Fixed Income Analysis: The Case For European High Yield

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Background: The Trump Reflation Trade

One of the main stories in financial markets post-US Election has been the Trump Reflation Trade, which is basically verbal shorthand for how asset prices would change if growth and inflation picked up. The consensus trade (which was strikingly evident) was selling bonds and buying equities, also known as "The Great Rotation" depicted in exhibit 2. The pickup in growth and inflation expectations rose globally amid speculation that the Trump administration would pursue a similar large-scale fiscal stimulus plan to Ronald Reagan's (Reaganomics) in the 1980's, which was characterized by increases in expenditures, heavy tax cuts, deregulation and widening budget deficits. Another cause for the recent strengthening of inflationary signals has been the rebound in oil prices and other commodities.

Inflation and The Yield Curve

Inflation is a bonds (especially long maturity) worst enemy as it erodes the purchasing power of the bonds future cash flows. In simple terms, higher levels of current inflation and future expected inflation (exhibit 1) will cause yields to rise along the yield curve since investors will demand higher returns (yield) to compensate for the higher inflation risk. Exhibit 9 in the appendix shows U.S. and European yield curves before and after the U.S. election.

The U.S. Federal Reserve also decided to hike rates by 25 basis points in December of last year and signaled a more hawkish stance on monetary policy as the Implied Fed Funds Target Rate currently projects (median estimate) 3 rate hikes in 2017. Taking into consideration the upswing in inflation expectations and higher interest rates, how should investors position themselves with regards to fixed income?

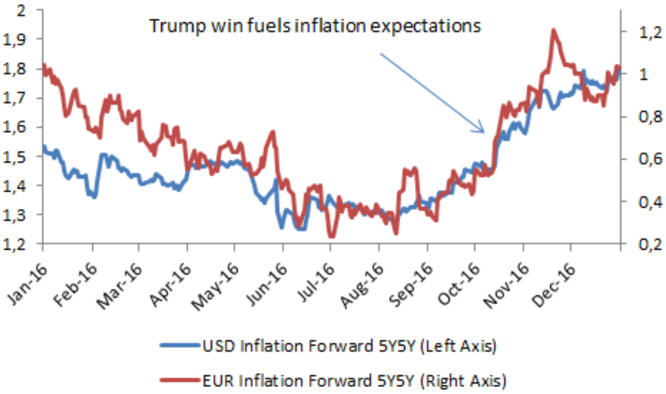

Exhibit 1: 5 year, 5 year USD and EUR inflation swap rates. These rates are commonly used by central banks and dealers to analyze the market's future inflation expectations.

These Times Call For Short Measures

One thing to keep in mind given the shift in expected price levels is long-dated bonds become more unattractive, as explained in the previous section. The key to investing in fixed income when inflation and interest rates are rising is to shorten the *duration*, which is a measure of how sensitive a bond is to interest rate changes. Long-term bonds have greater duration than short-term ones. Now that we have discussed some bond-related terms and narrowed down the investment scope, where do opportunities lie in the fixed income market?

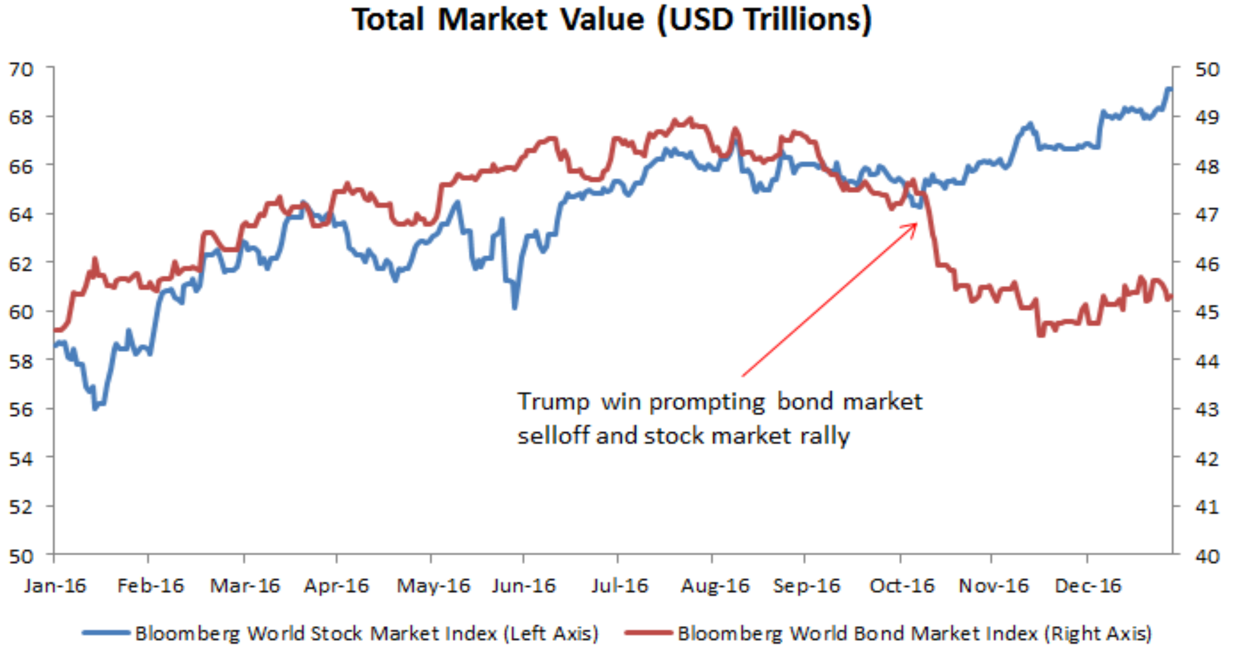

Exhibit 2: The Bloomberg World Exchange Market Cap is calculated from all shares outstanding. WCAP does not include ETFs and ADRs as they do not directly represent companies. The Bloomberg Barclays Global Aggregate Index measures global investment grade debt including GB, Treasury, IG corporate and securitized fixed rate bonds from developed and emerging market issuers.

Understanding High Yield Bonds

High yield bonds are defined as bonds rated below Investment Grade or BBB (Baa) as per exhibit 3 below. High yield bonds can offer investors a number of potential benefits in terms of their equity-like qualities, relatively shorter duration and portfolio diversification.

Credit Risk	Moody's	Standard & Poor's	Fitch
Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (strong)	A	A	A
Medium grade	Baa	BBB	BBB
Below Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	C	C
In default	C	D	D

Exhibit 3: Credit Rating summary for the three major rating institutes.

HY Bonds vs. Equities

HY bonds and equities generally move in tandem as depicted in exhibit 4 below. This means that both asset classes respond similarly to the overall market environment. The main historical difference between the two has been that HY bonds tend to be less volatile due to the more stable income component (coupons vs. dividends). The combination of higher yields compared to Government and Investment Grade bonds coupled with the prospect of higher capital appreciation (albeit lower than equities) means that the return profile for HY bonds is similar to equities over the long-term. Due to the capital structure of companies, bond holders also have a higher priority of repayment over shareholders in the event of a bankruptcy.

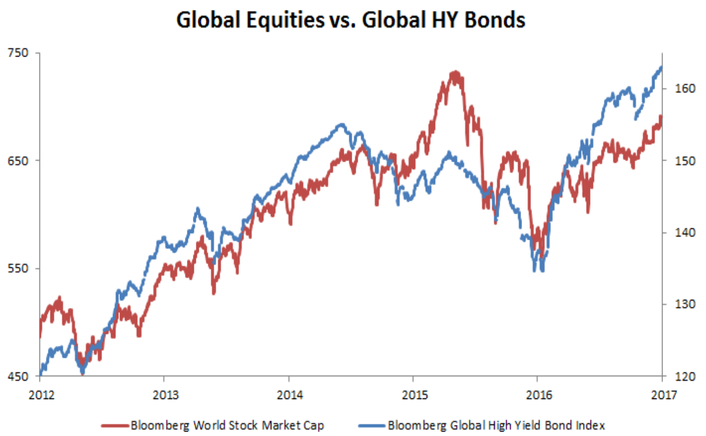

Exhibit 4: Bloombergs Global Stock Market Cap index and Bloombergs Global High Yield Bond Index performance past 5 years. A regression analysis conducted shows a significant t-value of 13,315 and a correlation coefficient of 0,639 between the two indexes.

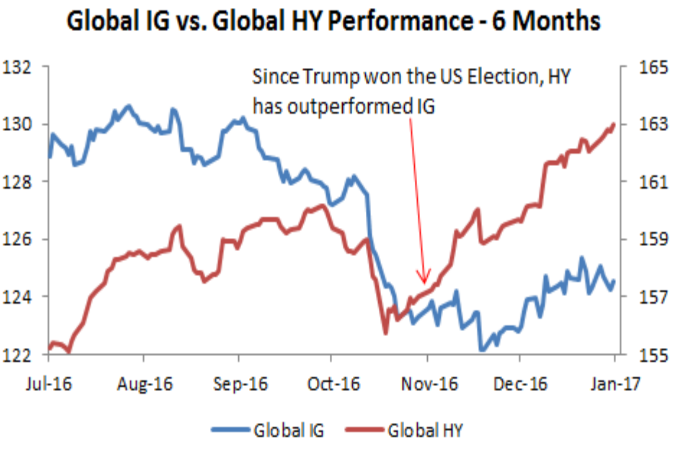

Exhibit 5: Performance of Global IG bonds and Global HY bonds past 6 months based on Bloomberg's aggregate indexes. Trumps reflationary policies are reflected in the divergence between the two asset classes.

Low Relative Duration

Compared to Government and IG bonds, HY bonds typically exhibit shorter duration in part thanks to lower maturities. They are usually issued with terms of 10 years or less and are often callable after 3-5 years. As mentioned earlier, HY bonds are more sensitive to corporate earnings and the overall market environment/outlook than interest rates. Looking at the current macro environment where we see improved growth prospects as well as higher interest rates and inflation expectations, HY bonds are expected to outperform other fixed income assets. This can be seen in exhibit 5, which shows the performance of HY bonds versus Government and IG bonds the past 6 months.

Higher Capital Appreciation With Total Return Strategy

To encourage investment in this asset class, HY bonds offer greater yields than Government and IG bonds. Yields in the HY sector usually vary more with the overall market environment so yields tend to rise in economic downturns as default risks increase.

An economic upturn or improved prospects of the issuing company can push up the price of a bond. This appreciation in capital is an important constituent when utilizing a total return investment strategy. Improved credit ratings, changes in management, positive product developments or Mergers & Acquisitions can enhance the bond price, hence, the return in your fixed income portfolio. The best way to take advantage of this is by purchasing an ETF or fund that tracks HY bonds.

What Are The Potential Risks?

As previously stated, HY Bonds are more volatile than IG and Government bonds due to higher default risk. The asset class is more sensitive to the overall market environment so defaults tend to rise in times of economic distress. Nevertheless, HY bonds are fixed income instruments with equity-like qualities that can provide much needed diversification to a portfolio.

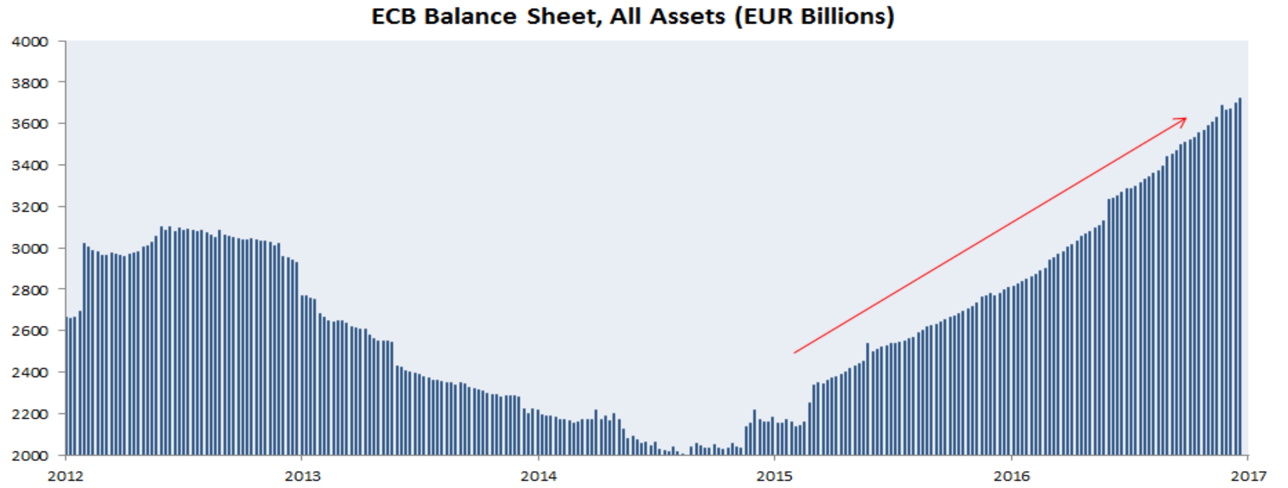

Exhibit 6: ECB total balance sheet

European Central Bank Remaining Accommodative

The ECB has vowed to continue increasing their balance sheet in an attempt to shore up the Eurozone economy, but recently surprised markets by reducing the amount of stimulus it provides to the European capital markets on a monthly basis (decreased from EUR 80 Billion to EUR 60 Billion). The ECB left rates unchanged (0%) at their last meeting and pledged to continue with the Quantitative Easing program to December or beyond "if necessary". This will assist in keeping yields lower for longer, which will benefit the European HY market.

How Does QE Influence the HY Market?

The ECBs QE program doesn't have a direct impact on the European HY market but there are some second order derivatives to consider. Firstly, persistent bond purchases by the ECB will help maintain yields at low levels. The resulting credit spread tightening in IG bonds will lead to an increase in demand for assets that generate higher returns, which bodes well for the European HY market. Secondly, corporate QE creates incentive for companies to improve their credit rating (QE only for IG corporates) in order to take advantage of the lower borrowing costs. We believe incentives will be an important factor behind the improving credit quality of HY in 2017.

Robust Fundamentals

The quality of European HY is at an all-time high with around 70% of the European HY Bond index rated BB (average of index is BB-). Default rates are also expected to remain low in 2017 (2.2% according to Moody's). This is partly due to the ECBs active participation in the bond market and an upswing in economic sentiment, which raises the attractiveness of the asset class.

Performance Analysis

Looking at the performance analysis tables in exhibit 7 and 8, it's evident that European HY outperformed both equities and its other low-risk counterparty in terms of total return and risk-adjusted return over the past 5 years. The past year has seen European IG exhibit low volatility and outperformed HY and equities on a risk-adjusted basis. According to this analysis, European HY seems to offer a significant upgrade in yield over IG bonds and lower volatility compared to equities.

Conclusion

The European HY bond market is likely to remain sensitive to fluctuations in sentiment caused by the Trump presidency, negotiations around Brexit and possible anti-EU sentiment in the Eurozone. Despite this, our view is that European HY will remain attractive predominantly due to the income it generates and low interest rate sensitivity. We also believe that the ECB will continue to adopt an accommodative stance, which will underpin demand for European HY.

	Total Return	Annualized Volatility	Sharpe Ratio
Stoxx 600 Index	**13,31%**	18,58%	0,72
EUR HY Index	11,09%	7,85%	1,41
EUR IG index	3,22%	**1,21%**	**2,66**

Exhibit 7: 1Y performance analysis. Based on same data as exhibit 10 in the appendix, which gives a graphical interpretation of numbers above. Sharpe ratio excludes risk-free rate. Source: Bloomberg

	Total Return	Annualized Volatility	Sharpe Ratio
Stoxx 600 Index	44,09%	16,18%	2,72
EUR HY Index	**48,95%**	6,65%	**7,36**
EUR IG Index	25,11%	**4,89%**	5,13

Exhibit 8: 5Y performance analysis. Based on same data as exhibit 11 in the appendix, which gives a graphical interpretation of numbers above. Sharpe ratio excludes risk-free rate. Source: Bloomberg

Appendix

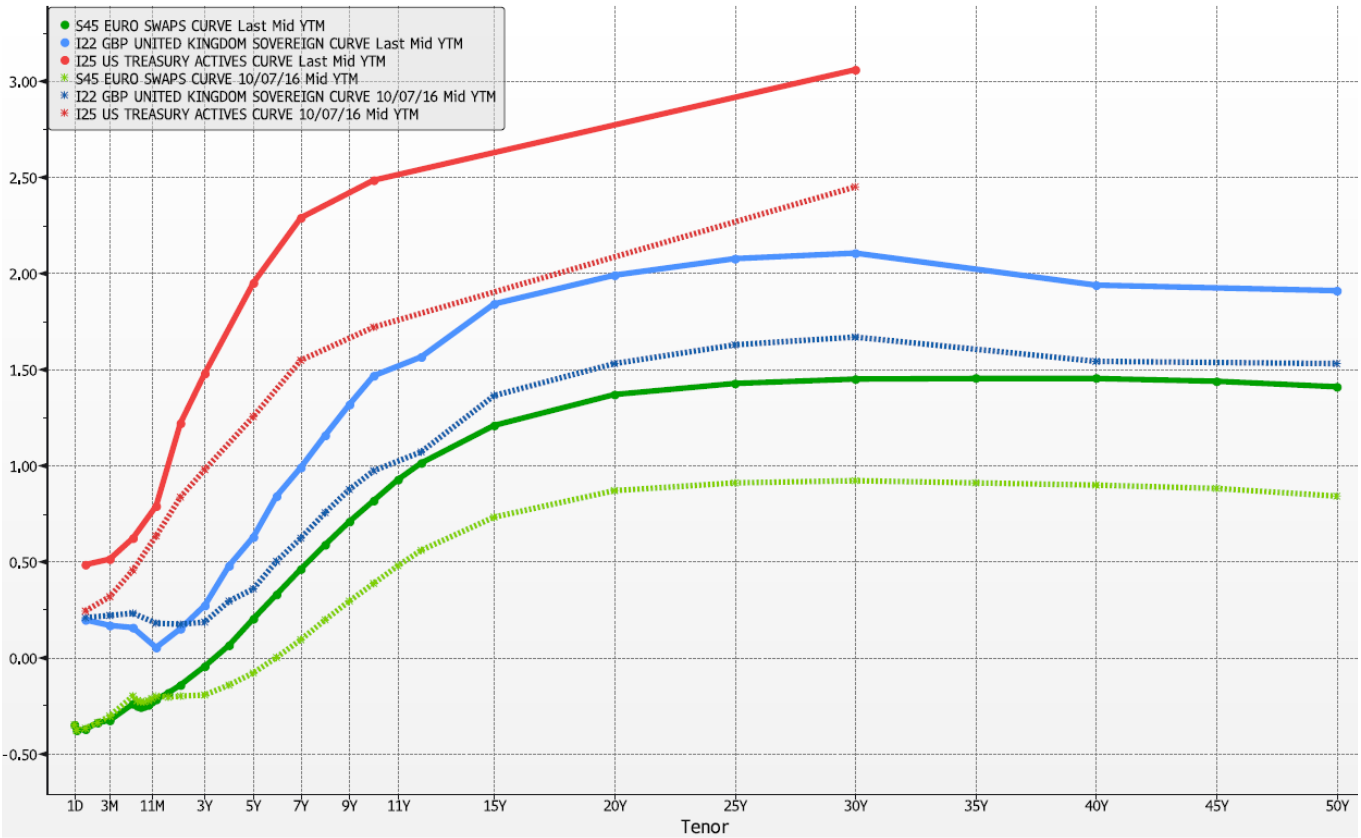

Exhibit 9: US, UK and Eurozone yield curves (Tenor on X-axis, Yield on Y-axis). Solid lines indicate yield curves as of 29/01/2017 and dotted lines indicate yield curves as of 10/07/2016 i.e. roughly one month prior to the US election. Notice how the yield curves have steepened.

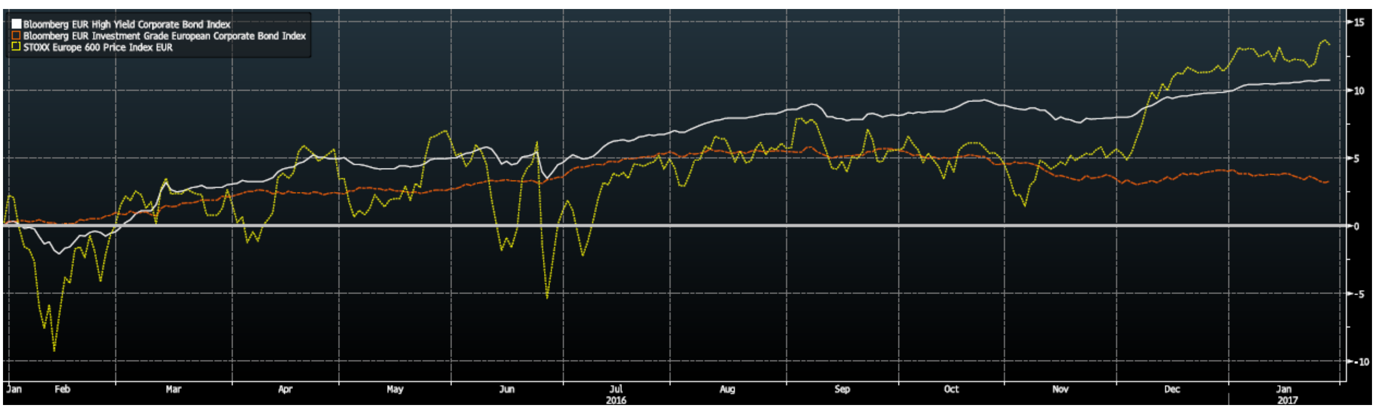

Exhibit 10: 1Y total return comparable analysis.

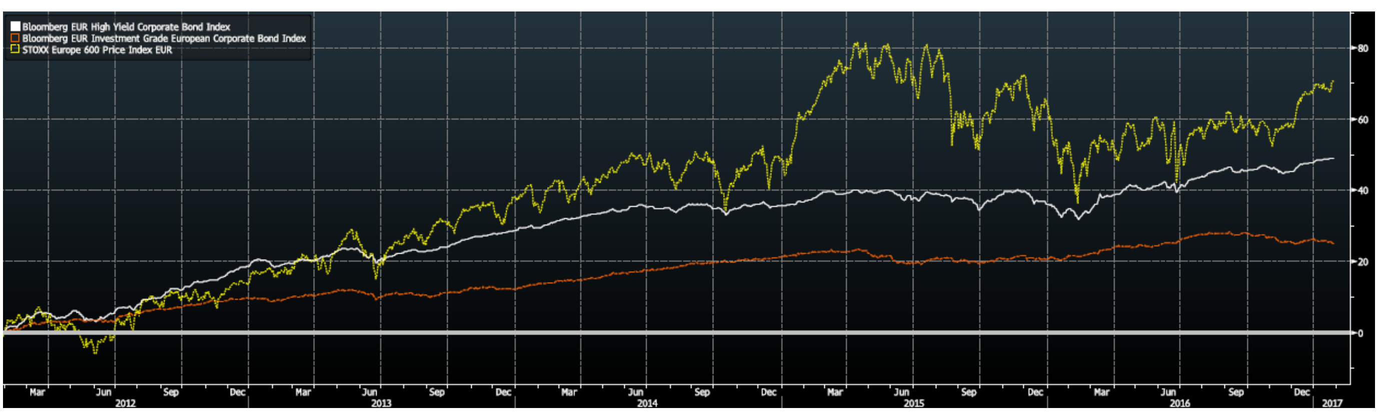

Exhibit 11: 5Y total return comparable analysis.

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