European High Yield: What's left for investors?

February 2015

Michael Della Vedova,
Portfolio Manager,
European High Yield Bond Strategy



EXECUTIVE SUMMARY

The European high yield market has grown in size, depth, and liquidity since the financial crisis. The rapid growth has helped the asset class generate strong returns over the last few years, leaving some investors questioning whether there is still value left. We strongly believe that there is, and investors that turn away now could miss out on some great opportunities.

In this Price Points, T. Rowe Price's portfolio manager for European High Yield, Michael Della Vedova, provides his latest thoughts on the asset class, and where to look for opportunities to add value.

New Issuers

New issuers offer a good way of finding fresh opportunities in European high yield markets. Around one in every three companies that brings a new deal to the primary market has never done so before. This is a trend we expect to continue as tighter bank lending standards drive companies to the public markets for their financing needs. Investors should not shy away from these new issuers, as they help broaden and diversify the asset class' opportunity set. Moreover, first-time issuers typically pay higher premiums. That does not make them all attractive though as credit intensive research is required to identify the successful stories. Looking at a company's credit quality, cash flow and management structure is a good starting point, but the assessment should not end there. The issuer's full capital structure alongside the maturity and liquidity profile of its debt also need to be evaluated. To get a full picture of the company and the potential risks involved from investing, all these areas must be analysed. This entails hard work, but is rewarded by higher premiums, and in an environment where yields on some eurozone government bonds trade in negative territory, such opportunities cannot be ignored.

Opportunities in single-B rated issuers

Investors can also find opportunities by looking beyond the BB-rated universe as more value can be found in B-rated names. Although this riskier segment of the market can suffer more during bouts of volatility, from an absolute yield and relative return standpoint it can be much more attractive. Yields are excessively low in the BB-rated sector, which is considered the safest part of the market, but in my opinion can represent a value trap as I feel investors are not being fully compensated for the potential risks involved.

Considering the full opportunity set

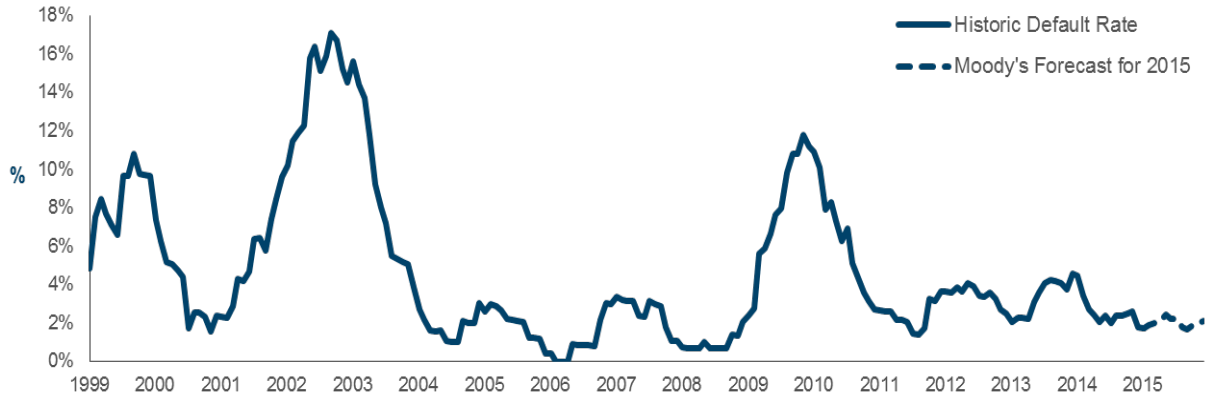
We believe it is important to consider the widest opportunity set possible when selecting securities. Once we have identified an issuer we like, we then screen for the security that provides the best investment, irrespective of currency. The euro's sharp depreciation against the dollar in recent months has made it cheaper for European corporates to raise money in dollars and swap it back into euros. As a result, dollar issuance from European-based companies is expected to increase as they take advantage of the cheaper funding costs. For investors, this adds diversity to the European high yield market and broadens the opportunities available to capture premiums, while the currency risk can be hedged back into euros.

Technical backdrop supports

The overall backdrop in European high yield markets remains favourable for investing. Fundamentals are supportive with the default rate low. See figure 1 below. Encouragingly, signs are emerging that economic conditions in the eurozone are improving. This could feed through into a better operating environment and corporate profits later on in the year. The European Central Bank's announcement in January that it is expanding asset purchases is also supportive as it ensures the low interest rate environment will continue for a prolonged period. While all these factors are complimentary for investing in European high yield, the biggest determinant of returns from the asset class will come from security selection. By casting the net wider and doing fundamental research, investors can uncover the best opportunities and be rewarded for it.

Figure 1. European High Yield Trailing 12-month default rate (%) From December 1999

As of 31 December 2014



Sources: Moody's and T. Rowe Price

IMPORTANT INFORMATION

This document, including any statements, information, data and content contained therein and any materials, information, images, links, sounds, graphics or video provided in conjunction with this document (collectively "Materials") are being furnished by T. Rowe Price for your general informational purposes only.

The Materials are not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the Materials and in certain countries these Materials are only provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction. Under no circumstances should the Materials, in whole or in part, be copied, redistributed or shown to any person without consent from T. Rowe Price. The Materials do not constitute a distribution, an offer, an invitation, recommendation or solicitation to sell or buy any securities in any jurisdiction. The Materials have not been reviewed by any regulatory authority in any jurisdiction. The Materials do not constitute investment advice and should not be relied upon. Investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

Issued in Australia by T. Rowe Price International Ltd ("TRPIL") (ABN 84 104 852 191), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. TRPIL is exempt from the requirement to hold an Australian Financial Services license ("AFSL") in respect of the financial services it provides in Australia. TRPIL is authorised and regulated by the UK Financial Conduct Authority (the "FCA") under UK laws, which differ from Australian laws. For Wholesale Clients only.

Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services. T. Rowe Price (Canada), Inc. is not registered to provide investment management business in all Canadian provinces. Our investment management services are only available for use by Accredited Investors as defined under National Instrument 45-106 in those provinces where we are able to provide such services.

Issued in the Dubai International Financial Centre by TRPIL. This material is communicated on behalf of TRPIL by the TRPIL Representative Office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

Issued in the EEA by T. Rowe Price International Limited ("TRPIL"), 60 Queen Victoria Street, London EC4N 4TZ which is authorised and regulated by the Financial Conduct Authority. For Qualified Investors only.

Issued in Hong Kong by T. Rowe Price Hong Kong Limited ("TRPHK"), 21/F, Jardine House, 1 Connaught Place, Central, Hong Kong. TRPHK is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Issued in Japan by T. Rowe Price International Ltd, Tokyo Branch ("TRPILTB") (KLFB Registration No. 445 (Financial Instruments Service Provider), JIAA Membership No. 011-01162), located at GranTokyo South Tower 7F, 9-2, Marunouchi 1-chome, Chiyoda-ku, Tokyo 100-6607. This material is intended for use by Professional Investors only and may not be disseminated without the prior approval of TRPILTB.

Issued in New Zealand by T. Rowe Price International Ltd ("TRPIL"). TRPIL is authorised and regulated by the UK Financial Conduct Authority under UK laws, which differ from New Zealand laws. This material is intended only for use by persons who are not members of the public, by virtue of section 3(2)(a)(ii) of the Securities Act 1978.

Issued in Singapore by T. Rowe Price Singapore Private Limited ("TRP Singapore"), No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. TRP Singapore is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

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

Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional 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. in the United States, European Union, and other countries. This material is intended for use only in select countries.

2015-GL-1499

02/15