T. Rowe Price
INVEST WITH CONFIDENCE

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T. Rowe Price
Fixed Income Newsletter

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SELECTIVITY KEY AS EUROPEAN HIGH YIELD MARKET BRACES FOR NEW ISSUANCE

KEY TAKEAWAYS

- An expected surge in issuance in the European high yield sector is likely to bring a number of compelling opportunities to market this year.
- The sector currently benefits from higher credit quality and a more favorable macroeconomic environment than U.S. high yield.
- U.S. investors who buy European high yield bonds and hedge their investments back into U.S. dollars can benefit from wider credit spreads than those available from U.S. high yield debt.
- Selectivity is the key to navigating the sector, with an emphasis on companies with improving credit stories based on sound business plans.

A confluence of factors looks set to make areas of the European high yield sector ripe for investment this year. Strong credit fundamentals, a benign macroeconomic environment, and a glut of new issuance could present a range of attractive opportunities for investors in the sector. But while many of these new issues will have the potential to deliver long-term results, others will not—so the ability to differentiate between them will therefore be vital.

DEFAULT RISK LOWEST FOR A DECADE

In terms of quality, the European high yield market is stronger than it has ever been. Ratings agency Moody's predicts the default rate among European high yield issuers will be 1.1% at year-end, the lowest rate in 10 years and less than half the 2.4% predicted default rate among U.S. issuers. This is partly due to the current composition of the European high yield sector: At present, there are more BB rated and fewer CCC rated high yield issuers in Europe than there are in the U.S. It is also partly due to the fact that the U.S. is further along its credit cycle than Europe and is therefore subject to greater inflationary pressures and potential currency weakness—and hence more risk.

HEDGING COSTS MAKE EUROPEAN HIGH YIELD ATTRACTIVE FOR U.S. INVESTORS

The U.S. high yield sector has typically been regarded as safer and less volatile than European high yield, but in recent years this has been reversed as credit spreads in Europe have fallen below those in the U.S. At first glance, this would seem to make U.S. high yield the more attractive option: If you can get better credit spreads from the U.S. market, why would you choose to invest in Europe?

But as Figure 1 shows, hedging costs change the picture considerably. Because of the euro's strength against the U.S. dollar, investors in the U.S. who invest in European high yield and then hedge their investments back into dollars are able to obtain spreads approximately 40 basis points (bps) wider than those available from U.S. high yield bonds. The reverse, of course, is also true: For European investors, it is currently very expensive to invest in U.S. high yield and hedge back into euros.

FIGURE 1: **Impact of Currency Hedging on European and U.S. High Yield Spreads**
As of April 30, 2018

		Below 5-Yr. Average By:	Above All-Time Low By:	Hedged to USD
EHY Spread	371 bps	74 bps	192 bps	**425 bps**
USHY Spread	387 bps	144 bps	124 bps	**387 bps**

Hedged on five years.
Source: J.P. Morgan.

REVERSE YANKEES SET TO MAKE A COMEBACK

U.S. issuers can also benefit from the exchange rate by selling bonds in euros (known as reverse Yankees) and swapping the proceeds back into U.S. dollars more cheaply than they can issue U.S. dollar paper. The U.S. tax reforms enacted in late 2017 cap the interest deduction that U.S. companies can take at 30% of income per year, which will limit the amount of debt that most companies issue. However, this does not apply to U.S. companies that sell euro-denominated debt via their European subsidiaries, making reverse Yankees even more attractive to issue than dollar paper.

The fact that Europe is at an earlier stage in the credit cycle than the U.S. is another factor likely to drive issuance. While the Federal Reserve has already embarked on rate hikes and begun unwinding monetary stimulus, the European Central Bank is unlikely to begin raising rates until it winds down its bond purchase program, which is not expected to occur until later this year and possibly not until 2019. When rate hikes become visible on the horizon, companies in Europe and elsewhere are likely to step up issuance in euro debt before it becomes more expensive to do so.

SELECTIVITY KEY IN CROWDED MARKET

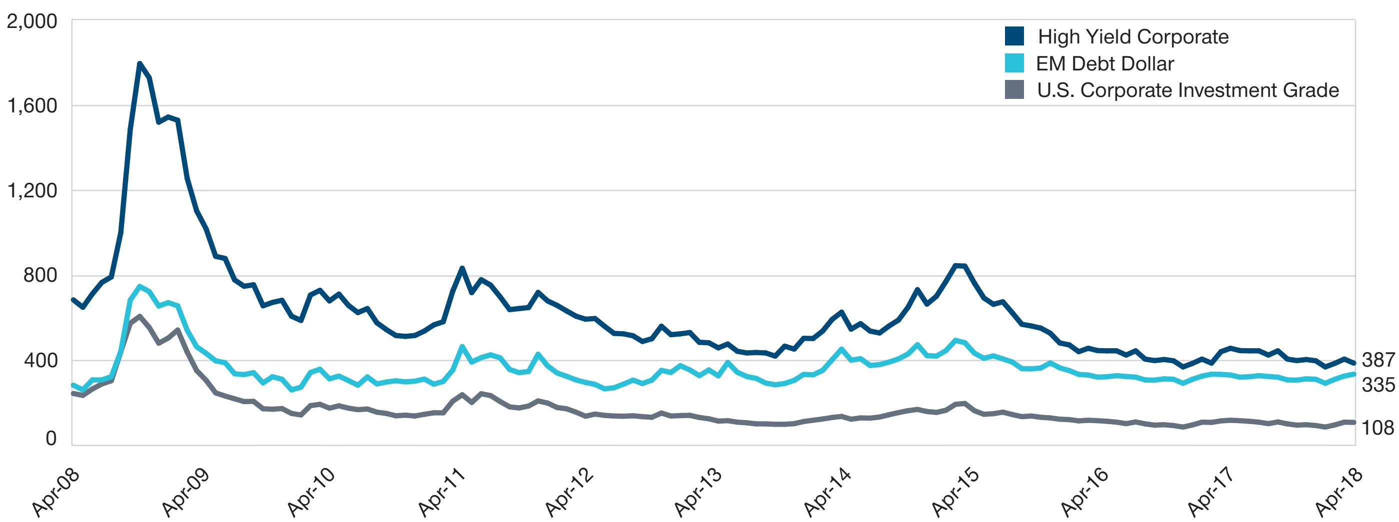
We believe that this expected surge of issuance will enrich and expand the European high yield opportunity set. However, this does not mean that investors should simply ramp up their allocations to the sector. While there will undoubtedly be some very high-quality noninvestment-grade paper among the new bonds on offer, there will also be some that is best avoided: All companies coming to market tell a rosy story, but not all can deliver on it.

When considering new allocations to European high yield, it is therefore imperative that investors are highly selective and undertake extensive research before deciding which bonds to purchase. The new issues to find will be from companies with improving credit stories based on sound business plans that are being implemented by strong management teams. New debt that looks simply cheap today may not be nearly as attractive in the future.

Flows into European high yield are marginally negative as of late April but could turn positive later in the year as the opportunity set ripens and issuance ramps up. For U.S. investors in particular, who are facing rising rates and relatively weaker credit fundamentals at home, in our view the time may be right to think global and embrace the opportunity to invest in European high yield bonds in addition to U.S. high yield.

Yield Spreads Over Treasuries (basis points)

April 30, 2008–April 30, 2018



Sources: High Yield Corporate—J.P. Morgan Global High Yield Index, EM Debt Dollar—J.P. Morgan Emerging Markets Bond Index Global, U.S. Corporate Investment Grade—Bloomberg Barclays U.S. Corporate Investment Grade Bond Index.*

Source for Bloomberg Barclays index data: Bloomberg Index Services Ltd. Copyright 2018, Bloomberg Index Services Ltd. Used with permission.

Yield spreads over Treasuries are the calculated spreads between a computed option-adjusted spread index of all bonds in a given rating category and a spot Treasury curve.

*Option-adjusted spread for the Bloomberg Barclays U.S. Corporate Investment Grade Bond Index as of April 30, 2018. Spread-to-worst for the J.P. Morgan Global High Yield Index as of April 30, 2018.

Relative Value Short-Term Outlook

Sector Returns
(As of April 30, 2018)**

Sector	Driver	One-Mo. Return	YTD Return	One-Yr. Return
U.S. Treasuries	U.S. Treasury yields have moved higher as growth remains stable, the Fed maintains increased confidence in the tightening cycle, and inflation expectations have increased. However, the market is digesting a moderation in growth, impacts from tighter financial conditions, and trade policy uncertainty, which could keep yields contained.	-0.81%	-1.98%	-1.07%
U.S. Treasury Inflation Protected Securities (TIPS)	Inflation expectations have increased as oil prices have been on the rise, placing upward pressure on breakevens. However, a reversal in oil prices or continued Fed tightening could cap breakeven spreads and TIPS performance.	-0.06	-0.85	0.27
Global Sovereign ex-U.S.†	Although European growth has shown signs of slowing from unsustainably strong levels, German bund yields have continued their upward trajectory. Also, bond purchases by the European Central Bank (ECB) are expected to end later this year, which should also push yields higher. Meanwhile, the Bank of Japan remains highly accommodative despite positive economic data, and the UK will need to raise interest rates, albeit gradually, as long as political uncertainty associated with Brexit remains under control.	-2.27	1.27	7.68
U.S. Municipals	Municipal yield ratios versus Treasuries are close to fair value as new issue supply has been light year-to-date. Favorable supply/demand dynamics in the sector are expected to continue, and the impact of tax reform does not appear particularly onerous.	-0.36	-1.46	1.56
Mortgage-Backed Securities (MBS)	Despite solid fundamentals, there is uncertainty in the sector due to the move higher in U.S. interest rates, a potential shift to a higher range in volatility, as well as technical challenges from increased seasonal supply and reduced Fed reinvestments. Offsetting demand from money managers and banks has also yet to materialize amid increased rate volatility.	-0.50	-1.69	-0.38
Commercial Mortgage-Backed Securities (CMBS)	Despite being in the later stages of the current credit cycle, credit fundamentals in the CMBS sector have remained largely healthy, and from a technical perspective, higher volatility is beginning to put pressure on new issue spreads.	-0.69	-2.00	-0.37
Asset-Backed Securities (ABS)	The ABS sector continues to benefit from strong consumer fundamentals and should continue to provide a relative safe haven if interest rate volatility were to increase; however, near-term technicals could be challenging.	-0.04	-0.42	0.27
Global Investment-Grade Corporate	Elevated volatility and issuance expectations have caused spreads to reprice wider. Fundamentals remain supportive in the near term, but the potential for earnings to become more challenging in the second half of the year, an increase in mergers and acquisitions (M&A), and fading overseas demand could weigh on the asset class.	-0.93	-3.22	0.67
Global High Yield Corporate	Spreads have retraced after widening in February due to equity volatility and rising Treasury yields, but valuations remain stretched. Fundamentals remain solid amid a supportive backdrop for employment, corporate earnings growth, and stable oil prices. Potential risks include volatility in commodity prices, outflows, weakness in equities, and corporate credit being late in the cycle.	0.39	-0.31	3.65
Bank Loans	Bank loans, with their floating rate feature, appeal to investors seeking shelter from rising interest rates. Solid fundamentals, low commodity exposure, low default rate expectations, and continued strong demand lead us to be constructive on the sector, but a reversal in technicals is a key risk.	0.42	1.95	4.64
Emerging Markets (EM) Dollar Sovereigns	Despite some recent widening, spreads remain tight for EM sovereigns on a historical basis. Continued volatility in risk assets leave EM markets vulnerable to additional spread widening, but encouragingly, underlying fundamentals look better than in past periods of market stress. In addition, we are selective in the sector due to continued idiosyncratic political risks (e.g., Mexico, Brazil, and Turkey) and as risk assets may be challenged in the near term from a risk-off environment in global equity markets.	-1.46	-3.22	0.19
EM Corporates	Despite a supportive technical backdrop, recovering fundamentals, and resilient oil prices, we are cautious in the near term given the recent weakness in the sector, less favorable liquidity profile, and little buffer for idiosyncratic shocks.	-0.66	-1.78	1.84
EM Local	We continue to favor countries in interest rate-cutting cycles or that offer high real yields, although we are cautious as the sector has seen much higher rates in some countries and is feeling pressure that we haven't seen over the recent past. Broad-based and resolute global growth, strong inflows, stability in China, and rising oil prices have also supported the sector but provide uncertainty should these factors reverse.	-2.96	1.36	8.38

Past performance is not a reliable indicator of future performance.

Sources: T. Rowe Price, Bloomberg Barclays, J.P. Morgan, and S&P/LSTA.

**U.S. Treasuries—Bloomberg Barclays U.S. Treasury Index, U.S. TIPS—Bloomberg Barclays U.S. TIPS Index, Global Sovereign ex-U.S.—Bloomberg Barclays Global Aggregate ex-U.S. Index, U.S. Municipals—Bloomberg Barclays Municipal Bond Index, MBS—Bloomberg Barclays U.S. MBS Index, CMBS—Bloomberg Barclays U.S. CMBS Index: ERISA Eligible, ABS—Bloomberg Barclays Asset Backed Index, Global Investment-Grade Corporate—Bloomberg Barclays U.S. Corporate Investment Grade Bond Index, Global High Yield Corporate—J.P. Morgan Global High Yield Index, Bank Loans—S&P/LSTA Performing Loans Index, EM Dollar Sovereigns—J.P. Morgan Emerging Markets Bond Index Global, EM Corporates—J.P. Morgan CEMBI Broad Diversified, EM Local—J.P. Morgan Global Bond Index—Emerging Market Global Diversified.

†European corporates are included in this sector.

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