



Confidence
must be earned

Amundi
ASSET MANAGEMENT

INVESTMENT INSIGHTS BLUE PAPER | Q3 2019

Seek high yield opportunities, but
be aware of liquidity conditions

GLOBAL HIGH YIELD

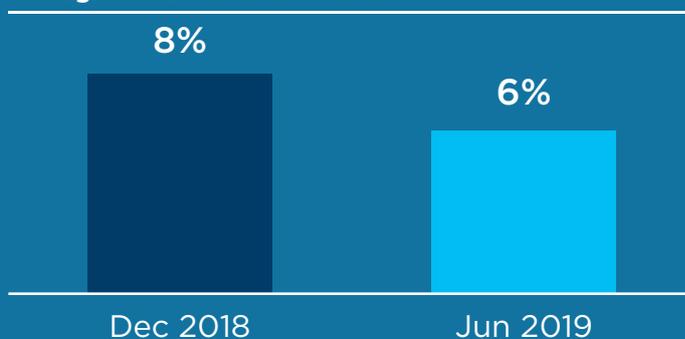
Three main themes driving investing opportunities

Q3-2019

Theme 1 - Central banks dovishness

- Low rates and accommodative central bank policies translate into lower funding costs and easier financial conditions for HY companies
- When the Fed and the markets get onto different pages volatility spikes
- The market may have gone too far in terms of rate cut expectations, but we expect the Fed to manage expectations

US High Yield - Yield to Worst



Theme 2 - Benign default outlook

- We expect the default outlook for the next quarters to remain stable towards year end and just slightly increasing in H1 2020
- Both in the US and in Europe the percentage of bonds trading at distress levels (more than 1,000bps spread) remains contained, with differences across sectors

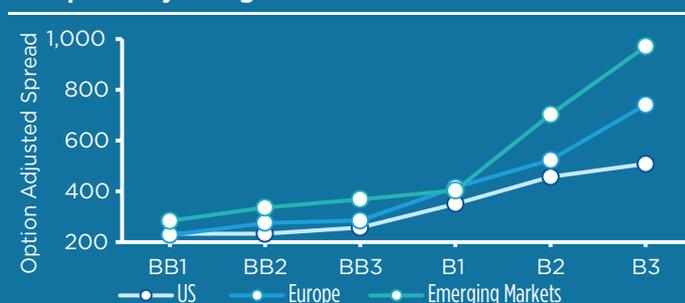
Default outlook



Theme 3 - Diverging technical and fundamental dynamics

- Going global in HY allows to benefit from the favourable fundamental and technical backdrop for European HY and EM HY that also offer appealing spreads;
- Diverging technical and fundamental dynamics result in opportunities to actively select bonds in different regions and sectors

HY Spread by rating



Definitions

Bond ratings: Source: Moody's and S&P. If the ratings provided by Moody's and S&P for a security differ, the higher of the two ratings is used. Bond ratings are ordered highest to lowest in portfolio. Based on S&P measures: AAA (highest possible rating) through BBB are considered investment grade; BB or lower ratings are considered non-investment grade. Cash equivalents and some bonds may not be rated.

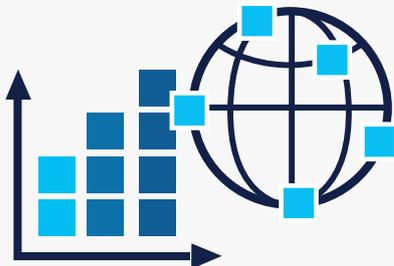
Credit spread: differential between the yield on a credit bond and the Treasury yield. The option-adjusted spread is a measure of the spread adjusted to take into consideration possible embedded options.

Default rate: % issuers that failed to make interest or principal payments in the prior 12 months.

Volatility: a statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

Yield to worst (YTW): it is the lowest potential yield that can be received on a bond without the issuer actually defaulting.

Go global to benefit from diverging fundamental



Global diversification allows to uncover opportunities in the Eurozone where technicals are supportive and in EM benefitting from a Fed accommodative stance and a possible weaker dollar.

Increase scrutiny at company level



As the cycle ages it is crucial to understand the challenges of each sector and seek within each sector strong business models and be mindful of areas of excessive leverage.

Put liquidity management at the forefront



Investors should focus on maximising opportunities while also building portfolios resilient to liquidity shocks through a mix of very liquid holdings and less liquid, higher potential total return holdings.

“ *The increasing dovishness from the Fed and the ECB provides an attractive investment environment for carry, but investors should be aware of possible volatility ahead as market expectations adjust to the effective Fed actions.* ”

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Source: Bloomberg, Amundi Research. Forecasts of 20 July 2019.

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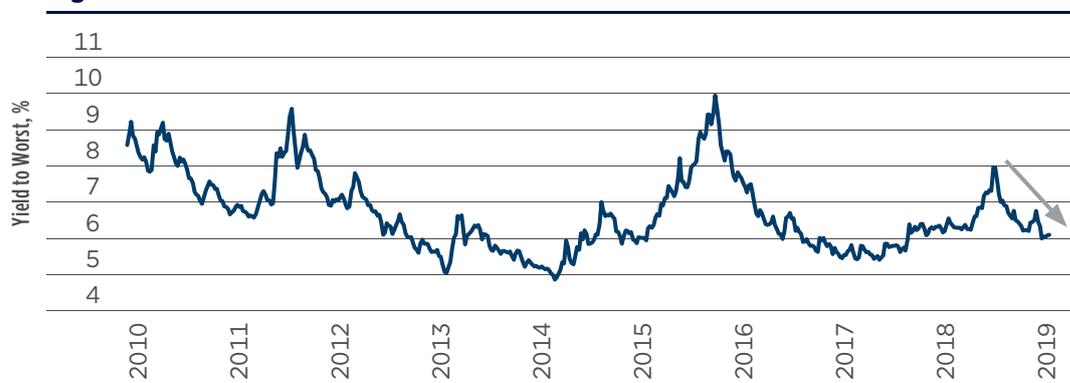
The backdrop for global high yield

Theme 1: Central bank dovishness

Speculative grade bonds have been among the major beneficiaries of the rapid turn of both Fed and ECB monetary policy stances to much more dovish positions. Lower rates for longer and more synchronised easing mean much lower funding costs and easier financial conditions for HY companies, which, as we know, are more sensitive than IG companies to the absolute levels of nominal and real rates.

Looking at the overall yield to maturity instead of the spread paid by speculative grade companies offers useful insights into the effects of central bank activism. The fall in risky assets that occurred in Q4 2018 and the consequent tightening in financial conditions saw a rise in the average yield-to-worst (YTW) of US HY bonds from September, at 6.25%, to December, at 8.10%. On the back of the change in the Fed's stance since January of this year, as we write, the average YTW for US HY companies has declined to 6%, a much more affordable level for a speculative grade company.

Figure 1: Evolution in US HY YTW



Source: Bloomberg. Data as of 18 July 2019. Data refers to the ICE BofAML US High Yield Index.

Furthermore, in the current late phase of the cycle, easier monetary policies reduce downside risks to the macro picture related to global trade uncertainties. At the end of the day, default rates cycles are a story of financial conditions, but also a macro story, as bankruptcies tend to spike in strong downturns or recessions. During previous credit cycles, we also observed that commercial banks follow the lead of central banks so when central bank monetary policy becomes more restrictive the availability of commercial bank financing declines and the cost of financing becomes more dear leading to an increased number of defaults. The recent shift to a more dovish stance by both the Fed and the ECB should therefore allow the period of below average default rates that the HY market has enjoyed to continue.

The area in which monetary policies play more of a supporting role, however, relates to technical factors. Thanks to the ECB opening a new round of easing, the search for yield has morphed even more into a sort of yield hunt in the Eurozone, as almost 50% of overall available fixed income debt is now trading in negative yield territory while a remarkable 20% offers yields very close to flat levels.

In the US as well, the sharp fall in Treasury yields has resulted in an improvement of relative valuations for corporate bonds, leading to a return of demand for the asset class, though to a lesser extent than is the case in the Eurozone. The demand/supply balance in the 'Old Continent' still appears supportive.

“Low rates and accommodative central bank policies translate into lower funding costs and easier financial conditions for HY companies.”

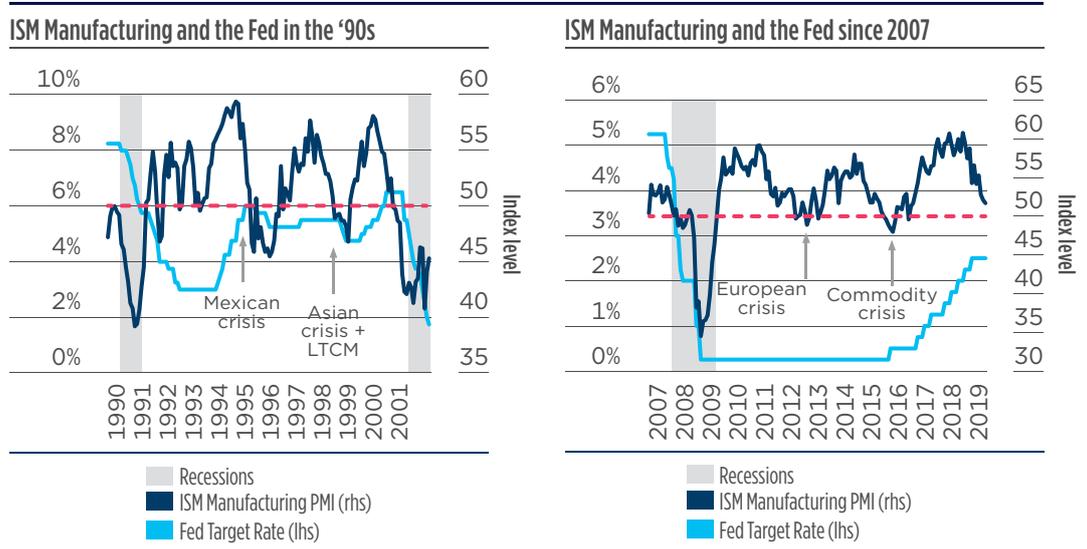
“We expect the Fed to act preventively, given the manufacturing slowdown, with low inflation risk”.

Moving ahead, Fed policy will continue to be a key theme to watch. We believe volatility spikes will occur when the Fed and the markets are on different pages. A great example of this was in Q4 2018, when the Fed viewed the US economy as being stable and therefore ready for more rate increases to achieve normalisation, but the markets were becoming increasingly concerned about sluggish global growth.

We think a policy mistake --- the Fed forcing rate increases onto a slowing global economy --- was narrowly averted; if this had happened, the risk markets would have declined more precipitously than the correction we experienced and this likely would have spilled over into the real economy.

Today, in our view, the US economy is doing moderately well and a manufacturing slowdown (and a possible manufacturing recession) as currently pointed to by the weakening PMI readings does not necessarily mean a general recession will occur. In the mid-1990s and in 1998, the Fed cut rates by 75 bps (as ISM was < 50) and eventually prolonged the cycle. Currently, the yield curve is inverted, which means that the neutral rate has probably been reached. Given, the deflationary risk (a big difference vs the 1990s), the Fed has decided to act in a preventive manner.

Figure 2: Fed to act preventively to prolong the cycle



Source: Amundi Research, Bloomberg. Data as of 18 July 2019.

“The market may have gone too far in terms of rate cut expectations, but we expect the Fed to manage expectations”.

In our view, however, the three rate cuts of 25bps each the market is pricing in are not warranted. Both growth and inflation are tracking at healthy numbers. We think the Fed governors can manage the market’s expectations through further communicating their economic outlook and reasoning; they have frequently used the Jackson Hole conference in August to unveil new ideas. If growth and inflation remain on their current trajectories, we think the Fed will cut less than currently priced in by the market; we believe the market won’t panic if the language in the releases and the governors’ comments are perceived to be adequately supportive and continue to echo their comments that they views are “data dependent” and subject to change as the data does.

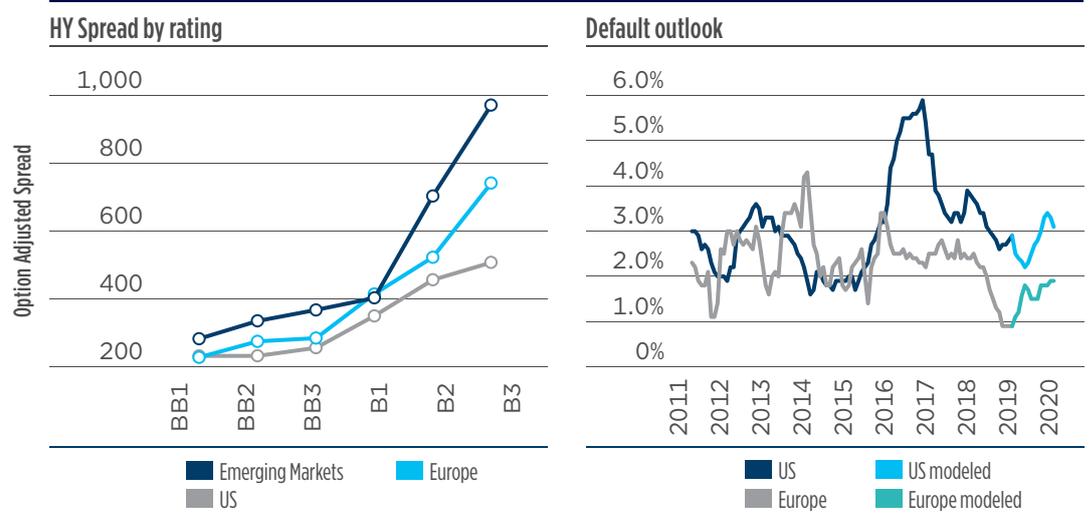
Theme 2: Benign default outlook

“We expect the default outlook for the next quarters to remain benign”.

Global default rates (DR) are still moving in a benign direction. In Europe, according to Moody’s, they reached a 10-year low at 0.9% in February 2019 and then remained stable at this level in the following months. H1 2019 saw US defaults edging only slightly higher, from 2.7% to 2.9%. According to our forecasting models, the outlook for the next quarters still appears benign: it has not materially changed with respect to the start of the year. On the back of top-down leading financial conditions, our one-year-forward model-based projections are pointing to a stable outlook over the next months and then

to a slight increase in H1 2020. For Europe, we project a rise of the DR to close to 2% in one year, while US DR should reach a “peak” in the mid 3% area in Q1 next year, only slightly higher than current levels.

Figure 3: Credit HY: benign default outlook – be selective



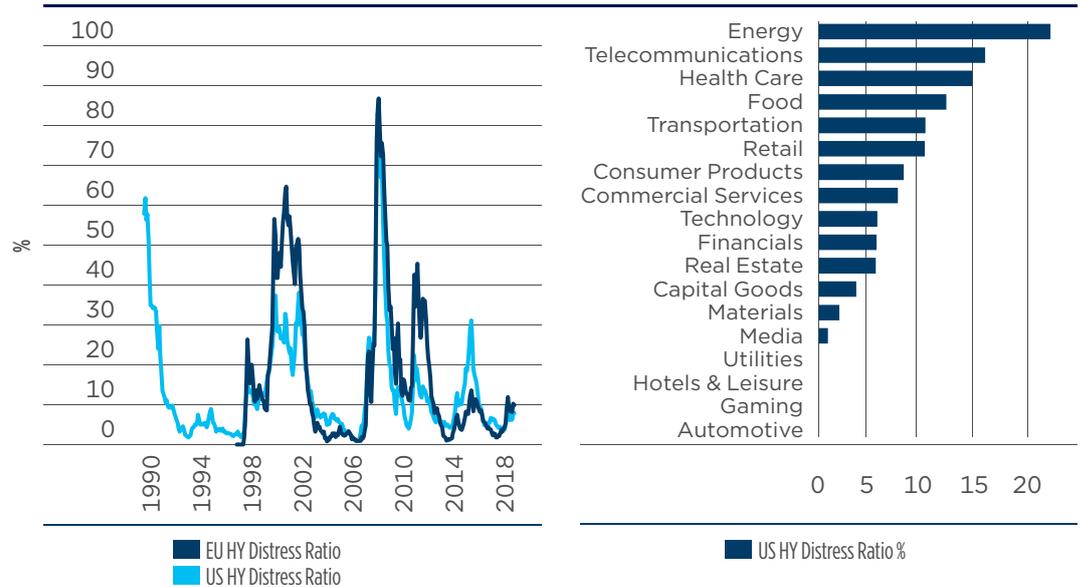
Source: Bloomberg, Moody's, elaboration by Amundi Research. As of 11 July 2019.

“Distress ratios remain contained, with differences across sectors”.

Over the last months, distress ratios have also remained on average quite contained by historical standards. In both the US and Europe, the percentage of bonds trading at a spread of more than 1,000bps over corresponding government bonds (distress bonds) remained below 10% and below last December's slightly higher levels. If the energy and commodity sectors are excluded from the computation, the US HY distress ratio is even lower, in a range of 6-8%, depending on whether it is calculated on the number of issues or in terms of nominal outstanding debt.

Analysis of the US speculative grade universe shows that by the end of June, energy was the only sector with a distress ratio between 15% and 20%. Most sectors were showing little distress (below 10%) and four no distress at all. Last December, the picture was different: at that time, as retail and telecoms were also much closer to energy.

Figure 4: Distress ratios on average quite contained



Source: Bloomberg, Amundi Research. As of 11 July 2019.

“Going global in HY allows investors to benefit from the favourable fundamental and technical backdrop for European HY”.

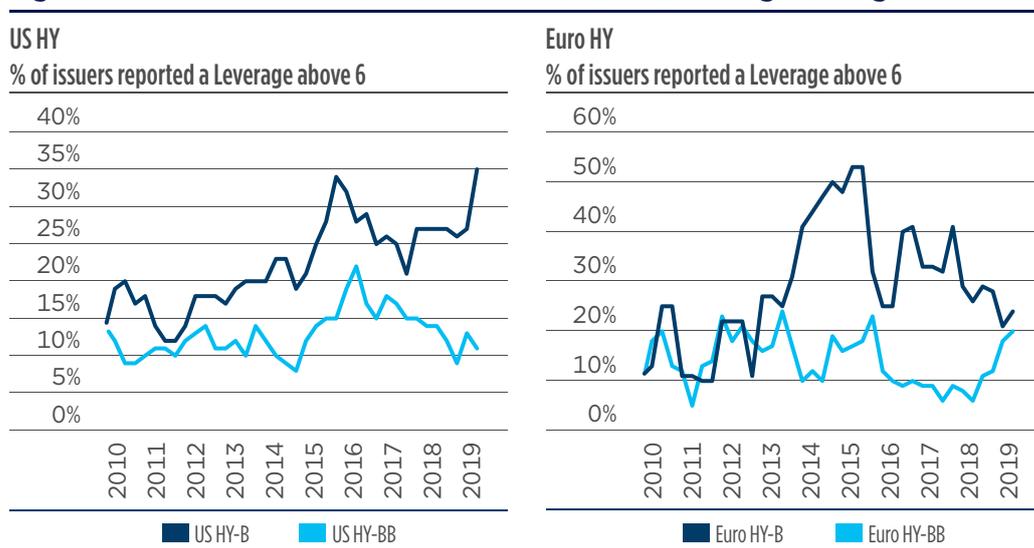
If we analyse trends by ratings, the picture looks comfortable as well. As we write, distress ratios of US B- and BB-rated names are at 4% and 0%, respectively: most of the distressed names are still concentrated among the lowest rated companies. The situation is similar for EUR denominated speculative debt, with distressed bonds almost equally split between CCC- and B-rated names.

Theme 3: Diverging technical and fundamental dynamics

Idiosyncratic risk rose in the Eurozone in the last months, but, on average, credit metrics still look better than in the US. European corporations show limited cumulated leverage and lower debt growth over the last years compared to the US: at the same time, the combination of weaker GDP growth and lower pricing power mean a more challenging trend for European companies' earnings. The gap in funding cost between the two sides of the Atlantic, however, is another factor supporting European companies: the average YTM paid by EUR denominated BB-rated bonds is currently 1.9%, less than half of the 4.45% paid by USD denominated similar rated bonds.

The attractive funding cost has recently attracted more US issuers into the EUR speculative grade primary market, despite spreads being quite in line: this has led volumes of new issuance of “reverse Yankees” to play quite a role in the last months, a situation that is likely to continue.

Figure 5: Fundamentals – Evolution in the % of issuers with high leverage



Source: Bloomberg, Moody's, elaboration by Amundi Research. As of 11 July 2019.

Technicals look quite strong in the Eurozone: supply remains relatively limited by historical standards while investment flows were back in size in dedicated ETFs and funds. HY debt is one of the preferred targets of yield hunting, as it represents just 3% of available debt but roughly 20% of positive yield left. Among the possible options at the ECB's disposal, the re-opening of the CSPP looks quite likely as the ECB's holdings account for just 20% of the eligible universe, a much lower proportion vs other programmes. A reintroduction of the CSPP would likely drive more yield-hungry investors into high yield bonds. Finally, the recent dramatic tightening of Italian BTP spreads supported peripheral financials in EUR denominated speculative grade as well.

How to play high yield

Go global, increase scrutiny and focus on liquidity

“Global diversification allows investors to uncover opportunities in the Eurozone where technicals are supportive and in EM to benefit from an accommodative Fed stance and a possibly weaker dollar”.

“As the cycle ages, it is crucial to understand the challenges of each sector and seek within each sector strong business models and be mindful of areas of excessive leverage”.

“Investors should focus on maximising opportunities while also building portfolios resilient to liquidity shocks through a mix of very liquid holdings and less liquid, higher potential total return holdings”.

Go global to benefit from diverging fundamental

Global diversification is increasingly relevant for HY investors in search of opportunities. The new issue calendar has been heating up with some attractive issuance in Euros and EM which have been capturing our attention. The EUR HY market continues to be supported by a stronger technical backdrop and lower exposure to energy and commodity volatility. The Euro HY market is of interest because we expect the ECB to eventually introduce a stimulus plan. Is CSPP round two on the way? Such stimulus could reduce the nominal yield on IG bonds thus causing IG investors to dip into Euro HY and Euro BBs in particular. We also recognise that the Fed's shift to an accommodative stance reduces the risk in EM as most of the corporate issuers in EM, and even the sovereign issuers, issue bonds in USD. So, a weaker dollar should be supportive. In addition, EM high yield issuers are often inexpensive to developed markets issuers, as sovereign ratings can set a ceiling for corporate ratings.

Increase scrutiny at company level

We expect security selection, rather than sector allocation, to be the most important driver of returns in this late cycle market. Even in sectors that are secularly challenged, we believe investors periodically can find companies with strong business models and bonds trading at attractive valuations. With regard to the US HY market, given the current level of spreads and high leverage, we do not think they have much further to tighten, so we think that a shift to more bonds we call “income producers” (bonds with possibly lower yield, but that are also less volatile vs the market, and from business perspective have more predictable financial performances) is warranted. In addition, investors should look at less cyclical issuers like cable TV companies. While the bonds of such sectors are not cheap, they are not at their tightest levels either, so they provide a balance of modest upside with less downside risk than the overall market. Selective opportunities are also in financials. Within financials, we would avoid companies using strategies that appear to be based on leveraging up; we prefer businesses with a value-added component such as mortgage servicers. We are mindful of the secular challenges that retailers face, and we question the ability of exploration & production companies within the energy sector to generate attractive returns on equity over the long term. We also avoid companies that are too highly leveraged and aren't growing quickly enough.

Put liquidity management at the forefront

We think market structure risk is among the key issues investors currently face. Limited liquidity has exaggerated market moves; we think that changes in regulation and a decline in buy-side diversity are to blame¹. We believe managing liquidity is more of an art than a science. We think that it is key for investors to have a mix of very liquid holdings and less liquid, higher potential total return holdings. This approach would mean that investors are paid well for less liquid holdings, but would also ensure that they are a smaller part of the overall portfolio. We believe it is important to avoid buying illiquid securities: we are aware that liquidity varies with each issuer, each issue and different market conditions, and this risk needs to be carefully monitored and managed. In order to measure the liquidity of each holding, investors should use different methodologies, including looking at ratings distributions. Global HY investors should run an assessment of each position every day to understand how much of it could be sold in a day and how long it would take to sell the entire position. In order to enhance the liquidity profile of the overall portfolio, investors can pair cash substitutes, such as Treasuries, with credit default swaps for a portion of the overall holdings, as these are often easier to liquidate than bonds. In our view, it is wise to hold some cash and highly liquid bonds in order to meet possible redemptions or to be able to purchase securities without having to sell any of the core holdings.

¹See also Amundi paper “How investors should deal with the liquidity dilemma”, February 2019.

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- **Credit spread:** differential between the yield on a credit bond and the Treasury yield. The option options.
- **Default rate:** % issuers that failed to make interest or principal payments in the prior 12 months. Default rate based on BofAML indexes. Universe consists of issuers in the corresponding index 12 months prior to the date of default. Indexes considered for corporate market are ICE BofA Merrill Lynch.
- **Volatility:** a statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.
- **Yield to worst (YTW):** it is the lowest potential yield that can be received on a bond without the issuer actually defaulting.

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Amundi Investment Insights Unit

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