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Market views and strategy

Ostrum ASSET MANAGEMENT

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Topic of the week: High yield: defying the odds

- **European high yield has overperformed this year in the context of sluggish growth in the euro area and ECB tightening;**
- **Negative net bond issuance has been supportive of the asset class and high yield ETF inflows have been strong throughout August;**
- **The credit quality remains rather strong with low default rates and rising stars outnumbering fallen angels so far this year;**
- **Valuations however point to some widening risk. The single-B bucket performed beyond expectations;**
- **Given rich valuations after a sharp compression move, euro high yield could reprice wider over the months to come.**

Market review: The Fed makes a statement

- **Fed rates to stay higher for longer;**
- **US T-note yields near 4.50%;**
- **BoE opts for status quo, UK Gilts outperform;**
- **Growth stocks take a hit from higher yields.**

Chart of the week

Comments: China has become the world's creditor, particularly towards poor countries. $500 billion in projects have been funded since 2008.

Most of these loans have reached maturity. However, since 2017 the number of loans has slowed down. Between 2020 and 2021, the amount of loans fell by 40%, reflecting the insolvency situation of many countries linked to the Covid pandemic.

Figure of the week

53

Source : BoJ

According to Bank of Japan estimates, the real effective exchange rate of the Japanese yen has dropped to a 53-year low.

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Topic of the week

High yield: defying the odds

The combination of ECB monetary tightening and slow growth in the euro area should spell trouble for European high yield. Yet, default rates remain low and the total return so far in 2023 is close to 7%. We explore the reasons behind the strong performance looking at fundamentals, flows and valuations to gauge risks ahead for the high yield asset class.

Strong performance despite monetary tightening

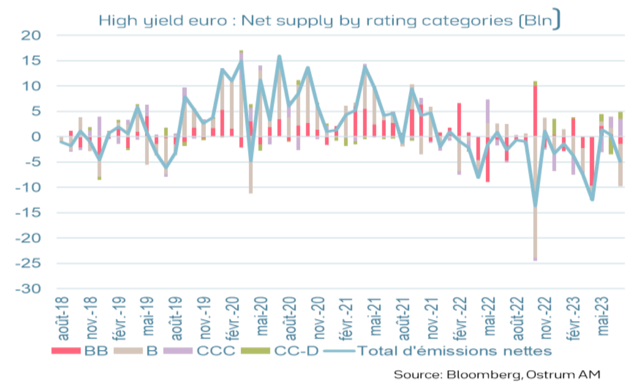
This is a great year for European high yield. The total return since the start of the year stands at 7%. As of September 18, high yield spreads trade at 428 bp in option-adjusted terms against German Bunds. In turn, asset swap spreads hover around 372 bp. The average spread on speculative-grade bonds has shrunk by close to 75 bp in 2023 even as the ECB pursues tighter monetary policy.

So far, European high-yield borrowers have thus dodged the impact from higher policy rates and tighter bank lending standards. Moreover, it appears that the single-B segment has continued to outperform even as single-B spreads are near multi-year tights relative to the BB group.

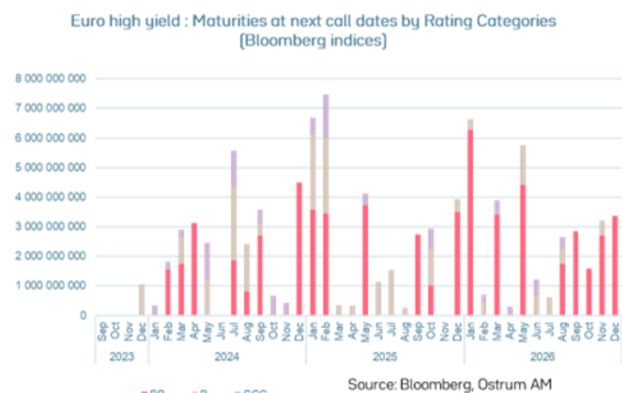
Low net issuance has kept a lid on spreads

High yield bond supply has been a supportive factor for markets so far. Gross issuance in the first semester of 2023 (€33 billion) is up sharply from €20 billion in the same period last year. The months of July-August were quiet as per usual but new transactions were launched in September. Net supply was however very light at €2 billion, with the bulk of primary market activity being for refinancing purposes.

BB-rated bonds accounted for just of over half of all transactions. The single-B share averaged a third of the deal flow in 2023. The remainder came from unrated corporate issuers, as there has been no CCC-rated corporate supply in 2023. That said, the net supply picture shows that the single-B issuance shrank the most, which helped the performance of the bucket. A larger share of senior secured bond was recorded in the second quarter.



Reduced net supply has thus contributed to the tightening in high yield spreads but, at the end of the day, higher interest rates will kick in and raise borrowing costs upon debt refinancing. It is therefore important to monitor the maturity wall for the asset class. Given the price action of 2022, most calls are out of the money for corporate borrowers. Effective duration in the European high yield market has nevertheless declined due to low net supply and a reduction in the maturities of new issuance.

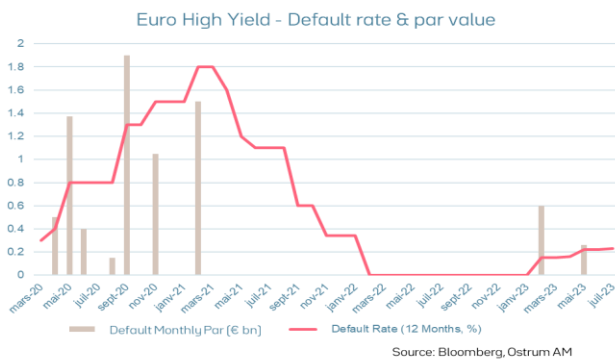


The chart above indicates that the refinancing risk may be more significant in 2025 and 2026 than in the year to come.

Current market yields in excess of average coupon rates also give a sense of the cost of refinancing existing bonds. The gap between 8.21% yields to worst and 4.19% coupons on the Bloomberg Pan-European high yield index suggests borrowing costs would rise by around 4 pp.

Default rates and credit quality

As the euro area shows tentative signs of an economic slowdown, default rates may increase from very low levels at present. There are several sources for default rates. Moody's estimate covers a broad region including Europe, the Middle East and Africa. Their default rate estimate was around 2.7% over the twelve months to July. The rating agency forecasts a deterioration under every scenario from 3.4% in the bullish scenario to 14.4% in a deep credit crisis. The Bloomberg data shown below is more representative of the euro high yield universe. The rolling twelve-month default rate is still very low at 0.23% in July on these estimates. In addition, the share of high yield bonds at immediate default risk based on market prices is just under 10% of the market for an aggregate par value of €8.1 billion. This is in line with the 5-year average.

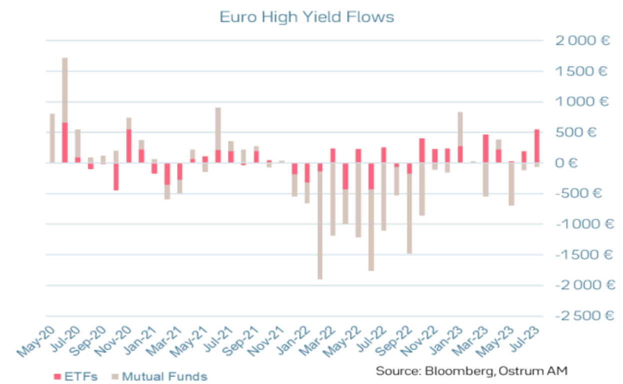


Source: Bloomberg, Ostrum AM

Overall, the credit quality remains relatively strong at this stage of the economic cycle. The ratio of rating upgrades to downgrades is roughly in line with the long-run average: slightly worse for Moody's but slightly better for S&P. On both Moody's and S&P counts, there are still more rising stars (high yield borrowers upgraded to investment grade) than fallen angels (IG names cut to speculative grade) in 2023. Interest coverage (measured by EBITDA to interest expenses) is steady for most borrowers. That said, the interest coverage ratio has deteriorated somewhat in single-B space over the last quarter.

Demand for euro high yield has been more upbeat than feared

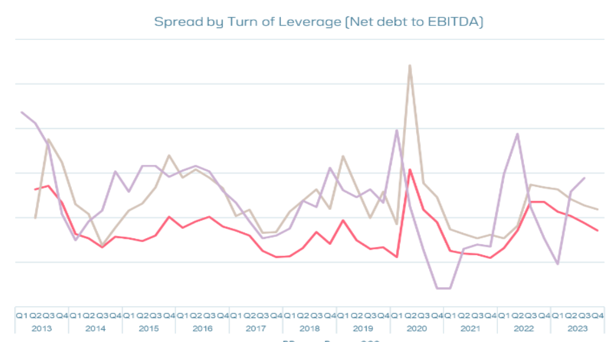
There have been conflicting signals as regards flows into the euro high yield asset class. Mutual funds continue to bleed outflows. However, as in many asset markets, ETFs continue to attract inflows. It is harder to track flows in and out of institutional investment mandates in high yield but it looks like appetite for yield premia on BBs remains strong enough to delay a full-fledged shift back into investment grade credit.



Source: Bloomberg, Ostrum AM

Valuations offer less comfort in lower ratings

It is hard to gauge valuations in high yield. A standard approach is a rock-bottom spread calculation where default risk compensation given the average credit quality in an index is deducted from prevailing market spreads to back out a clean high yield risk premium. We like to monitor the value proposition in high yield by looking at spread per turn of leverage. Leverage is indeed key to determine the probability of default.



The spread by turn of leverage is roughly in line with the long-run average or median in BB and possibly slightly tight in the single-B area. However, the current backdrop for interest rates could justify a higher spread per turn of leverage compared with the recent past. Furthermore, ECB quantitative tightening may affect some BB/Crossover names at the margin.

Conclusion

The strong performance of European high yield in 2023 is a surprise considering the slow growth environment in the euro area and ECB policy tightening. Default rates have stayed low and the balance of upgrade to downgrades or the number of rising stars are not signaling deterioration in credit quality. Default rate should not exceed their long-term average over 2024. The net bond issuance backdrop has been very supportive and there is little sign of immediate refinancing pressure. The refinancing issue may come in 2025-2026. That said, high yield asset swap spreads have rallied a lot to 370 bp currently and the value proposition is less compelling now. Some decompression looks overdue with the single-B bucket repricing wider. We therefore expect some high yield spread 40-50 bp widening in the months to come.

Axel Botte

Market review

The Fed makes a statement

The FOMC announces a prolonged period of high interest rates and markets must adjust to a new rate environment.

The Fed will not let its guard down. The September pause does not invalidate a future increase in Fed funds, probably as soon as the November FOMC. The financial markets are finally pricing in a scenario of higher for longer rate environment. T-note yield hit a yearly high at 4.50% after the FOMC decision driving the German bond yield towards its 2023 peak (2.75%). The tension in long-term yields weighed on growth stocks, as the Nasdaq plunging 3% last week. European stock markets were down about 2%. The announced monetary tightening offsets the rise in oil prices so that long-term breakeven inflation rates remain stable. Greek and Italian sovereign spreads widened marginally, above their respective thresholds of 140 and 180 bp. Credit, including high yield, is weathering this period of rate volatility rather well.

The Fed's pause in September is part of the pattern seen in June/July and undoubtedly foreshadows a final 25 bp hike in November. US economic growth turned out to be more sustained than expected and current inflation remains significantly above the 2% target. The FOMC raised its growth forecast to 2.1% in 4Q 2023 and 1.5% next year. The unemployment rate is projected at 4.1% over the next two years. In this context, underlying inflation will decrease from 3.7% at the end of 2023 to 2.6% in 2024 and 2.3% in 2025. Given these economic projections, the consensus within the FOMC sems to be that the potential for monetary relief is limited between 1 and 3 rate cuts, which suggest that the Fed funds rate will stay above 5% throughout 2024. Views diverge for 2025 and a debate on the neutral rate looks overdue. Indeed, 2.5% seems too low. Elsewhere, a narrow majority, 5 votes to 4, secured a monetary status quo in the United Kingdom. The latest inflation reading (6.7% in August) and Andrew Bailey's vote have tipped the decision towards no change. The BoE is nevertheless accelerating its QT to the tune of £100 billion next year. The BoJ decision was also highly anticipated by market participants. Kazuo Ueda's recent comments calling for an end to negative rates led to familiar inaction from the BoJ. In addition, Scandinavian central banks increased their interest rates by 25 bp as expected while the SNB left its rate unchanged at 1.75% due to the strength of the franc.

The bond markets are clearly bearish. The buying consensus is being undermined by the Fed's rhetoric and the weakness of the T-note (4.50% at the weekly peak) is dragging down the German Bund (2.75%) and the majority of the G10. The T-note spread to Bunds continues to widen. However, Gilt is outperforming thanks to the monetary status quo, whilst waiting for the November update of the BoE forecasts. The gradual normalization of long-term rates results in a steepening of yield curves. The 2s10s spread in the United States moved higher to around -65 bp. Persistently high rates should hit intermediate maturities the hardest, as medium-term bons compete with money market instruments. The sovereign primary bond market remains active in the euro area but issuance focused mainly on short maturities given the risk of curve steepening. Greek and Italian bond spreads widened by 3 to 5 bp last week. The persistence of inflation argues for an inflation-receiving position in the short term. Ten-year breakeven inflation rates are less sensitive to oil price changes and respond more to monetary tightening. In the emerging markets, fund outflows seem to have little impact on USD debt spreads in (418 bp).

On the credit market, the Euro IG spread (147 bp against Bund, 89 bp against swap) narrowed by 5 bp over the last five trading sessions despite a turbulent week on rates. Issuance totaled €15 billion last week with two-thirds coming from financials but exclusively BBB ratings. Medium-term credit funds are recording inflows which contribute to the reduction in new issue premiums and the sharp tightening of some hybrid debt deals issued without a yield premium. Despite a 9th week of outflows, high yield spreads show stability (ASW 375 bp). Spread compression in B vs. BB space continues. Cocos remain attractive with a discount estimated at 50-60 bp just like high yield hybrids compared to IG equivalents.

Equity markets correct by 2 to 3% in New York and 2% in Europe. The rise in rates logically penalizes growth stocks, including luxury, as cyclical consumer stock prices remain under downward pressure.

Axel Botte

Main market indicators

G4 Government Bonds	25-Sep-23	1wk (bp)	1m (bp)	2023 (bp)
EUR Bunds 2y	3.26%	+1	+23	+50
EUR Bunds 10y	2.8%	+9	+24	+23
EUR Bunds 2s10s	-46.4bp	+9	+1	-26
USD Treasuries 2y	5.12%	+7	+4	+69
USD Treasuries 10y	4.5%	+20	+27	+63
USD Treasuries 2s10s	-61.8bp	+14	+23	-6
GBP Gilt 10y	4.31%	-8	-13	+64
JPY JGB 10y	0.74%	+2	+13	-14
€ Sovereign Spreads (10y)	**25-Sep-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
France	55bp	+0	+3	+0
Italy	186bp	+6	+21	-28
Spain	107bp	+0	+6	-2
Inflation Break-evens (10y)	**25-Sep-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
EUR 10y Inflation Swap	2.62%	-4	+5	+7
USD 10y Inflation Swap	2.66%	+1	+6	+12
GBP 10y Inflation Swap	3.98%	+1	+14	+9
EUR Credit Indices	**25-Sep-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
EUR Corporate Credit OAS	148bp	+0	-6	-19
EUR Agencies OAS	72bp	-1	-3	-7
EUR Securitized - Covered OAS	81bp	+2	-4	-2
EUR Pan-European High Yield OAS	434bp	+6	-20	-78
EUR/USD CDS Indices 5y	**25-Sep-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
iTraxx IG	78bp	+9	+4	-12
iTraxx Crossover	423bp	+33	+10	-51
CDX IG	73bp	+10	+7	-9
CDX High Yield	448bp	+25	+6	-36
Emerging Markets	**25-Sep-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
JPM EMBI Global Div. Spread	423bp	+6	0	-30
Currencies	**25-Sep-23**	**1wk (%)**	**1m (%)**	**2023 (%)**
EUR/USD	$1.063	-0.608	-1.565	-0.7
GBP/USD	$1.222	-1.420	-2.854	1.1
USD/JPY	JPY 149	-0.733	-1.533	-11.8
Commodity Futures	**25-Sep-23**	**-1wk ($)**	**-1m ($)**	**2023 (%)**
Crude Brent	$93.3	-$1.2	$9.3	13.6
Gold	$1 924.1	-$7.0	$9.2	5.5
Equity Market Indices	**25-Sep-23**	**-1wk (%)**	**-1m (%)**	**2023 (%)**
S&P 500	4 320	-2.93	-1.94	12.5
EuroStoxx 50	4 162	-1.98	-1.76	9.7
CAC 40	7 116	-2.20	-1.57	9.9
Nikkei 225	32 679	-2.55	3.33	25.2
Shanghai Composite	3 116	-0.33	1.68	0.9
VIX - Implied Volatility Index	18.06	29.00	15.18	-16.7

Source: Bloomberg, Ostrum AM

Additional notes

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