NEUBERGER | BERMAN

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Finding Yield in Europe—and Beyond

European investors in investment grade fixed income have been struggling with yields of less than 1% for the better part of seven years. The pandemic crisis only exacerbated the problem. While 2021 has seen a rapid rise in yields in response to economic recovery, an uptick in inflation and global stimulus plans, it is likely to be a long time before they are back to anything like normal levels.

If you can't afford to wait, what are the potential solutions? Here are six possibilities to explore.

1. Portugal

The Eurozone's southern sovereign issuers are a common place to look for yield pick-up in government bonds, and they have drawn renewed attention since the agreement of the €750bn Next Generation E.U. Recovery instrument, which put lingering concerns about the integrity of the single currency to rest.

Italy, with its large bond market and Mario Draghi as its new Prime Minister, is the obvious choice. Portugal is often overlooked. It may yield a little less, but it presents much less political risk, is one the chief beneficiaries of the recovery funds which start to be disbursed in July and, after competent handling of the pandemic, looks set to remain open for a booming summer tourism season. In the event of any tightening of risk appetite, we think Portuguese government bonds will provide some downside diversification against other southern eurozone sovereigns.

FIGURE 1. PORTUGAL: YIELD PICK-UP WITH LESS POLITICAL UNCERTAINTY

Source: Bloomberg. Data as of May 27, 2021.

2. Cyclical Laggards and 3. "Rising Stars"

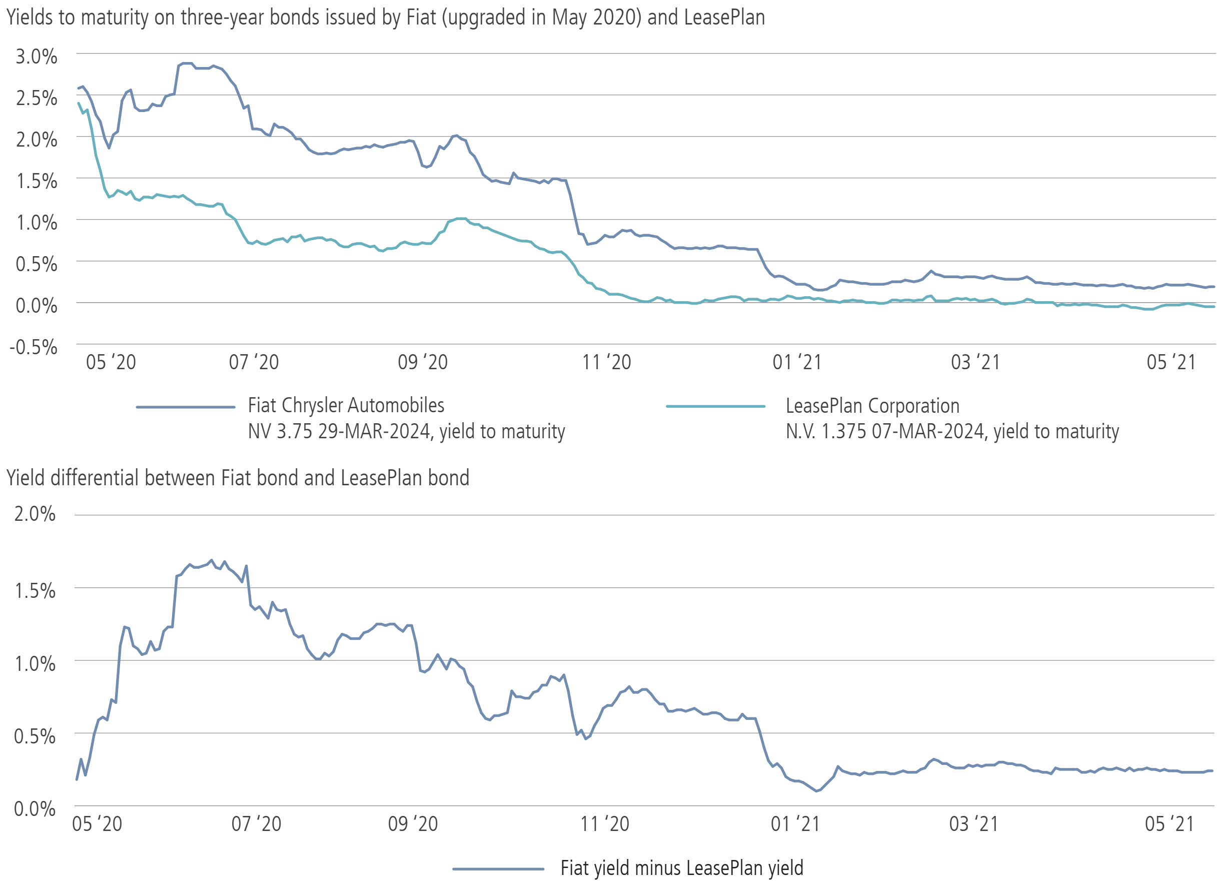
Turning to credit markets, we see a number of opportunities for those investors prepared to adopt a flexible, "go anywhere" approach.

While cyclical sectors have generally benefitted from the anticipated re-opening of the economy, some, such as autos, have led the pack while others, such as services, real estate and communication, have lagged. There may be opportunities for spread compression in these sectors as coronavirus vaccination programs continue to roll out and the recovery gains traction.

We see a similar spread-compression play among so-called "rising stars"—high yield-rated corporate issuers that have been or are about to be upgraded to investment grade. This is likely to be an important theme in credit markets over the coming months, as many pandemic-related downgrades get reversed.

In figure 2 we show the fairly typical case of the auto manufacturer Fiat, which was upgraded from BB to BBB- in May 2020. The key thing to note here is that rising stars tend not to get re-priced to investment-grade level immediately, which means they often enjoy a long period of outperformance relative to their investment-grade peers. The chart shows Fiat's steady yield compression versus the Dutch auto leasing company, LeasePlan, starting in July 2020, two months after its upgrade. The gradual spread compression that comes from an upgrade is likely to more than compensate for rising yields.

FIGURE 2. RISING STARS' YIELD COMPRESSION TENDS TO BE GRADUAL FOLLOWING AN UPGRADE



Source: Bloomberg. Data as of May 27, 2021.

4. Roll-down in Corporate Bond Curves

As well as looking across different sectors and different credit-rating bands in corporate bonds, it is well worth looking at different points on the maturity curve.

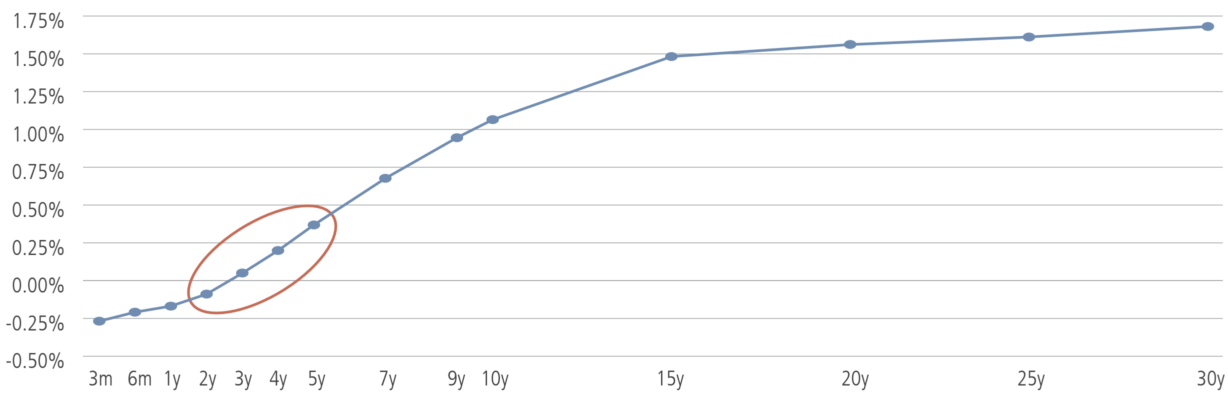
Right now, things are very interesting between the two-year and the five-year points on European credit curves. Yields out to two years are anchored close to the German sovereign curve by the European Central Bank's forward guidance on interest rates, and by massive demand for short-dated bonds. There is a marked, 40- to 50-basis-point jump in yields as we venture beyond that point, however, as we show in figure 3 for BBB rated industrials sector issuers.

This steepness in the curve presents an unusually impactful opportunity for roll-down return. This is the return investors get for simply holding a bond as it "rolls down" the maturity curve. It is intuitive that shorter-dated bonds have lower yields than longer-dated bonds, given that yield curves tend to slope upwards. Over the 24 months it takes for a four-year bond to become a two-year bond, therefore, part of its total return is the return that comes from that lowering of its yield—and the steeper the curve, the more pronounced that roll-down return becomes.

To look at it another way, if you bought a three-year bond with the intent to hold it for a year, the difference between the yield on your bond and the yield on a two-year bond from the same issuer is the amount that the yield on your bond would have to rise before it exceeds its yield to maturity when you bought it (or before its price falls below your purchase price). In other words, roll-down return can act as a buffer against rising yields.

FIGURE 3. ATTRACTIVE ROLL-DOWN OPPORTUNITY IN CREDIT CURVES

Yield curve, BBB rated euro Industrials, Bloomberg Barclays Euro Corporate Index



Source: Bloomberg. Data as of May 27, 2021.

5. Subordinated Securities

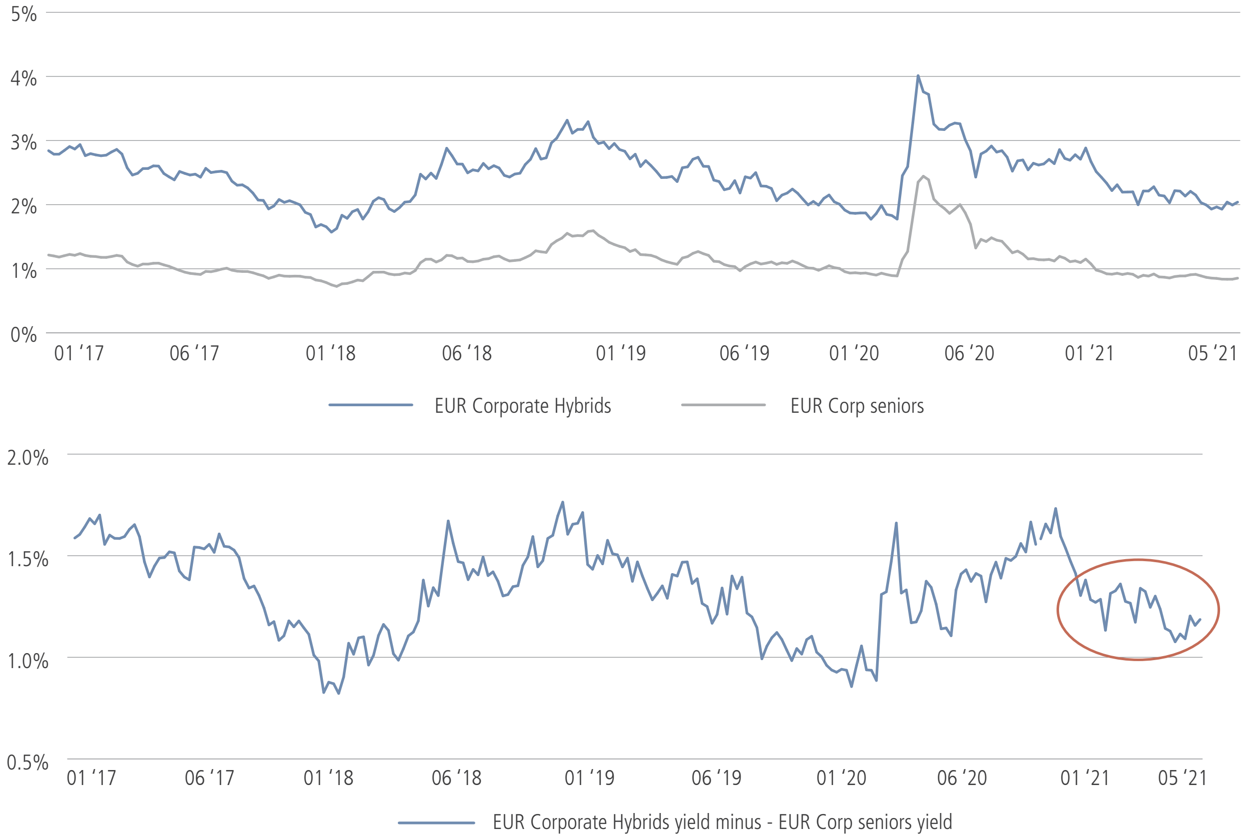
We've looked across sectors, across credit ratings and across maturities. Now let's look across issuers' capital structures.

Investors tend to think of companies issuing equity and issuing debt. But both banks and corporates issue securities that have the features of debt but can be converted to equity. In the case of banks, these are Additional Tier 1 securities, which can be forcibly converted to equity by the banking regulator in the event of the institution falling into distress. In the case of corporates, these are hybrid securities, which come with options that the issuer can trigger to make them more like equity-like, such as temporarily skipping coupon payments or choosing not to call the securities at their first call date. These conversion events are extremely rare, particularly among corporate hybrids, where there are strong incentives not to use the options and where the issuers are overwhelmingly investment-grade, non-cyclical companies.

Nonetheless, as one would expect, these subordinated securities trade with structurally higher yields than senior bonds from the same issuers, and that spread tends to widen when the broader market is volatile. The opportunity we see at the moment has arisen because the rapid spread compression between corporate hybrids and seniors that started in November last year, on news of successful coronavirus vaccines, has stalled in the first quarter of this year due to a crowded new issue calendar. Once that pipeline clears, we anticipate further compression, making corporate hybrids an interesting candidate to "barbell" against low-yielding senior bonds, for both yield pick-up and capital appreciation.

FIGURE 4. SUBORDINATED HYBRID YIELD COMPRESSION STALLED IN Q1 2021

Euro corporate hybrid yields over senior yields



Source: Bloomberg. Indices used are the Bloomberg Barclays Euro Universal Corporate ex Financials Hybrid Capital Securities Index and the Bloomberg Barclays Euro Corporate Bond Index. Data as of May 27, 2021.

6. Currency-hedged Non-euro Sovereign Bonds

In the spirit of "going anywhere" for yield, a final suggestion is that euro investors consider non-euro sovereign bonds, hedged back to their home currency.

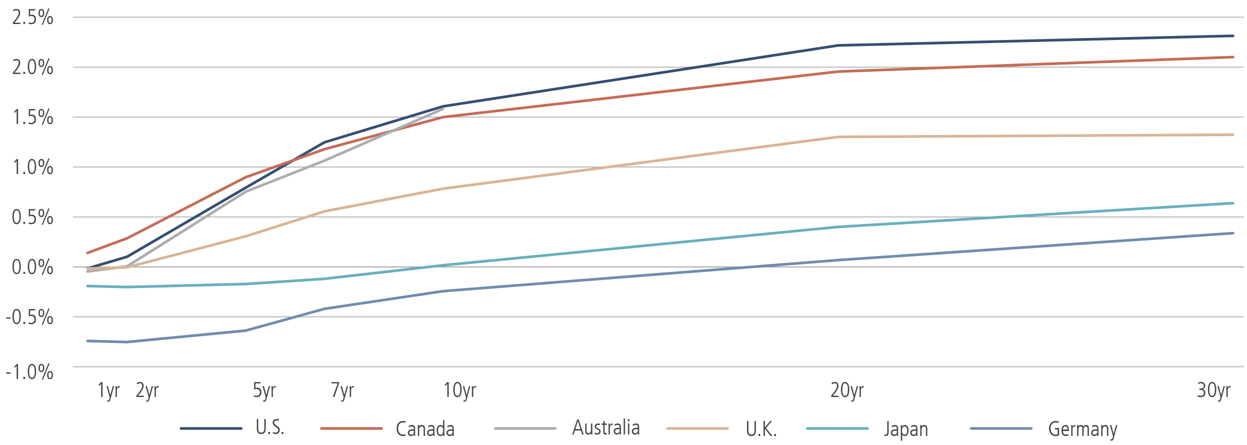
With a negative rate on the euro, hedging does come with a cost against most other currencies, but in many cases that is more than compensated for by the yield pick-up, which is shown across several curves in figure 5.

This is not to say that the highest-yielding sovereigns are necessarily the most attractive investments, however. We think that the yields on U.S., U.K., Canadian and Australian bonds, though relatively high now, are likely to go higher still. Instead, investors could consider looking for a market where there is good reason to anticipate stable yields. The prime candidate is Japanese Government Bonds, due to persistent disinflation in Japan and the central bank's ongoing efforts to cap long-dated interest rates with its yield-curve control policy.

At the 10-year point on the curve, even with a fully currency-hedged position, Japanese bonds offer a slightly positive yield in comparison to the negative yield on the German Bund. Depending on the maturity, these currency-hedged positions deliver a 20- to 30-basis-point premium over core euro government bonds.

FIGURE 5. OPPORTUNITIES BEYOND THE EURO ZONE

Government yield curves



Source: FactSet. Data as of May 27, 2021.

To sum up, finding yield in Europe has been a challenge for some time, and it's a challenge that's unlikely to go away soon. Until normalization returns, there are ways to mitigate the problem. The key is a flexible, "go anywhere" approach, which enables an investor to seek out attractively priced risk across sectors, credit rating bands, maturities and capital structures, and ultimately outside the Eurozone itself, before building them into a portfolio in a considered, well-diversified fashion.

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