

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

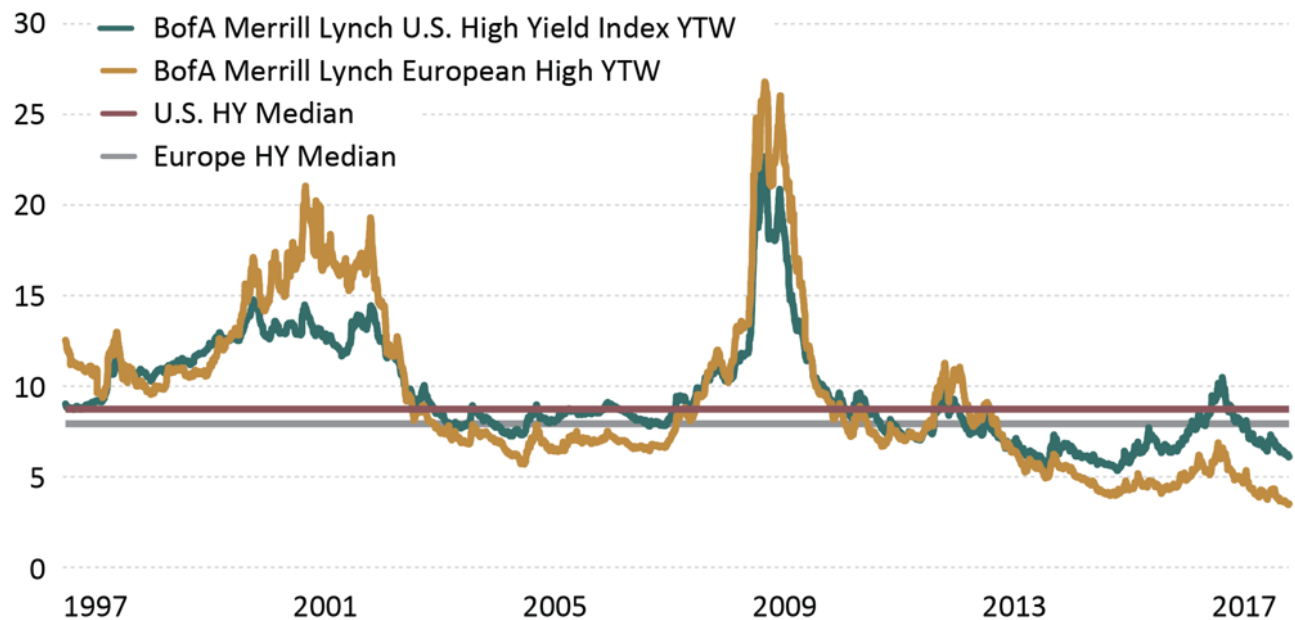
The European Central Bank’s (ECB’s) Corporate Sector Purchase Program (CSPP) has helped credit spreads tighten across the ratings spectrum over the past year. The ECB has bought up about 3.4% of the European corporate bond market, bringing the size of the CSPP to over €67 billion. With investors reaching 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](#)).

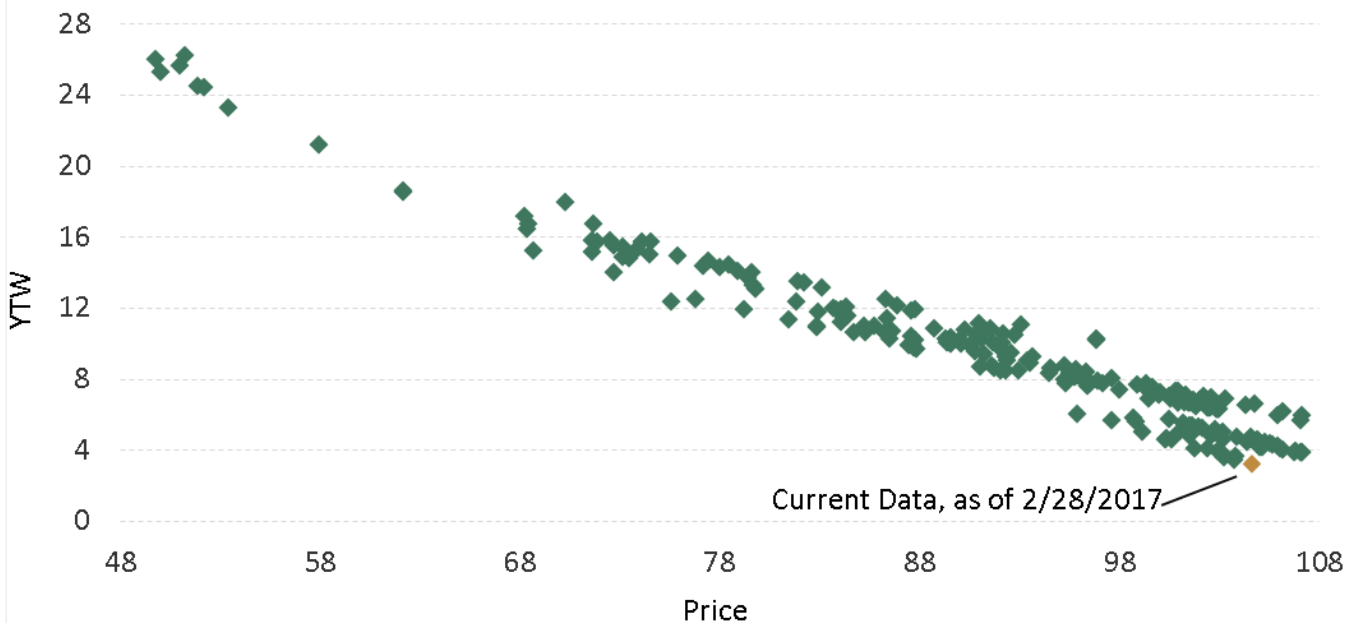
Chart 1 U.S. High Yield and European High Yield *Yield to Worst, As of 2/28/2017*



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](#)).

Chart 1: BofA Merrill Lynch European High Yield Index Price vs. Yield to Worst, As of 2/28/2017



Source: Bank of America Merrill Lynch and Brandywine Global

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.

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