PGIM FIXED INCOME

PART THREE

EUROPEAN HIGH YIELD IN THE ERA OF INFLATION

By PGIM Fixed Income's European Leveraged Finance Team

- **In our third post on the opportunities in European high yield, we place this year's jump in yields in the context of our expectations for inflation to peak soon and decline thereafter.**
- **Therefore, while yields are currently lower than inflation, we expect this relationship to reverse in 2023.**
- **In this scenario, actively selecting sectors and issuers with the ability to withstand inflation can provide compelling inflation-adjusted returns over a prolonged investment horizon.**

Inflation is peaking as GDP growth slows

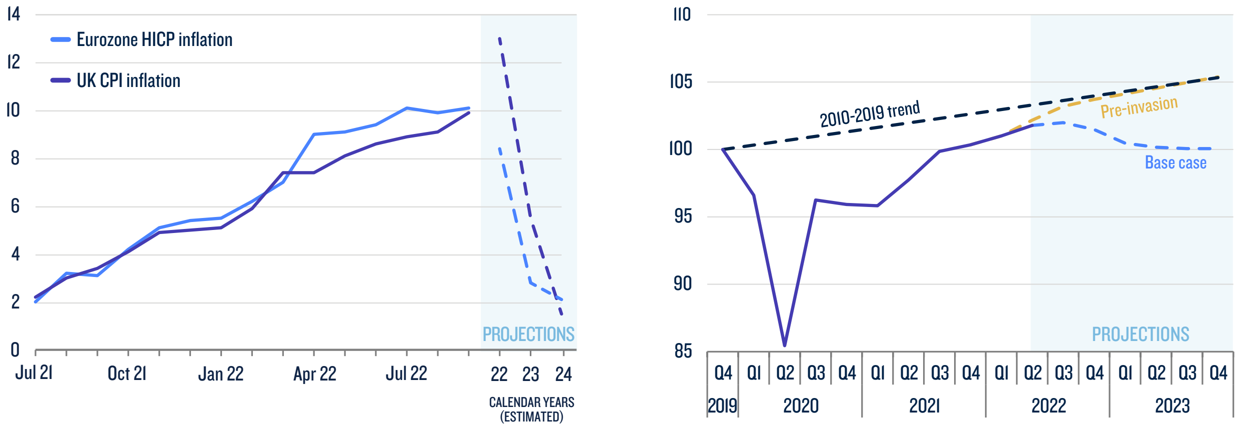
When looking at inflation globally, examining the regional drivers can add perspective to allocation considerations. In Europe, prices are rising mainly due to energy costs and not, as in the U.S., because the economy is overheating amidst elevated shelter and wage costs. For example: negotiated wage growth in the Eurozone is set to remain below 3%, which is consistent with the European Central Bank's (ECB) 2% inflation target and well short of 6%+ expected wage rises in the U.S.

Therefore, when looking at the totality of the inflation picture, we project that Eurozone inflation will decline from 8.4% in 2022 to 2.8% in 2023 as growth contracts (Figure 1). For the UK economy, we project 13.1% inflation this year that will fall to 5.5% in 2023.

On economic growth, we expect Eurozone GDP to grow 3.2% this year, but to shrink 1.4% in 2023. The sudden halt in Russian energy supplies remains a crucial risk to Europe's economy. If gas supplies remain suspended, growth in Europe might be impacted for several quarters.

Figure 1: Europe's energy-driven inflation is set to peak alongside GDP growth

(Left graph: %; right graph: indexed to 100)



Source: PGIM Fixed Income and Macrobond as of September 2022.

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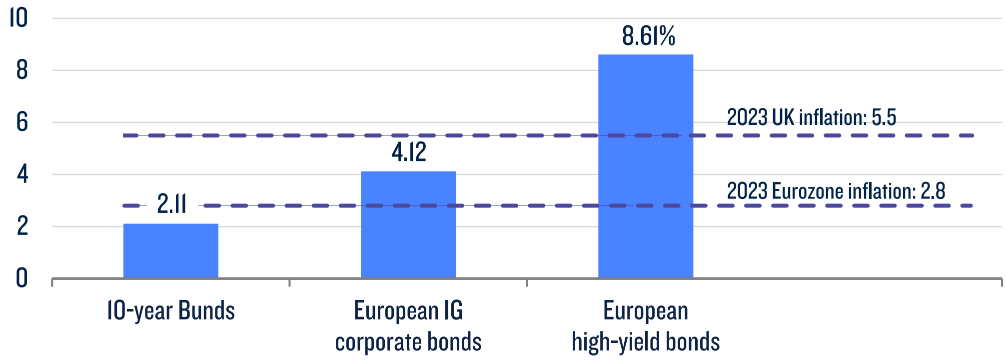
Figure 2: European Bond yields versus inflation

(%)



Source: PGIM Fixed Income as of 30 September 2022. **Past performance is not a guarantee or a reliable indicator of future results.**

High-yield bonds can provide healthy inflation-adjusted returns

The European high-yield bond index yielded around 3% at the start of 2022 and more than 8% at the end of September. If our inflation estimate for 2023 is correct, that would provide 5.8 percentage points in excess yield (Figure 2). Locking in these recent yields, or higher in the next few months, can provide attractive inflation-adjusted returns for years to come.

In addition, with inflation set to fall in 2023, if ECB policy rates peak at the end of this year (which would be sooner than current market expectations) that pivot could provide additional upside to the prices on European high yield bonds.

Issuer selection within high-yield portfolios can also help protect against inflation

As our research analysts and portfolio managers seek an optimal portfolio allocation, they select about one quarter of the issuers from the investable high-yield universe. That industry and issuer selection, which has occurred throughout market cycles and varying investment conditions, has historically helped us outperform our benchmarks along the way. In the current environment, selecting companies that are better able to manage inflation is a point of emphasis.

For example, we favour sectors with longer-term sustainable pricing power, such as telecom and cable firms, because their prices often adjust with inflation. At the same time, we look beyond short-term trends: travel and leisure firms, for example, had some pricing power after two years of lockdowns, but is that pricing power amongst consumer discretionary issuers sustainable heading into a recession?

Energy-intensive and high-labour cost sectors, by contrast, will find it difficult to pass on energy and wage inflation. This warrants caution about earnings prospects over the near to medium term. Finally, rate-sensitive sectors, such as real estate, have come under pressure as interest rates on government bonds have risen.

Conclusion

Yields on European high-yield bonds have more than doubled in 2022, but they remain lower than recent inflation readings. However, we expect inflation to peak soon and decline thereafter. So, locking in yields sooner rather than later can provide attractive inflation-adjusted returns over the longer term. That makes high-yield bonds a valuable addition to any portfolio.

Furthermore, corporate balance sheets across Europe are in good health as we enter a potential downturn, and the default outlook remains benign compared to previous downturns. That should allow investors to generate high risk-adjusted returns over the medium to long term.

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Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of 30 September 2022.

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