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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 The most concerning issue is that one day, the invisible hand of the ECB will be withdrawn.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.

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