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Global High Yield: Favouring US over Europe Even After the Recent Rally

Key takeaways:

- **The European and US High Yield markets have come under stress as a result of the COVID-19 crisis and subsequent shutdown.**
- **While the European market has a much higher weighting in BB-rated issuers, which have been relatively insulated from the volatility, the US High Yield market has outperformed its European counterpart in the year-to-date and since the trough.**
- **On a ratings-equalized basis, the difference in performance is even more apparent. A supportive Federal Reserve and stronger technical have boosted US outperformance in the BB segment in particular.**
- **We believe that US High Yield will continue to outperform European High Yield in near term due to a variety of factors present in today's market, including underwriting and defaults.**

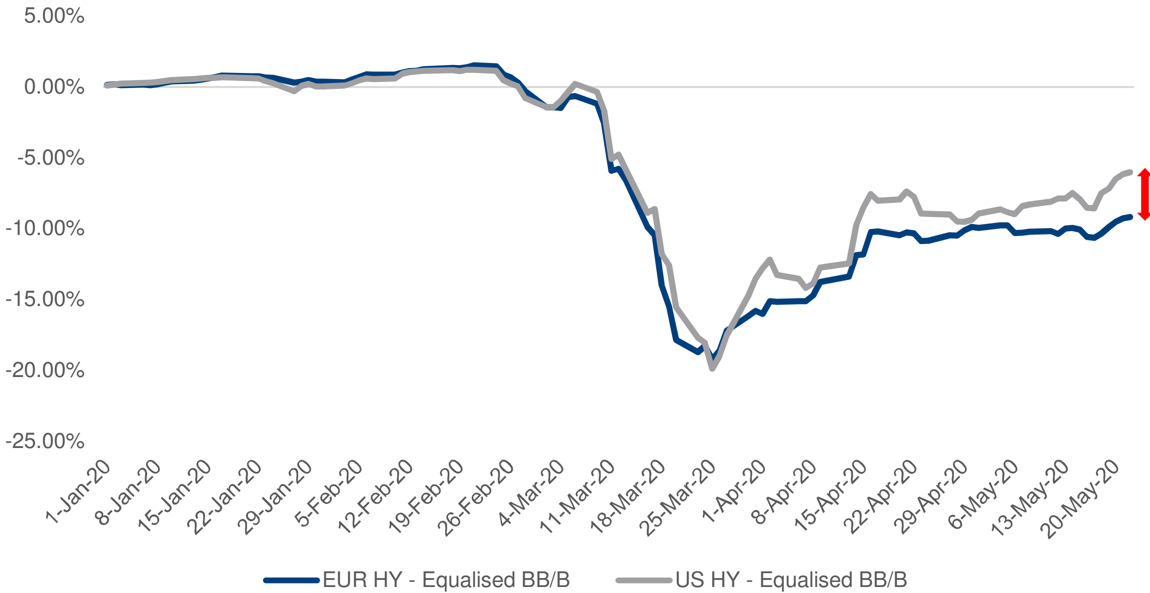
The ICE BofAML Developed Market High Yield Index saw significant volatility in March and April as the spread of COVID-19 forced the global economy to a standstill. Market declines were nearly indiscriminate through the first three weeks of March, at which point central banks and governments acted in an attempt to support economies and financial markets. The Developed Market High Yield Index has since recovered sharply from the March 23rd trough and has become increasingly discerning in the process. In our view, lasting uncertainty regarding how the next 12-18 months evolves has created increased demand for higher quality, more defensive assets utilizing active management and strong idiosyncratic security selection. In addition, we have witnessed significant disparity of returns on a regional basis. The US High Yield market has outperformed its European counterpart in the year-to-date and since the trough. In this note, we will discuss the profiles of each market and why we expect this return disparity to continue in the near term.

First, it is worth highlighting a few a major differences between the US and European (including UK) High Yield markets. The ICE BofAML Developed Market High Yield Index consists of North American and non-emerging market European High Yield issuers. European issuers represent ~20% of the Developed Market High Yield index. The European High Yield universe, with roughly USD $416 billion outstanding, is a higher-rated cohort, with nearly 70% rated BB- or higher and only 7% rated CCC or lower. In comparison, the US High Yield index, with $1.3 trillion outstanding, consists of nearly 56% in BBs and 11% in CCC or lower. In addition, the Energy sector, which has been whipsawed with acute movements in oil spot prices, accounts for ~12.2% of the US High Yield opportunity set versus 5.1% in Europe, the majority of which is exposure to large emerging market semi-state owned entities.

Since March 23rd, US High Yield has outperformed European High Yield by ~420bps. However, as outlined above, the relative size of BBs in Europe compared to the US disguises more pronounced underperformance of European High Yield within comparable ratings categories. To adjust for this and to get a true comparison of the underlying performance across the two markets, we took a look at the BB-B cohort on an equalised basis, assigning equal weight to BBs and Bs in each market (Chart 1). While both markets possess CCCs (EU at 7% and US at 11%), we have elected to compare these markets excluding CCCs given the idiosyncratic nature of these issuers and less-than-ideal trading liquidity, which may skew the analysis. On this BB-B equalised basis, European High Yield underperformance appears greater. Across Developed Market High Yield, BBs have outperformed year-to-date, regardless of market; however, European BBs have lagged its USD equivalent by 240bps year-to-date and a staggering 630bps from the trough. Why is this? We believe this is primarily a function of explicit support from the US Federal Reserve ("Fed") for Fallen Angels and High Yield ETFs which has resulted in greater demand for higher quality US assets. The Fed's response has also resulted in a significantly greater compression of the yield curve in

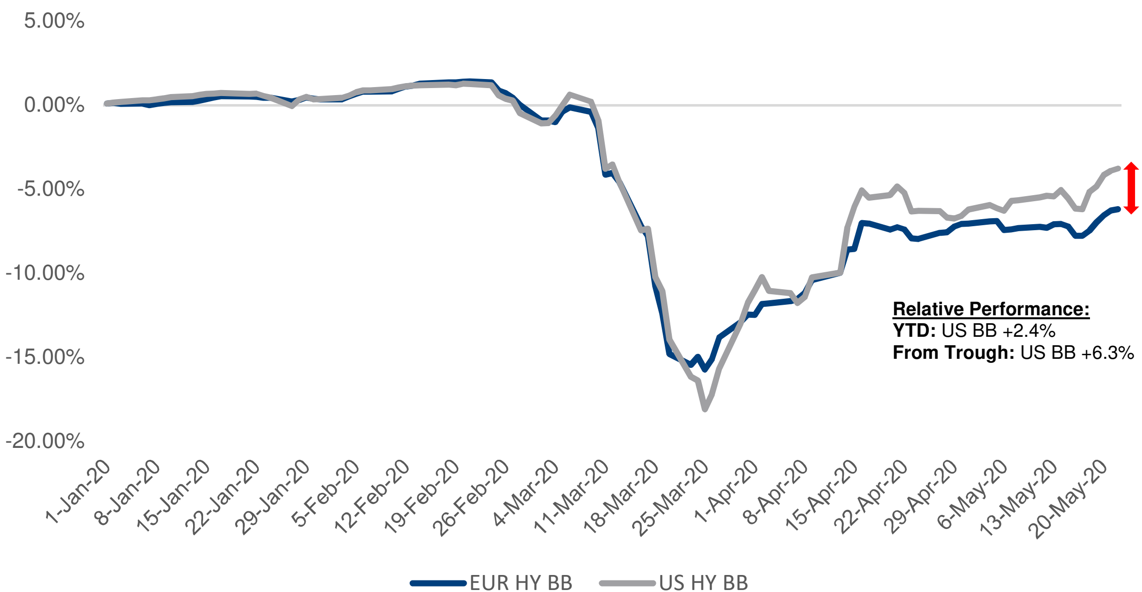
the US compared to Europe, benefiting longer dated US assets. Even in Bs, the US High Yield market has outperformed by nearly 400bps.

Chart 1: Developed Market High Yield Performance – Ratings Equalised



Source: ICE BofAML Indices, as of 22 May 2020

Chart 2: Developed Market High Yield Performance – US vs. EUR BBs



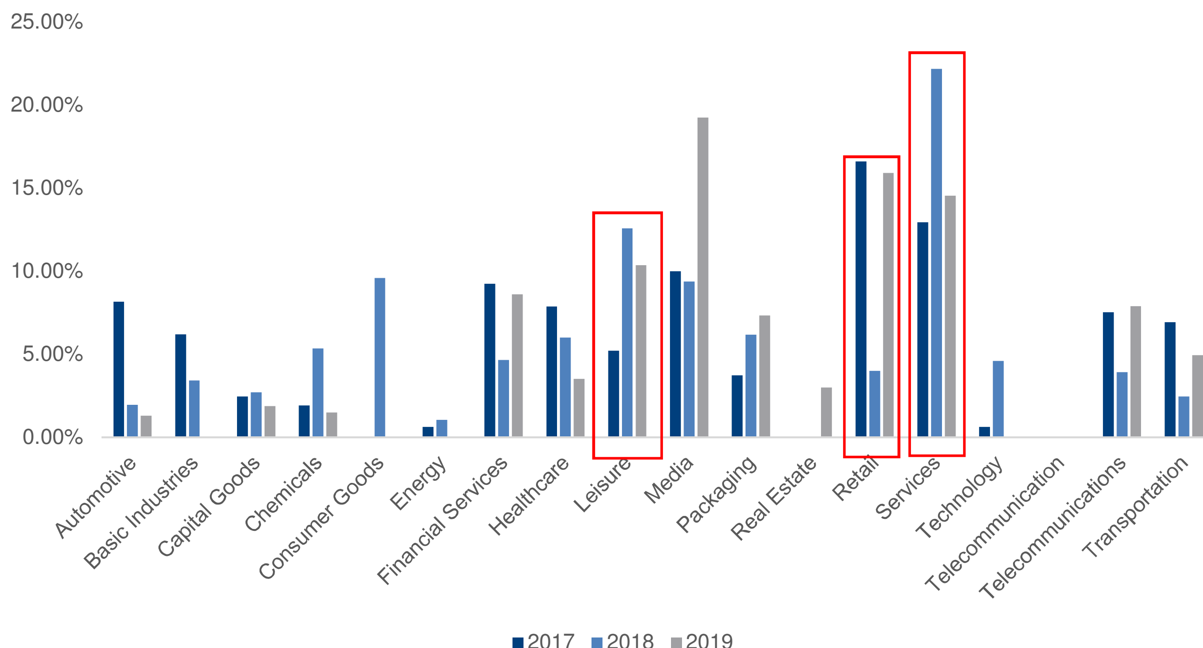
Source: ICE BofAML Indices, as of 22 May 2020

So, given the broad based underperformance, should we expect to see European High Yield revert to the mean and catch up?

In the near term, we believe that US High Yield will continue to outperform EU High Yield and we favour an overweight in US credit should spreads remain range-bound or even compress from here. In addition to the aforementioned technical, we also believe that recent underwriting, particularly for European single-Bs, may also be a factor. In recent years, we have become increasingly concerned that idiosyncratic risk has become more pronounced among the single-B cohort in Europe compared to the US. In our view, this is largely a function of the deterioration in quality of issuance of European High Yield single-Bs in recent years, with increased issuance in smaller businesses with weaker asset value and elevated vulnerabilities in sectors such as Retail, Leisure and Cyclical Services (Chart 3). Additionally, these companies have come to market with a smaller average issue size of ~€350m over the last three years, affecting trading liquidity particularly during periods of elevated volatility. Our concerns of lower underlying credit quality among European single-Bs has become more evident in recent months as highlighted in Chart 4, which illustrates a greater level of credit spread dispersion and stressed assets, which we define as an asset with a credit spread >800bps, in Europe. Such levels of price dispersion calls for a more discerning approach and highlights that an active approach focused on security and asset selection is more important today than it has at any point since the Great Financial Crisis. We also currently favour the BB cohort in the US market, owing to more favourable technicals, while valuations for European BBs are less attractive in our view. We believe the support from the Fed in addition to potential legal hurdles for further European Central Bank quantitative easing ("QE") will favour US BBs over European BBs. US High Yield mutual funds have experienced ~$27bn of inflows since the peak of the crisis, offsetting all previous outflows in 2020 and further strengthening the technical backdrop. European High Yield has seen some modest inflows, but on a significantly smaller scale than US high yield, even after adjusting for relative market size.

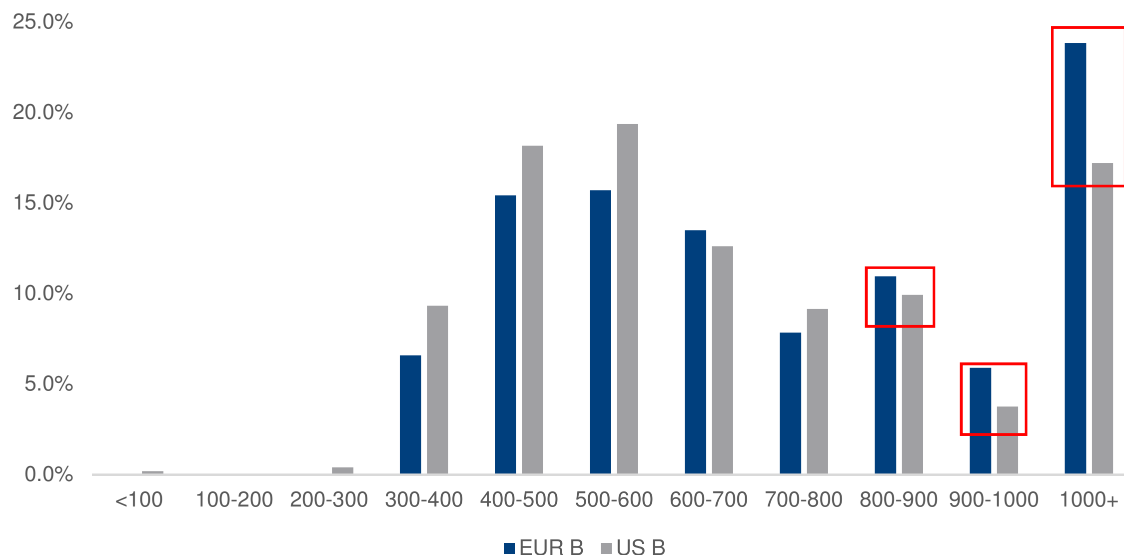
As highlighted, this view is based on our expectation of a sanguine near term outlook for the High Yield market with spreads in current context or tighter. However, if spreads widen materially, we could see a more defined shift to higher quality issuers, which would see BBs outperform lower rated issuers. In this scenario, we could see the European High Yield market outperform given the higher exposure to BBs mentioned above.

Chart 3: European Single B and Lower Issuance by Sector



Source: ICE BofAML Indices, as of 18 May 2020

Chart 4: EUR vs. US Single B Spread Dispersion



Source: ICE BofAML Indices, as of 18 May 2020

Overall, fundamentals across the High Yield spectrum will be challenged by the pandemic's economic fallout. We believe idiosyncratic selection driven by fundamental research across high yield products will be a critical driver of returns and alpha. Additionally, maintaining flexibility to make tactical top-down allocation shifts is especially prudent given potential for short-term uncertainty, market dislocations, and dispersion among credits, sectors and regions. In the current environment, we are favouring US over European High yield, though we believe European High Yield can offer some attractive idiosyncratic opportunities.

Finally, we think recent default trends could benefit US High Yield. We have already seen a pick-up in defaults in US High Yield market since the beginning of the crisis driven by a more straightforward bankruptcy process. European insolvency regimes tend to be more complex, resulting in slower realisation of defaults and recoveries. We believe the US High Yield market will benefit from this front-loading of defaults going forward. We expect default rates to peak earlier at a higher level in the US relative to Europe through this cycle. The higher rate in the US partly reflects the increased exposure to Energy issuers, however, these rates are further skewed by the credit quality profile of each market. As highlighted above, European High Yield has a much higher proportion of BBs than the US and, given the majority of defaults are sourced from single B/CCC issuers, we believe the default rates among this cohort will be actually higher in European High Yield compared to the US, especially once adjusted for energy.

As a leading manager in sub-investment grade credit markets with a balanced investment approach across the US and Europe, Alcentra is well placed to offer unique insights into Global High Yield. Our deep expertise and resources in both US and European markets offers opportunities for alpha when relationships between markets diverge. We believe the current market backdrop (fundamentals, structure and valuations) represent one such opportunity.

Please contact us with any questions.

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