HIGH YIELD INSIGHT

Competing forces in the high yield bond market

For professional investors only

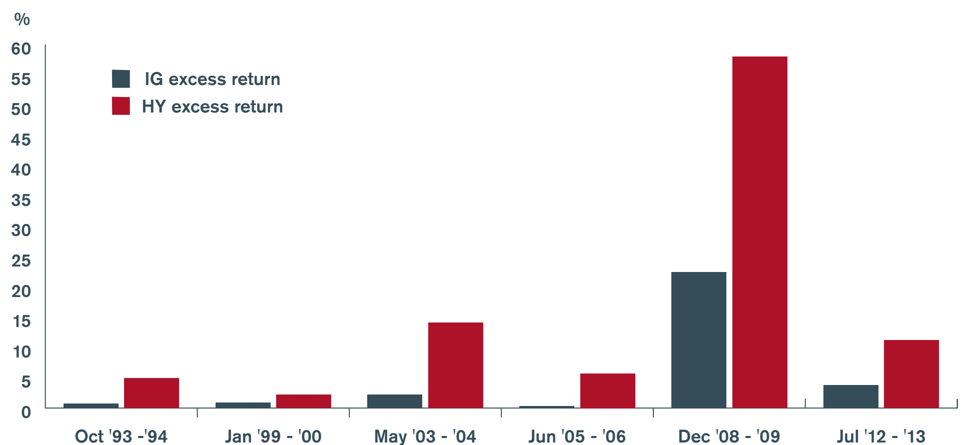
One of the attractions of high yield bonds is that they are typically less sensitive to interest rate risk than investment grade bonds, but at a time when central bank policy holds sway over so many asset classes does this relationship still stand? Are high yield bonds vulnerable to policy change, or could strong credit fundamentals and indications of economic improvement globally prove a more powerful positive force?

Policy change

The big elephant in the room is whether assets can withstand a shift in policy direction. The tightening – or perhaps more correctly lessening of monetary accommodation – in the US has been well signposted, although the actual date of the next interest rate rise has been somewhat elastic. Although a December 2016 increase by the US Federal Reserve looks likely, the Fed does have form in changing its mind, particularly if asset markets react negatively ahead of the decision.

High yield has typically been a better place to be within fixed income when yields rise substantially; although the historically low yields across much of the fixed income spectrum means past behaviour might not necessarily offer insight on the future. Figure 1 shows the excess returns that high yield (HY) and investment grade (IG) offered in the US market during episodes in the past when yields on government debt have risen by 100 basis points or more.

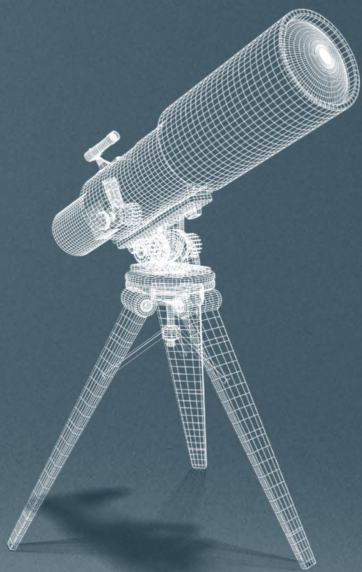
Fig 1: Excess returns for IG and HY credit in periods where 10y Treasury yields rise by >100bp



Source: Morgan Stanley US Leveraged Finance Strategy (30 September 2013), the Yield Book, Bloomberg
Past performance is not a guide to future performance

With average yields of 3.7% in European high yield and 6.3% in US high yield, the high yield sector continues to offer an attractive yield uplift compared to investment grade corporate bonds and developed market sovereign bonds. For comparison, a German 5 year Bund yields -0.4% while a US 5 year Treasury yields just 1.3%*. The spread on high yield bonds, therefore, offers a valuable yield cushion should policy tightening occur or if sovereign bond yields move higher.

*Source: Bloomberg, at 31 October 2016. Yield to worst on BofA Merrill Lynch European Currency Non-Financial High Yield 2% Constrained Index (HPIC), BofA Merrill Lynch US High Yield Constrained Index (HUC0), BofA Merrill Lynch US Corporate Bond Index (C0A0), BofA Merrill Lynch Euro Corporate Index (ER00); yield to maturity on sovereign bonds. Yields are variable and are not guaranteed.

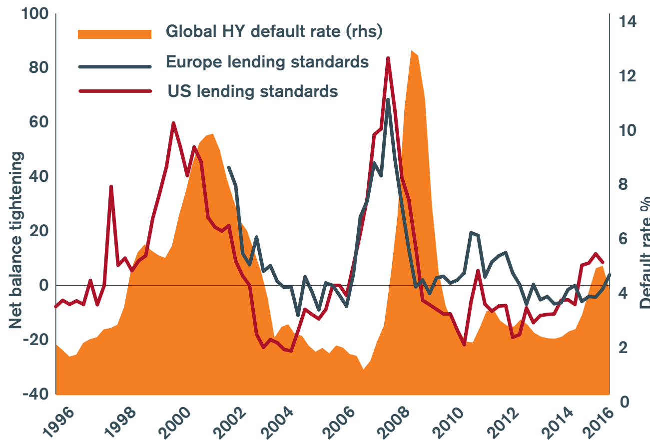


Henderson
GLOBAL INVESTORS
KNOWLEDGE. SHARED

Competing forces

In a zero interest rate environment, the lending practices of banks take on greater importance in terms of monetary policy impact. Banks on both sides of the Atlantic have been gently tightening lending standards recently as Figure 2 shows, which may have an impact on economic activity further ahead. That said, the tightening in lending standards is still fairly mild and not at the levels that have typically presaged a large pick-up in the default rate.

Fig 2: Bank lending standards and global HY default rate



Source: Thomson Reuters Datastream, Eurozone loan survey: net change in credit standards to firms next quarter, US C&I loan survey – large & medium firms, banks tightening credit, Moody's global speculative grade default rate, October 1996 to October 2016

The recent rise in the global default rate shown in orange above is primarily down to the energy sector. According to Standard & Poor's, 57% of the 136 defaults year to date (to 19 October 2016) have come from the energy and natural resources sector. That said, there does seem to be some stabilisation in the energy sector as the price shake out has brought greater balance between supply and demand. This has led us to have a more constructive view on the energy sector, albeit among the better quality exploration and production companies.

Scarce assets

In recent months, unidentified sources from the European Central Bank (ECB) revealed that it would consider tapering its asset purchases (Quantitative Easing) once the current programme ends. This caused disquiet in bond markets as it appeared to suggest that the ECB may not expand QE in its current form beyond the current end-date of March 2017. Mario Draghi, the ECB President, was quick to quell these rumours, which suggests tapering is unlikely in the near term. Either way, the ECB, along with the Bank of England, needs to address a scarcity of assets to buy.

Central banks have deep pockets but the distorting effect on the financial system (such as offering an advantage to larger, existing enterprises at the expense of smaller players or crowding out other asset owners) means central banks will ultimately want to limit their ownership of corporate debt assets.

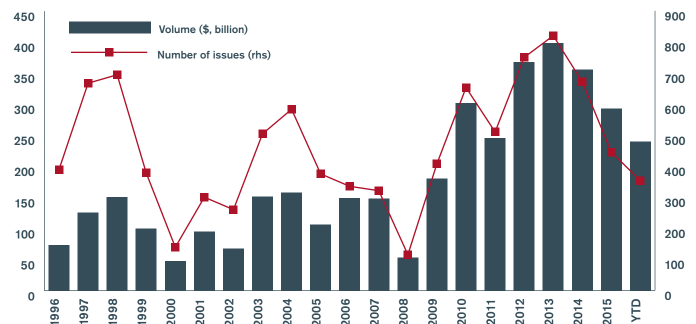
While it is something we keep a close watch on – given investment grade buyers dipping into high yield for a yield pick-up – we believe the ECB will not want to unsettle markets dramatically and will opt for an extension or gradual tapering of QE, likely to be revealed at one of the policy meetings scheduled for December, January and March.

Henderson Global Investors uses a four-pillar approach to top-down asset allocation across the credit markets. These four pillars are Macro Environment (our "big picture" views on interest rate policy, growth etc), Corporate Health, Valuations and Market Dynamics (the technical picture, supply and demand etc.). While all four pillars play an important role in our monthly analysis of the global credit markets, it is clear from movements in the high yield market on a year-to-date basis that Market Dynamics are the dominating factor.

Recall that in 2015 the global high yield markets returned close to -2.1%[1] and saw net fund outflows of approximately US$7bn[2]. This situation has been turned on its head in 2016 with year-to-date returns of 14.5%[1] in global high yield. Meanwhile the flows into the market have also reversed with US$11.1bn[3] of inflows into US high yield. Global high yield fund flows have been slower to turn but are now showing a positive flow of just over US$270m[2].

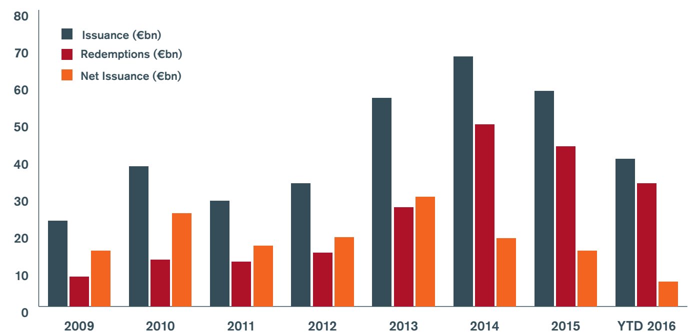
Strong returns have, therefore, been coupled with strong inflows. Equally as interesting, however, is the lower supply in the markets this year. Figures 3 and 4 below highlight the declining trend in high yield new issuance. US high yield issuance peaked post the Global Financial Crisis (GFC) in 2013 but has since been steadily declining, a trend now being echoed in European high yield. In fact, European high yield net new issuance in 2016 only turned positive for the year in September following a bumper month of supply, which was the second largest since the GFC.

Fig 3: US high yield issuance



Source: JP Morgan at 13 October 2016

Fig 4: Euro high yield non-financial issuance and redemptions (€ billions)



Source: Deutsche Bank, Markit at 30 September 2016

[1] Source: Bloomberg, BofA Merrill Lynch Global High Yield Constrained Index (HW0C), total return in USD (year to date to 31 October 2016)
[2] Source: Credit Suisse, Bloomberg (year to date figure is to 31 October 2016)
[3] Source: JP Morgan, year to date to 31October 2016

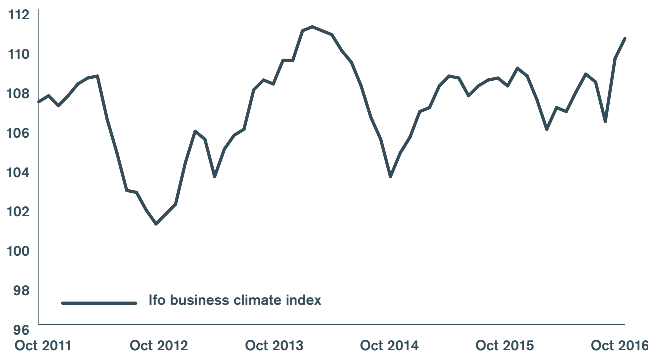
Competing forces

Improving backdrop

High yield has performed well so far this year but we anticipate further gains. We continue to see relative value at the yield level from US high yield but we are disciplined not to chase the very distressed part of the triple C segment of the market. Our caution rests on our fundamental credit views of many of the companies that populate this part of the market.

European high yield, like its equity cousin, has lagged the US all year but this may be set to change. European economic data has surprised positively in recent weeks despite the Brexit distraction. Eurozone composite PMI ticked up to 53.7 in October, the highest it has been since last December, while the German Ifo has recovered strongly (see Figure 5). European equities could offer a catch-up trade to US equities over coming months. If true, this could bode well for high yield, which seasonally tends to perform better towards year end.

Fig 5: Improving European economic data

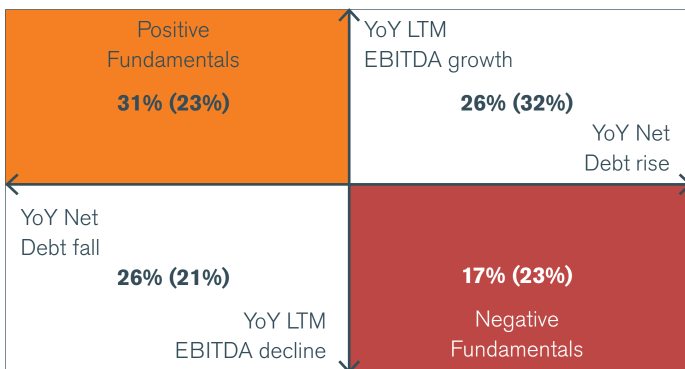


Source: Thomson Reuters Datastream, Ifo Institute for Economic Research, University of Munich

Fundamental strength in Europe

Credit fundamentals are also looking reasonably strong in European high yield. As Figure 6 below illustrates, the corporate strength of European high yield issuers is improving. 31% of European HY corporates displayed an improvement in earnings growth and reduction in net debt in the latest figures to Q2 2016, compared with 23% a year earlier.

Fig 6: Earnings growth and net debt changes within European HY



Source: Morgan Stanley Research, Bloomberg, company data, Q2 2016 (Q2 2015 in brackets), YoY LTM = year on year change for last twelve months, EBITDA = earnings before interest, tax, depreciation and amortisation

Another interesting point interpreted from the diagram above is that aggregate figures can easily conceal a wide disparity in corporate direction; some companies are showing deterioration, others improvement, while others are still mixed. In our view, this is a valid argument for active management and careful credit analysis, which seeks to identify issuers with a better credit outlook.

Shifting sands

A key aspect of fundamental analysis within credit is recognising change within an industry and how that impacts individual companies. The two examples below demonstrate how we are prepared to alter our view of a bond issuer as circumstances change.

Hudbay Minerals is a Canadian mining company with copper, zinc and precious metals operations across the Americas. Although Hudbay Minerals is smaller and more focused than some of its competitors in the metals & mining sector, which has itself transitioned from a much-hated to a much-loved sector since the beginning of 2016, the pick-up in yield offers good relative value, and we changed our view on the issuer accordingly, building-up a position in early Q3 2016. The company recently started to transition from growth to more moderate sustaining capex and should generate free cash flow in the near term. Management referenced refinancing of their high coupon bonds in the next 12-24 months in their Q2 earnings – the expectation that they may be called early should provide support to the bond price.

CMA CGM is the third largest container shipping company in the world. Until recently, this was a credit that we had avoided and had even been short via credit default swaps due to the cyclical nature of the shipping industry. H1 EBITDA went from US$894m in 2015 to US$119m in 2016 due to volatility in freight rates. CMA also acquired Singapore-based competitor Neptune Orient Lines (NOL) this summer which meant that net leverage went from 0.65x to 1.47x over H1 2016.

Fig 7: Consolidation could help freight rates to rise from lows

Source: Bloomberg, 31 December 2011 to 4 October 2016

Our view has recently changed on the company as fundamentals are gradually starting to improve and there are a number of self-help measures that the company may initiate. The recent bankruptcy of the South Korean shipping company Hanjin has led to an increase in freight rates, mainly on the Asia-US route, and some other competitors look vulnerable, which would benefit those that remain solvent. Moreover, the industry is consolidating rapidly with Hapag-Lloyd acquiring United Arab Shipping Company, COSCO and CSCL merging, Maersk looking to make acquisitions and the three largest Japanese container shipping companies merging. This consolidation should be positive for freight rates.

CMA has recently repaid half of its acquisition facility put in place to finance the purchase of NOL and the second half should be repaid by year end. Synergies with NOL should start to flow, which together with some better freight rates, means EBITDA could start moving up rapidly from Q4. In addition, the company has identified US$1bn in asset sales which would further improve the balance sheet.

Competing forces

Outlook

- We remain positive on the longer term outlook for European high yield, although cognisant of near term risks.
- European corporate health remains broadly robust, with default rates set to remain low.
- Yield to worst of 3.7% in European high yield and 6.3% in US high yield offers an attractive relative valuation in a low-yield world (notably to Euro IG). Yields are variable and are not guaranteed.
- The technical picture continues to dominate. Net supply was negative once more in October, keeping YTD net issuance low.
- Despite the rally seen this year, global high yield spreads remain 120 basis points wide of their tight levels in 2014*.
- Macro uncertainty may weigh on sentiment going into year end, with a pretty packed calendar (US election, Italian referendum, Brexit ruling, Fed)
- We continue to focus on generating performance from idiosyncratic risk in high yield.

*Source: Bloomberg, HWOC, at 31 October 2016.

Past performance is not a guide to future performance. The value of an investment and the income from it can fall as well as rise and investors may not get back the amount originally invested.

Contact us
General enquiries: **+44 (0)207 818 4411**
Email: **sales.support@henderson.com**
Website: **henderson.com**

Henderson
GLOBAL INVESTORS
KNOWLEDGE. SHARED

Important information
The Henderson Horizon Fund (the "Fund") is a Luxembourg SICAV incorporated on 30 May 1985, managed by Henderson Management S.A. This document is intended solely for the use of professionals and is not for general public distribution. Any investment application will be made solely on the basis of the information contained in the Fund's prospectus (including all relevant covering documents), which will contain investment restrictions. This document is intended as a summary only and potential investors must read the Fund's prospectus and key investor information document before investing. A copy of the Fund's prospectus and key investor information document can be obtained from Henderson Global Investors Limited in its capacity as Investment Manager and Distributor. Issued in the UK by Henderson Global Investors. Henderson Global Investors is the name under which Henderson Global Investors Limited (reg. no. 906355) (incorporated and registered in England and Wales with registered office at 201 Bishopsgate, London EC2M 3AE and authorised and regulated by the Financial Conduct Authority) provide investment products and services. Telephone calls may be recorded and monitored. Past performance is not a guide to future performance. The performance data does not take into account the commissions and costs incurred on the issue and redemption of units. The value of an investment and the income from it can fall as well as rise and you may not get back the amount originally invested. Tax assumptions and reliefs depend upon an investor's particular circumstances and may change if those circumstances or the law change. If you invest through a third party provider you are advised to consult them directly as charges, performance and terms and conditions may differ materially. The securities included in this document are not registered in the Foreign Securities Registry of the Superintendencia de Valores y Seguros for public offering and, therefore, the use of this document is only for general information purposes. Nothing in this document is intended to or should be construed as advice. Security examples are intended for illustrative purposes only and are not indicative of the historical or future performance of the strategy or the chances of success of any particular strategy. Henderson Global Investors, one of its affiliated advisors, or its employees, may have a position in the securities mentioned in this document. References to individual securities should not constitute or form part of any offer or solicitation to issue, sell, subscribe or purchase the security. This document is not a recommendation to sell or purchase any investment. It does not form part of any contract for the sale or purchase of any investment. The Fund is a recognised collective investment scheme for the purpose of promotion into the United Kingdom. Potential investors in the United Kingdom are advised that all, or most, of the protections afforded by the United Kingdom regulatory system will not apply to an investment in the Fund and that compensation will not be available under the United Kingdom Financial Services Compensation Scheme. A copy of the Fund's prospectus, key investor information document, articles of incorporation, annual and semi-annual reports can be obtained free of cost from the local offices of Henderson Global Investors: 201 Bishopsgate, London, EC2M 3AE for UK, Swedish and Scandinavian investors; Via Dante 14, 20121 Milan, Italy, for Italian investors and Roemer Visscherstraat 43-45, 1054 EW Amsterdam, the Netherlands. for Dutch investors; and the Fund's: Austrian Paying Agent Raiffeisen Bank International AG, Am Stadtpark 9, A-1030 Vienna; French Paying Agent BNP Paribas Securities Services, 3, rue d'Antin, F-75002 Paris; German Information Agent Marcard, Stein & Co, Ballindamm 36, 20095 Hamburg; Belgian Financial Service Provider CACEIS Belgium S.A., Avenue du Port 86 C b320, B-1000 Brussels; Spanish Representative Allfunds Bank S.A. Estafeta, 6 Complejo Plaza de la Fuente, La Moraleja, Alcobendas 28109 Madrid; Singapore Representative Henderson Global Investors (Singapore) Limited, 6 Battery Road, #12-01 Singapore 049909; or Swiss Representative BNP Paribas Securities Services, Paris, succursale de Zurich, Selnaustrasse 16, 8002 Zurich who are also the Swiss Paying Agent. RBC Investor Services Trust Hong Kong Limited, a subsidiary of the joint venture UK holding company RBC Investor Services Limited, 51/F Central Plaza, 18 Harbour Road, Wanchai, Hong Kong, Tel: +852 2978 5656 is the Fund's Representative in Hong Kong. Ref: 36J

H025676/1016 SICAV