PGIM FIXED INCOME

PART FIVE

THE BREADTH OF BENEFITS IN GLOBAL HIGH YIELD

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- **When considering a global high yield strategy, investors may initially contemplate the rationale of positioning based on differences in regional economic growth and relative value. While those variations remain critical to allocation decisions, investors should also remain cognizant of the structural benefits of traversing regions, which we explain in the concluding post of our series on European High Yield.**
- **Although there are numerous global strategies from which to choose, our macroeconomic scenarios continue to indicate a supportive backdrop for global high yield assets amidst expectations that default rates remain within historical norms.**
- **Furthermore, the increase in global yields to near decade-high levels indicates an opportunity to consider an actively managed global strategy given the potential to generate alpha and total return.**

Rapidly shifting conditions across global regions has become one of the defining characteristics of the current market environment. Although processing the implications of differences in GDP growth and relative value can be disorienting (Figure 1), they play into the strengths of an active global high yield strategy.

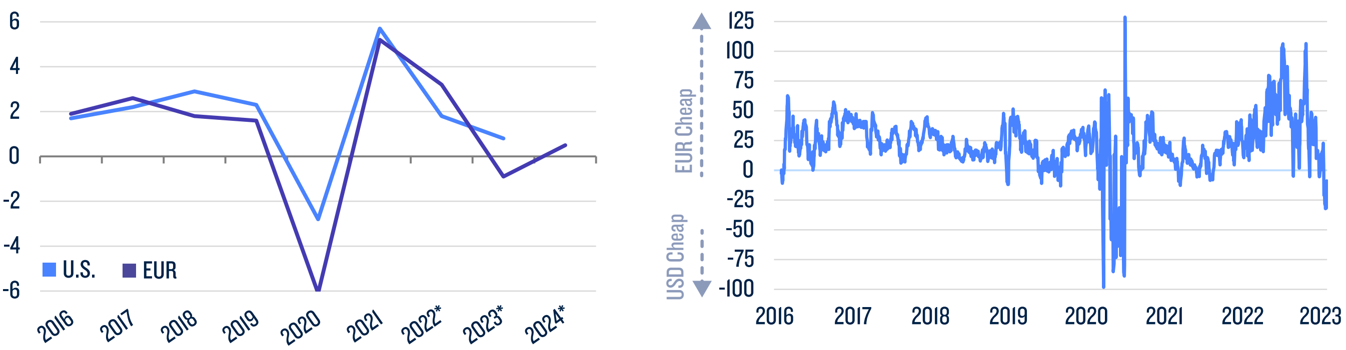
Yet, these factors are only part of the reason for investing across regions. An active global high yield strategy also features the flexibility to benefit from structural nuances in credit dispersion, issuer spread premiums, and opportunity sets.

Dispersion in two perspectives

Although the chart on the right of Figure 1 shows that the relative value between the U.S. and European markets is near a point of balance, the latter's usual long-term structural cheapness is also apparent. Greater

Figure 1: The shift in global growth and high yield relative value over time

(LHS: U.S. and EA GDP growth, %; RHS: Median EUR - USD L-OAS difference of selected dual currency bond issuers (average of mean and median))



Source: PGIM Fixed Income as of February 3, 2023. *Represents PGIM Fixed Income estimates.

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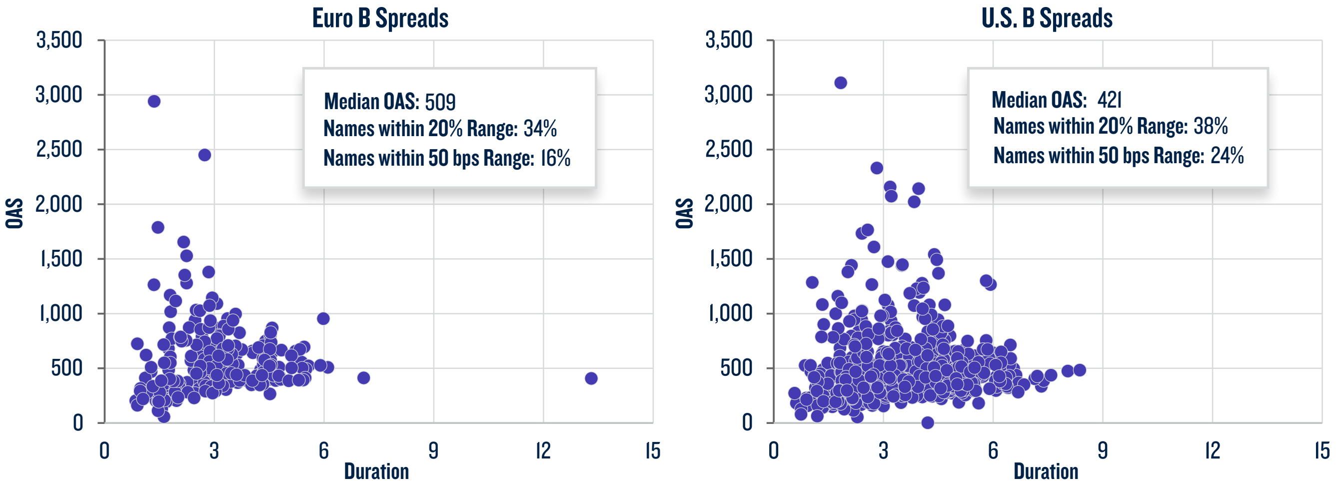
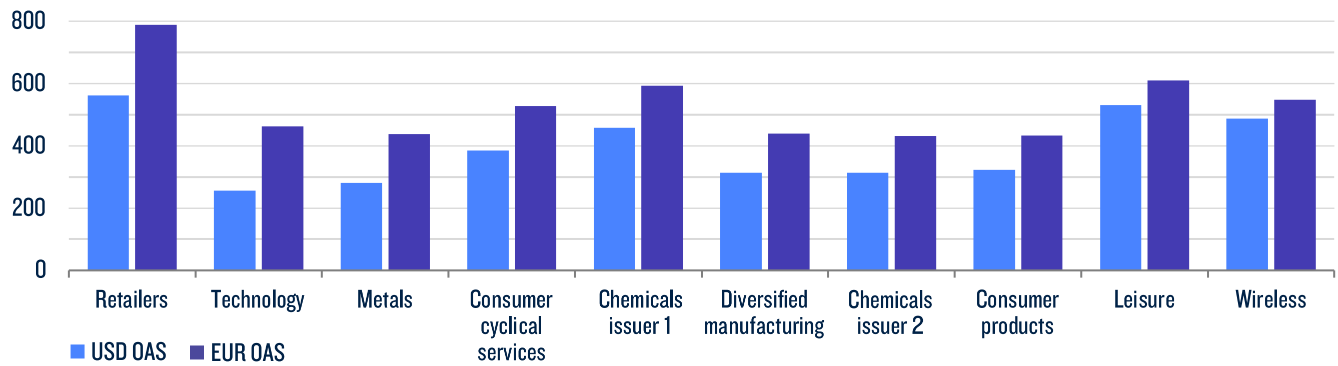
Figure 2: Dispersion in the European market is further afield than in the U.S.



Source: PGIM Fixed Income as of February 23, 2023. Spreads are based on single B high yield.

Figure 3: PGIM Fixed Income's analysis of high yield reverse Yankee spread premiums
(basis points)



Source: PGIM Fixed Income. Analysis conducted in November 2022.

dispersion amongst issuers and credit spreads is one of the contributing factors to that cheapness. Figure 2 shows the greater dispersion in European B rated spreads vs. those in the U.S., particularly in those further from the median. For example, although both markets had a similar grouping of names within 20% of the median, the European market had notably fewer within 50 bps of the median, indicating less concentrated grouping.

The implications of greater dispersion can be seen from two related perspectives. The first being that it reflects distortions that exist in individual credits (e.g., in business objectives or financial stability) after years of operating amidst the deluge of central bank liquidity. The second indicates an expanded field of potentially attractive issues.

In a logical progression, the breadth of dispersion also points to the stark dichotomy between potential winners and losers amongst names with attractive spread levels. Therefore, distinguishing the troubled names from those with the potential to contribute to alpha generation indicates the need for thorough, ongoing credit research.

Global analysis for global issuers

Names amongst the outliers in Figure 2 likely include reverse Yankee issuers (U.S. domiciled names issuing in euros or gilts), which may enter the market for a variety of reasons—such as diversifying their investor base—but at a cost. In late 2022, we conducted an analysis of 10 names from an array of industries that issued debt in a range of structures in the U.S. and European markets (Figure 3). We found the euro offerings were an average of 181 bps wide of the offerings in the U.S. with some premiums reaching as high as 271 bps.[1]

Although the bonds in the analysis have identical credit risk, the spread differential is driven by a combination of a lack of resources to analyse the breadth of U.S. issuers—prompting many European investors to avoid

[1] The spread differential is based on cross currency basis, option-adjusted spreads.

Figure 4: A global opportunity set that can expand by four to five times for European investors

	European high yield	Developed market global high yield	Global high yield including emerging market high yield
# of issuers	754	2,802	3,433
Market value	€382.49 billion	€1.59 trillion	€1.94 trillion
Composite rating	BB3	B1	B1
Yield to worst (EUR denominated)	7.24% (4.25% 12-months earlier)	8.28% (5.07% 12-months earlier)	8.63% (6.04% 12-months earlier)
Spread*	414	411	442

Source: PGIM Fixed Income and ICE BofA as of March 3, 2023. *Referenced spread is option adjusted spread over government interest rates.

the opportunity set—and the lower liquidity levels in the European market. Yet, the compelling opportunities amongst reverse yankee premiums presents another benefit for investors with the global research to cover transactions across regions.

An expanded playing field

In addition to the attributes above, a global high yield strategy is complemented by the depth of an expanded opportunity set (as well as the respective credit dislocations) in the U.S. and beyond. Figure 4 shows that the market value of the global high yield universe is several times larger than the European domestic market, depending on whether emerging market high yield credits are included. Furthermore, investors stand to pickup sizable increases in spread and yield when investing on a global basis.

For reference, the yields in Figure 4 represent increases of about 250-275 bps from a year earlier, and in an environment where yield may be considered destiny, the increased yields bode well for sector returns going forward.

The implications from mixed economic outlooks

At this point, investors have their pick of global fixed income strategies with yields that are notably higher than a year earlier. Thus, they need to consider the sectors that may be appropriately suited to their objectives. For those with a total return emphasis, our macro scenarios continue to support the benefits of a global high yield allocation.

Although a slew of negative risks remains on the horizon, recent developments warrant consideration as well. For example, surging inflation has been softened by cooling goods prices, slowing growth in China has been countered by its shift away from zero-COVID measures, Europe's current energy crisis has been mitigated (for now) by warm winter weather, and broad tightening in monetary policies has thus far been met with resilient economic activity. The mix of factors culminates in the scenarios described in Figure 5.

In the U.S., we assign equal probabilities to a recession and a soft landing with weighting potentially skewed to the latter as the demand for labour remains historically high. The soft-landing scenario (i.e., with inflation retreating towards the Federal Reserve's 2% target) could support the asset class—which represents ~75% of the Global High Yield universe—given the likelihood that long-term interest rates and credit spreads remain elevated enough to provide attractive levels of income. Even in a recession outcome, whilst spreads may widen for a short period, rates would likely rally and bolster the prospects for a positive total return.

Europe faces more "imported inflation" due to the effects of higher energy costs on goods prices, which is more difficult for the European Central Bank to control. Hence, our base case points to stagflation as policy rate increases cool demand and inflation remains elevated. Although our base case suggests risk assets have near-term downside, this is somewhat cushioned by the level and dispersion in European credit spreads (again, see Figure 2).

While investors tend to focus on the up-and-down movement in interest rates and spreads, the current

Figure 5: PGIM Fixed Income's central macroeconomic scenarios
(% chance of each scenario playing out)

UNITED STATES		EUROPE
30% Contraction of economic activity resulting in Fed easing cycle	RECESSION	15% Contraction of economic activity resulting in ECB easing cycle
35% Growth and inflation converge to 2%	SOFT LANDING	10% Growth and inflation converge to 2%
5% Growth <2%, but inflation gets stuck at higher levels	STAGFLATION	60% Growth <2%, but inflation gets stuck at higher levels; consists of 10% chance of severe stagflation
15% Growth remains resilient, and the Fed loosens policy prematurely, keeping inflation >2%	NOMINAL GDP BOOM	15% Growth remains resilient
15% Strong growth; inflation drops rapidly	ROARING 20s	N/A —

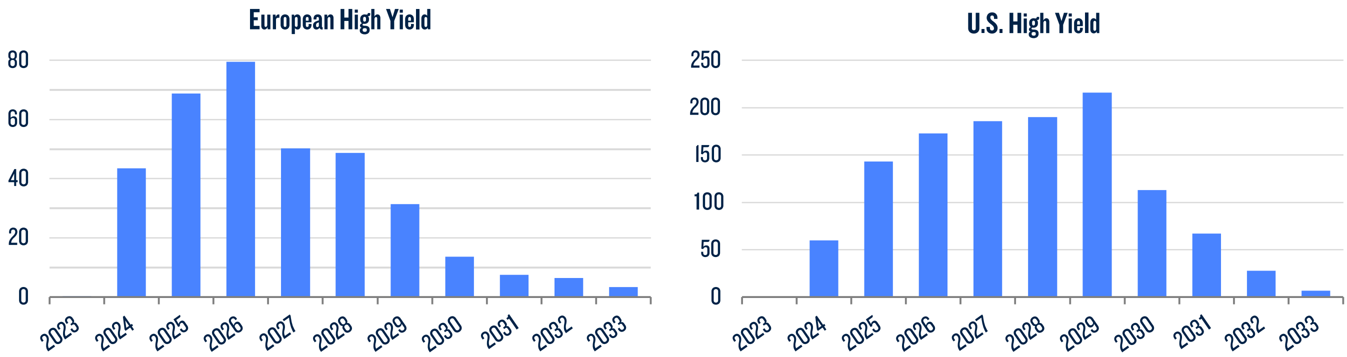
Source: PGIM Fixed Income.

macro configuration also lends itself to the possibility of a rangebound outcome. In a scenario where rates and spreads generally move sideways, the elevated yields and the income-related returns across the high yield universe would be another factor supporting performance across the sector (again, see Figure 4 for the year-over-year change in yields).

As a concluding thought regarding the implications of our scenarios, the potential for recession and/or stagflation has historically alluded to an uptick in defaults, therefore contributing to a volatile stretch for high yield. However, the credit cycle encompassing COVID and the consequent recovery benefitted corporates by lowering borrowing costs, supporting valuations, and boosting profitability (amongst other factors), which means that corporate balance sheets enter a period of potential stress in solid shape with strong liquidity.

This underscores the improving quality of the global market in recent years as the BB component rose to more than 54% of the market in mid-February 2023 from about 48.5% a decade earlier. The improving quality has been partially driven by smaller/more speculative credits gravitating toward leveraged loan financing. Furthermore, the global high yield market should benefit from the lack of a maturity wall through 2024 with refinancing needs likely to peak in 2026 and 2029 in Europe and the U.S., respectively (Figure 6). Therefore, in a recessionary scenario, four-year default rates would likely remain less than 12-15% in the U.S. and Europe, i.e., average annual defaults reaching about 3-4%. These rates are in line with, or below, historic medians and far below the levels from the financial crisis cycle of 2008-09 or the pandemic cycle of 2020-21.

Figure 6: The lack of near-term maturity walls support low defaults in 2023
(high yield bonds maturing by year; LHS: € billions; RHS: $ billions)



Source: PGIM Fixed Income and Barclays as of December 31, 2022.

Conclusion

The benefits of a global high yield strategy extend from the tactical to the structural. In addition to benefitting from changes in economic paths and relative value dynamics, active global strategies maintain the flexibility to capitalise on nuances that extend across regional markets.

When viewing the sector from a total-return perspective, the prior increases in interest rates and credit spreads will remain important aspects going forward. In the event of stagflation, spreads and rates have already repriced to some effect, thus likely cushioning some of the blow, whereas a recession could coincide with a decline in rates, thus offsetting some of the volatility in credit spreads. In a case where rates and spreads move sideways, the sector should generate attractive levels of income, an outcome where rates remain near their peaks and credit spreads contract may enhance the sector's total-return potential.

A global perspective provides a fitting conclusion to our European high yield series. Although the asset class represents a specific area of the capital markets, its attributes are capable of meeting the varied needs of investors across the globe, and it remains an asset class to keep front of mind amidst quickly evolving conditions throughout global markets.

NOTICE: IMPORTANT INFORMATION

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of February 2023.

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