

High Yield in 2021 – the positive trend should continue

La Française

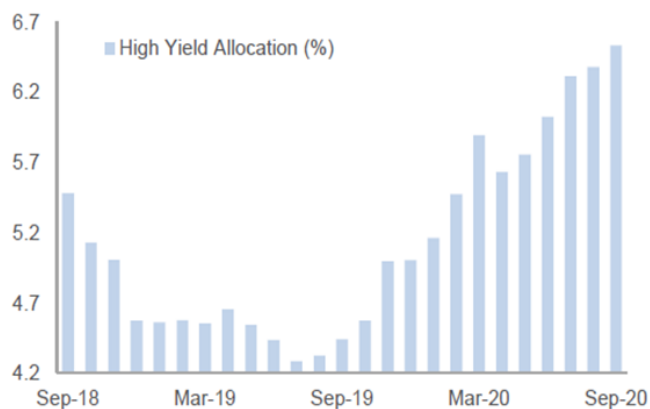
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- **US High Yield and EM High Yield expected to develop more strongly than European High Yield; however, uncertainties for EM High Yield to be considered;**
- **Fallen Angels, strong “BB+” rated issuers in sectors impacted by Covid-19 and “B” rated issuers in sectors not affected by Covid-19 could offer opportunities**

High Yield has not suffered as much in 2020 as other asset classes. Even though the positive trend should continue in 2021 on a global perspective, investors have to consider geographical differences. “We favour the US High Yield over European High Yield because we are expecting a strong economic recovery in the US, lower political risks, a larger decline in default rates compared to 2020 and a lower net supply. In EM High Yield we expect the highest total return with attractive valuations in Asian High Yield. However, there are uncertainties regarding the net supply of Asian companies due to significant refinancing needs and the default rates of Chinese companies”, explains Akram Gharbi, Head of High Yield Investment at La Française AM.

Positive 2021 outlook for High Yield markets and favourable technical signals

Figure 1: EUR IG Retail Fund High Yield Allocation (%)



Source: JP Morgan, IPREO, Markit Group, Bloomberg

Only 5% of the global Fixed Income market offers 4% yield or higher (Hedged in euros). This includes the High Yield market and the AT1 market. “The main driver for High Yield market flows will remain Investment Grade funds, especially in Europe”, states Gharbi. A 1% increase in EUR Investment Grade funds implies €28 billion of net inflows into High Yield which represents 7% of the total asset class in Europe. “This trend should continue as there is a lag of opportunities to get yield in an environment where the average sovereign rate in Europe is about zero percent”, says Gharbi.

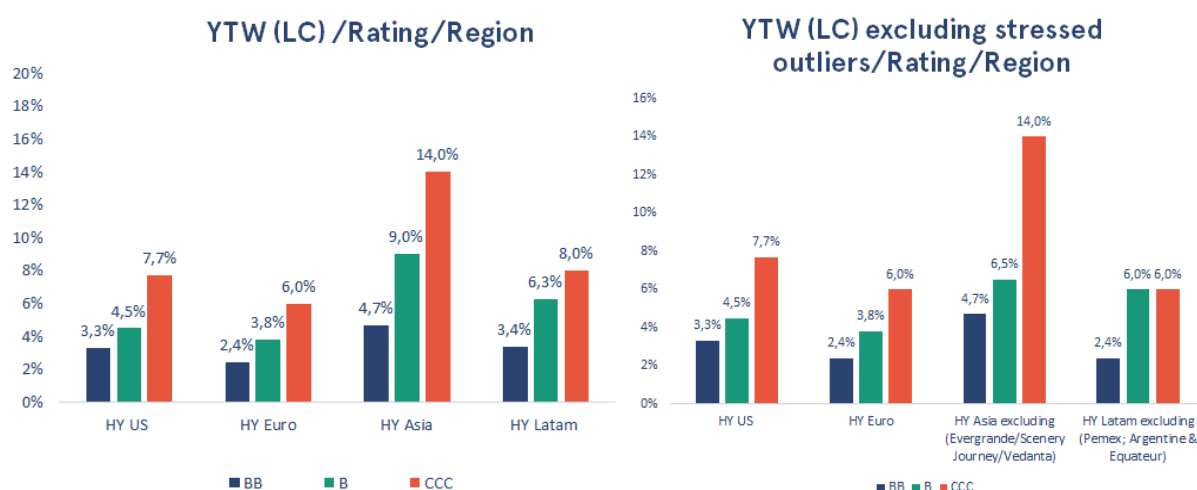
The fundamentals are expected to be especially strong in the US and stable in Europe as well as in the EM. “We expect a strong momentum for the US High Yield market with an almost 50% decrease in default rate compared to 2020”, explains Gharbi. The main reason being a strong recovery of the US economy which will most likely not be the case in Europe

due to the slow roll-out of the vaccine programmes. The massive government support of European companies which are in difficulty could be a swing factor for default rates in Europe as well. For EM, the situation is slightly different. The default rate should remain stable, but there is a lot of uncertainty. “Asian issuers, especially Chinese companies that are the biggest contributors to the Asian High Yield Index, have a huge amount of debt. The same is true for some Argentinian companies that are one of the biggest contributors to the Latin American High Yield Index (8% on the index). The question is whether there is enough liquidity to roll-out the debt.”

Market positioning could be a powder keg

The valuations are quite mixed for the High Yield markets. When comparing “BB”, “B”, and “CCC” issuers, the valuations for the EM look quite good (Figure 2). “But when the biggest contributors to the Asian and Latin American High Yield Index are excluded, the yield does not look that attractive anymore”, states Gharbi. Overall, the expert does not see a lot of opportunity in “BB” issuers. “More than 70% of companies with BB bonds are trading with negative convexity. In 2021, we do not see a lot of opportunity in European, Latin American and US High Yield BB issuers.”

Figure 2: YTW (LC) excluding stressed outliers/Rating/Region



Source: Bloomberg

What concerns the expert most is the current market positioning of Investment Grade in the US and Europe: “Investment Grade investors are exposed to a potential curve steepening. With 1.8% in the US and 0.5% in Europe, the level of yield-to-worst on Investment Grade is at the lowest ever. At the same time, the duration of Investment Grade funds of around nine years is at the highest level ever. The breakeven point is only around 20 basis point.” If the overall economic recovery is strong in 2021, there should be widening in the risk-free curve in the US and Europe. “If global economic recovery exceeds market expectations, the bear steepening could be more significant, affecting negatively investment grade positioning and hence driving outflows from Investment grade and more generally speaking, credit funds,” Gharbi points out.

Cherry-picking in 2021

Not all companies will profit from an economic recovery. Gharbi sees opportunities especially in Fallen Angels and selected “BB+” issuers in sectors impacted by Covid-19, except

commercial real estate and leisure, which could continue to suffer. “Fallen Angels were a big call in 2020. They offer 100 basis point spreads compared to legacy BB companies. Many Fallen Angels profited from state support in 2020 which we expect to continue in 2021”, Gharbi states. As the global economy is expected to recover in 2021 the compression trade should work too. “We prefer single B over double BB in the US and Europe but only in sectors that are not related to Covid-19. This includes companies from sectors like TMT (technology, media and telecom), non-performing loan companies and food retail”, Gharbi summarizes. Asian High Yield offers a good valuation versus OECD markets. “We expect opportunities in some sectors of the Asian High Yield market that offer a premium, but a careful selection approach is key,” Gharbi concludes.

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