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FOUR QUESTIONS ON THE OUTLOOK FOR EUROPEAN HIGH YIELD

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Q: WHAT DO YOU EXPECT ON THE NEW ISSUANCE FRONT IN THE REMAINDER OF 2018?

A: Following the traditional summer slowdown, the primary bond market reopened this month. It is likely that we will see bonds related to financing leveraged buyouts testing the waters early, including jumbo deals from Thomson Reuters Corp.'s Refinitiv and AkzoNobel's Specialty Chemicals. How these deals are received could determine what comes next.

While we believe that there is cash to put to work, the investor community has become more cautious this year – pushing back on pricing, which caused some deals to be delayed or even pulled during the second quarter. Essentially, investors wanted to be compensated for the risks they were taking. This conservative approach is likely to continue, so companies will need to get pricing right when they bring deals to the market. To be sure, this is a welcomed development for investors after seeing aggressive prices earlier on in the year.

Q: WHERE DO YOU STAND ON VALUATIONS?

A: After coming under pressure during the first half of 2018, we believe there is room for European high yield spreads to tighten versus the US. Valuations are attractive, particularly compared with US high yield, where spreads are now trading broadly in-line with Europe after five years of being wider. Working in Europe's favor is its lower duration profile and higher credit quality: at present there are more BB and fewer CCC high yield issuers in Europe than there are in the US As a result, overall risk and volatility tend to be lower in Europe.

Drilling down further, we feel that the most relative value pick-up can be found in the B space in Europe, and thus anticipate outperformance there versus the US over the next few months. The driver for this is likely to be technicals, as investors seek to capture carry and the higher yield on offer compared with the BB space.

Q: WHAT DO THE FUNDAMENTALS UNDERPINNING THE ASSET CLASS LOOK LIKE?

A: Fundamentals are robust. Corporate leverage remains subdued and most bond deals are for refinancing purposes as opposed to aggressive buyouts or to pay dividends. Corporate profitability is also improving. In addition, following a slowdown earlier in the year, the eurozone economy is stabilizing, which is supportive for European high yield companies.

We recognize, however, that trade tariffs pose downside risks for the global economy and thus for Europe as well. On the monetary policy front, the European Central Bank (ECB) remains accommodative. While the ECB plans to end its bond-buying program at the end of 2018, its path toward normalisation is likely to be slow and cautious, with rate hikes not expected until the second half of 2019 at the earliest. Moreover, it's important to note that even 40 basis points worth of hikes will still only bring the key rate up to zero.

Q: DO YOU FORESEE ANY HEADWINDS?

A: With the US continuing to pursue protectionist policies, global trade tensions have ratcheted higher this year. This comes as we approach key political event risks, including budget negotiations in Italy, mid-term elections in

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the US and ongoing negotiations between the UK and Europe on finding a Brexit deal. At the same time, several major central banks are moving toward normalising monetary policy in synchronization. Any one of these factors has the potential to trigger bouts of volatility and broad risk-off moves in financial markets. As such – given its sensitivity to broad risk sentiment – European high yield would be vulnerable in such periods.

Against this backdrop, we believe it is more important than ever to be selective. The conditions in the market this year remind us of that, most notably during earnings season when companies publishing anything other than strong and steady results saw their credit spreads punished. Credit-intensive, bottom-up research is essential: it is important to fully understand a company and the potential risks/rewards of investing in it. To know whether you are being compensated for your risks, you must first fully understand exactly what they are.

Key Risks – The following risks are materially relevant to the strategy highlighted in this material: Debt securities could suffer an adverse change in financial condition due to ratings downgrade or default which may affect the value of an investment. Investments in High Yield involve a higher element of risk.

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