Confidence must be earned

Amundi

ASSET MANAGEMENT

INVESTMENT INSIGHTS BLUE PAPER | Q4 2019

High Yield: deep diving needed due to a more uncertain outlook

GLOBAL HIGH YIELD
Higher scrutiny amid a more uncertain outlook

DETERIORATING GLOBAL OUTLOOK WITH ALTERNATIVE SCENARIOS IN SIGHT

10% UPSIDE RISK SCENARIO

Broad US-China trade deal

Government bond yields would rebound, while the higher coupons of the HY market and the shorter average duration would provide greater downside protection compared to IG corporate bonds or government bonds, which would be impacted more severely.

60% CENTRAL SCENARIO

Global growth slowdown

HY market is attractive given ample macro liquidity, loose financial conditions, and the benign default outlook.

30% RISK SCENARIO

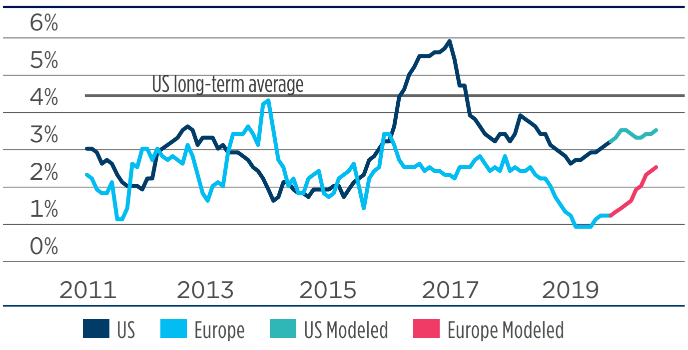
Trade war escalation

Sudden repricing of risk premia, tightening of financial conditions exacerbated by low liquidity conditions, lower earnings and a spike in the default rate.

SOME PICK UP IN DEFAULT RATES,
BUT FAR BELOW LONG-TERM AVERAGE

US HY default rate was 3.0% at end-September, below its long-term average of 4.4%. EU HY default rates was 1.2% according to Moody's. They are expected to rise to 3.7% in September 2020.

HY default rates



Source: Bloomberg, Moody's, Amundi Research's forecasts, As of 17 October 2019.

DIVERGENT TRENDS
IN FUNDAMENTALS AND TECHNICAL

Fundamentals appear healthier in Europe than in the United States, with corporate leverage being lower in the former. Technical factors will likely remain supportive in the Eurozone, on both the supply and the demand side.

Share of BB Issuers in the HY universe

71%

49%

Definitions

Basis points (bps): one basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).

Bond ratings: Source: Moody's and S&P. AAA (highest possible rating) through BBB are considered investment grade; BB or lower ratings are considered non-investment grade (high yields). Cash equivalents and some bonds may not be rated.

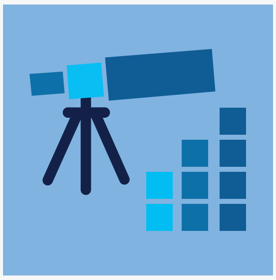
Credit spread: differential between the yield on a credit bond and the Treasury yield. The option-adjusted spread is a measure of the spread adjusted to take into consideration possible embedded options.

Default rate: % issuers that failed to make interest or principal payments in the prior 12 months. Default rate based on BofAML indexes. Universe consists of issuers in the corresponding index 12 months prior to the date of default. Indexes are from ICE BofA Merrill Lynch.

Duration: A measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.

GLOBAL HIGH YIELD

Be cautious in the search for yield



Exploit rising dispersion of returns with selection

When dispersion is low, investors describe the market as responding to 'risk-on' and 'risk-off' impulses. In a high-dispersion environment, such as what the market is in today, sector and security selection can create more value. Among our key convictions, we stay cautious on retail and energy sectors, as they both face increasing pressure.

Stay diversified amid risks from alternative scenarios

One key risk to monitor is financial fragility of balance sheets, with rising leverage among US corporates and heavier issuance by lower-rated companies. Those conditions need to be monitored especially under the negative alternative scenario. For this reason, it is important to avoid the concentration risk and limit the impact on the overall portfolio in case of a credit event.

Seek out 'rising stars' in Europe

Among the factors offering investment opportunities to HY investors, is the possibility of investing in "rising stars" – companies with improving credit quality that have the potential to be upgraded from HY into the IG universe. This year there has been a resurgence of 'rising stars' in Europe.

Watch out for deteriorating liquidity conditions

Liquidity remains a key risk for the HY market especially in case of a market sell-off. It is key for HY investors to balance their portfolios with a mix of liquid and less liquid holdings in order to meet any redemption scenario. Active managers can put in place different tools to facilitate good liquidity management.

> *"Barring any material deterioration of the main scenario, the picture is supportive for a selective global high yield approach."*

Kenneth J. MONAGHAN
Co-Director High Yield

Andrew FELTUS
Co-Director High Yield

Source: Bloomberg, Amundi Research. Forecasts of 23 October 2019.

Date of First Use: 28 October 2019. Devised by: Laura Fiorot, Amundi Investment Insights Unit.

Amundi ASSET MANAGEMENT

Kenneth J. MONAGHAN
Co-Director of High Yield

Andrew FELTUS
Co-Director of High Yield

Sergio BERTONCINI
Head of Rates and FX Research

Francesca PANELLI
Investment Insights Unit Specialist

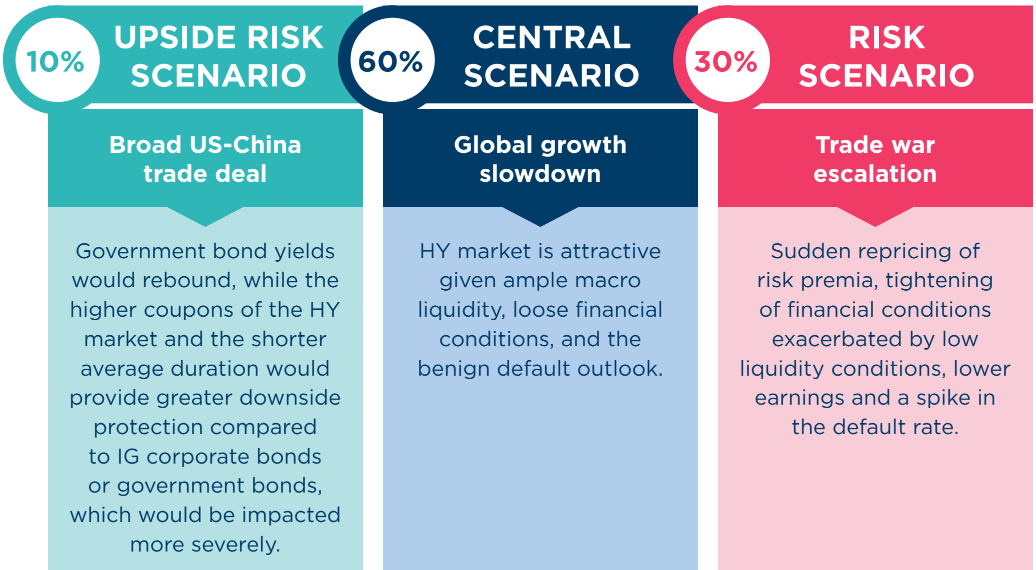
The backdrop for global high yield

Theme 1: Weakening global outlook with alternative scenarios in sight

Global growth has been slowing since 2018, due to a combination of factors, including trade wars – with consequently slower global trade -- past US Fed tightening, and rising geopolitical risks. This slowdown has become more pronounced in the last couple of quarters, especially in the most open economies, such as Europe and some EM, while the US economy has remained relatively more resilient despite losing momentum.

Our main scenario is for a synchronised global deceleration with the bottom to be hit in the first half of 2020 and growth below potential in most advanced economies throughout next year. The uncertain outlook is weighing on private investment, though we don't expect to see any major spill-over to private consumption. We expect some de-escalation of trade tensions between the United States and China, which would pave the way to a normalisation of trade trends in 2021.
Inflation should stay low and pick up slowly from 2020. Major central banks will remain accommodative, but market expectations have probably gone too far in discounting further easing. We expect the Fed to cut rates a further 50 bps over the next twelve months. Some contrasting communication from central bank boards (both the Fed and the ECB) is another feature of this final part of the year and will likely continue next year, generating some volatility in market expectations, and finally in market prices.
According to our main scenario, the global high-yield (HY) market is attractive given the search for yield supported by dovish central banks, loose financial conditions, and an overall benign default outlook. Spreads are tight, but still above the cyclical bottom. There is not much room for mistakes with the current level of spreads. Any spread widening associated with market volatility could be an opportunity to be exploited. Barring any material deterioration of the main scenario, the picture is still mildly supportive of a selective approach to the asset class for investors searching for carry.

Figure 1: Macroeconomic scenarios and possible impacts on the HY market



Source: Amundi Research. As of 25 October 2019.

Since the United States accounts for nearly 60% of the global HY market, its economic outlook is key here. Therefore, we are monitoring US corporate profit trends and the resilience of domestic consumption to detect any early warning signals regarding a larger-than-expected slowdown. We will be paying particularly close attention to consumer sentiment and spending.

While we do not envisage a US recession in our main scenario, such a risk is higher in case of an escalation in trade tensions, with full-blown contagion to private consumption and the service sector from the manufacturing segment. Such a scenario requires close monitoring, due to the recent decoupling between upbeat soft data and gloomier hard data. Under such a scenario, there would be a sudden repricing of risk premia, with a tightening of financial conditions exacerbated by low liquidity conditions, lower earnings, and a spike in the default rate.

"Barring any material deterioration of the main scenario, the picture is supportive for a selective global high yield approach".

A second alternative scenario could unfold if the United States and China agree on a broad or comprehensive trade deal or if fiscal policy gets more expansive in Europe to address the economic downturn. In such circumstances, government bond yields would likely rebound while the higher coupons of the HY market and its shorter average duration would provide greater downside protection vs investment grade (IG) corporate bonds or government bonds, which would be more severely impacted. This second scenario is the least likely – only a 10% chance, according to our estimates -- but investors should be aware of the risk nonetheless.

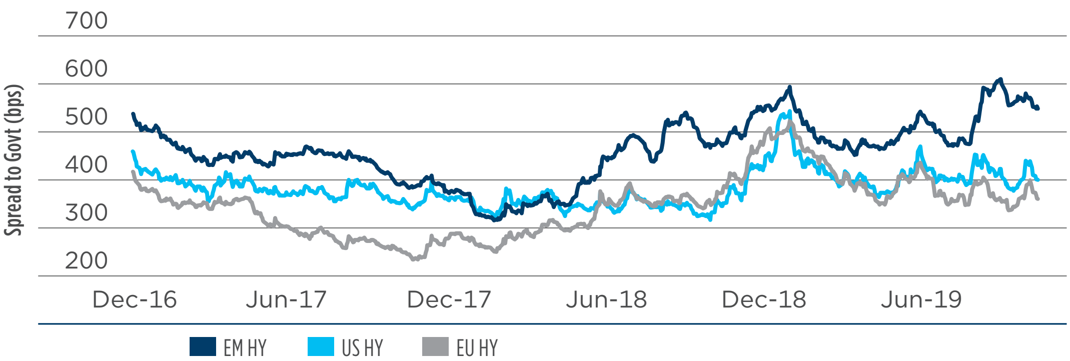
Theme 2. Some pickup in default rates, but far below long-term averages

"The HY market has proved healthy in 2019, showing tighter credit spreads".

The global high yield market has proved healthy so far this year, with HY credit spreads over government bonds tightening from the wide levels at which they traded in December 2018; they are now trading closer to cyclically tight levels. The only exception is the EM HY market, where spreads have been boosted by the sell-off of Argentina's bonds after the surprise *election result* in August. The index recovered in September, though, and such weakness has not spilled over to other areas.

"A few areas of strain remain in some sectors, but they are idiosyncratic stories".

Figure 2: Global HY credit spreads



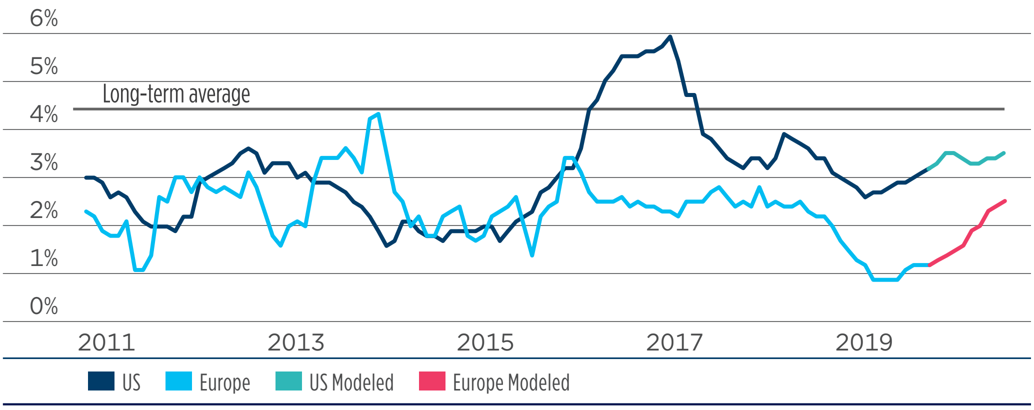
Source: Bloomberg, Moody's, Amundi Research. As of 17 October 2019.

A few areas of strain remain in some sectors, but they appear to be idiosyncratic stories. In the United States, the **default rate** has proved benign, thanks to healthy credit conditions. The trailing 12-month US HY default rate of 3.2% at the end of September was below its long-term average of 4.4%. Most US sectors show default rates close to zero, with a few below 4.5%. Energy is alone at above 8%. EU HY default rates are lower, at 1.2%, according to Moody's. We expect them to rise to 3.7% and 2.5% in September 2020 in the United States and in the EU, respectively.

The gap in the US-EU default outlook is partly explained by the different exposure to the commodity sector, which is much lower in Europe than in the United States. The US energy sector has shown elevated default risk this year, but the contagion risk to other sectors remains limited.

"Defaults are likely to increase somewhat over the next year, though to remain below their long-term average".

Figure 3: HY default rates: a mild pickup, but still under control



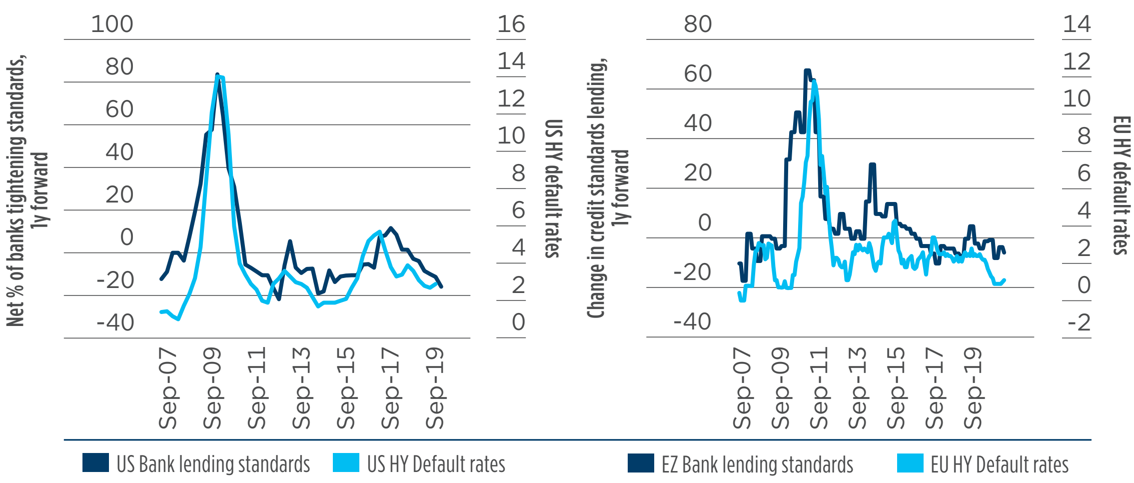
Source: Bloomberg, Moody's, Amundi Research, As of 17 October 2019.

In our main scenario, defaults are likely to increase somewhat over the next year, though to remain below their long-term average. Such an outlook is confirmed by recent trends in the **distress ratio** – that is, the share of HY bonds trading at spreads larger than 1,000 bps over government bonds. Both markets show about 10% of the number of HY bonds currently trading at distress, a low share by historical standards. Excluding the energy sector, the distressed ratio for US high yield bonds falls from 10% to 6%, boding well for a still benign default outlook over the upcoming quarters.

"Bank lending standards also point to subdued default rates over the next year".

Bank lending standards – another key driver of defaults – **also point to subdued default rates over the next year.** Surveys conducted by both the *Fed* and the *ECB* on bank lending practices show that, on average, banks are not significantly tightening the standards applied to corporate loans. The net percentage of banks tightening their standards has been low and stable over the past two quarters.

Figure 4: Bank lending standards still neutral



Source: Bloomberg, BofA-ML, Amundi Research. As of 17 October 2019.

"EU default rates will likely stay lower than their US counterparts".

Our models based on distress ratios, bank lending standards and debt growth point to a 3.5% average default rate in the United States in one year's time, while in Europe, the projection is for an increase to 2.5% from 1.2% currently. Despite the projected pickup, EU default rates should stay lower than their US counterparts, benefiting from lower exposure to the troubled energy sector, a higher share of high-rated bonds, and a lower share of low-rated bonds – CCCs account for about 6% in Europe vs 12% in the United States.

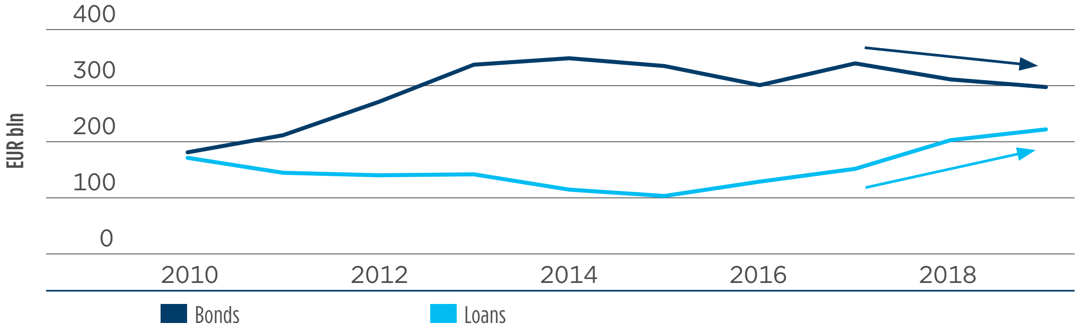
"Investors can exploit divergent trends in fundamentals among different segments of the same HY market and between the US and EU HY markets".

Theme 3: Divergent trends in fundamentals and technicals

Fundamental and technical trends have been decoupling this year in both the EU and the United States. Such divergence could be exploited by investors. **Fundamentals appear healthier in Europe than in the United States**, with corporate leverage being lower in the former, though corporate earnings growth for European companies has not been as strong. In addition, the HY market structure is more defensive in Europe than in the United States. As a reference, the share of BB issuers in the overall HY universe is higher in Europe than in the United States (71% vs 49%).

Technical factors will likely remain supportive in the Eurozone, on both the supply and demand side. This year, primary market activity has been subdued in the single-currency area, with the lowest issuance volume since 2012, and it is expected to stay low going forward. Despite interest rates being at historically low levels, many European corporates have preferred financing through bank lending, which has become increasingly competitive compared to bond issuance, as testified to by the recent rise in the volume of leveraged loans.

Figure 5: Volumes of leveraged loans versus bonds outstanding, Europe



Source: Bloomberg, elaboration by Amundi Research. As of 17 October 2019.

How to play high yield

Be cautious in the search for yield

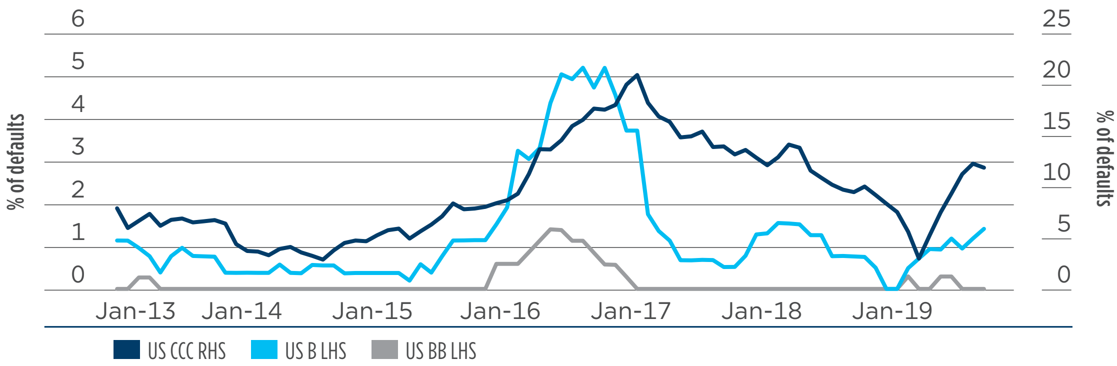
"With over $13 TRL of bonds trading at negative yields globally, the search for yield will remain key for investors".

Exploit rising dispersion of returns via sector and security selection

The search for yield intensified this past summer as global government bonds rallied and yields fell in the wake of actions by both the ECB and the Federal Reserve to provide additional monetary stimulus. Such movement has led to over $13 trillion of bonds trading at negative yields globally, heightening the hunt for yield. However, **investors should be aware of rising dispersion of excess returns across rating buckets** in both the US and the EU, and also **across single names.**

Unlike in 2018, this year, lower-rated names – CCCs, in particular – have, on average, underperformed the BB-rated bucket, with a subsequent widening of credit spreads between BB and CCC issuers. The BB segment appears more attractive than the CCC in both the US and EU HY markets, as it offers a better risk/return trade-off. Also, despite supportive monetary policies, market players are proving reluctant to move as far as the CCC segment hunting for yield. In a high dispersion environment such as the current one, idiosyncratic price drivers are key market movers. Sector and security selection can create more value when bond prices and yields move in response to idiosyncratic factors.

Figure 6: HY defaults: mostly a CCC-rated story



Source: Bloomberg, BofA-ML, elaboration by Amundi Research. As of 17 October 2019.

"High dispersion across single names is an opportunity for an active management approach".

Dispersion is also high across single names, as idiosyncratic inputs have become important, creating opportunities for high-yield investors focused on security selection. When dispersion is low, investors describe the market as responding to 'risk-on' and 'risk-off' impulses. In such a market, the beta component of a portfolio is what matters the most. In a high dispersion environment, such as the one we are experiencing today, sector and security selection can create more value. Among our key convictions, we remain particularly cautious on the retail and energy sectors. Both of these contain high shares of companies under pressure. While the energy sector, in general, and the exploration and production (E&P) segment in particular, are feeling the pain from weakness in oil and gas prices (see box below), the retail segment suffers from secular changes resulting from internet shopping competition.

When bond prices and yields are moving due to idiosyncratic factors, the input of a team skilled in analysing and valuing companies and bonds is imperative.

"Diversification is important in a late-cycle environment".

Stay well diversified amid risks from alternative scenarios

One key risk to monitor is the financial fragility of balance sheets, with rising leverage among US corporates and heavier issuance by lower-rated companies. Those conditions need to be monitored especially under the negative alternative scenarios.

Amundi
ASSET MANAGEMENT

For this reason, it is important to build well-diversified portfolios to avoid concentration risk and to limit the impact on the overall portfolio in case of a credit event. This is particularly important in a late cycle with some troubled industries.
Finally, as most HY investors appear to favour higher-rated issuers, such as BBs and Bs, the market as a whole currently has more interest rate risk built into it compared to previous cycles, as, historically, BBs have been more rate-sensitive than other HY segments. This is a factor to monitor in case an upside risk scenario materialises, leading to higher interest rates. Still, it is worth remembering that the duration of the high yield market is less than half that of the investment grade corporate bond market.

Seek out 'rising stars', particularly in Europe

"An active management approach is key in order to take advantage of rating migrations".

Among the interesting investment opportunities available to HY investors is the possibility to invest in 'rising stars' – companies with improving credit quality that have the potential to be upgraded from HY to the IG universe. **Within the European HY market, it is worth mentioning a resurgence of 'rising stars', especially among subordinated peripheral issuers.** This trend has caused a reduction in the average yield paid by EU corporate bonds, increasing the attractiveness of European HY bonds as one of the few remaining options offering positive yields to EU fixed income investors. Finally, the reopening of the *ECB QE* from November, including higher projected reinvestments within the corporate bond purchase programme, will continue supporting HY bonds indirectly, particularly higher-rated BB bonds. An active management approach is key here in order to take advantage of such migrations.

Watch out for deteriorating liquidity conditions

"Liquidity remains a key risk for the HY market, especially in case of a market sell-off".

As mentioned, in our view, markets have gone too far in pricing further accommodation by major central banks and the '*dot plot*' projections by the Fed suggest a heightened internal divide within the board. As such, if the Fed does not meet market expectations in terms of further easing, some liquidity tensions may emerge. So far this year, there has been no material deterioration of liquidity conditions in HY markets; however, such risk needs to be monitored closely, as highlighted by the IMF in its most recent *Global Financial Stability Report*. Finally, as HY investors may find better opportunities in the EU vs the US market, they should be aware that the former is typically less liquid than the latter, and some liquidity strains could arise in case of a market sell-off. **It is key for HY investors to balance their portfolios with a mix of liquid and less liquid holdings** in order to meet any redemption scenario. Active managers have tools at their disposal to deal with a liquidity crisis, including constant monitoring of market and investor liquidity and the building of liquidity buffers.

A focus on US energy sector

The US shale revolution has revived the US production of crude oil and natural gas. However, the revolution has not been kind to the investors who funded it. The high capital expenditures and fast decline rates – a measure of how quickly a well produces all of its available oil and gas – have resulted in weak returns on capital for investors in shale companies to the extent that investors are questioning whether these business models are broken except in the best energy fields. As a result, energy bonds – particularly in the Exploration & Production and Oil Field Services subsectors – have traded weakly and erratically. Even short-term oil price spikes tied to events such as the recent Saudi oil facilities attacks have not provided much relief to energy bond investors.

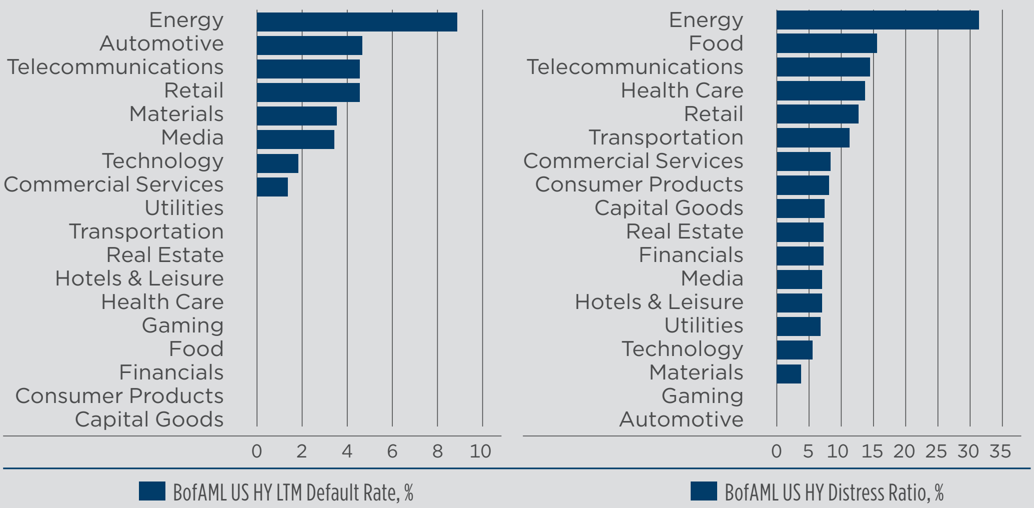
This year, the energy sector has taken back its role from the retail segment as 'most scrutinised' sector within the US HY universe. Out of 64 defaults recorded globally over the first nine months of 2019, 19 – or 30% of the total – have been in the energy sector, according to the latest Moody's report on defaults. This share was 19% in the same period of 2018. At the same time, the retail sector has almost halved its tally, with only seven defaults, down from 13 last year. **The key reason behind such deterioration has been the plunge in oil prices in Q4 2018** (from $77/barrel in early October 2018 down to $42D/barrel in late December 2018), **which is weighing on both the default rate and the distress ratio of the sector.**

"The energy sector is likely to stay in the lead on both spreads and distress ratio for 2020 as well. To reduce risks, exposure could be mainly in the midstream subsector".

While the overall US HY default rate is currently 3%, it is above 8% in the US HY energy sector. The energy sector also has the highest distressed ratios, the most powerful leading indicator of defaults in one year's time. US HY energy bonds currently trade at around 750 bps, the highest spread in over three years and the widest among any US HY sector. Also, the distress ratio for US HY bonds is currently above 30% while in most other sectors it is below 15%. **As we do not anticipate a meaningful and sustainable increase in oil and gas prices, the energy sector appears likely to stay in the lead on both spreads and distress ratio for 2020 as well.** The contagion risk should be limited, implying that the energy sector remains an idiosyncratic, not a systemic, story.

The September drone strikes on Saudi Arabia's oil fields had only a transitory impact on the oil price. However, a way to reduce exposure to such risks is by concentrating on the midstream subsector of the energy sector – which includes processing, storing, transporting and marketing for oil and gas – as its revenues are mostly calculated on volumes rather than on oil or gas prices.

Figure 7: US HY default and distress rates: an energy story



Source: Bloomberg, BofAML, Amundi Research. Data as of 17 October 2019.

Definitions

- **Asset purchase programme:** A type of monetary policy wherein central banks purchase securities from the market to increase money supply and encourage lending and investment.
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Beta:** The additional return above the expected return of the beta adjusted return of the market; a positive alpha suggests risk-adjusted value added by the money manager vs the index.
- **Bond ratings:** Source: Moody's and S&P. If the ratings provided by Moody's and S&P for a security differ, the higher of the two ratings is used. Bond ratings are ordered highest to lowest in a portfolio. Based on S&P measures: AAA (highest possible rating) through BBB are considered investment grade; BB or lower ratings are considered non-investment grade. Cash equivalents and some bonds may not be rated.
- **Credit spread:** The differential between the yield on a credit bond and the Treasury yield.
- **Default rate:** Share of issuers that failed to make interest or principal payments in the prior 12 months. Default rate based on BofAML indexes. Universe consists of issuers in the corresponding index 12 months prior to the date of default. Indexes considered for corporate market are ICE BofA Merrill Lynch.
- **EBITDA:** Earnings before interest, taxes, depreciation and amortisation.
- **Quantitative Easing (QE):** QE is a monetary policy instruments used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **Volatility:** A statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

Important Information

Unless otherwise stated, all information contained in this document is from Amundi Asset Management and is as of 23 October 2019.

The views expressed regarding market and economic trends are those of the author and not necessarily Amundi Asset Management, and are subject to change at any time based on market and other conditions and there can be no assurances that countries, markets or sectors will perform as expected. These views should not be relied upon as investment advice, as securities recommendations, or as an indication of trading on behalf of any Amundi Asset Management product. There is no guarantee that market forecasts discussed will be realised or that these trends will continue. These views are subject to change at any time based on market and other conditions and there can be no assurances that countries, markets or sectors will perform as expected. Investments involve certain risks, including political and currency risks. Investment return and principal value may go down as well as up and could result in the loss of all capital invested.

This material does not constitute an offer to buy or a solicitation to sell any units of any investment fund or any services.

Date of First Use: 28 October 2019.

Amundi
ASSET MANAGEMENT

Amundi Investment Insights Unit

The Amundi Investment Insights Unit (AIIU) aims to transform our CIO expertise, and Amundi's overall investment knowledge, into actionable insights and tools tailored around investor needs. In a world where investors are exposed to information from multiple sources we aim to become the partner of choice for the provision of regular, clear, timely, engaging and relevant insights that can help our clients make informed investment decisions.

Discover more of Amundi's investment insights at
www.amundi.com

Visit us on:

Discover Amundi Investment Insights at
http://www.amundi.com

Amundi
ASSET MANAGEMENT

REF-2577