

Catch me if you can

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In this focus piece we are having a closer look at the fundamental, technical and valuation characteristics of global credit markets, their potential returns for 2019 and indicate our preference for European HY and Subordinated bonds.



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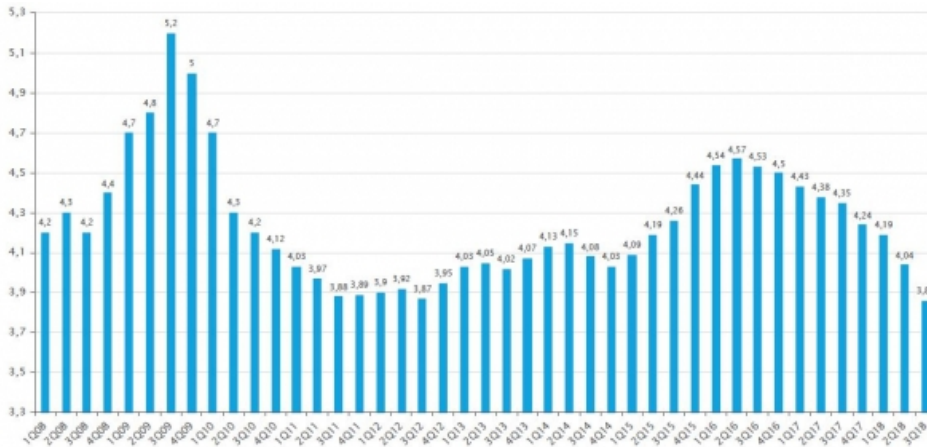
“Global credit markets started the year strongly as investors reacted positively to increasingly dovish central banks and improved valuations in an asset class that is still characterized by good fundamentals.”

Just like in the biographical film "Catch Me if You Can" where the elusive protagonist avoids apprehension by forging new lives, the US and European credit markets transform constantly and present new opportunities.

Credit markets rebounded from their December sell-off as fears over slowing global growth have moderated and more importantly as expectations of rising interest rate in the U.S. and Europe have decreased materially. Nevertheless, the health status of credit markets remains a concern for investors who are worried about leverage levels, use of proceeds, the level of defaults and return expectations for 2019. Let's have a closer look at all of the above and evaluate the current credit opportunity:

The U.S. high yield leverage level paints a positive image for the asset class's fundamentals as it has been decreasing for nine consecutive quarters and is in fact at post-crisis lows. More precisely, leverage decreased to 3.86x in the third quarter of 2018 down from 4.04x in the second quarter of the same year, and compared to a post-crisis high of 4.57x in the second quarter of 2016.

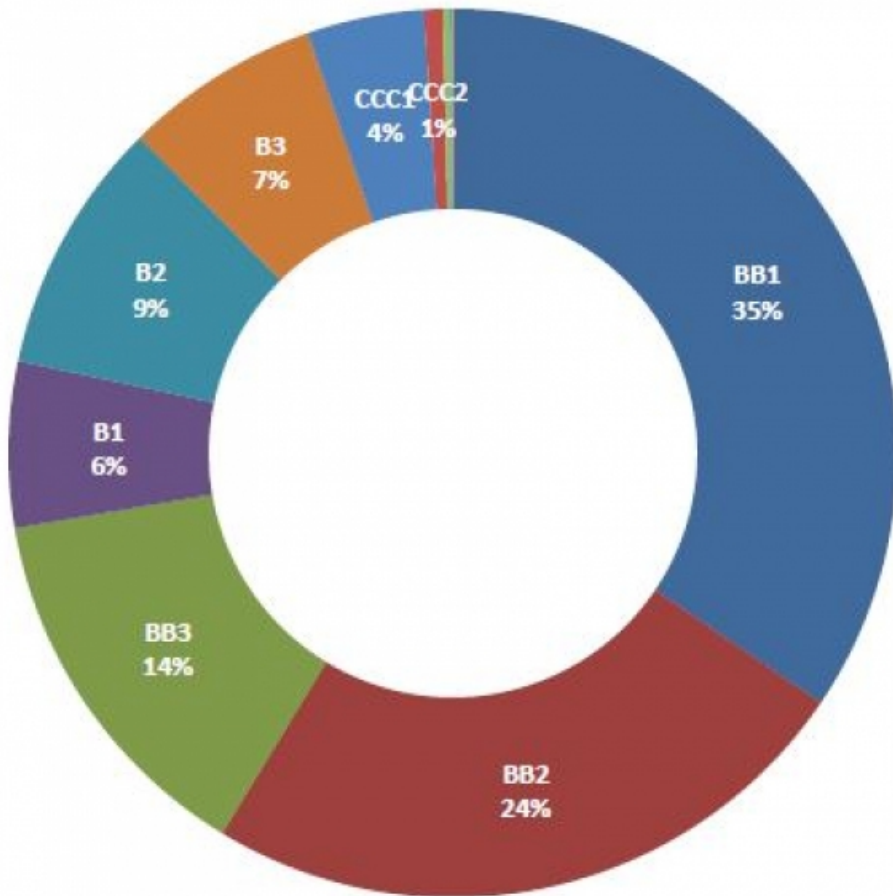
Leverage decreased materially



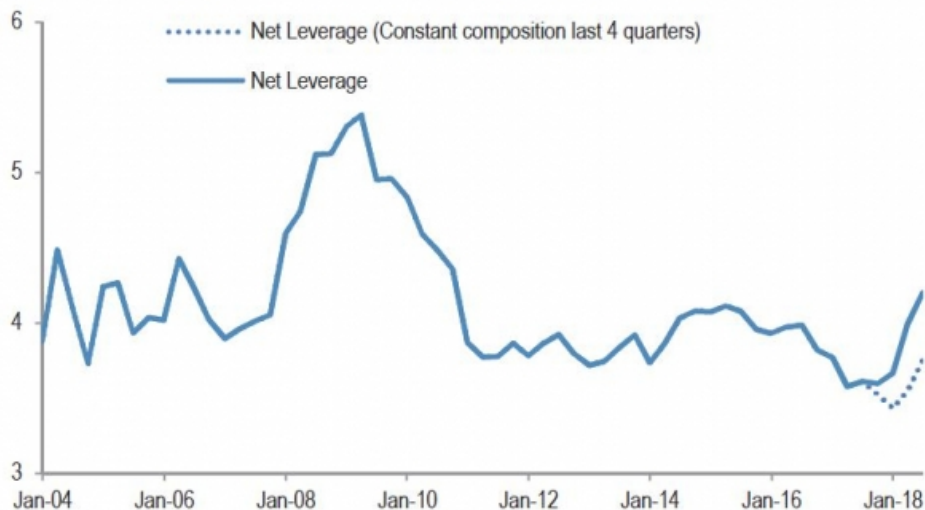
Source
Asset Management, JP Morgan. Data as at: 20 December 2018

For European high yield, leverage has been drifting higher at 4.2x, up 0.5x over 1H18 but below the all time high of 5.4x at the peak of the financial crisis. But this situation can be largely explained by changes in the market composition. In 2018 there were more rising stars (companies upgraded to investment grade) than fallen angels (companies downgraded to high yield) and in fact the volume of rising stars exceeded that of fallen angels by approximately €15bn. At the same time, there are currently approximately €94bn of bonds representing 34.5% of the European HY market that are rated one notch below I.G. This means that companies with low leverage are leaving the European high yield market.

European high yield market composition and leverage levels



Source
Bloomberg. Data as at: 1 February 2019



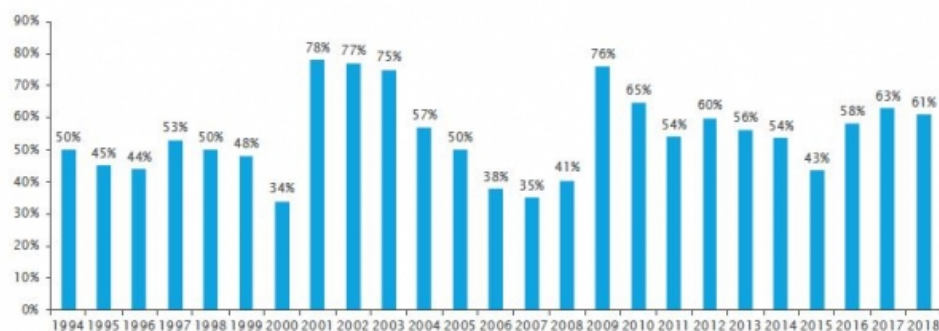
Source
JP Morgan, Bloomberg. Data as at: 1 February 2019

Defaults rates remain contained, and they are not forecasted to increase materially. Over 2018 the default rate for euro and sterling HY bonds was only 1.0%, and below the long term average of c.1.5%. For the US high yield market the par-weighted default rate registered 1.81% (1.08% excluding iHeart), up from 1.28% at the end of 2017 but it also remains low compared with the long-term average of c.3.5%. Very importantly the forecasts for 2019 remain modest at 1-2% for both Europe and the U.S.

Interest cover ratios are improving, suggesting that companies will have little trouble servicing their debt, as they have mostly refinanced into cheap funding. In the U.S., coverage increased to 4.9x (3Q18), the seventh consecutive quarterly improvement, off a low of 4.0x in 4Q16. In Europe, and for the same period, coverage registered just over 6x, a level last seen during 2005.

Share buybacks have been creating some noise especially in the US where 2018 marked a record with c. \$750bn spent. Clearly the low growth environment and weak consumer confidence levels we have experienced over a number of years contributed to this result. More importantly though, buybacks were driven by the repatriation of overseas cash, and even at the start of 2018 there were buyback projections of over \$800bn, which fully materialized at year end. What is important though is that refinancing remains the main use of debt proceeds which dominates issue activity at 61%, while acquisition financing represents 21% and general corporate activity 15%.

Refinancing activity remains high



Source

JP Morgan. Data as at: December 2018

Demand for HY also returned in 2019 with \$10.2bn (inc. \$4.9bn in ETF) of fund inflows for US HY, and €1.4bn for European HY (as at the 1st of March 2019), reflecting the positive market sentiment from the start of the year. Favorable market conditions might result in the increase of new bond supply this year, but this will have the effect of providing investment opportunities to investors and subsequently increase overall liquidity.

Valuations: Credit markets had a good start this year with valuations significantly better than last year's start. Year to date, spreads have tightened producing impressive positive total returns across investment grade and high yield markets. As carry contributes positively to total returns and spreads remain well above 2018 averages, the expectation is for credit markets to perform positively in 2019. In fact, as the 10yr government bond yield level forecasts are unchanged, it would not be unreasonable to assume a total return above 10% for the US HY and above 7% for European HY & subordinated bonds.

Credit market characteristics

Index	Duration (yrs)	(bps) 31/12/18	(bps) 5/03/19	spread (bps)	Yield (%)	2019 Total Return (%)
US HY	3.76	534	390	363	6.58	6.35
Europe HY	3.52	506	393	349	3.65	4.13
US IG	7.00	160	127	117	3.98	2.46
Europe IG	5.04	154	128	109	1.03	1.74
COCO Index	3.07	482	384	360	5.6	5.35

Source

Bloomberg, BofA. Data as at: 5 March 2019

*Tickers: USHY=HUCO, European HY=HE00, US Investment Grade=COAO, Europe Investment Grade=EROO, CoCo index=COCO

US and European HY historical returns



Source

Bloomberg. Data as at: 5 March 2019

Conclusion

Credit overall has benefited greatly in early 2019 from the dovish Fed and ECB narrative and the rapid improvement in oil and equity prices. Economic growth remains a headwind, but in the absence of a recession – which is our base case - we do not see enough issues to meaningfully impact fundamentals negatively. We remain positive on credit, especially European HY and subordinated bonds due to their favorable market composition and yield characteristics. By closely observing the constructive characteristics of the asset class, investors will find it easier to "catch" positive returns.

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