High Yield Bond Opportunities Are Going Global

A truly global high yield strategy can provide diversification.

September 2019

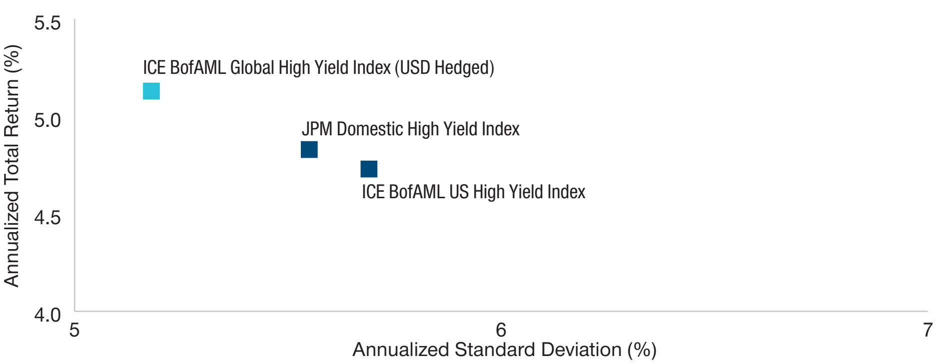
KEY INSIGHTS

- An actively managed global high yield portfolio seeks to benefit from divergent credit cycles, relative value disparities, and performance variations between regions.
- The diversification benefits of this type of portfolio have delivered results with less risk than a more traditional, U.S.-focused high yield strategy.
- The high yield market today has expanded beyond its traditional North American focus, with the growth coming from European and emerging markets.

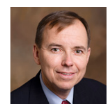
Fixed income investors may want to focus on higher-yielding, sub-investment-grade strategies as global central banks shift back into monetary easing, pushing yields on high-quality investment-grade bonds to very low—or negative—levels. In this environment, the diversification benefits of a high yield portfolio that invests across a truly global opportunity set may prove especially important. A global high yield strategy should seek to take advantage of unsynchronized credit cycles, relative value disparities, and geopolitical events that create pricing dislocations.

(Fig. 1) Global High Yield: Positive Risk/Return

Five-year annualized standard deviation and return
As of June 30, 2019



Past performance cannot guarantee future results.
Sources: Zephyr StyleADVISOR and T. Rowe Price.



Mark Vaselkiv
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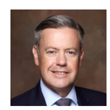

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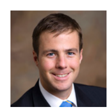

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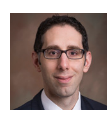

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USD 4.5 trillion

The global high yield market is now larger than USD 4.5 trillion.

Also, the diversification benefits of this type of portfolio have delivered results with less risk than a more traditional, U.S.-focused high yield strategy.

Risk and Return Data Show Advantages of Global High Yield

Risk and return data for the five years ended June 30, 2019, as shown in Figure 1, support this claim. Over that five-year period, the ICE BofA Merrill Lynch Global High Yield Index (USD Hedged) (BAML Global HY)—the primary benchmark for our Global High Income Bond Strategy and a suitable proxy for the global high yield opportunity set—outperformed the more traditional ICE BofA Merrill Lynch U.S. High Yield Index (BAML U.S. HY) with lower volatility.

In addition, as shown in Figure 2, a global high yield allocation, represented by the BAML Global HY, has held up meaningfully better in high yield market sell-offs while sometimes outperforming the U.S. high yield market in up markets. In the 10 years ended in June 2019, the BAML Global HY outperformed in negative markets and also performed slightly better in positive environments for high yield. The BAML Global HY's downside capture ratio improved across shorter time periods, with the global benchmark only experiencing 73% of the declines in the BAML U.S. HY for the 12 months ended in June 2019.

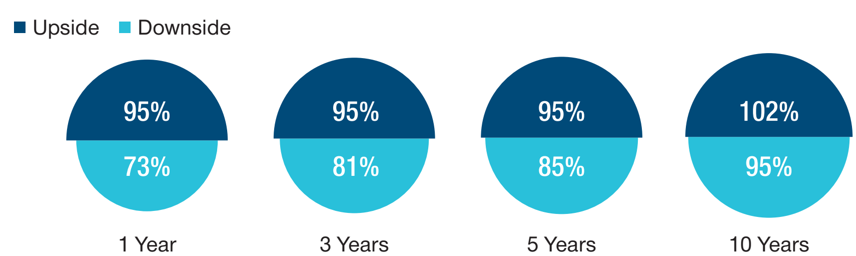
Global Component Can Be Volatile at Times, Necessitating Thorough Research

The global high yield market is now larger than USD 4.5 trillion. A decade ago, the high yield market consisted primarily of North American issuers; today it is much broader, with an increasingly international flavor coming from European and emerging markets (EM). This is largely due to an increase in issuance outside the U.S., while the U.S. high yield market has modestly shrunk—trends we expect to continue. As shown in Figure 3, the European high yield market has more than quadrupled in size since 2008 and is now almost one-third the size of the U.S. high yield market. The European market also has much less exposure to energy-related sectors, which can be an advantage when commodity prices are falling.

Like European high yield, the EM high yield corporate segment has experienced tremendous growth and now stands close to USD 1 trillion. Companies in emerging markets have primarily used the corporate bond market to refinance existing loans at more favorable terms. The balance sheets of EM corporations are often sturdier than those of their developed market peers, with lower leverage and higher cash-to-debt ratios, while EM

(Fig. 2) Attractive Upside/Downside Capture

BAML Global HY as percent of BAML U.S. HY returns
As of June 30, 2019



Sources: Zephyr StyleADVISOR and T. Rowe Price.

corporates, on average, provide more credit spread[1] for equivalent leverage.

Both the European and EM high yield markets are less mature and less followed by investors than the U.S. market. For example, dedicated EM corporate investors make up only 5% of that market.[2] Such low levels of dedicated ownership result in a more inefficient market and present more opportunities for skilled active managers to take advantage of pricing dislocations and attractive relative value.

Because macroeconomic and political developments, along with environmental, social, and governance (ESG) concerns, can have a large impact on the performance of international bonds, we supplement our fundamental credit analysis with top-down insights from our team of sovereign and ESG analysts.

Their input is essential for developing regional allocations and can help us sidestep country-specific issues, such as the turbulence in Turkey in the first half of 2018. We were able to capitalize on the dislocation in Turkey by adding select issuers early in the second half of 2018.

European Opportunities

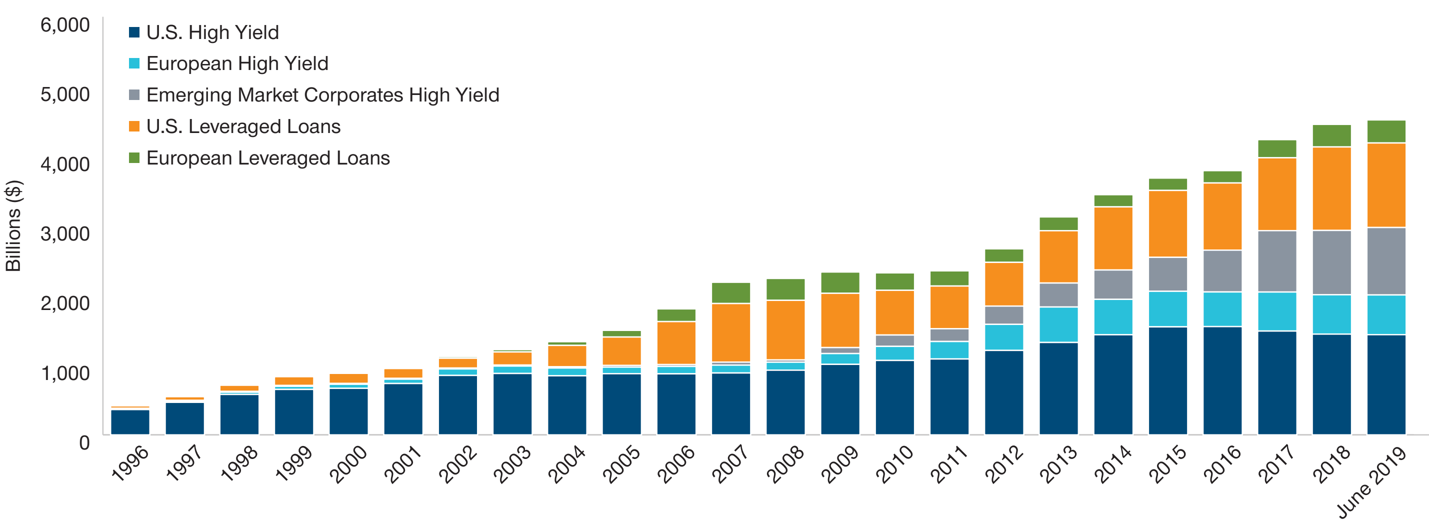
In our view, Altice[3] is a European high yield credit story that illustrates the benefits of detailed credit analysis and a flexible approach to portfolio construction. The multinational cable and telecommunication services provider, which has a complex capital structure, is one of the largest issuers of below investment-grade debt through various entities in Europe.

Weak earnings from Altice's French operations in late 2017 weighed on its bonds and convinced the company's

(Fig. 3) Global High Yield Universe Has Grown Rapidly

Size of global high yield segments

As of June 30, 2019



Sources: Credit Suisse and J.P. Morgan Chase & Co. (see Additional Disclosures).

[1] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

[2] Source: J.P. Morgan (see Additional Disclosures).

[3] The specific securities identified and described above do not necessarily represent securities purchased or sold by T. Rowe Price. This information is not intended to be a recommendation to take any particular investment action and is subject to change. No assumptions should be made that the securities identified and discussed above were or will be profitable.

Overall, we believe that the enhanced diversification of a global high yield strategy can help overcome periodic bouts of changing market sentiment toward particular issuers, countries, or regions.

founder, Patrick Drahi, to step in as CEO of the company's French entity. At that time, we sold out of positions in the Altice French complex and bought secured notes of Altice's other operating company (Altice International), where we saw better value. As Altice progressed with selling assets in 2018, we moved back into obligations of its French entity based on the potential for consolidation in European telecom markets. These positions have performed well, demonstrating the benefits of applying fundamental credit analysis with a long-term perspective in an effort to see through negative market sentiment.

EM Opportunities

The idiosyncratic nature of the global high yield opportunity set provides fertile opportunities to generate alpha.[4] For example, we have a generally favorable view of Minerva, a Brazilian beef producer with operations throughout South America. The company's bonds rallied in 2018 after it acquired competitor National Beef, making Minerva the second-largest beef producer in the world. Minerva deleveraged later in 2018 by spinning off parts of its South American operations and using the proceeds to pay down debt. We expect global beef demand to continue to rise, which, combined with the company's low leverage and attractive yield, supports our generally positive outlook on Minerva's debt.

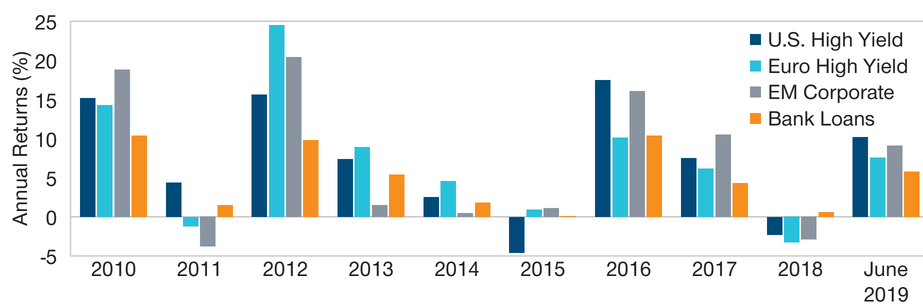
So far, a global approach to high yield investing has resulted in higher returns with lower risk, measured in terms of standard deviation. However, as with all high yield investing, it is not for the faint of heart. Due to the opportunity set's exposure to EMs with less developed political and economic systems, geopolitical developments and ESG concerns warrant caution and necessitate a robust and experienced global research platform dedicated to EMs.

In addition, market liquidity can be particularly challenging in EM debt, though liquidity has improved as the market has grown and matured in recent years. Volatility and economic uncertainty can also create rewarding investment opportunities. Overall, we believe that the enhanced diversification of a global high yield strategy can help overcome periodic bouts of changing market sentiment toward particular issuers, countries, or regions.

(Fig. 4) Diverse Returns Across Regions

Annual returns of global high yield segments

As of June 30, 2019



Past performance cannot guarantee future results. Sources: BofA Merrill Lynch, J.P. Morgan Chase & Co., and S&P/LSTA (see Additional Disclosures). U.S. high yield represented by the BofA Merrill Lynch U.S. High Yield Index; European high yield by the BofA Merrill Lynch European Currency High Yield Constrained ex Subordinated Financials Index Hedged to EUR; emerging market corporates by the J.P. Morgan CEMBI Broad Diversified Index; and bank loans by the S&P/LSTA Performing Loan Index.

[4] Alpha is the excess return of an investment relative to its benchmark.

Loans Provide Another Diversification Source

Bank loans are another segment of the global corporate high yield market that potentially can be a useful source of diversification from U.S. high yield bonds. Loans present opportunities to take advantage of valuation differences in an issuer's capital structure or to gain exposure to attractive loan-only issuers. Loans are often senior to bonds in the capital structure, giving them repayment priority in the event of issuer bankruptcy. However, given deteriorating loan underwriting standards, solid fundamental analysis is just as important for bank loans as it is for high yield bonds.

Global High Yield as a Core Allocation

As the world's credit markets continue to evolve, we believe that a global high yield portfolio should be a core allocation so that investors can take full advantage of the entire sub-investment-grade universe. An actively managed global high income portfolio benefits from exposure to divergent credit cycles, relative value disparities, and performance variations between regions, as shown in Figure 4, while not necessarily taking on more risk than a U.S.-centric high yield strategy. There is also potential to profit from valuation dislocations driven by the ever-present economic and political uncertainties across the global landscape. It's also important to note that our Global High Income Bond Strategy hedges any non-U.S. dollar holdings back to dollars, allowing our credit selection to be the main driver of returns.

WHAT WE'RE WATCHING NEXT

Prices of oil company bonds have been under pressure as investors weigh the sustainability of lower-quality exploration and production (E&P) and oil field services companies. Energy-related issuers constitute a smaller part of the European high yield market than the U.S. market. We can also limit exposure to volatile energy prices while maintaining allocations to the oil and gas industry through debt issued by higher-quality midstream companies, which process, store, and transport petroleum products.

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Diversification cannot assure a profit or protect against loss in a declining market.

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201909-965664