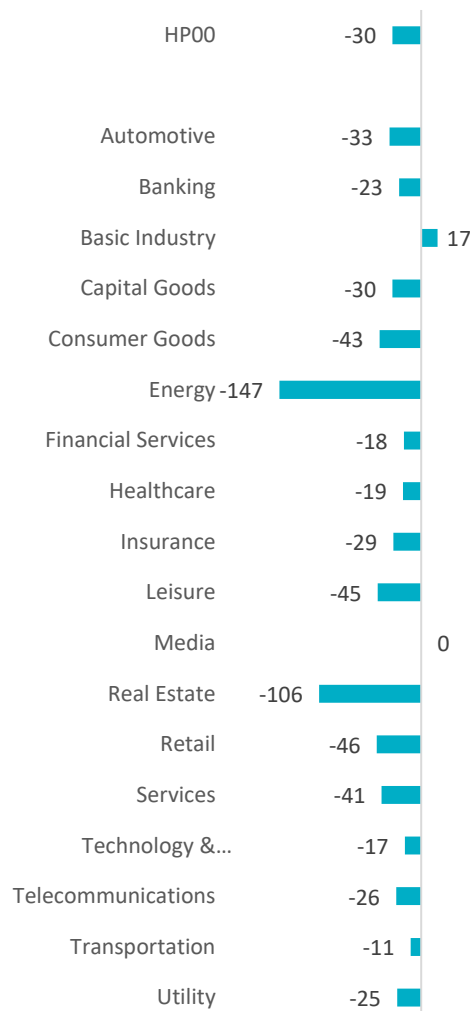


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# European High Yield

## Risk assets continue to leap higher

### What's happening



Source: Asset Swap Spreads changes MTD, Bloomberg, BofA AXA IM, 29/02/2024.<sup>1</sup>Shown for illustrative purposes only and should not be considered as an advice or a recommendation for an investment strategy

- February was another strong month for risk assets. A number of equity indices, including the CAC40 and the DAX in Europe, set record highs. Further afield, the S&P500 passed 5,000 for the first time and the Japanese Nikkei finally exceeded its previous high water mark from 1989. This was largely all due to a combination of continued macroeconomic strength, and further excitement around the potential of AI. The only wrinkle remains the stubbornness of the US inflation figures. The Core CPI print for January came in at a higher-than-expected +0.4% - pushing the annualised rate up to +4.0% and prompting further rises in government bond yields.
- Indeed, investors continued to reduce the implied probabilities of interest rate cuts by central banks. Neither the Fed or the ECB are now expected to do this until at least June, and the number of 25bps cuts assumed by the end of 2024 has reduced to close to three (from over six at the start of the year). The result was that in February the 10-year Bund yield rose to 2.4% and the 10-year US Treasury yield to 4.3% - for the latter, this was the worst monthly performance since September.
- European high yield, driven by healthy excess returns, posted another month of gains. It rose +0.4% with Bs, which have a lower duration than BBs, outperforming by +0.7% compared to +0.2%. Yet again, CCCs benefitted from their high levels of carry and from investors increasingly reaching down the ratings spectrum. They returned +1.1% during the month. US high yield performed broadly in-line, adding +0.3%.
- After a bumper January, primary markets showed more of a reversion to the mean in February. There were new bonds issued by TUI (Leisure) and Kier (Services), and Forvia (Autos) brought a two-tranche deal to refinance some of its debt. But companies are being a little less proactive than we expected in dealing with some of their 2025 and 2026 maturities. Despite spreads having tightened, and conditions improved, the reality is that all-in refinancing rates are in most cases still higher than existing coupons – and so many credits would prefer to leave these outstanding as long as possible.

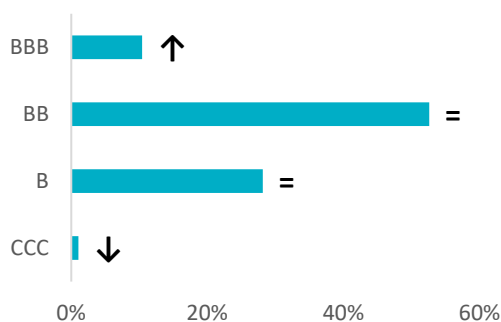
(Sources: all Bloomberg)

#### Short duration strategy characteristics

Yield	5.58%
Spread	257
Duration	1.56
Average rating	BB
ESG score	6.3

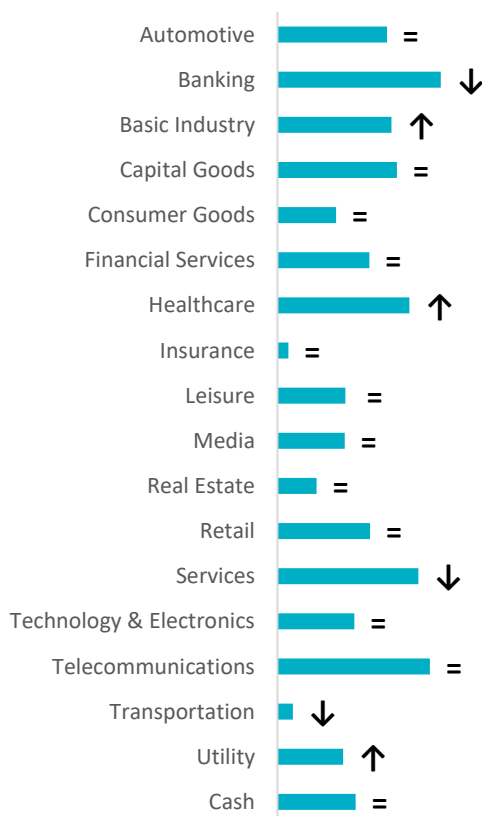
Source: AXA IM as of 29 February 2024

#### Our Rating Positioning



Source: AXA IM as of 29 February 2024

#### Our Sector Positioning



Source: AXA IM as of 29 February 2024

#### Short duration strategy positioning and performance

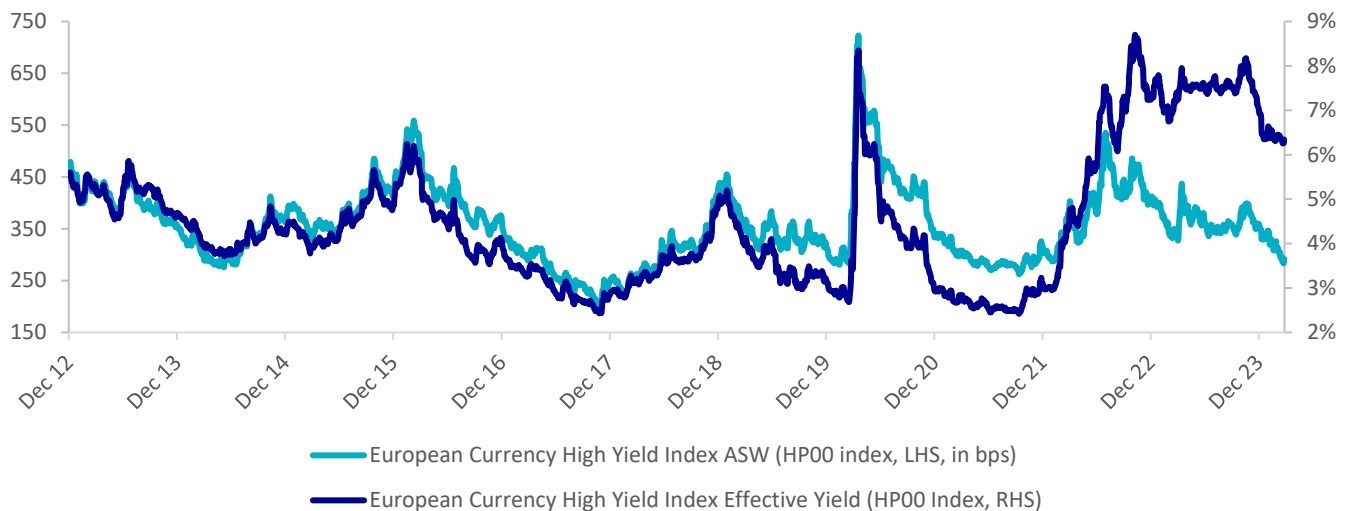
- A **solid upside capture ratio of >60%** meant we delivered much of the positive performance of the European high yield market during February.
- **February was a hefty month for redemptions** – banks Unicredit, BBVA and ING all called T2 paper which we held in the fund. We also saw Cirsia (Leisure), Stena (Transportation) and Autodistribution (Autos) take-out their bonds.
- Given the lack of suitable Primary, **proceeds were reinvested across the existing portfolio**. Additionally, we **added a couple of new banking names**, including Societe Generale, and **new corporate issuers** such as Lutech (Technology) and Cemex (Basic Industries).
- We took advantage of some **favourable price movements to exit our positions** in TalkTalk (Telecommunications) and Atalian (Services). Both names had previously been more volatile than we would like, though we remained confident that the best outcome was to be achieved by waiting for management to complete (Atalian) and commence (TalkTalk) reorganisations of the respective businesses.

#### One theme we've been watching

## KANTAR

- We had previously retained a degree of caution around the bonds of **Kantar Group**.
- As a media company, it is exposed to **cyclical** marketing budgets – which would have been hit in the event of a recession.
- Further, the business was partially spun out of WPP in 2019 with a **levered balance sheet** and large amounts of **adjustments** to earnings.
- But recent results have been strong, the credit is beginning to generate real **free cash flow** and the broader market outlook has improved.
- The secured bonds mature in 2026 and still offer an **attractive yield** to maturity. Further, with press reports that WPP is looking to offload the rest of its 40% stake, there is a chance of a full refinancing of the capital structure before then.
- In any case, we now think they represent a worthwhile holding for our **Short Duration High Yield fund**.

## European High Yield Market Valuation



Source: ICE 29 February 2024

## Outlook

We wrote last month about how European high yield was beginning to offer less value to investors. After a February where we tightened yet further, it is hard to make the opposite case now. But, since our priority is always risk-adjusted returns, we still think we can present some compelling arguments in support of the first half of this equation. That is to say: our asset class continues to get shorter and shorter and, therefore, less volatile.

As alluded to in the previous section, companies are quite happy to leave their current (generally low coupon) bonds outstanding as long as possible. The result is that the duration of the ICE BofA European Currency High Yield Index was just 2.87 years at the end of February, the lowest it has ever been (source: Bloomberg). Even more stark is the fact that the amount of debt in European high yield now maturing within three years is almost 40% - compared to a long-term median of close to 20%, and a previous peak of just 25% (source: Barclays). Whilst the historical comparisons are less stark, our Short Duration High Yield fund also has a duration of just 1.6 years.

Now, this could be a problem if it was a result purely of companies having difficulties refinancing their debt. This was the case during the GFC in 2008/2009 – primary markets were essentially closed for 18 months, duration collapsed, and the default rate spiked. This is very much not the situation we have today. Whilst some stressed names would clearly not be able to issue new bonds at sustainable levels, the size of this cohort decreases with every month that goes by. Indeed, Single-Bs are back to yielding around 7.25% - manageable for all but the most levered capital structures. And with Moody's recently updating their baseline global default rate forecast to a little below the long-term average, we see no reason why this fundamental picture should change any time soon.

Hence our belief that today's low duration really does represent a reduced likelihood of volatility going forward. This is true as represented by spread duration, or exposure to credit risk. And with investment grade and government bond indices in firmly negative territory so far this year, compared to +1.3% for European high yield, the asset class has once again demonstrated its relative immunity to interest rates. On this risk-adjusted basis, we think it is possible to view tight spreads in a more favourable light.

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