EUROPEAN HIGH YIELD: HEADING FOR A SWEET SPOT?

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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.

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