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INVESTMENT MANAGEMENT

# In a High Yield Minute: European High Yield Update

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There are two main triggers for default; (1) inability to repay a debt when due and (2) inability to meet a debt service payment.

In general, companies in the European high yield market have taken advantage of easy monetary conditions and low refinancing costs in recent years to term out debt; the next maturity hump isn't until the second half of 2022. Refinancing risk is not really an issue right now.

Paying coupons is another story. COVID-19 means that most sectors have seen a significant decline in revenues, with some companies literally having to shut up shop while lockdown measures took hold across Europe. This will weigh on the liquidity profile of companies in the asset class and, for the companies that do not have a rainy day fund, coupons are now at risk. This led to a material sell-off in the European high yield market[1] in March, a sell-off from which we have only rebounded 40%.

Set against this risk is the scale of the actions that governments around the world, and particularly in Europe, are taking to mitigate the economic impact of this unprecedented crisis. Swift and decisive actions have been taken to ensure that companies whose liquidity profiles have been challenged as a result of the virus can bridge the gap. Many investors underappreciate the impact of these actions.

Some countries have been clear that this provision of liquidity is for companies which have been hurt as a result of the virus, and not companies that were struggling beforehand. The KfW website, for example, clearly specifies that a company may apply for a loan provided it was "not already experiencing difficulties on 31 December 2019." Other countries have taken a broader stance and companies that were arguably struggling pre-crisis have been able to access liquidity. We count close to fifteen examples of

[1] ICE BofAML European Currency High Yield 3% Constrained Ex-Sub Financials Index

corporates accessing state-guaranteed loans in the European high yield market so far, with many more reportedly in talks.

The central bank response has been strong and supportive of high yield on both sides of the Atlantic as well, with the European Central Bank (ECB) accepting fallen angels as collateral and the Fed buying high yield Exchange Traded Funds. There has even been speculation that the ECB will expand the remit of the Pandemic Emergency Purchase Programme to include fallen angels. If this were to happen, we believe this would go a long way in restoring investor confidence in the asset class.

To be clear, this policy response isn't a get out of jail free card. The journey ahead for corporates, particularly in high yield, will be daunting and arduous. Consumer behaviour will have changed in ways we don't really know or understand yet and it will be up to corporates to adapt to these changes to stay relevant. However, the extent to which governments and central banks are willing to step in represents a clear difference to the financial crisis and is supportive of high yield as an asset class.

**DEFINITIONS**

The **KfW,** formerly KfW Bankengruppe, is a German state-owned development bank, based in Frankfurt.

A **Fallen Angel**, in the investing world, is a bond that was initially given an investment-grade rating but has since been reduced to junk bond status. The downgrade is caused by a deterioration in the financial condition of the issuer.

**INDEX INFORMATION**

The **ICE BofAML European Currency High Yield 3% Constrained Ex-Sub Financials Index**: contains all non-Sub Financial securities in the ICE BofAML European Currency High Yield Index but caps issuer exposure at 3%. Index constituents are capitalization-weighted, based on their current amount outstanding, provided the total allocation to an individual issuer does not exceed 3%.

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