EUROPE’S HIGH YIELD ADVANTAGE

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The attention of financial markets has shifted to oil and commodity prices recently. Concerns about a supply glut and fears over waning demand from China have been dominating the headlines, causing volatility and weakness in prices. With US high yield much more exposed to oil and commodity prices, does this put the European market back in favour?

Energy is one of the largest sector weightings in the US high yield market, comprising 14% of the benchmark. This exposure makes US high yield more vulnerable to moves in oil prices than European high yield, where energy issuers constitute just 5% of the benchmark. It also means that Europe is more likely to outperform when there is sustained downward pressure on oil and commodity prices. Looking beyond oil at the overall composition of each market, the US has a greater share of weaker-rated companies. C-rated issuers make up 14.5% of the benchmark there compared with 4% in Europe. As a result, overall risk and volatility tend to be lower in European high yield than in US high yield.

From a fundamental perspective, a current theme in both regions is that corporate earnings are improving, which is supportive. However, it is important to note that Europe remains at an earlier, more credit-friendly part of the economic cycle than the US, with inflation pressures low and growth improving. Europe also benefits from the European Central Bank’s (ECB’s) accommodative stance. While the Federal Reserve is tightening monetary policy and appears on course to deliver another two interest rate hikes this year, the ECB maintains a negative interest rate policy and currently buys €60 billion of bonds each month. Although we recognize the likelihood of a further reduction in the pace of the ECB’s buying, it is expected to remain accommodative. The technical picture is also strong in Europe: the default rate remains low, and there continues to be a supply/demand imbalance with fairly moderate new bond issuance at a time when the asset class continues to experience inflows.

Overall, the fundamental and technical factors underpinning European high yield are stronger than those in the US. And given the ongoing concerns about oil and resurfacing worries over China, the lower volatility in Europe compared to the US is also appealing. From our perspective, we continue to prefer higher coupons to capture income and are using our bottom-up credit research to help identify the best opportunities from across the rating and duration spectrums. This approach has driven the portfolio’s overweight in single B names and its lower duration stance versus the benchmark.

1BoA Merrill Lynch US High Yield Index as at April 28 2017
2BoA Merrill Lynch Euro High Yield Index as at April 28 2017
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