



EUROPEAN HIGH YIELD: HEADING FOR A SWEET SPOT?

May 2018
Mike Della Vedova
Portfolio Manager, European High Yield Bond Strategy

A confluence of factors looks set to make the European high yield (EHY) sector ripe for investment. Strong credit fundamentals, a benign macroeconomic environment and a glut of new issuance present a host of attractive-looking opportunities for investors in the asset class. But while many of these new opportunities will deliver long-term results, others will not – the ability to differentiate between them will therefore be vitally important.

DEFAULT RISK IS AT ITS LOWEST FOR A DECADE

In terms of quality, the EHY 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 for 10 years and less than half the 2.4% predicted default rate among US issuers. This is partly due to the current composition of the EHY sector: at present there are more BB and fewer CCC high yield issuers in Europe than there are in the US. It is also partly due to the fact that the US is further along its credit cycle than Europe, and is therefore subject to greater risks.

NEW ISSUANCE TO PICK UP

The fact that Europe is at an earlier stage in its credit cycle than the US is likely to drive issuance. While the US Federal Reserve has already embarked on rate hikes and begun unwinding monetary stimulus, the ECB is unlikely to begin hiking until it winds down its bond purchase programme, which is not expected to occur until later this year, and possibly not until next year. When rate hikes appear 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.

REVERSE YANKEES SET TO MAKE A COMEBACK

Another potential trend that could emerge is US issuers selling bonds in euros (known as “reverse Yankees”) and swapping the proceeds back into US dollars more cheaply than they can issue US dollar paper. US President Donald Trump's proposed tax reforms will cap the interest deductions that US companies can take to 30% of income per year, which will limit the amount of debt that most companies issue. This will not apply to US companies that sell euro-denominated debt via their European subsidiaries, making reverse Yankees cheaper to issue than dollar paper.

ACTIVE SECURITY SELECTION IS CRUCIAL IN A CROWDED MARKET

We believe this expected surge of issuance will enrich and expand the EHY opportunity set. However, this does not mean that investors should simply ramp up their allocations to the asset class. While there will undoubtedly be some very high quality paper among the new bonds on offer, there will also be some that is best avoided. Those to look out for will be from companies with improving credit stories based on sound business plans, being implemented by strong management teams.

For investment professionals only. Not for further distribution.



Important Information

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date noted on the material and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

DIFC - Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA - Issued in the European Economic Area by T. Rowe Price International Ltd, 60 Queen Victoria Street, London EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

Switzerland - Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

T. ROWE PRICE, INVEST WITH CONFIDENCE and the Bighorn Sheep design are, collectively and/or apart, trademarks or registered trademarks of T. Rowe Price Group, Inc. All rights reserved.

201805-496122

For investment professionals only. Not for further distribution.