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# High Yield: Oasis in search for yield?





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Since early 2016, US HY default rates have experienced a sort of “mini –cycle”, peaking at the end of 2016. Nevertheless, the recent rise and fall movements appear mostly commodity driven: default rates would have remained fairly stable if energy and material sectors were excluded from calculations. Looking at default rates from a rating perspective, the picture looks benign with default rates of high quality speculative grade bonds (BB rated) moving to zero in the last couple of years, B rated bonds stabilizing between 0 and 1.5% and CCC-rated names falling remarkably.

Here **we try to identify the main drivers of default rates in order to understand if the current low levels are sustainable** and ultimately if the corporate bond market can still provide a valuable source of returns for investors.

We group the drivers into two major categories: short-term drivers and structural drivers. Among short-term drivers, we include the macroeconomic conditions; we observe that what is relevant for default rates is not the level of growth rate but more the divergence from long-term trends. The current conditions with growth rates close to potential growth (i.e. not much divergence from trends) are favourable. In addition, top-down financial conditions (access to credit, via bank loans and bond market) are crucial, as low rated companies are highly dependent on external funding and vulnerable to sudden changes in liquidity conditions and investors’ risk aversion. Looking at bottom-up financial conditions (i.e. discriminating among sectors), even in the most stretched areas, the stress appears contained. Supply-related factors are also relevant among the short-term drivers of default rates. We do not see a major concentration of maturing debt; refinancing needs seem limited. We are more concerned about areas outside the HY space, such as the surging BBB swathe of debt. Downgrades or refinancing challenges could result in selected BBB issuers becoming HY. Financial conditions are crucial to keeping risks contained.

In identifying structural / long-term drivers for default rates, we observe that the current cycle of HY default rates in the aftermath of the great financial crisis continues to be the most benign since 1990. The current macro cycle could soon become the longest expansion on record in the US, thanks to the ultra-easy monetary policy, the benign inflation regime, and fiscal policy boost, which has prolonged the extension. From a long-term perspective, the cost of funding becomes crucial: what would happen if interest rates were to rise? This could be negative for the high yield market. In case of a sharp rise of interest rates, systemic risks would increase, leading to a renewed default cycle. The good news is that nominal and real rates, even if on an upward trend, are still low on historical basis, and likely to remain stable. In addition to the levels of real and nominal rates, the shape of the yield curve also could be a cyclical catalyst for defaults, and it is something to monitor as the slope has reached levels of “alert”.

In conclusion, from an investment strategy perspective, looking at short-term and long-term drivers of HY default rates, the outlook for the **default rate cycle still appears benign, even considering its length, if positive macro fundamentals (growth to continue around potential) and favourable financing conditions persist.**

In terms of investing, we view high yield corporate spreads as still reasonably priced given our outlook regarding defaults. With **central banks moving away from tightening regimes, search for carry will persist, and high yield continues to offer a decent spread over US Treasuries.** Global high yield should continue to perform, albeit at a slower pace than in the first quarter. We look for good companies at good prices. We look for opportunities across the whole rating scale and across all sectors but individual security selection is crucial for identifying value. Energy, one of the largest sectors represented in the US high yield market, is exposed to the oil price swings but given its heterogeneity, can offer attractive investment opportunities. Liquidity is a crucial factor to consider for high yield investors. We believe investors should monitor liquidity at the issue level, and, also rely on derivatives, such as credit default swaps to enhance the overall liquidity of portfolios.

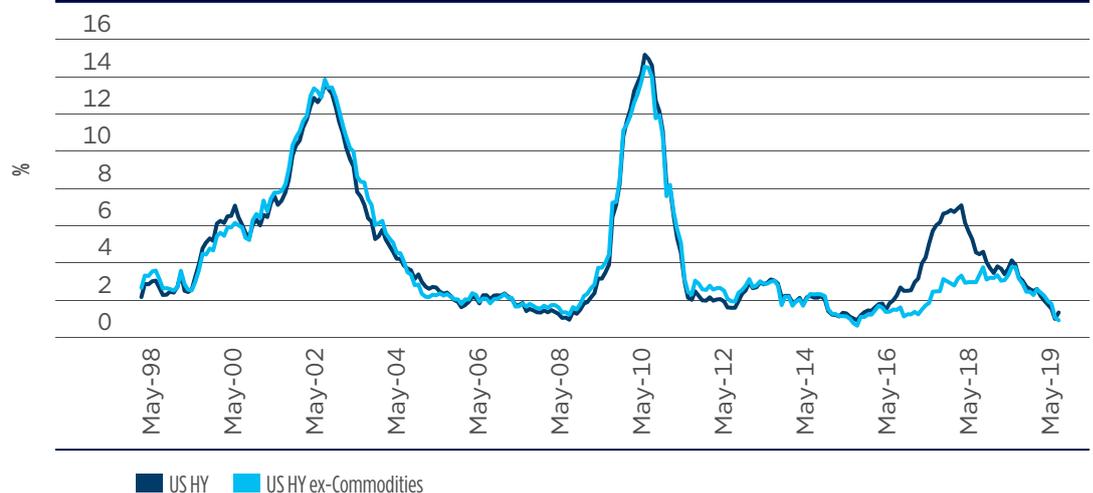
*“Default rates of US high-yield companies have fallen steadily after the peak of the commodity driven mini-cycle at the end of 2016”.*

## US HY: still benign default rates outlook

### Steady fall in US HY default rates recorded in the last two years, following the commodity driven “mini-cycle” in 2016.

The peak of the commodity driven “mini-cycle” reached in January 2017 has been followed by a steady fall of US HY default rates (DR) since then. Looking at default rates based on BofAML indexes (Figure1), the percentage of issuers defaulting had peaked at 7% at the beginning of 2017, then substantially slowed (it was 1.3% in April 2019). The rise and fall movements in 2016 “mini-cycle” were not recession- and/or crisis-driven, but mostly commodity-driven: default rates would actually have remained fairly stable (close to the low levels seen before 2016) if companies operating in the energy and material sectors were excluded from calculations. Looking at latest default rates by rating categories, the overall picture looks even more encouraging. DR of high quality speculative grade bonds, namely the BB-rated bond universe, have already moved down to 0% since January 2017, while B-rated bonds had declined to the same level over have since over the last two years default rates were mainly concentrated in the lowest rating category, ie the CCC-rated names.

**Figure 1. US HY default rate: last mini-cycle mainly a commodity-related story**



Source: Amundi Research, BofA Merrill Lynch as of 15 May 2019.

### Short-term projections

**Macro growth.** The intuitive link between macro growth and speculative-grade default rates would normally see peak years and default trends very much dependent on changes in the GDP trend. However, despite US GDP growth having slowed significantly since 1990, the US speculative grade companies have been significantly less affected by defaults, counterintuitively showing that the default cycle is actually driven by changes in GDP growth with respect to long-term trend rather than the level of growth. In this regard, although our forecasts point to a GDP growth slowdown in 2020, levels are close to potential growth thus not representing a material divergence from long-term trends.

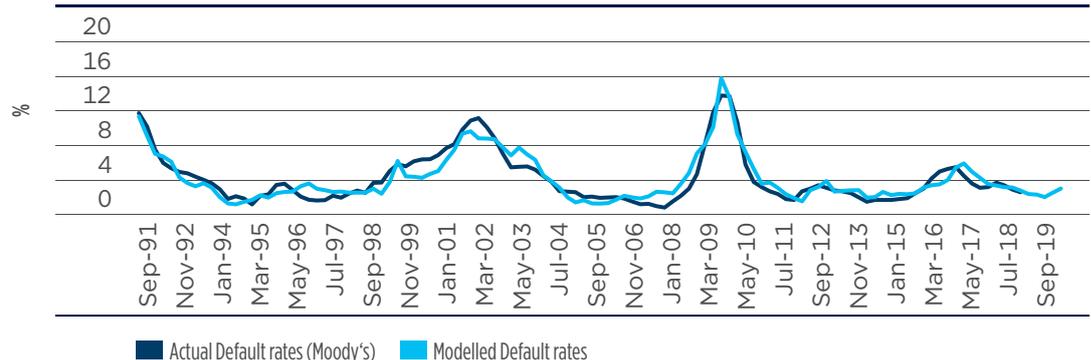
**Financial conditions** also represent a major driver of default rates, as low-rated companies are highly dependent on external funding and vulnerable to sudden changes in liquidity conditions and investors' risk aversion. As the capital markets (HY bonds and investor syndicated bank loans) have become a major funding channel for US speculative grade companies in comparison to commercial bank loans, the most powerful inputs of our forecasting models for default rates are the financial conditions for speculative grade companies in the capital markets.

*“From a top-down perspective, default cycles are very much a matter of divergences from long-term growth trends and financial conditions, which both points to a stable outlook”.*

The availability of bank loans is captured by the survey conducted and published by the Fed on bank lending standards on a quarterly basis, while the openness of the bond market to fund speculative grade companies may be measured by the distressed ratio (the percentage of HY bonds with a spread over Treasury bonds trading above 1,000 bps). The distressed ratio tends to be particularly important for the more highly speculative segments (CCC ratings), which have more limited access to bank lending. Interestingly, both factors lead default rates by around four quarters on average: intuitively, this makes sense, as the lack of availability of credit lines or the sudden closure of the bond market takes some time to produce a “drought” of liquidity and subsequently contributes to an extreme credit event. Both factors are currently pointing to default rates stabilizing around current levels in the next quarters. Moody’s most recent projections are actually even more positive than our model-based forecasts, as the rating agency cited the sharp fall in spreads recorded in 1Q19 as a supportive factor for default perspectives. The most recent projections published by Moody’s for the next 12-months depict a benign picture not only for the US but for global default rates. The rating agency expects US speculative grade default rates to fall close to 2.0% in one-year’s time, mainly thanks to “Central banks across both developed and developing countries either pausing or reversing the pace of monetary policy normalization. This dynamic will likely keep financial market conditions benign and the default rate low over the next 12 months.” (Moody’s – February 2019 Default Report).

To sum up, as the below chart shows, on the back of top-down, leading financial conditions and fundamentals, our one-year-forward model-based projections are pointing to a stable outlook over the next months and then to a slight increase in the last part of this year and in 1Q20.

**Figure 2: Modelled-based 1-yr projections point to a slight increase in 4Q19/1Q20**



Source: Amundi Research, Moody’s, Bloomberg. As of 10 April 2019.

### What about sectors?

As top-down factors point to a further fall of the DR and commodity sectors’ woes have receded, the first question from a bottom-up perspective relates to which sectors could move to the front line of defaulted issuers and lead an upward trend in the next months and quarters. This analysis is critical as in each of the past cycles a few industries contributed the most to a surge in defaults or acted as catalysts of more widespread trends. Past examples of sectors driving default rates higher include technology in 2000, financials during the Lehman crisis, or energy in 2016 following the commodity crisis. Historical evidence seems to indicate that when the distressed ratio for one or more sectors breaches the 20% level it may represent a sort of threshold, and may indicate either an increased likelihood of higher defaults within that sector(s) or a shift in the overall default environment. On this basis, the picture seems promising as no sector is currently showing high level of stress. Distressed ratios are at single digit levels in most industries, though there are some sectors where the ratio is elevated including transportation (around 18% mainly due to shipping issues) and retail and energy where the distressed ratios are also relatively high (around 11 and 12% respectively, compared to the overall market average of 3.7%). It is worth noting that the distressed ratio for the retail sector has dropped from a peak of 45% at the beginning of 2016, to current levels. Lagging the distressed ratio, the default rate has already fallen to current 6% from a peak of 13% reached one year ago.

*“Even by adopting a bottom-up approach, the default cycle story looks encouraging regarding most sectors”.*

*“The reduced need for refinancing in the short term and the good shape in which CCC-rated debt appears represent encouraging signs, but risk may come from other drivers”.*

Also Moody's one-year default rate forecasts by industry show quite a limited dispersion among sectors, as all but five sectors are expected to remain below the 1.5%, while the highest expected DR is 2.6%. Moody's expected one-year default rate for the metals & mining and retail sectors of 1.9% and 1.8%, respectively, are quite low by historical standards.

### Supply purposes, short-term refinancing needs and low-rated debt

Historically, the use of proceeds by a corporate borrower can impact credit risk and ultimately the default rates. Fortunately, an examination of recent trends in debt supply shows that refinancing is the dominant use of proceeds, which has a benign or negligible impact on defaults compared to spending on other purposes such as M&A. This is an encouraging sign, in light of US companies' limited refinancing needs in the next two years. Also in this respect, no major concentration of maturing debt seems to be in the pipeline over the coming quarters. Finally, in terms of credit quality, issuance of CCC-rated debt remained quite contained in this cycle within the US HY benchmark: after the Lehman crisis, in fact, the lowest-rated debt never exceeded the 20% threshold and actually moved down on the back of the commodity crisis to its current 12% level. The last two default rate spikes in the US saw CCC-rated debt reach one quarter and one third of the overall market, respectively.

Paradoxically, now risks seem coming more from the high-grade world, as concerns are mounting about the stock of BBB-rated debt maturing in the next years and therefore about consequent refinancing needs. Corporate BBB-rated USD denominated outstanding debt, in fact, has risen from roughly USD 1 trn in 2009 to current USD 3.2 trn, with its weight moving up from one third to half of the overall IG debt. This means that in each of the next few years, about 8% of the overall BBB debt will mature, representing a potential challenging technical issue for the sector and consequently an elevated risk of IG companies being downgraded to speculative grade or high yield and becoming “fallen angels”. Financial conditions, therefore, looks to be even more crucial than in previous cycles with regard to keeping these risks contained over the next one or two years.

To sum up, there seems to be no major red flags with respect to the very next few quarters. However, 2021 looks much more challenging than next year in terms of refinancing risks, combined also with the “BBB issue”.

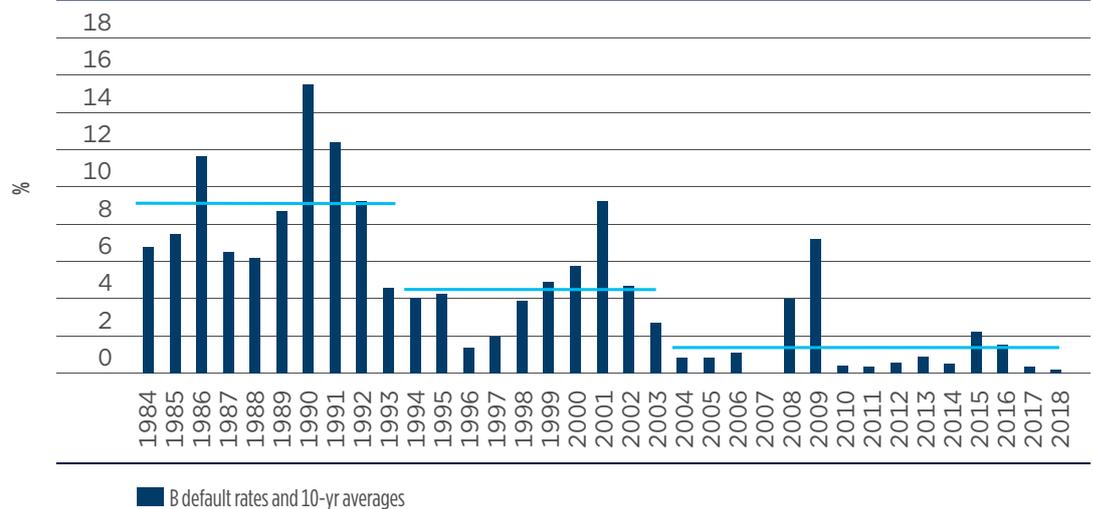
Lastly, when we look at the determinants of the US HY index's default rates, we have to consider also the evolution of the index composition: the increased weight of the BB rated portion has contributed to the improved credit quality of the index and supports the declining trend of the default rate. That said, the decline in default rates has also been recorded in the higher speculative segments of the index and the current low default regime is applicable to CCC segment of the market as well.

### A longer term perspective

**Long live this cycle, 15 years old! The current low default regime also survived the commodity-driven mini cycle.**

Apparently, in a quite paradoxical divergence between macro and financial trends, the current cycle of HY default rates in the aftermath of the Great Financial Crisis continues to be the most benign since 1990. Chart 3) shows annual default rates of US B-rated names since 1984. There are two main reasons for focusing on B-rated companies instead of US HY universe. First, single B-rated names have been the dominant component of the market in HY over the period, and secondly, by looking at rating-specific default rates rather than the default rate of the overall HY market we avoid an unwanted bias produced by the evolution of the average rating of the universe. Both ten-year averages and the worst yearly defaults followed downward trends. Interestingly, ten-year default averages fell from 8.8% in '84-'93 to 4.2% in '94-'03 and, finally, to just 1.5% in the fifteen years ending in 2018. The worst yearly defaults also fell from 15.5% (1990) to 9.2% (2001) and finally reached “just” 7.2% in 2009. What is most striking about the performance of the latest regime, however, is that default rates surpassed the 5.2% long-term average only once, while they remained between 0% and 1% in ten of those years. Defaults of Ba-rated issuers also show a very similar pattern, while defaults of CCC-rated names suffered more than other rating categories from the last commodity-driven mini cycle.

*“The current default cycle in US high yield has been the most benign since 1990, and we note also having survived the commodity-driven mini cycle”.*

**Figure 3: US B-rated yearly default rates and long-term averages**

Source: Amundi Research, Bloomberg. As of 10 April 2019.

*“Easing financial conditions and a favourable macro environment have contributed to keeping default rates low”.*

The reasons for superior performance of the HY market for the six years following the peak of the crisis (i.e. the period between 2010 and 2015) had much to do with an unusual phase of abundant liquidity and the search for yield, which ultimately supported the demand for speculative grade bonds, which in turn kept default rates from rising. However, despite the rise in defaults on the back of the 2014-commodity crisis, default rates also remained quite low by historical standards in the following years, especially among high and medium rated names (BBs and Bs). As we observed previously, however, default cycles are also a macro story and not just a story of financial conditions. In this respect, current macro cycle is consistent with the default cycle as it is currently the second-longest US expansion on record and in June is likely to become the longest one on record (121 months).

Major factors supporting this longest expansion in US economy are the following:

- 1) **Ultra-easy monetary policy** managed through unconventional measures together with ZIRP (Zero Interest Rate Policy);
- 2) **Very benign inflation regime**, which prevented a real tightening in monetary policy, which in turn adjusted only to a limited extent in terms of both rates and balance sheet normalization;
- 3) **Fiscal Stimulus** in the late phase of the cycle, which is fairly unprecedented in history: fiscal stimulus had a positive effect of elongating the cycle and, at the same time, did not exacerbate wages and inflation pressures. This was important, as supporting a temporary acceleration in US growth, it ultimately gave the Fed more space to normalize its policy, but without simultaneously forcing the central bank to become too tight.

Factors 1) and 2) above impacted the first and longest part of the cycle the most, while the third factor proved to be powerful in the very last few years and it still plays a role, though it is much less effective.

### Addressing financial factors, leading default rates by at least two years

#### 1) The level of real and nominal yields

In the first section, we focused on top-down factors leading defaults by one year, and we already mentioned the effective role played by Bank Lending Standards (BLS) indications and the distressed ratio. However, financial conditions are not only measured in terms of access to credit and volumes of funding available to companies in both bank and bond market channels: they also depend on the cost at which funding is made available to corporates. The level of rates with respect to real and nominal growth seems to determine even more the nature of the default cycle. In this respect, the experience

*“As an increase in the cost of debt seems to have been strictly related to a peak in default cycles, this variable should be on every investor’s radar”.*

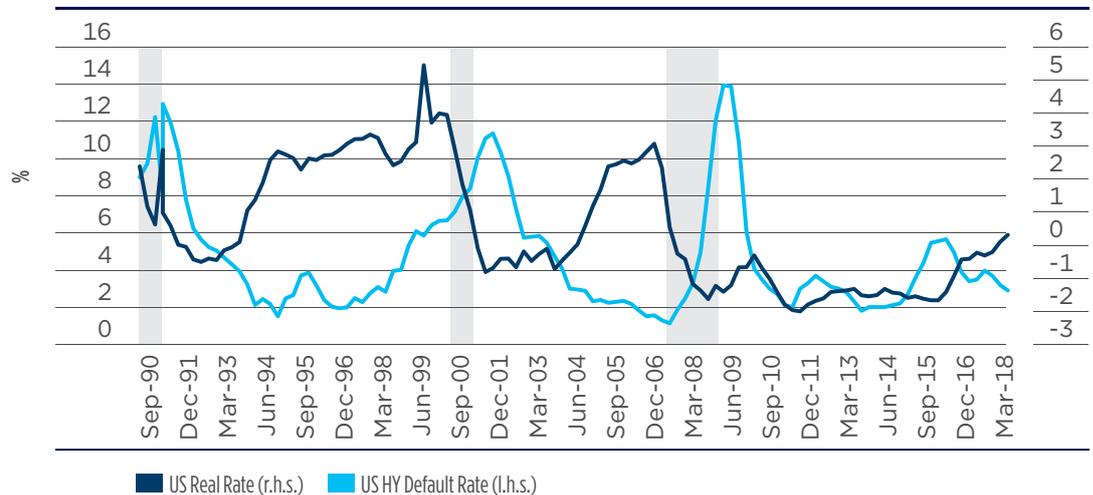
of the '80s, the '90s and the early '00s all resulted in real rates rising to the 2-3% area before the last three default cycles peaked. Chart 4) shows this link and to what degree this cycle is different from previous ones.

As the Fed proceeded further down its path of normalising monetary policy over the last few years, funding costs represented a key variable, which took centre stage on credit investors' radars. Specifically, market participants were increasingly asking themselves about the potential threat to corporate bonds arising from the future increase in yields and cost of debt. The potential threat from higher yields is typically twofold: on one side, rising yields tend to reduce the relative attractiveness of corporate bond valuations vs. underlying risk-free assets, possibly supporting a rotation in favour of equities. On the other side, higher bond yields may increase fundamental risks, leading to a renewed default cycle.

*“The US real rate is likely to be at the current historically relative low for longer, thus favouring the low values in defaults”.*

To address this topic, chart 4) shows to what extent a rise in real rates preceded the default rate spikes of the previous cycles. The “good news” comes from the fact that the current level of US real rates is still a long way from the highs seen in past decades and since rates normalization has been broadly achieved by the Fed, real rates are likely to stabilize around current levels.

**Figure 4: US HY default rate vs real rate (recessions shaded in grey areas)**



Source: Amundi Research, Bloomberg. As of 10 April 2019.

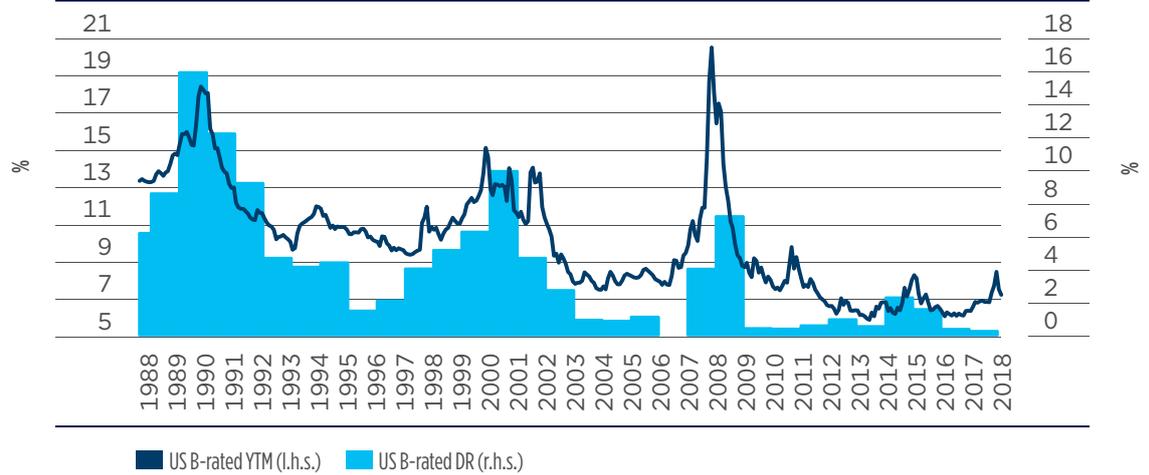
Moving from real to nominal yields, the link between defaults on one side and yields paid by HY bonds over almost the last 40 years seems to point to a strong positive correlation.

*“An ultra-low yield and real rate environment is supportive in keeping defaults of speculative grade bonds away from raising”.*

Chart 5 plots together the yields and default rates of US B-rated debt (B-rated debt represented and still represents the average credit quality of the overall market benchmark). The two variables moved in line, underlining that in an ultra-low yield environment default rates steadily fell below long-term averages and proved to be resilient to the latest sector specific mini-cycle. As we have already mentioned in a previous paragraph, this link between yields and defaults over the last 40 years or so is very similar to the one between real growth and defaults. In a nutshell, a low macro and micro growth, low real and nominal yield environment look quite supportive in keeping defaults of speculative grade bonds from raising.

In summary, as a result of the limited rate normalization, nominal and real yields are much lower in this cycle than in the previous ones. The level of yields and real rates are among the key drivers of the structural regime in defaults, as the last 35 years and three credit cycles have shown.

**Figure 5: Cost of funding looks a structural driver of default cycle levels**



Source: Amundi Research, Bloomberg. As of 10 April 2019.

*“The flattening of the yield curve used to affect defaults through a worsening of financial conditions. This relationship has weakened in recent quarters”.*

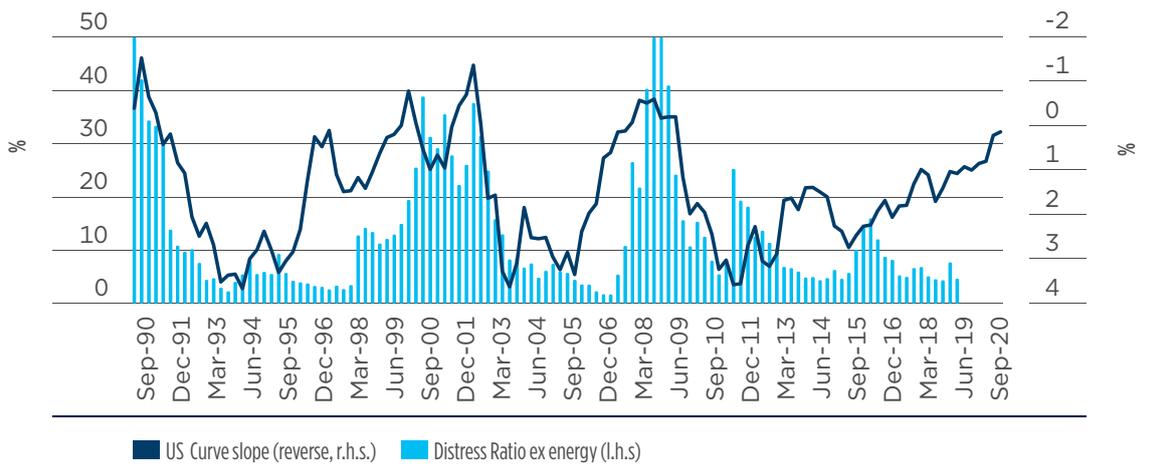
**2) The role of the yield curve**

If the level of rates plays a role as a structural driver, the yield curve looks more like the cyclical catalyst of defaults: furthermore, relative to the less worrying indications coming from real rates we outlined above, the slope actually reached more concerning levels, as the 2-10 yr is currently close to flat.

A factor to consider is that the flattening of the yield curve tends to signal a likely worsening of the economic cycle, in turn leading lenders (both banks and bond investors) to become more risk averse and to progressively tighten financial conditions available to speculative grade companies.

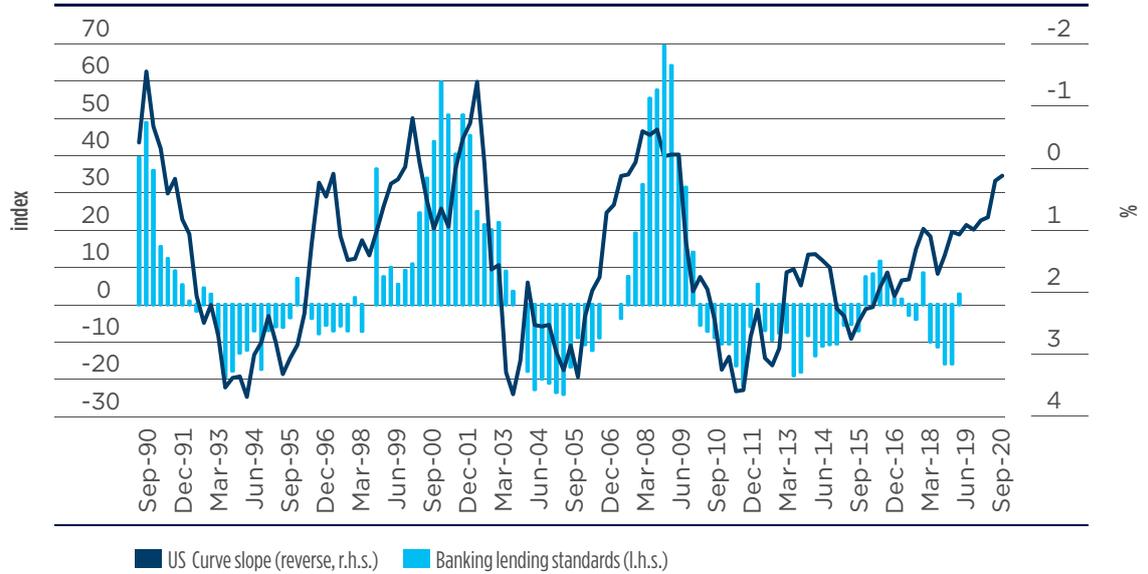
As chart 6 and chart 7 demonstrate, the link between slope and financial conditions has become weaker in recent quarters, despite the fact that the slope has already moved into territories apparently historically “dangerous” which previously triggered a tightening of credit conditions.

**Figure 6: The flattening of the yield curve failed so far to tighten funding conditions...**



Source: Amundi Research, Bloomberg. As of 10 April 2019.

**Figure 7: ... and bank lending standards, too**



Source: Amundi Research, Bloomberg. As of 15 May 2019. Banking lending standard: Net % of Domestic Respondents Tightening Standards - C&I Loans for Large/Medium enterprises. balance/diffusion index.

*“The yield curve is likely less predictive of the default cycle than in the past given the new regime in which term premium has moved after the GFC”.*

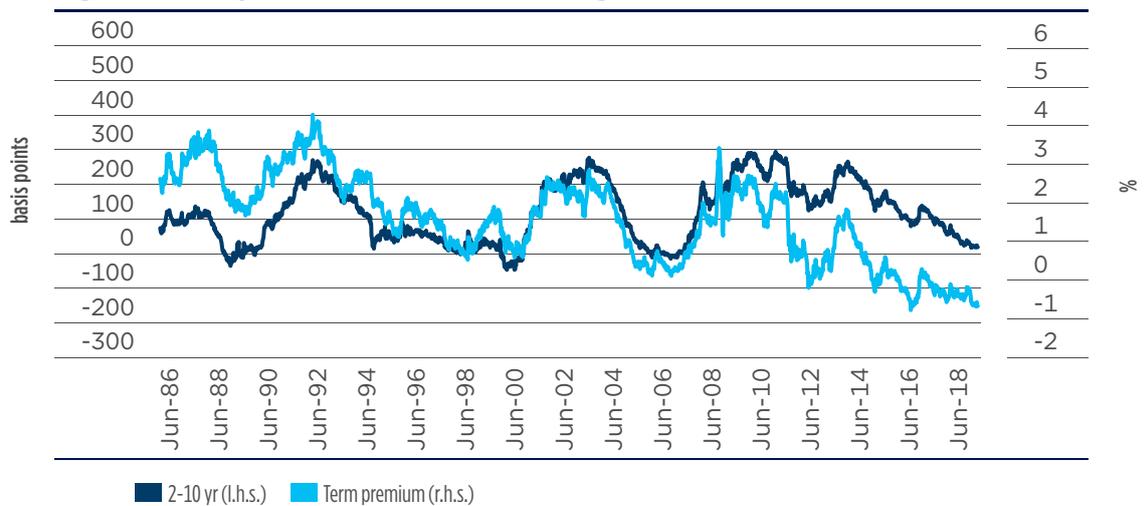
However, some rationales emerge as a partial explanation for this recent divergence. First of all, in an ultra-low yield regime, the opportunity costs for risk aversion look higher, as financial repression prevents the absolute yield levels from moving as they did in the past.

Secondly, a large part of the last year’s flattening was driven by term premium compression, which moved into negative territory for three major reasons:

- 1) Fed Balance sheet expansion, which will stabilize at 17% of GDP vs 6% pre-Lehman, pressuring long-term bond yields down by an estimated range of 25/50 bp;
- 2) A much lower risk premium attached to inflation upside volatility;
- 3) A relatively steady shift in market perception from the risk of the Fed being “behind the curve” to a too hawkish Fed (actually this was more than ever the case last year).

The chart below shows that the yield curve’s “predictive power” regarding the cycle is probably less significant in this new regime, for the reasons we outlined above.

**Figure 8: Term premium moved to a new “regime” after the GFC**



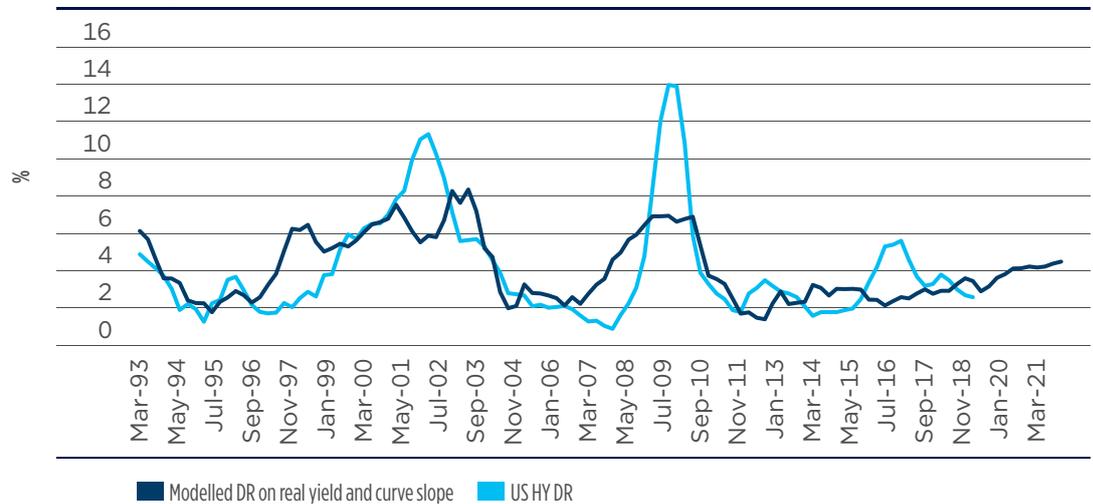
Source: Amundi Research, Bloomberg. As of 10 April 2019.

*“Our model forecasts point to the 4-5% area of default rates towards next years, at a safe far distance from the highs recorded in recession phases”.*

A simple regression analysis based on the two variables we focused on above (real yield and curve slope) predicts US default rates with a lead time of about two and a half years: we show the resulting forecasted path for default rates in chart 9). This simple regression, being based just on financial variables, has some clear weaknesses: the first limit has to do with the fact that it peaks at 6-8% in recession phases, failing to reach real highs of 10-12% in the cycle. Secondly, the analysis does not consider sector specific driven cycles: under this scenario, the chart shows that, as with most of top-down models, it failed to predict the 2016 energy mini-cycle. However, this analysis is useful in that it provides clues on default rates turning in the early phases of the cycle, the phase when the two variables are mostly effective in their predictive power.

The flattening of the yield curve is the major driver of the higher default rates that the regression points to by the end of next year and mostly in 2021. If we adjust the slope for the new “regime”, the path is still on the upside but it would point to the 4% area rather than to the 5% in 2H21. In any case, even without adjusting the slope for special factors (post GFC) a persisting scenario of low real rates prevents the model from showing a meaningful turn to the 6-8% in the next two years.

**Figure 9: Regressed defaults on the in late 2020/2021 mainly on the back of curve slope**



Source: Amundi Research, Bloomberg. As of 10 April 2019.

## European HY default rates likely to remain low in the next quarters

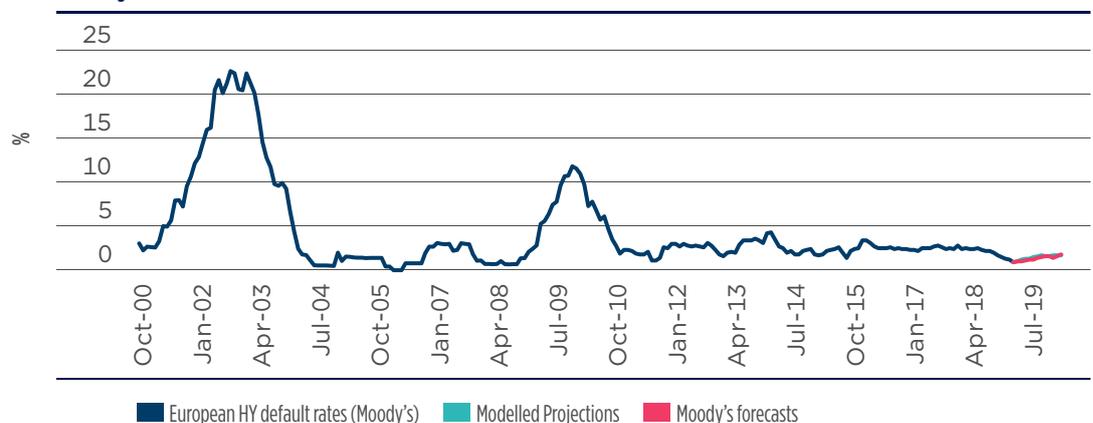
In contrast to US HY, European speculative grade default rates did not suffer from the same commodity driven mini-cycle in 2016. Over the last nine years, European default rates remained stable at very low levels, recently even reaching a 10-yr low at 0.9% in February 2019, according to Moody's numbers.

Two main reasons explain difference in trends and default rates on the two sides of the Atlantic over the last decade, both relating to top-down factors, namely the macro differences in the composition of the HY corporate bond universes denominated in dollars and in euros. Specifically, the European HY universe's lower exposure to the energy sector and higher average rating quality compared to the US asset class have made crucial contributions to European speculative grade bonds' resiliency to bankruptcies vs. their American counterparts. The limited proportion of peripheral issuers and the high percentage of BB-rated names also explains the relative strength shown by European speculative grade credit through the peaks of the sovereign crisis in 2011 and 2012, despite the fact that the distressed ratio had risen to a dangerous 40% area. The very rapid response of the ECB to the crisis played an important role in preventing a persistent tightening in financial conditions: at the same time, the composition of the benchmark also played a role in Europe's comparatively lower default rates. The sovereign crisis, therefore, had major impacts in terms of increased fallen angels' debt rather than on defaults.

Our one year forecasts confirm that European HY default rates should rise only slightly from current troughs over the next quarters: top-down regressions point to a gentle rise to 1.7% in one year's time and as chart 10) shows, our forecasts very closely match the Moody's forecasts. Low distressed ratios, stable lending standards and an overall supportive macro picture, despite slowing growth, support this conclusion.

*“Compared to the US, the European HY universe is more stable as it is less exposed to energy and constituents have an higher average rating”.*

**Figure 10: European HY default rates at historical lows, likely to remain low in the next year**



Source: Amundi Research, Bloomberg, Moody's. As of 10 April 2019.

**Bottom up analysis predicts a lower risk of defaults for the European universe on the back of its higher average quality.**

EUR vs US HY look like two different “beasts”.

Table A below shows the main differences in ratings for the two universes of speculative grade bonds considered: the table shows weights in terms of outstanding debt and in terms of the number of issuer companies. The quality gap is particularly clear when using analysis based on the number of issuers (on which the subsequent DR measures are primarily calculated), rather than analyzing based on value of the underlying debt.

The share of BB-rated debt is about 73% of the European market and a more modest 48% of the American universe. The metric demonstrating the higher risk implicit in the universe of US companies is the weight of CCC-rated companies (21% of the total issuers and 12% of the debt, respectively close to/more than double the corresponding European weights).

Table a): EUR HY and US\$ HY markets' composition by ratings			
EURO HY	Number of issuers	Number of issuers, in %	Outstanding debt, in%
BB	128	48%	73%
B	105	40%	22%
CCC	32	12%	5%
<b>Total</b>	<b>265</b>		

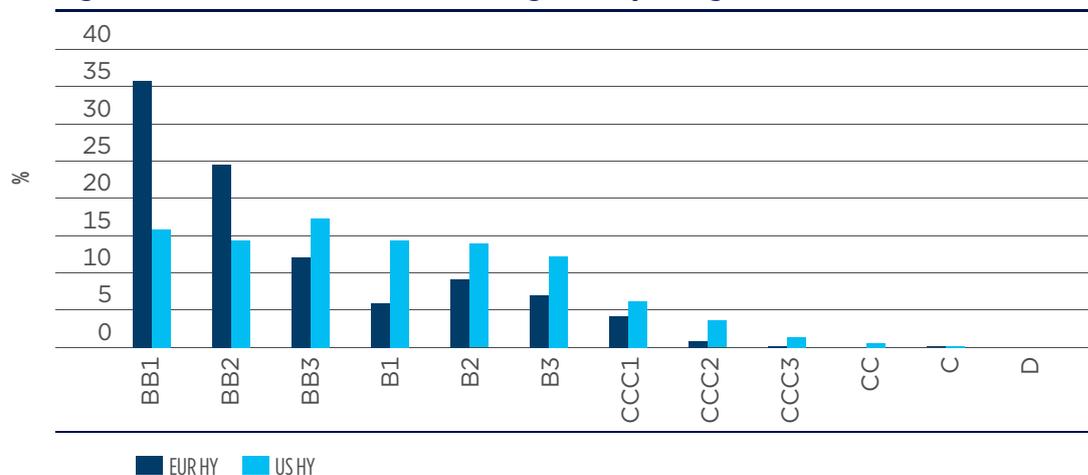
US HY	Number of issuers	Number of issuers, in %	Outstanding debt, in%
BB	262	33%	48%
B	356	45%	40%
CCC	165	21%	12%
<b>Total</b>	<b>783</b>		

Source: Amundi Research, Bloomberg, Moody's. As of 10 April 2019.

*“The “size factor” (large cap/small cap ratio higher in European HY) combined with the rating factor, increases the defensive nature of the European HY universe”.*

Another important consideration is that the percentage of debt rated BB1 (the highest notch for a speculative grade bond) in Europe is double versus the US: as chart 11) shows, 36% of European HY debt is BB1 rated, compared with only 15% in the US. The European benchmark's higher concentration in a lower number of companies increases this aspect of higher quality: in fact, most of the top 25 issuers in the EUR denominated benchmark (by outstanding debt) are BB-rated while only a few of them are B-rated. The “size factor” (large cap/small cap), combined with the rating factor, therefore increases the defensive nature of the European HY universe, contributing to a reduction in its volatility. Most of the issuers with greater weights are in fact large-cap, with global business or are financial “national champions” of peripheral countries, which have fallen from investment grade into the speculative grade area in many cases because of the effects of the sovereign crisis on ratings for their respective sovereigns.

**Figure 11: EUR HY vs US HY outstanding debt by rating notch**



Source: Amundi Research, Bloomberg, Moody's. As of 10 April 2019.

## Investing in the High Yield market

**Global High Yield market has delivered strong performance in Q1 after a tough end of 2018. Do you expect spread tightening to continue and why? Or do you expect a carry-like return for the remaining of the year?**

With the global high yield market up significantly, the “easy” money has been made. But spreads are still reasonably priced given our outlook for defaults. With central banks moving away from tightening regimes, carry should remain in favor. With China growth firming, the global economic outlook should also improve. Net net, global high yield will continue to perform, albeit at a slower pace than the first quarter.

*“With central banks moving away from tightening regimes, carry should remain in style”.*

**What will be, in your view, the main drivers of the market in the coming months?**

The main drivers will be whether the market remains in Goldilocks mode, with growth strong enough to sustain profits, but not sufficient to ignite inflation pressure and cause central banks resume a tightening stance. For us, the key is identifying good companies at good prices, with catalysts that could enhance the value.

**What are your main investment convictions in the global high yield market for this year?**

We find European high yield attractively priced. We find distressed sectors like retail and energy to be distressed for good reason, although there are select idiosyncratic opportunities in those sectors. We believe investors should not necessarily avoid cyclical sectors or CCCs, but they need to focus on specific companies and situations to identify value.

**Are there any specific areas of risk you are carefully monitoring or that are of concern to you?**

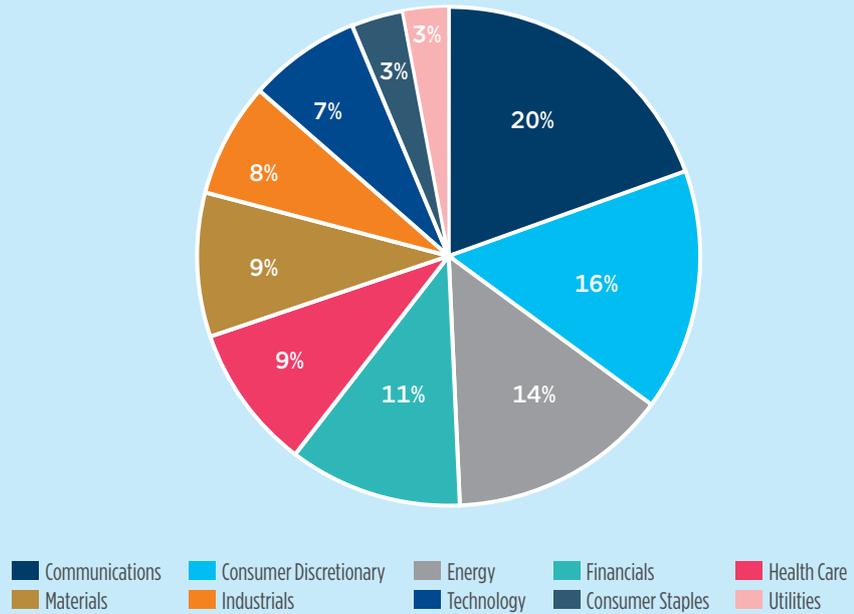
We are less concerned by cyclical factors and more concerned with secular technology disruption. Areas like retail reflect this but we need to constantly re-evaluate these business cases. We are also more concerned about areas outside of the high yield market, such as BBB issuance and aggressive syndicated bank loan underwriting. The risk is that a flood of BBB downgrades and/or a disruption in the syndicated bank loan market could push companies into the high yield market creating a negative technical environment, just as the cycle turns and credits are weakening. We have seen some improvement from BBB companies in the last few quarters, reducing the risk of downgrades, but we are still monitoring the situation.

*“While we are concerned with oil price volatility, there are attractive parts of the energy sector, which represent a significant share of the US HY market”.*

**In the US, the HY market is highly dependent on energy sector and oil? What is your view on this situation?**

Energy represents more than 14% of the US high yield market and is one of the largest sectors. While we are more concerned about oil price volatility, there are attractive parts of the market. Exploration and production companies are the most exposed to volatility in energy prices. We have become more defensive on shale companies, as they continued to disappoint in 2018 in generating free cash flow. However, this sector saw the most defaults over the past year, which has removed some of the riskier companies from the high yield universe. On the other hand, midstream companies (companies that process and pipe energy to end markets) show sensitivity to energy prices but their revenues tend to be regulated and more driven by volumes than by oil prices. As long as their balance sheets are in reasonable shape, we find these areas interesting. Oil services are the most varied. Drilling companies' stocks tend to have the highest betas,<sup>1</sup> and offshore drillers have particularly risky profiles. However, companies with more consistent revenues, such as those that provide compression services, can represent attractive investments, again, assuming their balance sheets are healthy. In summary, the energy sector is more diverse than generally apparent and that creates investable opportunities, rather than fear.

<sup>1</sup>Beta – Beta measures an investment's sensitivity (volatility) to market movements in relation to an index. A beta of 1 indicates that the security's price has moved with the market. A beta of less than 1 means that the security has been less volatile than the market. A beta of greater than 1 indicates that the security's price has been more volatile than the market.

**Figure 12: US HY Index composition by sector**

Source: Bloomberg. Index considered: ICE BofAML US High Yield Index. As of 8 May 2019.

### How do you assess the liquidity in high yield market? Have you seen changes so far this year vs last year?

Assessing liquidity is an art rather than a science. There are rules of thumbs (such as “bigger issues are more liquid”), but really it is more important to work with our traders to understand liquidity in the market and portfolios at any given time. Liquidity (both buying and selling) tends to improve in good markets, like this year, but it is always a case of making decisions issue-by-issue. While monitoring liquidity, we believe in investors should pursue strategies (like the use of derivatives, such as credit default swaps) to enhance overall liquidity of a portfolio.

## Conclusions

- US HY default rate steadily fell from the 6% energy-cycle peaks to the current 2.7% in the last two years: model-based short-term projections (on a 12 months horizon) show that a stabilization should take place at current level over the next quarters.
- Bottom-up factors show that no major red flags have appeared with respect to the next few quarters. In light of current distressed ratio levels, broadly low by historical standards, we do not see any major sector causing a surge in defaults that way that energy did several years ago. Retail became an increasing contributor to market stress in 2017 but has seemed to stabilize and its limited weight reduced its impact on the overall universe.
- Despite being in place for 15 years, the current low default regime looks therefore likely to persist for another year: on one side, in our central macro scenario, growth is expected to remain close to potential in 2020, while on the other side financial conditions do not appear to pose major threats to a stable picture in the short-term.
- Looking beyond the next few quarters, the picture is less supportive but it still does not point to a rapid turn in the cycle: defaults will probably be on the rise in 2020 and 2021, but a low growth/low inflation scenario should keep real and nominal yields from rising back to levels that have proved to be dangerous in the past. The Fed has probably already reached its targeted normalization in rates and will keep its balance sheet at much higher levels than in the pre-GFC world.
- Examining financial variables and financial conditions, the default cycle still looks relatively benign despite its length. As in previous cycles, the major risk to the upside is likely to come more from the credit fundamentals (a rapid slowdown in earnings growth) and from lower market liquidity.
- In contrast to US HY, European speculative grade default rates did not suffer from the same commodity driven mini-cycle in 2016 but remained stable at very low levels over the last few years. Some macro differences in the composition of the HY corporate bond universe in Europe vs in the US explain the different behavior of the asset class on the two sides of the Atlantic. The lower share of the energy sector, the higher quality of speculative companies and the higher size factor (large cap/small cap) in the European HY universe explain the more defensive nature relative to the US and have contributed to reducing the volatility of returns.
- Finally, we wonder if the benign outlook for default rates could further support positive returns for the asset class. While the “easy” money has been made, spreads are still reasonably priced given our outlook for defaults. With central banks moving away from tightening regimes, carry should remain in favor. We believe that global high yield will continue to perform, albeit at a slower pace than in the first quarter. The search for value and liquidity management will be crucial.

## 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.

**Correlation:** The degree to which assets or asset class prices have moved in relation to one another. Correlation ranges from -1 (always moving in opposite directions) through 0 (absolutely independent) to 1 (always moving together).

**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.

**Term premium:** The compensation required by investors to hold a long-term bond rather a series of short-end bonds. We use an estimate from New York Fed economists Tobias Adrian, Richard Crump, and Emanuel Moench (or 'ACM') available in Bloomberg.

## Important Information

Unless otherwise stated, all information contained in this document is from Amundi Asset Management and is as of 16 May 2019.

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