Incremental yield: The hidden value in European high yield

Standard spread metrics might suggest value is hard to find right now in European high yield. But investors should also pay attention to current bond prices, as Jamie Cane explains.

European high-yield credit spreads have tightened since 2022. At face value, spread-to-worst (STW) appears to be below the long-term average.

Figure 1 – Credit spreads are below their 10-year average

Figure 2 – Prices below par

Source: ICE Index Platform - ICE BofA BB-B European Currency Non-Financial High Yield Constrained Index (HP4N), as of February 29th, 2024. For illustrative purposes only.
Yield-to-maturity versus yield-to-expected repayment

Market convention prompts investors look at ‘to worst’ spread and yield metrics. When the cash price is below par, ‘to worst’ means to maturity. However, a key characteristic of high-yield bonds is their tendency to refinance around 1 to 2 years before maturity. This is what’s happening in the current environment, even though it might seem counterintuitive for corporates to refinance when interest rates are high.

Using the current average bond price of 94 as a starting point, an investor expects to receive 6 additional points at maturity. This takes the price back to 100 (par). However, given the tendency of issuers to refinance before maturity, this 6-point discount is recouped over a shorter timeframe, resulting in a significant increase in yield and spread.

Figure 3 – Services issuer 3.25% 2027 bonds

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<th>Yield (%)</th>
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<td>YTC Feb 2026</td>
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Source: Bloomberg, as of 10th March 2024. For illustrative purposes only.

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Figure 3 offers an example of this idea in action, involving a services company with an outstanding bond scheduled to mature in February 2027. The headline YTW is 4.7%. If the bond is repaid 1 to 2 years ahead of maturity, the yield to repayment is 5.4%-7.7%, a meaningful uplift. This bond is not atypical in the European high-yield market.

Hidden value

Overall, we believe this equates to an additional c.50 basis points over what is reflected in headline metrics. This takes European high-yield spreads back in line with their longer-term averages. In our view, this hidden convexity is a compelling feature of the asset class and something investors should consider favourably when assessing value.

References:

1. ICE Data Platform, ICE BofA BB-B European Currency Non-Financial High Yield Constrained Index (HP4N) as of 29th February 2024.

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Index Descriptions

HP4N – The ICE BofA ML BB-B European Currency Non-Financial High Yield Constrained Index contains all non-financial securities in The ICE BofA ML European Currency High Yield Index rated BB1 through B3, based on an average of Moody's, S&P and Fitch, but caps issuer exposure at 3%.

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