GENERALI INVESTMENTS

Focal Point

Mounting risks to EUR High Yield bonanza

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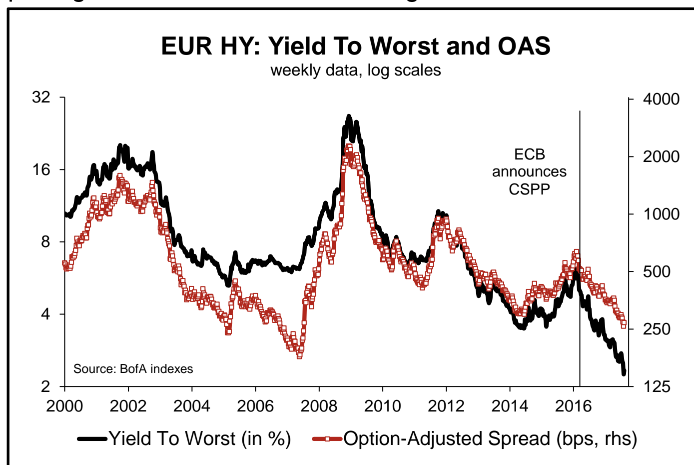
- Euro-denominated High Yield (EUR HY) corporate bonds have performed remarkably well this year. The year-to-date (ytd) total return (+5.3%) has been almost three times as high as the one of EUR Investment Grade corporate bonds.
- EUR HY valuation looks dear from a historical perspective. The Yield to Worst has recently hit a new record low, while the Option-Adjusted Spread has fallen by more than 100 bps ytd, reaching the lowest level since July 2007.
- That said, valuation is less extreme when the spillovers of the ECB's Corporate Sector Purchase Programme (CSPP) are taken into account. Our analysis suggests that the CSPP accounts for nearly 70% of the almost uninterrupted spread tightening occurred since March 2016.
- With the ECB tapering approaching and political woes in Italy likely to resurface later on, EUR HY should eventually experience some repricing. This would keep the total return over the next 12 months slightly below zero.

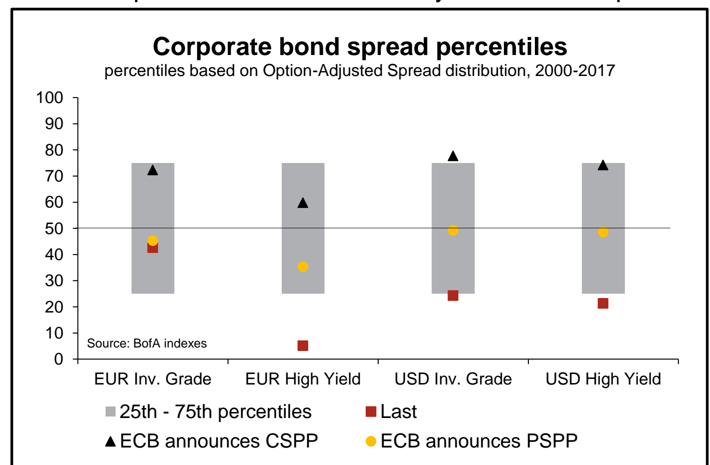
Global interest rates have been on a gradual, albeit volatile, upward trend since the lows reached in the summer 2016. Despite that, there are still a few asset classes in the fixed-income arena that have delivered positive total returns year-to-date (ytd). In particular, euro-denominated High Yield (EUR HY) corporate bonds have extended the positive performance seen in 2016 and reached a total return of 5.3% ytd (according to Bank of America index, BofA). This is almost three times as high as the return obtained by EUR Investment Grade (IG) corporate bonds.

However, the last leg of the rally seen in the past four weeks has further increased concerns over a possible bubble in the EUR HY market. We hereby try to assess market valuation and the triggers that could lead to a repricing in EUR HY over the coming months.

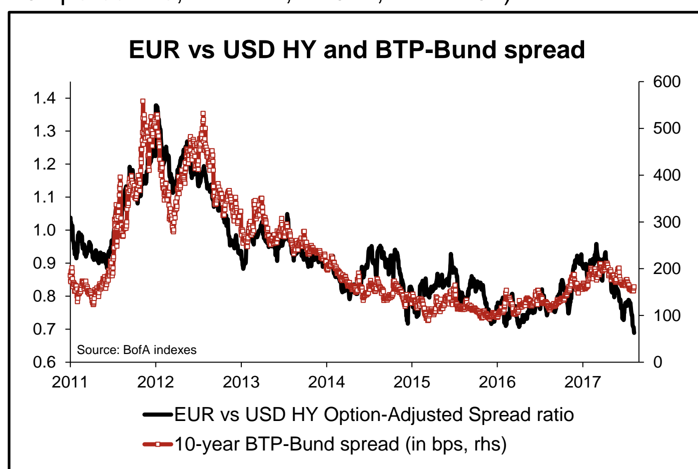


EUR HY looks expensive within corporate bonds

After the strong spread tightening following the victory of Mr. Macron in the first round of the French presidential election, the rally in EUR HY experienced a pause between late June and early July. However, it soon resumed thereafter, pushing the Option-Adjusted Spread (OAS) down to the lowest level since July 2007 (257 bps, almost 120 bps less compared to end-2016 levels). Even more importantly, the Yield to Worst – the lowest potential yield that can be earned if the issuer uses the provisions to benefit from falling market yields – has recently hit a new historical low at 2.25%, despite a moderate increase in the underlying Bund yield ytd. Even amid the risk-off mood caused by the North Korean vs US tensions this week, EUR HY spread has so far risen only back to 270 bps.



Historically, current OAS readings are indeed depressed. Compared to the 2000-2017 period, the current level of the EUR HY spread stands in the 5th percentile (217 bps below its long-term median of 487 bps). It means that only in 5 out of 100 occasions the spread has been lower. This is a rather extreme level, especially when compared to other credit asset classes. The OAS of EUR IG bonds stands in the 43th percentile (10 bps below the long-term median level), while the one of USD-denominated HY bonds is in the 21st percentile. Part of the expensive valuation of EUR HY is the result of the more favorable rating composition. Indeed, 73% of the EUR HY index (in market-value terms) is now rated in the BB category compared to a long-term median of 51%. That said, even after controlling for rating composition, the EUR HY index appears expensive. The percentile analysis across rating buckets confirms that the OAS of BB and B-rated bonds (both in the 12th percentile) are more expensive than investment grade ones (AAA: 46th percentile, AA: 44th, A: 32th, BBB: 25th).



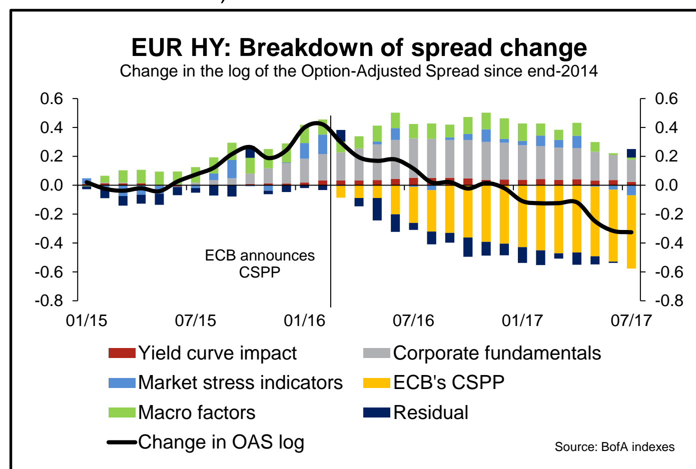
A comparison with USD HY – which is a key driver for the European market, with an average correlation of around 90% based on monthly total returns since 2000 – also shows that the EUR HY market is expensive in relative terms, with the OAS ratio between the two at the lowest level on record. This ratio is closely linked to the dynamics in the BTP-Bund spread (see chart above), which is consistent with the high share of Italian names in the EUR HY index (almost 20% vs 5.7% for the EUR IG one). A univariate regression suggests that the EUR HY spread is at present nearly 45 bps too expensive compared to US HY.

ECB's CSPP a key driver of past spread decline

In order to better understand the drivers of the impressive spread tightening occurred in the last 18 months, we built a quantitative model that provides a breakdown of monthly spread changes across different factors.

We identified four groups of variables able to track the changes in the EUR HY spread until February 2016: i) yield curve (lower core yields tend to result into wider spreads); ii) corporate fundamentals (profits and debt levels for US and euro area firms); iii) market stress indicators (equity volatility, interbank spreads, euro area government bond spreads vs Bunds); iv) macro factors (global growth momentum, FX and commodity prices). However, we found out that fundamentals, namely the improved macro momentum and the rebound in corporate profits in the energy industry after oil prices bottomed out in early 2016, explained only a small portion of the more-than-300-bps spread tightening occurred starting from March 2016.

We then incorporated the impact of the ECB's Corporate Sector Purchase Programme (CSPP) announced on March 10, 2016. While the CSPP applies mostly to IG securities (the ECB can purchase bonds usually classified as HY according to the second-best rating criteria if at least one credit agency assigns an IG rating to the security), the most risky segments of corporate bonds like HY have largely benefitted from the spillover effects of ECB's purchases. We add two variables in our model: a first variable to track the expected pace of monthly purchases (the so-called flow effect), and a second one that takes into account the accumulated holdings of the CSPP (the stock effect). These two variables were able to explain around 70% of the 300-bps-plus spread tightening occurred between February 2016 and end-July 2017 (see yellow bars in the chart below).



QE tapering to reduce the support to EUR HY

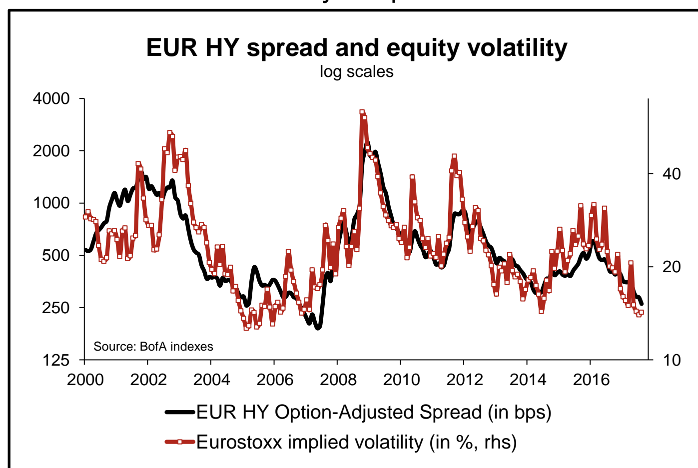
Given the large role played by the CSPP, it is worth investigating which could be the impact on HY once the ECB will eventually start tapering its Quantitative Easing (QE) programme. We expect the ECB to make the announcement in the fall (probably at the October meeting) and to start trimming purchases from January 2018 onwards.

In order to assess the repercussions on the credit market, it is worth to reflect on the flow and the stock effects determined by the CSPP. While acknowledging that the limited time span since the start of the CSPP makes the estimated coefficients more vulnerable to new data than in case of a longer history, our model suggests that the stock effect is dominating (nearly 85% of the total). This means that the positive spillovers from ECB's large (and still increasing) corporate bond holdings should largely offset the concerns caused by the reduced pace of purchases going forward. This is important because it suggests that the bulk of the downward distortion on spreads induced by the CSPP – nearly 200 bps according to our estimates – is likely to last, preventing a strong sell-off in EUR HY. That said, a knee-jerk reaction to the announcement of the QE tapering – like the spike in Bund yields after Draghi's speech in Sintra in late June – cannot be excluded along with a rebalancing of the impact between the stock and flow effects.

Risks from too low volatility and Italian politics

The upcoming ECB's tapering could also negatively weigh on EUR HY also through other channels. We see two main sources of potential risk. The first is represented by record low market volatility and the other is related to Italy's sovereign risk.

Over the last years, the strong increase in excess liquidity caused by central banks' QE policies has contributed to keep market volatility at very low levels. Recently, the VIX (the volatility of the S&P 500 index) hit a new historical low and also the one on European indexes decoupled from policy uncertainty indicators, which remain at high levels (though they have declined following the outcome of the French presidential election). Volatility is an important driver for EUR HY spreads (see chart below) and the gradual unwinding of QE policies (with the Fed likely to announce soon the start of its balance sheet reduction program) should lead to a moderate increase of this market risk indicator from today's depressed levels.



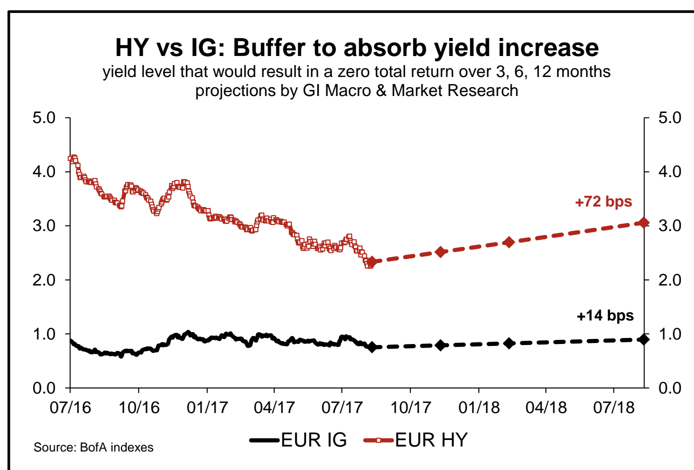
Finally, EUR HY spreads are likely to widen also due to the foreseen increase in political uncertainty in Italy. While a snap vote in September was avoided, the next general election is due by spring 2018. Given the high chances of a hung parliament, with Eurosceptic parties gaining in importance, the BTP-Bund spread may test again the 200 bps threshold in the run-up to the election. Given that Italian names account for 19.6% of the market value of the BofA EUR HY index (51.2% of EUR HY Financials and 12.5% of EUR HY Non-Financials), a repricing in the Italian sovereign risk is likely to result into wider spreads.

Below zero total returns ahead

The combination of the ECB's tapering, the projected increase in Italy's political instability and some correction from the extremely low volatility environment we are currently experiencing should lead to a gradual re-widening of EUR HY spreads going forward.

We project the EUR HY OAS to increase by 70 bps to 340 over the next 12 months, with two-third of the widening explained by the normalization in volatility and higher BTP-Bund risk premiums induced by a less prominent role of the ECB in terms of purchases. Given our expectations of a mild increase in the underlying Bund yields, we forecast EUR HY to deliver a slightly negative (-0.4%) total return.

While far from attractive from an absolute perspective, the projected total return for EUR HY is likely to exceed the performance of most of the European fixed income instruments over the next year thanks to its still relatively higher carry. However, given the higher implied volatility of this asset class, investors should consider European equities as an alternative. Euro area (EA) equities valuation is above the historical norm, but not as extreme as for EUR HY bonds. While a further expansion in equity market multiples looks unlikely, EA equities can benefit from rising earnings. Finally, the dividend yield of EA equities (now at 3.3%) is higher than the EUR HY Yield to Worst (at 2.33%), which is something unprecedented in the last two decades.



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