AllianceBernstein

The euro high-yield rally isn't over yet. New opportunities continue to arise for investors willing to do their homework.

A High-Yield Opportunity Not to Be Missed

The euro high-yield market may already have come of age, but it keeps on improving with time. There are challenges ahead, but our research points to several areas where investors can add value. With careful security selection, this market remains a key investment opportunity.

Economic Outlook More Benign

This year, we expect to see a changing macroeconomic landscape as economic activity shifts into a higher gear. Also, financial authorities are likely to start removing the crutches that propped up some of the world's economic powers through the darkest days of the downturn of recent years.

Notably—and perhaps surprisingly, given its predicament three to five years ago—Europe is on track to post positive growth in 2014. And we should continue to see recovery in the heavily indebted peripheral countries. We expect to see continued improvement in the region's fiscal position and a reduction in fiscal drag, leaving the apex of the euro area's fiscal pain threshold further behind us.

Meanwhile, the euro area's economic improvement will be overseen by a vigilant European Central Bank (ECB) that continues to do "whatever it takes" to ensure that stability and recovery remain on track. We may see additional monetary easing from the ECB if inflationary pressures remain subdued. And, as euro members continue to feel the warm glow of the ECB's Outright Monetary Transactions program, greater stability and less fear of a breakup of the euro should allow sovereign risk premiums to remain stable, at the very least.

Opportunity Knocks

We think that the European high-yield corporate bond market is going to be a key opportunity of 2014. So what does this opportunity look like? We'll discuss that on several levels: the changing profile of the market, changing valuations and the reasons for those, and some structural opportunities. Equally important:, we'll discuss the best ways to exploit the opportunity in the year ahead.

Our team of European fixed-income specialists have watched this market develop and grow from an immature niche sector into a broad and deep capital market worthy of any asset allocator's time and energy.

"Children Should Be Seen and Not Heard"

This well-known proverb (attributed to an Augustinian clergyman of the 15th century) sums up investors' attitude to the European high-yield market in the late 1990s. This infant sector might have had quite a lot to say for itself, but it was largely ignored by most global investors, who were directing their attention to the European market's more mature cousin, US high yield.

The euro market emerged into adolescence in the early 2000s, maturing but retaining an element of teenage awkwardness. There was a gradual increase in issuance, and some new entrants emerged as issuers began to utilize this source of funding to a greater degree. But, even as its size increased, Europe remained low on the list of candidates when global investors thought about their asset-allocation choices.

As we all know, the difficult teenage years eventually give way to maturity. And the same has applied to the euro high-yield market. In the shadow of the global financial crisis of 2008, interest rates plummeted and remained at very low levels; the banking sector severely curtailed its lending activities; and companies increasingly turned to the capital markets as their funding source of choice—specifically the corporate bond market.

In the aftermath of the credit crisis, corporate bond issuance rose in a dramatic fashion. In the five years since 2008, the number of corporate issuers has risen from about 200 to about 620, and a massive increase in downgrades of companies from investment grade to high yield (the so-called fallen angels)

has caused market value to expand further. In the past five years, the market has grown from less than €70 billion to more than €215 billion.

So euro high yield came of age. Thanks in large part to the 2008 crisis, the market grew up and positioned itself as a key asset-allocation choice, one that could no longer be ignored and, importantly, one whose value was now being recognized. This sector now had the depth and breadth to allow skilled investors to build well-constructed, well-diversified strategies. And the sector has generated exceptional returns over recent years, as the environment of increased supply, coupled with increased investor interest and demand, created abundant opportunities.

Managers Have to Be Smart

Certainly, euro high yield has presented investors with spectacular returns over recent years. The obvious question is: Is anything left? In our view, a return of between 6% and 8% is realistic in 2014. The next—more complicated—question is: How?

When it comes to unlocking the value in euro high yield in 2014, returns will depend much more on sector and security selection than on beta management (a big source of returns in 2012 and 2013.) In other words, just having broad market exposure will no longer be enough to ensure impressive results. Managers may find it almost impossible to add value if they don't have the expertise and resources to thoroughly analyze a company's micro fundamentals and engage with company management on a regular basis, from both debt and equity perspectives.

Relative Value in Europe

As discussed above, investors now have a choice of high-yield corporate bond markets (US and Europe), so relative value is a key consideration. Let's compare the two.

First, our analysis suggests that the US economy is firmly in the mid-cycle stage while Europe is just entering its recovery, and is therefore at an early stage of its cycle. Historically, early stage recoveries have been an optimal time to allocate money to credit markets, particularly high yield. Company behaviour in the two regions reflects where they are in their cycles. In the US, we're seeing a greater number of "equity friendly" actions—specifically increased dividends and higher levels of leveraged buyouts and merger and acquisition activity—than we're seeing in Europe.

Second, and as a direct result of the first trend, leverage remains lower in Europe than in the US and it's continuing to decline, fuelled by a continuing desire among European high-yield corporates to de-lever **(Display 1)**. As bond investors, this is music to our ears, as our rule of thumb is, first, to consider an issuer's willingness to repay and service debt and, second, their ability to do so. European issuers are both willing and able at the moment.

Low Default Rates

High-yield investors have enjoyed a period of low default rates. This helped generate the high returns of recent years because investors felt comfortable allocating to this market sector, and demand remained strong. Our research suggests that this happy state of affairs will persist, at least for the next 12 to 24 months, and that default rates will remain at these lower levels.

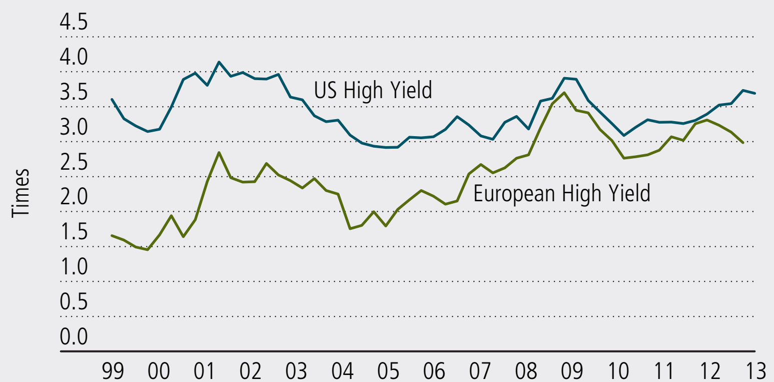
The Opportunity in Financials

One of the major opportunities in the high-yield market in recent years has resulted from structural change and regulatory action in the financial sector. And we expect further developments in 2014. As Basel III is implemented, financial institutions will be required to bolster the core capital that they have in place. This will be achieved through the restructuring of their balance sheets and the issuance of new a type of Tier 1 debt (Additional Tier 1, or AT1).

These new issues should provide a compelling opportunity, as they are likely

Display 1: Comparing Credit Fundamentals—Leverage Trends Diverging

Net Leverage



Through 30 June 2013 for US high yield and 31 March 2013 for European high yield
Source: Bloomberg, Morgan Stanley, company reports and AllianceBernstein

to be priced at more attractive levels than existing issues are. However, demand for these assets may not be aggressive because not all investors can buy them. They will be largely off-limits for banks and insurance companies. So, other investors, like us, are in a perfect position to take advantage of this opportunistic source of added value for at least the next one to two years.

Security Selection Is the Key

We think we're going to see a big divergence in the best- and worst-performing euro high-yield managers in 2014 and into 2015—driven by security selection. Returns will be driven by bottom-up analysis.

The post-2008 influx of new issuers in the market has, more recently, been joined by smaller players attracted by robust investor demand and low borrowing costs. They tend to borrow in smaller amounts, which means that they may either not be part of an index at all or represent a very low percentage of the index.

So, managers who don't have sufficient research resources may not be able or, indeed, willing to allocate time to researching these smaller companies and meeting their management teams. The potential consequence is a return to the "seen and not heard" problem: investors may ignore highly attractive investment opportunities. Moreover, they may constrain their investment universe to one that is dominated by credits that are fair value at best, and significantly overvalued at worst. This is a good opportunity for well-resourced asset managers to gain a competitive edge.

Be Willing to Think Small

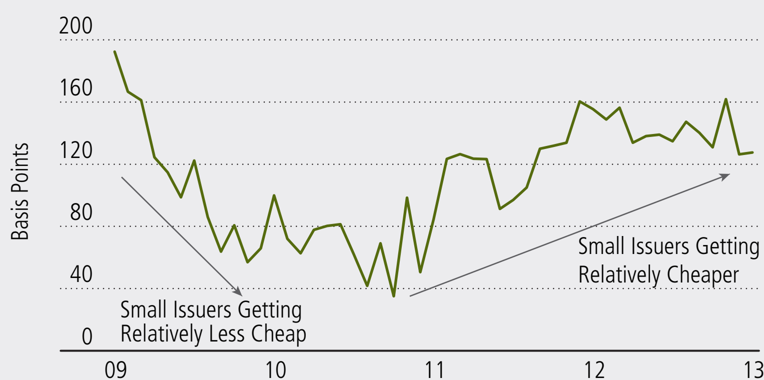
This year, we think that these smaller credits will provide compelling opportunities and help drive portfolio returns to, or even above, the upper end of our expected return range.

Investors should actively avoid those credits that don't adequately compensate them for the risks they take and focus on those that do. Currently, we see little value in the large issuers that make up the larger percentage of the market index, as these were squeezed to unattractive levels as investors flocked in to take general market exposure in 2012 and 2013. As shown in **Display 2**, in the new issues market, smaller issuers were paying an average of about 130 basis points more in spread than larger issuers by late 2013. In our view, the smaller names offer some very attractive valuations, and we have directed our analysts to devote time to covering these companies.

When approaching this part of the market, investors should be sure to diversify properly. If you are avoiding low-opportunity large issues and favouring high-opportunity smaller issues, it's necessary to have a greater number of issues and names in your portfolio. To avoid owning too great a percentage of any issue, the smaller the issue size, the lower the percentage weighting each security should represent.

Display 2: New Issues—Growing Gap Between Pricing of Small and Large Issuers

Spread of Small Issuers Minus Spread of Large Issuers



Through 31 December 2013
Chart shows option-adjusted spreads in the new issues market for amounts outstanding of less than €500 million minus option-adjusted spreads for amounts outstanding of greater than or equal to €500 million. Based on Barclays Pan European High-Yield Index
Source: Barclays and AllianceBernstein

The Bottom Line

The European economy is not in the clear yet, and uncertainties remain, so it's undeniable that we have challenges ahead in 2014. But the challenge of finding returns in a low-yield environment is nothing new. Luckily, euro high yield corporate bonds offer a solution to that challenge. It's a market that has come of age and, we believe, one that will keep on improving with time.

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