Fixed Income Insights

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European High Yield: High Yield, High Expectations

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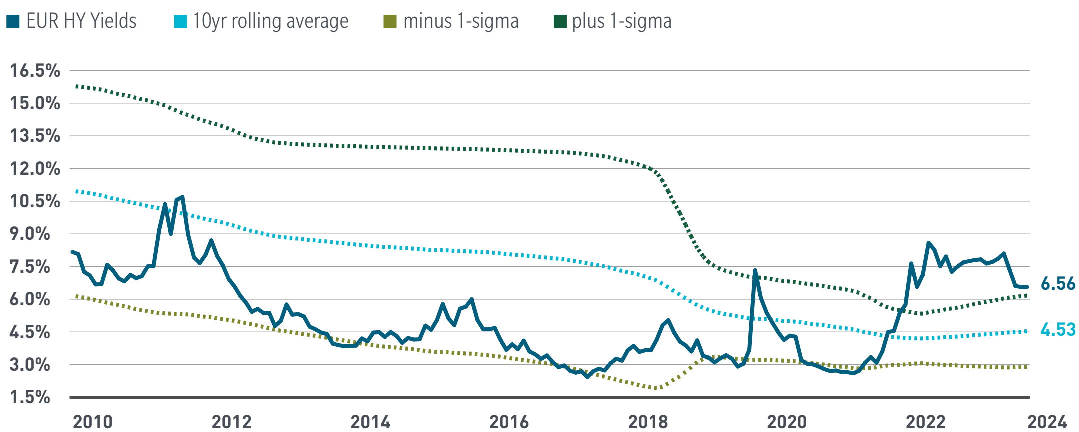
While the valuations of a number of asset classes now look stretched, that is not the case for European High Yield, which screens among the most attractive segments in global fixed income. Given that EUR HY remains supported by robust fundamentals, and that the macro environment is turning more favorable — including expected central bank rate cuts — we believe that now may be the time to consider increasing exposure to EUR HY. We at MFS® express our EUR HY views mainly through our global HY portfolio, our global multi-sector mandate and our EUR credit strategy.

EUR HY yields are attractive by historical standards. At about 6.56%, index-level EUR HY yields stand well above their 10-year rolling average of 4.53% (Exhibit 1). This is a major consideration as the current yield directly impacts future return expectations.

Exhibit 1: EUR HY: Historical Yields

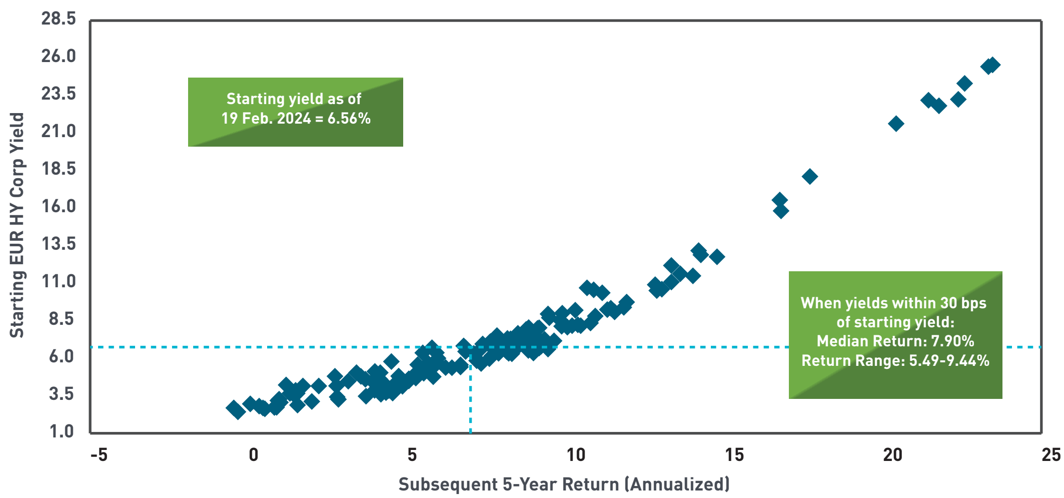


Sources: Bloomberg, ICE BofA. EUR HY yield = ICE BofA European Currency High Yield Index, HP00 index, yield to worst. Monthly data from May 2010 to Feb 2024 (Data as of 16 Feb). 1-sigma = one unit of standard deviation from the long-term average.

Entry points matter in fixed income, including EUR HY. Given the attractive level of current yields, the outlook for expected returns is robust, in our view. This is because there has historically been a strong relationship between starting yields, like today's, and relatively attractive subsequent returns. For instance, at a starting yield of 6.56% for EUR HY, the median return for the subsequent five years — using a 30-basis-point range around the starting yield — stands at 7.9%, with a return range of 5.49% to 9.44% (Exhibit 2). In addition, the prospects for fixed income expected returns have been strengthened by recent signals of forthcoming rate cuts from the major central banks, including the European Central Bank. Analyzing the heat map for EUR HY (Exhibit 3), it's clear that the likelihood of higher returns has gone up, compared with a few years ago, reflecting the higher starting yield. In addition, the outlook for higher returns is also supported by the strong possibility of rate cuts in the pipeline, based on recent ECB policy signals. Specifically, based on an entry yield of 6.56% and assuming no spread move over the next year combined with a drop in rates of 60 bps, a hypothetical return of 8.19% in one year could be realizable, based on the impact of a 60bp rate move to be multiplied by the index duration (60 x 2.71 = 162.6, which when added to 6.56% leads to 8.19%). By way of historical comparison, the 20-year annualized return for the asset class stands at 6.6%.

Meanwhile, it is also worth noting that under an extreme scenario — such as a combined rise of at least 270 bps for spreads and rates — would lead EUR HY to produce a negative return over the next year.

Exhibit 2: EUR HY: Starting Yields versus Subsequent Returns



Sources: Bloomberg, ICE BofA. EUR HY yield = ICE BofA European Currency High Yield Index, HP00 index. Monthly data from Jan 2005 through Jan 2024. Past performance is no guarantee of future results.

Exhibit 3: EUR HY hypothetical expected returns over the next year, based on spread and rate moves

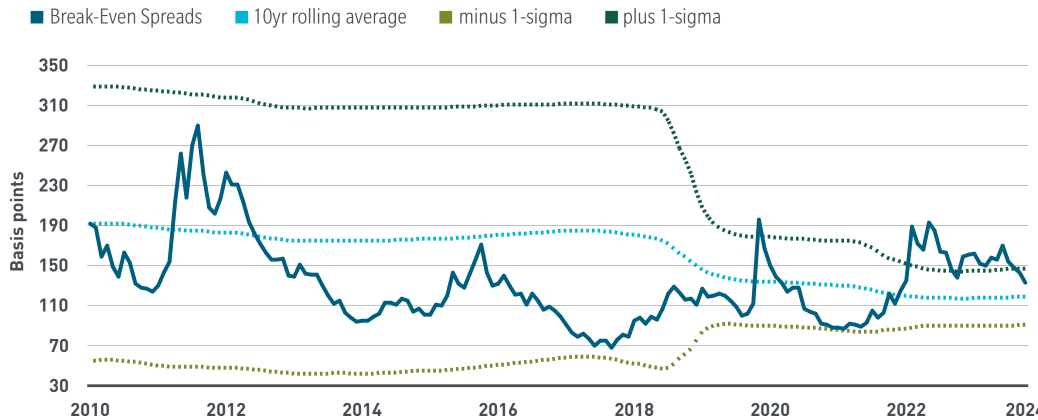
EUR HY — Spread Moves Over the Next Year (basis Points); rows: Rate Moves Over the Next Year (bp)

	-90	-60	-30	0	+30	+60	+90	+120	+150	+180	+210
+150	4.93	4.12	3.30	2.49	1.67	0.86	0.04	-0.77	-1.58	-2.40	-3.21
+120	5.74	4.93	4.12	3.80	2.49	1.67	0.86	0.04	-0.77	-1.58	-2.40
+90	6.56	5.74	4.93	4.12	3.30	2.49	1.67	0.86	0.04	-0.77	-1.58
+60	7.37	6.56	5.74	4.93	4.12	3.30	2.49	1.67	0.86	0.04	.-0.77
+30	8.19	7.37	6.56	5.74	4.93	4.12	3.30	2.49	1.67	0.86	0.04
0	9.00	8.19	7.37	**6.56**	5.74	4.93	4.12	3.30	2.49	1.67	0.86
-30	9.81	9.00	8.19	7.37	6.56	5.74	4.93	4.12	3.30	2.49	1.67
-60	10.63	9.81	9.00	8.19	7.37	6.56	5.74	4.93	4.12	3.30	2.49
-90	11.44	10.63	9.81	9.00	8.19	7.37	6.56	5.74	4.93	4.12	3.30
-120	12.26	11.44	10.63	9.81	9.00	8.19	7.37	6.56	5.74	4.93	4.12
-150	13.07	12.26	11.44	10.63	9.81	9.00	8.19	7.37	6.56	5.74	4.93

Sources: Bloomberg, ICE BofA: EUR HY = ICE BofA European Currency High Yield Index, HP00 index. Current yield as of 19 Feb 2024. Current duration as of 19 Feb 2024. One-year return projection is estimated as current yield + net change between rate and spreads times duration. The table illustrates a range of return using the yield to worst and applying incremental changes in interest rates and/or credit spreads. This analysis assumes that if interest rates and credit spreads are unchanged, the index's published yield-to-worst becomes the dominant factor for determining realized return over the next year, which allows for the full capture/earning of the starting yield-to-worst. This analysis assumes that no bonds default, come in or out of the index, and that all bonds are held until maturity. Changes in interest rates represent a parallel shift in the yield curve occurring at the end of the period and measures for duration and spread duration are option-adjusted.References to future expected returns and performance are not promises or estimates of actual performance that may be realized by an investor and should not be relied upon. The forecasts are for illustrative purposes only and are not to be relied upon as advice, interpreted as a recommendation for or guarantees of performance. The forecasts are based upon subjective estimates and assumptions that have yet to take place or may occur. The projections have limitations because they are not based on actual transactions but are based on the models and data compiled by MFS®. The results do not represent, and are they indicative of, actual results that may be achieved in the future. Individual investor performance may vary significantly. These hypothetical calculations are meant to depict how a fixed income index might behave in different market environments given the (1) current level of yield-to-worst, (2) option-adjusted duration (3) and spread duration. This analysis assumes that if interest rates and credit spreads are unchanged, the index's published yield-to-worst becomes the dominant factor for determining realized return over the next year. The analysis also assumes that changes in interest rates represent a parallel shift in the yield curve occurring at the end of the period, which allows for the full capture/earning of the starting yield-to-worst. Duration and spread duration are measures of price sensitivity to changes in yield and spread, respectively.

EUR HY spreads are still in attractive territory. This is particularly true when looking at break-even spreads (Exhibit 4). In keeping with other global fixed income asset classes, EUR HY spreads have tightened substantially over the past few weeks. But in contrast to its peers, we believe the spread valuation picture remains broadly attractive.

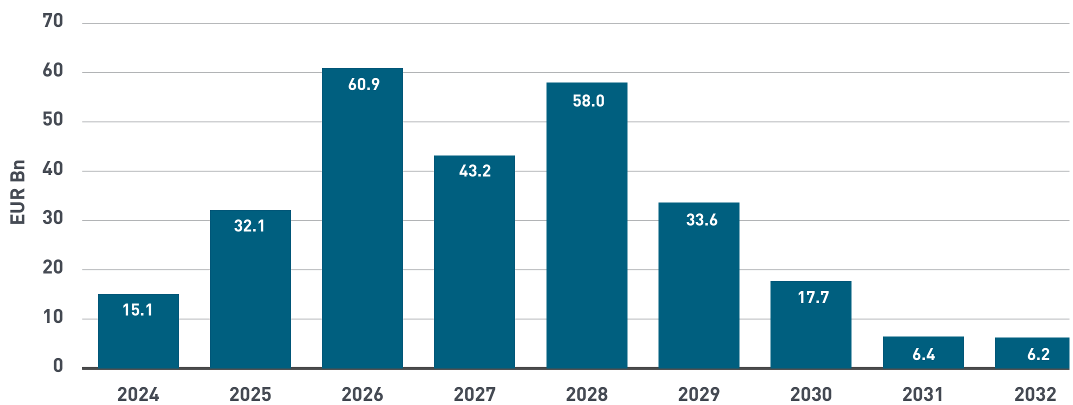
Exhibit 4: EUR HY: Historical Break-Even Spreads



Source: Bloomberg. EUR HY Break-even spreads = ICE BofA European Currency High Yield Index, HP00 index, government spreads divided by duration. The break-even spread is a measure of by how much the spread would have to go up to wipe out the excess return (*i.e.* the return from credit exposure, excluding the rate effect). Monthly data from May 2010 to Feb 2024 (Data as of 19 Feb). 1-sigma = one unit of standard deviation from the long-term average.

EUR HY remains supported by robust fundamentals. Overall, we are not concerned about a sharp rise in default rates or the so-called maturity wall. Refinancing risk remains limited in view of the prospects for rate cuts and a peak in maturities that may only materialize in 2026 (Exhibit 5). Fundamentally, the asset class has strengthened over the past few quarters, based on our Fundamental Indicator (Exhibit 6). The main source of strength arises from the free cash flow to debt ratio, along with the net leverage backdrop.

Exhibit 5: EUR HY – Maturity Due

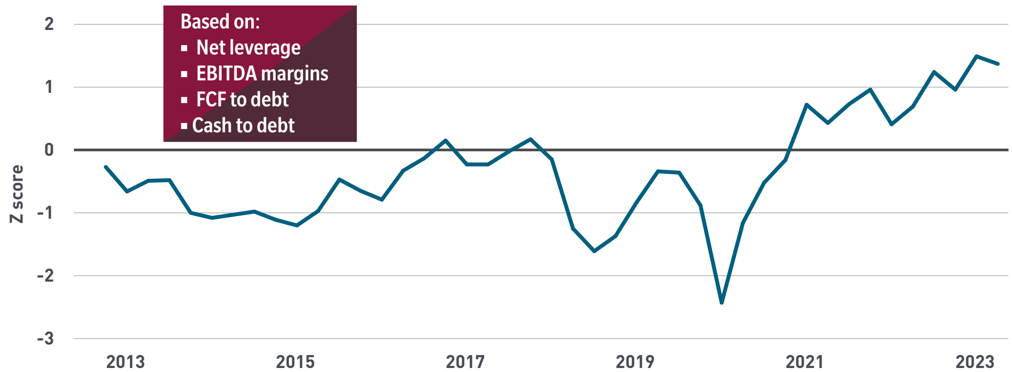


Source: Bloomberg. Data as of 14 Feb 2024.

The macro environment is turning more supportive of EUR assets. On the growth front, we are detecting some green shoots of improvement in macro conditions in the eurozone, though the baseline scenario remains one of near stagnation. However, the good news is that severe recession risks seem to be fading. Our Business Cycle Indicator for Europe, which aggregates several relevant indicators, points to a noticeable uptick from a couple of months ago (Exhibit 7). For instance, the well-followed ZEW indicator for eurozone growth expectations just reached its highest level in a year.

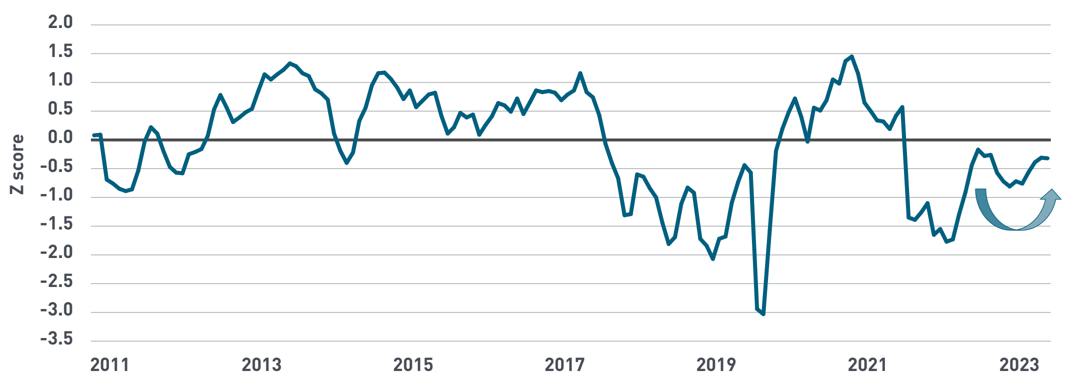
In addition, the ECB is likely to kick off an easing cycle soon, perhaps as early as Q2 this year. In our view, this is likely to boost the appetite for EUR assets which should benefit EUR HY.

Exhibit 6: EUR HY Fundamental Score



Source: Morgan Stanley. Quarterly data up to Q3-2023. Based on the simple average of the individual 10-year z-scores: net leverage, EBITDA margins, free cash flow to debt, and cash to debt. A z-score is a measure of deviation from the average in units of standard deviation.

Exhibit 7 – Eurozone Business Cycle Indicator

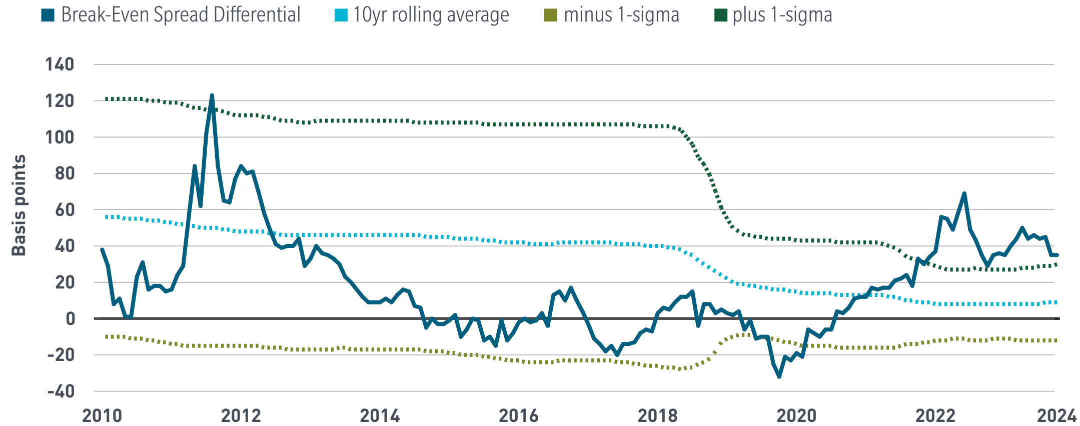


Source: Bloomberg. Ifo Pan Germany Business Expectations, Sentix Sentiment for the Eurozone, Zentrum fuer Europaeische Wirtschaftsforschung (ZEW), European Commission Economic Sentiment Indicator Eurozone. Monthly data from June 2011 to January 2024. The composite indicator is based on the average of the z-scores of these four variables.

EUR HY is attractive against US HY on a relative value basis. This mainly reflects the fact that US HY valuation looks particularly stretched. Specifically, the differential between the EUR HY and the US HY break-even spreads currently stand at 35 bps, well above the 1-sigma threshold from the long-term average (Exhibit 8).

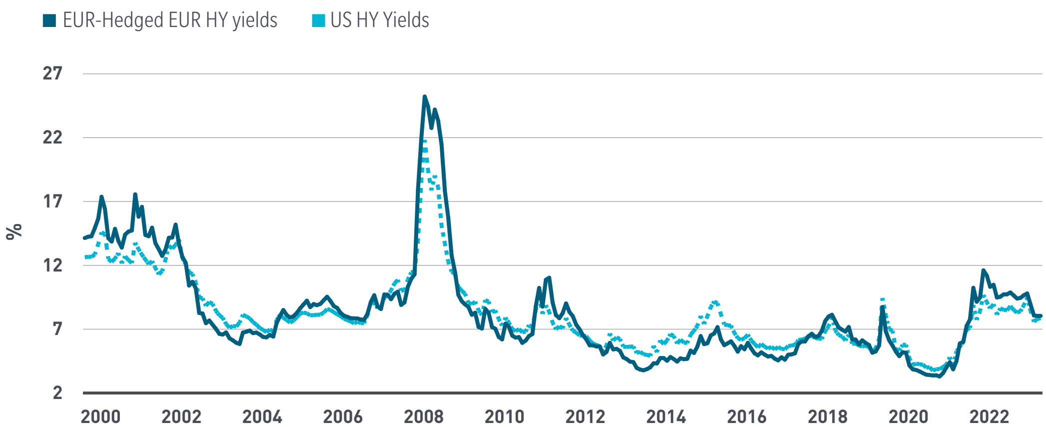
Likewise, EUR HY also looks particularly attractive when looking at hedged yields. A US-based investor seeking exposure to EUR HY on an FX-hedged basis could realize a yield of 8.04%, higher than what the investor would experience when buying US HY — despite the shorter duration of the EUR index (Exhibit 9).

Exhibit 8: EUR HY vs. US HY: Break-Even Spread Differentials



Source: Bloomberg. EUR HY Break-even spreads = ICE BofA European Currency High Yield Index, HP00 index, government spreads divided by duration. US HY = Bloomberg US HY Index. The break-even spread is a measure of by how much the spread would have to go up to wipe out the excess return (*i.e.* the return from credit exposure, excluding the rate effect). Monthly data from May 2010 to Feb 2024 (Data as of 16 Feb). 1-sigma = one unit of standard deviation from the long-term average.

Exhibit 9 - EUR HY versus US HY: Yield Comparison on an FX-Hedged Basis



Source: Bloomberg. EUR HY yields = ICE BofA European Currency High Yield Index, HP00 index, yield to worst. US HY = Bloomberg US HY Index, yield to worst. Cost of hedging the EURO exposure is based on implied yield from 3-month FX forwards. Monthly data from Jan 2005 to Feb 2024 (as of 16 Feb 2024).

EUR HY's long-term performance compares well relative to that of US HY. Looking at the return history, EUR HY (in USD terms) has delivered stronger returns than US HY over the 3-year, 5-year, 10-year and 20-year horizons. In addition, given that the return volatility of EUR HY has been broadly similar to its US peer, it means volatility-adjusted returns have been consistently higher (Exhibit 10).

Exhibit 10: Historical Returns of EUR HY (USD terms) and US HY

	3-year	5-year	10-year	20-year
EUR HY (USD hedged)				
Return	2.88%	5.09%	5.33%	7.87%
Volatility	7.34%	9.23%	7.12%	9.77%
Vol.-Adj. Returns	0.39	0.55	0.75	0.81
US HY				
Return	1.72%	4.08%	4.30%	6.49%
Volatility	8.36%	9.35%	7.59%	9.11%
Vol.-Adj. Returns	0.21	0.44	0.57	0.71

Source: Bloomberg. EUR HY (USD hedged) = ICE BofA European Currency High Yield Index, HP00 index, total return, hedged to USD. US HY = Bloomberg US High Yield Total Return index. Volatility = annualized volatility of monthly returns. Vol.-Adj. returns = return /volatility. Based on monthly data up to Jan 2024. Past performance is no guarantee of future results. It is not possible to invest in an index

EUR HY's long-term performance also compares well to that of European equities, although it has lagged equity performance substantially over shorter time horizons. Looking at the past 20 years, EUR HY has produced broadly similar returns relative to the Euro equity index, but with less volatility (Exhibit 11).

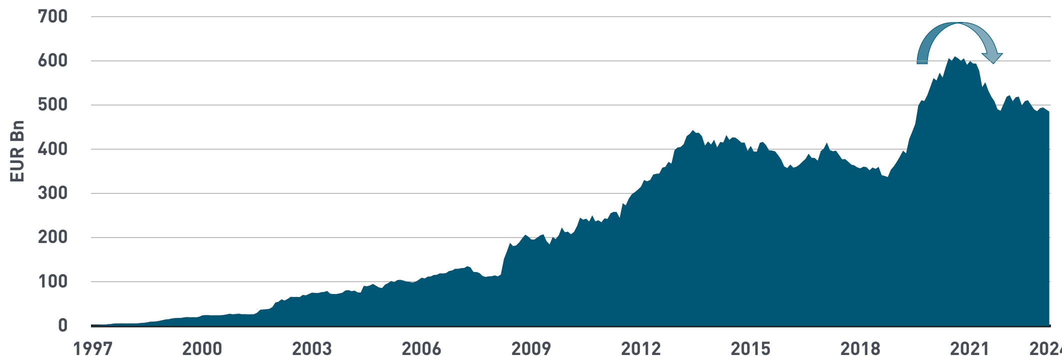
Exhibit 11: Historical Returns of EUR HY and EUR Equities

	3-year	5-year	10-year	20-year
EUR HY				
Return	1.01%	2.82%	3.52%	6.62%
Volatility	7.37%	9.22%	7.14%	9.93%
Vol.-Adj. Returns	0.14	0.31	0.49	0.67
EUR Equities				
Return	9.88%	8.89%	7.14%	7.05%
Volatility	13.97%	15.88%	14.08%	14.28%
Vol.-Adj. Returns	0.71	0.56	0.51	0.49

Source: Bloomberg. EUR HY = ICE BofA European Currency High Yield Index, HP00 index, total return. EUR equities = Euro Stoxx 600 Gross Return (SXXGR index). Volatility = annualized volatility of monthly returns. Vol.-Adj. returns = return/volatility. Monthly data up to Feb 2024 (as of 16 Feb). Past performance is no guarantee of future results. It is not possible to invest in an index.

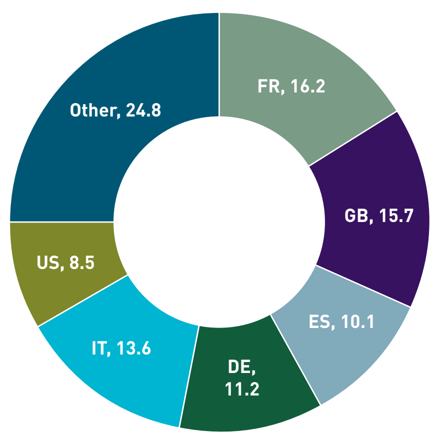
The technical backdrop for EUR HY is supportive. It is worth noting that the size of the market has shrunk since Covid, due to restricted supply (Exhibit 12). We would argue that this scarcity is acting as a positive technical driver. In addition, the EUR HY market offers significant country diversification, which helps manage the individual country macro risk exposure, as illustrated by Exhibit 13.

Exhibit 12: EUR HY Market Size



Source: Bloomberg. EUR HY = ICE BofA European Currency High Yield Index, HP00 index, face value. Monthly data up to Feb 2024 (as of 16 Feb).

Exhibit 13: EUR HY, Breakdown by Issuer Country



Source: Bloomberg. EUR HY = ICE BofA European Currency High Yield Index, HP00 index, breakdown by issuer country. Data as of Feb 2024 (as of 16 Feb).

Overall, we believe that EUR HY is an asset class that deserves to be on investors' radar given its attractive valuation characteristics, fundamental strength, favorable technicals and long-term performance record relative to comparable asset classes.