FOUR KEY TRENDS TO WATCH IN HIGH YIELD

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After generating returns of more than 5% so far this year[1], what can we expect from European high yield for the rest of 2016? Here are four key areas to watch:

1. CENTRAL BANK POLICY

The European Central Bank (ECB) remains highly accommodative, a stance we expect it to maintain for the foreseeable future. While no large expansion of current stimulus measures is envisaged, there is potential that the ECB will extend its €80 billion monthly asset purchase programme beyond its current scheduled end in March 2017. Overall, the ECB provides a supportive backdrop for European high yield. Meanwhile in the UK, the Bank of England is following in the footsteps of the ECB with plans to start buying investment-grade corporate bonds from September. Although sterling-denominated high yield bonds will not be purchased, they could indirectly benefit as investors move further down the credit curve to seek higher-yielding bonds. This is similar to what has happened in Europe, where euro-denominated high yield has been an indirect beneficiary of the ECB's corporate bond-buying, particularly bonds in the BB-rated space.

2. NEW BOND ISSUANCE

After a subdued start to the year, new bond issuance rebounded in the second quarter, although volumes were still lower than the same period last year. Looking ahead, we expect new supply to pick up in September after the traditional August slowdown. Some key risk events have now passed, most notably the British referendum on European Union membership. However, concerns over China linger, and it is likely that upcoming political events including a referendum in Italy on constitutional reform in October and the U.S. presidential election in November will gain more focus over the coming the weeks and months. These have potential to impact sentiment toward risk markets, which in turn could lead to issuers being more cautious on bringing new deals to the market.

3. OIL PRICES

Concerns about oversupply led to a decline in oil prices during July. If this trend continues, there's potential for European high yield bonds to outperform US high yield. Energy is one of the largest sector weightings in US high yield, comprising 14% of the index[2]. This exposure makes it more vulnerable to declines in oil prices than European high yield, where energy issuers constitutes just 5% of the benchmark.[3]

4. LIQUIDITY

A key discussion point this year has been liquidity in the secondary market. During the first few months of 2016, the lack of primary market deals led to a squeeze on liquidity. This improved in the second quarter as new issuance activity picked up. In our view, the two factors are interlinked, a trend we expect to continue in 2016. In essence, a functioning primary bond market is a precursor for liquidity conditions to improve in the secondary market.

In all, fundamentals and technicals underpinning European high yield remain sound. However, as in the first half of 2016, volatility is likely to remain a prevalent theme, with the consequences and impact of the UK's vote to leave uncertain. From a portfolio perspective, we will continue to focus on bottom-up credit research to identify the best opportunities for our clients and help to protect them against external risks.

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[1]BofA Merrill Lynch Euro High Yield Index (January 1 – July 29)
[2]BofA Merrill Lynch US High Yield Index
[3]BofA Merrill Lynch Euro High Yield Index

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