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Confidence  
must be earned

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ASSET MANAGEMENT

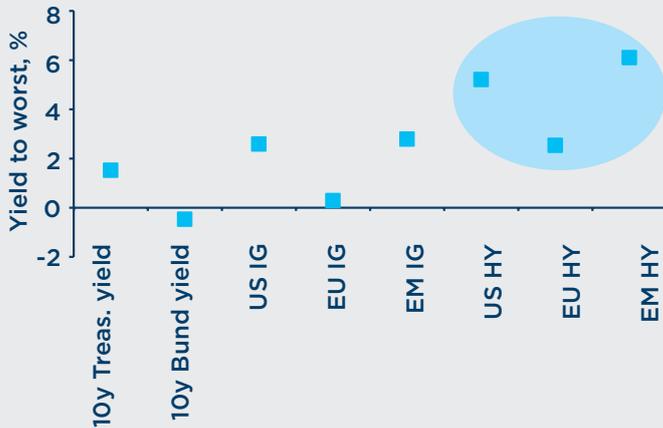
INVESTMENT INSIGHTS BLUE PAPER | H1 2020

# Global high yield outlook: Be confident, but not complacent



### SEARCH FOR YIELD

Still the mantra for bond investors

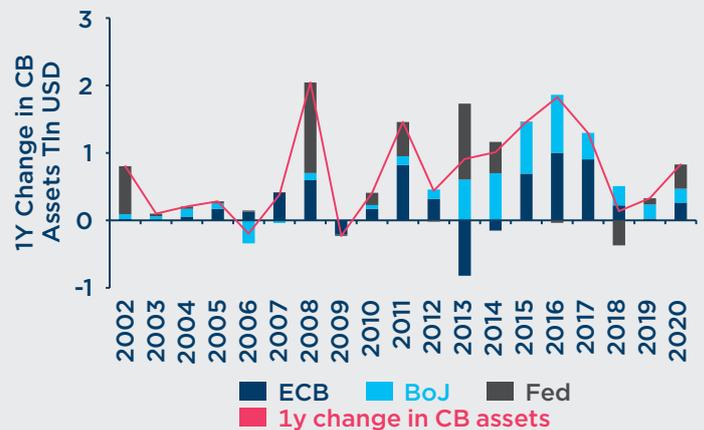


The search for income is likely to continue and possibly intensify, supporting the demand for global HY bonds.



### CENTRAL BANKS

More friend than foe in 2020



Accommodative Central Banks could support the fundamentals and technicals of HY markets.



### DEFAULT RATES

So far, so good



The recent increase in the US default rate has been mainly an energy story. In 2020 we expect defaults to stay benign and below their long-term average.



### US ELECTIONS

Potential dislocations



**Trump gets re-elected (50% chance)**  
No major impact on HY market



**Moderate Democrat (30% chance)**  
Only minor impact on HY market



**Populist Democrat (20% chance)**  
Potential threat, with impact greatest in sectors such as energy and healthcare

Active selection could help exploit opportunities and mitigate risks in sectors more sensitive to the election outcome.

**Definitions** Basis points (bps): one basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).

**Bond ratings:** source: Moody's and S&P. AAA (highest possible rating) through BBB are considered investment grade; BB or lower ratings are considered non-investment grade (high yields). Cash equivalents and some bonds may not be rated.

**Credit spread:** differential between the yield on a credit bond and the Treasury yield.

**Default rate:** the percentage of issuers that failed to make interest or principal payments in the prior 12 months. Default rate based on BofA-ML indices. Universe consists of issuers in the corresponding index 12 months prior to the date of default. Indices are from ICE BofA-ML.

**Duration:** a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.

**Option-adjusted spread (OAS):** the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option.

# GLOBAL HIGH YIELD

## Be confident, but not complacent

H1 2020

### PLAY REGIONAL DIVERGENCES

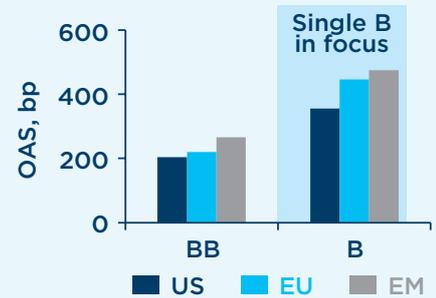
- Different sectors (i.e., less energy in Europe)
- Different cycles (i.e., more advanced in US)
- Larger number of issuers

In 2000, the US accounted for more than 80% of the global HY market. Its share has now fallen below 60%. The EM share of HY has moved up from about 12% to almost 30% over the same time span.



### NO NEED TO BE OVERLY DEFENSIVE

We do not see any reason to become overly defensive and overweight the BB-rated segment. We foresee security selection opportunities in the single-B segment, but bond picking will be crucial.



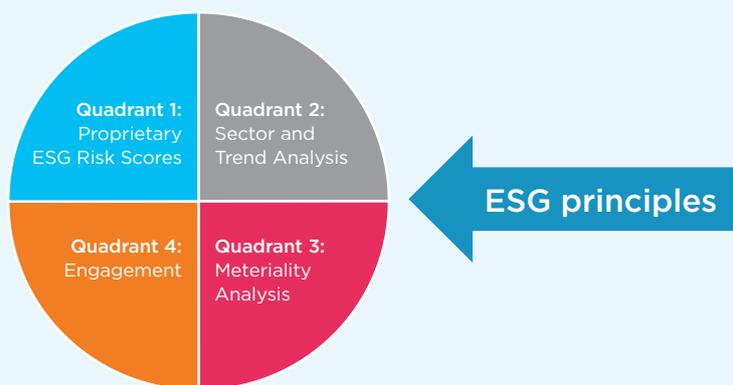
### ESG – FOCUS ON GOVERNANCE

Weak governance policies could lead to possible large losses at companies, so increasing scrutiny of ESG issues is needed for HY selection.



### LIQUIDITY AWARENESS

Market liquidity must be a factor in the decision-making process, given the structural decline in US dealer activity at a time when the credit market has increased significantly.



“ \$30 trillion is tied up in difficult-to-trade investments ”

Mark Carney, incumbent Governor of the Bank of England, June 2019.

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Source: Bloomberg, Amundi. Data refers to ICE BofA Indexes.

Date of First Use: 20 February 2020. Devised by: Amundi Investment Insights Unit.



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## Four hot themes for investing in global HY in 2020

Last year was a strong year for global bond markets, which were supported by the accommodative stance of the main central banks and strong investor demand. US, European and EM high yield (HY) bonds all returned more than 14% swapped into US dollars. The performance was led by the higher-quality segments of the market, such as BB-rated bonds, as well as the strong performance of CCC bonds in Europe. This was due to the search for yield across credit products, helped by positive risk sentiment.

As we enter 2020, financial markets appear to be in a tug of war between the cyclical stabilisation of the economy with the possibility of a rebound – thanks to the trade truce between the United States and China – and the emerging fears about the economic fallout of the coronavirus spread. The starting point is also a bit more challenging as financial market valuations are now less appealing than they were one year ago, before the US Federal Reserve's dovish turn. Since then, equity markets have rallied and corporate spreads tightened throughout most of last year. Meanwhile, liquidity remains abundant at the macro level but this liquidity hinges critically on the general economic backdrop and deserves strict monitoring as it could dry up quickly.

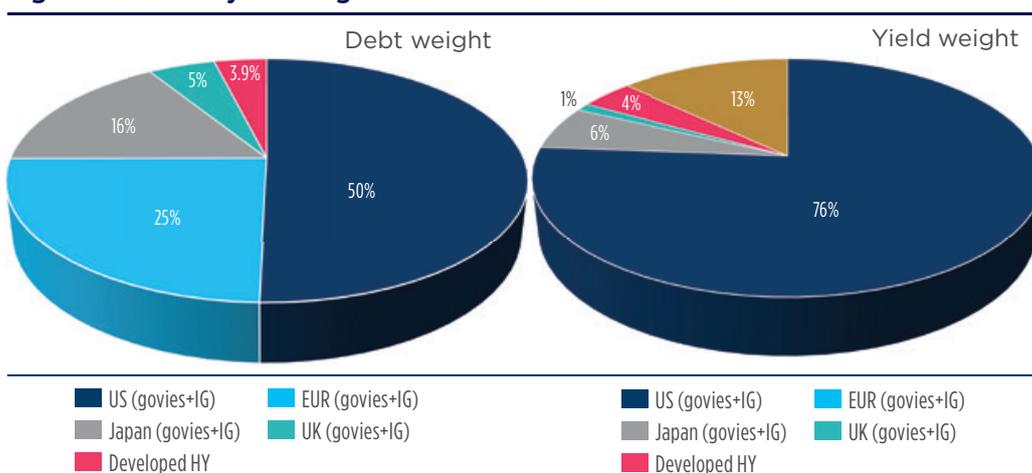
In this environment, we foresee **four hot themes for investing in global HY in 2020**.

### 1. Search for yield still the mantra for fixed income investors

**The global low-yield picture is likely to persist this year** as monetary conditions will remain loose and there are no signs of overheating in economic conditions. **In such an environment, the search for income is likely to continue and possibly intensify.** This will likely support the demand for global HY bonds, which still offer appealing opportunities to global fixed income investors.

Indeed, **HY debt currently accounts for only 3.9% of global developed fixed income markets, but makes up 13% of the overall yield available to investors in such markets, according to our calculations.** The remaining yield is concentrated in USD-denominated debt, including both sovereign and investment grade (IG) corporate bonds.

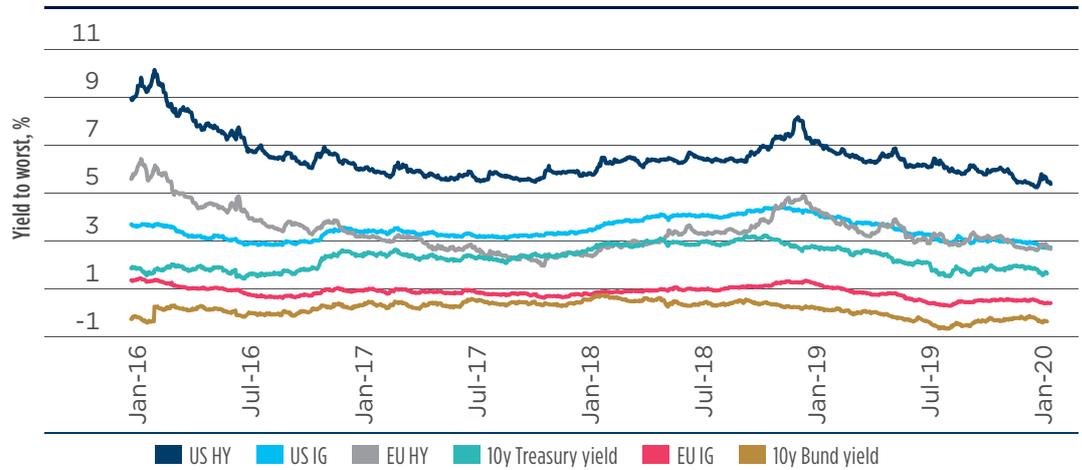
**Figure 1. Debt vs. yield weight across main DM bond markets**



Source: Bloomberg, Amundi Research. Data as of 23 January 2020.

In relative value terms, HY bonds offer appealing return opportunities compared with sovereign and IG bonds. However, from a historical standpoint, the HY market is not cheap as spreads remain close to cyclical troughs and below the long-term historical average.

**Figure 2. Yield to worst across main DM bond markets**



Source: Bloomberg, Amundi. Data as of 13 February 2020.

In 2020, we believe that the **performance of spread products will be driven mostly by carry-like returns**. We could see some further spread compression if the dollar moves sideways or weakens, if the US-China trade truce is extended and if the US economy holds well, as such a scenario would allow default rates to stay below their historical average. Current spread levels are tight but should produce excess returns if defaults remain near current levels. In addition, tight HY spreads need to be evaluated in the context of high equity prices and low sovereign yields.

## 2. Central banks: more friend than foe in 2020, but don't expect too much

Easy financial conditions and the accommodative monetary policy stance of major central banks will support both the **fundamentals and technicals of HY markets in major advanced and developing economies this year, but the bulk of monetary accommodation is likely behind us**. Investor appetite for HY bonds remains strong and corporates can refinance at low costs, allowing default rates to remain below their historical average. For instance, the yield currently paid by a US BB-rated bond is about 3.8%, while for a B-rated corporate it is below 5.5%, some 25/30bp below their end-January peaks in the wake of the coronavirus spread.

*“Easy financial conditions and the accommodative monetary policy stance will support both the fundamentals and technicals of HY markets this year, but most of the monetary support is likely behind us.”*

**Figure 3. US BB- and B-rated high-yield bonds, yield to worst**



Source: Bloomberg, Amundi. Data as of 13 February 2020.

The accommodative shift by global central banks was the main market theme of 2019 and **the trend is likely to continue this year, although with less intensity.**

The **Federal Reserve** cut official rates three times after having hiked four times in 2018 and the Federal Funds target rate now stands below its estimated neutral level. In addition, the US central bank restarted a policy of balance sheet expansion through purchases of short-dated T-bills. Such a policy cannot be seen as quantitative easing (QE) as it is not aimed at lowering longer-term interest rates to stimulate the economy. Rather, its purpose is to calibrate the optimal size of the Fed's balance sheet and ensure adequate liquidity in the system. Nonetheless, markets perceive it as being QE as it sends a clear signal on the monetary policy bias. A rate cut is still possible in the wake of the risk to the economy due to the unintended effects of the coronavirus, but the bulk of the monetary accommodation is likely behind us, taking into account the strong resilience of the US economy.

Meanwhile, the **ECB has restarted its QE programme, which supports euro-denominated corporate bonds, both directly and indirectly.** IG non-banking corporate bonds are being supported directly by the ECB's corporate sector purchase programme, which targets this market and can contain volatility within this asset class. Meanwhile, **HY bonds are receiving indirect support thanks to the pass-through effect of the hunt for yield caused by low IG yields.** In addition to QE — and specific to the financial sector — the ECB also supports banks through other tools, including a two-tier reserve remuneration scheme and enhanced TLTROs.

On the other side of the British channel, the **BoE also looks set to adopt a more accommodative monetary policy stance in the future,** with officials cutting their GDP growth forecasts as the UK left the EU in January to the lowest level since the global financial crisis. Two MPC members have voted for a rate cut at the last three meetings.

Finally — and despite slowing from last year — **EM monetary policy generally looks more accommodative this year than in 2019, especially in China, where it has to support a weakening economy in the wake of the coronavirus spread.**

*“Global central banks are more likely to remain on the friendly side of markets rather than on the unfriendly side.”*

**All in all, global central banks are more likely to remain on the friendly side of markets rather than on the unfriendly side** as — besides their macroeconomic assessment — they are also aware of the importance of keeping rates low to prevent any unwanted tightening of financial conditions, which could lead to an adverse loop between financial markets and economic trends.

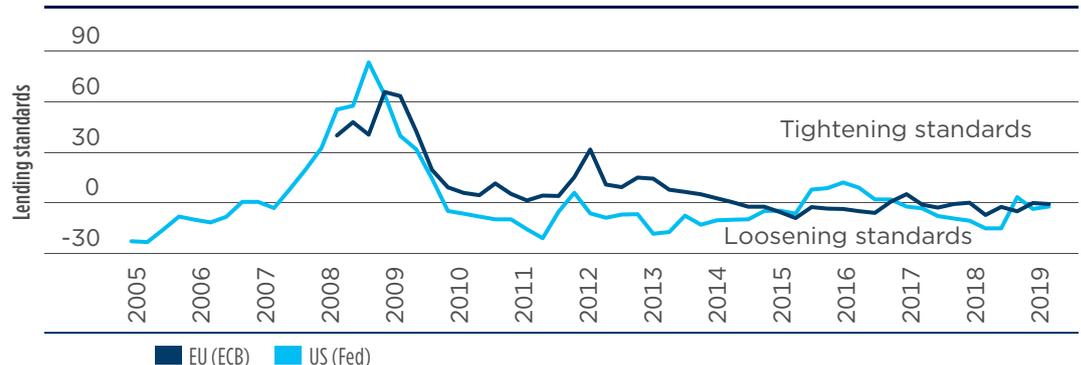
### 3. Default rates: so far so good, with an eye on alternative scenarios

Last year HY default rates remained below their long-term average. There was some pick-up in the United States over the course of Q4, though it proved mainly confined to the troubled energy sector. Default rates are an ex-post measure and, by definition, say little about the future. What are interesting to look at in this respect are the landing standards, distress ratios and recession risks. The main drivers of **default rates are bank lending standards and distress ratios, with a three-to-four quarter lead. On bank lending practices,** the most recent surveys conducted by both the Fed and the ECB paint a picture of overall neutral standards being applied to corporate loans.



**Sergio BERTONCINI**  
Head of Rates  
and FX Research

**Figure 4. Trends in bank lending standards**



Source: BofA-ML, Federal Reserve, ECB, IIF, Amundi. Data as of 10 February 2020.

*“Corporate fundamentals generally appear healthy across HY companies.”*

Distress ratios – that is, the share of HY bonds trading at spreads larger than 1,000 over government bonds – reflect corporate fundamentals, which generally appear healthy. **Sales are growing and capex growth is almost 10% across US HY companies (as measured by the four-quarter moving average) and the use of leverage appears under control.** For instance, the net debt to EBITDA ratio currently stands at 3.3 for US BB-rated bonds and at 5.3 for the single-B bucket, both low by historical standards. In the EU, the same ratios currently stand at 4.0 and 5.6, respectively. Additionally, the share of BB-rated bonds in both US and European HY has increased, a further recognition of increased credit quality. We believe lower rated financings that previously would have been executed as HY bonds have shifted to become leveraged loans.

**Figure 5. US, EU and EM HY distress ratios, % of issues**



Source: BofA-ML, ICE data indices, Amundi. Data as of 10 February 2020.

*“The recent increase in the US default rate has been mainly an energy story, while most other industries show low distress levels.”*

All this led the US HY distress ratio to drop to 9% in January 2020, below its long-term average of 11%. In terms of sectors, the troubled energy sector remains in the lead in terms of the distress ratio – at 24% at end-2019 – while the remaining sectors generally experienced a fall in defaults last year. In Europe, the distress ratio is even lower – at 8.3% in January 2020, according to BofA-ML data – with the highest share recorded by the transportation sector.

**According to our estimates based on the above indicators, we foresee a drop in US default rates over the next 12 months, while in Europe they are expected to pick up somewhat but still remain low by historical standards.** The assumption behind such a model is that 2020 US real GDP growth slows slightly to below 2%, from 2.3% in 2019, and that the European economy’s deceleration due to the coronavirus impact proves to be temporary.

With reference to the United States, under alternative macroeconomic scenarios, the US default rate would spike higher (see table 1). However, such downside scenarios are unlikely to materialise, at least in the short term, as the United States and China have signed a phase one trade deal. On the other hand, there is a risk that the economic fallout of the coronavirus spread could prove harsher than expected and undermine global growth leading to a global recession.

*“In 2020 defaults will stay benign and below their long-term average, unless an adverse scenario materialises.”*

**Table 1. US HY default rate under different scenarios, end-2020**

Scenario 1 (2020 US GDP around 2%.)	Scenario 2 (2020 US GDP at 1.1%)	Scenario 3 (2020 US GDP at 0.0%)
3.8%	6.0%	8.9%

Source: Moody’s, Amundi Research. Data as of 13 February 2020.

#### 4. US election: potential dislocations at sector/security levels

On 3 November the United States will hold a presidential election, an event that could impact the global economy and financial markets. We see three possible scenarios: the re-election of Trump, the election of a moderate Democrat or the election of a populist Democrat. If Trump or a moderate Democrat is elected, everything will stay on course for the economy, with some possible minor adjustments. The Democratic primary process will conclude this summer and will indicate how much risk the election in November holds. Despite the economy having been good in Trump's first term, many middle-class people feel squeezed as they have seen their earnings stagnate; they feel that the benefits of the Trump era (e.g., 2017 tax cut) are being felt by others. These people could vote for a moderate Democrat in the hope of getting a fairer economy.

Under such a scenario, taxes would go up and current policies would be amended to benefit these people. Mainstream Democrats are not feared by investors, as their policies are similar to Obama's and in keeping with the US mainstream. **For this reason, we expect an orderly market fallout in the event either Trump gets re-elected or a moderate Democrat wins the election, as such an outcome appears to already be priced in by financial markets.**

On the other hand, the election of a **populist Democratic candidate such as Bernie Sanders would cause a hugely negative market fallout in the short term** — including a possible significant widening of HY spreads — as the policies of candidates such as Sanders include wealth taxes, large income tax increases and socialising healthcare. However, even if a populist Democrat is elected, it does not necessarily mean that such policies will be implemented. This will depend on the outcome of the Congress election that takes place alongside the Presidential ballot, with US citizens voting to renew all 435 members of the House of Representatives and 35 Senate seats.

**If a populist Democrat becomes the 46th US President and the Democrats also win the Senate majority — the House of Representatives is likely to remain Democratic in any case — markets may be hit as they would fear the risk of interventionist policies, especially in the energy and healthcare sectors.** Under such a scenario, fracking might even be banned at the Federal level and large parts of the healthcare universe would find their business models existentially threatened.

Even if the Senate stays Republican under a populist Democratic President, these two sectors would face challenges, as energy companies may lose the ability to flare natural gas and waste water disposal standards would be increased. Rule changes would also hit many healthcare companies. **However, the initial market fallout may be greater than the ultimate economic damage to both these sectors.**

In any case, a populist Democratic administration would still need to present legislation moderate enough to attract the votes of Democratic senators in Red States (rural and Republican-leaning states). In addition, regulation needs to be grounded in statutes and the regulatory process is slow. **All this mitigates the risk of radical policies actually being implemented.**

*“Active selection could help exploit opportunities and mitigate risks in specific sectors more sensitive to the election outcome, for example, energy and healthcare.”*

**Table 2. Potential impact on HY market of possible US election outcomes**

Trump gets re-elected (50% chance)	Moderate Democrat (30% chance)	Populist Democrat (20% chance)
No major implication on HY market, as a re-election is the scenario priced into the market, with a continuation of the de-regulation policies.	Only minor impact on HY, as the result should be pro-growth and market friendly, with only fine-tuning of economic matters.	Potential threat with impact on some sectors (energy sector, fracking potentially banned, healthcare sector), especially if both houses are taken by the Democrats.

Source: Amundi. Data as of 13 February 2020.

## IMPLICATIONS FOR INVESTING IN GLOBAL HY IN 2020

Investing in high yield in 2020 will be a matter of building portfolios around two main themes.

### Theme 1: Play regional diversification to get exposure to different drivers

Regional allocation will be key for portfolio construction and for alpha generation, in our view, as well as for giving investors the possibility to diversify their exposure beyond DM.

The **EM HY** market delivered the highest return of the three regions (EU, US and EM) in 2019, even if such returns were tightly clustered, with less than 35bp difference between the three geographies. It is unusual for a region to deliver the best return two years in a row, but with the highest yield and longest duration, this could be the case for EM HY if the market tightens further and financial conditions remain loose, as we expect.

**A high degree of regional diversification may allow global fixed income portfolios to benefit from the different momentums in the economic and credit cycles, as well as provide exposure to different sectors and quality of corporate fundamentals.**

*“A high degree of regional diversification will allow global fixed income portfolios to benefit from the different momentums in the economic and credit cycles and in the quality of corporate fundamentals.”*

**Figure 6. HY default rates: different regional path**

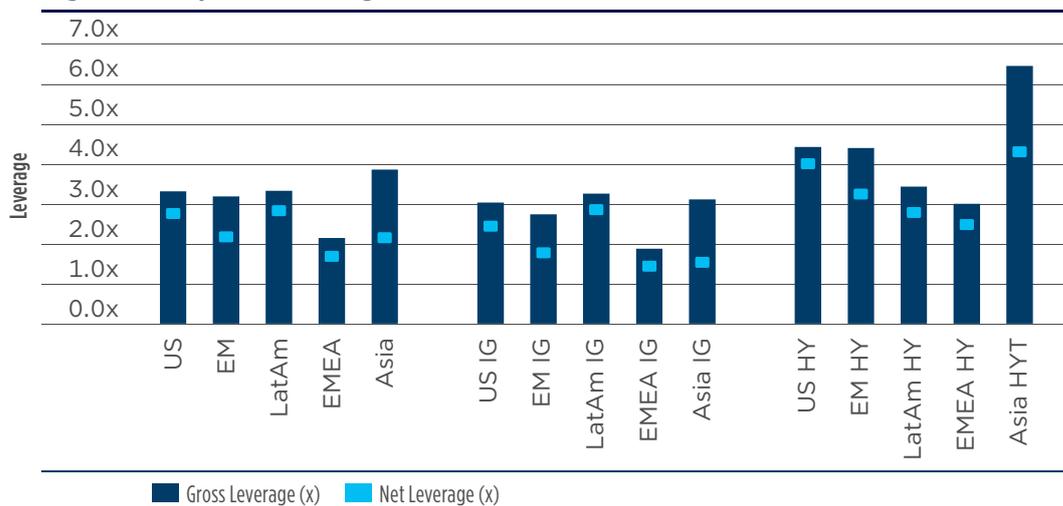


Source: BofA-ML, Amundi Research. Data as of 10 February 2020.

In terms of the credit cycle, if we look at the past 15 years we can see that the three markets (US, EU and EM) showed different default rates paths, with the main exception being the great financial crisis (GFC), during which the US triggered a widespread deterioration in the HY market. In 2012-13 Euro HY was affected by the Euro crisis, but it remained broadly immune to the 2016-17 spike in default rates in the US and EM, which were a consequence of Fed tightening and challenges in the energy sector. A diverse and active approach would help provide exposure to specific regional drivers (i.e., ECB support in Europe), different sector exposures (Europe less exposed to the energy sector vs. US) and different momentums in the economies. Regional diversification is therefore crucial, allowing investors to benefit from opportunities arising in different areas, while also helping to mitigate risks.

**The EM and EU HY markets have grown significantly since 2000, broadening the investment universe and the sources of opportunities.** Twenty years ago, the United States accounted for more than 80% of the global HY market, but its share has now fallen below 60%. At the same time, the EM share of HY has moved up from about 12% to almost 30% over the same time span.

Finally, regional diversification and accurate stock picking provide ways to dynamically play heterogeneity in corporate fundamentals, as illustrated in the chart below, with significant divergences in the gross/net leverage corporate profile.

**Figure 7. Corporate leverage across different markets**

Source: BofA-ML, ICE data indices, Amundi. Data as of 10 February 2020.

*“Increased scrutiny in credit fundamentals, corporate governance and liquidity is the right strategy for investing in the HY market in 2020.”*

## Theme 2: Not time yet to be overly defensive, but increase the focus on credit research, corporate governance and liquidity

With the global economy likely to stabilise and possibly reaccelerate mildly in 2020 — barring any long-term impact of the coronavirus spread — we expect only a modest pick-up in default rates this year, which are expected to stay below their historical average. If defaults remain stable, **we do not see any reason to turn defensive and overweight the BB-rated segment.** However, markets are close to all-time highs and volatility has already increased somewhat this year. Therefore, increasing exposure to CCC-rated bonds may be too risky. **We see good security selection opportunities in Bs** and prefer this bucket, but bond picking will be crucial to avoid idiosyncratic stories that are more vulnerable in case of a deterioration in lending standards or a weakening economy.

In Europe, both BBs and Bs offer premium credit spreads compared with their US counterparts, thus offering relative value opportunities. In the **US, the energy sector** has become a chronic issue in the US HY market, with the highest share of default rates and the largest distress ratio of any other US sector. We believe that a continuing high level of energy defaults is priced in by markets and see **opportunities in this sector at the single-security level, where high selectivity is needed, while keeping the overall exposure to oil and gas prices neutral.**

As one-way markets are probably behind us and with idiosyncratic risks mounting, **selectivity will be key to avoiding any credit event.** In a late-cycle phase, risks are skewed to the downside and a research-intensive approach performing single-name analysis is needed. **In this sense, a dedicated credit research team will be helpful in anticipating distressed credit situations.**

Moreover, in bond picking, **the integration of ESG (environmental, social and governance) principles will be a key challenge for asset managers in the 2020s in high yield.** The third pillar — **governance** — has already been implemented by asset managers for some time, as reflected in the idea of creditors needing to “think like a shareholder” to appreciate all the risks of a corporate bond. Since weak governance policies could lead to large losses at companies — as happened with Boeing, for instance — **increasing scrutiny of ESG issues will be needed for HY selection.**

Portfolio liquidity also needs to be monitored carefully. Following the GFC, changes in regulations have resulted in a reduction of bank and dealer activity in the United States at a time when the credit market size has increased significantly, especially in the less liquid HY segment. **Therefore, credit market liquidity will be a key factor that needs to be included in the investment decision process.** Cash buffers will have to be strong enough to be put into play in case of any market dislocation.

## Definitions

- **Asset purchase programme:** A type of monetary policy wherein central banks purchase securities from the market to increase money supply and encourage lending and investment.
- **Alpha:** The additional return above the expected return of the beta-adjusted market return; a positive alpha suggests risk-adjusted value is added by the money manager compared with the index.
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Beta:** Beta is a risk measure related to market volatility, with 1 being equal to market volatility and less than 1 being less volatile than the market.
- **Bond ratings:** 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 a 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.
- **Carry:** The carry of an asset is the return obtained from holding it.
- **Correlation:** The degree of association between two or more variables; in finance, it is the degree to which assets or asset class prices have moved in relation to each other. Correlation is expressed by a correlation coefficient that ranges from -1 (always move in opposite direction) through 0 (absolutely independent) to 1 (always move in the same direction).
- **Credit spread:** The differential between the yield on a credit bond and the Treasury yield.
- **CSPP:** Corporate sector purchase programme, part of the ECB's asset purchase programme.
- **Default rate:** Share of issuers that failed to make interest or principal payments in the prior 12 months. Default rate based on BofA-ML indices. Universe consists of issuers in the corresponding index 12 months prior to the date of default. Indices considered for corporate market are ICE BofA Merrill Lynch.
- **Diversification:** Diversification is a strategy that mixes a variety of investments within a portfolio, in an attempt at limiting exposure to any single asset or risk.
- **Duration:** A measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.
- **EBITDA:** Earnings before interest, taxes, depreciation and amortisation.
- **MPC:** Monetary Policy Committee of the Bank of England.
- **Quantitative easing (QE):** QE is a monetary policy instrument used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **Sharpe ratio:** A measure of excess return per unit of risk, as defined by standard deviation. A higher Sharpe ratio suggests better risk-adjusted performance.
- **Spread:** The difference between two prices or interest rates.
- **TLTRO:** The targeted longer-term refinancing operations (TLTROs) are Euro-system operations that provide financing to credit institutions for a predefined period. They offer long-term funding at attractive conditions to banks to further ease private sector credit conditions and stimulate bank lending to the real economy.
- **Two-tier/tiering system of the ECB:** A mechanism that allows banks to park their excess funds with the ECB. Under this, a portion of banks' deposits are exempted from negative rates.
- **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.

With the contribution of



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## AMUNDI Investment Insights Unit

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