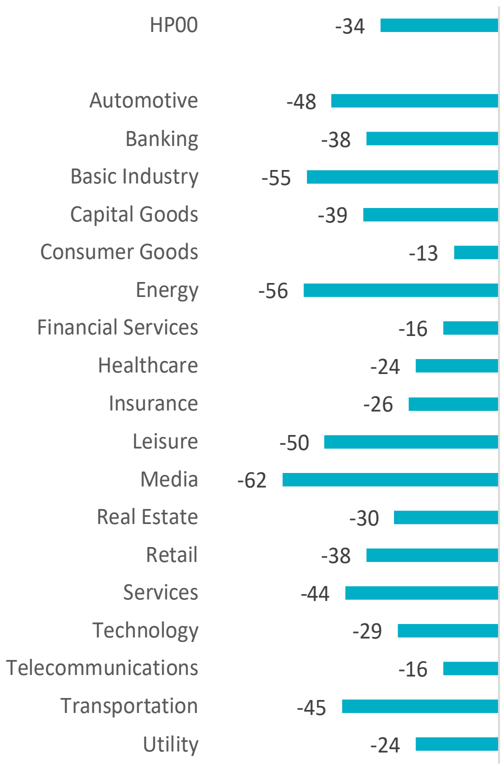
European High Yield

No new year hangover for markets

What's happening?



Source: Asset Swap Spreads changes MTD, Bloomberg, BofA Merrill Lynch AXA IM, 31/01/2023
[1]Shown for illustrative purposes only and should not be considered as an advice or a recommendation for an investment strategy

- We began 2023 with markets firmly turning the page on the turmoil of last year and delivering a very strong first month of this one. Sentiment was given a boost by further falls in the price of European energy, down 25% month-on-month in January and now back to levels last seen in September 2021 (source: Bloomberg). This has helped brighten the outlook for European economies and meant the Eurostoxx 600 returned +6.8% - its best start to a year since 2015 (source: Bloomberg)

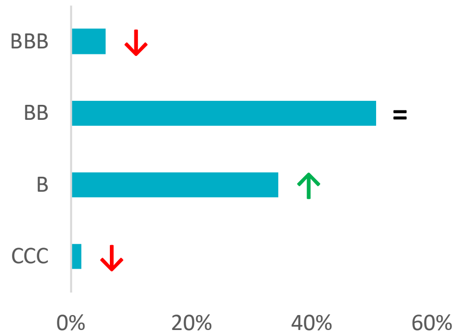
- China's rapid, and unexpected, pivot away from its zero Covid policy was also constructive for risky assets, as investors grew more optimistic that the reopening would support the global economy. Finally, markets were buoyed by an increasing consensus that central banks would begin to ease off on their rate rises. The Bank of Canada, which was one of the first from a developed economy to begin the hiking cycle last year, did indeed meet these expectations with a pause at its January meeting in the final week of the month

- Unsurprisingly, European High Yield was not left out of the rally – it returned +3.2%, its strongest start to the year since 2012. We saw heavy spread compression, with the weakest parts of the market faring best. Whilst BBs gained +2.9%, single-Bs were up +3.6% and CCCs an impressive 5.5% (sources: all Bloomberg)

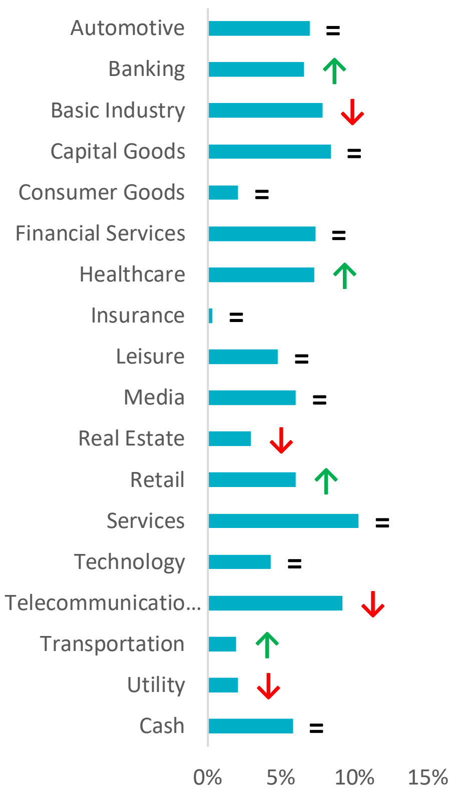
- For the first time in almost a year, we also finally saw the return of an active high-yield primary market. We participated in the deal for Lima Corporate (Healthcare), though Verisure (Services), Tereos (Consumer) and Italmatch (Basic Industries) also issued bonds (amongst others). These deals generally came with relatively limited new issue premia, and were heavily oversubscribed - no doubt a reflection of the pent up demand from investors for new paper. We also bought senior bank debt issued by Raiffeisen. Although this was rated investment grade, it came with an attractive yield that was comparable to higher-quality credits in our market

Short duration strategy characteristics	
Yield	5.99%
Spread	340 bps
Duration	1.85 yrs
Average rating	BB-
ESG score	6.0

Our Rating Positioning



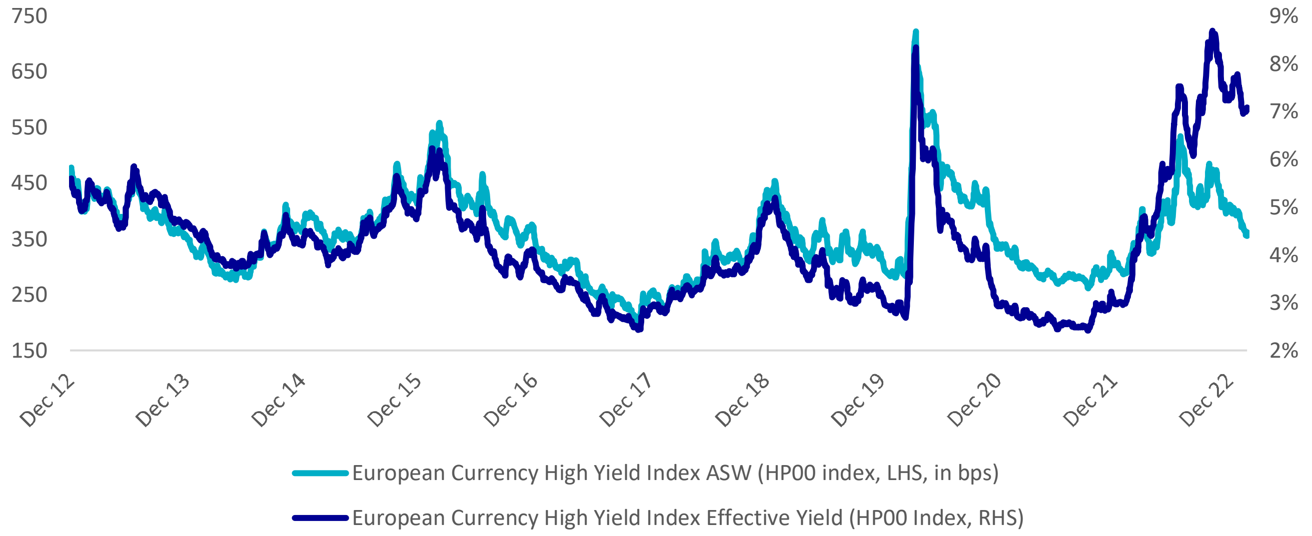
Our Sector Positioning



Short duration strategy positioning and performance

- The portfolio unsurprisingly lagged the performance of the wider high yield market, though it still captured over half of the gain
- We retain our preference for high-quality **BBs,** which we would expect to outperform on any renewed spread widening
- For the same reason, we are happy to keep **healthy cash balances** on hand, and have retained our **investment grade** exposure. This sits at over 5% of the fund, mainly in the **Banking** sector
- That said, and as the market outlook improves, we have been pairing this with increasing deployments into a small number of **high conviction B names**
- We remain **well diversified** by sector
- We continue to like defensive credits in **Capital Goods, Telecommunications** and **Healthcare,** and to avoid **Retail** and **Real Estate**

European High Yield Market Valuation



Source: ICE BofA Merrill Lynch, 31/01/2023

Outlook

It feels to us that the proverbial "fresh start" afforded by a near year has been particularly potent this January, allowing investors to put behind them the challenging performance, difficult markets and, most importantly, inflationary concerns of 2022 – and charge forwards into 2023 instead. For sure, the bullish data points mentioned above were helpful in driving the strong month that just finished. As we write just after the month end, and post a busy week of central bank meetings, it increasingly looks like the Fed and ECB may have done the same. Even if they haven't been explicitly more dovish, the hawkishness hasn't been ramped up either – and that seems to be enough for risk markets to declare the hiking cycle as good as over.

As is obvious from the performance numbers given above, the effect on our European high yield has been significant. The slight technical overhang of effectively closed primary markets, which represented a challenge to those issuers with imminent debt maturities, has turned into something of a tailwind. Good quality companies have continued to redeem their bonds, in many cases using the opportunity to reduce leverage and not replace the debt. These redemptions have so far outstripped the supply of new deals – providing a boost to the asset class. We ourselves are not immune to these pressures to put cash to work. Seeing bonds called, particularly from a couple of points below par, is always gratifying. But as markets continue to rally, the cost of not recycling these redemptions promptly is higher than it was.

That said, our outlook remains broadly the same. We still remain cautious as regards the medium term, since to us the chance of a perfectly seamless soft-landing appears slim. But we still think yields at the front end of the curve in particular are attractive and, in January, some of the concerns about refinancing have been allayed. Yes, spreads are lower than they were, but so are gas prices and, therefore, projected default rates. And whilst we therefore are not chasing this rally, and have been using the opportunity to rotate out of credits whose recent outperformance looks overdone, we are also happy to selectively increase certain holdings. With primary markets open and Europe safely through the winter, some of our favoured credits give us even more comfort about their prospects – even those that appear to be at the "riskier" end.

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