For Professional Investors Only

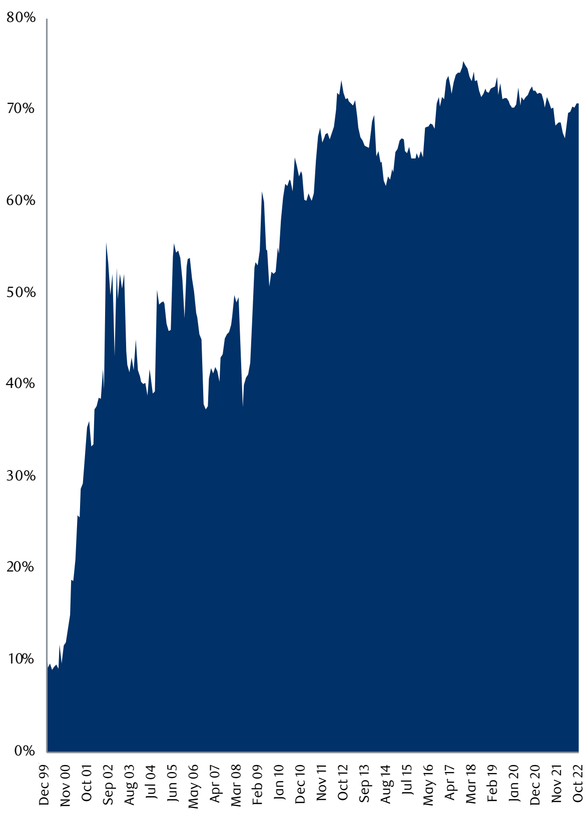
RBC BlueBay
Asset Management

European High Yield: forward looking expectations

As the world faces challenges from weakening growth, inflation and policy tightening, the good news for European High Yield investors is that the underlying strength in the asset class has been on an improving trajectory over the last two decades:

- In the early 2000s the asset class risk profile was dominated by smaller companies at an earlier stage of their business plans. Particularly the tech boom brought roll-out cable operators with high capex with revenue pay-offs which were several years away.
- In 2005-2008, pre–Global Financial Crisis (GFC), high yield markets were the key financing route for junior risk in LBOs; CCC supply increased bringing businesses with more precarious balance sheets into public markets.
- The index now has more mature multi-national companies whose balance sheet vulnerabilities are offset with more dependable cashflows. Across multiple sectors there are national champion brands such as Media, Chemicals, Automobiles, Telecommunications and Banking.
- For investors this is a noticeable improvement since the GFC, with the proportion of BB rated credits over 70% in Europe compared to 53% at the end of 2008.

% of BB in European High Yield Index



Source: RBC BlueBay Asset Management, ICE BofA as at 31 October 2022. Note: European High Yield Index refers to the ICE BofA European Currency High Yield Constrained Index

The drawdowns in 2022 have been substantial and have meaningfully reset valuations of European High Yield – the key investment question for our portfolios is whether this has sufficiently offset the building pressure on corporate earnings that we expect to cause an increase in credit stress and default loss. Defaults cluster because the two key inputs are earnings stress and credit availability. These are correlated factors, but with a strong starting position and capital rich banks our perspective is that it will take a lot of economic stress to generate a pick up in defaults that surpasses a reversion to long term averages of 2-4%.

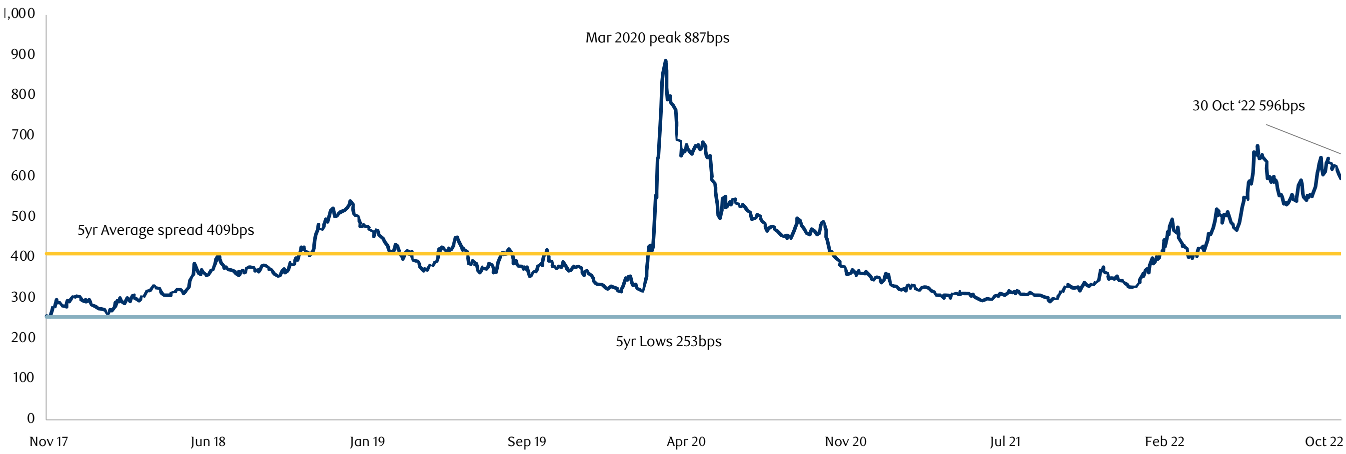
The more insidious long-term challenge to cash flows comes from a regime change on funding costs that will take a long time to play out – with limited maturities and largely fixed coupon debt this is a multi-quarter or even multiyear process. There will be plenty of water to pass under the bridge in terms of economic data and activity, but our current trajectory will create pressure into H2 2023 and 2024.

Governments are again taking away tails from consumers, and to some extent corporates, with substantial fiscal support to mitigate the impact of painfully elevated energy costs. This interventionist mindset supresses earnings shocks and defaults which is good news for high yield investors.

“The key investment question for our portfolios is whether this has sufficiently offset the building pressure on corporate earnings that we expect to cause an increase in credit stress and default loss.”

European high yield valuations are also trading at a discount to US high yield, as markets have priced in the higher probability of a deeper recession for Europe compared to the US. The relative valuation between both markets remains justifiable as there is no quick fix to Europe’s higher energy costs – but at some point, in our view, will offer a compelling opportunity when current headwinds began to ease.

European High Yield Spreads Last 5 Years

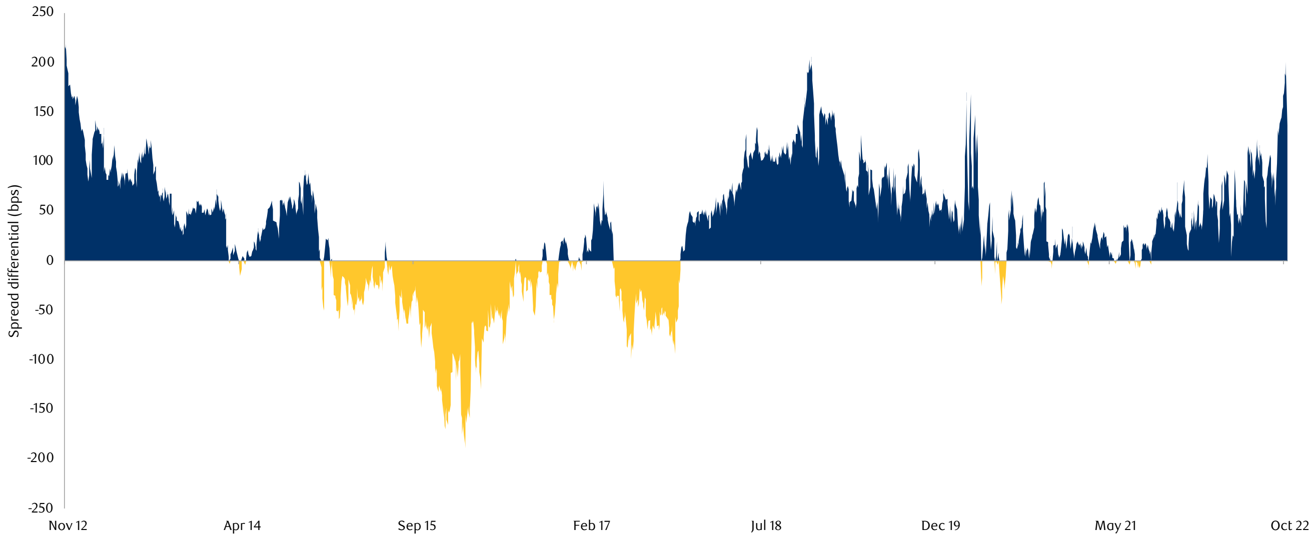


Source: ICE BofA European Currency HY Constrained Index, as at 31 October 2022

European High Yield YTW (%) last 5 years

Source: ICE BofA European Currency HY Constrained Index, as at 31 October 2022

Spread differential of European B-Rated High Yield – US B-Rated High Yield[1] over the last 10 years



Source: ICE BofA, as at 31 October 2022. Note: [1] European High Yield refers to ICE BofA Single-B European High Yield Index (HE20) and US High Yield refers to ICE BofA Single-B US High Yield Index (H0A2) using LIBOR OAS

Forward looking expectations for the European High Yield Market

Pessimistic scenario	Base case scenario	Optimistic scenario
Policy mix continues to tighten aggressively as inflation proves stickier and harder to dislodge with the ECB's terminal rate rising to 4%. US enters a marked recession and public capital markets are closed to the majority of HY issuers for a period of 2 or more quarters. Defaults start to pick up by end H1 and end at 4-5% by year end 2023. Markets price-in a repeat in 2024. Expect spreads to peak at > 850bps and not to recover inside 700bps by end 2023.	ECB policy rates peak at 3% and then come off slightly by end 2023 to 2.75%. Energy remains expensive in Europe as the terms of trade shock continues, though governments socialise impact to a sufficient degree leaving the real income squeeze akin to a "normal" recessionary profile. Real activity declines in Europe in 2023, with most notable declines in industrial sectors versus rest of the world. Activity slows more modestly in the US and capital markets across both sides of the Atlantic remain open if expensive. Expect spreads to peak at 750-800bps but to finish 2023 inside these levels – though still above 600bps. Defaults for 2023 to be 2.5-3.5% but H2 weighted and with some more priced and likely a another 3% in 2024.	Inflationary pressures subside and the terms of trade shock in Europe reduces – likely needs an end to the war or some truce and easing of sanctions. Terminal rates globally reduce, allowing for a more marked easing in rates by H2 2023. This would mean we are effectively close to peak rates now. Defaults remain very low (c. 2%) in Europe and spreads may have peaked at 600 in the summer and settle inside long terms averages (inside 450).

Source: RBC BlueBay Asset Management, data as at 31 October 2022

Recovery rates

It's difficult to differentiate between base and pessimistic cases with recovery rates most likely to be 30-35c. However, one large issuer at either end of the spectrum can significantly change the average rate.

Our expectations are slightly below historic averages given the lack of covenants to trigger new equity or bring things to a head with the owner before declines are more terminal. This is of course mostly a loan market question, but there will be feedthroughs into high yield from this process.

The optimistic scenario would represent a modest opportunity set for distressed investors and general recovery in asset prices would recovery rates in our estimation to be 45-50c.

Final remarks

Regardless of an investor's view on the forward path for the asset class, it is worth highlighting that, in our opinion, we have reached valuations that historically have generated compelling returns on a three -year horizon, even if spreads widen further. While moving into a recessionary period will lead to a deterioration in the operating performance of the companies we cover, credit metrics are at a decent starting point and the lower levels of primary-market issuance remain a positive technical for the asset class, which reflects the lack of need to refinance for most issuers.

1 and 3yr[2] Forward Returns in European High Yield when spreads widen past 500bps

1yr

Spread breakpoint	Number of times	Low	Average	High
Spreads cross 500bps	21	-6.58	7.97	16.98
Spreads cross 600bps	15	-23.91	7.61	16.13
Spreads cross 700bps	14	-25.57	10.97	23.20
Spreads cross 800bps	21	5.09	39.03	75.68

3yr[2]

Spread breakpoint	Number of times	Low	Average	High
Spreads cross 500bps	19	3.90	8.86	12.15
Spreads cross 600bps	14	6.03	10.67	12.32
Spreads cross 700bps	13	10.08	12.42	14.44
Spreads cross 800bps	21	10.70	17.50	26.63

- On a 3 year horizon, based on historical patterns, investors have never lost money buying European HY bonds when spreads cross 500bps.
- Entry points on a 1 year horizon are more challenging as reflected by the skew in returns.
- Considering the short duration profile of the asset class, breakeven spreads at these spread thresholds have tended to provide a sufficient margin of safety for the medium-term investor to generate positive returns regardless of entry points.

Source: RBC BlueBay Asset Management, data as at 31 October 2022. Notes: [1] ICE BofA Euro High Yield Index EUR Hedged; [2] Annualised returns. Analysis completed on index returns when spreads are above specified threshold at month end. Analysis completed on month end spreads from 31 December 2002 to 31 October 2022.

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Justin is a Partner and Head of European High Yield within BlueBay's Global Leveraged Finance Group. Justin joined BlueBay in 2009 as Head of High Yield Trading before moving into portfolio management in early 2012. He started his career at UBS in 2002 and was last Director of High Yield and Distressed trading in Europe. Justin holds a BSc in Economics from the London School of Economics.

Published November 2022

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