U.S. VS. EURO HIGH YIELD: REVERSAL AHEAD?

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Has the U.S. high yield market's outperformance of the European market run its course? Before Donald Trump's victory in the U.S. presidential election, there were signs that this trend was running out of steam, with Europe performing better than the U.S. in October. However, there's an expectation that Trump will pursue pro-growth policies. Will that put the U.S. market back in favour again? At this stage, there are still too many unknowns, but we believe that the fundamentals underpinning Europe remain robust and that they support the investment case for the region.

The European Central Bank (ECB) remains very much in easing mode, which is supportive. The ECB continues to ease monetary policy through large scale asset purchases, and while it's possible that the Bank will begin tapering its buying in 2017, it is likely to remain accommodative. By contrast, it's likely that the U.S. Federal Reserve will raise interest rates for the first time this year in December, and there is the potential for further rate rises next year, particularly if the pro-growth policies materialize and cause inflation to rise. Such an environment could be challenging for U.S. high yield, although this could be tempered if fiscal stimulus extends the credit cycle in the world's largest economy.

The driving force behind the rally in U.S. high yield and its outperformance versus Europe this year has been the recovery in oil and commodity prices from February's multi-year lows. In the U.S., energy is one of the market's largest sector weightings, making up 14% of the Bank of America Merrill Lynch US High Yield Index. Energy issuers constitute just 5% of the Bank of America Merrill Lynch Euro High Yield Index. The U.S.'s higher weighting to energy has given it an advantage so far this year, but we believe this will be reduced going forward as the rebound in oil and commodity prices is already reflected in the prices. What's more, there are potential risks on the horizon, with OPEC due to meet at the end of the month.

In all, fundamentals and technicals underpinning European high yield remain sound. Europe remains at an earlier, more credit-friendly part of the economic cycle than the U.S., with inflation low and growth moderate. From a portfolio perspective, we continue to prefer higher coupons and are using our bottom-up credit research to identify the best opportunities from across the rating and duration spectrums.

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