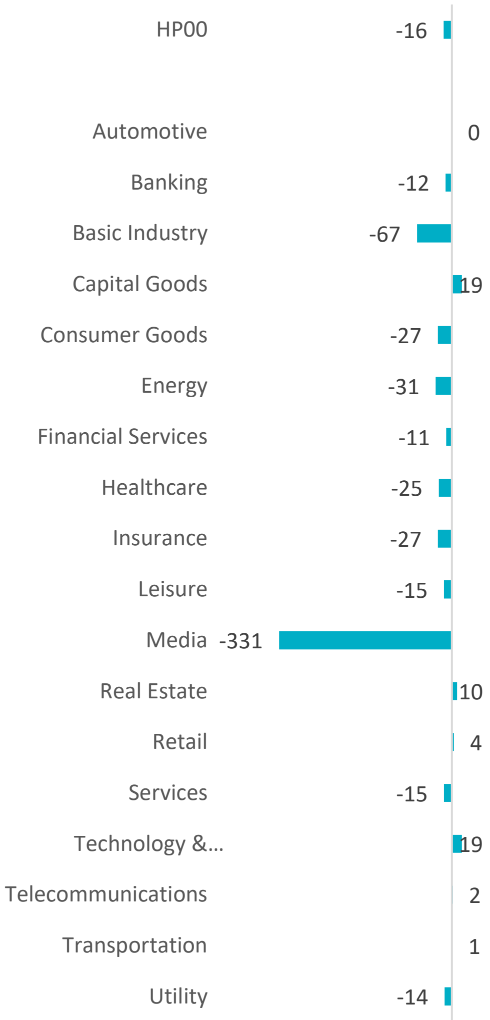
European High Yield

European High Yield heats up with its best month of the year

What's happening



Source: Asset Swap Spreads changes MTD, Bloomberg, BofA AXA IM, 31/05/2024.[1]Shown for illustrative purposes only and should not be considered as an advice or a recommendation for an investment strategy

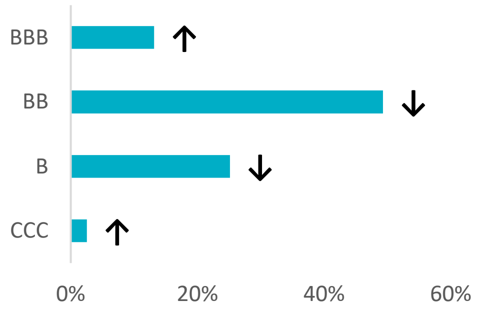
- Though May was broadly another good month for markets, it was really a period of two halves. There was a clear divergence in performance between the first few weeks and the last and this was determined, as ever, by expectations around the path of interest rates.
- A number of macroeconomic data points were received positively at the start of the month. The US CPI report for April showed a slowing to +0.3%, it's lowest level so far this year. There were also indications that the very strong US jobs market is beginning to (gently) cool down. Alongside some dovish Fed commentary, this was all viewed very favourably by investors: the S&P500 and STOXX600 both reached fresh all-time highs, and government bond yields fell. However, the mood changed in the middle of May – small inflationary signals in Europe, stronger US consumer data and more hawkish central bank communications meant that equity markets stalled, and government bond yields rose again. Still, the performance of the first half was sufficiently strong that overall monthly returns for the equity indices above was second only to March so far in 2024.
- European high yield had its best month of the year, rising +0.9%. It slightly lagged its US equivalent, where government bonds contributed more to the total return of +1.1%. The lowest rated parts of our market were the strongest – Bs gained +1.0%, and CCCs +2.0%, whereas BBs were only up +0.8%. After two difficult months, some more positive news flow for riskier credits (and the absence of any new situations developing) meant these segments were able to rebound somewhat.
- Primary markets continued to be active. Seasoned credits such as Fedrigoni (Capital Goods), Coty (Consumer Goods) and Bité (Telecommunications) all brought new deals to refinance some of their existing bonds. Though there were no debut issuers in the market, the gross supply numbers remain impressive – Barclays counted €14.1bn of bonds, the highest level since June 2021, and the third consecutive month greater than €10bn.

(Sources: all Bloomberg)

Short duration strategy characteristics	
Yield	5.68%
Spread	262
Duration	1.54
Average rating	BB
ESG score	6.3

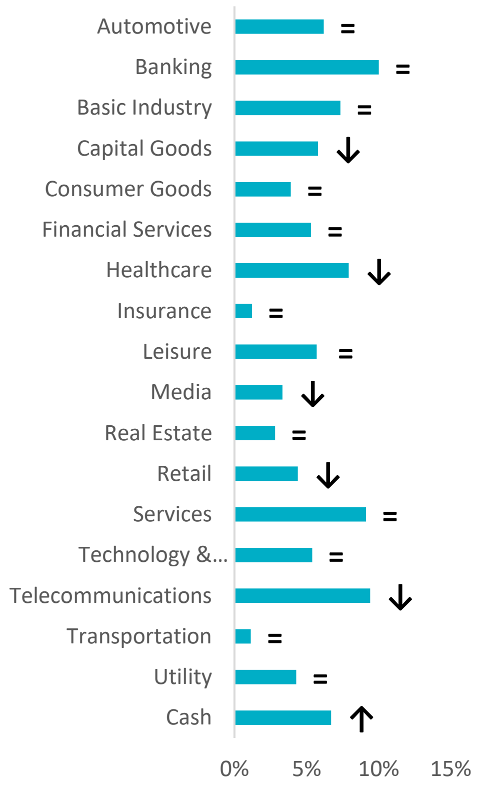
Source: AXA IM as of 31 May 2024

Our Rating Positioning



Source: AXA IM as of 31 May 2024

Our Sector Positioning



Source: AXA IM as of 31 May 2024

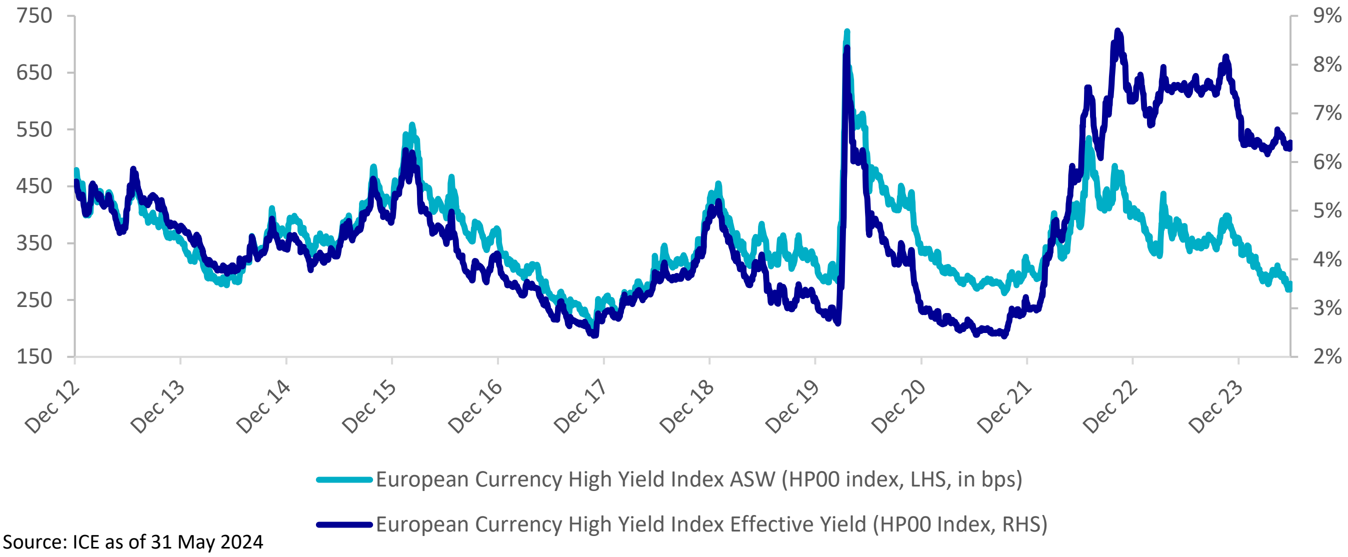
Short duration strategy positioning and performance

- Both the broader European HY market and our strategy achieved their strongest monthly performance year to date: +0.9% and +0.6% respectively (A EUR, net). Our lower risk profile and relative underweight in Bs and CCCs meant we slightly lagged, but this still represents a strong upside capture ratio ahead of the fund's long-term average (c.55%).
- Bonds issued by Marks and Spencer (Retail) and Rolls-Royce (Capital Goods) were redeemed.
- Adevinta (Media) also called its bonds, an event which had been long anticipated after the business changed ownership last year.
- We participated in the new deal for Coty, as mentioned above. Slightly unusually, the company chose to place 3-year debt – a solid fit, for our fund. We also built a new position in the existing bonds of Punch Taverns (Retail). The company continues to perform well, and we believe has good visibility into a possible refinancing next year.

One name we've been watching

- **Telecom Italia** has a long track record as one of the biggest issuers in the European high yield market.
- In recent years, operating performance has nonetheless been weak. To this end, it has recently been engaged in a protracted process of obtaining new equity investment from KKR and separating out its **infrastructure** and **consumer-facing** businesses.
- Last month, its existing bonds were finally **split-out** between the two new entities.
- Given the sheer number of bonds outstanding **(almost €15bn)** the market is still in the process of determining the right trading levels for each of these new pieces of paper.
- We like the credit and think there is value in both the separated parts of the business. We expect it to be an active name as it settles into its new capital structure and will be looking for **opportunities** within the debt stack.

European High Yield Market Valuation



Source: ICE as of 31 May 2024

Outlook

Something which has been an interesting feature of our market this year has been the increasing prevalence of tenders. More and more issuers, even those of strong credit quality and with an established high yield presence, have been opting to tender for their maturing bonds at a small discount to par – rather than calling them at 100, as is expected. This has been true even in cases where the saving represents barely a rounding error in the company's financial statements!

Whilst this is a little disappointing, and seems to go against the spirit of the market, it isn't really surprising. Because many of the bonds impacted were issued in the era of zero interest rates, some of them have coupons lower even than the prevailing Bund. It doesn't therefore feel particularly egregious for issuers to tender at what are effectively very, very low spreads. And while investors have no obligation to accept, we prefer to be pragmatic about these offers. When the price still leaves something on the table, we may be happy to run these (effectively) derisked positions into maturity. But when the implied level is well inside even strong investment grade credits, we think it is hard to justify such a holding – at all times, we like to ensure our investors' cash is working as hard as possible.

In any case, we think this will be a fairly short-lived phenomenon. After all, those extremely low coupon bonds are disappearing, and interest rates are (slowly) reducing. On our side, with our structural short duration bias, we remain relaxed about how quickly cuts do actually end up occurring. The front end of the curve continues to offer attractive carry, as well as providing the greatest protection against further rates disappointments. Of course, a rapid cutting cycle would be even more favourable. We'd see short duration outperform in the near-term, and it would provide a boost to heavily indebted credits. But we like to think that none of the names in the fund are reliant on such conditions. Whilst there remains a tail of distressed or near-distressed credits in the high yield market, our favoured approach, as it has been for much of this year, is to maintain a core of high-quality holdings. We do pair this with cautious selections from the riskier end of the spectrum – but of course, only when we find the credit fundamentals, even at current interest rates, sufficiently compelling.

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