



A 5-POINT GUIDE TO EURO HIGH YIELD IN 2019

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With a new year underway, here's our five-point guide for what we believe is in store for European high yield markets in 2019:

1. ECB STILL SUPPORTIVE DESPITE ENDING QUANTITATIVE EASING PROGRAMME

The European Central Bank (ECB) remains one of the most accommodative central banks in the world. While its quantitative easing programme formally stopped at the end of 2018, the central bank continues to reinvest proceeds from maturing bonds. This is important: the ECB is not tightening yet; its balance sheet will remain at elevated levels. Overall, we believe the ECB's path toward normalisation will be slow and cautious, with rate hikes not expected before 2020 now, unless the eurozone economy rebounds sharply. Moreover, it's important to note that, even if the ECB does hike, with the key interest rate currently set at -0.4% it will take two raises of 20 basis points before zero is even reached.

2. TECHNICAL PICTURE MIXED

Given the volatility we saw in 2018, the timing of bringing new bond deals will be pivotal, particularly for those linked to financing mergers and acquisitions. For those types of deals to proceed, we will need to see prolonged periods of market stability. Overall, we expect the trend of refinancing dominating the use of proceeds to continue. In terms of volumes, 2018 saw some traditional high yield bond issuers in Europe turn to the loan market for their financing needs. Whether this continues depends on a number of factors, including whether demand for loans from collateralized loan obligations (CLOs) remains strong. Flexibility and cost are also important: borrowers are most likely to go to the place which is flexible and most cost effective. Flows are more difficult to forecast and are expected to be driven by the external environment and broad sentiment toward risk markets.

3. VALUATIONS FAVOUR EUROPEAN HIGH YIELD OVER THE U.S

After a significant selloff during the second half of 2018, valuations in European high yield have improved. Furthermore, on an absolute yield basis, we believe European high yield is more attractive than its U.S. counterpart where spreads are now trading tighter than Europe after several years of being wider. Working in Europe's favor is its lower duration profile and higher credit quality: at present there are more BB and fewer CCC high yield issuers in Europe than there are in the U.S. It's also important to remember that Europe is in an earlier, more credit-friendly part in the cycle than the U.S., which is moving toward late cycle. As a result, overall risk and volatility tend to be lower in Europe.

4. SOLID FUNDAMENTALS CONTINUE TO PROVIDE SUPPORT

Corporate leverage remains subdued and the average default rate in the asset class is expected to remain well below its long-term average. After a bumper 2017, momentum in the eurozone economy slowed last year. There is potential for further moderation, although some of the factors behind the deceleration should start to abate. This includes oil prices which have come down considerably from their October peak, a factor that could provide a positive tailwind for consumer purchasing power and retail sales.



5. POTENTIAL HEADWINDS: POLITICAL RISKS, GLOBAL GROWTH SLOWING

Global growth has slowed, and political uncertainty continues to undermine a number of developed countries, such as the UK, which is set to leave the European Union before the end of March. This comes at a time when global liquidity conditions continue to tighten. Any one of these factors has the potential to trigger bouts of volatility and broad risk-off moves in financial markets. As such – given its sensitivity to broad risk sentiment – European high yield would be vulnerable in such periods. At the same time, it's important to remember there could be positive catalysts as well for risk sentiment, which European high yield could benefit from. For example, a deal between China and the U.S. on tariffs could be a positive development if it materializes.

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