PGIM FIXED INCOME

PART ONE

EUROPEAN HIGH YIELD—PLANNING FOR YIELDS TO PEAK SOON

By PGIM Fixed Income's European Leveraged Finance Team

- **In the first of a series of posts on European high yield, we look at the sector's compelling characteristics, including elevated yields, enhanced credit quality, short duration, and moderate default expectations.**
- **We then view these attributes in the context of external parameters, including how our expectations for monetary policy and inflation influence timing considerations.**
- **Indeed, as a peak in European inflation approaches, investors may be over-estimating how high the European Central Bank (ECB) will hike interest rates.**
- **The difficulty of timing market conditions underscores that allocation decisions need to be considered before interest rates and credit spreads peak.**

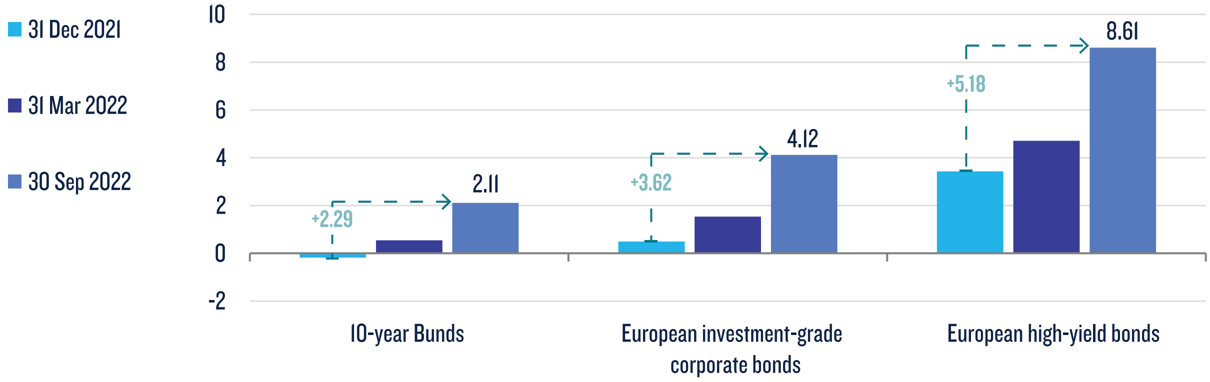
The year when yields more than doubled

Concerns about the global economy, rising inflation, and tighter central bank policies have raised bond yields around the world. When looking at European high yield specifically, the sector yielded an average of 8.61% at the end of September (Figure 1)—which was higher than the 8.10% yield at the depths of the COVID crisis and only trails the levels from the Global Financial Crisis of 2008-09 (26.91%) and the European sovereign debt crisis of 2011-12 (10.90%).

Compelling characteristics

Yields—Yields in European high yield have more than doubled in 2022 in an environment of increasing long-term government bond yields as well as widening credit spreads, which have also nearly doubled from 318 to

Figure 1: European high-yield bond yields have more than doubled this year.
(% yield to maturity)



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

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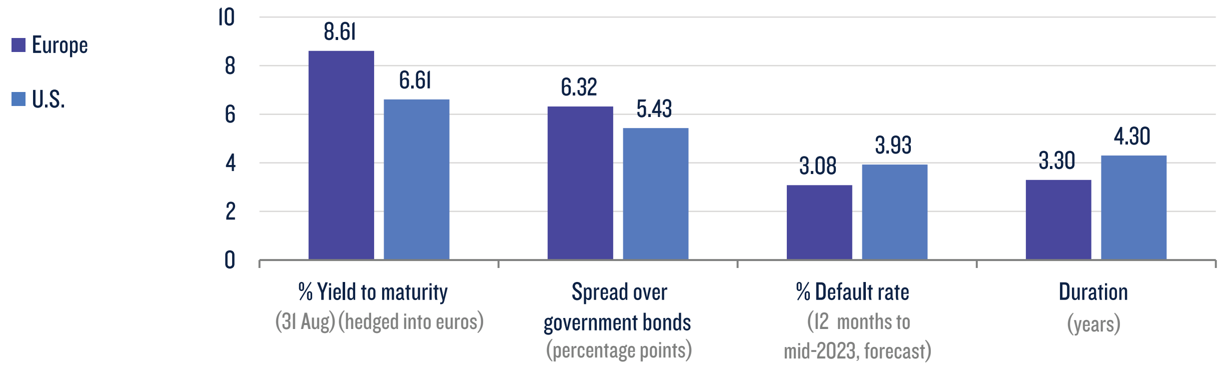
Figure 2: European high-yield bonds compare favourably to U.S. high-yield bonds.



Source: Bloomberg, PGIM Fixed Income, and Moody's as of 30 September 2022. **Past performance is not a guarantee or a reliable indicator of future results.**

632 basis points (bps) through the end of September. The effective yield that investors receive is even higher when issuers repay their bonds early, for which they pay a premium, and capital gains are amortized over a shorter time period. Such refinancings typically take place a year before maturity.

By comparison, U.S. high-yield bonds had a euro-hedged yield to maturity of 6.61%, but a spread over U.S. Treasury bills of only 543 bps (Figure 2). Furthermore, many investors seeking euro-denominated income from U.S. bonds need to pay hedging costs, which lowers nominal returns and makes European high yield more attractive by comparison.

Credit quality—Although European high yield spreads are nearly 90 bps wider than their U.S. counterparts, the average credit rating of European high-yield bonds is BB-, one notch higher than their U.S. peers. Furthermore, BB-rated bonds, for example, make up 69% of the European index and only 53% of the U.S. high-yield index. So, European high yield presents the combination of higher credit spreads and stronger credit quality.

Duration—As an indication of sensitivity to changes in interest rates, European high-yield bonds have a relatively short duration of only 3.4 years whereas U.S. high-yield bonds have a duration of 4.3 years, making them more volatile during periods of rising interest rates.

Defaults—Considering the relatively high credit quality, recent European high yield defaults have remained historically low, and we only expect a moderate increase in 2023. In the 12 months to 31 July 2022, credit rating agency Moody's assigned a default rating to just 1.95% of European high-yield bonds. If we exclude Russia and Ukraine from Moody's list, that proportion falls to less than 0.5%, which is far less than the sector's 2.94% 10-year trailing average.

Moody's European and U.S. baseline forecasts sees defaults of 3.08% and 3.93%, respectively, for the 12 months to mid-2023. Our analysis projects European defaults of 2.5% of par value in 2023, which we expect to outperform due to our credit selection and active management. Our second post in the series explores our default rate analysis under a range of economic scenarios.

While investors tend to focus on the sector's pertinent characteristics, such as elevated yields, enhanced credit quality, short durations, and moderate default expectations, external parameters—including interest rates, inflation, and timing—are critical as well.

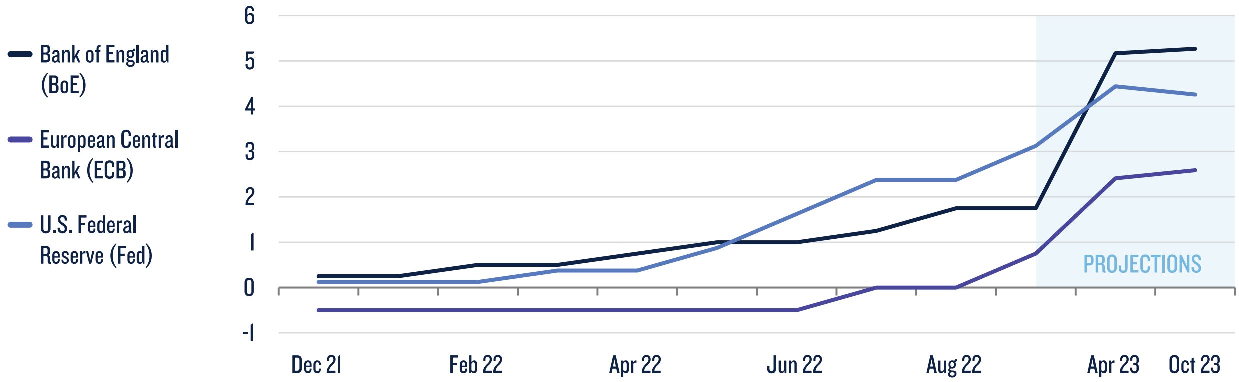
Policy interest rates approach peak hawkishness as inflation levels also peak

Central banks in most developed markets have raised interest rates this year, and markets expect that they will still go substantially higher.

- Since July, the **ECB** raised its main policy rate by 125 bps to 0.75% over the course of two hikes. Bond market prices currently predict that the ECB's main interest rate will rise to 3.5% by July 2023. But we expect that the Eurozone economy will enter a recession later this year, and real GDP will contract by 1.4% in 2023. Therefore, we anticipate the ECB policy rate will rise to at least 1.5% by year-end before peaking somewhat above 2.0% in 2023, which is our high-end estimate of the neutral rate.
- The **Bank of England** started hiking interest rates in December 2021. Since then, it has raised its base rate seven times to 2.25%, and more interest rate hikes are expected.

Figure 3: Market-implied central bank interest rate forecasts appear overly hawkish.

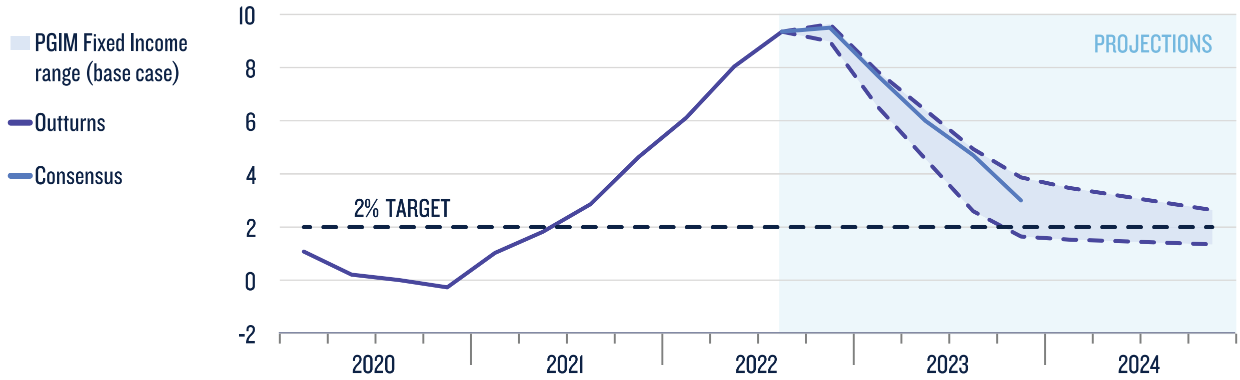
(%)



Source: European Central Bank, Bank of England, and Federal Reserve as of September 2022.

Figure 4: Eurozone inflation projections: peaking this year, declining after

(%)



Source: PGIM Fixed Income and Haver Analytics as of September 2022.

- The **U.S. Federal Reserve** has raised its target for the federal funds rate five times this year to a midpoint of 3.125%. Bond prices predict that it will rise to 4.5% by March 2023 (Figure 3).

Our estimates indicate that market-implied expectations of central bank policy rates may be reaching "peak hawkishness," and investors may be overestimating how much central banks will hike going forward. Investor expectations for monetary policy tightening has boosted bond yields to multi-year highs, and we expect that the ECB will fall short of such hawkish expectations. Despite the uncertainty around the timing, the attraction of investing in this scenario is that the opportunity exists before the ECB pivots away from tightening policy and fighting inflation to providing monetary stimulus to encourage growth.

Given central banks' collective efforts thus far, we think they will generally be successful, and inflation will abate from February next year—the anniversary date of the Russia/Ukraine-driven spikes in energy prices. As a result, we project Eurozone inflation will decelerate from an average of 8.4% in 2022 to 2.8% in 2023. Our projections through 2023 and beyond indicate a range of inflation that is generally lower than the consensus estimates observed in Figure 4. A scenario where the lower-end of that range materialises would provide additional support for bond prices and lower interest rates.

When is the right time to invest?

We expect bond yields to fluctuate as Russian gas cuts, central bank rate hikes, and economic data continue to trigger volatility in coming months. Europe's fundamental economic backdrop suggests that yields and spreads may rise over the near term, which warrants caution.

Yet, these factors also set the stage for a peak in yields and spreads soon, which are important trigger points for investors as they consider allocation timing. Their approach indicates an interesting entry point from which investors can generate attractive long-term returns.

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

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