For Investment Professionals only

The challenges facing European high yield – are you compensated for the risks you take?

September 2017

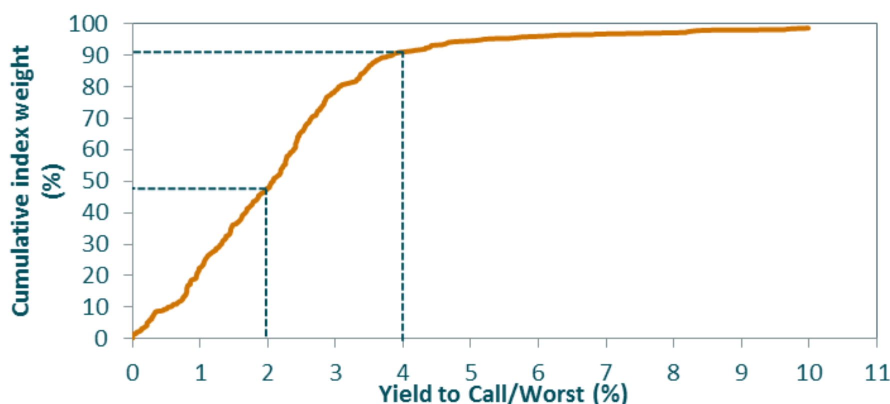
The value of investments and the income from them will rise and fall. This will cause the fund price, as well as any income paid by the fund, to fall as well as rise. There is no guarantee the fund will achieve its objective, and you may not get back the amount you originally invested.

Yield levels in the corporate credit sector are being squeezed ever lower, driven in part by continued weight of demand for assets that bear income. We believe that investors should, perhaps more than at any time in the recent past, question whether they are being compensated for the risks they take. With less value seemingly on offer from a top-down perspective, now may be a good time to reduce overall risk and to focus on identifying strong value opportunities from security selection.

Low yields in high yield

The degree to which yields have declined is often overlooked as demand for income remains strong. The distribution of yields of individual issues within the Euro High Yield Index demonstrates that a large proportion of the index's constituents currently carry very low levels of yields. Almost half the index yields less than 2% while just over 90% of the index yields less than 4%.

Euro High Yield: 'Some Yield' rather than 'High Yield'?

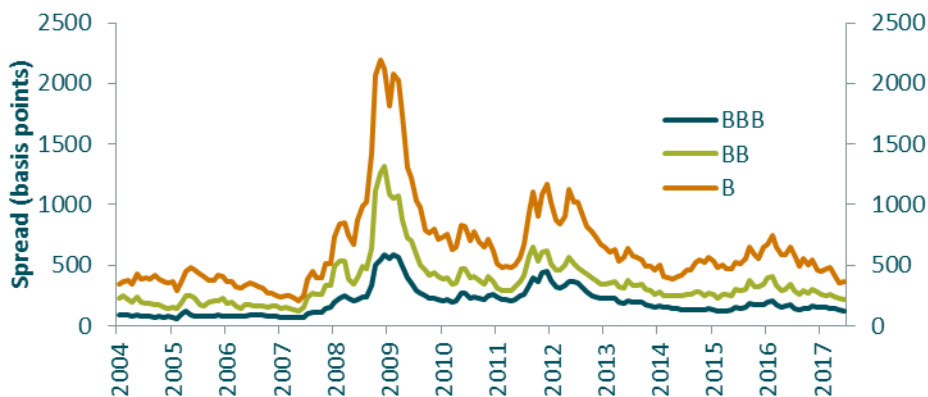


Source: M&G, Bank of America Merrill Lynch Euro High Yield 3% Issuer constrained ex-financials Index (HEAD) Yield to Worst, as at 31 July 2017.

Returning to historically low yield spreads

With bond yields in euro markets generally at low levels relative to their historical averages, many investors have sought to move further down the risk spectrum in order to secure the income streams they require. In this environment, credit spreads have continued to grind tighter.

Spread compression can make diligent issuer selection more important

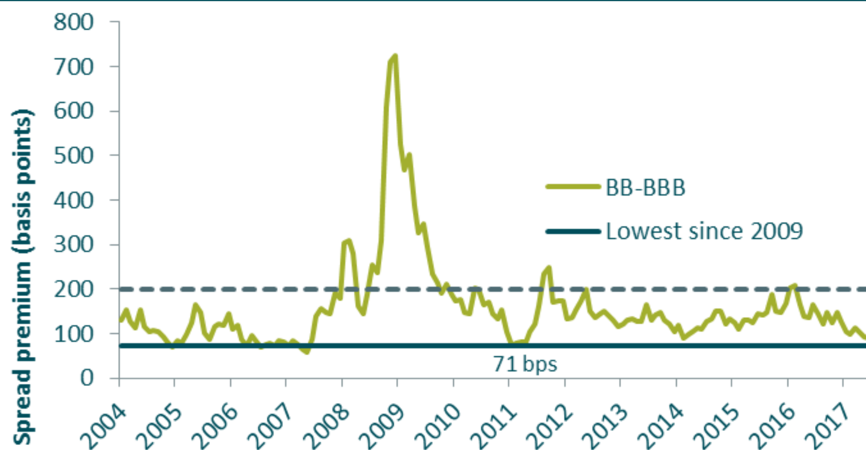


Source: M&G Bank of America Merrill Lynch Index (HE1M) (ER40) Option Adjusted Spreads, as at 30 June 2017

As the previous chart shows, spreads for higher yielding ratings buckets within the European (non-financial) credit markets have contracted towards their lowest levels since the global financial crisis of 2007/9.

The extent of the spread compression that has taken place in the high yield market can be illustrated by the reduction in the additional yield available in the next lowest rating bucket. At the height of the financial crisis, the high yield market offered more than 700 basis points of additional yield to an investor willing to move from the lowest investment grade sector (BBB) to the highest non-investment grade, or high yield, sector (BB). By 2011, that spread premium (or margin) had contracted to 71 basis points. Since then, the margin has oscillated between lows around 70-80 basis points, and highs of approximately 200 basis points. It is now approaching the lows again.

Yield levels in Euro credit have limited capacity to cushion wider spreads

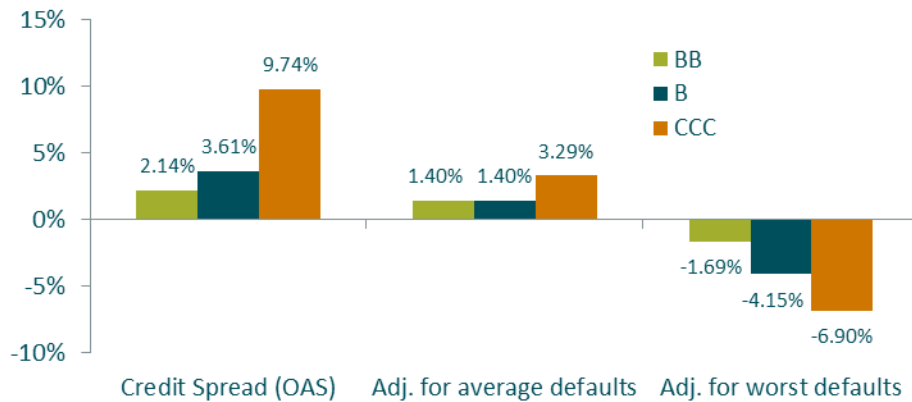


Source: M&G Bank of America Merrill Lynch Index (HE1M) (ER40) Option Adjusted Spreads, as at 30 June 2017

Ongoing demand for yield wherever it is available, means it is quite possible that the spread compression seen for all credit rating buckets could continue. This could lead to new low levels of spread and tighter yield gaps between ratings buckets. However, as value-driven investors we ask whether the returns available justify the risk entailed.

When considering current conditions alongside the historical incidence of defaults, investors may think that the overall credit risk premium on offer from the high yield market is becoming perilously thin. In the following chart, the premiums are shown by the option-adjusted spread (OAS) for each of the key ratings buckets in the respective Bank of America Merrill Lynch High Yield Index. Adjusting these spreads to reflect the average incidence of defaults over a five-year period since the 1970s (and assuming a 40% recovery rate) brings the credit premiums lower still. For the BB and B-rated buckets, the credit premium is eroded close to the prevailing spread for the BBB bracket (which was 125 basis points at the end of June 2017). However, if the market suffered a setback that is worse than the average it has experienced, the credit risk premiums could fall well below zero.

Narrow risk-adjusted spreads encourage greater focus on security selection

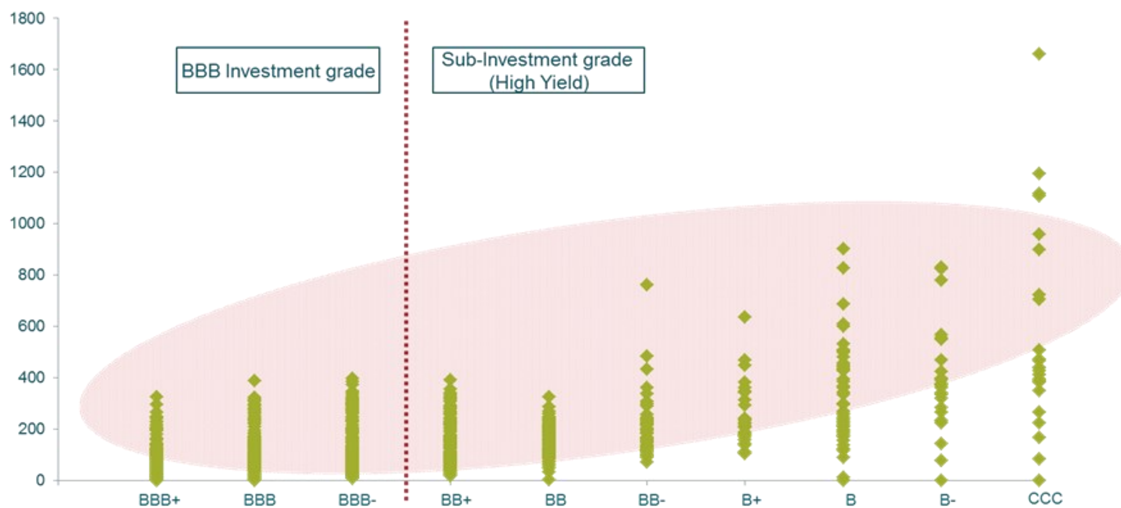


Source: M&G Bank of America Merrill Lynch Index (HE1M) (HE20) (HE30) Option Adjusted Spreads, as at 30 June 2017. Default rates from Deutsche Bank

With such potential risk scenarios, a more prudent strategy may be to wait for more opportune timing. The potential for negative risk outcomes, such as those indicated in the chart, makes it doubly important not to apply a blanket passive or top-down approach.

A better approach may be to seek individual value opportunities selectively and invest where research suggests there is sufficient yield cushion to compensate for the higher levels of risks.

Issuer level spread dispersion presents plenty of opportunities



Source: M&G, BofA Merrill Lynch Euro Corporate Index (Ref .ER00) and Non-Financial High Yield Constrained Index (Ref HEAD), composite credit rating derived from average of S&P/Moody's/Fitch as at 31 July 2017

In the Euro high yield universe, spread dispersion among issuers remains substantial, so opportunities to capture value still exist across the credit spectrum.

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