in the event of a default (as is so often the case in equities) as the average bond recovery is roughly 35 - 40 cents on the euro.

Diversification benefits – high yield bonds have a low historical correlation to government and investment grade bonds.

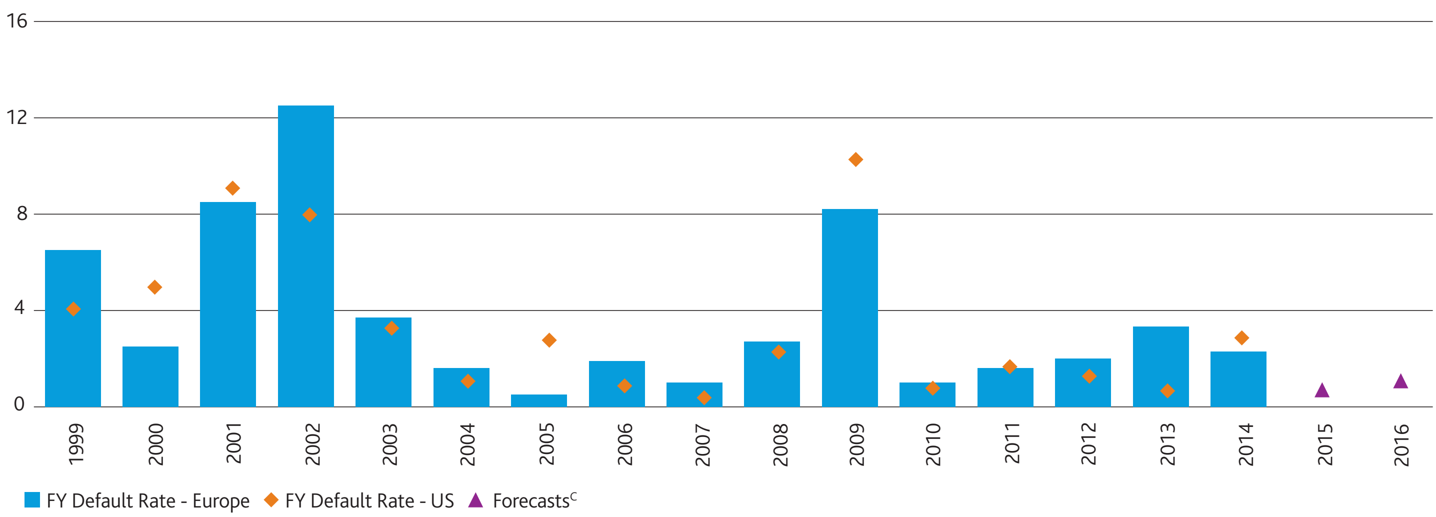
What is your outlook for defaults in 2016?

We're unlikely to see a systemic spike in defaults as witnessed in 2009, but rather periodic and correlated problems in certain industries.

In short, default levels should remain at the lower end of their historical range – somewhere between 2-3%.
Company fundamentals are in decent shape; earnings are stable and cash is being generated. Furthermore (and to reiterate), a lower oil price, low interest rates and a weaker euro are all acting as tailwinds for European companies.

On a longer-term basis, the fact that many companies are refinancing bonds and locking in much lower coupons means that even when interest rates do rise, their ability to service that debt will be enhanced. We believe that this refinancing activity is will help to keep defaults lower when the business cycle eventually does begin to turn.

High Yield default rates



Source: JP Morgan, S&P and Moody's Investor Services, November 2015.

[A] A contract that stipulates the terms of a formal debt agreement.
[B] Bonds that were once of investment grade but has been reduced to high yield, or 'junk', status.
[C] JPM forecast for the Europe in 2015.

The value of investments and the income from them can go down as well as up and your clients may get back less than the amount invested

Contact details

Should you require any further information, please visit **aberdeen-asset.com** for details of your local Aberdeen representative.

Important information

For professional investors and financial advisers only – not for use by retail investors

121023412 02/16