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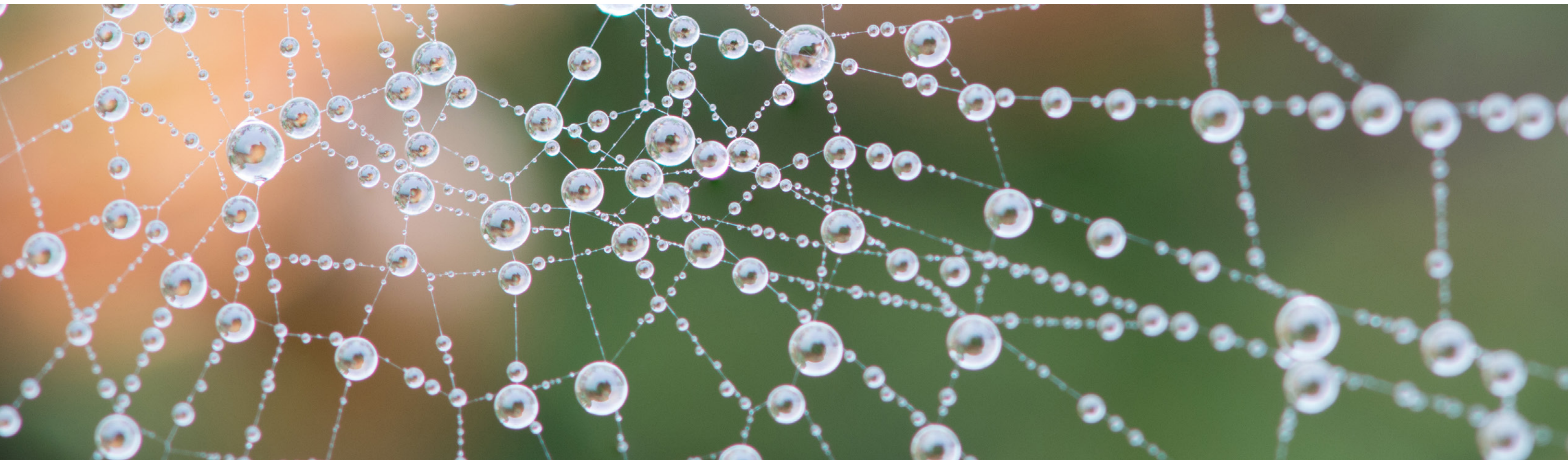

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High Yield Goes Global

Adding European and emerging markets to the standard U.S. corporate high yield universe brings regional and sector diversification without compromising on credit ratings.

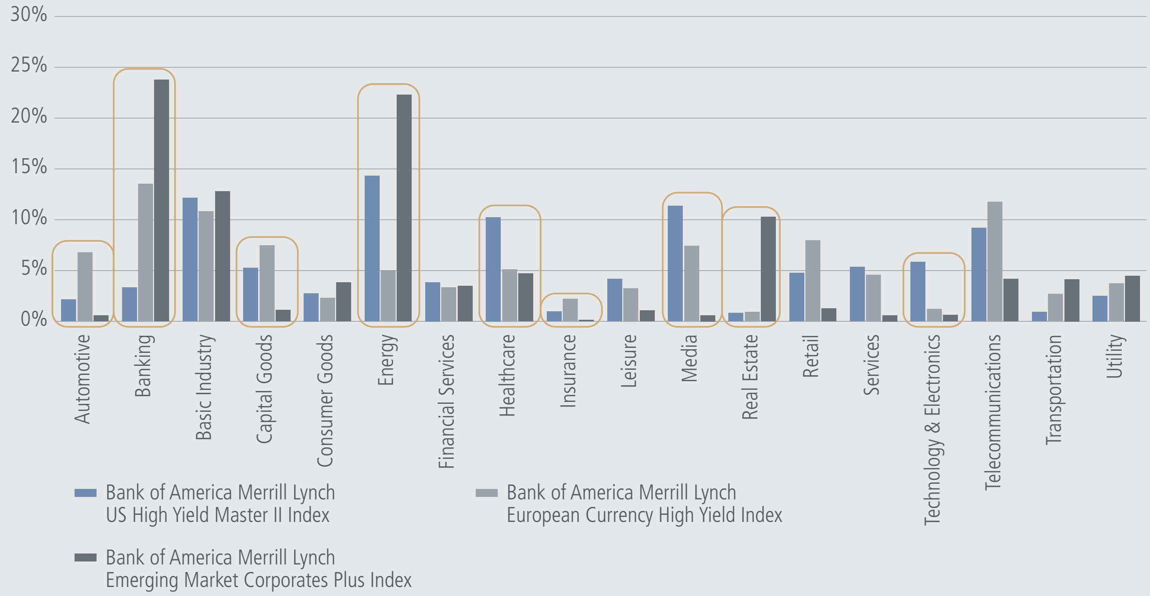
It is not all that long ago that "investing in high yield" effectively meant "investing in U.S. high yield". The rapid growth of these markets in Europe and the emerging world, however, makes it difficult to sustain this assumption. The size of the European market was less than $100bn back in 2005 and is now more than four times that size. Emerging market high yield has rocketed from just $60bn in 2005 to nearly $450bn today. Together they represent more than a third of the global high yield universe. On size alone investors can no longer afford to ignore European and emerging markets high yield; throw in recent outperformance from the former, extra yield from the latter and meaningful diversification benefits from both, and the case for going global looks compelling.

Executive Summary

- The growth of European and emerging high-yield bond markets now makes a genuinely global strategy possible
- But global high yield is also, arguably, a desirable option, too
- Europe and emerging markets introduce very different sector exposures
- New sources of diversification and alpha come from country-of-issuer risks, particularly in emerging markets
- In general, adding two more very distinct markets offers a wealth of new relative-value opportunities—which today can add extra credit spread over the U.S. market average

EUROPEAN AND EMERGING HIGH YIELD MARKETS ADD MEANINGFUL SECTOR DIVERSIFICATION

Index sector weights

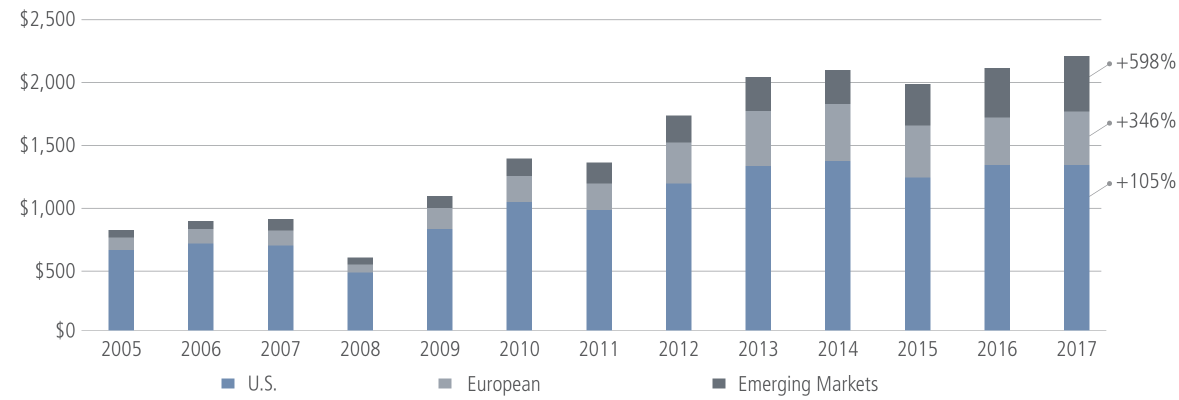


Source: Bank of America Merrill Lynch.

The past decade has seen a transformation in high yield bond markets. Globally, outstanding issuance has increased by 170%, driven by remarkable growth, from a low base, in Europe and the emerging world (Figure 1).

While investors may think this must be symptomatic of a borrowing binge that would see defaults rising at a similar rate, we believe that this is not the case. One reason is that a lot of the new issuance comes, not from companies that were already big users of the high yield markets, but from newcomers and companies diversifying their funding away from bank credit. Against the backdrop of a return to robust economic performance in the U.S., and the promise of recovery in Europe, corporate borrowers in general are already in good shape.

FIGURE 1. FROM A LOW BASE, EUROPEAN AND EMERGING HIGH YIELD MARKETS ARE GROWING FAST
Outstanding issuance ($bn)

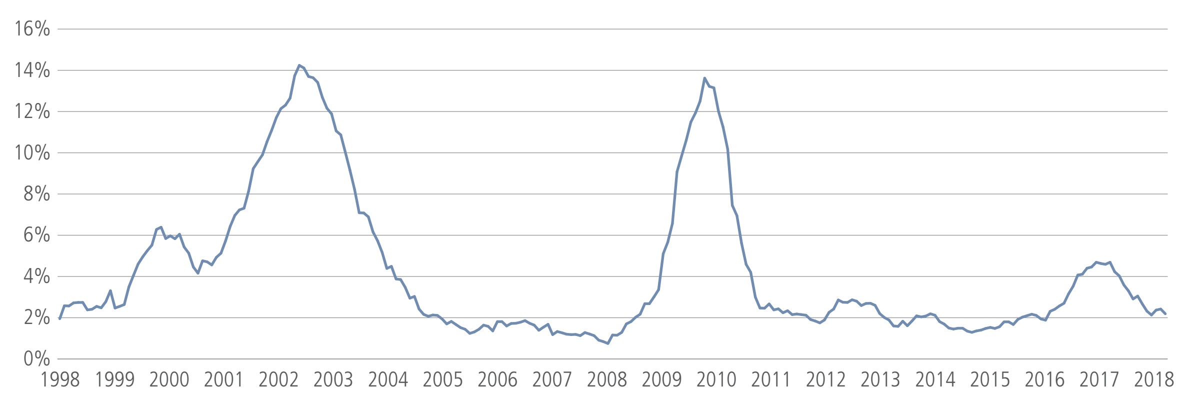


Source: Bank of America Merrill Lynch. Universe represented by the Bank of America Merrill Lynch Global High Yield Index. Emerging markets defined as issuers with a country of risk other than an FX-G10 member, a Western European nation, or a territory of the U.S. or a Western European nation. U.S. represents non-EM USD HY bonds. European represents European currency HY bonds. Data as of December 31, 2017.

High Yield Fundamentals Are Strong

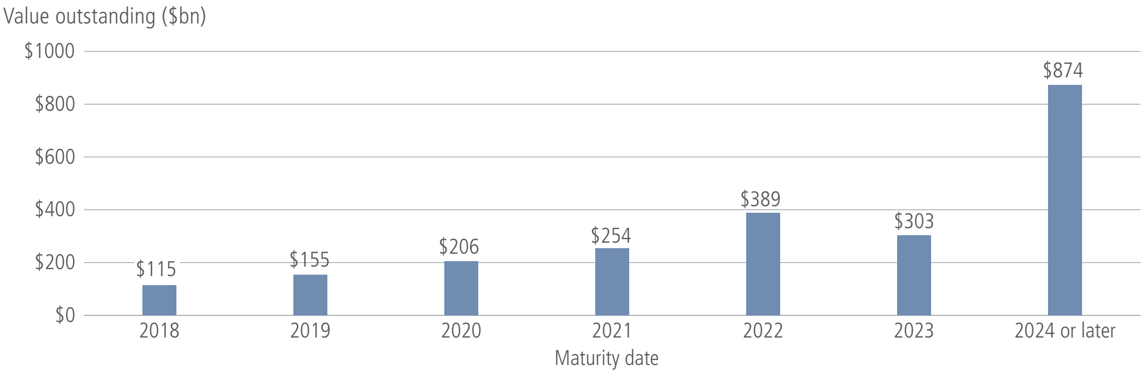
As Figures 2A and 2B show, the number of borrowers defaulting—globally and across all three regions—has remained steady over the past few years as the high yield market has grown. In general, cash flow has been strong and management teams conservative, using the extended period of low interest rates we have had to refinance with longer-dated, cheaper debt. As a result, default rates have plummeted since the spike during the financial crisis, and are forecast to remain low for the foreseeable future.

FIGURE 2A. DESPITE INCREASING DEBT ISSUANCE, DEFAULT RATES REMAIN SUBDUED
Trailing 12-month issuer-weighted speculative-grade default rates



Source: BofA Merrill Lynch Global Research. General methodology: Default rate is based on BofAML indexes and calculated on an issuer level on an LTM basis. Issuers are defined by the first six digits of cusips outstanding. The universe consists of issuers in the corresponding index 12 months prior to the date of default.

FIGURE 2B. GLOBAL ISSUERS HAVE TAKEN THE OPPORTUNITY TO PUSH OUT THEIR REFINANCING NEEDS



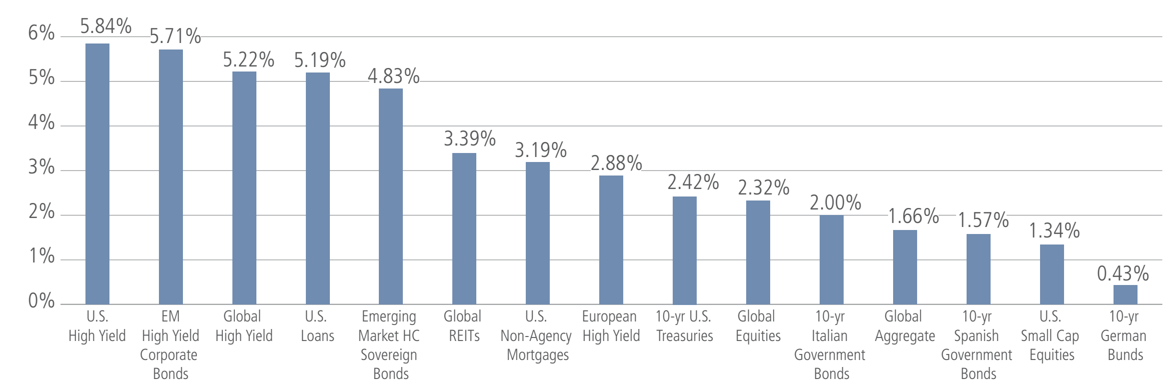
Source: Data is represented by the BofA Merrill Lynch All Maturity Global High Yield Index (HW0J). For each year set forth above, the table shows the amount of high yield bonds outstanding expected to mature. Amount of high yield bonds outstanding as of February 26, 2018 expected to mature. Universe is represented by the BofA Merrill Lynch All Maturity Global High Yield Index.

So much for the level of default risk. What about the potential level of return we expect to get for that risk? It is certainly true that a lot of demand has met the growth in supply of high yield bonds, fuelled by investors' search for income in a low-yielding world, and that this has tightened credit spreads. Nonetheless, those spreads are far from extreme, especially on a relative-value basis: Figure 3A shows just how much extra potential high yield offers compared to other income-bearing assets, defined using representative market indices.

Global High Yield Diversifies A Portfolio And Can Mitigate Against Rising Rates

On top of the credit-risk and value propositions, investors should also consider the diversification benefits of including high yield in their portfolios. Figures 3B and 3C show it to be a genuinely idiosyncratic asset class: monthly returns over the past decade have exhibited only modestly high correlation with equities and, for investors concerned about the approaching Federal Reserve policy tightening and the recent turnaround government bond yields, high yield has been significantly negatively correlated with 10-year U.S. Treasuries. While high yield, like most other asset classes, can react negatively in the short term while U.S. Treasury yields are rising, investment grade corporate bonds may be more likely to post losses. Over the medium term, while investment grade has been more likely to post a positive return following a period of rising Treasury yields, the average return to high yield bonds has still tended to be stronger.

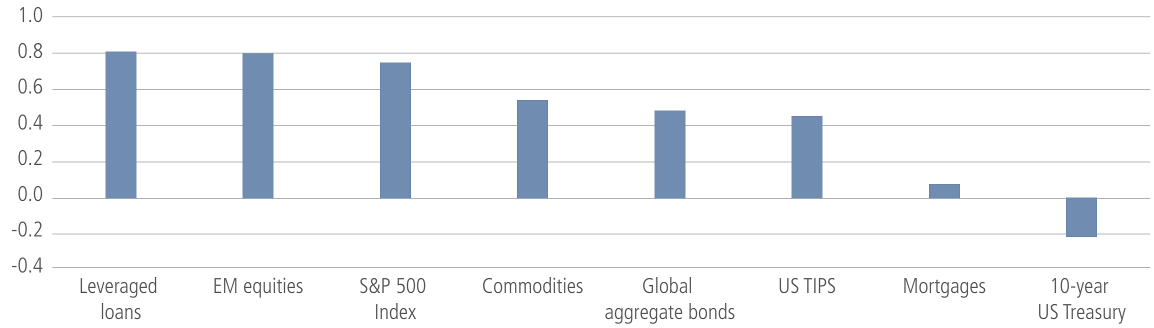
FIGURE 3A. YIELD LEVELS ACROSS A RANGE OF GLOBAL MARKETS



Source: Bank of America Merrill Lynch; S&P Dow Jones Indices; Bloomberg; Barclays POINT; JPMorgan; FTSE Russell. Indices referenced are: BofAML HY EM Corporate Plus Index; BofAML Global High Yield Index; BofAML U.S. High Yield Master II Constrained Index; BofAML European Currency High Yield Non-Financials Constrained Index; JPM EMBI Global Diversified Index; S&P/LSTA Leveraged Loan 100 Index; Barclays U.S. Non-Agency CMBS; Russell 2000 Index. Data as of February 26, 2018.

FIGURE 3B. HIGH YIELD DIVERSIFIES A PORTFOLIO…

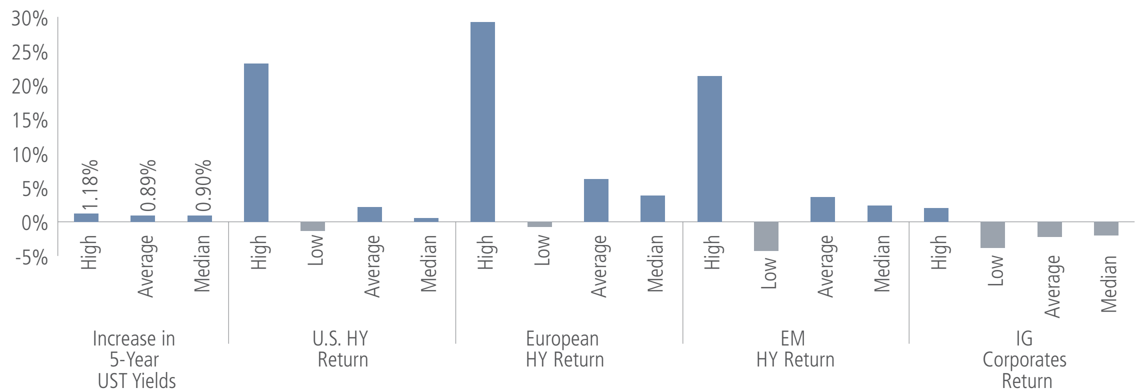
Correlations over 10 years



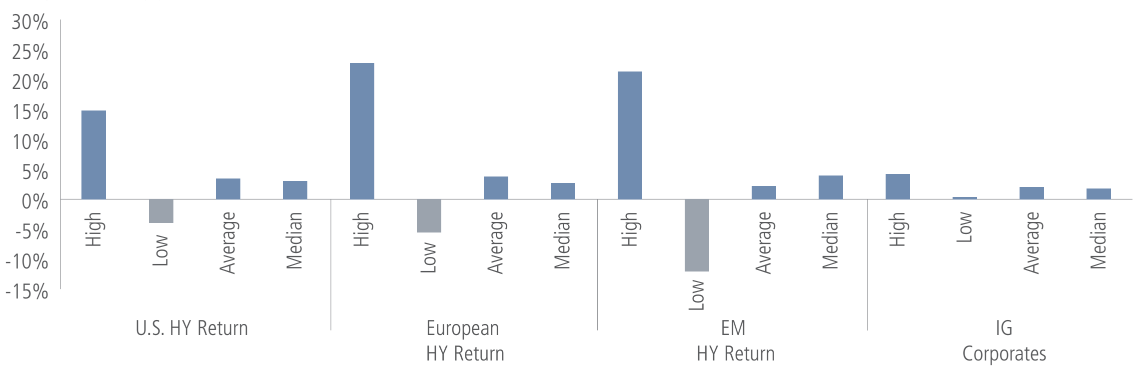
Source: Neuberger Berman and FactSet. As of June 30, 2016. Indices used in correlation analysis—Global High Yield: Barclays Global High Yield; Commodities: S&P GSCI Index; EM Equities: MSCI Emerging Markets Index; Global Aggregate: Barclays Capital Global Aggregate Bond Index; 10-Yr Treasury: ML U.S. Treasury Current 10 Yr; Leveraged Loans: Credit Suisse Leveraged Loan Index; Mortgages: ML U.S. Mortgage Master Index; U.S. TIPS: Barclays U.S. TIPS Index.

FIGURE 3C. …AND TENDS TO DO WELL WHILE U.S. RATES ARE RISING

Return to high yield and investment grade markets during three-month periods of rising U.S. Treasury yields, 2000 – 2015



Return to high yield and investment-grade markets in the three months immediately following a three-month period of rising US Treasury yields, 2000 – 2015



Source: Bank of America Merill Lynch. BofAML U.S. High Yield Master II Index; BofAML European Currency High Yield Index; BofAML High Yield Emerging Market Corporates Plus Index; BofAML U.S. Corp & Govt Master Index. The periods of rising U.S. Treasury yields are the three months ending in Jan 2000, Jan 2002, Aug 2003, Jun 2004, May 2008, Jun 2009, Dec 2010 and Jul 2013.

This makes fundamental sense in the U.S. and European contexts: the wider credit spread, relative to investment grade, acts as a cushion, and tightening monetary policy is usually a response to healthy levels of economic activity, which improves companies' bottom lines and generates the cash that services their debt.

Things become a little more complex in the emerging markets. One view is that emerging markets react more negatively to rising U.S. Treasury yields than developed. The 10% drawdown that emerging high yield suffered during the 2013 "Taper Tantrum" was indeed painful compared with the 2 – 3% lost in the developed markets. On the other hand, within emerging markets sovereign bond indices tend to sell off harder than corporate indices when a rising U.S. rates trade kicks in and, as Figure 3C shows, the overall experience for emerging market high yield remains positive, on average. The data suggests that, over the past 18 years, emerging markets high yield bonds have reacted, on average, more positively than the U.S. market in the short term, and in line with both the U.S. and Europe over the medium term.

While it is true that rising U.S. rates are often accompanied by a strengthening U.S. dollar, which can be problematic for borrowers that earn their revenues in local currencies but have issued bonds with dollar-denominated liabilities, these mismatches do not appear to represent a major risk to the asset class as a whole.

FIGURE 4. GLOBAL HIGH YIELD MARKETS: A QUICK COMPARISON

	BofAML Global HY (HW00)	BofAML U.S. HY Master II (H0A0)	BofAML European Curr HY (HP00)	BofAML HY EM Corp (EMHB)
No. of Issuers	3194	1898	611	731
Full Market Value	$2.17trn	$1.29trn	$421bn	$504bn
Yield to Worst	5.22%	5.84%	2.81%	5.41%
Spread (option adjusted)	349	363	294	348
Average Credit Rating	B1	B1	BB3	BB3
Effective Duration	4.03 years	4.04 years	3.92 years	4.04 years

Source: BofAML. As of December 31, 2017.

Adding The Emerging Markets Index To The U.S. Index Today Improves Credit Quality Without Narrowing Speads

Generally investors in emerging market high yield today enjoy similar yields and spreads, on average, as they do in U.S. high yield, ostensibly for better credit risk. Looking at spreads-to-worst across these markets in Figure 4, emerging market corporates traded at around 350 basis points and U.S. high yield at around 360 at the end of 2017. That spread differential is more than accounted for by the superior credit rating of the emerging markets index (BB3 versus B1).

The higher average credit rating seemingly is justified by underlying the fundamentals set out in Figures 5A and 5B. While high yield corporate leverage in emerging markets has been converging on that in the U.S. recently, it remains lower. Emerging high yield corporates are also more profitable. As such, emerging market default rates have been broadly in line with those in developed markets.

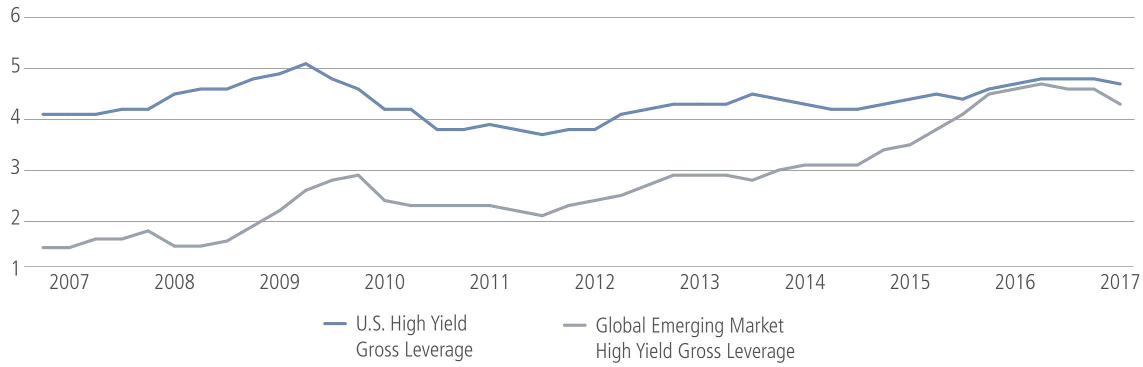
FIGURE 5A. HIGH YIELD LEVERAGE IS LOWER OUTSIDE THE U.S. …

	U.S. HY	EM HY	EURO HY
Net Leverage	4.1x	3.0x	3.6x
Interest Coverage	3.9x	3.7x	4.4x
Cash to Total Debt	10%	28%	19%
Gross Margin	31%	37%	30%

Source: Neuberger Berman and FactSet. As of June 30, 2017. Based on H0A0, HP00 and EMHB indices.

FIGURE 5B. …ALTHOUGH THE EMERGING WORLD IS CATCHING UP GROSS DEBT-TO-EBITDA

Gross debt-to-EBITDA (x) for high yield issuers



Source: Bank of America Merrill Lynch. Based on H0A0, and EMHB indices.

This background makes the case for including emerging markets alongside a U.S. high yield allocation compelling.

Adding The European Universe Today Generally Improves Credit Quality… But For Tighter Spreads

The valuation case for including European bonds is less clear. Figure 4 shows very clearly how much higher U.S. yields are relative to Europe's, and also a 70-bp difference in spread-to-worst. Nonetheless, that does not necessarily make European high yield hugely expensive relative to the U.S.

First, consider the macroeconomic picture. The U.S. and Europe are at different points in the economic, business and credit cycles. As rising default rates tend to lag rising interest rates by about two to three years, Europe could well enjoy another three years of low defaults. Moreover, the dramatic strengthening of the U.S. dollar against the euro during 2014–15 benefitted eurozone exporters and initiated a period of economic catch-up that should be supportive of high yield issuers.

Duration remains slightly higher in the U.S. universe (Figure 4), and this difference simply compounds the monetary policy divergence that already favors the European market: rates are likely to rise in the U.S. first, and U.S. high yield bonds are more exposed to them than Europe's. A look back at what happened during the "Taper Tantrum" of June 2013, when markets experienced their first jitters around the prospect of Federal Reserve tightening, makes the point: European high yield finished that month down 2.2% while U.S. high yield was down 2.6%, with the extra 40 basis points entirely attributable to the interest rate move. Interest rate differentials between the U.S. and other markets also make hedging costs expensive for non-U.S., dollar investors into dollar assets.

Turning to fundamentals, Figure 5A paints a very clear picture of how much less debt European high yield issuers are carrying than their U.S. counterparts, in general, how much more profitable they are, and how much more cash they hold. Recent years have seen a weakening in the covenants in high yield bond contract language, resulting in the terms of these contracts generally moving against investors and in favor of issuers. However, covenants still remain rather stronger for investors in Europe than in the U.S. The average credit rating in Europe is three to four notches better than that in the U.S.; and only 2% of the European index is rated CCC against 15% in the U.S.

Bringing The Three Together Generates Powerful Diversification Benefits

One current reason for the higher average spread available in the U.S. over Europe is the impact that the oil price collapse had on energy sector issuers since mid-2014. While energy accounts for 14% of the U.S. high yield index, it is only 5% of the European index.

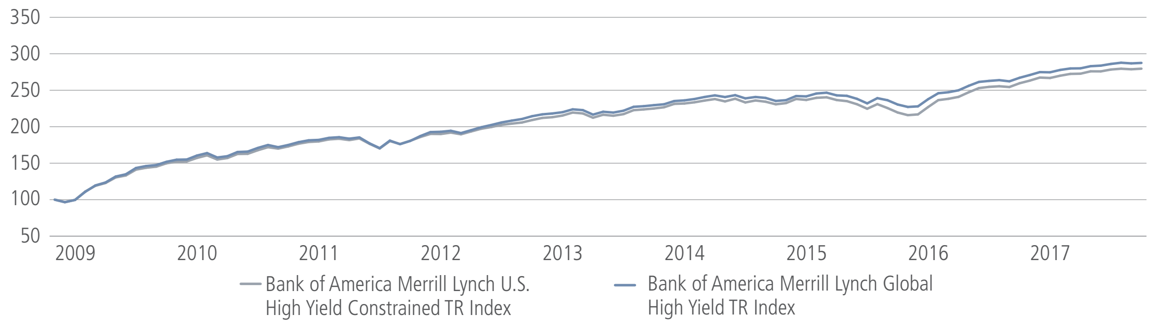
This brings us to the strongest argument for going global with a high yield allocation: diversification. This is not merely about adding 1,400 new bonds to your investment universe—these bonds come from markets whose profiles are substantially different from that of the U.S., and yet clearly belong to the same asset class.

The correlation statistics tell this story well. Over 10 years, monthly returns show high average correlation: 91% between U.S. and European high yield, 85% between U.S. and emerging markets, 83% between European and emerging markets. It makes sense to put these three together in the same portfolio. But correlation during the recent oil price rout was much weaker.

Add the outperformance by Europe that came from the low energy exposure in 2014 to the outperformance that came from new financial sector paper that flooded the European index in 2009, and we account for a lot of the extra return that global high yield has generated over U.S. since the banking crisis (Figures 6A and 6B). But of course the key point here is not that one set of sector exposures is better than the other—they are simply different.

FIGURE 6A: GLOBAL HIGH YIELD HAS BEEN OUTPERFORMING RECENTLY…

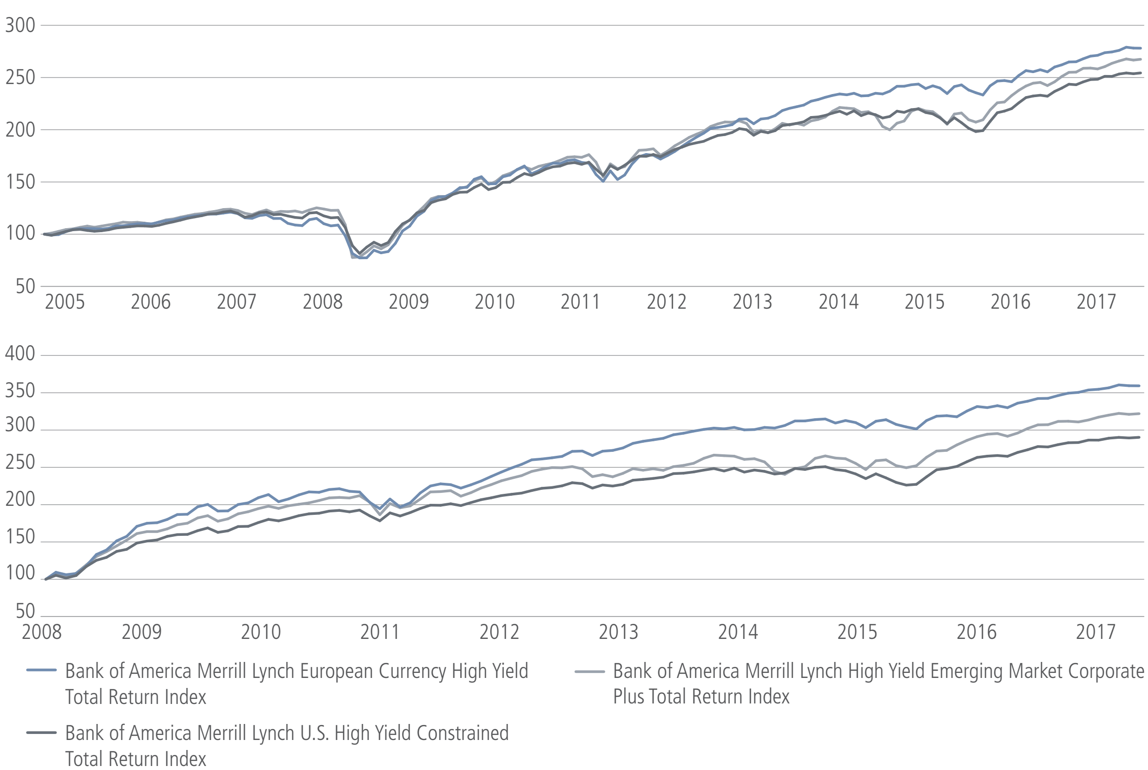
Total return in USD, rebased to 100



Source: Bank of America Merrill Lynch.

FIGURE 6B: …DRIVEN BY EUROPEAN HIGH YIELD, THE STAR PERFORMER SINCE 2009

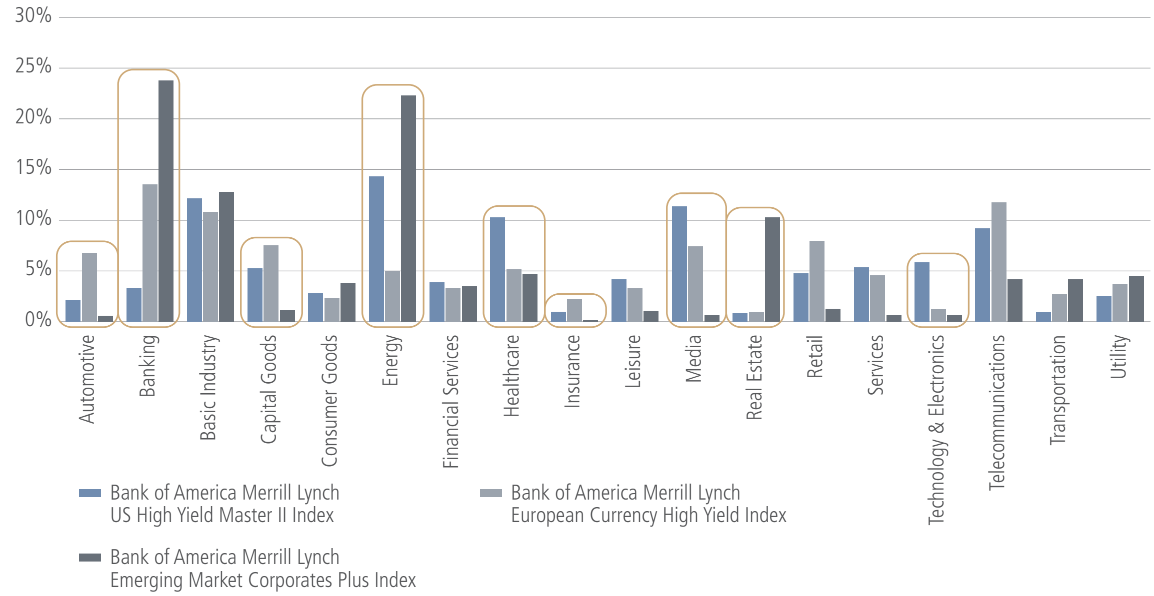
Total return in USD, rebased to 100



Source: Bank of America Merrill Lynch.

FIGURE 7A: EUROPEAN AND EMERGING HIGH YIELD MARKETS ADD MEANINGFUL SECTOR DIVERSIFICATION

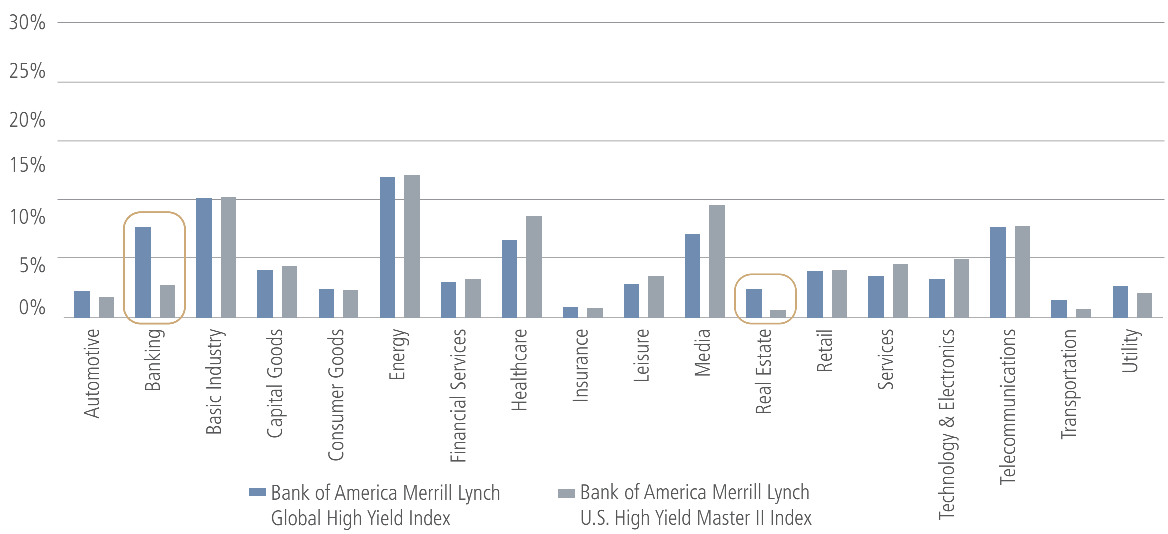
Index sector weights



Source: Bank of America Merrill Lynch.

FIGURE 7B: THOUGH LESS PRONOUNCED, THIS IS STILL EVIDENT AT THE GLOBAL INDEX LEVEL

Index sector weights



Source: Bank of America Merrill Lynch.

Figure 7A highlights the sectors in which there are meaningful differences in weights between the three markets: banking in Europe and emerging markets but other financial services in the U.S.; automotives in Europe; capital goods, services, insurance and media in the U.S. and Europe; energy in the U.S. and emerging; technology in the U.S.; real estate in emerging.

When we augment U.S. high yield with Europe and emerging markets together in a global index, rather than separately, some of that sector-level diversification erodes (Figure 7B). But in reality, the diversification story here goes much deeper than the simple headline sectors. Take the banks, for example. Speculative-grade issues from these entities in Europe can be highly subordinated—certainly they tend to be high beta thanks to the investment banking exposure they carry. In emerging markets high yield, most banks are traditional commercial banks, often among the top three in their respective economies.

The infrastructure and utilities issuers that investors have in the emerging high yield index are also less common in the U.S. or Europe, especially when the extent of state ownership and credit quality are taken into account. Again, these tend to be lower-beta investments, leavening much of the volatility that investors might expect to be characteristic of an emerging market allocation. Moreover, investors might like to consider the sectors that are more heavily weighted in the emerging market index—commercial banking, energy, utilities, consumer goods and, especially, real estate—and their exposure to growing middle class consumption in these economies.

Adding Europe and emerging markets to a U.S. high yield allocation introduces an entirely new region and country vector for both diversification and tactical asset allocation, too, because the correlation between the fortunes of sovereigns and their domestic corporations is especially high and persistent in emerging markets and certain European markets. Corporates often crack if their respective sovereigns head toward default—not least because this is often a symptom of high current account deficits and low GDP growth, which may reflect activity at the corporate level. More than 40% of the value lost in emerging market corporate defaults since 2000 occurred in just three countries: Argentina, Brazil and Mexico.

In short, while top-down asset allocation across sectors, regions and countries can be important during economic inflection points in U.S. and European high yield, in emerging markets it has to be a consistent part of a successful investment process, and that brings an additional source of risk, diversification and excess return to a global high yield portfolio. All of this can be exploited even before investors turn to the additional opportunity they would now enjoy, to allocate between these three distinct buckets of regional risk.

Conclusion

In summary, the case for going global with a high yield allocation could easily be made by simple reference to the size and growth of European and emerging markets today.

The deeper argument takes into account the added industrial sector balance, the entirely new source of diversification and alpha introduced by country-of-issuer risk, and the better quality credit fundamentals found in these markets. These are clear positives even before we take account of the extra spread available from the emerging markets.

Maintaining a U.S. high yield allocation may be a perfectly reasonable thing to do, of course. Many investors will continue to do just that. However, the assumption that a U.S. allocation is effectively a global allocation that brings all of the same potential benefits no longer stands up to serious scrutiny. We believe that the time has come for high yield investing to go truly global.

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