

# High time for High Yield

## Why the weakness in HY is looking increasingly overdone

- Euro HY spreads have performed poorly this year, and September has been no exception. While the € iBoxx Corp is 20bp (18%) tighter year-to-date, the € iBoxx HY is 16bp (5%) wider.
- The collapse of Phones4U took the market by surprise, and, especially given the influx of first-time issuers to the market this year, investors have been re-evaluating some of their previous enthusiasm for €HY as a product.
- We think this has gone too far. With defaults at cyclical lows, and most of the releveraging [we've observed](#) occurring in higher-rated corporates, we reckon investors have become overly worried about idiosyncratic risk.
- Market conditions have deteriorated, particularly following the record outflows from both US and European HY funds in August. But the subdued supply volumes, the improving trend in HY fund flows and the reduction in HY longs from their pre-summer high shown in [our survey](#) means that the technical picture is stronger than many appreciate, in our view.
- The prospect of ECB QE underpins our positive view on HY. In our [base case](#), we expect a large-scale QE programme to begin in either Q4 this year or Q1 of 2015. Although these purchases will presumably be limited to IG securities, the crowding out effect should prove supportive for HY spreads too.
- We think the market isn't currently pricing the impact of this effect sufficiently, and as a result, we think spreads at current levels make an attractive entry point for going long. We forecast the € iBoxx HY to hit 290bp by year-end, from 346bp now.
- The "trickledown" phenomenon is likely to have its biggest impact on higher-quality parts of the HY market, as investors crowded out of IG are more likely to buy BBs than CCCs. Furthermore, given that low-beta HY bonds have contributed disproportionately to the selloff in HY since June, it's these bonds that have the greatest scope for retracement, in our view.

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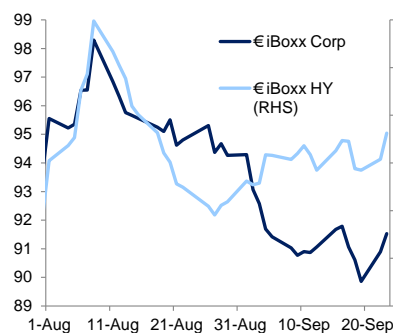
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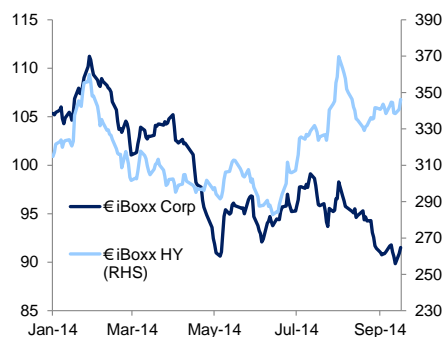
Notwithstanding the wobble over the last couple of days, September has so far proven to be a relatively positive month for IG cash spreads, with the €iBoxx Corp now 3bp (3%) tighter than where it was at the end of August. Sentiment in HY, however, has failed to improve, and the €iBoxx HY is 14bp (4%) wider over the month. The disparity becomes even more pronounced when looking further back: while IG spreads have tightened by 20bp (18%) so far this year, HY spreads are 16bp (5%) wider.

Figure 1. €iBoxx Corp vs. €iBoxx HY, 1 Aug – 22 Sep, OAS



Source: Citi Research, Markit

Figure 2. €iBoxx Corp vs. €iBoxx HY, YTD, OAS



Source: Citi Research, Markit

We think this underperformance is beginning to look overdone, particularly with the prospect of ECB QE being launched over the coming months. Even though we suspect any ECB asset purchases will be limited to IG securities, the “trickledown” effect should prove supportive for HY spreads too.

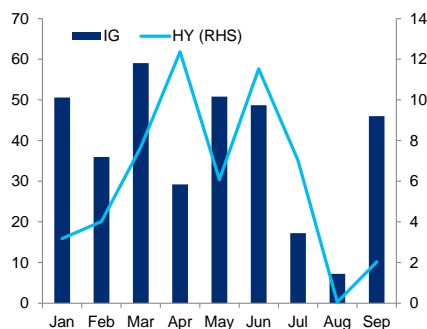
Although the current weakness may well have further to go in the near term, we expect spreads on the €iBoxx HY to reach 290bp by year-end, compared to 346bp now. This compares with the 11bp of tightening we forecast for the €iBoxx Corp.

### Why the decoupling?

Numerous factors have contributed to the underperformance of HY so far this year: for a start, technicals have been far less supportive. Euro-denominated HY has seen the largest volume of issuance in both gross (€54bn) and net (€47bn) terms on record. Much of this has come from first time issuers: we expect 75 new names to have entered the market by the end of the year. Conversely, net issuance in IG (€41bn) so far this year has been far less dramatic relative to history, with much of the increase in corporate issuance [being offset](#) by the ongoing contraction in senior financials.

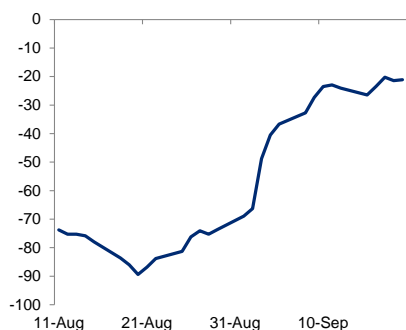
HY has also been particularly susceptible to the increased perceptions of geopolitical risk. This was evident in July, as investors cut some of their riskiest holdings as the situation in Ukraine deteriorated: while the €iBoxx Corp tightened by 2bp over the month, the €iBoxx HY ended July 29bp wider. The weakness in HY was compounded by record outflows from HY funds in August (\$7bn from US funds and \$859mn from European funds in the first week alone), and then again by the sudden collapse of Phones4U in September.

Figure 3. € Issuance volumes, IG & HY, €bn



Source: Citi Research, Dealogic

Figure 4. European daily HY Fund Flows, 22-day moving average, \$bn



Source: Citi Research, EPFR

### Why worry less now?

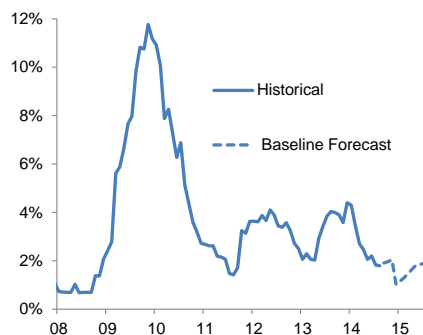
Yet we suspect that all of these factors are likely to weigh much less on euro HY going forward. The disparity in issuance has begun to reverse itself this month – while IG primary activity has picked up markedly, HY supply volumes have been relatively muted in September (Figure 3). Although we reckon HY primary activity is likely to pick up from these levels, the fact that we’ve seen so little of it since June has allowed HY investors’ cash balances to recover somewhat.

When it comes to geopolitics, it’s not just the fact that the September 5<sup>th</sup> ceasefire in Ukraine appears to be holding up that leaves us less worried. Our Global Political Analyst, Tina Fordham, [believes](#) that markets financial markets are likely to be relatively immune to geopolitical worries for the time being, given that these are mostly concentrated in areas without immediate direct significance for DM names.

Even when it comes to fund flows, the situation looks considerably less worrying than it did six weeks ago. European HY fund flows have been on an almost consistently improving trend for the last month (Figure 4). And the net picture remains far more positive in Europe than in the US. While US HY funds have seen \$4.5bn of net outflows over the last 12 months, European HY funds have had \$4bn of net inflows over the same period.

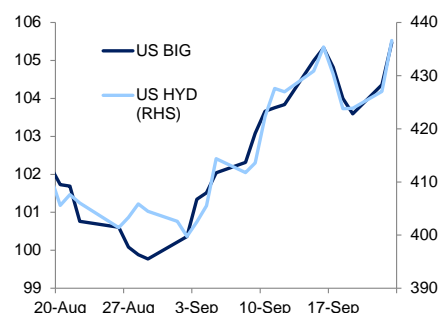
When it comes to idiosyncratic concerns, the Phones4U story certainly highlighted that highly-leveraged companies are susceptible to event-risk, when their business model is entirely dependent on a few key suppliers. But we doubt that this points towards deeper market malaise. The default outlook in Europe as a whole still looks relatively benign, with Moody’s predicting European default rates to fall to 1% by December (from 1.8% currently and 4% a year ago), in their baseline forecast (Figure 5).

Figure 5. Moody’s European 12-month issuer-weighted HY default rate



Source: Moody’s

Figure 6. US BIG OAS vs. US HYD spread to worst, bp



Source: Yieldbook

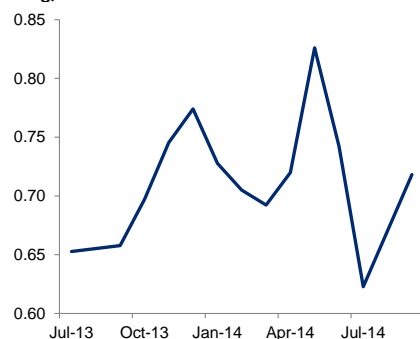
### And don’t forget the ECB...

To our minds, the biggest factor favouring HY at these levels is the prospect of additional ECB easing. We suspect that the reason euro HY and IG spreads have diverged this month, while they’ve traded in-line in dollars (Figure 6), is that while we’re only likely to see ECB QE if the Eurozone economy continues to deteriorate, ECB asset purchases will presumably be limited to the IG market, with limited impact on HY. Yet, as we argued in a recent [weekly](#), we think this underestimates the likely impact of “trickledown” as investors are crowded out of IG and are forced to look for opportunities elsewhere, with HY the most obvious alternative.

Of course, we think the immediate impact will be most keenly felt in the IG space, and this underpins our 80bp end-2014 forecast for IG spreads, from 91bp currently. But given that we believe much of the recent underperformance in HY relative to IG over the last month is attributable to the market not sufficiently discounting the impact of this crowding out effect, now is a good entry point for overweighting HY, in our view.

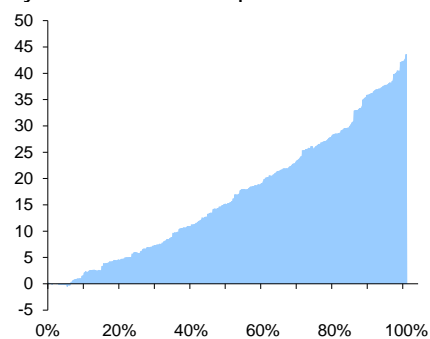
Investor positioning in HY should also be supportive if QE were to materialize, as we expect it to. While reported HY longs in [our survey](#) increased slightly in September, positions are still far less extended than they were at the start of the summer (Figure 7). This gives more scope for buying into the market were the outlook to brighten. And the fact that trading volumes are so low at present increases the scope for an abrupt reversal should increased ECB policy action draw nearer.

Figure 7. Global Credit Survey: overall positions in HY (Index, -2 Very Short, +2 Very Long)



Source: Citi Research

Figure 8. iBoxx € HY index, cumulative contribution to performance of bonds ranked by beta, 20 June – 22 September



Source: Citi Research, Markit. Note: Due to compositional changes and missing data the sample used in the charts does not correspond to the whole index.

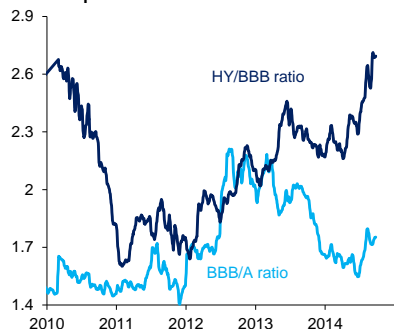
The effects of ECB QE are likely to be more keenly felt in some parts of the euro HY market than others. The line in our chart (Figure 8), which shows the cumulative contribution of each bond in the €iBoxx HY to index performance, ranked by beta, since June, rises almost linearly. This means that in risk-adjusted terms, low-beta bonds have contributed disproportionately to the selloff.

As [we argued](#) back in August, the low-beta underperformance is likely attributable to two main factors. Firstly, investors suffering outflows have cut the exposures they found easiest to liquidate, rather than where they perhaps ideally would have wanted to. Secondly, we suspect that much of the widening was due to IG funds cutting their off-benchmark exposure, and these funds are more likely to hold low-beta HY than CCCs.

This makes the argument from “trickledown” even stronger: if low-beta bond underperformance is partly due to IG investors cutting off-benchmark holdings, then these are the ones that are also most likely to benefit if ECB asset purchases push these investors back into HY again. Despite our generic preference for beta, we worry that HY bonds at the bottom of the quality spectrum may find it harder to perform, even in a QE scenario, given the subdued economic backdrop.

Weak technicals have helped to push HY spreads wider over the last few months relative to its IG counterpart. But with the HY / BBB spread ratio at the highest it's been in 5 years (Figure 9), we think this is looking increasingly overdone. While we'd be hesitant to call for an imminent retracement, we'd argue that spreads at current levels make an attractive entry point for going long.

Figure 9. iBoxx € HY / BBB spread ratio vs. BBB / A spread ratio



Source: Citi Research, Markit

## Appendix A-1

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