European High Yield in 2016

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Let's cut to the chase; we still like European High Yield and believe that, with the correct strategy, decent returns can be made in 2016. Over the past year fundamentals have been stable with issuers seeing positive growth in cash flow and some deleveraging. The lower oil price, weaker euro and quantitative easing (QE) from the European Central Bank (ECB) continue to provide a boost to economic activity, as well as a strong technical backdrop. Growth is set to accelerate over the next two years but not to levels that are likely to cause overheating, inflation or aggressive corporate activity; a decent backdrop for credit.

It took the Federal Reserve some five to six years of QE (in all its forms) to drive unemployment down from 10% to today's 5% level. In Europe, unemployment stands at 10.7% (having peaked at 12.1% in 2013) and we are less than one year into the QE programme. Since inception, the ECB has already made two further dovish policy moves, the most recent being this December's interest rate cut. It is likely that Europe will remain in a low yield world, with loose policy for several years yet. We should expect markets to be buffeted by world events but until the output gap in Europe closes, inflation stirs and employment picks up, we think yields are anchored at these low levels.

Growth in the Eurozone is not stellar, but is certainly good enough for the bulk of High Yield companies and at a level that encourages conservative behaviour from management teams. The asset class has minimal exposure to Emerging Markets, oil, energy and commodity sectors; lower commodity prices are beneficial to profit margins in the region. The outlook for defaults, the principal driver of returns from the asset class, is supportive. The medium term technical backdrop, with minimal maturities and a cash-rich investor base, also lends support in a market where new issue supply has disappointed.
In terms of valuation, credit spreads are around 150 basis points wider than when the ECB started QE and over 200 basis points wider than their 2014 lows. The market today has a credit quality higher than the historical average. Given the outlook for a continued low level of defaults, this makes spread levels look good value.

Much has been written over the past few months as to whether we are witnessing the end of the credit cycle. Nearly seven years post the "Global Financial Crisis" the US Federal Reserve has started to tighten monetary policy. The policy change caused a shadow over the market for most of 2015 and virtually all asset classes across the globe struggled to produce positive returns. Some countries, geographies and sectors are clearly experiencing structural changes for the first time in many years with the inevitable impact feeding through to equity and bond prices. We do not believe that this is the end of the credit cycle in Europe; we prefer to think of it as an environment with which we are very familiar; a "stock picker's" market. Simply making wholesale asset allocation decisions and expecting beta to work for you is, today, inadequate.

European credit markets do not exist in a bubble and whilst they may have been somewhat protected through a low direct exposure to commodities, oil, China and emerging markets, they will inevitably re-price when the US moves. We think this is broadly fair, serving to keep animal spirits in check and providing a better valuation entry point for long term investors.

At the time of writing, just a few days after the interest rate move by the Federal Reserve, financial markets are more volatile but overall, holding up fairly well. Fund flows are making headlines and some commentators are wondering whether the failure of the Third Avenue US High Yield Bond fund is the "canary in the coal mine". We don't believe so because this fund was heavily invested in illiquid positions and was not representative of the broader high yield market. The environment is one of weak global growth and deflationary pressures. Volatility will remain elevated until oil prices and commodities show signs of stabilisation and thereafter, the need for income in a low yield world will reassert itself.

Portfolio positioning and strategy

We are firmly of the view that if QE in Europe proves successful, inflation will eventually enter the system. This may be some years away, but meantime we do not believe that the market offers sufficient compensation for taking interest rate (or duration) risk. We are therefore underweight duration, with our fund positioned having a weighted position of 2.6 years versus the index of 3.5 years.

We do, however, believe that the market is over-compensating for the risk of defaults. Credit curves are too flat so we prefer shorter dated and higher coupon bonds. This leads us to a position of around 60% in single B rated credit (around twice that of the index of 30%). Optically, this implies a high level of credit risk, but in our opinion, simply looking at the credit rating overstates this. A large proportion of these holdings comprise shorter dated bonds. Indeed, some 25% of the portfolio is trading to fixed maturities or call dates within an eighteen month period. This provides several benefits; short call bonds not only display lower levels of price volatility, which helps to protect performance in difficult markets, they are also highly liquid relative to the broader market and cheaper to trade with relatively tight bid / offer spreads. The self-liquidating nature of these bonds (as they mature) also provides a rolling source of cash, enabling purchases of secondary or primary market opportunities.

The fund holds around 22% in sterling denominated bonds, which significantly benefited the fund in 2015 after outperforming euro denominated high yield by over 4%. This position has been driven by our usual individual and bottom-up stock selection process, the higher UK yields on offer as well as the attractions of a stronger UK economic backdrop. Whilst the sterling market can be slightly less liquid than euro high yield, we believe the additional spread on offer more than compensates for this. The impending vote on ("Brexit") Britain's membership of the European Union has the potential to cause some volatility. We remain vigilant but at this point, given there is no currency impact, the ramifications are more likely to be longer term in nature.

The fund weighting in floating rate notes is around 5%. These offer an attractive yield and tend to display lower levels of price volatility than their fixed rate coupon brethren. Reasons for their lower volatility are probably due to their low sensitivity to movements in government bond yields and the slightly different nature of the investor base, which tends to be longer term in nature.

In terms of sector positioning, for us this is more a function of preferring individual credits than any particular over-arching view on allocation. However, based on valuation, we have been underweight cyclical companies for some time and this has served us well. There were some major corrections in 2015 and whilst some opportunities have emerged, it may be a little early to step into some of these "value traps". The demand dynamics of sectors such as chemicals, autos and steel are still reeling from the slowdown in China and emerging markets, whilst supply side capacity issues persist.

We do like some European banks and these tend to be the national champions of the northern European countries. These institutions have never been as well capitalised or under such intense scrutiny from regulators to improve their balance sheets. We remain highly selective and given the correlated way they trade, view positioning here as an allocation away from high yield.

This is an unusual credit cycle where monetary policy continues to dictate the likely path. The default cycle this time will tend to look more like Table Mountain than the Matterhorn – i.e. we're unlikely to see a systemic spike in defaults as witnessed in 2009, but rather periodic and correlated problems in certain industries. This makes good credit research and stock selection key to navigating a decent outcome for our clients. We aim to deliver returns in the order of 4-6% over the next 12 months for our fund.

Steven Logan, Head of European High Yield, Fixed Income

The value of investments and the income from them can go down as well as up and your clients may get back less than the amount invested

Contact details
Should you require any further information, please visit **aberdeen-asset.ch** for details of your local Aberdeen representative.

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