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A 5-POINT GUIDE TO EURO HIGH YIELD IN 2017

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As the new year gets under way, here's a five point guide for what's in store for European high yield markets.

1. TECHNICALS: SUPPORTIVE FACTORS REMAIN

We expect technical factors to remain positive in 2017. The default rate is expected to remain lower than its historical average in Europe, while new issue volumes look set to be in line with, or slightly lower than, 2016 levels. Flows are more difficult to forecast. Since the election of Donald Trump as US President last November, there has been broad rotation out of fixed income and into equities. High yield, however, has managed to navigate this period relatively well, particularly in the U.S., where investors anticipate that the potential for more pro-growth policies could help to extend the credit cycle. However, it is uncertain how long this trend can continue, particularly with the Federal Reserve telegraphing a faster pace of rate rises than initially expected in 2017.

2. NEW ISSUANCE: DOUBLE-B NAMES LIKELY TO COME FIRST

Barring any significant risk events, it is likely that the primary bond market will reopen later this month. The highest quality segment of the market—double-B names—are likely to come first and, depending on how those deals are received, could dictate what follows. As always, the timing of bringing new deals will be pivotal, particularly for UK issuers, as formal talks on the country's exit from the European Union are expected to start this year.

3. FUNDAMENTALS: ECB'S ACCOMMODATIVE STANCE TO CONTINUE

We expect the European Central Bank (ECB) to remain accommodative, keeping in place a key source of support for European high yield this year. In December, the ECB extended its asset purchase program until at least the end of 2017, but from April the pace of buying will be reduced from EUR 80 billion to EUR 60 billion per month. To ease tapering fears, ECB President Mario Draghi reassured investors in the post-meeting press conference that the Bank's stimulus support would continue for as long as needed to bring inflation back to its target. This commitment to purchase bonds for as long as necessary sends a reasonably dovish message, and reduces uncertainty about the ECB's monetary policy stance this year. Nonetheless, it will not stop questions being asked about what the central bank will do next. As the year progresses, these questions will increase, particularly if inflation starts to pick up.

4. VALUATIONS: EUROPE VS U.S. HIGH YIELD

In recent years, oil has been a key factor in determining which regions outperform. This year, government policy could play a role, particularly as markets have been betting on Mr. Trump delivering fiscal stimulus, tax cuts, and reduced regulation. This has led to expectations that the U.S. credit cycle will be extended, which has helped U.S. high yield's performance relative to Europe of late. However, there are still many unknowns. For a start, Congress has not approved any of these policies yet. If, or when, it does, it could take a while before they are implemented. How this plays out through 2017 could influence which regions outperform.

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5. HEADWINDS: POLITICAL RISKS, CHINA

There is a busy electoral calendar in 2017, with votes taking place in some of the euro area's largest member countries: France, Germany and the Netherlands. On top of that, the UK plans to start formal talks on the country's exit from the European Union before the end of March. As in 2016, China remains a key risk, particularly as capital outflows have begun to pick up again. Any one of these events has the potential to trigger bouts of volatility and broad risk-off moves in financial markets. With its sensitivity to broad risk sentiment, European high yield would be vulnerable in such periods.

Overall, fundamentals and technicals underpinning European high yield are robust. However, as in 2016, volatility is likely to remain a prevalent theme given Brexit negotiations and elections in France, Germany and the Netherlands. For us, the most important thing is to be credit selective. This will be the biggest determinant of absolute and relative returns.

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