



European High Yield: Riding the Great Unwind

EXECUTIVE SUMMARY

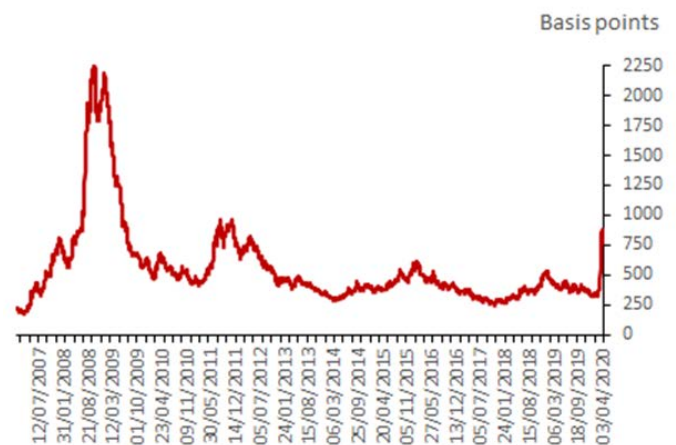
- European high yield has gone from the darling of fixed income to an unloved and almost un-investable asset class. We do not under-estimate the catastrophic humanitarian and economic cost of COVID-19. But we believe that the wild gyrations of recent weeks have created an excellent opportunity for an active manager to deliver strong returns over the medium term.
- The correction in valuations has been extreme: spreads have tripled. A re-rating was inevitable given the mark-down in the macro outlook, but valuations look to have over-shot the new reality thanks to market dislocation and extreme risk aversion. There is ample cushion here in spreads for the defaults that will inevitably come.
- There will be a global recession. But there will also be a policy response. Finance ministers will socialise losses and central banks will support markets. Their interests are aligned with credit investors. Europe will not allow the pandemic to trigger a cascade of defaults within the corporate sector, otherwise there will be no jobs for the population to go back to.
- The behavior of spreads in recent weeks follows a familiar pattern that is common to many crises. Spreads blow out, far in excess of the news on expected defaults, but then unwind at a sedate pace as new capital is only gradually deployed. Those who enter the market at an early stage in *The Great Unwind* can benefit from a significant and sustained compression in compensation for credit risk.
- A macroeconomic crisis is the moment for an active manager to shine. We will navigate through the coming default cycle and deliver strong returns with a determined focus on stable names and sectors, a keen understanding of where the support from the official sector may prove insufficient and by relentlessly stress testing corporate cash flows to identify the vulnerable.

EXTREME VALUATIONS

COVID-19 has had a catastrophic impact on society, the economy and financial markets. The death toll from the pandemic is already tragic. The authorities have been forced to lock-down society as a last resort to contain the spread of the disease and minimize the death toll. Locking down society will inevitably trigger a deep recession, and that demands a fundamental re-rating of financial assets which took place within febrile illiquid markets.

The change in sentiment in the European High Yield market was profound. The asset class went from being an oasis for investors searching for a yield in a fixed income desert of securities offering negative yields, to becoming virtually un-investable. Spreads tripled more or less, from a little less than 300 basis points to a high of about 900 basis points. Markets were dislocated. A flood of investors rushing to exit high yield ETFs all at the same time was predictably met with few takers. Those who sold had to take a hit in excess of 5% of NAV on exit. We believe an opportunity was created in this maelstrom. Markets have over-reacted, spreads have over-shot and that creates an opportunity.

High yield spreads



Source: Bloomberg, as of 6 April 2020.



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THE GREAT UNWIND

The blow-out in spreads in recent weeks has followed a familiar pattern that is common to most crises. A recent academic paper¹ on corporate credit risk in the *Review of Finance*, co-authored by the highly respected Professor Darrell Duffie, concludes:

"We find dramatic variation over time in credit risk premia even after normalizing these premia by expected default losses, median credit risk premia fluctuate over time by more than a factor of 10. Credit risk premia comove with macroeconomic indicators, even after controlling for variation in expected default losses, with higher premia per unit of expected loss during times of market-wide distress."

The research also documents a second key feature of the dynamics of credit risk premia over the cycle that is of particular significance to investors. Spreads may jump higher, but they crawl lower: risk premia only gradually decline from the highs observed in a crisis. Duffie and his co-authors conclude that this pattern is consistent with what economists refer to as frictions that slow the arrival of new risk capital into the market. In plain English this means money is being left on the table: those who invest at the beginning of this great unwind in spreads stand to benefit from a significant and sustained compression in the credit risk premium implicit in high yield bonds.

MACRO SCENARIO: PUTTING OUR FAITH IN POLICYMAKERS

A global recession is inevitable. There will be a formidable multi-dimensional squeeze on corporate cash-flow and profitability. Companies will face a combination of disruptions along supply chains, the loss of key labour input where tele-working is impossible, a sharp decline in demand, delays and defaults on trade credit receivables where customers are unable to pay for output that has already been sold, and access to credit of any form could become much harder to come by. But bills will still fall due. It is therefore no surprise that investors have become more concerned about the possibility of widespread defaults.

We do not challenge this global recession scenario but we think it is incomplete in three vital respects, which suggest a more constructive outlook for high yield.

- i. *The politicians are choosing to have a recession only for so long as we cannot control the spread of the virus without shut-downs* : the authorities have chosen to shut-down the economy and trigger a recession because this is the only way to control the spread of the disease. There is a huge economic cost but the authorities quite rightly consider this a price worth paying to save lives. Once the authorities can implement an effective alternative strategy to control the spread of the virus they will do so. In practice, that means some combination of: mass diagnostic testing and contact tracing; serological testing to identify those with acquired immunity; increased capacity of the healthcare to deal with acute cases; and continued self-isolation of the vulnerable. Once we can safely learn to live with the virus, the social distancing measures will be lifted and the economy will recover.
- ii. *Finance ministers cannot allow a default cascade to happen; otherwise there will not be a recovery in demand after the shut-down ends*: the politicians understand it is essential that the losses that are incurred by households and companies during the shut-down must be socialised if there is to be a robust recovery afterwards and a depression is to be avoided. If the recession eviscerates net worth in the corporate sector during the shut-downs, driving many companies close to or over the default threshold then there will not be enough jobs for the population to go back to once the shut-downs end. The interests of credit investors and the authorities are therefore aligned. From a macro perspective the cornerstone of the economic policy response to the pandemic is fiscal – that is, the various support measures that finance ministers have put in place to nurse companies through the lock-downs: to defer tax liabilities, to cover the cost of wage-bill, to provide cheap access to credit, and so on, as well as stimulus measures designed to speed the recovery once the shut-downs end. But from an investment perspective, the stance of monetary policy is also relevant.
- iii. *Central banks will suppress yields and spreads and will indirectly boost demand for high yield debt*: the global central banking community has already responded to the crisis by cutting interest rates where possible and resuming asset purchases. Bond buying programmes should both help to suppress risk-free yields, thereby creating the essential space for finance ministers to provide more support – including to companies, but also to contain spreads. The ECB may not buy high yield bonds but its own research² suggests that purchases of investment grade paper had an indirect positive impact on the high yield market. The ECB created a scarcity of the bonds that are eligible under the scheme prompting investors to rebalance their portfolios towards other similar, but riskier, segments of the corporate bond market. Moreover, once the immediate panic fades then we should expect investors to begin searching for yield once more, at which point high yield will once again appear an attractive proposition given a huge proportion of euro-denominated fixed income securities that will once again be offering negative returns.

¹ Berndt, A, Douglas, R, Duffie, D and Ferguson, M (2018), 'Corporate Credit Risk Premia', *Review of Finance*, 22(2), March, pp. 419–454.

² Zaghini, A (2020), 'How ECB purchases of corporate bonds helped reduce firms' borrowing costs', ECB Research Bulletin, 28 January.

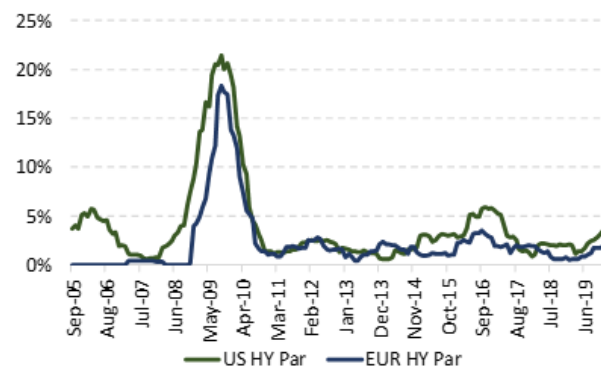
SPREADS MORE THAN COMPENSATE INVESTORS FOR COMING DEFAULT

The question as always at this stage in the cycle when spreads have already blown out in anticipation of looming defaults is whether spreads offer adequate compensation for credit risk. In our judgement, spreads are more than adequate. It should be possible to deliver solid returns even as those defaults crystallise. To fix ideas, a spread of 600 basis points is consistent with an expected default rate of 10% and an expected recovery rate of 40%. In other words, current spreads are pricing in an economic scenario on a par with the Global Financial Crisis. It is worth keeping in mind that even in the GFC, with defaults peaking in low double digits, investors still made 50% return on their money, including the credit losses. Currently, estimates that have come from S&P and various other banks have put the default estimates for European high yield at a range of 5-9% for the full year 2020. A rapid decline in default is then expect. Also, our assumption is that default will be less severe in Europe than in the US, owing to the low exposure to the energy sector in Europe vs the US. Also, there will be more willingness for the bank heavy European market to work through liquidity solution, than in the US where banks have less exposure. Finally, the bond maturity schedule in Europe is fairly benign as companies have largely refinanced and pushed out their debt maturities.

Of course, default and recovery rates are not just a function of the path of GDP. The absolute level of interest rates, the maturity structure of debt and the scope of loan covenants will all play a role in determining the incidence of default for a given macro scenario, and in this case, these ancillary factors look to be in investors favour, pointing in the direction of fewer insolvencies.

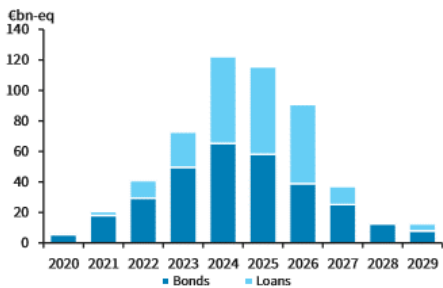
What will matter most in this recession is the support that companies can count on from the authorities and the banks to help them survive the squeeze on cash flow in the shut-downs. We expect the authorities to rise to that challenge to avoid the economy falling into a depression. However, we remain concerned that the capacity to support companies varies significantly from country to country according to the fiscal space that the sovereign enjoys. In other words, the health of the public finances in the country in which a company is resident may be a key determinant of its probability of default.

Default rates



Source: Bank of America Merrill Lynch .

A benign maturity profile for European high yield



Source: Bloomberg Barclays Indices, S&P LCD, Barclays Research

Source: Bank of America Merrill Lynch .

ACTIVE MANAGERS INVESTMENT PLAY-BOOK FOR COVID-19

If ever there was a moment for active management, this is it. Passive investments in high yield can give you exposure to The Great Unwind – the gradual compression in spreads as new risk capital is deployed. But it leaves you exposed to the losses from the defaults that must inevitably come. An active manager can out-perform through prudent security selection, minimizing the downside from defaults whilst still delivering the potentially significant upside to clients. A prudent portfolio manager does not need to take undue risk to generate high single digit returns over a 12 – 24 month time horizon. But that requires an understanding of where the defaults will occur and a plan to navigate through the default cycle.

We believe that most of the defaults are likely to occur among companies that were already treading water before the economy came to a juddering halt. Of course, some of these companies may survive the recession thanks to comprehensive support from the authorities or the banks, and it might make sense to add these names if we are confident that the support will come in a credit friendly way. However, we do not envisage a bail-out for business models that have been disrupted beyond repair by technological change, from the struggling fashion retailer to the small auto supplier. These are names best avoided.

Our play-book for delivering strong returns is based on the following core principles:

- i. **Stress test to identify the vulnerable:** we will stress companies with an assumption of two or even three quarters of severely depressed earnings to examine those which are most exposed from a cash flow and liquidity perspective;
- ii. **Bias towards resilience:** we will focus on stable names and stable sectors (healthcare, telecoms, and packaging sectors) and those resilient cyclical names, that have sufficient liquidity and balance sheet strength to allow them to survive the shut-downs;
- iii. **Identify value:** we can leverage our in-depth knowledge of individual credits to buy quality paper at yields that were not imaginable just a month ago. In times of market stress, bonds can become mis-priced. We think it pays not to panic and to take a long-term view.

INTRODUCING OUR FLAGSHIP

We entered the crisis with a high conviction underweight on “cyclicals” in our flagship fund, expressed across a number of sectors like retailers (consumer cyclicals), autos, travel and chemicals. These four sectors represent the largest performance contributors in our performance attribution. For more details on positioning in our flagship and the impact on performance please see the table below in which positions are expressed in terms of active DTS, duration times spread, with a positive number indicating an overweight, and a negative number indicating an underweight.

A summary of our flagship fund: key positions and impact on performance

Sector	Active DTS contribution	Active TR YTD (bps)	Sector	Active DTS contribution	Active TR YTD (bps)
Portfolio	150	176	Capital Goods	8	2
Automotive	-75	94	Gaming	37	1
Consumer Cyclical	-105	65	ETFs	0	0
Chemicals	-65	54	Real Estate	7	-1
Travel & Leisure	-69	43	Option	0	-1
FX (hedge only)	0	36	Term Contracts	0	-1
Derivatives	18	31	Energy	-26	-2
Consumer Non-Cyclical	46	20	Cash & cash equivalents	0	-3
Services	8	17	Technology & Electronics	37	-4
Utility	-34	15	Other	12	-5
Media Non-Cable	-56	11	Funds	38	-23
Building & Construction	-2	9	ABS	64	-27
Healthcare	14	8	Media-Cable	65	-33
Forestry/Paper	-8	6	Telecommunications	48	-45
Basic Industry	-2	5	Finance	189	-96

Note: Active DTS contribution calculated as an average across March.

That positioning served us well during the crisis. Our flagship fund was relatively resilient during what proved to be an extreme sell-off, and has significantly out-performed versus our benchmark. This followed a very strong year in absolute performance in 2019 where we delivered more than the benchmark. We think our robust top down and single name selection process has enabled us to navigate successfully both strong up and down markets and these skills will be key to continuing to deliver solid risk adjusted above benchmark returns.

Flagship performance (gross of fees)

TR (Bp)	2018	2019	Jan. 2020	Feb. 2020	Mar. 2020	YTD 2020
Portfolio	(262)	1,164	74	(143)	(1,183)	(1,245)
Benchmark	(312)	1,033	(5)	(186)	(1,237)	(1,405)
Active	50	131	79	43	54	160

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