



Glimpses of light at the tunnel's end

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- At the start of the crisis there were fears that as much as 10% of Europe's high yield universe would default within a year. However, government support packages have successfully kept the number of defaults surprisingly low and investors willing to refinance companies.
- At the beginning of 2021 the key question is how quickly can economies return to 2019 levels of GDP? Realistically, we think this year will be one of relatively strong growth from low levels with recovery beyond previous levels deferred until 2022.
- Given the expectation of continued monetary and fiscal support and market optimism for improvement as vaccinations are rolled out, Europe's high yield market looks set for a positive year. However as other market commentators share similar views, it is a risk in itself.





After a rollercoaster 2020 for European high yield markets, 2021 looks set to be more stable. Fears of high levels of corporate defaults have proved unjustified, allowing high yield to rebound in 2020 and setting the scene for the coming year. While the second Covid-19 wave, and the new variant, are weighing on recovery, once vaccinations bring the virus under control a degree of normality should return to the economy and high yield.

Looking in the rear-view mirror, 2020 saw a remarkable turnaround in all financial markets, including high yield. The authorities' powerful blend of monetary and fiscal support, plus widespread refinancing of corporate debt, sparked a strong rally after a dismal first quarter. At the 23 March 2020 nadir, European high yield markets had fallen close to 19% since the beginning of the year – yet by December's close they were up by almost 3%.¹

At the start of the crisis there were fears that as much as 10% of Europe's high yield universe would default within a year. However, government support packages have successfully kept the number of defaults surprisingly low, and investors and lenders have proved willing to refinance companies such as Rolls Royce, Lufthansa, PureGym and many more that should be viable businesses once the pandemic lifts. A low or zero interest rate environment gave yield-starved investors every incentive to buy high yield securities.

Even so, this is an altered landscape. As lockdowns across Europe led to deep economic contractions and huge stress on cyclical companies, so Europe's high yield market grew in size by about €100 billion,² or a quarter, largely due to investment grade companies being downgraded, becoming so-called "Fallen Angels". A number of large, high-quality, well-established businesses, such as Ford and Renault, have entered the high yield universe and appear unlikely to be upgraded in the near future.

At the beginning of 2021 the key question is how quickly can economies return to 2019 levels of GDP? Realistically, we think this year will be one of relatively strong growth from low levels with recovery beyond previous levels deferred until 2022. It might well be a less agitated year for high yield, helped by the fact that many corporate issuers refinanced in 2020. About 10% of the market – approximately €45 billion of bonds³ – has refinanced in the past 12 months, taking the opportunity to repay their bonds maturing in 2021 and 2022 – and beyond.

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Such a loose liquidity environment has spawned a number of "zombie" companies which are able to continue to exist for now. However, there is the question of whether they will be able to generate enough cash to cover their operating expenses and debts once the economy begins to recover given higher leverage levels and the pace of the recovery. However, we seek to avoid these through focusing intensely on cash flows, strong balance sheets, operational risks, strategic value and so on.

¹ Based on ICE BoAML Index HPS2 data.

² Based on ICE BoAML Index HPS2 data.

³ JP Morgan, Final Score: European High Yield Q4 and FY20 Review, 5 January 2021.





Given the expectation of continued monetary and fiscal support and market optimism for improvement as vaccinations are rolled out, Europe's high yield market looks set for a positive year. However as other market commentators share similar views, it is a risk in itself. According to our estimates, the overall market could return about 3.5%. That takes into account a current yield of just over 3%, the "roll down" effect of seasoned bonds, and the inevitable defaults on bond payments by a small number of corporate issuers, as well as the potential for credit spreads to tighten moderately as the Covid-19 crisis lifts.

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This is an attractive return in a low-yield world. Notably, in the past 12 months even the US has become a zero-yield country, as the short end of the yield curve has collapsed and the US 10-year Treasury yield dipped below 1%, before recovering somewhat in response to hopes of a large US stimulus package.

As the vaccine provides a pathway back to normality, so European high yield's expanded universe stands out as a possible source of relatively steady, positive returns.



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