Global High Yield—Managing Through Volatile Markets

Fundamental research is imperative as macro headwinds rise.

November 2022

KEY INSIGHTS

- Prices often become dislocated from fundamentals in volatile markets, which creates potential attractive entry points for investors.
- However, the macro backdrop is more challenging, so fundamental research and a risk-aware approach are imperative as defaults could peak over the next few quarters.
- We favor European high yield over the U.S. and see attractive value opportunities in European cable and services companies.

Mike Della Vedova
Co-portfolio Manager, Global High Income Bond Strategy

Stephen Marsh
Portfolio Specialist

Value is back in high yield, but rising macro headwinds are causing significant volatility in the asset class. To navigate this more challenging environment, it's more important than ever to follow a disciplined and risk-aware investment process that emphasizes rigorous research. Why? Because it's not just about picking potential winning companies; avoiding losers is just as important, particularly in the current climate where defaults could pick up over the next few quarters due to the slowdown in growth.

Volatile Markets Demand Far-Reaching Insights

Credit-intensive research is essential to fully understand a company and the potential risks and rewards involved with investing. This is at the heart of our approach, with a global team of more than 20 dedicated high yield analysts specialized by industry, region, and sector. This gives each analyst the in-depth credit and structure analysis skills that are needed to accurately assess the optimal risk/return trade-off. In addition, our analysts also leverage and collaborate with investment-grade; sovereign; equity; and environmental, social, and governance (ESG) analyst teams, which allows for a holistic credit assessment of a company. This cross-team effort combined with skilled active management helps inform decision-making and prudent risk management, which we believe leads to better long-term results.

As part of our process, analysts routinely stress test companies in order to develop a deep understanding of how companies might perform in a range of different market environments. Default scenarios are also constructed to identify the catalysts that could potentially trigger a credit event, as well as the likely effects thereafter. We conduct scenario analysis on an ongoing basis in order to identify both risks and opportunities to each individual security.

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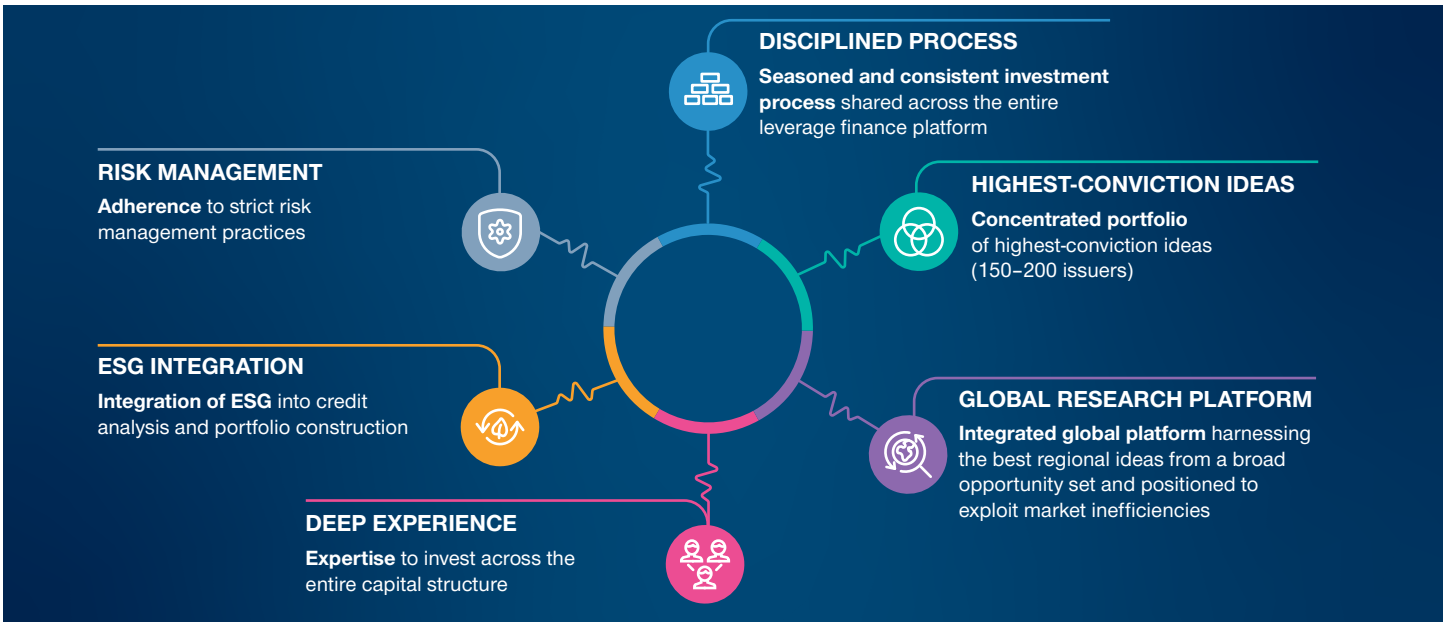
>
> — **Mike Della Vedova**
> *Co-portfolio Manager, Global High Income Bond Strategy*

Global High Yield Investment Philosophy

(Fig. 1) Research at the heart of our approach



As of September 30, 2022.
Source: T. Rowe Price.

> ...Europe's market is younger and less mature than the U.S., meaning it potentially offers more opportunities for price and information discovery....
>
> — **Stephen Marsh**
> *Portfolio Specialist*

This year, our analysts have been undertaking deep assessments of how companies in their coverage area might be impacted by slower growth and an environment of higher interest rates and inflation. For example, will the company be able to pass potential increased input costs onto their customers? Could their margins be impacted? And, if so, what does that mean for future revenues and cash flow generation? Often, some of the impacts come with a lag, so it's not just about evaluating what the conditions mean for a company now, but also how they might fare in 2023 and beyond.

In the current climate of heightened volatility, it's important to stick to our stringent investment process that prioritizes fundamental research. This should not only enable us to potentially uncover great opportunities where prices have become dislocated from fundamentals, but also help us to avoid companies that might not survive the more challenging macro conditions.

Regional Views: Favor Europe Over the U.S.

Looking into areas where we are finding the best opportunities at present, we believe that Europe offers value despite its potential recessionary outlook—although selectivity is more important than ever. While we accept that Europe's economy could suffer a deeper slowdown than its peers, the European high yield market should benefit from having less exposure than the U.S. to cyclical markets, such as commodities. Europe also has higher credit quality than the U.S., with more companies rated BB (70.7% in Europe versus 52.3% in the U.S.) and fewer companies rated CCC and below (5.5% in Europe versus 11.1% in the U.S.).[1] Furthermore, Europe's market is younger and less mature than the U.S., meaning it potentially

[1] Data as of September 30, 2022. Sources: European High Yield represented by the ICE BofA European Currency High Yield Const. ex Sub, and Fin Index. U.S. high yield represented by the J.P. Morgan Domestic High Yield Index. (See Additional Disclosures.)

Analyst Spotlight

Introducing Jonathan Moore

Jonathan Moore
Analyst

- 23 years of investment experience
- 6 years with T. Rowe Price

Company Example: *Verisure*, a defensive security business operating in the European residential household and small business monitored alarm market.

Thesis: We see potential for organic growth in the European market, given still-low penetration rates compared with the U.S. Furthermore, the service is often considered nondiscretionary by customers, which leads to low churn/attrition rates and long average lifetimes. Although leverage is high, which is typical for asset-life service businesses, cash generation is reliable, in our view, before new customer acquisition costs, even in an economic downturn.

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offers more opportunities for price and information discovery, which we can potentially take advantage of with our research and active management.

Sector Picks: European Cable and Integrated Telecom Operators

Digging down further into sectors, we see value in European cable and integrated telecom operators. This industry is supported by long-term trends in media consumption and stable, recurring revenue business models, which is important at a time when growth is slowing. We are also finding some value in the services sector. This is a large and highly diverse sector with lots of potential interesting opportunities on offer, but with rising prices, fundamental research is imperative.

The foundation of our investment philosophy is the detailed understanding of the companies being considered. We seek to invest in companies that have strong and improving credit profiles within their industries. Equally important are the companies to be avoided. Our focus seeks to identify and avoid weak companies that are either run by poor management teams or contain situations that create an elevated expectation of default. The current climate of heightened volatility and macro headwinds offers potentially high rewards but also risks. Security selection is imperative, and key to that is fundamental research and a risk-aware approach.

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