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European high yield: April update and outlook

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"'Unstoppable force meets the immovable object' paradox: how should the market price a once-in-a-century recession amid an unprecedented amount of high-powered liquidity?" – Hans Lorenzen, Citibank, 22 April 2020.

After the unprecedented market crash in March, European high yield (EHY) rallied strongly in April with almost +6% performance, as "B" credit outperformed "BB" credit and spreads tightened by more than 200 basis points from the wides seen in March[1].

The March sell off was the worst market collapse in history, given the speed and size, as central banks such as the Fed and European Central Bank (ECB), as well as governments, continued to announce new rescue programs including those which included HY either in outright purchases, support for the ETF market, or to be used as collateral, as efforts were made to maintain market liquidity. The wording "Whatever it takes" – first introduced by former ECB president Mario Draghi – has taken hold on a global level in the effort to maintain market liquidity, avoid a credit crunch for corporates, and support employment and consumer confidence.

Where this year's market turbulence started with Phase 1 (a total collapse), then moved to Phase 2 (massive central bank and government intervention resulting in a strong bounce back by the asset class), we are now moving into Phase 3 (a reality check). This is where real economic figures, generally turning out worse than expected, are finally giving indications of the negative effect from the Covid-19 virus. Given that worse news is expected for the second quarter figures and with firms withdrawing guidance (and the ongoing uncertainty of when, and in what manner, the world will exit lockdown), the risk of another downturn is being acknowledged by the market.

Issuers with a stronger credit profile have bounced back most, with lower-quality debt relatively weaker. The industry sectors heavily impacted have been autos, leisure, travel, transport and gaming. Liquidity is a key issue for companies' survivability. Over-

[1] Bloomberg ICE BoA index HPS2 performance, 1 May 2020.

leveraged companies are suffering the most, with weak credit struggling to perform. At the same time, some BB-rated credit is starting to look rich again, having reversed much of the price fall seen in March.

The EHY primary market remained shut until the second half of April when Verisure, the Swedish home security company, issued €200 million of floating rate notes on the back of a reverse inquiry (investor demand for issuance)[2]. This was followed the week after with issuance by Netflix (euro and dollar issues comprising a total of $1 billion) and Merlin, the entertainment theme park company[3].

Fallen angels have picked up, with eight new issuers added to the high yield index for the rebalancing at the end of April (also encompassing the March rebalancing that was postponed). They constitute about €40 billion being added to the index or about 10% of the index[4].

Though market liquidity continues to be challenged, it is now better than the darker days but still can be problematic. Bid/offer spreads are now two to three points wide and largely one-sided (either buy or sell). This is still a far cry from the normal market spread of 0.5 to 1.0 point, but better than the wides of as much as five to eight points seen in March – if pricing was even available. ETFs are more stable too, trading close to NAV.

Downgrades and default expectations are rising as fundamentals will remain weak. This will keep pressure on HY as credit rating agencies aggressively reduce ratings and their outlook. As commented by Deutsche Bank, HY spreads are pricing high default rates of 40%+, when assuming a 40% recovery rate[5]. They note that this is the worst ever observed five-year cumulative default rate.

Outlook

Even with April's rally, HY market valuations are still much more attractive than at the start of the year, even as spreads have tightened sharply from their wides of March.

European high yield spreads tightened 138 basis points last month to 670 basis points – still over 270 basis points wider than the five-year average, and 2.7 standard deviations wide of the five-year average[6].

The market bifurcation regarding the pricing differential between better quality names versus weaker names continues, with close assessment of who will survive the large market disruption and who will come out less unscathed. A key driver of consideration is the strength of the firm's balance sheet going into crisis. Companies with balance sheets that are strong enough to survive a longer economic downturn will probably receive sufficient liquidity. For those firms who already had weak balance sheets from the start of the year it will be more difficult, putting them more at risk.

Another question to be considered is: will there be a business (and how much of it will be left) when recovery returns?

Many companies (such as Renault and Europcar) might benefit from the liquidity programs in place (for example, the French and German government-guaranteed loan programs). Central bank support is getting wider and deeper. Their efforts are aimed at avoiding a liquidity crisis in addition to the medical and economic crisis and so we do not imagine many companies going bust due to liquidity given the massive programs now available. The support from central banks is positive, but ultimately the individual companies have to show that they have a sustainable business model in the post-Covid-19 era. Ultimately, we need to see if all of the fiscal and monetary measures are

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[2] Bloomberg 16 April 2020.
[3] Bloomberg 22 April 2020.
[4] Bloomberg/ICE BoA (HPS2) 01 May 2020.
[5] *2020: Default seems to be the hardest word*, DB Research, 27 April 2020.
[6] Bloomberg, ICE BoA 01 May 2020.

sufficient to prevent a severe and prolonged recession. From today's perspective, this looks rather difficult.

Strategically, in the HY space – just as in the IG – there are many companies that are absolutely essential for the functioning of the economy and that are not directly affected by the crisis, such as telecommunications.

Activity

Our HY funds remain cautiously positioned. The market is relatively cheap, but credit fundamentals are challenged which is why we retain this degree of caution. The funds continue to be defensively positioned with a moderately underweight market risk/beta; and we maintain, on a sector basis, an underweight in cyclical areas of the market such as autos, transportation, retail and energy, while we are overweight in healthcare, telecoms, media and financial services.

Positions added to the fund over the period include some of the "fallen angels" which entered the index at the end of April (such as Ford, Pemex, Marks & Spencer and ZFF), while keeping an underweight in the name and, in most cases, the sector.

We also added to issuers which we see as strategically important, including Adient, the largest car seat system manufacturer in the world), as well as those which we liked but previously found too expensive. We have also started to cover the underweight of issuers we see as survivors. High-quality credit over low-quality bonds was one of our investment themes going into the year, and we maintain that theme.

In summary, risks, uncertainty, and volatility remain high but we feel spreads currently offer material compensation for rising credit risk. We feel we are being well compensated with potential return for investment risk. Notably at current spread levels markets are compensating investors at many multiples of the worst historic default experience.

Figure 1: Threadneedle High Yield Bond Fund performance (calendar year)

Gross returns	2014	2015	2016	2017	2018	2019	2020 YTD
Fund	5.79%	2.97%	9.85%	7.18%	-0.79%	11.76%	-12.33%
Index	5.01%	1.23%	11.15%	7.09%	-2.25%	12.18%	-14.65%
Relative return	**0.78%**	**1.74%**	**-1.30%**	**0.09%**	**1.46%**	**-0.38%**	**2.72%**

Gross returns	1yr	3yr	5yr
Fund	-6.65%	0.72%	2.73%
Index	-9.20%	-0.55%	1.82%
Relative return	**2.81%**	**1.28%**	**0.90%**

Source: Columbia Threadneedle Investments, as at 31 March 2020. Past performance is not a guide to future performance. Data is shown in GBP Index is the ICE BofAML European Currency High Yield (3%) Constrained Index excluding sub financials hedged to £ (HPS2) from 1 June. The performance data does not take account of the commissions and costs incurred on the issue and redemption of units. The value of investments and any income is not guaranteed and can go down as well as up and may be affected by exchange rate fluctuations. This means that an investor may not get back the amount invested. Index returns assume reinvestment of dividends and capital gains and do not reflect fees or expenses. The index is unmanaged and cannot be invested directly.

Threadneedle High Yield Bond Fund

Key risks

Past performance is not a guide to future returns and the fund may not achieve its investment objective. Your capital is at risk.

Investment Risk: The value of investments can fall as well as rise and investors might not get back the sum originally invested.
Derivatives for EPM / Hedging: The investment policy of the fund allows it to invest in derivatives for the purposes of reducing risk or minimising the cost of transactions.
Issuer **Risk: The fund invests in securities whose value would be significantly affected if the issuer either refused to pay or was unable to pay or perceived to be** unable to pay.
Liquidity Risk: The fund holds assets which could prove difficult to sell. The fund may have to lower the selling price, sell other investments or forego more appealing investment opportunities.
Valuation Risk: The fund's assets may sometimes be difficult to value objectively and the actual value may not be recognised until assets are sold.
Volatility Risk: The fund may exhibit significant price volatility.
Inflation Risk: Most bond and cash funds offer limited capital growth potential and an income that is not linked to inflation. Inflation is likely to affect the value of capital and income over time.
Interest Rate Risk: Changes in interest rates are likely to affect the fund's value. In general, as interest rates rise, the price of a fixed rate bond will fall, and vice versa.
Currency Risk: Where investments are made in assets that are denominated in multiple currencies, changes in exchange rates may affect the value of the investments.

All the risks currently identified as being applicable to the Fund are set out in the "Risk Factors" section of the Prospectus. Please read the Key Investor Information Document and the Fund Prospectus if considering investing.