

European High Yield: High Income, Low Duration

The European high yield market appeared on course for an excellent year in the first half of 2011, with record levels of issuance. However, the eurozone's deteriorating sovereign debt crisis has badly affected the asset class during the summer and autumn months. During this period issuance has shrivelled and yields have spiked to levels that typically signify a recession. Those European companies that have come to the market have been forced to pay a hefty new issue premium.

However, we believe that the European high yield asset class does offer attractive opportunities to investors, namely an unusually high amount of spread and yield in a low yield world. The rally the market enjoyed in October, when the EU unveiled an initially well-received package of measures to address the sovereign debt issues, certainly suggests that investors are attracted to the yields on offer.

However, the asset class clearly faces serious threats. The economic backdrop is weak and is possibly set to deteriorate further. Indeed, the European Union recently drastically cut its growth forecast for the eurozone in 2012, from a predicted 1.8% to just 0.5%, and European Commissioner Olli Rehn has said there is a real risk of a new recession. A weak economic backdrop is generally negative for the high yield asset class.

Strong balance sheets and defensive qualities favoured

Thus, those companies which are likely to do best in this sort of environment, from a credit point of view, are those with strong defensive attributes and robust balance sheets. Sectors which are relatively insulated from an economic downturn will also clearly fare better than more economically-sensitive areas. However, these companies and sectors will also inevitably offer the lowest yields to investors.

In terms of geographic allocation, it's important that investors recognise that many European businesses operate beyond national boundaries and, consequently, the country of domicile of the company may not be overly important. This is particularly true in fixed income where the bond subsidiary will often define the domicile rather than the country of operation. That is not to say that domicile should be ignored.

We currently have an underweight in cyclical businesses and sectors in general and more specifically to companies and areas that are particularly exposed to domestic consumers in economies where the outlook is particularly poor. This includes countries where austerity measures are being implemented, such as the UK, Spain and Italy, while we are less concerned about consumer-oriented companies in northern European nations.

Underweight peripheral eurozone

We are certainly underweight in terms of the peripheral eurozone, which contains those countries that are most vulnerable to the sovereign debt crisis. But we are also underweighting areas, such as retailing in the UK, where tax rises and cuts in government spending, as well as other pressures on consumer spending, are likely to hit retailers. Another example would be the auto sector in general - the sovereign debt crisis has already hit demand for cars with new car registrations dipping by 0.8% in Europe in the first nine months of the year.

Seeking businesses exposed to global growth

Conversely, we are overweight in companies which have defensive attributes and which are more exposed to global rather than to European growth. Thus we favour European media cable companies, such as Germany's Kabel BW, the Dutch business Ziggo and the pan-European enterprise Liberty Media. Where we are exposed to cyclicals, we favour businesses that are benefiting from global growth, rather than those that are reliant on Europe. We have, for example, a position in UK-based Jaguar Land Rover, which is enjoying a boom in sales in emerging markets, as well as In Continental AG, which supplies high-end products for higher-end vehicles, with much of its sales also focused on emerging markets. Heidelberg Cement is another company that we favour. It is exposed to global growth and its European sales are focused on Germany.

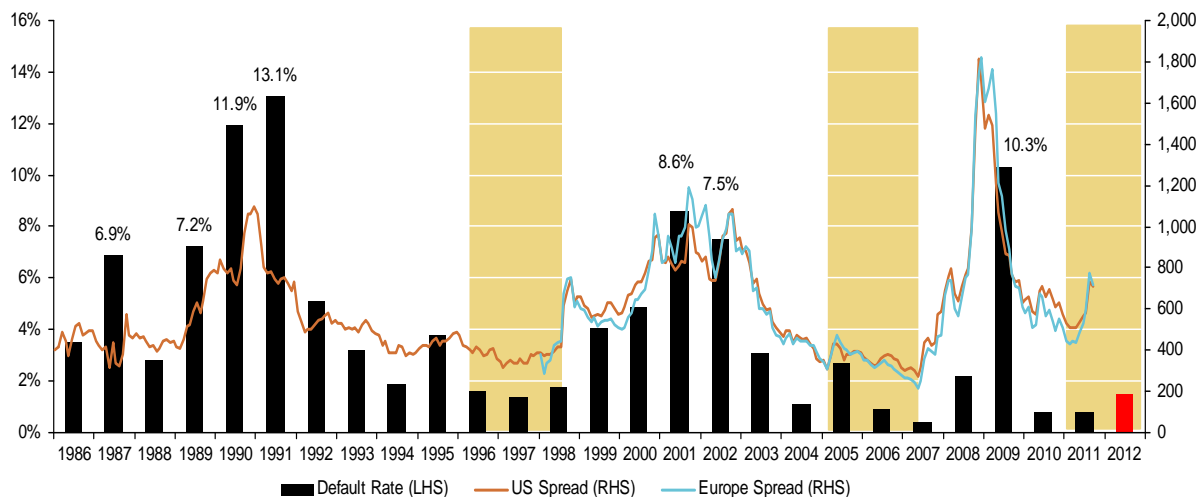
Of course, some investors may wonder why they should consider high yield bonds at all in the current environment. We believe that there are a number of factors that investors should consider. The asset class has re-priced quite markedly over the past four months and now offers a relatively high yield and spread. The market is certainly now factoring in significant bad news in terms of the economic slowdown.

Healthy corporate sector

In addition, the high yield asset class is a high income product, which intuitively appeals in a low growth world. Much of an investor's total return in the high yield arena emanates from income and takes the form of a contractual coupon usually paid semi-annually, rather than a dividend which is paid at the discretion of the company.

The obvious risk to the asset class lies in an escalating default rate should the economic slowdown intensify. We would certainly normally expect such a trend to develop during a recession. However, the corporate sector in general is currently in a healthy position in terms of leverage, liquidity and balance sheet structure. Companies are thus well placed to survive a sustained period of no or low economic growth. Consequently, we believe that default rates will stay unusually low over the next couple of years.

European High Yield - Default rate versus Spread to worst



Source: Credit Suisse, JP Morgan October 2011. European spread used is the HPS2 Index. US spread is H0AO Index

Income, therefore, is likely to prove a very powerful driver of total return over this period while the default rate, which is the major factor causing capital erosion that could offset income generation, will be less than many investors might anticipate.

The high yield asset class also has advantages in relation to other asset classes such as equities, corporate bonds or other alternatives. It has delivered a better risk-adjusted return than equities over history, and is much less volatile than equities. It also offers a much higher income and has much less rate duration than other bonds, such as government and investment grade. Thus, an income-seeking investor who wants to avoid the risks associated with equities but is overweight rate duration and is concerned about extremely low yields in other types of bonds might wish to consider their credit exposure, especially if their portfolio lacks income.

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