

April 9, 2017

# Are European High-Yield Bonds poised for a hawkish ECB?

*European high-yield (HY) bond prices have enjoyed strong support from the ECB's bond-buying program.*

April 2017 marks the first month of slowing in ECB bond-buying; monthly purchases of corporate bonds will be reduced from €80bn to €60bn. Over the next week, the effects of this should start coming through.

HY bonds, though not directly purchased by the ECB, could be one of the asset classes most impacted and should be closely monitored. HY bonds are debt instruments, rated below investment grade (i.e. BBB- or less). Their yield should be high enough to reward those investors willing to invest companies which carry greater risk. HY bonds have enjoyed hospitable conditions since the financial crisis. Fewer corporations were able to receive financing from banks, and so turned to non-bank alternatives, such as bond issuance. The European Central Bank (ECB) embarked on quantitative easing (QE) and in 2016 introduced its Corporate Sector Purchase Program (CSPP), under which they bought non-bank, investment grade (IG) corporate bonds; at the end of February, they had accumulated over €67.3 Bn. This capped borrowing costs for companies but suppressed yields and led to a scarcity in quality debt. Investors were thus pushed towards the riskier end of the debt spectrum in search of returns.

This influx caused European HY yields to dwindle and we are becoming increasingly bearish on this asset class. Why? European HY yields have fallen to just above 3% which does not compensate well for potential risks. This is partly due to low yields on Government bonds; HY should offer a "spread" above the so-called risk-free rate, but this risk-free rate has turned negative in some cases, if not very low. Low yields mean higher prices and HY is now expensive. It seems QE has skewed the market, in that investors are not pricing the risk in HY accurately... Today, the spread (reward) between IG bonds (rated BBB) and HY bonds in Europe is only 250 basis points.

Investors seem to have become accustomed to the benefits of infinite QE which has been

keeping prices high. The most concerning issue is that one day, the invisible hand of the ECB will be withdrawn. Though their bond purchase scheme was extended to December 2017, as of April 2017, they cut monthly bond purchases from €80bn to €60bn. The Financial Times calls this 'a QE taper cloaked in an extension'. When ECB support is fully withdrawn, this could potentially be the trigger of mass sell-offs in European HY.

At the same time, the upside is limited. Roughly 65% of European HY bonds have a call feature. This means that the issuer can buy back bonds at a price slightly above par before maturity. Almost 80% of European HY bonds are trading above their call price, and cannot appreciate much further, as their yields would become negative. At the same time, interest rates are so low, that spreads cannot tighten much further; the all-time-lows in spreads from 2007 are out of reach for European HY. Furthermore, corporations may begin exercising these calls, cutting the stream of coupons still due to investors, whilst at the same time re-financing to take advantage of the current low rate environment.

### **What's in a name?**

It may be fitting to start calling European 'high-yield' bonds by their alternative name: junk bonds. ECB tapering could indeed spell a bear market for the asset class and in the meantime, we believe investors are not adequately rewarded for the risk they endure - there is limited upside relative to the amount of downside you could have if there is a shock or bad news which ripples through the market. It is notable that IG bonds sold by financial institutions are not part of the ECB's CSPP. They often come with higher coupons for similar ratings. As such, they are seen as a cheaper, more desirable option by the markets. It could be time to consider moving back up the quality curve into safer, higher quality bonds or for the riskier investors, European equities.

## Disclaimer

All financial data and/or economic information released by this Publication (the "Publication"); (the "Data" or the "Financial data and/or economic information"), are provided for information purposes only, without warranty of any kind, including without limitation the warranties of merchantability, fitness for a particular purpose or warranties and non-infringement of any patent, intellectual property or proprietary rights of any party, and are not intended for trading purposes. Banque Internationale à Luxembourg SA (the "Bank") does not guarantee expressly or impliedly, the sequence, accuracy, adequacy, legality, completeness, reliability, usefulness or timeliness of any Data. All Financial data and/or economic information provided may be delayed or may contain errors or be incomplete. This disclaimer applies to both isolated and aggregate uses of the Data. All Data is provided on an "as is" basis. None of the Financial data and/or economic information contained on this Publication constitutes a solicitation, offer, opinion, or recommendation, a guarantee of results, nor a solicitation by the Bank of an offer to buy or sell any security, products and services mentioned into it or to make investments. Moreover, none of the Financial data and/or economic information contained on this Publication provides legal, tax accounting, financial or investment advice or services regarding the profitability or suitability of any security or investment. This Publication has not been prepared with the aim to take an investor's particular investment objectives, financial position or needs into account. It is up to the investor himself to consider whether the Data contained herein this Publication is appropriate to his needs, financial position and objectives or to seek professional independent advice before making an investment decision based upon the Data. No investment decision whatsoever may result from solely reading this document. In order to read and understand the Financial data and/or economic information included in this document, you will need to have knowledge and experience of financial markets. If this is not the case, please contact your relationship manager. This Publication is prepared by the Bank and is based on data available to the public and upon information from sources believed to be reliable and accurate, taken from stock exchanges and third parties. The Bank, including its parent, - subsidiary or affiliate entities, agents, directors, officers, employees, representatives or suppliers, shall not, directly or indirectly, be liable, in any way, for any: inaccuracies or errors in or omissions from the Financial data and/or economic information, including but not limited to financial data regardless of the cause of such or for any investment decision made, action taken, or action not taken of whatever nature in reliance upon any Data provided herein, nor for any loss or damage, direct or indirect, special or consequential, arising from any use of this Publication or of its content. This Publication is only valid at the moment of its editing, unless otherwise specified. All Financial data and/or economic information contained herein can also quickly become out-of-date. All Data is subject to change without notice and may not be incorporated in any new version of this Publication. The Bank has no obligation to update this Publication upon the availability of new data, the occurrence of new events and/or other evolutions. Before making an investment decision, the investor must read carefully the terms and conditions of the documentation relating to the specific products or services. Past performance is no guarantee of future performance. Products or services described in this Publication may not be available in all countries and may be subject to restrictions in some persons or in some countries. No part of this Publication may be reproduced, distributed, modified, linked to or used for any public or commercial purpose without the prior written consent of the Bank. In any case, all Financial data and/or economic information provided on this Publication are not intended for use by, or distribution to, any person or entity in any jurisdiction or country where such use or distribution would be contrary to law and/or regulation. If you have obtained this Publication from a source other than the Bank website, be aware that electronic documentation can be altered subsequent to original distribution.

As economic conditions are subject to change, the information and opinions presented in this outlook are current only as of the date indicated in the matrix or the publication date. This publication is based on data available to the public and upon information that is considered as reliable. Even if particular attention has been paid to its content, no guarantee, warranty or representation is given to the accuracy or completeness thereof. Banque Internationale à Luxembourg cannot be held liable or responsible with respect to the information expressed herein. This document has been prepared only for information purposes and does not constitute an offer or invitation to make investments. It is up to investors themselves to consider whether the information contained herein is appropriate to their needs and objectives or to seek advice before making an investment decision based upon this information. Banque Internationale à Luxembourg accepts no liability whatsoever for any investment decisions of whatever nature by the user of this publication, which are in any way based on this publication, nor for any loss or damage arising from any use of this publication or its content. This publication, prepared by Banque Internationale à Luxembourg (BIL), may not be copied or duplicated in any form whatsoever or redistributed without the prior written consent of BIL 69, route d'Esch | L-2953 Luxembourg | RCS Luxembourg B-6307 | Tel. +352 4590 6699 | [www.bil.com](http://www.bil.com).