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# Fixed Income Monthly European high yield: Reliable source of income

IN BRIEF

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European high yield bonds are rapidly evolving from a niche asset class into a strategic investment. In this Q&A, Pictet Asset Management's Roman Gaiser explains why.


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Before joining Pictet, Roman was at Threadneedle Asset Management where he co-managed the high yield business and was manager of the European high yield bond fund. Before that, he helped to build the high yield business at F&C Management where he also managed European high yield portfolios. Roman also worked as a research analyst at Bankgesellschaft Berlin with responsibility for government bonds and European credit. Previously, he was an economist at Louis Dreyfus Finance. He began his career as a counterparty analyst at RCI-Renault Credit International.

Roman graduated with a degree in Economics from the University of Hamburg (HWP) and a degree in International Economics from EDC-Paris La Défense. He also holds a postgraduate degree in International Economics and Finance from Université Paris-Dauphine. He is a Certified European Financial Analyst (CEFA).

**Investors looking for income have fewer options than they used to. To what extent could European high yield bonds reliably fulfil that need?**

Investors are facing an unprecedentedly challenging investment landscape. Income-generating securities are scarce as nearly EUR5 trillion of European fixed income assets are yielding below zero. So those requiring a decent yield will no doubt find themselves having to take more risk than they have been used to. Yet while the risk-yield trade-off is a complex decision, the unfolding dynamics in Europe's high yield bond market suggest the asset class should be considered a reliable source of income.

For one thing, high yield investors can count on benign financial conditions remaining in place for quite some time. While the US Federal Reserve will probably raise interest rates again this year, the European Central Bank has pledged to expand its monetary stimulus if necessary. The ECB has started buying corporate bonds under its Corporate Sector Purchase Programme, which is expected to run at least until March 2017.

Although the programme is mostly geared towards investment grade credit, the benefit for the high yield part of the market should not be underestimated, not least because around 3.5 per cent of the benchmark BofA Merrill Lynch EUR High Yield index is eligible for ECB purchases.

Under the programme, the ECB is allowed to buy corporate debt based on the highest available rating provided by four eligible credit rating agencies, not the average rating.

What's more, the central bank is not required to sell in case a bond is downgraded to high yield.

In the UK, the Bank of England announced an easing package in August, including corporate bond buying for the first time – an encouraging event which should underpin the UK high yield market as well.

All this is taking place at a time when Europe's economic environment – characterised by moderate growth and falling unemployment – should provide a decent backdrop for the asset class. (FIG.1).

**You say benign monetary policies should support high yield bonds. What other factors do you see reinforcing the high yield bonds' ability to generate income?**

One observation to make is that non-investment grade companies in Europe are in good financial shape. The interest coverage ratio[1] – which shows how easily a company can pay interest on its debt – in the EMU area stands at 3.5, compared with the 20-year average of around 3.

In addition, European high yield firms do not need to refinance heavily after a busy 2015, in contrast to the investment grade market which is experiencing heavy issuance activity.

European corporations issued EUR25 billion of high yield paper on a gross basis so far this year, half that of the same period in 2015 and the lowest amount since 2008.

1 Ratio of Earnings Before Interest, Tax to Debt Servicing Costs. Source: Pictet Asset Management Strategy Unit

These positive trends, coupled with easy monetary conditions, suggest default rates among high yield issuers should remain low.

With the default rate implied by market prices at more than twice Moody's central expectation of just 2.8 per cent, European high yield investors are well compensated for default risk, and, indeed, better compensated than investors in the US high yield market (FIG.2).

**What are the structural trends boosting the high yield bond markets credentials as a strategic asset class?**

Put simply, size, diversity and liquidity. The European high yield market has grown more than four-fold since end-2007 to EUR310 billion as of end-June as an increasing number of companies in Europe make the switch from bank to bond financing. And as the market has grown, its credit profile and liquidity has improved.

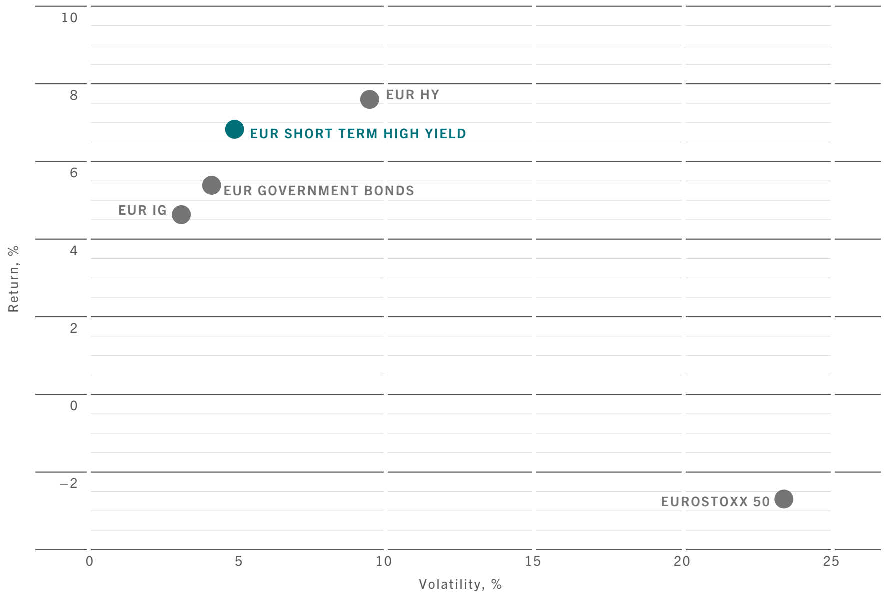
Indeed, a key structural difference between the European and the US high yield bond markets is the quality of bond issuers.

The proportion of issuers in the benchmark index rated triple-C or below stands at just 5 per cent for Europe, compared with 13 per cent in the US. The average rating in Europe is BB3, higher than B1 in the US. What is more, the relative weighting of stressed issuers, where bonds are trading below 80, is lower in Europe at 4.3 per cent than 13.9 per cent in the US. This is mainly because the European market has a lower share of energy and mining companies.

Improving economy and benign monetary policies should help European high yield bonds to generate income

FIG.1

EUR high yield attractive on volatility-adjusted basis

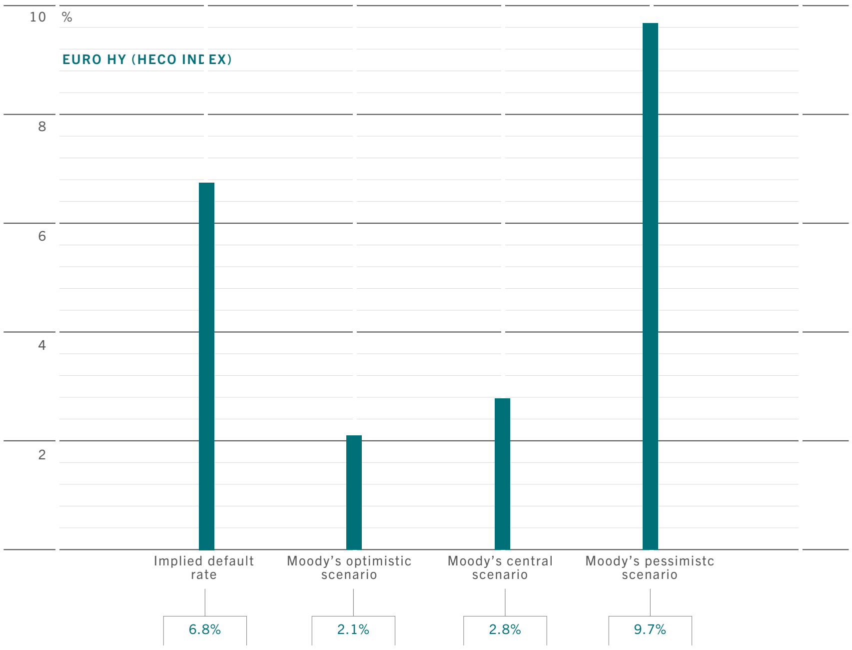



Source: BofA Merrill Lynch indices (weekly returns) as of 30.06.2016

European high yield investors are well compensated for default risk

FIG.2

Lower default rate in Europe




Source: Bloomberg, Moody's

### PICTET-EUR HIGH YIELD

Pictet-EUR High Yield is a benchmark-oriented approach with an active management style. The fund aims to generate stable income with lower volatility through in-depth credit analysis and strong risk management. The average rate duration is 3.42 years as of 30.06.2016.

Furthermore, European high yield bonds also enjoy better liquidity than their US counterparts, which makes such securities cheaper to trade. The Liquidity Cost Score for European non-investment grade debt, which is the cost of "round-trip" transaction as a percentage of the bond's price, stands at 1.18, compared with 1.91 for the US, according to Barclays. Providing further evidence of the European market's increased liquidity and heft is BofA Merrill Lynch's decision to increase the minimum bond size for its high-yield bond indices to EUR250 million from EUR100 million for euro-denominated issues and to GBP100 million from GBP50 million for sterling-denominated issues.

After the rejig, 66 bonds and 29 issuers – smaller issuers that are often lower-rated – are expected to leave the index on October 1. Interestingly, this will boost the overall share of BB-rated issuers and the overall index's average yield. By the end of this year, the proportion of BB deals could reach 70 per cent of the market.

We also like corporate hybrid bonds in Europe, a thriving segment made up of subordinated debt issued by well-established companies whose senior debt is often rated investment grade.

**How worried are you about the euro zone financial sector?**

Italy's financial sector, with EUR200 billion of net bad debt, is a particular drag on the euro zone's third largest economy and its credit growth. The country also faces a political risk ahead of the constitutional referendum in the autumn. Italian Prime Minister Matteo Renzi has said he will resign if voters do not approve the changes which he hopes will reform Italy's political system. With polls showing many of the 50 million voters undecided, it is a political gamble for the leader.

That said, I find it positive that Europe is tackling its banking sector problems. Stricter regulation should strengthen banks' balance sheets and reduce leverage in the industry. While negative interest rates weigh on their profitability, I believe European banks should come out of the deleveraging process stronger and healthier, which could give us some buying opportunities in the sector.

Pictet Asset Management

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